Moving with the times

Olivier Grimonpont Global Head of Collateral Management and Securities Lending at Euroclear argues that innovative approaches to collateral management are needed to help the buy-side implement new margining rules in the OTC derivatives space.

Lessons from Wave 1

Regulatory changes are re-shaping market practice in a fundamental way, requiring participants to adapt quickly to new circumstances and prompting demand for new services. Firms that fail to respond may pay the price in terms of missed opportunities, revenues or even clients.

It is clear, for example, from the approach of the large broker-dealers in the first wave of migration to Initial Margin (IM) rules, that use of triparty agents has been instrumental in achieving compliance with new regulations for non-cleared OTC derivatives. For any market participant to accurately and efficiently calculate, reconcile and exchange IM within the new T+1 window, many different post-trade processes must be completed in considerably shorter time frames and on a much larger scale, than has previously been market practice. Both at industry level and at the level of individual firms, much time and effort has been invested in the development and use of standardised processes and platforms to accelerate and smooth the IM exchange process. For example, use of AcadiaSoft as the de facto standard tool for market participants to agree on regulatory margin requirements.

Therefore it should be no surprise that all the U.S., Canadian and Japanese broker-dealers in last September's first wave, and the subsequent European wave in February, opted to outsource the last part of the IM workflow – the transfer of collateral assets and resulting collateral management processes – to triparty agents that have the global infrastructure to execute, oversee and report such transfers at scale and with the necessary speed. Indeed, this approach dovetails with developments in the growing cleared OTC derivatives market, where CCPs and large brokers have overhauled their operational infrastructure to accommodate new collateral requirements under Dodd-Frank and the European Market Infrastructure Regulation. For the initial wave of regulation, large-volume participants opted for third-party solutions rather than attempt to handle all elements in the transaction chain in-house. Their lead is one that the market is very likely to follow.

Falling in line

Buy-side firms, particularly those in the fourth and final wave of migration to the new rules might have less varied and/or frequent recourse to the OTC derivatives markets, and as such may expect to manage their more limited IM obligations on a bilateral basis. However, the decisions of the first and biggest movers may mean the die has already been cast. As the prime liquidity suppliers and product manufacturers in the OTC derivatives market, the first-wave broker-dealers as well as major CCPs may effectively be in a position to steer the terms of margining for the rest of the market – buy-side and sell-side – and may well penalise or decline to transact with firms that do not abide by the de facto IM process for reasons of operational risk and efficiency.

Following the lead of first-wave broker-dealers and CCPs, asset managers large and small may find it hard to resist requests from their sell-side counterparties to use the services of triparty agents. Outsourcing to a proven collateral management provider offers operational, cost and risk benefits when selecting collateral assets, handling settlement instructions and confirming that the exposure represented by the IM payment has been settled.

Dealing with a tricky situation

But while outsourcing collateral management is a sensible, if perhaps inevitable, response by asset managers to the need to exchange collateral assets quickly and smoothly, this creates challenges for asset owners and global custodians.

Global custodians are appointed by asset owners such as pension funds to safekeep those assets and provide various ancillary and value added services such as reporting and fiduciary responsibilities of a trustee. But when the asset managers that invest those assets also need to facilitate quick and ready access to the assets to post as collateral, exchanged as initial margin to support OTC derivatives transactions, complications and conflicts with their obligations as a custodian can arise.

Following the lead of first-wave broker-dealers and CCPs, asset managers large and small may have little choice but to adapt to market practice.

This is because provision of access to assets by the global custodian to a triparty agent can represent a loss of control over the assets, compromising the ability of the custodian to fulfill its core responsibilities to the asset owners. Under traditional arrangements, use of a triparty agent usually requires the custodian to open individual segregated accounts in the agent's book in order for the client assets to be available and selected for use as collateral.

A neutral solution

Under a new solution from Euroclear, custodians will be able to allow their own underlying clients to access triparty services as a receiver or giver of collateral without being forced to open individual segregated accounts. In our Collateral Portfolio model, custodians and trustees remain entirely in control of the chain – from asset allocation to settlement of the transaction. This is the custody and settlement agnostic model pushed to its extreme.

In effect, the global custodian gains a more granular access to our Collateral Highway infrastructure and is thus able to select and swap specific collateral via Euroclear's triparty programme – the responsibilities of which are strictly limited to the execution of operational requirements. These include: monitoring complex collateral schedules, transmission of settlement instructions to the trading counterparty, and fulfilling underlying reporting and administrative processes. This means that the custodian retains control of client assets in line with fiduciary responsibilities, but the asset manager is able to post collateral and meet IM obligations under the incoming new margining rules for OTC derivatives.

Preventing conflicts

The staggered introduction of the new margin requirements – both initial and variation – pose a lot of challenges for buy-side firms, which must reassess their collateral resources and reengineer their operational processes to ensure accurate oversight and efficient mobilisation of their assets. But the new rules – rolled out until 2020 – should not necessarily put them in conflict with the custodians charged with safekeeping the assets of end-investors. Similarly, custodians will facilitate the flexible approach to collateral mobilisation required by the emerging regulatory framework, but they should be able to continue to operate within their remit.

Even sell-side firms with a high level of sophistication will find that implementing the new margin requirements across (potentially thousands of) counterparties can only be economically viable and operationally sound if they can leverage the triparty infrastructure that they already use to exchange margin between themselves. With our Collateral Portfolio model, this will be possible irrespective of their counterparty's own custody arrangements.

Market infrastructure providers such as Euroclear have a responsibility to innovate in order to evolve new services that help market participants to adjust to new circumstances in a way that supports regulatory compliance as well as fulfilling their mandates. Change, as they say, is the only constant.

In our Collateral Portfolio model, custodians and trustees remain entirely in control of the chain, from asset allocation to settlement of the transaction.

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