



ISLA

INTERNATIONAL
SECURITIES LENDING
ASSOCIATION

Securities Lending Market Report

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POST TRADE

ISLA's 10th Annual Post Trade Conference

Regulation...Technology...Harmonisation

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Contents

Foreword	4
Executive Summary	6
Global Market Dynamics	8
Guest Contribution: <i>The Kingdom of Saudi Arabia Set For Capital Markets Expansion</i>	14
Global Government Bond Markets in Focus	16
Guest Contribution: <i>Know Your Counterparts' Creditworthiness (KYCC)</i>	22
Global Equity Markets in Focus	28
Guest Contribution: <i>Are you ready for SFTR?</i>	32
Collateral Dynamics	43
Data Methodologies	38
About ISLA & Disclaimer	40

Foreword

Dear Reader,

We are once again delighted to welcome you to the latest edition of the ISLA Securities Lending Market Report. This is now the 11th edition of the report, which continues to provide a platform for us all to better understand the forces that are shaping our markets today, and the implications for market participants and other interested stakeholders alike.

Since we published the last edition of the report in early 2019, we have seen something of a change of pace around several key legislative and business development initiatives that we for one are focused on here at ISLA. Whilst we will discuss SFTR a little later, it is important to recognise that the publication on 11 April 2019 of the Regulatory Technical Standards (RTS) for SFTR in the European Union's Official Journal (OJ), set out a clear implementation timeline for SFTR until Q2 2020 when the first reports are now due to be submitted. The publication of the RTS in the OJ has created certainty where uncertainty existed up until now and has provided a focal point for much of the industry over the coming six to twelve months.

Before we look at the further implications of what SFTR means for our industry, it is worth reflecting on some of the other trends that have shaped our thinking in the first six months of this year. Looking back to our annual conference in Madrid during June, we saw several consistent themes and broader messages that paint an interesting picture of our markets today. If attendance

and sponsorship tell us anything about the industry, then the high level of delegate registrations and record levels of sponsorship suggest that the industry is in rude health. However, the picture is probably not that clear cut. Anecdotal feedback at the conference combined with recently published profitability and revenue figures for the first six months of 2019, suggest revenues from securities lending are down on levels seen in 2018. Statistics recently published by IHS Markit highlight a 15% fall in revenues for the first six months of the year, compared to the same period in 2018. The most pronounced falls were seen in respect of government bond lending, which fell some 24% during the first half of the year. We will explore some of the reasons behind the apparent fee spread compression in government bond markets later on in this report, however it would appear that there was a fall-off in the demand to borrow High Quality Liquid Assets (HQLA), just as the European Central Bank's (ECB)'s Quantitative Easing (QE) stimulus program came to an end.

Another factor that was discussed extensively in Madrid, was the role of sustainable finance and ESG in the context of changing investor behavior more broadly and what this means for our markets. It was commented by one of our panellists that Environmental, Social and Governance (ESG) screening is now an integral part of the investment management decision making process, and this has clear ramifications for our markets. As so-called millennials demand different things and new criteria to judge 'return', securities lending must respond to these changing dynamics. ESG driven funds can present challenges around collateral acceptability and

the governance requirements that are enshrined within this ethos. This demands that institutional investors have a policy around their governance as well as their securities lending programmes.

Set against a backdrop of tightening revenues and the challenges presented by an increasingly complex regulatory and business environment, the market has to think more broadly about how it can use the structural rigor created by SFTR and CSDR to leverage real business benefits from these changes. Inevitably, the market like many others is turning to technology to help solve these challenges.

Today, we are seeing real momentum behind the development of Common Domain Models (CDMs) and digital contracts, as firms look to standardise technology platforms and create cross-product efficient documentation conduits. Increasingly, it makes sense for firms and markets to standardise taxonomy for the various data points and component parts of a trade. This should be done on a consistent and cross market basis, especially where those terms and life cycle events are common to a number of markets and products. In terms of the appropriate owner or custodian of any CDM for our markets, we would as you might expect, argue that this is something that should be held by a neutral third party for the benefit of all industry participants. Consequently, ISLA is investing time and resources to better understand how these technologies and frameworks can be developed for the benefit of the broader community. We have to be honest with ourselves and acknowledge that much of the

work to create a workable CDM framework, has only been driven by the regulatory imperative of SFTR. It is therefore vitally important in our view, that the industry does not miss this once-in-a-lifetime opportunity to drive change and reap the real benefits that SFTR could bring to us all.

We would like to take the opportunity of this Foreword to thank those who have contributed thought leadership pieces, each providing a unique perspective on an important topic. The first of our three guest contributions comes from Tadawul, who considers the development of the capital markets in Saudi Arabia. We should not forget that that the Middle East and Saudi Arabia in particular are growing in prominence, and that the role that securities lending has to play in supporting market liquidity and facilitating investor access to these markets is key.

Next, Credit Benchmark looks at the role of ratings in the context of better managing and understanding counterparty credit risk.

Our final piece has been produced by MarketAxess on SFTR, who explain why the industry needs to learn from past implementations of regulatory reporting, and start making earlier preparations for compliance.

As always, we would like to thank our data partners; IHS Markit, DataLend, FIS Global, JP Morgan Tri-party, Euroclear, BNY Mellon Tri-Party, and Clearstream for their valued data inputs.

For the six month period to 30 June 2019, the following are the key highlights from our review of the global securities lending markets.

- As at 30 June 2019, reported global on-loan balances were circa €2.2 trillion. This was broadly unchanged from the reported number six months earlier.
- Reported securities being made available by institutional investors within lending programs showed a notable increase, rising from €16.6 trillion at 31 December to €19.6 trillion at the half year end. However, it should be noted that during this period, the Dow Jones Industrial Index increased by some 15% over the same period. With over 67% of all securities being made available for lending being classified as equities, the reported increase in overall lendable appeared to be driven in part by increasing asset valuations rather than assets coming into lending programmes.
- Government bonds being made available for lending did appear to show new supply coming into the market, increasing by 13% to €2.8 trillion. As insurers take advantage of all-time record low yields, these securities are finding their way into lending programmes as holders look to maximise returns.
- Government bond lending represented circa 43% of all securities on-loan globally, highlighting its continued importance to overall secondary market liquidity and the role of securities lending in the context of HQLA
- The expected additional demand for high quality collateral as a result of the implementation of waves four and five of the uncleared margin rules in 2020, will drive additional requirements to borrow government bonds.
- In the run up to the half year end, we saw the expected reduction in on-loan balances as banks repositioned trading books to comply with binding regulatory constraints. Just prior to the half year end however, there was a sudden spike in the demand to borrow government bonds with on-loan balances increasing by 7% in the final days of June. Reasons for this sudden increase in the demand for government bonds may

be down to several one-off factors, including banks looking to capitalise on the USD liquidity premium seen at the half year which led to an increase in the demand for US Treasuries.

- In Europe, there has been less demand to borrow HQLA following the end of the ECB's QE program in December 2018. As demand has fallen, fees have been compressed which has in part been compounded by additional HQLA assets coming into programmes.
- In equity securities lending markets, balances remained stagnant as hedge funds and other Alternative Investment Managers (AIMs) appeared to lack investment conviction, with the uncertainties of the global trade war between China and the US, Brexit and wider central bank policies all creating a climate of uncertainty.
- Recently published statistics suggest that revenues from securities lending fell 15% in the first six months of the year compared with the same period in 2018.
- The provision of securities lending liquidity from Sovereign Wealth Funds (SWFs) continues to be a prominent feature of our markets. As at 30 June, SWFs made up 6% of available inventory and 14% of loans globally across all asset classes.
- Reported non-cash collateral was circa €1.5 trillion, and represented 67% of all lending business globally.
- In Europe, the reported amount of non-cash collateral held in tri-party was €1.4 trillion. Within this number, equity collateral increased marginally from 41% to 43% of the reported total.
- 37% of government bonds held as collateral within tri-party were classified as Asian securities.
- Following the publication of the detailed RTS for SFTR in April, the immediate timeline for the implementation of this important initiative has been defined. The industry will have to mobilise considerable resources to achieve compliance with the reporting obligations of Article 4 ahead of go-live in April 2020.

Global Market Dynamics

Many of the factors that created the geo-political and economic backdrop to the first six months of 2019, were very familiar to those observers who had watched events unfold in 2018.

As these factors played out more broadly into financial markets, we saw knock-on effects into areas of investment management and in the provision of market liquidity, both linking directly to the demand to borrow securities. This in turn changed some of the economics around our markets, leading to a depressed revenue picture for the first half of the year. More on this later.

After strong growth in 2017 and early 2018, global economic activity slowed in the second half of last year, reflecting a confluence of factors affecting major economies. China's growth declined following a combination of needed regulatory tightening to rein in shadow banking, and an increase in trade tensions with the United States. These trade tensions have, if anything, increased in the past few weeks, and at the time of writing, financial markets around the world have seen sharp falls amid growing fears that the US-China trade dispute could escalate into a full-scale currency war, with damaging consequences for the world economy.

On 5 August 2019, stocks plunged on Wall Street as the Dow Jones Industrial Average sank by more than 766 points (2.9%) – its worst trading day of the year – and the S&P 500 and Nasdaq both fell 3% and 3.4% respectively amid fears that the trade war was intensifying. London listed shares on the FTSE 100 fell by circa 180 points, almost 2.5% following steep losses on Asian markets, again reflecting the global uncertainties around the future direction of trading relations between the world's largest two economies.

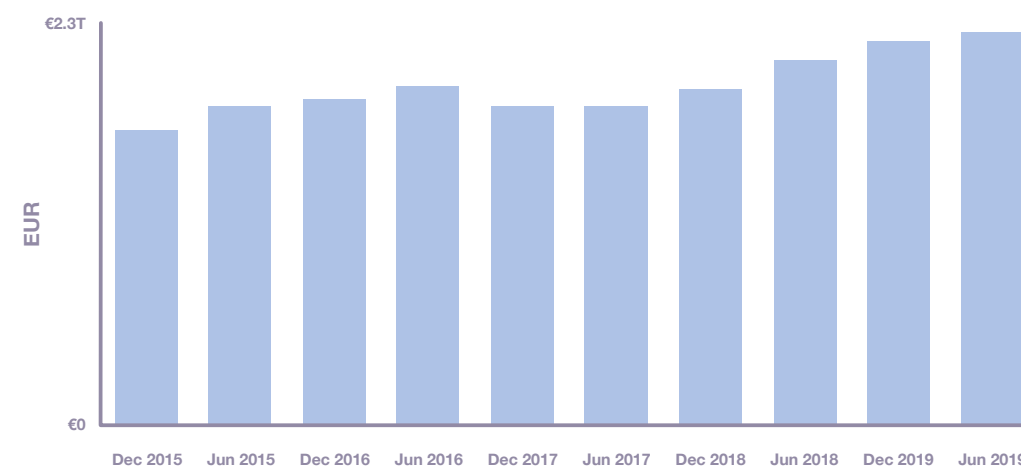
Closer to home, the risks associated with the way in which the UK will leave the European Union (EU) have intensified. In recent weeks, the change of UK Prime Minister has led to a very different stance from the UK. Although it remains to be seen as to how this plays out in terms of the separation from the EU, in the short-term markets are pricing further uncertainty, with sterling trading at all-time lows in the currency markets.

A constant theme that we saw in 2018 and into 2019, was one of uncertainty which not unexpectedly has led to varied investor sentiments, and at times inactivity. Ahead of the year end, we saw significant de-risking by hedge funds which was precipitated by a rise in equity market volatility, and meant that most hedge funds started 2019 in a risk-off or neutral position.

Whilst equity markets experienced strong growth through the first quarter of 2019, hedge funds were slow to re deploy capital, both on the long and on the short side. This conservatism prevailed through the first quarter of the year, with uncertainty relating to a number of key macro factors including global trade wars, Brexit and central bank policy; all negatively impacting investment conviction. As a result, hedge fund leverage levels and gross equity market exposures remained suppressed. Whilst reports suggest this improved modestly in the second quarter of the year, strong equity market performance meant hedge funds typically looked to maintain a net long bias, which negatively impacted global securities lending volumes.

Not surprisingly, the combination of some very challenging geo-political and increasingly difficult economic headwinds have begun to come through in bottom line performance across our industry. Data published recently by IHS Markit suggested that global revenues from securities lending for the first six months of 2019, down some 15% at €4.5 billion, compared to the same period last year. Revenue streams still come predominantly from equities securities lending, which represent circa 80% of gross revenues globally. Conversely and notwithstanding the high volumes of government bonds being lent today, they only account for 15% of global revenues.

Fig 1 - ISLA Global Securities Lending Aggregate



*see Data Methodologies for full details

Source: ISLA

Securities being made available by institutional investors for lending showed a notable increase from €16.6 to €19.6 trillion, an increase of some 18% over the period. Whilst we saw a 15% increase in the Dow Jones Industrial Index over the period, accounting in part for the increase in equity valuations, this is perhaps only part of the story.

Government bonds being made available for lending increased by over 13% to €2.8 trillion. There is clear evidence of increased bond issuance more broadly as issuers look to take advantage of record low yields. In addition, new or previously un-lent assets have entered programmes, as investors look to enhance revenue in the low or even negative yield environment.

Set against a backdrop of broadly flat equity supply and a notable increase in the availability of government bonds within the system, the ISLA Global Securities Lending Aggregate (**Fig 1***) remained broadly unchanged at circa €2.2 trillion compared to the 31 December 2018.

As we have seen from previous reports, banks and other prudentially regulated firms appear to be better prepared to hit various regulatory reporting hurdles over key reporting dates. Increasingly, as regulators demand average reporting or daily compliance, quarter or year end pressure will disappear. However, we did see some interesting volatility in terms of trading volumes during the period, and in particularly the final days of the quarter (**Fig 2**).

After some seasonality in trading volumes in the early months of the year, we saw general deleveraging across the market over the six month period, with less need for financing and consequently less pressure on yields/fees. This stemmed from actions taken over the 2018 year end and into 2019, where hedge funds took off risk positions. Furthermore, the fact that banks are generally well positioned for Liquidity Coverage Ratio (LCR) compliance, means less need to reverse in HQLA into the reporting date. The sudden spike in on-loan balances in the final days of the half year, was almost exclusively related to government bonds. Although the reasons behind this sudden increase will be considered further in a subsequent section, this is most likely related to a combination of reasons; the liquidity premium often associated with holding US

Dollars driving the demand to borrow US Treasuries, and the financing of long equity positions via collateral upgrade trades.

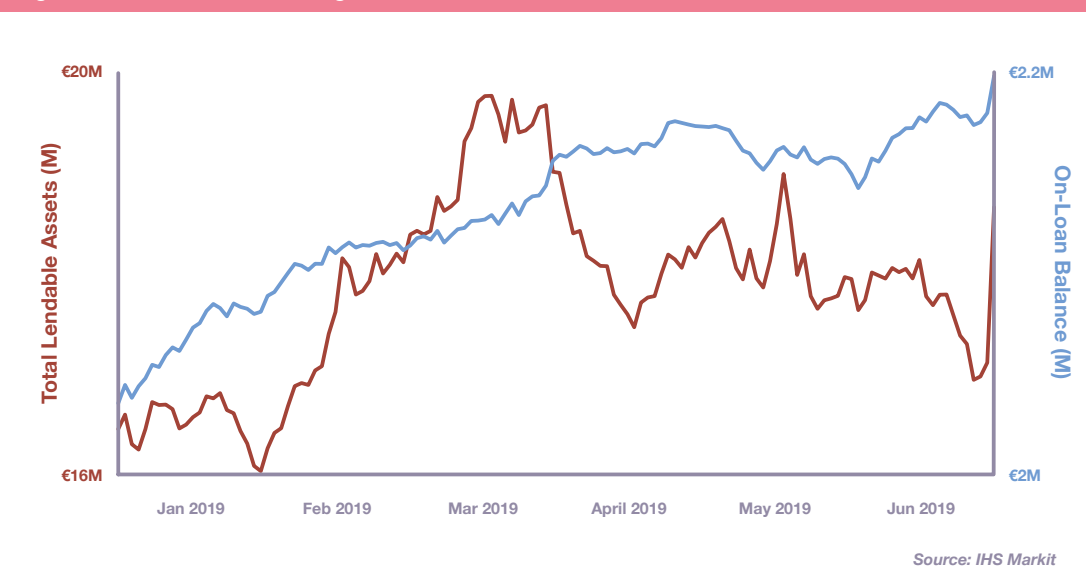
Further review of the composition of trading books and the use of cash or other securities (non-cash) as collateral, highlights how institutions actively and at times aggressively manage to various regulatory or market constraints. As highlighted in **Fig 3**, we saw the typical relationship between cash and non-cash collateral as the market moved to adjust balance sheet and exposures ahead of the 30 June reporting checkpoint. Loans collateralised with cash collateral were either being returned or recalled ahead of non-cash loans.

The reasons behind this trend are now well understood, with banks often preferring to keep HQLA regulatory driven non-cash trades open over the reporting date, preferring to scale back equity positions. There is also a preference to return cash collateralised loans to avoid having to engage in reinvestment markets, at a point when liquidity and investment opportunities could be limited. Typically, borrowers want to maintain regulatory driven HQLA trades over the year end, as part of an active balance sheet management strategy where the LCR is the primary binding constraint.

These trades are in turn often collateralised with other securities which are themselves balance sheet efficient if pledged as collateral as part of a term HQLA trade structure. As we have already noted, there was something of an anomaly in fixed income markets just prior to the half year that saw increased levels of borrowing of government bonds. As **Fig 3** highlights, the market perhaps off the back of a sudden change of sentiment or trading opportunity, seemed equally prepared to use both types of collateral over the turn in this particular case.

Although we saw small falls in both the absolute level of government bond lending as well as the percentage (45% to 43%) over the period, the intrinsic link between securities lending markets and the broader capital markets it still clear. Some of the apparent fall in the demand to borrow government bonds probably relates to either firms better managing their own balance sheets and inventories thereby reducing external demand or the rolling impact of the end of the ECB's QE program in

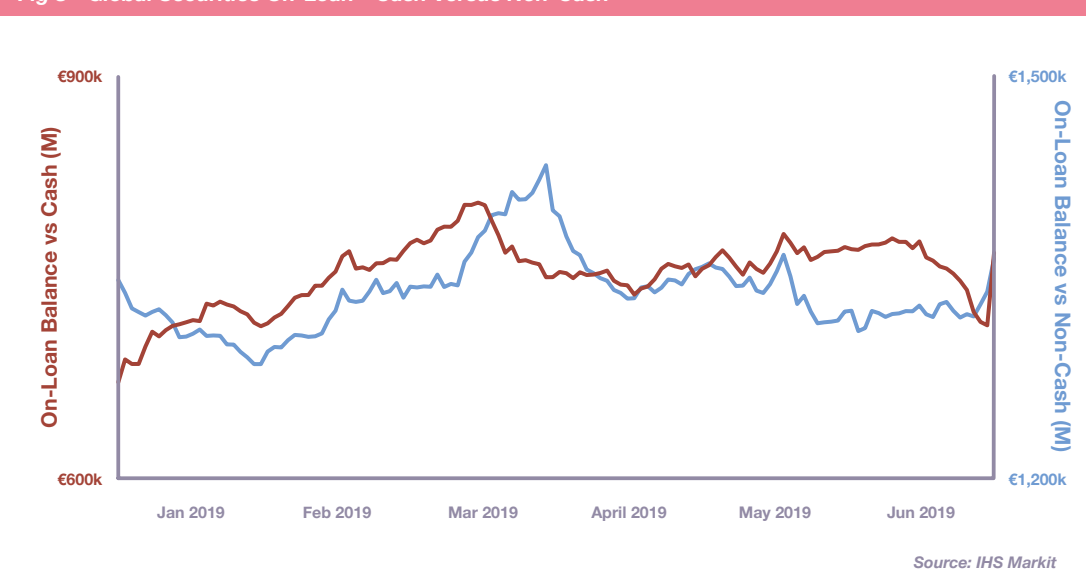
Fig 2 - Global Securities Lending Market



Europe. In the short term, the end of QE here in Europe appears to have released bond liquidity back into the market, reducing the immediate demand to borrow HQLA. However, this may only be a temporary factor as the market awaits the impact of waves four and five of the uncleared margin rules for derivative transactions in 2020.

The mobilisation and movement of collateral is one of the most strategically important parts of our market in the context of the Capital Markets Union (CMU) and other market facing initiatives. As the buy-side looks to implement these new mandatory obligations, the role of securities lending as a conduit to move liquidity around the markets will be key to their successful implementation.

Fig 3 - Global Securities On-Loan - Cash Versus Non-Cash



ISLA has for some time highlighted the disparity between the scale of investments held by mutual funds (including UCITS) and their actual participation in the lending markets (**Fig 4** and **Fig 5**). Much of that shortfall has been assumed by SWFs who today represent some 6% of available securities and 14% of all loans globally. There has been a marginal increase in the profile of SWFs during the period, with their proportion of global on-loan balances increasing from 12% at the year end. Their participation in the global securities lending markets is now a well understood feature of our markets, where their liquidity (especially in fixed income markets) is an important source of trading and overall market liquidity.

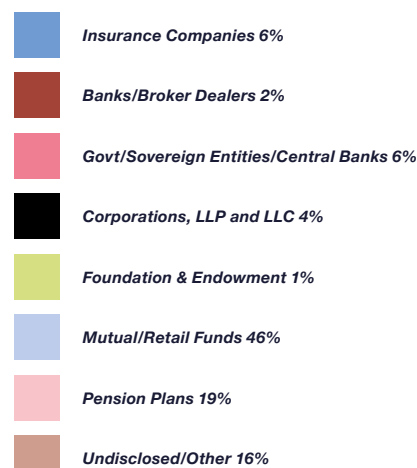
The imminent implementation of SFTR and CSDR are likely to change both the reporting and settlement landscapes across Europe. Whilst we fully support the broad aims and objectives of both of these regulatory regimes, they could push some participants away from the markets for cost reasons, as smaller lenders in particular better understand the full cost of compliance under SFTR. Similarly, CSDR could in certain circumstances reduce market liquidity, by discouraging institutional investors from lending securities due to fears associated with onerous settlement fines and rigorous buy-in regimes. ISLA continues to advocate for a more market-led approach when thinking about mandatory buy-in regimes.

In particular, our Master Agreements already provide for a series of clear remedies that allow the party being failed into (typically applies to the return leg), deal with a failed trade in a way that does not potentially jeopardise their own investment or portfolio objectives. The proposed mandatory structure could put parties being failed into at a significant economic disadvantage thereby potentially pushing them away from our markets.

We have tracked the composition of non-cash collateral in increasing granular detail since the inception of this report in 2014. Today, we see via the reported data how the market both uses collateral and how other external factors can influence the type and form of that collateral. Non-cash collateral continues to be a predominantly European phenomenon, with over 95% of all non-cash collateral reported within the data being held within the European tri-party infrastructure. As at the 30 June and detailed in **Fig 6**, the relationship between equity collateral and government bonds raises some interesting questions.

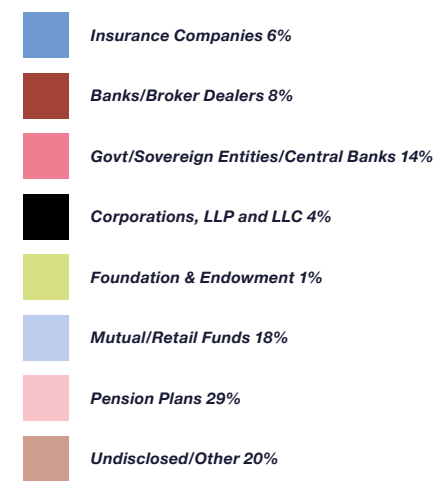
Reported equity collateral as at 30 June increased marginally to 43%, compared with 42% six months earlier. This is perhaps not surprising when we consider the increase in asset values into the half year combined with the previously discussed deleveraging of predominantly equity positions by AIMS.

Fig 4 - Global Lendable Supply Value - By Fund Type



Source: IHS Markit

Fig 5 - Global Securities On-Loan - By Fund Type



Source: IHS Markit

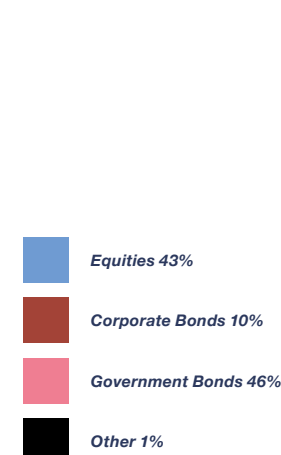
Even ten years after the crisis, lenders still appear uncomfortable with the concept of accepting corporate bonds as collateral.

Consequently, the marginal increase in equity collateral was broadly matched against a reported fall in the use of government bonds.

Here, the ongoing USD cross currency basis opportunities led to a demand for HQLA trades against JGB collateral.

This in part was reflected in the overall reported government bond collateral, of which some 38% was classified as Asian.

Fig 6 - European SL Collateral Held in European Tri-party



Source: Clearstream, Euroclear, JP Morgan, BNY Mellon



The Kingdom of Saudi Arabia Set For Capital Markets Expansion

The Kingdom of Saudi Arabia (a G20 member) is by far the largest economy in the GCC and MENA regions with a GDP of \$678 billion, high rates of investment and stable monetary and exchange rate policies. Demographically, KSA population has reached 33.4 million in 2019 with nearly 60% of Saudis below 30 years of age and an urbanization rate of 80%.

In 2016, the Saudi government initiated Vision 2030, a comprehensive agenda of socio-economic reforms which is transforming the Saudi economy and is creating unprecedented investment opportunities.

Capital market reform is one of the main pillars of Vision 2030 and has been a linchpin in unlocking economic and investment potential.

Far-ranging reforms undertaken by the Saudi Stock Exchange (Tadawul), the Kingdom's sole authorised securities exchange, in conjunction with the Capital Market Authority (CMA) have improved market function and efficiency, expanded access, enhanced corporate governance, and increased transparency, further aligning the Saudi capital market with international standards and making it more attractive to both domestic and foreign investors.

Tadawul is the largest equity market in the GCC and MENA regions, the seventh largest emerging market and the 24th largest stock market in the world within the World Federation of Exchanges members. Moreover, Tadawul is home to more than 200 Saudi companies with a combined market capitalisation of more than \$548 billion. Tadawul is considered highly liquid with an average daily trading value of approximately \$1 billion YTD, and offers exposure to a diversified portfolio of asset classes covering 20 sectors.

From a regional perspective, Tadawul accounts for 69.1% of the combined market capitalisation and more than 76% of the combined trading value of all GCC Exchanges as of July 2019.

Over the past three years, Tadawul has implemented numerous measures to enhance the effectiveness of the Saudi Capital market, foster an attractive investment environment for local and international investors and align its regulatory frameworks with international best practices.

These measures have paved the way for fulfillment of the varying criteria used by the global index providers to reclassify KSA from Standalone Market to Emerging

Market status. In 2018, Tadawul gained inclusion in all three of the preeminent global benchmark indices – MSCI, FTSE Russell and S&P Dow Jones. Foreign investment inflows resulting from index inclusion will further support liquidity in the Saudi Capital Market, which is already among the most liquid emerging markets in the world, and diversify opportunities for issuers and investors alike, contributing to greater market maturity and stability.

Internationally, the promotion to EM status marks a key milestone for Saudi Arabia and rewards the depth and pace of reform that has taken place within the Kingdom's capital market.

Since inception of the program, more than 1300 international financial institutions have joined the Qualified Foreign Investors (QFI) program with hundreds more at various stages in the qualifying process. We expect that Saudi Arabia's recent inclusion in emerging market indices of all of the global index providers to further increase interest in the program.

In 2017, Tadawul introduced its Securities Borrowing and Lending ("SBL") and Short Selling Regulations (SSR) framework. Recently, in June 2019, Tadawul issued a Consultation Paper on proposed changes to the SBL and SSR frameworks. The key proposals in the Consultation Paper were as follows:

For SBL:

1. The existing requirement that Lenders and/or Lending Agents must be a custody member of the Securities Depository Centre (SDC) proposed to be replaced with the requirement that Lenders/ Lending Agents must either be a custody member of the SDC or appoint a custody member of the SDC to facilitate the SBL.
2. The existing requirement that Borrowers must be a custody member of the SDC proposed to be replaced with the requirement that Borrowers must either be a custody member of the SDC or appoint a custody member of the SDC to facilitate the SBL.
3. Natural persons can be a Lender and Borrower.

For SSR:

1. The investment limits and monitoring process will be clarified.
2. Natural persons can participate in SSR.

The above changes are subject to final regulatory approval.

The proposed changes are expected to expand participation of SBL and SSR to a wider group of investors and intermediaries and will further enhance the market's efficiency and liquidity. The SBL and SSR proposals are part of a larger objective of Tadawul to become an active player in global capital markets, thus becoming an attractive investment destination, building on its current role as the regional hub leading capital market development in the GCC and the wider MENA region.

Mohammed Al-Rumaih has extensive experience in the financial sector, where he has successfully led several roles and responsibilities. Over the past 10 years in the Saudi Stock Exchange, he has successfully led various sales and marketing activities. Mohammed holds a Bachelor degree in Management Information Systems from King Fahd University of Petroleum & Minerals, and holds an MBA from the Manchester Business School.



**Mohammed
Sulaiman Al Rumaih**
Chief of Markets
Saudi Stock
Exchange (Tadawul)

Global Government Bond Markets in Focus

As at end of June 2019, there was just over €950 billion of government bonds on-loan which represented a 6% increase from the €900 billion reported as at 31 December 2018 (**Fig 7**). Notwithstanding the run-off in balances ahead of both the quarter-end (30 March) and the half year, we did see some notable utilisation spikes just prior to each of the key reporting dates. In particular, reported on-loan balances increased by some 7% over the final trading days of the half year.

Whilst the reasons driving these utilisation patterns are varied and will be discussed later on in this section, it is worth highlighting that overall borrowing levels seem to have hit a resistance level of circa €1 trillion after falls in balances during 2018.

The first six months of 2019 saw a steady increase in government bonds being made available for lending by institutional investors.

A cocktail of trade tensions and Brexit risks drove bond yields to record lows, as investors ignored slightly stronger economic data to move into so-called 'haven assets'. These assets appear to be finding their way into lending programmes, as these same investors look to maximise overall returns by lending HQLA assets in low or negative interest rate environments.

Whilst we have seen additional supply enter the market, immediate demand to borrow government bonds has been, at best, stagnant with global on-loan balances moving within a narrow 7% corridor of between €880 and €950 billion over the first six months of the year. In Europe in particular, there has been a notable fall off in demand to borrow European government bonds. **Fig 8** highlights how overall balances for the first six months of 2019 fell by over 14% from €314 to €269 billion, whilst available securities to borrow increased by over 10% from €806 to €891 billion.

Much of the recent decline in demand to borrow European government bonds can be linked directly to the ending of the ECB's QE program in December 2018. During the stimulus program, the ECB progressively bought securities in the open market thereby injecting cash into the system. This inevitably led to a reduction in the availability of government bonds, with market participants looking towards the securities lending markets, in part, as an alternative source for HQLA type assets. As the ECB and other central banks actively sought to make available assets purchased within QE programs back to the market through lending programmes, we saw on-loan balances increase throughout 2017/8. As these programmes have unwound, borrowers have turned elsewhere as lending has at times looked increasingly more expensive. This in

Fig 7 - Global SL Government Bond Market



Source: IHS Markit

turn has had a knock on impact on securities lending fee levels in this market.

In terms of revenues, government bonds have always been something of a poor relation compared to the fees generated by equity securities lending. Although government bonds consistently account for circa 45% to 50% of all securities on-loan, they typically account for only around 15% of all fees generated globally. In the first half of 2019, the growth in available supply combined with the slowdown in demand for HQLA in Europe, resulted in a 24% fall in reported fees compared with the same period in 2018.

The position is also likely to have been compounded as clients who set minimum lending thresholds to lend their securities, saw falling levels of utilisation as the market failed to meet their minimum lending criteria.

Although we did see something of a general tightening of the demand profile for this market, we did see something of an anomaly ahead of the half year. In the final trading day, reported on-loan balances of government bonds increased by over €62 billion. This sudden spike was seen in both North America and Europe, although it is possible that more than one factor was at play here.

When we examine specific trends in the North American government bond market, there was something of a resurgence in borrowing ahead of the half year (**Fig 9**). This slight movement against the downward trend that we have seen since the start of the year, may be in part attributable to a rise in the US Dollar liquidity premium. This increased into the half year, which led to wider cross-currency basis swaps and counterparts looking to source US Treasuries

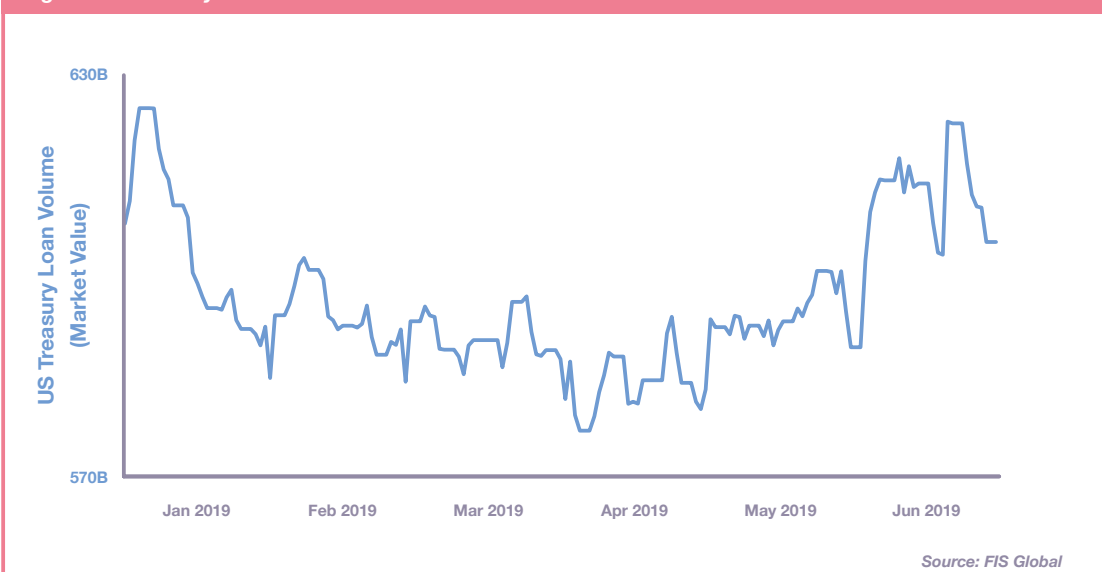
In contrast, the spike that we saw in Europe into the half year end (**Fig 8**) may have been owing to borrowers who were long equity securities, and were looking to effectively swap them for government bonds via the securities lending markets for balance sheet and reportable Risk Weighted Asset (RWA) purposes.

This idea tends to be supported when reference is made to the collateral composition of the European government bond lending market (**Fig 10**).

The very clear increase in non-cash collateral trades into the half year tends to confirm that most of this activity was balance sheet related.

Today, government bonds represent circa 43% of all securities on-loan. Whilst this is marginally down on the

Fig 9 - US Treasury Bonds On-Loan



45% seen over the year end, we have already discussed how the end of QE programs globally is a likely factor in that fall. That fall in demand is likely to be temporary though. In 2020, new rules relating to uncleared margin requirements will drive significant and new demand for collateral, including HQLA. Whilst the market is still trying to assess the quantum of these requirements, waves four

and five of these rules will demand engagement from a broader array of buy-side clients, who have not previously had to address these issues.

We therefore expect exponential growth in this area. As we have seen in previous reports, the government bond lending market continues to be a predominantly non-

Fig 8 - European SL Government Bond Market

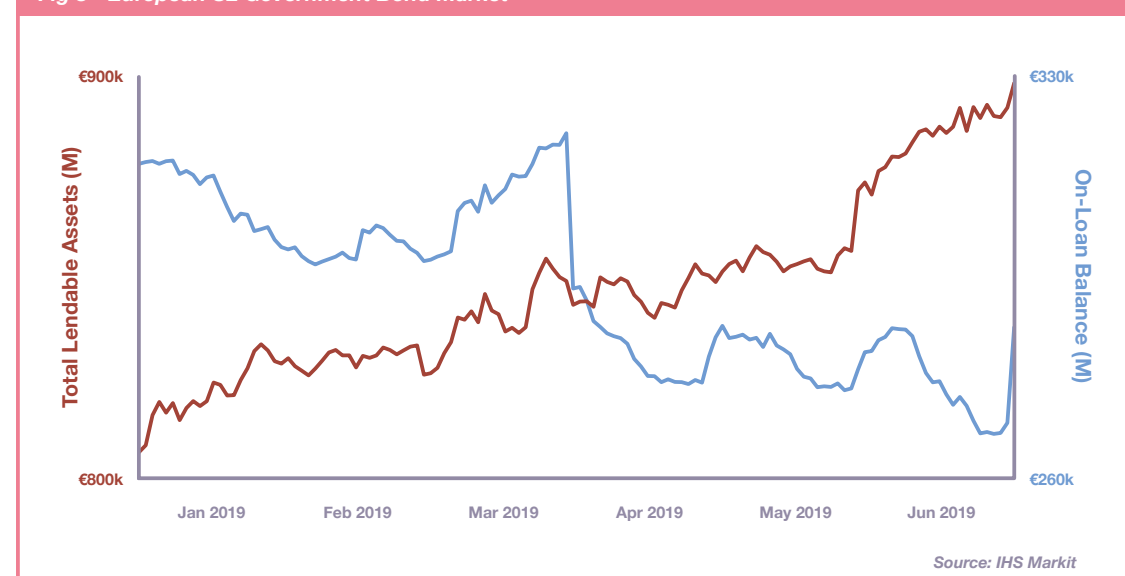


Fig 10 - European SL Government Bond Market - Cash Versus Non-Cash

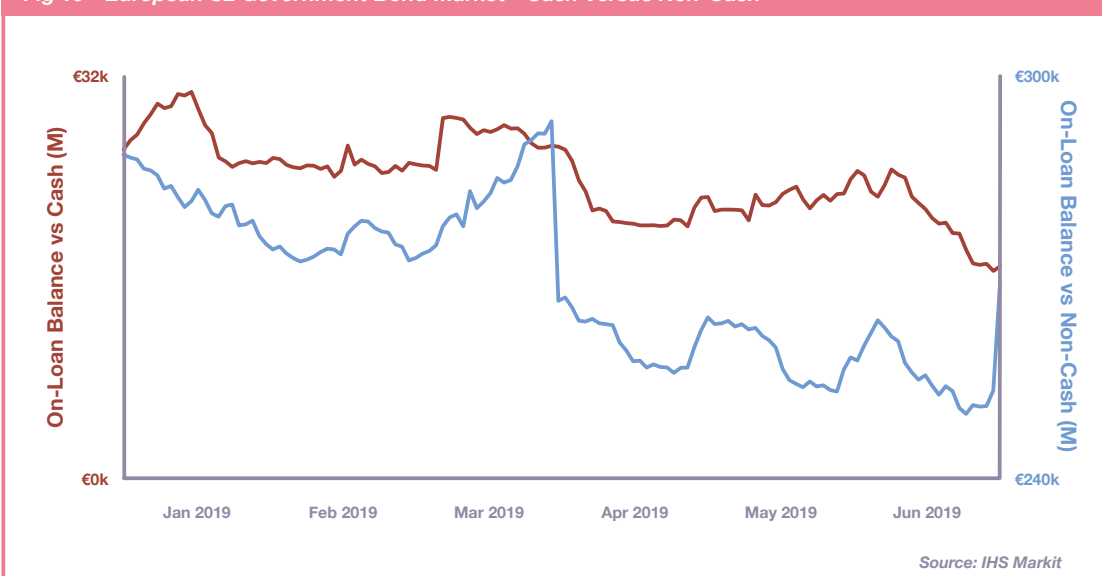
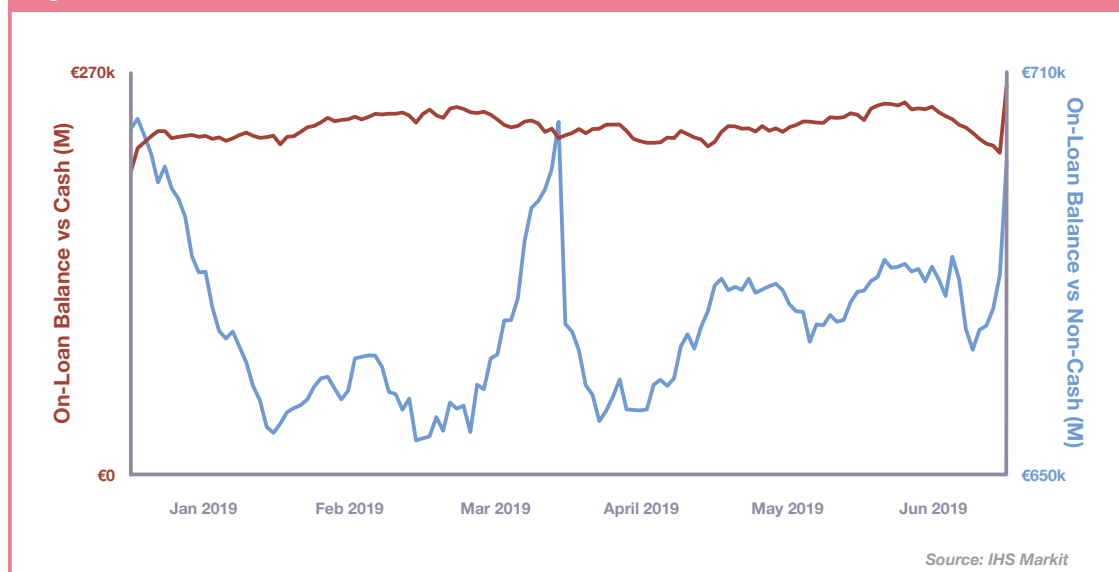


Fig 11 - Global SL Government Bond Market - Cash Versus Non-Cash



cash one. Of the €950 billion of government bonds on-loan as at 30 June 2019, 72% were against non-cash collateral (**Fig 11**).

The relationship between this market and the use of non-cash collateral is a feature we have tracked for a number of years. We have discussed in previous reports the link between the lending of HQLA, and regulatory compliance with prudential hurdles such as the LCR.

Recent data from the first half of this year underlines these relationships, and the importance of securities lending to banks in managing their prudential positions. The spikes in utilisation around the end of March and again in June were almost exclusively against non-cash collateral, suggesting a regulatory driver behind these trades.

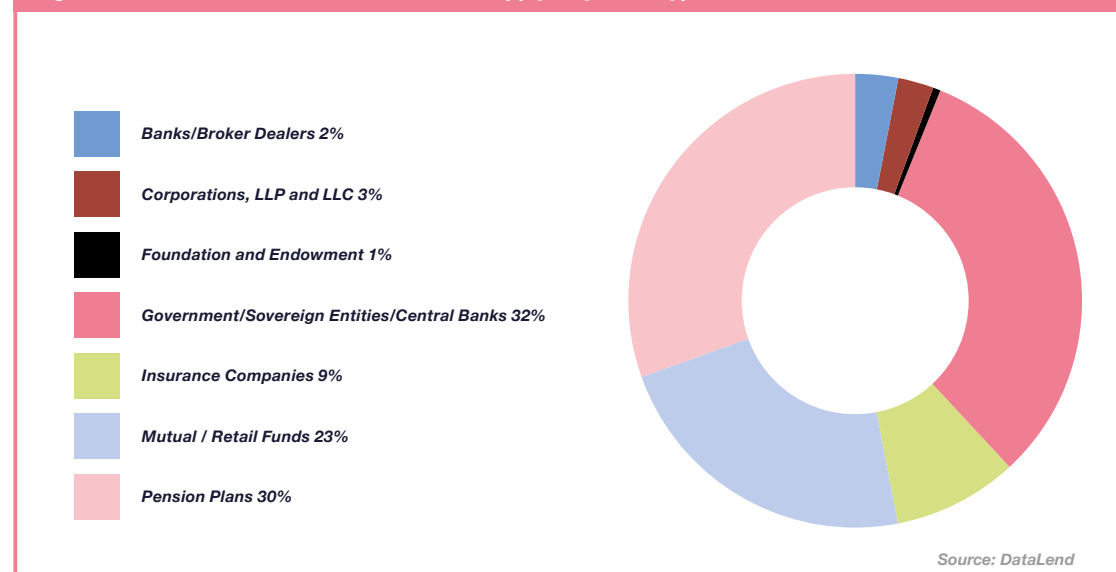
From our previous work in this area, we know that most term HQLA business is undertaken within a non-cash framework. It is therefore not surprising that banks wanting to keep these important regulatory trades on, are clearly prioritising them over the regulatory reporting date. Additionally, cash reinvestment opportunities are typically limited in nature as the availability of unsecured issuance and repo dries up when bank balance sheets contract over reporting periods.

Part of the drivers behind the mobilisation of HQLA in the context of prudential reporting regimes, is the ability to secure HQLA for periods of three months or more. This allows the borrower to include any borrowed securities in its LCR calculation as part of its balance sheet management regime. We have tracked the development of this term HQLA market for a number of years now, and whilst acknowledging the challenges in securing high quality data in this area, there is a clear and persistent core of term business that did not exist several years ago. Latest information from DataLend suggests that circa 15% of all government bond lending is undertaken on a term basis, although we feel that this number is understated with the real number being much higher, possibly as high as 50%.

As we look at the role that the lending of government bonds plays in the context of market liquidity, the mobilisation of HQLA is becoming increasingly important in the context of wider collateral usage. Set against that backdrop, we have tracked the supply-side of the market for some time now to better understand the link between key institutional investors and the provision of liquidity.

As at the end of June 2019, data from DataLend suggests that some 32% of available inventory of

Fig 12 - Global Government Bond Lendable Supply - By Fund Type

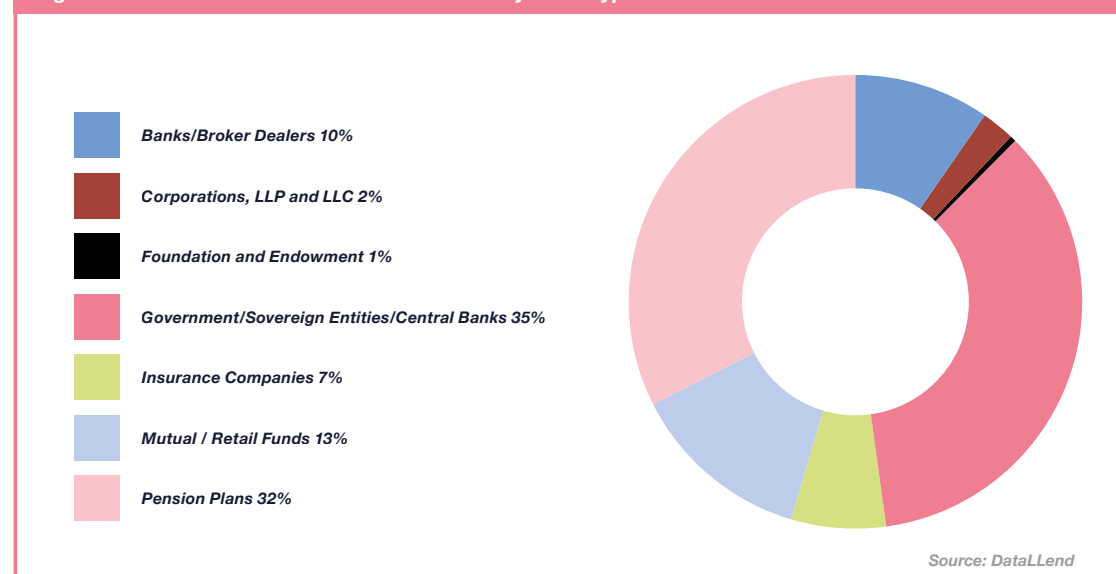


government bonds within lending programmes came from SWFs, with the proportion rising to 35% of reported on-loan balances (**Fig 12** and **Fig 13**). This is in fact a further softening of the previous concentrations, with SWFs representing 33% and 39% of available securities and on-loan balances respectively as at 30 December.

Although this may reflect minimum lending thresholds restricting utilisation as rates have fallen, their dominance in this sector remains.

As we look past Brexit, the role of these institutions in maintaining deep and liquid markets will be crucial.

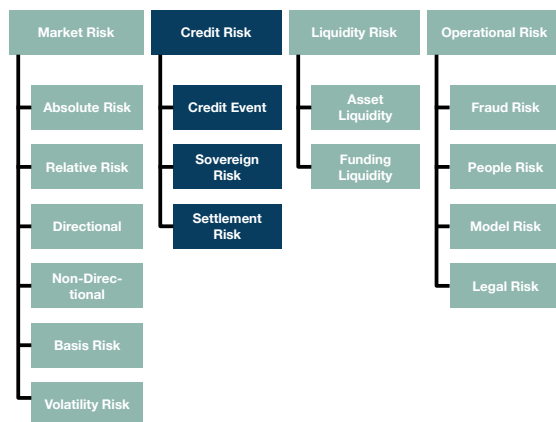
Fig 13 - Global Government Bonds On-Loan - By Fund Type



Know Your Counterparts' Creditworthiness (KYCC)

It is essential for all global capital markets participants to “know” the counterparts with whom they do business and factor these counterparts’ creditworthiness into their onboarding, risk management, capital, and operational decision-making. Irrespective of an organization’s position, whether on the buy side, sell side or as a principal/agent intermediary, risks exist. Legacy processes such as the 2006 Agency Lending Disclosure (ALD) are outdated and in need of revision. Forthcoming new regulations, such as the 2020 Securities Finance Transaction Reporting (SFTR), are fast approaching. Therefore, the need for an efficient, new approach to bring operational, risk management and capital benefits has never been greater.

Financial Risk



Financial risk comes in many different forms, as the diagram below illustrates - the good news is that the risks can all be understood and measured, and action can be taken to manage and mitigate them.

This short paper focuses upon the counterpart credit risk that occurs in the Securities Finance Industry. However, the approach outlined can be applied across the Capital Markets and include counterparts such as:

- Central Clearing Counterparts (CCPs)
- Asset Managers
- Custodians and Sub-Custodians
- Broker Dealers
- Execution Brokers
- Exchanges

Counterpart Credit Risk is defined as:

“The risk that a counterparty to a transaction or contract will default (i.e. fail to perform) on its obligation under the terms of the contract between the parties. Counterparty risk is not limited to credit risk (the risk that the counterparty cannot fulfil its contractual obligations for payment) but

may also result from other problems associated with a counterparty unwilling to honour the contract.”

Calculating counterpart credit risk typically involves the building of regulatory approved models (for banks), requiring numerous detailed data inputs under the management of sophisticated and experienced risk managers.

Recent research conducted by Credit Benchmark has concluded that one of the largest counterpart risk management challenges faced in Capital Markets is in the counterpart ‘heavy’ Securities Finance industry. Incorporating securities lending, repo and prime brokerage, this vital industry is at the epicenter of the Capital Markets. One of the key challenges is that many participants, in particular the numerous funds in this industry, have been hitherto unrated by the traditional Credit Rating Agencies (CRAs). This means that the participants have had to take responsibility for the complicated undertaking of counterpart risk assessment themselves, or otherwise adapt their behaviour.

Given that calculating and monitoring counterpart creditworthiness in-house requires a significant resource commitment, it is a function that banks are often best placed to meet. Many non-bank principal participants are left to rely on their best in-house efforts, dependent upon incomplete information from the CRAs, or restricted

in their counterpart selection in the interests of avoiding risks that they cannot fully understand.

The lack of CRA ratings for the supply-side (e.g. Sovereign, Pension, Mutual and Insurance Funds) and demand side (e.g. Broker Dealers and Hedge Funds) of the industry, combined with the fact that the agents cannot provide CRA-style information to their clients without accepting liabilities that they may not wish to accept (given that they are not CRAs and their credit opinions are proprietary and confidential) makes it challenging for the Beneficial Owners to assess their counterpart risk accurately.

For reasons stated previously, many Beneficial Owners and Hedge Funds do not have the capabilities in-house to assess and manage certain counterparts. However, it is ultimately their decision to make as they are often principals in the transactions. Ironically, they often struggle with counterparts that look quite like themselves – A.K.A. their “peers”, because they have no CRA rating.

Counterpart Restriction: Securities Finance participants could choose to restrict their counterparts to those with a CRA rating above a certain level – which constrains their business opportunities and reduces the performance of their lending programme via their agent (if they have one). This approach will potentially have negative commercial implications – with perfectly sound counterparts possibly being excluded from their counterpart list and

opportunities missed due to not having a CRA rating. Ironically, one could argue that lending to “peers” may in fact reduce counterpart credit risk as the chart below demonstrates.

Indemnification or Insurance: Securities Finance participants could also insist upon receiving an indemnification or insurance policy from their agent lenders. This is not without financial and capital cost and will potentially negatively impact their earning potential, alongside the capital and cost implications for the indemnity provider. This approach might help reduce the level of risk but could be considered to be “using a sledge hammer to crack a nut”. Market standard documentation, and liquid collateral held in a Triparty account with a positive margin marked to market daily should theoretically supplant the need for an insurance policy. Some of the larger more sophisticated lenders have taken the decision to not require indemnification at all.

There is an alternative solution to this problem. Securities Finance market participants including beneficial owners, agents, and principal borrowers can leverage alternative consensus datasets to improve business performance, save capital and increase efficiency. Some of the additional benefits of this approach include:

- Principals can select and monitor new and existing counterparts (e.g. hitherto unrated broker dealers or “peers”)
- Agents can increase reporting transparency to Beneficial Owners and better understand risk adjusted returns
- The borrowers can manage capital and Risk Weighted Assets (RWAs) more accurately
- All parties comply with forthcoming regulatory reporting requirements at time of trading
- Across the market enjoy better informed resource allocation and financing decisions

New, complementary data sources are now available, providing credit data coverage on funds – from sovereign wealth funds to hedge funds via mutual funds, insurance funds, pension funds, and others. Extensive data is also available on Custodians and sub-custodians, Prime Brokers and subsidiaries, Broker Dealers and subsidiaries, Indemnification Providers, CCPs, and Exchanges.

The challenge of reviewing and onboarding large numbers of funds that are unrated by the CRAs is a major resource

issue that will not go away. The frustrations of the 2006 Agency Lending Disclosure (ALD) process need to be addressed and the forthcoming 2020 Securities Finance Transaction Reporting (SFTR) regime will further challenge an already stretched credit infrastructure. The SFTR

regulation in Europe will prove a catalyst for change and bring much needed transparency - a new era of European ALD is around the corner. New, alternative credit datasets will help Securities Finance market participants make these processes more automated and efficient.

Fig 14 - Consensus data - average credit quality of unrated ‘peers’ versus broker dealers

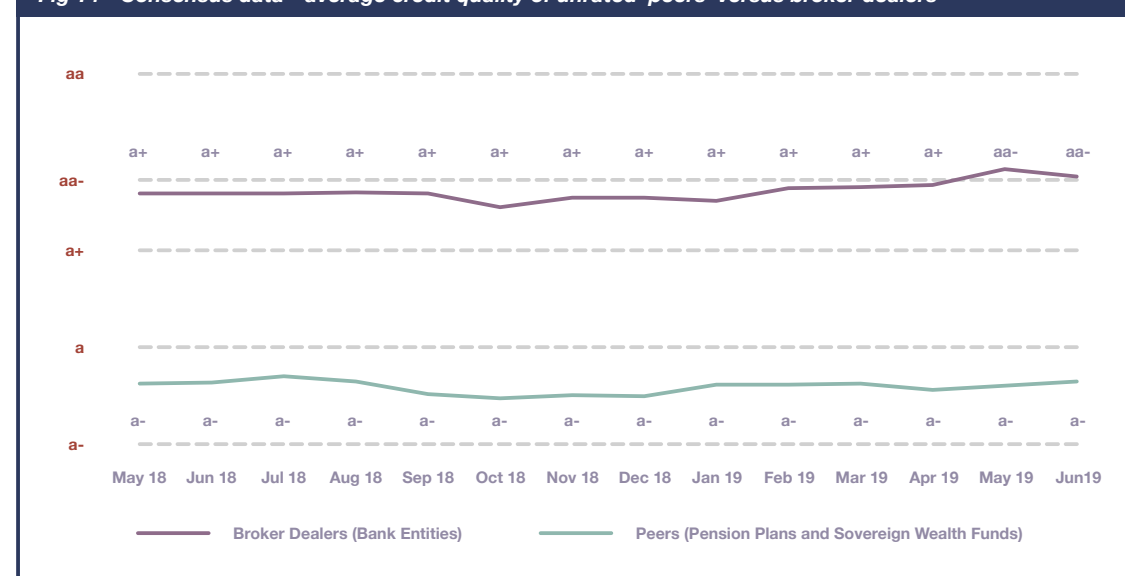
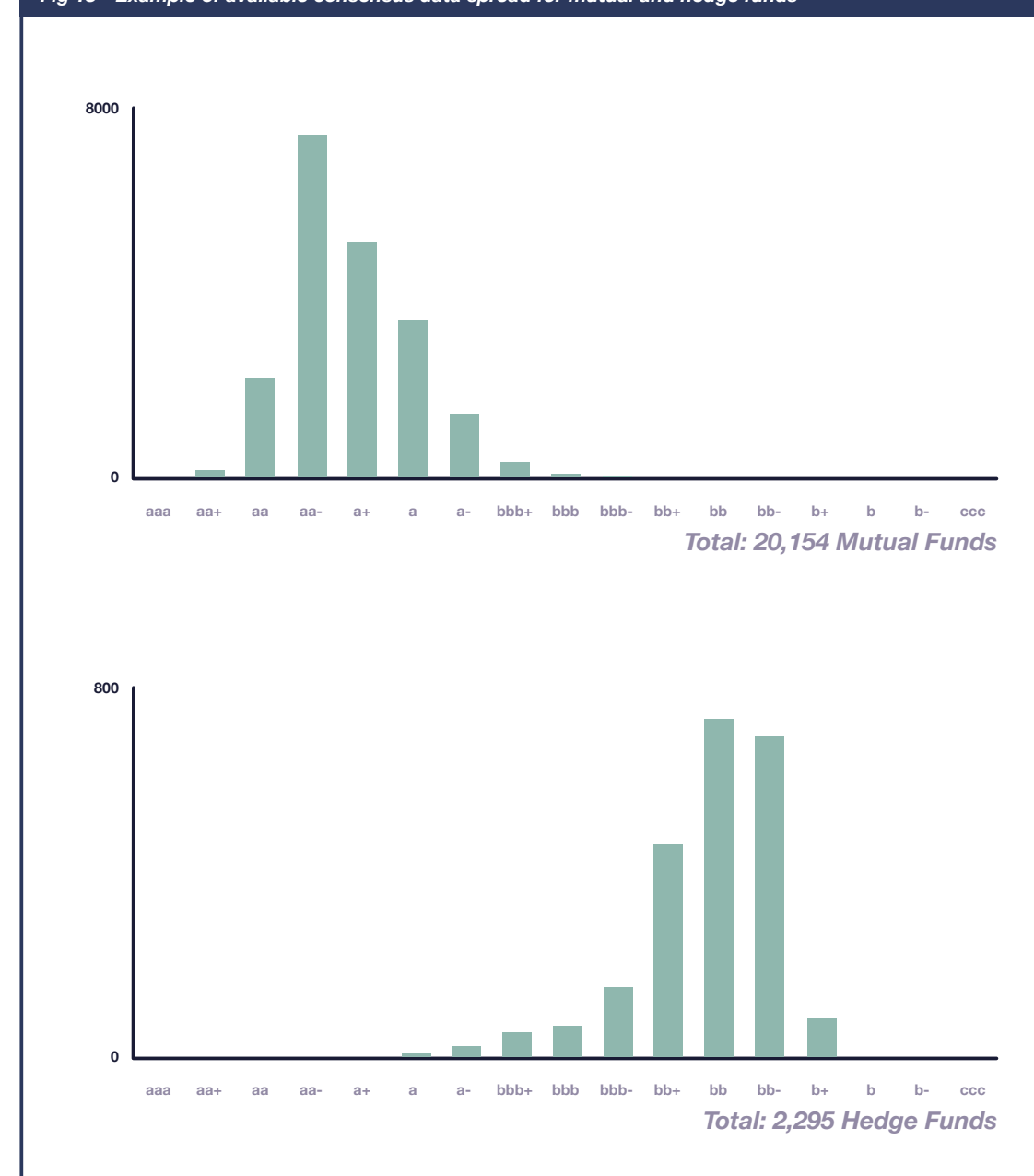


Fig 15 - Example of available consensus data spread for mutual and hedge funds



How can alternative datasets help your business?

For those who are responsible for understanding and communicating counterpart exposures within a firm or to clients, new, alternative consensus datasets can improve understanding and decision-making.

Knowing your counterpart (KYC) is essential and knowing your counterpart's creditworthiness (KYCC) is a critical part of KYC.

Because of the sheer number of counterparts involved in securities finance, upcoming regulatory changes, and capital implications of the transactions, securities finance participants can benefit from consensus data in the following ways:

Beneficial Owners

- Lending directly or via Agents, consensus data can support your activities beyond current limitations
- Inform and expand counterpart selection process, including hitherto unrated non-traditional counterparts
- Explore the opportunities of Peer to Peer lending confidently from a position of knowledge
- Automatically monitor your counterparts' creditworthiness – be alerted to changes as they happen
- Commission your own 'Comparative Credit Assessment' to expand business opportunities and counterparts
- Speed up your Know Your Counterpart (KYC) and Operational Due Diligence (ODD) onboarding processes

Agents

- Leverage a unique, new data set to remain competitive in a changing landscape
- Assist in your regulatory compliance with SFTR by better understanding the creditworthiness of your supply
- Add and automatically monitor additional, non-traditional counterparts to your borrower list
- Enhance your reporting and risk management capabilities - providing transparency to your clients
- Respond to the ongoing 'Peer to Peer' challenges and make them opportunities for your business
- Position your organisation for the development of new paradigms – e.g. Agency Prime or Enhanced Custody

Principal Borrowers

- As Capital Markets continue to evolve, the creative application of data provides a competitive edge
- Speed up your onboarding process so that you do not miss out on borrowing opportunities
- Optimize management of capital and RWAs and address the shortcomings of the legacy ALD process
- Allocate balances and balance sheet where it makes most commercial sense
- Prepare for the world of 'smart buckets' and SFTR and leverage existing market initiatives and benchmarks
- Expand collateral possibilities into areas such as ETFs

How does consensus data differ from credit ratings provided by the CRAs?

- Coverage: Alternative datasets can offer a complimentary opinion to CRAs for rated entities as well as greater visibility into the larger unrated universe
- Risk Aligned: Consensus datasets sourced from lender financial institutions are based on internal opinions that have actual exposure to a given counterpart – "skin in the game" versus "issuer pays"
- Dynamic: Consensus datasets are frequently updated, with credit transitions continuously under review by expert teams
- Forward-looking: Clear directionality trends and early warning of changes in credit quality status

Summary

The Securities Finance Industry and its participants find themselves at the epicenter of an almost 'perfect storm'. Whether your organization is a Principal Beneficial Owner, an Agent Lender, a Broker Dealer, Prime Broker or Hedge Fund, or plays multiple roles, this 'storm' impacts your business significantly. Increased regulation, higher capital requirements, and pressures to reduce costs are creating a challenging environment in which to conduct business.

These factors, combined with demands to improve process efficiency and meet client demand for more up to date information have coalesced to force behavioral change – an evolution that is necessary, and no longer optional. In an industry with so many hitherto unrated counterparts within it, the availability of more credible alternative data sources to assist in understanding a counterpart's creditworthiness is a valuable addition to the marketplace.

About Credit Benchmark

Credit Benchmark is the world's most comprehensive source of consensus risk data on 50,000 + entities, more than 75% of which are unrated by the Credit Rating Agencies (CRAs). By aggregating and anonymizing credit data from 40+ of the world's leading financial

institutions, Credit Benchmark provides a unique view on counterpart creditworthiness. Credit Benchmark data can be delivered securely into your proprietary or industry-standard systems to bring efficiencies and automation to your workflow and benefits to you and your clients. For more information visit www.creditbenchmark.com

About the Author

Mark has an established track record in bringing transparency to rapidly-developing areas of financial services. Alongside his business partner Donal Smith, he co-founded Credit Benchmark in 2013, introducing the world's most comprehensive source of consensus credit risk data. In 1994, Mark spotted an opportunity to provide customers in the securities financing industry with independent specialist advice and services. The company he founded, Data Explorers, became the leading provider of securities lending data across all global market sectors, and was acquired by IHS Markit in 2012. Mark graduated from the London School of Economics and held management roles at LM Moneybrokers, Goldman Sachs and Lehman Brothers.

In 2004 Mark wrote "An Introduction to Securities Lending" It was Commissioned by International Securities Lending Association and Endorsed by Association of Corporate Treasurers; British Bankers' Association; The London Stock Exchange' National Association of Pension Funds and The Securities Lending and Repo Committee.

The booklet was subsequently translated into many languages and remains accessible for free on numerous websites.

Mark Faulkner,
Co-Founder,
Credit Benchmark



Global Equity Markets in Focus

As we have highlighted elsewhere in this report, global markets, world economies and we as individuals have suffered from one thing in the past six months, uncertainty. After something of a very challenging year for equity markets in 2018, 2019 has not brought the sustained downturn predicted by many. Heightening geo-political tensions, looming trade wars and changing central bank policy have however, all negatively impacted market sentiment. Although it is not the role of this publication to comment on the political ramifications of Brexit, there is no doubt the uncertainties created by the current political impasse here in the UK, combined with a lack of clarity as to what exactly might happen next, are only compounding the already challenging economic and political headwinds seen elsewhere.

Inevitably, our markets have not been immune to this increasingly complex and interconnected macroeconomic picture. We have already discussed in this report how the end of QE has changed the dynamics of the government bond lending markets this year. Similarly, the broader economic backdrop has shaped investment management sentiment and therefore behavior in the past six months.

The final months of 2018 saw significant de-risking by hedge funds that followed a rise in equity market volatility.

The Chicago Board Options Exchange Volatility Index (VIX) hit a five year high of 36 on the 24 December, leading to hedge funds and other AIMs starting 2019 risk neutral. Although equity markets have shown some strong growth, especially in the first three months of the year, hedge funds were slow to redeploy capital on both the long and short side. This conservatism led to something of a lack of real investment conviction, and has prevailed for the rest of the year to date. The continued uncertainty that we have discussed elsewhere in this report has manifested itself in a generally suppressed equity market, with hedge fund leverage at modest levels throughout the first six months of the year.

As at the end of June 2019, there were circa €1.1 trillion of equity securities on-loan from an available lendable supply of just over €13 trillion. This represented a 6% increase in on-loan balances and a 19% rise in securities being made available for lending by institutional investors.

These increases should however be considered against the previously discussed circa 15% increase in equity market valuations over the period. Taking into account experiences from prior reporting periods and the impact that changes in asset prices can have on securities lending programmes, we are confident that most of

the reported increases in both available inventory and on-loan balances are asset price inflation, rather than significant new loans or equity assets coming into lending programmes.

As we think more broadly about the role of lending and retail investors, it is worth noting the growing importance of the sustainable finance agenda and ESG investment principles. For our markets, we have some very real challenges to ensure that there is sufficient secondary market liquidity through the provision of securities lending to compliment and support investors in and around these markets.

The provision of a deep and liquid supply of ESG securities will facilitate effective price discovery for investors, and ensure sufficient market liquidity to allow them to enter and exit these markets/investments.

Aligning the governance principles that are enshrined within the ESG investment ethos with securities lending, is also an important consideration for institutional investors. It is critical that investors aspire to discharge their governance obligations in an appropriate and responsible way. To do this, it will be important that institutional investors have fully developed approaches to both governance and lending. Both can exist, and ISLA

is working hard with key industry stakeholders to develop best practice and market codes of conduct to provide viable governance around these issues.

If we look at the first six months of the year in more detail, **Fig 16** highlights how the market appeared to trade more effectively with no real direction or momentum.

It shows how equities made available for lending rose broadly in line with equity market indices, whilst on-loan balances moved within a very small trading range, in or around €1 trillion.

None of the market volatility in terms of on-loan balances seen in the latter half of 2018, was repeated during the first six months of the year.

This trading backdrop led to a fall in reported revenues across the sector. Revenues from equity securities lending represented some 80% of revenues across the industry.

In the first half of 2019, total revenues fell by some \$900 million to \$5billion according to data recently published by IHS Market, of which equity lending was the largest contributor to the downward momentum. In Europe, we did observe some greater volatility in reported on-loan balances. As **Fig 17** highlights, there was some

Fig 16 - Global SL Equity Market



Source: IHS Markit

increase in on-loan balances through May into early June, indicating some seasonality across the market.

The role played by non-cash collateral, particularly in fixed income markets is now well understood. In equity markets, we have seen a constant drift towards the use of non-cash collateral as well. Although we would expect

the preponderance of non-cash collateral to increase over time, it has been stuck at around 60% globally for some time now. This relationship did not change significantly during the first six months of the year (**Fig 18**)

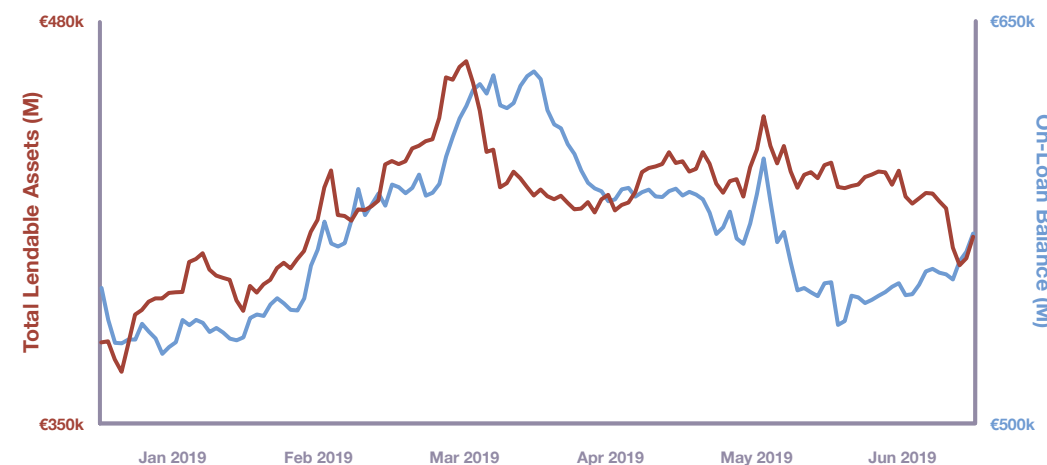
In North America, non-cash collateral remains around 46% to 47% of all collateral pledged in respect of equity

Fig 17 - European SL Equity Market



Source: IHS Markit

Fig 18 - Global SL Equity Market - Cash Versus Non-Cash



Source: IHS Markit

loans. We are aware of initiatives being led by our sister association, the Risk Management Association (RMA) to raise the awareness of the role that non-cash collateral can play within lending programmes as an alternative to the traditional US cash collateral business model. In Europe, whilst non-cash balances remained reasonably unchanged throughout the period, cash collateralised

loans (**Fig 19**) reflected much of the on-loan balance volatility over the period. This is perhaps not unexpected, as cash collateral does give immediate flexibility to borrowers who may not have access to the right mix of securities to execute trades in a timely fashion, especially when they are using their own equity inventory to support regulatory fixed income loans.

Fig 19 - European SL Equity Market - Cash Versus Non-Cash



Source: IHS Markit

Are you ready for SFTR?

“There is no such thing as being too prepared or starting too early”

Sunil Daswani, Senior Consultant & Business Development for Securities Lending at MarketAxess, explains why we need to learn from the past and start preparing earlier for new compliance and regulatory reporting demands. And when it comes to SFTR, to allow for at least 3 to 6 months of testing (or more) ahead of implementation. Which means getting ready now

From April 2020, the first phase of the Securities Financing Transaction Regulation (SFTR) reporting obligations will come into force. There is no doubt that SFTR will mean an extra reporting and control lift in securities finance functions across the industry.

This is evident when you outline, even in brief, the challenges and requirements of the new regulation.

What are some of the key challenges?

- Complexity – and the failure of tweaking legacy systems to be able to cope with that complexity
- Volume of Data – SFTR requires over 150 reportable data fields. We estimate that there may be anything up to, or exceeding, 115 million daily transactions that are reportable. So sourcing the required data is a huge lift, for everyone.
- Time and money – SFTR reporting is now only 8 months away, and the clock is ticking. There are potential fines waiting for those who fail to make the deadline.
- Time - phased implementation with backloading requires most firms to be ready in early 2020 due to matching with counterparties, if both are in-scope organisations for SFTR reporting

With the deadline fast approaching, some firms may find that they are still requiring help with preparation.

Lessons learned from past regulatory directives, including EMIR, show that there is no such thing as being too prepared or starting too early. From conversations with phase 3 go-live firms (e.g. Asset Managers, pension funds etc), it is clear that some are still yet to start planning for SFTR.

We would like to urge those who have not yet begun project planning not to ignore the extent of preparations needed ahead of the deadline, even if volumes are believed to be small.

The key lessons learnt from previous regulatory transaction reporting, like EMIR

EMIR was a long time in the making, and while derivatives trading now runs smoothly, it wasn't always the case. What we learnt from EMIR were two key lessons: one, that there are always those less prepared than they should be, and two, that regulatory change can, by its nature, change right up until the last minute.

What this means is that both firms and their potential vendor partners need to ensure they have planned for all the potential changes and anticipated what this might mean in terms of resourcing or adapting to the change as it happens.

To ensure proper preparation for the 2020 deadline, MarketAxess have already begun UAT (User Acceptance Testing) with key clients.

This ensures that any existing issues can be picked up and addressed, maximising our clients' ability to identify process gaps and development areas, and then action resolution steps in time for implementation.

So are you ready?

If the answer is not yet, then it is time to take stock and begin a strategic approach.

Here's our four top things to remember as you hit the autumn:

1. Easter weekend: SFTR Phase 1 goes live on Easter weekend 2020. Make sure it's in your diary, along with the chocolate egg reminders
2. Early commencement of UAT is critical – and we do mean early. Like now. No matter which phase you are in for “go-live”
3. Data needs to be sourced and source systems, trading systems and records need to be updated before end-to-end reporting can take place.
4. Controls need to be in place to ensure systems operate correctly and reporting is accurate

Remember, regulatory reporting can drive organisational change that goes beyond just simple compliance, and that can deliver greater operational efficiency, reduced costs and greater transparency. If you do it right.

What should you look for in vendor solution(s)?

More than anything, you need to be able to find a partner who you can trust, and who has the knowledge and experience to deliver a sophisticated, informed and modular approach to solving your particular problems. Your partner should offer:

- Access to near real-time reporting dashboards and reporting
- Regulator-approved solutions and services
- The ability to track the entire reporting process with full visibility.
- Affordable pricing
- The necessary people and expertise to be able to adapt your solution to additional regulatory changes post go live
- Experience with live platforms already in place for all types of regulatory reporting

About MarketAxess and Trax

MarketAxess operates a leading, institutional electronic trading platform delivering expanded liquidity opportunities, improved execution quality and significant cost savings across global fixed-income markets. A record \$1.7 trillion of U.S. investment-grade bonds, U.S. high yield bonds, emerging market debt, Eurobonds and other fixed income securities traded through MarketAxess' patented trading technology in 2018. The global community of 1,600 firms trading on MarketAxess today include the world's leading asset managers and institutional broker-dealers. MarketAxess' award-winning Open Trading™ marketplace is regarded as the preferred all-to-all trading solution in the global credit markets, creating a unique liquidity pool for a broad range of credit market participants.

Drawing on its deep data and analytical resources, MarketAxess enables automated trading solutions and, through its Trax® division, provides a range of pre- and post-trade services and products.

MarketAxess is headquartered in New York and has offices in London, Amsterdam, Boston, Chicago, Los Angeles, Miami, Salt Lake City, San Francisco, São Paulo, Hong Kong and Singapore.

For more information, please visit www.marketaxess.com.

Sunil Daswani
Senior Consultant &
Business Development
for Securities Lending
MarketAxess



Collateral Dynamics

As we contemplate the impact of waves four and five of the implementation of the new margin rules for uncleared derivatives, it is worth pausing for a moment to look at some structural differences between securities lending and other fully collateralised markets. Derivatives as well as repo markets use the idea of initial and variation margin. Initial Margin (IM) may be described as a haircut; the difference between the initial market value of an asset and the purchase price paid for that asset at the start of a transaction.

The difference between the two is merely a matter of expression. A haircut is expressed as the percentage deduction from the market value of collateral (e.g. 2%), whilst an initial margin is the initial market value of collateral expressed as a percentage of the purchase price (e.g. 105%). The concept is no different for our markets, however there is one significant difference.

The beneficiary or recipient of the overcollateralisation or haircut is nearly always the institutional lender of the security. This ensures that the underlying beneficial owner of the security enjoys the highest level of protection available in terms of initial trading risk.

In other markets, open transactions are assessed on an on-going basis, with Variation Margin (VM) being called for to cover adverse mark-to-market (MTM) movements over the life of the transaction. In securities lending, the process is similar but the daily MTM process is typically undertaken at a counterparty exposure level rather than on an individual trade-by-trade basis.

The global collateral footprint for the first six months of the year (Fig 20) highlights the key regulatory role played by non-cash collateral. With equity lending markets relatively stable in the context of both overall balances and the

collateral mix, collateral spikes (particularly around non-cash collateral) over the period relate almost exclusively to government bond lending.

In the final weeks of the period, there was clear evidence of borrowers reducing cash collateralised balances ahead of the half year, although the trading anomaly seen in the final days of the half year appeared to have impacted both cash and non-cash collateralised loans alike.

Furthermore, we know that borrowers or banks who use the lending markets to secure HQLA assets for LCR purposes, normally prioritise these trades over key reporting dates as part of their bank-wide balance sheet management activities. As most of these term transactions are normally against equity collateral, we tend to see a level of rigidity around non-cash collateral even around key reporting dates. Having said that, this expected norm was challenged this year as the demand for HQLA assets, particularly in Europe fell, pushing borrowers to unwind these traditionally sticky non-cash trades.

For the non-cash collateral held in Europe, we have seen for some time now how this market has developed but also how it responds to changes in the underlying cash markets. As at the end of June 2019, there was circa

€1.4 trillion of securities held with European tri-party providers. This is broadly unchanged from six months earlier, although we did observe some interesting shifts in the balance between the use of equities and government bonds as collateral (Fig 21)

As at the end of June, equities used as collateral were reported at 43%, a marginal two percentage point increase from six months earlier. The reasons behind this shift resonate with other changes and behaviours seen across the equity world. In particular, increasing asset valuations in the first six months of the year will have impacted equity collateral pools, thereby increasing some of their value. Not surprisingly, borrowers appeared to have therefore chosen to reduce the level of government bonds being used as collateral. With the end of QE reducing some of the velocity in government bond markets, combined with the relative expense of using government bonds over equities as collateral, the fall from 48% to 46% of all non-cash collateral is not unexpected.

As we delve a little more deeply into how government bonds are being used as collateral, we have observed again the clear relationship with other elements of the global FX and short-term money markets. As we look at the dispersal of government bonds held as collateral by domicile of issuer (Fig 22), as expected bonds from

Fig 20 - Global Securities On-Loan - Cash Versus Non-Cash

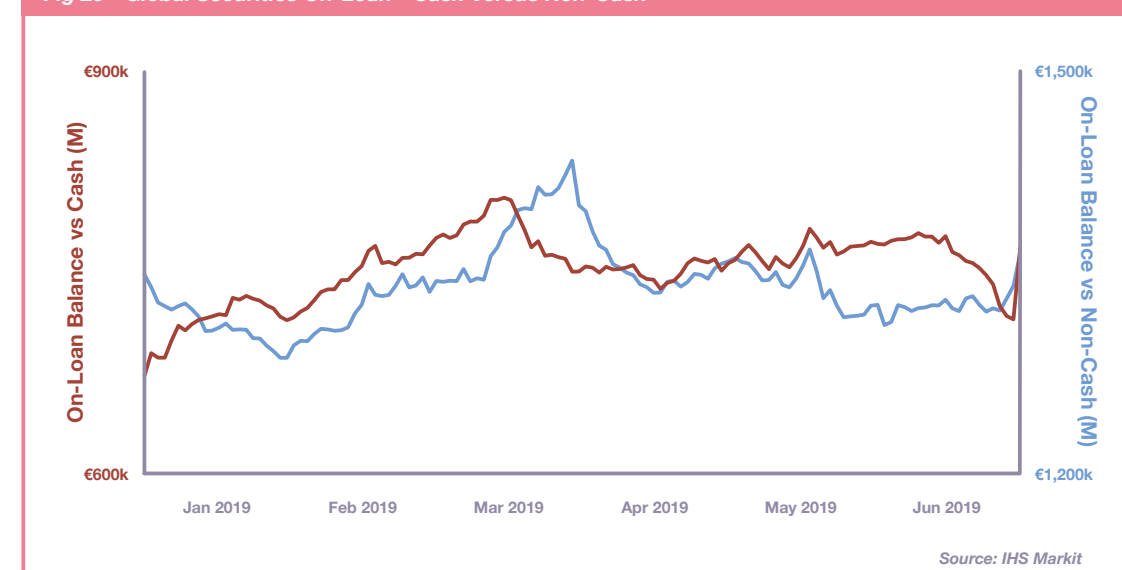
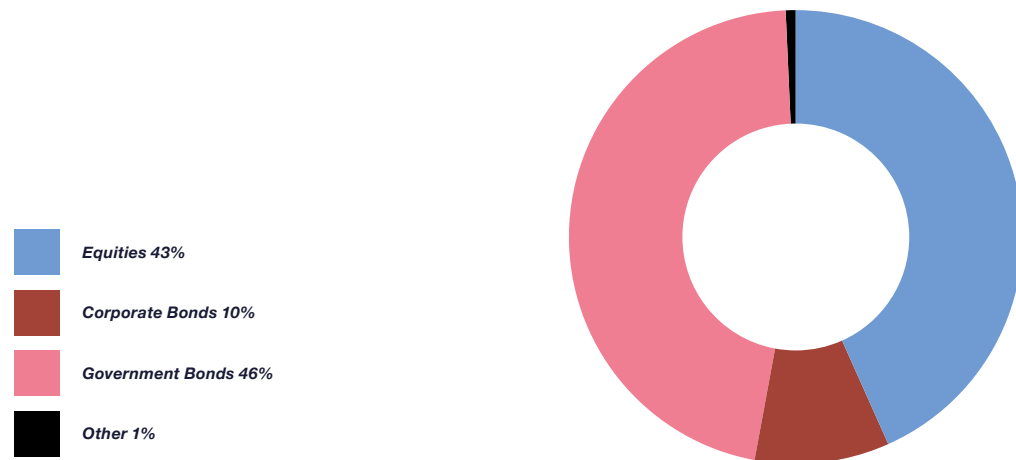


Fig 21 - European SL Collateral Held in European Tri-party

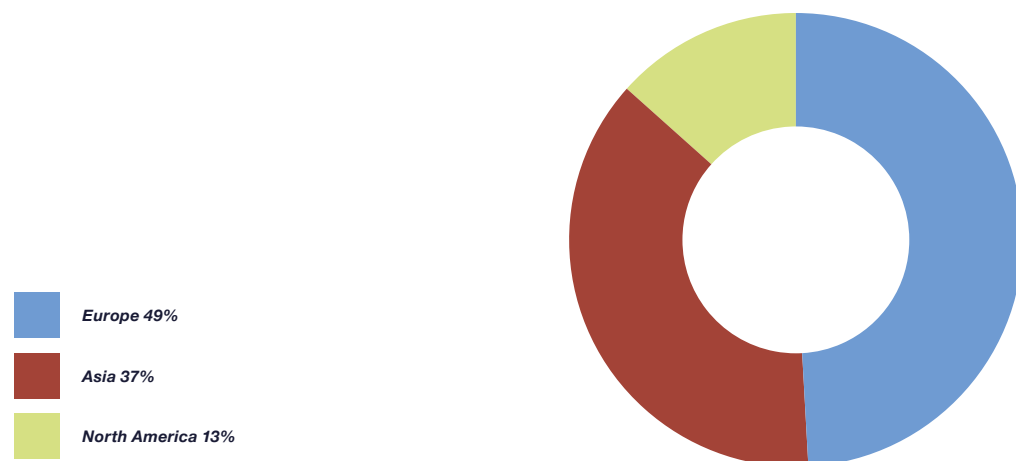


Source: Clearstream, Euroclear, JP Morgan, BNY Mellon

European issuers once again dominate the collateral pool, representing 49% of all government bonds held as collateral. This is however six percentage points lower than the reported number as at the end of December 2018. Again, the sudden fall in the use of European government bonds as collateral may be a reflection of the contraction of that market during the past six months. Most of the

apparent gap was filled with either US government bonds or issues from Asian governments, typically Japan. Here, cross-currency basis trading which allows investors to capture the premium demanded by the holders of US Dollars in the term FX market, is clearly still a factor that is leading to higher than expected levels of Asian bonds in these collateral pools.

Fig 22 - Government Bond Collateral Held in Tri-party by Domicile of Issuers



Source: Clearstream, Euroclear, JP Morgan, BNY Mellon

ISLA

ISLA Afternoon Briefing MUNICH 2019

UniCredit AG, Munich
4 October 2019

For more information visit:
www.isla.co.uk

#ISLAMunich2019

Data Methodologies

This ISLA Securities Lending Market Report has been compiled using a range of data contributors together with specific information provided directly by our members through surveys and questionnaires.

We would like at this point to thank all of the various contributors for their efforts in assisting ISLA in the production of this report.

Loan information that includes details of securities on-loan across different asset and client types has been provided by three institutions that provide commercial data and benchmarking services for the securities financing industry. DataLend, IHS Markit and FIS Global all collect data from industry participants on a high frequency basis and provide a range of securities lending benchmarking analytics that allow firms and their clients to better understand and assess the relative performance of any given lending programme.

Whilst each of these data providers covers broadly the same market we have chosen to use data from each to reflect the fact that each has a slightly different business model and client mix and therefore provide different perspectives across certain asset classes or regions.

By adopting this approach, we have been able to develop and publish the ISLA Global Securities Lending Aggregate. This aggregate, that will be used to develop consistent trend indicators over time, has been compiled by combining information from each of the commercial data providers. The ISLA Global aggregate was compiled to provide the most representative global estimation of the size and scope of the securities lending markets. In compiling the aggregate, we took the largest securities lending on-loan balance provided by the three commercial data providers as a starting point for the calculation. This global on-loan balance was then adjusted to reflect incremental data from the other commercial data providers where their reported on-loan balances across different asset classes or regions created a more representative overall global number.

All regional and geographic analysis reflects the location of the issuer of the securities (as opposed to the location of the lender or borrower) as this is the basis on which the providers collect and analyse their data.

Data from the principal tri-party service providers active in Europe today is also incorporated within the report as part of our analysis of collateral.



Coming soon...

ISLA & Linklaters Whitepaper

The Future of the Securities Lending Market ...An Agenda for Change

About ISLA

Who are we?

The International Securities Lending Association (ISLA) is a leading industry association, representing the common interests of securities lending and financing market participants across Europe, Middle East and Africa. It has over 155 members, including institutional investors, asset managers, custodial banks, prime brokers and service providers.

What do we do?

Working closely with the global industry as well as regulators and policymakers, ISLA advocates the importance of securities lending in the context of broader capital markets. ISLA supports the development of a safe and efficient framework for the industry, by playing a pivotal role in promoting market best practice, amongst other things. ISLA sponsors the Global Market Securities Lending Agreement (GMSLA) and the annual enforceability review in over 65 jurisdictions globally.

How do we do it?

Through member working groups, industry guidance, consultations and world class events and education, ISLA helps to steer the direction of the industry and is one of the most influential voices on the global stage.

Further details may be found at: www.isla.co.uk

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Notes

SAVE THE DATE

ISLA's 29th Annual Securities Finance and Collateral Management Conference

23 - 25 June 2020 | Marriott, Vienna

