



GLOBAL riskupdate

The quarterly independent risk review for banks and financial institutions worldwide

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The Myth about Exchange Traded Derivatives

The Myth about Exchange Traded Derivatives

As Head of Investment Risk Framework at Schroders (London), Sophie Dupree is an experienced risk manager in operational, investment, counterparty and liquidity risks with debunking a myth? Here's her view.

If you are not an investment risk expert, you would be forgiven to think that exchange traded derivatives are far safer than OTC ('over the counter') derivatives. If not, why would all the major regulators around the world be working together to force most of the OTC derivatives to be centrally cleared (i.e. cleared through an exchange), which is the key feature of an exchange traded derivative?

But as ever life is not that simple for players who are not direct members of exchanges, due to the high costs associated with membership, either in capital required but more importantly because of the associated back office costs. There are only a few buy-side (asset managers) institutions currently direct members of exchanges. Most of us have to make do with accessing the exchanges through a clearing broker. And that makes a big difference with regards to the attached counterparty risk.

Let me explain why

The exchange requests an initial margin for each new contract traded. Then it requires some additional margin if the price moves against the buyer, i.e. the marked to market ('MtM') is negative.

If the MtM is positive, the Exchange credits the MtM to the derivatives' buyer.

The clearer has to place all the initial margins with the exchange. The counterparty risk associated with the initial margin is therefore with the exchange, and could be deemed negligible, thanks to all the controls and safety measures surrounding the exchanges.

However, under most clearing contracts, the clearer broker has the right to net all the positions of his clients before calculating the amount of additional margin required. That means that on any one day the clients of a typical asset manager have got an undefined (although capped) exposure to the clearing broker chosen by their asset manager. The exposure is between 0 (if the mark to market of their position is positive) and the negative MtM of the instrument. Note that clients can also choose their own clearing broker.

The clearing broker generally deposits the cash with their parent bank. It is clearly labeled as client money but that does not mean that it would be readily available if the parent bank or the broker went bankrupt.

Definitions:

Exchange-traded derivative contracts are standardized derivative contracts (e.g. futures contracts and options) that are transacted on an organized futures exchange.

Exchange – Any organization, association or group which provides or maintains a marketplace where securities, options, futures, or commodities can be traded; or the marketplace itself.

Counterparty risk – The risk that the other party in an agreement will default. In an option contract, the risk to the option buyer that the writer will not buy or sell the underlying as agreed. In general, counterparty risk can be reduced by having an organization with extremely good credit act as an intermediary between the two parties.

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