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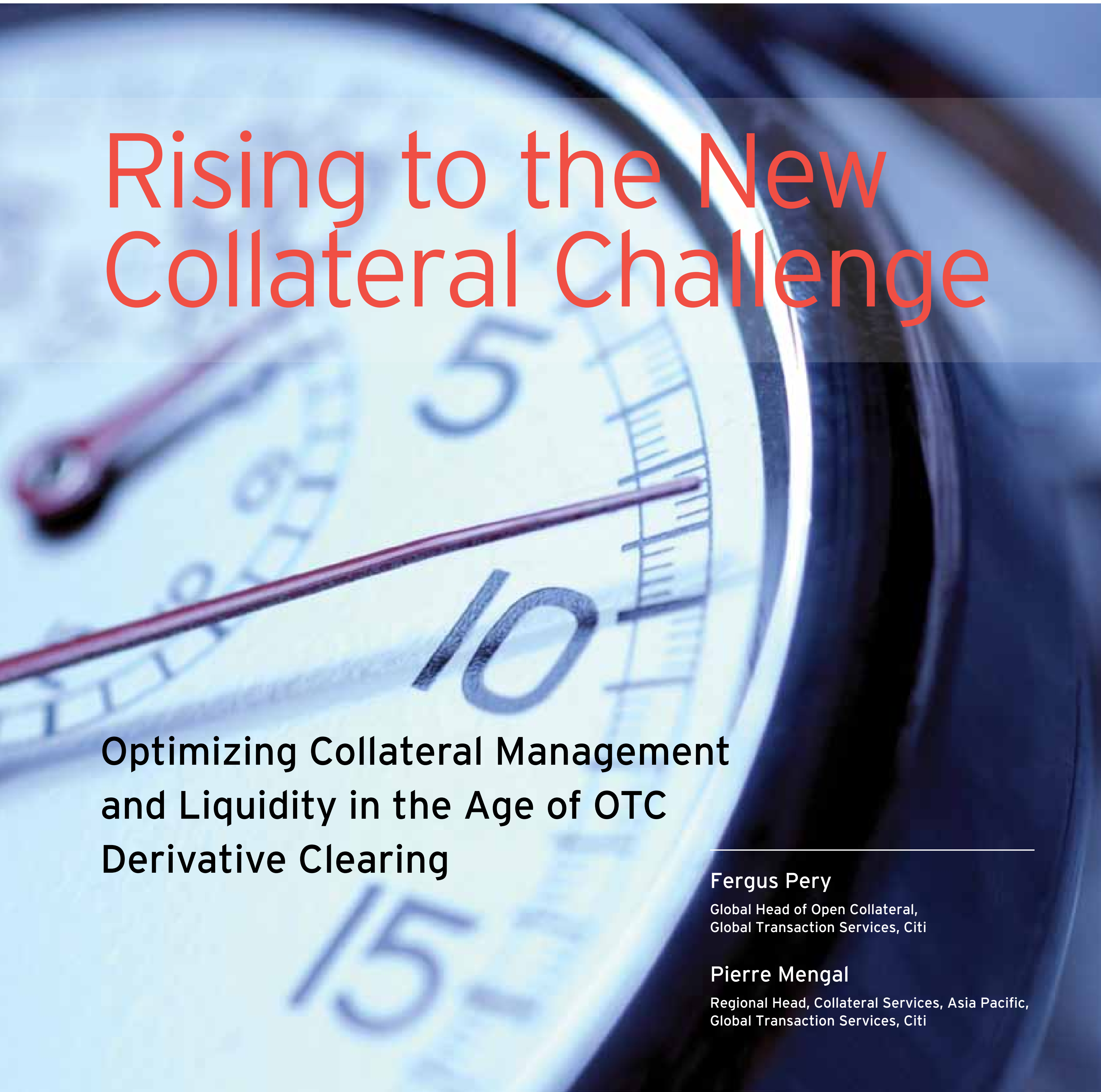

Rising to the New Collateral Challenge

Optimizing Collateral Management and Liquidity in the Age of OTC Derivative Clearing

Fergus Pery
Global Head of Open Collateral,
Global Transaction Services, Citi

Pierre Mengal
Regional Head, Collateral Services, Asia Pacific,
Global Transaction Services, Citi

The clock is ticking for all institutions trading OTC derivatives.

New rules mandating centralized clearing for interest rate and credit default swaps, together with tighter risk mitigation rules for other OTC products, will transform the OTC landscape in Europe, the U.S. and most probably other parts of the world within a very short time frame. Their purpose is to drive counterparty risk out of the marketplace. For investing institutions and broker-dealers alike, this poses a twofold challenge: not only to be ready for the changes when they come but to ensure that, in the process, counterparty risk is not simply swapped for operational or liquidity risk.

Collateralization is at the core of the changes – both for those trades cleared through central counterparties (CCPs) and those still subject to bilateral arrangements. In many respects, this formalizes a growing trend. According to the International Swaps and Derivatives Association, the number of collateral agreements in use in the OTC derivative market has mushroomed from just over 28,000 to more than 149,500 in eight years. Uncollateralized exposure has reached an all-time low of just 14% of the notional amount.

Institutional investors are now trading more, across more products, with a greater number of counterparties – all on a secured basis. As a result, the amount of collateral that needs to be mobilized, whether in the form of cash or securities, has materially increased. This has forced institutions to rethink the way they manage their liquidity management framework.

The squeeze on liquidity can only increase as the MiFID II legislation in Europe and the Dodd-Frank Act in the U.S. channel as much as 60% of current OTC derivative volumes through CCPs. The inability to rehypothecate assets once posted to CCPs, and reduced netting benefits as some CCPs will only clear a limited set of instruments, will affect global liquidity across all regions. An IMF study has calculated that an astonishing amount of US$1 trillion may be immobilized as a result of the introduction of CCPs.

Basel III, due for national implementation from the start of 2013, will strengthen the capital requirements for counterparty credit exposures arising from banks' derivatives, repo and securities financing transactions. Uncollateralized exposures will face regulatory capital charges. Unless banks impose collateral agreements on their counterparties, they may have to price additional capital costs into the trade itself. Even corporates that were traditionally reluctant to implement collateral agreements for liquidity risk reasons may have to reconsider their position. Uncollateralized bilateral swaps may soon be a thing of the past.

More Efficient Use of Collateral

Accessing, mobilizing and optimizing collateral become crucial functions in addressing the new liquidity challenges. Market participants must gain real-time visibility of all cash deposits and marketable securities eligible as collateral. "Firms need a number of essential tools in order to manage their positions at any given time," says Andy Sterry, EMEA Head of Derivative Clearing, Prime Finance, Citi: "They need to automate margining calculations to understand their net collateral position. They need to be able to screen inventories to assess eligible collateral and make real-time checks on counterparties' credit ratings. And they need to have full integration with a custody and settlement system."

As institutions trade across multiple products from OTC and listed derivatives to traditional repos, having access to a unified collateral platform providing a single inventory management tool is crucial. Too often, the operational processes involved in collateral management are siloed by business units with little transversal overview. Each operational group supports a separate process for a specific trading product leading to poor use of collateral, wasteful IT spend and operational inefficiencies.

Given the complexity of setting up such an operational environment, buy-side firms and regional banks alike must ensure they do not trade credit risk for operational risk. "Collateral management efficiency will be critical to your success if you are in OTC derivatives," says Stewart Catt, an Associate at investment consultants Mercer. "Many of the bigger names will build up their operations in-house. But the mid- to smaller-tier players will consider outsourcing. If you have anything less than $100 billion under management you should probably take this route," he says.

Outsourcing back- and middle-office collateral operations allows buy-side firms to focus on their core investment functions and sell-side firms to focus on collateral trading and arbitrage opportunities. Financial institutions are also looking to improve their risk metrics and analytics linked to their collateral management platform. Risk managers need to better understand the underlying concentration and correlation risks of the portfolio they control and be able to perform different stress test scenarios on their trading counterparts. This is putting further pressure on firms to come up with robust collateral management solutions.

An important first step for buy-side firms, says Mr. Catt, is to look at which asset classes they are holding and trading. "Firms trading only the rates and credit products that are moving to central clearing will need a clearing broker to handle the mechanical aspects of clearing," he says, "but they will also need expertise in effective collateral usage, possibly from a collateral agent, and they may need financing. Firms that also trade other products — such as inflation, variance or total return swaps — will need full-scale collateral management of some sort."

For firms in this latter category, trading derivative contracts that will still be the subject of bilateral agreements, the new rules being introduced in Europe and the U.S. impose new burdens and costs. Not only must all such transactions be collateralized but outstanding contracts must be marked to market on a daily basis. Valuations must be independently performed. "This is prompting many clients to review their entire post-trade activities," says John Read, EMEA Head of OTC Derivative Services, Global Transaction Services, Citi. "Where they are facing the prospect of having to support both CCP-cleared and bilateral deals, there are now a host of technology and people implications, and many firms are looking to outsource the whole middle office," he says.

The impact of Basel III is also relevant — particularly for hedge funds that tend to have major holdings of OTC derivatives. Where prime brokers lend to a hedge fund against collateral they will have to keep greater capital reserves. In turn, they will require independent valuations and management of the assets by the underlying owner, the hedge fund. This, too, is increasing demand for outsourced collateral management and middle-office services.

Manufacturing Eligible Collateral

Based on strong inventory management and an understanding of the collateral assets available, market participants must be able to mobilize those assets quickly to face cash outflows and margin calls. Given the relative scarcity of high-quality assets, converting lower-grade, less-liquid assets into eligible collateral may require access to financing mechanisms such as repos, stock lending arrangements and collateral upgrades. This is particularly likely for buy-side participants.

While initial margin in Europe and the U.S. can be posted in the form of either government bonds or cash, variation margin must be in the form of cash. "Pension funds do not typically have big allocations to cash and, as long-only investors, all their trades tend to be in roughly the same direction," points out Mr. Catt, "Unlike hedge funds, they will not get the benefit of offsetting movements in long and short trades to mitigate the amount of variation margin they need to post."

They must avoid at all cost having to restructure their portfolios just to meet CCP margin requirements. Many will look to leverage their existing fixed income portfolios, turning to collateral managers for collateral transformation services.

Others will turn to their banks for secured lines of credit to ensure they can always post cash, come what may. "If firms rely on the repo market and liquidity suddenly dries up, they run the risk of either defaulting at the CCP or having to sell other assets at the wrong price," says Mr. Catt.

Maximizing collateral efficiency means understanding the hierarchy of collateral defined by CCPs and counterparties. The process starts with the gathering of various fragmented asset pools from different business divisions and consolidating them into a pool of collateral with clearly defined liquidity and quality criteria. The allocation and transfer of assets to the respective counterparties/systems must then be optimized to reduce the amount of collateral assets being used as well as to minimize costs.

Time Is of the Essence

The move to central clearing for rates and credit products and the obligatory collateralization and daily valuation of all non-clearing eligible trades is currently scheduled to commence in the U.S. in 2012 and Europe in 2013. Barring further delays, the time frame is getting short. Firms need to move decisively — and quickly.

There are advantages in being an early mover. A buy-and-build approach will almost certainly entail the recruitment of critical staff. "There is already evidence of good people starting to move around," says Mr. Catt. "There is a relative shortage of expertise in this area." If the decision is to outsource, firms need to allow four to six months from initial scoping and preparation of an RFP to the start of implementation. Service providers have limited capacity to onboard a multitude of new clients simultaneously.

Similarly, the advent of Basel III means that sell-side firms will likely have limited balance sheet capacity for collateral transformation. Whether a firm is looking for prime broker-style arrangements, tri-party repo or simply wants to borrow in order to fund its margin calls, there is some merit to getting in the queue early.

The important message is that any firm that fails to put a sufficiently robust system in place to deal with the new regime — whether built in-house or outsourced — will find itself out of the game once the new regulations bite. There is therefore some urgency for market participants to define their strategy and start making it a reality. ■

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