

OTC Derivatives Industry

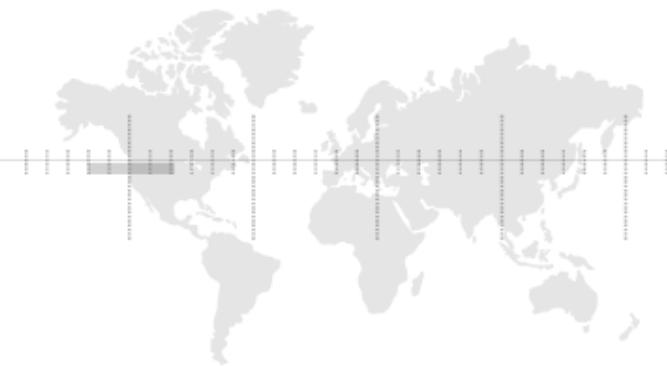
Observations on Credit Risk Mitigation

Cogesi meeting
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Director European Affairs – ICAP plc



Introduction

- OTC derivatives industry specialists
 - 20 years each working in the OTC derivatives industry
 - Focus on technology and services for risk management and risk reduction
- TriOptima
 - Swedish company with offices in Stockholm, London, New York, Singapore and Tokyo
 - Provides post trade services to the OTC derivatives industry
 - Services are focused around reducing and mitigating risks as well as reducing operational costs
 - Our clients consist of all major market making institutions over the world plus a number of buy side institutions
- Currently provides two services
 - triReduce – Portfolio compression
 - triResolve – Portfolio reconciliation



Our concern

- Selective regulatory focus on parts of problems
 - Recent years' focus on backlog of legal confirmations distracted attention from build up of counterparty credit risk
 - Current focus on CCP also misses more important sources of risk
- A more holistic approach would give a more comprehensive regulatory framework promoting a more resilient and well functioning OTC derivatives market

Collateralisation

- The most commonly used credit risk mitigation method today in OTC derivatives is bilateral collateralisation
 - 65% of credit exposure covered by collateral (*)
 - 150 000 collateral agreements in place (*)
- Bilateral collateralisation covers all asset classes and all product types
 - Interest Rates, Credit, Equity, Energy, FX etc
 - Swaps, options, forwards etc.
- During the last year all major dealers have started to reconcile all their OTC derivatives between themselves and with key counterparts on a daily basis
 - Currently an estimated 70% of all OTC derivatives in the world are reconciled regularly in triResolve
- The reconciliation covers all major risk elements of OTC derivatives – the trade population, the key financial terms and the mark-to-market value

(* = ISDA Margin Survey 2008)



Benefits of collateralisation

- Complete mitigation of collateralised exposure
- Coverage of all products and asset classes
- Coverage of all counterparties
- Already is established practice in the industry
 - In use for last 15 years
 - Extensive development of legal netting opinions in all jurisdictions worldwide



Comparison of CCP and Collateralisation

	Central Counterparty	Collateral (CSA)
Product / currency scope	Standardized & liquid	ALL
Available to	Large dealers with high credit rating	ALL
Risk Buffers	Initial margin, Default fund	Regulatory capital
Risk costs	Funding cost of risk buffer	No direct cost
Infrastructure costs	HIGH	LOW
“Netting universe”	Divided on several CCP & uncleared OTC	ALL
Multilateral Netting	Yes	Portfolio Compression
Margin movement	Enforced by CCP	Disputable



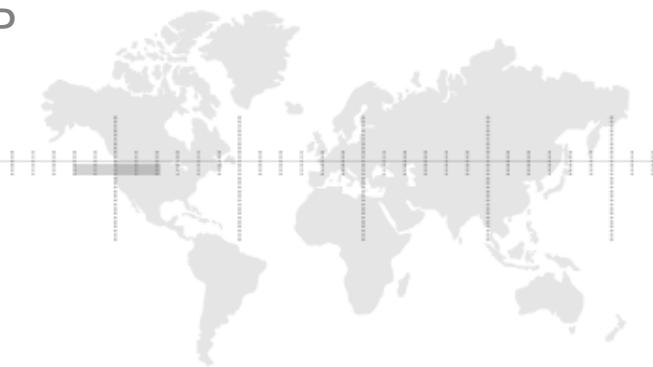
Comparison of portfolio reconciliation with the TIW

	TIW	Portfolio reconciliation
Product / currency scope	Standardized & liquid	ALL
Trades covered	Electronically confirmed	ALL
Matching frequency	One time on entry	Daily
Matched fields	All legal details	Key financial terms incl. MtM
Infrastructure costs	High	Low
Process re-engineering cost	High	Low
Transparency	Limited	Complete



Summary

- Watershed change in the way banks are managing the collateral process through the use of pro-active portfolio reconciliation
- Significant further improvements in the pipe-line
 - Dispute resolutions process
 - Automation of margin calling and movements
 - More counterparties joining the network
- Bilateral collateralisation is and will remain a very important credit risk mitigation tool complementing the use of CCP





Thank you.

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