Securities Lending and Repo – the “front line workers” of financial services

Maurice Leo, in Deutsche Bank’s Agency Securities Lending team, assesses the important role of securities lending and repo in accommodating and facilitating market order and liquidity during pandemic-related volatility

In just under twelve months, we have experienced a widespread reassessment of priorities and behaviours. We now measure our employment commute in metres not miles, parents reluctantly became tutors, children – often willingly in an act of reprisal - became hairdressers, bankers became bakers and many households welcomed pandemic puppies – who also became the disposal outlet for some of the less successful baking endeavours!

In the Securities Finance industry, there was also a re-stacking of priorities and approaches. This traces back to the primary motivation influencing institutional investors to participate in securities lending and repo markets.

In our experience, the primary motivation to engage in securities lending and repo differs across institutional investors but is summarised in the following trinity:

Orderly Market Motivation:

In addition to the execution of monetary policy, Central Banks have long recognised the invaluable role of securities lending in the orderly functioning of bond and repo markets. Orderly markets stimulate financing through capital markets as opposed to bank balance sheet led solutions that have been more customary in Europe.

Securities lending also underpins reduced trading costs due to improved transaction settlement rates and narrower bid/ask spreads.

This benefits the widest outreaches of the market including those investors that remain opposed to the practice of securities lending.

Liquidity Motivation:

The Liquidity Motivation tends to be a determining criterion for Asset Owners such as pension funds or sovereign investors.

It enables investors to recalibrate their lending programme to become 1) a source of cash or 2) a mechanism for collateral transformation in order to meet margin requirements arising from their core portfolio management activity.

This motivation was epitomised by the formal establishment of the Global Peer Financing Association in mid-2020, an organisation that now encompasses 11 global members with >USD6 trillion in AuM.

Revenue Motivation:

Historically the most visible incentive for institutional investors to participate in securities lending has been the revenue motivation – capturing the value embedded in otherwise dormant assets for the benefit of end investors/clients. Best illustrated by the fact that, in normal times, as an industry, we have a tendency to measure our success against the revenue indicators published by various independent data vendors.

In 2020, we witnessed a rebalancing of investor motivations as liquidity moved centre stage with all the panache of a former Mayor of London playing street rugby with primary school children in Tokyo.
This article examines the coalition of liquidity, securities lending and repo in 2020 from a beneficial owner standpoint.

Liquidity – a multilateral influencer.

As markets increasingly realised that Covid-19 was an international and not a regional public health event, we experienced a dramatic migration away from risk assets in February 2020. Global equity indices tumbled during the last week in February, with the S&P 500 and the STOXX 600 experiencing their largest weekly declines since October 2008. In March, the S&P 500 was down -12.4% on a total return basis, a "modest" decline relative to Southern European equities as Italy's FTSE MIB and Spain's IBEX 35 were both down >22%. The Hang Seng was amongst the best performing indices with a 9.5% decline in March. In a year of the extraordinary, April then became the best month for the S&P 500 (up 12.5%) since January 1987. Yet we were in a period where the world economy practically ground to a standstill. Try explaining that to a new graduate. The aforementioned volatility triggered an initial squeeze on liquidity. Throughout the market, we saw institutional clients become nervous about their liquidity profiles with redemptions and margin requirements the overarching considerations in H1 2020.

In the **regulated fund sector**, European and US domiciled fixed income funds experienced the largest investor outflows in Q1 at -€80bn and -€135bn respectively, although these amounted to ≈2% of total product AuM. These trends reversed in Q2 with European fixed income products securing €71bn and US offerings gathering €194bn in net sales. In Europe, the absence of any disruption to investor redemptions owing to securities lending activity appeared to vindicate ESMA's decision to introduce collateral diversification and term restrictions for UCITS lenders post the 2008 global financial crisis.

In November 2020[1], ESMA highlighted that redemption demands in a deteriorating liquidity environment were particularly challenging for EU investment funds that had invested in less liquid assets, such as corporate HY bonds and EM bonds. These observations amplify the strategic importance of ensuring continuity of securities lending supply as a liquidity reservoir for in scope securities as the effective date of the Settlement Discipline Regime within CSDR approaches.

In the same report, ESMA noted that EU Money Market Funds (MMFs) were particularly affected due to heightened redemptions on the liability side, as part of the 'dash for cash', while on the asset side the liquidity of commercial paper markets deteriorated quickly. Often utilised within securities lending programmes for the (re)investment of cash collateral, ESMA indicated that there will be further focus on MMFs within its 2021 Work Programme[2].

ESMA did note that whilst there were a small number of cases requiring UCITS / AIFs to implement Liquidity Management Tools (LMTs), these arose from valuation concerns in fast moving and one-sided markets. There was no association between LMT adoption and participation by the underlying funds in securities lending as was the case in certain fund complexes in 2008.

Insurers are an important liquidity demographic in securities lending and repo markets, particularly the HQLA lending sector given their sovereign debt bias and portfolio features. Participation by this beneficial owner constituency was amongst the most disrupted during 2020 as insurers took defensive measures to safeguard access to liquidity against fears that the pandemic would prompt a surge in claims and a sharp rise in their cash requirements. By early Q3, most of these clients had become more comfortable with their liquidity positioning, given the beneficial impact of Central Bank interventions in the intervening period, and had resumed securities lending activity after a brief hiatus.

For **sovereign investors**, particularly those with commodity-orientated economies, the experience of the global financial crisis coupled with more cautious end-of-cycle positioning left them with portfolios capable of contending with the government withdrawals that emerged in Q2 to support immediate deficits in public finances.

In the three weeks to March 25th there were record volumes (USD100bn) of sales by Foreign and International Monetary Authority (FIMA) holders of Treasuries. This coupled with the flight to quality and the associated demand for US dollars contributed to a surge in volatility in March to levels not seen since 2008. The Fed responded

[1] ESMA recommendation of the European Systemic Risk Board (ESRB) on liquidity risk in investment funds

[2] ESMA 2021 Work Programme

> *Eurosystem securities lending facilities serve as an effective backstop, supporting bond and repo market liquidity without unduly curtailing normal repo market activity.*
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> *Source: ECB*

by implementing the FIMA Repo facility enabling qualifying institutions to temporarily exchange their US Treasury securities held with the Fed for US dollars, commenting that "this facility should help support the smooth functioning of the US Treasury market by providing an alternative temporary source of US dollars other than sales of securities in the open market[3]".

There was evidence of significant portfolio rebalancing by sovereign investors as they responded to the impact of market volatility in equity and fixed income markets in H1 2020. This valuation volatility initially meant that they found themselves overweight their permitted fixed income allocations and underweight in terms of their target equity benchmark allocation. Investors elected to shorten the tenor of fixed income lending to ensure there was availability to meet the portfolio liquidations required to re-establish equilibrium versus their target allocations. With the improvement in equity valuations from Q2 onwards there was a subsequent reversal of the earlier rebalancing as funds sought to reduce the excess allocation to this asset class relative to their strategic benchmarks. Whilst the short-term liquidity required to support such rebalancing has some adverse impact on the ability of securities lending programmes to capture the term premium associated with portfolio stability, the industry readily accommodated the core rebalancing activity during the above period.

Central Banks were probably the busiest market protagonists in 2020. The measures they implemented to mitigate the negative economic effects of the pandemic were on a scale and timeline without precedent. Underpinning a number of these programmes were the principles of liquidity and systemic order. This was the case with the FIMA Repo facility previously mentioned.

In the Eurozone, the ECB unveiled a series of monetary policy responses in March including an increase in the existing APP[4], the establishment of the €750bn Pandemic Emergency Purchase Programme (PEPP) and the initiation of purchases of Greek sovereign debt under this facility[5]. These facilities are designed restore the orderly functioning of euro area financial markets, following the extraordinary volatility, fast de-risking and thin liquidity conditions during March as well as to ensure that accommodative monetary policy continued to be transmitted to all parts of the single currency area.

Importantly the ECB extended the securities lending framework that supplements the operations of longer standing APP facilities, to include the newly initiated PEPP. This ensures that the Eurosystem securities lending facilities continue to serve as an effective backstop, supporting bond and repo market liquidity without unduly curtailing normal repo market activity[6].

The PEPP was additionally recalibrated during 2020 to a current aggregate facility of €1.85tn with net purchases being undertaken until at least March 2022[7].

In November, the Eurosystem further adjusted the pricing principles on the APP, PSPP and PEPP facilities to reflect the changes in euro area repo market conditions since December 2016 and to ensure the continued effectiveness of the Eurosystem securities lending facilities. [6] Indeed, the beneficial influence of these adjustments was acknowledged by the ICMA European Repo and Collateral Council in its analysis on the performance of the European repo market at year-end 2020[8].

As a precautionary backstop to address pandemic-related euro liquidity needs outside euro area, the ECB also implemented the Eurosystem repo facility for central banks (EUREP) in June 2020[9]. This enables non-euro area central

[3] Federal Reserve announces establishment of a temporary FIMA Repo Facility to help support the smooth functioning of financial markets

[4] European Central Bank monetary policy decisions (March 2020)

[5] European Central Bank announces €750 billion Pandemic Emergency Purchase Programme (PEPP)

[6] European Central Bank: Securities lending of holdings under the asset purchase programme (APP) and pandemic emergency purchase programme (PEPP)

[7] European Central Bank monetary policy decisions (December 2020)

[8] ICMA: The European repo market at 2020 year-end

[9] European Central Bank: New Eurosystem repo facility to provide euro liquidity to non-euro area central banks

banks to borrow euro liquidity against eligible collateral and has been subscribed to by six institutions with >€10bn in approved lines to date. During periods of heightened disruption to Euro liquidity, we may expect to witness short-term displacement of eligible collateral from third party securities lending programmes into this facility if the underlying members are required to provide liquidity support their local banking sector.

Pension Funds are a key beneficial owner constituency for our industry given their traditional Government bond allocation, liability characteristics, regulatory profile and stable record of participation through market cycles. Illustrating this is the fact that they command over a quarter of total industry lendables and a third of outstanding loan balances. Liquidity is a cornerstone of pension fund operations. The volatility in market valuations during March and April translated into a dramatic increase in the requirement to access cash to meet the margin calls on the derivatives overlay and foreign-exchange hedges that are integral to the functioning of pension funds. As one of Europe's largest pension funds stated in a recent roundtable, in 2020 "for the first time I've put on a financing trade so that I'm taking in cash collateral for one of my funds who is looking for funding. Incremental income is important, but being able to help your clients when they need funding or hedging, is even more important than giving them some incremental income."

During March and April, there was ansiderable increase in volume and depth of inquiries around how to harness cash collateral raised within securities lending programmes to meet the demand for margin calls in unrelated products – a solution we refer to as "Agency Repo".

In response to the heightened volatility experienced in 2020, Pension funds have increased their cash buffers, and notably across different currencies, to ensure they have ready access to liquidity and to avoid being forced sellers in strained equity or private markets in particular.

In conjunction with these adjustments to portfolio liquidity, pension funds have been formally evaluating agency repo solutions where they use the established legal, trading, risk and operations infrastructure of a securities lending agent to gain access to secured funding markets. This can be in conjunction with their proprietary repo operations or on a fully outsourced basis. Agency repo solutions can be reinforced with balance sheet backed commitments to immunise against potential liquidity disruption caused by reduced bank intermediation in repo markets over key accounting dates or other periods of heightened market stress.

Since the 2008 global financial crisis, we have witnessed a series of lesser volatility events that nonetheless focused minds on the associated liquidity and funding challenges. Examples include the European Debt Crisis, Brexit referendum, equity sell off 5th February 2018 and now covid-19. Updates in regulation as well as monetary and fiscal policy intervention have been successful in addressing the liquidity challenges presented by each of these events. However, institutional investors remain conscious that future catalysts for market volatility – originating from populism movements, geopolitical tensions, environmental events or cybersecurity threats – will emerge with increased frequency and perhaps greater impact than those we have witnessed during the first two decades of this century. The events of 2020 illustrate that securities lending and repo are key workers in accommodating and facilitating market order and liquidity in response to such challenges.

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