

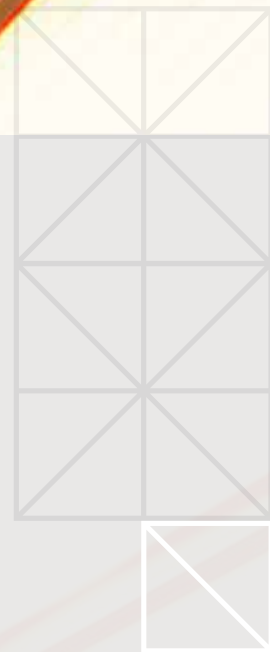
**DTCC**



# GlobalCollateral

## The Impact of Collateral

How collateral's rise will profoundly impact markets





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**Just as the deregulation of investment banks at the end of the last century had far-reaching effects over the two decades that followed, so today's re-regulation of capital markets will prove to be yet another defining moment in history. Already, changing market liquidity is signalling its consequences. And no other topic has received more attention from regulators seeking to safeguard the financial system than the derivatives and financing markets.**

In a few years' time, when the dust has settled, the drive to collateralize derivatives and the bolstering of firms' capital resources will have fundamentally changed the collateral management ecosystem. As flows of collateral multiply exponentially, the market's operating models will have to become more efficient and its infrastructures more streamlined. What's more, as the ecosystem adapts, some of its participants will need to change.

Collateral will, in a sense, be the markets' new currency, but it is a complex currency that should be mobilized swiftly and efficiently. Global banks and broker-dealers will have to master and mobilise their inventories of securities across borders, for instance moving US Treasuries from the US to Europe to meet the need for high quality assets as collateral. Asset managers, too, will need to step up collateral management capabilities, choosing either to have in-house collateral management capabilities or outsource.

Reforms like Basel III (Liquidity Coverage Ratio and Net Stable Funding Ratio), Dodd-Frank, European Market Infrastructure Regulation (EMIR) and BIS-IOSCO requirements for non-cleared derivatives are driving a significant increase in demand for collateral, especially high quality collateral. While estimates of how much additional collateral firms need to post may vary, there is a consensus that the global pool should be sufficient to meet demand. But firms have to identify, source, mobilize and post far more assets as collateral than they did in the past and with more counterparties.

For the industry as a whole this is a formidable operational challenge. In the OTC derivatives market, the volume of margin calls is expected to jump exponentially – by as much as 500% to 1,000%<sup>1</sup>. At the same time, regulatory technical standards are imposing the constant monitoring of complex collateral criteria, haircuts and thresholds, on either a bilateral or centrally cleared basis with a central clearing counterparty (CCP).

How well market participants process the new collateral currency will affect their competitiveness. If broker-dealers cannot mobilize sufficient collateral quickly their derivatives and futures businesses will suffer. Even asset managers, not directly affected by these new regulations, must improve their collateral capabilities. If they cannot mobilize the right securities for collateral, they must maintain cash buffers in funds to use as collateral, which will hamper performance. But participants do not just need to have sufficient collateral mobility — they must also be sure of a range of factors such as collateral safety, comprehensive reporting and messaging transparency.

<sup>1</sup> Taking Action on Collateral, GlobalCollateral Ltd, February 2015.

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# Shedding light on industry preparedness

Preparing for a new era in collateral management — which will be phased in over the next few years — is a collaborative endeavour. Both sell-side and buy-side firms work bilaterally with each other, and with central securities depositories (CSDs) to develop a fit for purpose cooperative processing model across the industry. Yet, at present, there is little visibility into the levels of preparation across the marketplace.

In order to shed more light on the industry's preparedness and remaining challenges, Euroclear recently released a paper entitled, *Collateral Management in Europe: Searching for Central Intelligence*, in which it interviewed 20 firms. Published in May, and produced by Aite Group, it highlighted the substantial need for internal investment in collateral management, drive for capital market infrastructure improvements and expectations for future services from market infrastructure providers.

The paper focused on firms' levels of preparedness and the remaining challenges, all within the context of Europe's currently unstable macro-economic environment. It highlighted the desire for greater standardization of messaging for collateral activities and more connectivity with market infrastructures. Market participants believed that there would be greater participation of asset managers in the triparty and cleared derivatives markets over time. And there was an expectation that EMIR would heavily impact firms' collateral management functions (see 'Key takeaways' box for more detail).

Mike Shipton, CEO of DTCC-Euroclear GlobalCollateral Ltd, the collateral processing joint venture, says that the task facing the industry is immense, and the level of preparedness varies significantly between market participants. "But the study confirmed our own experience that the industry will master this challenge like others in the past, although some firms may only rush to re-engineer their operations in the last few

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CEO, DTCC-Euroclear GlobalCollateral Ltd

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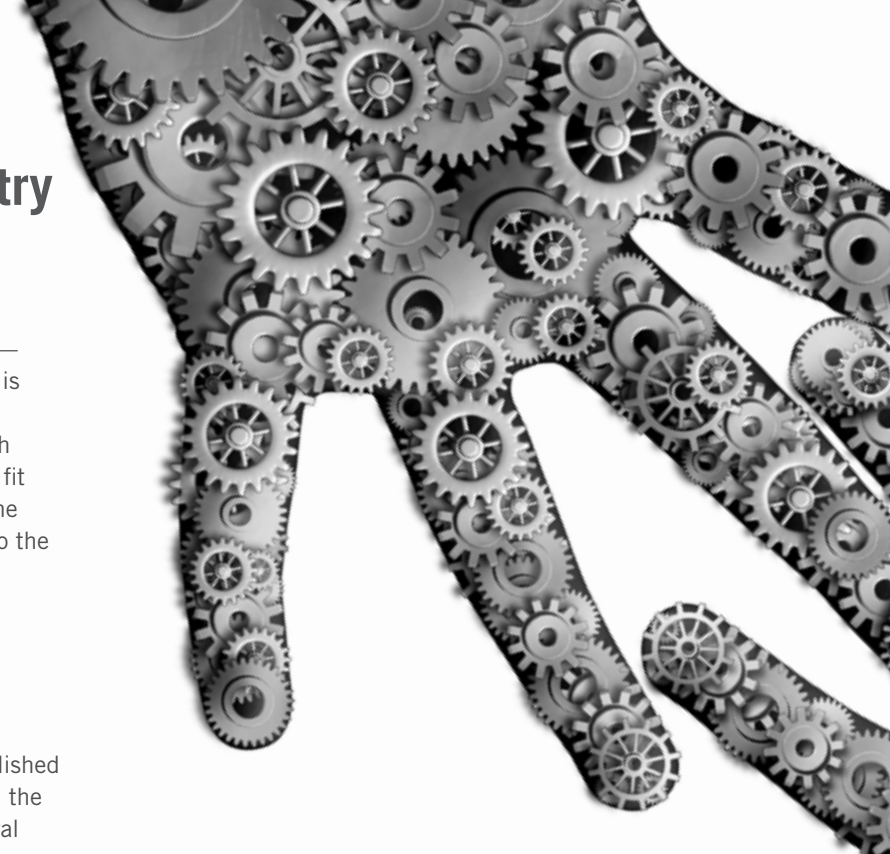
**Mark Jennis**


Chairman, DTCC-Euroclear GlobalCollateral Ltd

"Lots of firms are working on this right now," says Mark Jennis, Executive Chairman of DTCC-Euroclear Global Collateral Ltd. "I feel they are looking for various solutions. Some of the industry might choose to outsource. Industry consortia are looking to find solutions such as our recently announced collaboration with AcadiaSoft and ICAP TriOptima triResolve to create an open, seamless, end-to-end margin processing hub for non-cleared derivatives.

"What's indicative of the interest is the number of people in working groups for our Margin Transit Utility, which efficiently processes margin calls globally. For me that is a gauge of firms looking for solutions that are out there. Some firms are ahead of others but that's always the way.

"I am bullish that the industry will prepare itself in good time."





*This article extrapolates those findings to show how regulation will fundamentally change the shape and functioning of the derivatives markets, describing our vision of the future.*

“Additionally, there will be a range of new rules applicable to securities collateral in terms of eligibility, liquidity, haircuts, concentration limits, and so forth, all to be monitored on a continuous basis. That will require a high level of automation that can only really be provided by third-party agents and collateral infrastructures. In fact, by outsourcing the operational side of collateral management, you can focus on the risk management side, making sure you get seamless access to vital liquidity, so that you are adequately collateralized against your exposures, while containing your costs.”

*“The number of firms that will touch collateral management will exponentially increase. Yet, these firms don’t necessarily have collateral teams, procedures and systems in place like the ones at the large sell-side institutions.”*

**Jo Van de Velde**

Board Member, DTCC-Euroclear GlobalCollateral Ltd, and Global Head of Product Management, Euroclear

## From standardization to automation

Rising to the challenge of accelerating collateral flows enterprise-wide and developing the economic infrastructure that supports it will require nothing less than a revolution in collateral processing. Both firms themselves and the network of CSDs, CCPs and custodians that connect them will have to re-engineer their operations to facilitate fluidity and optimum efficiency at highly increased volume levels.

The broad change in collateral management’s scope shows the magnitude of the evolution required. Not only will the amount of collateral in circulation rise significantly, so too will the number of firms participating along with the various types of securities being posted as margin. Asset managers and even corporate entities will need to post margin. Additionally, margin will no longer be only government bonds; it will include a broader range of collateral with varying quality.

“There will be more and more clearing of buy-side transactions under Dodd Frank and Emir,” notes Jo Van de Velde, Board Member of DTCC-Euroclear GlobalCollateral Ltd, and Global Head of Product Management at Euroclear. “The number of firms that will touch collateral management will exponentially increase. Yet, these firms don’t necessarily have collateral teams, procedures and systems in place like the ones at the large sell-side institutions.

Standardization of messaging is essential. The paper found the lack of industry-wide standards for collateral messaging and data was a pain point for a quarter of respondents due to the operational risk and cost of manual intervention that is required to deal with email-based interactions. The lack of standards in messaging and reporting drags on the inter-operability and straight through processing (STP) of margin obligations. Initiatives for developing standards are emerging but there is still significant progress to be made.

The move to a more intraday environment will put pressure on the communication process for margin call activity in particular. This will mean that the current manual intervention required due to email communication (manual re-entry of data into dedicated systems), which is currently common practice, will need to become more automated.

“The industry is moving in the right direction but still has some way to go,” explains Mark Jennis. “Our view is the greater the level of standardization, the easier it is to move processing to utility-like operations and the more strategic solutions can be.”

Mike Shipton adds that continued volatility in Europe and the wide range of securities will force firms to add scenario modelling capabilities. “Understanding how macroeconomic events could impact collateral holdings is important in effectively managing capital, collateral, and liquidity, especially in light of Basel III and CRD IV. There is a growing realization that firms will also need the ability to be able to automatically mobilize their collateral on demand.”

“Risk management of collateral has become more critical,” says Jennis. “Systems need to look at the type of collateral and what is accessible. They need reports in terms of concentration such as are available on GlobalCollateral’s Collateral Management Utility. They need to do it more frequently: daily and intraday.”

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Over time, it is likely that firms will also improve their ability to manage collateral through centralizing their collateral management and financing desks. The paper reported that half of the firms interviewed had some degree of centralization in place at the operational level. Mid-tier firms have tended to make more progress towards global centralization, backed by a single technology platform for managing collateral across business lines. This is likely because their operations are more manageable in size; the simpler the operational structure, the easier it is to centralize. The remaining decentralized firms have not yet felt the urgency to create a single view of collateral inventory across their operational silos, though this is likely to change once EMIR and CRD IV have been fully implemented.

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Yet some of the larger sell-side firms are pioneering a more sophisticated approach. Only three firms surveyed for the paper, all of which were large sell-side firms, had got this far. They had invested heavily in technology, including multifactor algorithms that work with variables such as geographic location of assets, equity corporate actions data, market data to enable mark-to-market valuation, and eligibility criteria for margining or posting of collateral to counterparties. Future projects included improving optimization and building support for additional variables and scenario analysis capabilities.

## The ecosystem’s likely evolution

As with any substantial shift, the emergence of collateral as the markets’ new currency will gradually alter the state of the markets. Some firms may withdraw from certain areas of the marketplace, while others will spot new business or investment opportunities. There will also be more collaboration between infrastructure providers scaling up to meet their clients’ expectations.

Notably, banks and broker-dealers are already assessing whether they want to continue to provide derivatives clearing services; especially with Basel III capital requirements forcing them to commit capital more prudently. To some extent, disintermediation of the sell-side has already occurred as asset managers deal directly with CCPs. The Euroclear research paper showed that 45% of participants believed disintermediation is likely to happen in future, while 30% said it had already happened.

But buy-side firms face high initial costs when going direct to a CCP as a result of connectivity requirements, and finding sufficient sources of liquidity might prove to be a challenge. This is where triparty service providers might have a natural fit, providing access in a risk-mitigated environment and matching up assets on both sides of the custody network.

“There will be a change,” says Van de Velde. “People are asking themselves about clearing. Business models will change. Do banks still want to have their balance sheet used for some of these activities? What will the result be?”





*DTCC-Euroclear GlobalCollateral Ltd, the joint venture between DTCC and Euroclear, shows how two CSDs joining forces can provide the kind of global processing capabilities that the industry so urgently needs.*

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If people decide it's no longer interesting to be a general clearing member, does that mean that buy side firms access CCPs directly?"

Asset managers are likely to become more active participants in repo markets. Not only will they have to repo securities quickly in order to gain cash for variation margin calls, but also the repo markets will offer another secured avenue to invest cash. While the largest asset managers have established repo desks, medium and small sized asset managers will probably prefer to outsource this capability.

"I think asset managers will become more important participants in the market," asserts Jennis. "This will be especially beneficial for the US repo market, where more liquidity is needed. Similarly, if dealers start to withdraw from the cleared derivatives market, the more liquidity from the buy side the better. But I think the trend towards asset managers becoming more involved will take some time."

There will be more collaboration among infrastructure providers. Achieving the scale and technological capabilities needed to meet clients' expectations for collateral processing in the short time available is an arduous task for even the largest organizations.

Firms interviewed for the paper also foresaw the possibility of consolidation. Two-fifths of participants believed that T2S, Europe's single settlement regime that will be phased in from 2015 to 2017, would result in fewer members of the CSD and custodian community. Several sell-side respondents indicated that they were already assessing the potential to concentrate their settlement activities with a smaller number of custodians and CSDs.

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## Towards a new era

Undoubtedly, the new regulations that will be implemented in the next few years will gradually alter markets — in terms of the infrastructure provided by organizations such as CSDs, the firms that deliver market liquidity and how different types of firms choose to participate in markets.

Most notably, the principle of collateral being the security for derivatives transactions will make efficient collateral processing absolutely vital for all firms. Both sell-side and buy-side firms will need to make sure they can mobilize collateral efficiently, while infrastructure providers must be the conduits of collateral.

When Basel III and T2S are added to the mix, some firms may choose either to exit certain business areas or collaborate with competitors.

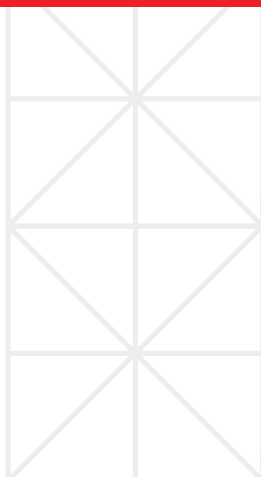
But the industry utilities such as DTCC-Euroclear GlobalCollateral Ltd will play the most crucial part, giving market participants the ability to identify, mobilize and optimize collateral far more quickly. They will provide the critical industry infrastructure that enables the market's collateral to go much further than ever before.

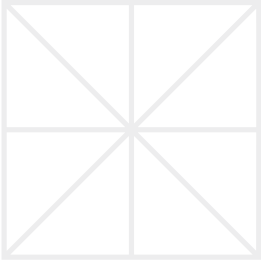
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## Collateral Management in Europe: 5 key takeaways

*Collateral Management in Europe*, commissioned by Euroclear and produced by Aite Group, highlighted the current realities facing treasurers and collateral managers at firms active in European markets. Based on interviews with respondents from 20 firms, it surveyed internal restructuring and investment in collateral management and expectations for future services in light of the introduction of key pieces of regulation and Target2-Securities (T2S).

1. An unstable macroeconomic environment in Europe has led sell-side firms to increase their scenario modeling capabilities to assess the impact of potential events, such as the exit of a country from the Eurozone, on collateral inventory. Asset managers and pension funds, on the other hand, have moved away from accepting and holding cash deposits along with money market funds originating from certain “peripheral” European countries.
2. There is a desire for more standardized messaging and connectivity with market infrastructures — CCPs and CSDs — across Europe and beyond in order to improve collateral mobility. This interest is driven in part by collateral scarcity, scenario planning and automation.
3. Firms are looking for greater standardization of messaging for collateral activities and a shift away from the current norm of email-based interactions. Some 25% of respondent firms highlighted a lack of standards as a key challenge to effectively managing collateral, while another 20% identified a lack of automation as a major pain point.
4. Both buy-side and sell-side firms believe there will be greater participation of buy-side firms and corporates in the triparty and cleared derivatives markets over time. Some 45% of respondent firms said it was possible that this would happen in the secured funding space, while 30% reported it had already happened.
5. The implementation of the clearing requirements under the EMIR is expected to heavily impact the collateral management function of 65% of respondent firms. The move of over-the-counter derivatives on to a CCP increases the frequency with which firms must pledge collateral, moving from a monthly or weekly cycle to a more intraday environment.





## About GlobalCollateral

DTCC-Euroclear GlobalCollateral Ltd (“GlobalCollateral Ltd”) is a joint-venture between DTCC and Euroclear, two of the world’s largest post-trade infrastructures.

An open architecture infrastructure designed to streamline collateral processing globally, GlobalCollateral Ltd provides collateral solutions for both derivatives and financing activity, delivering transparency, collateral mobility, efficiency and security through two powerful utilities:

- The **Margin Transit Utility**: enabling straight-through processing of margin calls, mitigating systemic risk and providing improved liquidity and operational risk management.
- The **Collateral Management Utility**: automating collateral management tasks, re-positioning inventory seamlessly across settlement locations, making collateral available wherever and whenever it is needed.

For more information, visit: [www.globalcollateral.net](http://www.globalcollateral.net) or contact:

### **Ted Leveroni**

Executive Director  
Chief Commercial Officer  
DTCC-Euroclear GlobalCollateral Ltd.  
tleveroni@dtcc.com

### **Joyce Thormann**

Director  
Sales and Relationship Management  
Euroclear  
joyce.thormann@euroclear.com