



The future of collateral redefined

As ghosts of the past drive the present day approach to collateral, what does the future hold? Staffan Ahlner, global head of Collateral+ at State Street Global Markets, provides some answers

The Global Financial Crisis in 2008 made the importance of collateral management apparent to both individual firms and the financial system as a whole. Collateral has consistently proven its resilience in times of turbulence whether caused by bank defaults, pandemics or due to unprecedented macroeconomic shifts. Organisations with efficient and effective collateral management sustained their operations through challenging times. Organisations that understood the turbulence and were prepared could take advantage of the changes to modify their working practices and behaviours to dramatically reshape and increase business.

Meanwhile, collateral management has adapted to the economic changes, regulatory developments and the evolution of technology. Service providers must continue to search for improvements and new ways to solve challenges, while maintaining their core role of protecting against risks in order to maintain the financial security of their clients. Collateral management, if done well, not only solves risk but also provides incremental revenue opportunities. However, if done poorly, it increases risk, drains liquidity and increases a firm's capital requirements with high operational and opportunity costs. It is, therefore, not surprising that collateral management must continue to evolve, with innovation at its core, to continue to find alternatives for each shift in the paradigm.

Sell-side demand caused innovation

Collateral was first widely used by the sell-side as firms needed to maximise their investment activities despite increasingly scarce resources. Regulatory pressures then added further incentives for them to optimise their activities, while economic pressures forced the same firms to seek ongoing incremental returns. As a consequence, several collateral tools and processes were developed for the sell-side and, for the most part, processes are still shaped around their needs. However, these changes were not without challenges, — which is apparent considering it took over a decade for many sell-side firms to merge fixed income and equity collateral for use to meet obligations arising from the same trade type.

Some progress

Most sell-side firms have now merged the post-trade processing for funding, with many now having combined securities lending for equities and fixed income. The post-trade management teams for derivatives are often still outside of these centralised functions and it is only over the last few years that we have seen leading sell-side firms set up resource management units that bridge the disciplines.

Contrast with buy-side approaches

The buy side, however, does not share the same historical divisional split, considering post-trade centralisation is taken for granted for many buy-side firms. Additionally, hedge funds, asset managers and asset owner firms have access to securities according to the type of trading activity they undertake; as opposed to a sell-side firm that sources the collateral to be used by means of re-use or securities lending.

While for buy-side firms, some of their collateral management focus has been driven by risk mitigation, much of this has developed as a result of the regulation governing their counterparts on the sell-side. The regulation, however, has recently begun to impact the buy-side firms directly. With this background and the lack of clear financial incentive, many buy-side firms have relatively underdeveloped collateral functions that are yet to build or access scalable, automated processes and technology.

However, the buy-side is working more closely with their global custodians than their sell-side cousins. Several buy-side firms need holistic solutions that cut across the full range of collateral optimisation capabilities. But for a majority, who are now only about to come under regulatory obligations, an initial compliance-based approach makes sense, while ensuring that they have the options and approach to add further elements as requirements evolve.

The future offers an opportunity to thrive

Collateral is about thriving. Therefore, achieving

the base level of compliance is just the beginning of the journey. Each firm will have its own path as it develops operational workflows, settlement automation, analytics and optimisation engines and access to the funding solutions it requires. Stepping back to ensure an understanding of the broader ecosystem, the organisation's role in the ecosystem, and the objectives in the long term, are as key to developing a collateral strategy as they are to any part of a business.

For custodians, in their role as service providers, it is important to develop a deep understanding of their clients' business, capabilities and objectives, as well as leveraging the latest technology and market utilities to help guide firms at all stages of the collateral development spectrum. At State Street, this has led us to build a brand new cloud-enabled platform with a modular approach that connects clients to all key market utilities, as well as future proofing their collateral optimisation and analytics needs. Organisations do not want to pay for services until they are required. Therefore, enabling this approach gives us flexibility to cater to a client's

current compliance need while providing ease of access to future pre and post-trade optimisation tools that keep down the costs of compliance in a margin-sensitive environment. The final pillar to the State Street Collateral+ service is provided by direct access to financing markets via sponsored and peer-to-peer repo, securities lending and cash reinvestment alternatives such as Fund Connect.

Delivering the product is just the first piece. Staying connected to our client's business – past, present and future – is what enables a custodian to help deliver the right services and products to meet a firm's needs as it grows and the revenue enhancement opportunities accelerate.

As we look to resolve the golden triangle of collateral challenges: inventory visibility, optimisation and mobilisation, the focus of work moves to crystallise the benefits coming from asset digitalisation. The next generation of securities financing tools bring with them much greater flexibility in digital form, further enabling collateral's ability to reduce credit risk and enhance returns.



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*Staffan Ahlner
Senior vice president and global head of Collateral+
State Street*