



Five drivers of collateral convergence

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In a year marked by challenges and quick adoption of new solutions, the securities financing market is renewing its focus on collateral management innovations that will allow businesses to operate even more efficiently. What is driving collateral convergence and standardisation across organisational structures, operating processes and technology, and what's next?

Structural convergence

As institutions evolve their business structures, we continue to see business reporting lines come together, central funding units arise, and investment spending on collateral services increase. These trends not only create new efficiencies within individual institutions, but also raise the potential for new synergies across securities financing. The question is: can we come together to create an even more efficient industry?

Yes. Abundant opportunities remain, because many of the fundamental operational processes for managing collateral have not changed in several years—despite the emergence of market solutions that could provide greater efficiency.

Initially led by some large investment banks who structurally aligned financing and derivatives collateral margining, optimisation and operations teams, many buy side firms are following similar approaches and leveraging best practise or core systems processing through the convergence.

Used traditionally for securities financing, the broad adoption of tri-party collateral management solutions to support the introduction of uncleared margin (UMR)

rules has created a new way of managing collateral for firms trading and collateralising derivatives. Buy side firms already leverage tri-party as collateral receivers in financing; under UMR, use of tri-party will materially increase to receive Initial Margin (IM). Some buy side firms are also embracing tri-party to post IM, becoming collateral providers for the first time and further centralising collateral inventory to create efficiencies.

The next step could be to further optimise the derivatives operating flow when it comes to collateralising variation margin for OTC derivatives. Can the industry get comfortable with the transfer of legal ownership occurring not through bilateral physical settlement, but by way of books and records settlement through a tri-party agent? The speed of collateralisation through tri-party might have helped to minimize settlement challenges experienced by derivatives counterparties, such as settling large same-day margin swings via bilateral physical settlement, back in March and April. Such a change, however, would need to be broadly adopted across the derivatives market in order for the benefits of tri-party to be widely felt.

Financing convergence

Creating central collateral business units has allowed firms to look at how collateral can be managed more holistically. Available collateral is no longer limited to margin assets provided by a hedge fund to an equity prime broker: now it is any unencumbered asset regardless of line of business, legal entity or custody location.

This has created significant interest in unlocking trapped assets to use them as collateral, and is an area we've addressed by working closely with clients across multiple markets. Trapped assets can be specific to a particular firm or legal entity where securities cannot be financed, or related to a security or market where operational, regulatory or legal inhibitors restrict the ability to mobilise and finance them. Some examples include emerging market equities, physical certificates or restricted share classes, or assets that are difficult to fund in their current custody location due to a lack of operational infrastructure or a depth of liquidity in the client base. Trapped assets need innovative financing solutions to reduce drain on alpha. Further, the ability to efficiently mobilise them unlocks value, making them available to meet margin calls to a CCP or to collateralise an OTC derivative transaction. In combination with tri-party solutions, including reuse technology, inter-entity funding can occur quickly and seamlessly.

Operational convergence

As businesses restructure and regulations change, operational support must continue to evolve. Operational challenges need technology solutions to maintain levels of STP but, with budgets often squeezed, they are too often asked to do more with less.

That's where data, analytics and insight from a collateral agent such as J.P. Morgan can help. We can provide a holistic view of their portfolios, including available collateral inventory, eligibility, allocation and exception management and diagnostic tools. Inventory management remains the starting point for effective allocation and optimization. Being able to view, simulate and allocate collateral held in any custody location and mobilise it to satisfy an exposure

remains challenging for most operational groups. Technology-driven solutions such as J.P. Morgan's Collateral Transport can enable greater efficiency and help solve these problems.

The desire for increasingly sophisticated optimisation capabilities is also increasing as the front office continues to seek efficient collateral allocation in order to positively impact profitability. With collateral overlay functionality, multi asset allocation orders and targeted client allocation, clients have access to granular and customizable capabilities that allow operational groups to meet the objectives set by their business unit.

Technology convergence

Managing collateral and identifying new solutions requires continuous technology development and exploration by collateral agents, clients and fintech providers. Creating new efficiencies will require ongoing integration and standardisation across the industry wherever possible, with near term opportunities that include:

- Increasing the use of APIs to provide system-to-system connectivity and create scale in data communication between agents and their clients.
- Expanding online options for managing eligibility to support faster time to market, particularly critical in times of market stress. This could include the use of APIs to update schedules directly from clients' risk systems to more efficiently manage counterparty risk with minimal delay.
- Embracing digitisation to accelerate legal execution and negotiation, by using e-signatures and document sharing, and the mobilisation of collateral by creating anonymised collateral tokens.

Longer term, the ongoing exploration of digitising general collateral, through the use of distributed ledger technology, could increase the velocity of collateral across the ecosystem and ensure collateral is effectively being utilised across counterparties and exposures.

Data convergence

Within the collateral ecosystem, data and insight provide both challenge and opportunity.

- **Transmission:** APIs have increased the ability to transmit data from vendor to client to third parties. However, with institutions that vary in size and scale, and technology budgets always under pressure, the road to a better connected ecosystem through true system-to-system integration remains a long one. The industry should review current data flows and connectivity to determine whether the work already done to meet the regulatory deadline for SFTR is sufficient or if there are additional opportunities to improve.

- **Standardisation:** This can encompass anything from identifying a trading volume data point for ETFs, a method of classifying an asset and whether it qualifies in an ESG bucket, an LEI for an asset issuer or the consolidation of reference data and pricing vendors into a common technical architecture to reduce costs. The technical limitations to some of these standardisation examples are often less of a barrier to change than the industry coordination and agreement required to reach the standard. Because different institutions, beneficial owners, risk managers and data providers could all have a separate view on the standard, industry trade bodies and associations should bring the market together to identify the framework for change. With viewpoints considered and consensus reached, unified standards could drive significant market improvements.

- **Analytics:** The convergence of ideas and best practices in data analytics can lead to a more efficient collateral ecosystem. Pre-trade analytics support fully informed decisions at the point of trade. This could allow the client to identify the best venue or trade type to execute a transaction, the optimal counterparty from a risk and capital perspective, how flexible the eligibility set is, should the trade be cleared, should it be done via a swap or other securities financing transaction, should it be a pledge or transfer of title, etc. This pre-trade information can impact the P+L value of that transaction.

After the trade is placed, post-trade analytics identify the right collateral to select and how to settle it to minimise any impact to a binding constraint. For example, this data can be used to efficiently allocate assets to minimise excess collateral usage of capital as determined by the regulatory environment. Operations dashboards can highlight exceptions and provide workflow tools to ensure accurate settlement of transactions, thus reducing fail costs.

These five drivers are interlinked and need to be tackled in parallel. Fortunately, with the frequency of regulatory reforms seemingly reducing, resources and technology are freeing up to focus on the opportunities that additional convergence could create. Some challenges can be addressed unilaterally, while others demand broader engagement and standardisation. As a global provider of custody and trading services, including agency financing and collateral management for tri-party and derivatives, J.P. Morgan is deeply engaged with these industry developments. We remain committed to working across client segments and industry groups to embrace new solutions and drive efficiency with holistic solutions for financing and margining.



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