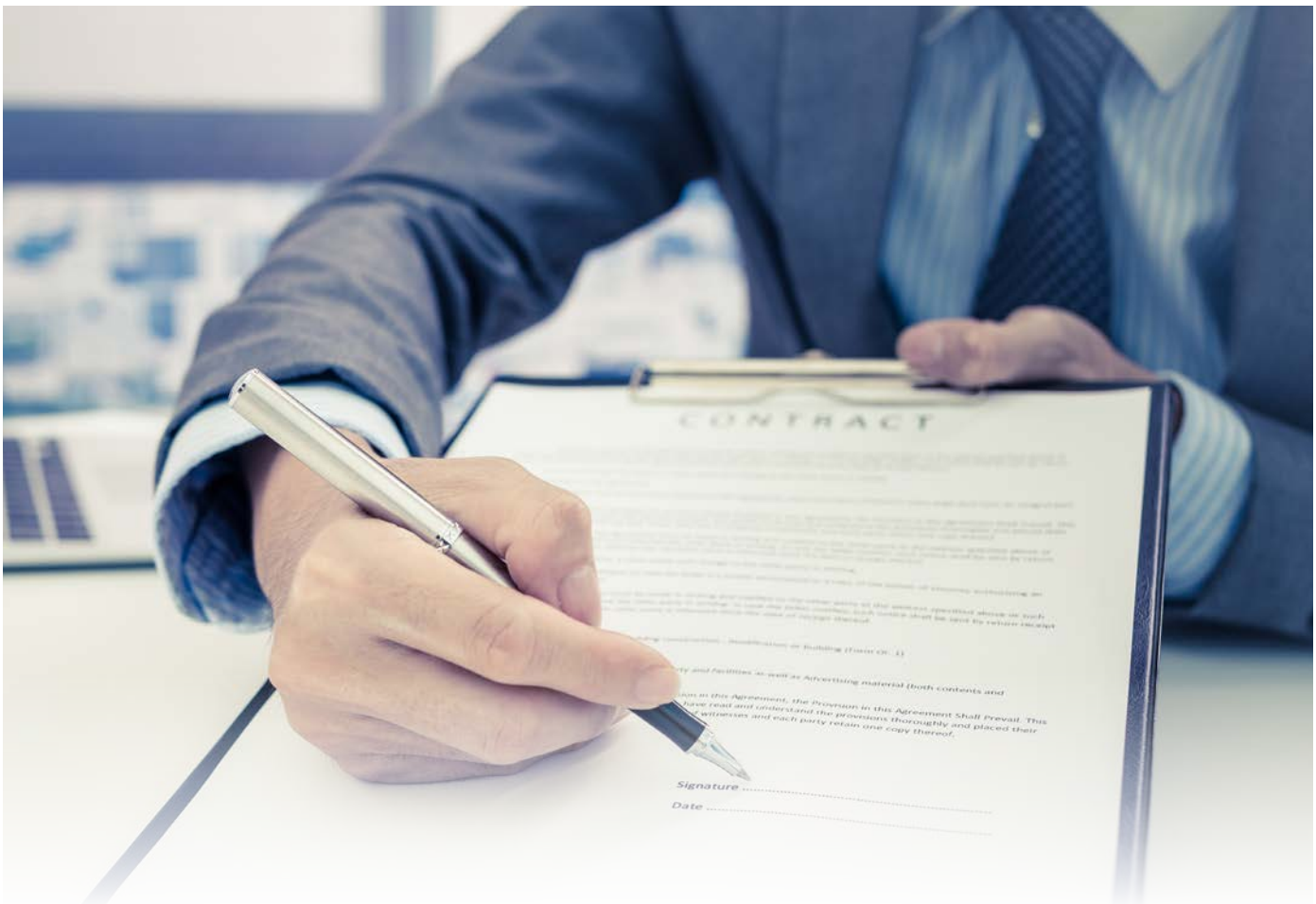


Worth more than the paper it's written on

Can collateral optimisation work if legal agreement execution remains pedestrian? Bimal Umeria and Jonathan Adams of Delta Capita take a look

The slow, fragmented and manual process of changing legal agreements increases risk for all market participants.

One consequence of multi-jurisdictional business growth, product diversity and increasing regulation is that the contractual process becomes more fluid. Legal agreements, their annexes and addenda require regular review and change. This has led to an increase in administrative burden and legal costs for all participants in the securities finance industry.

In many areas, the financial sector is at the forefront of innovative technology change due to product complexity and functional requirements. However, innovation in documentation processing has lacked the pace of other transformations in banking.

This is despite the significant growth in demand for documentation execution and change driven largely by regulation. Manual and slow contract maintenance has an undesirable impact on investment in a cross-product collateral optimisation infrastructure.

The problem

Many new regulations aim to simplify and standardise products to make them less risky from a financial system-wide perspective. This may work for certain vanilla products with sufficient volume to commoditise them without reducing existing liquidity. Complex products remain 'paper-based' without widely agreed standards to make them easier to process electronically. The problem gets worse when multiple parties are involved.

The current spectrum of documentation across organisations ranges from editable documents stored as files on servers or simple document sharing systems to automated templating using advanced content management systems.

The former requires manual intervention to make any kind of change, whereas the latter may have elements of automation usually in the form of templating and workflows. These systems may also break the documents into logical constituent parts, allowing easier localised

editing, and the potential for tagging specific terms and rules with standardised mark-up.

Then there is the transfer of the contract terms and rules from documents or templates to the systems that consume the terms and rules to turn them into actionable data. Agreements such as the Global Master Securities Lending Agreement (GMSLA), Global Master Repurchase Agreement and International Swaps and Derivatives Association Master Agreement can have a number of annexes and addenda attached.

There are diverse criteria and rules specific to collateral management, ranging from collateral eligibility rules (such as concentration limits, and inclusions and exclusions such as issuer, issuer domicile, rating and currency), minimum transfer amounts, collateral type (such as cash, fixed income and equities), collateral sets, collateral pricing, rehypothecable/non-rehypothecable, and so on. This adds significant complexity to efforts to automate the process.

Contract change can be a notification trigger to the business of a potential unexpected liquidity event. Changes to collateral eligibility or to the margin percentage can result in an unexpected outflow of liquidity. Automation of the process provides the benefit of preparedness for adverse liquidity events. For example, in adverse market conditions, a request from a client to raise its minimum quality level of collateral would prompt a substitution for higher quality securities collateral or even cash. This would force a change to an existing addendum or annex of a bilateral agreement.

While cash previously provided a straightforward and liquid form of collateral, the decline of interest rates into negative territory in several markets has made cash less attractive for some counterparties. Thus, there is a greater demand for high quality securities, which, in turn, require contract management. This is an issue particularly for institutional clients for which cash used to be an obvious option with low administrative overhead.

Contract change negotiation takes place often via document exchange over email, without a controlled protocol for sign-off and execution. Changes are then manually transferred from documents to the recipient collateral applications in both organisations (for bilateral agreements), which is a highly error-prone activity.

Risk is further increased by users having to intervene manually to ensure new rules are applied by the effective date. The lack of agility and precision in execution and processing turnaround can cause avoidable counterparty risk, particularly in periods of market stress.

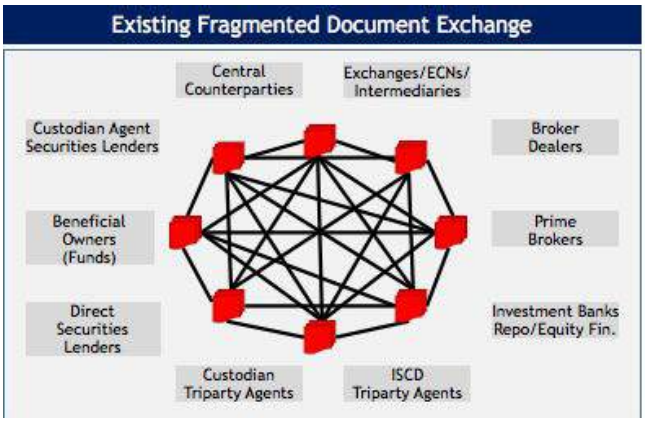
Solving the problem

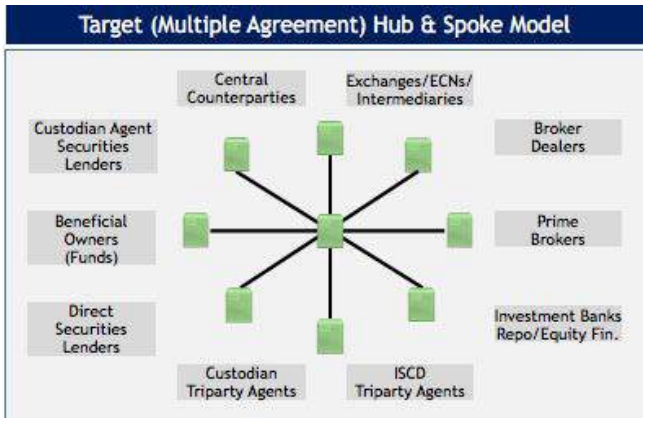
The fundamental requirement is for contracts that can be more easily changed and consumed by trading and risk management systems with limited manual intervention. This is a long way off, but there are encouraging developments in standardisation and technology that may eventually offer much higher automation and productivity.

At a macro level, the ultimate goal is a market-wide agreement with respect to approach and standards. However innovative a solution, it requires all parties (bilateral, tripartite or multilateral) to a contract to share a protocol if the process is to be properly digitised. Migration to this kind of a new paradigm is fraught with difficulty, as a large volume of existing contracts will remain live for years to come.

> ***The lack of agility and precision in execution and processing turnaround can cause avoidable counterparty risk, particularly in periods of market stress***

Jonathan Adams, Principal consultant, practice lead, securities finance and collateral management, Delta Capita





To begin solving this problem, existing paper (or PDF) documents need to be managed more easily in an electronic format.

The ideal solution requires technology to scan existing documents, extract relevant information and apply a taxonomy/tags to standardise the language. Efforts on product standardisation are underway in various industry bodies, such as the Enterprise Data Management Council's Financial Industry Business Ontology.

Further, the structure of contracts and how they are modelled electronically is another area of current research, development and investment—"smart contracts for financial services".

Taken together these developments would enable automated delivery of contract content to the business applications, delivering tangible efficiencies.

A centralised solution could offer a portal to allow all the parties to the contract to access, amend and agree efficiently. Furthermore, electronic interfaces would be required to feed downstream systems to enable further automation. Currently, this procedure requires specialist legal processes, which lack digital output.

New technology exists for the centralised management of multilateral document negotiation and execution. One instance is being piloted in the asset management industry.

Designing and building the appropriate functionality over this type of technology to make it suitable for securities finance is a complex process that requires collaboration between industry participants and bodies such as the International Securities Lending Association.

Much like clearing and settlement, highly automated contract management could be optimised through a utility, run by an impartial third party such as a central counterparty. Further benefits would include providing proof to regulators that legal change is effected and complied with quickly.

Moreover, the industry associations that represent market participants would gain a tool to help negotiate regulatory change more effectively.

Effective and low-risk collateral and counterparty risk management can only be achieved with accurate and up-to-date legal agreement rules and data. Many banks are currently addressing the problem largely manually, which is unsustainable in current markets conditions, let alone in a volatile market.

A potentially viable solution would be a utility or managed service offering a secure, centralised and standardised (as far as possible) management of contracts to all willing participants. An intelligent and dynamic solution would benefit all parties in the transaction chain, expediting contract change and mitigating risk.

A jump directly into a utility model would be difficult. Turning existing paper or PDF documents into electronic is an initial step to address the problem. This would entail scanning existing live agreements and using solutions to increase standardisation of the formats and language to allow more efficient change to the agreements.

The requirement for a functional and rapid change to contract management is not just a nice-to-have but a prerequisite for achieving more efficient and effective use of securities collateral. **SLT**

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Bimal Umeria, Managing partner, Delta Capita