COLLATERAL OPTIMISATION:
WHY ARE FIRMS LEAVING MONEY ON THE TABLE?

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Collateral optimisation has become a commonly used phrase across the industry. It is essentially a suite of practices where firms source, manage, substitute and pledge eligible collateral assets in the most cost-effective way to meet various liquidity and risk management demands. Internally mandated 'cost take-out' requirements and intensifying market pressures have meant that the collateral optimisation conundrum is growing in complexity. As a result, firms need to focus their attention on getting this right. As emphasized in our first article in this series, this requires joined up thinking across organisations.

The benefits of focussing on collateral optimisation are significant and wide ranging, from absolute basis point savings, leading to positive P&L impact, being better connected internally and externally to support centrally cleared trades, through to the increased usage of triparty agents to effectively utilise and manage collateral pools.

All approaches have proven to be successful to an extent, but given collateral optimisation is unique to each individual organization, optimisation strategies must align to a firm's business goals, infrastructure and financial make-up.

Firms must delve deeper into their internal blockers to fully answer the question: why are they leaving money on the table? This analysis may involve, but is not limited to, a review of existing external financial market infrastructure (FMI) and service provider relationships, technology upgrades and process enhancements, booking model changes and functional realignment to remove duplication and eliminate non-core competencies.

The need for effective collateral optimisation is continuing to grow and here we highlight a few reasons why firms must not take the challenge lightly and recommend a few activities firms can undertake:

MARKET TRENDS

Demand for high-quality collateral is constantly on the rise, due to prudent counterparty risk management, capital management and the rise of regulations governing OTC derivatives and liquidity. In the aftermath of the financial crisis, market participants have become more risk averse and less willing to provide unsecured funding, which means that financial institutions need more collateral to meet their credit risk management and funding requirements.

Under Basel III regulations, liquidity coverage ratio (LCR) mandates that banks must have an adequate pool of high-quality assets that can be easily liquidated to meet their obligations over a 30-day liquidity stress scenario. LCR guidelines also outline the characteristics that assets need to possess before they can be considered high quality liquid assets. Cash, central bank reserves and government bonds are considered superior to other assets and therefore the demand and competition for these types of assets continues to be higher.

The demand for high-quality collateral will only increase due to recently introduced legislation. Following the call made by the G20 countries measures have been taken to establish central counterparty (CCP) clearing of standard OTC derivatives contracts and to increase margin requirements on non-centrally cleared OTC derivatives, meaning that financial institutions will require more collateral for their OTC derivatives transactions. CCPs impose strict eligibility criteria as it is crucial that CCPs are adequately collateralised with high quality assets given that they take on the credit risks from their clients and due to their systemic importance within the derivatives and securities markets.

The new market landscape requires that banks become more adept at managing their liquidity, collateral and risk. Effective collateral optimisation will mean that assets are better sourced, priced and allocated, and that imbalances between demand and supply are managed in an efficient way.

TECHNOLOGICAL AND OPERATIONAL CONSTRAINTS

Firms tend to have a fragmented and obscured view of their collateral positions – ultimately, systems are not unified and so it becomes very difficult to have a single view of what collateral is available versus what has been pledged. This makes rehypothecation very difficult and thus collateral usage is not optimised.

Coupled with the point above, rehypothecation and substitution methods need the support of a robust inventory management framework. However, this becomes particularly hard where firms are unable to manage and oversee collateral across regions, jurisdictions, product lines and custodians; not to mention the complexities of rigid legacy inventory management systems and operational processes.

To overcome the above limitations, firms need to move away from fragmented architecture and towards a unified approach with consolidated data regarding the assets held by the firm across various operational teams, asset classes, central securities depositories (CSD), collateral and custodian agents.

The unified approach will allow self-servicing inventory management and regular collateral substitutions facilitated through either automated or manual processes. This will allow for regular movement of collateral across the board in line with market trends to ensure optimal utilisation of assets.

To enable the use of collateral in an optimal way across all asset classes, there is a trend towards the centralisation of collateral management functions, with the first step being to establish a consolidated collateral pool with a single view of the entire collateral inventory, ideally with an intra-day view. The degree to which this has been adopted varies due to operational and infrastructure limitations including organisational structures, lack of integration with treasury functions and the difficulties associated with transferring collateral across asset classes and geographies. We recommend that in the short term, whilst the above challenges are addressed, firms focus substitution activities based on 'big ticket items' whereby it is accepted that all identified substitutions are not going to be executed within the desired timeframe and therefore, the focus should be in a high nominal, high basis point saving pledges, which represent the best value.

FRONT OFFICE AND PRICING

Efficient collateral optimisation is a complex process, and traditional management processes need to be updated and automated for this to work. The increase in complexity has led to re-organisation within firms, such as moving responsibility for collateral and inventory management away from silo'ed desks such as repo and treasury, towards centralised optimisation trading functions and specific collateral management groups.

Traditionally, improvements have focused on workflows for margin calls automating key activities such as reconciliation and margin call messaging, shortening the collateral settlement cycle to reduce settlement risk, and broadening the range of assets to be used as collateral and automating substitutions. However, despite being important considerations in themselves, optimisation challenges are not confined to just these aspects.

It is also important to consider pre-trade optimisation. The objective here is to minimise the margin requirements related to the cost of a given new deal by identifying the optimal booking model i.e. consider the right broker, CSD, CCP relationship or bilateral counterparty to trade with, who will take the cheapest to deliver / hardest to place collateral (either in cheapest quality of collateral, or most efficient to deliver) thereby reducing the overall cost.

The move towards incorporating cheapest to deliver (CTD) variables within derivative inception pricing has focused attention on collateral eligibility and quality. Whilst CTD is widely incorporated into derivatives pricing, there is still some progress to be made in areas such as additional termination events, ratings triggers and substitution conditions etc.

Coupled with the trend for specific discounting curves for different types of non-cash collateral based on issuer and rating has resulted in counterparty specific pricing for otherwise identical trades. This could mean that there is a risk of mispricing those transactions if the collateral assumptions are incorrect or not optimised to be in line with what is expected with actual delivery.

With access to timely and precise information, along with the appropriate analytic tools, banks can perform a pre-trade optimisation assessment to give trades an accurate view of asset availability and the cost of the collateral associated with each transaction. This means that delivering collateral effectively can have a big impact on the trading desks efficiency.

REGULATORY CONSTRAINTS

Restrictions on optimisation activity can also be linked to regulatory pressures where firms are fully aware of balance sheet and leverage ratio concerns. We have a situation where the impacts of funding metrics such as liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) also appear to restrict collateral optimisation activities. LCR, being one of the key reforms of Basel III, requires banks to hold unencumbered high-quality liquid assets (HQLAs) that can be easily converted to cash if required. In general, the treasury function control these assets separately to the collateral assets controlled by the trading functions and specific collateral management groups.

The HQLA pool of assets is, therefore, inaccessible for optimisation purposes. This could result in some of those assets either not being used where they could have been or where particular specific types of collateral that could have been used elsewhere for collateral purposes (substitutions, for example) but were not and alternative solutions were required.

Further regulation such as the Securities Financing Transaction Reporting (SFTR) regulation will also be increasingly correlated to collateral optimisation due to the need to report collateral optimisation, collateral transformation and rehypothecation activity.

WHAT NEXT?

The factors above play a large part in contributing to firms leaving collateral, and therefore revenue on the table. The big opportunity is minimising the amount of revenue ‘wasted’ and a reduction in operating costs associated with collateral management.

Contact James Arnett to discuss how Capco can help you develop a collateral optimisation strategy.

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ABOUT CAPCO

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