

Migrating to a reliable and transparent system for managing collateral will have a profound effect on how the swaps market responds to risk and changes in the pricing environment, writes **Craig Welch**, co-founder of AcadiaSoft

# Limiting collateral damage

**T**he recent turmoil in the financial world highlighted the shortcomings of collateral management practices as the extreme levels of uncertainty among counterparties about the status and security of collateral were contributors to the credit crisis. As the market began to deteriorate, participants started to realize that their trades might not have been properly collateralized. The fact that there was little or no transparency about the total exposures

of institutions accelerated the concern about counterparty risk. The problem was compounded by a lack of confidence in the ability to take possession of collateral. The resulting flight to safety shut down credit markets virtually overnight. Firms can no longer assume that their counterparties will not become insolvent. Collateralization will no longer be an afterthought, periodically adjusted and passively managed. The risks, as we now know, are too great.



Craig Welch, co-founder, AcadiaSoft

### Rising expectations

The new expectation stemming from regulation and the industry's own response to the credit crisis is that standards for collateralization will become more rigorous; that the number of margin calls will increase; and that firms will have to be much more diligent and responsive in managing collateral, as well as being able to do so on a larger scale. In addition, the industry needs the assurance that collateral positions will be transparent and secure, so that counterparties can both understand why margin is being called and easily take possession of collateral in the extreme case of insolvency.

Much of this change is being driven by mandates to centrally clear more over-the-counter (OTC) derivatives. In the case of cleared swaps, counterparties will face the clearing house via their futures clearing merchants or "client clearing" provider. Leeway on collateral granted by a traditional counterparty will no longer exist. Central counterparties (CCPs) will transmit collateral calls daily or intraday on all net positions within the CCP. Assets posted as collateral will need to meet a high standard for quality and disputes will need to be resolved in a timely manner.

### Craig Welch – Résumé

2004 - Present	AcadiaSoft, co-founder
1994 - 2004	Evare, founder
1991 - 1994	Fidelity Capital Markets
1988 - 1991	Salomon Brothers

The International Swaps and Derivatives Association (ISDA) recognizes that the industry will face an increase in the number of collateral calls and understands that it must migrate from email, fax and phone as the primary communications channels for collateral messages. ISDA outlined best practices for communicating about collateral in its *Standards for the Electronic Exchange of OTC Derivative Margin Calls*, stating: "In order to increase automation, allow for scalability, enhance security, and provide an audit trail, the market needs tools which facilitate collateral messages to be exchanged electronically between participants in an open standard that allows for interoperability between existing platforms."

### Benefits of full collateralization

Efficient and effective collateral management using a reliable and transparent system for cleared and non-cleared swaps will have a profound effect on

how the market responds to risk and changes in the pricing environment. If collateral is marked to market every day, firms have no choice but to deal with declining asset values as they occur. In this fashion, downside risk is limited on a regular basis. Corrections are inevitable, but they will be steps downward, not freefalls like the industry experienced in 2008.

Questions about the cost of better collateralization for cleared and non-cleared swaps remain. However, any increase in cost will certainly pale in comparison with the potentially astronomical costs of slipping back into an environment lacking the proper tools to communicate about collateral and the transparency required to give participants confidence about the security of collateral arrangements.

In a fully collateralized system, asset managers benefit from more confidence about counterparty risk. Furthermore, the degree to which collateralization reduces the chance of market freefalls helps them manage portfolios with greater certainty. Dealers benefit from reduced counterparty risk and the opportunity to gain efficiency by automating manual processes. In addition,

"Efficient and effective collateral management using a reliable and transparent system for cleared and non-cleared swaps will have a profound effect on how the market responds to risk and changes in the pricing environment."

knowing the status of collateral calls in real time creates more clarity about exposures and increases capital flexibility.

### A roadmap for change

A precursor to mitigating risk and capturing these benefits, though, is migration to a centralised electronic system to manage and track collateral messages. As ISDA notes, the current methods of communicating collateral calls are simply inadequate and cannot accommodate the increase in volume of collateral-related activity the industry expects. Emails can remain unopened, faxes undelivered and phones unanswered. None of those channels are secure, nor do they enable status monitoring or provide a readily auditable trail of information. Simply put, the industry needs new tools to achieve the scale demanded by changing collateral requirements.

Electronic collateral messaging replaces the problems inherent in email, phone and fax with an electronic solution that connects counterparties through a common portal which allows them to synchronize, track and manage communications about margin calls for cleared and bilateral trades. Such systems provide a multilevel, integrated view of counterparty relationships and margin/collateral agreements and have

workflows to automate processes for collateral negotiation, collateral substitution and interest payments.

The collateral messaging and management solution developed by AcadiaSoft can be used as a web-based tool by small asset managers or integrated with multiple related systems by large institutions. AcadiaSoft has the support of several global dealers and asset managers can access it via MarkitSERV and thereby benefit from the ability to manage collateral messaging alongside the other post-trade requirements of OTC derivatives transactions.

Making the margin call process electronic has far-reaching benefits. Imagine the operational reality of a bank that transmits 500 collateral calls per day and receives 500 collateral calls per day. If only a portion of the calls it makes are fulfilled, then the bank needs to cover those undercollateralized positions. On the calls it receives, it must verify the requests with multiple systems and then individually authorize or dispute each call. When a margin call, either outgoing or incoming, goes unanswered, it creates uncertainty and risk in the system.

With electronic messaging, counterparties can negotiate and promptly execute calls without the confusion of

email threads and keep counterparties up-to-date about status of calls. No one is left in the dark about whether a call has been received, authorized or is in dispute. Electronic messaging also creates an auditable record of communications to satisfy the demands of compliance departments.

Linking messaging technology to other collateral management systems enables an exception-management approach to collateral and creates even more efficiency. For example, if 50 per cent of margin calls are automatically pre-matched and executed based on tolerances set by the user, firms can understand their cash position earlier in the day and focus on the calls that do not match. Furthermore, if the system facilitates partial agreement, the portion of the margin call that is reconcilable can be processed automatically and the counterparties can then direct attention to why the total call amount was not agreed.

As the uncertainty caused by unanswered margin calls or other communication breakdowns is reduced, the unknown becomes known and all parties benefit. In an environment where collateral messaging is electronic, even partial agreement to a call adds transparency because the counterparty has certainty about what portion will be posted, rather than wondering if any additional margin will be posted.

While other aspects of financial system reform might get more attention, transforming the way the industry communicates about collateral is at the heart of how the regulatory intent focused on reducing systemic risk will be achieved. Beginning this important work in OTC derivatives is a logical starting point, but collateral messaging has applications in numerous other markets such as securities lending, repo agreements and listed derivatives. Migrating to electronic messaging for collateral is an important first step for the industry to capture the benefits of comprehensive, transparent and secure collateralization in derivatives dealing and beyond. ■

“While other aspects of financial system reform might get more attention, transforming the way the industry communicates about collateral is at the heart of how the regulatory intent focused on reducing systemic risk will be achieved.”