CIO Brief

Collateral Drag – Capital, Liquidity and Derivatives

Version 2, January 2025

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Executive Summary

Most institutional portfolios do not underperform solely because markets move against them.
They underperform because capital is quietly immobilised in places no one is accountable for.

Collateral is one of those places.

Regulatory change has transformed collateral from a post-trade operational requirement into a material balance-sheet decision. Initial margin, mandatory clearing, segregation, and cash variation margin have made collateral a persistent consumer of capital. Yet in many institutions, governance, measurement and ownership have not adapted.

The result is structural performance drag that rarely appears in attribution, is poorly understood across functions, and compounds year after year.

This brief explains why collateral is now a CIO-level issue, where the drag comes from, and what high-performing institutions are doing differently to regain control.

1. The Silent Shift in Portfolio Economics

For much of the past two decades, collateral management could reasonably be treated as a back-office function. Margin requirements were modest, negotiable, and often embedded within broader counterparty relationships. Capital tied up in collateral was small relative to portfolio size and rarely constrained investment decisions.

That is no longer the case.

Uncleared margin rules and mandatory clearing have fundamentally altered the economics of derivatives. Initial margin must now be posted at scale. Variation margin is predominantly cash-based. Collateral is segregated and immobilised. Margin requirements expand precisely when markets are stressed.

These changes are structural and permanent. There is no realistic scenario in which the market returns to pre-crisis collateral economics.

Yet many institutions continue to operate with governance models designed for the old world – where collateral was frictional, but not strategic. This mismatch is now a meaningful source of underperformance.

2. Why Collateral Drag Persists

Collateral drag persists not because it is technically complex, but because it sits between silos.

Portfolio managers are accountable for investment outcomes, not for how much capital is tied up after trades are executed. Treasury manages liquidity and funding but typically reacts to margin calls rather than shaping derivative design. Risk teams focus on exposure and compliance, not capital efficiency. Operations ensure margin calls are met but are not empowered to challenge whether the structure itself is optimal.

No single function owns the total lifecycle cost of derivatives.

As a result, a series of individually rational decisions combine to create systemic inefficiency:

- Conservative collateral buffers are maintained “to be safe”
- Cash is posted by default, even when alternatives exist
- Counterparty sprawl reduces netting efficiency
- Bespoke CSAs increase operational friction
- Disputes trap capital for extended periods

Each decision appears sensible in isolation. Collectively, they embed permanent capital drag into the portfolio.

3. The Hidden Cost Stack Most Attribution Misses

Most institutions believe they understand the cost of their derivative programmes. In practice, they usually only see execution costs – spreads, fees and commissions.

The largest costs sit elsewhere:

- Initial margin posted in cash earning well below portfolio returns
- Securities immobilised as collateral and unavailable for deployment
- Funding volatility created by variation margin
- Systematic over-collateralisation driven by uncertainty
- Capital trapped in valuation disputes and settlement frictions

These costs rarely appear clearly in performance reporting. They are spread across treasury funding lines, opportunity costs and operational processes. Because they are diffuse, they are easy to ignore.

Ignoring them does not make them immaterial. It simply makes them invisible.

Institutions that measure the full lifecycle cost of derivatives routinely discover that collateral drag exceeds headline execution costs by a wide margin.

4. Collateral as Balance-Sheet Capital

The most important mindset shift is simple: collateral is capital.

It consumes balance-sheet capacity. It has an opportunity cost. It competes directly with other uses of capital across the portfolio.

Treating collateral as “plumbing” leads to over-engineering, excess buffers and conservative defaults. Treating it as capital forces discipline, prioritisation and trade-offs.

High-performing institutions explicitly recognise this and make collateral decisions alongside other capital allocation decisions. They ask:

- What return could this capital earn elsewhere?
- Is this structure the most efficient way to achieve the desired exposure?
- Are we paying for safety through buffers instead of design?

This shift in framing is often enough to unlock meaningful improvements before any technology or tooling is changed.

5. Operational Alpha and Why It Is Durable

Collateral optimisation is a form of operational alpha.

Unlike market alpha, it does not depend on forecasting skill. It is not zero-sum. One institution capturing it does not prevent another from doing the same. Once embedded, the benefits persist year after year.

Institutions that move from reactive collateral management to disciplined optimisation have, in practice, reclaimed between 15 and 40 basis points per annum, depending on portfolio complexity and starting point.

More advanced programmes may still find incremental improvements of 5–10 basis points over time.

In a world where incremental alpha is scarce and expensive, this is not trivial.

6. What Leading Institutions Do Differently

Despite differences in size and mandate, institutions that manage collateral well share common characteristics.

They assign explicit ownership of total collateral cost, rather than fragmenting responsibility across functions. They measure lifecycle cost before trades are executed, not after problems emerge. They simplify counterparty and CSA structures to maximise netting and reduce friction. They use collateral toolkits such as repo, securities lending and triparty custody to create flexibility, not complexity.

Perhaps most importantly, they plan liquidity under stress rather than relying on static buffers. They understand how margin behaves in adverse scenarios and design structures accordingly.

This is not about sophistication for its own sake. It is about discipline.

7. Why Most Optimisation Efforts Fail

Many collateral optimisation initiatives fail because they start in the wrong place.

Common failure modes include investing in systems before clarifying ownership, pursuing technical optimisation before fixing structural inefficiencies, and treating optimisation as a one-off project rather than an ongoing discipline.

Another frequent error is equating safety with excess collateral. Buffers feel prudent, but they are often a substitute for poor visibility and weak forecasting. Over time, they become entrenched and drag becomes permanent.

Successful programmes begin with governance and measurement. Technology follows.

8. Practical First Steps for CIOs

Collateral optimisation does not require wholesale transformation to begin delivering value.

Practical first steps include:

- Measuring the true lifecycle cost of existing derivative programmes
- Assigning clear accountability for total collateral efficiency
- Reviewing CSA structures and counterparty concentration
- Challenging default use of cash collateral
- Stress-testing margin behaviour rather than guessing buffer needs

These steps can be undertaken incrementally and without disrupting investment activity.

9. Closing Perspective

Collateral is no longer a back-office concern. It is a front-office capital allocation decision with direct implications for portfolio performance, liquidity resilience and governance credibility.

In an environment where alpha is scarce and scrutiny is intense, institutions that ignore collateral drag are choosing to accept permanent inefficiency. Those that address it directly are discovering that some of the most reliable performance gains available today have little to do with market direction.

10. Further Reading and Practitioner Resources

Para Bellum Advisors publishes practitioner papers and CIO Briefs: **www.parabellumadvisors.com/insights**.

11. About Para Bellum Advisors

Para Bellum Advisors is an independent advisory firm specialising in derivatives, collateral, and balance-sheet efficiency for institutional investors.

The firm works with lean investment teams managing complex, long-dated portfolios across FX, rates, credit, equity, and volatility risk. Its focus is not on product distribution or transaction volume, but on structure: how hedges are designed, how capital is consumed, and how portfolios behave under stress.

Para Bellum Advisors is practitioner-led. Its work draws on decades of experience across trading, structuring, and portfolio management in banks, asset managers, and insurance balance sheets. The objective is not theoretical optimisation, but durable improvement in capital efficiency, liquidity resilience, and realised outcomes.

For more information, visit **www.offers.parabellumadvisors.com**

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