Collateral Management Takes Centre Stage in Financial Markets

Growing regulatory and risk concerns and more sophisticated trading strategies have led to an increasing use of collateral management across the financial markets.

THE USE OF COLLATERAL MANAGEMENT as a central pillar of credit risk management has been growing in importance, and sophistication, over the last three years. Across all traded products, including repos and derivatives, there has been a movement in the market, driven by new regulations and market opportunities, towards more centralised and integrated collateral management processes.

Whereas previously an end-to-end collateral programme was auxiliary to trading activity, treated more as an accommodation for larger trading lines, it is now seen as a core component to this activity to the extent that “an institution with an integrated, well-run collateral management function will hold a competitive edge in...the marketplace,” ISDA, 2005(1).

A key driver for this shift includes the raft of regulatory changes - Basel II, Fed Rule 431, UCITS III and MiFID among others - that have led to collateral management becoming a key tenet of trading activity. With these changes, the regulators have become increasingly interested in the collateral management programmes of market participants, looking to ensure compliance and controlled, appropriate activity - “if you hear constantly “collateral, collateral, collateral is the solution” it leads you as a regulator to say “well, maybe I ought to check that solution is really going to stand up under pressure,” FSA, 2007(2).

The market has also witnessed a general move for greater use of collateral - repo collateralisation grew from $5 trillion to $13 trillion 2001-06, while OTC derivatives increased from $200 billion to $1.3 trillion 2001-2006 - against huge increases in the outstanding notional amount of both repos and derivatives. Part of this growth, especially in the last two years, has stemmed from buy-side asset managers entering new fund strategies away from pure ‘cash beta’ towards more sophisticated strategies that include short-selling, derivatives and complex structures.

But if collateralised financing mitigates credit exposure, it also creates a new form of risk to be managed: operational risk. The task of collecting and returning cash and collateral, recalling and substituting collateral, marking
collateral to market, asset-servicing collateral, and meeting demand to finance new types of collateral, is a complicated one.

At the same time, the increasingly sophisticated collateral management tools available - including re-hypothecation and complex eligibility testing and margin management tools - have led both buy-side and sell-side firms to aim high and explore the potential for integrating their collateral management processes. Such firms are looking at areas including optimal use of collateral across numerous market obligations, joined up clearance and collateral management, centralised reporting and a move towards more integrated margin management processes. This concept of ‘Enterprise Wide Collateral Management’ will take centre stage over the next few years as the sophistication of the market and size of balances involved encourages greater harmonisation across product silos.

The increase in opportunities and the related operational issues has given rise to a new class of third party specialists such as JPMorgan who can be relied upon to partner with firms to safely and efficiently manage collateral. Looking forward, in an environment where spreads are compressed and valuing and managing different types of collateral across markets and instruments and currencies is ever more demanding, the offerings of tri-party collateral management providers are likely to become increasingly core to both buy-side and sell-side firms.


(2) Thomas Huertas, UK Financial Services Authority, quoted in Risk magazine April 2007.

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JPMorgan has expanded the service since then to include enhanced cash reinvestment options, re-hypothecation, and the provision of credit to further smooth the flow of collateral. The service is now available to banks, asset managers, pension funds, governments, government sponsored agencies, hedge funds and corporates.

JPMorgan CommanD enables clients to better mitigate credit exposure and increase derivatives trading cost effectiveness. JPMorgan CommanD moves beyond the traditional custodial elements of a collateral management solution by covering many of the post-trade functions along the value chain, including OTC derivatives valuation, Credit Support Annex (CSA) management, re-hypothecation, settlement and custody.

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