COLLATERAL MANAGEMENT FOR INSTITUTIONAL INVESTORS

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Exploring the evolving role of securities lending in a cleared environment, the operational infrastructure changes and practical challenges that institutional investors must overcome to deliver an optimum derivatives programme.

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WHITE PAPER

Trends, risks and opportunities in collateral management

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Collateral challenges for the buy-side

Collateral is viewed as a solution to and a trigger of massive financial losses that occurred as a result of the financial crisis of 2008. In response, policymakers around the world have enacted new rules and legislation, including the Dodd-Frank Act (DFA) in the United States, European Market Infrastructure Regulation (EMIR) and Basel III regulations, to increase market stability and resiliency, enhance transparency and reduce risk. As a result, these rapid changes in the financial markets are impacting the management, mobilisation and transformation of collateral.

Mark Jennis, DTCC, provides an overview of collateral and highlights key drivers for change and the solutions and opportunities for buy-side market participants to respond to regulatory and industry challenges.

Organisations have attempted to calculate the amount of collateral that will be needed by financial firms as a result of new derivatives legislation, liquidity requirements and regulatory mandates. Driving the increase in collateral requirements are new rules that mandate central clearing for the majority of over-the-counter (OTC) derivatives trading and the introduction of operational controls and capital requirements for non-cleared OTC derivatives trades. In practice, clearing houses will have to impose initial margin requirements as well as reduce or eliminate thresholds for variation margin, which will dramatically increase the demand for high-quality collateral.

The Bank of England estimated in 2012 that the amount of collateral needed to meet requirements posed by new regulations globally could reach $800 billion. A more recent study by the Bank of International Settlements estimated this to be around $4 trillion.

Despite the anticipated massive increase in demand for collateral, many market participants are either not fully cognisant of their eligible collateral or unable to efficiently mobilise collateral to allocate it against specific exposures. In addition, many firms are not optimising their collateral, which could create a gap between supply and demand. Optimising collateral not only requires reviewing the eligibility criteria and understanding the terms of the collateral agreement, but also calculating the costs of putting that collateral to different uses and moving the collateral and following its settlement status across the extensive network of depositories and custodian banks.

A number of drivers are expected to dramatically increase margin call activity, which will likely have a significant impact on liquidity and risk. Discussions amongst DTCC, buy-side clients and market participants in the OTC derivatives markets indicate that this activity could jump 500-1000%. Primary drivers of the increase in margin call activity include:

Regulatory changes: DFA and EMIR could require initial margin for both counterparties and a reduction or removal of thresholds for variation margin. The inclusion of initial margin will significantly increase the amount of collateral required, and will create additional margin calls. The removal or reduction of thresholds for variation margin will mean any change in valuation may trigger daily margin calls. In the past, thresholds limited these calls to times of significant changes in underlying valuations.

Clearing fragmentation: With new clearing requirements for OTC derivatives transactions, Credit Support Annex (CSAs), which have historically covered an entire portfolio of deals with one margin call now may exclude products offered by different clearing houses - which may drive individual daily or even intraday margin calls for each clearing house. This clearing fragmentation reduces the historical advantage of calculating margin across a multi-product portfolio. This fragmentation effect may be exacerbated in the U.S. by the regulatory requirement that creates multiple collateral accounts for specific types of underlying transactions being collateralised: security-based swap, non-security based swap, future, option, or cleared/non-cleared activity.

Regionalisation: The potential creation of multiple regional clearing venues per product may have a splintering effect on collateral, increase the number of margin calls, and alter the mix of acceptable collateral globally.

Regulatory changes are making it difficult for market participants to keep their internal systems and procedures responsive to meet new challenges. Firms are concerned because the increase in collateral requirements, along with the subsequent increase in underlying margin activity, is expected to have an impact on costs and risks in a number of areas including funding costs; operational capabilities and settlement expectations management; and reporting and recordkeeping. Furthermore, the segregation of

accounts required by new regulations, while improving the safekeeping of collateral, will add a complexity to the collateral management process that existing technology will find challenging to manage.

During periods of extreme market stress, the volume and value of margin calls increase exponentially. The inability of firms to seamlessly connect collateral obligations and their ensuing settlements creates opacity in the market. This has the potential to cause destabilising market reactions and impact the decision-making of policymakers responsible for managing the crisis.

There are currently multiple collateral management solutions encompassing anything from portfolio margining to collateral optimisation trying to address the different segments of the collateral challenge. However, the situation requires a solution that can address both the scale and the efficiency of collateral management challenges, as well as the gap between the supply and demand of collateral. Without it, hedging risks will become more expensive, profit margins will continue to be squeezed and investment returns will become more challenging. DTCC is working closely with the buy-side on strategic solutions that address collateral processing challenges. This includes increasing transparency and reducing inherent risks related to margin, settlement and segregation processes through consolidated, timely reporting, and enriched reference data. Through leveraging Omgeo ALERT, DTCC will provide custodians and administrators with the processing infrastructure they need to support their buy-side clients, including standing settlement instructions enrichment for margin calls.

The complexity and global nature of the derivatives market have seen market participants express a preference for an industry-wide strategic solution to address the challenges related to collateral in a more holistic manner to avoid costly fragmentation. Toward that end, DTCC is continuing to collaborate with industry partners to develop solutions that address the operational costs and risks associated with the increased demand for collateral.

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