



MF Global's Lessons Learned: Four Steps to Reducing Counterparty Risk

Just three years after Lehman Brothers went bankrupt, the alternative investment world was shocked once again by the relatively sudden collapse of MF Global, a broker-dealer and clearing firm.

The reason for the downfall: MF made bad bets on European sovereign debt.

The even worse news: the revelation by its trustee that a substantial amount of money went missing from customer accounts that were supposed to be segregated from the firm's own assets.

What went wrong: either outright fraud; bad management or a combination of both.

So what's should a fund manager do? Hedge funds may have been relatively unscathed by the downfall of MF Global, but they should take the opportunity to evaluate their third-party service providers; investors will certainly encourage them to do so. Counterparty risk is once again taking center stage and here are four ways to mitigate that risk.

Use multiple prime brokers: While this is certainly not a new concept, what is different is the methodology fund managers will use. Because the middle and back office operations of a fund manager will become more complex under a so-called multi-prime model, many managers will outsource these tasks to external parties such as fund administrators as a way of reducing costs, while ensuring accurate reporting and reconciliation of records. The heightened complexity arises from the need to consolidate reporting of fund assets, positions and valuations from multiple sources into a single usable format for the front office. Under a single prime broker, fund managers would need to reconcile between their records and those of the prime broker once. The more prime brokers the fund manager uses the higher the number of reconciliations and the greater the workload for middle and back office operations executives which must reconcile not only cash and positions, but also profit and loss statements, estimates of net asset values, and projections of cash and collateral requirements.

Fund administrators are particularly well-suited to handling these middle and back-office functions for several reasons. First, they are well-versed in fund operations. Second, large fund administrators can offer substantial scale, broad geographic reach, as well as in-house expertise. Third, fund administrators can usually offer more cost-effective services that can not only satisfy the operational requirements of a fund, but also acceptable threshold for fund expenses.

Amend terms of prime brokerage agreements: Hedge fund managers are likely to increase their use of "amber terms" -- specific language written into a prime brokerage agreement which is meant to explain the potential for the prime

broker to default on its obligations. Breaching these "amber terms" could require the prime broker to segregate a client's assets into a separate segregated account and not have them pooled with other client assets. Just what constitutes a breach of "amber terms" differs depending on the agreement, but it most often occurs when the basis points on a prime broker's credit default swap contract exceeds a certain threshold. This threshold can be any amount; such an amount might, for example, be 300 basis points over the CDS spread of U.S. Treasuries.

Evaluate risk exposure: Hedge fund managers will want to better understand the underlying exposures of their prime brokers and custodian banks, which serve as hedge fund administrators. Before the collapse of MF Global, hedge fund managers rarely studied these exposures at length or performed any sort of stress test analysis. MF Global was, at least in part, by large one-sided bets on European sovereign debt. By performing more due diligence on the assets and liabilities of their prime broker or custodian bank, fund managers can determine just how exposed the firm might be to a particular industry sector, region or market change.

Get Protection: Hedge fund managers can purchase a credit default swap on their prime broker. That's similar to purchasing traditional insurance against a particular loss. Doing so, means that the hedge fund manager would hold an asset that provides it with financial compensation should the creditworthiness of the prime broker deteriorate. Such a scenario, however, does have some limitations. In theory, it is operationally cheaper to simply purchase CDS protection rather than maintain relationships with multiple prime brokers. However, ironic as it might seem, purchasing a CDS exposes the hedge fund manager to another form of counterparty risk. The hedge fund manager may have protected itself from the deterioration of the prime broker's credit, but it is now exposed to the creditworthiness of the counterparty to the CDS contract.