Breaking Collateral Bottlenecks
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The success of the G20 agreement finalized in Sept. 2009 to enhance transparency and increase market stability while reducing counterparty, operational and liquidity risk will be largely dependent on the efficient management and effective allocation of collateral. The industry's ability to meet this challenge, however, rests on cross-border collaboration and the development of holistic, industry-wide solutions.

Collateral has always been crucial to the efficient functioning of funding and capital markets and, in turn, essential for economic growth. Prompted by the G20's reform agenda, however, the introduction of central clearing and increased margin requirements for non-centrally cleared derivatives has put a strain on the ability of market participants to manage their collateral processes, largely due to a combination of outdated and siloed collateral management systems and collateral fragmentation.

In fact, a recent academic study published in June 2014 by the London School of Economics (LSE) highlighted the increasing occurrence of collateral bottlenecks due to weaknesses in financial market infrastructure. These weaknesses lead to eligible collateral becoming immobilized in one part of the system and unattainable by credit-worthy borrowers that need access to their inventory of collateral for central clearing purposes and increased margin requirements for bilateral transactions. Additionally, such borrowers also need to track and optimize their available collateral, including assets held at other banks and custodians, to fulfil their investment and trading strategies. In today's marketplace, the ability to successfully analyze the collateral implications of a trade before it is executed is paramount and enables more efficient management of the available assets.

Firms, having fully grasped their collateral obligations, are becoming increasingly concerned about their ability to comply with new regulations governing the use of derivatives, including Dodd-Frank and the European Market Infrastructure Regulation (EMIR). They now have a heightened level of awareness of the need to review their processes to account for new margin and collateral requirements for both cleared and non-cleared derivatives transactions, which will bring efficiency to their collateral management processes, enabling them to remain competitive and drive down costs. This has been made even more important now that assessments of available collateral have to be made in real time for transactions that are centrally cleared.

A large number of firms, however, are still using outdated processes and fragmented systems to manage their collateral. Indeed, too often, collateral is managed in silos across an organization – both geographic silos and across business lines. This makes it almost impossible to have a holistic view of what securities are in use and where securities collateral is at any given time. The net result: a sub-optimal collateral processing environment that is costly and by definition an environment that does not maximize the collateral possibilities of the firm's entire portfolio.

There are currently a plethora of automated collateral management solutions encompassing everything from portfolio margining to collateral optimization, all attempting to address the different components of the collateral challenge. However, the sell side, buy side, central securities

depositories (CSDs) and custodians alike all recognize that these fragmented solutions only address parts of the problem.

For firms that use fragmented and legacy systems, it is essential that they review their processes to ensure they can manage workflow changes – in many cases, legacy systems will no longer be flexible enough to adapt to the new regulatory requirements. Firms should therefore consider the impact of using these types of systems from an investment, trading and operations perspective. Perhaps an alternative would be to instead look at holistic solutions and offerings that can address these problems and help ensure compliance with collateral and clearing requirements worldwide.

Second, while reviewing processes and implementing collateral management solutions at an individual firm level is crucial, collateral mobility needs to be addressed at an industry-wide level. Given that its supply is finite, collateral must be able to move smoothly and efficiently throughout the financial markets – a collateral bottleneck in one part of the system can have a knock-on effect across the markets and risk choking the global flow of liquidity. Just as individual car owners do not control the traffic light system for the safe movement of traffic and reduction of congestion, nor can derivatives users be expected to manage global collateral mobility.

Recognizing 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. The joint venture will create a global Collateral Management Utility (CMU) that will follow the development of a Margin Transit Utility (MTU). [Note: Certain aspects of the MTU and CMU are subject to regulatory approval.]

The MTU, which is in advanced stages of development, will leverage DTCC-developed infrastructure, and will offer straight-through-processing possibilities for margin obligations. Using electronic margin calls between market participants, the MTU will utilize Omgeo's ALERT database to enrich the agreed margin calls with the standing settlement instructions for cash and securities transfers and pledges, and then automatically generate and send the appropriate delivery/receipt, segregation and/or safekeeping instructions to the applicable depositories and/or custodians. The service culminates with the investment managers, Futures Commission Merchants (FCMs), and General Clearing Members (GCMs), dealers, and clearinghouses 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 (GTR), providing a complete view of risk exposures in the event of a future market crisis.

As envisioned, the CMU will harness the open architecture of Euroclear's Collateral Highway and enable users on both sides of the Atlantic to consolidate assets under a single inventory and collateral management system. This provides them the possibility to optimally allocate mutualized assets to meet exposure obligations in both the European and North American time zones. Collateral processing is done across a single virtual pool even though the assets remain on the books of each

depository, with each opening accounts in the other depository. 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.

While the new derivatives trading and clearing environment will benefit the market and increase investor confidence in the long term, in the short term, firms must be equipped to adapt to these changes. The key to doing so is for market participants to understand their impact and to be able to prepare by implementing holistic and community-based infrastructure solutions. To that end, DTCC is continuing to collaborate with industry partners to develop solutions that address the operational challenges and risks associated with the increased demand for collateral.