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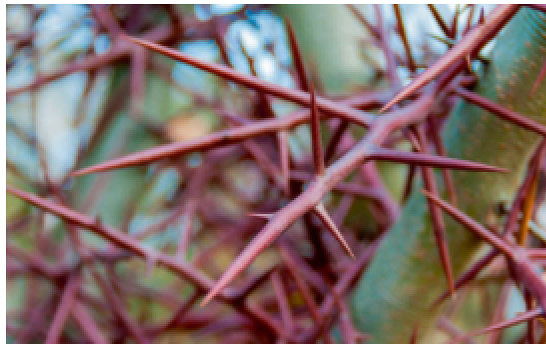
COLLATERAL MANAGEMENT: Thorns in the buy-side



Firms with collateral reporting duties have stalled to meet a key regulatory deadline – but at least fears of a collateral shortfall have receded a little. Lynn Strongin Dodds reports.

Implementing collateral rules for investors active in over-the-counter (OTC) derivatives market did not go as smoothly as hoped for after the March 1 activation date. Described as "chaotic" by one participant, the stalled introduction of 'variation margin' – a process to collateralise OTC derivatives that are not centrally cleared and so pose a systemic risk – covers all kinds of counterparties: investment managers, hedge funds, pension schemes, insurance companies and dealers.

All were expected to hit the ground running, but participants subsequently welcomed the breathing space granted after regulators accepted that many firms' systems were not ready to support this new piece of capital markets infrastructure reform.

In Europe, the reform falls under the European Market Infrastructure Regulation (Emir).

Regulators did not move the deadline but instead delayed enforcement by six months to September 1. The European Supervisory Authorities (ESAs) expect competent authorities to exercise their supervisory powers on a case-by-case basis taking into account the size of the exposure to an OTC derivatives counterparty. Participants must document the steps they have taken to achieve full compliance.

In the meantime, firms need to put in place alternative arrangements to ensure that the risk of non-compliance is contained.

This is not the first time that watchdogs have shown flexibility. The goalposts for the collateral rules for non-cleared OTC derivatives transactions had already been moved to September 1, 2016, from December 1, 2015, for the largest parties with derivatives in excess of €3 trillion. This is because some firms were slow to sign collateral transfer contracts with custodian banks, while others relied too heavily on manual systems to process margin calls.

A THORNY PROBLEM

But the main stumbling block for the March milestone was and continues to be the renegotiation of credit support agreements (CSAs). This has been a particular thorny problem for the biggest buy-side firms because they have had to review dozens of contracts with broker-dealer and bank counterparties across the world, as well as inform their underlying fund clients of the new terms.

Smaller firms also had their issues. In the pre-crisis world, OTC contracts were typically bilateral agreements between parties with established relationships, but under the new rules, many will be posting margin to back their swaps for the first time. This requires systems that conduct portfolio reconciliation, valuations, margin calls and margin delivery in a fairly shorter timeframe.

It is no surprise then that against this backdrop, the nitty-gritty practical and operational details of implementation have taken precedence over other aspects of collateral management, such as collateral optimisation, which was touted as a way to deal with the huge shortfall in quality collateral that had been predicted in recent years.

"The real challenge has been to be compliant with the VM [variation margin] March 1 deadline," says Trevor Negus, product manager at SmartStream. "Once the process has smoothed out and bedded down, firms will then look at collateral optimisation."

Phil McCabe, global head of collateral management at Bloomberg, adds: "People are less worried about the so-called collateral crunch and we are not really hearing much talk of optimisation from the buy-side at this stage. There could be a problem in the future, although I do not think it will be a crunch.

"At the moment, the practical challenges of the legal documentation and operational infrastructure improvements are at the forefront of people's minds, particularly for the smaller to medium-sized players. In many ways, though, the 'initial margin' requirements for non-cleared derivatives will be even more challenging because of the calculations that are required."

Initial margin is another aspect of Emir margening rules being phased in. Market participants will decide whether to follow the standards set out in the regulations for calculating initial margin, or develop bespoke initial margin models, which require regulatory approval.

STANDARD FRAMEWORK

A less expensive option is to employ the International Swaps and Derivatives Association (Isda) Standard Initial Margin Model, a standardised framework for calculating the amount of initial margin that needs to be exchanged between counterparties, thereby reducing the potential for disputes. It also employs risk weights and correlation tables to specify the requirement as a percentage of the gross notional amount of the exposure in each asset class.

Although not perfect, the view is that the standardised framework should help sidestep the problems that would have derived from firms developing multiple and disparate methodologies.

In the meantime, the general consensus is that as participants get their houses in order and the new rules gradually take hold, there will be more than enough collateral flowing through the system.

This has dampened the panic seen three years ago when bodies such as the Bank for International Settlements (BIS) said as much as $4 trillion of high-quality collateral could be needed over several years to meet requirements. While few are willing to make a concrete bet, the numbers are more likely to be around the $80 billion to $100 billion mark.

"The delays have allowed the industry to prepare and develop new solutions to ameliorate the effects of the liquidity squeeze," says Ted Leveroni, chief commercial officer at DTCC Euroclear Global Collateral. "However, when it is completed, we do not expect immediately to see the numbers that were forecast a few years ago. There will be a rising tide of demand for collateral but not a tsunami. The full extent will not be known until everyone is under the scope, which will not be for another three years."

Philip Whitehurst, head of service development for SwapClear, also notes that "concerns about not having enough collateral in the system turned out to be exaggerated, as to date there has been sufficient high-quality assets such as sovereign bonds to cover what is required.

"However, the uncleared margin rules [variation margin] have introduced a significant new demand on the amount of collateral required in the system and while this is driving an increased appetite for central clearing because it is less expensive, clearing is not the answer for every asset class."

As a result, Whitehurst says, firms will continue to trade bilaterally and the focus will shift towards more standardisation and efficiency of the margin processes in uncleared products.

It will, of course, depend on the size of the assets under management and volume of derivatives trading. For example, pension funds that run liability-driven investment strategies may make the move to clearing before their respective deadlines because of the cost. They are already being hit by falling interest and rising inflation rates and are loath to post cash for variation margin. While it has been relatively straightforward to set up the infrastructure to clear interest rate swaps, this has not been the case for inflation-rate swaps, although this is changing with an increasing number of banks now able to support the activity.

"I think the new uncleared margin rules are more challenging for pension funds than investment funds because they need to be invested at all times and they have little cash lying around to post as margin," says Jerome Kemp, global head of futures, clearing and collateral at Citi.

"This is not the case with real money or hedge fund managers who will have more cash that can be used."

David Beatrix, a business development manager for BNP Paribas Securities Services, also believes that funds operating under the Ucits IV and the Alternative Investment Fund Managers Directive (AIFMD) banners will make an early move to clearing because they have some of the same constraints as pension funds.

"They are different in the amounts and shape of their risk profiles, with pension funds being more directional," he says. "However, clearing offers better capital spreads and this could help offset the side-effects of the cost of the regulation as well as the market infrastructure that is being required."

ANTIQUATED PROCESSES

Another common thread is the antiquated processes many funds still employ. One of the main challenges for participants across the board is that they have legacy systems that rely on manual processes and spreadsheets for collateral management, according to Kemp at Citi. His view is shared by Leveroni, who notes that "compliance is only the first step, participants also have to optimise, automate and increase transparency".

These issues were highlighted in a study conducted last year by Isda entitled 'Future of derivatives processing and market infrastructure', which showed that, overall, compliance is being hampered by the lack of automation. Some firms still rely on faxes for some of their business communication and instruction.

It also expressed concerns that electronic messaging had not yet become the de facto standard for business communication in some areas of the derivatives market, particularly given the timing requirements for certain processes under new margining regulations.

HOLISTIC VEW

However, upgrading systems and procedures is not simply a matter of adapting middle or back-office functions for collateral management and margining to the front office.

"It requires a much more holistic view of collateral across asset classes, such as non-deliverable forwards, foreign exchange or OTC swaps," says John Southgate, regional head of derivatives and collateral product management at Northern Trust.

"They will also have to increasingly integrate liquidity management as part of the overall strategy. Many do not have the bandwidth or infrastructure to do it themselves so I expect to see an increase in outsourcing to third-party providers."

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