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Balancing the Shortage of High Quality Collateral

by Martin Seagroatt

*The market is concerned about liquidity shortages resulting from the central clearing induced collateral squeeze. **4sight Financial Software's Martin Seagroatt** (http://www.derivsource.com/content/martin-seagroatt) explores the possible solutions available to the market to potentially address this liquidity squeeze.*

There has been something of a 'collateral craze' (as The Economist recently referred to it) going on in the financial press recently. This largely revolves around the extent to which new rules laid out in the Dodd Frank Act (Dodd-Frank), EMIR and the Basel committee, The International Organization of Securities Commissions (IOSCO) will cause a shortage of high quality collateral.

Regulators, banks, consultancies, the International Monetary Fund (IMF) and industry associations such as the International Swaps and Derivatives Association (ISDA) have all weighed in with wildly varying estimates on how much extra collateral the new centrally cleared world will require.

Some estimates have put the shortfall of collateral at trillions of dollars and suggested that the subsequent liquidity drain will trigger another crisis for an already fragile global economy. Will liquidity shortages be as bad as expected? Well perhaps.

While the exact scale is tricky to measure due to the number of variables involved, it is likely that there will be some form of collateral squeeze due to the new supply/demand dynamics. Over the coming months it will become clearer whether or not this liquidity shortfall is of manageable proportions.

What are the solutions?
Rather than adding to the many articles and papers speculating on how bad collateral shortages will be, I am going to focus on some of the solutions that are available, i.e. how financial institutions and markets will adapt.

As any economics student knows, an increase in the price of a product typically has the effect of triggering an increase in the demand for substitutes for the product.

So what are the substitutes for pledging and receiving high quality collateral in large quantities? How will the market evolve to deal with more expensive collateral, and what will the new market equilibrium look like? While making predictions on how markets will change is always difficult, the list below discusses some of the options.

1. CCPs accept a wider range of assets
If central counterparties (CCPs) broaden the range of collateral they accept in exchange for larger haircuts, then this would reduce the strain on liquidity. Some CCPs are already accepting assets such as gold and corporate bonds.

The extent to which this occurs will depend on the regulatory viewpoint on broader CCP eligibility criteria. For obvious reasons, regulators want CCPs to remain bastions of stability if they are going to reduce systemic risk rather than simply shifting risk around. It goes without saying that the impact on the financial system of a CCP failing would be very bad indeed, so CCPs need to hold collateral they can liquidate easily in stressed markets.

2. Less use of derivatives for hedging
Some firms that are smaller end users of derivatives may find it uneconomical to post initial and variation margin against derivatives trades. This could lead them to simply stop using derivatives to hedge risk altogether, reducing one source of the extra demand for collateral.

3. Collateral optimisation technology
Market-wide adoption of collateral optimisation techniques will most likely occur over time and optimisation could become the norm for the majority of firms. This would free up large quantities of assets sitting idle on banks' balance sheets and reduce over-collateralisation. The resulting improvements in efficient allocation of collateral on a global scale could play an important role in reducing the strain on liquidity.

4. Greater diversity of product offerings at each CCP
As the CCP model becomes established, each CCP may start to diversify and clear more products. This will allow greater netting opportunities across different derivatives types cleared with the same CCP, further reducing collateral requirements.

5. Interoperability between CCPs
Should interoperability become prevalent, it will open up increased netting opportunities across different CCPs. However, the operational and legal obstacles to achieving interoperability are significant. This complexity may mean this could take a while before it becomes reality, if ever.

6. Full cross-product netting
Perhaps we will see full netting of exposures across derivatives, securities lending and repo business lines at some point, once netting agreements are standardised. This could significantly reduce margin requirements and add further efficiencies in collateral use.

7. Portfolio Margining
According to a recent TABB group analysis: "when all clearable IR swaps are eligible for portfolio margining, the industry will see margin savings of $618 billion". If this is the case, it could add up to a significant chunk of the extra collateral that markets will require.

8. Central Banks accept a broader range of collateral in exchange for cash
Central bank support could release some pressure in the event that the need for more collateral has a destabilising effect on the global economy. However, it would also shift risk from the banking sector onto the balance sheets of central banks, so may only be politically expedient to a certain extent.

9. Large corporations and retail investors contribute collateral
Some market commentators have suggested that retail investors or large corporations such as Google, Apple etc with huge holdings of eligible assets could contribute collateral in exchange for fees. This could unlock

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new sources of liquidity and free up collateral assets.

10. Collateral transformation
Most firms who intended to become Clearing Brokers or Futures Commission Merchants (FCMs) are planning to offer collateral transformation/upgrade services. This involves accepting a wider range of securities against margin liabilities.

They then use their own trading capabilities to acquire assets (or cash) that are eligible to pledge to a clearinghouse. This potentially gives clients the ability to pledge assets held within their investment funds against margin, on the understanding that their intermediary will rehypothecate them.

11. Cash
Cash is always welcome at a CCP, although the return paid on that cash by some CCPs right now is negative, meaning the CCP is charging you for the privilege for placing cash against margin. Most (if not all) pension funds are deeply unhappy about using the cash from within their funds to meet margin calls, reducing their return on investment. So far, regulators have granted a three-year exemption from the clearing mandate in Europe to pension funds.

Conclusion
Higher demand for more collateral will most likely occur to some degree; however there is still time for financial firms to adapt to the new environment. The responses discussed above will cushion the blow somewhat, although the combined benefits are hard to quantify to any degree of accuracy.

There is therefore a glimmer of hope that increased collateral requirements will not have the devastating effect on global growth and liquidity that many are predicting. Only time will tell what the outcome of this unprecedented experiment will be.

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In his 7 years at 4sight, he has specialised in Securities Lending, Repo and OTC/Listed Derivatives collateral management.

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