Into the unknown

Staffan Ahlner of BNY Mellon Markets pinpoints the challenges, risks and rewards that await the buy side as it ventures into new territory

What has changed for the buy side in today's collateral environment? What new challenges are they facing?

The buy side faces increasing challenges in maintaining its business with the same financial transactions that it has been using over the years. More of these transactions are requiring collateralisation, and with regulatory deadlines on the horizon, the demand for collateral assets continues to grow. This trend is nothing new—we have seen it building for some years. What is new, however, is the time pressure and the realisation that it is time to act. The buy side is now having more discussions around sourcing collateral, such as the collateral needed to cover initial margin and the cash for variation margin requirements.

This need for the right collateral, especially the cash needed for variation margin, comes at a time when balance sheet costs for the sell side are higher than ever before. Regulatory requirements give banks and broker-dealers (the sell side) less balance sheet flexibility to effect transformation trades. These transformation trades created liquidity for the buy side.

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Without these transformation trades, some buy-side participants will have to go directly to the market or stop using the transaction that creates the collateral requirement. With the sell side engaging in fewer transformation trades, the buy side has an increased need to interact with the market directly to raise cash and source collateral.

What is the main driver behind the need for the buy side to build an in-house collateral treasury function?

Capital cost is the main driver. This cost restricts some sell-side firms from providing the required collateral transformation transactions, and this will drive some of the buy-side firms to look at the alternative of entering the market directly. An in-house collateral treasury function can help the buy side mobilise and access the collateral and liquidity they require over and beyond what the sell-side firms can provide. Banks and broker-dealers have a long history of sourcing collateral and raising liquidity in the market, so the buy side needs to enhance its expertise in this area and build its own collateral treasury function if the sell side is unable to provide for the transformation.

Hedge funds have been the first movers in this space, and the larger hedge funds interact directly with the market. Now other buy-side market participants are pursuing this strategy for sourcing collateral and liquidity. Many large buy-side institutions have the resources to build an in-house collateral treasury function that helps to utilise the assets they have and source the collateral they need. It's the medium- and smaller-sized institutions that may struggle.

The good news is that there are tools available to help these firms, tools that the sell side has been using for decades such as the triparty structure. Medium- and smaller-sized firms can also find support through arrangements such as principal lending, in which a service provider can help them reach the market and source liquidity.

What are the costs associated with building a collateral treasury function?

Building a collateral treasury function incurs fixed costs, mainly for staffing and technology, but there are service provider tools and capabilities that the buy side can leverage that would incur variable costs. The buy side can access electronic platforms to connect to the market for price discovery and trading. They can outsource much of the post-trade activity for collateral trades to a triparty agent. If a transaction does not fit into a triparty structure then these transactions can be outsourced to a collateral administration service provider.

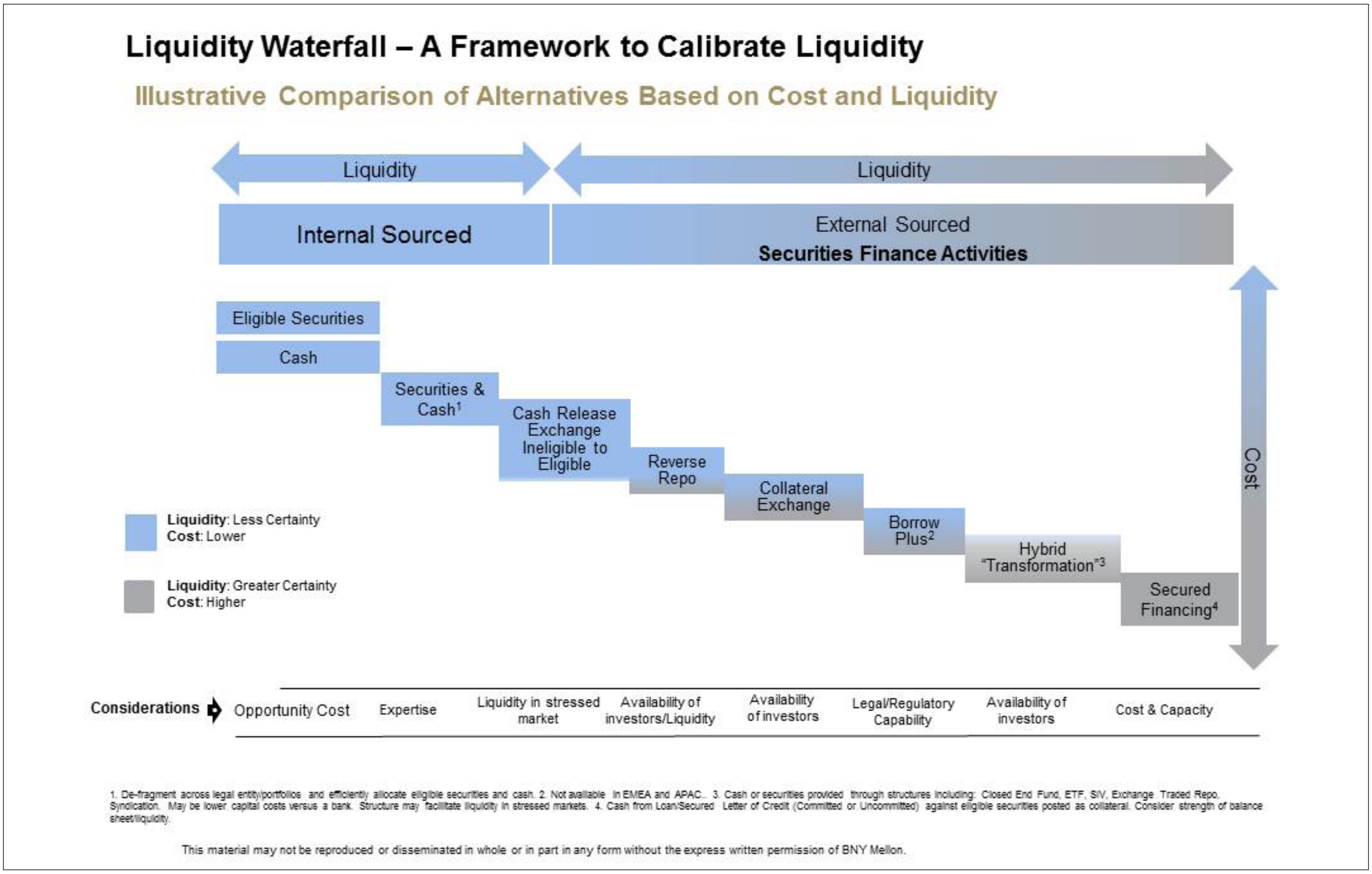
What are the risks of an in-house collateral treasury function?

By setting up an in-house collateral treasury function, and trading directly with the market, the buy side will incur counterparty risk. This counterparty risk is not something new, but it is changing. By sourcing the liquidity and collateral directly, the counterparty profile may change to include other buy-side firms. There might be a number of new counterparty types rather than one or two sell-side firms. Collateralising transactions helps to manage this counterparty risk and using an efficient collateral management model, such as triparty, provides further risk mitigation though it does not completely remove counterparty risk.

An in-house collateral treasury function also potentially introduces replacement risk, something that may be new for some buy-side firms. By entering the market to raise cash or borrow stock, the buy side has to give margin. The lending industry does offer various indemnifications to the buy side. The indemnifications were typically provided by banks and required capital. In our current environment, such capital usage would be expensive for the provider of the indemnity due to capital constraints.

An in-house collateral treasury function will help with access to liquidity. Are there any other benefits?

If a buy-side participant builds a strong collateral treasury function, it has the ability to be on both sides of a transaction, which presents a number of benefits. The buy-side institution can use its liquidity pool to invest in a repo transaction and then re-use the collateral received in that transaction to help with cash flows and do short-term funding if needed. The ability



to enter into the market on both sides of the transaction unlocks trapped liquidity. It also can help the buy side to enter into longer dated trades that are needed for the banks' funding ratios.

An in-house collateral treasury function also provides a buy-side firm with alternatives. The buy side can build large cash balances to meet variation margin calls, but this buffer may interfere with investment strategies. For example, if an asset manager holds excess cash in its portfolio, this could adversely affect fund performance. With an in-house collateral treasury function, the buy side has an alternative source for this cash buffer. In the event of increased cash demand, the collateral treasury function would convert assets into cash liquidity when needed, and the fund manager can keep its investment strategy on course.

Holding cash can have other adverse consequences. Typically, the banks that receive the cash do not want to hold it, and the buy side would also have a depository risk to the institution holding the cash. In most cases when the bank holds cash, the cash is part of the bank's property. Should the bank fail, the buy side would be an unsecured creditor to the failing bank holding the cash.

We do see the buy side using money market funds to help mitigate this risk. The buy side purchases the money market funds and if needed transfers the money market funds as collateral in exchange for securities in a securities lending transaction. If the money market funds are not sufficient, then the buy side could, if permitted, revert back to purchased high-quality liquid assets and use this in the repo market if they have access.

What are the tools available to help with documentation, trading and post-trade operations?

Industry standard documentation is a resource that can help buy-side participants when establishing a collateral treasury function. These documents are in line with industry standards. By leveraging these, the buy side has access to the legal opinions and updates for these documents. The challenge the buy side faces is the amount of documentation needed. If you are a fund with multiple legal entities, say 10 entities, and want to trade stock loan and repo with 10 counterparties, you will have 200 documents to sign.

This is a challenge for the industry, and we are therefore working on alternatives to this.

On the trading side, the buy side does need to connect up to the market. The sell side has established sales and trading desks and an information advantage over the smaller scale buy side. The market is developing peer-to-peer or buy-side to sell-side offerings to facilitate this. This is an area in which BNY Mellon is active.

The post-trade side is easier because the triparty structure helps with post-trade operations. Triparty makes this process very efficient, so that the buy side's collateral treasury function can focus on trading and not on post-trade operations such as settlement, corporate actions and collateral optimisation and substitution.

Documenting the triparty activities is straightforward, and the buy side can settle collateral obligations by signing one collateral management master agreement. After signing that document, the collateral provider only has to agree its collateral profile with the counterparty or trade using a pre-defined collateral set. **SLT**