

Collateral Rising

Managing Counterparty Risk with OTC Derivatives Collateral Management

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Managing credit risk remains a top priority of financial institutions and corporations, thrown into sharp focus by recent market events. As participants in OTC derivative transactions come under increasing pressure to mitigate counterparty risk, many have returned to the original risk management tool: collateralization.

The use of collateral in OTC derivatives has grown dramatically over the past eight years. While it is unclear how potential regulatory changes will impact this trend, the number of collateralized derivative trades is expected to show consistent growth. Demands for more frequent reconciliation and access to pricing utilities are adding new levels of complexity to the additional volume. These trends create a clear need for more advanced collateral management platforms to replace the increasingly stressed and outmoded spreadsheet-based systems.

The Impact of Regulatory Changes on Use of Collateral

The widely anticipated regulatory changes will likely impact the use of collateral in OTC derivatives trading. A move to central clearing for 'standardized OTC instruments,' for example, would eliminate the need for some trades to be collateralized bilaterally. As the vast majority of OTC positions are not standardized, however, such measures would be unlikely to seriously reduce collateral use.

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Ahead of these changes, the financial industry has taken a proactive stance on mitigating counterparty risk. In its June letter to the Federal Reserve, the International Swaps and Derivatives Association (ISDA) defined three key pillars for collateral management:

1. Rapidly put in place robust **portfolio reconciliation** practices to detect significant trade population and valuation differences that could generate disputed collateral calls. The Fed 16 dealers have already made strides towards daily reconciliation.
2. Set out a **road map for collateral management** focusing on independent amount risk issues; electronic communications that will standardize margin calls; portfolio reconciliation; CSA review; and the development of best practices for collateral management. Many of these recommendations are on track for implementation by year-end.
3. Develop a **new collateral dispute resolution process** for the industry.

Complexity and Scale

While mitigating counterparty risk, several of the ISDA recommendations place greater demands on collateral management systems. Daily portfolio reconciliations alone necessitate more robust collateral management capabilities.

Over time, the ability to sustain continued growth and understand counterparty risk on a global basis will require greater interoperability – significantly reducing the ability of collateral systems to remain in silos. Ultimately, these interconnections will promote enterprisewide collateral management.

Both the number of collateralized OTC trades and the total volume of collateral in circulation increased steadily from 2003 through 2008 (see chart above). According to a survey by the International Swaps and Derivatives Association (ISDA), the percentage of trades collateralized rose from 30% to 59%, while the collateral volume grew 60%. This trend rapidly accelerated as recent events increased the focus of counterparty risk. Estimated collateral in circulation will increase 86% this year to \$4 trillion (greater than the GDP of Germany). While this may well represent a near-term peak, an upward drift in the use of collateral is expected.

Interoperability and Standardization

Recognizing that community solutions are inherently stronger than private solutions, there is a strong move towards the use of peer-to-peer platforms in portfolio reconciliation. These platforms provide counterparties with common views of each other's data, allowing desks to confirm trades and resolve valuation issues.

They may also serve as an early warning system for systemic patterns of trade population and valuation discrepancies. During a recent J.P. Morgan OTC Derivatives Collateral Management Forum held in New York, the importance of shared data was a key topic of discussion. With shared data, desks can clean up the discrepancies stemming from timing and data source issues, clearing the way to

identify areas of genuine dispute. Standardized margin messaging would increase automation options and enhance speed.

Peer-to-peer platforms may also help solve discrepancies. In addition to providing an early-warning system, the ability to aggregate data from over 70% of all non-cleared OTC trades provides precedent to assist with difficult valuation issues.

Robust Systems and Experienced Management

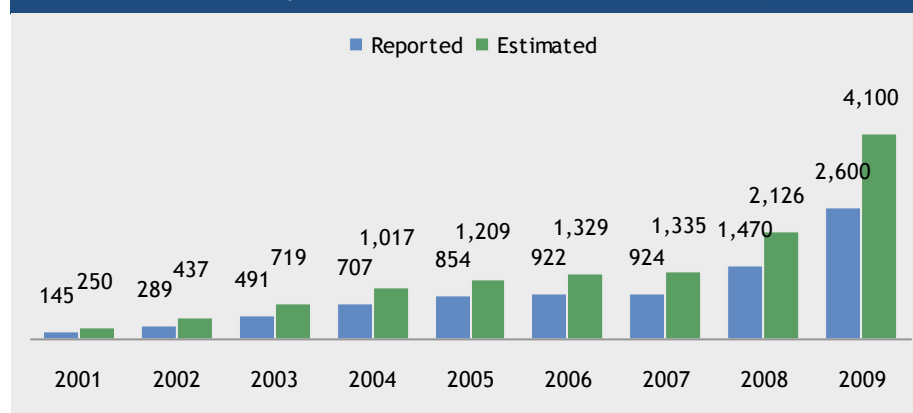
According to Colm Gaughran, Global Product Manager for Derivatives Collateral Management (DCM) at J.P. Morgan, “We increasingly see that spreadsheet-based operations cannot keep up with increasingly sophisticated demands of OTC derivatives collateral management.” Replacing such systems, however, requires a substantial investment from already constrained IT budgets. A limited pool of qualified professionals further hinders the ability of many institutions to upgrade their collateral management systems.

In the face of such challenges, J.P. Morgan's fully-outsourced DCM solution is a proven and attractive alternative to internal solutions. This scalable solution offers the ability to reduce counterparty risk while minimizing new operational risk. It enables interoperability, provides links to peer-to-peer utilities, and even supports the future direction of daily reconciliation without requiring any substantial IT investment.

While regulation will clearly evolve, the use of OTC derivatives as an essential tool to control investment risk is expected to grow. Collateralization will continue to play an increasingly important role in mitigating the counterparty risk of these transactions. Together, these imperatives reinforce the need for a robust, transparent and scalable OTC derivatives collateral management program.

J.P. Morgan's forums bring market participants together to discuss the latest industry trends and developments.

Growth in value of total reported and estimated collateral, 2000-2009 (\$ millions)



Source: ISDA, 2009