Baton

The Benefits of **Effective Collateral Management** in Cleared Derivatives

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The effective management and deployment of assets has always been an important factor in the performance of Futures Commission Merchants (FCMs). However, until now it's not been possible to achieve consolidated connectivity to multiple central clearing counterparties (CCPs) to enable FCMs to access real-time collateral and margin data – invaluable insight that can be used to optimise and instruct collateral movements across CCPs globally.

Collateral Management in Cleared Derivatives: An Area Ripe for Disruption

Market volatility resulting from the COVID-19 pandemic fuelled trading activity and led to a rise in margin requirements from CCPs – in some cases by more than 100%. Whilst recent activity has been more subdued, the backward-looking risk models deployed by CCPs mean that high margin requirements remain in place. This in turn, has led to increased pressure on FCMs to manage collateral effectively, maximise liquidity, and reduce risk.

Within FCMs, the function of collateral management involves multiple manual processes. Each CCP produces end-of-day reports in different formats and communicates with FCMs via its own dedicated channels. Very few firms have reliable access to the intraday data that can prove critically important in fast moving markets.

Added to this is the need for FCMs to monitor collateral and assess risk, optimise margin in line with tight CCP cut-off times, and check eligibility of collateral with multiple CCPs. While an FCM can to some extent reduce workload by setting its own criteria on the types and volumes of collateral it will accept from its customers, in practice a client may only have certain collateral to pledge. "And if an FCM won't accept it, the client will look to go elsewhere," explains Ragu Raymond, Director of Business Development and Client Success at Baton Systems. "So a lot of FCMs collect collateral but can't do anything with it. They're reducing risk, but not maximising liquidity."

"Another issue is time zones," Raymond says. "It can take up to three days to move collateral from EMEA to APAC, and this can prevent firms from responding to margin calls in a timely and efficient manner."

Every transfer of collateral therefore requires significant operational input. This limits the number of transactions which can be performed and further reduces efficiency.

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Technology is the Key

Respondents to a Futures Industry Association survey[1] conducted Q1 2021 cited collateral management as an area where technological innovation and modernisation is needed. There is a growing need for technology which can provide a single, comprehensive and accurate view of exposures and obligations.

"Baton's platform sits between the FCMs and the CCPs," explains Tucker Dona, Baton's Head of Business Development and Client Success. "The technology eliminates many of the existing manual working methods which impede FCM decision making, by providing real-time visibility of collateral, along with excess/deficit calculations and eligibility rules, haircuts and the risk thresholds for individual CCPs.

"The automation of these processes reduces costs, increases capacity and workflow efficiency and has a positive impact on the firm's overall liquidity profile."

Reducing the reliance of an FCM on manual processes and checks allows optimal decisions to be made about the movement of assets, resulting in significant economic benefits for the firm. Using Baton's technology, an FCM can implement automated rules and alerts to move specific, eligible collateral to and from CCPs based on intraday data, meaning that the excess collateral maintained by a firm at any given CCP can be reduced. In addition, Baton allows an FCM to monitor the efficiency of existing collateral placements – for example, by factoring in haircut changes or interest rates – thereby optimising the decision-making process regarding placement of collateral.

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Further, by automating the onward processing of collateral and tracking its location in real time, an FCM is able to efficiently utilise all available client collateral in custody, leading to improvements in funding and liquidity.

[1]FIA Industry Sentiment Survey Q1 2021,
www.fia.org/sites/default/files/2021-03/IndustrySentimentSurvey_Q1-2021%20Highlights.pdf

Looking to the Future

Baton is focusing heavily on building out CCP connectivity. "We don't require much work from the CCPs," Dona stresses. "I believe the CCPs are coming to

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Going forward, Dona is keen to explore the use of Baton's technology in the connectivity between FCMs and their clients. By using Baton's technology across multiple FCMs, clients and FCMs can replace existing email processes and have a better real-time view of the status of pledges and recalls. For Baton's FCM clients, this will also reduce the manual processing role of the FCM and ensure that assets are moved in a timely and efficient manner.

Empowering Trading

It is clear that, with multiple legacy systems and manual processes in place, it is becoming increasingly difficult for FCMs to maintain control of collateral and manage risk. The inability to act swiftly and the constraints of working with CCPs across multiple time zones consistently leads to delays, missed opportunities and trading inefficiencies.

Whilst some firms remain reluctant to replace existing systems, citing risk and cost as potential barriers, Ragu Raymond is adamant that existing collateral management infrastructures are hampering growth.

"At Baton, we can't dictate strategy to an FCM," Raymond says. "But we can educate them about the benefits of streamlining processes and gaining real-time insight that can be used to optimise decision-making and collateral placement."

"If everyone becomes more efficient," he adds, "it would release idle collateral so it can be more effectively deployed – which can only be a good thing for individual firms and the industry as a whole."

About Baton Systems

Founded in 2016 by technology, payments and capital markets veterans, and backed by venture capital, Baton Systems is reforming how payments are made in the world's largest financial markets.

By delivering on-demand synchronisation and orchestration of asset movements through its distributed ledger-based platform, Baton is eliminating friction to speed clearing and settlement, reducing risk and pre-funding requirements, and increasing liquidity.