Scope for more efficient collateral movement

A panel of experts from BNP Paribas, BNY Mellon and Euroclear discuss the opportunities for collateral management, the availability of eligible collateral, and the impact of the sovereign debt crisis and looming regulation

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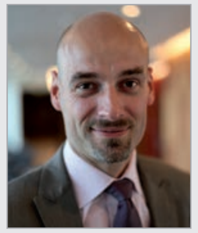
The Panel



David Béatrix is business developer of collateral management solutions for over-the-counter derivatives at **BNP Paribas Securities Services**. Prior to joining BNP Paribas, he was senior consultant at Altarys Consulting. He managed front-office and risk projects in investment banks and asset management companies. David began his career being responsible for the middle office at the International Finance and Development Company. He has a Maîtrise en Sciences Economiques (MBA equivalent) from Caen University.

Sam Jacob is managing director of global product management and strategy for **BNY Mellon**'s Global Collateral Services business. He was previously a management consultant with Ernst & Young, a strategy consultant with the Mitchell Madison Group, and financial solutions lead for IBM. Sam holds an MBA from the Kellogg School of Management at Northwestern University.

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Olivier de Schaetzen is director and head of global market products in **Euroclear**'s commercial division. He is responsible for the sale of equity and tri-party collateral management services, and syndicated loan services under the LoanReach brand. Olivier started in the commercial division in 1993, where he headed the client service group for London-based investment banks. In 1997, he transferred to network management, in charge of depository relationships in the UK, Benelux and Russian markets and, in 2002, he joined the relationship management team as a senior relationship manager. Olivier holds degrees in commercial engineering from Université Catholique de Louvain and a masters' degree from the Community of European Management Schools. He also participated in the JP Morgan Global Markets training programme in New York.

Sovereign downgrades will mean a shrinking supply of quality collateral

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Custody Risk: **What do you think the opportunities are at the moment for collateral management?**

Olivier de Schaetzen, Euroclear: As a tri-party collateral management agent, there are many opportunities arising from the migration of over-the-counter (OTC) derivatives into clearing. This development will substantially increase the amount of securities collateral to be managed by our clients. In fact, we see many similarities in collateral management trends for OTC derivatives to what we saw when repo trades began to clear through a central counterparty (CCP).

One opportunity for us is helping clients manage the complexity of multiple collateral locations and flows. In the new environment, there will be more CCPs receiving collateral, involving more clearing members acting as collateral custodians. The sourcing and management of collateral will become more difficult as demand rises across a larger number of stakeholders. As a tri-party agent, we are equipped to support all the stakeholders of this new clearing value chain.

The scale of collateral required – which will be immense according to the likes of the International Monetary Fund (IMF) – means highly scalable solutions are needed. Infrastructure service providers like Euroclear have the expertise, depth and proven safe environment to help. Market participants need the best possible asset protection for the collateral, and full traceability of the collateral they have allocated in order to be able to identify what it is, where it is and who holds it.

Sam Jacob, BNY Mellon: Clients also want efficiencies. Most of our clients operate on a global basis, which means they can start the day in the Asia-Pacific markets and then close up in the US, so we are supporting them in managing the collateral processes faster across time zones. Clients are looking for guidance, for example, asking how you 'move' collateral faster between the buy and the sell sides. We have platforms that can create such efficiencies.

Collateral management is rapidly moving to centre stage as a front-office function. This is tied to the profit-and-loss account you generate around your trading activity based on the availability and the types of collateral you have at your disposal. It is also tied to capital requirements from a balance-sheet perspective, and to the cost of the trade. The ability to manage collateral in the context of this new paradigm is the key to unlocking the emerging opportunities we see in the marketplace.

David Béatrix, BNP Paribas Securities Services: From a clearing perspective, there is a new playing field for banks willing to propose clearing services to clients that could not directly access the CCPs. There will be a new market entrant, which proposes a hybrid model between derivatives clearing and bilateral collateral relationship, but it is closer to derivatives clearing because credit risk assessment (from both sides' perspective, client and clearer) and the CCP nature of business, are quite pre-eminent.

There is also the third-party collateral management side. There is increased complexity driven by portfolios that comprise a wide range of OTC derivatives that are going to split into two streams: a stream where OTC derivatives are going to fall under collateral agreements, and a new path for the OTC derivatives eligible for CCPs. Acting as collateral manager, you will not only have one workflow under which all your OTC derivatives will be netted into a single agreement across each counterparty, but you will have OTC derivatives standing in front of (one or several) clearing brokers, and then OTC derivatives that are going to remain in front of their bilateral counterparties.

So, complexity is going to increase, which includes different settlement cycles. The more complexity, the greater the opportunity for banks and custodians to propose new models to their final clients.

Given the increase in the collateral requirements, there is going to be an increase in links to the initial margin requirements that are going to rise from the CCP business, and also to initiatives such as the one led by the Working Group on Margining Requirements (WGMR) calling for posting variation margin and independent amounts on bilateral trades. There is significant demand from clients relating to what services can be proposed around collateral transformation and collateral breakthrough.

Custody Risk: Can you provide a specific example of collateral movement?

Sam Jacob: Say we have a large margin call for a buy-side client and that client wants to deliver a piece of collateral that has a T+2 settlement cycle. Once we receive that piece of collateral, we can facilitate the pledging of that collateral without having to go through additional settlement cycles from the buy-side client to the dealer or futures commission merchant, and then on to the CCP. We do not have to wait for additional settlement cycles, so clients do not have to wait for additional settlement cycles to fund liquidity. It is much more efficient than physically moving the collateral across the various market participants.

Custody Risk: What collateral is going to be in the greatest demand, and will the costs of accessing this collateral increase?

Olivier de Schaetzen: We have seen an overall flight to quality in the collateral spectrum – in the securities financing business, repo business and securities lending business. The demand for quality collateral is increasing dramatically, and we are sure we will see more collateral being channelled to CCPs. And, by the nature of their systemic importance, they need to be very careful in terms of collateral profiling.

CCPs will limit the eligibility of collateral to the top end of the collateral curve, which will increase pressure on that segment. And there is a growing need for collateral givers that do not hold such assets to find solutions to upgrade the collateral they have in order to reach CCP eligibility levels to fund their activities. As a result, we foresee collateral transformations as being key for some firms.

Another aspect to acknowledge is the impact of the recent rating downgrades on sovereign bonds. Downgrades of previously top-quality collateral sovereign bonds are decreasing the size of the pool of eligible collateral, which typically satisfies the criteria for CCP-eligible collateral. So, on one hand, we see a growing demand for collateral and, on the other, a shrinking supply of the right collateral. You don't need to be an economist to understand that the cost of collateral will go up.

Custody Risk: Some people might call it a collateral crunch.

Olivier de Schaetzen: Given the growing need for collateral and the speed of downgrades, there is a risk that top-quality sovereign bonds will be scarce, so there will be a collateral crunch in that specific sector.

David Béatrix: It is going to be gradual because regulations are likely to make high-quality and liquid assets become quite scarce. The overall expected shortage of collateral is linked with European Market Infrastructure Regulation (Emir) and the Dodd-Frank Act, where a lot of collateral, and especially securities, is going to be required to meet those margin requirements and for which reuse is going to be limited, so circulation of collateral is decreasing.

The impact of Basel III, especially for derivatives, is likely to make assets less available because banks are going to be required to have more high-quality and liquid assets to meet the liquidity coverage ratio (LCR) and, therefore, it is also likely to reduce the scope and volume of collateral in circulation.

Custody Risk: What collateral do you think is going to become the best value for money or attract the most demand going forward?

David Béatrix: The government bonds from very highly rated countries are likely to be the most in demand. We have seen historically low yields on those bonds. It means the equation is quite difficult because, if you go away from government bonds, then risk and issuer risk on your collateral increases. And, if you move to cash, then you have asset protection issues. So the equation is difficult to read, but consensus is that government bond issues are going to be a sought-after area.

Custody Risk: How is it going be easier to get hold of eligible collateral?

Sam Jacob: CCPs accept different types of collateral and they are not harmonised across the board, so first we need to realise that not all of the institutions executing OTC trades have the exact type of collateral that is acceptable to every CCP. We are moving from sovereigns to corporates and we will stay within the realm of some corporates that will be utilised in the clearing world. This alternative collateral market will start to take off as more trades move into the cleared space. I believe we are going to see more high-grade collateral, like corporate bonds and other fixed-income instruments, becoming eligible for long utilisation.

Olivier de Schaetzen: There is a need to find ways of accessing the right supply of eligible collateral, for example, highly rated government bonds. We see many firms already trying to tap new sources of collateral in that segment. Finding institutions holding these assets – such as pension funds, sovereign wealth funds or central banks – and engaging them to enter into collateral swap agreements will enable firms to swap the collateral they have for CCP-eligible collateral. Such collateral transformations will increase in the future.

There is a lot of dialogue now about tapping into new pools of collateral. Because demand will increase, there will be increased opportunities for holders of quality collateral to earn attractive fees when swapping collateral.

David Béatrix: There is the need for greater flexibility in the collateral eligibility matrix. Swapping collateral against other collateral implies that, if you want to make an upgrade transaction, you have got something that is a bit lower grade. If you look at the recent long-term refinancing operation, the European Central Bank has released some of the constraints on the rating criteria of some asset-backed securities transactions. That is not proof, but there is a trend appearing that, given the scarcity of high-grade assets, the eligibility matrix will need to be released at some stage.

Custody Risk: Will the more people you bring into the process – more pension funds and sovereign wealth funds – mean there is going to be more risk in the system?

Olivier de Schaetzen: Obtaining access to high-quality collateral will have a price. The price is the remuneration for downgrading the quality of the collateral giver's overall holdings. It will always be a question of risk/reward. It is true that the holders of government bonds are buying them for their safety, so they are not going to enter into swap transactions where they are massively downgrading their overall holdings. So, collateral transformations with a given counterparty will be limited.

On the other side, we could imagine a CCP to marginally – and only marginally – relax its collateral eligibility criteria. As we have seen so many downgrades from some agencies of major countries, CCPs will need to consider whether their collateral criteria of accepting just AAA and even AA+ rated bonds can be amended to take a limited portion of collateral issued by countries that have recently been downgraded to AA.

David Béatrix: If you don't increase the number of high-quality and liquid assets in circulation, you will still have to loosen eligibility rules. And then you have got side effects that are becoming more prominent – you have more volatile collateral, liquidity of collateral and more frequent valuation issues.

Operational risk and risk around collateral management is likely to increase with the amount of collateral that is increasing. On one hand, you have the regulators and the IMF, which recommend CCPs should allow for a broad range of collateral and, on the other, the volume of assets available as collateral is not increasing as quickly as collateral is required.

Sam Jacob: Not necessarily and, from an operational perspective, we're not doing anything out of the norms of how we operate today. If a client is holding a particular type of asset and wants to convert it, then there are several mechanisms we can provide to help clients to achieve this. But, from a collateral management perspective, we do not direct clients specifically to which collateral they need to be holding or which mechanism to choose. The eligibility requirements will be established via negotiation with the clearing houses. So the CCPs will determine which type of collateral is required for eligible trades, while the dealers – based on their risk management guidelines and regulations – will determine the type of collateral they will take for non-cleared trades. As it relates to the position that the clients are holding, you either have it or you don't.

Custody Risk: What is Euroclear trying to do differently?

Olivier de Schaetzen: We are positioning ourselves as an open infrastructure provider. We want to offer the market a robust and scalable infrastructure to which securities service providers can channel their clients' business in a safe and tested environment. We are developing our collateral management platform into a 'Collateral Highway' to extend our scope of collateral sourcing to cover securities finance, derivatives, CCP margins and central bank liquidity, among other segments.

Custody Risk: And are you trying to get the central banks heavily involved?

Olivier de Schaetzen: It is a key strategy for us to leverage the long-standing relationships we have with central banks as custodians of their fixed-income assets to collateralise their open market operations – in Europe, the US and other countries as well. Central banks are key because they are the last link in the collateral chain, as are the CCPs. They are key to the Collateral Highway because they are the end of collateral flows.

This is why we are trying to expand our activities with those entities. We have been doing collateral management for major CCPs in Europe for many years, but that has been to support broker-dealers in their

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repo clearing business or their swaps clearing business. In the future, even more flows will come through the CCPs, involving the buy side and custodians.

Custody Risk: Which upcoming regulation is the most significant in terms of suppressing the supply or putting pressure on the demand of collateral?

Sam Jacob: They are all tied to each other; it is not one issue alone. A combination of regulations – from Dodd-Frank, Emir, Ucits and Basel III to the Alternative Investment Fund Managers directive – are driving this increased demand for collateral.

Olivier de Schaetzen: Basel III's liquidity regime, particularly the introduction of the LCR for banks, means that the need to hold liquid assets will be significant. However, all the new regulations are going in the same direction and pushing for more collateralisation. Emir and

Dodd-Frank will impact our clients in a different context, which means they will be looking for collateral management solutions beyond the conventional securities financing business.

David Béatrix: Dodd-Frank and Emir require collateral to be exchanged by their own because of the clearing requirements on a bilateral basis, through what Emir calls risk mitigation techniques for non-cleared trades.

The initiative of the WGMR for non-cleared trades asks whether bilateral independent amounts should be exchanged between parties on a bilateral trade, so these are very direct effects. Basel III will make unsecured transactions much more costly for the parties engaging in OTC derivatives transactions, especially due to the credit valuation adjustment (CVA), which worries participants about how much it is going to cost for unsecured transactions and whether they have to collateralise. In addition, there is a funding issue on unsecured relationships or entities that are in one-way a collateral agreement, where you have a distortion between what the dealer has to pay for collateral on the hedging transactions and what he really receives from its clients.

There are side effects, but the market is moving towards collateralisation even for those that are not collateralised yet. On the corporate side, many people are looking at the European Parliament to find out whether the corporates are going to be exempt from the CVA obligation, because one of their main worries is how much their OTC transactions are going to cost in the near future.

Custody Risk: **Can you give guidance around the risks involved, such as pro-cyclical margin?**

Sam Jacob: At the start of these transactions, we are seeing a lot of questions specific to risk. These include questions around where the assets are being held, how you are diversifying, who is holding the collateral and what happens in the case of default. There is a huge demand across market participants for an independent or neutral third party to provide these types of collateral management services. And then there is venue selection: given the different collateral impacts of one market versus another, what is the ultimate impact going to be? Providing these services can help enable clients to more effectively manage risks in their portfolio.

Custody Risk: **How are you making it easier for market participants to access and move collateral?**

Sam Jacob: The key is greater flexibility. There is going to be an increase in the cost and in the demand for high-grade collateral, but to what level will depend on how much the market ultimately takes off. If the market takes off and the requirements are up in the trillions of dollars, then you are going to see an increase in demand and a subsequent shortage of collateral in the market. But, if those numbers are not as high, then this will be less of an issue. If there is a shortfall, then obviously the costs will rise. However, several efficiencies around the management of collateral can be provided to market participants to allow them to access and manage their collateral process in a cost-effective manner, while also supporting their needs around essential services such as segregation and optimisation.

Olivier de Schaetzen: The mandatory clearing of OTC derivatives trades will create a new clearing value chain. Buy-side clients will have to mobilise securities as collateral for their derivatives transactions to be cleared through a CCP. There will be a need to identify and transfer the right collateral, with the support of their custodian and clearing member counterparty, to the CCP.

We can use the existing infrastructure we already have in place for securities financing purposes to meet these new demands. Our collateral reuse facility will be particularly helpful to clearing members, who will be sourcing collateral from the buy-side customer through its custodian for reuse with the CCP. And, we have the technology to ensure full segregation of collateral flows and full traceability of securities for all parties. From dashboards, they can identify which piece of collateral belongs to which counterparty and for which transaction.

It is important to be able to trace and segregate assets in a safe environment for asset protection. We have all the components needed for this new clearing value chain. We will leverage our existing and proven collateral management infrastructure and develop it for derivatives clearing.

Custody Risk: **And would a move to same-day settlement help? Is this going to happen?**

Sam Jacob: We would ideally like the markets to move to same-day settlement but, given that there are many different infrastructures across the globe, we are not convinced we are going to get there in the short term. But same-day settlement would be a very good thing for the market in the long term.

David Béatrix: The move to same-day settlement would facilitate the process, but there are technical difficulties. Most custodians are capable of internally making collateral transfers on the book-to-book basis because that is the concept of the Collateral Highway. If the market infrastructure is moving towards a same-day settlement, that would facilitate the transfers of securities between institutions.

Olivier de Schaetzen: Same-day settlement is not an easy job in practice. The devil is in the details, especially with so much collateral fragmentation, particularly in Europe. You need the right pipes everywhere to ensure that securities collateral can move as easily as cash.

Custody Risk: **Will we see a return to unsecured lending in money markets?**

David Béatrix: Probably not. Given the financial crisis and the environment, which implies that risk managers are constantly looking at credit risk, it is not what will happen. It is not going to be the major trend even if collateral becomes scarce, so we may be even more in a position to see a larger eligibility rule in terms of collateral rather than going straight to unsecured lending on the market.

Olivier de Schaetzen: The only unsecured lending we may still see will be on the very short end of the curve, such as overnight. Beyond that, lending will almost always be secured. That is the trend we have observed over the last four years – a migration away from the unsecured to the secured, which is increasing the reverse repo market. Many money market funds, for example, are moving away from outright investment to reverse repo investment, and a large number of corporates are looking to take away banking deposit risk from their treasuries with reverse repo transactions to secure their money.