

# Using Collateral to Enhance Returns and Mitigate Risks

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The use of collateral is a time-tested mechanism for mitigating credit risk. However, as the uses of collateral have grown in scale and complexity, the core tasks of effective collateral management have challenged even the most sophisticated market participants. As a result, many investors are increasingly turning to 'tri-party repo' solutions to manage their collateral positions. Since the onset of the financial crisis, this trend has grown as market participants place heightened value on the additional risk mitigation and other benefits that tri-party repo brings.

## Background and Evolution of Collateral Management

Collateralization helps to counterbalance some, or all, of the loss that may ensue if one counterparty is not able to meet its obligation to another. In essence, collateralization serves to offset the primary credit risk, although it neither affects the likelihood of default nor impacts the value of a defaulted transaction.

In addition to addressing essential risk concerns, collateralization offers options to enhance liquidity and returns for both the cash provider and the cash taker. Cash providers – who act as the securities buyer and cash lender in a repurchase agreement (or “repo transaction”) – can leverage their long cash positions to gain additional benefits. By lending otherwise idle cash to repo sellers (typically broker-dealers), they achieve enhanced returns while still remaining collateralized.

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## Benefits of Repurchase Agreements (Repos)

Repos are a particularly effective method for mitigating credit risk, since the use of securities is embedded within the repo structure itself. Originally, repo contracts were arranged bilaterally: that is, directly between the cash provider (buyer) and cash taker (seller).

Repos are now used to enhance liquidity, improve upon returns, and support any number of funding strategies and other objectives. As repo markets have grown, the uses of securities have expanded in scale and complexity, and the core tasks of effective management on a bilateral basis have placed an increasing strain on internal resources. Effective collateral management requires substantial investments in infrastructure and technology, specialized expertise, and experience across the full spectrum of collateralized trading. For many investor institutions, the development of these capabilities internally can be daunting.

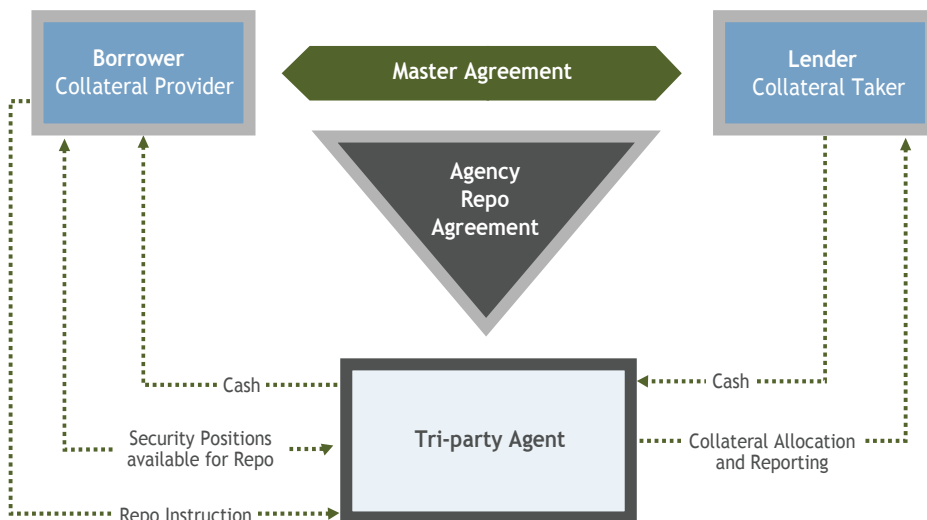
In addition to the administrative burden, bilateral collateral management poses other limitations. As investor institutions typically maintain bilateral agreements with a relatively small number of institutions, they are faced with credit risk concentration concerns.

Tri-party repo was developed in response to market demands for a better way to hold and manage collateral. The structure enhanced operational flexibility and capacity while putting independent controls in place to safeguard counterparties. During the recent market crisis, the tri-party market performed as designed, affirming the value of the structure and demonstrating continued investor confidence in the protections that tri-party provides.

## The Role of a Tri-Party Agent

Given the current risk-averse environment, the choice to employ a third party – or tri-party agent – has become more obvious than ever before.

### HOW A TRI-PARTY REPO TRADE WORKS



The tri-party agent serves a vital role in the collateralization process. The agent's fundamental responsibility is to administer the transaction and hold the assets. The tri-party agent manages those functions previously handled by each party to a bilateral arrangement:

- the collection and return of cash and collateral
- eligibility testing
- collateral optimization and margin management
- recall, substitution and reuse
- asset servicing and marking collateral to market

The right tri-party agent, with the right infrastructure, is able to manage the operational, settlement and market risk that stems from collateralization. Tri-party repo agents such as J.P. Morgan go beyond the basics to offer a wide range of additional services.

J.P. Morgan introduced the tri-party model in Europe in 1987 and today delivers its tri-party repo service under English, New York, German, New South Wales or Japanese law, offering appropriate market protections in accordance with clients' jurisdiction.

### MECHANICS OF A REPO TRANSACTION

- In a repo transaction, one party exchanges securities for cash with an agreement to repurchase the securities at a specified future date. The securities serve as collateral for the cash transaction.
- The repo market, therefore, is accessed both by those seeking to borrow cash and those needing securities for a variety of reasons, including making delivery on futures contracts and supporting funding strategies.

## Deconstructing a Tri-Party Transaction

Unlike a bilateral transaction, where the two counterparties agree on the specifics of the securities to be exchanged, a tri-party transaction involves an independent third party collateral agent. This agent manages the securities and ensures that the buyer's exposure is adequately covered by allocating eligible securities from the seller's securities pools according to the repo buyer's pre-defined eligibility schedule. The eligibility schedule allows the repo buyer to list securities, margin to be applied and any concentration limits they require. Sellers are able to optimize the use of securities by ranking their securities in terms of ideal delivery order within the eligibility criteria.

The core functions of a tri-party service include:

- the setup and maintenance of eligibility criteria
- settlement of securities
- acceptance and rejection of securities in adherence to eligibility criteria
- daily mark to market analysis and reporting
- margin notification to borrowers
- the calculation and payment of coupons if securities are held over record date
- comprehensive Corporate Action and Tax service

Additional functions include Record Date substitution, optimized securities allocation, automatic search and replacement of securities on an intra day basis, and complete reporting solutions.

#### A GROWTH TRAJECTORY FOR REPO

- Use of tri-party repo in Europe has grown 47% in the last five years (through year-end 2008)
- In the US, repo transactions grew by 29% between 2004 and 2008]

## Specific Benefits for Lenders

Using a tri-party structure provides the repo buyer with several key day-to-day advantages:

- Margin calls and corporate actions are managed by the tri-party agent.
- Pricing information, sourced from independent vendors, provides daily securities values
- Exact parameters can be set for the securities that will be accepted. The lender can define eligible securities by asset type (including equities or indices), or set limits (including dollar amounts or concentration limits). Haircuts and margins can also be specified, removing all ambiguity from the securities allocation process.
- Multiple allocation runs (both scheduled and ad hoc) ensure that the buyer is margined on an ongoing basis. With allocation algorithms that automatically assess, refresh and reallocate securities according to current information, buyers are always margined in accordance with the eligibility parameters established.
- Cash can be deployed globally, either at home or in other markets, without any additional infrastructure.
- Realize savings with reduced transaction, custody and operations costs.
- Securities can be re-used (or rehypothecated) to lower costs and increase liquidity, realizing further value from received assets, without compromising the clarity of asset ownership.
- Projections and simulations allow for maximum flexibility, through the use of “what if” scenarios which allow participants to see the effect of selecting different eligible securities or asset configurations.

#### BENEFITS OF TRI-PARTY REPO FOR CASH PROVIDERS\*

- Leverage the expertise of the third-party collateral agent to minimize operational, settlement and market risk; manage margin calls and corporate actions; and ensure constant collateralization – without costly investments in operations and technology
- Set exact parameters for the types of securities that will be accepted as collateral, according to a broad range of criteria, as well as desired margin and concentration limits
- Gain introductions to a broader array of potential counterparties
- Generate additional returns from otherwise idle cash, while mitigating counterparty and credit risk through the use of collateral

\* Cash providers act as the securities buyer and cash lender in a repo transaction.

## Conclusion

The use of collateral is a risk diversification strategy. Credit risk is transformed into other forms of risk that need to be understood and managed: operational, settlement and market risks.

To successfully use collateral to control credit risk, the cash lender must be equipped to effectively handle the operational requirements of managing that collateral. If collateralization takes place within a tri-party arrangement, the independent agent steps in to manage the details of the transaction, delivering substantial efficiencies and significant safeguards against risk to the cash providers.

Partnering with the right tri-party agent alleviates the need for a cash lender to create and maintain internal systems to manage and track collateral. This permits the lender to focus the full resources of its organization – time, talent and technology – on its core business.