Smooth as the buy side likes

Martin Seagroatt of Broadridge Financial Solutions analyses the challenges that buy-side firms must overcome in the new collateral management landscape

Buy-side firms face a number of major challenges around the collateral management process.

These challenges include a need to hold or source larger quantities of cash or high-quality collateral for variation margin and initial margin to support cleared and uncleared derivatives activity. This creates a significant drag on alpha for many buy-side institutions in the current low-interest rate environment.

Another challenge is the rise in the volume and frequency of margin calls. This results in an increase in collateral movements to meet more demanding settlement cut-offs for both centrally cleared and bilateral counterparties.

The third is demand from the sell side for beneficial owners to move down the liquidity curve in the collateral they will accept. This is coupled with a preference from the sell side for longer-term financing structures due to regulations such as the Basel III's liquidity coverage ratio (LCR) and potentially the net stable funding ratio (NSFR).

Each of these trends results in a need to re-evaluate existing processes and technology solutions to adapt effectively to this large-scale paradigm shift in the collateral management landscape. In this article, Broadridge will discuss the technology implications of each of these trends.

Increased need to hold or source high quality collateral for derivatives margining

Regulation has resulted in the market pulling in two different directions to some extent. On one side, buy-side firms need to source more collateral of a higher quality than in the past to satisfy these increased obligations. However, holding these asset classes internally creates a major drag on returns. It is therefore more cost effective for the buy side to engage in collateral transformation/upgrade trades with the sell side in the securities lending and repo markets to meet this need.

However, the leverage ratio has resulted in a balance sheet impact on the sell side when offering these trade types. This imbalance between supply and demand has resulted in a rationing of collateral upgrade trades and limited availability, particularly over sell-side balance sheet reporting periods.

The market is now increasingly interested in new electronic peer-to-peer collateral platforms in the securities finance space to take up the slack. This sees, for example, two pension funds trading directly with each other where one is short high-quality liquid assets (HQLA) and the other has excess HQLA.

Of course, sell-side intermediaries provide valuable services for the buy side, including indemnification, maturity transformation and counterparty credit risk intermediation. For these reasons, peer-to-peer appears set to become another channel to tap into market liquidity rather than completely disintermediating the sell side.

This hybrid model sees liquidity sourced via different routes to market depending on cost and availability at a given moment in time. In future developments, technology solutions may play a bigger role in providing analytics that guide decision making around the optimal source of liquidity for buy-side firms.

Some larger buy-side firms have already begun this transformational journey and an emerging theme is the creation of central collateral funding and liquidity functions to create internal markets for collateral.

Technology has become a key foundation for this new model. Systems such as the Broadridge Securities Finance and Collateral Management (SFCM) solution allow the firm to centralise collateral inventory and exposures across funds and geographical locations.

Collateral managers can then utilise this technology to internally source the lowest cost collateral for margining needs before sourcing more expensive collateral from external providers.

Once collateral has been sourced in an automated way to meet margining needs, the collateral solution can identify any surplus collateral that is trading special or is CCP- or Basel III LCR-eligible and lend/repo it out to the market. In the current low-interest rate environment, this provides significant opportunities to enhance yield.

The key to all of this is the ability to aggregate inventory using technology and then automatically source cheapest-to-deliver collateral at the touch of a button. This can result in significant time savings over more manual methods of sourcing assets.

An integrated solution for securities lending, repo and derivatives collateral management is another cornerstone for this matching process. It allows a clear view of liquidity across siloes and business lines and paves the way for more effective collateral optimisation.

As new platforms arise, the ability to connect collateral systems to market infrastructure will become more important in the future. Connecting to central counterparties (CCPs), clearing brokers/futures commission merchants (FCMs), peer-to-peer platforms and electronic markets, and then combining aggregated market views of collateral supply and demand with the firm's own inventory provides a way to match collateral supply and demand more efficiently and effectively.

Likewise, solutions offering real-time connectivity with triparty agents are becoming essential as use of these services becomes more widespread in response to regulatory mandates around segregated third-party custodian accounts.

A rise in the volume and frequency of margin calls and collateral movements

Regulatory mandates for more frequent margining to more demanding settlement cut-off times create an exponential increase in operational workload. The need to mobilise collateral more quickly also results in a major rise in collateral lifecycle processing, settlement failures, reconciliations and disputes.

Technology solutions that can automate these manually intensive processes are now critical to meeting regulatory requirements with minimal increase in headcount. They also help to mitigate the increase in operational and settlement risk. Solutions such as Broadridge's that offer settlement automation, coupled with clear workflow views to manage settlement failure, offer significant improvements on manual processing or spreadsheets.

This allows collateral managers and operational leads to focus on making strategic decisions around the firm's collateral and liquidity profile, rather than constantly battling day-to-day operational tasks. Integrated margin messaging and reconciliations platforms also provide a way to increase automation of these time consuming activities.

In the future, we may also see the rise of blockhain platforms for mobilising collateral more efficiently. Technology solutions that can plug into this infrastructure will enable buy-side firms to take advantage of the benefits of blockhain, should it become widely used.

A move down the liquidity curve in acceptable collateral and longer term structures

Regulatory demands for the sell side to meet Basel III liquidity coverage ratios have seen borrowers in the securities finance markets offer higher fees for beneficial owners that are prepared to accept lower-quality collateral in exchange for lending HQLA at longer terms.

The ability to manage the eligibility and concentration risk of this collateral using sophisticated technology solutions allows the buy side to increase returns from lending programmes and expand business opportunities in a way that is acceptable to the firm's risk profile. Likewise, systems that can handle evergreen and extendible term structures are now becoming essential components in the changing collateral landscape.

The widespread regulation-driven step change described above is resulting in a need to either outsource collateral management activity or improve existing technology solutions to ensure they are fit for purpose in the new, more dynamic environment.

Strategic collateral management technology solutions such as Broadridge's can provide major benefits in matching collateral supply and demand across the firm, allocating costs, automating manual processes and improving decision making around the collateral lifecycle.

While some regulatory mandates are yet to fully affect the buy side, it is important to take a long-term view of these trends and begin selecting future proof technology systems to position the firm for success. With collateral increasingly becoming a key performance indicator for the buy side, it is important to act now to ensure a smooth transition to the new operating environment. **SLT**

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