OPENING NEW HORIZONS : TRI-PARTY COLLATERAL

Today, financial institutions are rethinking their practices of collateral management and breaking the existing silos. They are seeking more sophisticated collateral solutions in order to use a wide range of securities to back their trades and mobilise their assets when and where they are needed.

Increasingly, market participants are turning to the tri-party model. Acting as a neutral party, the tri-party agent manages the collateralisation of exposures resulting from trading activities between two counterparties. How can a service, designed historically for interdealer transactions, be leveraged to fully meet any collateral management requirements? What are the conditions necessary for an efficient tri-party collateral management?

Let's have a look at three different collateral requirements: variation margin on uncleared over-the-counter (OTC) derivatives, initial margin on non-cleared OTC and securities financing transactions.

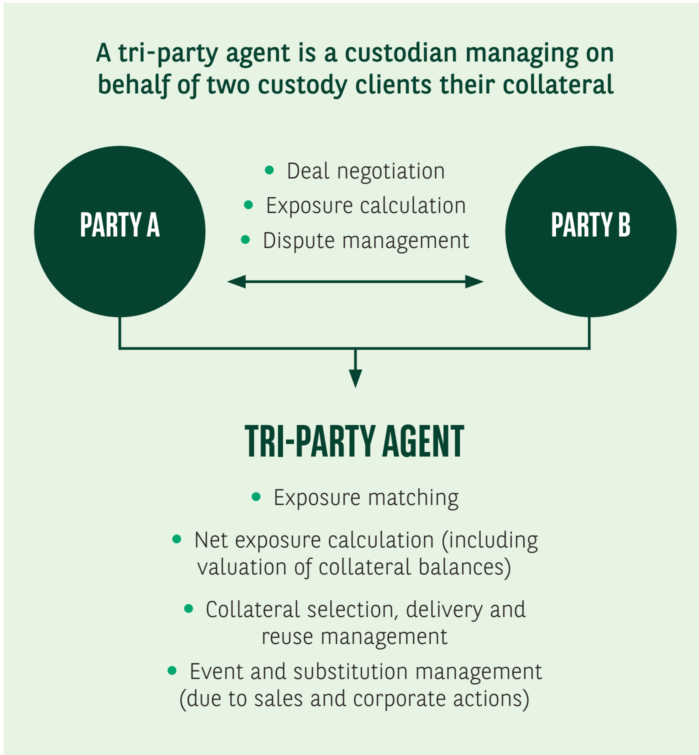
USING EQUITIES AS COLLATERAL

The main characteristic of bilateral management on uncleared OTC derivatives is the almost exclusive use of cash and government bonds. There is an inherent risk in using equities as collateral due to the frequency of corporate actions. When these occur, there may be a tax risk when failing to detect such an event or substitute on time.

Therefore some asset managers have had to change their investment profile to hold cash or bonds. This may have an impact on their returns, especially for UCITS funds which cannot "transform" their equities because of regulatory guidelines

The tri-party model is perfectly suited to manage equities as collateral. However, this solution is viable for the buy-side only if various criteria are met:

- Both buy-side and sell-side participants adapt their OTC derivatives processes to create a new operational path for tri-party collateral management
- The tri-party agent complies with any asset segregation rules which would be imposed by regulation or local market practices
- Tri-party management must be directly "connected" to the client's main account to avoid constantly having to manage collateral inventory realignments



BNP Paribas Securities Services is the only global custodian with a tri-party service directly funded by the customer's current account. Too often, the customer has to manage an additional account (called a "longbox"), which reduces the benefits of the tri-party model. In a "longbox" configuration, the customer must pre-select the securities to be transferred to the "longbox", recall the surplus securities to the main account, reconcile their positions over several accounts, etc.

BNP PARIBAS

The bank for a changing world

INITIAL MARGIN ON NON-CLEARED OTC DERIVATIVES

Initial margin requirements for non-cleared derivatives will impact a larger number of non-cleared swaps counterparties from September 2020 and 2021[11] . On one hand, market participants will have to pledge a significant amount of collateral. On the other, they will have to implement a specific framework to comply with the new regulatory requirements.

In addition to the calculation and portfolio matching, OTC derivatives participants have to set up a specific process for initial margin:

- Initial margin comes in addition to the current variation margin flow (used to cover the OTC derivatives mark-to-market), with a different set-up
- Initial margin is a two-way gross margining process. Each party needs to transfer collateral, from both the pledgor and pledgee' perspective
- Parties have to determine, with each of their counterparties, the minimum transfer amounts (MTAs), the initial thresholds, the eligible collateral and haircuts
- Collateral cannot be re-used or re-hypothecated, and it has to comply with stringent concentration and wrong way risk limitations
- Initial margin needs to be pledged in favour of the counterparty, on a segregated custody account, with a specific legal framework (dedicated "Account Control Agreement")

In Europe, tri-party collateral agents have strongly supported their clients during the first waves. They offer a fully automated solution for the matching and allocation of initial margin across counterparties, as well as the appropriate pledge mechanisms and default management process. Given the approaching deadlines and expected workload, firms must now quickly agree and implement a target framework, looking at the best combination between calculations, collateral management and custody services.

WHAT ABOUT SECURITIES FINANCING?

Today, the hundreds of billions of collateral linked to securities financing transactions mainly come from inter-dealer transactions with few
buy-side participants. With quantitative easing, low interest rates, and the requirements of Basel III, banking counterparties are seeking high quality liquid assets over the long term. As a result, institutional investors are eyeing new opportunities for securities lending or repo transactions, in order to generate additional income, which is particularly welcomed in the current environment.

For post-trade, it is essential to optimise the full operations chain: confirmation with the counterparty, fees calculation, portfolio accounting, monitoring funds' ratios and collateral management, etc.

As with OTC derivatives, tri-party platforms are well positioned:

- Basket repos can be easily managed as the cash leg settlement is synchronised with several lines of securities defined by an eligibility matrix (also known as the "basket")
- They provide more velocity to the collateral giver, notably when refinancing small lines of securities
- The type of collateral can be broader - equities or corporate bonds - enabling the buy-side to obtain more attractive execution spreads

AT THE TURNING POINT

Financial institutions are rethinking their collateral management practices and breaking down existing silos. Although the concept of a tri-party service was initially created for the interdealer business, it will be used more widely across financial institutions' derivatives activities. To make it a success, market players should have a comprehensive approach that involves multiple teams. They need to ensure that processes along the value chain, from front-office and middle- and back-office, are fully adapted to a tri-party service.

The role of a tri-party collateral agent encompasses:

- Recording of any collateral agreements, including global master repurchase agreement (GMRA), global master securities lending agreement (GMSLA) or credit support annex (CSA)
- Receiving and matching client instructions across various types of transaction (repo, securities lending, OTC derivatives, financing, etc.)
- Valuation of collateral assets and calculation of net exposure, for various types of collateral assets (equities, fixed income, ETFs, cash)
- Real-time selection and allocation of collateral allocation from the available collateral inventory
- Event and substitution management (corporate actions, sell of collateral holdings)

1 Smaller buy-side participants will not be impacted

FOR ADDITIONAL INFORMATION, PLEASE CONTACT YOUR RELATIONSHIP MANAGER

FOLLOW US

FIND US

securities.bnpparibas.com

040220U_SSC_CAATP_AR_EN