Paul Walsh: What is the impact of the initial margin (IM) and variation margin (VM) requirements on collateral management?

Michael Albanese: We are in an important period for the industry and we have plenty of experience under our belt when it comes to helping clients adapt to regulatory change overall.

Since the IM requirements were implemented in several jurisdictions on September 1, there are lessons from this experience that everyone can benefit from, not just collateral agents and custodians.

One example is from the September 2016 implementation of initial margin rules in the US and Japan. A significant industry effort was required to prepare legal documents and to agree on collateral eligibility parameters. This produced some important lessons for counterparties, custodians, and collateral agents.

PW: What specific actions need to be taken ahead of the next stage of the implementation?

MA: The first thing I would say is: get started early. Some participants waited longer than they needed to in order to be ready in time for the rules to take effect.

Secondly, if there is a time crunch, I would definitely advocate prioritising. One example is determining those counterparties that are critical to be up and running for trading on day one, versus those that can be onboarded post-implementation. Another example is negotiating collateral eligibility parameters—and potentially saving time by starting with basic eligibility for day one, and negotiating additional permissible collateral types after implementation.

Also, don’t presume deadlines will be extended. In the US, even up to 48 hours before the launch, some market participants were hoping for some degree of regulatory forbearance.

Finally, really try to adhere to the deadlines set by custodians and collateral agents. The up-front work required to meet these deadlines is well worth the peace of mind that your collateral agent and custodian will be able to smoothly onboard your volumes in advance of regulatory deadlines. Frankly speaking, some of our own clients were not always happy that we established interim deadlines, but these deadlines enabled a smooth and orderly transition to the new initial margin rules by September 1.

PW: So does the industry need to go through short-term pain for long-term benefit?

MA: For J.P. Morgan, as a collateral agent and custodian, we’ve collaborated with clients well in advance of the deadlines. We’ve focused attention on making preparations early. While there is always some element of last-minute work done by market participants, making concerted efforts to prepare early is worth the short-term pain, so clients can smoothly adapt to this regulatory change with minimal disruption.

PW: Were there any other developments from the IM and VM rules being introduced?

MA: In some cases, the new rules impacted segments of the market that had never needed to source collateral: the likes of pension funds and other buy-
overnight trades. The more liquid collateral is used for to collateralise longer-term trades, so to ensure less liquid collateral is used net stable funding ratio and be keen a large bank that is raising cash. That all cases. One example is to think of necessarily be optimal anymore in settlement, first. This has changed noticeably in many cases - cheapest to deliver may not optimal collateral means the cheap- est to deliver. So if a cash borrower

PW: How has the concept of ob-taining ‘optimal collateral’ changed in recent times?
MA: The definition of optimal collateral has become more nuanced as it means very different things to counterparties in different segments of the market.

Two years ago, I would have said that optimal collateral means the cheapest to deliver. So if a cash borrower needed to collateralise a counterparty or meet a derivatives margin call with securities, they tended to use the less liquid security, with the lowest cost of settlement, first.

This has changed noticeably in many cases - cheapest to deliver may not necessarily be optimal anymore in all cases. One example is to think of a large bank that is raising cash. That bank might also be constrained by net stable funding ratio and be keen to ensure less liquid collateral is used to collateralise longer-term trades, so the more liquid collateral is used for overnight trades.

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A client’s optimal requirement has become much more bespoke, and again, collateral agents have a role to play in providing these tools.

PW: Why is accessing collateral in a timely manner so important?
MA: The consequences of not having timely access have become more serious. Take an investment manager that trades derivatives on multiple exchanges; each of the exchanges might use a different central counterparty—each with different margin deadlines.

Suppose the treasuries that investment manager needs in order to meet that margin call are tied up in a different trade—but the manager has other eligible collateral, corporate bonds, that can meet the obligations of that different trade. The ability to quickly substitute the corporates for the treasuries could help the manager access the securities needed for the derivatives trade. Collateral agents that provide these substitution tools can assist clients in accessing collateral more quickly on an intraday basis.

PW: Why is collateral management still of critical importance to custodians in today’s environment?
MA: Collateral management remains vitally important for clients to quickly adapt to regulatory change.

Regulatory change can be quite daunting for counterparties but collateral agents have experience with regulatory implementations, have deep relationships in the market, and can share insights on how collateral management tools can facilitate a smooth adoption of new rules.

It is also an attractive time in the collateral management space for custodians to differentiate themselves—and collateral management offers them a chance to do that.

Different custodians may bring different perspectives to collateral management—some have trading desks of their own and are users of collateral management. Others have seats on regulatory and infrastructure committees so they can see first-hand how policy is shaped in regard to market practices governing collateral.

PW: What does the future hold for the collateral management space?
MA: Without a doubt, the space has become more automated and this will develop further.

When it comes to the management of VM which is kicking in, we are in the final few months of increasing our own process.

This is important for the market because it gives clients the ability to scale up volumes without operational difficulty, especially as timeframes for posting VM get tighter. So scalability will benefit everyone.

Constant innovation is key, but I believe that even the smart use of existing technology and the ability to connect that technology with industry utilities that are already in existence will make collateral management more efficient.

This greater interoperability is a way of blending current and future systems with a healthy dose of innovation.

Constant innovation is key, but I believe that even the smart use of existing technology and the ability to connect that technology with industry utilities that are already in existence will make collateral management more efficient.