LME Insight

SETTING THE GLOBAL STANDARD

LME Insight: Collateral mobilisation – how is the metals industry working to navigate increased margin requirements?

Since the 2008 financial crash, the international regulatory agenda has been focused on reforming financial markets to reduce the risk of a recurrence. One of the key outputs of this drive included mandated clearing for certain over-the-counter (OTC) trades and increased margin requirements for non-cleared trades by a central counterparty (CCP). In this month's LME Insight piece we explore how the market and CCPs are overcoming the increased collateral burden.

By way of a reminder, collateral is pledged as security against a trade, which can be used to meet any losses in the event of the default of the counterparty holding the position. With the increased margin requirements now placed on derivatives trading, there were initially concerns in the industry of a collateral squeeze i.e. not enough high quality collateral to cover margin requirements to support trading. The focus of the industry has turned to mobilising different types of collateral and making efficient use of it so that there are sufficient amounts to accommodate trading activity.

With that in mind, CCPs such as LME Clear are looking at ways to accept and mobilise new types of collateral that are efficient for their markets, in order to ease the burden for companies and traders to raise traditional forms of collateral such as government securities.

G20 Washington Summit and five principles

After the 2008 financial crisis, leaders at the G20 Washington Summit set out a framework for preventing future catastrophic economic events, whilst securing sustainable and balanced global growth and reforming the architecture of global economic governance. They agreed on closer macroeconomic co-operation to restore growth and reduce the risk of recurrence based on five guiding principles:

1) strengthening transparency and accountability
2) enhancing sound regulation
3) promoting integrity in financial markets
4) reinforcing international cooperation
5) reforming international financial institutions.

Regulation – increased margin requirements

The clearing obligation under Article 4 of the European Markets Infrastructure Regulation (EMIR) requires that certain OTC derivative contracts that were entered into or novated on or after the relevant clearing obligation start date will be subject to mandatory clearing by an EMIR EU authorised, or non-EU recognised, CCP. Although this does not affect metals transactions directly, with more trading across products which are obliged to clear, the collateral burden has increased across the wider market.

Whilst providing various efficiencies and risk management benefits, mandatory clearing can result in members and clients needing to find more collateral to cover the risk on their positions. This increases the strain on them to be able to raise conventional collateral, such as government securities, within a narrow range accepted by multiple locations. Increasing the range of acceptable collateral can allow some of those more traditional forms of collateral to be used more effectively elsewhere. For non-cleared trades, the margining requirements are now being introduced in multiple phases creating further demands to use collateral more efficiently.

EMIR's changing view on letters of credit

Traditionally, commodities markets have accepted bank guarantees or letters of credit (LCs) from banks as a way of collateralising trades. A letter of credit is a letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount. In the event that the buyer is unable to make payment on the purchase, the bank is required to cover the full or remaining amount of the purchase, or in a CCPs case, defaulter's margin requirement. Using LCs as a means of posting collateral has been popular in metals market.

Under EMIR, accepting uncollateralised LCs - which in theory creates an unsecured exposure to the guaranteeing bank - as a form of collateral for margining requirements is no longer allowed. Since this pool of collateral has now been removed or demobilised, market participants have been required to look to other ways of collateralising trading activity. To further facilitate this, LME Clear have mobilised LME warrants to be posted by members as collateral.

The evolving nature of acceptable collateral

LME Clear accepts a range of collateral and is seeing broader types of collateral being used to support trading. To support evolving needs of the market, as well as more traditional forms of collateral, LME Clear now accepts gold and LME warrants as collateral.

Posting warrants as collateral is unique to LME Clear and enables members, and soon UK affiliates and clients of members*, to cover and hedge their cleared exposure in a particular metal, on a metal-for-metal basis – for example aluminium warrants can cover aluminium positions. Metal warrants are a feature of the LME's physical market and by using this service, other types of collateral can be used to cover other LME positions or for other trading activity.

LME Clear also accepts gold to cover margin requirements across both base and precious positions. Like LME warrants, using gold can prove more efficient for market participants as it frees up other forms of collateral.

Furthermore, using warrants and gold as collateral has potential risk-management efficiencies for both members and the clearing house. When a member's position becomes large, it could take the clearing house longer than the standard two days to close this out in the event of a default and result in concentration margin being applied. By providing warrants or gold as collateral, these can potentially serve as natural hedges against short positions (collateral positions are always long). Therefore, using this type of collateral is more efficient for market participants as they can reduce concentration margin requirements and for LME Clear, they can serve as a natural hedge during a liquidation event.

Conclusion

The world's financial community now operates within an increasingly regulated environment in order to prevent a crisis similar to that of 2008 from happening again. This brings consequences and changing business practices in order to make trading safer, such as increased margining and collateral requirements. It is down to the industry to innovate and find ways of balancing the integrity of the market with trading activity. As previously shown, CCPs like LME Clear are looking for characteristics of their market to leverage and use to their advantage and help enable the market to function more efficiently. Services such as the introduction of warrants as collateral can help relieve the margin funding problems discussed above.

Looking ahead, we plan to make the LME warrants service available to UK affiliates and clients of LME Clear members*, reaching throughout the value chain to benefit more industry participants.

For more information on how to use warrants as collateral visit our website or contact our product development team.

*Subject to market consultation