

In The Spotlight: OTC Derivatives

The European Commission and regulatory authorities in the United States are currently fast-tracking moves to restrict the likelihood of Over-The-Counter (OTC) derivatives threatening the recovering stability of the financial markets. They are worried this could happen in the event of default, or a market participant collapsing.

What concerns the regulators is the size and apparent lack of transparency of the OTC markets, particularly in the credit default swap markets.

If action is taken against the banks it could severely impact corporates and other firms who access the OTC markets to hedge primary risk, e.g. interest and exchange rate risk.



The European Commission have come forward with a number of ideas which include:

- Uniform legal frameworks (e.g. ISDA documentation);
- Greater standardisation of OTC Derivatives to assist automation and e-processing;
- Standard deal parameters (value dates, rates and settlement procedures);
- The posting of collateral by bilateral parties to a trade;
- The novation of trades to a central counterparty to reduce system-wide exposures through the netting of positions; and
- The posting of collateral margin calls on mark-to-market revaluations.

All of this has the feel of the authorities pushing the market for transactions to move onto an exchange-traded basis, through a central counterparty.

This is likely to have an effect on overall market volumes and liquidity and would have a negative impact on companies in particular who, in the current climate, may be strapped for cash and pushing against funding limits.

Watch this space!

Building an ALM System: Problems and Practicalities

Selecting and building an ALM model is a large undertaking for any organisation. There are two broad choices; build your own, or buy one 'off the shelf'. Few organisations relish the idea of investing significant time and money on what may be a risky software project. For this reason, most opt to buy proven solutions which may be more simply implemented.

The main concerns about the packaged-system route centre on data integration and functionality – will it work for the business? All too often, this route may be less than satisfactory and, in many cases, results in frustrated customers. If a product vendor does not update the package regularly, then problems will inevitably result. This is an acute issue in the dynamic environment of contemporary asset and liability management. Often, problems occur because the product has not been sufficiently adapted and integrated to the customers specific requirements and is unable to react to the changing demands of the business and the regulatory environment.

Each institution is to some extent unique and, therefore, output and financial modelling requirements are likely to be different. A further concern is that each ALCO is different and, typically, its requirements for information and output evolve and change. Can any product be flexible enough to satisfy the diverse

range of financial institutions that exist around the world? Perhaps not, but with the range of available products on the market, it should be possible for almost any institution to find a system that adequately suits its needs. The main challenge is to employ a solution which is capable of aggregating the entire balance sheet, whilst still analysing the individual component businesses. There is little point in reporting isolated business information without understanding the big picture.



Ingredients

The basis for any good ALM model is adequate and accurate data. Typically, this has to incorporate historic data, current inputs and future projections. If this is achieved, the rewards are significant. This will provide an institution with:

- the ability to monitor and control key ratios, limits and risks and to be able to react swiftly to change;
- efficient management of hedging, funding and solvency as a result of the ability to manage portfolio risk rather than having to manage individual business streams (often only possible on a matched funded basis); and
- planning and business modelling both in assessing past strategy and performance and in developing forward-looking and pragmatic scenarios.

However sophisticated the technology required to achieve this, it is essential that an ALM system be carefully tailored to meet the needs of the business. The core of any system is the common data model – basically, measuring, recording and modelling all risks on the balance sheet using one single homogenous format.

Only in this way can truly meaningful output be derived and a clear vision of the overall business and the risks it faces, be presented.

Outputs

Obviously, a crucial factor is the end-user interface – in other words, the output format which will allow ALCO to most effectively manage the assets and liabilities of the institution. Particular attention should be focused on:

- Liquidity risk
- Credit risk
- Market risk
- Interest rate risk
- Operational risk

The ability to separate and reintegrate these risks is something which an effective ALM model should provide. Control and integrity can be effectively maintained by constantly building and overlaying new transaction data generated by the model.



Of course, the interpretation of output is something which needs to be carefully considered – poorly interpreted data will produce distorted results and defeat the object of having an ALM system in the first place.

To achieve this, it is likely that some degree of process re-engineering will also be required. It is important that the system alone is not seen as a panacea, rather that it is an essential tool for a well structured ALCO to better manage the balance sheet.

End-user data is presented periodically to ALCO in the form of the regular ALCO pack. In addition to this, the ALM Manager should have instant access to a wide range of more detailed reporting and modelling tools in order that he may present the most appropriate and focused event analysis to ALCO. This functionality is also invaluable for maintaining effective management action triggers.

Analytical Tools

The process of data design and analytics is an area which should be considered at

the early stages of any ALM project. The data warehouse and common data model, typically maintained by middle office, will produce reports and analysis which highlight exceptions to and potential breaches of established parameters. Any such exceptions should immediately trigger the appropriate escalation procedure and thus protect the institution from exceptional risks and losses. On the upside, these outputs should also help to maximise returns.

These benefits will only accrue if the ALM model has been well set up, correctly configured and populated with complete and accurate data. Stating the obvious perhaps, but a surprisingly difficult goal to achieve.

Another important function of any ALM system is to look forward. This is achieved by modelling scenarios which both simulate specific future events and which incorporate behavioural trends within the business. This will project the net financial impact and provide measurable targets, against which future performance can be monitored.

In summary, ALM systems are seldom a 'plug-and-play' solution. Any institution considering such a system should develop a clear understanding of their current and future requirements and of the organisational changes which will have to be made. Fit the product to the requirements and not the requirements to the product!

XMI can help each step of the way and has a strong track record of helping clients with a range of ALM projects. This can involve anything from individual steps a project to the entire end-to-end project itself, including system selection, development, implementation and process re-engineering.

We also help our clients to revisit and reassess the continuing effectiveness of systems in order that they can maintain the most contemporary solutions.

In Brief: The US Dollar – World Bank Warning

World Bank president Robert Zoellick has given the United States a warning over the future of the dollar as the world's key reserve currency, saying that the United States would be mistaken to

take for granted the dollar's place as the world's predominant reserve currency. Mr Zoellick delivered the warning as part of a speech at the John Hopkins University in Washington DC this month and said that "looking forward there will increasingly be other options to the dollar". He said that the huge economic change of the last two decades, which started with the breakdown of Communist economies in the Soviet Union and across Eastern Europe, have seen the emergence of India and China as economic powers thanks to the reforms they made.



Mr Zoellick, who replaced Paul Wolfowitz as World Bank president in 2007, will also call on the G-20 to work as a steering group for international economic co-operation.

He will suggest that countries with emerging economies should be treated as responsible stakeholders by the G-20, while recognising that many developing nations face the challenge of bringing millions of their citizens out of poverty.

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