Securities Lending Revenue Estimates: Art or Science?

By Paul Collard

Revenue estimates are one of the central pillars around which a securities lending program is built. For existing beneficial owners they form a crucial part of the annual review/benchmarking process and give the lender the opportunity to explore and predict future performance, as well demonstrating any effect that changes in the program guidelines could make. For prospective clients, they are even more important and they often form one of the pivotal pieces of information in an RFP. Moreover, in some cases, they also become the deciding factor that leads to the award of a mandate. This makes the construction of a revenue estimate vitally important and yet they remain one of the most opaque and unchallenged areas of the securities lending world. So, we at MUFG Global Security Lending Solutions think it is time to shine some light into the darkness and explore how and why estimates are done and, perhaps more crucially, how they can be done better.

If the securities lending market is so inherently unpredictable, why are revenue estimates so important?

Revenue estimates are one of the lenders' most closely guarded tools of the trade. They are used to calculate the potential performance of a portfolio of securities in the securities lending and financing markets, so that all parties understand the opportunity contained within that portfolio. At their heart, they are a detailed analysis of every security a beneficial owner holds. They indicate how those securities have performed or how they will perform in the future. So far, so simple.

Except, it is not that simple. Not at all.

Every lender will have their method for calculating an estimate. This makes it almost impossible for a beneficial owner to look at the data they are given and understand how accurate it may be. Benchmarking estimates is even harder. There are tools available and data providers exist to assist in this tricky process. However; in some instances, there can be no doubt that interpreting an estimate becomes very difficult indeed. Factoring in different trading strategies, client-enforced guidelines, lender collateral acceptance and indemnitees only adds to the complexity.

So how can a lender give an accurate and understandable estimate?

This is the holy grail of the revenue estimate. I expect every lender would claim that their estimates are both accurate and understandable, and I am sure that every lender strives to achieve just that.

But the truth of the matter is that revenue estimates really are straightforward to perform. Many tools now exist that can produce an estimate in a matter of minutes. But to our mind, this is a good example of the right data being poorly used. We are all familiar with the caveat that past performance is no indicator of future performance, so why run a beneficial owner's portfolio against historical market data? Such analysis tells you little. There is no notion of why some of that historic revenue was generated, whether that lender could have captured it, or even if it would have been applicable to that beneficial owner. Comparing a portfolio against existing clients doesn't help either. There are too many variables and too many customizations that we can never get to a position where we are truly comparing apples with apples. There are also too many pitfalls in an estimate that solely relies on market data, no matter how scientific, especially in a portfolio that contains securities that had significant value in the past. Just because a security had substantial value six months ago, is by no means an indication that it will have that again in six months. In recent months, we have all become used to being told to follow the science but here it really can be a case of following the science too closely.

And what about those "magic" revenue estimates - the ones where a lender can increase an existing estimate at the drop of a hat to show a potential increase in performance when they are pushed to do so. Or worse, an estimate that predicts future revenue that greatly exceeds what has been achieved in an existing mandate. If estimates are that flexible, how can they be seen as fit for the purpose for which they are intended?

So how do we enhance the process?

All is not lost.

Detailed and insightful examinations of a portfolio are certainly possible. But they require a significant investment of time and deployment of the very best technology on the part of a lender. The right data overlaid across a portfolio can produce a clear and accurate explanation of why revenue was made with those securities in the past and how that might impact that same portfolio's performance in the future. But it is a case of extracting the right data, overlaying it across the portfolio and then demonstrating the production of the analysis to the beneficial owner.

And there is more to it. Data gets an estimate to a certain point. What takes it to the next level, is expertise. In our science-led world, this can feel something of an anachronism. Yet it remains crucial. Experience and market knowledge adds the color to the framework of the data-based numbers. Only detailed market knowledge can explain the performance and give a beneficial owner the critical extra level of information about the specific securities they hold.

Where does this all leave the beneficial owner?

I think it is becoming more important for all beneficial owners to understand that estimates are more than a simple number. They should be based on a thorough and detailed analysis of every security in a portfolio. The estimate should include all the different factors that will likely effect the program, both positively and negatively. Lenders should be able to talk to a portfolio manager in exacting detail regarding potential performance down to the level of exact transactions that should be expected. The lender should become an expert on that portfolio, so that the beneficial owner fully understands where and how revenue will be derived from their securities. This should all be backed up with the right data and the analysis that goes with it.

There is also another tool at a lender's disposal. Put simply, they can put their money where their mouth is. Floors and guarantees can be given that fully demonstrate the lender's confidence in their estimates. This can often be a good way of separating the optimistic from the realistic. It also aligns the interests of both lender and beneficial owner, so they are working to exactly the same goal – extracting every last ounce of value from the securities in the portfolio under that beneficial owner's choice of guidelines.

So to conclude.

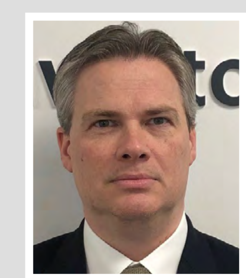
There is no escaping the fact that securities lending revenue estimates are vital.

They are vital to the pension funds who count on the securities lending revenue to boost their returns.

They are vital to the asset managers who count on the alpha to offset costs and help outperform their competition.

They are critical to index funds and ETF's.

But they are relevant only if they are done in the right way. Beneficial owners need to challenge their lenders and require them to examine their portfolio in much greater detail than perhaps has been the case in the past. Only then can a true picture be given. Performance may still vary. After all, if the current COVID crisis has taught us anything it is to be humble and accept that the future is, and always will be filled with uncertainty. But that doesn't mean lenders can skimp, or not give a beneficial owner's revenue estimate the time it needs and deserves. Through the blending of art and science, a lender can provide a beneficial owner a clear and detailed understanding of the portfolio's performance potential. And at the end of the day, that is exactly what is needed.



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MUFG Investor Services

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