Collateral rising

Intrinsic lending has arisen as regulatory pressure on collateralisation has created new sources of demand. Michael McAuley of BNY Mellon explains

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Is intrinsic value lending still the aim of the game for beneficial owners?

Yes. Beneficial owners and agent lenders are both focused on intrinsic value lending. The practice of lending securities solely to raise cash with the expectation of deriving most of the revenue from the cash reinvestment is basically gone from the market. This is due to several factors, including the low interest rate environment and the fact that many lenders have adopted more conservative guidelines for cash reinvestment.

Even if interest rates increase, it is unlikely that this practice will return due to structural changes that have taken place in the lending market resulting from new regulation.

While lending is based upon intrinsic value, it does not mean that all loans are 'specials' or hot stocks. Looking at data across the securities lending market, approximately 70 percent of loans still fall within a more general collateral bucket. But those loans are demand-driven and can produce good revenue streams for lenders. It's important for lenders to understand how their securities lending revenue is being generated.

At BNY Mellon, we can provide our clients with detailed attribution analysis that shows exactly how their revenue is derived, which should allow them to make better decisions on how to structure their lending programme.

Where are you seeing demand for client assets?

Demand tends to fluctuate as economic conditions change. Demand can also vary by geographic location. Global equities and small and mid-cap equities are generally in demand. Some of the top sectors in the equity space include IT, consumer discretionary and healthcare. The energy sector is of interest right now due to pressure on oil prices.

Also, recent volatility has increased the volume of macro hedging, resulting in increased demand for China-centric, high-yield bonds and general index exchange-trade funds.

For fixed income, there is good demand for sovereigns resulting from volatility, the flight to quality, and increased collateral needs. European debt is also benefiting from current central bank policy, along with decreased issuance.

How new would you say the concept of the collateral upgrade trade to beneficial owners?

Collateral upgrade trades are not new to the securities lending market. What's new is that regulatory changes such as liquidity ratios and mandated clearing have created new sources of demand. This, coupled with increased leverage ratio requirements affecting borrowers, has resulted in a significant increase in the number of transactions collateralised by securities collateral. This makes collateral flexibility key to taking advantage of these new opportunities.

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Many lenders have already expanded, or are in the process of expanding, their collateral guidelines. The markets in Europe and Canada have been more open to securities as collateral in general, but now US lenders are accepting a wider variety of securities as collateral, including equities.

How are CCPs developing to meet beneficial owners' needs?

Central clearing models for the agency securities lending market are still in their infancy. BNY Mellon has been working with industry participants to develop a clearing model that meets the needs of beneficial owners. I expect that a workable model will emerge in the near future. However, certain regulatory changes will be needed to allow for broad participation.

The move to central clearing is being driven in large part from the pressure on dealers' balance sheets as a result of increased leverage ratio requirements. Central clearing will allow dealers to maintain their existing volumes, but in a more balance sheet-efficient manner due to the increased netting benefits. As a result, central counterparties will become an important distribution channel for our clients' assets that could allow them to maintain balances and, in some cases, potentially obtain better pricing.

I expect to see central clearing develop as a point of trade discussion just like any other loan term. The negotiation with respect to how the trade will be cleared (centrally or in the traditional bilateral manner) will likely be based on the benefits that the borrower may derive from central clearing.

Accordingly, I would expect to see a pricing differential develop between centrally cleared loans and traditional bilateral loans.

What other trends are you seeing?

Due to increased collateral requirements resulting from mandated clearing, many beneficial owners are becoming interested in the role that securities lending can play in meeting their liquidity and collateral needs while reducing costs and improving fund returns. This is particularly applicable for funds that employ liability-driven investment strategies, which typically involve large derivative positions that can require significant amounts of liquidity to meet margin requirements and result in a drag on the overall fund return.

By combining securities lending with collateral management tools, overall fund returns may be improved while still meeting liquidity needs. **SLT**

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