



# T+1 and *Securities Lending*

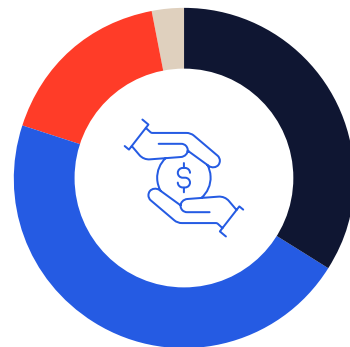
*“Securities lending is going to be the solution to facilitate T+1, not the problem. We’re going to need more securities lending liquidity if we are going to settle trades faster – and those who can manage their inventories in real time will have a significant advantage.” – Anonymous*

## T+1 and securities lending: What is the link?

Securities lending and borrowing is one of the single-most impacted area by the move to T+1, across the entire trade cycle, with 80%<sup>1</sup> of firms seeing significant to some impact on their businesses in this space (see chart).

As a worst case, uncertainty around securities movements may drive both asset owners and brokers to reduce their lendable inventories after T+1, creating a significant drain on market liquidity. Asset owners could be deterred from lending by increased settlement risks on their portfolio trades, while brokers could withhold too many securities from lending (i.e. over-buffering) in an effort compensate for potential shortages in delivery, driven by challenges in recalls. By contrast, a best case could see those with (real time) certainty of inventories turn the T+1 transition into a major commercial opportunity.

Expected impact of a shortened settlement cycle on securities lending activity



● Significant impact	34%
● Some impact	46%
● Little impact	17%
● No impact	3%

## Where are the potential challenges?

In the US and Canadian context, the risk of impact is divided into two core groups. Those participating in the US onshore/ domestic lending market (typically lending USD securities for cash collateral and settling on T+0 on a DVP basis) are unlikely to see significant pressures after the shift to T+1. Those engaged in the offshore lending market (lending USD or CAD securities against securities as collateral, and settling on an FOP basis on T+1 or T+2) look set to struggle due to the manual nature of their lending and recalls processes today.

On the lending side, existing indemnifications (by agent lenders to asset owners) should protect asset owners from any potential liquidity implications of the T+1 move and hence avoid any discouragement from trading – and from deriving the important investment returns from lending. However, these same pension funds may opt to reduce their lending in certain areas where there is perceived to be an increased settlement risk (and hence potential for any negative portfolio impact).

On the broker side, the management and processing of recalls poses significant risks. Recalls are one of the most manually intensive activities in the securities lending space today and the risk of errors and delays will escalate in a T+1 regime as firms struggle to communicate, book and reconcile their positions at the required velocity across the market. These elevated risks are compounded by the fact that each recall may entail several settlement legs – meaning an exponential growth in risk across a multi-leg settlement. Looking ahead, the timing of recall bookings is also likely to prove critical, in order to ensure that stocks can be returned in good time for settlement to continue.

*“We already deliver stock loans on T+0, but you have to remember that everything always gets sold off – and that means a new returns process when we accelerate settlement cycles.” – Anonymous*

There is also a risk of imbalance for borrowers looking to recall stocks from hedge funds – who may be using lent stocks to cover short-selling activity. With limited penalties applied to a failed trade under the current US regime, hedge funds may opt to decline a recall request because the economic case for doing so is compelling (i.e. significant returns versus very limited penalties).



## Where are the potential solutions and opportunities?

While the lack of certainty around settlement movements may be a challenge, those who can ensure maximum visibility of their inventories in real time will be able to benefit from the T+1 opportunity in several ways.

With most firms running on batch processes today, critical inventory can be tied up in processing delays. By transitioning to real-time infrastructures, brokers can not only avoid reducing supply, they can significantly increase their lending activities, provided that they can communicate (and hence recover supply) in real-time with counterparties; and then book the recall instantly in their platforms, updating their lendable inventory straight away. With speed and certainty, these brokers will be able to increase lending and borrowing at a time when others can't.

Building on the above, those firms who can manage their provisioning risks on a real-time basis will be able to avoid unnecessarily over-buffering throughout the day and hence increase the amount of stocks available for loan. Those willing and able to manage partial recalls will also have an advantage in avoiding failed recalls, although the timely and automated management of the client authorization leg will key.

Finally, those with inventory (and low settlement risk) can begin to provide ‘fails coverage’ solutions to the market – providing coverage for otherwise expensive, failing trades.

## What lies ahead?

Unfortunately, the highly interconnected nature of the securities lending market today means that no one firm can succeed entirely on their own. While technologies exist to support a significant improvement in settlement certainty, the ability to move to real-time processing will depend on the timely, ecosystem adoption of core platforms in the US and further afield if firms are to deliver for the move to T+1.

As a core area of impact for the T+1 transition in the US and Canada, securities lending is the center of much industry discussion today (notably at the RMA, CASLA and ISLA). These discussions will continue to center on driving industry-wide clarity around:

- Recall notification timing and deadlines
- The communication/response process for recalls
- Settlement standards, including the management of partial recalls

*“T+1 must not end up deterring people from providing liquidity. If accelerated settlements mean that there are fewer lenders available, then we've done a bad job as a market. We must use this as an opportunity to create an environment that encourages lending.” – Anonymous*



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