Collateral, Rehypothecation, and Efficiency
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Rehypothecation: the repledging of collateral

For example, prime broker re-uses clients' collateral to back up its own trading and borrowing (provided that the clients permit this).
Rehypothecation economizes on scarce collateral.

• Without rehypothecation, the lender keeps collateral idle until he returns it to the borrower.
• Rehypothecation enables the lender to raise additional funds,
  – Decreasing the lender's opportunity cost of holding collateral
  – Allowing borrower to obtain more funds against the same collateral

In short, rehypothecation provides more funding liquidity to the economy
Rehypothecation and counterparty risk

However, rehypothecation comes at a cost.
• The receiver of collateral may go bankrupt having re-pledged his borrower's collateral to the third party:
  – Collapse of Lehman Brothers in 2008 and MF Global in 2011
• Rehypothecation failure leads to misallocation of the assets
  – The collateral cannot be returned to the borrower who is likely to put the highest value on it.
Rehypothecation and the Financial crisis

• In 2007, $4.5 trillion in rehypothecatable collateral held by the six largest U.S. investment banks.
• In the wake of the Lehman Brothers collapse in 2008, hedge funds limited the amount of their assets to be rehypothecated.
• In 2009, the total value of rehypothecatable collateral held by these investment banks dropped to $2 trillion.
• Debates about regulating rehypothecation continue.
• Main questions in this paper

• What benefits and costs does rehypothecation produce?
  – Is rehypothecation socially beneficial?
• Are individuals' preferences between rehypothecation and non-rehypothecation aligned with social efficiency?
• When can we expect that rehypothecation is more (or less) likely to occur?
A borrower is subject to the moral hazard problem.

Posting collateral induces the borrower to make effort to avoid default.

This increases the borrower's credibility and ability to raise funding for his productive investment.
Collateral is transferred from the borrower to the lender at the time the contract begins. As in a repurchase agreement, the borrower exchanges the asset for cash, and effectively buys it back later on. However, financial distress in the lender can tie up the collateral.
Collateral is more valuable to the initial owner than to the others. (less than perfectly liquid)

- Portfolio considerations
- Costs of resale
- Certainty of title
Two periods, risk neutrality, no discounting

- Firm A wants to borrow to finance an investment project, but lenders face limited commitment to repay
- If the lenders can, after the fact, only attach a fraction of the cost of the investment, they will be unwilling to lend
Aside—

One source of limited commitment: Moral hazard

- Suppose the success of the investment depends on A's unobserved actions
- Then the ability of creditors to extract value is limited by the need to induce effort from A
- In this case, borrowing backed only by future gains may not be feasible
Collateral relaxes the constraint

• If A has another asset that is of value to him at a later date, he can offer the asset in pledge, for redemption at the repayment date.

• The greater the value of the asset to A, the greater an amount he can credibly borrow—even if the asset is of little value to the lender.
• Optimal arrangement

• We describe the loan as “over collateralized” or “under collateralized” depending on whether the total amount to be repaid by A is greater or less than the value of the collateral to A.

• In general depends on both the amount extractable from the project, and the details of the incentive problem.
• Risk of loss of collateral by lender

• Provided the possibility of lender’s failure is sufficiently small, it can still be desirable to engage in collateralized borrowing.

• The lender compensates for the risk by lending at better terms for the same collateral.
Three periods: Date 0, 1, and 2. Three players: Initial borrower A, A's lender B, and B's lender C.

- **Timing:**
  - **Date 0:** A borrows funds from B for his investment by pledging his asset as collateral.
  - **Date 1:** B borrows funds from C for investment by re-pledging A's asset.
• Rehypothecation Model (continued)

• Date 2: Both A's and B's investments mature, and B recovers A's collateral from C by making the payment and then B returns it to A in exchange for receiving the payment.

![Diagram showing A, B, and C with collateral flows between them.]

• If B defaults, collateral is seized by C; collateral remains in the wrong hands since it is worth less to C than to A.
• Optimal Contract with Rehypothecation

• A sequence of two contracts:
  – Contract between A and B at date 0
  – Contract between B and C at date 1

• Solve the model by backward induction
• Compare with optimal contract without rehypothecation (contract between A and B alone)
• Contract between B and C

• Straightforward: If B defaults C retains the collateral; if B does not default the maximum he can pay C is the amount he will receive from A.

• B borrows the maximum consistent with these constraints.
• Welfare Tradeoff

• Rehypothecation supplies more funding liquidity to the economy, so that additional productive investment are undertaken.
• Rehypothecation failure may incur costs by misallocating assets.
• Results: inefficiency of rehypothecation decision

• The wedge between the value of the collateral to the borrower and the value of the repayment is determined by the incentive problem that the collateral is solving.

• But this means that the shadow value of collateral to the middleman is not the same as to the borrower
• Results: inefficiency of rehypothecation decision

• If the loan is undercollateralized; there tends to be an insufficient use of efficient rehypothecation:
  
  B values the payment he receives from A more than A values receiving his collateral back, and thus B tends to prefer not to rehypothecate

• Result is reversed for overcollateralization
Permission to rehypothecate

If the initial borrower A has the right to permit rehypothecation or not,

- A will tend to be more reluctant to permit rehypothecation as the optimal contract between A and B involves increasingly over-collateralized lending.
• **Summary**

• Analysis of the economics underlying rehypothecation

• Model highlights the trade-off determining the costs and benefits of rehypothecation:
  – It supplies more funding liquidity to the economy, but it incurs deadweight costs by misallocating the asset when it fails.

• The spread between value of collateral and promised repayment leads to incentive conflicts between the parties