ISLA Digest

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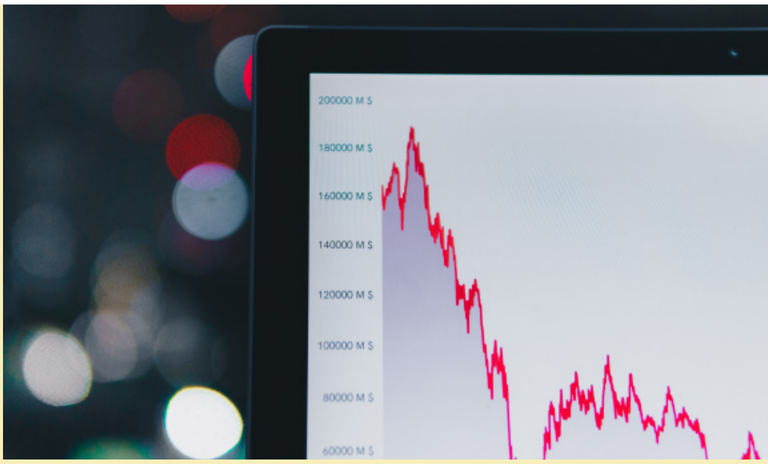
Quarterly Securities Lending Market Commentary

APRIL 2023

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 first quarter of 2023 saw many of the themes that defined much of 2022. From the perspective of financial markets however, the narrative changed in March as we saw Silicon Valley Bank followed shortly thereafter by Credit Suisse in need of significant support, leading to both institutions 'failing'. From a policy perspective, this new narrative makes the regulatory balancing act of tightening monetary policy, in the form of interest rate rises to choke-off inflationary pressures, harder to achieve, especially when further tightening could in turn undermine other institutions. The rate at which different economies are moving through the inflationary cycle is also a factor that may influence politicians looking ahead to the next election cycles, as voters in many countries are still feeling the full effects of the cost of living crisis.

Trading

Set against this often fast-moving backdrop, it is not surprising that the recent uncertainty is driving strong and continued demand to borrow High Quality Liquid Assets (HQLA) across most countries of issue. Of note Bunds, particularly sub-10-year, continue to be in demand as they were throughout 2022, but levels have eased and there are fewer specials since the Bundesbank issued €54 billion of new paper in the final quarter of 2022. Notwithstanding this, there was an increase in activity in the March 2023 cheapest-to-deliver (CTD) across bunds and BTPS suggesting that banks had sufficient balance sheet during the period. Looking further out and given the size of the ECB's Targeted Longer Term Refinancing Operations (TLTRO) and the incentive for the market to repay these loans, this is expected to generate further demand around the HQLA space in the coming months.

There were also strong basis trades including UST/JPY, EUR/GBP, Bunds/BTPS, and USD/Scandinavia paper executed in good size in the first quarter.

In equity markets overall balances remained steady throughout the first quarter, although there was some softening partly driven by the bearish positioning from 2022 unwinding, following the market rally in the latter part of the year. The ongoing conflict in Ukraine, supply chain issues, and central bank rate rises continue to weigh on companies though rising costs and growing distressed debt throughout the value chain.

Specials trading appears to have been a bit of a mixed bag in the first quarter, with some increase in demand for 'event' names. Despite this interest however, other commentary suggests that hedge funds appear to have struggled to find conviction in market direction, and have to some extent been sat on the fence in terms of where they want to commit risk.

Seasonal demand to borrow securities has been robust as most European companies have held or increased dividend payments this year. Energy stocks were the strongest performers buoyed by additional special dividends, including Equinor (EQNR NO) and Total (TTE FP).

Financial Resource Management & Regulatory Developments

After the extremes of the latter part of 2023, the first quarter was calm with funding markets once again behaving in an orderly way.

The market began to pay more attention to the future regulatory landscape in the form of the Basel IV framework. The first quarter of the year saw key developments on the Basel framework across Europe with an open consultation in the UK, and the Capital Requirements Regulation (CRR) / Directive (CRD) proposals at an advanced stage of negotiation within Brussels. Although any implementation of the full framework is still some time off, market participants are already looking both at the implications of the revised rules on their current business models as well as how they may change elements of current business to minimise the extremes of the new regime.

Consequently, borrowers are progressively looking to access lending clients through capital-efficient structures including 'Pledge' and smart bucketing when facing low risk-weighted assets (RWAs) clients, especially over quarter-ends. More recently and in preparation for Basel IV, discussions have begun amongst market participants on alternative means of distribution, including 'Pledge Back', Central Clearing, and Agency Swaps.

For borrowers who are sensitive to liquidity coverage ratio (LCR), there has been an increase in demand for longer term funding in the six months plus. This is due, in part, to the unwind in TLTRO structures mentioned previously and an increase in available balance sheet.

We are also seeing some evidence of credit and counterparty limit shortages, with firms hitting counterparty and regulatory hurdles with each other. The reasons for this are likely to be a combination of factors, but in Europe in particular the reduced number of active borrowers is likely to be a driving one. We have known for some time that as buyside hedge fund businesses coalesce around a smaller number of primes, lenders who provide indemnification for their lending clients are increasingly likely to run into single counterparty concentration limit issues. How this plays out over the coming months, will also be influenced by other factors including the growth of peer-to-peer trading.

From an operations perspective, CSDR still requires daily management but firms' experiences in 2023 appear to be better (or at least no worse) in equity markets, whilst fixed income markets appear to remain problematic. What is not clear at this stage is to what extent any improvements in and around the settlement discipline regime have been achieved at the cost of significant additional headcount in reconciliations departments.

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Environmental Social & Governance (ESG)

To an extent, some of the focus seen around ESG post-COP 26 in 2021 has been lost due to the ongoing conflict in Ukraine as well as the cost of living crisis. Whilst we expect this pause to be only temporary, the pace of change in securities lending markets reflects some of those same sentiments. Due in part to the absence of clarity around the ESG regulatory environment, funds retain a level of caution when looking at securities lending.

From a collateral perspective, it is still rare for a client or prospect to require collateral screening for ESG. Most investment managers still identify collateral primarily as a risk mitigation tool, not an investment tool. Typically clients have no economic interest in the performance of the collateral securities, with the liquidity and saleability of that collateral the most important factor to many lenders. Potentially by screening out collateral assets, clients could create concentration risk if lenders find themselves with a less diverse collateral pool.

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