Empowering a strategic treasurer/ collateral manager

Collateral management in alternative investments

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Broaden the treasurer's role in collateral management

The time has come for the role of treasurer in alternative investment (AI) firms to be elevated to one that is considerably more strategic in order for treasury to advance operational, financial, and technological goals to meet the ever-changing financing landscape.

Forward-thinking management teams at AI firms will need to strengthen that role, and we offer a five-step action process to help empower the position for the benefit of the entire organization.

These five steps deal with a treasurer's central strategic role in:

— Risk mitigation, especially through the elimination of much of the manual entry processes that increase the chances of errors, resulting in slow processes, and escalating costs;

— The pursuit of alpha through sophisticated collateral management capabilities, including the management of friction costs associated with regulatory compliance;

— The creation of a newly strengthened and centralized governance structure for financing, overseen by the treasurer, who coordinates efforts carried out collectively by C-level executives;

— Coordinating efforts to attract and retain technology and finance-savvy talent, which is needed to transform this position;

— Digitizing collateral management to replace the still widely used manual processes that hamstring progress.

A look back; A look ahead

It was not very long ago when collateral management at AI firms was only about operational execution of collateral transfers. While two parties exchanged assets to lower credit risk between them, collateral management typically was considered more of a reactive duty than strategic mandate.

> *"We see an opportunity for alternative investment firms to differentiate themselves among the pack and move well beyond collateral management as an operational function, to a more strategic one. Significant value could be realized in areas such as improved balance sheet usage, reduction in certain friction costs, better regulatory compliance, a more complete understanding of counterparty credit risk, and even enhancing returns."*
>
> **Jim Suglia**
> **KPMG,**
> **National Practice Leader – Principal, Advisory**

Those days are long gone.

Regulators and investors alike are paying very close attention to how collateral management and the risks associated with it are being managed at AI firms. Credit providers are succumbing to regulatory pressures to segregate more collateral, thus making credit extension to AI clients more complex and difficult to manage.

We see collateral management for the leverage deployed on investment portfolios as part of the strategic execution of an AI firm and an all-important differentiator to investors, regulators, and counterparties in a crowded and hypercompetitive industry. We also view the treasurer's complete understanding about how leverage is deployed, managed, and utilized as key to a firm's survival as balance sheets at banks and brokers continue to be constrained by hyperactive regulation across the globe.

From 2008 to today, proactive collateral management has started to take a front-and-center position. AI firms know they must "up" their collateral management experience in the face of intense scrutiny by key stakeholders and regulators. And, while collateral management is recognized as fundamental for an AI firm's financing needs, there still is quite a bit of manual effort associated with the collateral management effort.

The need, therefore, to coordinate collateral operations in a *strategic treasurer's office* could not be more important than it is today as the treasurer role goes far beyond corporate accounting. It is meant to put a senior-level executive in a pivotal position of integrating disparate—but connected—functions at a time when converging forces and drivers are creating new collateral-management challenges.

Done well, significant benefits can be realized when alternative investment firms differentiate themselves by making collateral management a more strategic function. We believe that making such a move adds significant value, can improve balance-sheet usage, reduce certain friction costs, enhance regulatory compliance, provide a clearer understanding of counterparty credit risk, and perhaps even enhance returns.

Just as we believe that the industry will need to put next-generation IT systems and platforms in place, we also believe a next-generation treasurer is important going forward. In our view, alternative investment firms can manage collateral issues in a more holistic fashion by empowering their treasurers with much broader responsibilities. This position will be essential in the face of the regulatory constraints that have produced "a rise in central clearing for over-the-counter (OTC) derivatives, use of trade repositories, tightening eligibility criteria, Basel III capital charges, and a change of internal counterparty credit risk management practices; firms simply have no choice but to now be a part of the collateral management world."[1]

[1] A Practical Guide to Collateral Management, *The TABB Forum*, December 2015

KPMG point of view

A treasurer with an unobstructed line of sight across organizational sectors would be invaluable in this postcrisis collateral management environment where there have been unprecedented changes in the industry, to existing organizations, their processes and technologies.

A cohesive strategy, managed by a centralized office, which can organize interrelated processes and functions that have a direct impact on collateral management issues is needed.

Treasurers should be breaking out of traditionally defined roles and take on developing strategies that support business and operating models,

The ideal person in that role would have:

— A background in strategic development and execution

— Well-honed portfolio financing skills – Trader-like capabilities that include the ability to understand trade implications in order to get financing at the best possible price and returns

— A deep understanding of the shifting credit issues affecting collateral management in AI.

— Experience in front/middle office operations

— Strong project management skills relating to IT and data management development including the ability to recognize, recruit, and retain the requisite talent

— Experience in dealing with third-party technology firms that could be used in a strategic alliance to accomplish certain collateral management goals.

It is most important, in our view, that AI firms not be halted in their search simply because the list is long. Getting started on the path is the most essential aspect of the process.

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Changing landscape; changing imperatives

Increasing margin call and trade volume bringing operational pressures

The still-evolving regulatory rules affecting collateral continues to create pressure and uncertainty, which has added to the complexities associated with today's collateral management responsibilities.

Whether it is settlement activities, the need for more sources of credit, trading with central counterparties, or rules affecting acceptable margins for over-the-counter (OTC) derivatives, effective collateral management requires a focus on efficient and transparent monetization of assets as collateral.

Addressing inefficiencies has taken on even more importance with the recent exponential increase in margin-call and trade volume, driven in part by new rules relating to central clearing and bilateral OTC trading rules, daily tracking and reconciliation of collateral allocation, and other current and pending mandates. A recent International Swaps and Derivatives Association report "indicates an increase of over 50 percent in the total collateral volume related to cleared OTC transactions, with client-related clearing volumes more than quadrupling."[2] Another industry observer suggests "volumes will eventually increase by 150 percent by March 2017."[3]

Given the rules changes and the escalating volumes in the system, "we are seeing what amounts to alternative investment firms having to create new operating models in order to manage issues such as optimization of the balance sheet, compliance with the variety of regulatory risks, and the need for better overall performance," said Adam Hirsh, a KPMG advisory director in

A number of forces are creating the demand for improved collateral management:

- **Global regulation, such as Dodd-Frank Act (DFA), European Market Infrastructure Regulation (EMIR), Basel III and others.**
- **Pressure from AI funds' boards of directors and investors for significant improvements in transparency and risk management.**
- **Steep increases in volume related to cleared OTC and other transactions.**
- **Increased demand for richer and more-timely reporting requirements.**
- **Movement towards operationalizing portfolio margining and collateral optimization.**
- **Collateral management is moving from the back office to the front office.**

[2] Collateral Management: Navigating the Regulatory Maze, *The Field Effect, Bank of New York Mellon*, March 2016

[3] New Collateral Management Policy Framework Coming September 2016, *SS&C Solutions*, March 28, 2016

Changing landscape; changing imperatives *(Cont.)*

Service Operations. "The new model needs to be focused on putting the right people in the right seats. So much in how collateral must be managed has changed so quickly that most of the traditional models and ways of working are no longer relevant."

New regulations aimed at improving transparency and liquidity are impacting alternative investment firms in number of ways, says Jeff Kollin, KPMG's Lead Principal for Alternative Investments. "Virtually every firm has had to add quite a few people in compliance functions. Along with that, there have been many more collateral transactions. Taken together, it has meant there are more and newer procedures and processes. It really is an entirely new world for firms. As a result, there is lot of pressure not only on operational efficiency and costs, but also on the overall organization's structure."

> *"In today's (AI) industry we see few executives who have a clear view of the end-to-end operating model. And, that's what is needed with the flood of regulations and all of the expectations that go along with them related to risk and efficiency. This new position of a treasurer as strategist and as a risk-mitigation specialist, fits that need."*
>
> ***Adam Hirsh, KPMG, Advisory Director, Financial Management***

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KPMG point of view

Changes in collateral management supply and demand, coupled with new regulations that mandate much more transparency, better margin management, and more liquidity are creating as many opportunities for better collateral management operations as they are creating challenges.

The question that remains unanswered is whether alternative investment firms are poised to take advantage of the opportunities.

With the array of stakeholders demanding a higher level of performance and sophistication by AI firms, we expect much more focus to be placed not only on an organization’s information technology (IT) and data management capabilities, but also on its operational-, liquidity-, and counterparty-risk management acumen.

Consequently, AI would be well served by a thorough evaluation of their people, process, and data-management infrastructure. The AI industry has been criticized for its reliance on spreadsheets, rather than digital solutions. That situation begs the question: What is leadership’s judgment regarding the organization’s data completeness, quality, and the ability to gather it in a timely manner?

An important takeaway in any review of an organization’s IT infrastructure is that it should not be viewed solely as a processing tool. Rather, organizations must view IT as an enabler of differentiation, where people and tools work in tandem toward swift, accurate analysis of data for operational decision-making and risk-management purposes.

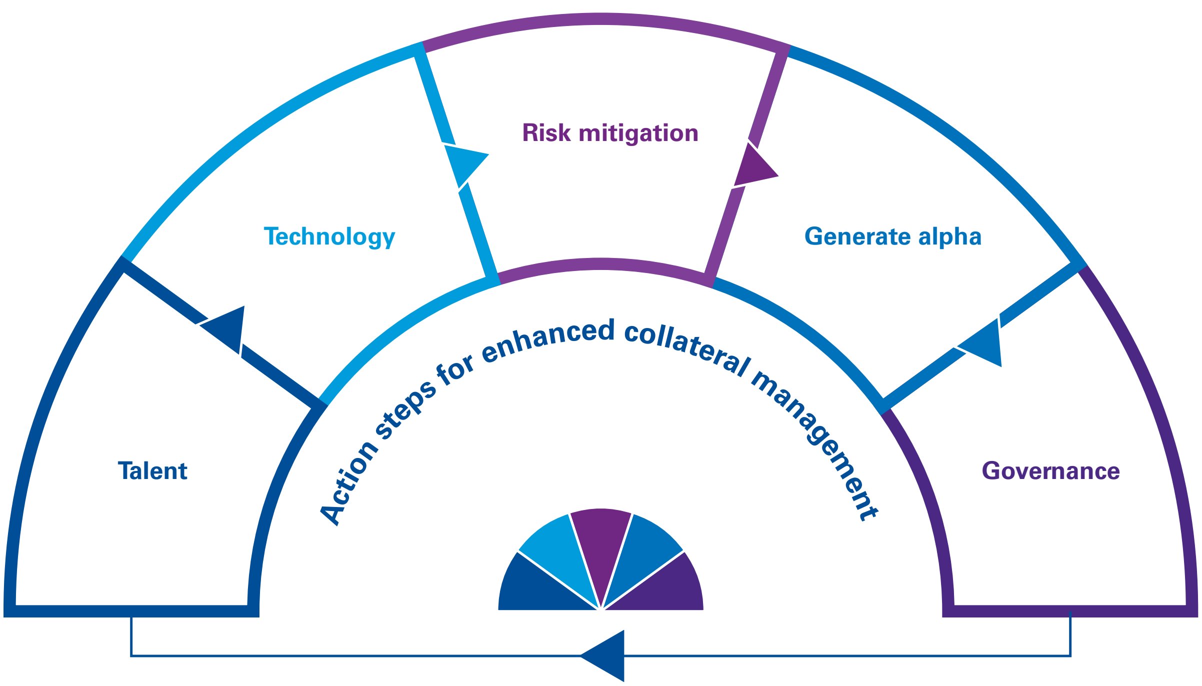
Action steps to empower the treasurer as strategist

Treasurer takes the lead

Leaders of AI firms have an opportunity to recast the role of their treasurer into a strategic position by taking five action steps. In that way, the organization can empower the position for the benefit of the entire organization.

These five steps deal with risk, generation of alpha, governance, talent, and technology. While each have separate issues to manage to make them work, each also is part of an overall continuum that makes up a focused collateral management program led by the newly enabled treasurers.

There are individual and collective processes and control structures that serve to foster interaction and collaboration for the good of the firm's collateral management program.



1 Never lose sight of risk mitigation

Faxing?

In our recently published whitepaper, *Speed. Control. Growth. Alternative Investment Keep Their Luster*, a major risk we identified in this industry is its broad reliance on manual processes. Use of spreadsheets and faxes, for example, remain common—perhaps even preferred. As a result the possibility for errors is high, and there is cause for concern due to heightened expectations for transparency and accuracy by regulators, investors, and credit providers…among other stakeholders.

While manual inputs through cut-and-paste processes and the use of e-mails and faxes are part of a firm's technology challenge, they may pose even more of a fundamental collateral management risk than a technological one.

A first order of business going forward for the organization would be to put an end to these outdated modes of operation.

Reduce risk; boost growth

Collateralizing trades with counterparties is meant as much to diminish potential exposure as it is to increase the bottom line. Very often firms seeking to increase trades with a counterparty face certain credit limits. Those limits may be managed to the benefit of both parties when a higher-profile treasurer has clear line of sight and strong operational relationships with other functions in the organization, such as a chief financial officer, a director of operations, a chief technology officer, general counsel, and others in business units.

With hedge funds and private equity firms seeking to boost alpha in an increasingly volatile marketplace, firms may consider doing business in markets or with counterparties that, for a long time, may have been considered out of their reach because of their perceived riskiness.

But, with well-developed collateral management programs, even some trades—considered out of bounds not too long ago—might now be able to be made with the firm's upgraded collateral management/risk mitigation capabilities driven by a strategic treasurer's comprehensive organizational structure.

That structure can enhance collateral management through clear sight into portfolio risk, financing risk, operations risk, along with counterparty risk. A strategic treasurer in a cohesively aligned organization will benefit by rapidly receiving accurate information about such critical issues such as transactions, margin calls, and rehypothecation—the practice of an AI firm's prime brokers of using the AI firm's collateral to back its own transactions and trades.

2 Relentless pursuit of alpha

A matter of sophistication

Generating alpha—the measure of performance on a risk-adjust basis against an index used as a benchmark—in the midst of an increasingly regulated and uncertain marketplace has placed an enormous premium on enhanced sophistication of collateral management abilities in AI firms.

With collateral management an undeniable enabler of risk mitigation, as well as a fundamental financial tool, AI firms will increasingly need to prove to a fragmented collateral marketplace that they are deserving of sometimes cautious suppliers.

Creation of the role of a high-profile strategic treasurer who has a broad mandate, possessing proven analytical abilities, has the backing of both the board and senior managers, and understands the current intricacies of collateral management may provide a competitive advantage.

Creating alpha will hinge on the firm and its leaders recognizing that now is the time for demonstration in the marketplace that their firm possesses sophisticated collateral management capabilities.

The demonstration of those capabilities that can provide the foundation for the creation of alpha may also rest on being able to prove that the firm can recognize the subtleties and implications of such varied issues as compliance with regulations (such as those dealing with cleared and noncleared over-the-counter derivatives) and those dealing with liquidity and capital.

> *"We see a growing importance for a firm to empower the treasurer to assist the business in its strategic mission. This empowerment, in our opinion, will help an AI business thrive in this marketplace."*
>
> ***Tom DeMattia, KPMG, Advisory Director, Financial Management***

3 Strengthen governance

Framework for oversight

Though each alternative investment firm will confront individualized issues and conditions, we offer this collateral management governance structure as an example approach led by a strategically empowered treasurer.

Strategic Collateral Management Driven through Treasurer's Office

(*Coordination with Chief Operating Officer*)

Office of General Council	***Chief Technology Officer***	***Chief Operations Officer***	***Chief Financial Officer***	***Chief Compliance Officer***	***Chief Risk Officer***
— Negotiate legal terms in counterparty documentation — Monitor trigger events — Normalize risks in counterparty documentation	— Handle systems development and monitoring — Oversee vendor due diligence — Manage data normalization	— Monitor Collateral movements — Monitor margins — Manage cash and interest marks	— Maintain financial controls — Conduct friction-cost reporting	— Supervise legal parameters set in counterparty documentation	— Oversee credit ratings — Review market and credit volatility — Maintain CCR reporting (DTD, MTD, QTD, YTD)

Collateral management in today's marketplace, where volume has spiked and numerous new regulatory rules from around the globe are affecting myriad decisions, requires a new organizational approach.

KPMG suggests that a newly empowered treasurer should sit atop of structure where the organization's general council, top technology officer, senior operations executive, the chief financial officer, the compliance chief, and senior risk executives report into the new office.

The purpose is to centralize collateral management operations in order for one individual to have clear sight into the trading opportunity decisions, the operational process function, the technology strategy and controls decisions, the financial operations and controls, and the data strategies that affect decision making.

We believe it is vital for a treasurer to lead this team, given that the treasurer function can provide this array of senior officials with integrated business-process insights. We believe the strategic treasurer in the role of overseeing the collateral management team can provide senior leadership and the board with a unique and coordinated view of business risk, technology deployment and effectiveness relating to trades and credit, leverage of business-critical information through data mining, and an overall view into financial well-being.

Strengthen governance *(Cont.)*

Further considerations

Even though collateral management led by a treasurer may differ somewhat from enterprise to enterprise, we believe there are fundamental issues to be confronted:

— The newly designed organization must be created through the use of a senior-level-officers agreement.

— The fundamental goal must be to give the treasurer a clear view of disparate organizational functions to allow for collateral management best practices.

— Silos separating functions must be removed in order to establish a free flow of data to the treasurer, to provide for a clear understanding of internal process constraints and opportunities, and removal of obstacles that might inhibit technological interaction.

— Buy-in rests on unfettered communication and removal of parochial boundaries that could stymie an open exchange for efficient collateral management practices.

— Control structures must be collectively created and agreed upon across functions.

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4 Focus on talent

The right fit

Having the right people managing the proper processes with the most appropriate technology is never easy. With it often being said that people are the most valuable assets in any business, collateral management reorganization with a newly empowered treasures will test that adage.

Talent in collateral management is inextricably related to process and technology, given how fundamental new technologies are now being leveraged across the industry for an array of tasks. And, that reliance on technology will be even more critical as AI firms steadily move away from using spreadsheets in favor of more sophisticated hardware, applications, and algorithms.

The demand is rising

Across the financial services industry, the need for tech savvy individuals to help incumbent businesses break out of traditional operational and procedural ruts cannot be overstated. The rub, of course, is that landing the requisite talent has not been easy, as many tech specialists have chosen other industries with stronger innovative reputations over financial services firms.

That situation leaves a number of avenues for AI firms to pursue:

- Do a much better job of telling their story of innovative plans to the technology community
- Develop in-house talent to help build new technology systems that enable the collateral management programs of the future
- Form strategic alliances, purchase, and create joint ventures with Fintech partners.
- Admit they are behind the curve on technology development and in-house talent and seek a third-party to help them ramp up their learning curve.

The needed technology must address and optimize firm's ability as it relates to fundamental areas such as margin management and valuation of positions. Such stress testing can help predict the impact of market occurrences that could fundamentally alter the firm's risk management profile.

5 Technology

Due diligence on people needed and tools

In addition to the people needed to help upgrade the overall business, a major issue standing in the way of improving collateral management programs through the digitization of processes is the costs involved in installing a technology backbone to replace the manual processes, and the array of service providers who promise technology solutions. But it is not the only one.

At the all-important intersection of people, process, and technology, the consequence of years of patchwork activities in the alternatives businesses is four fundamental operations and strategy challenges in the industry that can have an impact on the collateral management mandate.

— The middle office—through which much of an alternative organization's critical data flows—appears to be "disconnected" in many firms. The middle office frequently is not integrated operationally with front-office and back-office functions.

— Too many firms lack consistent control mechanisms necessary to capture, store, and retrieve data across portfolio holdings.

— Organizations must improve their performance measurement and reporting capabilities by leveraging data they already have in silos.

— Integrated technology platforms are scarce in the industry, exacerbating challenges related to data and operations.

> *"It is very important to understand that technology by itself is just a tool. Better collateral management is achieved when the tool is used as a means to extract and analyze information so that we have actionable information. The tool itself does not provide the answers. Instead, it gives you means to find the solutions that are right for the organization. It is up to people to use the tool in a constructive way."*
>
> **Jeffrey J. Kollin**
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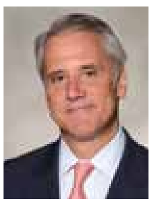

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