FIXED INCOME

Beyond the Matched Book: How MIM Differentiates in Securities Lending

Discussion

May 2024 —Guy Haselmann, Head of Thought Leadership at MetLife Investment Management (MIM), recently sat down with Alex Strickler, Head of Securities Lending at MIM to discuss the team's approach to generating excess yield with Securities Lending

Guy: What is the basic definition of securities lending?

Alex: Securities lending involves the temporary loan of securities, typically equities or fixed income instruments, from a lender (like MIM) to a borrower, on a collateralized basis. Borrowers seek these securities for various purposes, including to cover shorts, support trading books, making markets in collateral, hedging specific exposures, or pursuing arbitrage opportunities. For MIM, we primarily lend US Treasuries.

Guy: And how does MIM approach or view that definition?

Alex: In the context of how we manage the business and given the required over-collateralization, securities lending is a low-risk market transaction in which liquid securities are exchanged for cash collateral. It is done for the purpose of generating incremental income from asset portfolios, thereby enhancing overall earned yield. It is a way to allow assets that are held in the general account, for liquidity or duration purposes, to work harder.

Guy: From a risk management perspective, how are lenders protected in such transactions?

Alex: This is the collateral component I referred to. To mitigate the risk of borrower default, collateral is critical to the transaction. Borrowers provide cash or other securities which exceed the value of the loaned assets. In the event the borrower fails to return the securities, this over-collateralization serves as a safeguard for the lender.

Guy: MIM's approach clearly differs from the traditional model of a matched book.

Alex: That is correct. MIM prioritizes two key aspects: Liquidity and Capital Efficiency. This is most evident in our reinvestment strategy. Typically, lenders aim for a "matched book" approach, where the duration of the loan of securities aligns with the duration of the reinvested collateral. However, MIM employs a calculated "mismatch" strategy. In other words, we strategically reinvest the cash collateral with a longer weighted average life profile than the loaned collateral. This allows for potentially larger margins. What makes this strategy more liquid and capital efficient is the large allocation to high quality liquid assets (HQLA).

I would also note that the goal is to minimize loan balance volatility which enables us to maintain stable program balances. Stable balances allow us to express our reinvestment strategy.

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Guy: What are the implications of such a difference? Is this how you generate extra yield beyond that of a "matched book"?

Alex: Our mismatched book is intended to generate a yield differential that we can capture but it introduces interest rate risk. So, if interest rates rise, this can negatively impact the fixed-rate reinvestment portfolio and potentially offset some of the gains from the "mismatch."

Guy: So, it's a calculated risk-reward proposition?

Alex: Indeed. MIM actively manages this risk by employing risk-reducing hedging strategies via interest rate derivatives, such as caps. These instruments act as a safeguard, limiting earnings margin erosion should interest rates experience a significant upward shift.

Guy: I bet this sophisticated approach requires constant vigilance.

Alex: Absolutely. While we believe MIM's strategy has the potential to generate a superior and consistent income stream from our securities lending program, it necessitates proactive management and acknowledges the presence of additional risk factors. It may result in income volatility as a result of interest rate curve shifts, but managed prudently, the strategy has the potential for higher long-term income and higher margins vs traditional "matched book" lenders.

Guy: Could you elaborate further on some of the portfolio differences from a matched book?

Alex: As I mentioned, we seek higher collateral utilization rates which results in larger loan balances and ultimately higher adjusted earnings. Most agent lenders seek to prioritize the value of the collateral lent, resulting in lower program balances and utilization rates and ultimately lower income.

In addition, we seek to allocate a larger percentage to the HQLA segment of the portfolio, predominately U.S. Government Securities, which means lower allocation to credit assets vs. our peers. Our non-HQLA allocation prioritizes floating rate spread assets due to the favorable ALM profiles.

And lastly, most agent lender's reinvestment strategies are limited to matched durations which can potentially lead to being overweight credit which carries its own set of risks.

Guy: Besides the extra potential yield what is the reason portfolio managers might be interested in this strategy?

We believe this approach is best suited for managers who are seeking to generate incremental income and comfortable with measured level of interest rate and credit risk. MetLife has a long history on both sides of the balance sheet, and we can tailor a prudent liability portfolio and diversified asset portfolio to meet a client's objectives. The strategy also provides access to MIM's unique asset organization capabilities.

Guy: Thank you for this comprehensive explanation, Alex. I now have a much clearer understanding of securities lending and the nuances of MIM's approach within the broader context of portfolio optimization.

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