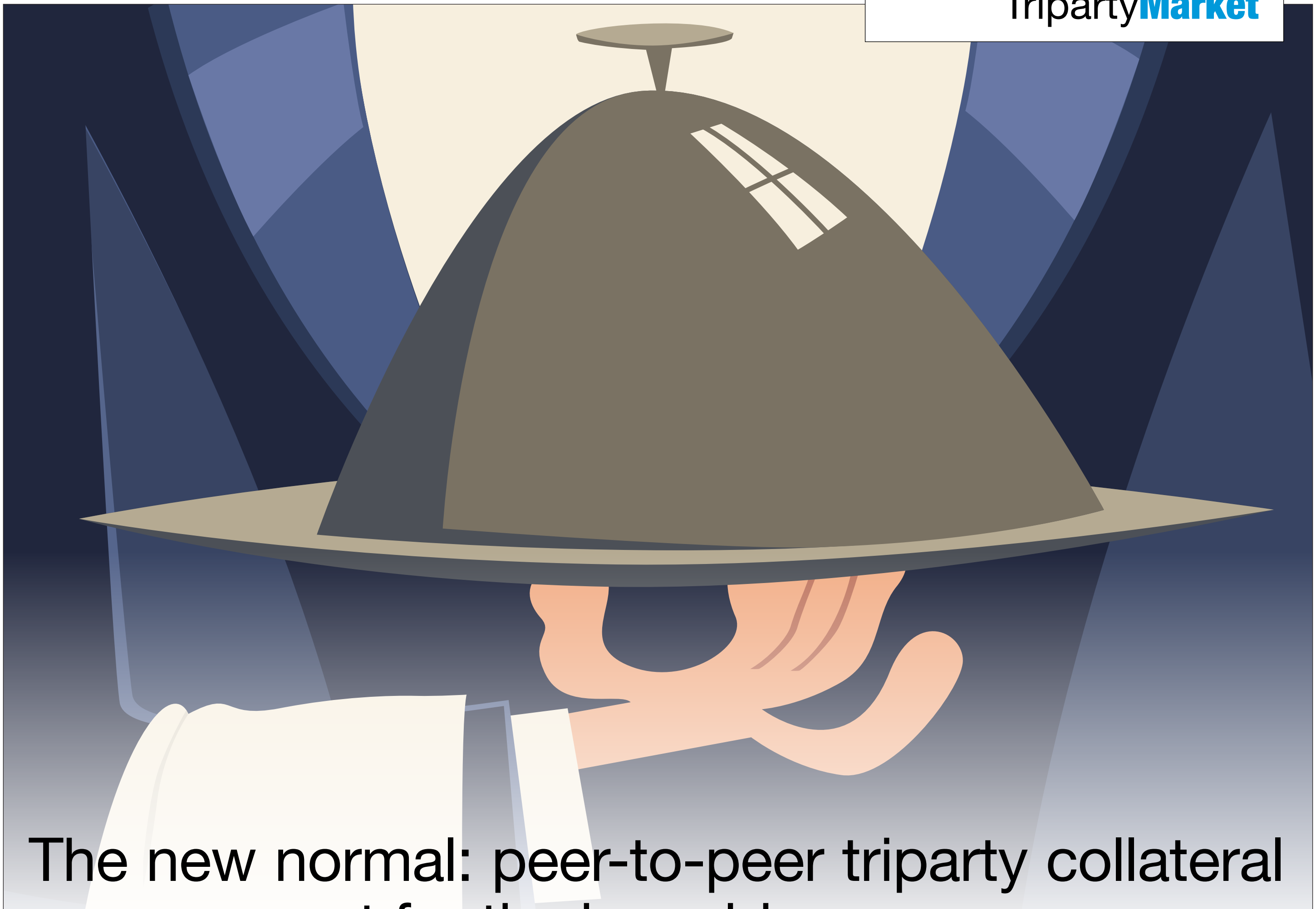


The new normal: peer-to-peer triparty collateral management for the buy side

Collateral is the currency of the capital markets and flows through more transactions than ever before. The buy side is looking at a new horizon, where new thinking, approaches and strategies are key to a successful future, says Staffan Ahlner of BNY Mellon

The financial crisis demonstrated that collateral is critical to managing liquidity, counterparty, credit and market risks. In the years following the crisis, regulators worldwide have defined the use of collateral in various markets. With these new regulatory guidelines, financial institutions worldwide are now focused on managing collateral as a front-office function to drive performance improvement and manage risk.

Structural shifts in the market are changing business models in the financial industry. We have seen how the cost of capital has reduced trading activities of broker-dealers and banks, making them more selective in how they choose to use their capital in triparty transactions. This change in behaviour has a significant impact, because the demand for triparty collateralised transactions has not gone away but instead has shifted to the buy side. Though we have not yet seen the full impact of the various regulations, the larger, more sophisticated buy-side clients are increasingly exploring how to utilise triparty for their collateralisation needs, looking to the techniques that the sell side has been using over the past two decades.

Traditionally, the buy side participated in triparty programmes as collateral receivers, collateralising their non-cash lending or serving as cash providers in a triparty programme. Pre-2008, there were some large hedge funds entering the market as collateral providers, but the buy side remained predominantly in the collateral receiver camp. Today, buy-side firms are more frequently becoming collateral providers as balance sheet constraints of some sell-side firms prevent them from entering into triparty transactions.

As always, the financial market shifts and finds alternative ways to gain efficiencies. In this case, it's the emergence of the interest in a peer-to-peer triparty model, in which buy-side firms are both the collateral provider and receiver. In this brave new world, the buy side needs to look at collateral management holistically in order to succeed.

Triparty efficiencies

The triparty market was developed by sell-side demand to create an efficient collateral technique, and sell-side firms have for decades been perfecting how they operate and gain efficiencies. The efficiencies of triparty are mostly realised in the repo and securities lending markets. According to the International Securities Lending Association's (ISLA) Securities Lending Market Report (December 2014): "Triparty collateral management is [an] intergral part of non-cash collateral management. Of the estimated €850 to 900 billion of non-cash collateral received by lenders the vast majority was held and managed by specialist triparty collateral service providers."

The efficiency and success of triparty collateral management lies in its operating model and scale. The triparty operating model includes the ability to settle collateral on a books-and-records basis which provides settlement efficiency while reducing settlement risk. With this books-and-records model, the triparty mechanism allows the collateral provider, whether from the buy side or the sell side, to effectively trade its securities inventory and use its fully paid-for securities as collateral with reduced settlement risk. Scale allows a triparty collateral manager to invest in automated processes that can be utilised by its participants (buy side or sell side) at a lower marginal cost compared to the triparty participants investing in their own collateral technologies. Triparty also allows for full traceability of any collateral transaction in the triparty system.

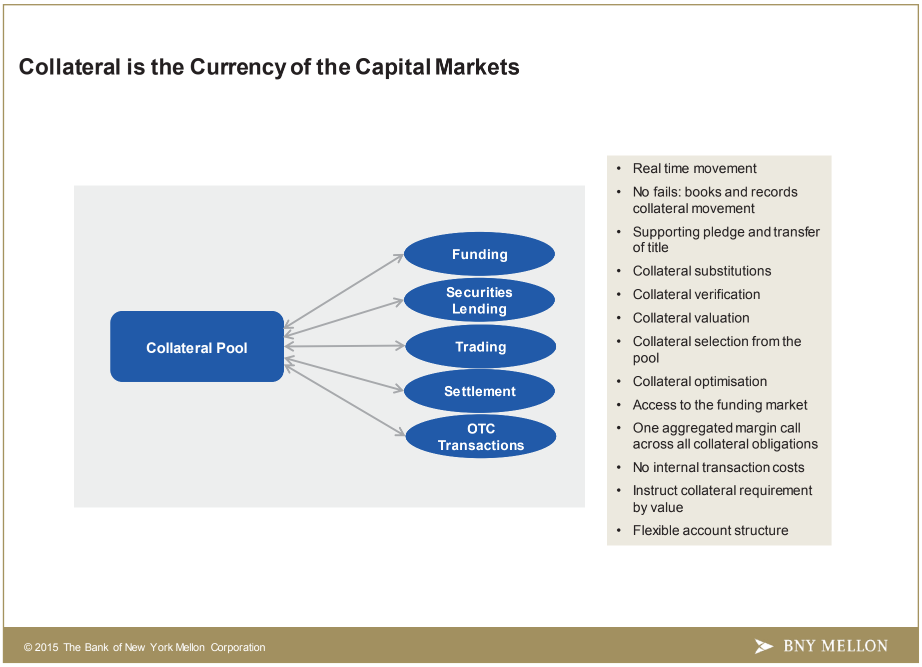
Challenges for peer-to-peer triparty

What are the challenges in this new buy-side peer-to-peer triparty environment? Some challenges will be similar to those experienced by the sell side, such as the ability to post initial margin and raise financing for variation margin. Other challenges will be unique to the buy side, such as those involving scale and the efficiencies built in response to it. More buy-side participants are entering into triparty transactions, but they haven't built up the volumes experienced by the sell side. With high volumes of triparty transactions, the sell side has developed the internal processes, systems, reporting and expertise required to operate efficiently, whereas many buy-side triparty participants traditionally handled triparty transactions as part of a securities lending programme through their custodians.

In this new environment, where the buy side will become more actively engaged in triparty collateral management outside of traditional securities lending, participants will need to effectively manage collateral. This includes efficiently allocating collateral, mobilising inventory and sourcing through various liquidity and financing tools. Yet another challenge in this new peer-to-peer environment is that not all buy-side firms are equal. They have different trading patterns, asset holdings, risk appetites and regulatory guidelines that they need to follow.

The buy side is facing a complicated collateralisation environment. The traditional method of delivering collateral bilaterally across a custody network and agent banks has, up until now, been a common choice, but with the increased complexity, there is a need for increased efficiencies similar to those experienced by the sell side. We suspect this is why we are seeing increased interest from buy-side firms to enter into the triparty market as collateral providers.

With all of these challenges, a successful collateral management programme for a buy-side participant depends on building up internal knowledge and infrastructure, or outsourcing functions to a collateral management service provider and leveraging this provider's specialised expertise, processing and technology. Buy-side participants can turn to an experienced third-party triparty collateral manager, such as BNY Mellon, for guidance and support. For example, BNY Mellon combines its broad-based knowledge of buy-side trading activity, portfolio composition and operational requirements with its collateral management



technology services and reporting capabilities to build triparty programmes that can work for the diverse group of pension funds, hedge funds, insurance companies and asset managers that comprise the buy side. We can take each client's individual operating model into account and implement a triparty programme that can work with its trading and portfolio needs and individual risk profile.

The currency of the capital markets

While the regulations that requre collateralisation of additional financial transactions are not yet in full force, assessing and preparing for the changing marketplace is essential. We see an increased interest in peer-to-peer buy-side triparty arrangements. The key to developing an efficient and successful approach to triparty collateral management involves looking at it holistically rather than focusing on a particular transaction type or the need to interact with a new counterparty. The collateral markets are similar to an ecosystem, where the inhabitants are interconnected and interdependent in many ways. A regulation that may not affect one buy-side participant might affect its counterparty and upset the delicate balance of a triparty collateral relationship.

It is important for buy-side institutions to understand the implications of market reforms, assess their readiness and be proactive. Buy-side institutions are not alone in this new environment, and they can work with third-party collateral managers to structure a triparty programme that leverages scale and expertise while acknowledging individual portfolio, trading and risk profiles.

Collateral is the currency of the capital markets and flows through more transactions than even before. The buy side is looking at a new horizon, where new thinking, new approaches and new strategies are the key to a successful future. **SLT**

Collateral management: a checklist

- Do you have the processes in place to determine which collateral to use and where?
- Are you evaluating the operational aspects of holding collateral?
- What are your strategies for optimising collateral and posting more efficient collateral against your obligations?
- Are you ready for the operational challenges of managing more collat-eral for transactions?
- Do your plans cover the adequacy of collateral relative to your posting needs?

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