How To Maximize Your Performance Through Collateral Management

Are you overlooking potential performance impacts from your collateral management practices? Collateral management products can help optimize pledging collateral, reduce claims and fees, and reduce headcount.

When derivatives fail, they tend to fail big. Scars from 2008 aren't as fresh as they used to be, but the regulations put in place following the fallout persist and have only gotten stricter. Historically, collateral management has simply been an afterthought; a required post-trade operational function as far removed from portfolio management as settlement processing or accounting. Thanks to modern product offerings and technology advancements increasing operational capabilities, collateral management is now being seen as opportunity to maximize performance while minimizing costs and effectively mitigating risk. Recent regulations, such as Uncleared Margin Rules (UMR) and SEC rules for security-based swaps, have increased the complexity of collateral management affecting asset management firms more than ever before. Additionally, firms are starting to realize that management of collateral obligations should be viewed as part of the portfolio management process that, when properly managed, can create performance gains or, if improperly managed, performance losses. Despite the increased complexity, the right tools can positively impact a firm's performance by optimizing collateral structure and strategy.

Across the industry, collateral has predominantly been managed through homegrown applications based largely on Microsoft Office products like Access databases and Excel. These applications heavily rely on static data for user input such as start of day positions and theoretical collateral movements. This information is prone to negative feedback loops as failed substitutions lead to failed market trades. Commonly, the IBOR position is not dynamically updated throughout the day, leading to fees assessed for failing market trades as traders act with incomplete information. For example, in a period of significant volatility, increased trade activity may necessitate collateral substitutions as securities posted for collateral are traded in the market. Given the same day settlement timeline required for collateral movements and their impact on balances held at custody, traders can be making decisions with incomplete information due to static data, incurring fees as a result. In one case, a firm incurred fees far more than the typical amount seen in a year over a two-month period of volatility. This accumulation can be an unnecessary performance drag and can be avoided with dynamically updated balances and automated settlement functionality, enabled by a collateral management system.

Excel and Access-based applications don't just enable scenarios that incur unnecessary costs, they prevent firms from optimizing collateral to positively impact performance. Some investment managers rely on cash for collateral regardless of the cash drag on the portfolio because less dynamic tools make posting securities less appealing due to the shorter settlement window and operational constraints around substitutions. A modern collateral management system can make posting and recalling held securities a simple exercise, enabling previously segregated cash to be invested. These systems can also enable firms to easily adjust the way they margin to reduce the interest paid on cash deficits at clearing brokers. Additionally, these systems can dynamically update cash figures throughout the day, reducing overdrafts. These small advantages taken together can have a measurable impact on firm performance and the overall efficiency of their operations.

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The overall efficiency that a proper collateral management system provides is an added benefit on top of helping a firm move away from cash by optimizing and automating securities posting. Unlike Access and Excel-based applications, a collateral management system can set desired hierarchies of securities to post based on complex eligibility rules and even automate workflows through SWIFT messaging. Firms can then integrate their order management systems and automate the substitution process when posted collateral is traded in the market. The ability to update balances in real time intraday gives traders, risk managers, and operational groups better information on demand. With these efficiencies, firms can effectively manage collateral across more assets with fewer analysts, further contributing to a firm's performance.

Additional regulations, increasing complexity, and the performance impact of improper collateral management should drive firms to assess their capabilities. While collateral has traditionally been framed purely in terms of risk management, the right collateral management system can streamline operations while positively impacting performance.

HOW MERADIA CAN HELP

Meradia has the experience to assist with selecting and onboarding the right collateral management vendor. Regardless of your firm's derivatives exposure or collateral model, Meradia knows the challenges firms face with these products. Our expert consulting team utilizes best practices to fully leverage vendor capabilities and help firms improve not only performance, but operations across front, middle and back offices.

Jake Daly-Leonard
is an investment management technology expert who provides Meradia's clients with strategic guidance on the adoption and utilization of the industry's leading solutions. A seasoned project manager, Jake has deep experience serving as the liaison between institutional asset managers and front-to-back office platforms. His perspective of the financial services industry, coupled with his knowledge of the technology landscape, provides unique value for firms looking to optimize operations through new systems.

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