Conquering the Cost Conundrum

Current changes in the financial industry are proving to be costly for market participants. For example, the push by regulators for more centralised clearing of OTC derivatives means that portfolios will have to be split between cleared and un-cleared derivatives. Margining for OTC markets is also becoming increasingly complex and the management of assets delivered to cover these exposures are another source of cost. Knowledge that the cost of trading could increase further still has prompted many to re-asses their stance. Many are turning to market infrastructures with sophisticated triparty collateral management solutions such as Clearstream's Global Liquidity Hub for a one-stop-shop solution to meet this multitude of challenges in an efficient and cost-saving manner.

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by JAMES CHERRY

It is now common knowledge that non-collateralized trades leave a firm exposed to potential losses in the event that the counterparty defaults. From a Basel III perspective, this exposure is a liability on the firm's balance sheet that demands a higher capital charge; logically this charge is then passed from the bank to the buy-side. Uncollateralised swaps market participants have long accepted that there is an additional implicit cost in the price they are shown by their relationship bank reflective of a wider credit spread.

Triparty Repo

This explains the uptick in interest from the corporate community in triparty repo as an alternative to placing unsecured cash with banks. Banks are prepared to pay a higher yield on the cash they receive from corporate counterparties in exchange for collateral in a triparty repo transaction. It's a win-win situation - for the banks this improves their liquidity coverage ratio (cash is taken onto the balance sheet and in return the repo'd assets are removed). And corporates have the additional security of collateral that can be monetised in the event of a bank default. This collateral can also be onward mobilised to meet CCP obligations.

Conversely, collateral received on bilateral swap portfolios can also be mobilised to cover triparty exposures or again in favour of a CCP. Collateral can also be sourced via Clearstream's Liquidity Hub Connect partnerships that allow customers to unlock silos of assets held in custody networks of local custodians for use within Clearstream's own triparty programme.

There is increasingly a drive towards uniformity and standardisation: TARGET2-Securities (T2S) and the DTCC Margin Transit Utility (MTU) and other market utilities seek to achieve a common strategic goal in place of individual firms' tactical solutions.

Capital requirements

Currently there is a focus on EMIR, but of course further regulations will follow, leaving the market in a state of flux for the foreseeable future. With the implementation of CRD IV, financial institutions' exposures to clearing houses will lose the 'zero-risk weighting' they currently enjoy; instead they will be subject to 2% or 4% risk weights. The resulting capital that must be set aside comes with significant additional cost and strain on balance sheet for financial institutions. It is important to consider that this additional capital requirement could result in a significant decrease in liquidity. What this could translate into for some is that cost becomes a significant enough disincentive to appropriately hedge market risk.

Unlocking pools of liquidity by connecting to or partnering with market infrastructures, thereby enabling firms to leverage their mutual strengths in favour of common goals, will be a key requirement of survival in

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the new landscape. The market is being forced to evolve to ensure that regulation, however well intentioned, does not inadvertently have a counterproductive effect through decreased liquidity and increased market risk.

OTC Regulations

Following on from BCBS IOSCO's paper of 2013 (establishing minimum standards for non-centrally cleared derivatives), there has been a shift towards the exchange of two-way margin for all users of derivatives. Even amongst national and supranational entities. A precondition to the exchange of margin is of course that an entity must first be in possession of, or have the ability to source, assets which it will then use to satisfy the requirement.

The Macroeconomic Assessment Group on Derivatives (MAGD) has estimated the additional global pre-funding requirement of holding 'precautionary collateral' (held available to post as margin) to be an additional €104bn[1]. This figure must of course be subject to an additional multiple, which is less easy to calculate: the cost of reduced liquidity imposed by regulatory restrictions on collateral reuse.

Transformation

Clearstream's Global Liquidity Hub services allow for the sourcing and transformation of collateral to meet a plethora of obligations. Collateral trading can be bilateral with Clearstream as principle through the Automated Securities Lending (ASLplus) service. However, Clearstream not only offers a platform to source and mobilise collateral but also offers a complimentary marriage broking service to clients, effectively acting as an extension of the clients' own sales and trading. With a holistic view of all inventories within the programme, Clearstream can anonymously match and suggest collateral givers and takers to each other, allowing clients to meet their securities financing requirements with minimum effort.

Optimisation

Collateral optimisation not only requires making a judgement over which collateral is cheapest to-deliver but also the ability to choose the most cost-efficient means to deploy that collateral both bilaterally or to a given CCP. This decision must of course be made before trade execution. To ensure this is possible for any given scenario, a firm must have the correct web of market connectivity. Clearstream as a flexible service provider ensures that this is possible. In fact, a 2014 study by Clearstream and Elton-Pickford found that European banks could reduce their Basel III equity capital requirements by up to 20%, equivalent to EUR 40bn, through collateral optimisation as offered by the Global Liquidity Hub.

Bilateral Margin Documentation

The new regulatory landscape is forcing the market to negotiate more, and or renegotiate existing documentation as more counterparties are forced to collect margin and new requirements are enforced on the existing framework. Unless a harmonised industry approach can be adopted, a large percentage of ISDAs will have to be renegotiated during the course of 2015 and 2016, as indicated by BCBS-IOSCO[2]. Bilateral renegotiation of CSA/CSDs to accommodate ESMA's regulatory technical standards (RTS) will be legally and operationally burdensome when considering the thousands of contracts impacted.

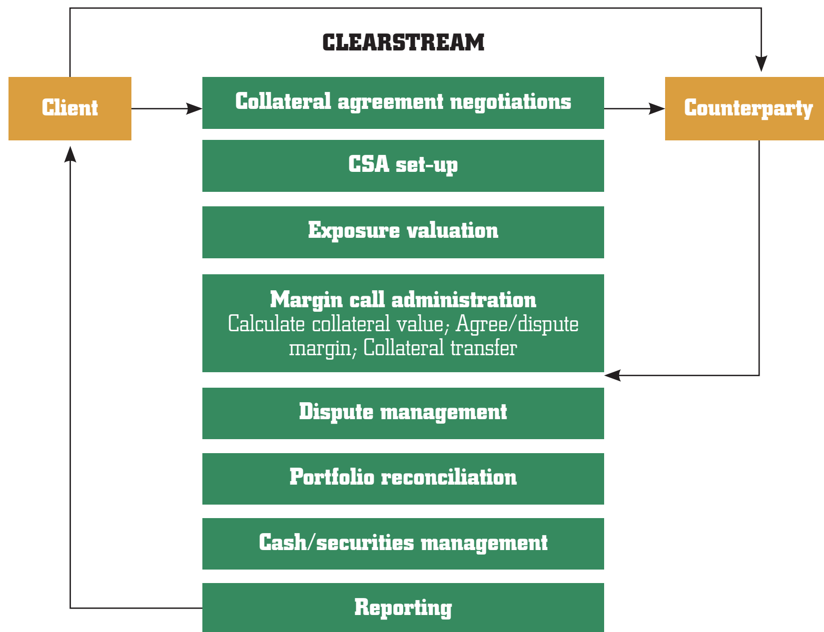
Clearstream have surveyed several banks who state that they need, with regards to non-cleared margin, to repaper in the region of several hundred new regulatory compliant Initial margin (IM) CSDs. A further 4,000 – 8,000 CSAs to cover variation margin requirements also need attention and if that wasn't enough… the banks quote a figure of around 2,000 – 3,000 new CSAs for clients they don't yet have legal documents in place for as well as any non-ISDA docs, for example prime brokerage agreements, that also need to be looked at.

There could, however, be a credible alternative solution if the derivative industry were to take inspiration from the triparty repo market. Here, we have seen the introduction by Clearstream of innovative multilateral documents (the Clearstream repurchase agreements, CRC) that allow a customer to sign a single standardised document once, in turn allowing trading with all other entities who have also signed up to the agreement. This would offer a significant decrease in time and cost and allow valuable resources to be redeployed to other pressing tasks.

Impact on firms

What has not yet perhaps been fully considered or rather is yet to be quantified, is the indirect

Figure 1: Bilateral Collateral Management for Derivatives



impact of regulation, the knock-on effect of regulation on clients. This must be considered for entities new to collateral management, those moving from an unsecured to a collateralised relationship or for those who currently employ a less than sophisticated internal model. Being forced to collect or post margin on a new industrial scale when not operationally setup to do so, in itself poses an issue for the counterparty on the other end of the transaction (namely the bank).

Collateral Outsourcing

Clearstream can offer solutions to alleviate these issues. 'OTC Collateral', Clearstream's bilateral collateral management outsourcing service, enables customers to cover all their derivative exposures from a single collateral pool out of the Global Liquidity Hub. The service covers all aspects of bilateral collateral management from CSA review and administration, mark-to-market, margining, dispute management and portfolio reconciliation to payment/settlement follow-up and reporting. With the regulatory horizon still so clouded and uncertain, outsourcing models offer firms a greater degree of certainty. Indeed, they allow the client to translate uncertainty into a fixed cost. In financial terms, they can act much like the purchase of an option, a hedge against future uncertainty.

Asset Visibility

The challenge of dealing with parallel streams of both cleared and uncleared derivatives is even more daunting against the background that many organisations have no or a limited overview of their collateral in the first place. Inefficiencies in banking collateral management systems can prevent the consolidation of collateral pools both within organisations and externally across multiple locations. Up to 15% of collateral available to financial institutions is left idle, costing the global industry more than EUR 4bn a year, according to a study by Clearstream and Accenture in 2011.

This means institutions cannot monetise all their available collateral, which can limit their operations and force them to search for increasingly expensive unsecured funding. This problem is set to be exacerbated once new rules kick in, an IMF working paper (The changing collateral space 2013) indicated that regulatory demands stemming from Basel III, Dodd Frank, EMIR etc. could lead to the lock down of $2-$4 trillion of collateral globally. It is imperative for firms to overcome the problem of fragmentation before these regulations enter into force or they might not be able to mobilise the necessary collateral for their derivative trades.

Clearstream's Global Liquidity Hub helps customers to overcome this fragmentation and cover all their exposures from a single collateral pool. Clearstream's collateral management programme allows a high degree of flexibility, enabling more than 550 participants to customise the services they receive in accordance with their individual regulatory and business requirements. In addition to supporting internal customers, the system is powerful enough to also provide collateral links to external partners such as agent banks, trading platforms and CSDs. For example, the Global Liquidity Hub is the collateral management system of choice of The Liquidity Alliance.

There is no one-size-fits-all solution to the current issues faced by the financial services industry. However, what is certain is that partnerships with a trusted and reliable market infrastructure provider such as Clearstream will allow firms to navigate the uncertain waters of change more effectively. Clearstream's Global Liquidity Hub services for OTC derivatives provide complete and efficient support during the entire trading cycle from clearing to registration and collateral management. By outsourcing the administrative burden of managing OTC derivatives to Clearstream, customers will reduce their costs by freeing up backoffice resources and using collateral more effectively while improving their risk management.

Footnotes

1 Macroeconomic impact assessment of OTC derivatives regulatory reforms report issued by the Macroeconomic Assessment Group on Derivatives (MAGD) August 2013

2 Margin requirements for non-centrally cleared derivatives, Board of the International Organization of Securities Commissions. September 2013