

# NGR PROFESSIONAL RESEARCH

***INSIGHT***



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**Collateral management offering  
for OTC derivatives in the context  
of Frank-Dodd and EMIR**

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### *Collateral management offering for OTC derivatives in the context of Frank-Dodd and EMIR*

#### **Context**

The trend for collateralization of OTC derivatives transactions is being driven mainly by:

- Counterparties risk mitigation, starting with Basel II, but reinforced after the financial crisis.
- Regulatory initiatives (Dodd-Frank Act & EMIR).
- Need to meet capital adequacy requirements (Basel 3, Solvency II)
- The volume in derivative markets to be expected in the next years is unclear. Some banks are cutting back capacity in expectation of falling margins.
- Corporates who have been big users of OTC derivatives in the past 15 years are expecting a degree of standardization of a hitherto made-to-measure market and higher processing costs (e.g. Lufthansa).
- The experience in OTC markets during the crisis has mainly shown the products to be robust hedging tools, despite some major issues around handling default and collateral liquidation in the case of Lehman Brothers and AIG.

#### **Strategic challenges for investor service banks**

- Risk of losing existing clients or client business.
- Requirement to offer adequate services to handle client business, including liquidity and collateral requirements over a multitude of clearing platforms at a reasonable cost.
- Differentiation and positioning of the offer to be competitive, taking account that the American banks have more experience with this type of solution and will presumably try to transplant their expertise to Europe.
- Ensure the business case for this activity is maintained in the medium/long-term.

#### **Challenges for asset managers active in OTC derivatives**

- Managing collateral to meet increasing requirements: increasing initial collateral and fragmentation between CCPs, brokers and counterparties...
- Adapt processes to manage clearing and collateral.
- Increasing collateral requirements for bilateral transactions.

#### **OTC derivatives third-party collateral offering**

- Calculation of net exposures and margin calls by counterparty.
- Collateral selection and transfer (cash and securities).
- Disputes management (valuations, late deliveries).

#### **Other complementary offers:**

- Reporting collateral and position valuation.
- Portfolio and transaction reconciliation.
- Liquidity management.
- Collateral optimization.
- Pricing either based on client prices or calculated by the bank.

#### **Advantages of concentration - One ops hub covering multiple operational types across jurisdictions**

#### **Pros:**

- No client credit risk.
- Reduced unit costs of hub operational by concentrating in one structure (if adequate management and quality control resources are available).

#### **Pricing the service:**

- Fixed costs should be covered by fixed fees and maintenance fees (e.g. per collateral agreement by fund or by AM).
- Variable fees per collateral transfer, dispute resolution.

### Status in the depository banking market

- Banks in Europe and the USA are reviewing collateral management offers.
- US banks have more experience in third party collateral management offers and may try to leverage this in the European market.
- Development will be required to roll out complete solutions
  - to identify and value new transactions requiring collateral cover
  - transaction revaluation functionality to calculate margins
  - operational facilitation of custody and cash services to enable the management of collateral transfers

### Outlook

- CCP will clear standardized, eligible OTC derivatives
- Non-standard/non-eligible bilateral OTC derivatives will also need to be collateralized.
- Collateral management will require functions to permit asset optimization and substitution.
- We will see both stand-alone made to measure solutions for large AM groups, with special requirements and a more general custody offer, including collateral operations offering a single collateral solution for AMs covering:
  - OTC derivatives
  - Listed derivatives
  - Payments and securities settlements
  - Prime brokers
- ISDA best practices will be required by AMs and brokers with respect to
  - Eligibility rules
  - Managing cash and securities as collateral
  - Daily adjustments

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#### Who are we ?

NGR is an independent consulting firm specialized in the financial sector; it provides services to the main financial institutions in order to help them optimize their global performance. Combining strong expertise of the funds industry, private banking, asset management, and solid market knowledge, NGR closely works with its clients to define innovative strategies and operating models allowing to quickly deliver return on investment.

If you also want to experience a new way of consulting, do not hesitate to contact us at [info@ngrconsulting.com](mailto:info@ngrconsulting.com)

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