SCI Conference

Risk Management under Dodd-Frank

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Managing Market & Counterparty Risk

Managing market risks

- Analyze exposure levels necessary to conduct business
- Evaluate whether risk capital and appetite would support likely exposure
- Establish risk limits
- Monitor compliance with limits (requires appropriate position and risk systems)
- Identify and monitor bespoke risks (risks that are not fully captured by VaR or volatility reports)
- On a regular basis, discuss large exposure and bespoke risks
- Establish scenario analysis to evaluate p&l impact of certain scenarios

Managing counterparty risk

- Monitor counterparty exposure
  - Deposits, OTC margins, prime brokerage holdings, ...
- Avoid/reduce peak exposure
- Create redundancies across regions, products, creditworthiness of counterparty
- Monitor counterparties' credit spreads, news
- Define triggers for reducing counterparty exposure if counterparty deteriorates
  - Assigning trades away; unwinding; buying protection on counterparty
  - Assignments require counterparties' consent; not in a cleared world

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Uncleared and Non-Standard CDS

- How to deal with complex and less liquid CDS that are not cleared?
  - Banks
  - Sovereigns
  - Non-standard trades (non-standard documentation, bespoke CDOs) – risks that is not DTCC eligible
  - Continue to transact as done in the past
    - Bilateral ISDA Master Agreement
    - Margin agreement with counterparty
    - Push-out provision under Volcker rule: structure of counterparty unknown; may create new market
  - Single-name trades regulated by SEC (cleared and uncleared)
  - Indices, tranches and structured trades regulated by CFTC

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Hedging

- **Hedging at position level**
  - Sell/unwind position
  - Enter into offsetting trade, keep both legs (later assign away as package)
  - Transact proxy hedge (usually includes basis risks)
    - Hedge single-name exposure with CDS index on a beta basis
    - Bonds for hedging IR swap exposure (appropriate only short term)

- **Hedging the portfolio**
  - Determine key risks in the portfolio
    - Map portfolio to set of key risks (principal components)
  - Determine which (liquid) instruments are closely related to these risks
  - Transact hedges in order to mitigate portfolio risk

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Best Practice for Managing Collateral

- Tri-party collateral agreement
  - Elect how collateral is held at custody account (bank deposit, FDIC insured bank deposit, money market fund)
- Daily margining
- Manage/limit rehypothecation of assets by prime broker
  - May impact funding costs

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