

Improving the collateral management process

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Following the Lehman bankruptcy in the fall of 2008, many buy-side firms found that loose collateral management policies for their OTC derivatives portfolios left them as unsecured creditors trying to reclaim their funds. Since then, many firms have rethought their collateral management programs and have adopted more proactive policies to avoid this situation in the future. In addition, financial services regulators have demanded improvements in the collateral management process from the banking community changing the landscape of collateral management dramatically.

Lessons from the Lehman Bankruptcy

Prior to the Lehman bankruptcy, it was assumed that the buy-side posed the largest risks in OTC derivatives trading; and collateral arrangements between sell-side and buy-side institutions generally favored the sell-side. There was no real consideration that a major market participant would default, and most collateral arrangements reflected that assumption. Collateral agreements tended to be one-sided, and over-collateralization was common.

After Lehman, buy-side firms needed to rethink their policies. They were urged to adopt infrastructure to make regular collateral calls in a timely fashion; to implement effective means to resolve margin call disputes; to address the risk of over-collateralization; to identify and implement early warning triggers and remedies in the face of a counterparty's deteriorating credit position; and to reevaluate existing collateral documentation for cross-affiliate liens in master netting arrangements.*

Many of these recommendations have been implemented by the buy-side for their OTC derivatives portfolios, with proactive portfolio reconciliation seen as the foundation for effective collateral management. Industry forums such as the ISDA Collateral Committee have undertaken projects to improve other aspects of the collateral management process like dispute resolution and margin call communications drawing from the expertise of buy-side, sell-side and vendor organizations.

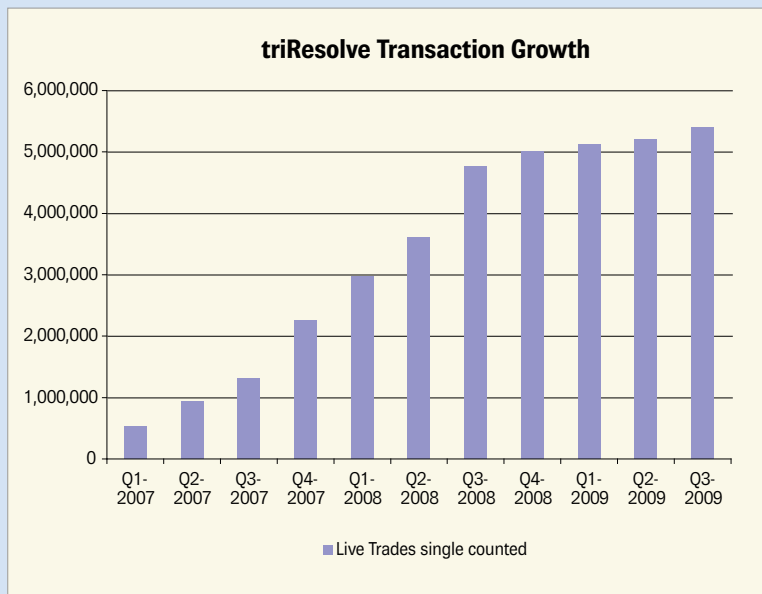
With all the major dealers accessible within one network, more and more buy-side firms have also joined triResolve. With over 5.4 million trades on the service, an estimated 75% of the global OTC derivatives market is now being reconciled on a regular basis on triResolve.

A Crisis-Tested Solution

One of the keys to facilitating the margin process is transforming portfolio reconciliation from a reactive into a proactive process. In the reactive mode, collateral managers wait for a collateral call dispute and then begin a reconciliation process with the counterparty to identify why their collateral calculations are not in agreement. They exchange spreadsheets and manually reconcile their OTC derivatives portfolios. Before any differences in the mark-to-market (MTM) values of the transactions are attacked, differences in the trade population characteristics must be resolved. Then differences in valuation are compared and addressed. As swiftly-moving market events have proven, this can take too long.

Most of the Fed 16 banks had already implemented TriOptima's triResolve portfolio reconciliation service prior to the market turbulence in 2008. By proactively reconciling their portfolios on a regular basis before the crisis, those firms had already resolved the basic population differences with their counterparties. They had seen their automatching rates increase from 87% to 98% after several reconciliations. Once the differences were researched and resolved, the matched trades remained matched from one reconciliation to the next, and only incremental trades or those still unresolved showed up as unmatched. This enabled the triResolve users to focus on MTM disputes when

* *Lessons from Black September: Know Your Collateral, ISDA October 2008, Lauren Tieglund-Hunt*



the crisis hit. They weren't scrambling to start the dispute resolution process from scratch. They were able to produce reports that identified their largest exposures by counterparty and by transaction type, facilitating dispute resolution and the more rapid deployment of collateral.

By early 2009, the entire Fed 16 group of financial institutions had adopted triResolve. With all the major dealers accessible within one network, more and more buy-side firms have also joined triResolve. With over 5.4 million trades on the service, an estimated 75% of the global OTC derivatives market is now being reconciled on a regular basis on triResolve. triResolve's network community approach enables buy-side firms to connect with all their counterparties in one place and eliminates the need to manage multiple data formats and data standards.

The triResolve Revolution

Using the triResolve service, clients submit data on their bilateral relationships daily or weekly, and receive the results within a few hours. The data is submitted for all OTC derivative transactions between counterparties across all asset classes. triResolve only requires 10 key fields as a minimum for reconciliation but clients can submit as many as they like.

Most importantly, data can be submitted in any format the user chooses. This is critical in facilitating implementation since TriOptima assumes responsibility for normalizing data from all participants. The data is frequently taken directly from the user's collateral management system. Automation is the goal, and automated data uploads are the norm for most users.

The unique concept behind triResolve is the network community approach to proactive, regular portfolio reconciliation. The service is web-based and interactive, so there are no programming requirements or software installation. triResolve replaces email as the standard communication tool, with instant access to a single, secure data entry point. Trade discrepancies are resolved on the triResolve website through direct,

online communication with the counterparty by commenting at either the trade level or relationship level. Scanned confirmations can be attached to a comment allowing easy resolution of differences.

triResolve's sophisticated reporting functionality and advanced analytics provides information for senior management, for department analysis or for any regulatory requirements. Senior managers can have access to reports of the largest MTM exposures by counterparty or transaction type or age of dispute. Operations/collateral management can perform a drill down analysis at any level of the counterparty relationship or the product portfolio to determine the root causes of breaks.

triResolve's matching algorithm helps solve the challenges of reconciliation by proposing matches for splits and structured trades that users can approve on line. Once a match is recorded in the triResolve database, it remains as a persistent match until affected by expiration of a market event.

triResolve is interoperable with electronic confirmation platforms such as DTCC and MarkitWire as well as internal confirmation systems. A daily DTCC Deriv/SERV feed ensures that established matches on triResolve are consistent with the electronic confirms. triResolve also facilitates automatic reconciliation between the Trade Information Warehouse and each institution's position-keeping systems to ensure that in-house trade records stay in-sync with DTCC's golden copies.

As buy-side users become familiar with the benefits of triResolve, they have identified new ways to use the information from the service including working with their independent auditors to tackle the difficult challenge of verifying valuations. The wealth of information that triResolve offers the user often leads to innovative uses of the data which enriches the risk management efforts of the firm.

Setting New Standards

ISDA's Collateral Committee has been consulting with the industry including both sell and buy-side participants as it evolves its commitments to the banking regulators for collateral management. The Fed 16 dealers are already reconciling all their OTC derivative portfolios with more than 500 transactions on a daily basis and submitting reports on MTM differences and reconciliation activity to the regulators. The Committee is also conducting a feasibility study on market-wide portfolio reconciliation that would extend the current standards beyond the Fed 16 to a wider group of market participants including smaller banks, buy-side participants and derivative end-users. Many of these market participants have already followed the lead of the Fed 16, and moved to frequent reconciliation of their OTC derivatives portfolios in order to minimize counterparty credit risk and maintain control over collateral resources.

Given the lessons of the Lehman experience and the general advance in market practice, it seems clear that proactive, regular reconciliation of collateralized OTC derivatives portfolios will become the market standard for all market participants with TriOptima's triResolve standing as the leader. ■