Collateral Management: *Back to basics*

Fueled by fast-shifting regulatory dynamics and increasing market volatility, demand for high-quality liquid assets (HQLA) has never been greater. With it comes an increased need for robust and cost-effective collateral management systems.

Obtaining HQLA is now a strategic priority

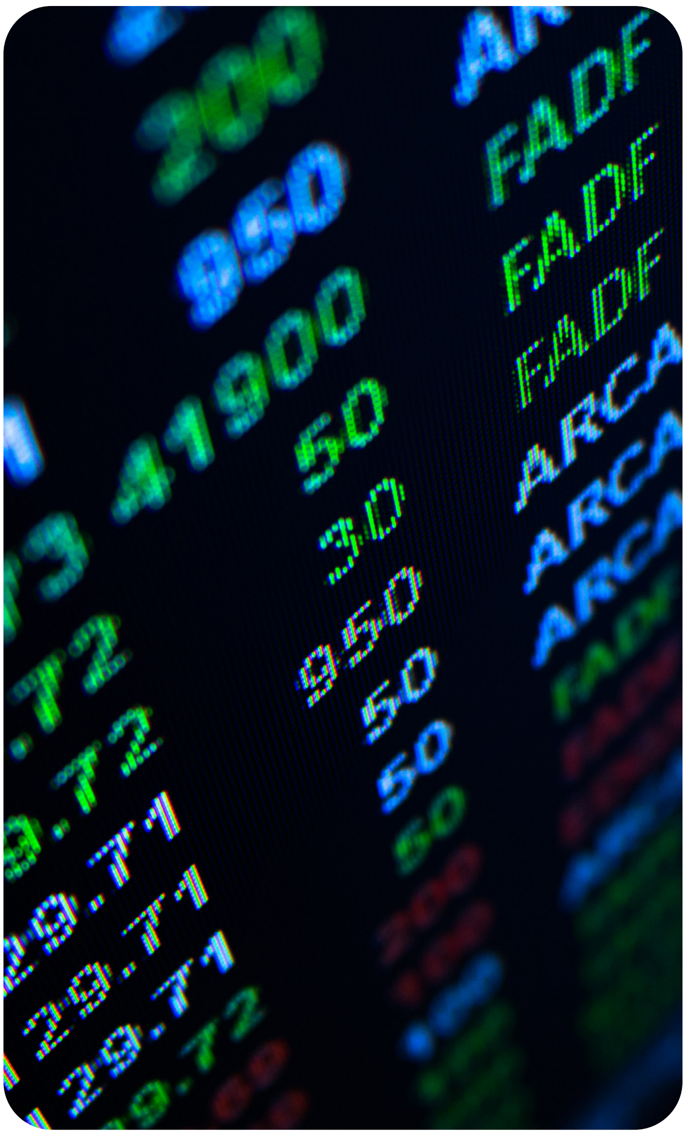
HQLA is in hot demand.

Post-crisis regulations have placed a premium on HQLA, such as cash and highly rated sovereign bonds. The Basel framework, for instance, imposes stringent risk-weighted capital requirements on banks, forcing them to hold large quantities of unencumbered HQLA to cover potential shortfalls caused by market stress events, while the EU's Solvency II regime does the same for insurers.

Meanwhile, firms trading Over-the-Counter (OTC) derivatives are subject to strict margining obligations under Dodd-Frank and the European Market Infrastructure Regulation (EMIR). These firms must post HQLA as collateral either at their central counterparty clearing house (CCP), if the transaction is cleared, or with their bilateral counterparty, if the trade is uncleared.

With markets also volatile, HQLA is becoming even more sought after, as firms flock to safer assets and CCPs and bilateral trading counterparties double down on their margin calls, exacerbating collateral scarcity in some corners of the market.

Firms should maintain a continuous state of evolution in their collateral management programs within *an ever-changing market environment.*



This all comes at a time when the industry is dealing with revenue pressure and rising operating costs, further underlining how important it is for firms to have best-in-class collateral management solutions.

Crisis Event	Impact on margining
Covid – March 2020	CCP initial margin increased by $300 billion – or 40% – between end-February and mid-March 2020; variation margin surged from a $25 billion daily average to a single day peak of $140 billion.
Russian invasion of Ukraine - 2022	Margin calls on the Title Transfer Facility (price of gas) futures saw a 16-fold increase in variation margin calls in the first half of 2022.
UK Liability Driven Investment (LDI) crisis - 2022	The spike in Gilt yields meant LDI funds came under significant stress from margin and collateral calls.

Source: Bank of England – July 18, 2024 – Late call – speech by Nathanael Benjamin

Deloitte highlights that even a 1% improvement in collateral efficiency can help medium-large sized firms generate added revenues or reduce costs by over $1.1 million in normal market conditions, rising to $1.7 million- $3.5 million during bouts of volatility.

Source: Securities Finance Times -September 2024 – Tech enabled collateral optimisation: From must have to game changer

Getting the fundamentals right

A successful collateral management strategy hinges on firms getting the basics right.

“The ability to manage collateral is contingent on having an efficient and scalable core system and service, where the foundational processes are handled flawlessly,” said Eric Ilardi, Global Head of Collateral Management, Investor Services, Citi.

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This means consolidating collateral activities and avoiding a siloed approach to optimization—something that can be enabled by using a single collateral service that supports multiple investment products (for example, OTC derivatives, exchange-traded derivatives, repos, and more).

These solutions also need to be directly integrated with custodians and embedded with real-time inventory feeds, all of which help facilitate collateral optimization.

Optimization extends beyond just collateral. Fund managers have diverse needs for HQLA, including covering overdrafts and meeting liquidity requirements and redemptions. A holistic approach to optimization is therefore essential.

Automation is also a key criterium for effective collateral management.

"Automation can mitigate manual risk, free up time for analytics, and alleviate liquidity concerns. Straight-through processing (STP) of collateral sourcing and subsequent movements provides firms with greater real-time insight into asset locations. This understanding can be integrated into automated workflows to substitute collateral as needed, allowing additional time to settle collateral and avoid settlement failures and potential charges," noted Ilardi.

Given the erratic and unpredictable nature of markets today, a thoughtful approach to risk management and counterparty oversight is equally pivotal.

"Many firms integrate counterparty exposure metrics into best-execution decisions, aiming for diversification while also monitoring the impact of potential defaults. Particular attention should be given to counterparties with whom firms frequently dispute, ensuring that adequate collateralization is always maintained," continued Ilardi.

In practice, managers need to deploy tools capable of forecasting margin requirements based on specific shocks and correlations arising from market events. By doing so, firms will be well positioned to manage liquidity, especially during periods of heightened volatility.

Firms should maintain a continuous state of evolution in their collateral management programs within an ever-changing market environment. A solid core infrastructure is imperative to ensuring scalable STP, real-time inventory access, and accurate data for portfolio management. Robust settlement oversight is also crucial for preventing fails and overdrafts and for maintaining appropriate liquidity.

Getting the right support

A frictionless collateral management strategy will not come naturally to all buy-side firms.

Many organizations lack the resources to invest in collateral management infrastructure, while others operate in silos or rely on manual processes—creating costs, inefficiencies, and fertile ground for risk.

Buy-side firms must continuously evaluate their collateral management processes and infrastructure, as well as determine whether these activities should be performed internally or outsourced.

This is where service providers, such as Citi, can help.

By externalizing collateral management to third parties, asset managers can free up internal resources and focus on alpha generation and fundraising. Outsourcing also allows buy-side firms to benefit from economies of scale and access to cutting-edge technology that may previously have been out of reach.

"Ultimately, this helps managers support increased collateral demand, shorter settlement cycles, and complex collateral processes, while also meeting regulatory requirements. Service providers can assist with asset optimization through short-term investment processes, whether via money market funds, securities lending, or repurchase agreements," said Ilardi.

Why collateral management is key

A robust collateral management solution is non-negotiable if firms are to navigate what has become an increasingly challenging market.

It also helps organizations future-proof their operations—only once the industry has the basics in place will it be able to incorporate new technologies and tools, such as tokenization and artificial intelligence, into collateral management activities.

Collateral management should not be viewed as merely a cost center, but rather as a risk-mitigation mechanism that, when deployed well, can significantly contribute to alpha generation and protect firms during extreme market events.

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