Collateral Conference 2019

Day one

A wide variety of securities finance market participants gathered in Brussels for the 18th Euroclear Collateral Conference to discuss the resilience and expansion of the global collateral management industry, which is facing a plethora of regulatory, economic and even political challenges.

The need for optimisation of the processes around collateral management was a key theme of the day as low-yields, negatives rates, as well as new factors such as environmental, social and corporate governance (ESG), take hold in the market.

Multiple speakers made clear that issues around collateral had only become more acute for both borrowers and lenders in recent years and all aspects of the market must adapt to remain competitive.

Panel one: Recent evolutions in collateral trading and optimisation

In the first panel of the day, the potential problems posed by the fast-approaching year-end liquidity crunch in the EU and US repo markets were put under the microscope.

Panellists noted that in September the US overnight repo rate was the victim of what one speaker described as a "butterfly event" that saw the unintended consequences of post-crisis regulatory requirements become compounded by a series of market events around the Q3 quarter-end, which created a notable liquidity shortage.

The result was that over one week in mid-September the overnight repo rate soared from its usual 2 percent to peak just shy of 10 percent as liquidity dried up and the New York Fed was forced to step in and inject liquidity into the market.

Looking ahead to year-end, the speaker explained that the US would see "a lot more volatility" around year-end because banks have to manage their balance sheets and the issues from September have not gone away.

The speaker went on to explain that in Europe the market is notably different in that it is less concentrated and has smaller banks than the US and, as such, although there will also be volatility here, it will be much less pronounced.

Optimisation

The conversation turned to the need for optimisation of balance sheets in order to adapt to leverage ratios and not contribute to market-wide liquidity concerns.

A second speaker said that a key feature driving optimisation in the European market was the introduction of negative hair cut rates and the need for solutions that can offer zero-rate returns.

Partial and unsecured financing has also developed as a new feature of the European market in reaction to today's market environment.

"From the perspective of liquidity, it actually brings a lower margin capital requirement and therefore brings balance sheet savings as well," a speaker explained.

Borrowing versus unsecured was estimated to be between $80 million to $100 million and speakers said they expect this market sector to grow in the future.

Calculating ratios

Turning to the various ratios that market participants must now consider, panellists agreed that the liquidity coverage ratio was a simple enough calculation to manage, but the net stable funding ratio (NSFR) was another matter entirely.

It was noted that the final rules of NSFR are yet to be released, despite a prolonged period of market consultation that began in 2016.

"We are starting to form an idea of the complexities [around NSFR] and, in fact, it is quite a game-changer when you consider the one-year stress horizons," a panellist said.

"We are going to have to change the way we fund our balance sheets and probably go back to transactions versus cash," they concluded.

Panel two: Securities lending - Why still do it?

Some of the main themes discussed during the panel included data, technology, collateral optimisation and ESG.

Panellists agreed that collective data is key to improving the market, however, this aim is not without its challenges.

One speaker said: "The difficulty is getting the data. The problem is that we operate in an over-the-counter-based market, which makes it very difficult to get standardised data."

As well as this, panellists noted that it can be very difficult to compare data so there is a need for greater transparency.

"The collection of data is important but

the next challenge is how are we going to use it," one panellist added.

One buy-side speaker explained: "Data is very important, and we have a lot of data sources at our disposal and we have spent a lot of time in resources and working on new tools when monitoring our agent lender so that we have a good overview of rates and volumes."

"In the past, we relied on spreadsheets and so it was difficult to identify any trends," the speaker continued. "One important consequence is that we can now have much better targeted-discussions with our agent lenders and counterparties."

Later in the panel, panellists looked to how technology can improve the securities finance industry. Highlighting its importance, one speaker said: "Technology is at the focus of every strategy. Our strategies rely heavily on high volumes and a lot of manual tasks are required. We want to reduce the workload and human error that can occur."

They added: "We are using a lot of electronic trading platforms but I have noticed that, in terms of electronic trading, the securities lending industry is lagging a bit behind."

"However, regulations such as the Securities Financing Transactions Regulation should push securities lending market towards a technological route."

Speakers went on to discuss collateral optimisation and noted that while "efficiency is the name of the game" and collateral optimisation is trending on the sell side, it is now also a central focus for the buy side.

"The buy-side side of the coin is becoming increasingly complex," the agent lender speaker continued. "If you are a traditional asset manager you might not be expecting it [collateral optimisation] to interfere with your lending process, but you are now going to have to start thinking about the dynamic shift. If you have different actors in the chain, then that can be a bit of a conundrum."

Ending on the topic of ESG, one panellist noted that there are different approaches to implementation. They cited: "As an agent lender we can support recalls in voting but it comes at a cost as it can make the overall attractiveness of your portfolio less attractive."

According to the panellist, there is an increased focus on what is deemed to be acceptable collateral.

"While the same principles are being applied it can be challenging because that approach can be varied and ultimately it is the investor who makes that decision on what matters to them (such as carbon footprint, weapons or tobacco)," the speaker concluded.

Panel three: Improving liquidity in emerging markets

The existence of robust domestic money markets and bond markets within emerging economies is an essential ingredient in ensuring developing countries progress and grow, explained a speaker.

A second panellist countered that effective monetary policy of an emerging market's central bank was the "bedrock" of any good economy and must be the first thing to be in place before any financial market can flourish.

The development of a liquid repo market was described as a "classic chicken and egg" scenario when it comes to introducing major international players to a new market by a panellist.

The speaker went on to note that although the existence of major players was always welcome, it was essential that domestic markets were not over-reliant on foreign entities to function as it left emerging markets at the mercy of sudden changes to global risk appetite.

A speaker representing a global bank that is active in several emerging markets outlined that the key challenges were understanding often opaque insolvency laws regarding counterparties and other local features that might be unique to that market.

When speakers were asked what they would like audience members to understand about engaging with an emerging market, the responses included the need for a scalable triparty solution, a requirement to be flexible in your collateral requirements and a willingness to engage with local customs and truly understand market rules.

Panel four: Global regulatory reforms - A cross-border collateral perspective

It was noted at the opening of the panel that market participants often complain about the divergence of regulatory frameworks across national borders. However, a speaker explained that a global regulator could never exist as national priorities are "radically different".

Another speaker explained that regulators were cognisant of the industry's desire for parity and efforts had been made to align standards where possible.

Speakers also countered a common idea that the US regulator "leads the dance" in the global regulatory block's efforts to de-risk. It was noted that sometimes the EU leads and sometimes it's the US, but it is true that where one regulator goes, the other often follows shortly after.

European regulators were praised for their efforts to deliver in the past 10 years on its five key areas: reporting, clearing, capital, trading and margining. "Now it is a process of fine-tuning," a speaker explained.

The CCP conundrum

The conversation shifted to the development of central counterparties (CCPs) as a growing feature in the market.

Concerns were raised that although they all boasted robust risk management processes, no amount of protection was impregnable.

A speaker with an understanding of the regulatory process told conference delegates that CCPs would soon be asked to double down on their "skin in the game" in order to further protect against a major failure, which could be "catastrophic" to affected parties.

It was noted that more safety nets were needed as national regulators had categorically said that taxpayers would not bail out a CCP in the event of a wide-spread market collapse.