

# The pursuit of collateral

Headlines about collateral shortfalls have been muted in the last year or so, but the penalties for being left short – effectively being cut off both from traditional sources of funding and from key markets and clients – are such that no one is taking any chances.

Demand for high-quality assets has been so intensified by post-crisis regulation that few sources of eligible collateral will be left in peace over the next five years. No stone will remain unturned, no depository unscoured. Both buy-side and sell-side firms are placing a premium on making sure they can put the

right collateral in the right place at the right time, potentially whisking those assets away at short notice if a margin call so demands. These market participants are also realising they may need outside help to perform the collateral juggling act that the post-crisis world expects.



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Pre-crisis, collateral needs were generally less frequent, less urgent and less likely to turn up empty-handed. Indeed, many firms' collateral management functions – if they existed – were under-utilised, under-invested and, in the case of larger banks, fragmented across business lines. As such, the collateral implications of the post-crisis settlement have set many firms on the path to a major reappraisal. Although collateral is now needed to support a much wider range of activities, there are three key drivers. First, the Basel III capital adequacy framework requires banks to bolster their balance sheets with high-quality assets and also imposes new liquidity standards. Second, the G-20-mandated reforms to the OTC derivatives markets force many swaps to be centrally cleared, obliging market participants to post collateral in support and with central counterparties. For many on the buy-side, this involves setting up entirely new processes. Third, swaps that cannot be centrally cleared will be subject to both initial and variation margin for the first time.

### Dealing with the unexpected

Many of the new rules kick in next year, but the regulatory timetable rolls on to 2020, gradually increasing demand for high-quality assets. Under normal market conditions, the post-crisis rules might add US\$4 trillion to global collateral demand, but stressed market conditions could more than double that level, throwing into question the ability of market participants to get their hands on the assets they need.

In addition, compared to pre-crisis, firms and regulators are now much keener to protect assets and more focused on counterparty risk. Macro-economic conditions also act as a brake on collateral velocity: prolonged uncertainty promotes investor conservatism, potentially burying high-quality assets deep in buy-and-hold vaults.

The increased demand for collateral leads to a number of responses. Market participants need to get better at understanding how much collateral they have, how much



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they need, and how to deploy it effectively. If they don’t have enough of the right kind of collateral at the right time, service providers need to help out, working with market infrastructures to facilitate access, valuation and exchange of assets.

Because many had never had to post collateral to a CCP before, and therefore had few existing in-house collateral management capabilities, the buy-side have generally been reckoned to have the biggest post-crisis change of requirements.

According to EY’s 2014 survey of risk management for wealth and asset management firms in EMEIA (Europe, Middle East, India and Africa), with the exception of liability-driven investment and hedge fund firms, most houses were not focused on following which CCPs were being authorised, how to tackle client clearing or how to optimise their risk capital. A total of 56 percent of firms were concerned about a future scarcity in quality collateral (defined

as pledged as titled and fully fungible), compared with 48 percent in 2013. Thirty percent of respondents had run or were in the process of conducting a selection process across their brokers and custodian banks to assess their collateral management, execution and prime services. A total of 45 percent of firms were concerned there might be extra costs arising from using OTC derivatives, while 41 percent said they had conducted a study to look at acceptable collateral.

For these asset managers, the challenge is made stiffer by the fact that the assets regarded as eligible for collateral by CCPs – typically medium- to long-term debt issued by AAA-rated sovereigns – do not generate high returns for clients and as such are not kept close at hand. But asset managers that are part of large insurance firms typically already have a repo and/or securities lending desk with the skills and the market connections to gain access to the collateral they need. Similarly, the cash management skills developed to handle redemptions and cor- →

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porate actions can be leveraged to respond quickly to margin calls.

Helene Virello, head of collateral management, BNP Paribas Securities Services (BNPP SS), says buy-side collateral management requirements have evolved. “It is now clear that buy-side firms need to manage their collateral much more carefully than in the past and that they are looking for more transparency and safety when it comes to cleared and non-cleared OTC derivatives,” she comments.

Custodians such as BNPP SS have been upgrading their collateral management capabilities to provide an end-to-end service. Typically these services cover three distinct areas: middle-office servicing, which covers transaction management, reporting, evalu-

ation and portfolio reconciliation; capital markets operations, which optimises, transforms and allocates collateral, with financing if necessary; and settlement and custody, which covers the traditional responsibilities of the custodian for ensuring assets are segregated and protected effectively.

It is this second area that is the most complex, because it requires the provider to have a global inventory of the client’s assets, positions and exposures, access to a broad array of assets through accounts and arrangements with market infrastructures, and the ability to identify the right collateral for the job. In BNPP SS’s case the process is highly automated, with a complex algorithm used to aggregate the many inputs and charged with selecting and allocating the necessary collateral to

the correct counterparty. A crucial factor is timing. Virello admits that collateral managers often face a race against the clock to go through the necessary channels to secure the required collateral, especially if they are not also servicing the client's assets. For this reason, BNPP's algorithm works in real-time. She also points out that the range of collateral management services is evolving in line with regulatory drivers, such as the central clearing mandate.

"If a buy-side firm is not comfortable posting margin directly with a counterparty – for example a broker – it can opt instead to hold it in a segregated account with a third-party custodian which offers a separate and safe, but accessible, legal and operating environment," says Virello.

### CSD support

Custodians are also partnering with central securities depositories (CSDs) to hold client collateral required in support of a margin payment to a CCP, which under the European Market Infrastructure Regulation must be held in a securities settlement system. For example, BNPP SS supports the full-segregation client protection model announced by CME Clearing Europe, which segregates collateral with an external custodian at the client level. SIX Securities Services was the first CSD to support the model, meaning collateral posted with CME Clearing Europe can be held in BNPP SS's account at the CSD.

As well as these new arrangements between custodians and market infrastructures to support market participants' collateral management needs, collateral managers are crossing the line between the two. BNY Mellon has established itself as a CSD in support of its drive to provide clients with access to collateral, while J.P. Morgan has developed a partnership with globeSettle, the new Luxembourg-based CSD launched by the London Stock Exchange Group for similar reasons. Both US firms are also major European tri-party agents, along with

CSDs SIX Securities Services, Euroclear and Clearstream, which means they can act on behalf of clients in the repo markets in pursuit of collateral transformation opportunities.

Neil Wright, industry advisor at Sapient Global Markets, says rising collateral needs will increase the proportion of tri-party repo deals. "I wouldn't say tri-party agents have an advantage over other custodians in the collateral management space, but there will certainly be an increase in use of tri-party agreements to support the posting of the right collateral with the right counterparty," he says.

For many market participants, the big collateral management question is: how much do I outsource? Clearly, the challenges are complex, but the optimisation and transformation services are not cheap. The answer may come down to individual circumstances and philosophy. The asset manager that wants to exercise control and expects to use derivatives regularly in its investment strategies may well choose the in-house route. "As long as you have the resources and data to take informed decisions on posting collateral, it is entirely feasible to take matters into your own hands, says Wright.

EY's director of regulatory reform and risk management, Dr Anthony Kirby, suggests that the in-house route may become easier as market infrastructure developments pave the way for smoother access to collateral. "TARGET2-Securities (T2S) could be an eventual game-changer in terms of asset managers' access to collateral by 2017," he says. "Right now, proactive management of assets held by custodians is a relatively complex paper chase, but once T2S creates a single standardised platform for securities settlement spanning 24 CSDs, asset managers will have access to a much deeper collateral pool of CSD-titled assets. This should lead to a greater capacity for auto-collateralisation of flows by asset managers that could increase their trading velocity." •