Risk & Compliance

THE NEW ERA OF CREDIT RISK AND LIQUIDITY MANAGEMENT

The craft of "good banking" is a fine art that has evolved over the centuries. It has always been based on a balance between profit, containment of credit risk and liquidity management.

Credit risk is usually defined as the risk that a counterparty will not settle an obligation for full value. It stems out from the extension of any form of unsecured credit (i.e. non-collateralized) or/and from a failure in synchronizing the various interrelated elements (or "legs") of a transaction.

The above leads to an obvious - but not trivial - assumption: in finding the balance between pursuit of profit, containment of credit risk and liquidity management, collateral play a crucial role. They have been used for hundreds of years to provide securities against the possibility of payment default by the opposing party in a trade.

In the 1980s, Bankers Trust and Salomon Brothers moved from simply "take" collateral to "manage collateral". Collateral management includes a continuous process aimed to

control the correspondence between the effective market value of the relevant collateral and their required value. At the very beginning, there were no legal standards and most calculations were performed manually. Collateralization of derivatives exposures became a widespread market practice in the early 1990s while standardization began in 1994 under pressure of IMF and Banking Associations.

Collateral management has evolved rapidly in the last 15–20 years with increasing use of new technologies, competitive pressures in institutional finance, and heightened counterparty risk from the wide use of derivatives, securitization of asset pools, and leverage. The failure of Lehman Brothers on 15 September 2008 and the market stress that followed provided valuable insights into how market infrastructures and markets perform in very stressful conditions. Normally liquid markets become severely strained.

The recent financial crisis has also exacerbated the relation between efficient management of collateral and its impact on capital adequacy needs of European banks. Under the pressure of the market discipline agreed by G20 to mitigate any new financial crises, retail and wholesale payment systems will evolve and unsecured interbank deposit markets will be gradually replaced by guaranteed ones.

As a consequence, the use of collateral as a means for a balance between profit, risk containment and optimal management of liquidity has returned to play a central role in the art of banking. However, as collateral becomes scarcer it will also become an increasingly precious resource: on one hand, the level of collateral required for regulatory purposes will increase significantly; on the other, the current way of managing collateral shows significant inefficiencies estimated at about € 4 billion per year (source: Collateral Management – Unlocking the Potential in Collateral, Clearstream, 2011).

The “next gen” in collateral management practices is represented by optimized use of collateral (substitution, re-use, etc.), a very complex process with interrelated functions involving multiple parties within banking organizations.