# Optimising Collateral Management By Reimagining The Operating Model

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## Optimising Collateral Management By Reimagining The Operating Model

**The economic imperative for collateral optimisation has taken centre stage over the last decade, as the increased regulatory requirement for collateralisation of products has led to higher demand for the assets that underpin it. Whilst traditionally seen as back office function, the emergence of collateral as an asset class in its own right has led to significant investment across capital markets organisations as they attempt to price and optimise inventory.**

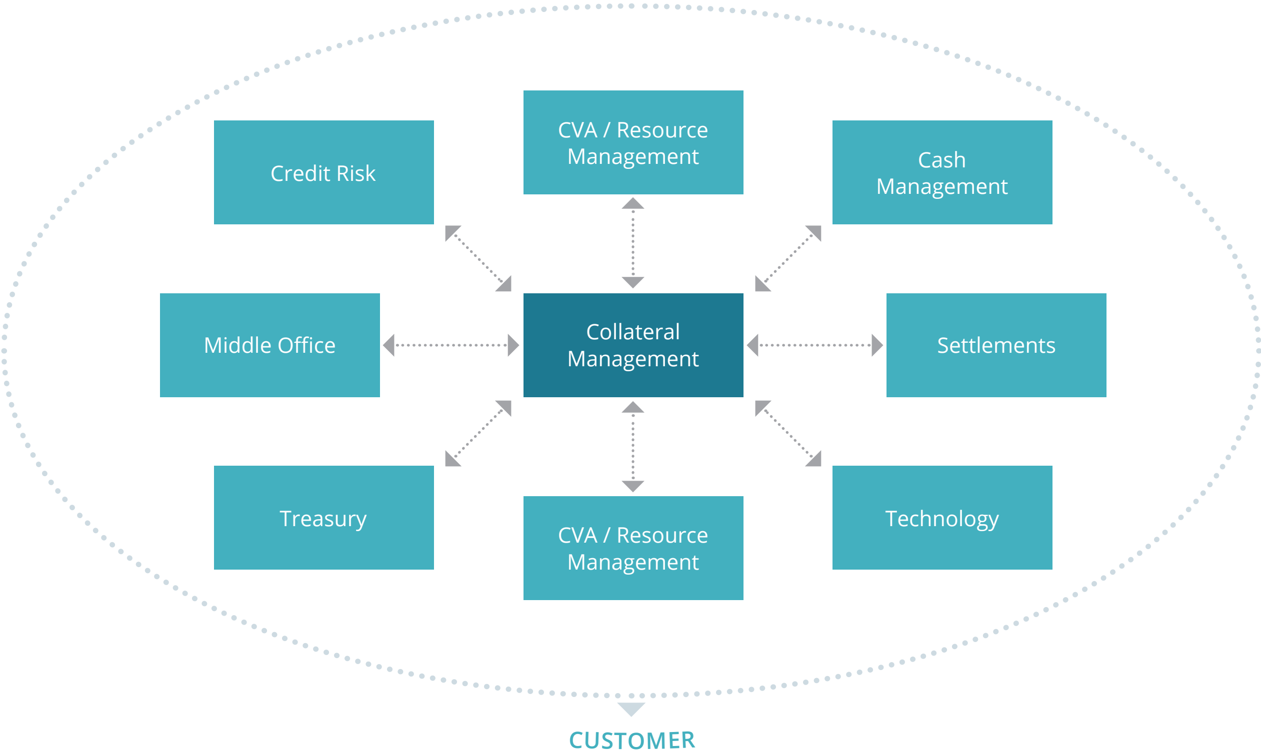
But what has been less well understood is the cost opportunity that persists for many organisations through understanding their internal processes for collateral management and how those themselves can be optimised. With successive waves of regulation layering rapidly upon the industry – the IOSCO rules for uncleared margin, mandatory clearing, MSFTA requirements in the US – opportunities for reflection have been limited given the level and pace of change. So, whilst collateral optimisation has been a  commercial focus for COO's, process optimisation has not attracted the same level of interest.

Global regulation has driven standardisation of legal structures (such as CSAs) and processes (for variation and initial margin rules) which has enabled financial market infrastructure providers (FMIs) – such as Acadiasoft or DTCC – to deliver standardised services around areas such as margin call management or collateral settlement. But adoption of common process standards through an FMI is only part of the challenge for most organisations, who maintain disparate and inconsistent processes internally to support externally what appears to be a commoditised process. This complexity and process fragmentation makes it extremely challenging to drive end to end efficiency and limits the benefits available through integration with industry platforms and adoption of market standards.

## The Need for Change – An Industry Perspective

The operating model for most capital markets institutions is a complex web of systems and processes that have been assembled over a long period of time. This historical journey – often labelled as the 'legacy architecture challenge' – reflects the biography of the institution and manifests itself in the heavily customised systems and process that support day to day operations. They are designed to deliver throughput – using words such as 'STP' or 'exception rates' – that are typically used to describe performance of most post trade processes. With each functional owner thinking in terms of the box that sits around their control – think fails management, margin calls, confirmations. Small, incremental improvements are made around the edge of the box with the aim of reducing friction between process hand-offs but never materially impact the end to end process cycle. And more importantly, the nature of the functional structure prohibits any consideration to the 'customer journey'. The below highlights what for most organisations is the daily journey for a margin call showing the common internal interactions that support it:

## A Typical Margin Call Experience




There is little or no functional overlap between the groups involved in the daily process, who all operate independently from each other. This limits any opportunities for standardisation or enhancement to the 'journey' as the functional responsibilities of each group limit change thinking to the boundary of that function. Alongside this challenge, the IT organisation is typically aligned alongside these boundaries, with an application focus dedicated to the sub-processes it is aligned to (such as settlements or reconciliations) – which further limits capability for end to end thinking. It becomes common in these models for functions to report that they have achieved notable operational improvements, but overall costs remain unchanged.

In a recent engagement for client, we performed an operational assessment of their collateral management function to help them understand opportunities for efficiency and also provide insight into best practice across the market through peer comparison. Whilst industry participants are at different stages of maturity around the collateral management process, our research highlighted several consistent themes that reinforced the typical operating model outlined above. And the problems that it creates.

1. **Fragmented Cost Landscape.** Few organisations have a detailed understanding of their cost of operation, with finance functions allocating costs out separately to IT, Operations, Middle Office etc. As a start point, this makes proactive management of the collateral management process challenging – and collaboration even harder.

2. **Lack of Functional Granularity.** Organisations understood at a macro level what teams did – such as margin call management, cash management or portfolio reconciliations – but lacked deeper insight into the work drivers of the function. This covered areas inside the collateral management function – time spent compiling manual data requests – as well as outside – such as effort spent in middle office validating valuation breaks.

3. **Effective Measurement Points.** The KPI's to monitor effectiveness of the internal process are typically vague, based upon data points that are available rather than what is required. And are also subjective, chosen to highlight in some cases the good whilst ignoring the bad.

One clear example of this was an organisation with high adoption and utilisation rates of FMI tools – which they used as a measure of their relative effectiveness. What became apparent however was whilst the customer experience was positive, the organisation deployed significant internal resources in low cost locations to clean up data and reconciliation breaks prior to margin call generation. So, whilst demonstrating credible efficiency measures on one hand, it was unable to measure the cost of the margin call journey. In addition, it was deploying nearly double the number of people within the collateral management process versus its peers with similar business models.

4. **Internal Data Challenges.** Whilst external standardisation of processing (and supporting data) has been a feature of the collateral management landscape, the ability to extract and distribute internal data to process stakeholders is still a fundamental challenge for most. We estimate that on average 15-20% of the collateral management workload is driven by basic data extraction (such as intraday status monitoring) and formatting data for internal consumption (reports etc). This also acts as a drain on management time, who lack the basic data to support effective process oversight. As a result, they are reliant on small pools of subject matter experts to adequately maintain day to day control – an issue highlighted by most respondents as being a significant challenge during the market volatility created by the pandemic.

5. **Siloed Operating Models.** Whilst consolidation into a single function labelled 'collateral management' was a common path taken across firms, few organisations had undertaken an exercise to map the interaction points and synergies with other groups. The inter-connection of the collateral management process with liquidity management and treasury functions is key to any collateral optimisation journey – but few have been able to successfully integrate the functions. This creates inefficiency in communication flows and ultimately impacts the ability to deliver synergies in both liquidity usage and process optimisation.

   One organisation had achieved this level of tight integration across the liquidity and collateral processes, but this had been driven by internal focus from the CFO on being extremely 'liquidity conscious'. Where this top-down pressure does not exist, different teams are unable to collaborate effectively across functional boundaries to drive efficiencies.

   Most organisations know where they want to be – and corporate leaders in capital markets regularly champion their internal performance against efficiency benchmarks to validate their own performance (FMI adoption, competitor benchmarks). But this focus on cost justification rather than performance measurement does not deliver the enterprise-wide impact needed to deliver efficiency – and the stubbornly high TCO for most organisations within their post trade environments highlights a need for change.

   We continue to maintain (and see supporting evidence) that most organisations have opportunities for 30-40% TCO improvements within their post trade domains – but what is preventing these opportunities being realised is the functional agendas pursued internally by different management teams. This strangles good intention where an end to end focus on performance is ultimately how these levels of efficiency can be achieved.

## Re-imagining The Collateral Management Operating Model

If we look at organisations who have been successful outside of capital markets in driving process efficiency alongside improving customer satisfaction, they have done so by adopting different ways of operating from those that have persisted in the past. They have looked to disrupt their own legacy operating models by recognising that functionally driven efficiencies have been exhausted.

McKinsey[1] have noted two key shifts as part of this operating model journey, where organisations have focussed on adapting the way they work. These are:

1. **From running uncoordinated efforts within siloes to launching an integrated operational-improvement program organized around journeys.**

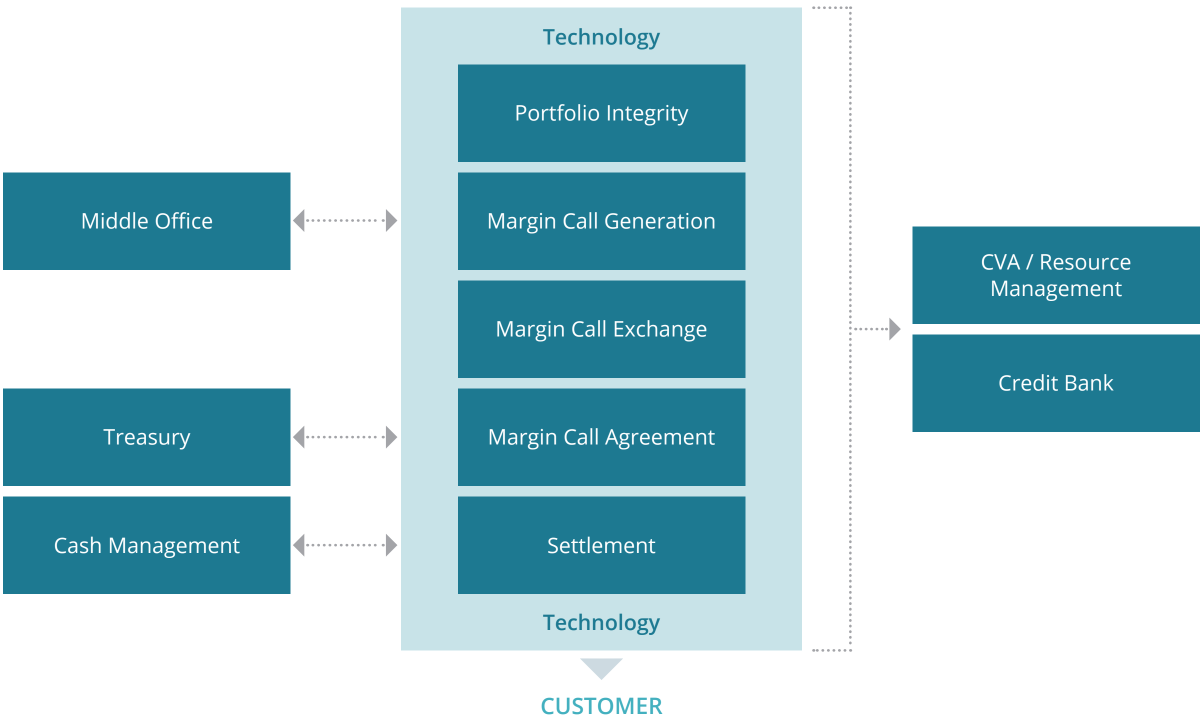
   This moves emphasis away from efforts within functional boundaries – such as collateral management – towards a holistic approach to thinking about journeys – such as a margin call. This approach forces organisations to focus on the journey and how organisations can deliver improved customer experience. And the fact that these internal processes cut across organisational boundaries – such as middle office or IT – makes the concept of a journey a logical operating principle.

2. **From applying individual approaches or capabilities in a piecemeal manner to adopting multiple levers in sequence to achieve compound impact.**

   Once the journey has been defined, the next shift in mindset is to adopt the appropriate lever to optimise the processes that underpin the journey. In the context of our margin call process, we could see different levers – such as RPA – being applied to call generation whilst digitalisation – using an FMI such as Marginsphere – could be the solution to call agreement. Digital workflow tools could be utilised to support the interactions with other stakeholders in the process (such credit risk management), whilst self-service data and relevant analytics solutions replace what are typically manual hand-offs or email-based exchanges of information between groups. Underpinning all of these solutions is the IT function performing an enabling role, enriching the journey with automation and innovation to optimise the end product.

As we re-frame the typical margin call process outlined previously, we can see how these steps are sequenced into a journey that enables an optimised, end to end focus on the outcome.

## The Reframed Margin Call Journey




[1] The next-generation operating model for the digital world by McKinsey

Adopting this enhanced mindset requires organisational focus, to support cross-functional collaboration and create the right environment for a journey-led approach to take root. Alongside this, the organisational structures that supported the legacy systems and processes of the past have to adapt in parallel. This doesn't require wholesale dismantling or redesign of functional organisation charts, but it does require a change in mindset around how performance is monitored and measured. And this tone must be set from the top, where management structures that straddle functional leadership and set organisational direction – CEO's or COO's – create the shared goals and objectives to catalyse this change in approach.

Functional heads need to be equipped with the right resources to manage this change, with funding and cost allocation models being aligned differently to support collaboration. They also require the tools to effectively monitor performance, understand the cost to service and be able to drive decision making to ultimately optimise the outcome.

Where organisations are able to mobilise resources to drive alternative ways of thinking to reframe the problem statement, they will find that the complexities limiting their organisational performance start to become unlocked. And those that are able to execute this shift in mindset will benefit from the value this creates in terms of reduced cost – improving C/I performance – and resilience – through higher levels of automation and scalability. Enhancing the strategic value of any firm operating today within capital markets.

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