Great challenges, greater opportunities

Regulatory change remains a driving force behind many of the new opportunities and challenges facing the securities finance industry. James Slater, global head of securities finance at BNY Mellon Markets, discusses the causes and effects, and how market participants are adjusting their behaviour to adapt to this new paradigm.
Market participants and global regulators acknowledge the critical role that repo agreements and other securities finance activities play in the efficient functioning of capital markets.

The financial crisis exposed real weaknesses, especially where providers of liquidity fundamentally lost confidence in dealers and banks resulting in the near collapse of the wholesale funding markets. The crisis brought to light unique risks from the excessive use of short-term wholesale funding and repo agreements in particular. Furthermore, maturity mismatch in wholesale funding and the nature of the triparty repo settlement mechanism highlighted further systemic issues that needed to be addressed. These created a situation only made worse by the tendency of money market funds to regard the repo market as equivalent to a bank deposit from a risk perspective, creating additional systemic issues and prompting government intervention.

The resulting loss in funding liquidity led to significant instability across the broadest range of securities finance structures contributing to market volatility as borrowers of all types and sizes adjusted to increased margin requirements, increased costs, recalled loans and in extreme cases, the total loss of funding availability. Looking back, it is easy to see how certain behaviours and market practices necessitated government intervention with wholesale funding and collateral management reforms becoming a cornerstone of global regulators' post-crisis efforts to reduce risk in the financial system.

High-quality collateral

The new regulations, particularly the Basel Committee on Banking Supervision's leverage and liquidity coverage ratios, have significantly altered the business models of all the world's largest financial intermediaries. While the leverage ratio significantly discourages the use of cash as collateral, the liquidity coverage ratio rewards the control of high-quality collateral, or as referred to under many of the new regulations, high-quality liquid assets (HQLAs). The defining criteria for HQLA eligibility is that it should be relatively easy to monetise via sale or funding transactions even during periods of significant market instability. Broadly speaking, the effect of the new regulations is that financial institutions can no longer intermediate as they once did, despite increasing demands from buy-side market participants for additional liquidity. Naturally, this has caused dealers and banks to pursue ever more creative ways to achieve optimal balance sheet and collateral management efficiencies in order optimise returns for their investors.

There are several consequences from a securities lending perspective. There is more focus on the pledging of securities as collateral due to its superior balance sheet efficiency relative to cash. This is a big change from the pre-crisis environment, especially in the US market where cash, unlike in Canada and Europe, has always been the predominant form of collateral. For lenders able and willing to take non-cash collateral this has the potential to lead to increased fees, but to be fair this may not offset the loss of increased returns realised through more aggressive reinvestment programmes. At the same time, some beneficial owners are also benefiting from a brand new source of borrowing demand resulting from the market’s need for HQLA to manage liquidity coverage ratio or other collateral requirements. Referred to as collateral upgrade trades, lenders are benefiting from an increased demand for high quality collateral and borrowers are willing to pay reasonable premiums for term commitments when they are available.

CCPs and bilateral collateral

As we look forward into 2017 and beyond, we believe that banks and dealers will continue to be more constrained in their ability to
further intermediate in the market, which will increase the need to optimise their activities in every way possible. Another potential avenue being discussed in the context of balance sheet efficiencies is the increased use of central counterparties (CCPs), which will allow market participants to more efficiently net offsetting cash transactions as well as achieve material risk weighted assets (RWAs)-related capital efficiencies. The dealer community and certain banks are looking at CCPs as a way to continue to keep scale in their business.Beneficially, CCPs are generally willing to accept high-end HQLAs such as treasury securities, further increasing demand for high-quality collateral.

New and evolving margin rules for both cleared and uncleared derivatives transactions (including non-deliverable forwards (NDFs), FX forwards and FX swaps) are also creating increased HQLA collateral demand. Going forward, generally all market participants can expect to have to post both initial and variation margin requiring many buy-side clients to consider issues that they’ve previously never had to address. These include simpler tasks such as managing the collateral provision and recall process, but also potentially something materially more involved and risky such as transforming non-conforming assets into eligible collateral.

Anticipated changes in collateral acceptability and the borrower’s and collateral manager’s desire to optimise any collateral they have on hand, whether that be cash or securities, underscores the need for flexibility to address the constantly changing needs for the full range of jurisdictions and transaction types. In addition, this is a global initiative, one that may require either a significant investment in technology and human capital or the securing of a third party’s collateral management services.

The collective regulatory changes and the market’s response have resulted in a range of interconnected inefficiencies. The leverage ratio has driven banks to be reluctant to accept cash deposits and has steadily driven investors back to money market funds offsetting the reductions realised during the crisis. That trend, however, is expected to reverse once again with the money market fund reforms coming this fall. In fact, it has been estimated that as much as several hundred billion dollars will relocate from prime money market funds, many previously providing repo finance for a broad range of asset classes, into treasury funds. This is going to put more pressure on the wholesale funding markets and the demand for HQLAs, which will create a new environment for the market to contend with. In short, collateral is the new cash. Or, as we like to say, collateral is king.

Due to new collateral requirements and reduced capacity of many intermediaries, we believe the buy side needs a range of solutions to more efficiently mobilise their assets. For example, traditional multi-manager structures create difficulties in accessing securities in one portfolio that could be used as collateral or to support leverage strategies in other portfolios.

Taken in aggregate, these are big changes for the marketplace. Collateral flexibility and liquidity solutions have never been more important. We see an opportunity to create new services and capabilities for our buy-side clientele. At BNY Mellon, we are working with clients to develop solutions to help them unlock the full value of their assets, raise liquidity and to provide and manage needed collateral when required. We continue to invest around innovative solutions, automation and technologies that help us understand and service our clients better. SLT

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