Collateral Management
Dispute Resolution and Learning to Reconcile your Differences

The popularity of collateral as a tool to mitigate credit risk continues to grow as the annual market surveys performed by the International Swaps and Derivatives Association (ISDA – www.ISDA.org) illustrate. The use of collateral arrangements in the privately negotiated derivatives markets has had the effect of dampening the effect of the credit crunch and the well publicised failure of a number of hedge funds by providing protection to their counterparties.

There is a danger of complacency, however. One senior manager at a leading investment bank reports that the greatest single trading book credit loss that the bank has ever suffered was from a collateralised counterparty. The collateral the bank was holding did not match the credit exposure to the defaulting counterparty.

So how could this happen? The effect of demanding collateral from a counterparty is to turn the counterparty credit risk (the risk that you won’t get paid) into more manageable types of risk. Back in November of 2006, Thomas Huertas, Director, Wholesale Firms Division and Banking Sector Leader at the FSA announced that the regulators were worried about the operational risk in collateral programmes. More recently, one of the effects of the credit crunch has been to turn the spotlight on the collateralisation process and on how well the operations of the organisations involved are managed. One of the risks is that although you have signed your collateral agreement and you make your collateral calls, you still don’t have enough collateral to cover your exposure when your counterparty defaults. You don’t have the complete protection you had assumed you would have from the collateral agreement. There are many potential reasons for this such as not capturing all the exposures, having illiquid collateral that can’t easily be sold, delays in the call process and fails in the collateral movement process. However, the focus of this discussion is what happens when your counterparty does not agree your calculation and gives you less collateral than you ask for.

There are a variety of underhand tactics that can be used to avoid or delay having to put up collateral, such as making specious disputes of collateral calls. This exploits one area of the collateralisation process that remains problematic: the fact that these privately negotiated contracts do not necessarily have published prices and in a bilateral collateral arrangement, you need agreement between the two parties on the amount of collateral required. Agreeing the amount of collateral required depends upon agreeing the population of the underlying trades and their total value. An easy way to put up less collateral is to dispute your counterparty’s valuation of the trades. The potential delays that the dispute process provides can engender significant operational risk. Strong controls around the dispute resolution process can significantly improve the protection given by a collateral programme.
There are mechanisms to guard against this risk. The standard documentation used to govern these arrangements makes provision for the handling of disputes. By far the most prevalent standard-form contract collateral agreement in use in the privately negotiated derivatives markets is the ISDA Credit Support Annex (CSA). It comes in various flavours; there are versions that can be used under the different legislative regimes in North America, Europe and Asia and it has been around for 15 years or so. The most recent version, the 2001 Margin Provisions, was created in response to previous market disruptions and one of its goals was to streamline the process. It sets out a strict timetable for the resolution of disputes designed to minimise the effectiveness of sharp practices. It requires the undisputed collateral amount (the lower of your value and theirs) to be moved immediately. Crucially, it also requires the disputing party to provide a file with their view of the trade population and valuations by the end of day. This means that you can get to work on identifying the differences on the same day that you made the call. The reconciliation itself is to be completed by the following morning and the balance of collateral settled that day. This puts a hard limit on the delaying tactics if you can prove your numbers within the timescales.

Unfortunately, many institutions viewed these requirements as overly onerous and have stuck with earlier versions of the CSA which did not make the same demands. Indeed it is only relatively recently that any of these new agreements have begun to be signed. The lack of stringent contractual controls around dispute resolution in these older forms of the document gives opportunities to the potential collateral delinquent.

It is easy to understand the reluctance to sign up to tight rules. A collateral call is usually made up of many hundreds or thousands of underlying trades and a valid dispute can result from either or both of a population difference (some of these trades missing from one side) or a valuation difference (differences in how some of the trades are valued caused by misbookings of the economics of the trades, differences in the valuation models or differences in the market data inputs to those models, or indeed any combinations of the above).

The only way to resolve the dispute and agree the numbers is to perform a line by line tick back of the counterparty’s view of the trades to yours and to identify the differences. This means matching the main trade attributes (trade date, maturity date, principal amount, etc.) and then comparing the valuations.

The process of identifying the differences then is not simple at its base level and the problem is compounded by the lack of adoption of standards in how the data is formatted. The habitual manner for collateralising counterparties to exchange the data is simply by e-mailing electronic files containing extracts from their collateral system. Comparing the two sets of data to quickly identify individual differences and trends is tricky enough at the best of times, but when you have to contend with data mapping and translation problems as well, it becomes difficult to commit to the timescales. The
difficulty comes not only from having to reformat data (moving columns around in an Excel spreadsheet at its most base level) and translating data formats and product codes, but also from differences in booking strategies for structured trades. To illustrate an example, some organisations strip out optionality from the underlying trades while others do not. So one person’s callable swap is another person’s swap and a separate swaption. The challenge to the reconciler is to identify the structure and to be able to put it back together when there may be no common identifier to help.

To get around these problems, the ISDA Collateral Committee established an offshoot working group made up of industry collateral practitioners and vendors of collateral management software to focus on data standards in trade reconciliations. In 2003 that working group reported back with recommended standards for the exchange of this data in flat file and in xml format. This standard defined how the data should be laid out and formatted and how the structures should be represented. If everyone uses the same standard, the reconciliations can be automated to a much greater degree and much of the time-consuming legwork removed from the job. Unfortunately, as with the 2001 Margin Provisions, these standards were roundly ignored (with the exception of the software vendors who did provide the tools). At the time of writing, the Collateral Committee is having another attempt at pushing these standards and it is to be hoped that the market participants take the relatively straightforward step of adopting them. The next challenge will be to see similar standards adopted in cross-product collateral arrangements where the collateral requirements can be netted across multiple business lines, including repo, fx and securities lending, not just OTC derivatives.

ISDA has been active to help the market and again its initiative has not been widely taken up. Its 2003 Guidelines for Collateral Practitioners recommends regular reconciliations between counterparties outside of the dispute process, not just when a collateral call is disputed. These may be daily, weekly or even monthly, but the concept is that if you can keep on top of the reconciliation during peacetime, in the event that a dispute war breaks out, you can quickly resolve the differences. If you keep your reconciliations up to date, you should only be verifying previously matched trades and the few new trades that have come on since the last of the regular reconciliations so breaks can be quickly identified.

The theory is good, but in practice this can be problematic. A large investment bank may have several thousand collateral agreements in place and a million or more positions to reconcile and even with a substantial investment in technology and people, that requires some effort. Smaller institutions without the same resources face compounded problems. The lack of standards mean that even with the best will, portfolio reconciliations can drag on over several days.

So what are the strategies available for addressing this problem?
It is clear that regular reconciliations outside of the dispute cycle are desirable, but it is a time-consuming task that requires skilled collateral practitioners with an understanding of what the data actually means to do it effectively. Technology is part of the answer. All the major vendors of collateral management systems now provide reconciliation tools either as stand alone modules or integrated into their collateral software. These are of differing quality but are generally more efficient than spreadsheet solutions and most have the benefit of storing historic matches. A number of vendors have now also started offering outsourcing reconciliation services. This can be an attractive option if you can get over the hurdle of data confidentiality as it removes the need to pay for the technology and manpower to run the reconciliations. However most vendor solutions, be they outsourcing initiatives or off the shelf software, concentrate on the identification of the differences and are short on providing workflow tools to manage the time-consuming process of actually resolving those differences. The resolution process (getting trades rebooked or revalued and so on) again requires effort from skilled resources who understand the underlying products, how they are valued and the institution’s booking mechanisms.

When considering where to start it bears re-emphasising the fundamental goal of the collateralisation programme: credit protection; minimising the loss from counterparty defaults. To successfully achieve that, you have to take into account the probability of default and target your effort on the most suspect counterparties. So it matters little if you have successfully reconciled 95% of your trades if the remaining 5% are with the counterparties most likely to default because that is where the bulk of the risk lies. Rather than throwing resources at the biggest portfolios or the biggest differences, it makes more sense to target resources at the regular reconciliation of the riskiest portfolios where the differences may be smaller, but they have greater potential to become real losses.

Regular ‘peacetime’ reconciliations do not on the surface have the immediacy of other parts of the process. If a sufficient level of importance is not applied to the reconciliation process. People can be easily distracted from performing reconciliations into firefighting as other problems in the area come up. A number of the more sophisticated banks have created ring-fenced specialist reconciliation teams outside of the collateral line with some using their global presence to take advantage of the time difference (and lower labour costs) by locating the reconciliation team in Asia.

Progress is being made on a number of fronts. There are unilateral initiatives from some of the larger banks that recognise the importance of peacetime reconciliations and ISDA’s efforts in pushing standards are to be applauded. Policies and procedures always get a good working over during periods of market turmoil and the recent high profile troubles will surely cause many banks and regulators to look closer at the operational risk in the collateral programmes.
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