SHIFTS IN COLLATERAL MANAGEMENT

IN THE FACE OF REGULATORY CHANGE, RENEWED FOCUS ON COLLATERAL MANAGEMENT COULD BRING EFFICIENCIES ALONG WITH RISK AND COST REDUCTION, ARGUES KARL WYBORN

For corporate treasury functions using and managing collateral, the next 12 to 18 months will bring significant changes in the regulatory environment, with new regulation driving, directly and indirectly, considerable change to conventional business models.

In this, the first of two articles on the role of collateral in corporate treasury, I will look at the nature of the changes impacting the market now and over that 12- to 18-month time frame, and comment on how innovation is bridging the gap between the new and old operating paradigms.

For some time now, where collateral is concerned, market commentators (and scaremongers) have been commenting on the timing and impact of forthcoming regulatory changes and how they will affect treasury management. Despite all the negative forecasts it seems, with few exceptions for corporate treasurers at least, that management of collateral has remained broadly unchanged during this period. In fact, I'd argue that, despite delays, the status quo will be challenged over the next 12 to 18 months. What is more, from a corporate treasurer perspective, by leveraging advancements being made in the field of collateral management, it is possible to materially reduce cost and risk and, at the same time, increase efficiency without major investment in new technology or material disruption to the overall strategic direction of the business.

To better evaluate the significance of the changes that are taking place, first let us understand and assess the role of collateral where it is used to support financial markets activity.

In short, collateral is an exchange of risk. Users of collateral are replacing counterparty credit exposure with a series of other risks associated with the management of the collateral itself. The concept being that these new risks, which are operational, legal and liquidity related in nature, can be directly managed where credit exposure cannot. Until recent times, this pact has been relatively straightforward to manage for most corporate treasury functions. The benefits have been material – where the values of collateral have remained quite modest, where available liquidity has not caused undue concern and where the operational processes associated with

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Definitions explained

Variation margin – the mark-to-market difference on a portfolio.

Initial margin – the sum of money that could conceivably be lost over a defined period, post a default. The period is defined by regulation and differs by instrument from one to 20 days or more. Critically, it is a forecast rather than a function of currently observable market values. The calculation of this forecast and the agreement with a counterparty (where their forecast may differ) is a material challenge for those market participants captured by these regulations.

The **liquidity coverage ratio** refers to highly liquid assets held by financial institutions in order to meet short-term obligations. It is designed to ensure that financial institutions have the necessary assets on hand to ride out short-term liquidity disruptions.

SOURCE: INVESTOPEDIA

the exchange of margin have been straightforward.

Shifting sands

The changes impacting collateral management as it relates to a corporate treasury can be divided between first-order and second-order effects (with ironically the second-order effects being, currently, at least, more apparent) and between cleared and non-cleared instruments, ie repo or non-cleared OTC derivatives and futures and options, and cleared OTC derivatives.

Let us primarily consider first-order versus second-order effects. First-order effects relate directly to those changes that the regulators, globally, are looking to implement to make markets safer. These range from the mandate to clear all vanilla OTC derivatives to the mandatory exchange of variation margin on OTC derivatives and the requirement (for the largest users of swaps) to exchange initial margin bilaterally.

From a corporate treasury perspective, the impact of these changes will be correlated to the instruments traded along with the scale of that activity. For a vast majority it is likely, in the near term at least, to involve a higher frequency of margin calls for non-cleared transactions (perhaps from zero) and the appointment of one or more OTC derivatives clearing brokers.[1] Both requirements (or indeed each individually) will lead to higher values of collateral being demanded.

It is the second-order effects of the new regulations, however, that are causing the nearer-term challenges. Much has been written about the zero (or lower) interest rates and quantitative easing that have defined central bank policy for many years now. No let-up is forecast for some time to come. The response from a number of treasury functions has been to use repos as a means of securing (albeit still modest) enhanced returns as an alternative to bank deposits or money market funds. Repos clearly involve some element of collateral. Again, dependent upon size, the ongoing margining of 'in-flight' repos is becoming more commonplace among treasurers who are keen to avoid the credit risks that are created through mark-to-market of collateral.

In addition to the above, those users of futures and options (and, in the future, cleared OTC transactions) are subject to some rather ugly second-order impacts created by the new capital rules impacting clearing brokers. In short, where cash is used as collateral, a clearing broker incurs far higher costs under Basel III (as a result of the liquidity coverage ratio).

Many treasurers have already witnessed the response from these same clearing brokers, which is to encourage the use of securities as margin wherever possible and discourage the use of cash buffers, historically used to avoid the operational headaches of moving margin every day. This is, of course, in tandem with many clearing brokers raising minimum fees and trimming their client bases to only those institutions that pay the higher fees. Notwithstanding the obvious challenges that increased fees and reduced access to clearing brokers represents, the use of securities as collateral, while delivering a desirable benefit, represents a meaningful operational challenge for many treasury units.

In line with the comments above, while these second-order effects are perhaps more apparent now, the new regulations driving the first-order changes will be implemented over the next 18 months or so, and hence will serve to compound the challenges that some corporate treasury functions face as they go about their core business.

In a nutshell

So, regulators' responses to the global financial crisis have had the effect of making the use of collateral far more commonplace than was historically the case. This expansion in the use of collateral brings with it an increase in cost and risk. Where, in turn, these increases negatively impact the exchange of risk pay-off that collateral represents, a solution is required to redress the balance. Where there is no solution, there is the (well-documented) possibility that the use of collateral starts to increase the overall risks that any given institution faces.

Needs must when the devil drives

In broad terms, where we might categorise this expansion of the use of collateral as a challenge, the various industry responses to the new financial 'landscape' could (or perhaps should) be considered an opportunity. As is often the case, innovation is at the heart of the more exciting advancements that are being made.

Very broadly speaking, it is possible to divide these advancements between new technologies and new infrastructures, with both terms being used in their widest possible sense. Whether technology or infrastructure, however, the objective remains the same: that is to support/facilitate the ongoing market activity in light of the new operating models created by the new regulation.

Whether any given corporate treasury function can simply continue on a business as usual basis is broadly a function of the nature or scale of its specific trading activity, ie whether its trading activity has a focus on non-financial counterparties with a positive or negative trading threshold.

In a second article, we will evaluate what options are available now to help redress the balance between the risk versus reward and the risk versus cost dynamics of the use of collateral, and what might act as a trigger for their adoption. It will argue that by leveraging some of the new solutions available, the corporate treasury function can reduce risk and cost without material disruption to other activities.

1 Whether this relates to whether the institution is an NFC- or an NFC+. For more information, refer to www.esma.europa.eu. The reality is, however, irrespective of whether an institution is captured by the regulations – they are not immune from the impact. Banks will charge more for uncollateralised transactions for a host of reasons.

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