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**Julia: Hello and welcome to a DerivSource podcast. I'm Julia Schieffer, the founder and editor of DerivSource.com.**

**A recently published paper "OTC Derivatives Reform: Putting Asset Owners and Sovereign Wealth Funds in the Driver's Seat," asserts that both sovereign wealth funds as well as some asset owners are in a good position to benefit from the repo and securities lending markets due to the regulatory change taking place in the OTC derivatives space.**

**In this podcast today I'm speaking to James Day, Head of Securities Finance EMEA at BNY Mellon, and we're going to shed some light on the findings of this paper and other research on this topic to discuss the potential revenue opportunities for sovereign wealth funds and how they can take advantage of the changes in the OTC space, and specifically repo and securities lending.**

**Welcome to the podcast, James.**

James: Thank you, Julia. It's a pleasure to be here.

**Julia: Before we begin James, can you give our audience a little bit of background into yourself.**

James: Yes, sure. I'm responsible for the securities financing business here at BNY Mellon in EMEA which incorporates the agency's securities lending business and also the principal secured financing business.

**Julia: So let's look at the activity first. James, do you foresee sovereign wealth funds will be increasing their securities lending activity say in the next 5 - 10 years, and if so, to what extent?**

James: In the joint study by BNY Mellon and the Official Monetary and Financial Institution Forum we surveyed sovereign wealth institutions between April and July of 2016. The institutions collectively hold more than $4.75 trillion dollars of assets under management. 75% of the respondents are interested in increasing their securities lending activities.

Today we're witnessing an increased interest from sovereign wealth funds to participate in lending programs, with the sovereign wealth funds already participating expanding their guidelines.

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Securities lending is a reliable source of revenue in this low-yielding environment. In some instances, the lending return from a specific asset can exceed the yield on the underlying asset. Negative interest rates in certain jurisdictions have lowered volumes to the point where lending returns exceed the yield.

Collateral and counterparty flexibility have a bearing on the amount of revenue that can be generated from an asset. The natural holders of cash, some sovereign wealth funds are exploring ways to deploy the cash through various funding structures.

With banks moving away from balance sheet intensive activities, opportunities exist for sovereign wealth funds to participate to a greater extent in the repo market and through peer-to-peer financing opportunities, especially those in the Middle East, and we expect this trend to continue.

The recent fall in the oil price has prompted sovereign wealth funds to look closely at lending opportunities. The extent to which sovereign wealth funds will expand their activities will depend on addressing counterparty risk, legal obstacles, regulatory barriers and limited secondary markets if they want to play a more active role in easing the liquidity pressures by participating in securities lending.

**Julia: So why are sovereign wealth funds well-positioned to benefit from the securities lending market?**

James: The new rules implemented since the financial crisis aim to increase the ability of financial institutions to deal with the future market constraints. The rules require banks to hold large amounts of liquid assets to minimise liquidity crunches in time of stress. There is a narrow definition of the assets considered sufficiently liquid for the regulatory purpose and include cash, central bank reserves, US and other top-graded government securities, and a certain amount of top-graded corporate debt.

James: Banks are required to hold sufficient amounts to cover the total net cash outflows over a 30-day stress period. Banks are also required to have enough net stable funding to cover at least 100% of the liabilities for a one-year period.

The implications of the regulations have increased funding costs, reduced appetite and increased cost across the balance sheet intensive activities.

Central bank policies of quantitative easing are designed to pump liquidity into the market. Effective bond buying programmes have contributed to a



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global shortage of safe assets at a time when demand is increasing significantly.

The reason why sovereign wealth funds are positioned well is they're not covered by the stringent rules on capital and leverage ratios; they are large holders of government securities which they can make available to the securities lending market. Having the access to funding to enable them to step into the financing activities that is costly for banks, particularly through repo.

**Julia:** **To lean in a little bit more deeper, James, how does securities lending and repo activity complement sovereign wealth funds investment strategies, and what value is this likely to add?**

James: The sovereign institutions are hungry for yield and it's becoming more important in the current low interest rate environment.

Liquidity is viewed by 95% of the respondents to the OMFIF (Official Monetary and Financial Institution Forum) Survey as 'Important' to 'Very Important'. Low yield on high quality assets are pushing investors into market with illiquidity risk when monetary conditions or market sentiment changes.

The regulatory changes have reduced the overall market liquidity. Banks have stepped back from intermediation. Instead, non-bank financial institutions now present in the market generally trade in small amounts. These institutions are less capitalised, more information-sensitive, and hence shorter in term than the sell-side institutions that they replace.

This creates a greater risk of price instability in times of market stress. Access to capital and financing is key to avoiding financial shocks. Sovereign wealth funds activity in the funding market, both through repo and securities lending, should improve market makers' ability to finance long inventory and cover short positions.

As holders of high quality liquid assets, sovereign wealth funds ability to lend these assets in return for lower grade assets, equities and corporate bonds via counterparties, the assets eligible to be used in the repo market are acceptable to CCPs. The liquidity of the underlying capital assets is likely to improve as a result.

**Julia:** **Let's look at the wider market factors. Can securities lending mitigate the effects of low interest rates and geopolitical uncertainties on investment returns?**



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James: The regulatory requirements pushing banks to hold high quality liquid assets, coupled with central bank bond buying programmes removing HQLA from the system, is pushing increased demand to borrow HQLA. As large holders, sovereign wealth funds are in a good position to capitalise on this demand but a well thought out collateral and counterparty guidelines and term lending structures for returns available from lending HQLA can exceed the yield achievable on the underlying asset.

Collateral is becoming an asset class in its own right and starting to influence the investment decision to hold the asset itself.

**Julia: Finally, James, for the sovereign wealth funds that are listening today, which regulatory reforms do you think they need to be aware of with regards to securities lending?**

James: There are a number of regulations that while not directly impacting sovereign wealth funds, the implications of the regulation is having an effect on the wider market. The sovereign wealth funds we have spoken to said the biggest regulatory impact has come from the introduction of Basel III with the focus on leverage and liquidity.

The liquidity coverage ratio (LCR) requires banks to hold sufficient high quality liquid assets to cover the total net cash outflows over 30 days.

Net stable funding ratio (NSFR) imposes longer term funding requirements based on asset quality and maturity profile.

Supplement leverage ratio (SLR) is intended to be a backstop to the risk-weighted capital requirements and limit the amount of leverage that a banking organisation may incur as a blunt, non-risk-based measure.

The combination of these three regulations is having a number of effects, imposing longer term funding requirements based on asset quality and maturity profile, driving the demand for evergreen and term funding and borrowing structures necessitates greater retention of unencumbered HQLA for banks and penalises the use of cash collateral.

Sovereign wealth funds that have flexibility in their collateral schedule to accept a lower grade collateral, i.e. equities, are prepared to engage in [term] structures are well-positioned to capitalise on the opportunities presented in the market.

Future regulation that will impact the market is the introduction of SFTR (Securities Financed Transaction Reporting). The European Commission wants to increase the transparency of securities financing transactions



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which are not covered through other regulations. Securities financing transactions include repurchase agreements, securities lending activities, and buy sell-back transactions.

All transactions conducted with the firms established in the EU, regardless of where the individual branch is, EU branches of non-EU firms, and any SFTs where the securities used are issued by an EU issuer or an EU branch or firm, are required to be reported to an EU Trade Repository.

The regulation will add a significant overhead to clients participating in the securities finance transactions and could lead to some counterparties withdrawing from the marketplace which will create further opportunities for sovereign wealth funds to participate.

**Julia: Well we haven't focused on sovereign wealth funds in the past, so I hope that our listeners have found this useful today.**

**Thank you James for joining us in this podcast and giving us some expert insight into this topic.**

James: It's been a pleasure.

**Julia: If you would like to find out more about the paper and reports references in this podcast, you can find details on the show notes page on DerivSource.com, but do get in touch if you have other topics that you'd like us to cover in upcoming podcasts in the coming year.**

**Thank you for listening, join us next time.**



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