Throwing caution to the winds of change

Chris Benedict of DataLend charts the rise of non-cash collateral and assesses beneficial owners' risk tolerance for alternatives to cash

'Cash is king' is a well-worn phrase we've all heard plenty of times, especially when it comes to collateral for securities finance transactions in the US. Unlike Europe, Asia and Canada, agent lenders in the US have long preferred to receive cash as collateral for securities finance transactions due to the possibility of yield pick-up in the cash reinvestment market, as well as regulatory restrictions such as the Employee Retirement Income Security Act or 1940 Act. But in the past few years, use of non-cash collateral has been increasing. The reasons for this increase can be boiled down to a few major factors:

- Interest rates around the world are at historic lows (or in some cases have gone negative). This makes obtaining a decent yield in cash reinvestment products while managing principal risk a challenging task.
- As a result of recent legislation, borrowers are engaging in more collateralisation with non-cash assets in an effort to take advantage of balance sheet netting.
- Prime brokers, third-party lenders, custodians and asset managers have invested in information technology to achieve improvements in their collateral allocation and optimisation abilities, allowing their clients to better use their assets as collateral.

Different types of non-cash collateral pledged by broker-dealers can have an impact on fees collected by agent lenders due to perceived collateral risk. This includes credit, liquidity and duration mismatch risk. That 'risk premium' can increase as beneficial owners allow less conservative (and potentially risker) forms of non-cash collateral.

With all of the different assets out there available to be used as non-cash collateral, we wanted to see where beneficial owners' risk tolerance stood in the middle of 2015. We reviewed beneficial owner data from the DataLend Client Performance Reporting suite, a securities finance performance benchmarking tool for agent lenders and their underlying beneficial owners, to see the state of allowable non-cash collateral by beneficial owner legal structure and region to gauge the current risk appetite of beneficial owners around the world.

We began this exercise by reviewing a risk hierarchy of non-cash collateral, starting with US treasuries (and equivalents) as the safest and most conservative form of non-cash collateral.

These asset classes appear in the legend of Figure 1, arranged by quality in descending order with lower-grade equities (ie, companies with smaller market capitalisations and more volatility) at the bottom as the riskiest form of non-cash collateral. We then reviewed those asset classes across the different legal structures of beneficial owners and their allowable non-cash collateral stored in DataLend to see what types of assets they would accept. The results were interesting, and at times, a bit surprising.

We were not surprised to see European beneficial owners exhibiting a little more leeway when it comes to allowable non-cash collateral types than their peers in North America. Non-cash collateral has long been the dominant form of collateralisation in Europe while the cash reinvestment market has had little opportunity to grow. Indeed, 73 percent of all European securities finance transactions booked in 2014 were versus non-cash collateral. As a result, beneficial owners in Europe appear to be more comfortable taking various forms of non-cash collateral that their North American colleagues might not accept.

Registered financial institutions in Europe appear to be among the more conservative beneficial owner types, with 35 percent accepting only US treasuries and equivalents, 40 percent accepting highly rated non-US sovereign debt and 25 percent accepting highly rated corporate debt as the riskiest form of non-cash collateral.

European government/sovereign entities appear to exhibit a relatively high-risk tolerance with 55 percent of them indicating they would accept high-grade equities as non-cash collateral.

Corporations in Europe seem to be a lot more risk averse than their North American counterparts. Ninety-five percent of them said they would accept highly rated non-US sovereign debt as the riskiest form of non-cash collateral, and only 5 percent said they would accept highly rated corporate debt.

European foundations and endowments exhibited a little more risk tolerance than their North American counterparts, with 65 percent accepting sub-investment-grade sovereign debt as the riskiest form of non-cash collateral.

After reviewing the whole of our global beneficial owner risk profile data, a few themes emerge:

- North American beneficial owners exhibit the most conservative stance overall. Their European counterparts appear to be more 'middle of the road', while Asia is more flexible with the non-cash collateral that beneficial owners will accept.
- Registered financial institutions appear to be among the most conservative beneficial owner types across the world with the majority accepting only US treasuries and equivalents or non-US sovereign debt.
- Asian trusts, Asian pension plans, North American corporations and European government/sovereign entities appear to be the most flexible.
- There is a wide variance exhibited between North American and European corporations. The former is flexible, while the latter is very conservative about which types of non-cash collateral they will allow.
- Pension plans globally exhibit some degree of flexibility. Roughly half accept US treasuries and equivalents or non-US sovereign debt as non-cash collateral, while others accept highly rated corporate debt, high-grade equities and sub-investment-grade sovereign debt.

As new regulation begins to take hold throughout the financial services world, it will be interesting to see how this landscape changes in the coming years.

If current trends are any indication, we may see most beneficial owners be more flexible about the non-cash collateral they will allow their agent lenders to accept. **SLT**

Chris Benedict
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Figure 1: Allowable non-cash collateral by beneficial owner type in Europe

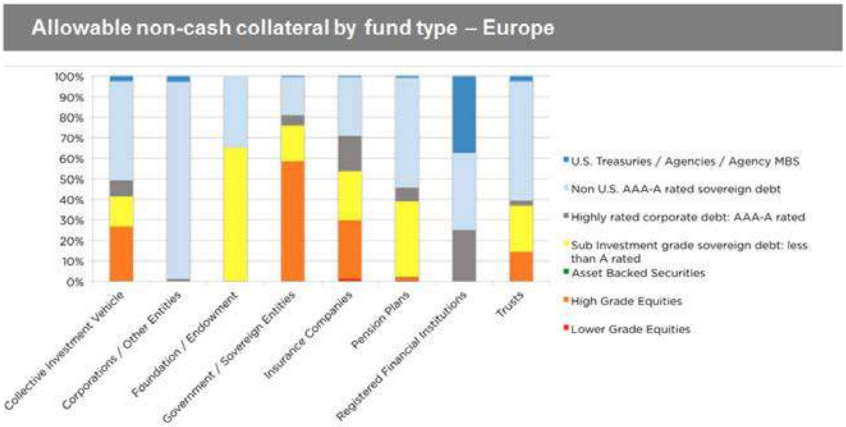

Figure 2: Allowable non-cash collateral by beneficial owner type in North America

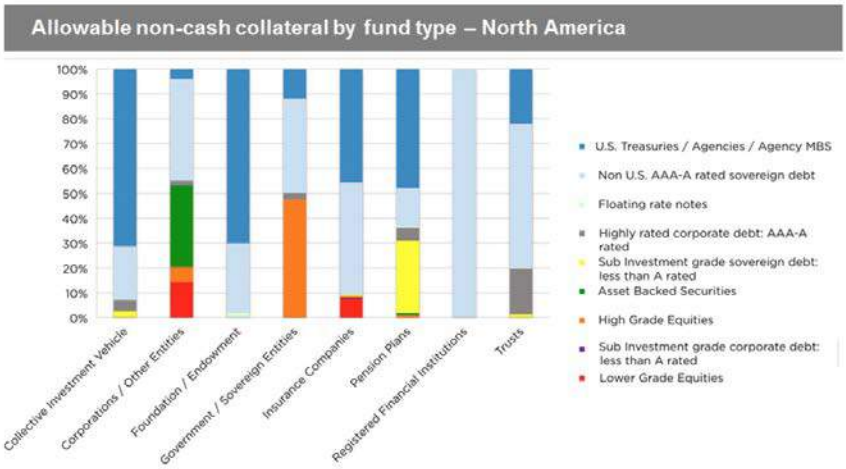

Figure 3: Allowable non-cash collateral by beneficial owner type in Asia