A HEALTHY STATE OF AFFAIRS

Funds Europe **talks to Stephen Kiely about a more mature, post-crisis attitude within the securities lending market from all participants.**

THE SECURITIES LENDING market is currently in its healthiest state since the financial crisis of 2008, says Stephen Kiely, Managing Director and Head of Securities Finance New Business Development at BNY Mellon Markets Group.

In 2015, the appetite for securities lending has remained strong and, more importantly, has been balanced. While the number of general collateral (GC) trades and general utilisation may be down, the demand for hard-to-borrow stocks or specials-only programmes are both up.

"We have seen some uncertainty in the market due to macro events e.g. anxiety in the Eurozone, but the securities lending market has taken this on-board and the appetite has remained," says Kiely.

There was also some anxiety around changes to the regulatory environment, especially Basel III, but as the implementation dates of these new rules have come closer, the details of the new requirements and their likely impact on the market have also become much clearer. Kiely believes that there has also been greater collaboration between market participants and regulators with regard to the new regulation recently.

Basel III has been at the front and centre of this changing regulatory landscape and its requirement for both asset owners and borrowers to have better balance sheet management has helped them to take a different and more mature view of their securities lending activity.

RECOVERING: BNY Mellon's Stephen Kiely says the appetite for securities lending was strong and balanced in 2015.

"Over the last decade, and prior to the financial crisis, beneficial owners looked at securities lending as a way to achieve alpha and to extract as much as possible from their available assets. For lending agents, the level of utilisation was a way for their clients to assess the value of their service. But after 2008, some participants viewed lending as a distraction. As a result, there was a decline in volumes and a greater focus on the assets that could generate the greatest yield.

"Similarly, for the borrowers, fixed income and government bonds have become a more expensive collateral asset class, especially in the low interest rate environment that has persisted. So the trend is being driven by both sides – the lenders and the borrowers."

EQUITIES AS COLLATERAL

The demand for high-quality liquid assets (HQLA) has given rise to a number of themes in the securities lending market. "There has been a proliferation of equities used as collateral. It is now rare for an equity lending programme not to accept equity as collateral. This is due to both the high price of government bonds and a greater awareness of balance sheet management.

"It is something that we have promoted because we think equities-to-equities give a greater correlation. We have also seen the margin for these transactions contracting, which suggests they are becoming commoditised as they become more commonplace," says Kiely.

However, there is still some way to go for beneficial owners in their adoption of equities as collateral, especially when it comes to lending government bonds against equities. Some beneficial owners, such as public sector funds, are prohibited from doing so by their investment rules, while others are reluctant to on-board collateral assets with a different credit profile.

Another development has been with regard to the use of the protection offered by the agent lender to beneficial owners in connection with a borrower insolvency (commonly referred to as 'indemnification'). Whereas this was a common feature of the pre-crisis market, the high cost of capital in the intervening years has made such protection a much more expensive service for lending agents to offer to their clients.

Moving forward, for longstanding participants, it may be somewhat easier to request that the status quo be maintained through existing indemnification arrangements. For new entrants, however, the cost element is more pronounced. For example, if the beneficial owners (e.g. a public sector pension fund) want indemnification, the agent lender may now look to price it into the fee split.

On the other hand, there are a number of beneficial owners that have become much more sophisticated in their risk management and are happier to take a more nuanced approach to indemnification; one that takes into account the relative risks of individual trades. "Indemnification has been a binary tool up until very recently," says Kiely. "Beneficial owners have historically either been 100% protected or not at all."

In the future, Kiely expects three things could happen. The first is that there may be different fee splits for different trades based on the risk-weighted relief that is available. The second is that you may see, within the same programme, some trades are indemnified and others are not. The third possibility is for limits to be put on the indemnification rather than it being absolute. "We may see a cap placed on the indemnification so that it only pays the first $5 million, for example, or else there may be a voluntary excess – the type of features that you would expect in an insurance policy," says Kiely.

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Stephen Kiely, BNY Mellon Markets Group

Despite the above, Kiely says that he sees a number of requests for proposals (RFPs) that simply ask whether indemnification is provided or not. However, he is heartened by the fact that a growing number of asset owners, especially the consultant-led ones, are not only making more granular enquiries regarding indemnification but also asking follow-up questions.

A BETTER MARKET FOR ALL

While these changes have been prompted by the high cost of indemnification, Kiely believes that they will ultimately lead to a more efficient securities lending market for all participants and that it will encourage greater risk management and more transparency.

There are various third-party services available to beneficial owners to help with risk management. Additionally, there has also been an effort to make the securities lending market as transparent as possible in terms of the information made available. Ultimately, though, the responsibility for maintaining a high standard of risk management rests with the participants themselves.

Fortunately, it seems this this responsibility is being met. "Risk management is exponentially greater among participants now than it was in the pre-crisis era," says Kiely. "Beneficial owners are much more aware that, when it is managed properly, securities lending is a comparatively low risk business.

"Securities lending is now being seen as another front-office investment tool rather than a back-office process."

Essentially, the more engaged beneficial owners are recognising that a more managed approach to securities lending can also contribute wider benefits for the organisation. This includes balance sheet management and collateral optimization, rather than simply generating immediate incremental revenue from available assets.