CENTRAL BANK SECURITIES LENDING PROGRAMMES COME TO THE FORE

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Securities lending can provide central banks with a mechanism through which to boost market liquidity, and in turn help tighten bid/offer spreads and elevate activity levels. At the same time securities lending can help central banks extract value and gain incremental income from their large (and growing) holdings. Along with the clear benefits, lending securities naturally brings additional risks and requirements – such as counterparty risk and regulatory reporting. That reason can induce central banks to contract with securities lending providers, providers that they should select carefully in order to maximise value while minimising cost and risks.

WHY MARKETS NEED CENTRAL BANK SECURITIES LENDING

"Central banks have long used securities lending and repos to support monetary policy and financial market stability", notes Florence Lubineau, Europe Head of Central Banks, Multilateral Development Banks and Supranationals at BNP Paribas.

Lending securities or using repos to sell bonds to commercial banks removes cash from the market, which can help reduce competition for assets and dampen prices. Securities lending also injects liquidity by enabling borrowers to fulfil their trading strategies and manage their balance sheet or by facilitating orderly transaction settlement.

But in today's world of quantitative easing, securities lending has potentially become even more important.

"Demand for high quality liquid assets (HQLA) has soared, driven by central clearing rules and more stringent regulation", says Lubineau. "Meanwhile, the trillions of dollars in securities bought under central banks' quantitative easing programmes have increased the size of their HQLA portfolios, positioning them as important suppliers to meet borrower demand."

TAPPING PORTFOLIOS' COMMERCIAL VALUE

In the current low (and in some cases negative) interest rate environment, securities lending also offers central banks valuable commercial benefits.

"By monetising their holdings, central banks can extract significant and stable income streams from their otherwise dormant portfolios, generating a return on what is an often untapped source", says Lubineau. "It's a proposition many central banks are finding increasingly attractive, especially as their portfolios have expanded."

"Central banks' reserves have tripled since 2008[1]", notes Lubineau. Portfolios have also become more diversified to include corporate bonds, asset backed securities, emerging market instruments and equities.

"But with this increased portfolio size and heterogeneity comes a need for more sophisticated management strategies", she says.

OPTIMISING THE RISK/REWARD BALANCE

While the revenue potential that securities lending programmes offer is a welcome fillip for central banks, the associated risks and challenges need to be carefully assessed and managed.

1 Source: Large central bank balance sheets and market functioning, Bank for International Settlements, October 2019

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"Counterparty risk is the most obvious", says Benoit Uhlen, Head of Client Management for Market and Financing Services at BNP Paribas Securities Services. "Operational risk is a further factor. The level of flows, taking collateral, marking to market, managing corporate actions and equity votes, manufacturing back dividends and coupon payments all bring high operational demands. These need to be addressed both to limit the risks and minimise inefficiencies."

"In the current environment, central banks have also had to start thinking more like fund managers, as they seek to stimulate additional returns and support management costs", says Ross Bowman, Global Head of Client Management Agency Lending at BNP Paribas Securities Services. "They've had to engage more with the lending market, and look more proactively at the asset classes they own and their programme selection process."

"Regulatory reporting responsibilities, not least MiFID II, add further requirements", notes Uhlen. "Increased regulation can make securities lending activity more costly and labour-intensive. For a lender to gain value, they will need cost-efficient solutions that can support their regulatory reporting and other obligations."

"The answer for a growing number of central banks has therefore been to use a securities lending specialist that is also well connected to their custodian, a trend that has been gaining ground in the last three to five years", says Uhlen.

SECURITIES LENDING MODELS AND HOW CENTRAL BANKS BENEFIT

Partnering with a provider with efficient and flexible lending capabilities (principal or agency) allows central banks to take advantage of the benefits securities lending offers, without the burden of dedicating scarce internal resources to it. Lending providers should be able to streamline loan recalls and manage corporate actions and regulatory reporting in order to maximise operational efficiency. This has become even more important in the context of new regulations fostering settlement efficiency and reporting obligations. Lastly, lending service providers bring valuable expertise in distributing assets from what have often become highly- diversified portfolios spanning multiple countries. This is an expertise that central banks may lack in house.

"The indemnification policies introduced by a number of agents offer a further advantage, by protecting lenders against borrower credit risk in case of counterparty default", notes Uhlen. "Agency indemnification guarantees are often buttressed by the use of over-collateralised transactions and careful borrower selection to ensure exposure to only high-quality counterparties. Together, these safeguards provide central banks with important risk mitigation assurances."

QUALITY AND EXPERIENCE MATTER

Delivering unmatched programme value to central banks has long been a priority for BNP Paribas.

"Our track record in managing mandates for official institutions dates back to 1975", says Lubineau. "Since then, we have continued to develop new technical capabilities and expand the services we offer to central banks."

For instance, recent updates to BNP Paribas Securities Services' trading platform mean that assets can be lent globally around-the-clock, five days a week. The bank's offices in New York, London and Sydney – together with its newest trading desk in Hong Kong – can all handle multi-asset portfolios. BNP Paribas also has a dedicated Official Institutions Coverage team to support and advise central bank clients.

This focus has strengthened BNP Paribas' role as a leading provider of securities lending services to central banks – as acknowledged by Central Banking magazine, which recently named the bank as winner of their 2020 Specialised Lending Initiative Award[2].

"Financial strength is another advantage", notes Eric Deudon, Head of Market and Financing Services at BNP Paribas Securities Services. "Our size and robustness also give weight to our indemnification policies."

"The scope of our branch network is a further benefit for many lenders", explains Bowman. "Many of the borrowers in our programme retain our services, so the securities lent out often stay within the BNP Paribas network."

The quality and effectiveness of the service – and BNP Paribas' ability to optimise a portfolio's utilisation rate – is where clients will ultimately benefit most.

"We have an on-lending ratio close to 24%, compared to a market average of around 14%[3]", says Deudon. "That is an important driver of participants' profitability. Since we are not flooded with US HQLAs in particular, we can on-lend without diluting the existing client base and negatively impacting the returns for every participant in the programme."

"And we continue to innovate. For instance, we have aligned our securities lending programmes with environmental, social and governance (ESG) principles, a key concern among our central bank clients", says Deudon.

"This includes a preselection of the borrowers based on their ESG ranking, and the capacity to filter acceptable collateral in line with each client's ESG criteria", he explains. "We also ensure our customers have easy access to their titles in order to vote during general assemblies."

SOPHISTICATION DEMANDS FLEXIBILITY

As well as becoming increasingly active securities lending participants, central banks are among the most sophisticated. They understand how securities lending works and usually have specific requirements for their programmes. Providers with agency and principal lending expertise are well placed to support central banks' expanding activities – provided they have the flexibility, service reach and risk controls to accommodate their clients' often bespoke requirements.

2 Source: Specialised lending initiative: BNP Paribas, Central Banking, 6 February 2020

3 Source: IHS Markit, from 29 January 2020 to 28 January 2020