COLLATERAL OPTIMISATION

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EXECUTIVE SUMMARY

Up to €40 billion in equity capital gains

Basel III and Dodd-Frank have reined in banks by requiring them to assign more equity capital to cover risks and strengthen their solvency in times of crisis. The new regulations necessitate assets to be weighted according to risk so that their impact on the balance sheet can be more accurately assessed. Adequately securing risk via collateral provides appropriate risk mitigation in line with regulatory requirements and therefore reduces the quantity of equity capital to be allocated. This study demonstrates that the implementation of a collateral value chain would allow European banks to save up to €40 billion in equity capital. The regulators are also urging banks to protect themselves against a potential liquidity crisis by setting aside a quantity of High Quality Liquid Assets (HQLA) that can be sold quickly for cash. The challenge here is to access and mobilise liquid assets and to establish the organisation, legal framework, the liquidation (sale for cash) or transformation (asset swap) procedures that might need to be used.

The rise of a new holistic practice across business models

Collateral can be defined as any asset, securities or cash, given as a guarantee by a debtor counterparty to cover a risk, exposure or to fulfill a regulatory or, prudential risk requirement or an economic obligation. In the broadest sense of the word, collateral can be considered as an asset associated with:

- A liquid market (e.g., bilateral repo, triparty repo, securities lending)
- A process (e.g., cleared/non-cleared through a CCP, posting to a central bank)
- A legal contract (e.g., CSA, GMRA, CRC, GMSLA)
- Specific risks (e.g., CVA, FVA, etc.).

Collateral management and the optimisation thereof is a new discipline that maximises the effectiveness of the guarantees. Collateral management is relevant not only for financial institutions (investment banks, private banks, wholesale banks, central banks and global custodians) but also buy-side firms (asset managers, insurance companies, supranationals, pension funds and even industrial corporates); These entities hold and manage collateral both in connection with the collateralisation of OTC derivative activities (providing securities to cover IM obligations) and in connection with the management of their treasury positions (receiving securities to secure financing obligations).

Collateral value chain: a strategic choice for survival

Even if the objectives of financial institutions and buy-side firms diverge significantly, the best lever for enhancing collateral management involves a value chain, that is to say the implementation of a succession of sequential steps that make it possible to select securities, to ensure their availability and mobility as well as the robustness of the liquidation process. This study defines “optimisation” as the complete process from the assessment of collateral needs and constraints governed by group policies to the final effective allocation of eligible assets.

The best lever in a “truly chaotic” environment

Collateral management and optimisation (an activity close to treasury, ALM and risk management functions) is now organised to comply with all-powerful regulations and an economy whose convalescence will continue for the long-term under the influence of unconventional central bank monetary policies. This study demonstrates that the major European players are choosing to optimise collateral as their best lever to remain profitable and to cope with volatile financial flows.

Clearstream’s Global Liquidity Hub maximises the effective use of collateral

ICSDs such as Clearstream supply powerful tools and services to manage and optimise the effective use of securities. One of the key missions of the Global Liquidity Hub is to reduce collateral fragmentation by:

- Improving access to liquidity sources and to collateral pools
- Facilitating access to new collateral counterparties
- Creating links to CCPs, central banks and systemically important market infrastructure
- Optimising the access to and mobilisation of house or firm positions
- Optimising collateral and creating efficient re-use processes
- Providing flexible access to markets.

The need to include collateral management services to the operational chain of market players has become a fundamental strategic issue. Through the achievement of regulatory, prudential or financial goals, Clearstream offers a key partnership that permanently shapes the economic model of stakeholders.
COMPOSITION OF THE PANEL AND METHODOLOGY

Study objectives
The survey consisted in gathering the responses of European market players on the status of their current organizational set-up and their views with regards to collateral management in terms of liquidity and capital gains. The authors have endeavoured to be faithful to the opinions expressed by the interviewees (text in blue italics in the study). The objective was not to provide a technological benchmark but to present valuable solutions that could be adopted by market participants.

Methodology used
The survey consisted of a combination of open-ended qualitative interviews and a quantitative questionnaire, each containing 25 questions and the survey results are based upon the analysis of the responses provided by a sample of 22 institutions. The survey was conducted during the first quarter of 2014.

Questionnaires
The topics covered encompassed:
- The strategic positioning of the firms
- The challenges they faced in regards to collateral optimisation
- Their main focus for 2014 and the impediments to the development of a collateral value chain across their firms.

Structure of sample panel
The panel was designed to provide a good balance of market entities from different countries and market segments taking scale, volume and market concentration into consideration.

The panel represents around 20% of the balance sheet of European banks, i.e., €6.5 trillion out of a total of €30.8 trillion. Eight of the top 30 major banking players judged “systemic” by the European regulator were included on the panel.

The authors would like to thank all the study interviewees for their gracious participation and the quality of their contribution.
Under the “fair value” notion, the new IASB and IFRS13 accounting standards introduced CVA and DVA as new adjustment measures that integrate the market prices of OTC derivative portfolios and the market price of counterparty risk into bilateral negotiations.

CVA - credit value adjustment

CVA (Credit Value Adjustment) is the market value of counterparty credit risk = the difference between the “default risk-free” value and the value that takes into account the possibility of the counterparty’s default.

CRC - Clearstream Repurchase Conditions

This is a legal master agreement for triparty repo transactions developed by Clearstream to enable market participants to sign just one contract for multiple counterparties and speed up counterparty “marriage broking”. The CRC is governed by Luxembourg law and effectively enables customers to be able to trade with their chosen counterparties within just a few days and save legal costs.

DVA - debit value adjustment

DVA is a measure introduced to align the symmetry of prices and take into account the risk of bank default. It depends on factors specific to bank credit:

- The probability of default, market spread, the rate of recovery in case of failure, etc.
- When the bank fails to meet its commitments on cash outflows of its derivatives portfolio (partial payment of a coupon, a deadline not met, etc.)
- When the bank fails to meet its commitments on one of its liabilities (short-term or long-term debt).

CVA and DVA are not symmetrical.

FVA - funding value adjustment

FVA is a correction applied to the price of a financial product to take into account the costs of bank financing. It applies in particular to unhedged or not fully hedged derivatives transactions in the OTC market. It is the cost of financing hedging positions (with or without CSAs). In other words, it corresponds to the difference between the amount of collateral collected by the CSA and the “perfect CSA” multiplied by the funding spread (standard rate found when the financing rate is higher than the risk-free rate). FVA may represent a cost or a “benefit” as the collateral received may be monetised or used to reduce exposure.

CSA - credit support annex

CSA is a contract appended to the relevant master agreement. In general, it specifies:

- The frequency of margin calls according to the related volatility
- The threshold: this is the maximum threshold amount for which the company agrees to bear risk without collateral (depends on rating of the counterparty)
- The minimum transfer amount (MTA): it defines a minimum trigger amount for margin calls
- The haircut: adjustment (+ / -) applied according to the characteristics of the security used as collateral
- Rounding: to avoid decimal places.

Imperfect CSA

This is when an FVA is needed on collateralised transactions when the parameters of CSA (see above for the definition of CSA) imply inadequate levels of collateral collection i.e. a situation which does not allow a bank to secure its exposure against the risk of counterparty default.
Perfect CSA

Perfect CSA occurs when collateral thresholds paid and received are nil and when the entire collateral can be collected instantly.

RWA – risk weighted assets

Evaluation of asset related risks held on the balance sheet. The RWA level depends on:
- The business model
- Risk management models
- IT infrastructure and data quality
- Supervisory practices
- Accounting standards.

More precisely, RWA is an internal based model that relies upon:
- Counterparty credit risk (CCR)
- The capital charge for potential mark-to-market losses of OTC derivatives (CVA)
- Asset value correlation (AVC) in the internal ratings-based (IRB) approach for exposures to regulated and non-regulated financial entities
- Capital charges for specific wrong way risk
- Collateral management and margining relief.

HQLA - high quality liquid asset

Cash or assets that can be converted into cash at little or no loss of value in private markets to meet liquidity needs for a 30 day liquidity stress scenario.

LCR - liquid coverage ratio

The Basel Committee has developed the LCR to promote the short-term resilience of the liquidity risk profile of banks by ensuring that they have sufficient HQLA to survive a significant stress scenario lasting 30 days. In other words, LCR estimates the gap between the amount of available high quality liquid assets and the total net cash outflows over the next 30 days.

Liquidity buffer

This is the pool of high quality liquid asset (HQLA) that is unencumbered, transferable and compliant with prudential liquidity requirements. Liquidity buffer management is performed from the analysis of the balance sheet of the bank onwards to measure, analyse and manage liquidity risk and the associated interest rate and forex risks.

There are basically two buffer levels:
- Buffer level 1: cash + central bank deposits + sovereign debt (0% risk weight in the calculation of RWA)
- Buffer level 2: other sovereign debt and equivalent securities (weighted 20% in the calculation of RWA) + corporate bonds rated at least AA-.

Cheapest to deliver

This refers to the cheapest security to deliver irrespectively of the market and instruments concerned. This goes beyond simple valuation criteria and demonstrates that “good” collateral is not necessarily the cheapest but that which fulfils all of the objectives (availability, opportunity cost) and constraints (eligibility, sufficiency) that the user, stakeholder or regulator assigns to it.

Collateral value chain

This is the succession of processing steps (selection, mobilization, aggregation, transformation, optimization and liquidation of collateral) that make it possible to select eligible securities, to ensure their availability and to guarantee the reliability of the route of liquidation or transformation. The collateral value chain is a part of the overall collateral management process and consists of:
- Definition of needs and constraints
- Implementation of a robust collateral framework
- Operation of an efficient daily collateral process.
The objective of Part I is to demonstrate that the optimisation of collateral is a primary concern for banks and other players as it significantly enhances capital and liquidity.

**Equity capital: compliance**

The European banking market estimates that compliance with a core Tier 1 solvency ratio of 9% as imposed by the Basel III prudential rules requires banks to maintain equity capital of between €110 and €280 billion. However, the ECB’s Asset Quality Review (AQR), due to be published soon, is likely to push this figure much higher.

In recent years, European banks have increased their equity capital by more than €200 billion by transferring a portion of profits to reserves. Moreover, €25 billion of additional funds have been raised on markets through the issuance of new shares and hybrid debt since the summer of 2013 while in the same time, the aggregate capital requirement has been reduced by €50 billion, exactly the amount and convergence that the Director of the International Monetary Fund (IMF), Christine Lagarde, called for two years previously. However, the figures show marked regional disparities: 40% of the total equity capital is accounted for by banks in southern European countries and Ireland (sometimes refers as GIIPS or “peripherals”) - while €20 billion concerns Italian banks alone.

Faced with these new standards and a notable deleveraging in the market, it is widely recognized that improving the solvency ratio (equity capital/RWA) is an effective measure of efficient capital utilisation.

Incidentally, one of the best-placed levers for optimisation is active portfolio management particularly when this includes the implementation of risk coverage strategies; in other words, the taking of collateral as a guarantee or risk mitigator implicitly requires the active management of incoming and outgoing collateral.

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(1) Full Basel III implementation.

(2) Capital structure under Basel III = common equity Tier 1, additional Tier 1, Tier 2.
Liquidity: compliance

At the same time as improvements to equity capital were made, European banks embarked on considerable work to meet LCR requirements. This compliance work was achieved through a deep restructuring of activities, organisation and use of resources including an increase in deposit-taking and a reduction in credit usage. The intensity of the effort made by the banks since 2011 has been clearly demonstrated: the average LCR is currently 104% for the first group (G1) and 132% for the second (G2): more than 58% of banks in G1 are at 100% and 69% in G2.

Internal challenges for collateral activities

The optimisation of equity capital management, the development of better access to liquidity and the management of operational costs are the focus of everyone’s attention. For banks and other market players, the internal challenges are huge and require a restructuring of the internal business model to enable new objectives to be achieved.

Fig. 2 – Change in LCR by bank group (%) EBA monitoring

![Chart showing change in LCR by bank group]

Fig. 3 – Internal business model evolution

GLOBAL MACROENVIRONMENT
- Market mistrust
- Central Banks: QE / Monetary policy
  => dramatic changes in flow dynamic

INCREASED DEMAND FOR COLLATERAL
- Needs to adapt its strategy
- Liquidity access, Funding, Cross-asset, HQLA, Processing strategy, GMRA-GMSLA, CSA, CVA-DVA, FVA

REGULATORY ENVIRONMENT
- Basel III: LCR, leverage ratio, intraday, metrics
- EMIR-Dodd Frank: derivatives margining
- ESMA: re-hypothecation, re-use
- FSB shadow banking: reporting, haircut
- Etc.

OBJECTIVES: Collateral management set-up must
- be compliant with new regulations
- provide liquidity as a result of a calibrated buffer with robust and diversified processes
- be optimised (gathering and asset utilisation)
- be profitable (cost control and profitability generation)

(3) G1 & G2: banks typology adopted by EBA for LCR monitoring purposes. Group 1 banks are banks with Tier 1 capital in excess of €3 billion and internationally active. All other banks are categorised as Group 2 banks. Among the Group 2 banks there are 21 banks that have a Tier 1 capital in excess of €3 billion but are not internationally active.
Elton-Pickford

External challenges: an evolving ecosystem

As a consequence, we can see a major shift in the balance of the new “collateral ecosystem” involving many players searching for a new strategic positioning: on the one side, we see asset managers, large corporates and supra-nationals, while on the other, we see market infrastructure such as central banks, ICSDs, CSDs and CCPs which now have a leading role to play in the restructuring of the post-market landscape alongside the banks and global custodian banks. The restructuring is organised around two concepts whose boundaries are increasingly blurred: partnership and competition.

96% of the sample consider that the collateral market meets the definition of an ecosystem in the sense that it is business formed by an association of entities that interact with each other and with the environment and that it has specific rules, codes and its own dynamic.

Fig. 4 – The shift in balance of the ecosystem
Building a value chain

A bank’s capacity to meet its obligations in times of stress is represented by setting aside a certain amount of available liquid assets equal to the value of the obligations, i.e. by building a liquidity reserve. This is the second key element of Basel III after the strengthening of equity capital. Our average estimate of the amount of liquidity reserves is 8% to 15% of the balance sheets of the banks surveyed for this study. This means that some of the banks that we interviewed held liquidity buffers in excess of €200 billion.

Managing this new constraint is a complex process and a decisive organisational component. It implies the development of an industrial cycle of collateral management that we call a “high quality liquid asset value chain” within the banks.

The impact of the shift in collateral management activities on the securities industry ecosystem balance is massive both in terms of market structure and settlement flows, as we shall demonstrate further.

Our valuation of the capital savings for European banking system made on the basis of the implementation of an optimised collateral value chain
PART II: INTERNAL BUSINESS MODELS

The objective of PART II is to show how various business models are developed on collateral management although their objectives diverge significantly. Organisations rely specifically on three pillars:

- The back-office
- The front-office
- Prudential and regulatory compliance.

Fig. 5 – Collateral Management Machine: components and orientations

The Collateral Value Chain includes:

- **Client Collateral Management**
  - CSA IM VM
  - Risk
  - CVA FVA
  - EMIR - Dodd Frank
  - Trade repositories

- **Funding, Financing & Transformation**
  - Treasury - ALM
  - Money-market
  - RI – EQ trading
  - Agency Lending
  - RWA impact
  - Deleveraging impacts

- **Prudential Collateral Management**
  - Treasury-ALM
  - LCR, NSFR
  - HQLA
  - Liquidity buffer
  - Time to cash=0

**Back-office**

**Front-office**

**Prudential LIQUIDITY DESK**

**Asset Pool**

**Liquidity**
Global players

The specialisation of the activities dealt with and their relative independence from each other mean that collateral management and the optimisation of this process has to be carried out in several entities (silos) and under the constraint of radically different individualised objectives. This state of facts leads to several levels of optimisation: functional, operational and geographical. In terms of positioning, collateral is unanimously considered a new asset class: “like a currency associated with new risks, with its own dynamic; this makes it essentially an FO activity where the capacity to take the risk means you can capture the P&L of the collateral part as well as the investment part (purchase of asset) posted to the balance sheet”. The elements mentioned above mostly concern business lines that have the primary objective of profitability and the creation of a customer franchise (e.g., equity and fixed income).

Equity finance

Faced with the volatility of the markets observed in recent years, equity activities have been overhauled with firms looking to improve their ROE by increasing profits and reducing capital consumption. The constitution of cross-border and cross entity securities pools and the implementation of active collateral management processes have been the preferred tools of this reform. In the majority of banks, the key discussion point remains whether the market has entered a new equity cycle that is also a sustainable bullish market. Collateral management will therefore be central to the aim of achieving an equity capital saving on the activity and meeting expected revenue targets.

Fixed income

For the bond business, collateral management, as a standalone function, has provided the necessary financing to develop its business line (often its primary objective), depending on client activity and the management of the group’s own assets. “Books of ‘basis’ and ‘relative value’ financing needs have been addressed by evergreen, medium-term triparty repo or long-term repo agreements with insurers or asset managers: corporate and high yield bonds, ABS, CLO have been dealt against liquid assets or cash”. Collateral optimisation is dependent upon three key elements: prudential management, profitability and processing. Currently, the main constraint on this business line is liquidity; the primary objective of a fixed income business is to generate a positive P&L function, with a low consumption of RWA. However, the substantial drop in average fixed income revenues since 2009 means this activity remains highly vulnerable. The regulatory constraints, in particular the leverage ratio, are felt most acutely here, with some observers bluntly describing them as “lethal”. The regulator has laid down its framework and as a result, players are adapting and promising a tight future competition: “certain core activities of the sector are going to assume the unenviable status of loss leaders while others are going to emerge forcefully into the new paradigm. Whatever the case may be, real strategic choices are being made and are going to mark out a new positioning of all the players”. The combination of low anticipated growth across the sector (short term rates supposedly remaining low for the next two years and uncertainties on quantitative easing policies) along with heavier regulation creates a crucial need for optimisation. Taking this into perspective, the management of collateral is unquestionably the most critical aspect of any solution.

What is the amount of collateralised assets that your establishment manages at ICSDs?

- Less than €10 billion: 19%
- €10-50 billion: 22%
- €50-100 billion: 28%
- €100-200 billion: 19%
- More than 200 billion: 12%
The third source of collateral optimisation in global institutions comes from treasury, often coupled with short-term asset and liability management (ALM), the role of which is to manage the balance sheet of the bank. In addition to the central treasury functions, organisations (depending on the size of the bank) also have local treasuries that deal with domestic issues such as the convertibility of currency, specific operational and regulatory constraints, time-zones etc. Treasuries work in synergy with sovereign collateral policies and have three main objectives:

- To protect the bank from a liquidity crisis
- To play the role of the lender of last resort for the business lines, and
- To comply with regulations.

“Steering and managing the LCR buffer involves creating the capacity to mobilise this buffer efficiently when and where the bank needs it to support funding”.

Upstream, treasury activity hinges around the sourcing of securities, the centralised compilation of collateral requirements as well as the allocation and optimisation of eligible positions. "Therefore, collateral management draws on a centralised approach, in the sense that there are group principles and a central vision of collateral while monitoring and liquidity management procedures are local". The goal is therefore no longer the creation of a “physical” centralised collateral pool which would be at odds operationally with an environment in the process of “balkanisation” (legal aspects, specific geographical features). Improving the liquidity profile of banks is also achieved by extensive work on cost reduction. Indeed, the liquidity buffer is a strategic and little used emergency device with high set-up and maintenance costs (test, back-up etc.) but it is an unavoidable part of a firm’s inventory management process in this new regulatory environment.

For many banks, one of the essential challenges in 2013 has been to build an accurate inventory (mapping) of securities held in custody. “To ultimately determine what securities are LCR-eligible on the one hand, and central bank-eligible on the other, with the associated haircuts, all integrated into a real-time front office tool”. This work has been facilitated by the use of a broadly accepted definition of HQLA in the European Economic Area. However, it is a completely different story outside the EEA where the definition of HQLA remains subject to local interpretation.

2014 is about implementing operational procedures (entity by entity) and policy elements in order to have the capacity to monetise the buffer. This means in particular:

- Optimisation of access to markets (private, NCB, CCPs)
- Opening of new liquidity routes
- Optimisation of local custodian networks in the context of T2S
- Optimisation and standardisation of asset transfers (inter-business and inter-company in particular).

A “fully-optimised” process

For any organisation aiming for a “fully optimised” collateral process, the first challenge is to ensure its equity, fixed income and treasury businesses are all working together in what could be termed a collateral value chain. The rationale of this model, both organizational and economical, should be to build a set up aligned with the banks’ overall activities.

“The model of the future is an ex-ante optimisation model in which collateral is the appropriate unifying lever structuring both liquidity and the balance sheet.”

The generally accepted parameters used to describe a “fully optimised” organisation are as follows:

First and foremost, optimisation of:

- Regulatory compliance (LCR compliant, EMIR etc.)
- Scope (gathering, HQLA pool)
- Organisation (silos and centralisation, local and global)
- Workflow (cheapest collateral to deliver, possibility of netting)
- Revenue (alpha creation)
- Cost management.

To move towards:

- Minimisation of capital costs
- Minimisation of cost of funding/liquidity (FVA impact)
- Minimisation of cost of credit risk (CVA impact).

How would you assess the costs (financial cost, time, energy) required to achieve your objectives?

- High or very high: 85%
- Low or very low: 15%
Local players and specialists

Small to medium-sized banks (Tier 2 and 3), broker-dealers or specialist regional banks also link collateral management to their equity, fixed income and treasury activities. Nevertheless, the prudential driver always prevails, coupled with a tighter centralisation of collateral (in particular for broker-dealers), by simply mirroring the geographical proximity or small number of entities within the group. At the far ends of the spectrum, collateral management can be strongly dependent on client activities (prime brokerage), focused for example on an agent lender specialisation where the notion of profitability is paramount. It can also take the form of a service centre for collateralised refinancing aimed at the group and the client needs. Some banks have opted for a separation of the activity with the management of securities on one side and the management of liquidity and the associated interest rate risk on the other. P&L management has sometimes been radically shaken up for these desks undergoing a “negative” internal arbitration: "optimising the bank’s liquidity profile is less expensive on the repo and collateral segment than on some other activities (retail, corporate banking etc.) where falls in profitability would be more visible".

As much as back office centralisation is no longer really an issue, front office centralisation remains at the core of the debate; either the desk is organised as a traditional business line according to asset class expertise or in a more innovative way, according to collateral expertise. The asset specific knowledge (equities, government bonds, high-yield bonds, RMBS, convertibles, loans, etc.) along with related constraints (liquidity, value, specifics of settlement, regulatory aspects, operational etc...) advocates the first solution. "So, one may ask: under what conditions would such expertise – within the same desk positioned as a cross-asset desk – be more valuable?"

This question is all the more relevant since a significant part of the added value in collateral management comes from the proximity of the core interbank market (repo market, market-making, client contacts), the centralisation of collateral management being only recommended for the close functions of ALM-treasury focused on asset management (centralised compilation of regulatory requirements and internal funding needs, HQLA issues) and steering of prudential liquidity.

What are the risks that you identified resulting from your involvement in a collateral ecosystem?
- Loss of operational independence: 40%
- Gradual loss of an overall view: 40%
- Systemic risk: 20%

Indeed, these different forms of activities are highly constrained by cost management. In more than 70% of cases, banks estimate that the portion of costs applied to the business of managing collateral represents 5% to 20% of gross revenues. It is therefore easy to understand why pooling and sharing, outsourcing or partnerships on non-differentiating activities with no strategic value currently are the preferred management choices. Many banks are weighing the outsourcing option versus direct access and the use of in house management (platforms, systems, CCP connections). As regards this issue, the choice of partner is critical. Considering the strong connectivity required between clients and collateral service providers, the choices left to middle-sized players are limited with respect to the issue of insourcing versus outsourcing. Nonetheless this question is crucial as regards capital gains improvements and operational costs reduction.
Corporates and asset managers

In this mixed category of very dissimilar players, the main issue is how to better secure the financing of the company business and increase its profitability. The prudential part is marginal for the majority of our corporates sampled.

Collateral management is still a discussed matter for the buy side: “is this an additional cost or an opportunity? Do we have to enter this market and invest in it? If so, when?” Few corporates, even the largest, have overcome the first operational hurdles, namely their ability to create an internal set-up allowing the use of securities as collateral.

However, by challenging their organisation and “simply” complying with EMIR and anticipating prudential regulation enforcement, corporates have developed links between the cash part of treasury and the securities-derivatives aspect. These include:

- More robust framework with counterparties (reporting, alerts),
- A reduction in the number of banking counterparties
- Compliance action on long-dated and sensitive derivatives (interest rates and forex)

Even though the shift of OTC derivatives onto SEFs and OTFs\(^5\) introduces a new paradigm for corporates, the induced transparency reduces the bid-ask spread on these products by 35% to the benefit of non-market-maker users such as corporates. There is one critical point raised that remains: on one hand, there is a liquidity excess in some corporates (outstanding between €1 billion and €10 billion) and, on the other, there is a presence of substantial securities portfolios (often specifically created for mandatory reasons) estimated between €5 billion to €15 billion, according to our sample. These liquidity and asset portfolios take little or no advantage of the opportunities offered by the collateral market and these, are the two major challenges.

On the cash side, we observe that corporates are taking on more and more long-term debt to become more independent on short-term liquidity, the surpluses being invested in short-term instruments (unsecured term deposits, MMFs). “This results in a costly reverse transformation, even if the price of the latter is substituted for the price of the (previous) banking commitment required to obtain a line of credit.”

At the same time, banks have considerably improved their unsecured term deposit taking capacity (with a higher pick-up) so as to exploit this LCR-compliant liquidity: for the banks most ahead on this issue, we are talking about tens of billions of euros.

We observe how paradoxical this essential shift in the market is insofar as it leads in the end to corporates funding state treasuries via banks.

Furthermore, for large corporates, we identified needs that are shifting from cash financing, which is no longer really an issue for these players, to commercial financing requirements (bank guarantees, performance bonds, and guarantees on advance payment). This commercial financing requirement is connected to a long-term relationship with banking partners (duration of projects). One of the more promising areas for large corporates to explore is their ability to use letters of credit (guarantees) and documentary credits (payment instruments) in triparty repo. This would undoubtedly be a powerful attraction for corporates towards new practices.

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(5) SEF & OTF: Swap electronic facility and organised trading facility. After the G20 members agreed that there could be advantages to regulating trading activity, the US included a requirement in the Dodd-Frank Act that: “with respect to transactions involving swaps subject to the clearing requirement … counterparties shall … execute the transaction on a board of trade designated as a contract market … or … execute the transaction on a swap execution facility…”. In Europe, MiFID II introduced in a draft proposal a broad definition of OTF: “to capture any facility or system that is not an MTF or regulated market, operated by an investment firm or market operator in which multiple third party buying and selling interests in financial instruments are able to interact in the system in a way that results in a contract.”
## The main objectives

### 1. PLAYER TYPOLOGY

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| Treasury Mgmt | 
- Clients  
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### 2. COLLATERAL ACTIVITY INVOLVED

- P&L
  - Client  
  - Funding  
  - Short covering
- Risk Mgmt
- Treasury Mgmt
- Liquidity
  - Buffer  
  - HQLA  
  - LCR
- Servicing
  - Clients  
  - Group
- Treasury Mgmt
- P&L
  - Client  
  - Funding  
  - Short covering

### 3. DRIVEN BY ...

### 4. IMPROVEMENTS MAIN OBJECTIVES

- Reduce the operational costs of collateral management
- Reduce the economic set-up costs for collateral towards just-in-time management => time savings
- Optimise collateral upgrade vs collateral downgrade spread (transformation)
- Strengthen the expertise for each class of assets making up the collateral (proximity of the core-underlying market)
- Aggregate collateral flows coming from different activities (CSA, stock loan, repo, inventories etc.) by optimising the valuation coherence
- Price the impact of the collateral in mark-to-market at the time the operation is carried out by simultaneously including all of the operational and balance sheet constraints
- Set up a “most optimal collateral to deliver” chain
- Definition and optimal calibration of the size of the LCR buffer
- Strategic and effective constitution of the buffer (HQLA excess-shortfall management)
- Use of the buffer to limit its cost (collateral up-downgrade)
- Optimise the operational management => “time to cash = 0”
  - Granular inventory of securities (HQLA)
  - Capacity to monetise the buffer (market access, custodian network, T2S, security transfers, etc.)
  - Access to private markets and central banks
  - Reporting-display: capability to publish the LCR on a daily basis in case of crisis
- Management of indirect clearing issues (clearing-member selection)
- Mobilise the collateral with a GCM (general clearing member) to manage the margin call and deposits (IM, VM) with the CCPs
- EMIR-AIFMD compliance
- Relations with sub-custodians in the context of the collateralisation of OTC derivatives
- Choose agent lender if decision to lend securities
- Choice of ATS (type: 360T)
- Secure the company’s financing and access to liquidity
- Maintaining strong partnership with the global sub custodians
- Importance of netting
- No overall and aggregate view of the collateral; no business model on collateral
- “Derivative” part - CSA: collateralisation of OTC derivatives (IR & Fx) in connection with EMIR (essentially cash); lack of resources for daily tracking (=> threshold)
- “Cash-funding” part: invest surplus risk-free (MMF, unsecured term deposit); essentially cash-rich
- “Securities” part: assets outstanding often large (regulatory) but no/ little “cultural” logic of securities lending, no adapted set-up, lack of information (price of the assets in repo).
The objective of PART III is to show how optimising collateral management depends on a processing chain.

The collateral value chain hinges on the three following processes:
- Optimisation set up and constraints
- Management framework
- Daily processing cycle.

In order to proceed with these definitions, it is necessary to note as a preamble the different uses of the LCR:
- **Level 1**: the LCR is a tool based on accounting periods (month-end/quarter-end closings); it is not a management tool; it used ex-post and is relevant for the entire bank.
- **Level 2**: the LCR managed by the treasury department; the idea is to set up a process creating an ex-ante collateral management tool.
- **Level 3**: the LCR is a day-to-day operational tool brought down to the level of the business lines as a transaction analysis parameter. It measures the capital consumption per transaction.

As noted by many participants in the panel: “the setting of the best definition of HQLA is particularly complex because the regulator has only provided a limited framework to the countries of the European Economic Area”. For assets outside the EEA, the global players who have several multi-currency collateral pools around the world must therefore refer – according to the EBA’s recommendation – to the local regulations to establish the HQLA nature of an asset. This situation involves three major types of issues:
- The local definition of HQLA?
- The minimum buffer calibration: “What is available? What is needed?” The challenge is to measure the local net cash outflow on a daily basis in a consistent way between bookkeeping and operations
- The consolidation of the different local buffers in consideration of the group’s overall requirements.
What are the most important parameters for determining the “cheapest/most efficient collateral to deliver”?
- Constraints associated with LCR management: 60%
- Constraints associated with RWA: 25%

Set-up and constraints definition

One of the objectives assigned to collateral “is to be a centralised tool for minimising liquidity risk, compliant with the regulations, therefore implying the possession of specific characteristics”.

The challenge here is to integrate in real-time, as mentioned earlier, the best possible definition of HQLA.

The second challenge concerns the quality of the processes aimed at minimising operational costs.

Given these fundamental objectives, set-up optimisation is organised around four main points:

1. The regionalisation (local specificities and local versus global issues)
2. The calibration (size)
3. The asset composition (asset quality)
4. The stability of the resources (the buffer must be based on stable resources > 1 month and must not present any imbalances between asset structure and liabilities.

Point 4 is essential as it pushes market players (banks especially) to finance for term with a compelling focus to lock-in liquidity for at least 30 days to be LCR compliant. This heavy trend is the reason of a major market overhaul already taking place.

At this stage, the management of the haircut (variability mainly depending on CCPs) is key, to avoid creating potential risk and liquidity disruptions: “with asset volatility, the financing is not locked from the start for the full duration of the transaction”. The variability of haircuts may lead to arbitrage operations taking position constraints in CCPs and NCBs into consideration together with expenses, additional operational risks, RWA charges and counterparty risk adjustments.
Collateral framework definition

The setting-up of the collateral framework relies on the ability of the company to trigger synergies in its organisation and on choosing the best combination of parameters to take the previously mentioned constraints into account.

The collateral framework is based upon:

- Central management rules (gathering and use of assets, setting priorities)
- The asset pool fed by the company strategic business lines
- The calibration of the buffer (from the assets pool) and from the objectives the buffer must achieve
- Underlying assets traded by the front office and inventory or positions held at custody service providers (ICSDs, global custodians).

Fig. 8 – Collateral Framework
Definition of the daily collateral processing cycle

Optimisation ultimately boils down to building a sequential value chain making it possible to match needs with deliverable collateral (the "most optimal" to deliver). This consists of being able:

- To monitor the set-up of the pool
- To calibrate the level of the pool for each type of need
- To optimise the assets composition (market aspects)
- To allocate the collateral effectively.

Whilst taking into account the booking by transaction type:

- Trading book (business lines)
- Prudential book (ALM-treasury).

At the end of the chain, the most optimal collateral to deliver is determined by an algorithm that includes:

- HQLA definition + haircuts (CCPs, CB)
- RWA + CVA cost
- Cost of funding + FVA
- Transferability constraints
- Liquidity
- Rating.

In order to take advantage of the full dynamic of the environment, the value chain model should allow simulation scenarios considering, for instance, potential credit rating or liquidity changes, in order to evaluate the full impact on the pool.

Each step of the cycle generates challenges:

- STEP 1: Collect data and system coordination
- BETWEEN STEP 1 & 2: Stress tests (Group, local, intraday)
- BETWEEN STEP 2 & 3: Reliability of asset gathering rules (guidelines); ICSD coordination, local versus central optimisation axis.
- BETWEEN STEP 4 & 1: Consistency and robustness of links with NCB, CCPs, E-platforms...
Maximizing the synergies between your centres of excellence

Even if bank revenues have risen, revenues from market activities have declined on average since 2008. Trading has become an intense capital consumer and we have observed an important change in the consideration given to the commercial relationship. In this regard, we have felt “a real desire to monetise the bank’s corporate relations in order to stimulate cross-selling”. Up to this point, many establishments likened trading counterparties to clients; “today, it is going to be necessary to shift from this “completely theoretical” reality to a “true” client reality, a mini revolution at the FO level."

- Intensification of links with the sales forces
- Increased emphasis on internal optimisation features (because revenues are anticipated to go down)
- More relationships with support functions at the level of exposures, for example; we also note horizontal value chains in activities that used to be independent.

Fig. 10 – Front-Office involvement

RWA: risk management tool and macro-prudential policy tool

The advanced approach for RWA or IRBA (internal rating based approach) calculation relies on four components:

- Exposure at default (EAD): pledged sum owed to the bank in case of default
- Probability of default (PD): is the risk of the project estimated over a one-year horizon
- Loss given default (LGD): is the effective loss of the bank following recovery proceedings and collateral sell
- Residual maturity: time remaining until the end of the operation.

An advanced model developed using internal methodology leads to pricing the collateral “over the entire life of the derivative (‘at point of trade’) which involves the front office, including the CVA desks, from the beginning of the negotiation of CSAs.” Following Basel II, RWA was calculated when the trading operation was carried out and booked (ex-post calculation); “today, the integration of RWA must be handled ex-ante, as a full-fledged factor of the front office strategy.” Collateral management necessitates a shift from a portfolio manager approach to an “activity manager approach”, which coordinates many parameters upstream of the deal. The decision to strike a new deal on the market is no longer based on pricing as the exclusive parameter. Nowadays, many elements specific to the company itself are factored in, which effectively raises new issues such as the debate concerning the FVA. What is at stake here is not anticipation but a new optimisation model that collateral management has allowed to emerge at the expense of a reviewed front office/middle office/back office relationship in order to efficiently take into account all the risk parameters involved in the new environment.

Despite the difficulty related in particular to heterogeneity in the industry (dispersion ranging from one to five), the “minimising” impact of an optimal collateral management function (instrument-workflow-agreement) is indisputable in the calculation of RWA from 10% to 40%.

The banks and regulators positions must now converge to avoid a debate drifting towards RWA being substituted by a leverage ratio more favourable to US banks.
Local versus global: the end of globalisation?

“A central vision of collateral associated with local liquidation and monetisation rules”: This seems to be the 2014 model approved by internal experts. One of the stumbling blocks stressed by many participants is the “balkanisation” of the environment, which adds a political, geographical and even accounting dimension to the operational aspects of collateral fragmentation. This vision contradicts the street view according to which centralised collateral management is the preferred approach.

“Thus, an open world in which capital is allocated based on the best anticipated profitability is a bygone world buried by the FED”. The challenge is therefore to manage global activities with mixed optimisation (local and global) under the constraint of local regulations specific to each legal entity. To illustrate this comment, three banks with global operations confirmed to us that they are facing these kind of problems: “liquidity consumption and RWA consumption are global problems while P&L is local through a very independent activity; the choice of governance and of the collateral policy becomes absolutely crucial here.”

In this context, sticking to local rules and avoiding the introduction of the new systemic risk is crucial. The “ Liquidity Alliance” created by CSD’s around the globe and building on Clearstream’s collateral management solutions delivers effective solutions to meet both, local and global requirements.

For international institutions, the different accounting rules are a further challenge even if collateral movements between two geographically distinct entities of the same group are rare.

The major banks questioned anticipate a decrease in the fluidity of the allocation of capital and cash and in the allocation of assets themselves. Indeed, the increased risk of fragmentation is quite real. In reaction to this change in the model, the major establishments are accelerating their regionalisation at the level of their activities, clients and the related collateral: “the balance between global and regional needs is still a model that needs to be defined; here, the netting challenge is an essential issue”.

(6) The best example of this balkanisation at work for the last two years is the Tarullo rule, adopted permanently by the FED March 18 2014. This requires large institutions to form a holding company consolidating their activities in the USA and it will be subject to the same strengthened capital, leverage and liquidity ratios as the 24 major American banks from July 2016. They will also have to submit to the same stress tests. This rule is said to concern “15 to 20 major foreign banks” with assets in the USA equivalent to USD 50 billion or more and it also concerns, to a lesser extent, around 100 foreign establishments active in the USA and these will be subject to “prudential management standards”. This new rule deriving from the Dodd-Frank Act aims to strengthen the equity capital of foreign banks as well as their liquidity reserves while, at the same time, limiting the risk that these establishments might cause the American financial system.
The objective of PART IV is to show (a) that recent developments in the role of collateral management and optimisation have completely changed flows in repo and securities lending markets, and (b) that the increased competition for HQLA assets does not necessarily lead to premium pricing for these securities.

Fig. 12 – Global & local needs

Σ BUFFERS AND LOCAL NEEDS

- Pools of collateralised assets and the HQLA liquidity buffers are sensitive to central and local adjustment variables

BUFFER & CENTRAL GROUP NEEDS

- What type of governance is foreseen for dynamic and consolidated optimisation of needs and buffers?
Decrease in repo outstanding

In addition to the reduction of activities directly carried on the balance sheet of banks (proprietary trading), the sharp decrease in client volumes (market-making, repo, triparty repo, agency lending) was mentioned by all the participants in this survey; “either the lines of credit have been largely reduced bilaterally (not set off via CCPs) or the banks have deliberately decided to no longer finance the other competitor banks (Tier 1 and Tier 2) and particularly the broker-dealers.”

The feeling of less liquidity available in the markets (repo, triparty repo, security lending) is corroborated by the volumes of repos measured at the end of December 2013 by ICMA (a 21% fall since June 2010).

This decline can be explained by:

- An increase in regulatory compliance (mandatory deadlines)
- Low interest rates have made profit margin conditions difficult (making it unattractive for clients)
- The new repricing model of collateralised operations, which, by including more and more parameters, makes this market less competitive or less profitable (less interest coming from pension funds, for example).
No HQLA shortfall anticipated

Collateral bid and ask quotes take the opposite course of many of the studies published over the last few years as they predict a growth in the net demand for collateral and a related shortage of HQLA. Volumes are clearly increasing in some segments (activity of CCPs, collateral posted for OTC derivatives), “however, this is not priced in the market, for which AAA or AA collateral is still offered on the short-term yield curve both in the USA and in Europe”. We estimate that the additional demand for collateral resulting from the prudential and regulatory aspects would be offset by a decreasing quantity of assets to be financed by banks on one side (in particular as participants noted strong deleveraging), and an expanded offering of high rated paper on the other side.

**Fig. 14 – Collateral supply and demand**  
(Source: IMF 2013)

<table>
<thead>
<tr>
<th>COLLATERAL SUPPLY AND DEMAND (in $ billion 2007-2015)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sovereign issues</td>
</tr>
<tr>
<td>Sovereign issues that no longer correspond to riskless asset</td>
</tr>
<tr>
<td>Securitized products</td>
</tr>
<tr>
<td>Corporates investment grade debts</td>
</tr>
<tr>
<td>Covered bonds</td>
</tr>
<tr>
<td>TOTAL SUPPLY</td>
</tr>
<tr>
<td>LCR impact</td>
</tr>
<tr>
<td>EMIR impact</td>
</tr>
<tr>
<td>Secured funding versus unsecured funding shift</td>
</tr>
<tr>
<td>Solvency II impact</td>
</tr>
<tr>
<td>TOTAL DEMAND</td>
</tr>
<tr>
<td>Bank B&amp;S deleveraging</td>
</tr>
<tr>
<td>Ring-fenced collateral in CCPs and CB (less velocity)</td>
</tr>
<tr>
<td>TOTAL MISCELLANEOUS</td>
</tr>
<tr>
<td>NET COLLATERAL SURPLUS</td>
</tr>
</tbody>
</table>
Weakness and dependence of the banks’ business model on securities lending

Significant variations in the supply side were observed by major asset-managers (insurance companies, pension funds, management companies) and this threatens collateral management businesses (repo, securities lending, triparty repo, collateral upgrade-downgrade, etc.). The choice and strategy of the main asset managers whether to lend their securities or not (bilateral repo or agency lending) considerably affects the activity of the banks. Banks are impacted in the access they have to securities (sourcing) thus limiting their ability to supply specific ancillary activities such as market-making and short covering on credit, for example, of high yield, corporate bonds, etc. This situation leads to a reduction in liquidity and a fall in the efficiency of other markets. The model is also in the process of changing due to the regulatory impacts on the agent lenders: “the activity as agent now supposes providing capital to deal with the risks taken (indemnification clause). To be profitable, agent lenders must lower the fees given to beneficial owners (the asset managers), who, as a result, have less incentive to lend their securities.”

The LCR constraints imposed on banks have also strongly weighed upon the development of transactions with asset managers:

**Fig. 15 – Securities lending trade cycle**

- ASSET MANAGER
- AGENCY LENDER
- BANK

**Securities Lending**
- Interbank Markets
- Clients

**Cash or collateral + Fees**
- Repo
- Short covering
- Market-making (Credit, sovereign, structured…)

**Bid-ask spread mismatch**

“The large majority of agent lenders do not accept collateral below A- since they cannot themselves replace it with clients and bank counterparties who in 90% of cases no longer accept it (each collateral must be reusable). This restriction freezes the market since, precisely, it is sub A- assets rated that need refinancing. Today 70% to 80% of the assets held by the banks are rated BBB (financial, corporates, etc.), 10 to 15% are A- and 10 to 15% are higher than A-. This situation is not reflected in the market spreads.”

**Fig. 16 – Term: 3 months AAA versus BBB and < BBB (Indicative levels)**

<table>
<thead>
<tr>
<th>3 months</th>
<th>SPREAD</th>
<th>HAIRCUT</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA / A-</td>
<td>5 bps</td>
<td>&lt;5%</td>
</tr>
<tr>
<td>AAA / BBB</td>
<td>15/20 bps</td>
<td>10%</td>
</tr>
<tr>
<td>AAA / &lt;BBB</td>
<td>20/30 bps</td>
<td>15%</td>
</tr>
<tr>
<td>AAA / BTP</td>
<td>15bps</td>
<td></td>
</tr>
<tr>
<td>AAA / Equity (main index)</td>
<td>15bps</td>
<td></td>
</tr>
</tbody>
</table>
The collateral transformation market

Collateral transformation activity can be seen as the ongoing market between the players with collateral and the players who are structurally lacking or in a shortfall situation for this type of asset.

If collateral transformation should be used to meet the demands of counterparties looking to swap non-LCR eligible for LCR-eligible assets, then this market can only develop with counterparties that are not impacted by the LCR requirement (insurance companies, corporates, funds or certain supranational organizations). Beyond the interest that these counterparties may have (price/liquidity ratio), “this simply involves no more and no less the financing of a liquidity gap filled by a typology of specific players and will sooner or later reach a point when the regulator will put an end to it due to the concentration of risks that will result from it. The regulator’s approach does not consist in having the insurance industry finance the banks’ LCR shortage!” Many feel that there is room for developing “some arbitrage”; however, the regulatory breeding ground is not conducive to a deep and structurally sound market.

By positioning the debate on the organisational front, some users highlight the following point: “in the end, the transformation market consists in making the presentation of the EMIR or LCR objectives compatible with an acceptable market model where this market would be an oligopoly of the clearing members, i.e., the largest players. The transformation service must not be imposed on participants who can manage it themselves.”

Interpretation of market regulations

The interpretation of the new regulations is a real challenge especially as they are not fully implemented and digested across all markets and segments. More importantly, all banks do not have the same interpretation and do not address the regulation constraints at the same speed. This results in distortions in competition and the risk of being off-market for certain activities (with resulting shifts in clientele as well). By widely anticipating certain regulations, some leading market players have been clearly positioning themselves too far ahead of the market before seeing other players converge. For example, triparty repo pricing over very short maturities with or without integration of the LCR constraint.

“The question is to know how much time the market will take to find the right model (flow, connection with the FMIs)”. The instability of times does not contribute to the development of liquidity routes which at times take too long to emerge. The most frequently mentioned topics in this regard are:
- Definition of HQLAs
- Leverage exposure and RWA
- Adaptability of CSA (under EMIR and Dodd-Frank respectively)
- EMIR (definition of liquid contracts and rules for less liquid contracts)
- Shadow banking (FSB consultations)
- Repo constraints for monetary funds (ESMA)
- Debate over FVA.
CONCLUSION

Findings

In an environment characterised by:

- The prevalence of regulation as a development driver
- The end of “free money”
- The repricing of credit risk
- The impact of unconventional central bank monetary policies on the 0-3 year segment
- The quasi-deflationary or “lowflationary” situation.

The flows in the collateral-liquidity area can be described as “truly chaotic”, reflecting the current strategic choices still being considered by internal experts.

Thus, the optimisation of collateral is a source of savings, potential profitability and a primary lever that can be used to meet ever increasing capital equity and liquidity needs.

Recommendations

Whatever the business model, optimisation of collateral management should take a structured approach and implement a “collateral value chain”, aimed at fulfilling the following three objectives:

- Prudential liquidity management
- Regulatory compliance
- Profitability.

Collateral management is the discipline that maximises the efficiency and availability of collateralised assets. Instruments and procedures proposed by triparty agents like Clearstream offer powerful optimisation features and allow participants to achieve their own objectives throughout internal mechanisms.

A centralised view of collateral, associated with local liquidation rules seems to be the best management model to face this new fragmented environment.

Next steps

The distinctive features of triparty repo (presence of an independent collateral agent and an ICSD as a neutral depository), its flexibility (multi-currency, substitution/optimisation, open or term financing), a harmonised view of bank risk (presence of a CCP to support GC products), with a simplified set-up (single legal agreement) could in the near future supersede the non-financial firms’ interest for bank term deposits, an unsecured product with blurred characteristics still exposed to a high credit risk.

The Net Stable Funding Ratio (NSFR) implies that long-term assets are funded with a minimum amount of stable liabilities. This is likely to be the 2015-16 markets hot topic on liquidity compliance; therefore a related boost is expected on market liquidity beyond one year term.

The current market discussion around the profitability of liquidity buffer portfolios built by banks would most likely enable collateral management to be linked to asset or portfolio management: a new discipline perhaps?
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Didier is a senior consultant at Elton Pickford with a long track record in the securities industry acquired in an international market infrastructure and a large investment bank, where he was in charge of operational functions as a back office manager and served as projects director. His experience of the post-trade market has led him to work on large industrial projects from the 1990s onwards (ESES, TARGET2, T2S, CMS and €GC). His expertise has been sought by the national and European institutions (ECB, EBF, ICMA) to contribute to the development and implementation of these above-mentioned industrial projects. He now aims to serve focused strategic projects in securities and the securities financing marketplace designed to meet the challenges of a transforming financial world.