

**EXECUTIVE BRIEF**

Collateral Drag

Capital, Liquidity, and Derivatives

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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 it 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. Governance, measurement, and ownership have not adapted at the same pace.

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

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.

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. Yet many institutions continue to operate with governance models designed for the old world, where collateral was frictional but not strategic.

The mismatch between how collateral behaves and how it is governed is now a meaningful source of underperformance.

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 but typically reacts to margin calls rather than shaping derivative design. Risk teams focus on exposure and compliance. 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 maintained for safety, cash posted by default when alternatives exist, counterparty sprawl reducing netting efficiency, and disputes trapping capital for extended periods.

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

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. The largest costs sit elsewhere: initial margin posted in cash earning well below portfolio returns, securities immobilised as collateral, funding volatility created by variation margin, systematic over-collateralisation driven by uncertainty, and capital trapped in valuation disputes.

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 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.

Collateral Is 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 make collateral decisions alongside other capital allocation decisions. They ask what return this capital could earn elsewhere, whether the structure is the most efficient way to achieve the desired exposure, and whether they are paying for safety through buffers instead of design.

Operational Alpha

Collateral optimisation is a form of operational alpha. Unlike market alpha, it does not depend on forecasting skill. It is not zero-sum. Once embedded, the benefits persist year after year. Institutions

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

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

What Leading Institutions Do Differently

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. They plan liquidity under stress rather than relying on static buffers, and they design structures with an understanding of how margin behaves in adverse scenarios.

Most optimisation efforts fail because they start in the wrong place. Successful programmes begin with governance and measurement. Technology follows.

Practical First Steps

Collateral optimisation does not require wholesale transformation to begin delivering value. The starting points are straightforward: measure the true lifecycle cost of existing derivative programmes, assign clear accountability for total collateral efficiency, review CSA structures and counterparty concentration, challenge the default use of cash collateral, and stress-test margin behaviour rather than guessing buffer needs.

Collateral is no longer a back-office concern. It is a front-office capital allocation decision. Institutions that ignore collateral drag are choosing to accept permanent inefficiency.

About This Brief

This Executive Brief is a companion to the Para Bellum Advisors practitioner paper: Collateral Drag: Capital Economics of Modern Derivatives.

Available at www.parabellumadvisors.com/insights/

About Para Bellum Advisors

Para Bellum Advisors is an independent advisory firm specialising in derivatives, structured finance, and balance sheet efficiency for institutional investors, family offices, and corporate treasury teams.

The firm focuses on hedge framework design, overlay mechanics, collateral efficiency, and portfolio resilience across FX, rates, credit, equity, and volatility exposures. Its work is practitioner-led, drawing on three decades of experience across trading, structuring, and portfolio management in APAC and globally.

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