Collateral Issues: A DTCC/CSFI Post-Trade Fellowship round-table discussion with Manmohan Singh (IMF), Godfried de Vidts (European Repo Council) and Stephen Lyle (LCH.Clearnet).

Held on Tuesday, March 20 2012, from 12:30 to 2:15pm.
At the Armourers’ Hall, 81 Coleman Street, London, EC2R 5B

Part of the DTCC/CSFI Post-Trade Fellowship Programme

The Fellowship took advantage of a brief visit to London by Manmohan Singh, a senior economist with the IMF in Washington, and invited him to lead a Post-Trade round table on collateral issues. Manmohan caused a stir in 2011 when he forecast that the planned shift of standardised OTC derivatives trades to CCP clearing from end-2012 would expose a collateral shortage of at least $2 trillion. He later suggested imposing a levy on dealer banks to force them to be more rigorous in taking collateral from their clients.

Also on the panel were Godfried de Vidts, director of European Affairs at ICAP plc and Chairman of the European Repo Council, who earlier in 2012 was appointed chair of a new industry working group dealing with collateral issues that is supported by a number of trade associations. Stephen Lyle, head of group collateral services at LCH.Clearnet, the Anglo French CCP was the third member of the panel. Stephen deputised at short notice for Andrew Howat of LCH.Clearnet, who was unable to attend.

The meeting was well attended. As with most Fellowship events, the discussion was held under the Chatham House rule, which allows ideas to be discussed and disseminated but without attribution. This is reflected in the following account of the meeting.

One reason for holding the meeting were recent reports authored by the lead speaker that highlighted a significant under-collateralisation of bilateral OTC derivatives contracts, through the exemption of counterparties such as sovereigns, municipalities and state backed enterprises from the obligation to post collateral.

The reports, published by the IMF as “working papers” and therefore not necessarily representing IMF views or policy, estimated the consequent under-collateralisation at around $2 trillion, spread among 14-15 globally important dealer banks.

With standardised OTC derivatives mandated to be cleared under the G20 Pittsburgh commitment, the Fellowship wanted to explore the implications of this shortfall for the post-trade sector.

The Fellowship reasoned that collateral would have to be found to margin OTC derivatives when they were cleared by CCPs. Would the estimated bilateral OTC collateral shortfall add to other worries about a shortage of collateral? And how would the post trade sector be able to fill the gaps?

The meeting heard how market and policy developments were likely significantly to increase overall collateral needs while draining supply.
- A proliferation of swap clearing houses around the world since the September 2009 G20 Pittsburgh statement mandating OTC clearing was fragmenting the hitherto global market in swaps and would limit the effectiveness of netting in the CCPs.

- Similarly, the use of central clearing in the OTC derivatives space risked upsetting bilaterally cleared and collateralised swap arrangements and the ability of the leading 14-15 dealer banks to net positions. And yet some OTC contracts would continue to be bilaterally cleared because not all existing under-collateralised bi-lateral contracts would be suitable for CCP clearing.

- At the same time, the prospects for rehypothecating collateral were decreasing because of steps to protect investors, especially in the wake of the MF Global default, which had prompted some investors to opt for segregated accounts. The re-use (or “velocity”) of collateral was lower than in pre-Lehman days. In the course of the discussion, one person around the table warned that segregation could lead to “overkill” and an immobilisation of collateral.

- Moreover, there was no prospect of saving collateral through interoperability among CCPs clearing swaps. Interoperability for swaps CCPs was seen as a non-starter because swaps clearing was too complex: indeed, far more complex than clearing equities, where there is now some interoperability among CCPs in Europe. There was no chance that interoperability could be an economic proposition for swaps CCPs because margin requirements would be prohibitively expensive and because of differing legal systems and bankruptcy regimes around the world.

Such considerations provoked doubts as to whether CCPs clearing swaps were the best instrument for dealing with risk in OTC derivatives.

It was argued that instead of there being 14-15 pockets of risk (concentrated in the commercial banks that under-collateralised), there would in future be up to 40 pockets of risk, comprising the banks and the CCPs clearing OTC derivatives around the world. In consequence, CCPs could become extremely risky SIFIs (systemically important financial institutions) which could, in the event of trouble, oblige central banks to provide liquidity or intervene more drastically.

This was a gloomy analysis, based in large part on US data. It provoked a more nuanced assessment of the situation in Europe in response.

It was pointed out that the Repo market, which turns unsecured into secured lending, had recovered to its pre-Lehman dimensions in Europe. This was partly because a wider range of instruments were being used as collateral and because tri-party agents were offering more sophisticated collateral management systems. An important consideration, however, was the pricing of collateral. “Comfort” that collateral was accurately priced was required before there could be any proper idea of the resulting liquidity that would be available to lubricate financial markets from some of the instruments available.

A look at European markets pointed to a mixture of negative and positive developments. Among negatives, pension funds and insurance companies (the buy-side) were querying the solidity of CCPs and consequently unhappy at the prospect of providing collateral in the course of clearing. The pension sector had won a time-limited exemption from the clearing obligation under EMIR. Meanwhile, insurance companies, with their experience of managing risk, were also asking why they should have to hand over collateral to a prime broker who would pass it on to a CCP.
Other negatives included problems pricing corporate bonds for collateral purposes and a lack of enthusiasm among regulators over the possible use of equities, even though equities could be priced easily. Liquidity was being tied up in the ECB through banks re-depositing cash acquired through ECB liquidity operations.

Adding to the arguments against interoperability, it was suggested that CCPs practicing interoperability in equities clearing absorbed more collateral than non-interoperable CCPs. (However, the relevance of this point was disputed later in the discussion when it was argued that interoperability in equities clearing could be economic because greater netting efficiency in equities markets – which are relatively low risk - offset the cost to CCPs of posting more margin in respect of their interoperable positions).

Among positives, there were moves involving Europe’s five leading CCPs and the two ICSDs to move collateral more freely between the ICSDs so that it could be used more efficiently. The big banking institutions were now aware of the importance of collateral and had acted to remove inefficiencies in supplying it for their own in-house purposes. The planned acquisition of LCH.Clearnet by London Stock Exchange Group, which operated a CCP in Italy, could save collateral. A new industry forum – CICF – was looking at ways of improving collateral supply.

It was suggested that removing unnecessary regulation could help: a new requirement for banks to make daily reports about their collateral positions was singled out as a candidate for scrapping because the information it provided was swiftly overtaken by market developments. Buy-side institutions were urged to use the collateral under their control to both make money and benefit the markets. It was argued that more pro-active approaches would help fill collateral gaps.

The discussion then shifted to the role of CCPs. Velocity of collateral was identified as an issue for the CCP sector as a whole. The meeting was told of a need to educate the market in services available - such as tri-party collateral management in cooperation with CCPs. Such tri-party cooperation formed part of a more service driven culture in clearing houses that helped move collateral to where it was needed. Having more mobility of collateral would not only cut costs. It would help overcome any problems arising from the global proliferation of CCPs clearing OTC derivatives.

On the other hand, the priority among CCPs was to make markets safer. In this regard, it was vital they first met stringent risk management criteria, complied with official oversight requirements, and ensured that liquidity was available to deal with a default. Action was needed to reduce operational risks at CCPs. At this point, the disclosure that a leading CCP still used faxes in its operations caused gasps of surprise from some in the room.

One person at the table suggested that CCPs and ratings agencies made insufficient distinction between credit risk, which he argued was relatively low in the crisis, and liquidity risk. This elicited a strong defence from the clearing house side of their power to increase margins where necessary in times of stress.

Another speaker from the floor warned that the G20 clearing obligation was not the optimal solution. Fragmentation of clearing, with many CCPs serving OTC markets, meant less optimal results because the benefits of multilateral netting were lost. Far better would have been a system,
similar to that adopted by Clearstream (an ICSD) 15 years earlier, of bi-lateral netting and collateralisation, but with multilateral optimisation of re-use of collateral to minimise the total amount of collateral required on a net basis to margin all counterparty positions. This speaker warned that the clearing requirement was coming at a bad time and would act as a $2 trillion margin call on global liquidity.

At this point the meeting heard of the suggestion – already aired in IMF working papers - that a levy should be imposed on dealer banks transacting OTC trades that were not centrally cleared, in order to incentivise either the collateralisation of bilateral deals or the use of CCPs.

This prompted heated discussion. Indeed, at various times during the meeting the post-trade aspects of the collateral shortage were drowned out by controversy as participants differed over the workings of the OTC derivatives market.

The exchanges exposed a gulf in perceptions between what might be described as an academic/official view that uncollateralised OTC derivatives contracts represented risk for global economic stability, and an industry view, strongly expressed from the floor, that they represented a business decision that could be considered equivalent to granting a credit. The industry view prompted counter charges that banks and Sovereigns were free-riding and a challenge: It was asked why banks should not formalise the absence of collateral by making loans to the counterparties instead, and putting aside capital on their balance sheets to reflect these loans.

Bringing some light relief towards the end of the discussion, one round table participant put forward the contrarian view that uncollateralised swap transactions among the 14-15 dealer banks might be safer than transactions that went through CCPs, because each of the counterparties would take great care to ensure that the other was a good risk.

The round table ended shortly afterwards. It had aired the problems surrounding the perceived shortage of collateral but done little to illuminate how the feared shortage might be addressed or the role that the post-trade infrastructures might play in this. These are issues for more research in fora other than a round-table discussion.