Collateral is a core competence for the buy side

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It was in October 2012 at the Amsterdam collateral conference that Juan Jose Fortun from BBVA Asset Management made the statement that collateral was becoming a core competence for the buy side. I remember thinking at the time what a strong statement that was and wondering how widely the view was shared among his buy side peers.

Today, few would disagree about the prominent role that collateral has come to occupy on the buy side. In this article, we will briefly look at the reasons for this and the drivers of collateral's rise to prominence, before considering the implications for buy side firms.

It was undoubtedly the global financial crisis of 2008 that was the trigger of the many changes we now see in the collateral world, and it is worth reflecting on why so much emphasis has been placed on collateral since then; because one thing is for sure—it was not a collateral crisis. It was both a credit crisis and a liquidity crisis, and the reason that collateral is so important is because it proved to be very effective at mitigating both credit risk and liquidity risk. Where collateral was in place, in most cases the losses were fully covered. When liquidity dried up, it was only by pledging collateral that loans could be secured. In a very real sense, it was collateral that fuelled the recovery from the crisis. So it is not surprising that both regulators and the industry have been focused on collateral ever since. It is not that collateral failed, but because it is so important it has been thoroughly examined, and any weaknesses—and there were many—are being addressed to ensure that the protection collateral affords can be as effective as possible going forward.

And it is not just regulators that are driving improvements to the collateral systems. During the crisis and afterwards, the industry itself recognised the importance of collateral and implemented many initiatives both at firm level and at wider industry level through groups like ISDA. And the reviews really have been comprehensive: every link in the collateral process chain from valuations to margin call processing, disputes to delivery and reporting has been examined in detail. The frequency, velocity, quality and concentration of collateral have been measured and stress tested. The legal and contractual terms, enforceability and default processes, eligibility and haircuts have all been put under the microscope. And while it is probably true to say that the collateral system was not broken before, it is certainly a much more robust and greatly improved situation today.

So what are the key changes that will affect the buy side, and why do those justify a change in the status of collateral at buy side firms? In summary:

- The number of margin calls will increase by tenfold or so
- The range of collateral assets deployed will broaden from predominantly cash to include bonds and other assets

- The security of collateral—where is it, when and how will I get it back, could it be lost or trapped? The risks need to be understood and managed more effectively
- Increasingly, front office traders need to understand how trades will be collateralised and what the costs will be, as these factors can affect trading decisions
- The direct and indirect costs of collateral are set to rise significantly
- The choice of which collateral services and which service providers to use needs to be actively managed and monitored

Let's look in a little more detail at each of these key changes—not all the items will affect all firms equally, some might be more or less relevant depending on the products, markets, currencies and geographies, and how the business is collateralised and managed.

Increasing number of margin calls

In the past, many buy side firms might have faced collateral margin calls on a weekly or monthly basis, but daily margin calls are becoming far more frequent under the new regulations. There is also pressure to reduce thresholds and minimum transfer amounts, and as a consequence there will be more frequent deliveries of smaller amounts of collateral and fewer days when no call is required. In addition, portfolios are becoming more fragmented, as some OTC derivatives move to clearing houses. Margin calls will originate from each clearing broker and clearing house combination used. A variation margin is increasingly being charged in the currency of the exposure, so for firms with exposures in several currencies there is a multiplier effect on the number of calls.

Many buy side firms will start paying initial margin for the first time on their derivatives portfolios. As soon as derivatives move to clearing, initial margin is payable. For non-cleared OTC derivatives, two-way initial margin is being introduced in phases from 2015 to 2019.
Ability to use cash and securities as collateral
Today, most firms pay collateral in cash only. The variation margin is likely to remain cash only, but initial margin can be paid in cash or eligible securities—typically high-quality bonds. Many buy side firms do not have sufficient cash on hand to easily fund initial margin and the problem will become more acute as two-way initial margin on bilateral portfolios is phased in. Therefore, many firms would like to be able to deliver non-cash collateral as well as cash. Decision making about what to use can then be based on funding costs, interest rates and the availability of cash and eligible securities.

The frequency, velocity, quality and concentration of collateral have been measured and stress tested

Security of collateral

The segregation models used for collateral vary by product type, jurisdiction, broker and clearing house, although what is actually available to any particular firm through its brokers may be very limited. The risk a firm faces is of losing all or part of its collateral assets for a period of time or forever in the event of the default of their clearing broker, clearing house or even another client with commingled collateral. Unsurprisingly, higher levels of protection—if they are available at all—come at a higher cost. The trade-offs are, frankly, unappealing.

Front office impacts

Due to the costs, risks and capital implications of collateral, the front office trading and risk teams are increasingly interested in the detail of margin and collateral. A trade might be risk-increasing if directed to one clearing house or risk-reducing at another, and the margin costs can be significant enough to affect trading decisions. Pre-deal margin estimation and smart order routing requirements mean that real-time information is required. If securities are pledged as collateral, then it becomes important that traders understand the impact on inventory—which securities are pledged and when inflows and outflows are expected.

Increasing cost of collateral operations

Unsurprisingly, costs are increasing. It is worth separating the funding cost of collateral from the operational costs. Funding costs today are low due to low interest rates and plentiful liquidity, however these conditions will not last forever. Minimising funding costs is the aim of collateral optimisation where sophisticated algorithms are used to select the cheapest option, taking many factors into consideration such as availability, eligibility, haircuts and concentration limits. The operational costs of collateral are rising inexorably, and although the impact has perhaps not been fully felt yet at many buy side firms, it is certainly coming. As described above, the increasing number and complexity of margin calls will inevitably increase costs, although these factors are also driving efficiency improvements and higher levels of STP. Regulatory and compliance costs are going up, as more oversight and reporting is introduced along the collateral chain. An example is the dispute regulation introduced during 2014, which has driven improvements in collateral systems and processes, as well as the increased use of reconciliations. Any long-running disputes now have to be reported to regulators, and it is almost certain that the costs of non-compliance would be higher than the cost of an efficient and robust collateral operation.

Collateral service providers

All the factors described above affect buy side firms, but it is clear that they also affect sell side firms that provide collateral and derivatives services. An additional factor for sell side firms that handle clients' collateral is the balance sheet impact as the collateral passes through their books. The situation is complicated and depends on jurisdiction, segregation model, security type and other factors, but in general, there is a significant level of balance sheet utilisation at sell side firms from processing this business. As a result, several sell side firms are either reducing or exiting from the business, and the remaining firms are frequently reluctant to expand their customer base. It is important that buy side firms understand these pressures and take the necessary steps to ensure continuity of access to markets.

Unsurprisingly, costs are increasing. It is worth separating the funding cost of collateral from the operational costs

Despite these pressures, sell side firms have service providers including clearing houses, custodians and CSDs, which have continued to invest in collateral systems and processes and in developing new collateral models such as tri-party and quad-party collateral and collateral transformation services.

Implications for the buy side

Given all the factors described above, I think it is clear that collateral has become and will remain a core competence. So what are the implications of that, and how should buy side firms prepare for the future? What operating models are appropriate, and which aspects of the collateral operation should be outsourced and which kept in-house? How should the in-house operation be supported?

We can start with some high-level objectives: minimising cost, minimising risk and maximising control would be some obvious targets, but they do not suggest specific actions. If we consider the general structure of buy side firms, whether they are asset managers, insurance firms or hedge funds, they typically have many funds and possibly many business lines or entities. It may or may not be possible to combine margin and collateral across funds. It would be impractical for each fund to manage its own collateral independently, so typically, firms are setting up a central collateral operation to oversee collateral at a group level. It normally makes sense to combine collateral management with liquidity and funding and any securities lending operations into an integrated treasury function.

The responsibilities of an integrated treasury function would include governance and policy decisions; communications both internally and externally to fund managers, trustees, regulators and service providers; oversight of daily collateral operations, including monitoring and checking of valuations, holdings and transfers; cash and liquidity management; and regulatory reporting.

Firms have traditionally used sell side service providers for much of the post-trade processing including collateral management, and it is likely that will continue. But I hope it is becoming clear that not everything can be, nor should be, outsourced. Overall governance and responsibility for collateral cannot be outsourced, and a level of monitoring and oversight is essential. In order to support even a minimally scoped collateral operation there is a requirement for accurate, complete and timely data in a robust application. Manual processes and spreadsheets were extensively used in the past, but these will struggle to cope with the changes that are coming and are not looked at kindly by regulators. So, if collateral operations are becoming centralised within a treasury function and some level of system is put in place, where should the line be drawn between what is done in-house and what is outsourced?

Once the decision has been made to support an internal collateral operation with a competent system, it then becomes easier to make tactical decisions based on costs and benefits about what to outsource and what to insource. It is likely that those decisions will be reviewed periodically as market conditions change and opportunities arise.

At Calypso, we believe that as collateral has become a core competence for the buy side, it is now essential to have a collateral competence within the firm that can properly understand the complexities and support the many stakeholders in providing a secure and cost-effective collateral capability in line with current best practice standards that can adapt to future changes.

To the **point**:

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- The range of collateral assets deployed will broaden from predominantly cash to include bonds and other assets
- The security of collateral – where is it, when and how will I get it back, could it be lost or trapped. The risks need to be understood and managed more effectively
- Increasingly the front office traders need to understand how the trades will be collateralised and what the costs will be as it can affect trading decisions
- The direct and indirect costs of collateral are set to rise significantly
- The choice of which collateral services and which service providers to use needs to be actively managed and monitored