ISLA INTERNATIONAL SECURITIES LENDING ASSOCIATION

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Introduction

The International Securities Lending Association (ISLA)[1] is grateful for the further opportunity to input into the **Commission's forward-thinking on the Capital Markets Union (CMU) agenda.**

The nearly €2 trillion securities lending market (globally) links institutional investors (UCITS/mutual funds, pension funds and insurance companies, and also increasingly central banks) who lend their securities either directly or via agents (custodial banks, asset managers or specialist firms) to prime brokers and other borrowers. It has grown over the years from primarily a tool to help participants avoid settlement failures to a mechanism that now also supports a) market making, b) hedging of risk and c) traders and investors' long/short directional strategies.

As such, **securities lending connects with circa 50% of the global market at any given time – and therefore provides very useful insights into the broader financial markets, including trends and possible emerging risks, as well as into how regulatory changes may impact behaviors that support (or hinder) well-functioning, liquid capital markets.**

Since 2014, ISLA has been tracking a wide data set on the securities lending market that seeks to inform its members as well as policy makers and regulators about the evolution of this market. From our latest report (http://www.isla.co.uk/wp-content/uploads/2017/03/WebSL-Report.pdf) for the 6 months between June and December 2016, we would like to draw certain **findings that we believe are of the utmost relevance to the Capital Markets Union agenda.**

The two findings that we particularly wish to draw the Commission's attention to relate to

- The **growing disproportionate imbalance between securities held by UCITS that are available for lending vs UCITS securities actually on loan** – showing major untapped potential for improving liquidity in the market.
- The **continued developing trend of government bonds, in particular EU government bonds, being used in securities lending transactions** – showing potential rising risks of a liquidity squeeze in those instruments, which could impact EU governments' costs of funding.

We encourage the Commission to consider addressing these issues by

- **Reviewing** those elements of the **UCITS directive** that restrict UCITS ability to fully engage with securities lending.

[1] ISLA is a trade association established in 1989 to represent the common interests of participants in the securities lending industry. ISLA has approximately 140 full and associate members comprising of insurance companies, pension funds, asset managers, banks, securities dealers and service providers representing more than 4,000 underlying clients. Based in London, ISLA represents members from more than twenty countries in Europe, the Middle East, Africa and North America. More information is available at http://www.isla.co.uk/

- **Setting up an expert group to analyse potential upcoming liquidity stresses in the EU government bond market** (similar to the ongoing expert group on Corporate bond market liquidity)

These issues are particularly relevant in the context of questions 2 (*Making it easier for companies to enter and raise capital on public markets), 3 (Investing for long term, infrastructure and sustainable investment), 4 (Fostering retail investment and innovation) and 6 (Facilitating cross-border investment)* of the Commission's consultation paper, but also go beyond it.

1. The Mutual funds/UCITS case

Our data shows that **mutual/retail funds (including UCITS) and pension plans continue to dominate the global lending pool, accounting for 66% of all securities available for lending**. There has been little change here since 2014.

What has changed however is the continued widening in the disproportionate relationship between supply and demand for securities in mutual/retail funds. Although mutual/UCITS funds account for 45% of all securities available for lending (circa €15 trillion), we have seen a further decline in their proportion of actual lending (circa 15%, from circa 18% three years ago).

Our conversations with market participants provide strong anecdotal evidence that the reason behind this trend is linked to the increasingly restrictive regulatory environment for lending securities facing many retail funds, notably UCITS, which in turn is reducing borrowers' appetite to access securities from these funds and restricts UCITS ability to fully engage in securities lending.

The **four main obstacles** are:

- Current UCITS directives favor the use of title transfer arrangements in respect of any collateral received from borrowers. This means that UCITS are accept receipt of other recognised collateral structures including on a pledge rather than title transfer basis. Borrowers who may want to pledge collateral are likely to look for alternative sources of supply.
- This also means that UCITS cannot consider any central clearing models for securities lending or repo transactions, which often rely on pledge structures. It seems strange that the regulatory drive to move to central clearing is currently closed to these institutions.
- In general, UCITS are unable to contemplate trades with a maturity of more than 7 days, which is often at odds with banks who are looking to secure assets, particularly HQLA, for periods in excess of 30 days as they manage to LCR (see paragraph 2 below).
- If the ongoing ESMA deliberations around asset segregation lead to an obligation to segregate all client assets on an individual basis within the sub custodial network, the associated costs to comply with these guidelines will make it uneconomic for many UCITS to continue making their securities available for lending.

The main **policy implications** are:

- From a **market liquidity and broader market stability** perspective, although the supply of assets made available for lending from UCITS funds remains broadly unchanged at circa €6.6 trillion, the demand for these assets has dramatically fallen since 2014. This means there are fewer securities available in the market to cover potential settlement fails and to support market-making and efficient hedging of risk. Certain restrictions on UCITS also act against the securities lending market moving to CCP clearing.
- From an **investor protection** perspective, this takes away fund management efficiencies and could lead to lower returns for end/retail investors.
- From a **market transparency** perspective, this trends seems to be contributing to the continued growth of less regulated Sovereign Wealth Funds and the inverse disproportionate relationship that we are observing between their supply (6% of lendable assets) and demand (13% of on-loan balances).

We therefore encourage the Commission and ESMA to proactively **consider reviewing those elements of the UCITS legislative texts and Guidelines that restrict UCITS ability to engage in securities lending activities**.

2. The EU government bond market case

Whilst the lending of government bonds has always been a feature of securities lending markets, it has seen a **dramatic evolution in recent years**, as a direct consequence of both regulatory changes and central banks' actions.

Whilst dominantly an equities lending market originally, we have observed continued growth of government bond lending activity in recent years; our latest data shows that **for the first time since tracking the data (2014) , the value of government bonds on loan matched the value of equities on loan** (circa 45% of global on-loan balance each). As at 31st December 2016, over €800 billion of government bonds were on loan - a 19% increase in the last six months. Over an extended time horizon (31st March 2014 to present), the on-loan government bond balances increased from €633billion to €841billion, representing a **33% increase**.

The prominent reason for this evolution is the development of a term lending market, as bank borrowers actively look to manage new Basel liquidity requirements, in particular the Liquidity Coverage Ratio (LCR). Securities lending programs naturally provide a source of High Quality Liquid Assets (HQLA). Term HQLA loans offer banks the opportunity to improve their LCR using securities lending markets, which is precisely what we have observed: the movement of HQLA via lending programs has shown to be a key source of market liquidity over the year-end, especially as repo and cash markets have contracted. The data in our report clearly shows that borrowers are actively seeking to maintain loans of EU government bonds over the year-end, with positions against non-cash collateral increasing in the final four weeks. This is further supported by the high concentration of term transactions, with 24% of all loans of government bonds being for periods of 3 months or more. The increasing demand for HQLA may also reflect the global regulatory push (such as EMIR in Europe) to move towards mandatory centralised clearing for derivatives transactions and the associated significant collateral needs of CCPs. As centralised clearing of derivatives transactions matures, we expect this demand to increase further.

However, whilst demand from banks to access EU government bonds is increasing, the supply of EU government bonds made available for lending by institutional investors is falling (by 4% in the second half of 2016). Should this trend persist (and notably as further liquidity requirements, such as the Net Stable Funding Ratio, are implemented), EU Government bond markets could experience significant stress.

Factors driving this dynamic unquestionably relate in part to recent changes in prudential regulation, but appear to also correlate closely to those government bond markets where central banks have been actively buying back government bonds as part of the Public Sector Purchase Programs (PSPPs) introduced by the European Central Bank (ECB) in January 2015. Under the PSPP, the Eurosystem started to buy sovereign bonds from euro-area governments and securities from EU institutions and national agencies (France, Germany, Netherlands Italy, Finland, Slovenia, Austria and Portugal). Supporting this process should be an efficient securities lending program to allow these assets to be recycled back into the system to support HQLA and other requirements. Without effective ways to recycle bonds purchased into the markets however, PSPPs could be an additional drain on overall liquidity.

From a CMU perspective, and in particular for smaller Member States, we believe it is essential for Europe to have liquid and sustainable government bond markets – even more so post-Brexit. Therefore, **in addition to the important work that the Commission is coordinating on corporate bond market liquidity, we encourage the Commission to consider conducting a similar effort for EU sovereign bond markets.**

Conclusion

Through its interaction with the entire market participants value chain and across all asset classes, the securities lending market is uniquely placed to provide a "window" into changes in behaviors and dynamics across the whole market.

Whilst we do not claim to hold the perfect answers to the changes that we are observing (which would require in-depth analysis into the specific asset classes and market participants), we hope that our data and commentary will help policy makers in "joining the dots", and see it as our role to alert them to developing trends that we believe deserve their attention – in this case with the CMU objectives in mind more specifically.