

Collateral Management: New Challenges Call for Improved Processes

Financial markets finally appear to be recovering from the shock of the latest global financial crisis. However, the resulting turmoil has turned the focus heavily onto collateral management processes. Risk managers are increasingly relying on this type of practical risk mitigation to ensure high recovery rates in future times of crisis. The question is, how is collateral management coping, and what are the new challenges it faces?

By Simon Lillystone, director, Omgeo

Although the financial recovery is well entrenched in many of the world's leading economies, especially those in the Asia region, collateral managers continue to face many new challenges brought about by the crisis of 2008.

For most market participants, the financial crisis and the sudden instability of many previously well-respected identities resulted in a significant increase in pressure placed upon collateral managers. Whereas collateral management had typically been viewed as the last port of call on the credit risk management coastline, rather than the first, financial institutions across the globe now recognize that flaws in their collateral management operations can result in significant new exposures in overall risk management and introduce additional hidden risks if a trading counterparty defaults.

Evolution in OTC Derivative Trading

Throughout the decade preceding the most recent financial crisis, the development and use of derivative products, not only for hedging but also for speculative purposes, became the driving force behind the growth of many financial institutions. As traders moved away from traditional homogenous financial products such as foreign exchange, equities and government debt and began to focus on the creation of new exotic and structured products, so the landscape for collateral managers began to shift dramatically.

The emergence of these derivatives products resulted in the need for improved systems, together with greater flexibility and scalability within those same systems. Greater trading volumes



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over a more diverse landscape of traded products has increasingly put pressure on the collateral manager to process and manage effectively the firm's collateral obligations arising from the master agreements and credit support annexes signed with counterparties.

Following the crisis participants pulled back somewhat from these structured trading and hedging vehicles, but as the market now shows significant signs of recovery, so the demand for new products is returning and forcing the requirement for sophisticated, automated collateral management processes.

Increased Scrutiny of Internal Risk Management Processes

The crisis left many organizations reevaluating how they manage counterparty risk in real terms: how much was founded on optimism rather than pessimism; how much was theory and how much practice? In many cases, companies have fundamentally changed their methods of measuring counterparty credit worthiness: reliance on third-party credit

ratings has been severely tested – and in some cases found wanting.

Firms have also devoted renewed efforts to tease out the occasionally visible, but often hidden effects of risk transfer. Using collateral as a mitigant might diminish overall credit risks but introduces additional, supposedly more manageable risks, such as settlement, liquidity, concentration, and correlation. But are collateral managers suitably equipped to identify and handle the diversified risks?

Above all, much tighter controls are being applied to the eligibility criteria for collateral types: classifications of eligibility are being more finely specified, haircuts are more aggressively defined, rehypothecations rights are considerably restricted, and location and ultimate control of collateral is being heavily ring-fenced.

These features are now regularly being written into Credit Support Annexes and other types of margining agreements.

Credit risk tolerances are also being redefined, and agreement parameters, such as unsecured thresholds and minimum transfer amounts are either being re-assessed or removed altogether as an increasing number of practitioners revisit their collateralised coverage ratios in their trading.

As internal risk management practices have come under focus, collateral management is emerging as an enterprise-wide critical function in a company's counterparty risk management strategy – the new first line of defence.

Potential Changes to the External Regulatory Landscape

Regulators have been closely observing the uses and practices of collateral and

margin management, and also taking much counsel from industry organisations such as ISDA. Practitioners already generally work collaboratively with their collateralising counterparties, and have therefore been keen to demonstrate that the current state of self-regulation is working well within this area of credit risk mitigation.

Broader Implementations of Collateral Management

Many firms that had previously underinvested in collateral management are now implementing new programmes, including an increasing number of investment managers and hedge funds – all openly acknowledging that they need better defence mechanisms against the potential default of their counterparties. Many of these firms are adapting to a changing environment in which they are trading with multiple prime brokers, re-negotiating margining terms, developing dedicated resources and meeting new operational challenges.

For the sell-side, the growing number of buy-side institutions requiring collateral arrangements to be in place has resulted in an increasingly complex matrix of collateral agreements. This demand has always been in place – but is now being seen as a differentiator of client service levels from the sell side to the buy side.

Growth in Collateral Volumes

The amount of collateral in use has grown substantially and the number of collateral agreements has more than doubled since 2005 (according to the 2009 ISDA margin survey).

Furthermore, volumes of collateralised OTC trades, whether by population or valuation, have grown from 25% to over 85% in little more than five years. At the same time, firms who were experiencing a handful of margin calls per month in early 2008 are now talking of hundreds per month, some requiring billions of US dollars in credit support terms to counterparties. Yet more evidence that sophisticated systems are now a must.

Knowing your Counterparties

The collapse of Lehman Brothers highlighted another unforeseen risk – legal entity risk. Who exactly is the collateralising counterparty? Will the existing collateral arrangements actually hedge against the default of that particular

entity, and if collateral is transferred to that entity, will it be easily recovered if a default occurs?

Uncertainty in the potential outcomes has led to collateral givers to request hard or soft-segregation of collateral balances (especially in the case of Initial Margin) with custodians or third-party collateral carers. This ensures unfettered recourse should a default occur. This contrasts with the current, prevalent use of physical transfer of collateral directly to the in-the-money party.

Benefits of Automation

Automating the collateral management function enables increased efficiency while reducing risk and uncertainty. It offers the opportunity to cater for growth on a variety of fronts; numbers of collateralised counterparties; volumes of open transactions, margin calls and collateral transfers across multiple business lines simultaneously; enhanced reporting and analysis of collateral and margin obligations at any given moment: all ultimately increasing an institution's ability to meet current and impending regulatory requirements, whilst at the same time strengthening and extending trading relationships with counterparties.

Active, rules-based automation can increase the proportion of straight-through-processed activities, enabling collateral and margin managers to concentrate on exceptions, and have the bandwidth to handle residual, semi-automated and manual processes. With fewer discontinuities in the workflow and inter-system dependencies, managers can begin to resolve misunderstandings over portfolios with their counterparties.

Moreover, the industry has finally placed the cart behind the horse: collateral management can now be a recipient of timely, qualified and acknowledged portfolio data, which will help improve the accuracy of margin calls.

The industry now wishes to go further, with an aspirational goal to automate the margin cycle on an end-to-end basis.

Margin calls are currently and predominantly issued via email or facsimile, however the processes thereafter are far too manual and prone to error and delay. Steps are being undertaken, with guidance from industry bodies, vendors and participants from both sides of the financial community to reach a common understanding on how far these automa-

tion initiatives can and should reach.

Beyond automation and bipartite collaboration within the reconciliation processes, the industry is now promoting standards for electronic messaging to cover not only communication of margin calls, collateral transfers, substitutions, and disputes, but also business rules to help parties avoid margin disputes and increase certainty in the delivery and safeguarding of eligible collateral.

Other initiatives, such as the adoption of new industry-wide data standards to remove 'noise' from the collateral and margin management processes; repositories of standard settlement instructions (SSI) to increase further the certainty in collateral delivery and settlement; and golden sources for the accurate identification of all collateralising participants (i.e. "know your customer"); will all eventually contribute not only to increased transparency in the market, but also improved transformation of subjective credit risks into objective and manageable other risks. ■

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