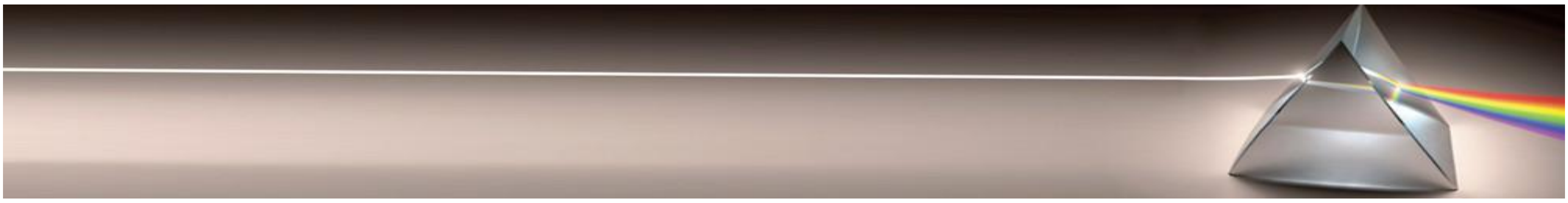

Viewing collateral management through a new lens

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“As transactions will increasingly need to be collateralised to mitigate credit risk, implementing the best possible collateral management strategy maximising the use of eligible assets will be imperative for both buy-side and sell-side.”

Abstract:

In a low-interest rate environment, where liquidity is abundant and funding is cheap, some may question whether efficient collateral management is a priority concern. If you think this is the case, we invite you to read a SGSS thought-leadership piece. There are already signs that interest rates will rise, liquidity conditions will tighten and it is important that you are prepared for the challenges ahead …

Viewing collateral management through a new lens

It is a time for asset managers and financial institutions to make some bold decisions as they adapt their collateral and liquidity management functions to support the future growth of their global investment activities.

The combined effects of the European Market Infrastructure Regulation (EMIR), Dodd Frank Act (DFA), Basel III and the Markets in Financial Instruments Directive (MiFID) are changing the landscape of financial markets, prompting participants to adapt their strategies. Economic studies estimate that demand for high-grade collateral may rise by between US$4 trillion and US$11 trillion (Basel Committee on Banking Standards, Bank of England & ISCO-CFTC) during the next two years, principally as a result of Basel III capital requirements and margining requirements for OTC derivatives cleared via central counterparties (see below). Coping with these new requirements will create a need for firms to enhance their processing capabilities, to manage the associated costs and to refine their funding strategies.

Critical Timing

According to the EMIR timeline, mandatory clearing for OTC derivatives in Europe will be implemented by mid-2016 for clearing members (category 1), end of 2016 for category 2 counterparties, mid-2017 for category 3 and mid-2019 for category 4. For bilateral OTC derivatives transactions, collateralisation (through posting initial margin and variation margin) will be required from September 2016. The strain thereby imposed on pools of eligible assets will start to increase in 2016.

In current economic conditions, it may seem logical to employ cash collateral to meet a major share of collateralisation needs. Interest rates are low across many EU markets and funding costs are near their historical minimum, amplified by sizeable asset purchase programmes from the European Central Bank, the US Federal Reserve, and the Bank of England in response to the 2008 global financial crisis and the more recent Eurozone crisis. As an example, in March 2015 the European Central Bank purchased €60bn of highly-rated securities through its asset purchase programme and it expects to repurchase €1140bn in securities between March 2015 and September 2016.

Significantly, many securities that are likely to be eligible for collateralisation are otherwise engaged, stored by participants in an effort to comply with the Basel III Liquidity Coverage Ratio and Net Stable Funding Ratio requirements. Even though the Basel Committee on Banking Standards has recently broadened the category of eligible assets that can be accepted, these ratios are draining a sizable amount of the pool of available high quality assets. There appears to be an immediate and easy answer to address these issues: choosing cash. Indeed, ISDA estimates in its 2014 Margin Survey that approximately 75% of collateralised exposures are currently met through use of cash collateral, 15% through Government securities and 10% through other securities such as corporate bonds and equities.

Yet, we need to look at the bigger picture. The truth is, these low interest rates and cheap funding environment will not continue indefinitely. There are already market signals demonstrating that investors are anticipating a rise in interest rates in coming months. Furthermore, firms will need to think carefully about how they meet their collateral commitments – negative rates may be applied to credit cash balances held at CCPs and there may also be a significant spread (e.g. EONIA minus 35bps for EUR credit cash balances, London Deposit Rates applied at LCH.Clearnet). Also, there is an 8% haircut on cash if the currency differs from the derivatives obligation for bilateral margining, which is much higher than the haircut applied to high-quality government bonds.

Where the opportunity lies

In these circumstances, firms that can allocate collateral efficiently from their global pool of cash and securities will be well positioned to make competitive gains. This demands that the firm can establish a global view of its collateral holdings across business lines and geographical markets in which it is active. In collateralising its exposures, it must be able to identify the asset that is cheapest to deliver in each specific context, taking into account all the allocation constraints (eligibility criteria, haircuts, concentration ratios, wrong way risk, allocation preferences, and economic factors) that might apply. Then it must identify the best funding sequence to cover each margin requirement – thereby selecting the funding sequence with the lowest opportunity cost.

Needless to say, this is a complex process. Some asset managers may have the skills and resources to do this internally. But many will benefit from outsourcing to a specialist collateral management agent that focuses on this area as its core skill. Collateral eligibility parameters and level of "haircuts" will vary, depending on the destination of the assets – and identifying the ideal funding sequence can be complicated when multiple counterparties are involved. Alongside this, we must factor in the costs of collateral settlement, which may have significant effect on the overall cost of collateralisation. These settlement costs can be controlled, with the help of your outsourcing provider, through utilising an integrated post-trade service that combines collateral management and custody services.

With the increased number of margin calls that EMIR will generate, both for centrally-cleared and bilateral OTC derivative transactions, the operational cost of collateral will rise substantially. Many firms need to sharpen up their valuations, collateral management and operations environment to manage margin calls on a near to real-time basis. Timeliness and accuracy are essential here and it is important to have an effective operational infrastructure in place to ensure this is done correctly. There is also significant regulatory and compliance cost as more checks and oversight are introduced along the transaction lifecycle (reconciliation frequency, dispute reporting, dispute duration follow-up, escalation process…).

If you get these things wrong, the impact can be damaging – exposing a firm to residual risks (credit, liquidity, compliance and reputational risks) as well as limiting its ability to optimise return on its assets. However, a firm may also be able to realise significant cost savings through efficient collateral administration, collateral optimisation and collateral transformation. The collateral administration function involves managing movement and settlement of collateral in order to cover outstanding exposures. Collateral optimisation involves mobilising collateral that may be sitting in fragmented pools and ensuring this is allocated most efficiently in line with collateral eligibility parameters specified by collateral receivers. In cases where a firm does not have collateral of required quality in its portfolio to meet a specific requirement, collateral transformation services (often a collateral upgrade) may be required in order to meet this specific need.

Additionally, firms must engage in detailed forward planning, preparing for how they would meet their collateral and liquidity requirements under stress conditions. By running detailed stress tests and scenario analysis, a well-qualified collateral management agent can deliver significant value to the client through helping them to plan how they would meet their funding and collateralisation needs in crisis conditions.

Efficient collateral management is an industrial process that relies on building economies of scale. Few asset management companies have the necessary critical mass to warrant developing their own in-house capability. Though some large asset management houses may choose to support the necessary collateral management expertise in house, for many smaller and mid-tier fund houses it makes sense to outsource this task to a collateral management specialist.“We believe that the time when asset management companies elect to handle the full processing chain themselves are now gone,” says Clément Phelipeau, Product manager, Derivatives and Collateral Management Services, at Societe Generale. “Just as most fund managers have already taken the decision to outsource their fund accounting and fund administration duties to a specialist external provider, now in times ahead we can expect most fund managers to utilise a specialist provider of collateral agency services to handle their collateralisation requirements and to manage related operational commitments.”

Collateral management outsourcing solution

In helping clients to manage this complex collateral management environment, Societe Generale launched a collateral management outsourcing solution in April 2015. Named *“Tempo”*, this collateral agency service provides support to clients across a full range of asset classes and across the full range of their collateralised exposures, including derivatives trading (both listed and OTC), securities lending and borrowing and repo transactions. “Tempo” is part of Societe Generale’s global offering for derivatives, “Orchestra” and is a unique combination of Societe Generale’s multi-asset collateral management expertise helping clients to make the most of their assets in the years ahead.

For Phelipeau, this new solution allows clients to benefit from a single centralised collateral management service across the entire value chain, from central margining and asset pool management to asset allocation and optimisation, thereby reducing operating and funding costs, alleviating complexity, and increasing their overall performance through an efficient post-trade strategy.