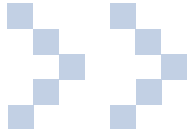




COLLINE[®] White Paper

Proactive Collateral Management



Enterprise Wide Collateral Management has become an important part of creating a successful collateral management program, particularly in larger organizations with diverse trading portfolios. This article outlines the advantages that can be gained from true Enterprise Wide Collateral Management.

Proactive Collateral Management is the concept of granting access to the margin desk's assets for trading purposes. In reverse, the trading desk opens its books for the margin managers to view and assign long excess positions for use in external deliveries. There are billions of dollars worth of assets circulating the market at any one time and much of it could be pinned down for use as variation margin.

Although the vast majority of margin for derivatives is made up of Cash – estimated to be about 70% of the total – the remainder is derived from Equities and Bonds. As organizations expand their derivative margin businesses, they are increasingly looking for sources of collateral to both place out and invest internally, resulting in a 'churn' of the organization wide asset pool.

Proactive Collateral Management was born out of the organization wide consolidation of business units or 'silos' into one central Margin Management and Collateral Trading environment. Certainly, most of the larger organisations have long since merged the OTC Derivatives, Repo and Stock Lending margin functions into one 'Global Margin Management Unit'. Such merging of business lines has provided operation economies of scale, bringing together skilled teams in one place, often with one application reporting net portfolio activities.

Once merged, it has allowed some organisations to go a step further and create 'Master-Master' agreements offering all products under a single 'umbrella' operational agreement. These portfolios of trades will

require margining on a regular basis, with assets being received and delivered as defined in the terms of the supporting legal contracts.

With a strong platform in place to net exposure and calculate margin requirements, the next logical step has been to consider a wider use for the applied assets. In the case of cash, the rehypothecation, or re-use has been simple. What comes in, goes out, so to speak. Any positive cash balance is usually invested overnight at prevalent market rates with interest income offset against payments due to the party depositing the cash as margin. And being cash – usually Euro, Sterling or USD – it is rarely considered as ineligible, undesirable or difficult to fund. That fundability and ease of management makes cash 'king' of the collateral world when it comes to derivatives margin. It is the remaining 30% of margin made up of Bonds, Equity and other forms that gets a little more complex, risky and exciting.

The last ISDA Margin Survey estimated the total value of assets in circulation today used as margin for Derivatives at about USD 1.3 trillion, with more than twenty five percent of that thought to be Bonds or Equities. That's over USD 300 billion, which is a fair amount but still tiny when compared to the total value of assets traded as collateral. The Collateral Trading market (repo/stock loan, etc) is a positively huge market in which many organisations are involved. It is this involvement combined with the derivatives margin management process that has brought on the proactive, enterprise wide collateral management concept.

For those organizations willing or able to view both the Collateral Trading and Collateral/Margin Management portfolios as one view, it becomes possible to consider all bank assets for use as margin and/or trading. It is often the case that a margin desk receives in a bond that may have gone 'special' in the market (desirable). To the average Margin Manager the asset is simply another bond on account with rehypothecation rights ready to go out as margin on the next demand received. But to the Collateral Trader, that asset is just what he needs to sell or lend out.

In the reverse situation, consider that the margin manager is in need of bonds to cover his margin obligations. Without any further reserves it will be necessary to borrow assets from the trading desk for onward delivery to the counterparty. Enterprise wide, Proactive Collateral Management should allow both parties within this organisation to have views on the complete asset pool at any one time, making full utilisation of all assets on account. Of course this method of sharing assets across desks and business units comes with associated risks, which is why many

organizations have decided to keep them apart. One of the key issues against Collateral Management is the need to return margin, often at very short notice on a delivery cycle shorter than that usually experienced in the trading world. Failure to deliver that margin can lead to serious reputation and credit risks that should certainly not be ignored.

The key to making this work seems to be the access to data and use of assets over short periods of time. Any margin management tools should be able to list clearly what has been booked at both trading and margin management desk/book level with clear segregation and rights of use. Ideally the collateral taken as margin and utilized by the desk should be readily available for recall on very short notice (book on open), while the assets taken from the desk and used as variation margin should be confirmed as available for use over a fixed period of time. Once more, functionality for this is something that is being incorporated into Lombard Risk's sophisticated collateral system, Colline® and is expected to be utilised increasingly as access to suitable assets becomes restricted through the recent credit crunch.

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