Is History Repeating Itself?

*With the case building for using equity collateral to secure securities lending transactions, Keith Haberlin, Head of BBH Global Securities Lending, explores how US lenders can use past lessons to avoid potential pitfalls.*

Collateral would never again be risked for extra return. Intrinsic value lending was here to stay. We were going back to basics.

That was the narrative in the securities lending industry following the 2008 financial crisis, when some lenders incurred losses from what was meant to be a practically risk-free business. The culprit then was impaired or defaulted credit instruments purchased by securities lending cash collateral vehicles. Disputes followed about who was to blame. Were agent lenders at fault, having breached client parameters, or was it beneficial owner lenders, having not paid close attention to their collateral portfolios?

**Impacts on Supply and Demand**

Seven years beyond the crisis, those scars have largely healed and most lenders have returned to the market, many with adjusted risk profiles—especially with regard to cash reinvestment parameters. At $15 trillion, the supply of lendable assets has more than recovered from pre-crisis levels and the industry is arguably safer than ever for the lessons learned.

Demand is a more complex story, however. While robust in certain sectors, the aggregate value of securities being borrowed is still 50% below pre-crisis highs, and this has some calling for lenders to loosen the reigns, once again, on their collateral profile. Specifically, in the US, there is a budding case for the use of equity collateral with regulators being urged to remove the historic restrictions which have led to cash and Treasuries being the pre-eminent method to secure loans.

The portfolios suffering the most from the altered demand environment are those containing large-cap, liquid, easy-to-borrow stocks or, to use industry parlance, “general collateral.” While the low interest rate environment is at least partially to blame, there is also a secular cause, namely the regulatory constraints under which prime brokers are now operating. The combination of liquidity, leverage, and capital rules has, according to one prime broker, increased financing costs as much as five-fold. Faced with mounting costs, it is not surprising then that they are reserving their most expensive collateral, such as cash or government debt,
for hard-to-borrow stocks, and looking for cheaper alternatives to finance their borrowing of more liquid stocks.

This is concerning news for lenders who have come to expect an annuity stream from their general collateral holdings, and the pressure is building to make these positions more attractive to borrowers. Hence the case for equity collateral, as borrowers are long this inventory and it is much cheaper for them to simply pledge it, instead of raising cash or government debt. For example, an equity versus equity general collateral trade can generate 15bps—more if termed out—and given the liquidity of equities, the argument goes that they are a highly secure form of collateral. In short, more revenue for the lender with practically no more risk, a statement which has echoes of past excesses.

**Equity Collateral – The Devil is in the Details**

It’s true that equities have some positive characteristics as collateral, especially in comparison to other, less liquid instruments, such as corporate debt. A favorable risk comparison can also be made versus cash collateral depending upon the reinvestment profile. However, like the reinvestment of cash collateral, the devil is in the details and it’s imperative that lenders closely analyze the risks of accepting equity collateral, understand in detail how those are being mitigated, and, finally, make sure that they are being compensated accordingly.

Equities by definition are volatile—especially in reaction to a major market shock. Further, given it will be the default of a major financial institution that necessitates use of collateral, thought needs to be given to the likely market reaction of on-loan and collateral portfolios. You do not, for example, want your collateral portfolio to be overweight financials, if the on-loan securities you need to replace are defensive and likely to react comparatively better. Examining these correlations, managing this risk dynamically with a well-diversified collateral portfolio, and ensuring sufficient haircuts, are key mitigants. There is no right or wrong approach, though, and in the end, each lender has to make their own decision as to whether they are being paid adequately for this extra risk and oversight.

**The Intrinsic Value Approach**

An alternative scenario for lenders is to avoid the temptation to compromise on collateral altogether and instead focus on lending only hard-to-borrow stocks, for which borrowers are prepared both to pledge their highest-quality collateral and pay a premium to source. In other words, a disciplined intrinsic value lending program. In comparison to the 15bps earned on a general collateral trade against equity collateral, the average loan fee in the BBH intrinsic value program is 12 times higher, at 190bps, collateralized against cash or a subset of G-10 sovereign debt. On average, our clients can generate 90% of the portfolio’s total income potential from this strategy, while simultaneously using less than 5% of their portfolio. In the BBH program, sophisticated technological tools are available to give our clients as much transparency and control as they wish to ensure lending their hard-to-borrows does not compromise their core investment objectives.

**Learning from the Past**
That’s not to say that general collateral lending can’t also be a viable strategy, even when factoring in the compromises lenders will need to make to borrowers in this new regulatory environment. But it’s imperative lenders learn from past lessons, truly engage in understanding in detail what additional collateral risk they are taking on, and determine if the risk/return trade-off is right for them.

But for those clients whose portfolios do contain stocks in demand from borrowers, feel free to break the pattern and hold the line on your collateral demands.

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