CUSENZA TO GRENSTED

Paul Cusenza

In this month's Pass the Microphone, Paul Cusenza of Nodal Exchange puts his questions to Simon Grensted, Managing Director, Business Development, at LCH.Clearnet

Interviewer: Paul Cusenza, CEO of Nodal Exchange

Interviewee: Simon Grensted, Managing Director, Business Development, at LCH. Clearnet

Q1. Last September, the G20 leaders issued the following statement: "All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest." What are your views on this objective? Do you think it will be met?

The big picture objective is to reduce credit risk and the systemic nature of credit risk in a crisis. However, there are challenges to clearing derivatives and I don't think all derivatives will fit easily into a cleared business model. I think a lot will, but I don't think all can.

The main challenge is that clearing houses have to be able to manage the default of a member and have sufficient margin and financial resources to do so. Clearing houses are very good at innovating and we welcome challenges but solutions must be within the central tenet of 'defaulter pays'. For us there can be no other mechanism than using the defaulter to pre-fund the cost of us closing out their position if they were to become insolvent.

Managing a default is our central concern. So from that 'defaulter pays' premise, the next question we ask is 'do we have sufficient margin?' and from there we ask 'is there sufficient market liquidity to take on positions and for people to buy them from us in a default?'

So we always look at whether there is sufficient liquidity and whether we are confident in the pricing we're using to value the portfolio. These are key facets in deciding whether we can introduce a product for clearing.

The difficulty with some illiquid derivatives is that the level of margin that the clearing house may need to charge could make the use of clearing services financially unattractive, and potentially alter the economics of what the user is trying to do in the first place. If there isn't sufficient liquidity in a specific derivative trade, the clearing house may have to effectively margin those trades at 100% of the net position. That could be quite expensive to the user and consequently they may prefer to hedge the risk in a different way.

We view products in two classes – futures lookalike products, of which there are many examples in the energy markets, and the 'real' OTC market, where we've created clearing services that don't alter the economics and don't reduce the flexibility of the derivative to match the risk that you have.

We've done this in a number of products, but interest rate swaps is where we have the largest notionals – around $212 trillion. This is a pretty big percentage (over 40%) of the global market. When you look at these trades, 97% of them are different because of the flexibility of dates, rates, amounts, tenors, indices, frequency – there's so much choice and because of that people use them. There are all sorts of things that you might think are easy to standardise, but actually, people want the choice and flexibility.

Standardisation works well for some products but not all.

Q2. In September 2008, Lehman Brothers defaulted with LCH.Clearnet on a $10 trillion portfolio. How did you handle such a massive default and what was the end result?

The end result was that we sold all the positions of Lehmans and transferred them with no loss to the clearing house and we also transferred about two-thirds of Lehman's margin payments back to their administrator. So we closed out the default in approximately a third of the initial margin.

We take a different approach for each asset class. We managed the default of the cash-equity portfolio very differently – it's got different timeliness requirements and is over much faster – then we managed the default of the $9-trillion interest-rate swap portfolio. Our risk department has a large number of staff and they are divided by asset class. Each asset class has a default team leader. The general approach is to decide whether to hedge the risk and sell off the portfolio or just to sell off the portfolio depending on the scale.

In futures, for instance we sold off the futures and options portfolios in energy, equity derivatives and interest-rate futures very quickly through our auction processes.

The main lessons from the crisis should be: don't rely on models too much, and that it's important that people look for the unexpected

Simon Grensted

For interest-rate swaps it's more complicated. We have a Default Management Group, which conducts fire drills and has very rigorously defined processes. Members of the committee come from our membership and each member, when it's their turn, has to put a senior trader on to the group and it rotates every two years. Every member has to sign up to rules around defaults, which include confidentiality. If a default occurs, the members of the committee effectively cross a Chinese wall and stop working for their firm and start working for us.

So for the Lehman default, on Monday morning the Default Management Group convened and the dealers worked with our risk group. It means we're always able to access the latest thinking on risk management and the market. They started to hedge the positions – the big macro hedges first, then the smaller ones. The process lasted a few days.

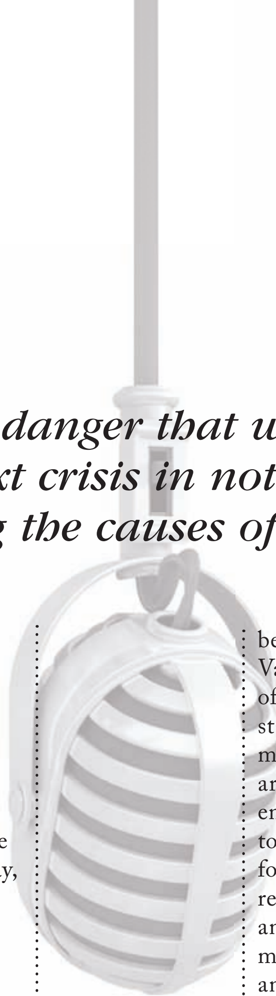
The portfolios were then packaged up and issued for auction. We saw very competitive bidding for portfolios. We then transferred portfolios to the winning bidder.

There are lots of fire drills and practices around defaults so that all the members of the committee will have rehearsed something similar before.

It was a very interesting time for us and we certainly learnt things that will help us going forward– but I think it was the fact that we had invested a lot of time and money with our members to put such rigorous processes in place that enabled us to handle it smoothly.

Q3. What counsel would you provide to risk managers given the reality that entities like Lehman Brothers can default?

Risk managers should know they



> *There's a danger that we sow the seeds of the next crisis in not thoroughly analysing the causes of this one*

have to expect the unexpected. They should know that they've got to be prepared and that multiple defaults are a possibility and that multiple markets can go very quiet. Liquidity even in big markets can dry up. Liquidity in the Lehman crisis was demonstrably better in the cleared markets, but on that Monday, markets were in shock.

There's a long list of things that they have to try and not keep themselves awake with every night.

Our risk committee and risk design processes are around default management. You don't expect them to be annual events yet we've managed around five defaults in recent years. We've managed as many again that have been 'near misses', but we've worked with the entities concerned to manage their positions out of the clearing house in an accelerated way, thereby avoiding a default. So defaults can take many shapes.

It's much better if you can work with the company to wind down than work with an administrator.

You need to invest in risk processes and technologies and you do that in the full expectation that you might not need to use them.

Q4. LCH.Clearnet is the central counterparty for Nodal Exchange and uses value-at-risk (VaR) for setting initial margins. Can you comment on the benefits of using VaR for this nodal power market?

We have been developing risk engines for over 20 years. We quickly started adapting the capabilities of simple futures margin engines to take better account of correlations and offsets between asset classes and contracts. VaR gives you the opportunity to offset in a more effective way. We started working on VaR engines for margining 12 years ago and we have around a dozen different margin engines, all fine-tuned according to the product. The VaR engine for Nodal exchange allows us to recognise offsets between contracts and is a more efficient way of managing risk between the positions and portfolios. It gives a better view into the risk and allows clients to see the rationale behind margin allocation.

Q5. LCH.Clearnet recently opened an office in New York. Can you comment on your plans for North America?

We have a lot of business in the US. We've had an office in New York for about a year and are just moving to a bigger one. Roughly 30% of our shareholders are US firms. We have over $70 trillion in US-dollar interest-rate swaps for instance. Our business with Nodal is growing. Having an office in the US allows us to support these customers locally.

Q6. What lessons do you think we can learn from the most recent financial crisis?

One of the things I've been fairly frosty about hearing is risk managers talking about how we seem to have a once in a 100 year event occurring every seven or so years. The main lessons from the crisis should be:

- Don't rely on models too much. We've had maths for a millennia or two but sophisticated markets for only two to three decades.
- It's important that people look for the unexpected. People should look for things that people took for granted. People found it difficult to believe a crisis like the one we've just had could happen.

If you look at [the stock market crash of] 1987 or at the 1998 Russian bond crisis, or [the failure of] Long-Term Capital Management, people did learn from these. In a way the markets have already moved on from the latest crisis, but the confidence impact on banking has been a very salutary lesson for many economists and regulators.

There's a danger that we sow the seeds of the next crisis in not thoroughly analysing the causes of this one. Legislation will increase the use of clearing and that will help counterparty credit. The worry is that you can't clear everything or you change the economics and that may force some people not to clear or not to use hedging strategies using derivatives. That will then have some negative consequences and introduce a different kind of risk.

I think a more evolutionary approach to learning and tightening up is sometimes better than radical changes, which are bound to create unintended consequences because of the scale of the changes proposed. The unintended consequences I think are something we're going to be dealing with in Europe and the US for the next two to three years.

Q7. What wine would you select to relax after a successfully managed default?

After the Lehman's default I did manage to get to the pub and have a pint of Guinness. As far as wine goes I think you can't beat Haut-Brion 1990. ■