



BNY MELLON

Refinancing Challenges and the role of Collateral

By Rossana Abueva Strategy
BNY Mellon Corporate Trust

Contributors

John Spedding

Business Management

BNY Mellon Corporate Trust

David Somers

Product Management

BNY Mellon Corporate Trust

The banking industry is undergoing a transformation. Regulatory change, coupled with massive refinancing needs over the next couple of years, is altering the way that banks work, stimulating new financial structures and products.

As a trusted partner in many aspects of bank funding, BNY Mellon has a broad vantage point on the industry. Here we highlight the shifts we have been seeing so far this year in light of these changes: among them, growth in longer-term funding, instruments that can hedge against major macro-economic risks and the increased use of collateral.

In the current volatile and uncertain environment, the broad trend towards more conservative funding is an attempt to give investors the comfort they seek, and issuers the resilience demanded by regulators.

Looking ahead, in order to improve banks' balance sheets and better match their funding, the growth we have been seeing in the use of collateral is likely to continue.

Driving demand: The trend towards more conservative funding

Investors' search for safe havens naturally intensifies during periods of volatility and uncertainty, so demand is driven by those areas of the market which give investors the most comfort.

One such source of comfort has been corporates, whose prudent balance sheet management has led to falling default rates - in direct contrast to banks and sovereigns, which have been the major cause of market jitters.

Our issuance data year to date (YTD) confirms the trend towards more conservative funding. In particular, it shows the strength of both longer-term sources of funding (and a corresponding fall in issuance of short-term) and of instruments that can protect against some of the major macro-economic risks.

A good example of this has been the increase in Stand Alone Bond issuance for which we witnessed a 31% YOY increase Q3 YTD. In contrast Euro Medium-Term Note issuance has seen a significant decrease of 25% YOY Q3 YTD trending to shorter tenors and Euro Commercial Paper (CP) financing continues its decline from 2009 levels - falling 17% from 2010 Q3 YTD volumes and 40% when compared to 2009 levels. This is a trend that is likely to continue into 2012; with the market responding to pressure from the regulators to seek longer-term funding.

Meanwhile, investors' search for protection against some of the major macro-economic risks has intensified. There has been a significant rise in products with a derivative element – particularly those which allow investors to hedge against contagion in Europe. In addition, for a second year running, we have seen phenomenal activity in pure warrant issuance, up two and a half times on 2009.

The one stand-out exception to this trend towards more conservative funding was the high yield space earlier in the year, particularly in some emerging European economies. While any evidence of the market's appetite for risk is welcome, the strength of the high-yield space is, in fact, often the result of a poor syndicated loan market. As banks have lessened their focus on syndicated loan books, borrowers have been forced to find other sources of funding. Activity has significantly dropped and/or plateaued primarily in response to the deepening sovereign debt crisis.

Collateralised activity increasing: collateral to be king

Whether it is through its role as loan agent, or facilitating the whole life-cycle management of loans, BNY Mellon is in a prime position to identify trends in the market.

With the need for funding being driven by banks' significant refinancing requirements, regulatory measures and changes in the insurance market, the need for collateral is being driven by investors. Apart from government guarantees, longer-term funding at a much preferable cost of funds than unsecured has been achieved through collateralised financing. We have also tracked how investors are considerably more interested in collateralised debt, as a route to added protection and how Issuers have responded with depositing/pledging all kinds of assets from various jurisdictions.

In addition to the demand for collateral, what is also apparent to us is that the credit crisis has led to a real change in the way banks have been working to meet both funding and collateral demands. Many have begun to adopt a more holistic approach. For example, treasury, securitisation structurers and repo groups, who traditionally worked more independently, now enjoy far greater co-operation leveraging structures and practices.

Refinancing risk: driving short-term change

The amount of refinancing due over the next two years is vast – partly the result of central banks' liquidity schemes beginning to roll off in the UK and the rest of Europe. As a consequence, refinancing risk is currently very high.

So as to provide greater investor comfort, there has been increased use of collateral to get term funding done, with participants generally trying to match the tenor of collateral with the tenor of funding.

There has been a rise, too, in collateralised bilateral loans between institutions – particularly banks looking for three to five-year funding. BNY Mellon frequently has a crucial involvement in these, as it can provide secure custody arrangements and support bespoke collateral monitoring requirements. These give investors the comfort of seeing their collateral held in a secure third-party account, rather than being held by the Borrower.

Banks are finding residential mortgage-backed securities (RMBS) coming back on to their balance sheets: the challenge for them is to unwind some of these securitisations and create new structures to meet investor requirements.

Regulatory demands: transforming the industry

Along with refinancing, regulation is driving change in the industry and encouraging the development of new financing structures – including increased use of collateral.

We are seeing more and more evolution of products to meet the requirements of regulators and central banks, particularly in the collateralised space, in order to improve banks' balance sheets and better match their funding.

The broad demand of regulators is for banks to have a lot more resilience to extended periods of illiquidity. To meet these requirements ahead of Basel III, astounding amounts of capital are needed, should banks wish to remain in the same businesses, with similar sized balance sheets.

Among the regulatory demands are:

- A liquidity coverage ratio that is on the short end, so that an institution has eligible liquid assets to cover any liability that matures in the next 30 days. Previously, banks had been working to a much shorter window – as we saw in the case of Lehman Brothers, which defaulted in as short a time as three days;
- The net stable funding ratio, introduced by Basel III, which acts as a means to get banks to have suitable longer-term funding against the assets on their balance sheets;
- Living will requirements, whereby banks are expected to have a plan as to how to liquidate or repay investors in the event of a default. In terms of collateral in such an event, a loan on a bank's balance sheet is much more difficult to use as collateral than a security. Banks may need leverage tools such as Declarations of Trust and Equitable Assignments to achieve perfection of collateral or securitisation as a means of moving these assets off balance sheet.

No bank wants to wait another seven or eight years before enacting change, especially when Basel III and Dodd-Frank phase-in periods commence in 2013. With these kinds of demands rapidly approaching, banks will have no option but to reduce their balance sheets, exit capital-heavy businesses, and de-risk. They will also need a much more thorough understanding of the risks that remain on their balance sheets.

One way that BNY Mellon can help here is through compliance-type monitoring of portfolios of collateral. In often complex scenarios, we can analyse portfolios by various factors such as geography, sector, industry and rating, allowing either the investor or lender confidence that they are achieving certain levels of compliance around the collateral provided.

Regulators' requirements are transforming the industry, and are bringing changes to the types of assets/liabilities on banks' balance sheets. Last year, for example, the first collateralised CP programme came to market, driven by that bank's repo funding desk. Like other instruments using collateral, the collateralised CP gave investors the comfort they were looking for, as well as the flexibility to go further out in the yield curve. We expect to see further evolution of this product in order to improve its efficiency under the liquidity coverage ratio.

Following on from collateralised CP programmes have been collateralised note programmes, allowing the holder to trade the note in the secondary market.

BNY Mellon is involved in many of these types of programmes, through its issuance and paying agency functions. For example, where a client wishes to issue through a note programme, as well as doing the collateral monitoring and management, we can carry out the issuing and paying agency functions of the note: we get the note issued through the central securities depositories initiating settlement and we help facilitate secondary trading by being able to provide collateral level reporting to the secondary market.

Insurance companies: reacting to a changing regulatory landscape

An interesting aspect of these industry changes is the role of insurance companies and how they are having to adapt to new regulatory rules such as Basel III which govern and impact both the financial and the insurance sectors.

Insurers themselves are going through a transformation; as Solvency II moves the industry to a mark-to-market regime it also moves it to a capital adequacy framework that will change the way insurance companies invest their balance sheets. The current proposed capital adequacy framework encourages insurance companies to invest in government / sovereign instruments and collateralised investments. The adverse impact on their margins and revenues has encouraged many insurance companies to participate in liquidity swap-like trades with banks, as a means of shoring up their margins, and collateral is widely used.

Again, BNY Mellon has expertise in this area: for those clients who need collateral marked to market, we provide services including calculation of margin and margin calls.

The pressure on insurers' margins is likely to remain, if not increase, for the foreseeable future, so we expect a lot more collateralised activity between banks and insurance companies.

Conclusion

The transformation of the banking industry, as demanded by both national regulators and Basel III, is being accelerated by the scale of refinancing needed over the next couple of years.

With the scale of these changes comes opportunity, and collateralised instruments look likely to be among the main beneficiaries. As the trend towards more conservative funding continues, trustee and agency banks can play a crucial role – from monitoring portfolios of collateral to offering secure custody – in building markets' confidence during uncertain times.

Contact

Europe, Middle East and Africa:
Robert Wagstaff
robert.wagstaff@bnymellon.com

Latin America and Canada:
Sonia Chaliha
sonia.chaliha@bnymellon.com

Asia Pacific:
John-Paul V. Marotta
j.p.marotta@bnymellon.com

United States:
John Polito
john.polito@bnymellon.com

Mark P. Brown
mark.p.brown@bnymellon.com



BNY MELLON

bnymellon.com

The Bank of New York Mellon is authorised and regulated by the Financial Services Authority. The Bank of New York Mellon, DIFC Branch (the "Authorised Firm") is communicating these materials on behalf of The Bank of New York Mellon which is regulated by the Financial Services Authority.

BNY Mellon is a corporate brand of The Bank of New York Mellon Corporation and may also be used as a generic term to reference the corporation as a whole or its various subsidiaries. Products and services may be provided by various subsidiaries and joint ventures of The Bank of New York Mellon Corporation, which may include The Bank of New York Mellon (each, the "Bank"), a banking corporation organised and existing pursuant to the laws of the State of New York and operating through its branch at One Canada Square, London E14 5AL, England. Registered in England and Wales with FC005522 and BR000818 and authorised and regulated in the UK by the Financial Services Authority.

Material contained within this brochure is intended for information purposes only. It is not intended to provide professional counsel or investment advice on any matter, and is not to be used as such. No statement or expression is an offer or solicitation to buy or sell any products or services mentioned. The views expressed within this brochure are those of the contributors only and not those of the Bank, and no representation is made as to the accuracy, completeness, timeliness, merchantability or fitness for a specific purpose of the information provided herein.

The Bank assumes no liability whatsoever for any action taken in reliance on the information contained herein, or for direct or indirect damages or losses resulting from use of this brochure, its content, or services. Any unauthorised use of material contained in this brochure is at the user's own risk and any reproduction, distribution, republication and retransmission is prohibited unless the prior consent of the Bank has been obtained.