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Collateral Conference 2019

Day two

Panel one: Uncleared Margin Rules - Getting ready for phases 5 and 6...now!

On the first panel of day two of the conference, panellists turned their attention to the Uncleared Margin Rules (UMR).

Asset managers, pension funds and insurance companies are scheduled to come in-scope of UMR based on their volume thresholds either with phase five on 1 September 2020 or with phase six on 1 September 2021.

Primarily, UMR initial margin (IM) requirements for non-centrally cleared derivatives seek to establish international standards for non-centrally cleared derivatives.

Panellists reviewed the challenges associated with UMR, and one speaker observed that although there were complications for the first four phases, there was funding from the banks and the process was not particularly painful.

However, it was noted that the next two phases are likely to be “a huge challenge” as there will be less funding available for margin requirements next time around.

The differences between the earlier phases, the panellists identified, is that banks and broker-dealers were quite used to triparty securities lending and triparty repo.

It was highlighted that those coming into scope for phase five and six, they are not used to this kind of environment. Panellists stressed the need to conduct an analysis on which model of calculating and delivering margin is best suited for their needs.

“This is a complex new infrastructure with lots of new counterparties,” explained a panellist. “Looking at collateral eligibility schedules as decisions will have to be made as to whether they want to go for a so-called “third party model” or go in-house or chose a triparty provider.”

Another speaker added a word of warning that the third-party model can become “very complex and historically custodians have taken care of that for everybody”.

Continuing on this point they said: “There are some very significant differences and one of the myths is that everyone’s using triparty, but a that is not for everyone.”

“There is a great deal of new developments out there but also you should go for something simple; you will have to live with this for a long time and no one will have the appetite to unpick it so give really careful thought to the model and what is going to be most efficient to you,” the speaker continued.

UMR’s ripple effect

Looking at UMR on a global scale, a panellist observed that there is a knock-on effect occurring in Asia. “If you look at the Asia environment, they generally don’t deal in securities and even if they do it’s not the right type of security, they also mainly deal in cash,” explained a speaker.

“So it starts to crawl into how can they get the triparty infrastructure to accept that Asian world into the European environment and more importantly how do you start to facilitate it in the portfolio of clients, which I think is going to be another interesting challenge. It will add an additional layer to the decision process over which structure to use.”

Panel two: How can the industry take tokenisation forward?

At the panel’s opening, it was stated that many conversations around distributed ledger technology (DLT) and tokenisation suffered from a lack of mutual understanding of what basic terms in the crypto world actually mean.

The panel set itself up to bring a realistic perspective of the value and applicability of tokenisation, highlight challenges to adoption and set expectations for the industry over the next few years.

A panellist opened the discussion by stating that the legal infrastructure that underpins any tokenised security must be almost identical (in terms of the rights it conveys) to the legal constructs used today, in order avoid introducing new risks.

On the subject of risks, the controversial topic of cryptocurrencies was put to panellists. One speaker involved in a DLT project noted that a decision was made early on in development not to include any digital cash assets on the platform as they were too volatile and had liquidity issues.

Elsewhere, the question was put to panellists whether the introduction of DLT platforms would create new silos in the market.

The speakers were unanimous that their DLT solutions would in fact do the opposite as they would allow for the free-flow of data between counterparties and would even create links between firms that currently struggle to interact.

"I'm optimistic that the direction of travel is away from silos," a panellist stated.

Challenges to adoption

Turning to the limitations of DLT and tokenisation, it was noted that fintech firms alone cannot drive the introduction of crypto to the capital markets and the inclusion of central banks and central securities depositories was essential to ensure mainstream adoption.

Panellists also called on developers of DLT solutions to spend the time educating traditional market participants in the realities of the pros and cons of their products as they related to real-world problems in the market.

In closing a speaker called for a change to the tone of the market's conversations around tokenisation. "We talk too much about how the technology will disrupt and take people out the market," the speaker said. "We should be talking about how it will help people collaborate."

Sustainable finance: From small-stream to mainstream

The final panel of the conference looked at the myriad challenges that stand in the way of incorporating environmental, social and governance (ESG) policies into into the mainstream processes of the financial world.

A panellist observed that in term of regulatory drivers for ESG-friendly financing, the situation posed a unique twist, compared to usual matters dealt with by market rule-makers. Namely, the fact that new regulatory frameworks usually came in response to a negative market event, but in this case, the situation required regulators to be pro-active in encouraging entities under their remit to contribute to ESG initiatives. This, it was noted, was an on-going challenge for national and global regulators that would not be resolved in the short term.

Shortly after, delegates were offered a bullish report on asset managers' and banks' efforts to incorporate ESG into their investment decisions. "It's not just marketing," a panellist explained. "Managers are convinced that ESG strategies have a sound business case and will bring returns."

Another panellist representing a fund manager said that for their firm, ESG was a mainstream topic. This point was reinforced by a second speaker who referenced market research that surveyed 300 asset managers and found that ESG policies and exclusion lists of undesirable assets, including for securities lending collateral, were commonplace throughout the industry; and were more established today compared to previous years.

However, it was also noted that although socially-conscious policies had permeated some investment strategies, it was often not consistent throughout large financial institutions and further work was needed to ensure ESG was a factor at all levels of decision making.

ESG on collateral

The primarily impact of the emergence of ESG on the world of collateral and securities finance transactions was the added layer of complexity it put on collateral selection. Many beneficial owners now maintain exclusion lists of market sectors (such as tobacco, weapons manufacturing and fossil fuels) that they are unwilling to engage with. As such, borrowers must now comply with these lists when posting collateral as part of a securities lending or repo trade.

A speaker noted that although this was undoubtedly a new complexity for asset managers and brokers to manage, it was not insurmountable and wasn't largely different from well-established collateral requirements held by beneficial owners. "ESG and securities lending are not incompatible," stated a speaker.

Data deficit

Research of ESG, it was noted, was hampered by a dearth of legitimate data on the scale and prevalence of these types of investments. There is a lot of data on the 'environmental' piece, explained a speaker, but its often provided on a voluntary basis and therefore often inconsistent.

However, the 'social' and 'governance' sections had very little data publicly available to offer any satisfactory insight into market strategies in these areas.

A speaker added that internal measurements for ESG strategies within financial institutions to rate their portfolios and track their actual positive impact on communities was often lacking as well.

To conclude the event, a speaker highlighted that although ESG as a market trend had begun in developed markets in recent years it was actually businesses in developing economies that should be most invested in making an impact in this arena.

The panellist said that 100 million people are expected to be put into poverty as a result of climate change, with the vast majority of the hardest hit communities located in developing countries.

The speaker added that despite this, until recently, ESG-related activities were not a priority for institutions based in the parts of the world most vulnerable to the extreme weather scenarios caused by climate change. Thankfully, perceptions around the need for immediate action on climate change, as well as social issues, appear to have shifted for the better and today financial market participants appear to be united in pushing for a better tomorrow.