the changing role
of the third-party collateral manager

Collateralized financing has evolved from a capital markets financing tool into a trading instrument, balance sheet management technique and money market investment class that generates considerable value for both sides of the market. Likewise, third-party collateral management has evolved to provide a range of sophisticated services and technologies essential to the realization of that value.

Collateral is the guarantor of the liquidity of the capital markets. It is what allows short positions to be covered and long positions to be financed.

The use of collateral has now grown far beyond its origins in the repo markets, to become a trading tool and a balance sheet management technique that encompasses every asset class. It is the consequent administrative complexity that gave rise to the third-party collateral manager. The role of the third-party collateral manager is to provide sophisticated collateral allocation and optimization tools across a broad range of geographies and instruments.

At JPMorgan, major broker dealing clients now use third-party collateral management to mobilize every instrument they trade across up to 27 separate markets. The most progressive use the service as operational support for a fully integrated internal collateral management and trading desk that spans every major business line: fixed income, equity and derivatives.

By outsourcing all of these functions to a third party that can spread the costs over multiple clients, broker dealers have found they can reduce their overhead, cut their technology investment costs and concentrate on trading and financing activities. Cash providers, on the other hand, find they can lend on a fully collateralized basis without any administrative cost. Third-party collateral management on a global scale has enabled cash providers to enjoy enhanced yields without any loss of security or increase in administrative costs.

But the value being released for both sides of the market by global collateral management is now being further enhanced by a range of new services. These include the development of sophisticated collateral allocation engines for collateral providers, including simulation functionalities and intraday reoptimization services, which are designed to help them finance their activities at the optimum combination of cost and flexibility. Maintaining the effectiveness of these collateral optimization engines requires constant investment. Broker dealing is a naturally dynamic business, in

which both new asset classes and new ways of trading existing asset classes are broached continuously, and third-party collateral management has to adapt constantly to maintain the balance between what broker dealers hold and what cash providers are prepared to accept as collateral.

The development in recent years of rehypothecation services, which facilitate the multiple reuse of collateral, is a good example of this. Rehypothecation, long used in bilateral markets, is an important product evolution for third-party collateral managers, and will need to be available for complex international collateral and be fully automated to meet market requirements. JPMorgan has made collateral management a key strategic overlay to the clearing and settlement services it provides in more than 60 markets around the world. The aim is to enable clients to mobilize collateral wherever it is held, in whatever form it is held, and for whatever purpose they choose — not only in domestic markets, but across borders, as well.

It is an ambitious goal. As collateral has moved beyond cash and government bonds into corporate bonds, asset-backed securities, equities, and even mutual funds, bank loans and commodities, collateral managers have had to both work with independent pricing providers to address the need for pricing of emerging assets and broaden the range of cash providers they access.

But the eventual vision of global collateral management is clear. It is to make available for use as collateral, in any type of transaction anywhere in the world, the entire inventory of a client, of whatever type it is and wherever it is held. There are many legal, regulatory, fiscal, cultural and corporate obstacles to the realization of this grand vision. Even the lending of securities is not yet legal everywhere. The repo, securities lending and derivatives markets remain divided by obstacles as basic as multiple forms of documentation, and many investment banks have yet to integrate even their equity and fixed income divisions, let alone their derivatives and treasury arms. But it is the purpose of the global collateral manager to make these barriers as invisible as possible today, and eventually to help to clear them away altogether. ○○○

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