
FTfm – OTC derivatives special report

Collateral will be key in shake-up for derivatives

Industry view

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The \$600,000bn OTC derivatives market is about to undergo the most significant change in its history. Regulatory changes, which will have considerable legal, operational and commercial impact on dealers, users and processors of OTC derivatives are set to be implemented over the next 12-18 months.

Through Title VII of the Dodd Frank Act in the US, and the European Market Infrastructure Regulation (Emir) in the European Union, the use of collateral for what have been bilateral agreements will be altered permanently.

Today, OTC derivatives counterparties typically do not use a collateral agent because the trading is primarily bilateral, with margin calls and collateral management handled in-house by one of the counterparties. The kind of collateral accepted is discretionary and governed by the “credit support annex”, a legal document that agrees collateral terms for derivatives transactions, and is part of an Isda (International Swaps and Derivatives Association) contract negotiated between the counterparties.

Once Dodd Frank and Emir are enforced, when a derivative contract is centrally cleared that previously would have been OTC, both sides of the trade will have to meet the stringent collateral requirements imposed by the central counterparty. If the trade is not centrally cleared, regulators plan to impose new, more rigorous margin and capital requirements for the parties.

Swap dealers and major swap participants are expected to have additional reporting and margin segregation

requirements, and will be required to post initial margin for trades and transactions where it was not previously required.

After the regulatory changes, all market participants will have to post more collateral than previously, and will face more frequent collateral calls.

Firms with a siloed approach to collateral management will face the greatest challenge, as they struggle to track their positions and exposure as activity increases. More active market participants will also have to manage the operational complexity of a portfolio with both cleared and uncleared securities. As a result, they will need to manage margin calls from a broader spectrum of counterparties, potentially with vastly different eligibility criteria and settlement timeframes. These participants may also face the risk of being short of eligible collateral and will need to finance or transform the assets they do have into an eligible form. Under Dodd Frank and Emir, margin calls will move to same day, and market participants are likely to struggle to continue to manage collateral in-house. Participants will have to either build their own systems to handle the complex collateral requirements, license a less expensive but generic existing system, or partner with an agent or outsourcing provider. The last option is likely to be the most cost effective and places the responsibility of having up-to-date technology on a third party.

In addition, all OTC derivatives used by dealers and major swap participants have to be fully collateralised with highly liquid instruments, such as cash and US treasuries. It will probably have to be held in a segregated account by a third-party custodian.

Choice of custodian or collateral manager will be critical to facilitating the right operational environment for a market participant to ensure he or she is compliant in each of these areas. Custodians can make sure all eligible derivatives are cleared through a central counterparty, raise cash or highly liquid securities, such as treasuries, at short notice to ensure full collateralisation, and safely segregate collateral to protect the transaction counterparty.

The final details of these regulations will not be fully known until later this year. When they are finalised, market participants will have only 60 days to implement the new rules. To ensure compliance and keep ahead of these changes, it is prudent to put measures in place that are expected to be required under the new regulatory regime. The changes are far-reaching and regulators will expect compliance quickly.

Here is a check list of what market participants should consider implementing:

- Establish and maintain a collateral account for meeting counterparty margin demands
- Choose a clearing broker and central counterparty to clear eligible trades
- Choose a collateral manager that can help raise cash or securities eligible to collateralise derivatives trades and potentially to provide short-term financing to raise cash against certain securities if necessary
- Safe-keep and segregate independent amounts/initial margin in either bilateral or triparty legal arrangements

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