Untrapped

Ed Corral, global head of collateral strategy at J.P. Morgan in New York tells GI/isf how the company's work with trapped assets is opening a valuable new collateral resource for tri-party lending transactions.

What are trapped assets?

A trapped asset is any asset that has value but is challenged in terms of tri-party financing: for example, it may be restricted or is not held at a traditional depositary. Examples of such assets include ETFs, master limited partnerships and restricted shares.

As a result, the asset will fall outside the traditional channels of clearing and settlement – effectively trapping it from use in a securities finance transaction. To free it we must develop a process to support its accessibility within our securities finance programme.

It's important to be able to utilize all assets to support overall market liquidity and help institutions generate incremental returns while also managing collateral to meet capital and other binding constraints.

We have been identifying asset types, which by virtue of their lack of transparency, location or lack of familiarity have not previously been available for use as collateral in tri-party lending transactions. Our work has focussed on improving access, pricing and transparency so that participants are more comfortable accepting them as collateral. We have concentrated on remediating whatever was lacking for those assets in the eyes of those who would be asked to hold them – whether that is ratings information, pricing information or other static data..

What is the size of the market for trapped assets?

As one example, the market for master limited partnerships was estimated to be around $235bn at the end of March 20201.

Lately we have been working on addressing issues specific to restricted shares where there is significant opportunity: one such program alone currently has $78.8b in outstanding market value.

These can be tough assets to price – we are not talking about shares of a S&P 500 company here. The result is that these assets are either not being financed, or they are being financed through complicated synthetic products. The latter are hard for the holder to structure. In most case these synthetic structures focus on shifting the risk within a financial organisation: typically this will be moved from the dealer to the banking entity, where the excess financing is located.

By contrast, the ability to turn trapped assets into straightforward financing assets available for collateral management, as we have successfully done, brings a huge amount of capacity online.

Can you give a specific example of how trapped assets are released?

Certain restricted shares, such as those issued in preparation for a future event such as an IPO, are trapped because of their location. As a result, the shares don't settle at the DTCC like all other non-governmental securities in the US. Instead they are held at a transfer agent.

The value add for a tri-party agent is to gain access to the restricted shares at the transfer agent in an efficient manner, as additional holdings in these shares may be restricted to the institutions that already hold them. Given our leading positions in both banking, trading and custody, J.P. Morgan is often one of those institutions. By utilizing our integrated agency collateral management and securities lending services, we are then able to facilitate the use of these assets in tri-party lending.

Until recently the only way to access these types of shares in a securities lending transaction was to create a synthetic route, including inter-company funding. Our process lets them be deployed more traditionally, and we are seeing strong interest from the broker-dealer community.

Why have ETFs been so frequently trapped in the past and how is that changing?

ETFs are now beginning to make their way in some limited capacity into tri-party financing transactions. In the cases of the major names, such as SPY (the SPDR S&P 500 trust) and the Invesco QQQ (another a popular ETF that tracks the Nasdaq 100 index), lenders have now become comfortable taking them.

But as you go deeper into the asset class and the names become less familiar, lenders tend to become less comfortable.

The main reason for this is the lack of transparency. In order to be comfortable taking ETFs as collateral, lenders need to know what they comprise – which is to say they need to have transparency on the underlying assets. They need to avoid the situation of having to say to a regulator or an auditor 'we accepted the asset without really knowing what it was'.

How do you create this transparency?

Our work is focussed on providing lenders with enough static data for them to analyse the asset to their satisfaction.

J.P. Morgan is a huge consumer of data itself as a top trading house, asset and investment manager, custodian and collateral agent – through the leading providers such as IDC, Bloomberg and Reuters, as well as through the smaller boutique agencies. When we see enough demand in a trapped asset, we approach these pricing vendors to secure this key descriptive information, including the security's price, daily trading volumes and ratings. This coupled with our ability to leverage our Firm-wide capabilities in dealing with trapped assets places J.P. Morgan in a unique position to provide solutions in this space.

Where a security does not settle at a traditional depository, our main job is to build a settlement pathway so it can be integrated into our tri-party programme.

Where the security settles with a transfer agent, many of the processes during the securities lifecycle, such as reconciliation, still include manual elements. To comply with our automated daily reconciliation requirement, we will need to build an independent electronic feed, and that can be harder than it sounds.

What specifically does J.P. Morgan bring to this space?

The traditional tri-party financing space is a mature one, which is well served and in which there are few opportunities for differentiation. We see a particular opportunity for J.P. Morgan to deliver incremental value in additional activities such as trapped assets because they play to our particular strengths, notably automation and optimisation.

We have leveraged these strengths elsewhere in the past. Solving market settlement and legal issues with Korean and Taiwanese equities in tri-party is a strong historic example. One prospective example is in the CCP space, where both firms and client clearing organisations have very large margin requirements and the process of retrieving and delivering collateral is often manual and poorly optimised. J.P. Morgan has begun to work with a CCP to develop a third party collateral agent solution to address these issues.

So the mobilisation of assets is a central pillar of what we do when it comes to securities finance. And these cases are no exception. For borrowers, or those operating in the agent lending space, providing the means to move assets that formerly proved hard to move has become a very valuable service.

Clearly delivering this level of transparency provides value to the borrower by providing access to an asset that was not previously available. But the lender also gains: it gets greater diversification and, potentially, a better price. Now that the asset can be financed, the borrower no longer needs to employ another high value asset, such as a gilt, that otherwise would be used in its place, freeing that asset for use elsewhere. This creates a financial benefit for which they may be prepared to pay. ■

[1] For MLPs, the estimate I got is $235bn (end of June 2020); this is in line with another source (as of Sep'19) showing $288bn and trending downwards
Source: Using MLP data, which is a website referenced by the MLP Association, an org referenced by the SEC for MLPs.