Collateral Management: Gaining Prominence
For many years, asset managers viewed collateral management as a routine function of their middle office. An activity to facilitate the trading of certain asset types in different markets, collateral management was considered perfunctory; it simply helped execute the desired strategy of the front office. As such, this ‘must have’ did not require significant investment or innovation.

That is no longer the case.

Several macro trends are responsible for this development, including global regulatory reform, cost reduction and more robust risk management.

These factors are forcing asset managers to transform collateral management: to improve or even reshape it in a way that adds value to the firm. Doing so requires taking a fresh look at the entire process. Potential solutions include operating model changes, technology upgrades and outsourcing.

Drivers of change

Regulatory requirements

As noted, global regulatory requirements are playing a key role in driving change in collateral management. They are disrupting buy-side firms’ collateral management operating models. The European Market Infrastructure Regulation (EMIR) and Dodd-Frank-driven regulations are demanding greater levels of collateral. Additionally, they are imposing more timely margin movements (T+1 to T+0) and mandatory variation margin for over the counter derivatives.

The Working Group on Margining Requirements (WGMR), Basel Committee on Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSCO) have collaborated in this arena. They jointly established new collateral standards for uncleared instruments, which now necessitate initial and variation margin.

On top of greater volumes of calls at a higher frequency, international regulations place higher demands on firms to report timely metrics and exposure calculations across their organization.

Fund performance

Collateral’s impact on fund performance also is in focus. With the tightening of expense ratios, the current low return environment and the rise of passive funds, every opportunity to improve a fund’s performance and/or reduce cost—no matter the size—should be considered. The posting of collateral enables the trading in different asset types. However, the choice of collateral can cause a fund performance drag and increase costs. For example, posting cash makes it unavailable to deploy in ways that are more advantageous and posting securities may cause a delay in selling them when desired. In addition, funds may be required or incentivized to hold securities it may not otherwise hold, such as treasuries, to meet collateral requirements.

Central counterparty clearing houses, jurisdictions and governing bodies have different collateral requirements. However, they are all the same in that they offer access to investment options that enable the fund to gain similar exposure. With varying costs of collateral across these instruments, asset managers should consider the full cost of each trade in advance of its execution. Ultimately, the cost impact of collateral management depends on multiple factors, including transaction type, jurisdiction and collateral inventory.

Complex transactions

The importance of collateral management as a risk area is also on the rise. Not so long ago, collateral was a minor element of the risk profile framework, but that is changing due to the increased complexity of collateral management and proliferation of transactions requiring collateral. With collateral posted for multiple asset types, markets, locations, legal entities and functions, there is a growing need to view exposure in near real-time across the enterprise.

What’s more, collateral is not managed solely for derivatives. It can also be required for securities lending, exchange traded funds, repurchase agreements, foreign exchange contracts and the management of short positions. Asset managers often have different business units and technology platforms to manage these functions, which makes it difficult to aggregate all of them into a single view of exposure. This problem becomes more complicated given an asset manager’s geographic footprint and varying technologies used across sites.

Solutions: Three areas of focus to evolve your collateral management

1. Operating model

In evaluating its operating model and technology infrastructure, an asset manager must consider multiple factors, including core investment strategies, how they are implemented, regions of operation, product domicile and the breadth of business lines. Additionally, collateral can be spread throughout the business, which can result in its management emerging in different areas that use different technology, both purchased and proprietary.

Upgrading technology and redesigning the operating model at the same time forms a sound foundation. This is realized through reducing operational and credit risk, addressing organizational data transparency, and providing the infrastructure for product growth and scale. The assessment of operations and technology is the path to opportunities. That is, it holds promise for strategic enhancements in the collateral space with the benefits going beyond immediate, tactical changes.

The natural progression for collateral management, if kept internal, is to move from a segregated process across business lines to a stand-alone, centralized functional area within the middle office. This evolution is desirable for several reasons. One of the main collateral-related challenges for asset managers is to find experienced, knowledgeable staff in this subject area. A more centralized function enables the firm to better leverage its resources, expertise and capabilities across the enterprise. It also promotes the development of a single core collateral operating model. That, in turn, fosters a common view and transparency across all collateral types and counterparties.

Through a global lens, refocusing collateral management within key operating regions and stressing standardization across locations increases efficiency. It enables a pass-the-book model across locations to effectively utilize the 24-hour clock; this is an added benefit and major advantage in staying ahead of rigid timeframes. This framework also supports the ability to queue up issues that arise throughout the process and facilitate resolution by the next regional office that comes in for the day.

Aside from pronounced cost and risk reductions, an improved collateral operating model extends to the asset manager’s counterparties. In doing so, it strengthens ties. As industry expectations
get higher, fostering bonds is key to avoid alienating key counterparties, which could lead to higher total costs of trading or the loss of a trading relationship. Counterparty management should also be identified as a responsibility of the centralized function.

2. Technology
Technology is crucial in managing collateral, whether facilitating the standardization of the collateral management process, instituting a pass-the-book model, or addressing regulatory reporting, optimization, or risk management needs. The constantly evolving, analytics-based collateral management of the future could lean even more heavily on technology. Because of this trend, asset managers are facing the question: do we build or buy?

For those in the industry with existing proprietary collateral management technology, building upon those systems could seem like a reasonable solution to address industry changes. However, that approach can often become a series of short-term solutions or stopgaps as it may lack the strategic arc of future needs and opportunities. Since collateral is a key risk area within the industry, regulators will continue to focus on it, which might cause fluctuating requirements. The constantly changing environment makes it essential for asset managers to determine a long-term strategy and focus on building a broad, flexible solution that considers potential future requirements.

This far-reaching view has several advantages. If the firm chooses to upgrade internally-built technology, the asset manager should focus on managing the data across all functions for use in reporting, dashboards, and analytics. This approach aligns with a centralized, global operating model. It also positions the firm to keep up with regulatory requirements. This said, the challenge with the proprietary option in a rapidly changing environment is the substantial commitment to maintain the system and meet future business requirements.

The alternative option is to use external software. Technology vendors are constantly working to develop advanced functionality. Their work fulfills the demand for near real-time, enterprise-wide data transparency; at the same time, it facilitates prompt margin calculations and movements. These platforms also support regulatory reporting, including both existing and upcoming regulations. Additionally, they offer functionality to enable the pass-the-book model for use across multiple regions.

Specific to derivatives instruments, many platforms offer pre-trade analysis that can be completed to directly compare the cost of collateral a trade would incur based on whether it is executed uncleared or cleared, while considering its trading venue and futures commission merchant (FCM). Once the total cost is considered, the optimal instrument and exchange can be used to minimize explicit and implicit costs. Collateral optimization features also allow for the daily assessment of collateral pledged, the portfolio’s available assets, and collateral types allowed by the agreement to determine the cheapest type of collateral for the portfolio to pledge. Lastly, through utilities, the vendor products can allow for a direct connection to counterparties to enable more efficient end-to-end processing of collateral.

The purchase of a collateral management platform may not be the right choice for all asset managers, but is an option for those seeking to overhaul their collateral management operating model. This is especially true for the firm that uses multiple technology solutions, relies heavily on manual processing or does not have the desire or resources to keep up with the ever-changing collateral requirements.

3. Outsourcing
Service providers are investing in collateral services and are adding them to their suites of middle-office offerings to address the operational needs facing asset managers. Asset servicers have accounted for the operational implications of the regulatory revolution through roadmap planning, expanded data and reporting capabilities, and enhanced connectivity to third parties. Outsourcing is a feasible alternative for asset managers seeking to leverage technology available in the industry without having to purchase and support it on their own. It is also a desirable option for firms that have already outsourced other middle-office functions or plan to do so in the future. In that instance, the service provider may already have access to information required to calculate the necessary collateral movements. In this case, the gap to complete the process in its entirety would be minimal.

While the outsourcing of collateral management may be a good alternative to keeping the function in-house, it is by no means a turnkey solution. Service provider offerings have grown over time to meet their clients’ needs. Therefore, the degree to which a new client has similar needs could dictate how well tailored the service is to that client’s business.

There is a downside to outsourcing an operating model. A critical process becomes one step removed from the asset manager. In an area as sensitive as collateral, hours or minutes could make a significant difference if a major market event occurs. Adequately managing that risk could mean leaning towards keeping it internal. The asset manager must also consider how, if at all, the benefits of pre-trade analysis and optimization could be incorporated into an outsourced model.

Putting it all in perspective
An abundance of regulatory changes is shining a light on collateral. At the same time, asset managers face an ultra-competitive quest to maximize each basis point of investment returns. As such, they strive for tighter enterprise-wide risk governance and transparency. All of this positions the collateral function for modernization.

These factors are forcing firms of all product types and sizes to review their operations and assess their options to accommodate both current and potential future requirements. There are viable choices ranging from enhancing in-house development to buying a vendor technology platform or choosing to outsource the function. The decision regarding how to proceed depends on the asset manager’s specific situation.

Large asset managers tend to have many complex business units with collateral management needs. They also have collateral expertise in-house, which can be difficult to find. The pre-trade analysis that accompanies instruments with collateral requirements is a value-add process that borders on a front-office activity and influences trading strategy. These reasons, plus the preference from regulators for large asset managers to keep collateral management close, could make the case for in-house completion.

Smaller, less complex asset managers are another matter. For them, the high cost, potentially scarce expert-level resources and overall infrastructure needed for the process could make the case for outsourcing. However, firm-specific considerations could easily tip the scale in either direction for managers of any size.

Determining the best solution begins with analyzing the current model. Next comes fully understanding gaps and shortcomings, followed by the development of a target model to work towards. After defining this vision, the method used to execute it is a complex decision. It requires weighing the gains from increased operational efficiency, leveraging collateral analytics, and reducing operational and credit risk against the total cost of the solution.

Collateral management is no longer a token activity completed only to support certain trading strategies. It is now a strategic component of a firm’s operations, risk management and investment decision support. It thus deserves — and requires — a closer look.
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