New risk model sparks interest

Risk management consultants are seeing an increasing number of oil company clients consider whether to implement what they have dubbed the Schwartz-Smith Two Factor Model, a new commodity risk model. Published last month as the Short-term/Long-term Model, it measures long-term dynamics and short-term deviations of commodity prices. Although created with crude oil in mind, the model can be used to track the root causes of deviations for any commodity that exhibits similar behaviour – such as heating oil, natural gas and jet fuel oil.

Rather than predict what price a commodity will come back to after a spike, the new model measures the rate at which it will come back, said Jim Smith, co-developer of the model and an associate professor at Duke University's Fuqua School of Business in North Carolina. "It's not a (price) forecasting tool. It's a risk management tool," he said. Banks can use the model in the same way that traders at oil companies do.

The model operates through and focuses on the long-term equilibrium spot prices and the short-term shocks to that price. For pricing contracts using the Schwartz-Smith model, firms need to input historical data to establish volatility parameters. Current futures prices must also be fed into the model to arrive at the current factors influencing a model's equilibrium price during a deviation, said Smith. They would then have to run simulations to generate price paths for valuing the exotic options. "If you are trading anything over the counter, you need to get consistent quotes," he added.

For consultants assisting firms with enterprise-wide risk management, the model can be used to uncover a natural hedge in another place.

"It could mean that they don't have to buy a hedge, a futures or derivative contract," said Samir Shah, a consultant at Tillinghast-Towers Perrin. "Basically, to implement the model, all people need to do is read the paper, understand the math, and implement it. The way you use it – you have to set the parameters," he said. IFR

Moody's in RiskMetrics alliance

Moody's Risk Management Services and RiskMetrics announced plans to kick off a fourth-quarter strategic alliance. The link-up will marry RiskMetrics' value-at-risk methodology for credit portfolios with RiskCalc, Moody's web-based product for default predictions.

A few years ago RiskMetrics launched CreditManager, a product that extends its value-at-risk methodology to credit portfolios. Until now, the firm has left it to users of CreditManager to define how to rate obligors. "This lets them react quicker to credit changes," said Bernard.

Currently, if an obligor does not have a rating, firms can use their internal ratings system or subscribe to Moody's RiskCalc. For now, RiskCalc contains default models for public and private companies in the US, Canada and Australia. Data on publicly-traded non-financial companies will be out by the year-end in Europe, and next year in Asia, said Lea Carty, managing director at Moody's Investors Service in New York.

Private-side editions will be rolled out for Continental Europe and the UK this autumn and the first quarter next year, respectively. A default database for private companies in Asia is set for 2002.

According to Herwig Kinzler, risk management consultant for credit risk at Tillinghast-Towers Perrin in Cologne, the service will help banks calculate their credit risks more accurately. IFR

These extracts are from IFR (International Financing Review). For further details, please contact Philippa Young on 020 7369 7521 (tel) or 020 7369 7397 (fax).
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Proposal for regulatory arbitrage

The Federal Deposit Insurance Corporation, Federal Reserve Board, the Comptroller of the Currency, and the Office of Thrift Supervision have drafted the final version of a proposal that if ratified would increase the amount of capital that banks must hold against residual interest retained from securitisations.

The proposal could open up opportunities for credit derivatives houses to offer regulatory arbitrage trades to issuers who may be eager to get this exposure off their books. The proposed rule would require 100% regulatory capital to be held against the residual interest kept on the balance sheet of an institution that is consummating a securitisation.

Currently, the minimum risk capital requirement is 8%.

Residual

Opportunities may exist for issuers who want to swap out to a third party the credit risk of the riskier pieces that they hold from securitisations. Selling the residual asset would be tricky, as there is not much of a market for residuals unless they are of good quality.

By using a credit derivative solution, an entity would be able to keep the residual interest off its books and it would then only have to hold 8% capital against the asset.

Concern that the 8% cap on capital charges is insufficient to cover all risks drove regulators to draft the rule proposal.

The rule proposal also calls for imposing a capital limit of 25% of tier one capital that arises out of securitisations. This means that an institution would have to take the residuals together and aggregate them.

If the residual interest is above 25%, the institution has to deduct it from tier one capital. Few banks, if any, will be hit by this part of the proposed rule. IFR