ISLA™

INTERNATIONAL SECURITIES LENDING ASSOCIATION

Thought Leadership:

The Pledge GMSLA

Introduction

ISLA has been working on developing documentation for securities lending where the collateral is provided by way of pledge, or, more accurately, security interest rather than through the title transfer mechanism that is embedded in ISLA's market standard Global Master Securities Lending Agreement (GMSLA). Given that the market is familiar with the GMSLA and indeed has had occasion over the last years to test it, and so is familiar both with the document itself and with implementing it in a default scenario, you might ask why develop a new document? This article gives some background to the development of the new document and identifies some aspects of the new agreement which potential users should give some thought to before entering into it.

In this article, the current market standard GMSLA is called the "Title Transfer GMSLA" to distinguish it from the new document which is being developed and which is called the "Pledge GMSLA".

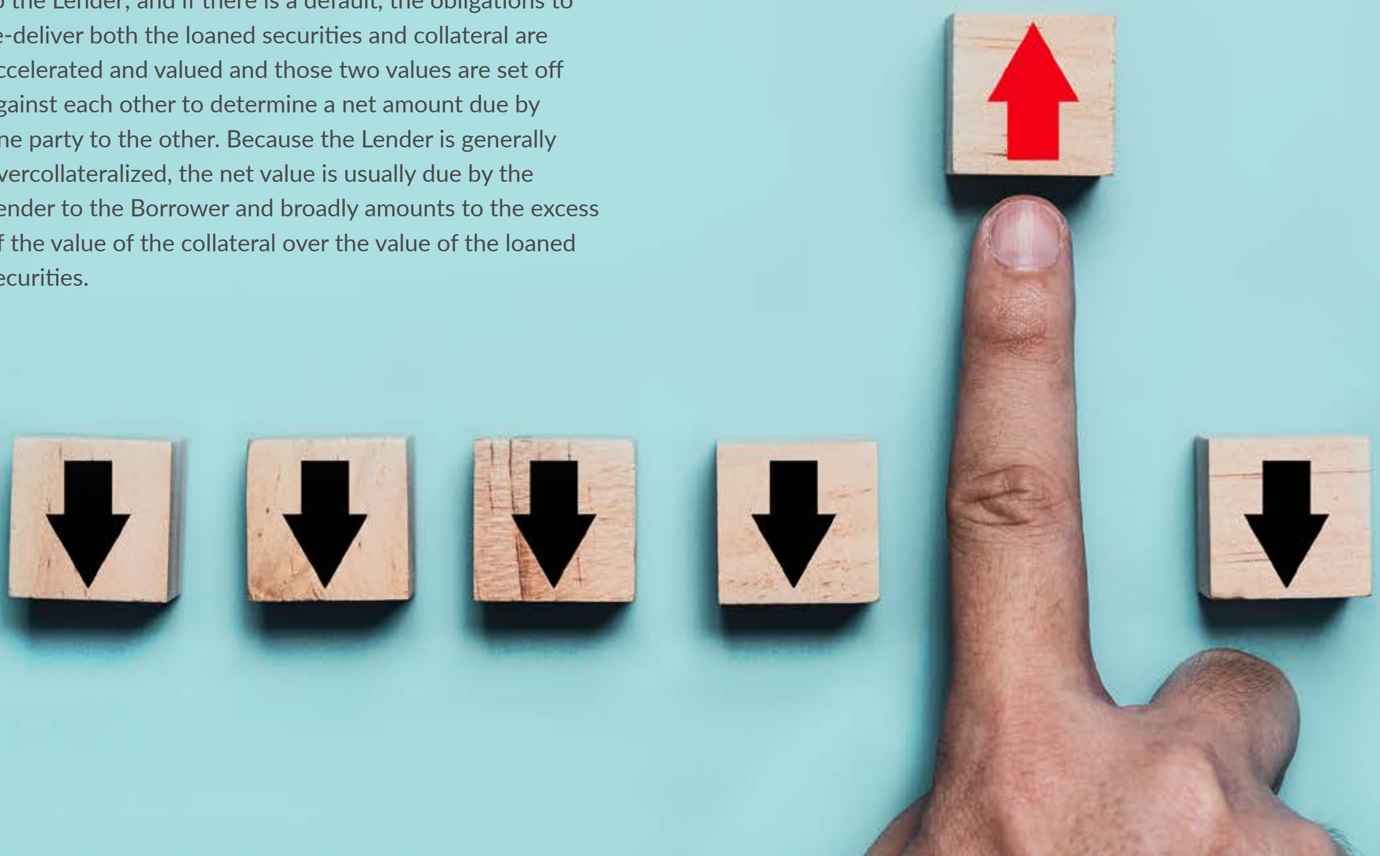
Background

The Title Transfer GMSLA was originally developed some 30 years ago when the legal environment for taking and enforcing security interests over securities collateral or cash collateral was very fragmented: different countries had their own often very different rules and procedures for taking security; there was frequently a cost in the form stamp tax (hands up those who remember the Italian "fissato bollato"); the procedures frequently required each individual movement of collateral to be registered; and the rules on enforcement in the event of a default frequently mandated going to court, handing over collateral liquidation to a court appointed officer, who in many cases was required to sell through a public auction, and hoping the proceeds achieved would cover the exposure. In short, this was not a very practical mechanism for collateralisation of trading activities.

The Title Transfer GMSLA structure was developed as a response to these problems. Its core mechanism is very simple: ownership of the loaned securities is transferred to the Borrower, ownership of the collateral is transferred to the Lender; and if there is a default, the obligations to re-deliver both the loaned securities and collateral are accelerated and valued and those two values are set off against each other to determine a net amount due by one party to the other. Because the Lender is generally overcollateralized, the net value is usually due by the Lender to the Borrower and broadly amounts to the excess of the value of the collateral over the value of the loaned securities.

This Title Transfer GMSLA structure depends on the ability to affect that set off or netting being recognised in the jurisdiction of the defaulting party. While recognition of netting was more limited in the early days of the Title Transfer GMSLA, over the years the legal landscape has changed, and netting is now very widely recognised by laws around the world.

Because of the general overcollateralization in favour of the Lender, the Borrower bears an exposure on the Lender, and of course the Title Transfer GMSLA contains a margin maintenance mechanism to preserve the Lender's overcollateralization and thus the Borrower's exposure.



Timeline for an example Borrower default scenario

Day	Title Transfer	Pledge
1	Date of default/Event of Default	Date of default/Event of Default Lender gives Notice of Exclusive Control to Tri-Party Custodian Lender instructs Tri-Party Custodian to transfer collateral to Lender's account
2	Commencement of realisation of collateral Commencement of buying in of Equivalent Securities 50% of collateral liquidated 40% of Equivalent Securities bought in	40% of Equivalent Securities bought in Commencement of buying in of Equivalent Securities
3	Realisation of collateral completed 50% of collateral liquidated 30% of Equivalent Securities bought in	30% of Equivalent Securities bought in
4		
5	20% of Equivalent Securities bought in	20% of Equivalent Securities bought in
6	Lender not successful in buying in 10% of Equivalent Securities by close of Business Day 5	Lender not successful in buying in 10% of Equivalent Securities by close of Business Day 5
7	Lender calculates close out amount by taking actual prices achieved for 90% of Equivalent Securities and, for the 10% of Equivalent Securities not successfully bought in by close of Day 5, Lender determines a value based on market value at close of business on Day 5 Lender gives notice to Borrower of close amount calculation and resulting net amount due by Lender to Borrower	Lender notifies Borrower of value of Equivalent Securities payable by Borrower Lender calculates close out amount by taking actual prices achieved for 90% of Equivalent Securities and, for the 10% of Equivalent Securities not successfully bought in by close of Day 5, Lender determines a value based on market value at close of business on Day 5
8	Lender pays net amount	Borrower fails to pay amount demanded
9		50% of collateral liquidated Commencement of realisation of collateral
10		Up to 50% of collateral liquidated Realisation of collateral completed
11		Any surplus collateral exceeding that required to cover exposure returned by Lender

The Pledge Structure

Fast forward to today, and not only has the legal environment relating to netting recognition changed significantly, but so has the legal environment in Europe for taking and enforcing security over securities and cash collateral. So much so that many of the original difficulties with taking and enforcing such collateral are no longer the problem they once were and taking and enforcing security over securities and cash collateral has become relatively straightforward in Europe.

Nevertheless, one might ask, if the Title Transfer GMSLA works so well already, why is there a need for an alternative? One issue for Borrowers with the Title Transfer GMSLA is that the Borrower's exposure or claim on the Lender is a risk weighted asset for regulatory capital purposes with an attendant requirement to allocate regulatory capital. For the large financial institution Borrowers in particular, this regulatory capital requirement can be very significant and if there was some way of reducing the cost of it, that would be very attractive to these Borrowers.

Where collateral is provided by way of security, it remains the collateral provider's asset, albeit subject to a security interest. Under a security arrangement, in principle the security taker can realise the amount of collateral that he needs to discharge the collateral provider's obligations following enforcement, but any remaining collateral must be returned, as it belongs to the collateral provider.

In a security arrangement context, the collateral provider's exposure in respect of the "excess collateral" is different from the position where collateral is being provided by way of transfer of title. In the latter case, the collateral provider's claim to the excess collateral is a contractual claim, carrying the credit risk of the collateral taker. In the case of a security arrangement, the collateral provider's claim to the excess collateral is a property claim – this is his property and so does not carry the same credit risk on the collateral taker. For this reason, the regulatory capital position is quite different, and, in principle, Borrowers would not expect a regulatory capital charge in relation to this excess, meaning that the pledge structure would represent a considerable cost saving for them.

Additionally, for some very large lenders who accept equities as collateral, the transfer of equities as collateral under the Title Transfer GMSLA can mean that the receipt of particular equities in which they already hold a significant position can push them over disclosure thresholds in the relevant stock. With a pledge structure the provision of equities by way of security interest collateral generally will not add to their proprietary holding and may thus avoid these disclosure triggers. The pledge structure can therefore also be advantageous to some large lenders.

What is the Pledge Structure Documentation?

The documentation for the Pledge structure comprises an adapted version of the GMSLA, a security document and a tri-party custody agreement.

Market feedback to ISLA was that initially at least the Pledge structure would be used only in conjunction with a tri-party custody arrangement. Because the location of the custody account over which security is taken affects the security documentation to be used, in particular which governing law to choose for it, ISLA concluded that it would work with the identified tri-party custodians both so that the security documentation was appropriate for the location of the tri-party custodian account and to facilitate alignment of the tri-party documentation with the ISLA documentation.

The adapted GMSLA is an English law document. There will be an English law security document for use with BNY Mellon's and J.P. Morgan's tri-party arrangements where the relevant custody account is in England, a Belgian law security document for use where the tri-party custodian is Euroclear and the account is in Belgium and a Luxembourg law security document for use where the tri-party custodian is Clearstream and the account is in Luxembourg. The tri-party custodian documentation will be in each case documentation prepared by the relevant tri-party custodian itself.

Whilst the broad approach has been to try and develop an arrangement that is as similar as possible to that which applies in relation to the Title Transfer GMSLA, there are inevitably differences between the arrangements that will apply in relation to the Title Transfer GMSLA and those that will apply in relation to the Pledge GMSLA. An important consequence is that those considering using the new Pledge structure should consider carefully how it will operate and how it differs from the current Title Transfer GMSLA. The expectation is that the new Pledge GMSLA will not necessarily suit all market participants. Some may prefer to continue to use the Title Transfer GMSLA. ISLA has been very clear that the Pledge GMSLA is not a replacement for the Title Transfer GMSLA. Rather it is an additional structure available to market participants to use if it suits them and in circumstances that suit them.

Some of the differences from the Title Transfer GMSLA

One important difference is that in the Pledge GMSLA structure, the collateral will be held in the Borrower's account at the custodian not the Lender's account as is the case with the Title Transfer GMSLA. There are two important consequences. First, when evaluating the suitability and operation of the structure, Lenders should take into account the additional step of accessing the collateral, and the need for a transfer of the collateral, from the custodian. Second, leaving the collateral in the Borrower's account creates challenges with implementing a legally effective pooled principal structure and, for the initial stage, ISLA has decided not to address pooled principals. Another difference is that the Pledge GMSLA also does not permit the Lender to hypothecate or re-use collateral.

A further crucial difference is that the procedures involved in realising and liquidating collateral are different. While they are obviously intended to put the Lender in a situation where it can cover its exposure through an ability to liquidate the collateral, there are differences in the way this is implemented, and it is important for both Lender and Borrower to evaluate and understand the implications. Table 1 sets out, by way of illustration only, an example timeline in a borrower default, comparing the Title Transfer GMSLA and the Pledge GMSLA, and this brings out some (although by no means all) of the differences in the way the two structures operate. For example, the Table shows that the timeline between an Event of Default occurring and the time when the Lender can commence liquidating collateral may well be a number of days longer in the case of the Pledge GMSLA than it is in the case of the Title Transfer GMSLA. Lenders might for example want to consider that when determining collateral eligibility criteria and haircuts. Some of the differences affect Borrowers too.

For example, the time before the Borrower will be entitled to a return of the excess unused collateral following a close out and payment by the Borrower may be later than the time when the Borrower would be entitled to the close-out net payment in a Title Transfer GMSLA.

As collateral subject to the security interest in the Pledge structure will continue to be property of the Borrower, dividends or distributions received by the Lender on collateral will be required to be added to the collateral pool and there will be no manufactured payments in respect of them. Manufactured payments will continue to be relevant to loaned securities.

Market participants contemplating utilising the Pledge structure should of course verify that utilising this structure is something they are permitted to do. There has been some discussion for example as to whether UCITS are permitted to take collateral through a security interest mechanism. ISLA has been involved in pursuing that question with European regulatory authorities. Agent Lenders may also wish to verify not only that their principals are permitted to take security interest collateral, but also that the Agent Lender's mandate from its principals permits adoption of the security interest structure.

With regard to the regulatory context, apart from the regulatory capital treatment differences, potential users will need to understand how other regulatory aspects are affected. For example, resolution stay provisions are relevant to security interest arrangements as well as to title transfer arrangements, but there are stay provisions which specifically relate to the enforcement of security, which should be identified and understood.

Habib Motani
Partner, Clifford Chance

Conclusion

The Pledge GMSLA will add to the modalities through which market participants will be able to engage in securities lending. It is clear that it provides some advantages, such as in relation to regulatory capital costs for those market participants subject to the relevant regulatory capital requirements. The important message is the need for those contemplating using the Pledge GMSLA to evaluate it carefully and to understand it fully before proceeding to use it so that appropriate processes and systems can be put in place to best accommodate its use. It may be tempting to assume the Pledge GMSLA will work in exactly the same way as the Title Transfer GMSLA but making that assumption would not be wise.