ISLA Digest

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Quarterly Securities Lending Market Commentary

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In collaboration with a range of agent lender and borrower member firms, ISLA Digest is a quarterly market commentary that looks at some of the recent trends and driving forces behind securities lending and financing market activity. ISLA would like to thank the contributing firms for their continued support*.

Macro Reflections & Market Drivers

The final months of 2022 were played out against a familiar backdrop of persistently high inflation and the uncertainties created by the war in Ukraine, that have led to a 'cost-of-living crisis' across Europe. Although we may have seen inflationary trends peak in some markets, further political turmoil in the UK has magnified potentially structural issues that are unique to the UK. These in turn have fed directly into our markets, with moments of intense volatility and scarce liquidity in the UK Gilts market seen in the autumn of last year.

The much-anticipated post-COVID growth in corporate activity has failed to materialise, and except for a limited number of high-profile deals, investment activity seems muted. In response to this, investment banks and other financial institutions have been looking to cut costs, with some observers suggesting layoffs across the financial services industry at levels not seen since the financial crisis.

One of the recognisable benefits of the post-financial crisis regulatory agenda is that banks and other prudentially regulated institutions are much better capitalised and therefore able to withstand market shocks, particularly as markets have reacted to recent global events. However, during the Liability Driven Investment (LDI) led crisis in the UK during autumn, risk came from a different source as the markets themselves reacted badly to certain changes to UK economic policy. This in turn led to a collateral squeeze on LDI funds as they sought to access sufficient eligible collateral to meet margin calls. This crisis was only effectively averted from becoming a full-blown financial stability issue, by direct intervention by the Bank of England.

A defining factor of 2023 will be how central banks manage market interventions and interest rate levels as global economies look past the current recessionary environment.

Trading

The final quarter of the year could be characterised by broadly reduced client risk levels, with gross and net leverage amongst hedge fund (HF) clients at lower levels versus history. Shorts, where they were kept on the trading books, were focused on consumer discretionary, with clothing and big-ticket items such as white goods and autos reflecting, in part, the cost-of-living squeeze being felt by many consumers.

Also, COVID-related issues in China in the final part of the year led to a heightened interest in stocks that were exposed to supply chain issues, as well as sensitivity to the rising interest rate environment.

There was also consistent demand for rate sensitive equity plays, specifically in REITs.

More specifically in Europe, short exposure reduced into the year end relative to other regions. Although there was heightened interest in energy stocks which were the most borrowed sectors amongst the large caps, notably in France and Norway, industrials were the largest borrowed sector amongst the mid and small caps.

Fixed income demand was heavily concentrated in the general collateral space. At the time of writing, 2022 specials have largely reduced, year-end funding trades are unwinding, US Treasury/ Japanese Yen spreads have deteriorated, and fees for bunds are normalising given the Bundesbank's liquidity injection into the market.

Gilts, however, are still trading at elevated levels as an overhang from the LDI crisis last year. That is unlikely to change in the near term unless the UK Debt Management Office adds further liquidity to the market. Although from a market perspective this may make sense, this may not be an option politically, at least in the short term.

From a resource management perspective, the dealer side of the market appeared to have gone through the year end relatively comfortably. Balance sheet management not seen to have been an issue due to continued market sell offs during 2022. The brief market rally in November and December didn't change things much. The previously highlighted lack of leverage in the HF space meant low balance sheet demand from prime brokerage businesses.

Risk-weighted assets (RWA) optimisation opportunities continued to be an important theme running through trading books. RWA and G-SIB status are most likely to be the overall binding constraints dependent on limit allocations, volume, and market timing now, with plenty of underlying liquidity in the market at the present time.

The period marked the first time during the year, when G-SIB management was not viewed as a major exercise due to a lack of leverage. With market beta and the aforementioned lack of leverage taken on by HFs, it continues to reduce any potential balance sheet concerns due to continued market sell offs during 2022. Increasingly, lenders and borrowers continue to focus on their RWA consumption, a theme we will most likely see throughout 2023.

Post-Trade Environment

CSDR has been one of the most transformative pieces of legislation seen in our industry.

Approaching the first anniversary of its implementation, much still needs to be done across our markets. On the loan or outward leg of a new transaction, settlement rates are reported to be above 90% in equities and fixed income.

However, reported loan return statistics are not so favourable across both equities and fixed income, and more needs to be done to help borrowers in particular improve settlement discipline by booking returns off settled as opposed to projected long positions.

To try and deliver better settlement rates, some lenders have taken steps to require one-day prepays versus certain collateral types, and in markets with early deadlines, particularly from borrowers whose collateral teams are based in the US.

After the initial rush of settlement fines, firms appear to be better at managing them, and CSDR processes and are getting more efficient. However, many firms are still using significant resources to fix breaks and fines manually. Although expedient in the short term, this structure does not afford the longer-term sustainable solution that is needed across our markets.

While many firms are looking to develop technical solutions to deliver these efficiencies, the often-vexed issue of partial settlement will need to be addressed if we want to unlock the very real opportunities this technique offers our markets and those adjacent to us.

Regulatory Developments

The market is also paying close attention to the finalisation of the latest Basel rules which have been delayed to date. The UK has indicated a delay into 2024, whilst Europe has proposed an implementation date of 1 Jan 2025, and US regulators have yet to confirm their proposal.

Participants continue to monitor the potential RWA impacts on their respective businesses, and seek solutions for capital efficient borrowing and distribution.

In Europe in particular the proposed changes to the output floor methodologies will potentially put the economics of a securities lending transactions under some strain, as higher RWAs are likely to apply across trading books more broadly.

In addition, unrated lending counterparts which are an important part of our market in terms of available supply, could be significantly disadvantaged under the new regime. Without some form of regulatory dispensation for these counterparts or the development of alternative trading structures including pledge collateral or central clearing models, trading liquidity from this important community could be lost or diluted over time.

At the time of writing, the UK has also initiated a review of short selling rules, with a similar one expected in Brussels over the coming months. Whilst ISLA supports any review of existing legislation our sense from talking to market participants is that the current rules both here and in Europe are generally working well and provide sufficient control and transparency for the regulatory community.

We are also monitoring closely the development of the UK's post Brexit regulatory agenda, which is anchored around the so-called Edinburgh Reforms. As we understand the direction of travel from the UK, we will of course be working with our membership to respond to these new and novel regulatory developments during 2023 and beyond.

In the context of our markets, ESG screening of collateral is already bespoke across all market participants, where ESG profiles are being requested.

The industry continues to work with the SEC in North America to consider amending rule 15c-3-3 to permit broker-dealers to pledge equities as collateral for securities lending transactions. This will unlock previously under-utilised collateral and enable more efficient intra-company funding. Once approved, the permitted equities will likely be large cap, liquid equities and they will likely only be permitted to be pledged on equity borrows. Certain lenders including mutual funds and ERISA plans would still be excluded from accepting equities as collateral, so dialogue with relevant regulatory authorities to permit these clients to accept equities as collateral must be initiated.

Environmental Social & Governance

There is no doubt that the war in Ukraine has taken some of the momentum out of the debate around ESG, as countries deal with the fallout from the war including energy security issues, which in the short term at least may be more compelling than longer time climate change concerns. Having said that, there is no doubt that the ESG agenda will move back into focus as the conflict in Ukraine comes to some sort of conclusion.

In the context of our markets, ESG screening of collateral is already bespoke across all market participants, where ESG profiles are being requested. However, this is not seen as a top priority as most main players have already implemented their desired changes.

Some lenders have reported that occasionally managers running ESG funds enquire about ESG collateral, but these are few and far between. Most managers identify collateral primarily as a risk mitigation tool, not an investment tool. Little economic interest in the performance of the collateral securities; the most important factor is the liquidity of the collateral. By screening out collateral assets, clients could create concentration risk if they find themselves with a less diverse collateral pool.