

CSA ADMIN: IN-HOUSE OR OUTSOURCED?

Like many treasury tasks, CSA administration can be outsourced or done in-house (see box below):

■ In-house: Minimize and harmonize CSA terms.

To utilize fewer resources for CSAs, firms should consider harmonizing key terms across all agreements, e.g., use the same threshold schedule (see main story) for every bank. Other key terms to harmonize include:

- Frequency of posting (daily, weekly, monthly);
- Minimum transfer amount (required collateral must reach a certain amount before a payment is made);
- Calculation agent (most often the bank counterparty, but the company has a right to dispute the calculation).

■ **Outsourced: The more counterparties, the more it makes sense.** More counterparties make for more challenging admin because chances are they will differ in credit strength. Rather than constrain CSA usage for admin ease, outsourcing CSA admin does not add much cost while permitting more granular terms and thresholds, plus it lets treasury “wash its hands of it.”

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Risk management

The Dos and Don'ts of CSAs

By Anne Friberg

Should you or shouldn't you have credit-support annexes with your derivative counterparties? Recent discussions with treasury managers flesh out the main considerations.

Pending the potential elimination of OTC contracts (see *IT*, May 2009), members across The NeuGroup's peer-group universe are increasingly looking to implement credit support annexes (CSAs) with collateral agreements with counterparties to limit risk. For example, well over half of the members in the two FX Managers' Peer Groups (FXMPG 1 & 2) either have or are in the process of putting in place CSAs with all or some counterparties (of the others, many are still working on negotiating their ISDAs, a process that has also increased in awareness and importance in the last year). But as one member noted, they are not necessary across the board; “if a bank is not competitive in derivatives, there is no need for a CSA with that bank,” he said.

A CHECKLIST FOR IMPLEMENTATION

In a presentation by an FX director from a large MNC at a recent meeting, he explained the process his company has gone through to review and update legacy CSAs that had become cumbersome to manage, which served as its starting point to implement CSAs with all major derivatives counterparties. In reaction, corporate treasury practitioners exchanged views on their response to the new environment with a particular focus on the role of CSAs and how to make them work to their best advantage.

■ **The Goals of the CSA.** Before putting a CSA in place, the objectives of having one should be clear. For the presenting MNC, the objective was to allow continued trades with key option counterparties, where in-the-money option positions had chewed up credit limits. In an environment of increased volatility, strengthening dollar and deteriorating bank ratings, the firm – which had established credit limits per counterparty based on agency credit ratings – had several counterparties that would be vulnerable to exceeding their limits. This was due to a number of long-dated hedges that were put on when the dollar was on a weakening trend, and thus substantially in-the-money. The FX group's practice of “borrowing” from other treasury areas' credit limits (allowable in the treasury policy) was growing unwieldy.

A secondary, yet often overriding concern for many is the ability to administer the agreement with available bandwidth, in particular with regard to posting collateral. A review of the presenting company's legacy CSAs, written for counterparties equipped for collateral management, revealed low thresholds and hence high likelihood of frequent collateral exchanges (i.e., the CSAs were high maintenance). Thus, a properly structured CSA “would effectively cap FX exposure to any single bank and minimize exposure volatility to an acceptable level,” the FX

WHO SHOULD MANAGE THE CSA ADMINISTRATION?

Outsourced collateral admin costs money but permits more granular management of terms and posting.

In-house

- Harmonized terms
- Wide margin thresholds
- Infrequent posting

Outsourced

- Individual terms
- Narrower margin thresholds
- Frequent/daily posting

Source: The NeuGroup's FX Summit, 2009

director said and summarized his company's CSA goals to three main points:

- Protect the firm in the event a counterparty bank is downgraded.
- Minimize the likelihood of the firm having to post collateral.
- Minimize internal resources required for CSA administration.

Other firms noted the ability to win better pricing as their principal objective (particularly with longer-dated contracts), as the CSAs mitigated the credit/non-performance risk now frequently embedded in quotes received from dealers.

■ **Set the posting thresholds.** Part of the CSA structuring exercise is to balance downside risk mitigation against posting requirements. One way to set appropriate collateral posting thresholds is to use a ladder approach; this provides protection in the event a bank's credit rating gets downgraded (a ratings-based approach is most common). However, a collateral payment is only triggered when the mark-to-market amount hits a predetermined \$ level, for example:

- AAA-rated counterparty: \$100mm
- AA: \$50mm
- A: \$25mm
- Lower: \$0

■ **Stress test the covered derivatives.** A CSA is a double-edged sword in that a company could find itself in a position of having to post large amounts of collateral in volatile markets. One way to help structure CSAs, or target their use, is to stress test various combinations of included instruments and types of hedges over time to determine the probability of having to post collateral. The outcome could be affected by the instrument mix (options, forwards, etc.), for example, on the FX side, but also by including or excluding other derivatives in the CSA, such as interest rate swaps. For example, purchased puts for cash-flow hedges can offset forward losses from balance-sheet hedges. In some scenarios interest-rate swaps can offset declines in option values. But if correlations break down, a company can find itself on the "losing" end of both trades.

■ **ID acceptable collateral.** It is important to determine and include in writing what is acceptable collateral for your firm. The language in some CSA templates specifies that collateral can only be cash. Cash is fungible; securities are not. But CSAs can allow for a wide spectrum of acceptable collateral. The key is to spell out exactly what kind is acceptable (down to issue, rating, tenor, etc., if it is a security). Most corporates will go as far as T-bills, but nothing more "risky"

than that. However, the general rule is the bank pays back the same collateral asset class as it receives. In dealing with banks, firms are advised to scrutinize the contract: "Make sure your language is strong and bests the language of the bank," said the FX director, because they will readily interpret any unclear terms in their own favor.

■ **Check with your auditor.** Finally, before signing on the dotted line of the CSA, it is imperative that companies speak to their auditors because of the many conflicting views on how to account for them. For instance, there is not any clear direction on whether collateral is to be recognized on the balance sheet. If it's on the balance sheet, it could potentially become a FAS 157 issue. While there are few guidelines, the typical choice is between gross-up and netting.

Fortunately, another issue that arose with the presenting firm's auditors was whether a CSA would trigger a de-designation/re-designation event relative to FAS 133 hedges. This has been resolved by an agreement between the "Big 4" (that it would not trigger de-designation).

KEEP IT SIMPLE

CSAs should not be entered into without considering their full ramifications. The initial instinct of many corporate treasuries implementing CSAs is to structure them with an eye to ease of administration: e.g., set posting thresholds and frequency so that the burden is not too great. Many treasury managers even contemplate asymmetrical requirements, with the idea that banks are set up to administer credit support as part of their institutional business already, so they won't mind. Complicating CSAs may not be wise, however, since times change and, suddenly, the corporate might again be the "weaker" of the two counterparties and wish it had set up the CSA differently (see also sidebar).

There is also the potential for OTC derivative contracts to cleared and settled via centralized counterparty entities and, with this, collateral and margin administration. Simpler CSAs will make migration easier and may also ease quick outsourcing to a custodial bank if needed.

Finally, neither CSAs nor ISDAs should take the place of carefully selecting the banking partners with whom to do business. One FX director observed that his firm was only doing business with banks that are "good with options or we think won't fail." It is also reviewing exposures to relationship banks and staying away from those where it already has a sizeable exposure. CSAs don't negate the need for common sense. ■

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When outsourcing, choose a non-trading partner bank as the provider.

To reduce risk, the administration should not be done by a bank that is also one of the company's major derivatives counterparties. Treasury FX professionals note that Bank of New York Mellon, Northern Trust and State Street offer good CSA services; post-trade admin provider Misy also has a collateral management service. JPMorgan got favorable mention but is a big trading partner with many MNCs. But, on the other hand, a firm using State Street noted the custodial nature of the relationship virtually eliminated any counterparty exposure to the bank.

CSAS AND SYMMETRY

While most treasuries would like their counterparties to post collateral, while forgoing the requirement themselves, it is most common to have bilateral and symmetrical CSAs; it's hard to negotiate a contract that favors one party over the other. It is not unprecedented for a highly-rated corporate to be able to negotiate a unilateral CSA with some banks (using the threat of withdrawing business), but it is not common. Asymmetrical CSAs, where the triggers or posting requirements are different for the each side, are also uncommon, but there are instances when asymmetry can make sense, for example:

■ They only cover special transactions and not the entire relationship with the bank/counterparty;

■ Weaker banks have to accept lower thresholds for posting; and

■ If the CDS spreads between the company (or company's industry sector) differ significantly from the bank. ■

Risk management

More FX-Related Risks to Consider

By Anne Friberg

Dire market conditions in the recent past have increased awareness for all risks associated with FX trading and hedging.

Until recently, the only way with FX risk was up. FX volatility had increased multifold since mid-2008 and the spreads even on spot trades were widening in response to counterparty fears. As a result, FX managers have become much more attuned not only to FX market risk, but the array of risks surrounding their FX management activities. While banks benefit from high vols and wide spreads, they also can be responsive to customers by offering lower-cost hedging strategies (see sidebar right) and educating them on the changing risk environment. A presentation by Deutsche Bank's New York-based FX team to The NeuGroup's Treasurers' Group of Thirty (T30) in January helped shed light on how the financial crisis had upped the ante on risk awareness.

BEYOND MARKET RISK

In addition to pure market risk (see also below), FX managers need to pay attention to:

■ **Settlement risk** stems from the timing mismatch between payments between the two parties to a transaction. Not getting paid could trigger untold losses but can be overcome, for example, by settling trades via CLS (continuous link settlement); a central counterparty (e.g., an

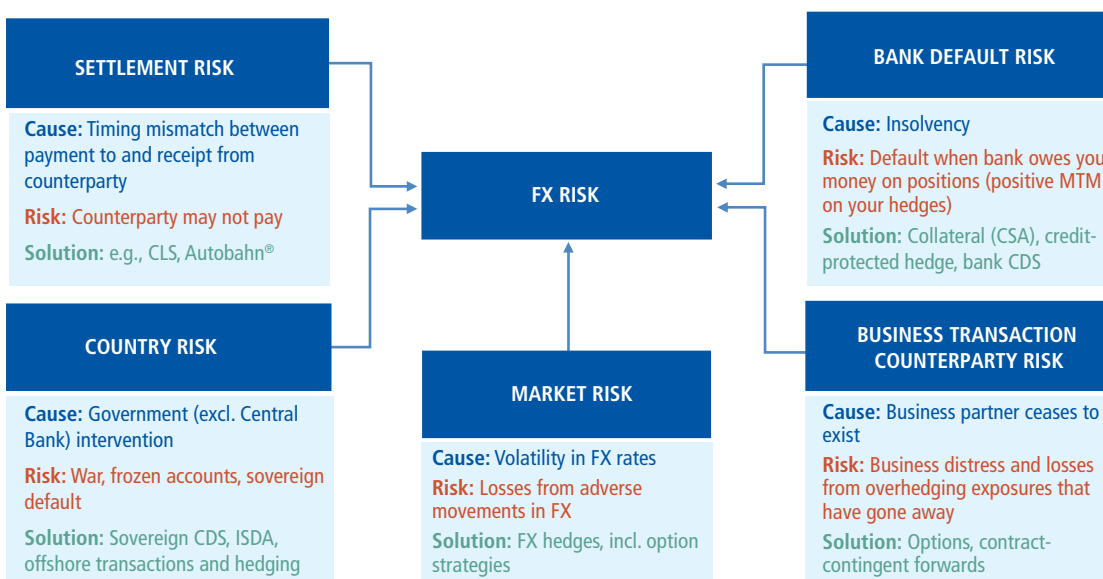
exchange clearing house); or bank proprietary tools (like Deutsche Bank's Autobahn®).

■ **Country risk** is also on the upswing with Argentina and Venezuela leading the way. Bad economic conditions increase the risk of government intervention like frozen bank accounts or even expropriation (Cargill Venezuela). Minimizing transactions onshore and sovereign CDS (credit default swaps) can reduce the exposure.

■ **Bank default risk** had a quiet few years before roaring back to the center of attention in 2008, starting with Bear Stearns. Counterparty credit risk mitigation is now top of mind for corporate treasurers vis-à-vis their banks. Adding CSAs (credit support annexes) to ISDAs and purchases of bank CDS adds protection.

■ **Business transaction counterparty risk**, while the risk to a bank is top of mind, not all FX managers are as focused on the risk of a customer or supplier failing. They too may be a party to an FX transaction. Traditional methods and instruments are available to limit this exposure (credit limits and insurance, supply-chain financing, etc.), but there are also other ways to cover the FX risk with options or contract-contingent forwards (linked to the underlying contract). ■

FINANCIAL CRISIS EXACERBATES FX-RELATED RISKS



Source: Deutsche Bank

OPTIONS WITH HIGHER HEDGE COSTS

While higher volatility means options cost more, their value also increases with greater risks in the FX environment, according to Deutsche Bank's FX team.

■ **Options best to fight volatility.** FX managers shouldn't automatically turn to forwards when higher vols make options more expensive. The reason: in times of heightened volatility, the uncertainty surrounding both the notional amount of the underlying (and hence how much to hedge) and the payment by the business counterparty (the full risk to the underlying cash flow) is much higher.

Accordingly, in a scenario where the currency moves differently than expected or where the transaction hedged does not materialize, a forward will generate a bigger P&L hit than the option premium.

■ **Premium-reducing alternatives.** While fighting off volatile market conditions with an option is best, not every FX manager can pay the premium. For them, Deutsche Bank recommended a delta replication strategy or an option-in-arrears contract.

In the former, an FX manager replicates the delta of an ATM option using on-market forwards and a contract for difference.

In the latter, the option premium is a function of realized volatility over the life of the trade and not implied volatility; thus, the premium is limited to a given level should actual volatility be high over the life of the trade. ■

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