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What market infrastructures can do for collateral managers

Expectations of a global shortage of collateral have not disappeared. They have merely receded. The question is what might precipitate a squeeze on eligible collateral. To avert a shortage, it is essential to widen the range of eligible collateral and broaden the range of market participants to include corporates as well as fund managers.

Giving market participants the ability to move assets quickly and efficiently from wherever they are to wherever they are needed is a crucial to that process. While greater internal efficiency in collateral management is helpful, seamless movement of collateral also requires market infrastructures to develop automated and standardized collateral mobilization services.

MI Forum Magazine editor Dominic Hobson discussed with Ted Leveroni, executive director of strategy and buy-side relations at the Depository Trust and Clearing Corporation (DTCC); Andrea Tranquillini, managing director, business development, at globeSettle, the central securities depository (CSD) owned by the London Stock Exchange Group; and Jean-Robert Wilkin, executive director and head of product management, global securities financing, at Clearstream in Luxembourg how market infrastructures can contribute to the development of a truly liquid global marketplace in eligible collateral.

Jean-Robert Wilkin

Executive director and head of product management, global securities financing, Clearstream

Ted Leveroni

Executive director of strategy and buy-side relations, DTCC

Andrea Tranquillini

Managing director, business development, globeSettle

"There is an increasing need, due to regulation, for a change in market practices. The world has evolved from an unsecured to a secured environment, from an un-cleared to a cleared market, and from commercial bank money to central bank money, but the infrastructure to underpin all this has not kept pace."

- Andrea Tranquillini, globeSettle

The predicted global collateral shortage has not yet materialized. Why?

Wilkin: In my opinion, this is due to delays in regulatory implementation, especially concerning the transition from bi-lateral trading to centrally cleared OTC derivatives. Sell-side firms have also de-leveraged, reducing their need for collateral. If you combine that with low interest rates, it is not surprising volume growth is lower than expected. Curiously enough, at the moment we even see a decrease in the amount of collateral we manage on behalf of central banks. The collateral deposited at central banks, at least in Europe, is decreasing. We were expecting repo volumes to pick up again, which they started to do two years ago, but now we see a downturn in the amount of collateral volume being mobilized in repo markets too.

Leveroni: The drivers of the collateral shortage were going to be mandatory OTC derivative clearing in the United States (U.S.), Europe and Asia, and implementation of margin calls in non-cleared markets, which were going to require copious amounts of collateral. Of those five drivers, only one has been implemented, and in one country only. Firms that we deal with still believe that a collateral squeeze will occur. They also expect the squeeze to be felt in a non-equal way, based on what firms trade, the nature of their business and what they have naturally at hand in terms of available collateral.

What will trigger that collateral squeeze?

Leveroni: Implementation of the mandatory clearing regulations in Europe and Asia, and of the non-cleared margin rules globally, in the U.S. as well as Europe and Asia. The collateral shortage will not be a tsunami that occurs on a certain date. It is a tide that will rise as each of these regulations is implemented, and the impacts will increase as a greater proportion of swap transactions fall under the new collateral requirements.

Wilkin: The balances of all tri-party collateral agents have increased. This is due to the increasing use of equities as collateral, and the greater use of tri-party structures by securities lending agents, which are replacing cash with non-cash collateral. We also see central counterparty clearing houses (CCPs) move away from cash as collateral because, like the banks,

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they do not know where to reinvest it.

Tranquillini: globeSettle looks at the collateral management world from a different perspective, because we do not provide collateral management services directly. Instead, we are an infrastructure that aims to help market participants manage the regulations that are coming into effect over the next few years. From that perspective, the concept of collateral "scarcity" is not correct. It would be more accurate to say that collateral is misplaced, and that the infrastructure is not efficient in moving collateral to where it is supposed to be. For this reason, there is an increasing need, due to regulation, for a change in market practices. The world has evolved from an unsecured to a secured environment, from an un-cleared to a cleared market, and from commercial bank money to central bank money, but the infrastructure to underpin all this has not kept pace. Take, for example, the fact that you can leverage the Correspondent Central Bank Model (CCBM) of the Eurosystem quite efficiently for collateralization in central bank money, but only until 4.00 pm in the afternoon. So you have limited operating hours for transferring collateral. Think how many trillions of Eurobonds we have that could be eligible as collateral. $25 trillion? In five years' time, money market funds and exchange traded funds (ETFs), as well as Eurobonds, could be eligible. But they can be used only if we have an efficient infrastructure to get the collateral moving. I believe we should try to build the concept of a single global collateral day, because we are talking about global banks that think globally, whose treasury is global, and who serve as collateral agents and clearing members in different locations and geographies.

What will the infrastructure that supports a global collateral day actually look like?

Leveroni: There are going to be challenges, but what will make them surmountable is to change the model, and the model is changing already. What we now see is collaboration. Standardized, quasi-utility services are being offered not only by individual infrastructure providers but also by groups of industry players that have got together and said, 'You know, we could use an industry solution here.' DTCC-Euroclear Global Collateral

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Limited, the partnership between Euroclear and DTCC, is an example of one. There is collaboration, there is co-operation, there is creation of solutions, at unprecedented levels. That is the model going forward. It is not the creation of a single global pool of collateral. It is collaboration between the CSDs to create a single virtual pool of collateral.

Tranquillini: I agree. We see more and more co-operation between infrastructures and commercial entities. It helps to create a globally integrated collateral market, but the industry is still fragmented. T2S is an improvement but it is limited to Europe. How we connect Europe to the rest of the world, mobilizing non-European collateral into Europe and vice-versa – this is the next frontier. The more U.S. collateral becomes eligible in Europe, the better, because Europe is in the middle of the global collateral day. I agree there will never be a single global pool of collateral, but we will have what we are missing today: efficient connections between different pools of collateral. For this, we also need to overcome conflicts between the Dodd-Frank Act in the U.S. and the European Market Infrastructure Regulation (EMIR).

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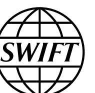

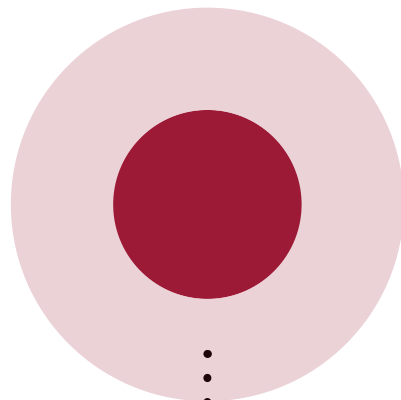

Wilkin: The Liquidity Alliance partnership we have formed with other market infrastructures makes the collateral management technology and the expertise Clearstream has developed available to local CSDs around the world on a white-label basis. It is a business process outsourcing (BPO) arrangement, where we at Clearstream white-label our technology and operate the platform on behalf of the local CSD. This makes it easy for the CSD to provide a collateral management service in their market at a relatively low cost. It connects the different collateral pools, making it more efficient and less costly for market participants to move collateral around. To a certain extent, the Liquidity Alliance is comparable to the DTCC-Euroclear joint venture because, instead of implementing a collateral management solution alone, the partners have chosen to share technology and expertise.

Leveroni: Global Collateral Limited is indeed similar. It not only offers the linkage between the DTCC and Euroclear to permit collateral mobility east–west, but leverages the Euroclear tri-party collateral management service via a Collateral Management Utility (CMU). By linking the CMU to the Margin Transit Utility (MTU) at the DTCC, firms can agree on their exposures, identify the optimal collateral to deliver via the CMU, and then deliver it via the MTU. If it is within the DTCC-Euroclear environment, the collateral can be moved by electronic book-entry transfer. If the collateral is elsewhere we can electronically instruct its movement. The end result is increased automation and mobility.

What factor do you think will be most powerful in driving the creation of a global collateral market?

Tranquillini: The principal driver is regulation. We should admit that the most significant changes on the infrastructure side are driven by regulation, and from the Giovannini Barriers until T2S regulation has been in the driving seat of re-shaping the market infrastructure.

Leveroni: There needs to be an infrastructure to move collateral from locations that are collateral-rich to locations that are collateral-poor. That is pure infrastructure. It is the roads and the bridges that collateral move across. There probably is enough

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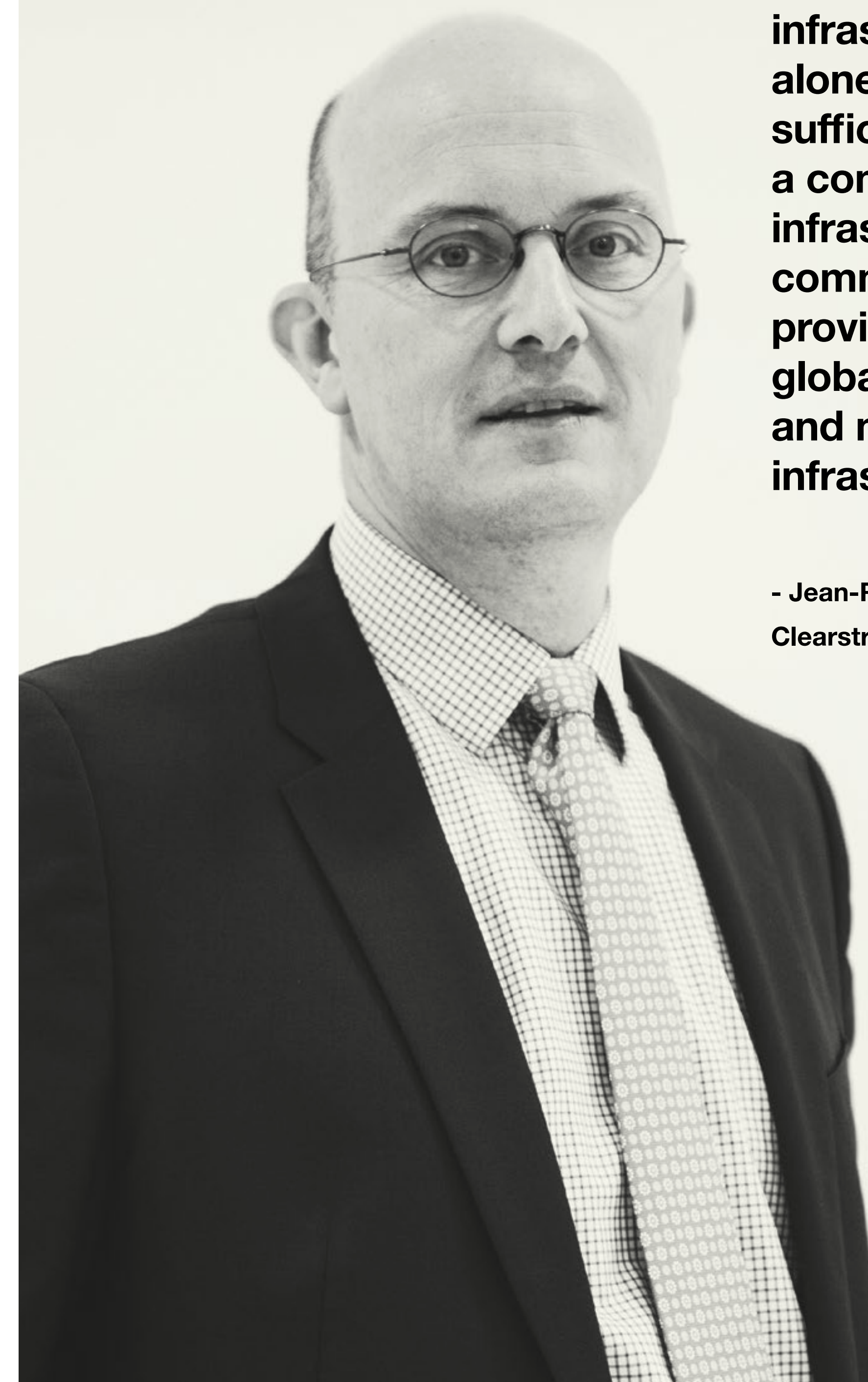
collateral in the world in aggregate. It is ensuring that it can be mobilized, and transformed, and optimized so it gets in the hands of the right people at the right time. That is where infrastructure comes in. That is where all of us are looking to help the industry.

Wilkin: Market infrastructures alone will not be sufficient. Why? Because the biggest challenge we face is the dramatic increase in the number and the type of participants in the collateral management market. For the last four or five years, we have talked about the inter-bank market and the commercial bank to central bank market. Tomorrow, the challenge is to introduce the buy-side to collateral management. Fund managers need to deliver collateral for cleared and uncleared margin calls. They need access to collateral givers. In many cases, they lack the right assets, because investment managers are not paid to manage cash. They will then need to deliver. Will we be able to support that? None of us can do it on our own. It requires a combination of the infrastructures and the commercial service providers – between global custodians and market infrastructures.

Why will the buy-side require a different combination of providers to the sell-side?

Wilkin: Market infrastructures are really collateral *administrators*. The buy-side needs providers that are prepared to use their balance sheet to resolve their collateral challenges. That role will not be fulfilled by the investment banks any more, because they want to move away from that type of business. The global custodians will have to play a more active role in servicing their buy-side clients, including putting their balance sheet at risk.

Leveroni: It is worth remembering that the buy-side is not a single, monolithic entity. Each buy-side firm has a different mandate, different holdings and different needs. There are firms that have eligible collateral in their portfolios. Other firms have no need for eligible collateral, because they do not trade derivatives, and can actually leverage what they have in their portfolios by lending it, or repoing it out for an extra return. Some buy-side firms look at the future collateral challenge as an opportunity - others as simply a challenge.



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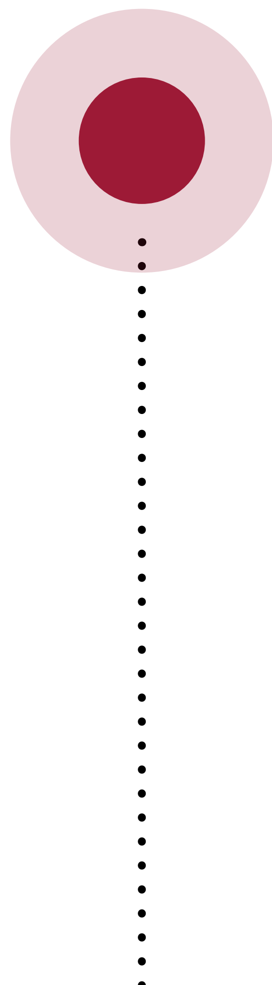
Can you envisage a time when the buy-side open accounts directly with the market infrastructures?

Leveroni: It is possible but difficult, especially at the CCPs. Mutualization of risk is an essential component of CCP risk management, and that is difficult for a buy-side firm to accept. So there would have to be a significant model change for the buy-side to become self-clearing. However, the motivation is there, so it may happen.

Wilkin: Eurex Clearing has already opened up to buy-side firms for certain types of repo and securities lending transactions. Our sell-side clients are actually calling for buy-side membership, because they need to collateralize transactions with fund managers, and where else can they do that? They are happy with the solutions we have provided for them, and they want to re-use the same solutions with their buy-side clients because it is the easiest way to do it. It is not as easy for the buy-side because they are not connected to market infrastructures. That is why we need collaboration between market infrastructures and global custodians, who are the natural service providers to the buy-side.



What can be done to encourage corporates to participate in the collateral markets?

Leveroni: Corporates are active in the tri-party repo market today. Many are cash-rich, and act as cash providers. But no two corporate treasuries are alike, in the same way that no two fund managers are alike, so to talk about them as a monolithic entity is inaccurate. In fact, you see a lot of corporates acting like investment managers in the money markets. Investing cash in repo is, for the foreseeable future, the space they will play in. However, there is discussion about getting corporates to be more active liquidity providers in a cleared environment, and some firms see that as an opportunity.

Wilkin: It is the same in Europe, where corporate treasurers are not involved in the centrally cleared markets, but like to place cash against collateral, and tri-party is the easiest way to do that. We have connected our service to money market trading platforms, and devised a simplified multi-lateral trading agreement to encourage corporates to participate. Despite our efforts, not all corporates are SWIFT participants, so not all of them can

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use SWIFT to instruct their tri-party agents. However, I strongly believe that we will soon see corporate to buy-side transactions developing because, once we have connected corporates to our infrastructure, they can trade with non-banks as well as banks. It is of course in commercial bank money only, since they do not have accounts at the CSD.

Does tri-party have wider application in facilitating the growth of a global collateral market?

Wilkin: Yes. Tri-party is one of the tools which will definitely be leveraged for many different types of collateralization. One of the challenges all of us are trying to address is non-cleared derivative margining, as its moves from cash to non-cash collateral. The sell-side wants to use tri-party to meet it.

Leveroni: I agree. We are going to see more tri-party collateral management. The implementation of the regulations is so challenging that participants will come to rely on tri-party more and more. It also meets an operational challenge. Firms are becoming more holistic in how they manage their collateral, but most still have separate collateral management solutions for different lines of business. It is difficult to leverage these to cover foreign exchange, repo, securities lending and cleared and non-cleared OTC derivative collateral management.

What part can standards play in making collateral management more efficient?

Leveroni: A lot. An example would be the SWIFT messages for collateral. The challenge is to get people to use them. We all benefit from standards once they are used, but everyone has a long list of more pressing technology priorities, especially in terms of regulatory compliance, so standards adoption is at risk of falling behind. That is where community-based offerings can facilitate the use of standards on an industry-wide scale.

Wilkin: As tri-party agents, we make good use of SWIFT messages, and they are well accepted by our clients too. We are now applying them for CCP collateralization, but only for exposure notifications, when we

face many other problems, such as collateral eligibility and concentration criteria. Standards for these do not exist today. But there is a big demand for them because, if we want to automate collateral flows on a global scale, standards are essential. Either everybody uses a single provider for global collateral management – so that entity can impose its own standards – or SWIFT must come up with a collective set of industry standards to facilitate inter-operability between different providers.

Is the main obstacle to standardization the fact your counterparties are not on SWIFT?

Wilkin: No. The standard goes beyond the SWIFT network. Once we adopt a standard, we propagate it externally with our clients, as well as internally. Many of our clients use the SWIFT messages without even knowing it, because we present them with standardized formats. They might even believe it is a Clearstream standard but, if they go to another tri-party agent, they will realize that they are expected to provide exactly the same thing. That is the benefit of SWIFT coming up with the standards. They can be adopted and used on and off the SWIFT network.

Leveroni: There is a growing understanding that standards need to be leveraged, in more and more of the collateral space in the U.S.

Standardized documentation on a global scale would help too. Who should drive that?

Wilkin: This is an opportunity for the International Swaps and Derivatives Association (ISDA) to come up with a pragmatic solution. If thousands of market participants could sign up to a single document it would make it easier to exchange collateral.

Leveroni: The documentation challenge is a balancing act. We want standardized documents but there is a reason to resist them, especially in the derivatives markets, which need a lot of customization. It is up to ISDA and the Securities Industry and Financial Markets Association (SIFMA) to look at that dilemma and ask, `How can we create more standardization while still allowing for the customization that individual firms are going to require?' One of the biggest success stories of standardization is the move towards

open standards that are breaking through global barriers

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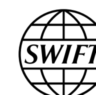

clearing in the U.S. That created a huge new collection of standardized documentation and contracts.

Wilkin: In standardized financial transactions like repos or securities lending or OTC derivatives, even if they are not centrally cleared, the days of expensive bi-lateral agreements should be over. We have come up with single multi-lateral agreements for both fund managers and corporates, which enable them to trade tri-party with every other counterparty. Contrary to perceptions, these marketplace agreements do not compete with or replace standard documents, but they have encouraged much wider participation in the global collateral markets.

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