

# UNSTRUCTURED HAZARDS OF STRUCTURED PRODUCTS

Treasury personnel should fully appreciate the characteristics and deficiencies of the OTC market for structured products.

by Mark Waugh

**T**HE CANADIAN MARKETPLACE has witnessed ongoing advancements in the creation of various types of structured financial products for short-term investment. Over the counter (OTC) or non-exchange-traded structured products have received much attention from treasurers looking for enhanced returns to cash.

While there is a tremendous variety to the financial attributes of these products, one common feature is the way in which they are dealt in the marketplace: bilaterally. Although treasury personnel may not realize it, expected return calculations may be jeopardized by certain incalculable risks that arise from dealing in this marketplace.

Newcomers in particular need to understand how OTC transactions differ from exchange-traded products and how these differences affect risk/return expectations. In fact, to say that OTC transactions occur in a financial marketplace is somewhat misleading. Most financial marketplaces provide the benefits of multilateral trading to its participants. But the OTC market does not.

Institutions have competed for decades to bring to market financial products that incorporate the latest theories from the fields of microeconomics and finance. Technology plays a pivotal role in this financial engineering competition.

Given the disruptions in 2007 of certain areas of the OTC market, however, a serious discrepancy seems to exist between the creation of a financial instrument and the ability to efficiently deal in it. The breakdown in the inter-bank market for credit and liquidity has left all participants with unaccountable systemic risk that traditional risk measures cannot readily capture. This market for liquidity and credit may have been well-established, but it was far from well-functioning.

While a theoretical analysis relying on game theory is probably warranted to

investigate the breakdown of this market, concepts associated with gamesmanship may be just as well suited. Successful professional games have endured on three fundamental tenets:

1. There is a venue for the game to take place.
2. There are rules that all participants endorse and understand, which don't change during the game.
3. There are referees to monitor the game and, when necessary, intervene to enforce the rules and penalize participants who break them.

Even the most unregulated, unstructured amateur game, such as British Bulldog, follows rules and codes of conduct, possibly laid out by the group just before the game begins, by which all participants abide. Dirty players and rule-breakers are ostracized by the greater group for undermining the integrity of the game.

Sound gamesmanship principles also exist in some financial markets such as equity and commodity exchanges. In these arenas, everyone plays by the same rules. All participants understand the nature, quality and meaning of the traded instruments. No single participant controls the definition of an instrument, and definitions, once established, are not open for interpretation. In each of these marketplaces, regulatory referees oversee the interests of all those involved in the marketplace.

Marketplaces for trading equities, commodities and their derivatives operate on well-established mechanical principles. Questions about whether or not the actual marketplace exists or where it's located would be viewed as nonsensical.

Certain benefits flow from the existence of a multilateral marketplace to all participants. Tangible benefits include the sourcing and sinking of liquidity; the ability to discover prices through immediate reference points, and the ability to gauge dealing activities against third-party dealing activities. In addition, all participants can use the marketplace as a way of transferring risk immediately, rapidly and reliably.

## Dirty players and rule-breakers are ostracized.

Participants do not enjoy these benefits in a bi-laterally negotiated, cleared, and settled OTC market. Fundamental flaws in the operation of this marketplace have become apparent in the breakdown in the OTC inter-bank dealing market for credit and liquidity.

The extensive liquidation of financially engineered securities, whose intrinsic value relies on instruments two or three times removed from them and whose seminal transaction may have taken days, if not weeks, to create and put on the books, was expected to occur immediately, an impossible expectation.

Exacerbating this pressure were dissenting interpretations of legal language supporting various flavours of OTC products. Parochial interpretations of legal agreements clearly undermine the integrity of dealing in these products, just as players who change the rules midway through a game undermine its integrity.

Furthermore, according to probabil-

ity theory, conducting deals based on who is involved rather than what is involved jeopardizes the factor independence necessary for a risk-efficient system.

Finally, since banks act as agents of private enterprise and government policy, their dual role exacerbates the negative effect of a systemic failure on the rest of the economy.

Some say these factors in the OTC game are part of the risk in dealing in structured products. They say the buyer should beware when dealing in OTC transactions. This advice may apply to personal, private transactions involving second-hand cars in flea markets, but it has no place in the professional conduct of risk-management strategies in a financial marketplace regulated by a federal government.

Instead of transferring well-defined and understood risk profiles and assuming a more desirable risk profile, parties who repudiate the rules through selective interpretation, after the game is in play, turn the exercise into a fiasco. Counterparties who have followed the original rules are left unfairly and unethically with deteriorating risk profiles.

The move in Canada toward active portfolio management has sent pension funds and money management firms searching for new books of business to secure greater, non-market-correlated returns. As a result, many firms

have brought in-house operations and technologies that are completely foreign to their existing business.

In such a context, established professionals in the OTC market, who know the natural buyers and sellers, profit at the expense of the newcomers. Market direction, tone and other valuable price dealing signals are gained at the expense of inexperienced counterparties. Newcomers don't necessarily realize that profitable dealing in the OTC market essentially requires dealing in a series of one-way transactions across counterparties to achieve the desired positional outcome.

Not only do manufacturers of OTC products create instruments that suit their respective needs (based on their own firms' desired position), they also have insight into the overall marketplace through their market-making activities. Those who are new or relatively inactive in this market do not have access to this aspect of information.

The current bi-lateral dealing model for OTC products is not efficient. While many experienced players have built valuable franchises arbitraging inefficiencies on dealing alone, self-preservation and selective dealing are often at odds with the role of intermediary that that global central banks expect these participants to play.

The creation of a multilateral dealing facility does not necessarily have to compromise the value of these fran-

chises, if the model functions on anonymity. A means test in advance of admission to the facility should permanently remove the counterparty give-up requirement. Moreover, security deconstruction and pricing must be readily and electronically available within the facility for efficient examination of tier composition across respective securities.

Until a new model is created, participants must co-exist within the existing framework. To reduce the systemic risk for all market participants new entrants to this market will require counterparty dealing depth and efficiency equal to that of established market players.

Success in this market requires a cohesive, holistic approach across the disciplines of business, operations and technology. Therefore, information, dealing, booking, clearing and settlement people, processes and systems should be expected to exist, equally, amongst counterparties to a deal.

If these conditions do not apply, then, as in poker, a cursory look around the table will identify who should probably not be in the game; or at least, won't be for long.

*Mark Waugh is Director of Capital Markets & Risk at Stratix Consulting in Toronto (www.stratix.ca), co-host of the 4th Annual FPL Canadian Electronic Trading Conference in Toronto in May (www.etradingcanada.ca).*

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