

## Collateral Use for OTC Derivatives

1. Collateralization is one of the primary means of managing credit exposure among financial market participants. In derivatives transactions that are presented to a central clearing house, collateral is posted with the clearing house. And, in a bilateral market such as over-the-counter derivatives, market participants post collateral directly with each other.
2. Collateral usage for OTC derivatives continues to grow in terms of trade volume subject to collateral agreements and in terms of credit exposure covered by collateral. This reflects a long-term trend toward increased collateral coverage. According to the 2009 ISDA Margin Survey,<sup>1</sup> 65 percent of OTC derivative trades worldwide were subject to collateral agreements at the end of 2008, compared with 63 percent the previous year and 30 percent in 2003. And according to a recent informal ISDA poll of the sixteen largest dealers, coverage of credit derivatives is even higher, with 91 percent subject to collateral agreements.
3. Collateral usage for OTC derivatives also continues to grow with regard to coverage of credit exposure. The 2009 ISDA Margin Survey reports that 66 percent of OTC derivatives net credit exposure worldwide is covered by collateral, compared with 65 percent last year and 29 percent in 2003. The US Office of the Comptroller of the Currency found similar results for all US banks as of the end of June 2009, with 63 percent of net credit exposure covered by collateral.<sup>2</sup>
4. ISDA estimates that the amount of collateral used in connection with over-the-counter derivatives transactions was almost \$4.0 trillion during 2008. Cash is the most commonly used form of collateral, at approximately 84 percent of collateral received and 83 percent of collateral delivered. Government securities are next in importance, at 9 percent of collateral received and 15 percent of collateral delivered. The remainder consists mainly of government agency securities, corporate bonds, and equities.
5. The most important reasons for using collateral are reduction of credit risk and freeing up of credit lines with counterparties.
6. Approximately 50 percent of collateralized counterparties of the largest derivatives dealers are hedge funds or institutional investors, while 15 percent of their collateralized counterparties are corporations and 13 percent are banks.
7. Collateral is an important method of managing counterparty credit risk, especially with financial institutions and investors. But cash collateral is not appropriate for all transactions. For example, oil

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<sup>1</sup> ISDA Margin Survey 2009, available at [http://www.isda.org/c\\_and\\_a/pdf/ISDA-Margin-Survey-2009.pdf](http://www.isda.org/c_and_a/pdf/ISDA-Margin-Survey-2009.pdf).

<sup>2</sup> OCC's Quarterly Report on Bank Trading and Derivatives Activities - Second Quarter 2009, available at <http://www.occ.treas.gov/ftp/release/2009-114a.pdf>.

producers routinely enter into commodity swap transactions in order to lock in a known price of crude oil; doing so helps producers plan their resource requirements in advance. If a producer locks in a price of \$50 per barrel, for example, the dealer will owe the producer money when the price falls below \$50 while the producer will owe the dealer money when the price rises above \$50. Suppose the price rises to \$80 per barrel; the producer owes \$30 to the dealer. Although the dealer is exposed to credit risk, it does not typically require that the producer post collateral to cover the obligation. The reason is that the dealer knows the producer will be able to meet its obligation when the producer sells the oil. In other words, the dealer is making a credit judgment on the producer's ability and willingness to pay. Such a judgment is no different from that made by a banker who lends money to the producer, who will pay the bank loan when the oil is sold. For both the swap and the loan, the oil in effect secures the obligation.

8. Had the dealer demanded cash collateral from the oil producer, the producer would likely need to borrow money because nonfinancial companies do not typically maintain large cash reserves as do banks and other financial institutions. If posting cash collateral were made mandatory for all clients, it would represent an additional expense for corporations, not just in the form of interest but on the need to develop a new infrastructure to administer the margin process. Faced with such additional costs, many nonfinancial corporations might choose not to hedge and therefore leave themselves with more exposure to market changes and less certainty in their production planning process.