SIFMA ASSET MANAGEMENT GROUP

Why does Counterparty Risk Management Matter?

COUNTERPARTY RISK FORUM

Failure of a counterparty ("CP") can lead to losses in many different ways, including economic, reputational, time, effort and management focus. While there has been (and continues to be) a great deal of positive industry evolution since the Global Financial Crisis ("GFC"), the risk of counterparty failure remains. Even with increased use of central clearing for derivatives, the risk has not been eliminated, but rather it has shifted – making counterparty risk management an imperative for investment firms to appropriately assess and manage around the evolving landscape.

As a fiduciary, it is important that asset management firms have a robust process to manage counterparty risk arising from trading with financial institutions. Each investment manager is different. Factors, such as organizational structure, resource availability, regulatory requirements, investment approaches, and so on, play an important role in how asset managers set prudent counterparty risk tolerances, policies and practices for firms they view as "counterparties".

This narrative is a consolidation of the experience and views from a variety of firms represented in the SIFMA Asset Management Group Counterparty Risk Forum. Therefore, when articulating views on why counterparty risk matters using the following talking points, it's important to consider and incorporate the manager's business objectives and organizational structure. The following factors are key, but not all of them may be relevant for each manager when discussing counterparty risk.

CLIENTS / END-INVESTOR EXPECTATIONS

- Clients expect investment managers to have a counterparty risk ("CP Risk") function and have it closely related to the investment process (much like ESG). Not having effective capabilities may result in lost business/opportunities.
- Clients don't expect to be impacted by loss or adverse performance arising from counterparty distress – they expect investment managers to address these problems with appropriate risk management measures. A client who suffers a loss from a preventable counterparty default, including the need for them to attempt asset recovery through long-term bankruptcy proceedings, would not only be an unfortunate outcome for the asset owner, but a blow to the investment manager's reputation. Depending upon the situation, such events could lead to a client engaging in litigation against the investment manager or drawing these events to the attention of a regulator.
- Home regulator focus / client requirements are increasing. Regulators generally consider counterparty risk management to be part of an investment manager's fiduciary duty.

GFC LESSONS LEARNED

- Among SIFMA AMG Counterparty Risk Forum members, many have increased their focus on CP risk since the GFC, in some cases creating a dedicated CP Risk function or at least creating enhanced CP Risk processes within other functions.
- CP Risk is typically a part of a centralized function within an organization. It may be structured as an independent second line function or aligned more closely with the first line: trading desk or investment professionals. This model is very important to maintain independence from portfolio management and trading functions when coordinating risk mitigation activities, identifying and working with stakeholders, and responding to a crisis event.
- It is critical to know and understand the legal entity faced at each parental group, including credit risk assessment, home-regulator bankruptcy rules, settlement process, etc. (DVP and non DVP), and capital controls to prevent money from moving from one legal entity to another.
- It is not a time to be complacent – in the past few years, counterparty "disruptions" have been minimal, which may cause observers to question the need for counterparty risk resource investment.

IMPORTANCE OF TRANSPARENCY AND COLLABORATION

- Transparency and understanding of details regarding trading counterparties (legal entities and related financials, organizational structures) and client exposures to them (potential loss estimates, collateral offsets) is fundamental in prudent counterparty risk practices, including the timely response to a counterparty risk event or crisis. The ability to acquire and maintain these inputs requires significant information technology (IT) investment and ongoing support.
- Understanding how financial markets regulation (e.g., bankruptcy protections) and trading agreements impact how end-clients assets are affected and protected from a counterparty default or business disruption is critical and requires close collaboration with legal professionals. Complexity has grown tremendously in this field as global regulators have discretion in how post-GFC rules are implemented in their home market. This regulation has focused on the stability of the financial markets, at sometimes in lieu of end-client protections. Derivatives agreements have also been revised over the past few years, often times to protect the viability of a counterparty in a default scenario.
- As the industry, technology and market participants evolve, so do trading products, workflows, and tools. It is important that CP Risk professionals help assess the adoption of new tools and practices to consider how they may impact the counterparty risk profile.

NEED FOR INDEPENDENCE

- Incentives/interests of counterparties (banks, broker dealers, CCPs, FCMs, etc.) are not always aligned with the buyside/end-investors.
- Rating agency opinions can be useful but should be paired with independent credit analysis that can be timelier and more tailored for the specific use cases, based on the nature of individual firms' exposures. Despite increased SEC oversight, conflicts remain in the rating agency process.
- Many counterparties are private and/or not covered by external sources and may not have public ratings or publicly available financials; these counterparties need proper analysis as they could be important trading partners to achieve best execution.
- Counterparty risk management decisions may be prescriptive, or judgment based. Looking solely at historical financials is often incomplete analysis – there is no one formula or set of statistics. Instead, analytics that provide a comprehensive view of the counterparty are an invaluable part of the decision-making process.
- The focus of "governance" has grown in importance within the investment process, as many investors now consider how "ESG" input is considered within the business strategy of organizations that they invest in. Similarly, counterparty risk professionals are increasingly considered experts in the "G" within ESG-type principles applied to key external relationships - counterparties, exchanges and clearinghouses, trading platforms, prime brokers, 3rd party vendors, etc. - to assess how these organizations conduct business and manage risk.

CHANGES TO MARKET STRUCTURE / REGULATION

- Changes have not necessarily reduced counterparty risk but has transformed/shifted it.
- Post GFC, regulation has moved certain higher risk activities (such as market making, proprietary trading) to tier 2 institutions which are monitored by different regulators.
- Not all counterparties are regulated the same way. There are multiple entity types in the financial markets (e.g., whole loan originators, whole loan sellers/buyers) that desks want to buy from/sell to that are subject to no (or little) regulatory oversight.
- Central clearing has emerged: CAMELS (Capital Assets Management Earnings Liquidity Sensitivity) style analysis is not as relevant for clearinghouses (it's the new"too big to fail"); need new inputs/analytical capabilities to conduct default waterfall analysis, PFMIs, rulebooks, etc.
- In some cases, such as CCPs, there is a regulatory structure in place. However, the regulatory structure may not have kept up with the evolving demands of the market. In some cases, our clients/investors could be negatively impacted – and potentially asset managers themselves.
- Operational risk is emerging issue given the advancement of technology and complexity in workflows.
- On cyber risk, there are new ways for "bad actors" to commit illegal activity that may result in counterparty credit risk, or operational risk if certain information (e.g., client settlement instructions) is contaminated or unavailable.
- Stay protocols freeze client assets at counterparties under stress/at default. It is important to understand the impact and work closely with the legal department to structure trading documents appropriately.
- Unintended consequences of stricter collateral requirements in a stressed environment, such as strains on client portfolio and general market liquidity.
- Lack of global regulatory harmonization causes complexity when assessing counterparties and their home-regulator rule set as well as potential higher risk of counterparties in certain geographic regions.