

Pension Funds: Improving Collateral Management for OTC Derivatives

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Pension funds are looking to improve collateral management to better mitigate counterparty risk and are reviewing outsourcing services or off-the shelf software solutions. In a Q&A, **Investit's Sarah-Jane Dennis** offers sound advice to pension funds on how the factors to consider when setting up a governance structure, daily monitoring process and debating whether to outsource or license specialist software.

Q. Why are pension funds increasingly focused on collateral management? What were the internal and external motivations and what are the goals?

Following Lehman's collapse, senior management across the industry reprioritised their time to look into the controls around their collateral management standards and capabilities to tighten their counterparty risk management.

Pension funds were no exception, pension funds around the globe struggled, in some cases significantly, to meet their government's required cover ratio. Although by the start of 2010 we have seen a promising recovery, now is not the time to relax. There are still funding gaps to be closed as well as a strong desire not to revisit the experiences of the last two years. As a result, more so than ever, it is essential to minimise costs and to ensure that every penny spent is spent wisely, particularly in the case of closed pension funds and defined benefit schemes.

The ever increasing demands upon derivative intensive investment strategies deployed by pension funds to accurately manage their liabilities can mean that collateral management is a greater cost than it needs to be. If not managed well, collateral management can become an unwanted drain on resources; over-collateralisation ties up essential assets and under-collateralisation exposes the fund to unwanted counterparty risk. Not to mention the cost of delivery of assets, the cost of administering collateral-in and the cost of the function itself.

In response to this Q&A I have focused on collateral management specific to OTC derivatives, although collateral management is a key element of many other aspects of investment activity such as stock lending and repos.

Q. What options does a pension fund have in improving collateral management? What are the pros and cons or factors to be considered when evaluating either outsourcing or implementing new software systems?

To improve collateral management the first step is to ensure you have strong governance in place. This governance must provide clarity to the fund's appetite for counterparty risk by setting out such elements as the exposure thresholds, transfer amounts and collateral characteristics such as hair cuts, concentration limits and correlation rules. It must also set out the process for ongoing proactive monitoring and decision making. If you are outsourcing your collateral management then the service provider can offer readily available guidance and advice to ensure your governance is not only practical to support but also reflects industry standards.

Once the governance is in place all of the credit support annexes (CSA) or collateral support documents (CSD) must be brought into line. This is a time consuming exercise but one well worth doing to put controls in place as well as to open up opportunities for efficiencies. As for all operational tasks, the more standard the "shape" of the thing to be processed, the easier they are to support and ultimately automate. Naturally this leads to a reduction in operational risk and credit exposure.

For example, prior to the Lehman's collapse, we had seen exposure thresholds in the range of hundreds of thousands and even millions. This has been dramatically reduced and the common market standard that we are seeing now is the setting of exposure thresholds to zero.

Another highly visible change has been in relation to the frequency of monitoring and exchanging collateral with the majority of investment funds moving from either a monthly or weekly to a daily cycle. However, when you consider that a pension fund does not have the concept of a daily NAV, but is valued on a monthly basis you can empathise that monitoring and exchanging collateral on a monthly basis still makes operational sense; it is clear that the processes that are needed to move to a daily cycle for collateral management will not be readily available.

This is not to say that pension funds cannot or do not monitor and exchange collateral on a daily basis. Just that the transition from monthly to daily is more of a conscious effort for pension funds and involves putting in place the operational steps for daily processes that are potentially of value only to the collateral management function. The current industry focus on collateral management helps to justify the cost of these operational changes as well as the cost of sourcing independent daily valuations but it can still be a difficult story to sell.

Outsourcing the collateral management function is therefore becoming more frequently considered as an alternative to justifying internal spending. The service provider will already have in place the mechanisms to support daily reconciliation, valuation and exchange of collateral through their service offering to daily priced funds. This doesn't mean that the service provided will necessarily be less costly than maintaining the service in-house – life isn't that simple.

The decision as to whether to outsource to a service provider or to implement software does not have an obvious outcome, there is no market best practice approach. Outsourcing works well where there is a culture of outsourcing functions and/or there is no appetite to invest in the collateral management function in-house. There are some very strong software packages out there that fully support collateral management teams both in-house and at third party administrators. It is no longer the case that you have to pay sell side

prices for these systems.

A point in favour of maintaining collateral management in-house is the same as for keeping any team in-house; a dedicated team that will be fully responsive to the front office (all within the governance and collateral legal agreement structures of course) and to maintain detailed control over the function. When looking at the available collateral management solutions to support the team, it is important to ensure that the range of functionality fits your needs and you do not end up in a situation where less than 50% of the application is used but you are still paying for 100%.

However, a point that is very much in favour of outsourcing is the effort and cost of keeping up with the ever-changing regulatory environment. By outsourcing, the issue is one of monitoring that the service provider is putting in the required developments and keeping up with the latest standards. Service providers will typically spread an element of this cost across their clients. The balance of the costs will be born by the provider, described as "the cost of doing this business". By keeping the function in-house, the effort and cost of "keeping up" is concentrated.

Q. What is the biggest challenge for a pension fund when improving collateral management?

This is actually a difficult question to answer because the biggest challenge depends on where you are starting from. In some cases it will be right at the start of the journey, defining and establishing the governance around collateral management as well as trying to take in the implications of central clearing. Where pension funds are further down the path, the challenge will be to understand how well the existing collateral management process is really doing and ensuring that the overall risk profile is what the pension fund wants.

I think that establishing a daily cycle that requires daily valuations for a vehicle that values on a monthly basis can represent a challenge in terms of justification of the cost as well as getting the required mechanisms in place.

And, of course, the changing regulatory requirements bring challenges to everyone. We are still waiting to find out what the actual impact of the central counterparty clearers for OTC derivatives is going to be for the buy side. It will not simply be a case of working out what it means in terms of the cost of margin but also how it will change the operational processes. This will require particularly clear and calm thinking when trading a range of OTC derivatives. OTC derivatives eligible for central counterparty platforms require operations to support margin management and non-eligible OTCs require operations to support bilateral collateral management.

Q. What advice would you give to pension funds considering making a change?

As for all changes, understanding where you are now is as important as understanding where you want to get to. Taking the time to define both of these views pays off in spades when you come to working out the benefits of change and then weighing up whether the expected costs (in terms of risk management as well as financial budgets) make it worth while.

To achieve the right change for the pension fund you need the right skills. Expertise in this field is essential to ensure that where you want to get to is right in terms of best practise as well as in terms of

what is best for the pension fund.

If it seems onerous, don't worry, it is not a case of everyone having to become a collateral management expert, you only need a minimum of one subject matter expert to highlight the areas requiring focus and to make recommendations. Outsourcing the function may mean that your subject matter expert is also outsourced, which is fine but just make sure that you talk to them and involve them actively.

Q. What advice would you give generally about collateral management?

Specifically for collateral management, I cannot stress enough how important the governance structure is. It is not enough for everyone to sign off on a structure and then file it away never to see the light of day again. The governance has to be active. By that I mean that there needs to be regular meetings held (which are well attended on an ongoing basis), reviews of aspects such as hair-cuts, correlation of collateral to exposures, concentration limits etc. All of this data needs to be proactively monitored and management information reviewed and discussed.

** Sarah-Jane Dennis is a consultant for the Operations and Systems practices at Investit.*

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