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Avoiding the pitfalls of collateral management

AS THE fallout from the sub-prime mortgage crisis continues – and credit is increasingly more difficult to obtain – it is vital to understand the collateral process governed by master agreements and the pitfalls to avoid.

Master agreements, which include the International Swaps and Derivatives Association (ISDA) and repo agreements, define and govern the trading relationship between two entities. Their provisions describe settlement instructions, termination events and margining parameters for trades executed under the agreement. These margining parameters include eligible collateral, minimum transfer amounts, thresholds, dispute resolution, notification and payment times, and collateral interest transfers.

There are three basic components of a collateral call between master agreement counterparties: independent amounts (the fixed amount of margin on a transaction); variable margin (the mark-to-market amount of margin on a transaction); and collateral posted/received to or by the counterparty. The net amount of the three equals the exposure between the counterparties. If the exposure exceeds the threshold and is greater than the MTA, additional margin can be called.

There are five pitfalls to avoid when managing the collateral process, as follows.

Tying up cash or securities with the counterparty needlessly

Do not make the mistake of meeting counterparty margin calls and not calling collateral when it's in your favour. Check your exposure daily. While independent amounts are fixed for the duration of the trade, the variation component may offset this amount and allow you to pull your margin back. Why risk having your collateral tied up with a counterparty when it could be used elsewhere to finance other positions?

Assuming your counterparty's calculations are correct

If a counterparty is calling for margin, be sure to reconcile trades, independent amounts, market value and collateral posted to your details. Bank margining systems are not always robust and, especially in busy markets, the information may not be up to date (eg, it may not reflect unsettled trades). Dispute any differences, and pay only the undisputed amount. Reconciling collateral calls is a way to identify differences between your records and that of your counterparty. The earlier any differences are discovered, the less chance there is of losing control.

Failing to monitor your fund's collateral calls

Follow up with your counterparty if cash or security collateral is not received on time. Do not assume that because the counterparty has agreed to the call that it has been paid or paid to the correct entity. Cash payments and security pledges can be input improperly causing non-receipt. Bank accounts need to be monitored daily to ensure receipt. Your counterparty may have forgotten to make a payment or booked it incorrectly. In the worst case, it may be a sign they cannot make payment.

Not responding to a counterparty's collateral calls within the parameters defined by the ISDA

Banks get nervous when they don't receive acknowledgement of their calls. The collateral community is small and rumours spread fast.

Not knowing your ISDA provisions

The ISDA defines events that can lead to its termination. These include NAV triggers, cross-default clauses and non-ISDA transactional default. It's important to know how these events can potentially terminate your ISDA or require the posting of additional collateral. These events can give your counterparty the right to start termination of the agreement. Even if it doesn't escalate to that point, it's another instance that can cause bad press and rumours.

OPERATIONAL ISSUES AROUND COLLATERAL CALLS ARE OFTEN PERCEIVED AS WARNING SIGNS THAT YOUR FUND IS IN TROUBLE

Ensuring that your fund has access to credit and maintains adequate liquidity to fund trading activity is always important, but even more so in this environment. Operational issues around collateral calls are often perceived as warning signs that your fund is in trouble. Banks are quick to act to protect their exposure when they sense problems. Managing margin agreements proactively avoids increased scrutiny from counterparties and unwanted attention that can spread rumours. It ensures you are applying your cash to its most value-creating purposes.

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