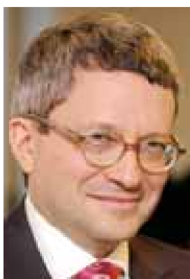
Optimising collateral management

Georges Bory, Managing Director and Co-Founder of Quartet FS, explains why banks do not need to invest in completely new systems to manage their collateral requirements efficiently.


Georges Bory
Quartet FS

Why has collateral optimisation become such a key issue for financial institutions?

It is because of the changes in regulation and market structure triggered by the collapse of Lehman Brothers and the financial crisis. One of the major changes has been in derivatives. Most transactions now have to be cleared in a Central Counterparty Clearing House (CCP). One of the key features of a CCP is that both counterparties have to post initial margin at the inception of a trade and during the life of the trade. Prior to the crisis, the only margin requirement in a bilateral trade was the mark-to-market, and only one counterparty would post collateral. Now everybody posts it, so the amount of collateral firms need to post has grown considerably. If you combine the fact that everybody now has to post initial margin, plus the fact that the trade has to be cleared through CCPs – which are ready to accept non-cash collateral – the result is a problem that is becoming significant in terms of profitability.

Because of this, profitability in the derivatives market is under stress, and firms are trying to optimise all aspects of trading. One aspect of that is the margin firms have to post, either in a CCP, or if you are doing bilateral trade, where regulation also forces you to post initial margin. So, there is an increase in collateral requirement and firms want to minimise the initial margin they have to post. Once you have done this you also want to minimise the cost of funding of the collateral being posted either in CCPs or in bilateral trades.

How can firms adapt to the new environment?

The way firms can adapt is not just to optimise on a silo-basis, as used to be the case, splitting their pool of assets and designating some to securities financing and some to use as collateral. What firms need to do is put everything in one place. Firms can then benefit from arbitrage: for example deciding whether to post certain collateral with a CCP or to lend it in the market and post cash, and potentially benefit from a better rate.

There is an arbitrage opportunity, but firms can only benefit if they manage their assets from a more front office point of view. They can do this by having a central place where they can have a global view of their positions in collateral assets, in collateral requirements in the market for bond lending and securities finance in general, and not only optimise them, but look for arbitrage opportunities. I think that is how firms are evolving.

Why are existing silo-ed collateral management systems proving inadequate?

If you have silo-ed collateral management and you ring fence a set of securities for collateral and you ring fence another set of securities for your other trading activities, you have suboptimal asset allocation.

What approach is Quartet FS taking to deliver a solution?

Our technology has the ability to aggregate data from multiple sources. It enables us to solve this problem without creating a new infrastructure. Firms already have a collateral system and a securities lending system and what they don't want to do is create yet another system that will combine the two. What we offer the market is a way to solve those data federation issues in a different way.

The problem of collateral is not a problem of reporting, it is an operational problem – you have to take decisions all the time. So a standard solution like a data warehouse that is going to work very well for producing reports is not going to work for you if you are actually looking for arbitrage opportunities and optimisation of initial margin collateral. We aggregate all those data from multiple silos to a central in memory database, from which we are able to provide users with combined views, what-if analytics and the ability to perform optimisation. From a cost point of view it is efficient because we don't create yet another system. It is an overlay of existing systems. We use the data as it is, and consolidate it in memory and make it available for real time trading.

What makes it different from other systems on offer?

Other people tend to think what was there before is not adequate and therefore you need to build a new system. Our view is that the bank has already invested a lot of money and intellectual capital into their collateral systems, their trading systems, their bond lending systems and equity financing systems and what is really needed is a technology that brings this together.

For further information: www.quartetfs.com