

# BACK TO BASICS

We take you back to the credit basics to review everything you thought you already knew but were too afraid to ask...

**Susan Hinko of TriOptima explains **multilateral terminations****

OTC DERIVATIVE PORTFOLIOS grow significantly through the normal course of active flow trading, but most of the trades booked are not necessary to maintain an institution’s desired risk positions versus the market. Nevertheless, as long as these trades remain in inventory, they incur operational and capital costs as well as create credit and operational risk exposure. In the event of default, they also generate legal and administrative costs.

Counterparties have the ability to terminate or unwind trades before they expire (early termination) if they can agree on the mark-to-market value of the trade and the payment that is owed to the in-the-money counterparty. However, that requires bilateral negotiation between the counterparties to the trade, and the market can move before the negotiations are completed. Even if you are able to negotiate termination of a risk-neutral package of several trades in a bilateral relationship, like those illustrated in chart 1, you are limited by the net risk in that relationship. You can only eliminate as many bought trades as there are offsetting sold trades with each bank.

Multilateral termination maximises the netting efficiency of the process. By introducing more participants and more trades, it is easier to net off bought and sold positions among the counterparties while maintaining overall market risk neutrality across counterparties as illustrated in chart 2. Note that in the multilateral case, it is possible to reduce net counterparty credit risk by offsetting ‘peaks’ against ‘troughs’.

Multilateral terminations in credit products began in 2005. Currently compression cycles are offered in the range of credit default

swap transactions including all types of indices, single names and tranches in Europe, US, Japan, and emerging markets.

Compression cycle results are completely market risk and cash neutral. Participants can manage their counterparty credit exposures by setting a cycle tolerance for each counterparty in the cycle. This feature enables a participant to increase or decrease exposure to a particular institution depending on current market conditions.

## How compression cycles work

A compression cycle is completed in several steps. First, trades are identified for compression and uploaded into the compression service. Trades are cross-referenced versus the DTCC’s Trade Information Warehouse for data verification. Usually there is a dress rehearsal followed by a live execution. Both of these require the trades and tolerances to be submitted at close of business. The next morning an unwind proposal is produced for each cycle participant where most of the trades in the portfolio are terminated and a number of replacement trades are generated to replicate the net position of each participant. For live execution, the proposal must be accepted by all participants.

The benefits of portfolio compression are significant since the risks and costs associated with each trade are actually eliminated. These include regulatory and economic capital costs, operational costs for processing the trade during its lifetime, potential legal and administrative costs in the event of default, operational risk, and counterparty credit exposure.

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