Counterparty Risk – Its Return and Implications

Counterparty risk, following the collapse of MF Global.

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Recently, I was asked to speak to a group of fourth-year undergraduate students at one of Canada's leading business schools, primarily on the topic of hedge funds and other alternative investments. After the lecture had closed, an enjoyable and spirited Q&A session included a discussion of the American and European debt situation, both at the corporate and national levels, and the corresponding risk to the portfolios of average investors.

At one point, I casually asked the group how they would define risk; seeing as the whole world at this moment seems to feel at risk, it seemed appropriate. The answer I was provided, after some deliberation, was "standard deviation". Struck by this, I asked them to expand on their answer. I was told that in class they had learned that the riskiness of an investment or group of investments could be reflected in the standard deviation of that investment relative to a normal distribution. Ah, the beauty and naivety of youth!

Remembering that these students lacked real-world experience, and sensing an opportunity to stretch some young minds, I asked them if they felt that was a good definition of risk. Most concurred, saying that the fluctuation around a mean return was as good a definition as any for the riskiness of an investment. After my best efforts to swallow a chuckle at the mention of a "mean" return, I asked them to imagine the following: if the investment were to return more than that mean return, was this a risk? The revelation was immediate for some, delayed for others, but absolute in the end; defining risk, it seemed, was risky itself.

The conversation continued and the discussion of a "risk-free rate of return" came up. I asked them what that risk-free rate of return would be. That would be the rate of return on an asset with no risk of financial loss, they reported. How very academic! I asked what asset that might be and the answer was, predictably, a short-dated government bond. So, I said, a 3-month bond issued by the government of Greece or Italy was risk-free? Well no, certainly not Greece or Italy, but another larger, more established nation. The United States then, with its own enormous debt problem and a recent credit downgrade? Perhaps not, they said, but how about another AAA-rated nation? Yes, came my reply, France's AAA rating is rock solid right now, isn't it? The sarcasm was perhaps over-the-top, but the point was taken.

Risk – Think About It

My goal, of course, was not to bash this particular group of students. Nor was it to lay claim to being a pre-eminent expert on the topic of risk. Rather, I was hoping to get these students thinking about what risk is and how they define it, both in their own financial lives and in the world at large. As we all know, risk extends an awfully long way beyond standard deviation and it is dangerous, as these students discovered, to simplify risk into something it is not.

As real-world practitioners of risk management, individuals who left the classroom many years ago, we can see quite clearly that the students have a fairly short-sighted perspective on risk, its calculation, and its importance. In addition, with just a few years of experience in simply following global capital markets, these students also lack the necessary time horizon to properly understand risk and its many facets.

The need to think about risk, in all of its forms, has taken on new importance in light of recent events. We have seen the unwelcome return of another type of risk over the last month or so, a risk that is too often ignored or downplayed. This is a type of risk that these students are never taught in school, likely have never particularly considered, and almost certainly have not had to deal with themselves. However, many of us might think that this risk, especially in this day and age, is the principal risk to a portfolio. I am speaking, of course, of counterparty risk, which has reared its ugly head once again in the form of MF Global.

Managing Counterparty Risk in Alternative Investments

Halloween 2011 may very well be remembered for a less traditional horror film that played out on our screens, namely the collapse of MF Global, an established and respected broker dealer and clearing house. Adding to the frightening story was the development that some $600 million of funds in supposedly segregated accounts is unaccounted for, adding a potential fraud to the already disastrous situation.

With this collapse, and following just three years on the heels of the failure of Lehman Brothers (not to mention the near failure of countless other firms in late 2008 and early 2009), investment managers and the investors they serve are taking a renewed interest in the mitigation of counterparty risk. While all counterparties are worthy of analysis and the appropriate due diligence, the failure of MF Global puts the prime broker at the forefront for this renewed scrutiny. The key is how to mitigate this risk and managers are quickly finding they have multiple tools at their disposal.

One very obvious option is a true multi-prime model, where a fund has more than one prime brokerage engagement at their disposal. This alternative spreads the counterparty risk across multiple prime broker relationships and can also offer portfolio management flexibility for the front office. However, the middle and back office burden becomes larger with each account that needs to be monitored, reconciled, and reported upon. As such, the trend towards outsourcing these operational functions, most typically to a fund administrator, has increased noticeably as a way to decrease costs and foster independence and transparency.

Another tool that is being utilized more by investment managers in recent months has been the use of specific terms and language in prime brokerage agreements. As an example, there has been an increased use of so-called “amber” language, which triggers certain changes in the event that a prime broker’s CDS spread exceeds a particular, pre-defined level. This type of clause within a prime brokerage agreement gives the investment manager a contractually-obligated safety net should the credit worthiness of their prime broker deteriorate, allowing for the segregation of their assets into separate accounts.

A third option that is seeing new traction is the use of actively hedged positions to manage counterparty risk, most notably in the aforementioned CDS market. Though certainly an expensive way to mitigate the risk of their prime broker failing, some investment managers are seeing this simply as a cost of doing business in this era of counterparty failure. To some, especially those operating under a single prime broker model, sacrificing a few basis points to protect against calamity is a reasonable price to pay.

Notice that these are just three of the tools that are at the disposal of a modern investment manager. There are a multitude of options out there, but it is important to note that all of them hinge on the proper due diligence. A rigorous and complete examination of all counterparties must be undertaken at the outset of a relationship as well as on an ongoing basis. Quite obviously, the standing of a particular counterparty can change over time, often relatively quickly, so it is imperative that the due diligence process is part of the ongoing operations of a fund.

These due diligence requirements have become progressively more necessary in recent times, and not simply due to the operational risks faced by an investment manager. More and more, an increasingly knowledgeable and involved investor base is demanding to know, as part of their own due diligence, what steps an investment manager is taking to mitigate counterparty risk. Still reeling from the lack of liquidity they faced during the credit crisis of a few years ago, investors are asking hard questions about the risk management practices of the investment managers with whom they have entrusted capital.

Conclusion

We must be careful, as prudent risk practitioners in Canada, to not become complacent concerning counterparty risk. The Canadian banking system is extremely sound, highly regulated, and specifically designed to withstand shocks; as such, it is easy to forget how large counterparty risk can be. However, many investment managers deal with American or other international counterparties, so the risk is all too real, despite our relatively insulated domestic banking system.

As we saw in my example from the group of undergraduate students, risk has the potential to be improperly or too narrowly defined. Such simplistic thinking can lead to a false sense of security and a partial, if not full, lack of understanding of the true risks faced by an investment manager and investors. Armed with some of the counterparty risk management tools presented previously, in addition to performing ongoing due diligence of third party relationships, investment managers can effectively understand and manage their counterparty risk. As with many items, looking ahead is crucial; if you are planning on surviving a great flood, it is best to build your ark before it starts raining. *