



Buy-side firms, triparty and a new look at generating alpha

The use of triparty by collateral providers is growing across the buy-side. This elevates the triparty relationship from the traditional collateral receiver model, where the dealer pays, to one where the buy-side firm is responsible for its financial dealings with the triparty agent. This article investigates why buy-side firms are making this change and what benefits can be gained.

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Operational alpha is defined as revenues that can be earned from better treasury or financial management functions. A popular example is hedge funds creating treasury divisions with supporting technology, where active adopters say that they are generating 50-80 bps in increased earnings with a high point recorded of 150 bps. Hedge Fund treasury desks have become a source of strategic importance with the ability to source liquidity, generate cost savings, manage risk and support longer-term strategic expansion. Other forms of operational alpha include better settlements, collateral optimization and outsourcing of non-investment functions.

The decision to expand a relationship with a triparty agent is a newer element in the framework of operational alpha. Here, buy-side firms can take advantage of a triparty agent's infrastructure to optimize and automate the collateral process across a network of counterparties. This is part of the broader evolution of buy-side firms taking control of their own collateral and liquidity and not relying solely on their bank counterparties.

UMR has focussed attention on collateral

The big driver of change in buy-side thinking around collateral has been Uncleared Margin Rules (UMR), which brought over 1,000 new firms into triparty relationships for collateral segregation. UMR adoption happened in waves from 2016 to 2022 and created a funding drain for buy-side firms by consuming collateral that had previously not been required, as well as new operational costs. It also spurred several new waves of technology innovation and efforts to de-silo collateralized activities across over-the-counter (OTC) derivatives, repo and securities finance.

The need for non-cash with regards to initial margin created both complications and a unique new set of requirements for firms accustomed to posting cash. Cash is not typically an eligible form of initial margin collateral under UMR regulations. This means in some cases that cash needed to be transformed into non-cash with T+1 collateral needs that can swing with market stress events. Tighter margin call regimes, highlighted as part of the rchegos collapse, meant that buy-side firms needed faster response times in collateral delivery than

previously. Both large and small firms had to add staff or acquire new vendor services to remain compliant.

The need for collateral has led to some buy-side firms holding back cash or non-cash collateral to ensure they can meet their margin calls, or to protect their exposure to trading strategies that require high amounts of collateral. This has introduced inefficiencies for both the buy-side and their dealer counterparties, with both reporting a drag on investment returns that can reach 1-2%.

The post-UMR collateral opportunity

In 2024, buy-side firms have now had a chance to assess their needs and strategic positioning, while service and technology providers have gotten past the initial rush of paperwork and had time to holistically evaluate their buy-side offerings. A primary focus has been value-added content such as collateral processing and market connectivity, compared to the initial single-minded goal of regulatory compliance.

An immediate opportunity is for buy-side to appoint a triparty agent to manage parts of their collateral activities. This relieves firms

of the burden of building and managing their own infrastructure and technology to manage tasks that nearly all dealers worldwide have outsourced.

Ted Leveroni, Global Head of Margin Services at BNY Mellon, notes that the buy-side adoption rate of triparty throughout UMR waves five and six was approximately 40% of BNY Mellon's UMR client base. Following the product's successful implementation with buy-side clients as collateral providers during UMR, BNY Mellon is now promoting its triparty services tailored for buy-side firms to a wider audience.

Leveroni says "we now are observing an increasing number of buy-side firms looking to transition their UMR activity to a triparty agent. The benefits include broader collateral schedules and leveraging the optimization and automation capabilities provided by the triparty platform."

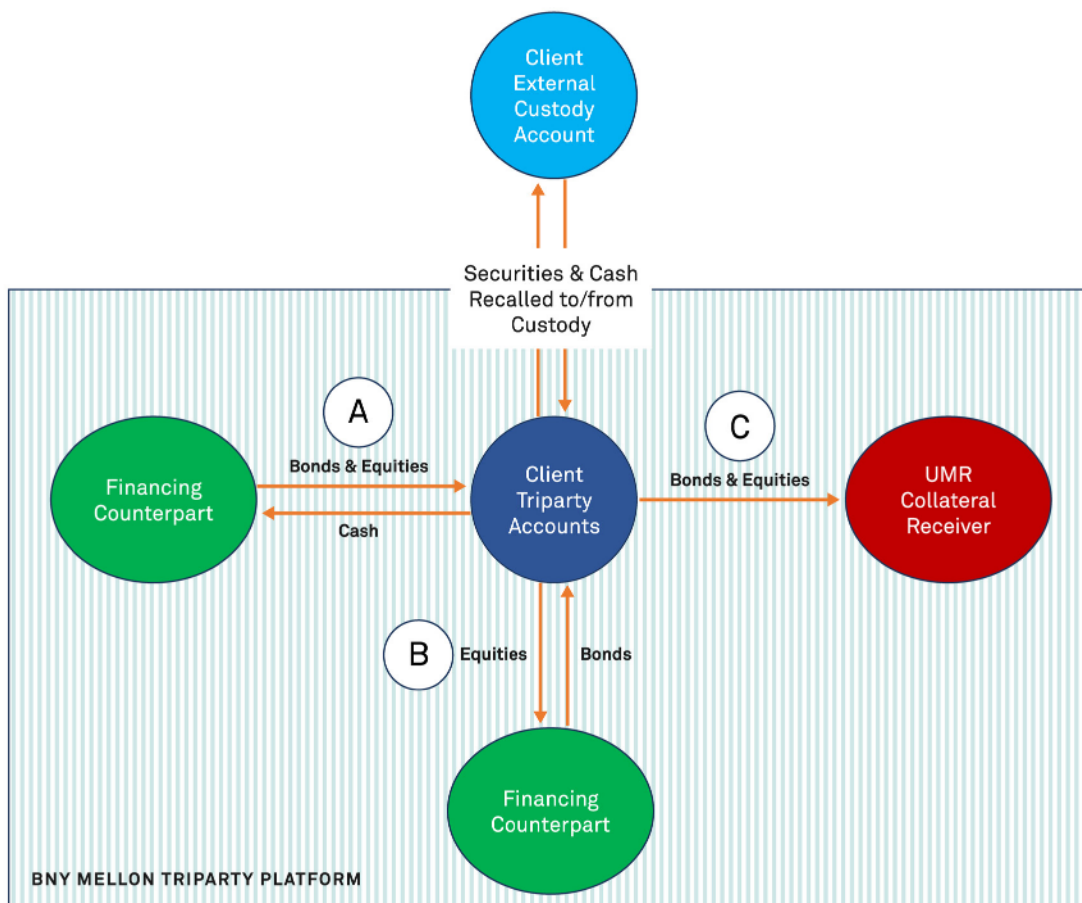
Assessing operational alpha in triparty

One of BNY Mellon's buy-side clients noted to Finadium that there are immediate financial benefits to be gained from onboarding to triparty. The most immediate advantage is a reduction in

internal management of technology and staffing, especially in a highly competitive environment for resources. After that, benefits in lower financing costs are generated as more collateralized trading activity is conducted in triparty.

The financial benefits of a buy-side's move to triparty are realized through three key themes: 1) centralizing of securities to optimize across a network of trading counterparties; 2) the depth of asset classes and markets supported to help broaden securities available for use in your inventory pool; and 3) the ability to generate liquidity from securities financing relationships and

Exhibit 1: Client accounts and connectivity in BNY Mellon triparty



Source: BNY Mellon

connect this into collateral requirements within the same eco-system (see Exhibit 1). This creates a cost effective and efficient method of sourcing, optimizing and delivering collateral, according to Finadium conversations with buy-side firms and BNY Mellon.

Nick Kurzel, Buy-Side Strategy & Product Management at BNY Mellon, says “buy-side clients can appoint a triparty agent to support collateral activities across repo, securities lending, and other non-regulatory margin requirements like variation margin on OTC derivatives. It addresses the growing market demand of buy-side firms looking for a single ecosystem to manage both their collateral and liquidity requirements. Kurzel says “to help streamline this for our buy-side clients we recently collaborated with GLMX on a new integration allowing our buy-side clients to direct repo trades at point of execution to BNY Mellon’s triparty platform.”

The financial benefit of connecting repo and UMR in triparty is cited in the 10-25 basis point range, according to Finadium research. An example could be leveraging triparty repo to transform US Treasuries into cheaper UMR compliant securities in triparty compared to posting US Treasuries on a bilateral basis. There are also opportunities to make further cost enhancements as part of a structural review in a buy-side’s collateral business model. For instance, it may be more cost effective to deliver US equities to be used as collateral, reserving hard to borrow securities to lend to brokers for short sale covers. Another example is freeing up expensive US Treasuries and allocate to cleared FICC repo by leveraging a broader basket of collateral within a triparty agent configuration.

Looking forward, buy-side firms may consider expanding their triparty activity by adding margin on cleared trades as well as uncleared on central counterparties

(CCPs) that have direct relationships with the buy-side. Triparty agents have already integrated with a variety of CCPs to make this work for dealer clients. Another option is improving collateral workflows, including projecting bilateral margin obligations, to more efficiently deploy cash and non-cash collateral. Third is capitalizing on new data services including rate curve projections to best consider a combination of investment strategy and collateral requirements.

The ability of the buy-side to take advantage of triparty services opens new doors for a new scalable generation of operational alpha. As both clients and triparty providers gain more experience with one another, we would expect that product development efforts will help both sides deliver efficiency gains for themselves, their counterparties and market functionality.

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