Collateral makes the world go round

As Europe progresses on the journey that began in Pittsburgh in 2009, it is arriving at an interesting regulatory crossroads. The impact of this wave of new regulation – and the implementation thereof – is creating a rather more fragmented market, something that Clearstream's James Cherry is keen to change

The Group of 20 (G-20) Summit in Pittsburgh in 2009 agreed a set of common goals aimed at reducing risk and improving transparency within global financial markets. However, as the old adage goes, there is more than one way to skin a cat. In relation to the world of over-the-counter (OTC) derivatives, differences in implementation (of the G-20 pledge) by local regulators under the European Market Infrastructure Regulation (Emir) and Dodd-Frank Act have, in practice, been translated into a more fragmented global market. In addition to creating opportunities for regulatory arbitrage, an increase in cost is common across both regimes. The implementation of new rules has meant that firms are increasingly hamstrung by everything – from the cost of capital to the drag of the cost of infrastructure and IT investment.

The result is a greater focus on risk management practices. New regulation requires more margin to be collected for cleared and uncleared derivatives, and collateral management has been pushed to the top of the financial industry's agenda. In general, market participants will have to manage their collateral more effectively. This is not an easy task when global inventory could be spread over multiple locations or locked in siloed jurisdictions.

Choose your collateral management provider carefully

Collateral management service providers – custodians, banks, brokers, etc. – come in a variety of shapes and sizes. However, since the onset of the financial crisis, many organisations are actively seeking to reduce their exposure to specific financial counterparts and are increasingly looking to neutral agents such as like central securities depositories (CSDs) and international CSDs to provide collateral and risk management. A 'one-stop shop' outsourced service provider, such as Clearstream's Global Liquidity Hub, can achieve centralisation of workflows across products and obligations (central clearing counterparty, bilateral, tri-party, central bank liquidity) and a reduction in fragmentation enables a more efficient use of global inventory. Further partnership with the service provider can enable access to funding and collateral transformation services such as tri-party repo and securities lending to further enhance and monetise the collateral function.

A single master agreement for initial margining?

New requirements for non-cleared initial margining also create a considerable legal and documentation challenge. Unless a harmonised industry approach can be adopted, a large percentage of International Swaps and Derivatives Association Master Agreements will have to be renegotiated during the course of 2015 and 2016, as indicated by the recently published Basel Committee on Banking Supervision and International Organization of Securities Commissions report.[1] Bilateral renegotiation of Credit Support Annex/Credit Support Deeds to accommodate the European Securities and Markets Authority's Regulatory Technical Standards will be legally and operationally burdensome when considering the thousands of contracts impacted. There could, however, be a credible alternate solution if the derivatives industry were to take inspiration from the tri-party repo market. Here we have seen the introduction of innovative multilateral documents that allow a customer to sign a single standardised document once, in turn allowing trading with all other entities that have also signed up to the agreement. This would offer a significant decrease in time and cost and allow valuable resources to be redeployed to other pressing tasks.

Dealing with increasing regulatory complexity

Further regulations will follow in addition to Emir, leaving the market in a state of flux for the foreseeable future. With the implementation of Capital Requirements Directive IV, banks' exposures to clearing houses will lose the 'zero-risk weighting' they currently enjoy. The resulting capital that must be set aside comes with significant additional cost and strain on balance sheets for the banks. Moreover, there will undoubtedly be increased costs for the non-cleared world as well. It is important to consider that this additional capital requirement will result in a significant decrease in liquidity. What this could translate into for some is that cost becomes a significant enough disincentive to appropriately hedge market risk. Unlocking pools of liquidity by connecting to or partnering with market infrastructure, enabling firms to leverage their mutual strengths in favour of common goals, will be key to survival. There is a phrase that has been quoted often at recent industry events: "collateral makes the world go round, but it doesn't go round the world". We're aiming to change that view. The market will be forced to evolve to ensure that regulation, however well intentioned, does not inadvertently have a counterproductive effect through decreased liquidity and increased market risk.

James Cherry

James Cherry is a global securities financing sales and relationship manager for the UK, Ireland and Americas at Clearstream. Based in London, his focus is primarily on OTC derivative solutions for clients domiciled in the UK, Ireland and the Americas, as well as repo, securities lending and collateral management. Prior to this, James spent five years at the Royal Bank of Scotland, working in securities finance collateral management and for the flow rates trading business of the markets and international banking division, as well as two years with Citigroup in equity prime brokerage. James holds a BA (hons) in history from the University of the West of England, Bristol, as well as various project management and finance qualifications from APMG-International and the Chartered Institute for Securities & Investment.

[1] *March 2015 http://www.bis.org/bcbs/publ/d317.htm*