Julia: **Welcome to a DerivSource podcast. I'm Julia Schieffer, Founder and Editor of DerivSource.com.**

Today we're talking about the decision to buy or build collateral management functionality. This is the decision that firms of all types have already had to make, or will make in the near future. Investment in collateral management capabilities is clearly needed to manage the new demands of CCP clearing, but also the new margin requirements for uncleared derivatives and firms are at various different levels of readiness for either of these demands. Most focus first on what they're going to do in terms of buying new technology from various software vendors or building internally. They can also consider outsourcing, but we're not going to go into too much detail on that option today in this podcast.

With me today I have David Little, Director of Strategy and Business Development at Calypso Technology, who is going to shed some more light on this decision process for all of us.

Julia: **David, let's start with the status quo and focus on the buy and build here. Do firms firms actually build these days? And, if so, why or why not?**

David: So, I think there's certainly been a change, and the number of firms who are building today has gone down. I'd say even stronger that there really aren't very many firms today who are building *large* functional components. You will see firms with quite substantial development teams, but they will more be focused on smaller functional components and of course interconnectivity and the hooking up of different systems with each other.

The reasons why that's gone out of favour: cost of development is high, the ongoing support is challenging, it's difficult to keep up with all of the market changes, the firms don't like the burden of large numbers of systems, so there's a tendency to try to rationalise down and simplify infrastructures with fewer and larger systems, and the very high revenues that were available before the crisis simply aren't in the business any more, so that's the underlying reason why we've seen this trend more towards vendor systems.

Julia: **David, are there trends with particular types of firms, for instance the buyside might be more likely to *buy* technology, whereas maybe some of the sell-side firms might have the resources to at least consider *building*? Is there a difference between institution types?**

David: Well, there is. I would the say the buy-side has traditionally been in favour of outsourcing as much as possible and having a smaller technology footprint. They might have some quite specialist development teams working on their real competitive edge, so it's around real competitive differentiation that you might see people still wanting to build software.

***Julia*: Sticking with the building, what are some of the common challenges that firms that firms considering building would face?**

David: Well, it's cost and timescale to summarise it. So, I think the justification for building is only there if it gives them a big commercial advantage. Maybe if there isn't a vendor system available or, as I said, if there's some particularly strong competitive edge to be had, or perhaps where independence from a vendor… that lack of dependency is an important part of the business strategy.

But those are really quite specific things. A vast majority of staff is suitable for using vendors and there are good choices of vendor systems out there. I think that's the preferred route for most parts of the infrastructures that we see in capital markets where the buy side, sell side or infrastructure components like clearing houses or central banks.

***Julia*: What is the driving force behind buying technology? As we discussed earlier on, have the motivations changed in recent years due to the financial crisis and new evolution of the derivatives industry?**

David: The driving forces are quite easily stated. I think there's better value for money because the costs get neutralised across the entire customer base. There's quicker time to market because you've got an already developed solution. There are higher risks with build solution because you've got the risk that the project might not work, so there's a long track record of projects that have failed to deliver to the full expectations. And also you've got the ability to keep up with all the market changes. So, yes, I think there has been a change since the financial crisis. I think all these points have become more important, and because of the pressures on balance sheet and on cost / income ratios (cost / income ratios have gone up), balance sheet is getting compressed, so banks especially are forced to look very hard at costs, and the high costs of software development are simply not justified in most cases today.

***Julia*: When considering buying versus building, which as we discussed already a lot of firms of all different types are considering now, David what is the one piece of advice that you would give these firms as they begin this debate, or maybe factors that they should be focused on considering in this process?**

David: Well, I think it's this… Vendors compete intensively, and you certainly see that in the collateral management space. The customers benefit from the selection pressure that that competition produces. It really is an evolutionary arms race, and the survivors of that, the best system vendors, they've proved their fitness for purpose time and time again. By contrast, a new build hasn't got that battle-hardened quality. A new build in a bank is a kind of protected environment and not a very critical or demanding environment. The specs tend to get written by the same IT group that build the software and test it and by definition declare it successful. The business users don't always agree at the end of the day.

If you think about venture capitalists and investors they're an interesting group, and in a way they deliver a verdict on this. There's a continuous stream of in-house built developed products that get floated off and put into the market and trying to survive as individual products. Most venture capitalists would say *you don't have a product until you've got at least 3, 4, 5, a dozen customers,* and that's simply not the case for most build projects.

So, the one piece of advice I think would be: pay attention to that Darwinian selection pressure. The vendor systems that have survived have survived because they're fit for purpose.

***Julia*:** **Final question: looking into the next year, 2015, people are still investing in collateral management operations and technology. Is there an emerging trend that you expect at Calypso Technology and what you see from your clients and potential new clients in terms of the appetite going up or down, or appetite for a particular functionality changing?**

David: Yes, definitely. What's starting to focus and concentrate minds a great deal now is the BCBS/IOSCO margin requirements for the non-cleared derivatives. So, that is the bilateral margin calls and we're going to see two-way initial margin being introduced, it's phased in between 2015 and 2019, so it's going to affect the largest houses first. That adds considerable complexity to the collateral management process; it increases the number of margin calls, which means that it's going to be operationally expensive, and it's adding functional complexity as well. That's what we're going to see driving the next phase of evolution of collateral systems.

We're working hard and keeping pace the regulatory change, but there's been a lot of change since the crisis, lots of regulatory requirements, dispute processing, concentration risks, wrong way risk, haircuts and cross-currency haircuts, there's still more to come. The pace of change is, and remains, quite high.

***Julia*:** **Great. That's some good last minute advice and insight into 2015 for our readers and listeners today.**

Thank you David Little of Calypso Technology for sharing his insight with us today via this podcast.

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