Optimising programmes through collateral flexibility

eSecLending's Simon Lee explains how tweaking your collateral parameters can significantly improve your securities lending revenue

The enormous amount of regulatory and structural change in recent years has created new revenue opportunities for beneficial owners that are willing to review their lending programme parameters in light of new market dynamics. In the 'Optimising Your Securities Lending Programme' series, eSecLending outlines the opportunities for beneficial owners to modify their parameters and take advantage of the evolving market.

In today's market, collateral flexibility is an important consideration for lenders looking to optimise programme returns. In what is a competitive environment, revenue optimisation is best achieved by addressing the requirements of both the supply (beneficial owner) and demand (borrower) sides of the lending transaction, relative to overall programme objectives.

At first glance, opportunities for lenders to increase earnings without unduly increasing risk may appear limited in today's market environment, but by recognising the joint dynamics of programme structure and collateral requirements, beneficial owners can benefit from the increased emphasis regulation has placed on collateral and its associated cost to the borrowers in your programme.

As the cost of collateral diverges across different collateral types, it becomes increasingly important for lenders to recognise the impact that their collateral choice has on overall programme performance, particularly as it relates to the type of programme in which they participate.

Lenders that employ a flexible collateral schedule enjoy advantages over lenders with restrictive collateral schedules. By accepting additional types of collateral, beneficial owners can attract a larger and more diverse set of borrowers, increasing on-loan balances and revenues. Lenders that restrict their collateral profiles constrain their distribution channels, which can reduce their balances and their revenues.

The acceptance of equity collateral has been increasingly recognised as a tool to improve programme performance. From the borrower's perspective, equity collateral has always been a preferred form of collateral due to its plentiful supply, relatively low costs and liquidity. However, historically, there was little demand from lenders and their agents as equity collateral was harder to administer, indemnity costs were higher and programme performance was not unduly hindered without it.

As indemnity costs become better known and managed, administration of equity collateral by triparty providers becomes more sophisticated. Employing a flexible collateral schedule is an actionable way to improve programme performance, and many beneficial owners that traditionally accepted only non-cash collateral have broadened their collateral guidelines and are now also accepting equity collateral.

Lenders are always interested to know how much they will be able to increase their revenue by when they diversify their collateral schedule.

It is important to understand how the type of programme the lender participates in also impacts performance. This is particularly true for lenders participating in a pooled programme where their assets are commingled with those of other lenders and loans are allocated through a 'queuing' system.

For example, a borrower wants to borrow a position that is held by three lenders in the pooled programme. Lender A and Lender B accept equity and government bond collateral, whereas Lender C only accepts government bond collateral.

Rather than allocate this loan across three lenders—with two different forms of collateral and two different costs—the borrower will source the supply from A and B that accept the cheapest form of collateral (equity).

This means Lender C, which only accepts the more expensive form of collateral (government bonds), will miss out on the loan entirely.

Lenders that participate in pooled programmes must always consider how changes to programme parameters, especially as they relate to collateral or programme enhancement, are viewed relative to other lenders in the same programme, as this can significantly influence the impact that any changes may have.

For lenders that participate in segregated programmes, where assets are not commingled across lender accounts, the question of performance relative to other lenders does not apply.

In these programmes, changes in collateral schedules can directly enhance the performance of the individual lender, given that their performance is not influenced by the parameters of any other competing lender.

For lenders that wish to take a more active role in enhancing securities lending performance, and where the opportunity to do so exists, lending via a segregated programme structure may be advantageous, particularly when considering expanding collateral schedules. **SLT**

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