A new dawn

What are the opportunities and risks for beneficial owners in the new collateral environment, asks Martin Seagroatt of 4sight Financial Software

Most market participants know by now that the move to central clearing of derivatives will increase demand for high quality collateral. Central counterparties (CCPs) demand more collateral consisting of higher quality assets than in the traditional bilateral margining model. Demand for high quality liquid assets to meet Basel III liquidity coverage ratios and reduced rehypothecation of assets will also change supply and demand dynamics.

In this new world, buy-side firms and other end users of derivatives require CCP-eligible collateral to pledge against their derivatives exposures. They do not necessarily hold these types of assets in the quantities they require, and do not want to hold them. For many funds, they disrupt asset allocation strategies and create a drag on returns.

Others on the buy side are sitting on large supplies of these eligible assets. Efficient collateral usage is a way to manage risk and reduce costs. However, it also has the potential to generate alpha for those holding supply in excess of their own needs.

What are the opportunities?

Using data from Markit Securities Finance, at the time of writing there were $14.8 trillion of lendable assets available. However, only $1.5 trillion of this is was on loan.

At some point in the future, interest rates will normalise, cash will become more expensive and collateral demand will increase. At this point, the returns on lending assets for collateral purposes may become more attractive.

This could incentivise holders of large supplies of eligible assets back into the market as the risk/return dynamics change. This will happen gradually rather than in a big bang. Bilateral swaps contracts will roll off and move to a cleared environment over time, and the clearing exemption for pension funds is in play until 2015. Basel III will also be phased in over a number of years.

On the supply side, quantatitive easing has tied up a lot of high quality government debt on central bank balance sheets. This will become available to the market as tapering gets underway, adding to supply and reducing shortages. Central bank tools such as the Federal Reserve's reverse repo facility could also help to alleviate a collateral crunch. However, we expect collateral to become more expensive to some degree over the coming years.

The key problem in the new market engine is mostly around bringing more supply on to the market and matching collateral supply with demand. The market needs to move/mobilise collateral at a high velocity and in a way that minimises settlement costs, manual processing, counterparty risk, liquidity risk and operational risk. Confidence among providers of collateral that risk in their lending programmes is properly managed is fundamental.

> It's now a matter of portfolio management; it's not about lending securities anymore, it's about borrowing collateral

Who will do this?

Many derivatives end-users assumed their clearing brokers/futures commission merchants (FCMs) would provide unlimited collateral transformation/upgrade services at a low cost. However, it is now becoming clear that balance sheet and Basel III leverage constraints will limit this capacity. Transformation may be prohibitively expensive for many.

Global custodians and triparty agents may be in a good position to match this supply and demand. As the market develops and the move to trading via CCPs comes online in Europe, these institutions will be able to centrally map eligibility requirements across all CCPs and allocate assets efficiently. Effectively, they will become giant optimisers and transformers of collateral. Euroclear's Collateral Highway and Clearstream's Liquidity Hub are examples of this model. Their scale will allow them to do this in a cost-effective way, especially if lenders of previously untapped high quality assets sign up to provide additional liquidity.

Likewise, technology solutions that can rapidly identify CCP-eligible collateral are essential. CCP schedules can change on a daily basis for each CCP, so keeping on top of them is a sizeable task.

From there, systems can pool inventory across all of a firm's funds and geographical locations. They will then offer straight-through processing to filter down availability that is CCP eligible and broadcast it to the lending markets. This will offer significant operational efficiencies for those trading collateral.

It is important for buy-side firms supplying collateral to the markets to have a consolidated view of exposures. This will allow them to ensure they have enough collateral for their own clearing needs first and then identify any excess collateral that they can lend out to generate alpha.

Data benchmarking vendors will also play a role. Collateral pricing and identifying collateral opportunity costs are currently some of the more tricky aspects of optimisation. A central data source offering a clear picture of collateral costs for different assets will provide benefits for both lenders and borrowers of collateral.

Collateral confidence is key

During the 2008 collapse in financial markets, there was a sudden loss of confidence in the quality of collateral backing short-term bank funding in the repo markets. Often, this collateral consisted of mortgage-backed securities that rapidly became illiquid and opaque. As bank funding dried up, this created further concerns about bank solvency, resulting in a downward spiral.

In the new environment, it is essential that market participants manage collateral risk effectively to keep collateral flowing around the plumbing of the financial system. The move to trading via CCPs should reduce counterparty risk, but it will then convert this risk to liquidity and market risk on the collateral.

Likewise, collateral transformation shifts counterparty risk in the derivatives markets to counterparty risk in the repo markets. There is also maturity mismatch risk in collateral upgrade trades. A pension fund seeking CCP-eligible collateral for a long-dated swap is sourcing collateral in the repo markets, typically at a much shorter term. This exposes the pension fund to rollover risk in a crisis where the repo markets freeze up and funding disappears. It would then perhaps have to unwind the derivative, with a potentially significant mark to market loss.

> Sound collateral management policies help lenders to ensure the collateral they are taking is in line with their eligibility and concentration guidelines

New shadow banking regulations pushing for a trade repository for securities lending and repo trades may help to bring transparency to these markets. This could give added confidence to lenders of collateral that they can participate in these trades with an acceptable level of risk. If this then

> The securities lending and repo markets are effectively a giant collateral transformation engine

evolves into the widespread use of a CCP model for securities finance, it could also entice new lenders to the securities lending markets, providing it doesn't increase costs significantly.

As a final aside, at 4sight we believe that it is important to think of collateral management as a tool for risk mitigation rather than simply an operational burden or a cost to optimise.

Sound collateral management policies help lenders to ensure the collateral they are taking is in line with their eligibility and concentration guidelines, and they can easily liquidate it in a crisis with minimal losses. Collateral diversity, wrong way risk and appropriate haircuts for less liquid collateral are also important to consider.

From a technology perspective, you need to ask yourself a few questions. In a stress scenario could you:

- Obtain a clear view of all of your exposures to a given counterparty in one place across business lines?
- Dynamically manage credit limits with your counterparties?
- Liquidate your collateral, confident in the knowledge that the assets you have received are correctly haircutted, and meet your eligibility criteria and concentration guidelines?
- Meet sudden variation margin calls from your counterparties quickly with collateral that meets their eligibility criteria in an automated way?
- Prioritise margin calls with workflow to manage the margining process?
- Reduce the strain on liquidity and optimise your asset holdings by giving out the cheapest to deliver assets your counterparties will accept?

In this environment, a full-service automated solution from one of the established technology vendors is essential. Should another crisis occur or—under the new regulations—a CCP goes under, then the cost of a leading edge collateral management system will seem like money well spent. **SLT**

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