DTCC-Euroclear Global Collateral Ltd.

Breaking down the silos: adopting a holistic approach to collateral management

Mark Jennis, managing director for strategy and business development at DTCC and executive chairman of DTCC-Euroclear Global Collateral Ltd., explains the rationale and the planned service offerings of this new joint initiative.

Having the right collateral in the right place and at the right time is crucial to the effective functioning of markets globally. Following the G-20 meeting in Brisbane in November 2014, the world's leading economies agreed that completion of major financial regulation, developed in response to the financial crisis, should be finalised within the next year. This regulation, which has focused on enhancing transparency, increasing market stability and resiliency and reducing counterparty, operational and liquidity risk, will, however, be largely dependent on the efficient management and effective processing and allocation of collateral. The industry's ability to meet this challenge rests on cross-border collaboration and the development of holistic, industry-wide solutions.

Under G-20-led reforms, mandated central clearing for derivatives is now underway in the US, while in the EU central clearing will be phased in early 2015. While these changes will ultimately bring efficiency to collateral management processes, there will be challenges for firms to realise these efficiencies, especially in the early days.

Mark Jennis

Significant operational change

Globally, clearing houses will impose initial margin requirements as well as reduce thresholds for variation margin, dramatically increasing the demand for high-quality collateral. Initial margin requirements, in particular, are not currently applied to a large number of swap transactions and so this will be unchartered territory for some. Therefore, the industry needs to be ready to restructure operations as the requirements represent a significant operational change that will need to be managed. From an operational perspective, the increase in collateral requirements and the subsequent rise in underlying margin activity are expected to have an impact on costs and risk in a number of areas, including funding costs, capabilities and settlement exceptions management, and reporting and recordkeeping.

There are two potential areas of initial concern: a) firms that have not traditionally collateralised their OTC derivatives will need to set up the proper operations to process margin transactions and hire personnel to deploy the technology as well as execute collateral agreements with counterparties; and b) many firms that may already have existing sophisticated collateral operations will have to start calculating and processing two-way initial margin, which will add further pressure when firms are facing an exponential increase in margin call volumes.

There is currently a plethora of automated collateral management solutions encompassing anything from portfolio margining to collateral optimisation, all attempting to address the different components of the collateral challenge. However, the sell-side, buy-side, central securities depositories and custodians alike all recognise that these fragmented solutions only address parts of the problem, which have left them struggling to cope with the efficient management of their collateral. Firms should consider the impact of using these types of systems from an investment, trading and operations perspective and look, instead, to holistic solutions and offerings that can address these problems and help ensure compliance with collateral and clearing requirements worldwide.

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Leveraging infrastructure

Recognising that the industry requires a solution to address both the scale and efficiency of the collateral management challenge, DTCC has been working on a key initiative, by leveraging infrastructure enhanced through a partnership with Euroclear. A global collateral joint venture was established to create the Collateral Management Utility (CMU) which will follow the development of the Margin Transit Utility (MTU)[1].

The MTU is in advanced stages of development, expected to be launched in 2015. It will leverage DTCC-developed infrastructure, and will provide straight-through processing of margin obligations. Leveraging electronic margin calls between market participants, the MTU will utilise the Omgeo ALERT database to enrich the agreed margin calls with the standing settlement instructions for cash and securities transfers and pledges, and then automatically deliver the appropriate delivery/receipt, segregation and/or safekeeping instructions to the applicable depositories and/or custodians. The service culminates with investment managers, futures commission merchants, general clearing members, dealers and clearing houses receiving electronic settlement status and record-keeping reports for all collateral movements.

This facility will mitigate systemic risk and provide significant additional risk and cost benefits to both sell-side and buy-side market participants by increasing scalability and operating efficiency, and providing greater transparency across collateral activity. Longer term, the solution will connect collateral data with information reported to the DTCC Global Trade Repository, providing a complete view of risk exposures during a market crisis.

Optimal asset allocation

As envisioned, the CMU will harness the open architecture of Euroclear's Collateral Highway and enable users to consolidate assets under a single inventory and collateral management system across the two depositories. This provides them the possibility to optimally allocate mutualised assets to meet exposure obligations in both the European and North American time zones. The assets remain on the books of each depository, with each opening accounts in the other. Collateral allocations will seamlessly integrate with other settlement obligations at the relevant depository, significantly reducing the risk of blockages and settlement failures during market stress conditions.

The CMU will address the pressing problem of accessing collateral globally and automatically coordinate collateral settlements and substitutions with other settlement activity. Market participants often cite sub-optimal collateral mobility, allocation and settlement coordination as issues at a global level, and the CMU will fill this gap. ■

1 Certain aspects of the MTU and CMU are subject to regulatory approval.

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