BREXIT DAY 2:
IT'S TIME FOR COLLATERAL MANAGEMENT & OPTIMISATION

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As we have discussed in previous articles in this series, the focus for financial services firms should now turn to refining their Day 1 Brexit plans due to the Hard Brexit extension; with one of the most critical areas being collateral management and optimisation.

Even prior to Brexit, collateral optimisation has been an area of focus for firms in their search for cost reduction and process optimisation. Effective collateral optimisation can make a material impact to a trading desks and firms' P&L, through enhanced inventory management, better internal connectivity and centralised portfolio management. If collateral optimisation is not done properly, there is the potential to leave large basis point savings on the table.

Collateral fragmentation from Brexit planning can take two forms:

1) the addition of new or pre-existing EEA entities as part of Brexit Day 1 planning, and;

2) the potential for the division or relocation of portfolios between central counterparty clearing houses (CCPs) as a direct consequence of Brexit.

FRAGMENTATION AND THE IMPACT

From a CCP perspective, there is still uncertainty as to what proportion of the OTC derivatives market will move to the EEA. Business activity currently concentrated in London to various financial centers in the EEA would fragment what is presently a single market. This is especially true for some key markets such as interest rate swaps. This will add further complexity to collateral optimisation, as the direct costs arising from market fragmentation, calls for a more mature collateral optimisation solution.

Furthermore, the fact that trading activity may now be shared across an additional newly created or pre-existing EEA legal entity has numerous implications.

Initial margin volume, which needs to be deposited as collateral by clearing members, tends to fall when their clients' portfolios are large. This provides opportunities for better risk netting and cross-margining effects at respective CCPs.

A division or relocation of portfolio between CCPs implies higher initial margin, and in an economic sense, even though it isn't a cost, collateral still needs to be funded. A similar impact can also be seen on the default fund contributions by clearing members where it is expected to be high initially, till the time volumes increase and more participants become members of the clearing houses. As memberships increase, the share of each participant towards the default fund decreases.

This fragmentation and its associated costs may eventually manifest as a larger bid-offer spread, and hence collateral will not only impact back and middle officers, but also trading desks. Fragmentation of business across multiple CCPs is likely to result in greater costs and greater liquidity demands for market participants. This in turn needs to be offset to some degree by enhanced collateral optimisation techniques, such as having a global view of their asset pool and consider collateral costs before making trading decisions.

While non-cash collateral can used to cover requirements, each CCP will have their own list of eligible securities with EU-based ones preferring Euro-denominated collateral. This will require clearing members to keep a constant check on their collateral pools, and ensure continuous calculations are done to meet the requirements in the most efficient way.

There will also be implications from a resource, process and technology perspective. Any increase in complexity from additional memberships and relocation of portfolios between CCPs will add pressure to the operations support model, technology stack and additionally from a regulatory reporting perspective.

THE BIGGER PICTURE

Brexit and its implications should not detract from the necessity for firms to optimise their use of collateral – paradoxically, although Brexit Day 1 preparations increased the need for a higher, organisational level view of collateral management, firms have rightly focused on the areas required to maintain business as usual for their clients ahead of Brexit.

Now is the time for firms to review their collateral management processes to provide a cohesive and collaborative use of collateral across the organisation, rather than siloed by business as has historically been the case. This requires an assessment of each business unit's collateral management process, the quality and ability to harmonise collateral data across the organisation and an executive level view on the purpose of collateral optimisation, including transfer pricing across businesses. As regulatory pressures kick in, market fragmentation persists, and the market moves to a cleared model (likely across more legal entities post-Brexit) it is crucial that organisations start managing liquidity and funding requirements in a smarter and more cohesive manner.