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# A critical moment for collateral management

## BNY Mellon's Paul Harland assesses the changing environment for collateral management

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As the financial crisis enters a new and uncertain phase, collateral management has taken on a new and profound significance. For an insider's view on the issue, Securities Lending Times turned to Paul Harland, managing director with BNY Mellon Broker-Dealer Services, who characterises the current environment as one of "evolution, revolution and regulation."

**SLT: BNY Mellon is one of the largest global collateral managers so I imagine you have a pretty good feel for what market participants are looking for?**

Paul Harland: That's right, we have been one of the world's leading collateral managers for many years now. We pioneered this business in the early 1980's and have built the industry's most comprehensive collateral management platform, managing over US$1.8 trillion in collateral transactions every single day. We service dozens of major institutions including every major investment banking business in Europe and 16 out of the 20 primary dealers in the US.

**SLT: What are the main drivers of client demands in the aftermath of the financial crises?**

Harland: We would perhaps characterise with the words evolution, revolution and regulation.

We have seen evolution of the financing models driven by many things, including a desire to be self-funding, an aversion to reliance upon unsecured lines with a need to diversify funding sources.

The financial crisis caused revolution – a collapse of counterparty confidence, a scramble to quality and an increased focus upon collateral. More collateral is being called and on a more frequent basis. I will give you an example; in the OTC derivatives market many buy side firms had not previously considered calling collateral. In addition, Credit Support Annexes (CSA's), if signed, were rarely reviewed or relied upon. I can assure you, that's no longer the case and many of those firms - as many as 50 percent according to our research - have passed their collateral management to third-party providers like BNY Mellon.

Which brings us to regulation, something that has perhaps consumed more time and energy than anything else over the last couple of years and is going to significantly shape the markets over the next decade.

**SLT: Can we talk about how the secured financing markets have behaved since the financial crises?**

Harland: The equity financing market consists of multiple trade structures; stock loan short covering, equity collateral against stock borrows, upgrade trades, total return swaps, repo, etc. All trade independent of each other, and each has proven resilient thus far.

Doubtless in the immediate aftermath of the crisis we saw balances fall, but we are back well-above record highs.

**SLT: Looking at the regulatory changes, what do you anticipate?**

Harland: One thing is certain – collateral is going to be more important than ever before. Let's look at the proposals; we have Dodd Frank, ok it's been deferred for six months, but is going to happen, then we have EMIR and the detailed rules under ESMA due at the end of June 2012.

All swap dealers and major swap participants are going to be impacted and each of these entities will be obligated to post margin either to its clearing member, who will in turn have margin obligations to the CCP.

The gross numbers are potentially huge, as much as US$2 trillion has been suggested, though in reality no one can say with certainty yet and that's going to raise all sorts of issues.

The only thing that is certain is that there will be a cost, a cost that ultimately is paid by reduced yield and as much as 200 basis points have been suggested, but plenty is unclear.

Eligibility, for example: how does an equity-based institution faced with a requirement to post cash or G7 debt accommodate the collateral obligation?

Then there are timing issues. CCP's are suggesting multiple intraday margin calls and that is not something that's easily achieved outside of a book entry tri-party collateral manager.

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That's why we are sure that collateral managers like BNY Mellon are going to be increasingly important and collateral optimisation critical for efficient operation of the post-trade infrastructure.

**SLT: What is BNY Mellon doing in light of all these new changes?**

Harland: Our clearance and collateral management services have been crucial to the sell side infrastructure and increasingly, over the last few years, our expertise and robust platforms have been relied upon by the buy side.

What does all that mean? We have a significant securities processing business and are a technology-based infrastructure provider. We have the scale, focus, expertise and long-term commitment to address market needs during this period of unprecedented change.

We are also consulting across all market participants in order to leverage our broad range of post-trade services. That includes not just collateral management, valuation, screening, margining and optimisation, but also middle and back office services and safe keeping and segregation of assets as well.

We are talking to buy side firms about fulfilling their obligations and helping them shape post trade infrastructure. We are talking to sell side FCM's because they also face infrastructure challenges and increasingly are looking to BNY Mellon to deliver on our core competencies whilst they focus upon theirs. Finally we are talking to CCP's who recognise that, whilst they may want to call margin many times a day, the requirement is challenging and a tri-party collateral manager is uniquely positioned to deliver.

**SLT: Looking forward, what do the next ten years have for us?**

Harland: Well, that's the $64,000 question, isn't it?

Perhaps I'm being overly pessimistic, but as George Bernard Shaw once said, 'If history repeats itself, and the unexpected always happens, how incapable must man be of learning from experience.'

Perhaps the thousands of pages of committee-generated rules will create the Nirvana of stability and certainty. An alternative view could be that regulators and authorities are creating a framework with potential for a systemic perfect storm.

What do I mean by that? Well all the CCPs are, relatively speaking, thinly-capitalised relative to value of business transacted. In addition, given their global business models, most do not benefit from a definitive lender-of-last-resort or support from any nation state. Similarly, their default funds, whilst large, are not limitless and though they comprise high-quality fixed income securities, we have all seen this summer everything has risk.

As Alan Greenspan said at the time of the Long Term Capital Management collapse 'This decade is strewn with examples of bright people who thought they had built a better mousetrap'. SLT

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Paul joined BNY Mellon in 1997, and previously worked as Client Executive for Investment Banks and Broker Dealers where he was responsible for several of the largest clients in Europe.

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