Overcoming the margin challenge

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Collateral has always been vital in ensuring the smooth functioning of funding and capital markets and in turn it has been essential for economic growth. However, regulation is creating fundamental challenges to existing operating models of market participants that trade over-the-counter (OTC) derivatives.

A particular challenge for firms globally is the introduction of central clearing and new rules around initial and variation margin for non-cleared derivatives. Regulatory changes could prompt a ten-fold increase in margin call volumes which has the potential to overwhelm operational processes and system infrastructures.

Under G20-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.

As regards non-centrally cleared OTC derivatives, regulatory proposals in both the US and Europe require the implementation of new risk management processes, including operational processes and increased margin requirements for many. According to IOSCO, there will be a measurable impact from margining non-centrally cleared derivatives on market liquidity, as the assets that are provided for collateral purposes cannot be readily deployed for other uses over the life of the non-centrally cleared derivatives contract.

In practice, global regulations 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 OTC derivatives transactions. Firms need to be ready to restructure their operations as the requirements represent a significant operational change that will need to be managed.

The extent of the challenge of implementing the new rules will vary from firm to firm, depending on the existing levels of sophistication of a firm's middle office processes. Two areas of potential concern are firstly, firms that have not traditionally collateralised their OTC derivatives which will need to set up operations, hire people and deploy technology as well as execute collateral agreements with counterparties. Secondly, 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.

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, operational capabilities and settlement exceptions management, and reporting and recordkeeping.

Funding costs will rise because the increase in volumes will require firms to fund larger cash balances to meet expected margin calls; while firms will need to further increase their liquidity buffer to ensure all margin calls can be met to reflect the expected increase in calls and the risk associated with not meeting a call. The lack of certainty around intraday obligations and settlements will magnify intraday exposures and funding squeezes during times of extreme market stress.

Furthermore, firms will need to invest in both technology and the reengineering of the settlement process, exceptions management and dispute resolution. Also, the increase in margin call volumes will necessitate more comprehensive record keeping across a broad category of services.

Among the most critical factors for successful management of complex collateral processes is leveraging standard messaging platforms for collateral processing and collateral settlements. Standard messaging to communicate margin calls and settlement activity is particularly critical given the growth of interconnected players and segments in the collateral markets.

In order to meet the challenges around collateral supply, new solutions and opportunities in collateral management are being implemented by the industry. Some offerings focus on specific problems while others represent elements of larger strategic initiatives. Essentially, however, firms require end to end straight-through processing (STP) to support trading infrastructure and compliance needs, and to help them navigate the new regulatory landscape of increased margin calls.

Large and small asset managers, fund administrators and custodians, have indicated that they would prefer strategic, industry-led solutions to address the challenges related to collateral to avoid costly fragmentation.

Recognizing that the industry requires a solution to address both the scale and the efficiency of the collateral management challenge, DTCC has been working on a key initiative with Euroclear to develop new open architecture services, which aim to reduce systemic risk in collateral processing on a global scale and to help market participants improve efficiency, reduce risk and enhance collateral mobility.

The joint venture will bring to market the Margin Transit Utility (MTU) and Collateral Management Utility (CMU). The MTU will provide STP of margin obligation settlement, leveraging current DTCC infrastructure, as well as additional infrastructure currently in development in coordination with the industry. Industry testing of the MTU is scheduled to begin in mid-2015. The CMU will address the global challenge of sub-optimal collateral allocation and mobility, through utilizing Euroclear's Collateral Highway technology, and will follow the launch of the MTU.

Margin Transit will be open to all collateral processing providers such as custodians, international central securities depositories (ICSD), and collateral management vendors. Establishing links to all participants will facilitate the establishment of the first industry-owned, comprehensive, STP solution for streamlining the management, settlement and reporting of collateral.

Collateral will continue to play a critical role in underpinning the efficiency and stability of the financial markets; however, new regulations will create greater collateral demands on market participants. As a result streamlining margin settlement processes and enhancing access to collateral, will become a pre-requisite to the smooth functioning of the financial markets and a means of, more generally, improving the safety and soundness of the financial markets globally.