



Trends and Technology Strategies for Mitigating Counterparty Credit Risk

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Relevance of Counterparty Credit Risk

Hedge funds have traditionally managed counterparty risk by restricting trading to reputable and solid prime brokers.

Pre-settlement Risk

Settlement Risk

Most pressing needs

- Multi-strategy funds
- Hedge fund firms with multiple legal entities
- Funds with multiple products – OTC derivatives, repos and other collateral-related transactions

Evolution of Counterparty Credit Risk

Recent market events have underscored the importance of counterparty risk management.

Top reasons include:

- Limited understanding of the exposure to any given trading counterparty
- Long process to aggregate exposure to a single counterparty
- A simple position aggregation exercise will not provide an accurate view of risk and exposure
- Sell side tools and techniques for aggregation and limit management are not widely available in the alternative investment management industry
- Limited appetite to invest in expensive tools and systems

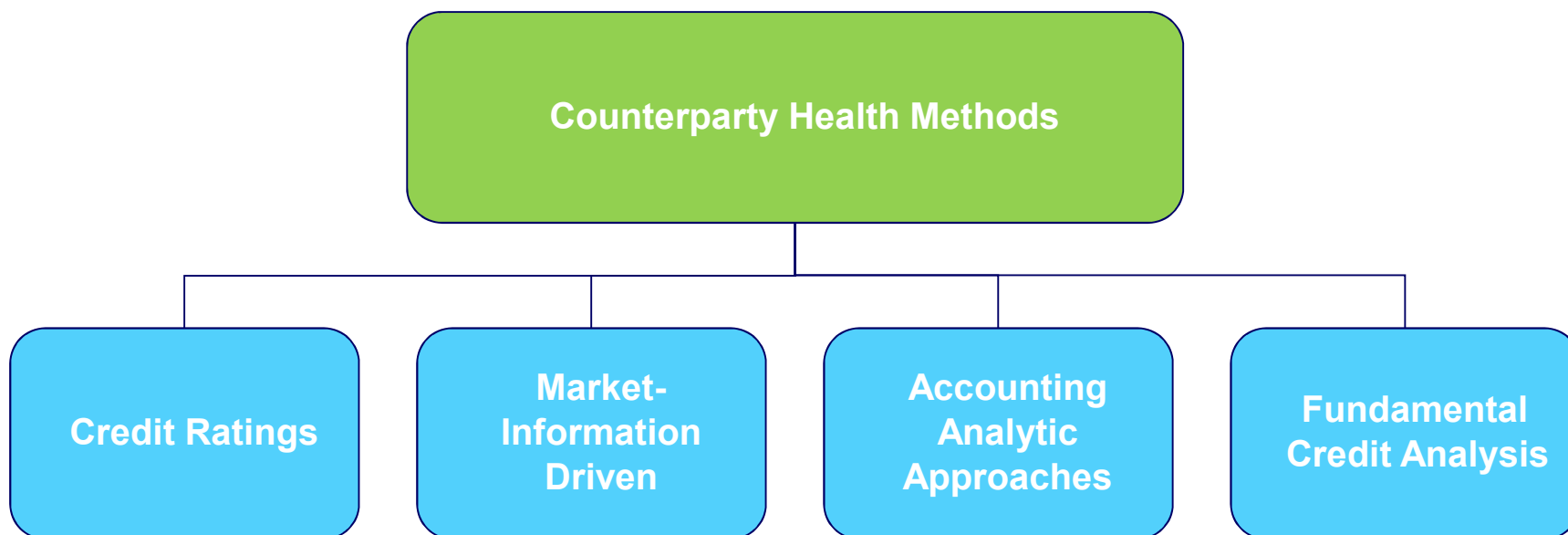
Two Dimensions of Counterparty Risk

1. PREVENT

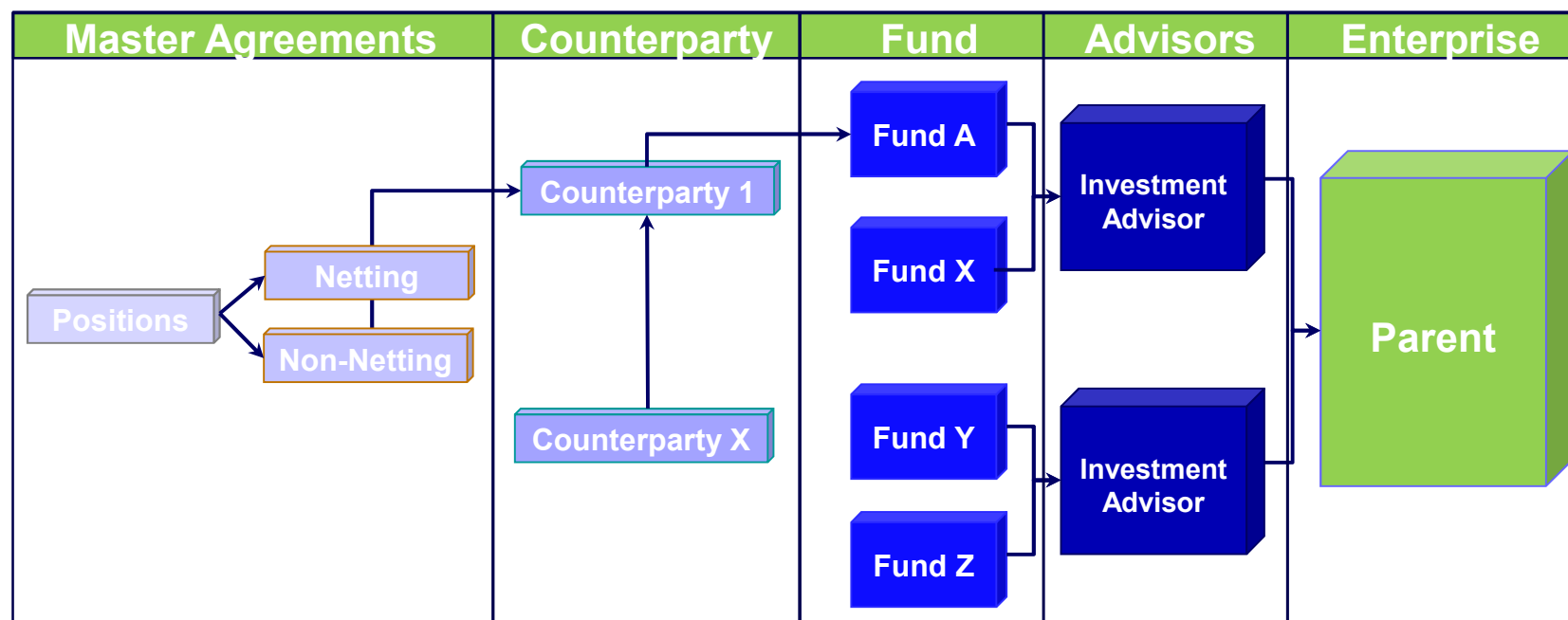
- Risk Analyses
- Aggregation logic
- Exposure monitoring processes
- Due diligence and site visits

2. RESPOND

Monitoring Analyses



Exposure Aggregation Logic



Sample aggregation metrics:

- Gross/Net Receivables and Payables
- MTM
- Gross Exposure
- Net at Risk
- Maximum at Risk
- Add-on

Emerging Counterparty Risk Management Practices

Description	Buy Side	Sell Side
Use of relevant and forward-looking metrics		✓
Monitor exposure pertaining to prime brokers, custodians and other third parties	✓	✓
Availability of common data across business lines		✓
Ability to monitor and react to market events	✓	✓
Consistency of risk measures, analytics and data across the firm		✓
Identify acceptable counterparties and exposure		✓
Assess the implication of market stress events on the value of the collateral		✓
Model risk identification and control		✓
Trade confirmation and reconciliation process	✓	✓
Reporting, processing capabilities and technology	✓	✓
Correlation between market and credit risk		✓

Approach

High level steps to address the challenges of implementing a counterparty credit risk management framework include:

Current State Analysis

Gap Analysis

Design and Implementation

Business Analysis

Counterparty Analysis





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