



Criteria for Fund Managers to consider when selecting an OTC derivatives CCP

Part 2 - Collateral movement and holding

For many firms on the buy-side, meeting the collateral sourcing and management demands of centralized clearing represents a considerable new burden. The obvious challenges - such as maintaining access to cash to meet variation margin calls and to eligible securities, especially amid recrudescing fears of a global collateral shortage - are now well understood. However, because CCPs manage risk in real-time, recalculating margins continuously to take account of shifting market conditions, clearing members often have as little as one hour to meet a margin call. This means that, even if there is sufficient eligible collateral available, it may still prove hard to mobilize it in time.

“Mandatory clearing of OTC derivatives, and the mandatory collateralization of non-cleared OTC derivatives, plus the demand for high quality assets to meet the Liquidity Coverage Ratio (LCR), the consumption of eligible securities by the Net Stable Funding Requirement (NSFR) and higher mandatory haircuts mean that there will be a higher demand for eligible collateral than there is today, and a smaller supply,” explains Phil Simons. “That is not the same thing as a shortage. There is enough collateral in the system as a whole. The problem is that it is not in the right place or in the right form to get it to where it needs to be at the right time. The industry has a year to a year and a half to sort itself out from a collateral perspective, and make sure collateral is in the right place at the right time.”

This infrastructural bottleneck is one way in which the collateral markets might have an adverse impact on fund managers. However, there are a number of less obvious issues which might easily prove even more damaging than lack of timely access to the right collateral. One is the practical effect of the concentration limits set by CCPs. With clearing business now heavily concentrated at a small set of clearing members, and an even smaller group of major CCPs, fund managers may run into caps on the eligibility of securities they hold.

To diversify their own risks, some CCPs set quantitative limits on the amount of a single issue they are willing to accept, in either cash or percentage terms, or apply them by individual customer or clearing member. Given this potential constraint, it makes sense to choose CCPs which have a wide geographical spread, since they are less likely to exhaust their willingness to take particular government securities. The alternative is to run a larger risk of having to engage in costly collateral transformation trades.

A second potential collateral constraint is the payment of interest on cash collateral. EMIR requires CCPs to reinvest 95 per cent of the cash collateral they receive. Unlike Eurex Clearing, most CCPs tend not to have banking licences, so they cannot lodge client cash at a central bank, or use securities collateral to raise cash at a central bank. Instead, client cash tends to be invested in either third party bank deposits or overnight reverse repos. This creates maturity mismatches and the risk of illiquidity in the assets that secure the repo transactions. Above all, it creates counterparty credit risk, and often of a particularly perverse kind, since reverse repo counterparties tend to be the self-same investment banks that dominate the derivative clearing business.

“The risks to be managed are traditionally seen as clearing member and CCP risk, but what happens if a repo counterparty defaults?” asks Jaki Walsh. “Unlike a clearing member default, it does not trigger the standard default management process of a CCP. It is a non-default investment loss, potentially.” She advises fund managers to understand how CCPs allocate such losses between users.

This is partly a jurisdictional matter. The Bank of England, for example, protects CCPs by allowing them to pass through to their clearing members any non-default losses which they incur, including losses on reinvested client cash. CCPs outside the jurisdiction of the Bank of England have a choice not to pass losses on. So far, some have agreed to absorb losses up to a certain amount, though this figure can be as low as €15 million, while others claim not to pass losses on to their users at all.

“I have discussed this issue at length with almost every major clearing member,” says Walsh. “Every single one has confirmed to me that any investment losses passed on to them by a CCP will be passed pro rata back to their clients.” She advises fund managers to assess the investment policy of every CCP they use, to understand how they allocate losses, and how well they manage the risk of incurring losses through diversification of their counterparty risks.

In effect, CCPs are protected from the consequences of their investment decisions, which may encourage a less stringent degree of care. "We would disagree with this," says Phil Simons. "If regulators do not think CCPs have enough 'skin in the game,' they should force CCPs to put more 'skin in the game.'

But the problems with the management of cash collateral do not end with a potentially unjust allocation of losses stemming from inadequate counterparty risk management on the part of a CCP. At present rates of interest, the risks incurred are not merely unmanageable. They are unrewarded, and can even be penalized. With interest rates so low, it is difficult for cash to earn a positive return, especially once the CCP has taken a management fee and the counterparty has charged a spread.

"Quite often, in certain currencies in this market, cash is actually generating a negative return," says Jaki Walsh. "Gone are the days when rates could not fall below zero. The cost of that negative rate is being passed through to clearing members by the CCP. Fund managers need to take into account the fact that it might actually cost them money to use cash as collateral."

A third potential collateral constraint stems from the desire of many users of derivatives to segregate the collateral they post to clearing members and CCPs. There are variations in the degree of protection and cost between the different forms of segregation - individual, direct, third party and so on - as well as between omnibus and segregated accounts in general.

Some clearing members are offering segregation at a premium price only, on the grounds it adds to their administrative costs. Others are not offering segregation at all. However, as Jaki Walsh points out, CCPs are able to maintain extremely accurate and up-to-date records of collateral posted by clearing members. "Why cannot clearing members do the same?" she asks. "After all, the higher the level of collateral segregation, the lower the capital requirement. The reluctance of clearing members to offer segregation other than at a premium price is something which needs to be questioned by the buy side."

One powerful reason to opt for individual segregation is that it facilitates the porting of positions to a new clearing member when an existing clearing member fails. It is difficult to be confident of finding a new clearing member in the stressed market conditions that are bound to follow the default of any clearing member. But it is close to impossible when the positions and the collateral are held in an omnibus account that commingles the activities of hundreds of clients. The new clearing

broker will have only a day or two to assess each of those clients, so will in most cases refuse the business.

“I struggle to see how porting works in an omnibus scenario,” says Phil Simons. “A large clearing member may have 1,000 clients. Can you port 1,000 clients in a single day? That is pretty challenging, especially if all those clients sit in a non-disclosed omnibus account, so you do not even know who they are. In a fully disclosed omnibus account, you have got a better chance of porting them all because you know who they are, and both their positions and their collateral are held gross. The big advantage of individually segregated accounts over omnibus is that you do not have any fellow customer risk. It is your positions and your collateral, and the CCP can protect them. It is much easier for a new clearing member to assess the size of the positions and the quality of the collateral of a single client.” In fact, some larger fund managers are obviating the risk of porting altogether by becoming direct members of CCPs.

Dominic Hobson, Founder, COOConnect