

How Buy-Side Firms Can Manage the Collateral Squeeze Caused by Central Clearing - a Service Provider's Perspective



*In a Q&A, **Rajen Shah**, global head of collateral management at **Citi Global Transaction Services** explains how collateral management service providers can help buy-side firms manage the collateral squeeze they face as a result of the complexities associated with central clearing for OTC derivatives.*

Q. How is collateral management an important element of central clearing operationally?

Collateral management is a fundamental element of central clearing. The concept of central clearing is to ensure that the collateral held by the central clearer is of a good quality, and the operational process by which the collateral gets there is streamlined in order to minimize the counterparty risk that you would otherwise have in a bilateral trading situation.

Q. How will collateral management services deliver added value to buy-side institutions in this changing financial industry?

Firstly, for buy-side clients, collateral management as a function is not a core competency. Buy-side firms are there to make investment decisions so their staff's expertise is within that area. For us, providing collateral management is a core discipline and so the investment we put into it, and the expertise we have in collateral management personnel, is what allows our service to deliver added value to our clients.

Secondly, typically a buy-side firm does not necessarily have the scale to have an industrial-strength collateral management operation that is also cost effective. We are able to provide our buy-side clients with an industrial strength service, but at a price that is comparable with their scale. This allows them to get the best of both worlds because they can keep their costs low and variable without losing the industrial-strength service, which is so important given collateral management is a significant risk mitigation method and tool.

As a result of the market crisis, which highlighted limitations of the market, the landscape around Over-the-Counter (OTC) derivatives is going to evolve significantly, including the introduction of central counterparty clearing. These new market developments make collateral management and processing trades for buy-side clients even more complex than they have been previously.

First of all, the operating model is more complex. Market participants now have to manage both bilateral clients and trades in addition to the central counterparties.

Secondly, central clearing mandates market participants to post initial margin, and requires the collateral posted to be of a high quality, such as cash or government securities. The combination of having to post more collateral and only collateral of high quality, adds to the difficulty buy-side firms face when managing collateral obligations in this new market environment.

Service providers are able to alleviate this collateral squeeze felt by buy-side firms by offering collateral upgrade services. Through the upgrade collateral service, the service provider can act as an intermediary between client and the clearinghouse to solve the mismatch between the collateral a client can offer, without disrupting its trading strategy, and the collateral required by the central clearers to meet the central clearing collateral requirements.

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In fact, a large part of the collateral management service offering is the ability to shield the buy-side clients from the complexity created from new market initiatives including central clearing. For instance, service providers will have the various connections to the multiple clearinghouses and general client clearing service providers in place so the buy-side client only needs to maintain one relationship. Also, as new general client clearing service providers come to market, the service provider will manage the new connections so the client will not be concerned about market changes and will benefit from a fully 'future-proof' service.

Buy-side clients have a combination of OTC and exchange-traded derivatives and other types of trades that make up their investment strategy. We are able to provide a holistic collateral management service across all those different trading activities and optimize the collateral across different commitments, which is important as buy-side firms face the squeeze on their collateral. A collateral management service provider who has line sight over all of the commitments, plus everything that a firm may receive as collateral, is better equipped to optimize collateral for the client.

Q. What type of technology does a service provider require to provide robust collateral management functionality and superior services to clients?

Going back to the basics, one of the key principles of why a firm takes collateral is to mitigate counterparty risk, however, taking in collateral create other risks that a firm then also has to manage. One such risk is the operational risk including, for instance, the risk associated with having the correct data to value the collateral accurately. From a technology perspective, this means that it is essential to have a system in place that can reliably validate data efficiently because if a system receives bad data, a firm will base collateral decisions on incorrect data, which creates additional risk.

Also, the use of a streamlined workflow system for the entire collateral management process is important to ensure no fundamental functions are missed.

Collateral optimization also requires technology support. Technology provides the transparency of activities including the current commitments and the collateral held, but also delivers sophisticated analytics to work out what long collateral is available and how a firm can use it for other various commitments given each collateral obligation has different eligibility requirements. The technology is important because having an operational staff do this analysis manually would not get the same effective optimization that would be achieved if a rules-based system were used instead to create optimize collateral suggestions for the operator to then act upon.

Technology also plays an important role in managing collateral during heightened states of alert, such as the default of a major counterparty like Lehman Brothers. The technology used has to have the ability to deal with the shocks that can occur in the market. This includes flexibility to be able to cut data so you can get the right information quickly to understand the types of exposures that you might be facing.

Additionally, flexible technology is required to support scenario analysis and the quick adjustment to collateral management procedures, such as eligibility criteria. For example, if a firm sees a potential crisis, such as with Greece, it needs to have the complete analysis of the scenario to see what it holds and what it would mean if the firm stopped taking Greek government bonds for its collateral agreements. The firm would also need flexible technology so it can conduct the scenario analysis and make the necessary changes to help protect a firm during heightened states of alert when decisions need to be made in hours to best protect a firm.

Q. How can a potential client differentiate one collateral management service offering from another?

There are many important aspects of a collateral management service that a buy-side client should consider.

First of all, a buy-side firm wants to choose a client clearing service provider who has access to as many central-clearing members as possible now and in the future. Therefore, pedigree and breadth will be important to a client because it would not need to worry about appointing another clearing service for any new markets that arise because market coverage is already there. Breadth is important to allow buy-side clients to invest in a 'future-proof' clearing and collateral management service.

Secondly, the value-added services a provider offers are important to help buy-side clients manage the various collateral pressures that will be introduced as a result of central clearing. For example, through the upgrade services, the service provider can help oil the wheels of the process by acting as collateral intermediary between client and central clearer to help a client most efficiently meet collateral obligations. The service provider that offers this service most effectively will have a huge advantage.

Timing is another element of a value-add service that will differentiate offerings because some service providers may be able to offer clients extra time to meet the service provider's collateral request, but will meet central clearing collateral obligations on its behalf in the meantime. This extra time delivers extra value because the buy-side clients will be less rushed when sorting out what collateral they need to provide and by when.

Netting is an important part of the clearing and collateral management service because one of the disadvantages of central clearing is that participants lose some of the netting benefits of trading bilaterally. A service provider can help replenish some of those netting benefits because if a service provider is trading bilaterally with a buy-side client, then it can net the exposure of the client's bilateral trades with the centrally cleared trades. In doing this, the service provider can help reduce the amount of collateral the buy side would then have to post to support centrally cleared transactions.

In summary, the main thing is that collateral management services help to cushion the challenges the buy side would have to face with central clearing and to comply with other industry changes that may occur as the market landscape continues to evolve.

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