



Ignorance is not bliss - How well do hedge funds know their Counterparty Credit Risk?

The last few months have provided market participants with a reminder that counterparty credit should be actively managed and monitored. The disruption in the U.S. sub-prime mortgage market has served as a warning to the broader financial community including investment banks and hedge funds. Specifically, hedge fund managers should pay close attention to the collateral rights and obligations that they have with their financing counterparts. While there is no quick solution to address all covenants pertaining to collateral rights and obligations, we believe that prudent hedge fund managers should put a robust process in place to address counterparty credit issues.

The primary issues that need to be addressed are: (1) Market Driven Issue; (2) Single Counterpart Issue; (3) Consistency Issue; and (4) Cross Product Margining and Netting Issue.

Market Driven Issue: One of the biggest concerns for a hedge fund manager should be that a counterpart can change margin and financing terms due to a market event and not a fund specific event. Potential solutions include establishing Term Financing Commitments and Synthetic Prime Brokerage. Term Financing Commitments may enable the fund to lock up its portfolio margin and pricing (with the right to substitute positions) for a period of time (e.g. 90 days). Synthetic Prime Brokerage replaces overnight financing on a position or portfolio with a commitment for an agreed upon period of time. These solutions can be used in concert at a fund and can enable the hedge fund to ride out a storm.

In exchange for a term commitment, counterparts often request a general lien over assets held by a counterpart with the right to move collateral to other jurisdictions and entities, including those that are unregulated. Further, counterparts may include new default events and close-out rights across products in their Term Financing Commitment agreements.

A hedge fund should consider pursuing its counterparts to obtain these Term Financing Commitment structures that may insulate it against a counterpart's response to market driven events, while managing collateral and default event triggers.

Single Counterpart Issue: Funds that are single primed face potential concentration of credit and business risk issues.

Hedge funds should consider expanding to multiple financing counterparts, not only by adding prime brokers, but also other select counterparts such as Insurance and Re-insurance companies. Funds can look to achieve "best execution" across multiple providers. This would not only address fund economics, but also fiduciary responsibility to look for appropriate providers. While many funds have multiple prime broker relationships, typically those prime brokers are separated by strategy, portfolio manager or some other means.

Despite some incremental operational burden, time and resources allocated to establish, it is worthwhile to have a select group of alternative financing providers. Those incremental burdens can be addressed by focusing on appropriate selection, documentation review and negotiation.

Consistency Issue: Our view is that a fund should seek to systematically “normalize” contractual language across financing counterparts as well as across products of the same counterpart. Typically, hedge funds add counterparts and/or new products from existing counterparts on an ad hoc basis over time. This process lends itself to a potential lack of consistency in contractual terms between counterparts and across products with the same counterpart.

Normalizing the contractual language should (1) reduce the operational burden with uniform delivery requirements (margin and information package) and less covenant tracking, and (2) reduce default risk (fewer unexpected default events). The fund may encounter some resistance from counterparts, and normalizing may create all or nothing events (if a trigger event is hit, all counterparts have to agree to amend).

Overall, consistency across counterparts and products provides greater operational efficiency and can mitigate a fund’s risk of default and cross default.

Cross Product Margining and Netting Issue: A single margin call from a counterpart can mitigate counterparty credit risk, while providing the fund capital efficiency with that counterpart, and easing the operational burden by netting margin excesses with deficits across products.

Many providers have the capability to cross product margin and net across multiple products. Accordingly, in selecting financial counterparts due consideration should be given to those with good cross margining platform capabilities. At the same time, funds need to ensure that their documentation supports those activities.

In exchange for pre-close out cross product margining, counterparts frequently seek a post close-out right across products (although many financial product agreements already permit this). In addition, counterparts often insist on having the right to move a fund’s collateral around among regulated and unregulated entities and across jurisdictions.

Cross product margining is worthwhile as it reduces operational burdens and provides capital efficiencies. Credit exposure is improved, but credit risk must be managed as a result of the location and entity holding the collateral.

As an aftermath to the issues at many hedge funds have revealed, financing counterparts have significant power and rights that they can exercise based on the covenants the fund manager has agreed to. Thus, a much needed sanity check needs to be done by every hedge fund to understand their own credit counterparty and documentation risk. The risk is real and has put hedge funds out of business.

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