



HSBC Securities Services

ISSA Symposium June 2010,
Wolfsberg

Presented by: Christine Coe, HSS CRO

HSBC 
The world's local bank

The slide features a black and white photograph of a harbor at night with a boat in the foreground and a city skyline in the background. A red graphic overlay on the left contains the text.

As a banker, I am not going to tell you how banks manage their counterparty risk. Rather, I am going to talk about how our clients are, or should be, managing their own counterparty risks. I do this based on my practical experience.

Counterparty Risk

- Counterparty Risk – what does it mean?
 - Cash ?
 - Assets ?
 - Operational Integrity ?
 - Business Continuity ?
 - Reputation ?

As Lehman went into insolvency, everybody started talking about counterparty risk. But nobody said precisely what they meant by it. I put a few elements on this slide. To me, counterparty risk is all of the above, and more. Reflecting on that, three things stick to my mind.

Firstly, RFPs: I have not exactly been bombarded lately by our business development people with difficult questions in RFPs, asking how we do certain things, how we control the risks within our business. Why not? My conclusion is that our clients are either extraordinarily good at their own risk management and they do not need to ask. Or, their memories are very short and they have already forgotten the pain.

Secondly, just after Lehman had gone, and before some other institutions had been rescued, there was frantic activity with clients begging us to take their cash and other assets. Before one particular weekend, it was so frantic, they did not even care whether we paid them any interest. They just wanted us to look after their assets, because they saw HSBC as their safe haven. The problem that posed for us was: We could just shove their money into our cupboard, as it were. But could we first get it out from where our clients had it at that moment? The practical issue – as we all know – is to change a custodian, an administrator or a client broker in a very short period of time. Particularly, if that institution tells you "Sorry I can't do it right now", because they know that their own survival may depend on your not moving the assets in question. So when clients are actually looking at their risk management and their counterparty risk, they need to mind not only about the theory, but also about the practical reality.

And the third thing that really struck me – again post Lehman – was about documentation. Does everybody really understand what their contract says? If you talked to anybody involved in the Lehman administration of insolvency, they would tell you that, if you asked any two counterparties what they thought was in their documentation, their answers probably bore no resemblance to what was actually written in there, if indeed they could find the documentation in the first place. I bet you, there is not one institution in this room that can honestly say it was one hundred percent sure, that they had every necessary document and understood the meaning of every term.

No matter how painful it is, it is crucial from a risk management perspective that both sides are absolutely clear about what their contract means, from each party's point of view.

Still today, we are asked by clients to trade forex transactions for them without any market standard documentation, because it is only short term, isn't it? Or they may have a custody agreement, so what is the need for an ISDA Agreement on top of it? One key lesson for us that came out of the Lehman case is indeed: We need to remind clients of these things, because memories are indeed very short!

Counterparty Risk

- What is valued?
 - Financial Strength
 - Operational Efficiency
 - Price
 - Strength of relationship
 - Influence
 - Continuity



3

So, what is actually valued? What really matters to our clients? Is it just about financial strength, about the balance sheet size of a custodian? Or is it operational efficiency? You can have the biggest balance sheet in the world and be operationally weak. If clients buy a service that requires precise and efficient administration, then clearly, clients have to balance those two things.

It is not enough to simply look at credit risk. You absolutely have to understand the operational risk you are potentially exposed to. And it goes beyond that. Earlier today, we talked about systemic risk, about failing infrastructures. How many clients really look at comprehensive scenarios to test the whole of their operational flows? Some will, but I bet many won't.

I still get clients who say "Please do my agency stock lending for me. I just leave it to you, I do not need to give you a formal mandate, you know best what you are doing while I do not." How many clients realize what their potential risks are, for instance in terms of the market infrastructure involved? Pat Parkinson talked about improvements in the repo market structure. Do the clients who are using the repo market really understand all those things? And if they don't, do we as their custodian have a responsibility to help them understand those issues?

That is a fundamental question. We talked about transparency. Is transparency also about being open and honest with our clients to ensure that they understand the full risk? I am not talking about giving investment advice. I am talking about sharing with them our operational experience, our knowledge and our understanding of what these risks actually mean. Is that an area where we as individual custodians can actually add value? Or should our industry organizations do this? Either way, unless you have that understanding, you simply cannot manage your risk properly.

Strength of relationship is extremely important. Clients appreciated our helping them to get through the most turbulent times. They remember that loyalty, and loyalty is a two way street. Again, you have to be able to understand your collective risk and help your clients go through it together. If you do not, it is a recipe for total disaster.

Value is different things to different people. It is also different in different parts of the world. Loyalty also means different things in different cultures. When people look to choose their suppliers, they will look to the cultural similarities between their own organizations and the organization they might choose. That is very important to understand for Western firms as they expand into emerging markets, particularly in the Far East. It is very important to understand your clients' and their client's needs and expectations.

Counterparty Risk

- What drives the decision/demand?
 - Investors
 - Regulators
 - Legislation
 - Fund Board Directors

So what drives those choices? Is it the investors? These days, the investors are extremely nervous as we heard many times today. But do they actually care – and should they – what counterparties their fund manager is using? And if so, what should they do about it?

One thing we see a big rise in, is queries from investors and potential investors who want third party re-assurance. That poses new difficulties for the suppliers because it creates a legal relationship with an investor which they probably did not have before or indeed want. So, how far should suppliers go in providing such re-assurance? Is it something legally they want to create?

We know that regulators are now looking to give stability to the market through new legislation and regulation. But there are things we can do for ourselves. Fund boards of directors will have an important role to play. But how does the fund manager actually influence all of this? What value does the fund manager and the fund board place on the name that they are giving the supply to? What is important? Is it sustainability and longevity, or is it important to have just operational efficiency? And what decisions do the fund managers make about *their* perception of what *their* investors need? These things are important in the whole decision making process. We as suppliers need to understand that and we need to work through those issues with the people that come to see us for those supplies.

Role of the Custodian

- What is the custodian liable for?
- Can the custodian decrease the risk of fraud?
- Client directed mandates
- Third party validation
 - Direct access to third party records



5

A very hot topic these days is the role of the custodian. I do not want to discuss the relevant European draft directives in detail here. But, very fundamentally, what should the custodian be liable for? And what do clients and third parties think a custodian should be liable for? Because there could be a huge difference between the two!

Are we involved in the investment decision making process? Or is custody completely different? If I am expected to give complete restitution for assets that I am being asked to look after as a custodian, then I need two things: more money to actually do that, and controls that I can be completely comfortable with. I need comprehensive checks and balances to know that those assets are safe and secure. And that does not necessarily just mean relying on my sub-custodian if I delegated any responsibility. It may mean that I want to go to the ultimate custodian or CSD and check their records for myself. That may be the only way to get an independent third party validation.

Also, if the custodians are going to be liable, then the whole way in which the infrastructure interfaces with itself has got to be more aware of the potential needs and of the liabilities of the investor's first port of call. We see it today, where investors appoint prime brokers: The prime brokers are very reluctant to let the custodian come in and look not only at their own records, but also at the next layer down. They see it as an intrusion, and as something unnecessary. However, the fact of the matter is, if the custodians have that liability for a full protection of the assets, they need those levels of insight and control. The industry really has to look into how it is going to facilitate that.