The proliferation of equities as collateral

There has been a gradual growth in the idea of equity collateral as an alternative to debt or cash since the financial crisis, according to Andrew Dyson, CEO of the International Securities Lending Association (ISLA). This attitude shift stems in part from the liquidity issues faced by corporate bond holders during the peak of the crisis, which has led to many market participants turning to still-liquid equities as collateral.

"Collateral preference was a matter of how easy was it to sell the assets: did you have an executable pricing strategy? In the crisis, equities were eminently saleable, corporate bonds less so," says Dyson.

Over the past decade, there has been greater take-up of equity as collateral in securities lending and beyond, although this has largely been a European phenomenon due to structural factors in the US which favour use of cash over any non-cash alternatives. Even so, around the time of the crisis, non-cash collateral still largely consisted of corporate and government bonds.

In Europe, Tri-Party Agents' (TPAs) use of non-cash collateral on behalf of lenders is a good proxy for overall non-cash trends. A total of 85% of non-cash collateral usage is via TPAs, versus bilateral transactions.

By aggregating TPA data, ISLA has charted the rise in use of equity as collateral, peaking at 57% of all non-cash collateral in June 2015 – extremely high in terms of historical levels.

Making the most of your collateral

The need to make the most effective use of all available resources is a key theme for many financial market participants in the post-crisis environment. New capital requirements and OTC derivatives market reforms have made the very highest quality collateral (AAA-rated government bonds) a somewhat scarce resource, especially with central counterparties (CCPs) cautious about opening up their eligible collateral criteria.

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This scarcity has been extended to high-rated corporate bonds through central banks' quantitative easing programmes, which have bought up bonds to stabilise asset values and pump money into economies, and the withdrawal of many market-makers due to the steep costs of liquidity provision under Basel III.

All these developments in the fixed income markets have been a key driver in the reassessment of equities as an acceptable form of collateral for multiple uses. Nevertheless, the more widespread use of equity as collateral would have been slower and more difficult were it not for a parallel change in the attitude of investors to equities as an asset class.

Many traditionally conservative long-term institutional investors have long-since followed a strictly or predominantly fixed-income investment strategy. But pension funds, insurers, sovereign wealth funds, even central banks (the Swiss National Bank being a prime example) have reappraised the asset mix of their portfolios in recent years.

Much of this trend can be traced to the low-interest rate, low-yield environment that has deterred cash and bond investments. But advances in risk management capabilities have also contributed to an 'equalisation' of portfolio preferences.

New entrants have encouraged greater take-up

There is a cautious, but noticeable expansion of central banks and sovereign wealth funds into equity investments. This suggests their acceptance of equity as collateral should be less of a stretch.

Moreover, while some firms were once wary of using equity as collateral, due to its higher level of volatility compared with government bonds, for example, the differences between the two asset types are narrowing as better risk management tools and policies help firms better understand the risks of taking equities as collateral.

The key point is that if lenders only accept government bonds as collateral they will have a limited experience, as so few borrowers can afford to provide it. High demand is driving up the costs of high quality liquid assets (HQLA), meaning use of equity collateral becomes essential.

One possible brake on the growth of equity collateral for securities lending is indemnification, not only due the difference protections provided across asset classes, but of the different risk and cost implications under Basel III.

Agent lenders providing beneficial owners with indemnification against counterparty failure previously incurred low or no capital charge, partly because the loan transactions themselves were structurally over-collateralised.

Post-crisis, however, agent lenders have to hold more capital against the Risk-Weighted Assets (RWAs) incurred as a result of offering borrower default protections to lenders. Basel III essentially hikes the RWA required, meaning extra capital is needed by agents in order to offer indemnification.

The impact varies across providers and asset classes, potentially skewing existing costs, practices and preferences. Lending against cash absorbs much less RWA than a bond or S&P 500 stock, thus minimising indemnification costs.

Under the new rules, deals may become under-collateralised – due to supervisory haircuts – especially if backed by equities, leading some agents to focus on servicing lenders with big portfolios of high-demand assets to maximise revenue opportunities.

How regulation is actually helping

As well as contributing substantially to the scarcity of fixed income collateral, regulatory change has also played its part in changing attitudes toward use of equity as collateral. For example, the Basel Committee on Banking Supervision acceded to sell-side requests for blue-chip index constituents to be included in the definition of HQLA under Basel III's Liquidity Coverage Ratio (LCR).

Similarly, the collateral guidelines for margin payments for non-cleared OTC derivatives – as set by IOSCO-CPMI – also explicitly include equities. Although movement has been slower in areas where practice has already been well established, there have been widespread industry discussions on the use of equities for collateral at clearing houses and in central bank settlement operations.

Even in such a conducive climate, progress can be gradual, and not necessarily linear. Indeed, there are still several reasons for market participants to cleave to the tried-and-tested forms of collateral, despite previously-noted restrictions on supply, at least in the short term. These include regulatory inconsistency on equity eligibility, the need to develop the necessary risk management expertise and tools on enterprise-wide collateral desks, and regulatory limitations on use of lower grade equities. Supply of equity collateral might even be a concern due to the risk management obligations being imposed UCITS and other mutual funds.

According some a leading agency lender, there has been 'tremendous' growth in demand among borrowers to pledge equity as collateral, versus cash or fixed income instruments, but also acknowledges the challenges this presents.

At the time of writing, Citi agency lending business estimated there was a 50:50 split between cash and fixed income five years ago, in terms of collateral pledged to facilitate transactions between borrowers and lenders.

More recently, equities has accounted for around 30% of collateral. Evidently, one of the main drivers was stock borrowers' growing willingness to pledge equities (regardless of what they're borrowing) and the 'upgrade trade', i.e. banks and other market participants that pledge equities in order to borrow cash and high-grade fixed income instruments, often for regulatory reasons.

First, pledging equities when borrowing equities can lead to a strong risk correlation, which may need to be offset via access to a diverse range debt and equity collateral. Second, participants in the upgrade trade could fall foul of wrong-way risk in times of market stress, whereby equity prices go up and the value of bonds goes down, calling margins and haircuts into play.

Furthermore, the impact of regulatory change on collateral preferences can be both temporary and unpredictable. Although TPA data shows that banks increased the proportion of equites used as collateral as their balance sheets have expanded – rising to 57% of all pledged non-cash collateral in June 2015 – constrained balance sheets subsequently led banks to hold fewer high-RWA equities on balance sheets, resulting in a drop to 41% in early 2016.

The impact of NSFR and LCR

Macro factors may have played a role, as early 2016 saw some extreme volatility in the price of equities, potentially impacting their value as collateral, or at least complicating the mechanics of their usage.

Banks could not pledge equities at this point so had to use more expensive HQLAs, making securities lending transactions more expensive. But equities rebounded to 48% of non-cash collateral in December 2016, rising to 49% sixth months later. This suggests balance sheets are being rebuilt and perhaps reflects delays or even amends to implementation of the Net Stable Funding Ratio (NSFR) in key jurisdictions.

Because the LCR gradually ratcheted up to its full requirement over four years, reaching 100% in January 2018, most banks have adjusted their balance sheets accordingly (this is reflected in a slight dip in demand for longer dated loans in recent market data), but NSFR still looms.

Aimed at reducing their reliance on short-term funding, NSFR demands banks have stable funding sources over a 12-month horizon, based on varying liquidity risk factors assigned to assets. The NSFR's precise impact on the equity collateral market is unclear as yet, and may depend on fluctuating cost characteristics of other collateral types, but is widely predicted to increase demand for longer-term structures, i.e. six to twelve months.

Dyson suggests some banks could be gradually holding less equities versus government bonds on their balance sheets, but notes that the adjustment to Basel III continues to drive trends. "Banks are getting better at complying with Basel III and some of the stricter interpretations (e.g. NSFR in the US) are being reined in, with banks' balance sheets beginning to increase."

As such, banks' use of equity as collateral can be a sign banks are feeling emboldened, perhaps benefiting from greater activity from hedge fund clients, as being long on equities is consistent with higher levels of RWA and balance sheet capacity. "Use of equities as collateral may be a very sensitive bell-weather indicator of wider issues for banks and brokers," says Dyson.

Equity collateral may fall in and out of favour for different market participants for different reasons, but its presence as a viable option seems assured.

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