Key Securities Lending Trends for 2016: Blame it on Basel

After a bumpy ride in 2015, what trends can beneficial owners expect to see in the securities lending markets over the next 12 months? At BNY Mellon, we believe familiar regulatory and macro-economic developments will continue to influence the market, with three key themes playing a particularly significant role in the decision-making process for securities lending clients. Two of these themes – the growing use of equity as collateral and the increased demand for term trades – will be familiar to any active market participant from 2015, but the third – rising costs to the lending agent of providing borrower default protections (commonly referred to as 'indemnification') – has emerged relatively recently, and could assume much greater importance this year.

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THEME ONE: THE RISE AND RISE OF EQUITY COLLATERAL

Recent years have witnessed growth in the use of equities as collateral for stock loans in Europe and there is every reason to expect this to continue in 2016.

According to the most recent report from the International Securities Lending Association (ISLA), dated September 2015 (based on January-June data), the market is moving further toward non-cash collateral, with equities being the main beneficiary. The proportion of total securities loans collateralised with non-cash collateral rose from 55% in the second half of 2014 to 60% in the first six months of 2015; indeed ISLA noted that loans of government bonds in Europe these days are only collateralised using non-cash collateral. Based on data from the four main tri-party service providers in Europe (BNY Mellon, Clearstream, Euroclear and JP Morgan) – which collectively hold the vast majority of non-cash collateral received by lenders – 57% of securities held in tri-party were equities at the end of June 2015, up from 53% six months earlier. Clearly, post-crisis regulatory and macro-economic trends have turned conventional wisdom in the securities lending market (i.e., where asset owners historically lent out equities in return for government bonds as collateral) on its head!

Although low interest rates and the very real possibility of downgrades for OECD government bonds have played their part, Basel III's Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) are the key reasons for this switch. These ratios encourage banks to hoard high-quality liquid assets (HQLAs) – largely government bonds, while other aspects of the Basel capital and liquidity framework (which is being rolled out by national regulators up to 2019) punish balance sheet holdings of equity securities. Moreover, lenders that are naturally long on equities can experience operational and cost efficiencies in accepting equities as collateral, even when lending out equities.

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That said, there are limits on the use of equities as collateral for stock loans. Some beneficial owners still regard equity as inherently too risky to serve as collateral. Price volatility of equities is undeniably higher than for corporate bonds, for example, but the higher margins for deals backed by equity collateral reflect this volatility and seek to offset the attendant risks. Regulatory issues may stay the hand of certain buy-side market participants – such as public sector pension schemes or mutual funds subject to UCITS V – but other securities lenders can benefit from as much as a doubling of revenues on individual transactions by accepting equities as collateral. In the prevailing environment, this could be the difference between making a trade or not.

THEME TWO: THE TREND TOWARD TERM

Like equity collateral, the trend toward term is already fairly well established and has similar drivers, notably the strain on sell-side balance sheets stemming from Basel III. For this reason, it is likely to continue into 2016 and beyond.

Figures from DataLend suggest that the proportion of three-month or longer loans has increased from 8% at the end of 2013 to 12% by the end of June 2015, at which point open / rolling securities lending transactions were reported at 84% of all transactions. This may appear a gradual shift to the casual observer, but the increase in the volume of three-month-plus loans is a rapid and significant shift in the context of historical trends in the securities lending market.

Again, the key factor is Basel III's LCR, and its effect on banks' need to have ready access to HQLAs. The LCR requires banks to hold levels of HQLAs that exceed expected net cash outflows for the next 30 days, creating consistent demand for government bonds. This dictates not only a preference among sell-side borrowers for term, but also for offering evergreen structures, which effectively rolls-over existing loans with minimal effort by counterparties. The impact of the LCR is further underlined by the fact that 24% of all government bond loans in the DataLend universe were for three months or longer at the end of June 2015.

The fixed income side of the securities lending market has always been driven more by the financing needs of the borrower than the intrinsic value of a particular security, but an interesting development in today's market is that this also now applies to demand for longer-term equities transactions, offering substantial benefits to lenders prepared to accept equities collateral.

For example, lending a US blue-chip stock in return for a basket of MSCI World component equity collateral on an overnight basis might earn a 20 bps return, but the borrower's demand for term is such that the beneficial owner could be rewarded with a 60% uplift (i.e., 32 bps) by agreeing to a longer-term evergreen structure.

Many lenders fight shy of longer-term transactions due to concerns about locking up their assets, causing potential access problems. But it's important to remember that term-lending is not a binary decision and need not commit a lender's entire programme. As an agent lender, BNY Mellon works with beneficial owners to identify opportunities and advise on the proportion of a programme that might be lent out for longer terms, based on prevailing market circumstances. Moreover, agent lenders can factor in the added complications that can arise in longer-term stock lending – such as quarterly index rebalancing – seeking to ensure minimal impact. As such, for more passive beneficial owners in particular, we believe that term lending using equity as collateral will continue to represent a good opportunity in the year ahead and beyond, offering revenue uplift and stability of supply.

THEME THREE: COLLATERAL CORRELATION

At the risk of repetition, the third key trend for 2016 can be traced to the Basel regulations too. Unfortunately, it's one with little upside for the securities lending community, but there is an opportunity to minimise the downside.

As mentioned above, Basel III's guidelines are being rolled out over the course of several years, with different deadlines for various aspects of the new regulatory framework. One issue that has been on the radar for a couple of years, due to Basel III's proposal on risk-based capital and leverage requirements, is the potential for agent lenders to hold more capital against the borrower default protections they offer to lending clients (prime brokers acting for borrowers also face higher capital charges). The cost of providing these 'indemnifications' could rise steeply as banks come into line with the new rules.

This means that the hurdle rate for agent lenders executing transactions on behalf of securities lending clients will be significantly higher than previously, causing banks to be more cautious in the new business they take on and more precise when calculating the likely outcome of proposed transactions involving existing clients.

Agent lenders will continue to offer indemnification to clients, recognising that it has become a critical pre-requisite to stock lending for many risk-averse beneficial owners that require a remedy providing for the replacement of loaned securities and/or protection against a shortfall in the value of collateral in the event of a borrower default. It is inevitable, however, that clients will see shifts in pricing from agent lenders and should adjust their approach accordingly in order to pursue profitable opportunities and avoid situations where the capital implications are likely to prove counterproductive.

Beneficial owners should expect different fee splits across their lending programmes reflecting the cost of capital to agent lenders for different transactions, rather than a standard approach across all trades. One way of reducing the impact of the regulatory change could be for lenders to move in favour of transactions in which the currency of the loan and the underlying collateral are correlated, as this can significantly reduce the cost of capital for the lending agent providing protections.

FINAL THOUGHTS

In a fast-changing regulatory and macro-economic environment, where interactions between different forces can lead to unpredictable outcomes, securities lenders will achieve the best returns by remaining alert to the possibility of change. Securities lending volumes were buoyant in 2015, in part driven by the demand for HQLAs on the sell-side, but also by the ongoing search for additional yield on the buy-side amid continued macro-economic uncertainty. But the market continues to be reshaped by regulation as much as pure demand and supply forces. Eighteen months ago the use of equity collateral was an emerging trend. Now, it is so dominant that market participants are being disadvantaged if they do not follow suit. Indemnification costs will be a major theme for 2016, changing the economics of transactions along the lines suggested above, but perhaps in other ways too. As such, beneficial owners should be prepared to respond quickly. I will be sharing my thoughts on evolving market trends on a quarterly basis across the year, but BNY Mellon's agent lending staff are always available to discuss challenges and opportunities as they arise.