

# Counterparty risk: a concern for transitions too

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**P**erhaps the most critical lesson learned by investors thus far during the economic crisis has been to expect the unexpected. In 2008 -- almost one by one it seemed -- pillars of “standard investment practice” long taken for granted were toppled as investors looked on aghast.

Whether the minefields were within securities lending programmes, portable alpha strategies, or even, in some cases, plain vanilla money market funds, collective jaws dropped. A common refrain echoed, “I never thought I would have to worry about that!”

A dimension of risk that should not have caught investors off-guard has nonetheless received renewed focus. As high-profile pyramid schemes have been exposed and with contagion concerns related to derivatives swirling all about us, fears of counterparty risk are again on the minds of prudent investors.

But addressing counterparty risk is not simply about preventing fraud. Neither is counterparty risk solely the province of collateralised debt obligations and other exotic instruments. Rather, counterparty considerations should be central to virtually every dimension under the investor’s governance.

While a renewed sense of urgency to due diligence programs is vital and to be applauded, exhaustive scrutiny should be extended to all partners to the scheme not just potential hedge fund managers.

In addition to conventional asset managers, consultants, custodians, and auditors, institutional investors would be well advised to include transition managers and other implementation specialists in their regular due diligence reviews. As has been well publicised, the last six months have witnessed significant dislocation in the transition management marketplace.

No fewer than five high-profile franchises have exited the space due to bankruptcy or

due to severe balance sheet pressures forcing these providers to re-examine their commitment to transition management. No scheme wants to hear that their preferred provider has suddenly come to the conclusion that transition management is no longer a “core competency”. And yet we are aware of a number of instances where the asset owner had the rug pulled out from under them as their transition partner walked away and wished them luck.

A recent trend being driven by pension schemes and consultants has been to assemble panels of transition managers well in advance of anticipated activity. A stable of appointees is selected, presumably with complimentary skill-sets, and contracts are established for the transition managers to be on call.

When the occasion arises for the investor to consider tapping the resources of an expert to implement scheme investment decisions, a cadre of pre-approved, contracted specialists stands ready to make the designs a reality.

This initiative is entirely sensible. Historically, transition managers were often first consulted only in the eleventh hour – long after the target asset managers had been appointed and almost as an afterthought to the asset allocation study or new manager shift that precipitated the transition in the first place.

As part of the RFP phase during the selection process, we urge investors to renew due diligence related to transition management providers by considering the following questions:

- 1) Why does the candidate company offer transition management services?
- 2) Is transition management offered as a stand-alone service and as a dedicated programme for asset owners only, or does the transition team trade on behalf of other types of investors as well?
- 3) With whom would the client contract? A global financial institution with sound

capital adequacy ratios or a subsidiary or shell organisation with limited recourse to the financial strength of the parent?

- 4) Finally, central to the guiding principles of the T-Charter<sup>1</sup>, is there adequate transparency concerning the provider’s business model and sources of revenue?

As one transition manager after the next has walked away from this highly specialised business, never has considering the counterparty risk of your transition partner been more important. Too much is at stake in the typical asset transition for the investor to lose vigilance when it comes time to the selection of a trusted partner. ■

<sup>1</sup> The “T-Charter” is a voluntary Code of Best Practices for transition managers that was first issued in October 2007.

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