Managing Complexity

Centralised clearing of over-the-counter derivatives will reduce counterparty risk and improve transparency, but it also threatens to increase complexity and costs. *John Southgate*, Northern Trust's EMEA head of derivatives product management explains how investors are likely to be affected, and how the asset servicer is responding to assist its clients

In the past, arranging an over-the-counter (OTC) derivative trade was largely a matter of picking up the phone to an interested third party and agreeing the deal. The finer details of the transaction were usually left to the two parties to negotiate, including the issue of how much up-front capital should be provided.

Not anymore. In a bid to create a more stable financial system, legislators in Europe and the US have been drawing up new rules to force all such derivative trades through centralised clearing houses. Whilst this may offer much greater protection for markets, since the credit default risk will now be borne by large clearing houses rather than individual investors, it poses some huge challenges for investment managers. Without careful consideration, the complexity and costs inherent in this more prescriptive world of financial trading could have dramatic consequences.

The new rules were to a large extent borne out of the collapse of Lehman Brothers. Since most of the derivatives on Lehman's books had been agreed bilaterally, there was no clearing house available to pick up the pieces when the investment bank went into bankruptcy – this was left to individual investors.

In April 2009, finance ministers from 20 major economies (G20) agreed that, in order to avoid similar crises in the future, a centralised clearing system was needed, which would substantially reduce counterparty risk by allowing exposures to be netted.

In the US the new rules on centralised clearing are enshrined in the Dodd-Frank Act, which should come into force by the end of 2011 at time of writing. Europe is behind slightly and the equivalent piece of legislation from Brussels – the European Market Infrastructure Regulation – is not due to be implemented until the end of 2012.

"Central clearing is the biggest change that has happened to OTC derivatives," said John Southgate, European Head of Derivatives Product Management at Northern Trust. "It is going to significantly increase complexity and costs for investment managers."

One of the main costs that investment managers will have to face is over how much capital they will now have to deposit in order to cover a derivative trade. Whereas the current system allows margin requirements to be negotiated bilaterally, under the new system highly-regulated clearing houses will dictate the level of capital that is needed.

There are two types of margin requirements to consider. One is the initial margin, which can be covered either by cash or certain eligible collateral such as high-grade government securities. The other is a variation margin requirement, which must be met on a daily basis. This can only be covered by cash. Lobbying efforts for other types of collateral to also be used have so far not been successful.

These new, more stringent requirements could have serious repercussions for the way that investment companies manage their portfolios, as Southgate explains.

"Forcing investors to come up with extra cash could have a potential impact on fund performance, since this is an asset which could be put to work elsewhere. Furthermore, the need to back variation requirements with cash on a daily basis is going to add a whole extra level of complexity to fund management, because if managers don't have the cash to hand they will need to perform collateral upgrades or transformations."

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The problem is that many buy-side users of derivatives don't necessarily keep enough cash to respond if the daily margin requirements suddenly change. Northern Trust, though, can help clients with the process to transform non-eligible instruments into cash.

One of the areas where the firm can particularly assist, says Southgate, is in helping clients to determine the most efficient way to finance margin requirements, and the team is currently looking at ways to extend its collateral management service to help with this type of optimisation process. Another option being assessed is a repo agency service. This is because many smaller investors don't have a dedicated repo desk, and so could find themselves impacted by the new rules if they can't quickly turn non-eligible assets into cash when they need them.

However, cost is not likely to be the only challenge for investors but also the sheer complexity of the new environment, which could see many fund managers spending large amounts of time trying to establish clearing relationships rather than running their fund.

Southgate explains that, as the size of an investment portfolio grows, managers will need to spread the risk between different clearing members – and that this is not a trivial process.

"For smaller managers, two relationships will suffice, but two is really a minimum requirement," he said. "If you are a much larger investment manager, with hundreds of portfolios, and you have only two relationships in place, then you have a problem. For example, who will want to take on the operational risk of a hundred-plus portfolios in one 'big bang' in the event of a clearing member default? The larger managers may look to establish three, four or even more of these relationships."

Northern Trust offers a centralised service to clients who want to establish multiple relationships with clearing members, which often involves a fairly significant integration process.

"There's a huge operational overhead in terms of making margin payments on a daily basis to each of the different clearing members, whatever size of manager you may be," said Southgate. "You have to deal with margin payments per account per clearing member, so there are substantial order-of-magnitude issues to consider. The good news is this is a level of complexity that we are used to dealing with and can help with."

There are currently no uniform market standards in place for producing daily margin statements, with the result that each clearing member uses a different format and that all market participants interact with each other differently. In this arena Northern Trust can act as an aggregator and is in the process of creating a reporting standard of its own to provide some consistency for clients.

Southgate says there are some signs that investors are starting to take the forthcoming legislation seriously, but warns that those who choose not to are running a huge risk.

"Very soon, and perhaps sooner than most people think, there will be a scramble to get the right clearing member onboard, to develop those relationships, and to build the interfaces between them," he said. "People who delay could be left behind in the rush to get on board. That's why we're building systems that can meet clients' changing requirements, and are working closely with them, explaining why we recommend they prepare even if at this stage they don't think they're necessarily affected."

Many pension funds use large portfolios of OTC derivatives to manage their liabilities, and European pension funds have managed to obtain a three-year exemption from the new rules, after voicing concerns over their cost. However, Southgate cautions them against sitting on the fence for too long.

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"Regardless of when the legislation comes in, central clearing is going to happen," he said. "With proposed margin rules in the bilateral market and increased regulatory capital requirements being imposed on dealers as part of the incoming BASEL III and CRD IV regulations, investors are likely to be forced down the central clearing route anyway."

Over the years, Northern Trust has built up an established derivatives platform, using its single global operating model, which means that complex information can be collected, channelled and viewed via one system, enhancing speed, efficiency and accuracy of data delivery. A complete package of services for those wanting to execute derivative trades can also be provided, as Northern Trust offers comprehensive valuations services, with embedded vendor solutions that can provide an independent valuation on 100% of what clients are trading. This pricing of instruments becomes even more important when switching to the need to meet margin requirements on a daily basis.

Besides valuations, Northern Trust can help clients establish and manage relationships with clearing members, make and receive margin calls, help transform investments into collateral that can meet variation requirements, and provide a range of interactive reports to assist clients in managing their investments.

Clients can either make use of this full range of derivatives services that the company provides, or just those that are most useful for them on a component basis. Either way, Southgate expects the firm's role to become ever-more prominent as the derivatives landscape evolves.

"We see our role as an asset servicing provider as a broadening one, whereby we help clients with their operations and technology and help provide the infrastructure for their trades," said Southgate, "And as the regulatory environment for OTC trades becomes more stringent, it is likely we'll take an ever-more central role in the clearing process, particularly as trends such as the continued take-up of investment operations outsourcing continue to strengthen the links between investors and their asset servicers."