Credit Benchmark

The Importance of Knowing Your Counterparts' Creditworthiness (KYCC) for Peers Considering Counterpart Extension

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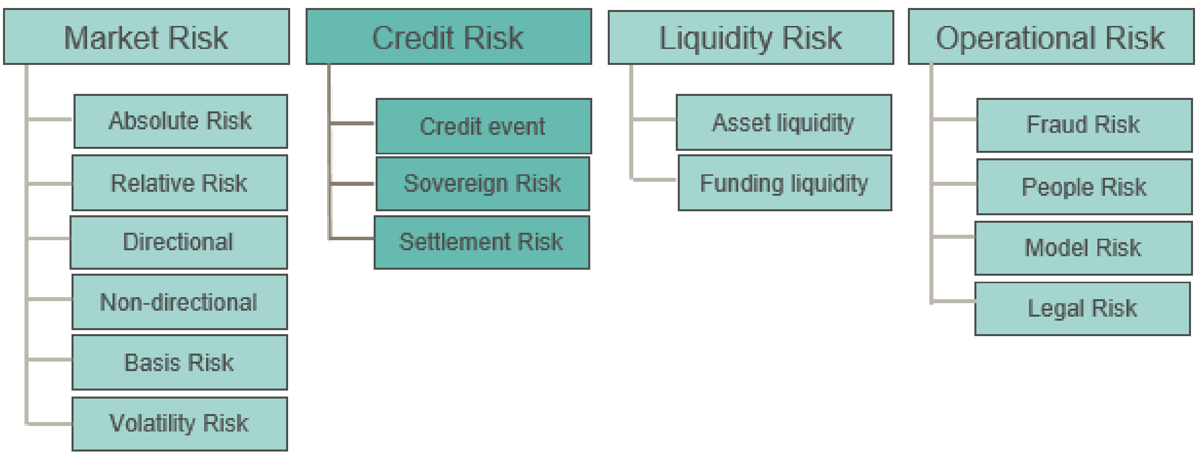
It is essential for all global capital markets participants to "know" the counterparts with whom they do business and factor counterparts' creditworthiness into their onboarding, risk management, capital, and operational decision-making. Irrespective of an organization's position, whether on the buy side, sell side or as a principal/agent intermediary, risks exist. Legacy processes such as the 2006 **Agency Lending Disclosure (ALD)** are outdated and in need of revision. Forthcoming new regulations, such as the 2020 **Securities Finance Transaction Reporting (SFTR)**, are fast approaching. Therefore, the need for an efficient, new approach to bring operational, risk management and capital benefits has never been greater.

Knowing the creditworthiness of prospective counterparts is a significant factor in securities finance, and a lack of transparency can manifest as a gating issue for organisations considering "peer to peer" transactions. Without a clear understanding of a counterpart's creditworthiness the transactions are untenable. Whether your "peer" is a beneficial owner (e.g. a sovereign wealth fund, pension fund or mutual fund) or an asset manager ("traditional" or "alternative"), there is no denying that you must be able to understand, monitor, articulate and seek permission to deal with a new counterpart.

These transactions can be referred to as **"counterpart extension"** rather than "peer to peer," given that the functions performed and transaction profile remain largely the same regardless of the counterpart in question. There are no fundamental differences between adding a broker dealer to your list as compared to adding a Sovereign Wealth, Pension or Hedge Fund – and many of these entities are unrated by the major Credit Rating Agencies.

Financial risk comes in many different forms, as the diagram below illustrates - the good news is that the risks can be understood and measured, and action can be taken to manage and mitigate them.

Financial Risk



This short paper focuses upon the counterpart credit risk that occurs in the Securities Finance Industry, with particular emphasis upon "peer to peer" or **"counterpart extension"** activities. However, the approach outlined can be applied across the Capital Markets and include counterparts such as:

- Central Clearing Counterparts (CCPs)
- Custodians and Sub-Custodians
- Broker Dealers
- Asset Managers
- Execution Brokers
- Exchanges

Counterpart Credit Risk is defined as:

> *"The risk that a counterparty to a transaction or contract will default (i.e. fail to perform) on its obligation under the terms of the contract between the parties. Counterparty risk is not limited to credit risk (the risk that the counterparty cannot fulfil its contractual obligations for payment) but may also result from other problems associated with a counterparty unwilling to honour the contract."*

Calculating counterpart credit risk typically involves the building of regulatory approved models (for banks), requiring numerous detailed data inputs under the management of sophisticated and experienced risk managers.

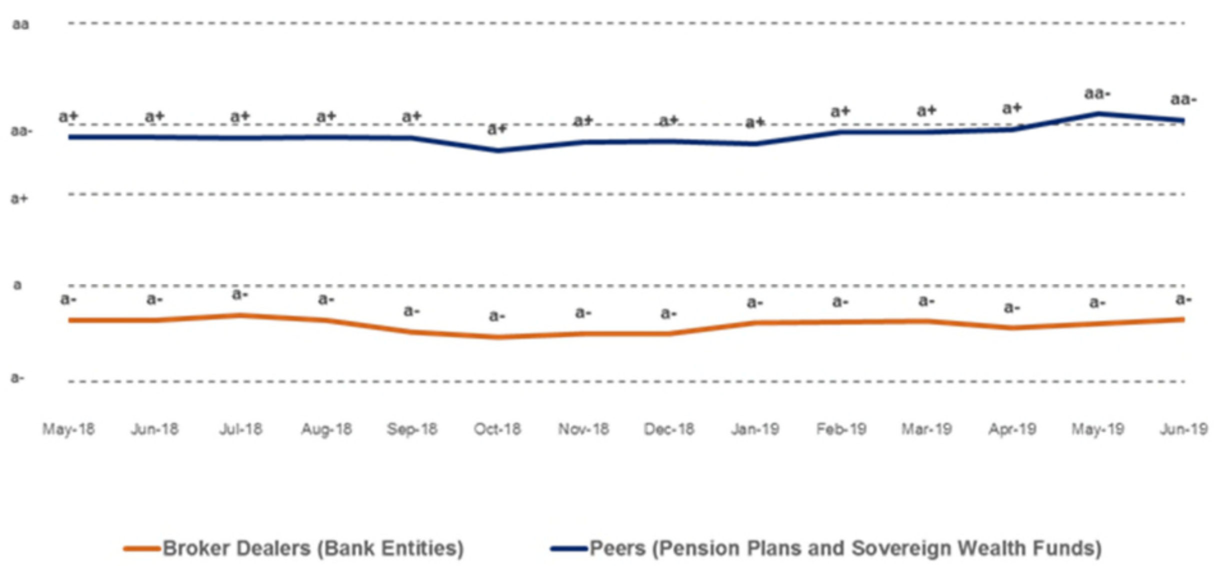
Recent research conducted by Credit Benchmark has concluded that one of the largest counterpart risk management challenges faced in Capital Markets is in the counterpart 'heavy' **Securities Finance industry**. Incorporating securities lending, repo and prime brokerage, this vital industry is at the **epicenter of the Capital Markets**. One of the key challenges is that many participants, in particular the numerous funds in this industry, have been **hitherto unrated by the traditional Credit Rating Agencies (CRAs)**. This means that the participants have had to take responsibility for the complicated undertaking of counterpart risk assessment themselves, or otherwise adapt their behaviour.

Given that calculating and monitoring counterpart creditworthiness in-house requires a significant resource commitment, it is a function that banks are often best placed to meet. Many non-bank principal participants are left to rely on their best in-house efforts, dependent upon incomplete information from the CRAs, or restricted in their counterpart selection in the interests of avoiding risks that they cannot fully understand.

The lack of CRA ratings for the supply side (e.g. Sovereign, Pension, Mutual and Insurance Funds) and demand side (e.g. Broker Dealers and Hedge Funds) of the industry, combined with the fact that the **agents cannot provide CRA-style information** to their clients without accepting liabilities that they may not wish to accept (given that they are not CRAs and their credit opinions are proprietary and confidential) makes it challenging for the Beneficial Owners to assess their counterpart risk accurately.

For reasons stated previously, many Beneficial Owners and Hedge Funds do not have the capabilities in-house to assess and manage certain counterparts. However, it is ultimately their decision to make as **they are often principals in the transactions**. Ironically, they often struggle with counterparts that look quite like themselves – A.K.A. their "peers", because they have no CRA rating.

Counterpart Restriction: Securities Finance participants could choose to restrict their counterparts to those with a CRA rating above a certain level – which **constrains their business opportunities** and reduces the performance of their lending programme via their agent (if they have one). This approach will potentially have negative commercial implications – with perfectly sound counterparts possibly being excluded from their counterpart list and opportunities missed due to not having a CRA rating. Ironically, one could argue that lending to "peers" may in fact reduce counterpart credit risk as the chart below demonstrates.



A comparison of a sample of Broker Dealers' creditworthiness vs "Peers"

Indemnification or Insurance: Securities Finance participants could also insist upon receiving an indemnification or insurance policy from their agent lenders. **This is not without financial and capital cost** and will potentially negatively impact their earning potential, alongside the capital and cost implications for the indemnity provider. This approach might help reduce the level of risk but could be considered to be "using a sledge hammer to crack a nut". Market standard documentation, and liquid collateral held in a Triparty account with a positive margin marked to market daily should theoretically supplant the need for an insurance policy. Some of the larger more sophisticated lenders have taken the decision to not require indemnification at all.

There is an alternative solution to this problem. Securities Finance market participants including beneficial owners, agents, and principal borrowers can leverage alternative consensus datasets to improve business performance, save capital and increase efficiency. Some of the additional benefits of this approach include:

- Principals can select and **monitor** new and existing counterparts (e.g. hitherto unrated broker dealers or "peers')
- Agents can increase **reporting transparency** to Beneficial Owners and better understand risk adjusted returns
- The borrowers can manage capital and **Risk Weighted Assets** (RWAs) more accurately
- All parties comply with forthcoming **regulatory reporting** requirements **at time of trading**
- Across the market enjoy better informed resource allocation and financing decisions

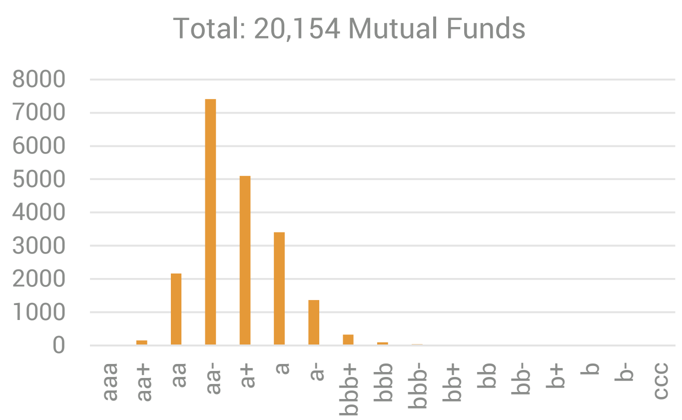
How does selecting peers as counterparts impact a counterpart risk profile?

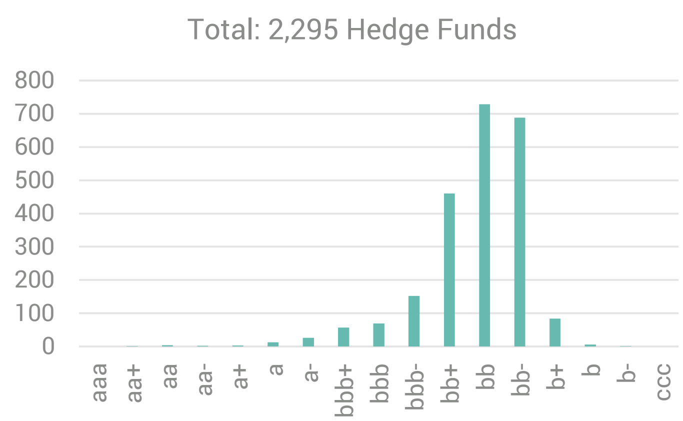
The answer is dependable, however, as the previous chart demonstrates, concentrating on a select group of peers with a high average creditworthiness actually reduces the level of counterpart credit risk taken. By extending your counterpart list to peers and continuing to adopt the same lending procedures and protocols it is possible to reduce your overall risk profile.

Counterpart risk is a two-way phenomenon. The borrower typically assumes more risk than the lender, as the borrower provides collateral and a margin to the lender. When facing the prospect of potential change to their risk profiles, some of the larger borrowers (e.g. large hedge funds) rely upon alternative credit data sources to evaluate the counterpart risk of their borrowing transactions with beneficial owners. They are often unfamiliar with the creditworthiness of such counterparts - irrespective of the fact that many of them may be investors in their funds.

New, complementary data sources are now available, providing credit data coverage on funds – from **sovereign wealth funds to hedge funds via mutual funds, insurance funds, pension funds**, and others. Extensive data is also available on Custodians and sub-custodians, Prime Brokers and subsidiaries, Broker Dealers and subsidiaries, Indemnification Providers, CCPs, and Exchanges.

The challenge of reviewing and onboarding large numbers of funds that are unrated by the CRAs is a major resource issue that will not go away. The frustrations of the 2006 Agency Lending Disclosure (ALD) process need to be addressed and the forthcoming 2020 Securities Finance Transaction Reporting (SFTR) **regime will further challenge an already stretched credit infrastructure**. The SFTR regulation in Europe will prove a catalyst for change and bring much need transparency - a new era of European ALD is around the corner. New, alternative credit datasets will help Securities Finance market participants make these processes more automated and efficient.





Example of available consensus data spread for mutual and hedge funds

How can alternative datasets help your business?

For those who are responsible for understanding and communicating counterpart exposures within a firm or to clients, **new, alternative consensus datasets can** improve understanding and decision-making. Knowing your counterpart (KYC) is essential and knowing your counterpart's creditworthiness (**KYCC**) is a critical part of KYC. Because of the sheer number of counterparts involved in securities finance, upcoming regulatory changes, and capital implications of the transactions, securities finance participants can benefit from consensus data in the following ways:

Beneficial Owners

- Lending directly or via Agents, consensus data can support your activities beyond current limitations
- Inform and expand counterpart selection process, including hitherto unrated non-traditional counterparts
- Explore the opportunities of Peer to Peer lending confidently from a position of knowledge
- Automatically monitor your counterparts' creditworthiness – be alerted to changes as they happen
- Commission your own 'Comparative Credit Assessment' to expand business opportunities and counterparts
- Speed up your Know Your Counterpart (KYC) and Operational Due Diligence (ODD) onboarding processes

Agents

- Leverage a unique, new data set to remain competitive in a changing landscape
- Assist in your regulatory compliance with SFTR by better understanding the creditworthiness of your supply
- Add and automatically monitor additional, non-traditional counterparts to your borrower list
- Enhance your reporting and risk management capabilities - providing transparency to your clients
- Respond to the ongoing 'Peer to Peer' challenges and make them opportunities for your business
- Position your organisation for the development of new paradigms – e.g. Agency Prime or Enhanced Custody

Principal Borrowers

- As Capital Markets continue to evolve, the creative application of data provides a competitive edge
- Speed up your onboarding process so that you do not miss out on borrowing opportunities
- Optimize management of capital and RWAs and address the shortcomings of the legacy ALD process
- Allocate balances and balance sheet where it makes most commercial sense
- Prepare for the world of 'smart buckets' and SFTR and leverage existing market initiatives and benchmarks
- Expand collateral possibilities into areas such as ETFs

How does consensus data differ from credit ratings provided by the CRAs?

- Coverage: Alternative datasets can offer a complimentary opinion to CRAs for rated entities as well as **greater visibility into the larger unrated universe**
- Risk Aligned: Consensus datasets sourced from lender financial institutions are based on internal opinions that have actual exposure to a given counterpart - **"skin in the game" versus "issuer pays"**
- Dynamic: Consensus datasets are **frequently updated**, with credit transitions continuously under review by expert teams
- Forward-looking: Clear directionality trends and **early warning** of changes in credit quality status

Summary

The Securities Finance Industry and its participants find themselves at the epicenter of an almost 'perfect storm'. Whether your organization is a Principal Beneficial Owner, an Agent Lender, a Broker Dealer, Prime Broker or Hedge Fund, or plays multiple roles, this 'storm' impacts your business significantly. Increased regulation, higher capital requirements, and pressures to reduce costs are creating a challenging environment in which to conduct business. These factors, combined with demands to improve process efficiency and meet client demand for more up to date information have coalesced to force behavioral change – an evolution that is necessary, and no longer optional. In an industry with so many hitherto unrated counterparts within it, the availability of more credible alternative data sources to assist in understanding a counterpart's creditworthiness is a valuable addition to the marketplace. Irrespective of whether you are assessing the creditworthiness of a typical broker dealer borrowing panel or looking to lend to peers or even extend your approved counterpart list the application of new data sources in the credit space can complement your processes and facilitate the exploration of new opportunities.

About Credit Benchmark

Credit Benchmark is the world's most comprehensive source of consensus risk data on 50,000 + entities, more than 75% of which are unrated by the Credit Rating Agencies (CRAs). By aggregating and anonymizing credit data from 40+ of the world's leading financial institutions, Credit Benchmark provides a unique view on counterpart creditworthiness. Credit Benchmark data can be delivered securely into your proprietary or industry-standard systems to bring efficiencies and automation to your workflow and benefits to you and your clients.

About the Author

Mark Faulkner, Co-Founder, Credit Benchmark

Mark has an established track record in bringing transparency to rapidly-developing areas of financial services. Alongside his business partner Donal Smith, he co-founded Credit Benchmark in 2013, introducing the world's most comprehensive source of consensus credit risk data. In 1994, Mark spotted an opportunity to provide customers in the securities financing industry with independent specialist advice and services. The company he founded, Data Explorers, became the leading provider of securities lending data across all global market sectors, and was acquired by IHS Markit in 2012. Mark graduated from the London School of Economics and held management roles at LM Moneybrokers, Goldman Sachs and Lehman Brothers.

In 2004 Mark wrote "An Introduction to Securities Lending" It was Commissioned by International Securities Lending Association and Endorsed by Association of Corporate Treasurers; British Bankers' Association; The London Stock Exchange' National Association of Pension Funds and The Securities Lending and Repo Committee. The booklet was subsequently translated into many languages and remains accessible for free on numerous websites.