Valuation of counterparty risk

Speaking at Hubbis' Investment Solutions Forum 2017 in Singapore in June – Vladimir Pavlov of Numerix talks about how to address technology challenges with counterparty risk valuations.

The impact of collateral management on derivatives valuations is becoming more important, according to Vladimir Pavlov, vice president, financial engineering at Numerix.

As regulators have an increasing influence on the derivatives markets, it is impacting the traders, particularly in terms of driving up costs and making trading more complicated.

For people who need fair value-type products for mark-to-market or mark-to-model, if they don't have any collateral, then the calculations are fairly straightforward and can use set formulas or models.

Where it gets more complicated, however, is when valuation changes where there is counterparty risk.

For example, explains Pavlov, people can no longer treat their trades individually; the risk valuation becomes a counterparty-level valuation.

At the same time, with global regulation, there is likely to be a need to post some collateral for future exposures that need to be covered.

Counterparties will also face similar problems; on their side, they will have some post-margin collateral, so there is going to be replication.

According to Pavlov, it is important for calculations to be done in different systems. For example, one system is used to value trades – a front-office or internal valuation system – where the data may come from a different source. And there will be a separate system to give the measure for managed risk.

The challenge in doing valuation with counterparty risk, however, is the requirement to have unified data. ■

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Link to Event Agenda

Link to Speaker Biography

Link to Presentation Slides