OTC Derivatives and Transparency

An Argument for Less is More

Adam Greissman
alg@udico.com

February 7, 2011

Agenda

- Background – Capital Markets and Standards
- The Risk of Risk Analysis
- Public Exposure and Risk
- Transparency – Just the Facts
- Trade Level Details
- What's Wrong with this Picture?
- Why Johnny Can't Read FpML
- Where do We Go from Here?
- Postscript – The Drafty Kimono

Background – Capital Markets and Standards

- 1982-1992 Commercial Software
- 1992-2000 Director, PwC – Global Risk Technology
- 2000-2011 UDICo, Citi, Independent Consultant, etc.
- Standards Efforts
  - FpML co-founder of an XML standard for currency, interest rate and credit derivatives
  - XBRL participant, secretary for an XML standard for financial business reporting
  - DDF5 development services and software for an XML standard for regulatory exchange of policies and holdings between insurors and reinsurors (AMBAC, MBIA, etc)

The Risk of Risk Analysis

- 2008 was *Off Piste* – not captured in the financial models – so why bother?
- Risk is Forward Looking which implies prediction and Point of View
- Public opinion about risk is subjective and easily manipulated
- The mathematics of risk are complex, controversial and difficult to calculate
- The barriers for institutional compliance could take years to resolve
- The practical challenge of associating transparency with risk measurement is that everyone will love the idea, but nothing will ever get done

Public Exposure and Risk

- Public Exposure Requires Public Disclosure
  - Banks or institutions that are too big to fail (sell side)
  - Government entities (states, municipalities)
  - Corporate treasuries of public companies
  - Pension funds, mutual funds, etc.
  - *Anything I will have to pay for!*
- It's not about *How Much* is at risk (MTM, VAR)
  - Too difficult to quantify without a religious debate
  - Even experts within an institution argue about valuation
  - Even unwinds of *profitable positions* have enormous slippage
  - Who do you think the *Calculation Agent* is anyway?
- It's about *The Fact* of the risk
  - Should public money be exposed to subprime debt?
  - Should public money be exposed to third world local market debt?
  - Should public money be exposed to illiquid interest rate and credit derivatives?
  - The buy side "money managers" think *dollar cost averaging* is an *investment strategy!*

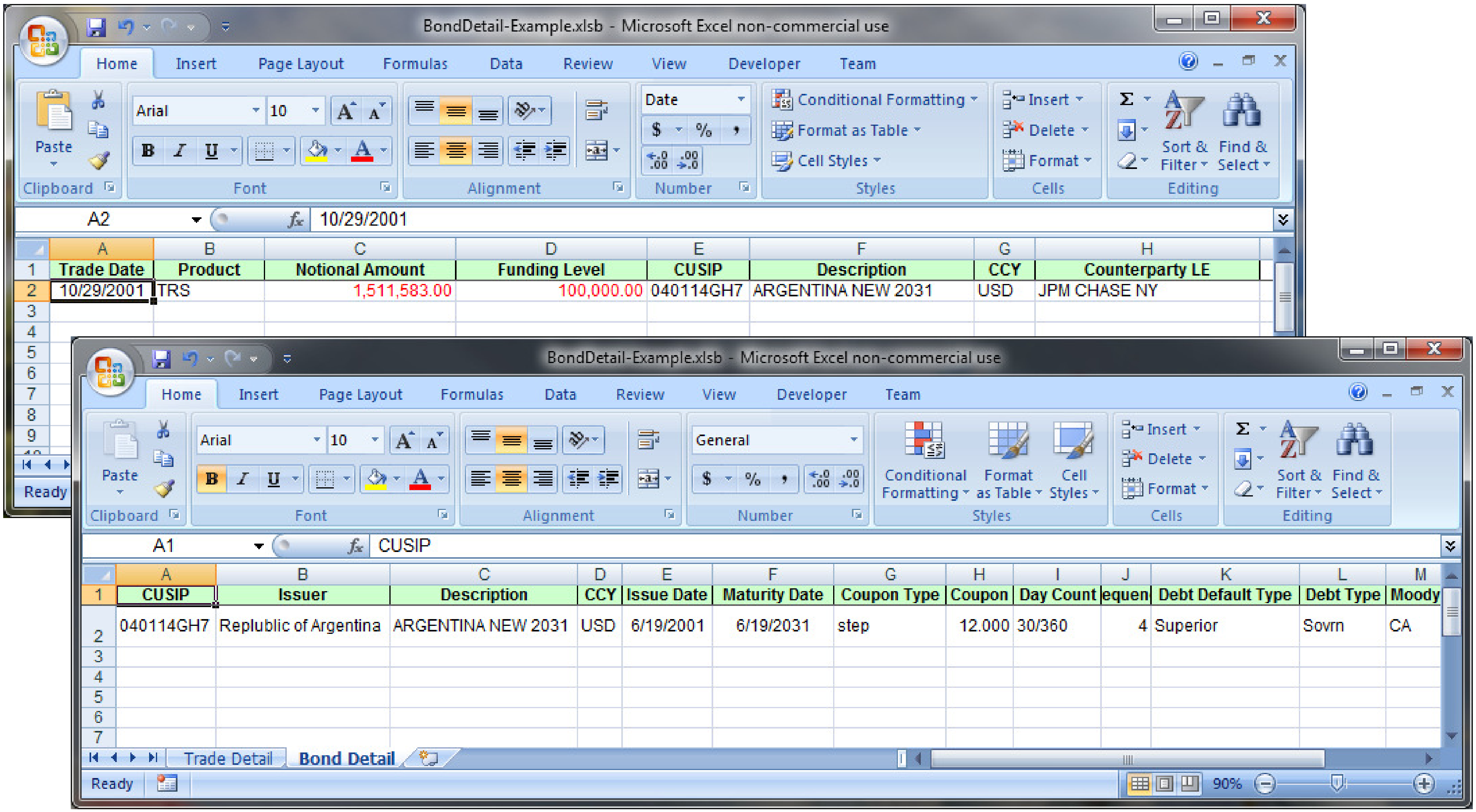
Transparency – Just the Facts

- Trade Level Details – Not Aggregated Risk
- Products – Bonds, ABS, CDS, CDO, TRS, CLN, etc. at the Trade Leg Issuer/Individual Level
- CUSIP/Issuer, Loan/Credit Score (quality of debt)
- Coupon and Term Structure (cash flows)
- Notional Amounts and Funding/Margin (level of actual capital exposure)
- Counterparty LE Level Detail (ability to pay)

Trade Level Details

- Risk Reporting is Not Enough Because Valuation is Subjective
  - My Credit Risk is Zero – Because my model tells me so!
  - AAA Debt is the Subjective Valuation of the Agencies
  - VAR (value at risk) like MTM (mark to market) is an opinion – not a fact
- Trades Carry Individual and Specific Risks
  - Each OTC Derivative is a Unique Contract
  - Interest Rate Risk is exposure to value
  - Credit Risk is exposure to issuer obligations
  - Counterparty Risk is exposure to counterparty payment
- Example: Total Return Swap (or TRS)
  - CUSIP – A specific bond or issue
  - Issuer – the sovereign or legal entity for the issue
  - Term Structure – bond or underlyer, rate definition, payment schedule
  - Credit Contingency – default events, recovery, principle exchanges, valuation

What’s Wrong with this Picture?



Why Johnny Can't Read FpML

- Trade Parametric Details Require SME
- Difficult for Experts to Follow
- Requires Product Knowledge
- Understanding of Taxonomy
- Institution Specific Features
- Familiarity with Underlyers

If trade details for credit derivatives require too much SME, what pray tell does that say about MTM and VAR?


```
<?xml version="1.0" encoding="utf-8"?>
<!--View is reporting-->
<!--Version is 5-0-->
<!--NS is http://www.fpml.org/FpML-5-0/reporting-->
<!--Omit some adjustments, details of procedures,
and other information not required for a report-->
<dataDocument>
  <trade>
    <tradeHeader>
      <partyTradeIdentifier>
        <tradeId
tradeIdScheme="http://www.swapswire.com/spec/2001/tr
ade-id-1-0">37260</tradeId>
      </partyTradeIdentifier>
      <partyTradeIdentifier>
        <tradeId
tradeIdScheme="http://www.swapswire.com/spec/2001/tr
ade-id-1-0">37260</tradeId>
      </partyTradeIdentifier>
      <tradeDate>2002-08-22Z</tradeDate>
    </tradeHeader>
    <creditDefaultSwap>
      <generalTerms>
        <scheduledTerminationDate>
          <unadjustedDate>2007-08-
28Z</unadjustedDate>
          <dateAdjustments>

<businessDayConvention>MODFOLLOWING</businessDayConv
ention>
```

Where do we go from here?

- Quantify Transparency
  - FpML is an Off-the-Shelf Industry Standard Data Model
  - Widely adopted by the institutions and vendors
  - Makes compliance a real possibility
- Lobby Congress: <u>Public Risk</u> Requires <u>Public Disclosure</u>
- Expose OTC Derivatives at the Trade Level
- Plenty of people will rush in to think great thoughts about risk and regulation
- Caveat: This is still setting the bar high, because the trades themselves require SME to understand

PS - The Drafty Kimono

- Is it unfair to require counterparties to expose their proprietary positions?
  - Only if they are risking public money
- Will this destroy the market for derivatives?
  - Not if they are used for hedging
- What about the hedge funds?
  - Directional trades are still possible
  - Allow anonymity for private counterparties

The public cannot be exposed to economic *junk in the trunk.* History had demonstrated what happens when kimonos are opened only at the discretion of the sell side institutions.