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Minimizing the Risk of OTC Derivatives

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Various financial regulations are rapidly evolving which could entail the migration of the trading, valuation, settlement, and margin processes of Over-The-Counter (OTC) derivatives to be handled in a very similar fashion to those of exchange traded instruments. Currently the debate continues on how the regulations and processes will evolve. The intent of the proposed regulations is to add transparency to OTC transactions to allow market participants and regulators to clearly see the types of transactions, magnitude of the positions, company entities involved, net valuation one party owes the other, and when payments are due. The goal is to put in place trading processes to minimize large OTC positions from collapsing that could (and have) cause massive disruption in the derivative markets. These disruptions can then impact other capital markets and the economy in general. The trading processes for OTC derivatives will likely include valuation of the positions on a daily basis, and settling between the OTC contracting parties on a daily basis, so no large imbalances in payments from one party to the other exist.

However, before you read this article on OTC derivatives deeper we suggest you read the first article in this three part series entitled Establishing Comprehensive Derivative Policies and Guidelines. This series of articles provides insights for establishing solid procedures, strong oversight controls, impenetrable trade systems, and timely reporting of derivative trading with respect to governing policies.

However given the unique nature and lack of liquidity of some OTC derivatives, there will still be a variety of OTC derivatives which will likely not flow through the new “exchange traded box” very cleanly once regulations are in place. Core information of the trade will likely need to flow through new exchange systems. However, daily valuation and settlement specifics will likely not be able to be handled correctly by the exchange process given the uniqueness of some very complex OTC derivatives. This information will need to be separately reported instead. Thus, a recommended approach is to structure these unique OTC contracts with counterparties such that they are constructed to be transacted in very similar manner to exchange traded derivatives. OTC derivatives are valued and the payment between the parties is set at various time frames based on the derivative terms established at the inception of the negotiated contract. An issue in pricing positions could exist if market comparables are used but thinly traded. This is not an issue if the mathematics of pricing the OTC derivative are specially agreed and included in the OTC contract.
Monthly and quarterly payment terms are typical in OTC derivatives. Counterparty risk exists, that is the risk either party may default on the agreement. This risk can put the probability of being paid at risk, as well as loosing favorable market terms locked in at the inception of the derivative contract. To manage this risk, an OTC contract can be structured for frequent settlement. This will increase the back office work load, but the additional effort is justified. Counter party risk was not a large concern several years ago but the crisis in the OTC derivative markets has changed the landscape and increased the need for the addition of risk management procedures. It is just prudent business sense to settle as frequently as possible. Daily valuation and settlement of the OTC derivative position between parties is recommended. If party A owes party B the cash settlement should be made the next business day.

An additional consideration is to negotiate OTC contracts in a manner such that margin levels are established in the transaction and used in a similar fashion to exchange traded derivatives. The margin account establishes a cushion of cash ready for payment and should be based on the likely volatility risk of the transaction. Transactions which are likely to be more volatile should require higher margin levels. This is akin to what the exchange traded markets utilize. This margin process will allow valuation changes to debit or credit the margin accounts held by a third party such as a trust, or posted directly to each side of the trade. Once cash settlements are made, the margin account is trued-up by both sides. The end result is essentially the replication of the settlement process utilized for exchange traded derivatives, which should be the goal. The vital information required by the exchange(s) can then be reported instead of flowing through the daily exchange given the uniqueness of the OTC derivative.

If the terms of an OTC derivative contract are negotiated correctly, the risks to both sides of the transaction are greatly reduced. Companies should strive to negotiate OTC derivatives contracts in a manner to reduce risks. This involves replicating the contracts very closely to the aspects of the underlying exchange-traded instruments.

This concludes the second article of a three part series on derivatives. The next installment will address the effective use of derivative trade and risk management systems.

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