The evolving role of collateral

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Discussions around collateral use and re-use has always been central to the CCP debate. As central clearing takes a more prominent place in the market, Eurex Clearing discusses its role in manage its member's risks and increasingly large collateral pools

In a poll of the audience at Eurex's recent derivatives forum in Frankfurt, a clear majority of respondents stated that the optimisation of margin requirements is the biggest challenge currently being faced in collateral management. This is not at all surprising given the current market environment. Indeed, optimisation will become an even greater challenge as we approach the next phase in the implementation of the Uncleared Margin Rules (UMR) and as volatility returns to the market – something we have had a taste of in recent weeks. Greater volatility will mean, for many market participants, more frequent and larger collateral calls across multiple relationships and this will only make the optimisation challenge even greater.

Optimisation from a CCP perspective

From the point of view of a central counter party (CCP), our role is to manage risk and part of this involves collecting margin from our clients and members. If you look at the total collateral that is currently placed at CCPs globally, it's in excess of a trillion dollars. So, as a major CCP,

we have huge amounts of collateral to manage and our primary concern here is to ensure the safety of this collateral – both cash and securities – and maintain the integrity of the system. Roughly speaking, around half of this collateral is cash. What we do with this cash is very important; we don't want to give it back. For example, reverse repo transactions – to the same members that posted it with us as this could cause an issue in the case of a default. This is one of the reasons we are strong advocates of CCPs having banking licences at Eurex, with such a licence, we can deposit this cash with a central bank. We also accept a broad range of collateral. This is important as not only does it help our end clients stay fully invested, but it can also help us, as a CCP, to diversify our risks; we would not want all of our clients to provide exactly the same collateral as we need to manage both wrong way and concentration risks. So, when we think about optimisation, from our perspective it is the safety and integrity of the collateral that we're being given that is crucial.

Technological change: automation and digitisation

There are several aspects to the use of the latest technology in our business. We are a real time risk manager and our clients are constantly executing new trades. All these trades need to be collateralised before we will accept them and, while clients are carrying out new trades, the market is moving and the value of all their existing trades thus also changes. This means we use very sophisticated technology to calculate the value of new trades in connection with the value of trades that the client already has in their portfolio against the value of their collateral – all in real time.

Going forward, one very exciting area in terms of margin and collateral optimisation is the digitalisation of collateral. You can envisage a situation where, in a closed environment like a CCP, you could effectively digitalise the securities that you have there and that this then allows you to utilise them without having to physically move the securities. Of course, this will likely have to take place in a highly controlled and regulated environment. There's a company we partner with called HQLA^X that has already taken steps down this path, and we're excited to explore this innovative area with them.

Opportunities for the buy-side

Collateral transformation is an interesting area for the buy-side. We have many buy-side clients that have high quality liquid assets in their portfolio, and other clients – for instance, EM funds – who have assets that, as a CCP, perhaps we don't accept as collateral. So, there's a huge opportunity for buy-side firms that own high quality collateral to generate extra alpha. For firms that don't have the right quality assets, rather than having to divest, they can instead borrow those securities and then place them at the CCP. I think collateral transformation within the clearing and collateral management space is a huge opportunity to boost efficiency for many buy-side firms as relationships that were previously bilateral are brought into the CCPs.

In a similar vein, the potential to reduce fragmentation within a single currency that is accompanying the growth of central clearing across multiple asset classes – for example repo, futures and over-the-counter (OTC) derivatives – presents a great opportunity to bring together formerly disparate pools of collateral. Where there are properly correlated risk offsets, the potential for optimisation by reducing the amount of margin required is huge; as well as the operational benefits, if you only need to use one pool of collateral then you only get one margin call, and so on. The chance to unite these things is going to be a big opportunity for buy-side firms to increase efficiency.

Collateral and the growth of ESG

Clients want us, as a CCP, to be able to accept as broad a range of collateral as possible; we constantly have clients coming to us asking us to add this or that security. This is clearly going to happen increasingly often with respect to new environmental, social and corporate governance (ESG) products. From our perspective, we need to look at the risks associated with any collateral. For instance, how liquid is it and could we easily dispose of it at a fair price, if need be?

An interesting example of this came recently at a meeting with the German Finance Agency. They were about to issue some green bonds and wanted to make sure that these would be deliverable into the normal Bund futures basket, so they came up with a really good design for how this could work. The issue here was that you had a bond issue that isn't particularly large – something that could negatively impact liquidity – and they effectively made it fungible with regular Bunds, so it still has the advantages of that big pool of liquidity.

Comparing the US and European landscapes

The US is a few years ahead of us in the implementation of mandatory clearing and we have a little catching up to do. They have very clearly

defined rules, while we have the issue of 28 different regulators working together. They also have a more positive interest rate environment.

We're in danger of lagging behind and we need to be more innovative to compensate. But there are certainly opportunities to do this: for instance, at Eurex we created total return futures, where we looked at the total return swaps market and decided with our members that a futures version of this was needed. There's more innovation still to come, but a lot of resources have so far been tied up with addressing regulatory compliance and this has certainly slowed things down.

Another thing that's missing in Europe is getting direct access for the buy-side to things like repo and securities lending. While Eurex Repo and Eurex Clearing do have well established models in place, what would really benefit the marketplace is a European version of the US Fixed Income Clearing Corporation (FICC) model, which has been incredibly successful over there; this is something that Eurex, with a number of key market participants, is working to develop.

Regulatory issues

The amount of new regulation over recent years has been challenging for many market participants from a resource point of view, and it would be nice to have a pause in this respect. However, we accept what this regulation is designed to do, and that there may well be even more regulation coming. In this respect, one development we would like to see is permitting the reuse of cash from UCITS funds which would be a massive help to many market participants.