



**Collateral Management –
a practitioners perspective**

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Agenda

- ▶ Drivers behind Collateral
- ▶ Operational Aspects
- ▶ Market Overview

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What is Collateral Management

- ! Definition - Collateralisation is a credit enhancement technique and is a means of mitigating credit risk associated with privately negotiated derivatives transactions.
- ! Can be used for either individual deals or a large portfolio of deals.

Source ISDA guidelines for collateral practitioners

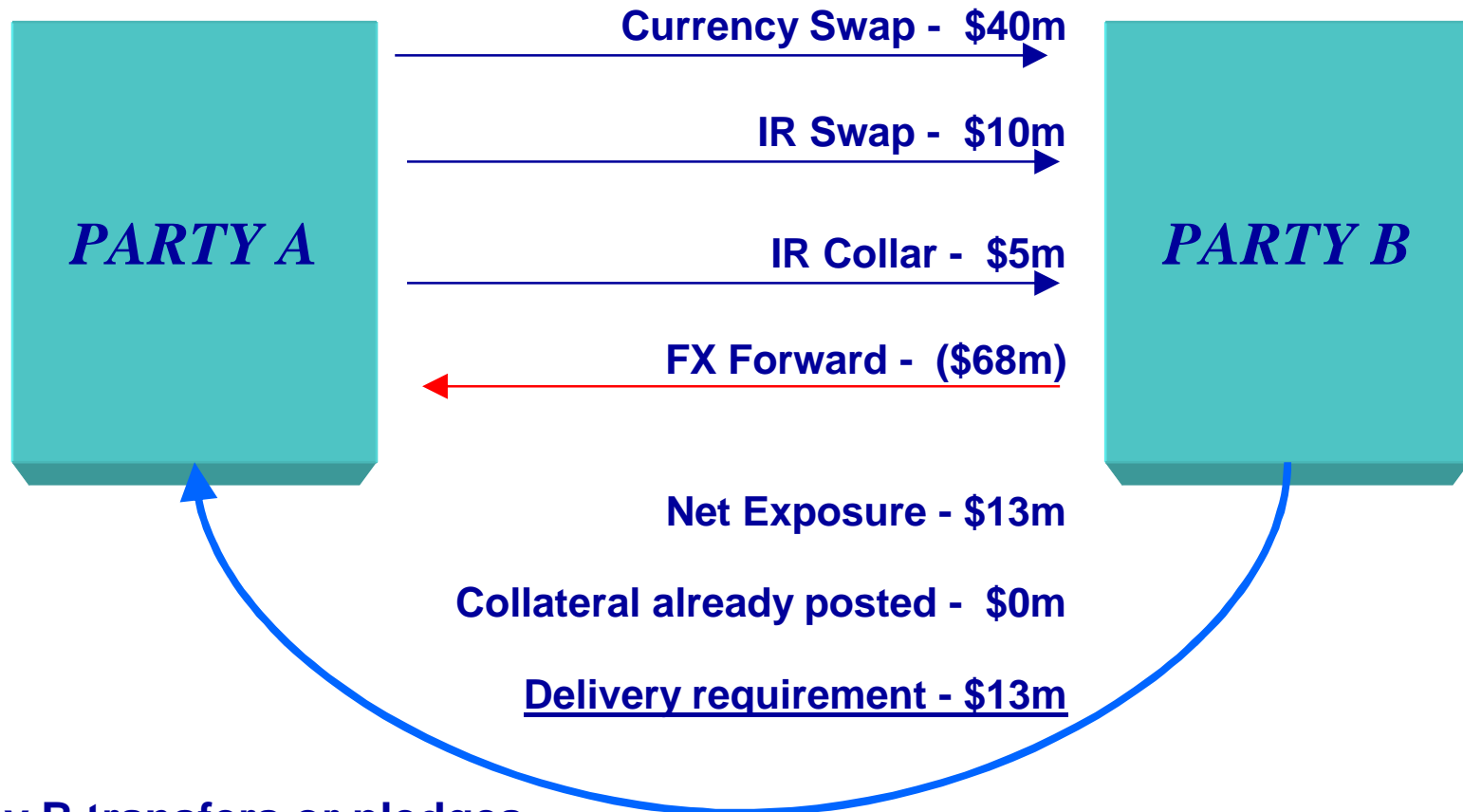
What is Credit Risk

- ▶ Definition - The risk that a counterparty will default under its obligations in whole or part.

Source AFMA Handbook August 2002

Collateral Calculation

Zero Threshold



Party B transfers or pledges \$13m minimum cash or securities as collateral to Party A until exposure returns to an acceptable level for Party A

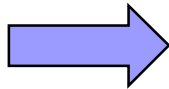
Why use Collateral

- ▶ Reduce Credit risk
- ▶ Capital savings
- ▶ Increased competitiveness
- ▶ Improved market liquidity
- ▶ Access to complex or higher risk trades
- ▶ Required by counterparty

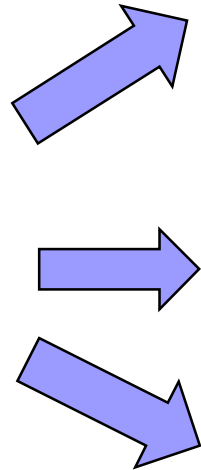
▶ Source ISDA Margin Survey 2002

Risk transference?

Credit
Risk



Collateral



OPERATING RISKS

Agreement structure risk

Monitoring control risk

Concentration risk

Market risk on collateral value

Correlation risk

Third party and settlement

“Murphy risk”

LEGAL RISKS

Procedural risk

Perfection risk

Recharacterization risk

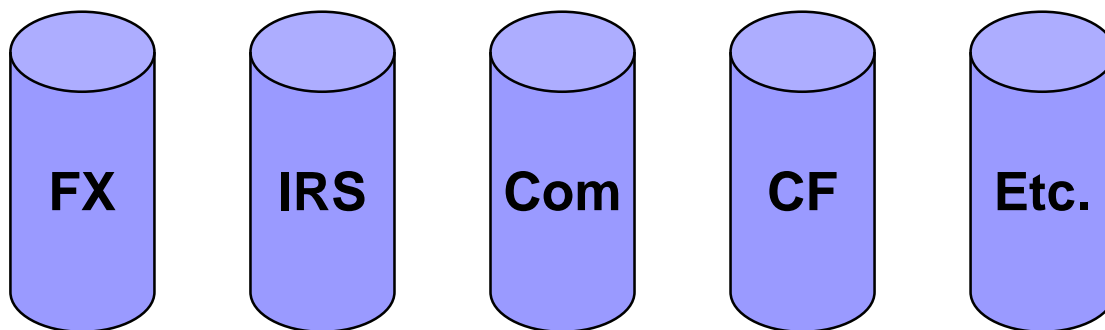
Priority risk

Enforcement risk

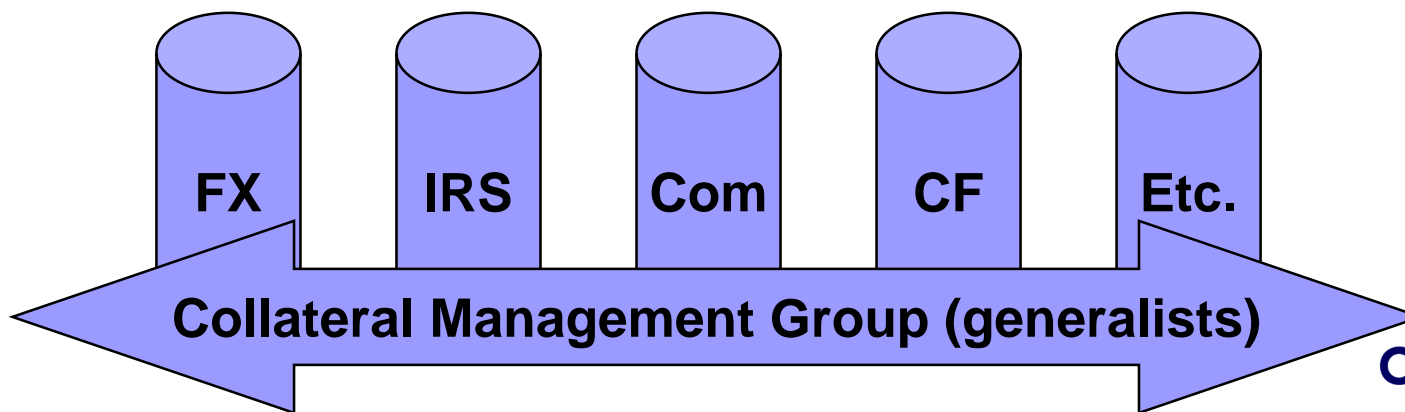
Local risk factors

Effects of Collateralising

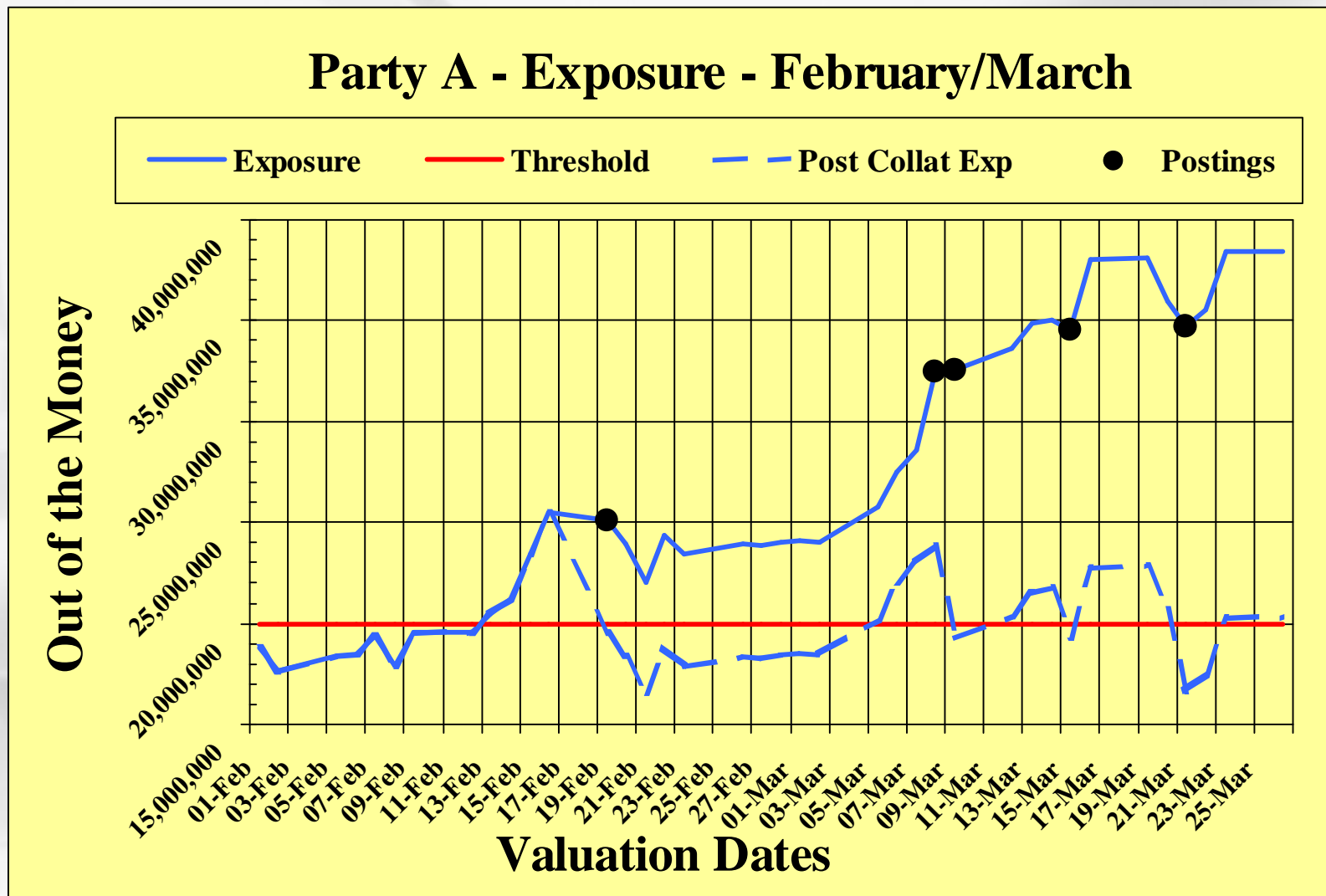
Non-collateralised client - “trading mentality”



Collateralised client - “relationship mentality”



The real effect of collateral...



Operational Issues

- ▶ Relationship between Collateral operations, Credit, Front Office & Legal Department
- ▶ Involvement in agreement negotiations
- ▶ Timing of margin calls and collateral deliveries
- ▶ System Development – Can your system capture all the requirements of the agreement
- ▶ Withholding Tax?

Agreement Issues

- ▶ Products covered generally means all trades covered by ISDA Master agreement (Derivatives + FX)
- ▶ Can exclude entire product type e.g Credit Derivatives
- ▶ Agreement must reflect operational capabilities
- ▶ Should include all existing + new trades
- ▶ Compare trades & mark to markets before agreement is signed

Daily Margin Call Procedure

- ▶ All trades and collateral are marked to market daily
- ▶ Collateral can be called/recalled daily
- ▶ When a call is received pay the undisputed amount , work out the rest
- ▶ Collateral moves next normal settlement day

Disputes with a counterparty

What do you do if a counterparty disagrees

- ▶ Check the collateral values are correct
- ▶ Check major fx spot rates
- ▶ Check branches/products covered by CSA are correct
- ▶ Check Thresholds, MTA, and rounding amounts correct
- ▶ Perform trade tick back with counterparty
- ▶ Get External Quotes as part of formal dispute resolution procedure

Eligible Collateral

- ▶ Must be approved by credit department
- ▶ Must be included in the agreement
- ▶ Important to enforce with counterparty
- ▶ Easy to Settle
- ▶ AAA rated
- ▶ Haircuts must be taken into account

ISDA Margin Surveys

Global collateral

- 2001 USD250b
- 2002 USD437b
- 2003 USD719b
- 2004 USD1,017b
- 2005 USD1,209b
- 2006 USD1,329b

Margin Agreements

- 2000 - 11,000
- 2001 - 16,000
- 2002 - 28,000
- 2003 - 37,500
- 2004 – 55,000
- 2005 – 71,000
- 2006 – 110,000

Collateral

- Cash – 72.9%
- Govt Securities – 11.8%
- Other – 15.3%

Type of Agreement

- NY law (pledge) – 53%
- Eng. law (transfer) – 22%
- Eng. Law (deed) - 0.2%
- 2001 Margin Prov. - 0.1%

Market Initiatives

- ▶ Electronic data interchange 2003
- ▶ Collateral Asset Definitions 2003
- ▶ Enterprise wide Collateral Management 2003
- ▶ Glossary of terms for the Chinese market 2005
- ▶ Review and republishing of Collateral Guidelines 2005
- ▶ Collateral Market Practices (current)
- ▶ Portfolio Reconciliation (current)

Australian market - case study

- More cross-border than domestic
- Purpose is facilitation rather than mitigation
- Relatively long “start-up” periods
 - *Expertise, systems, global revals, CSA negotiations*
- “Toe-dipping” (high thresholds, inactive CSAs)
- Collateral generally non-AUD (IWT concerns)
- Emerging Asia-Pacific “time-zone”
 - *Tokyo, Hong Kong, Singapore, Sydney*
- Corporate activity is only among top tier & some funds
- Understanding was low on both sides

Further Information

- 2005 ISDA Collateral Guidelines
- ISDA Margin Surveys
- Mastering Collateral Management & Documentation-A Practical Guide for Negotiators, P Harding & C Johnson, Prentice Hall 2003
- ISDA Collateral Committee

- www.isda.org

Questions!