Too early for the buy side?

Awareness building is imperative to ensure that collateral management efficiency is given focus so that is can have an impact on the bottom line, according to Jonathan Adams of Delta Capita

Earlier in 2016, it was reported that despite some considerable investment and development of collateral management applications, utilities and services, there was very little take up by the buy side. This is a significant finding given the potential benefits for asset management firms to further mobilise portfolio assets for day-to-day requirements such as managing liquidity risk and meeting margin call obligations.

The compliance deadline for the European Market Infrastructure Regulation (EMIR) mandating the clearing of over-the-counter (OTC) derivatives and the exchange of initial margin for bilateral (uncleared) OTC derivatives has been pushed back a couple of years. There is currently little perceived benefit for buy-side firms to change the existing cash-driven margin call process for both cleared or uncleared OTC derivatives, especially as the current requirement in bilateral OTC is to exchange variation margin only for the time being.

Industry spokespeople indicated that it was unclear which requirements and obligations the delayed regulations would bring. Furthermore, there did not appear to be clarity on how the changes would affect the clients of clearing members (if at all) and what the value was versus expenditure. As is often the case, competitors wait to see to see how their industry rivals will approach the matter given the perceived hypothetical nature of what might be required.

Some feedback indicated that products appeared more sell-side focused and perhaps that they represent functional overkill for asset managers. Then there were operational risk concerns for those participating agency securities lending programmes with third-party lending and exclusive deals on portfolios, which all add complexity to the location of assets, including whether they can be recalled on time for sell orders and assessing when assets are used for collateral purposes or in lending programmes. Given that the decision process is always an assessment of what is a core activity and what activities can be outsourced, in the absence of a regulatory driver, there has to be clarity on the benefits from a revenue perspective.

One custodian triparty agent indicated that the take-up of triparty collateral services by their asset management clients was less than expected and there have been a couple of significant market infrastructure services that have been either abandoned or delayed.

In addition to these factors, there is an awareness of ongoing developments at the central counterparties (CCPs) to provide facilities such as cross-margining and to have triparty capabilities, which would might further delay the choice on products.

This perfect storm of product diversity, perceived lack of immediate necessity and an uncertain regulatory landscape might explain the situation, but perhaps there are less evident factors that could bring different conclusions.

The very organisations that have traditionally provided services to the buy side and been their transaction counterparties have been affected greatly by regulation, such that it has been considerably less attractive for banks to trade with their buy-side customers. Consequently, there does exist an immediate justification to beef up their collateral management capabilities in order to not rely solely on the sell side.

Let's examine two quite different scenarios where a collateral management capability would be of benefit to the buy side.

Clearing client or clearing member?

In the period leading up to the 2008 global financial crisis, there was an abundance of cheap client clearing services. Banks were almost exclusively the clearing members that provided these for high-volume plain vanilla OTC derivatives products such as interest rate swaps.

This 'group' monopoly continued in the immediate post-crisis period as regulatory reforms mandated central clearing of OTC derivatives for most counterparties, which led to increased demand for the service. However, with the expansion of central clearing, banks have been burdened with having to be members of multiple CCPs in order to service their global buy-side clients. This, combined with the post-crisis regulatory changes on how to manage their balance sheets and having to comply with capital requirements, and suddenly the business of offering client clearing services is a less attractive revenue proposition and requires strict compliance and monitoring.

As a clearing broker, a bank sits in the middle of a transaction between its clearing client and the CCP. In doing so, it uses capital (for leverage and risk-weighted assets), balance sheet, funding, and takes on liquidity risk as it often pre-funds margin call payments, which are automatically taken by the CCP and later charged to the clearing clients. There is also a capital charge for the exposure that the clearing member has with the CCP. The clearing broker also has to fund the provision of high quality collateral to CCP guarantee funds and for initial margin.

This has undoubtedly had an impact on how much banks have to charge their clearing clients to provide the services they require. Buy-side clients transacting significant volumes across multiple CCPs could certainly benefit from being able to self-clear. A sophisticated collateral management capability then becomes a worthy and immediate consideration.

The cost of liquidity

Investment and wholesale banks have traditionally been providers of liquidity to the buy side. Due to capital adequacy requirements and balance sheet usage, collateralised transactions versus cash have an adverse balance sheet impact. Even when the collateral is of the highest quality, there is an impact for banks. Where such transactions are collateralised by non-government assets, corporate bonds and equities, there is an impact on their risk-weighted assets (RWAs) and capital adequacy ratios. This is reflected in the rates they are able to provide when asked to bid for collateral.

Slowly but surely, regulation has had an indirect impact on the buy side via its sell-side relationships. With this changing banking landscape, there is value in seeking non-traditional counterparties that are not suffering from the same constraints, such as other buy-side counterparties, including treasury desks at large corporations. In this context, triparty collateral management looks very attractive as it enables the collateral giver to commoditise pools of assets and outsource the re-valuation, recalls and substitutions to the triparty agent. The marketplace is already responding to this and services such as Euroclear's RepoAccess are taking the headache out of negotiating individual global master repo agreements (GMRAs) with each counterparty. It enables a group of participants to sign a single agreement to appoint Euroclear as the agent, allowing Euroclear to enter into GMRA contracts with each of the participants.

Other products are in development that will enable collateral transformation in a similar pooled fashion and so a different landscape is emerging, providing the buy side with alternatives to seek liquidity, transform collateral to higher quality assets to meet collateral obligations, or downgrade to earn revenue.

Managing liquidity is not an insignificant task for portfolio managers and being prepared for investor redemptions, managing portfolio restructuring, meeting margin call obligations, covering liquidity shortfalls and investing excess liquidity has required that they invest in dedicated teams and technology to manage the process. Yet nowadays, where major currencies have near zero or negative interest rates, the disparity between the yield of a strategically invested portion of a fund's net asset value (NAV) and the portion that is invested in short-dated products such as repo and money market funds is considerable.

The impact of the poor return from the liquid portion of a fund's NAV on the overall return is referred to as 'yield drag'. This could be mitigated to some degree by rebalancing the ratio of the strategically invested portion to the liquid portion (invested in short-dated products).

The transformation of strategic investment assets into high quality assets would enable a similar liquidity ratio as before, with the ability to raise cash readily against the HQLA or use HQLAs to meet collateral obligations. The annual cost of collateral transformation is a fraction of the yield improvement gained from reducing a fund's liquidity.

Building awareness

Collateral management and optimisation has traditionally been the focus of the sell side, which is typically leveraged and focused on balance usage. The focus for the buy side is different, with a decision process in play that determines the deployment of expertise and resources for core activities while outsourcing activities that are considered to be non-core.

With that in mind, awareness building is imperative to ensure that collateral management efficiency is given focus so that is can have an impact on the bottom line rather than be just about regulatory compliance. To take advantage of the available benefits, there are specialist advisory consultancy services that can will help clients get the right balance between in-house capability and outsourcing. **SLT**

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