

Countering risk through collateral management



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Risk: Where are financial institutions currently focusing their risk management efforts?

Paul Elflain: We are currently seeing all financial institutions undertaking a rigorous assessment of all their risks in business, including market, counterparty, credit, liquidity, legal and operational risk. Valuation risks associated with structured product and non-vanilla over-the-counter (OTC) derivatives are clearly going to be a big focus from here on, but we are also seeing firms placing immense focus on the reduction of counterparty risk. High-profile credit failures, such as that of Lehman Brothers and the economy of Iceland, coupled with the complexity of OTC instruments has meant that counterparty risk has become a daily concern for market participants.

Risk: How can counterparty risk be mitigated?

PE: The bilateral nature of the OTC markets, combined with the lack of a central counterparty, means that counterparty credit risk has become a significant focus for market participants in this space. In order to mitigate this risk, a growing proportion of OTC derivative transactions are collateralised. The International Swaps and Derivatives Association's most recent figures estimate that \$2.1 trillion of collateral, consisting mainly of cash and government securities, was placed as security across 149,000 collateral agreements at the end of 2007. In addition to this, it has been reported that the coverage ratio has increased significantly to 63%, over double the figure for 2003. Additionally, from our conversations with collateral practitioners, we hear of day-to-day operational activities required to manage open transactions in the millions, and executed agreements in the tens of thousands.

Managing this amount of exposure and mitigating collateral poses a massive operational challenge, to which the industry is responding through increasing the automation of processes such as collating data, calculating margin requirements, reconciling collateral positions, making margins calls and moving collateral between counterparties.

We also expect that, as more financial products become eligible for centralised clearing, there will be an increased focus on developing interfaces and how these interact with the risk management systems of central counterparties.

Risk: Are current collateralisation practices adequately reducing counterparty risk?

PE: There are two sides to the practice of collateralisation: one is the structural, legal and increasingly regulatory framework that

is commonly employed, such as the Master Agreements, Credit Support Annexes, and the national and supranational statutes. The other aspect of collateralisation is the operational management and processing that needs to happen to effect the frameworks that are in place.

Regarding the frameworks, we are noting more and more interest in the market to simplify and harmonise the structures, firstly to remove the 'nuisance' and 'noise' that some of the calculation parameters create, but also to explore valuation techniques, such as value-at-risk, that perhaps more fairly and keenly measure likely credit risks.

However, on a day-to-day basis, effective collateral management is predominantly an 'operational risk' management exercise. It is a highly procedural activity involving the simultaneous handling of a large number of interactions, both electronic and human, with many parts of a firm's business, their counterparties, their third parties, external systems and external sources of data – therefore, the more automated the collateralisation process is, the more effective it is in reducing counterparty risk. Automating and streamlining collateral management activities enables firms to focus on exceptions, therefore freeing up tremendous resources, while minimising risk.

Risk: What else can be done to improve the collateral management process?

PE: Automating and streamlining data collation, portfolio allocation and reconciliation, as well as improving processes such as the handling of collateral liquidity, can all help in improving collateralisation. In particular, the growth of the derivatives market has resulted in many counterparties having a large number of outstanding trades with one another. Automating the position reconciliation process can significantly reduce outstanding trades between counterparties and therefore the number of disputes that arise.

These can be viewed generally as internal opportunities for improvement, and are likely to be bespoke for each and every collateralising party. However, on the horizon lies an opportunity that requires a quantum leap on an industry and vendor-wide basis. This concerns the introduction of harmonised, open messaging and communications between collateralising parties to mitigate some of the most hidden, transferred risks lurking within collateral management.

Collateral management is all about converting intangible credit risks into tangible risk mitigants and so long as email and 'phone are predominant means of communication, there is considerable weakness and great potential for failure in, what should be, an end-to-end automated process. With this in mind, we are working with our customers and the market to develop these sorts of features in our offerings for collateral and margin management.

Mitigating counterparty risk was recently named as one of the top operational priorities for financial institutions. Efficient collateral management is an effective route to achieving this. Omgeo will be hosting a free breakfast seminar in London on April 2 and an online webinar on April 7 where you can receive useful insight into how automation of collateral management and position reconciliation can help to reduce counterparty risk. To register visit www.omgeo.com/collateral