Securities Lending: 2014 outlook

The recent SLT and Citi joint breakfast seminar looked at regulatory concerns and the future of fixed income

Despite the early hour, Securities Lending Times and Citi's joint breakfast seminar saw beneficial owners and industry participants eager to thrash out the changes taking place in the securities lending market.

The panel brought together experts from all sides of the securities lending chain, including: Gavin Callan, director of securities finance at Citi, and moderator of the discussion; Kevin McNulty, CEO of the International Securities Lending Association (ISLA); David Martocci, global head of securities finance at Citi; David Brand, head of short term product sales for Europe at Morgan Stanley; Roger Fishwick, director of investor services at Thomas Murray; and Joseph Molloy, head of index equities at Legal & General Investment Management.

McNulty kicked things off with a comprehensive and insightful look at the state of regulation as pertaining to securities lending. First assuring the audience that regulators were not picking on the industry unduly, he outlined four areas that are demanding the most attention at the moment: Basel III, the European Securities and Markets Authority's (ESMA) guidelines on exchange-traded funds and other UCITS issues, the Financial Transaction Tax (FTT), and the Financial Stability Board's (FSB) work on shadow banking.

Basel III reforms are going to require banks to adapt all of their activities, including securities lending and borrowing, to set aside more capital than they have historically—and McNulty explained that ISLA has set up a working group to consider how the market might need to evolve to better serve its clients in a world where capital is constrained. The specific issue McNulty had with Basel III—and where ISLA is lobbying for change—was to do with the leverage ratio.

"There was a proposal put forward in 2013 to treat secured financing transactions in a very specific way for the purposes of the leverage ratio, which is essentially a deliberately blunt mechanism to cap the activity of banks (relative to their Tier 1 capital)," said McNulty.

"The issue is that secured financing transactions such as securities lending and repo would need to be recorded on a gross basis, and that might limit some activity, particularly for the fixed income department. But we're hoping to change some of these rules and ease the situation."

Brand gave his view on how Basel III could reduce bank demand in securities lending activity. With potential systemically important financial institution (SIFI) buffers and counter-cyclical buffers, Brand foresaw banks needing to raise their Tier 1 capital ratios, in some cases significantly—either by raising capital or reducing their balance sheets. Brand noted that there could also be a potential requirement to gross up repo balance sheets, which could also affect demand from banks and a reduction or increased cost in current market financing opportunities.

McNulty next detailed ESMA's guidelines that deal with UCITS funds, which were released last year. Fishwick jumped in to explain the one worrisome aspect of the guidelines; that a UCITS fund manager should not be able to take a return from the securities lending carried out on behalf of the fund. This would be a significant change to the current practice, and ultimately mean that there are no incentives for managers of UCITS funds to lend assets.

But McNulty answered that although this created a lot of initial concern about whether a UCITS manager which acts as securities lending agent could charge commercial fees for their service—ESMA has clarified that it is acceptable for them to be paid "normal compensation".

"The authority was more concerned about fund managers taking a cut in addition to what the agent may charge—a three-way split type of arrangement. It's a little unclear how national regulators are viewing these arrangements. It seems to us, in the way ESMA has worded the guidelines, that fund managers can make a charge that covers the cost of servicing securities lending programmes provided these are fully disclosed."

As the discussion on regulations progressed, the FTT came to the fore.

The panel observed that the FTTs implemented to date have exempted securities lending transactions, while the potential FTT from the group of 11 EU countries considering it would not meet a 1 January 2014 implementation date, but that further discussions were likely to take place during 2014.

The FSB's definition of shadow banking—which includes some elements of securities lending such as the reinvestment of cash collateral—was another item on McNulty's agenda.

For more than two years, the FSB has focused on how to regulate the securities lending and repo markets, and now has 11 final policy recommendations covering transparency, collateral management and CCPs.

McNulty stated that broadly, ISLA thinks that these policy recommendations are fine. However, there are reservations about proposals for the regulation of haircuts. The consultation period on this ended in November 2013 and ISLA submitted a joint response with the European Repo Council, expressing concerns over the scope of the proposals.

"There are two issues," McNulty explained. "[The FSB] would like to impose what it calls numerical floors on haircuts, ie, if you're in the business of providing secured financing, you cannot do certain types of business with a haircut below a certain level. The FSB is attempting to exempt cash collateral and certain collateral upgrade businesses. It's rather technical, but we think that the language used to exempt those businesses is a bit flawed."

"The other side is requiring everyone in the market to have a methodology that has minimum standards to set haircuts. We think, for a securities lending market, that is a bit confusing, because if everybody has to have one it's a bit unclear who has to give who a haircut, so we want clarification on that."

As the discussion on regulations came to a close, McNulty summarised by saying that the industry is, year-on-year, in a better position. "There is greater clarity on the regulations and how they are evolving and a key objective for ISLA in 2014 will be to continue to monitor and influence their development."

Collateral transformation

Callan's next question was to do with collateral transformation, described by Fishwick as "the great white hope" of the industry. The US has already implemented the Dodd-Frank Act, which has required a lot more collateral to be deposited with CCPs, and the European Market Infrastructure Regulation (EMIR) will kick off in the eurozone in around 3Q 2014.

CCPs, stated Fishwick, are going to require "good-old high quality government bonds" and supranationals. "They won't take corporate Europe bonds, because they're being pressured to look into taking equities, and they're also being pushed into looking at taking the likes of gold as collateral."

As to whether beneficial owners are looking at these collateral transformation trades, Fishwick stated that their interest will have to be pushed by the agents. He then asked Molloy whether, on the fixed income side, he could see Legal & General lending out all of its government bonds and taking in equities as collateral.

Molloy answered in the negative, but quantified this by explaining that Legal & General does not lend fixed income as part of a collateral transformation trade as existing collateral requirements for stock lending mean that G7 (excluding Italy) government and AAA-rated supranational bonds will only be accepted as part of collateral requirements.

Molloy went on to say: "But I would say that it's changing quite quickly, so I would never say never. At the moment, it would go against what we think is a good stock lending ethos. We acknowledge that securities lending is not free of risk. However, we believe that the risk involved can be mitigated and controlled effectively."

"We have been offering our service in this area on the principle that we must avoid any potential for conflicts of interest between ourselves and our clients. For this reason, we have decided that all revenue from securities lending (net of administrative charges) should go to the fund for the exclusive benefit of clients."

He explained: "Accordingly we ensure that: (i) securities lending is undertaken only in markets where we believe that the expected return considerably outweighs the risk involved, and where the risk can be controlled effectively. For these reasons, we only engage in markets where we consider there is a well-established securities lending market; and (ii) no compromises are made in terms of the quality of either the collateral or the counterparties."

"We are currently reviewing new stock lending markets such as Malaysia and Russia, where further risk/return analysis will take place before execution."

Fishwick went on to question where new fixed income collateral will be coming from, given that insurance companies are all facing Solvency II and will have to figure out how their lending practices fit into its parameters. He suggested that sovereign wealth funds will hopefully will be more proactive in their lending—and that China on its own could solve the collateral crunch, with its $2 trillion of US government bonds.

Martocci was more upbeat: "Will collateral transformation bring back fixed income? Maybe not in the same way that we have known it, but there will be increased demand for high quality assets. The agent lender is ideally positioned to facilitate these trades to support the market needs. This will hopefully lead to increased lending and borrowing opportunities for beneficial owners."

Martocci concluded the discussion on a positive note by reflecting on how adaptable the industry has been since its inception and how, as an essential part of the financial markets, it will continue to adapt and play a prominent role in the future. **SLT**