Derivatives collateral management: A long and winding road for the buy-side

For buy-side users of OTC derivatives, the rubber really hit the road in 2017, in terms of getting to grips with new margin rules.

As of 21 December 2016, the application of European Market Infrastructure Regulation (EMIR) requirements introduced clearing obligations for the large European asset managers (Category 2) to start posting variable margin and initial margin for cleared OTC Derivatives transactions – initially liquid interest-rate swaps – at central counterparty clearing houses.

Mandatory compliance for Category 1 counterparties – typically global banks and brokers – already had taken place with the clearing obligation as from June 2016. Other clearing obligation deadlines will hit the other categories of firms until August 2019 (Category 4).

For the non-cleared OTC Derivatives, initial margin and variable margin requirements applied in Europe for the high-volume users as of 4 February 2017 – following the US, Canada and Japan who had to comply as of 1 September 2016.

In addition, on 1 March 2017, variable margin requirements started to apply for all counterparties not impacted by the initial February date. However, the rules introduced a staggered schedule for the implementation of initial margin equirements which means that some firms, mainly buy-side, need only to comply by 1 September 2020.

Buy-side taking stock of their options

Understandably, buy-side firms are still finding their feet, coordinating their front- and back-office processes, and developing the most cost-effective procedures for accessing and delivering collateral to support both cleared and non-cleared OTC Derivatives trades.

As reflected in a panel session on derivatives collateral management at the Euroclear Collateral Conference 2017, this effort also includes closer collaboration with key partners and suppliers, including clearing houses, custodians, brokers and technology vendors.

For many, the end-goal of these changes is a closer alignment of clearing and collateral management across cleared and non-cleared OTC Derivatives transactions. To achieve such harmonisation, however, firms are first looking to improve automation and standardisation of their workflows to handle the increased volume and frequency of margin calls.

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According to Christian Bohlke, Head of Investment Operations at Nordea Life and Pensions (NLP), large buy-side firms have already climbed a steep learning curve. Like many peers, NLP is seeking to develop a scalable, automated approach to meeting margin calls for both cleared and non-cleared trades. But their efforts are hampered by existing market practice for clearing and margining, which are not suited to buy-side business models.

"As long-only asset managers, we don't want to hold cash and nobody wants to hold our cash. It's not a big issue for us to over-collateralise our positions, but we do want to see broader collateral schedules and we want to post securities as collateral," Bohlke explained.

"Our business model is based on scalability, which means we're used to automation. From a collateral management perspective, we want solutions that deliver STP, rather than having to hire extra staff."

According to Bohlke, there is no consensus yet on the treatment of OTC Derivatives trades that lie outside the clearing obligation framed by EMIR, meaning that buy-side firms are asked by counterparts whether they wish to clear centrally or not.

The non-cleared route is evidently attractive to firms keen to use their securities inventory for margin purposes, but Bohlke would like to deploy these assets in the cleared space too. As such, he called not only for wider eligibility criteria from clearing houses, but also a shift from transfer of the beneficial ownership of collateral assets to pledge structures.

How clearing houses are helping out

Tina Hasenpusch, Global Head of Clearing House Operations at CME Group, noted that whereas clearing houses are already accepting a wide range of collateral and are constantly looking to extend their range of eligible collateral, their ability to do so was ultimately limited by the need to only ever hold highly liquid resources.

The guidelines for margin payments between counterparties to non-cleared OTC derivatives permit a wide range of collateral, but clearing houses, unlike banks, typically cannot accept the liquidity risk associated to an equally wide range.

"To comply with the Principles for Financial Market Infrastructures (PFMI), CCPs can only accept non-cash collateral that is highly liquid. CCPs will never be able to accept the same range of assets that a buy-side firm can include on its collateral schedule with a sell-side counterparty that is willing to price risks bilaterally. But we can partner with firms that offer collateral transformation to bridge the gap between what the client wants and what we can offer," she said.

On the matter of title transfer versus pledge, Hasenpusch noted that CME Group is in the process of developing a direct funding participant model which allows entities that have historically accessed the cleared derivatives markets as clients to have full control and visibility into the posting of collateral for initial margin and the payments of cash for variable margin to the CME clearing house.

Bruce Kellaway, Global Head of Repoclear, Equityclear and Collateral at LCH, said his firm also enabled end-users to retain ownership of their assets, adding: "There is a wider debate on how to bring end-users into direct clearing. Introducing models such as 'sponsored clearing' for our RepoClear service have significantly changed the clearing model and has facilitated a lot of change in a short period," he said.

Standardisation and new technology

To mobilise collateral cost-effectively, buy-side firms typically require new services from custodians, many of which are positioning themselves as collateral management providers.

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SVP, Investment Manager Services at State Street

According to Kyla LaPierre, SVP, Investment Manager Services at State Street, buy-side needs range from collateral transformation services, to legal and operation support. Reflecting Bohlke's concerns, LaPierre highlighted a need to improve STP rates in response to higher collateral transfer volumes, and there is a strong appetite for 'plug and play' utility-type tools that support standardised processes along the transaction chain.

This need for standardisation and automation of collateral management processes will only increase as smaller buy-side firms become subject to margin rules over the next two to three years, predicted Chris Walsh, CEO of AcadiaSoft, a workflow solutions vendor that has integrated evolving industry standards into its collateral management offering.

"As a result of the first two waves of firms complying with new margin rules, the industry has had to collaborate at a new level, concentrate on standardising its activities, and focus on automation," he said.

"In this way, tools like ours let firms communicate with all their margining counterparties, agreeing margin, moving and confirming collateral, in a single place. As the rules start taking effect across a broader swathe of firms, a more automated, standardised and controlled market will emerge."

The road ahead

But survey evidence taken during the panel session suggests there are many miles to be travelled before uniformly high levels of automation and standardisation are achieved.

An audience poll found that 39% of delegates considered their processes for financing collateral to be only 'somewhat automated', while 26% regarded them as 'very manual'.

A total of 41% of delegates said their collateral settlement processes were 'mostly automated', while 27% described them as 'somewhat automated'.

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As preferences and practices evolve, the automation and standardisation needed to handle more collateral movements is expected to erase remaining differences between the processes supporting cleared and non-cleared transactions.

According to the two clearing houses on the panel, this is already beginning to happen among large market participants, including the clearing of certain non-mandated, but highly standardised instruments.

CME Group's Hasenpusch said non-cleared margin requirements were encouraging firms to clear transactions that do not yet fall under the clearing obligation, as they step up efforts to optimise derivatives collateral management.

"Firms are moving into clearing not just for the multilateral netting opportunities or the reduced margin period of risk, but also for the portfolio offset capabilities. Our studies show it is possible to achieve up to 80% portfolio netting rates by combining a USD swaptions portfolio with a cleared USD rates portfolio," she said.

LCH's Kellaway acknowledged that some complex OTC Derivatives may never be suitable for clearing, but suggested that the non-cleared margin rules were prompting a reassessment of how participants process their trades. "We have seen an increase in demand for clearing of non-mandated products such as FX derivatives and inflation swaps. At the same time, customers who are not able to clear certain products are looking for efficient, non-cleared solutions that leverage the standardised documentation and workflow tools typically associated with clearing."

Whether this trend spreads widely to the buy-side may depend on how clearing houses and other service providers in the derivatives collateral space accommodate the evolving needs of Bohlke and his peers.

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