Solving the collateral conundrum

Margin and collateral efficiency have been two of the most frequently discussed topics over the past year or two and will continue to be so for some time. Why is this topic so important? Simply put, the market as a whole is going to need more collateral, and will have to learn to deliver it with greater frequency and efficiency. This article summarizes the key suggestions on how to address these challenges.

by RICKY MALONEY

Asset managers, pension funds and the like are being forced to re-evaluate their derivative hedging or investment strategies to the extent that collateral cost implications form part of the pre-trade function. In considering those costs the market needs to become as efficient in terms of identification, selection and delivery of collateral as it possibly can.

There are a lot of excellent papers available on collateral optimization – many with the common recommendation to centralize collateral inventory. It is not unusual for firms to have multiple pools of collateral spread across various custodians and collateral management systems, or agents. To have an efficient and optimal view of collateral, firms must be able to see it at once, and in one place.

Cross margining is part of the solution

That however is just the starting point. Reducing collateral requirements demands maximum efficiency, whilst some efficiency for cleared product margin requirements is possible by aligning listed clearers with OTC clearers, many clients are looking to achieve additional efficiency through cross product margining within a CCP. This combination of both listed and OTC derivatives within a single account, may achieve significant risk reduction, dependant upon correlation, therefore requiring a lower margin.

Further efficiencies can be gained through the utilization of collateral inventory that is perhaps otherwise unused. Eurex Clearing accepts over 25,000 products as collateral. This enables clients to utilize a wider range of assets for collateral purposes, as opposed to their highest rated assets, or cash, which could be put to better use elsewhere, seeking alpha.

Eurex Clearing has access to the European Central Bank refinancing window and as such is able to exchange securities collateral for cash at times of defaults and of stress. The clearing house is therefore able to negate the requirement to sell collateral assets in a depressed market, which would drive asset values down further leading to additional margin calls that would further propagate pro-cyclicality.

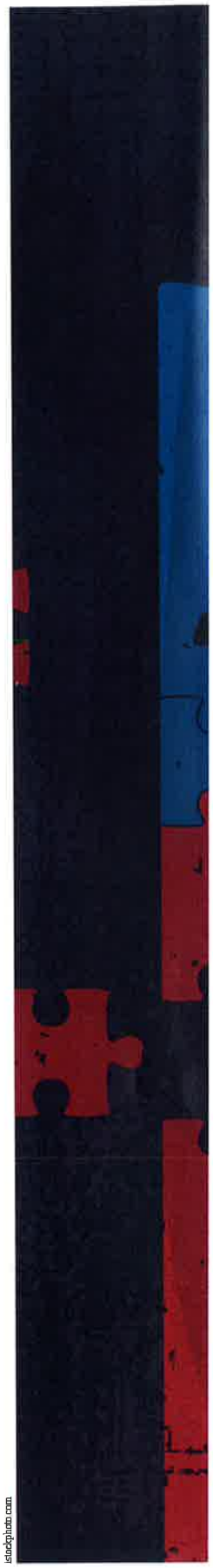
Having identified their optimum collateral, clients' considerations should then turn to how efficiently and securely that collateral can be delivered to the CCP. The importance of this should not be underestimated and in this respect Eurex Clearing sets the standard.

A single margin call across all asset classes

Eurex Clearing makes a single margin call across all asset classes, per currency, each morning, meaning that clients can satisfy their overnight margin calls for all exchange-traded or over-the-counter derivative activity, as well as any securities financing obligations with just one payment, per currency.

The second advantage to clients is the opportunity to deliver collateral directly into their Clearing Members account within Clearstream. Available within Eurex Clearing's Individual Segregated Account (ISA), 'direct delivery' negates the requirement for a Clearing Member to act as a pass-through agent for client collateral, and by utilizing this method Registered Customers can reduce a leg of transit risk when paying and receiving collateral, and reduce the associated collateral processing charges.

Furthermore, there is optionality on how those



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Clearstream accounts are constructed, at the central securities depository (CSD) level, either individual (sub)-accounts have to be opened per Eurex Clearing collateral pool or multiple Eurex Clearing collateral pools can be linked to the same (sub)-account. Where the latter is chosen, security collateral is allocated to the respective Eurex Clearing pool by way of asset tagging. This provides for operational and collateral processing efficiencies.

The 'Client Custodian Gateway', is a solution whereby Clearstream and Eurex Clearing offer a collateralization model that allows clients to **satisfy margin requirements under the individual segregation model whilst keeping securities at their existing custodian.**

It is very important to remember that even with tagging, whilst security collateral is held in one account at the CSD, at Eurex Clearing, the security collateral holdings are clearly segregated at ISA account level. The asset protection remains exactly the same regardless of the account construct at the CSD.

Eurex Clearing is developing its collateral offering further with the 'Client Custodian Gateway', planned for Q2 of 2016. This is a solution whereby Clearstream and Eurex Clearing offer a collateralization model that allows clients to satisfy margin requirements under the individual segregation model whilst keeping securities at their existing custodian. There is significant market demand for this service which leverages clients existing infrastructure and relationships with custodians, clearing members and international central securities depositories (ICSDs).

In addition to the efficiencies already mentioned, clients of Eurex Clearing have a tremendous opportunity to take advantage of a CCP offering that not only provides the opportunity for cross margining, be it product or portfolio, but also affords the capability of satisfying margin requirements by utilizing Eurex Clearing's securities financing platforms.

Opportunities for the GC Pooling and securities lending markets

Leveraging Eurex Repo's GC Pooling market, a market that has been live since 2005 and currently sees up to 115 participants executing repo transactions to the order of some EUR 80 billion a day, GC

Eurex Clearing was the first CCP to develop an individual segregation model (...) **which provides gross segregation of a client's actual assets and highly likely porting**. As Registered Customers positions and collateral are fully segregated, in case of a CM default, the positions and collateral can be transferred without the consent of the insolvency practitioner appointed to the defaulted CM's estate, enabling clients to continue their trading activities.

Pooling Select Invest (secured funding for corporate clients) seeks to aid buy side clients in meeting their variation margin commitments.

The variation margin must be paid in cash in the underlying currency of the derivative and for fully invested clients such as pension funds, who are typically short of cash, this can be a problem. GC Pooling Select Invest goes a long way towards resolving that problem. In becoming a direct participant in this market segment buy side clients can exchange assets for cash via a market executed repo trade, the cash proceeds of which can be used to cover a client's variation margin requirement.

As soon as the trade is executed, Eurex Clearing immediately steps in as the counterparty to both sides of the trade and counterparty exposure is therefore with the CCP, rather than to the bilateral counterparty, the capital impact of this trade will be significantly lower compared to a bilateral trade.

An alternative product GC Pooling Select Invest allows cash providers to enter into repo transactions and the securities received can be utilized to cover their margin requirements across the CCP as a whole, this is termed as collateral reuse.

Continuing the securities financing theme, Eurex Clearing's Lending CCP allows clients to clear securities lending trades, a trend which is being strongly promoted by banks as they look to reduce balance sheet pressures. Centrally cleared financing trades also have a greatly reduced capital cost when compared to bilateral trades.

A securities lending CCP simplifies a clients multiple counterparty credit structure to a single CCP relationship for all novated loans, improving distribution for borrowers and lenders with restrictive counterparty parameters whilst maintaining bilateral trading relationships.

Furthermore it provides transparent and standardized risk management and default procedures, guaranteeing the return of the loan and collateral securities offering protection from counterparty default.

Choosing the right type of segregation and safety

Identifying an optimal collateral strategy is one thing, ensuring its safety in the event of a default is something else altogether. Eurex Clearing offers net and gross margin under three types of segregation:

- Standard Omnibus Segregated Accounts (OSAs),
- Multiple Omnibus Segregated Accounts (MOSAs) and
- Individual Segregated Accounts (ISAs).

Eurex Clearing was the first CCP to develop an individual segregation model in accordance with EMIR requirements which provides gross segregation of a client's actual assets and highly likely porting. As Registered Customers positions and collateral are fully segregated, in case of a CM default, the positions and collateral can be transferred without the consent of the insolvency practitioner appointed to the defaulted CM's estate, enabling clients to continue their trading activities. Eurex Clearing additionally allows clients an extended period to find a Replacement Clearing Member if they are unable to port immediately. Alternatively, clients can elect to close out their positions to receive the collateral. Eurex Clearing, under the ISA model guarantees to return, or deliver to a Replacement Clearing Member, the actual collateral provided by clients.

What the future will bring

Eurex Clearing continues to enhance its collateral services. For example in 2014, it launched the direct collateral transfer service for ISAs, extended cut-off times for cash collateral recalls, automated distribution of the admissible securities list and implemented real-time distribution of collateral movement reports on an event driven basis.

In 2015, Eurex Clearing will further enhance its direct collateral transfer service by connecting to Clearstream's tri-party platform enabling ISA clients to benefit from the auto-allocation and auto-substitution service for security collateral. Further, Eurex Clearing will extend its permanent initial margin currencies and will continue with the development of its custodial segregation solution which will be launched in 2016.

In recognizing the collateral management challenges clients face, Eurex Clearing is working hard with those clients to address those challenges and to provide appropriate solutions. The fully integrated product set, and the collateral and financing efficiencies described herein, allied with the market leading asset protection capabilities, make Eurex Clearing a very powerful proposition indeed.