



Operational and Credit Risk in the Bilateral Margining Process

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Buy side market participants have developed an intense interest in the OTC derivatives bilateral margining process as a way to control operational and credit risk. As pointed out in the roundtable discussions there are several reasons for this interest. In general the buy side is becoming more aggressive in managing collateralization as a result of negative experiences affecting collateral in the post-Lehman settlement process. There is also a trend towards cross-pollination of ideas and practices between the buy side and the sell side as professionals move between firms bringing with them newly-implemented ideas and infrastructure.

As also noted by the roundtable contributors, buy side participants in the OTC derivatives market have focused attention on risk management activities including collateralization as they realize that the introduction of central counterparty clearing may well increase costs and diminish the benefits of cross netting. Bilateral margining is a cost-effective way to mitigate risk and minimize costs in OTC derivative trading.

Recent improvements in the bilateral margining process have contributed significantly to reducing operational and credit risk in OTC derivatives portfolios. Despite the current focus on central counterparty clearing for OTC deriva-

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tive transactions, the majority of OTC derivatives are not cleared now; and a substantial portion of those transactions including highly bespoke, potentially risky trades may never be cleared. Therefore it is important to focus on how recent and future achievements in operational and credit risk control in the bilateral margining process will continue to mitigate risk in these portfolios. An overview of all aspects of collateralization was recently published as “ISDA Best Practices for the OTC Derivatives Collateral Process.”

Bilateral margining/collateralization can approach the same levels of risk mitigation as a central counterparty when a market participant adopts robust, resilient and auditable processes for:

- agreeing exposures and collateral balances
- managing margin calls and settlements
- preventing and resolving disputes
- identifying and eliminating over-collateralization.

Agreeing Exposures and Collateral Balances

In the past the industry took a reactive approach to reconciling both trade populations and valuations. They would wait for a disputed margin call, and then begin the burdensome activity of exchanging spreadsheets and comparing portfolios. Portfolios could number in the tens of thousands of trades so trying to reconcile this large a trade population in response to a collateral call created major operational and credit exposures for the firms. Oftentimes, the market would move before the dispute had been resolved and the reconciliation was never completed.

Proactive portfolio reconciliation of the trade population and valuations was identified as a key change to operational processes that would reduce operational risk and minimize counterparty credit exposures. With the introduction of TriOptima’s triResolve portfolio reconciliation service in 2006 first the G-14 banks and then a range of regional banks, buy side firms, asset managers and asset servicers changed the way they managed the collateralization process in order to achieve these goals.

Currently over 6 million trades including mark-to-market valuations are reconciled on triResolve, most daily. In addition to the obvious benefits in reducing collateral disputes, triResolve users

find that many departments within the organization use the information in triResolve to enhance their functions, especially since historical data is available for analysis. Product control, internal audit, middle office, counterparty credit risk, documentation and senior management are all users of triResolve information.

Reconciling trade population characteristics and valuations regularly before a dispute arises contributes to decreasing the number of collateral disputes and minimizes misbookings, thereby eliminating operational and credit exposure. It is also important, however, to reconcile collateral balances, held between counterparties to identify over or under collateralized positions that can lead to significant credit exposures.

Managing Margin Calls and Settlements

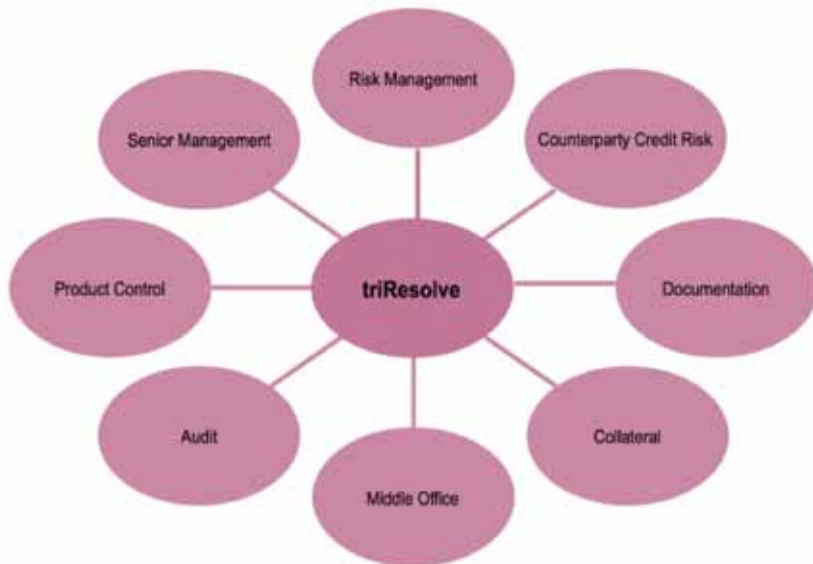
After reconciliation, the next step in the bilateral margining process involves managing margin calls and settlements. Margin calls must be timely and, most importantly, accurate. Margin should then be posted according to the timelines stipulated in the credit support documentation.

ISDA has published a paper, in consultation with the industry, that standardizes the margin call process, "Standards for the Electronic Exchange of Margin Calls and Interest Payments." The need for an industry standard was highlighted during the market turbulence of 2008 and has become a regulatory priority as well in order to reduce counterparty exposure. The standards are intended to increase automation, provide a scalable process, enhance security, ensure an audit trail and establish the goal of interoperability among institutions and vendors. Automated messaging is a key to improving the margin call process, and there are several efforts underway currently to introduce automated messages.

Preventing and Resolving Disputes

The introduction of proactive measures for reconciliation of portfolios and collateral balances has contributed significantly to dispute prevention. Proactive reconciliation platforms provide counterparties with a way to analyze root causes of persistent problems and address them operationally. A robust platform will provide communication tools so that any disputes that do arise can be resolved quickly and efficiently in conjunction with a well-defined workflow framework and relevant tools.

ISDA has also been active in the area of dispute resolution testing a process that would accelerate resolution by defining step-by-step procedures with deadlines, identifying points of escalation and insti-



tuting active monitoring. The benefits of preventing as many disputes as possible and then resolving any that do arise quickly and efficiently will contribute to a reduction in operational and credit exposure as well as potential systemic risk in the event of large exposures.

Identifying and Eliminating Over-Collateralization

With the collapse of Lehman, many counterparties could not access their collateral, even over-collateralized balances. It is crucial that each counterparty acquires or develops a set of tools to track its collateral positions and to identify over-collateralized relationships in order to minimize its exposure to any future market disruptions.


An industry review of the structure of collateral relationships including the requirement for independent amounts and the posting of disputed amounts was presented in ISDA's "Independent Amount White Paper" which calls for segregation of independent amounts to protect counterparties. The industry is also targeting additional areas for consideration including segregation of over-collateralized amounts and posting of independent amounts to third parties as solutions to the problems experienced with Lehman.

triResolve Strengthens and Improves the Bilateral Margining Process

The triResolve service began by revolutionizing the portfolio reconciliation process for OTC derivatives. It currently reconciles 75% of all uncleared OTC derivative trades, 6 million unique

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trades. Its users can track discrepancies in population characteristics as well as MTM valuations and then investigate, adjust or amend trades. The web-based triResolve network community enables direct communication between counterparties through chats or shared work adjustments. Most disputes are prevented, but where they do arise they can be resolved quickly. Most importantly, key performance reports are generated for all levels of management within an organization.

Now triResolve is applying its award-winning technology and service to all aspects of the bilateral margining process by expanding its reconciliation functionality to include collateral balances, key terms of the ISDA CSAs, and securities financing positions as well as by introducing a margin call calculation and administration function including electronic messaging of calls. Firms that aim to achieve bilateral margining relationships as effective as clearing relationships in mitigating operational and credit risk will want to implement the robust, resilient, and auditable services provided by triResolve. 

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