ISLA INTERNATIONAL SECURITIES LENDING ASSOCIATION

EUROPEAN COMMISSION
Directorate-General for Financial Stability,
Financial Services and Capital Markets Union

**Online Submission**

**January 31, 2016**

**Dear sirs,**

**Call for Evidence: EU Regulatory Framework for Financial Services**

We appreciate the opportunity to provide some comments in relation to the Call for Evidence on behalf of the International Securities Lending Association ("ISLA"). ISLA is a trade association established in 1989 to represent the common interest of participants in the European securities lending and borrowing market. It has 100 members including insurance companies, pension funds, asset managers, banks and securities dealers. Our members therefore include both the banks that act as principal intermediaries in the securities lending market as well as the investing institutions and their agents that they borrow securities from. (For more information please visit the ISLA website www.isla.co.uk).

Securities lending and the economically and legally similar repo markets, are the main forms of securities finance transaction ("SFTs"). SFTs are used by a wide variety of market participants as a low risk method of generating incremental returns, generating secured financing, and safely transferring collateral within the financial marketplace. These transactions provide essential liquidity to markets and therefore our comments relate to the negative impact that regulation is having on market liquidity, which is relevant to the discussion on "Rules affecting the ability of the economy to finance itself and grow". Indeed there are intimate links between the functioning of secondary markets and the ability of companies and government to fund themselves on primary markets.

Our comments in this response relate to both securities lending and repo markets. The International Capital Market Association ("ICMA") has submitted its own response to the Call for Evidence. We fully endorse its position and findings in relation to repo and SFT markets, in particular those that relate to the imposition of mandatory buy-ins under the CSDR, concerns about the impact of the NSFR and Leverage Ratio which will reduce the capacity of banks to intermediate in these markets, and certain elements of the SFTR and MiFID II/ R reporting requirements. In addition we are growing increasingly concerned about the development of UCITS regulation (particularly as it relates to investor disclosure and collateral management) and how this is discouraging this important class of investor from participating in these low risk markets.

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At a high level, much of the post crisis regulatory agenda would appear to support or even require the ongoing involvement of the SFT market in terms of its ability to support the use of collateral within the system (EMIR, CRD IV), for improving settlement efficiency (CSDR) and to provide the conditions for suitable levels of secondary market liquidity in general support of the CMU. At the same time the cumulative effect of these regulations is acting to disincentivise market participants from engaging in SFTs.

We would note that much of the regulation we express concern about is either in its early stages of implementation (CRD IV), or has yet to be implemented (CSDR, SFTR, MiFID II/R). This makes the provision of quantitative evidence at this point in time somewhat difficult to provide. The full effects of the cumulative impact of this regulation have therefore yet to be felt but we believe it important to review these areas as there may be opportunities to take action in advance of likely problems. In relation to regulation that has been implemented, we do highlight data that demonstrates that mutual funds are withdrawing from the market.

## Background on securities lending

Securities lending is a technique employed by long term investors such as pension funds, insurance companies and mutual funds as a means of generating incremental returns on portfolios. Securities loans are fully collateralised and conducted within a well-established legal framework. Banks and prudentially regulated broker dealers provide the market for securities lending by acting as principal intermediaries, borrowing securities from long term investors for use by themselves or for on-lending them for a variety of purposes, including facilitating market making and trading strategies such as covered short selling. Securities lending activity is acknowledged as adding to secondary market efficiency which benefits all users of the capital markets[1]. More specifically:-

- Globally, long term investors generated around EUR 8bn of revenues from securities lending activity in 2015, with Europe accounting for around EUR2.6bn[2].
- Securities lending provides an important source of liquidity to securities markets, allowing market makers and primary dealers (for government bonds) to make efficient two way markets for investors.
- Securities lending supports investment strategies employed by asset managers including arbitrage, hedging and short selling which are widely accepted as adding to market efficiency through provision of liquidity, lower relative volatility and more effective asset price discovery.

[1] http://www.fsb.org/wp-content/uploads/r_130829b.pdf "Securities lending and repo markets play crucial roles in supporting price discovery and secondary market liquidity for a variety of securities issued by both public and private agents."

[2] Datalend: http://www.datalend.com/infographic/infographic2015.php

- SFTs such as securities lending and repo are the principal mechanisms for transferring collateral within the financial system. In the context of the debate around collateral scarcity we expect that these markets will be required to play an increasing role in ensuring that the market has access to suitable collateral.

- Central Securities Depositories use the securities lending market to cover imminent settlement fails helping to reduce systemic risk. (A large European ICSD has estimated that settlement fail rates could increase by as much as 100% if securities lending stopped).

More information on this market is available on the ISLA website and in the guide for investors "Securities Lending: An Introductory Guide"[3].

In other words, securities lending has two principal benefits. It provides tangible low risk returns to long term investors, which is particularly useful during times of pension fund deficits and low real investment returns. Secondly it provides the financial marketplace with liquidity that ultimately supports its ability to efficiently match providers of capital with those in the real economy who need it.

When liquidity in a type of security is low, investors will rationally require a return premium to compensate for the higher costs and risks faced should they need to sell the security. Whilst many investments are purchased by investors as part of a long term investment portfolio, changing circumstances may dictate that investors have to sell or liquidate investments. For instance an insurance company may have to liquidate investment to meet claims or other liability obligations and pension funds may need to rebalance investments to reflect the changing demographics of its beneficiaries. Without the ability to both value or price an asset and sell it quickly and efficiently, long term investors may shy away from such investments or markets altogether. And without access to a liquid pool of securities to borrow, market makers will either increase their bid-offer spreads to compensate for the risk of not being able to deliver a security or decline to make markets in a particular security or market. Without market derived mark-to-market valuations investors may have to resort to model based valuations that may be subject to model risk and underlying price volatility.

Thus low liquidity resulting in risk premia raises the costs to the end user of raising investment capital, costs which could otherwise be invested in jobs and growth. The positive effect of SFTs in providing this secondary market liquidity is understood by the debt management offices and central banks of many EU and other countries, who positively encourage the development and growth of government bond repo in order to create efficient conditions for the issuance of debt securities. Securities lending provides the same benefits to both bond and equity market participants and issuers.

[3] http://www.isla.co.uk/images/PDF/Publications/sl_intro_guide_9_10.pdf

SFTs are now also playing an increasingly important role in the provision of collateral to users of the financial markets. Post crisis regulatory reforms are requiring that more transactions and investment activity be collateralised (EMIR, CRD IV). The use of collateral in such transactions is designed to lower risk in the system, but the ability of the markets to function with these developing requirements relies on the existence of an efficient mechanism for mobilising collateral. SFT markets have been playing this role for many decades, but the combined effects of much developing regulation could put at risk the willingness of investors to participate in SFT markets.

Whilst long term investors, who provide their securities to the market through SFTs, value the returns they generate, they consider this activity to be ancillary to their core business of investing in securities. It is therefore an activity that they could easily cease to conduct should regulation serve to increase the cost or complexity of doing business. We highlight evidence that regulation for UCITS mutual funds is doing precisely this. This would have the undesirable effect of withdrawing important liquidity from the market.

In the next section , we have sought to summarise the combined effect of various regulatory initiatives on SFTs markets.

**Example 1: Market liquidity. Impact of several regulatory measures on the ability of banks to provide intermediation on securities lending and repo markets (specifically CRD IV, CSDR, SFTR, MiFID II/R)**

In this regard, the combined effect of the Leverage Ratio, NSFR, MiFID II/R, SFTR and CSDR, are expected to severely inhibit the ability of banks to act as principal intermediaries in SFTs.

The CRD IV framework is making it increasingly harder for banks to act as intermediaries between the demand for financing or funding and the supply of institutional investment flows. We support the CMU's broad objectives of transitioning Europe towards a more markets-based funding model but we also feel that it is important that banks are still able to actively match some of these investment flows and that regulation is appropriately calibrated to facilitate this transition. New capital rules, particularly the Leverage Ratio (LR), liquidity rules including Liquidity Coverage (LCR) and Net Stable Funding (NSFR) ratios are examples of current regulation that may need recalibration in the context of their ability to support securities financing activities if banks are to be able to fully participate in the development of the CMU.

For example, the LR was conceived as a simple gross balance sheet ratio that looks at total assets versus capital. However by effectively ignoring collateral received within securities financing transactions, 'higher volume lower margin' collateralised business tends to be unduly penalised by this regime. This means that the banks' ability to support the movement of government bond collateral within the system through securities lending and repo is potentially marginalised by adherence to the LR.

The NSFR although designed to ensure adequate term funding for riskier assets such as equities fails to address certain short term businesses such as securities lending where an equity asset may only be on balance sheet for a very short period, but still requires a minimum of 50% of the exposure to be funded for at least 12 months.

In addition to prudential measures, SFT market participants will be required to report details of their activity under several developing regulations. These include the SFTR, MiFID II/ R and the ECB's Money Markets Statistical Regulation. We remain supportive of transparency and have been engaged in the discussions about how best to achieve this at both a global policy level (with the FSB) and with policymakers in Europe. We however have concerns that different regulations may require similar reporting of the same activity for fundamentally the same policy reasons. Whilst we understand that it is intended that transactions reported under SFTR will not be required to be reported under MiFID II/ R we believe there may be some further clarification required on this point, and harmonising the standards for reporting between SFTR and MMSR will help to reduce costs whilst creating more consistency across the regulations. Furthermore some types of SFT may be reportable under the pre and post trade disclosure requirements of MiFID II/R. As SFTs are not price forming transactions we believe that this should not be necessary and in fact could create a misleading picture of market liquidity and valuation. Finally, whilst we fully support the objective of better settlement disciplines that settlement fail fines and mandatory buy-ins will encourage under the CSDR, we are concerned that these measures will potentially discourage lenders from making their securities available for lending.

The CSDR contemplates that any failing settlement in cash securities would automatically trigger a buy-in after four days in most instances and after seven days for least liquid securities. The Regulation would apply to securities lending transactions which by their very nature are loans and not outright purchases or sales and as such any buy in would effectively turn a loan exposure into an outright long cash market position which would fundamentally change the economic and market risk exposure within the transaction. Using an outright purchase of a security to remedy a failing temporary exchange of securities (which was never intended to create a market exposure) is an inappropriate remedy for a failing SFT. In effect it would create a market position that would need to be sold or purchased, exposing the SFT market participant to additional market risk. It seems perverse that this regulation, which is designed to encourage settlement, may serve to increase risk in the SFT markets which are expected to be part of the solution.[4] We are not aware of any other market in the world, which incorporates mandatory buy-ins for failing settlements, applying these also to securities lending transactions themselves.

[4] It is expected that a failing transaction can be remedied by borrowing the security temporarily. Settlement fail fines under the CSDR are being contemplated at levels which are meant to incentivise such borrowing.

In its response, ICMA notes that as a result of the combined effect of these regulatory measures, banks are already restructuring their SFT businesses and this is likely to lead to a reduction on their willingness to provide as much support to the SFT markets in the future.

One possible solution to this may be for non-bank market particpants to disintermediate the banks. In the context of securities lending this might take the form of long term investors lending securities directly to other asset managers. Anecdotally our buy-side members are disinclined to accept the risks and operational complexities that arise in this type of scenario and we believe it is therefore unlikely to provide a meaningful solution to the void created by banks' withdrawing from their traditional role as intermediaries.

In light of these effects the following options should be considered:-

- Increased scope under NSFR to allow for the application of netting, or off-setting, of interdependent assets and liabilities, in particular in the context of intermediated 'matched' repo and securities lending transactions and inventory financing.
- More focused reporting requirements under SFTR, that are also broadly consistent with other SFT reporting initiatives (such as being required under the ECB Money Markets Statistical Regulation), would not only minimize costs and disincentives for SFT market liquidity providers and investors, but would also provide scalability and efficiency for the authorities who are expected to compile, process, and interpret the data.
- Remove SFTs from pre- and post-trade transparency requirements under MiFID II/R, as well as transaction reporting, on the grounds that these transactions are not price forming and that the transaction reporting duplicates what will be required under SFTR.
- Resolution stays should be subject to the maintenance of payments (as in fact stated in BRRD Article 71) and it should not be possible to override this using powers to invoke payment suspensions (under BRRD Article 69). Furthermore, there should be symmetry of treatment for cleared and non-cleared transactions.
- Extended deferral of the implementation of mandatory buy-ins under CSDR , or at the very least maximizing the term of SFTs for which the near-leg of SFTs are exempted under the regulation, so as to avoid dis-incentivizing longer-term financing transactions.

**Example 2: Market liquidity. Impact of several regulatory measures on the willingness of long term investors to engage in securities lending and repo markets (specifically CRD IV, CSDR, SFTR, MiFID II/R, UCITS V, ESMA Guidelines for ETFs and other UCITS, and AIFMD)**

As discussed in our introduction, the long term investors that engage in SFT markets generally do so on an ancillary basis. The combined impact of the regulations noted is causing many such investors to question their willingness to participate. As also explained earlier a withdrawal from

the SFT markets by these investors will have a negative effect on market liquidity, which in turn will damage the ability of the markets to provide capital to end users on the best terms.

Whilst the CRD naturally impacts the banks that act as intermediaries, the costs of compliance with the prudential requirements is beginning to impact on the willingness of banks to participate as extensively as intermediaries in these markets. A lack of bank capacity will naturally reduce the demand for investors to undertake SFTs.

The increased risks and costs (as described in Example 1) associated with the mandatory buy-in regime under CSDR also apply directly to the investors who lend securities. This will further disincentivise them to participate in SFT markets as they will perceive the risk of being bought in (on a transaction that they do not have to do) as being too high.

The BRRD provides resolution authorities with extensive powers to stay the termination rights of banks' counterparties in a wide range of financial contracts. The BRRD contemplates two situations – that the stay would be imposed but that the parties' payment obligations would be honoured during the stay period (Art 71), but in addition, authorities may also suspend payment and delivery obligations (Art 69). Whilst it is generally understood that temporary stay measures are helpful in allowing authorities time to consider bank resolution options, the power to further suspend payments and deliveries (which would mean that SFT counterparties are unable to make margin calls during this time) would be considered by many market participants to materially increase the risk of doing business with such banks. This is considered to raise the likelihood that market participants would seek to terminate contracts earlier than they might otherwise, for fear of having their bank counterparty placed into resolution with the risk that they may be unable to maintain collateral margins. On top of this, the situation is exacerbated by the fact that certain bank counterparties (such as CCPs and governments) are exempt from the stay provisions (which creates an unlevel playing field and introduces the risk that such exempt investors could move early to terminate financial contracts and liquidate collateral ahead of the rest of the market). This creates yet another reason for investors to question their involvement in SFT markets with potentially negative consequences for market liquidity and collateral fluidity.

In addition to the above which generally apply to all investors, the development of the regulations for AIFs and UCITS are impacting the willingness and ability of regulated funds to engage in SFT markets. These developments may be divided into a number of topics:-

**Investor Disclosure**: Articles 13 and 14 of the SFTR will require regulated funds (Collective Investments in Transferable Securities, UCITs, and alternative investment funds, AIFs) to make specific disclosures about their SFT activities in prospectuses (or other pre-investment documents) and in periodic investment reports. UCITS and AIFs are already required to make extensive disclosures about SFT activities (e.g. under ESMA's Guidelines for Competent

Authorities and UCITS Management Companies[1] (the 'Guidelines'). The SFT regulation introduces some very specific requirements that are not explicitly required by the Guidelines, which will require the wholesale re-issue of prospectus documents and production of revised periodic reports by fund managers funds - a cost estimated in excess of €320mm[2], for no obvious benefit to investors. All disclosure requirements on regulated funds relating to their SFT activities should be made consistent.

**Treatment of collateral**: Under AIFMD and UCITS V there is growing concern that rules requiring segregation of assets may essentially prevent these funds from using the triparty collateral management services which have been developed by the banks and market participants to allow for the efficient and safe transfer of collateral held by SFT market participants. Whilst we fully support the objective of clear and transparent segregation of client securities, any requirement to segregate collateral securities at the sub-custodian level (rather than in the books and records of the tri-party custodian bank) would not permit the use of such services by UCITS and AIFs. We estimate that in excess of 80%[5] of all SFT securities collateral is held in triparty arrangements and should such segregation be required it would preclude UCITS ad AIFs from using these arrangements. The only alternative would be to require that collateral be separately delivered outside of the triparty system and this would render the funds as very unattractive counterparties. We appreciate that this is a very technical subject area and would happy to explain in further detail.

**Restriction on ability to conduct term loans**: Under the ESMA Guidelines UCITS funds are prohibited from conducting securities loans that are for more than one day. Increasingly the demand to borrow securities is now on a term basis (regulations such as LCR and NSFR are driving this), meaning that UCITS are becoming less attractive as counterparties to banks. According to the ISLA Market Report published in September 2015[6], 32% of the government bond lending market is now conducted on a term basis.

The combined effect of these regulations means that European mutual funds are becoming less willing to engage in lending, or finding that they have become unattractive as counterparties. This effect is highlighted in the ISLA Market Report as whilst mutual funds represent 43% of all securities being made available for loan, they have only 18% of the market.

[1] ESMA, Guidelines for competent authorities and UCITS management companies, 18 December 2012, https://www.esma.europa.eu/sites/default/files/library/2015/11/2012-832en_guidelines_on_etfs_and_other_ucits_issues.pdf

[2] Assuming just 25% of UCITS funds (8000) engage in SFT activity. Costs per new prospectus for index funds are estimated at €40 000. Active fund prospectus costs are higher.

[5] ISLA estimate using data from the four main triparty collateral managers and three market data vendors.

[6] http://www.isla.co.uk/wp-content/uploads/2015/08/ISLAMarketReportSEPT2015.pdf

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Of course the regulations covering UCITS and AIFs are designed to create high levels of investor protection. In the area of SFT activity we believe it is possible to create rules that will sensibly limit and restrict the business that such funds may do, such that any risks to liquidity or counterparty credit risk are contained at low levels, without effectively marginalising them as counterparties. We would encourage a holistic review and recalibration of the rules that govern SFTs by regulated funds.

In light of these effects the following options should be considered:-

- Resolution stays should be subject to the maintenance of payments (as in fact stated in BRRD Article 71) and it should not be possible to override this using powers to invoke payment suspensions (under BRRD Article 69). Furthermore, there should be symmetry of treatment for cleared and non-cleared transactions.
- Investor disclosure rules under SFTR should be aligned with existing comprehensive disclosure requirements under ESMA Guidelines.
- The rules that govern the use of SFTs by regulated funds should be reviewed and recalibrated to allow for their participation in a suitably regulated and risk controlled manner.

We hope that this response is helpful to the Commission in its ongoing work and look forward to working further with you on this matter.

Yours sincerely,

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