ISLA Digest

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Quarterly Securities Lending Market Commentary

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This commentary is the first of a new series entitled the 'ISLA Digest'.

In collaboration with a range of member firms, representing agent lenders and borrowers, we look at some of the recent trends and driving forces behind securities lending market activity. The commentaries will be published on a quarterly basis, and ISLA would like to thank the contributing firms for their support*.

Macro Reflections & Market Drivers

Throughout 2022, global events such as post-COVID recovery, inflation and the conflict in Ukraine have underpinned the trends seen in financial markets, characterised by rising interest rates and market volatility.

As we emerged from the pandemic at the beginning of the year, market participants expected strong growth in corporate activity, as firms looked for a much-needed influx of capital. However, political tensions in Eastern Europe, followed by levels of inflation not seen for many years led to a sustained period of muted activity and stunted growth throughout 2022. This is a trend that has continued into Q3, with deleveraging and market selloffs being seen across the board, particularly in the consumer discretionary sector as market participants anticipate a potential drop in demand as we enter into a recessionary environment.

The risk-averse market generated a flight to quality and strong demand for governments bonds in the first half of the year, however soaring yields have led to further uncertainty even within the fixed income markets. Demand has therefore shifted to core government bonds, with locates most dominant in France and Germany. Despite the volatility, the effect on securities lending markets has been limited, with stock borrowing and lending (SBL) fees remaining static in the fixed income space.

Trading

Q2 saw a marked increase in the level of focus borrowers are placing on risk-weighted assets (RWA), and credit-efficient borrowing was witnessed over Q2 as a result of rising interest rates, the cost of capital, and general deleveraging across market participants. As a result, both borrowers and lenders had been taking a more proactive approach to managing their RWA exposures. While RWA consumption remains a continued focus for the industry in Q3, balance sheet management and RWAs are so far not at stressed levels. Year-end positioning is already becoming an area of focus and many funding markets are pricing at a premium for this period.

Shorts were generally down throughout Q3 (largely due to prime brokerage clients running low risk profiles), however directional shorts and bearish positioning in sectors such as travel and tourism sustains demand for short cover within EMEA. A lack of consumer spending power, soaring oil prices and ongoing staffing issues have left the travel industry struggling to recover to pre-pandemic levels, giving rise to a proliferation of directional shorts in this sector, much of which continues to trade at special levels. This same trend is being seen across the sectors expected to be most affected by a recession. Conversely, there has been a reduction in short positioning in defensive sectors.

European markets have been particularly impacted throughout Q3, with the energy crisis generated by the Russia-Ukraine war meaning that manufacturing companies in particular have come under huge pressure to keep costs down and avoid further contributing to inflation. As a result, most major European indices are ending the quarter at low market capitalisation.

Post-Trade Environment

In the period immediately after the implementation of CSDR, an improvement in settlement rates was observed. This was largely down to behaviour changes across the market; earlier cut-off times, failing loan chasers, and improvements in operating procedures between counterpart's operations teams had led to an initial feeling that the new penalties regime were having a material impact. However, more recent experience suggests that settlement rates have begun to fall away again with problems associated with market liquidity and recent volatility undermining any previous improvements.

A lack of auto-partialling in SBL transactions can limit the extent to which manual intervention can prevent settlement fails. This can create particular concern for borrowers who may be stranded between sell-side clients with the ability to auto-partial on inward returns, and agent lenders who are generally unwilling or unable to accept partials. As recommended by ISLA Best Practice, auto-partial facilities should be applied by default for failing securities lending trades where its use does not disadvantage either party.

The ongoing requirement for market participants to absorb the cost of regulatory developments is also becoming increasingly challenging, with technology and system upgrades continuing to be necessitated by changes such as a move to T+1, as proposed by the SEC Rule 10c-1. Over time, this could lead to smaller participants leaving the market, concentrating securities lending flows in the hands of an increasingly small number of large players. This in turn has implications for market choice, competition, and long-term market stability.

Market Stress & Liquidity

Tight margins and inefficient processing when transferring additional margin continues to pose timing and settlement risk, particularly during periods of market volatility. If the industry is to alleviate some of this risk, improving the efficiency at which loans and collateral can be marked-to-market, and collateral be delivered intra-day, will become an increasingly important topic for consideration.

Distributed ledger technology (DLT) and the use of smart contracts was identified as one potential solution to reducing intra-day exposure, by enabling the ability to simultaneously transfer loan securities and collateral and facilitate near real-time settlement. While in the early stages of development, it may be interesting to track the extent to which new technologies such as DLT are being utilised to reduce one-day market risk and optimise transfer efficiency. Use cases are starting to provide demonstratable examples of how DLT can be applied to business practices, however work on legal structures and capital regimes for tokenised assets is required before scalability of this emerging technology can be achieved.

A reduction in small and mid-cap liquidity at lenders has led to an increased level of specialness.

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ESG

This time last year the ESG agenda was being set against the backdrop of COP 26 with an increasing level of interest in ESG amongst agent lenders and their clients. However geopolitical events in the guise of the invasion of Ukraine by Russia earlier this year appears to have taken some momentum away from these initiatives, at least in the short term.

Notwithstanding this, lenders are starting to use the various ESG datasets that are available to them in order to formulate internal policies over how ESG is incorporated into acceptable collateral tolerances. This interest is now starting to percolate into day-to-day activity, with more ESG-collateral profiles starting to be requested by some agent lenders.

A lack of standardisation in setting these tolerances can lead to variabilities in how ESG is being considered in relation to collateral, making it difficult to identify where the boundary of 'acceptable' actually falls.

There is also a growing trend in the number of recalls occurring for voting purposes, as funds begin to take a more active shareholder stance. This underlines ISLA's view that well-managed securities lending programmes are highly compatible with ESG principles and objectives. While business is not currently constrained by ESG, it may be a fair conclusion that ESG considerations will start to feature more heavily when setting acceptable collateral schedules in the future, and will likely start to have an impact on collateral availability in the market.

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