The **evolving role** of equities in **collateral management**

When a new type of participant enters a market in sufficient numbers, with different methods and motivations from existing players, the existing dynamics can shift dramatically. Think of high-frequency trading firms in the FX and equity markets at the turn of the century, or the explosion of hedge funds looking for stocks to short a decade before, prompting the development of the prime brokerage industry, while also providing a substantial source of demand for the securities lending market.

Today's equity collateral market is seeing an extensive change of leading actors, with some leaving the limelight, some entering the stage and others assuming new roles. Both on the supply and demand side, evolving needs and motivations are impacting level and type of participation, often as a result of macro-economic, macro-prudential and other regulatory developments over the past decade.

The market is in flux, uncertain whether supply will be able to meet demand in the longer term and with much attention focused not only on regulatory reforms, but also the new mechanisms, market infrastructures and technology-driven solutions that have the potential to support market activity in the emerging environment.

Already the volume and type of transactions being transacted in the equity collateral market is evolving, with tenors lengthening in some cases. But the priorities and motivations of equity collateral users continue to evolve, with implications unknown. In the first article of this three-part series, we look at the organisations traditionally and newly active in equity collateral and how their priorities are reshaping the market.

Equities and the buy-side

Perhaps the most significant development in the demand for equity as collateral is the growing numbers of buy- and sell-side firms seeking to use equities to meet regulatory mandates, specifically the margin requirements of OTC derivatives market participants and Basel III's capital and liquidity ratios.

From a buy-side perspective, many firms that are long in equities for reasons of

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investment strategy are looking to broker-dealers and prime brokers to provide collateral transformation services, i.e. swapping equities for other instruments (traditionally government bonds) that are eligible as margin paid to central counterparties, following the introduction of mandatory central clearing for the most liquid OTC derivatives.

93% of government bond borrowing in Europe is collateralised by non-cash sources

According to ISLA H1 2017 trading volumes

This buy-side demand for equity collateral transformation will grow in coming years, in part due to the staggered launch of margin requirements for cleared OTC derivatives, in Europe and other jurisdictions, but also because of the need to collateralise non-cleared OTC derivatives too (with obligations also rolled out in stages). Although main index equities are permitted as eligible collateral for both initial and variation margin purposes for non-cleared OTC derivatives, buy-side demand for equity collateral transformation is likely to be a permanent feature, due to ongoing fluctuations in the availability and cost of alternative collateral types.

How the sell-side are using their equities

Sell-side demand for and supply of equity collateral is influenced both by OTC derivatives collateral rules, and – even more profoundly – by Basel III's various capital and liquidity ratios. As well as catering for buy-side clients' demand for collateral transformation – with capacity dependent on business model and balance sheet factors – most large broker-dealers and other sell-side firms are refining their adjustment to new collateral rules for OTC derivatives trades. The very largest swap dealers have been exchanging margin for non-cleared deals since September 2016, for example, and are increasingly taking advantage of broad eligibility rules to bring equities into collateral schedules.

Basel III's impact on equity collateral usage by the sell-side is a complex and still-evolving story, with many firms having accommodated the requirements of the Liquidity Coverage Ratio (LCR), focusing now on the Net Stable Funding Ratio (NSFR), applicable from January 2018, but delayed by 12 months in some major jurisdictions. Many banks and broker-dealers – notably those with equity assets, and the ability to deliver them cost-effectively, inclusive of balance-sheet costs – ramped up their use of equity collateral when sourcing greater holdings of high-quality liquid assets (HQLA), to meet LCR requirements. While equities are explicitly eligible as HQLA for LCR purposes (although subject to higher capital weightings vs government bonds), there has still been a healthy uptick in banks and brokers seeking to lend out equities and other less-liquid assets to borrow 'Level 1 HQLA' (cash and government bonds), generally via evergreen and extendable structures for terms longer than the 30-day LCR stipulation.

The fact that 93% of government bond borrowing in Europe is collateralised by non-cash sources (according to the latest report from the International Securities Lending Association (ISLA) based on H1 2017 trading volumes) reflects the role of the securities lending market in mobilising HQLA by banks for compliance with prudential capital regimes. Banks can include borrowed HQLA in their LCR calculations if the trades are for three months or longer.

"Each bank has a different set of specific regulatory drivers, depending on factors such as their existing business model and balance sheet profile," says Gareth Mitchell, Citi's Head of Agency Lending. A firm with a big retail base will have very different priorities to niche investment bank, for example. Some will be focused on Risk-Weighted Assets (RWAs); others NSFR. This diversity of demand is typically seen as positive, driving counterparties to successfully match their needs against others. "Banks and broker-dealers are just looking for efficiencies in how they handle regulation, and equity collateral is just part of that," Mitchell adds.

The challenge of using equities

Although two key planks of the post-crisis regulatory reform agenda encourage greater use of equities for collateral purposes, other incoming rules are having a negative impact on suppliers.

A major threat to both the upgrade trade and the supply of securities into the lending market are new guidelines issued by the European Securities and Markets Authority on the securities lending activities of mutual funds (regulated as UCITS in Europe), which currently account for roughly half of lendable securities globally. There are two key issues from the new rules, which are designed to reduce risks carried by UCITS. First, the rules mean UCITS cannot enter into lending transactions lasting more than seven days; second, they can only receive collateral by title transfer, not by pledge, which rules them out of activity facilitated by CCPs. ISLA is concerned that both of these measures limit supply from UCITS to the securities lending market, thus acting against a key aim of the European Commission's Capital Market Union initiative. "A deep and vibrant secondary market for equities is dependent at least in part on a robust securities lending market," says ISLA CEO, Andrew Dyson. "The commission needs to think holistically about market liquidity."

A further risk to supply is represented by the reporting requirements of the EU Securities Financing Transactions Regulation (SFTR), which will oblige agent lenders to provide more details on out-of-scope securities lenders than at present. This includes Middle East Sovereign Wealth Funds (SWFs) and US pension funds that currently represent as much as 60% of supply, but may be less keen to comply with the additional administrative efforts required by SFTR, thus reducing supply.

Although mutual funds account for around 46% of the lendable security universe, according to ISLA's latest figures, they only represent 14% of actual loans. There has been a steady decline in balances in response to post-crisis regulatory change, says Dyson. In contrast, SWFs represent 6% of total supply but 11% of loan balances. He suggests that banks increasingly find SWFs easier to deal with, both generally and in terms of handling collateral, but also notes the deterrent effect of high RWA costs of borrowing from many SWFs.

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ISLA CEO

These supply challenges have coincided with a rise in inter-dealer borrowing. While SWF borrowing has not increased over the past six months, according to ISLA, lending between banks and broker-dealers grew from 15% of global on-loan value in June 2016 to 19% in December 2016 to 29% in June 2017 – almost doubling in 12 months.

Different strategies

"We on the equities finance desk have become more closely coordinated with the repo desk, in order to leverage their expertise"

Jamie Anderson
Managing Director, HSBC's Collateral Treasury Trading Team

While regulatory reform is directly changing the roles of players in the equity collateral market, second order impacts of post-crisis reforms are also changing behaviours and priorities. On the one hand, opportunities are arising for greater collateral management efficiency among global market participants from the globalisation of market structures, with Europe acting as a bridge between US and Asia. On the other, there are many examples of growing internal coordination by market participants looking to improve the efficiency of their collateral management operations, including greater integration and collaboration of equity finance trading desks with repo desks, for example and treasury departments.

As reflected during the panel sessions at the recent Euroclear Collateral Conference 2017 in Brussels, greater collateral-based coordination has been a growing trend among broker-dealers for the best part of a decade. The 'how' and 'why' of collateral mobilisation will differ – perhaps aimed at balance sheet management or offering consistent low pricing to OTC derivatives clients – but it will generally include a higher profile for equities and greater communication between previous asset class-based silos.

According to Jamie Anderson, a Managing Director within HSBC's Collateral Treasury Trading Team, the bank has undertaken a significant reorganisation of its operating infrastructure in recent years to improve visibility and mobility of assets for collateral purposes.

The key driver was to facilitate business expansion while adjusting to the post-crisis capital adequacy regime. As it has increased its equities-focused prime brokerage business over the past five years, HSBC has also needed to grow its balance sheet capacity and develop a more comprehensive and coordinated framework for monitoring and managing the assets on that balance sheet.

"As our book has evolved, for example taking on more upgrade trades, we on the equities finance desk have become more closely coordinated with the repo desk, in order to leverage their expertise in trading and financing government bonds, for example," says Anderson.

As witnessed in the rise and fall of the upgrade trade, the motivations of equity collateral market participants are unlikely to remain constant as they all make their adjustments to the post-crisis regulatory settlement. But it seems clear that recent structural efforts to mobilise equities will mark a permanent change in their utility for collateral purposes.

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