Collateral Management Guide PART 8: Rehypothecation and Tri-Party Collateral Management

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Collateral Trading: Rehypothecation of Collateral

When a net creditor in a deal receives marketable collateral from the debtor counterparty, the creditor may then turn around and pledge that collateral for another transaction with a second counterparty. This is known as **"rehypothecation",** an odd word meaning the **secondary re-use of collateral.**

The **basic function** of rehypothecation is to **provide counterparties with a broader array of collateral availability and the ability to enter into a wider breadth of trade types**. In certain transactions with credit risk such as credit default swaps, the quality and marketability of collateral is essential to be able to enter into and maintain a deal over its life. A trader who is able to access different types of collateral from other transaction has a greater ability to get into trades where collateral security is required, and to obtain and post additional collateral as needed by leveraging other profitable deals. The trader may also earn an interest rate spread between the haircut charged and the haircut paid to two different counterparties.

Rehypothecation has been traditionally used in **bi-lateral trading relationships**. However, to rehypothecate collateral efficiently and on a larger scale is very complex and requires dedicated staff, inventory and accounting systems, and legal support unavailable to many smaller institutions such as hedge funds. Without the proper systems and procedures, there is a **risk of double-committing collateral** or not being able to **obtain the collateral back** when needed. These factors have led to the rapid growth of the **tri-party collateral** business.

Tri-Party Collateral Management

Tri-Party or multi-party collateral managers provide a central service to **manage, clear, and rehypothecate collateral** among many different OTC counterparties in the market. With tri-party management, collateralization can be done at a **net portfolio level** and rolled up into a single statement in near real time. Collateral agreements are **standardized in ISDA format** across the entire pool of trading counterparties, eliminating inefficiencies caused by differences in contractual interpretations.

Collateral rehypothecation is the foundation of tri-party collateral management services. In exchange for providing access to different markets and collateral types to the service membership, the tri-party manager acts as a **central broker,** taking a small portion of each collateral transaction as a **fee or trading spread.** Usually this is in the form of a **haircut differential** between the haircut paid to the collateral giver (lower), and the haircut received from the collateral taker (higher). Facilitation of **tri-party repos** and **total return swaps** provides access to a common pool of collateral posted by a wide variety of market participants from different locations around the world, across a broad array of products. For this valuable service, the tri-party manager takes a small cut of each collateral movement.

Additional services provided by tri-party collateral managers include:

- **Securities Lending Escrow (SLE):** Manages securities received from borrowers for the benefit of lenders.

- **Holding securities** (security, safekeeping, accounting)

- **Mark-to-market and mark-to-model valuation**

- **Reporting and recordkeeping**

- **Substitution** of collateral

- **Delivery and receipt** of collateral postings

- **Collateral eligibility testing**

- **Margin calls:** issuing and managing responses versus margin agreements

- **Rehypothecation tracking:** Accounting for and managing the movement of collateral through the chain of trading counterparty accounts.

- **Asset servicing:** Processing bond coupons, interest payments and receipts, interest accruals, dividends, stock voting, etc.

- **Trust services:** Calculation and payment of interest on cash collateral in the form of trust assets, at negotiated interest rates

The benefits of using a tri-party collateral manager include:

- **Reduced overhead:** There is no need to maintain a large back office team and IT investments required to process, rehypothecate, and account for collateral on OTC positions.

- **Technology:** Tri-party collateral managers utilize the latest sophisticated real-time processing and communication systems.

- **Concentrating on core business:** The counterparties can concentrate on their core businesses of trading, financing or lending, instead of managing collateral.

- **Enables higher trading volume:** By outsourcing the back office functions of collateral to a highly efficient and automated service provider, a common bottleneck is removed, and the trading instution can trade at much higher volumes without overwhelming the back office function.

- **Enables diversification** into more instruments: The typical bi-lateral trading relationship is limited to 2-5 unique instruments. Tri-party member institutions can have access to 50 or more different transaction types to choose from.

- **Arbitrage rates** of borrowing and lending across different collateral types (e.g. Treasury Bonds vs. Corporate Bonds): Trading institutions can use the collateral function as a source of arbitrage or directional trading, as if they purchased and sold deals directly with an OTC counterparty.

- **Segregated reserve bank accounts under SEC Rule 15c3-3:** The SEC Act of 1934 requires broker dealers to maintain "special reserve bank accounts" strictly for customers which are separated from the broker dealer's own accounts. Cash deposits may be invested in "qualified securities" or held as cash deposits. There is no limitation to a broker dealer placing client cash in such accounts, and there are no limits on the number of withdrawals. This compares to 50% of excess net capital for money market deposit accounts. Similar segregation is provided pursuant to rules of the **Investment Industry Regulatory Organization of Canada (IIROC).**

- **No cost to the Lender:** Lenders do not pay for the tri-party collateral management service

- **Access new forms of collateral** at competitive rates

- **Commodity Futures segregated accounts: CFTC Rule 1.20 Commodity Customer Segregated Account and CFTC Rule 30.7 Secured Amount Bank Account:** Futures Commission Merchants (FCMs) must invest customer cash in a way to protect client assets. Accounts must accept and maintain only cash, with no securities allowed. Segregation is required to prevent cash assets from begin mixed with securities payments and failures to pay. Cash deposited is held in a segregated trust acccount which is FDIC-insured and accounted for on the trust ledger of the bank. Accounts can accomodate multiple currencies.

Tri-Party Service Providers include:

- JPMorgan http://www.jpmorgan.com/tss/Product_Index_New/Collateral_Management/1114735364452

- Bank of New York Mellon http://www.bnymellon.com/products/assetservicing/collateral.html

- Clearstream http://www.clearstream.com

- Depository Trust and Clearing Corporation (DTCC) http://www.dtcc.com

- Deutsche Bank http://www.db.com/en/content/gto/investment_banking_operations.htm

- Euroclear http://www.euroclear.com

- Northern Trust http://www.northerntrust.com

- State Street Bank and Trust http://www.statestreet.com

- SWIFT http://www.swift.com

<< BACK TO PART 7

CONTINUED IN PART 9 >>

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