Collateral management
You will not operate the same way
From a buy-side perspective, we note that with inadequate and weak regulation, stakeholders might not recover their assets. For this reason, both client and regulatory considerations have prompted financial institutions to adopt more transparent market practices. Collateral management consequently became the hub of the new regulations under implementation, which are substantially reshaping the way institutions operate in the market.

To fully understand these regulations and most importantly, their impact on the financial landscape, let us take a step back to examine how collateral is currently managed in the financial industry from an operational point of view. This could partially explain the major current concerns about collateral management and the fact that no financial institution will be able to survive without taking into account this major issue in the operational landscape and development plans for the following year.

Collateral management is currently viewed as a support function, managed by back-office teams. Their main activities are focused on valuation, margin calls, and providing Central Securities Depositories (CSDs) with a back-office and accounting perspective.

Furthermore, collateral management is a daily activity, performed once or several times a day, but not in real time, sometimes even not within an integrated system, which leads to a waste of time in the mobilisation of collateral and a lack of efficiency.

Finally, the investment decision by the front office is usually taken without any consideration of the collateral’s impact.

Consequently, and for all these reasons, it is perhaps misleading—or at least limiting—to point out a lack of collateral without taking into account another dimension which is the limited access to collateral. In this context, market solutions coupled with an in-depth review of the current operational model of all COOs in the financial industry, could bring effective solutions.
The introduction of regulatory reforms - MiFID and the Dodd-Frank Act

The Markets in Financial Instruments Directive (MiFID) of November 2007 signalled the intention of European regulators to rein in financial markets and protect investors from investment service providers and credit risk. The main aspects were the safekeeping and administration of financial instruments, thus providing a framework for the development of collateral management activities. It enforced a harmonised regulatory environment across all member states of the European Economic Area.

In parallel to European regulations, collateral management functions acquired increased importance in investment management activities in the United States, with the Dodd-Frank Act, an attempt to make financial markets more efficient and stable. To promote greater transparency of financial activities, the Dodd-Frank Act passed by the United States House of Representatives as “The Wall Street Reform and Consumer Protection Act of 2009” aims to push Over-The-Counter (OTC) derivatives trading activities as much as possible onto central exchanges and central counterparties. It provides guidelines for strict time limits, multiple counterparty reconciliation, margin calls generation and collateral optimisation. Collateral monitoring and record keeping on a near real-time basis were adopted to manage daily requirements and limits. The shift towards OTC clearing has a substantial impact on the operating model of investment firms, focusing on mutualised risk that strikes bilateral arrangements activities. In line with standard exchange-traded derivatives, all derivatives contracts (IRS, CDS, etc.) now have to be cleared with initial margins based on daily mark-to-market.

The post-Lehman regulatory momentum that aimed to regulate financial markets, reduce systemic risk and improve transparency, has promoted the use of regulated platforms, such as Central Counterparty clearing houses (CCPs), Multilateral Trading Facilities (MTFs) and Organized Trading Facilities (OTFs) to capture OTC business.

Moving forward with EMIR

The global effort to regulate the products and markets involved in the 2008 financial crisis (e.g. CDS), led the G20 leaders to launch the European Market Infrastructure Regulation (EMIR) in order to supervise and monitor OTC derivative markets. It aims to build secure market processes for standardised OTC derivatives, promoting their use through financial constraints on non-standardised ones, establishing reporting requirements for OTC derivatives positions through trade repositories and risk mitigation for uncleared trades. It specifies clearing, reporting and risk mitigation rules. EMIR adds real value, going further than MiFID since derivatives were not in the scope of the 2007 regulation.

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The clearing obligation for standardised and liquid OTC derivatives through CCPs had a massive impact on financial institutions’ operating model, where the rigorous risk management practices applied by CCPs (initial margins, haircuts, eligibility rules, limited range of collateral assets, etc.) led to reconsidering collateral management as a strategic activity to make the best use of available assets. These changes have come in addition, to address risk mitigation requirements for uncleared trades with initial and variation margin requirements, daily valuation, timely confirmation, reconciliation, portfolio compression and dispute resolution (these requirements will be effective by the end of 2015). It will help the market transition to a stable environment, as well as prepare for the regulations to come.
New regulatory requirements to drive European Markets

The ambition of MiFID II is clearly to take further steps towards reducing systemic risk, in order to reinforce financial stability and increase investor protection. In addition to the EMIR regulation, the European Commission has worked on providing transparency to the OTC markets and extending requirements currently applicable to equity markets, to non-equity ones. The MiFID II regulations adapt a number of existing features and introduce new constraints on positions (position limits and reporting), business rules (wider inducement and best execution) and increase transparency requirements. They also seek to remove the current opacity in OTC markets by introducing a new venue for non-equity instruments, the OTF. Derivatives within the scope of the clearing obligations defined by EMIR will have to be traded on regulated markets, MTF and OTF to shape a more liquid market, making excellence in collateral management a must.

The Alternative Investment Fund Managers Directive (AIFMD) and the Undertaking for Collective Investment in Transferable Securities (UCITS V) regulations are impacting investment management market practices, leading to substantial changes in collateral management activities by depositary banks. They both impose efficient and strongly monitored portfolio management techniques with account segregation, rigid requirements on counterparty risk limits, qualitative and quantitative criteria on collateral received, reinvestment of this collateral, and oversight.

Past and coming regulations are highly involved in collateral management transformation practices. It has evolved from an under-considered back-office function performed on self-developed solutions, to a strategic and supporting exercise for front office or risk management activities.

Towards greater centralisation in collateral management

Going forward, banks will have to manage collateral much more centrally. They already have a certain level of experience in centralising processes, as the trend towards the centralisation of cash across multiple currencies through treasury management has been in place for several years.
However, this change will not only affect banks (sell-side institutions) which up to now have mainly carried out collateralised interbank transactions. It will also greatly impact a number of their clients (often referred to as buy-side institutions) which are progressively entering a much more collateralised, and therefore secured, financial world.

The implications for the buy-side raise a number of operational ‘collateral challenges’. For example, where will the sell-side and the buy-side meet to exchange collateral when required? If they restrict themselves to only using cash as collateral, this is still workable due to the efficiency of the payment infrastructures in place, which are readily available in the main currencies.

However, for numerous reasons, cash will increasingly be replaced by securities as collateral. In this case, banks and their buy-side clients, mainly serviced by global custodians, must find a neutral space to deposit and exchange collateral.

Integrated solutions
This is where integrated solutions such as Clearstream’s Global Liquidity Hub can help. It was launched in 2009 and now covers a wide range of integrated products and services which cover the growing need for settlement and custody of collateral.

Numerous collateral management and securities lending services allow for a seamless transfer of collateral between banks and increasingly also their clients, often supported by their global custodians.

Such integrated solutions provide centralised access to numerous central banks, CCPs and many other large institutional collateral takers worldwide. In addition, they offer extensive asset consolidation possibilities, for example by pooling multiple collateral asset classes such as cash in numerous currencies, debt, equities and even investment funds.
Full alignment with market developments
These integrated solutions are constantly adapted in line with changing market and regulatory requirements. This means that banks and buy-side counterparties do not have to worry about keeping abreast with other market developments, such as the growing need for secured term-funding by banks, central clearing for OTC derivatives, repo and securities loans as well as mandatory margining for uncleared derivatives.

It is also worth mentioning the implementation of new settlement infrastructures such as the new European settlement platform T2S, enhanced settlement finality in the US and the extension of the settlement period for JGBs in Japan. All this is taken care of by triparty collateral management providers such as Clearstream.

The ultimate aim for these providers is to offer a real-time platform running close to 24 hours a day, which connects all major collateral pools and a maximum of market participants across the globe. Thanks to increasing automation, banks and institutional investors can rest assured that their assets are in good hands and are put to maximum use by fully automated, highly sophisticated collateral management solutions.

You will not operate your collateral the same way
In line with the current and future regulatory agenda, the demand for collateral will continue to increase. Several surveys have appeared in recent years on collateral scarcity and have tried to quantify the missing collateral required to support the future regulatory framework (EMIR, CRD IV, etc.). Astronomic amounts of new collateral requirements were mentioned with huge variation from one study to the other, depending on the business model hypothesis and the collateral definition used. Navigating this wave of different figures is difficult.

For the first time, we believe that the question is not necessarily about collateral scarcity, but much more about how you can better use the existing collateral.

As demand for collateral continues to increase, it is critical to understand how the market for collateral management services will evolve and enable firms to meet their various collateral obligations.

The regulatory framework impacts directly the operations related to the collateral and affects the composition of assets a firm may hold in terms of their quality.

The liquidity coverage ratio requires firms to hold more high-quality assets on their balance sheets. The derivatives markets reform (EMIR, DFA,) will require firms to hold high-quality collateral for margining not only the central cleared derivatives transactions, but also the bilateral transactions.

While the collateral implementation for the centrally cleared and bilateral transactions will be phased out during the coming years, the importance of the impact in terms of business organisation and operations leave firms with no choice but to design their future target operating model today.

These increased demands are coupled with changes such as limits on the reuse of collateral as well as new segregation requirements that increase the operational complexity associated with collateral management.

All in all, these different changes enlarge the market participants’ focus on collateral from the sole management of assets for balance sheet purposes to a broader scope and consideration in the way the collateral is managed on an intraday basis. Moreover, these changes are driving innovation in the provision of collateral management services.
Not only are the services changing, but also the range of users is expanding. Collateral management was mainly a sell-side business story where their systems provided solutions to enhance the use and optimisation (triparty repo services) of collateral. With the advent of central clearing and bilateral margining on derivatives transactions, buy-side participants are now looking more closely to help them managing their collateral obligations with maximum efficiency.

Collateral management is no longer a simple back-office function but is now a key function with close links to trading, treasury risk, liquidity management and capital optimisation.

The function will also need to be centralised within the market participant’s organisation for meeting these challenges along the value chain:

- **Front office**: minimise collateral funding
- **Treasury**: minimise balance sheet impact while ensuring the most efficient use of collateral
- **Operations**: automation of daily process
- As an example, the custodian bank will have to adjust their framework offering both ways to match their client’s needs and CCP requirements. In parallel, they will have to introduce control mechanisms aiming at:
  - Reconciling the collateral position deposited in the respective account
  - Verifying that the placed and received collateral is in line with the eligibility criteria (from the CCP or with the other counterpart)
  - Verifying the accuracy of the haircuts, especially in case of bilateral exchanges

Similarly, buy-side clients have also key transformations to manage in line with collateral in order to:

- Deliver accurate, timely, and appropriate segregation of exchanged collateral
- Set up individual segregation or omnibus accounts
- Maintain sufficient liquidity for placing as collateral (particularly during periods of financial stress)
- Apply risk-sensitive haircuts models
- Set up dispute mechanisms to resolve in a timely manner any discrepancy of collateral amount to be exchanged

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More than any other financial business, collateral management is impacted by the current and future regulations together with transformation of the European post trade environment. How the firm will use one or multiple custodians and/or (international) central securities depositories will have a significant impact on its collateral management activities.

Up until now, the information on collateral obligations and which securities can be used to meet these obligations has existed in fragmented form across securities desks or regions. This fragmentation of information is the result of collateral management not being the primary driver for the firm in the management of their service provision for securities.

Operations and organisations should have to be deeply reviewed and reformed, eventually supported by centralised market solutions, keeping in mind the objective of positioning collateral management as a key function with close links to trading, treasury risk, liquidity management and capital optimisation.

Tomorrow’s major challenges are not necessarily related to the scarcity of collateral assets, but much more to the access to collateral when it is needed. This is true not only for the sell-side but also for the buy-side firm wanting to reshape its collateral activity around four main dimensions:

1. **Organisations**: define strategic collateral model (including product strategy), assess collateral services solutions, evaluate financial impacts
2. **Operations**: manage both cleared and bilateral process, connect to market infrastructure (T2S/CSD), daily valuation and reporting, evaluate the margin requirements
3. **Needs**: anticipate and manage liquidity, optimise and transform collateral
4. **Safety**: review depositary bank responsibility and compliance, set up service level agreements and segregation of accounts, review rules on collateral eligibility and haircuts calculation, limits on reuse/re-hypothecation

**Conclusion**