FOCUS ON

OTC TRADING

As the task of managing collateral becomes more complex, Marc Russell-Jones of J.P. Morgan examines the changing face of OTC trading

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Around the globe, new players are emerging to reshape how collateral is employed. As central counterparties (CCPs) are introduced as intermediaries in the derivatives markets, and certain hedge funds find themselves classified as margin swap participants for their non-cleared over-the-counter (OTC) transactions, how will the collateral management landscape change?

The use of a CCP, once optional, will become mandatory for the majority of OTC transactions as a result of G20 recommendations – forever changing the OTC derivatives markets. Regulatory initiatives, such as mandatory clearing required by the Dodd-Frank Act and European Market Infrastructure Regulation, will reshape the role of CCPs.

As a result of this new legislation, more than two-thirds of current bilateral trade volume is expected to be cleared through CCPs. Swap participants who enter into a centrally cleared transaction will be required to post initial margin to be held by a CCP. Variation margin will then be passed from one counterparty to the other through the CCP, either directly or in the case of a hedge fund through appointing a clearing broker or their prime broker as they do for futures today. These requirements, coupled with a CCP's expected acceptance of highly liquid, high-grade collateral, will put great pressure on the supply of collateral and the cost of trading.

However, although an increasingly broad range of institutions are turning to collateral to effectively mitigate risk, the advent of mandatory clearing introduces a new and more complex market paradigm. As CCPs replace bilateral collateralisation for certain transactions, they effectively become counterparties in their own right. With this in mind, it is important that when a hedge fund appoints their clearing partner or prime broker that they in turn clearly understand the CCP's obligations, both during business-as-usual market conditions and during times of market stress. Within the present regulatory framework, CCPs employ a number of risk mitigation tools that collectively are referred to as the 'risk waterfall'. This establishes a priority as to how available funds are used, and may differ by CCP, which can have different available financial resources. However, CCPs do not present a uniform risk profile to participants as they are not required to have a uniform structure.

In considering the risk profile of individual CCPs that their prime broker is clearing through, hedge funds will therefore also want to understand:

- The reinvestment policy: CCPs are principally allowed to reinvest the collateral received by the participants, which can then (partly) be executed in unsecured form.
- Handling of non-cash collateral: Traditionally, accepting non-cash collateral was not considered to be a strength of CCPs. The implementation of more robust solutions, perhaps utilising tri-party models, will reduce operational risk for the parties involved.
- Adoption of international messaging standards: Historically, CCPs have relied on proprietary communication formats. The incremental option of international standards (such as Swift) may help to reduce the risk of processing errors.
- Insolvency law: The effectiveness of asset segregation models for CCP collateral, as well as the feasibility of portability, depends on the legal framework.

Although historically many transactions have been collateralised bilaterally (such as directly between counterparties), managing and administering collateral in-house can be burdensome. Given the complexity, resourcing and investment required, many hedge funds are now turning to a third-party collateral agent.

Tri-party collateral agents are able to help reduce operational risk and complexity, manage counterparty exposure and support the management of their collateral globally with a wide array of sophisticated solutions to transform and optimise collateral.

In addition to technical support, the tri-party collateral management structure offers an efficient solution to a whole new set of collateral management challenges.

With the cost and complexity of collateral management almost certain to increase in the post-reform environment, tri-party could well emerge as a structure able to address a broad range of collateral management needs of hedge funds.

Having acted as collateral agent within the first tri-party transaction that took place 20 years ago in Europe, J.P. Morgan is well-positioned to support hedge funds' diverse collateral management needs. Today, J.P. Morgan is working closely with CCPs to enhance operational efficiencies and maximise the use of collateral assets, using its tri-party agency service to mitigate operational complexity. ■

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