Securities Services

Collateral Management
Can 'Collateral Values' prevent the next crisis?

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Executive Summary

Collateral has become a focal point for financial institutions. While in the past the capital markets enjoyed abundant collateral and liquidity, the ongoing financial crisis has spawned regulation and risk management principles which are forcing a collateral lockdown.

In particular, the Dodd-Frank Act, Basel III and the European Market Infrastructure Regulation (EMIR) are introducing greater demands for collateral. The central clearing of OTC derivatives under Dodd-Frank and EMIR calls for contracts to be collateralised and higher liquidity buffers to be put in place. The Basel III Liquidity Coverage Ratio (LCR) and increased capital requirements are locking further collateral away.

In this challenging regulatory environment, financial institutions are paying more attention to collateral management and collateral optimisation than ever before. While this presents an opportunity for providers of collateral management services, the industry itself is very much at a crossroads.

Our research indicates that 75% of financial institutions believe collateral management has become, or is at risk of becoming, a commodity product like oil or gas. The commoditisation of collateral management presents fresh risks as it plays a central role in the control of counterparty risk exposure and the mitigation of both market and operational risks.

Fears over commoditisation may be a cause of the concerns of many institutions over how portfolios are being securitised and repackaged to create new collateral pools.

While changing attitudes to existing portfolios may be thought of as an opportunity by some collateral management providers in the short term, capitalising on such attitudes may lead to greater market risk.

This is not the only fear the investment banking community has over the next few years. Over half the institutions in our study believe that there will be a collateral shortfall before 2015, although estimates of the exact size of this shortfall vary greatly.

As high-quality collateral becomes ever more scarce, most institutions are understandably concerned that the cost of such collateral is set to go up in the coming years. Should some financial institutions be willing to accept low-quality collateral simply because it is cheap, some collateral management providers may be prepared to compete on the quality of collateral they accept, sparking a race to the bottom.

Hopefully this will not happen. Our research indicates that investment institutions place more importance on clarity and ease of use of collateral than cost. While cost will always be an important factor in collateral management, it is critical that the capital markets do not compete on collateral quality. Collateral must be simple, of a high quality, liquid and easy to value. These ‘Collateral Values’ are fundamental to the future success of the financial markets.

Collateral Crunch?

Collateral plays a pivotal role for a growing multitude of financial services and products. A lot of the industry's attention has quite rightly focused on recent regulatory efforts to push the enormous OTC derivatives market through central clearing (and therefore subject it to more stringent collateral requirements), but collateral plays a much more diverse role than just for the OTC derivatives market.

Collateral lies right at the heart of securities financing, is a key enabler of risk mitigation solutions such as the credit valuation adjustment (CVA) and can even open up new revenue streams for firms through effective collateral management.

Regulatory efforts to protect the financial system – notably Dodd-Frank, Basel III and EMIR – are placing demands on collateral for both the buy side and the sell side. These demands are occurring at a time when banks are unwilling to lend.

Central banks' quantitative easing also plays a role in ebbing the flow of eligible collateral, with a sizeable amount locked up in their reserves. The days of abundant collateral and liquidity that the financial markets have historically enjoyed may be coming to an end.

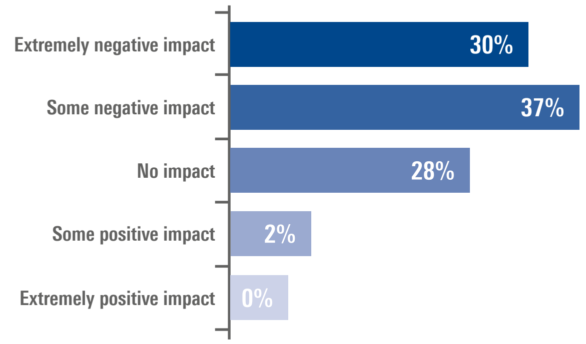
With these trends in mind, it is perhaps not surprising that just over half of the financial institutions (53%) surveyed for this study believe that there will be a collateral shortfall by 2015.

However, estimates of this shortfall vary massively. Some institutions put the shortfall as a (relative) drop in the ocean at less than USD 10 billion, while others put it to the tune of several trillions of dollars.

Compounding doubts around whether enough high-quality collateral exists for the markets to function properly is a further question: is collateral where it needs to be in order to meet demands? Firms must note that the issue of collateral mobility is no longer simply about maintaining efficiency but also about ensuring that markets are safer than in the past. However, the problem remains the same. Whether the collateral exists or is simply stuck in the wrong places, the issue is one of scarcity.

The uncertainty and concerns of the industry are not just limited to the future either. The vast majority of institutions report that present circumstances having a negative effect on trading as well. Both the buy side and the sell side feel that they are struggling under the auspices of the credit rating agencies. Almost three-quarters (70%) say that those agencies are having a negative impact on their recovery from the financial crisis; only 2% feel that the influence from those agencies is having any kind of positive impact.

Do you believe that credit rating agencies are having a negative impact on the recovery from the financial crisis?



How big do you estimate the size of the collateral shortfall to be by 2015?	Total
Less than USD 1 billion	0%
USD 1 billion to USD 10 billion	6%
USD 10 billion to USD 100 billion	22%
USD 100 billion to USD 1 trillion	41%
USD 1 trillion to USD 3 trillion	19%
USD 3 trillion	13%
Average estimated collateral shortfall (USD million)	$ 1,110.81

What these mixed responses show is that there is a great deal of uncertainty over the future of the capital markets. Some institutions think there will be a collateral crunch, others do not. Some think the collateral shortfall will be enormous, others that it will be relatively minor. Responding in this backdrop of uncertainty is proofing a real headache for all financial institutions.

Collateral Values

With 53% predicting a collateral shortfall in the next couple of years, it is unsurprising that most of these businesses foresee a rise in the cost of high-quality collateral in the same time frame. On average, firms estimate that high-quality collateral will increase in cost by 9% by 2015. However, this was a controversial topic.

Only half of those questioned were able to suggest a figure by which the value of high-grade collateral would change; one optimistically suggested that «increased competitiveness will keep the costs down», while another one said that the cost «will rise as long as risk continues to be perceived as being high». Although most point to an increase over the next few years, in many there was a distinct uneasiness as to which way the price might move.

While cost is always an important factor, is it the only factor that matters? On a positive note, only 22% of the institutions believe that the cost of collateral is all that matters. Selecting a market infrastructure on cost alone may increase an institution's exposure to risk. In the eyes of most institutions, collateral is not a commodity product – yet.

78% do not believe that the cost of collateral is all that matters

For our study, we asked institutions about the importance of four Collateral Values, four factors that would improve the transparency and resiliency of the financial markets. 43% of institutions believe that collateral must adhere to these 'Collateral Values' – it should be:

- **Simple**
- **Of a high quality**
- **Liquid**
- **Easy to value**

Collateral Values: 43% believe collateral should be simple, of a high quality, liquid and easy to value

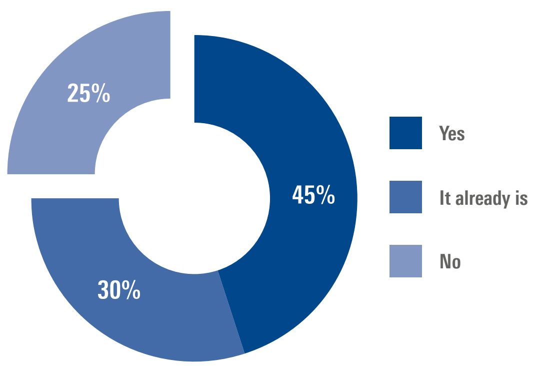
It is clear that there is a premium involved in simple, high-quality, liquid and easy-to-value collateral, and many institutions are willing to pay that premium. Given the recovery environment in which banking still operates and the less-than-positive outlook financial institutions feel over the future, this is not altogether surprising.

Attitudes to Collateral Management Today

The sell side and broker dealers have always regarded collateral management as a key function due to their reliance on securities financing. Now, in the wake of regulatory pressure and concerns over collateral scarcity, collateral management has moved from a back-office function to a board-level concern for retail and wholesale banks as well.

With collateral management growing in importance, some financial institutions believe that collateral management is shifting or has already shifted to being a commodity product.

Do you think collateral management is at risk of becoming a commodity?



Commoditisation is the process in which products and services move to a market of undifferentiated price competition. While commoditisation may be desirable for uniform items such as petroleum or electricity, collateral management offerings differ greatly in many other factors besides price – such as risk mitigation, operational efficiency and ease of use.

Collateral management is very much at a cross-roads today.

The direction it takes in the future will naturally depend on the markets. If they choose an external collateral management provider, will market participants choose the cheapest provider or seek out providers with value-added differentiators?

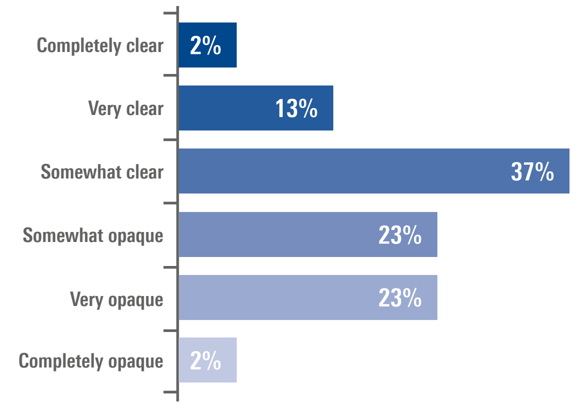
In addition, financial institutions are worried that in the race to find more collateral, some institutions and collateral management providers are securitising and repackaging existing portfolios to create new collateral pools. Just under half of respondents (48%) think that this will result in additional risk and potentially sow the seeds of the next big financial crisis; only around one in three (37%) disagrees.

Whichever direction the industry takes, the repackaging of existing portfolios is surely not the answer. Much of the crisis of 2008 has been attributed to the repackaging of portfolios of subprime US mortgages. The fact that the financial services industry is even contemplating repeating the sins of the past is cause for deep concern. The financial markets need to be as transparent as possible: repackaging only leads to opacity and incomplete views of risk exposure.

Post-trade: An opaque industry?

Many investment institutions choose to use the services of third-party post-trade service providers for their collateral management needs. However, financial institutions are struggling to understand the pricing structures of the post-trade industry, with just 15% of institutions claiming that these structures are very or completely clear.

How opaque do you find the pricing structures of the post-trade industry?



These findings indicate that the majority of firms are to some extent in the dark about the fees incurred once a trade has been made. The potential consequences of poorly understood costs for post-trade services include:

- Poor selection of post-trade service providers
- Higher costs through payment of unnecessary fees
- Poor trading performance due to trades not being as profitable as hoped
- Increased systemic risk

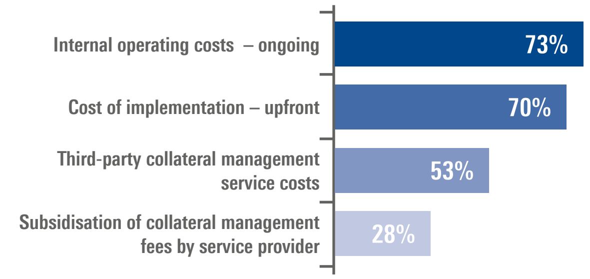
The opacity of the post-trade industry is obviously a major problem for financial institutions. Those post-trade service providers that make their fees as clear as possible to their customers should have an advantage over the competition.

A reason why market participants find the pricing structures of post-trade service providers so hard to understand is because there are so many factors to consider beyond the explicit 'fees' of the provider.

When deciding upon the choice of collateral management providers, the majority consider ongoing internal operating costs (73%) such as IT costs for maintaining the interface with the provider, internal staff costs and other factors. Most also consider the one-off upfront cost of implementation (70%) and on-boarding. However, just over half consider the fees of third-party collateral management services, and only a quarter (28%) consider the cost of subsidisation of collateral management fees by the service provider.

Subsidisation of collateral management fees by the service provider is a particularly tricky factor for financial institutions to consider. The issue here is that some collateral management providers may choose to offer fees that are artificially lower than the market average in the hope of getting the customer to pay higher fees for other services across the value chain such as clearing or repossession.

Which of the following factors do you consider in end-to-end collateral management?

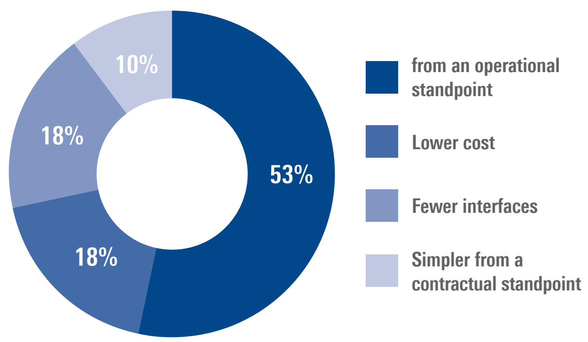


The Role of Collateral Management Providers

Why do financial institutions choose to use third-party collateral management providers? The principal benefit that most firms cite for choosing an end-to-end collateral management provider is that they make things simpler from an operational standpoint. Collateral management is a complex undertaking, and many institutions prefer to outsource this function to specialist providers.

Only a small minority of institutions consider the fact that collateral management providers lower total cost as the main benefit of using them.

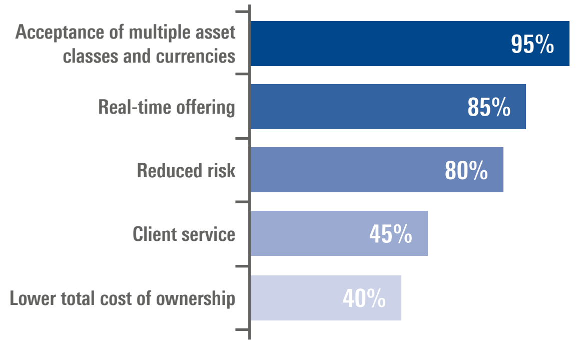
What is the main benefit of using an end-to-end collateral management provider compared to a point solution?



To understand why more investment institutions are enjoying a simplification of their operational processes rather than reduced costs when using collateral management providers, it is important to look at the litany of service features they require collateral management providers to deliver.

With the aim of making trades simpler, most say that accepting multiple asset classes/currencies, real-time offering, and reducing risk are absolutely crucial to the proposition. Notably, fewer than half say that client service or lower cost of ownership is essential – adaptability, compatibility, and lowering risk are much more important to them than lowering the cost.

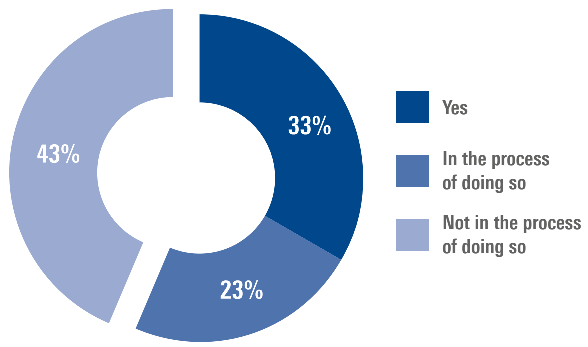
Those who have moved to a collateral management system in the last 18 months and say that each factor was very important to the decision



Because it is recognised that collateral management providers bring simplicity and clarity to the trading process, investment banks are naturally interested in new providers who claim to offer a better proposition than they receive at present.

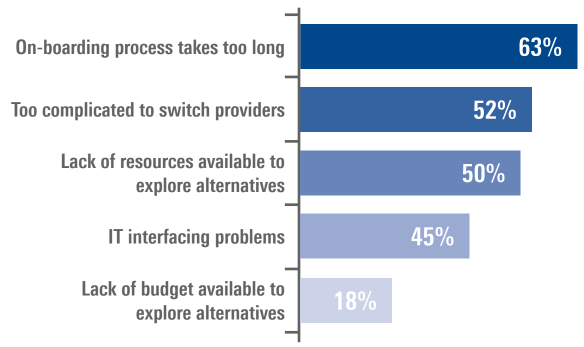
A third of financial institutions surveyed have added a new provider or replaced an incumbent in the last 18 months, and another quarter (23%) are in the process of doing so.

Have you replaced or added a new collateral management provider in the last 18 months?



Nevertheless, bringing in a new collateral management provider is no easy task. Over half (55%) say that adding a new provider took over nine months; one in five said that it took over a year. Indeed, when asked why current providers are retained, the most popular reason (given by 63%) is that the on-boarding process takes too long. Similarly, over half (52%) report that it is too complicated to switch providers.

Why do you retain your current collateral management provider?

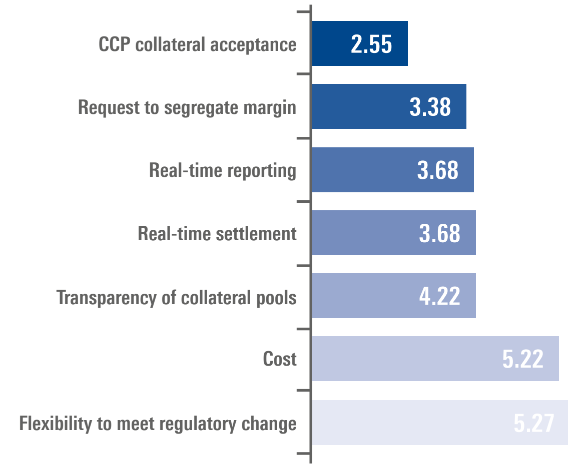


It is rarely the case that the budget required to investigate alternatives does not exist, again emphasising the fact that so many institutions value the benefits that providers can bring and, in the main, make the budget available to adopt them.

Collateral Management Solutions

Given what we have seen, it is no surprise that when investment institutions look for collateral management solutions, they choose functionality over cost. On average, the most important requirement of a system is that it covers central counterparty acceptance – 38% selected this as the single most important factor, compared with just 2% who put cost as their most important factor. After CCP acceptance, the next most important factors on average are the ability to request segregation of margins (73% of institutions surveyed said that they require this capability at least some of the time), real-time settlement and real-time reporting.

Average importance of each factor when choosing a collateral management system, where 1 = most important and 7 = least important

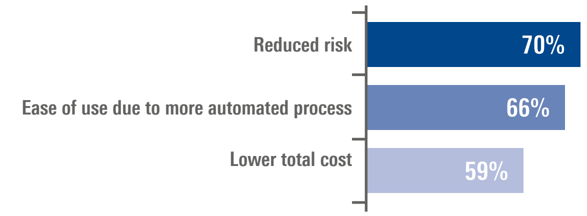


Respondents rated every factor highly in their decision-making process. To illustrate this, let's take real-time settlement; this was only the third most important factor on average overall, and yet over half say that it would be a critical requirement in any collateral management system they would consider. It is clear that collateral management systems not only need to offer wide functionality, they also have to demonstrate quality and reliability if they are to satisfy their demanding potential customer base. Again, this emphasises that these systems are premium products, and that cost is of relatively low importance.

Most firms (73%) are currently using a tri-party collateral management system. Under such a tri-party collateral management system, a third-party collateral manager assumes responsibility for administering exposures (pledged assets) and collateralising them using assets of the same value. The advantage of a tri-party system is that the third party provides access to a central pool of collateral from a wide array of market participants from around the world. However, users of this services have to pay a fee.

Most firms in our survey appreciate the benefits of such a system over a bi-lateral solution; the majority of those using a tri-party system say it offers reduced risk, ease of use due to processes being more automated and a reduced cost because of a reduction in time spent on collateral management. Once again, cost is less of a concern compared to other benefits that such solutions bring.

Percentage of respondents who have a tri-party collateral management solution that consider each factor a benefit of that system which a bilateral solution does not have



Conclusions

With regulators imposing greater collateral demands, financial institutions are rightly concerned about whether enough collateral exists to service the system. However, regulators, post-trade service providers and market participants themselves must not dilute their definitions of what constitutes acceptable collateral.

Collateral management is no longer simply about maintaining efficiency but also about ensuring that the financial system is safer than in the past. We believe that collateral must be:

- **Simple**
The repackaging of securities to create 'new' collateral pools is foolhardy. Complex securitisation practices make it difficult for financial institutions and CCPs to gauge obligations to counterparties. Simple collateral streamlines internal operations and provides transparency to the institutions and markets.

- **Of a high quality**
Regulators and CCPs must resist the temptation to make low-quality collateral acceptable. The rating agencies are not infallible but still provide a useful indication of credit-worthiness.

- **Liquid**
CCPs need to remain bulwarks of stability if they are to reduce systemic risk rather than move it elsewhere. The collateral that CCPs hold must be liquid so that they can return it easily under times of market stress.

- **Easy to Value**
Financial institutions need to easily value their own and their counterparties' assets so that they can minimise risk.

Our research has demonstrated that cost is not all that matters to financial institutions when choosing their collateral management systems. Collateral management is no longer a back-office function but an issue of board-level concern. To stand a chance of competing, institutions must ensure that collateral management is far more than a simple aggregation and a netting of collateral stream across silos. Good collateral management should make a firm's operations simpler and safer rather than just cheaper.

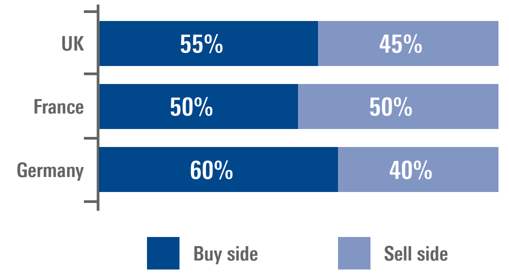
Institutions must therefore consider a wide range of variables when choosing their collateral management provider. These include real-time counterparty risk exposures, knowledge of local markets and the quality of the on-boarding process. Real-time and multiple asset class functionality will also be crucial, as will a level of counterparty participation that meets the firm's needs.

Another important differentiator is tri-party collateral management, with which a firm's collateral can be safely ring-fenced. This approach protects institutions from the commingling of assets, ensuring that assets can be easily segregated and returned to their owners should there be a default.

As this research shows, we are seeing a growing market demand for automated, comprehensive collateral management solutions that not only lower the total cost of ownership but also enable firms to source the best collateral. As the race for collateral intensifies, those firms which look beyond price and equip themselves with bespoke, real-time collateral management services stand the best chance of success.

Methodology

The findings in *«Collateral Management: How Collateral Values Can Prevent the Next Crisis»* are based on the results of an independent survey conducted by Vanson Bourne on behalf of SIX Securities Services. 60 interviews were undertaken with senior officials in investment banking institutions, or the investment banking arms of large general banks, during November and December 2012. Respondents were targeted on the basis of seniority and their involvement in trading, e.g. heads of securities, financing, equities, collateral management, etc. 20 interviews were performed in the UK, 20 in France, 20 in Germany. 55% of those we approached said that their roles were primarily on the buy-side of trades, though many considered their roles to be so senior as to cover both buy- and sell-side roles in their organisation.



«Figure 1:» Split of percentage of respondents who classified themselves as primarily buy- or sell-side

Respondents were interviewed by telephone, allowing the research to be quantitative but to also encompass some qualitative digression where appropriate.

About SIX Securities Services

SIX Securities Services specialises in post-trade activities. Its services are available for both the domestic Swiss market and international markets. These services include CCP Clearing, Risk Management, Real-Time Settlement (including real-time realignment of holdings), Custody (domestic and international), Securities Finance, Global Fund Services and Share Registration Services. www.six-securities-services.com

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