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DECEMBER 2007



Technology Forum

Collateral management



Collateral management

A business practice in its own right

Roundtable partners Allustra, TriOptima and Lombard Risk recently took part in a unique forum to discuss how collateral management has become an essential part of financial institutions' frameworks for risk and regulatory compliance. This roundtable provides leading technology vendors and consultants a unique forum in which to disperse intellectual capital through a question-and-answer roundtable activity



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Risk: What do you see as the most significant advances in collateral management in 2007?

Simon Lillystone: Popular answers to this will probably include the new emphasis on trade reconciliation, increased use of the web as a messaging and reporting medium and emergence of client valuations reporting as a new responsibility for collateral managers. However, Allustra has observed that the most significant advances are not such headline grabbers.

Predominantly, 2007 has been the first year in which cross-product and multi-product margining has turned from talk to action. Being able to provide expert and dedicated margining support for over the counter (OTC), repo and securities borrowing and lending as standard and on the same platform has been key to Allustra's success. While it was still just a concept, Allustra recognised that cross-product margining would never be a 'one-size-fits-all' situation. Each type of margining has its own unique features and, therefore, the important thing was to design a 'one-stop' solution that would, at the same time, meet these individual demands thoroughly and expertly. With concept becoming reality, Allustra's strategy has proved a profitable one.

Another advance is the increased awareness and understanding of collateral management and its benefits by the business at large. Until recently, collateral management had itself been a 'silo' – operating quietly and efficiently outside the general milieu of the financial environment. However, things have changed. Progressive collateralisers are now focusing on the bigger picture – recognising the importance of collateral across their business, from trading to risk to asset management, and developing new degrees of enterprise-wide connectivity to gain greater returns on investments.

During 2007, more organisations than ever before entered the collateral management space, including a major influx of asset managers, prime brokers, hedge funds and corporates. Interestingly, and unlike the historic uptake of collateral by investment banks – which in a sense meant 'more of the same' to vendors – these new players bring many different needs and exacting requirements. Consequently, the market has generally become more demanding and Allustra has responded to these exciting, fresh challenges with new business and user-driven product features such as dashboards, workspaces and support for leveraged trading.

Finally, 2007 has seen increasing demand for global inventory as firms tackle collateral optimisation and look to consolidate asset use and reuse across business lines. Allustra has long advocated and offered system support for the Global Book – an internal market for collateral – as the ideal platform for advanced collateral management, and the market is now clearly moving in this direction.

Risk: What will be the areas of risk optimisation in 2008?

SL: Structured products, cross-margin netting and offsetting, and new valuation methods will all be high on the agenda for collateral management in 2008 – strongly driven by larger firms exploring ways to develop and enhance relationships with their sell-side counterparties. Development of new techniques to evaluate and manage exposure to currencies, markets and issuers through strategic combinations of transactions and collateral in single portfolios is likely. Modelling exposure and collateral requirements over time may be another method firms will use to optimise collateral holdings and reduce the number of collateral transfers.

Risk: How do you see current trends affecting the market in the next 12 months?

SL: Allustra has already observed a trend among the larger collateral management programmes to restructure their operational teams to provide dedicated service from a single solution platform to their different business streams, for example, distinguishing between sell-side and buy-side counterparties. Between these streams there is likely to be divergence in both the operational processes encountered and the sorts of margin calculations employed: interbank, low-risk relationships will probably tend towards a simplification of market standards, while the higher-risk collateralised relationships will continue to utilise ever more advanced, tactical calculation methods.

Risk: What are the biggest technological challenges for investors now?

SL: There is a clear desire to make greater use of straight-through processing and to move towards an exceptions-based approach to operational activities. Configurable, event-driven, roles-based workflow – a standard feature of Allustra's solutions – can help firms make significant moves in this direction. The real challenge is for firms to embrace new technologies in order to improve levels and degrees of connectivity, both internally and externally, and to develop infrastructures in which collateral has fault-tolerant, bi-directional connections upstream and downstream.

Risk: What types of investors are looking to use collateral management and how do they attempt to mitigate risk using technology?

SL: The range of businesses employing collateral management appears almost endless and, in fact, just about any organisation trading OTC derivatives is either already using collateral or negotiating agreements with counterparties. In certain sectors, collateral has become a prerequisite for business entry, retention or expansion. For example, contractual margining has long been commonplace in sell-side/buy-side relationships, and many of these buy-side firms are turning to Allustra's solutions to monitor and gain deeper understanding of their collateralised relationships. While firms have to abide by the margin calls they receive, they still want to compare daily margin requirements with their own calculations.

Risk: What differentiates your techniques from those of competitors in the market?

SL: Nothing is ever future-proof; however, Allustra believes that the unique foundations of its solutions, which include configurable, event-driven workflow and global asset management, provide firms with the optimum platform for their collateralised future.



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Risk: What do you see as the most significant advance in collateral management in 2007?

Henrik Nilsson: This year has seen a revolutionary change in the approach to portfolio reconciliation, triggered by the growing need to reduce operational risks and costs in a turbulent market. Instead of reactive dispute resolution, which until very recently has been the norm, proactive portfolio reconciliation is giving dealers better control over collateral management issues.

Reactive dispute resolution has basically meant that dealers would reconcile only when there were sizeable margin call discrepancies. Typically, the party that was owed money would initiate a process of collecting data from its counterparty, normalising the different data formats and running the data through match engine software or spreadsheets. Results would then need to be communicated and agreed on. Given the growing size of the portfolios, this proved increasingly laborious.

TriOptima's new service triResolve enables proactive portfolio reconciliation, changing the way that OTC derivatives dealers can deal with prevention and resolution of margin call discrepancies. In contrast to reactive dispute resolution, triResolve proactive reconciliation is a joint effort by both parties to reconcile on a frequent basis – independent of any disputes – to stop large margin call discrepancies from developing in the first place. The process is extremely straightforward: dealers submit files to the triResolve secure website, where they can see the exceptions online. The web-based service enables interactive communication with counterparties, and offers extensive break resolution functionality and historical analysis.

The triResolve service has been available since the first quarter of 2007. Most subscribers now reconcile on a weekly basis and have seen the time spent on dispute resolution decrease dramatically, as well as having better control over portfolio risk issues.

Risk: How do you see current trends affecting the market in the next 12 months?

HN: It is clear that the current credit crunch makes it even more imperative to stay on top of counterparty credit exposure. This exposure cannot be correctly measured – neither in terms of actual nor expected future exposure – without the portfolio being fully reconciled, i.e., the trade population verified and the mark-to-market valuation agreed.

At the same time, we expect OTC derivatives volumes to continue to grow strongly due to market volatility and the increased number of participants in this market. This poses an additional challenge not only to collateral managers but to operations managers in general. Again, proactive reconciliation is a necessary step to reduce costs and risks following from margin disputes, settlement breaks, legal entity mis-bookings and so forth.

Risk: What key compliance issues have you found to have the greatest effect on your business lately?

HN: Under the Basel II advanced approach, banks are relying on their own risk models to calculate capital requirements. Avoiding margin disputes basically lowers unsecured exposures and decreases any charges for operational risk. At the same time, Undertakings for Collective Investment in Transferable Securities III legislation is encouraging regulated funds to enter the OTC derivatives market. This will further increase the number of participants and volumes traded. This means that both sell-side and buy-side need to review how best to treat the operational aspects involved.

Risk: What types of institutions are looking to use proactive reconciliation in their collateral management?

HN: There is a growing interest from all types of dealers, large sell-side institutions, small and medium-sized banks, hedge funds and institutional asset managers to engage in proactive reconciliation.

Originally conceived to handle large interdealer portfolios, the triResolve service from TriOptima has clear benefits for the buy-side as well. In addition to margining aspects, breaks in trade population and valuation can be easily identified and resolved. Sell-side trade data is available in a normalised format across dealers and asset classes. This simplifies greatly any reconciliation effort and facilitates timely publication of accurate net asset values.

Risk: What differentiates your technology from that of competitors in the market?

HN: triResolve is a community network service, where subscribers

can communicate interactively, resolving differences together, rather than working on a 'stand-alone basis'. Since the service is fully web based, no software needs to be installed on clients' servers, no installation or maintenance charges apply and the latest version of the technology is always available to subscribers without tedious updates. triResolve is therefore extremely flexible and cost-effective.

Launched early in 2007, triResolve has the majority of the main OTC derivative dealers as active customers. In addition, there is a fast-growing number of smaller institutions joining the service. Currently, 2.3 million trades in over 60 bilateral relationships are reconciled weekly through triResolve. There are now four million live trades on the system, growing at a rate of 15% per month.

Individuals from both dealers and their clients are resolving differences daily, in an online interactive environment. This forms an active user community, with a common goal to maximise accuracy and transparency and minimise operational costs and risks.



Lombard Risk



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Risk: What do you see as the most significant advance in collateral management in 2007?

Helen Bramley: As the International Swaps and Derivatives Association reports, the number of margin calls doubled and the required collateral per call increased significantly. Collateral management desks struggled to keep up. Executives began to realise that managing collateral on an ad hoc basis is over. Collateral management became a 'business-critical' function.

Further, while the importance of managing capital for credit mitigation purposes is clearly understood, the recent credit tightening highlighted the need to preserve a greater cash cushion. Fortunately, the ability to utilise non-cash collateral assets progressed to the point where it is not only cheaper but also more manageable with the right technology. Global collateral management solutions like Colline® evolved to a level whereby every facet of a collateral team's day can be covered, from legal agreement automation through to exposure management and dispute resolution.

Risk: What are the three key areas for collateral operations teams to address in the coming year?

HB: Put simply: to manage risk levels, gain more control, and stay compliant. During times of turmoil, the old adage 'cash is king' rings especially true. Liquidity is paramount and measured by the speed and cost with which an asset can be realised. Collateral teams must improve non-cash assets' utilisation to increase the return on cash and provide trade flexibility without reducing returns. Further, although individual investment areas may be satisfied with their investments, collateral desks must guard against overexposure due to asset concentration. Automated collateral management can help control concentration risk by tracking concentration limits and providing the basis to analyse exposures.

In addition, collateral operations teams will be expected to

impose more stringent controls over the whole risk management process. A good way to accomplish this is to streamline day-to-day processes with a solution that handles routine collateral calls automatically. Collateral desks can then be free to handle major collateral issues prioritised based on business impact. Again, with agreement volumes growing, collateral teams must effectively tackle the increased reconciliation burden. It's nearly impossible to keep up without a good system. More frequent reconciliation provides greater protection. The challenge lies in doing it. Again, this is where a good collateral management solution such as Colline® can step in to reduce operational risk.

Recent events highlighted weaknesses in some risk management operations because critical information about exposure levels and asset utilisation wasn't readily available. Collateral teams will be challenged to provide up-to-date information, ranging from counterparties to assets at risk. Automated collateral management solutions have all of the reports necessary to help make informed decisions.

Risk: What are the components of a successful collateral programme?

HB: The most effective operations take an integrated approach to collateral management by incorporating trading, credit, customer support, legal, treasury, regulatory and technical requirements. An enterprise approach to collateral management ensures that all collateral-related information is consistently processed and managed according to policy at all times, not just when collateral calls may be required. Additionally, automation dramatically improves a collateral desk's ability to support increased volumes while avoiding additional risk.

Risk: What types of investors are looking to use collateral management technology and how are they attempting to mitigate risk using this technology?

HB: Higher credit standards and changing market conditions make it necessary for all parties involved in any type of collateral-based activities to use collateral management technology.

Banks can have collateral agreements with thousands of counterparties and, apart from pure risk reduction, automated collateral management offers the ability to enter into more complex or structured products in a more controlled manner.

Hedge funds and asset managers are increasingly taking control of collateral management directly instead of relying on a sell-side bank or prime broker to advise when collateral is required.

Fund administrators and custodians offer a 'one-stop-shop' including 'self-service' to provide their customers with collateral solutions and expertise in one central environment. Hedge funds can have their collateral safely managed, yet still retain control over collateral movement decisions and exposure calculations.

Corporations are increasingly using collateral management as leverage to yield more trading power to their firm. A robust calculation tool is a prerequisite to avoid being at the mercy of a completely reactive function.

Risk: What market developments would help Lombard Risk develop new products and services?

HB: Industry standardisation concerning trade valuation guidelines and global regulations governing multinational trading would be important new developments for Lombard Risk. These advances will fuel Lombard Risk's ability to develop solutions that improve inconsistent collateralised global trading and reduce incomplete manual counterparty reconciliation.