The importance of global collateral has never been higher. Over the last decade, collateral has become a key mitigant against market risk and in that process, collateral management, trading, regulation, reporting and auditing have all undergone a sea change. This process is not over and as these changes are internalised, they are forcing banks and asset managers to make huge changes to their organisations.

For global banks, the issue of collateral management is now a senior management concern and a core strategic focus as they strive to increase their returns on equity. Current market conditions are sharpening that focus.

**Ready for change**

“Capital requirements for banks have risen substantially in recent years and given that the current excess liquidity from central banks will inevitably be withdrawn at some point, the pressure on financing capacity will return,” says Ciaran O’Flynn, Managing Director at Morgan Stanley. “There is a window right now where we have to focus on collateral and clearing.”

In response to this pressure, banks are working hard to unify their collateral desks, they are devoting resources to complying with the new regulations coming into force in 2019 and they are seeking ways to increase the electronification of the market.
Global relevance, locally available

“Regulatory-driven changes to the collateral landscape have led to banks adapting their organisations in order to comply with new regulatory framework. This has resulted in the need for investment and greater collaboration across internal functions within banks to ensure they have the necessary tools to determine the true balance sheet that can be put to work for their clients.” Says Antoine Danneel, Head of Equity Finance EMEA at BNP Paribas.

Client demand for collateral may be pushing banks to unify their internal desks so as to maximise its availability. But this collateral still needs to be available globally, and that requires a certain degree of fragmentation.

“For efficient collateral management, centralising and optimising pools of collateral is key but there is also a need to more efficiently physically realign securities across different markets according to the clients’ needs,” says Nicola Danese, Managing Director, responsible for EMEA FI Financing at J.P. Morgan.

Demanding regulatory precision

It is not just clients who want a more unified internal approach to collateral: the regulators are demanding it as well.

“The regulators want to see all of a bank’s activity that involves collateral,” says Greg Markouizos, Global Head of Fixed Income Finance at Citi. “Increasingly, they want to see one set of reportable and auditable numbers and they want to see collateral exposures managed at the very highest level.”

The new reporting requirements under the EU’s Securities Financing Transactions Regulation (SFTR) and further implementation of existing regulation such as the Uncleared Margin Rules (UMR), which will come into force in 2019 and 2020, are also having a huge impact within banks.

Each transaction requires the reporting of 153 separate pieces of data. This is pushing banks to find ways to electronify and standardise the business.

“The trade capture and data enrichment under SFTR for a huge data set – along with a lack of existing standardisation in the way certain mid-life events are managed – will make the SFTR implementation a very complex operational challenge, to which participants will have to allocate significant resources,” says Danese at J.P. Morgan.

Enabling buy-side participation

The implementation of waves four and five of UMR, are similarly impactful. The initial waves of this regulation affected the largest asset managers in the world.

But the forthcoming waves will affect those asset managers who have open OTC derivatives positions in excess of USD 8 billion. This will represent a far greater challenge for the industry - as UMR will now impact a large number of asset management entities worldwide.

“The burden of the new regulations on our clients is enormous,” says O’Flynn at Morgan Stanley. “As banks, we are managing our way through, but our clients are finding it very difficult to respond to so many different demands at the same time.”

Buy-side firms that will be captured by wave
5 of UMR do not, by and large, have any existing collateral management operations. The lessons learned from the implementation of waves 1-3 are that this infrastructure can take more than a year to set up.

“Collateral management and optimisation are now key operational capabilities for the buy-side,” says Markouizos at Citi. “Holding collateral has become essential to support any trading strategies.”

**Far-reaching impact**

The final impact of changes to global collateral management systems is to the markets and their securities themselves.

Some derivatives are reportedly being priced according to the cost of the collateral that is needed to be posted. This is now in the pricing models of the derivatives themselves. This change perhaps shows most clearly the journey that collateral management has made from firmly stuck in the back office, to right in the front office.

The changes to collateral management over the past decade are having a huge impact on all parts of the market.

Without any viable off-the-shelf solutions from the market, many banks fear that a large proportion of the buy-side universe might have to cease trading. This process, known as de-marketisation, may not be exclusively the fault of wave 5 of UMR, but it is a huge contributory factor. And banks report that it is happening right now.