Editorial

Collateral Management after the Crisis

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Regulatory change developed in response to the financial crisis has increased the importance of collateral management, both to financial market participants and corporates. OTC derivatives have to be supported by higher levels of collateral. Revised capital rules penalize a bank's operational inefficiencies when managing collateral and funding constraints have increased the importance of collateralized financing. But there is also a more fundamental behavioral change. Buy-side participants have, in some instances, viewed collateral management as an operational hurdle to overcome, rather than a risk management tool. Post crisis, collateral management is now seen as pivotal to their risk management approach. All of this is causing change.

Many firms traditionally operate a number of collateral management silos that cover specific businesses, like equity or debt capital markets, prime brokerage, futures, structured products, or OTC trading. Such structures are no longer economically viable given the crisis, which amplified the opportunity costs associated with these structural inefficiencies. For example, the type of collateral posted to counterparties is increasingly used to determine the appropriate discounting rate at which to price OTC derivatives. Going forward, other factors such as thresholds or frequency of the collateral exchange could affect how counterparties price transactions. This economic pressure will require many firms to invest heavily in internal capabilities or employ third-party providers to improve their operational efficiency and control over the collateral flows across multiple business lines.

In response, collateral management is developing at a fast rate and the need to continuously invest is unlikely to disappear. Regulation has created a permanently higher demand for collateral that will impact the wider market and business models. Yet, there is more change to come. The present work by the Financial Stability Board in the context of "shadow banking" seems to suggest a market-wide centralization of risk parameters if it were to finally recommend the introduction of minimum haircuts for collateral. Regulators are also discussing whether additional rules or processes are needed that would, for example, prevent cash lenders such as money market funds from taking on collateral that they could not properly manage or permissibly hold outright. Collateral management practices thus increasingly interact with rules applicable to the asset management industry.

The shift of OTC derivatives towards central clearing will significantly increase the demand for high quality collateral and could thereby have an impact on asset pricing. Academics and regulators are focusing on the consequences should different assets with identical payoffs be priced differently by the market, depending on their collateral value. Collateral rules thus can impact the overall capital allocation, causing unintended consequences.

There are wider systemic risk implications driven by a potential supply-demand imbalance for collateral, aggravated by restrictive collateral eligibility requirements. Certain assets cannot be universally used for different exposures. Work is underway to discuss whether further fine-tuning of several related regulatory frameworks is necessary, with a view to look at the consistency (or lack thereof) of collateral eligibility between central counterparties, Basel III and central bank funding.

Finally, the industry may see the appearance of specialized collateral market infrastructures in the areas of collateral transformation or collateral liquidation because these activities involve a level of credit capacity to which not all market participants are able to commit.

Effective collateral management solutions must allow market participants to efficiently allocate collateral across various exposures. Those institutions that are able to manage their collateral to maximum advantage will have a competitive edge.