

## The Benefits of Collateral Diversification in your Securities Lending Program

One of the key components to risk mitigation in any securities lending program is collateral. In managing a securities lending program, both the collateral, including the haircut and marking to market the loans and collateral on a daily basis, as well as the combination of counterparty quality and collateral mix, are highly important. But what is the current market trend for collateral?

Notwithstanding the market turmoil and issues raised by the Lehman default and ongoing credit crisis, we have seen a continued recovery in loan volumes over the past three years. Demand however remains suppressed despite a healthy appetite from beneficial owners to lend securities, in fact we have seen a positive trend in new beneficial owners lending their securities for the first time. This lack of demand is in part driven by over supply in the fixed income market, lower

hedge fund activity, deleverage in the equities market and a changing and uncertain regulatory environment that is impacting all market participants. Regulation, in particular, is really changing and driving the way in which borrowers manage their balance sheet and capital, which in turn is driving the cost of borrowing and the manner and way in which borrowers collateralize loans from beneficial owners. Basel III, Dodd-Frank, EMIR and FSA Liquidity Rules are just a few of the specific regulations that are impacting the borrower side of the industry. This is

manifesting itself in the ways we see different borrowers prefer to collateralize loans. This, in turn, is critical to understanding the forces that are driving demand for collateral itself as well as securities to cover various trading strategies.

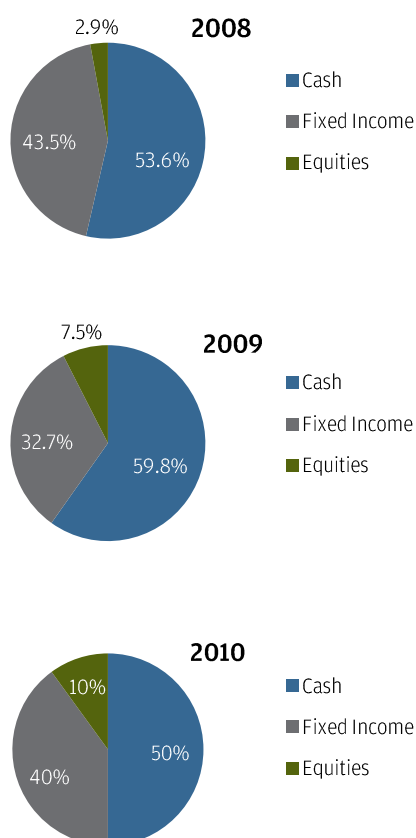
If we look at J.P. Morgan's overall program (see chart), cash collateral now accounts for approximately 50% of all collateral. However since 2008 the largest growth has been in equities, while overall there is a more balanced breakdown of the types of collateral we have been receiving.

As noted above this has typically been driven by the individual funding needs of borrowers. Additionally we have seen many borrowers undertake internal collateral/funding optimisation which has led those borrowers to display contrasting preferences as to the type of collateral they wish to provide. This is in contrast to the market several years ago, where we tended to see market shifts in waves with either cash or fixed income being more or less favourable. Today, there is no such consistent shift - each dealer has clear and distinct preferences to the

type and term of collateral they want to deliver. It is possible that for the same transaction, in terms of collateral and duration of the loan, four different dealers will have four different requirements. For example, term loans versus cash collateral, open loans versus equity collateral, or term loans versus fixed income collateral are just a few examples of the different types of current loan and collateral structures.

The impact of these trends can be quite significant for beneficial owners. Balances can be built, or lost, simply because of a borrower's collateral requirements. As we have stated previously, while collateral is a prime risk mitigant, a beneficial owner who is able to accept a broad range of collateral types, will benefit significantly in terms of balances and revenues.

The dynamics between the correlation of the underlying securities on loan and acceptable collateral is fundamental to understanding that collateral flexibility does not imply increased risk. On the contrary, the benefits of diversification have



long been recognised, this holds true for a portfolio of collateral as much as it does for a portfolio of investments. Risk can be reduced by diversifying collateral to several asset classes, differing or by higher margin levels. Equities are a good example, whereby the acceptance of correlated collateral, for example equities against equity collateral, enables beneficial owners to benefit from increased utilisations and spreads. Borrowers who are actively trading in equities will pay a premium to use their own long positions as collateral against borrowed positions and benefit from higher haircuts (7-10%), and highly liquid and easily priced collateral.

Accepting these concepts is one thing, but diversification in collateral requires more resources and technology, for two reasons. First, diversification requires appropriate reporting to clients about the nature and whereabouts of the collateral that is being accepted and second, diversification of collateral needs to be monitored, marked accessed, liquidated and realized in a rapid time frame if required. The Lehman default proved that securities lending processes around these events actually worked, the new landscape and the rise of collateral trading techniques to optimise balance sheet usage has renewed the challenge to ensure process, procedure, documentation and controls are sufficiently robust.

Without transparent reporting beneficial owners are limited in their ability to satisfy their internal due diligence and governance requirements that enable them to broaden the scope of acceptable collateral.

J.P. Morgan provides a wide breadth of client reporting through Views Portfolio Reporting, with key functionality including report customisation, data drill-through, flexible output formats, and alternative delivery options (e-mail, auto-save, file ftp, auto print). The reporting function also provides a scheduler feature that allows data and time dependant reporting events to be created and automatically e-mailed to recipients.

The Securities Lending Dashboard has been introduced to allow beneficial owners to view all key reporting parameters and information in a single customisable view.

The continued investment in reporting enhancements for beneficial owners has been important in assisting beneficial owners with evolving compliance checks in a changing market environment. Historically, the oversight of the securities lending program had been carried out as a back office function but this has progressed to a front office and risk and compliance function. Transparency of collateral parameters has clearly been an integral part of beneficial owners' additional oversight of the program with the following reports typically being interrogated:

- Daily Securities Collateral Detail - detailing the security collateral allocated to the lenders loans
- Investment Daily Accounts Statement - detailing the lending client's collateral investments with key features including settled and pending investments, ratings and maturities including a summary providing sub totals for various categories with weighted yields
- Investment Mark to Market - proving the latest market value of investments within the lenders cash collateral investment portfolio
- Reverse Repurchase Collateral Detail - providing underlying collateral on the repo buy counterparty

J.P. Morgan has always offered segregated cash collateral investment guidelines which allow the lender to tailor the guidelines according to their risk parameters and appetite. This flexibility has allowed lenders to tailor their investment guidelines according to a changing environment, for example, amending maximum tenor, quality guidelines, products and concentration guidelines.

As noted, collateral flexibility ensures diversification of collateral and borrowers while aiding optimum performance. The securities collateral schedule focuses on high quality, diversification and concentration of non cash collateral. Securities collateral includes U.S. Government and agency debt in addition to minimum AA- rated Eurozone, OECD and U.K. Government debt. Beneficial owners also have the ability to add Equity collateral to their schedules where appropriate.

In the same way that borrowers have disparate collateral preferences so too do clients. The trend has been for a greater desire for customised collateral schedules, particularly in the Central Bank, Sovereign Wealth and Insurance sectors. Traditionally agency programs have adopted pooled collateral techniques to maximize efficiencies and the scalability of their models. This still holds true, but in today's environment there is a clear need to offer customized solutions for specific trade types.

These forces have consequently fed the demand for the need for a tri-party collateral agent who can manage, clear, and re-hypothecate collateral among many different counterparties in the market. A tri-party collateral agent amongst other

services, can hold securities (security, safekeeping and reporting), mark-to-market, optimise the use of long inventory, test for collateral eligibility and issue margin calls.

Because the tri-party collateral agent acts as a centralized exchange between lenders and borrowers the benefits include but are not limited to:

- Reduced costs for both lender and borrower as back office and IT are effectively outsourced.
- Lender and borrower can invest in core business instead of collateral management.
- Scalability and ability to trade at higher volume more frequently.
- Diversification in acceptable collateral as tri-party agents handle a much wider variety of collateral instruments than would typically be the case in a bi-lateral arrangement.
- Standardization; collateral agreements and protocols are typically dealt with in industry standard agreements across the whole spectrum of collateral givers and receivers helping to eliminate inefficiencies and uncertainties that can exist due to variances in legal interpretations.

The use of an organization with the depth of resource to invest in efficient collateral management is a prerequisite to positioning a lending program to enable its optimum performance in today's securities lending and collateral trading market.

J.P. Morgan undertakes strenuous review of acceptable collateral, conducting stress tests and analysis and applying appropriate haircuts based upon eligibility, asset class, liquidity, diversification and currency of collateral. In order to maintain greater control, given increased complexities of collateral management, we have fully integrated our securities lending activity with J.P. Morgan's market leading tri-party collateral management offering to provide our clients greater flexibility and increased control.



By Paul Wilson, Managing Director  
Worldwide Securities Services  
Financing and Markets Products

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