ISLA

INTERNATIONAL SECURITIES LENDING ASSOCIATION

The Regulator & Policy Maker Guide to Securities Lending

PRODUCED IN ASSOCIATION WITH FINADIUM

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Contents

** This is an updated version of the original guide produced September 2019, to reflect changes to SFTR and CSDR*

Executive Summary

Securities lending plays an important role in today's global capital markets. It has long been a fundamental component of financial markets as a means of meeting settlement and collateral requirements, as well as providing vital liquidity to secondary markets. It supports important hedging and investment strategies and helps to facilitate timely settlement of securities.

Today, securities lending is being used as a key tool around the mobilisation of collateral including High Quality Liquid Assets (HQLA) within the financial ecosystem, as the demand for these assets has grown.

Securities lending, a fundamental component of capital markets activity, has been more influenced by regulation in the last ten years than any other factor, leading to deep seated changes in how the industry works and how external actors see the business. As new rules-making begins to subside and regulators engage in implementation and monitoring, regulators and policy makers have become an important part of the fabric of the securities lending industry.

Much of the current regulatory framework facing securities lending can be traced back to the period immediately after the Global Financial Crisis of 2008/9 and the work undertaken by the Financial Stability Board (FSB). Their paper entitled 'Strengthening Oversight and Regulation of Shadow Banking'* dated 29 September 2013 described the shadow banking sector and its importance - 'The "shadow banking system" can broadly be described as "credit intermediation involving entities and activities (fully or partially) outside the regular banking system" or non-bank credit intermediation in short. Such intermediation, appropriately conducted, provides a valuable alternative to bank funding that supports real economic activity.' Since then, the FSB has redefined its reference to the activity more broadly as 'market-based finance'. This is in recognition of the value it adds as an alternative to traditional bank funding.

This Guide has been written to assist regulators and policy makers in identifying the benefits, risks and stakeholder perspectives of securities lending, in order to facilitate knowledgeable and pragmatic engagement with this activity that is an integral part of the capital markets.

** Available at http://www.fsb.org/wp-content/uploads/r_130829c.pdf*

2. Introducing Securities Lending

Securities lending is the temporary exchange of a security against receipt of collateral.

A lender will receive collateral from the borrower, generally in the form of either cash or other securities (see Exhibit 1). In Europe, in excess of 90% of securities lending transactions are backed by non-cash collateral. The exchange of collateral is an important means of risk reduction in the securities lending transaction, and therefore the level of overcollateralisation will reflect the characteristics of the trade (levels typically range from 2% - 5%, but can be as high as 50%). Collateral is marked to market daily, ensuring that both lender and borrower of securities have the right amount of protection and collateral outstanding.

In return for lending their securities, the lender receives a payment. This can be in the form of a simple fee in respect of non-cash collateralised transactions, or through an implied fee for cash collateralised loans.

Non-cash collateral such as government bonds or equities is delivered at the beginning of the transaction, adjusted daily to market prices, then returned when the transaction is closed out. A tri-party agent is often responsible for the safekeeping of these collateral assets, monitoring and rebalancing non-cash collateral on a lender's behalf. Non-cash collateral is less popular in other parts of the world: in the US, the split of non-cash vs. cash was roughly 50/50 in 2018.

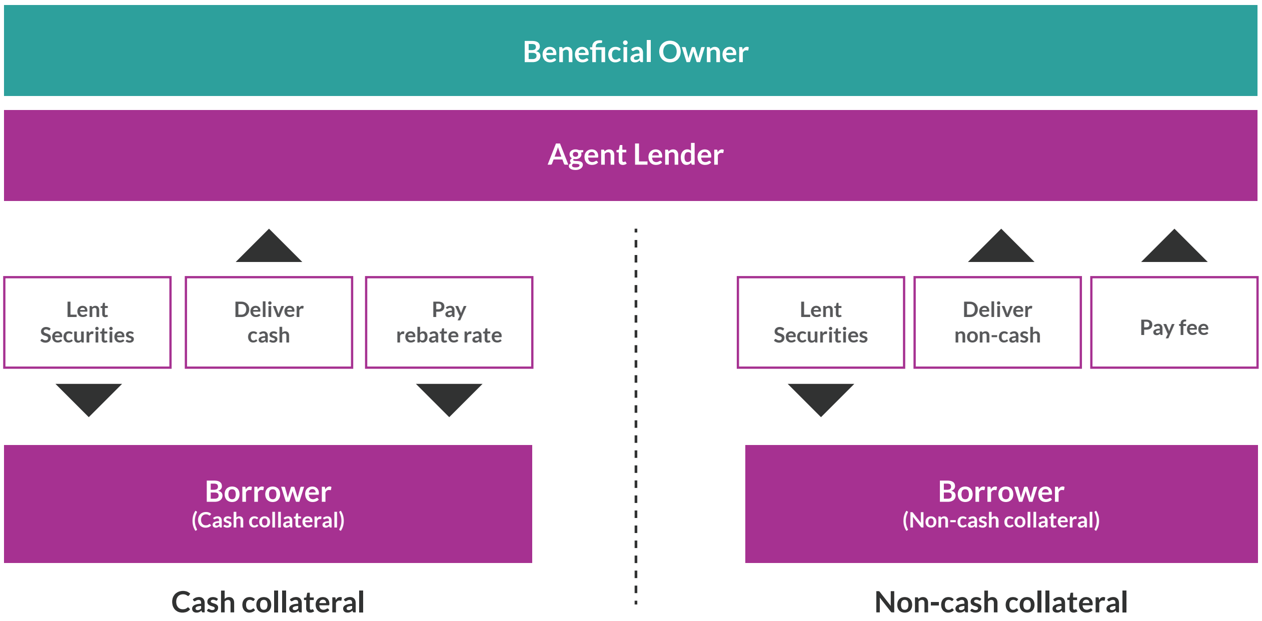
In a cash collateral transaction, a borrower delivers cash when the transaction is initiated. The lender invests the cash in approved financial vehicles that may produce additional revenues. A proportion of the cash reinvestment revenue earned is 'rebated' back to the borrower. In this case, the cost of the transaction is referred to as the rebate rate. The difference between the cash reinvestment earnings and the cash paid to the borrower is the 'implied' fee. For example, a lender may receive €1,000 in collateral, earn a return of 50 bps, and rebate 30 bps back to the borrower. The lender keeps the remaining 20 bps as income for the loan. In theory, the value of the non-cash fee and the implied fee from cash collateral earnings should be the same, although this is not often the case.

The level of fees earned by the lending institution for securities lending transactions can change depending on multiple factors; the type of collateral lenders will accept, restrictions placed upon the credit worthiness of the borrower, operational efficiency, the consistency of the lender/borrower relationship, any fixed term nature of the transaction, and any recall activity that may be demanded by the lender's corporate governance and oversight departments.

Internal buffers, also referred to as programme guidelines, can influence fees by permitting larger amounts of securities to be lent or by restricting the lending of securities over a specific time period.

Whether based on cash or non-cash collateral, adjustments in the borrowing rate can occur based on the ebb and flow of demand for the particular security borrowed. This rerating can occur at the behest of either the borrower or lender, and is typically initiated by the party in whose favour the market has moved. Billing statements and fees are normally produced, accrued and paid on a monthly basis.

Exhibit 1 - Cash v non-cash securities lending flows



Principal types of securities financing transactions (SFTs)

Type	Description	Master Agreement
Securities Lending	An agreement where one party lends a security to another party for a limited period. In exchange for either other securities or cash, the borrower pays a fee to the lender for the use of the loaned security.	Global Master Securities Lending Agreement (GMSLA)
Repurchase Agreement (repo)	A repurchase agreement (repo) is the sale of securities together with an agreement for the seller to buy back equivalent securities at a later date for a higher price, the difference representing interest or the "repo rate" .	Global Master Repurchase Agreement (GMRA)
Sell-Buy Backs/ Buy-Sell Backs	A transaction by which a counterparty buys or sells securities, commodities or guaranteed rights, agreeing, respectively, to sell or to buy back securities, commodities or guaranteed rights at a future date, such transaction not being governed by a repurchase agreement.	Bespoke / Long Form Confirmations
Margin Lending	A transaction in which a counterparty extends credit in connection with the purchase, sale, carrying or trading of securities, but not other loans that are secured by collateral in the form of securities. Margin loans are part of the range of services that prime brokers offer to their clients (i.e. investment funds). The loans are collateralised by a portfolio of securities, or securities held in a margin account, that prime brokers manage as part of the other services they provide, including trading in repo, derivative and cash markets. A key difference with repos and securities lending is that margin loans typically do not require the use or pledge of any additional collateral.	Bespoke

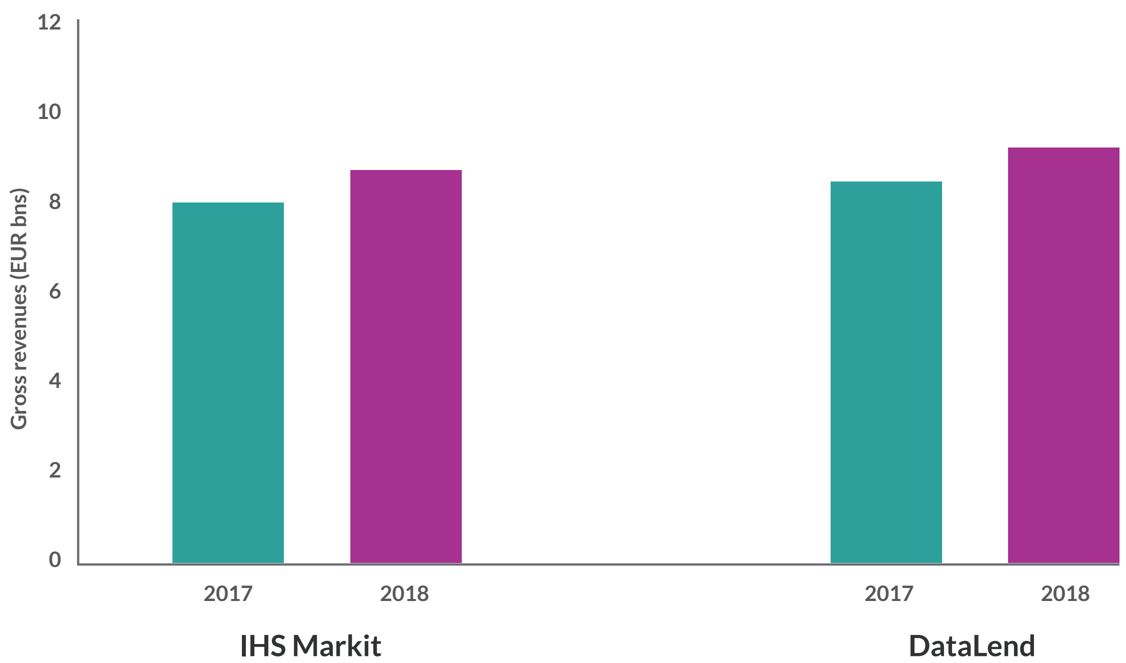
3. Who Uses Securities Lending & Why

At the global level, the value of outstanding securities lending transactions averages around €2.2 trillion at any one time*.

There are over €17 trillion of securities being made available in securities lending programmes today**. Securities lending produced around €8.9 billion in gross fees for institutional investors and their agent lender service providers in 2018, according to industry data providers. (See Exhibit 2).

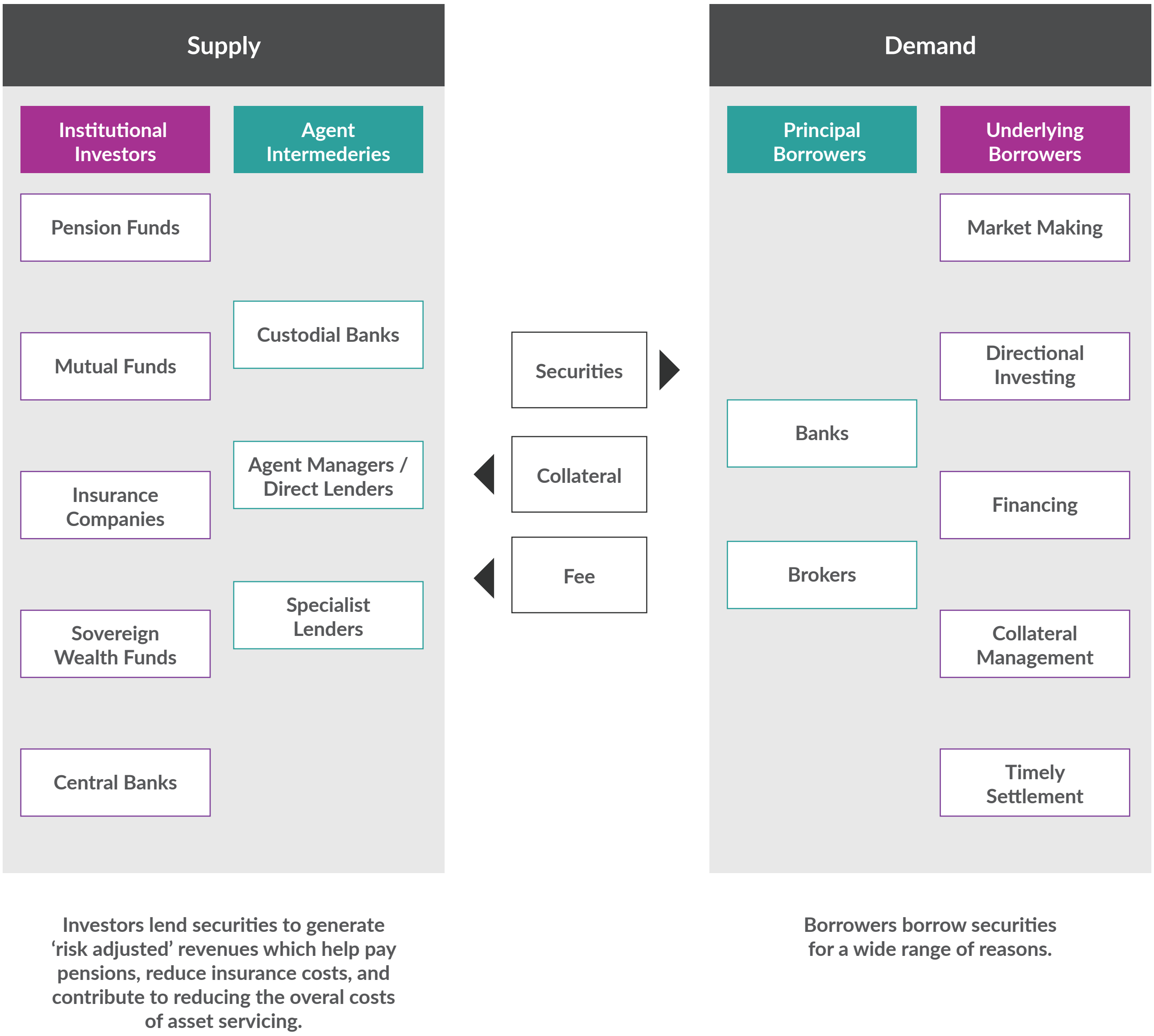
There are three to four counterparties in most securities lending transactions, with variations that may add or subtract actors based on the inclusion of service providers.

Exhibit 2 - Securities lending industry gross revenues (institutional investors and agent lenders)



** According to FIS Astec Analytics*
*** Data as at December 2018*

Exhibit 3 - Securities lending value chain

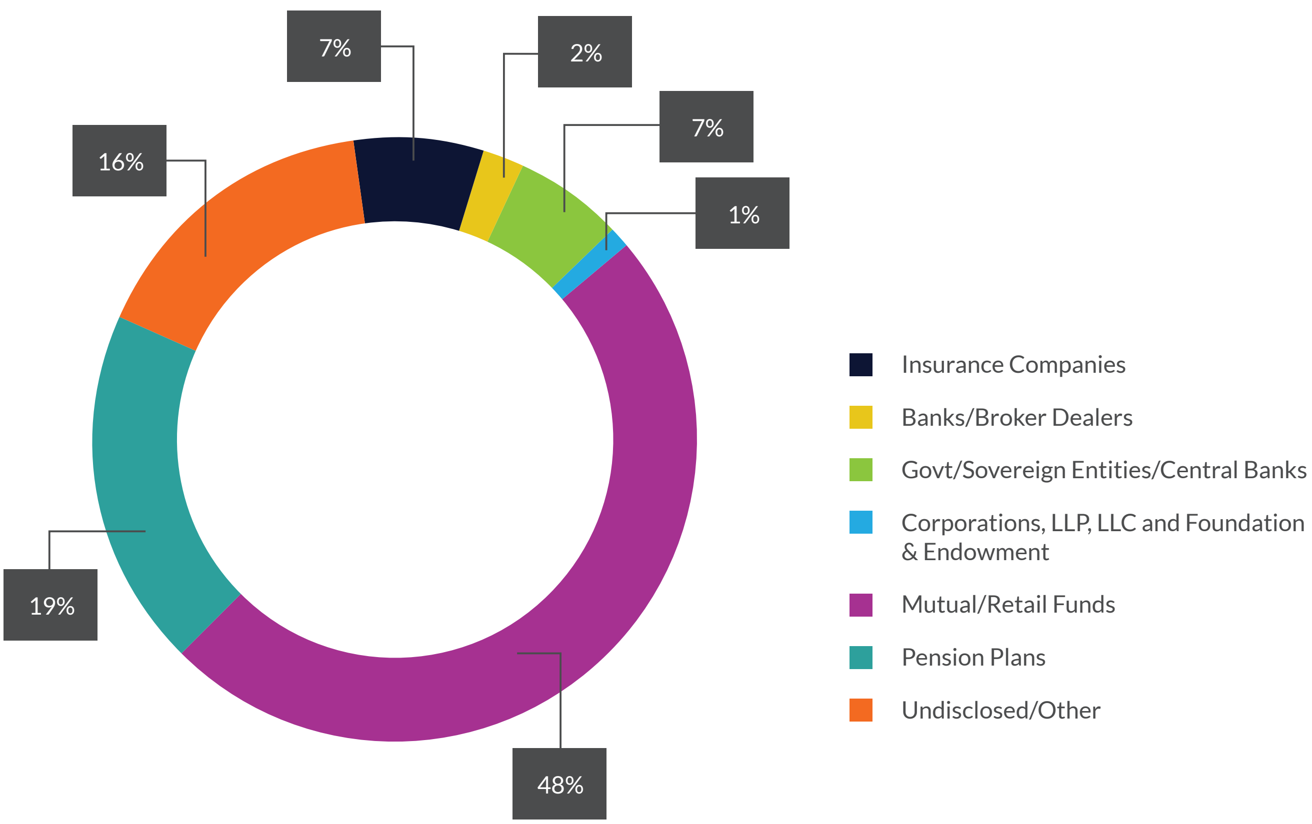


3.1 Institutional Investors

The basic value chain begins with the institutional investor, who as the beneficial owner of a security has the legal right to lend it. The institution is ultimately responsible for the risk in the transaction, with mitigations provided by the amount of collateral held and by protections offered by service providers. There are over 20,000 institutional funds of various types lending securities in today's market globally, including pensions, sovereign wealth funds (SWFs), corporations, insurance companies, UCITS and ETFs.

Nearly half of lendable assets come from mutual and retail funds around the world, with another 19% from pension plans (see Exhibit 4). This does not necessarily correspond to what types of firms lend the most assets however. Some institutional investors are active lenders with most of their portfolios available at any given time, whilst others are engaged more sporadically or for limited amounts of their portfolio. Notwithstanding this, others have regulatory limits on how much of their portfolio they can lend at any one time, or internal policies that place restrictions on lending activity. In addition, legislation aimed at bolstering retail investor protection has led to constraints on the amount and type of securities lending that certain retail funds may engage in. Whilst ISLA continues to work with relevant policy makers and regulators, this theme has opened up opportunities for other institutional types, most notably SWFs, who have seen disproportionately high levels of demand to borrow their securities, particularly in certain fixed income markets.

Exhibit 4 - Lendable assets by fund type



Source: IHS Markit, December 2018

3.2 Agent Lender Intermediaries

An institutional investor may lend its securities from an internal desk, or more likely will appoint an agent lender to lend on their behalf. The institution gives the agent lender an omnibus mandate (ongoing authority) to lend their securities, and the agent lender is responsible for lending at the best combination of rate, term and collateral available to the institution in the marketplace. The agent tracks collateral holdings and valuation, oversees delivery of securities on-loan, and recalls for securities when needed (for example, to satisfy a cash market sale). Agent lenders may be part of a custodial bank (custodial agent lender) or may be affiliated with a separate bank, institution or specialist provider (third-party or non-custodian agent lender). The typical pricing mechanism of agent lenders is a fee split. Although it is not the remit of this guide to discuss or recommend these split levels, current market norms suggest that a beneficial owner receives circa 80-90% of gross lending revenues. The fee split is based on various factors including the size of the lender, the value of their assets to the marketplace, and the potential balance sheet impacts of the client's business and portfolio to the agent.

Indemnification

An important service offered by agent lenders is counterparty default indemnification, a type of insurance policy. In the event of a counterparty default, the agent, acting on behalf of the lending client, will immediately take control of any collateral delivered by the defaulting counterparty. In the case of non-cash collateral, it will usually sell the collateral securities and use the cash proceeds to buy back equivalent on-loan securities. In the case of cash collateral, the agent will liquidate assets in the cash collateral reinvestment portfolio, again using the proceeds to purchase equivalent on-loan securities. In both cases, if the relevant cash proceeds are insufficient to cover the full cost of the purchase of the equivalent on-loan securities, the agent's indemnification may be called upon to cover any monetary shortfall.

Indemnification has often been bundled in to the agent lender's fee split, although Basel III and related regulatory costs mean that indemnification may now be quoted separately. Indemnification is not necessarily required to engage in securities lending, but most agency lending clients prefer to have it. In November 2018, consultancy firm Finadium found that 83% of pensions and SWFs said that indemnification was an important part of their securities lending programme.

It is important that institutional investors recognise that indemnification in most cases only applies to the counterparty default element, and not to the holding of some non-cash collateral nor the reinvestment of cash collateral. In some cases, agent lenders have also indemnified repurchase agreements (repo) in cash collateral accounts, although this should not be assumed. The lack of indemnification protection in cash collateral reinvestment accounts caught some institutions off guard during the Global Financial Crisis, and has resulted in greater focus around cash reinvestment guidelines going forward.

When utilising the services of an agent lender, the securities lending process should be seamless to the institution. The agent is responsible for all trading and operations activities. Any sale of securities on-loan will generate a recall notice to the agent. All corporate actions and dividends are received and enacted on, as if the securities had not been lent out. The only right that cannot be guaranteed is the voting right. In order to undertake a vote, securities must be recalled in advance to ensure the lender is the holder of record at the record date.

3.3 Borrowers

Borrowers of securities are mostly large banks and broker-dealers, including many of the same banks that offer agency lending services to institutions. Institutional investors have traditionally preferred to lend to large banks and their affiliates only, since bank credit risk exposure is both low and well understood by the market. Some institutions are also willing to lend to smaller banks and brokers, although these firms represent a smaller percentage of the market. There are roughly 200 borrowers in the securities lending market globally.

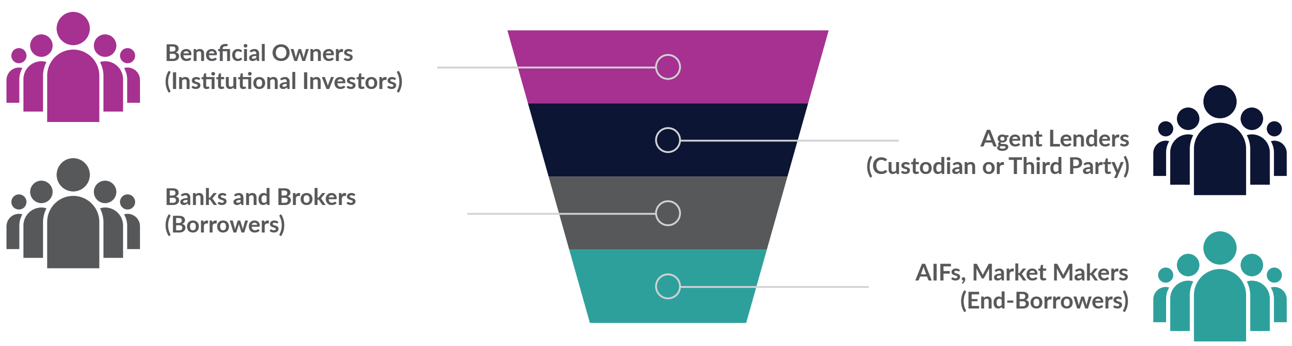
The reasons to borrow securities fall into five main categories:

- To assist the settlement process to prevent or remediate a failed delivery. The delivery requirement can be created by short-sellers needing to borrow securities to deliver for settlement, or by market-makers obligated to quote two-way prices but who may not have securities on hand to deliver.
- To obtain securities that can be delivered as collateral for other types of transactions, and that are not currently in the borrower's portfolio. Securities lending is a key component in the mobilisation of collateral including HQLA. This is an important component of facilitating overall financial stability, as banks and other prudentially regulated entities generally look to borrow low risk high quality assets.
- To obtain the rights to the security in the event of a corporate action, including scrip dividends and rights issues.
- To receive cash in order to re-invest in other short-term investments, whilst retaining market exposure of the lent securities.
- To support a bank's balance sheet by obtaining HQLA in exchange for lower quality assets.

When borrowing on behalf of an Alternative Investment Fund (AIF) as a prime broker to meet settlement needs, banks act as principal intermediary between the institutional lenders and the AIF. An important service prime brokers provide in this case is credit intermediation. Only recently have institutions considered lending based on the credit quality of an AIF, preferring instead the generally higher credit quality and ratings of a bank or broker. Also, many AIFs do not have identifiable independent credit ratings that many lenders look for as part of a due diligence process.

Securities lending is dependent on demand by the ultimate borrowers of securities, whether an AIF, a bank or a broker for its own purposes. If there was no requirement to cover a failed delivery either by mismatched market making activities, from a short sale, or to ensure adequate HQLA for balance sheet purposes, then no activity would take place. Lenders and their agent lenders must wait on market demand; this is a borrower driven market.

Exhibit 5 - Participants in the traditional securities lending market



4. Master Agreements

Master agreements provide market participants with the opportunity to execute bilateral trading arrangements that reflect common trading terms and conditions. By adopting these standards, market participants can increase legal certainty and reduce residual legal risks. ISLA has been a long supporter of master agreements for the industry, supporting both the core Global Master Securities Lending Agreement (GMSLA) as well as undertaking periodical updates and enforceability work on a multi-market basis.

4.1 Title Transfer Model

The EMEA model of securities lending is typically based around the delivery of collateral on a full title transfer basis, where the lender has legal ownership of the securities that are received as collateral from the borrower.

The Global Master Securities Lending Agreement (GMSLA) was originally developed some thirty 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. 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. This was not practical.

The Title Transfer GMSLA structure was developed as a response to these problems. Its core mechanism is 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 overcollateralised, 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 recognised by laws around the world.

Because of the general overcollateralisation in favour of the lender, the borrower bears an exposure to the lender, and of course the Title Transfer GMSLA contains a margin maintenance mechanism to preserve the lender's overcollateralisation and thus the borrower's exposure.

4.2 Pledge Collateral Model

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. Taking and enforcing security over securities and cash collateral has become relatively straightforward in Europe.

Within a pledge arrangement, collateral is provided by way of a security interest. The collateral is held normally in the books of a tri-party agent in the name of the borrower but with a legally binding security interest for pledge over the relevant collateral account. Because full legal ownership of the collateral does not pass between the borrower and the lender, pledge collateral arrangements are treated differently from a balance sheet and Risk Weighted Assets (RWA) perspective than a title transfer. Consequently, a borrower may receive a different outcome when looking at its key binding constraints.

In certain circumstances, both lenders and borrowers in securities lending appear to favour the pledge model over transfer of title. Borrowers appreciate the reduced balance sheet cost, which remains a driver of business decision making through the firm.

For lenders, other benefits may accrue including better haircuts, lighter regulatory reporting requirements and potentially improved fees. ISLA has developed a new market standard GMSLA (Security Interest Over Collateral). This can be used by both parties entering into security interest arrangements.

The following table (Exhibit 6) summarises some of the main differences between the Pledge GMSLA and the 2010 GMSLA. This list is not intended to be exhaustive and should not be construed as legal advice. All market participants should take independent legal advice before entering into any form of contractual arrangements.

Exhibit 6 - Key differences between the Pledge GMSLA and 2010 GMSLA

Terms	Pledge GMSLA	2010 GMSLA
Parties' roles	One party is lender and the other is borrower.	Either party may be lender or borrower under any given transaction under the agreement.
Posting of collateral	Borrower provides collateral by transferring it to the secured account. Under ISLA's GMSLA security interest structure, the collateral is provided using a tri-party arrangement.	Borrower delivers collateral by title transfer to the lender.
Valuation of posted collateral	The value of the posted collateral is determined under the Control Agreement by adjusting the market value to take into account any specified haircut or margin percentage.	Collateral delivered by title transfer has its market value for the purpose of the margining calculation.
Collateral mechanics	The amount of any collateral transfer required is calculated on an aggregated basis across all transactions under the Pledge GMSLA.	The parties can choose to carry out margining on either an aggregated basis or a loan-by-loan basis.
Manufactured payments on collateral	There is no obligation on Lender to transfer interest or other distributions received on posted collateral because the collateral is in borrower's account, therefore borrower will receive the distributions directly.	Lender is required to make manufactured payments in respect of interest and other distributions received on posted collateral.
Manufactured payments on loaned securities	Borrower is required to make manufactured payments on loaned securities during the term of the relevant loan.	Borrower is required to make manufactured payments on loaned securities during the term of the relevant loan.
Termination	If any event that constitutes an event of default occurs and is continuing, but the non-defaulting party does not declare an event of default by notice to the defaulting party, the lender has the right to accelerate all loans. The non-defaulting party may prefer to use this provision to trigger exchanges of securities and cash, rather than to effect a close-out and pay or receive the net termination amount.	No equivalent provision as upon an event of default the lender has unrestricted rights to the collateral.
Borrower's warranties	Borrower represents that it has the power and authority to grant the security interest. It is the beneficial owner of all collateral to be credited to the secured account and Lender will obtain a valid and perfected first priority interest in such collateral, except to the extent subordinated to any lien which is routinely imposed on all securities in a clearing system.	No equivalent provisions because the representations relate to the security.

5. Securities Lending & Risk Management

The collateralised nature of securities lending, combined with robust daily mark to market (MTM) procedures and tried and tested legal frameworks, make securities lending a relatively low risk activity. However, there are risks that market participants should be aware of when undertaking securities lending. These should be understood, quantified and mitigated wherever possible. As with all investment strategies and activities, securities lending can involve certain potential risks.

The following table describes the main types of risks involved with securities lending activity, together with ways in which each one can be managed or mitigated through effective oversight, including agreements, indemnification, collateral guidelines, and internal controls and audit, to name but a few.

Type	Description
Borrower Risk The risk that the borrower defaults on the loan (for example, the borrower becomes insolvent and is unable to return the securities).	The lender must consider who they are willing to lend to and how much they are willing to lend.
Collateral Risk The risk that the value of the collateral falls below the replacement cost of the securities that are lent. If this happens AND the borrower defaults on the loan, then the lender will suffer a loss equal to the difference between the two.	Establishing rules governing collateral can be complex and lenders are advised to discuss this with their agent or adviser. A lender's collateral policy will affect the returns that are achievable (the riskier the policy, the higher the return). The main issue to be considered are: What is acceptable as collateral? Lenders must consider what types of collateral they are willing to accept. How much of any one type of collateral should be accepted? Lenders should place limits on the amount of any one bond or share that is received as collateral to avoid ending up with a concentration of one type of collateral that might prove more difficult to sell. What level of overcollateralisation is required? It is commonplace for a lender to require collateral that is worth more than the value of the loaned securities. The lender needs to decide what level of margin is required. In setting these policies, the lender and agent should take into account technical factors such as liquidity (i.e. the ease with which the collateral may be sold at a fair value), and price correlations between the loans and collateral (i.e. whether the price of the collateral is generally expected to move in line with the price of the lent securities).

Type	Description
Cash Collateral Risk The risk that the lender suffers a loss on the re-investment of the cash collateral.	Where a lender takes cash collateral, the cash must be reinvested to generate a return. The lender must ensure that the investment guidelines governing the investment of cash collateral are fully understood and provide an acceptable level of risk and return. Lenders should be aware of the liquidity risk inherent in the investment of cash collateral should investments need to be sold at short notice to return the collateral. This is likely to be a matter for consideration by someone with knowledge and responsibility for portfolio management decisions.
Intraday Settlement The risk that the securities being lent are delivered to the borrower before the collateral is received.	Lenders should consider whether they wish to receive their collateral a day before the loan settles to avoid this risk. At the end of this loan, lenders should ensure that their shares are returned before or at the same time as collateral is released back to the borrower.
Operational Risk This covers day-to-day operational risk matters, such as: What happens if shares that are sold are recalled late? What happens if the lender or its agent fails to claim for a dividend or other entitlement?	It is important that the lender understands if the agent takes responsibility for operational risks and in what circumstances, if any, they do not. If the lender is undertaking the lending activity directly then robust procedures need to be developed to protect against operational risks.
Legal Risk The risk that the lender's legal agreement does not provide full protection in the event that the borrower defaults.	Lenders should review their legal agreements (typically a securities lending authorisation agreement signed with their agent, and the agreement that the agent signs with the borrower). That latter should conform to commonly used market standard documentation. In case of any doubt it is recommended that the lender seeks professional advice.
Other Risks Consideration should be given to other non-financial risks, such as ethical or reputational risks which can sometimes arise as a result of investing activity.	Lenders should consider whether lending securities is consistent with their policies and investment objectives.

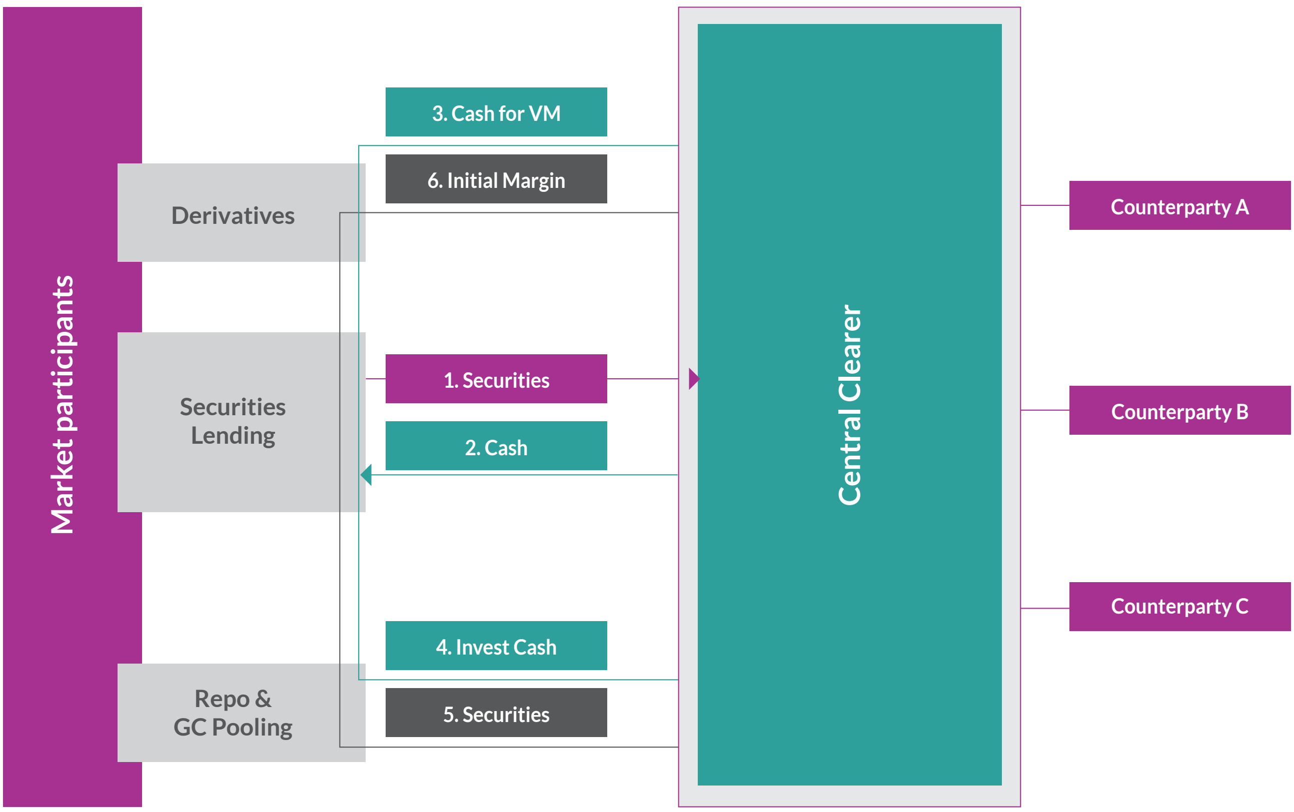
6. Other Routes to Market

Lending between institutional investors, agent lenders and banks is not the only model for securities lending transactions.

6.1 Central Clearing

The concept of a central counterparty (CCP) in securities lending has gained traction over the last decade due to regulatory pressure on bank balance sheets (see Exhibit 7). A CCP is market infrastructure that assumes responsibility for every trade through a process called novation: the CCP becomes the buyer for every seller and the seller for every buyer. In a CCP transaction, borrowers are able to lower their balance sheet capital based on a combination of the CCP's 2% risk weight, and the potential for netting. Lenders may one day find that pricing is better on a CCP due to lower borrower capital costs, but this has not happened as yet. It is expected that central clearing will become a feature of the securities lending market place, even if only applied to a subset of transactions.

Exhibit 7 - Integrated CCP cleared solutions for securities financing & collateral management



6.2 Direct Lending including Peer to Peer

Due to regional variations in regulation, collateral policies and financial market structure, some parts of the European securities lending market have employed a direct lending model (there are many instances of institutions lending directly to borrowers without the services of an agent lender). The popularity of direct lending is unique to Europe; in North America and Asia, the model has been built around the use of agent lender services, with direct lending as an outlier.

Direct lending is developing further nuances with the growth of Direct, Peer to Peer and All to All marketplaces. These electronic venues provide opportunities for lenders of cash and securities to meet borrowers with or without bank intermediation. Whilst the nature of the transaction has existed for decades, the business is seeing a new evolution, as major service providers enter the space with organised, structured product lines. These platforms challenge current ideas about who is a safe counterparty and provide opportunities for revenue generation and product expansion.

One key to the growth of Direct, Peer to Peer and All to All markets is the availability of borrower balance sheet, which in turn supports or limits credit intermediation. A plentiful supply of bank capital will augment the ability of banks to transact in the securities lending market, thereby reducing opportunities for non-bank borrowers. If banks can no longer borrow due to balance sheet constraints or can do so only at a high fee, then lenders and non-bank borrowers may turn to each other directly. The idea of eliminating the credit intermediation function of a bank and retaining any incremental income may sound attractive, but getting there can require careful analysis. Lenders may also want to retain agent lender indemnification, and agents and their clients may have different opinions about acceptable counterparties. Agent lenders may also face hurdles in providing indemnification to a non-rated, small hedge fund counterparty. This too could limit the growth of the market or result in higher costs for institutions that wish to engage.

7. The Value of Securities Lending to Capital Markets

Securities lending is a direct contributor to market efficiency, and bolsters liquidity management in open capital markets. Although securities lending originated in the era of paper certificates and missing or late delivery of partial holdings, it has maintained its key function of supporting operational functionality for meeting settlement obligations at banks and brokers. As a contributor to market liquidity and operational efficiency, securities lending transactions help create a reliable, trustworthy and transparent marketplace.

Securities lending is crucial to supporting capital markets financing in the European Union (EU), including Europe's more ambitious Capital Markets Union (CMU) project. The nature and form of securities lending means that it can operate at a number of levels across markets more broadly, ranging from supporting important market making activities, to being a key implementation tool of monetary policy.

Securities lending allows banks and other institutions to fulfil their obligations as market makers in debt and equity securities, giving them ready access to securities that they may not be holding.

The provision of secondary market liquidity aids overall market efficiencies and effective price discovery for institutional investors.

It has also been recognised for some time that as part of the broader investment landscape, short selling plays an important role in the investment markets today. As part of what is now a well-regulated activity, securities lending provides the necessary liquidity and access to securities to support this side of the capital markets.

From a prudential perspective, it is an essential tool used by EU financial institutions to meet their EU risk management regulatory requirements, thus helping to both manage and reduce systemic risk. EU legislation rightly requires banks and other market participants to hedge risk by 'collateralising' their exposures to counterparties.

The provision of secondary market liquidity aids overall market efficiencies and effective price discovery for institutional investors.

The mandatory bilateral margin requirements under EMIR for OTC derivatives is the best example of this. In terms of prudential legislation, banks are incentivised to hold high quality securities, such as government bonds, to ensure their own financial stability. The Liquidity Coverage Ratio (LCR) requirement for banks under the Counterparty Credit Risk (CCR) framework is one instance. Securities lending enables market participants to access the securities they need to help meet these obligations.

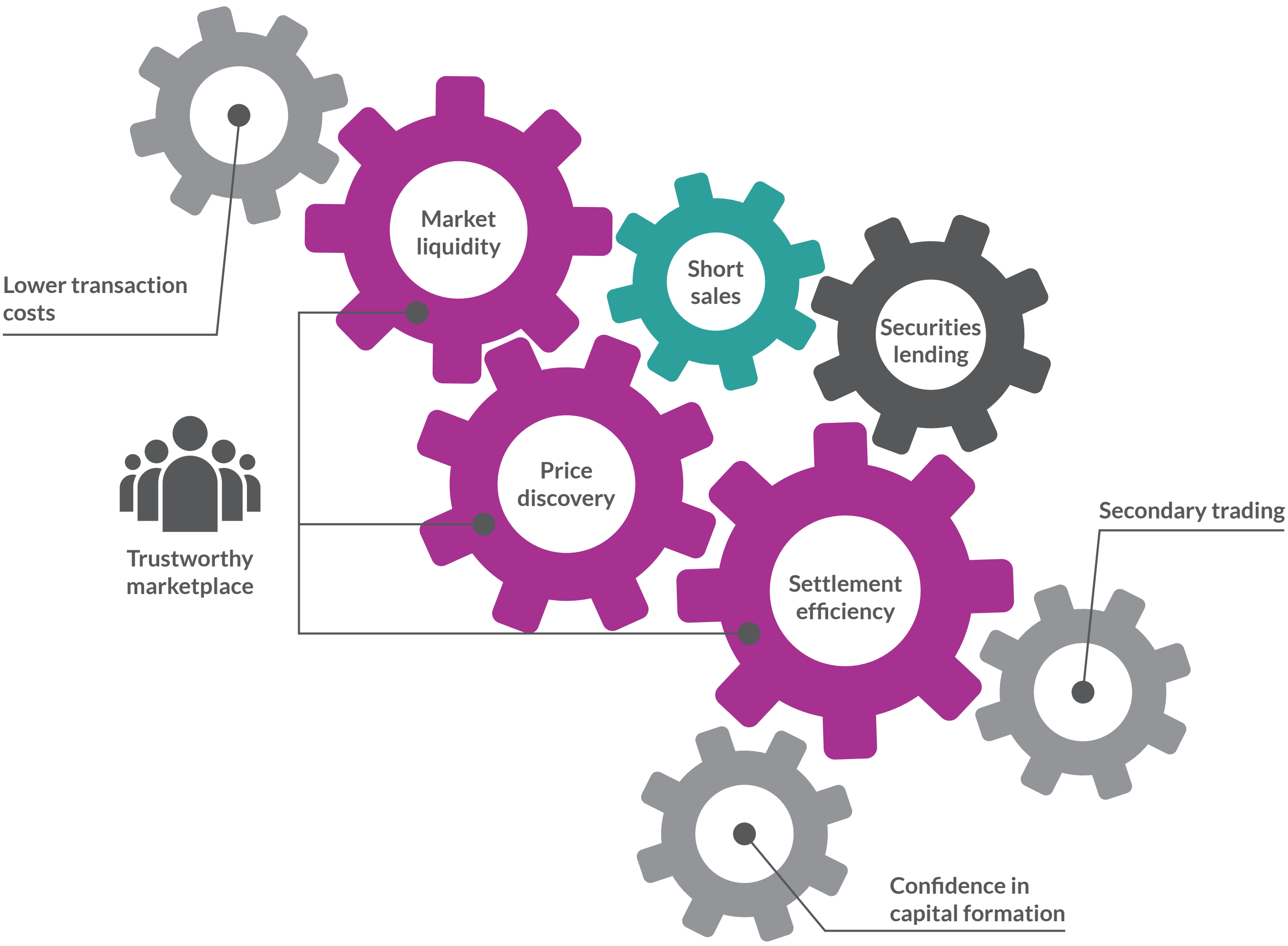
It can also play an important role in reducing operational risk and friction within the system, by helping to reduce the incidence of 'failed trades'. Where a market participant is aware of an imminent failing trade, they can borrow securities in the short term to cover settlement obligations.

For institutional investors including retail investors and pensioners, securities lending can provide incremental returns. By lending securities, investors receive a fee in return, which either flows directly to the end-investor or may be used to reduce management costs for the end-investor. In this regard, it can also be used as a driver to support the increase of retail participation in the capital markets.

The emergence of very low-cost retail investment products such as zero tracker funds is in part due to management costs being supported by the revenues from securities lending.

When used appropriately, securities lending can also stimulate good corporate governance, one of the cornerstones of the sustainable finance agenda. With the right incentives for investors to demand transparency on how their securities are lent and their voting rights used, securities lending can powerfully support the reorientation of investments towards sustainably friendly activities.

Exhibit 8 - Securities lending contributions to market efficiency and economic growth



The healthy functioning of capital markets is directly linked to that of the real world economy. Without the short selling that securities lending supports, wider bid-offer spreads mean that investors pay more to invest than they might otherwise.

This also increases costs for issuers. Policy makers should be aware of the broad consequences of existing and proposed regulations on the ability of banks to continue to support securities lending activities.

8. Revenue Generation for Retirement & Other Savers

The value of securities lending to retirement plans and other savers should be considered as an important feature of the product. Securities lending is intended to produce a consistent, incremental return for asset holders. However, securities lending is not intended as a core alpha or beta asset class; it is an incremental revenue stream, and may be more appropriately classified as 'additional alpha'.

In Europe, securities lending generated €2.3 billion in revenues for lenders in 2017, and 2018 was up 20%, according to data provider DataLend. The majority of these revenues are returned directly to pension, UCITS and insurance funds that are held by institutional and retail investors. While securities lending is often seen as a bank product, the reality is that it is firstly an investor-led product.

It is appropriate that not all funds lend, and not all portfolios carry the same value in the securities lending market.

Institutions and asset managers commit capital because they seek returns that are commensurate with the risk they assume.

Likewise, securities lending fits into the risk/reward profile of some firms but not others. However, those institutions that have elected to participate in securities lending can earn regular incremental returns.

Securities lending is intended to produce a consistent, incremental return for asset holders.

9. The Evolving EU Regulatory Environment

Regulation has become the most important factor in the securities lending business over the last 10 years. From Basel III to MiFID II to the Securities Financing Transactions Regulation (SFTR), European authorities have introduced new regimes that have reordered business priorities and even caused a reorganisation of basic business processes. Regulators and policy makers recognise the impacts their regulations have had on the financial services industry generally; this section provides an overview of the specific impacts to securities lending.

Markets Regulation

9.1 Securities Financing Transactions Regulation (SFTR)

Through SFTR, the EU aims to enhance transparency and enable regulators to better monitor risks by introducing reporting requirements for SFTs.
These requirements are similar to those already applicable to derivatives transactions under the European Market Infrastructure Regulation (EMIR). The regulation also introduces limitations on the reuse of collateral, not just in the securities financing markets but also in the wider collateral markets. . The initial phases went live in July 2020, delayed from April 2020, due to COVID-19. The final phase went live in April 2021.
An important component of the regulation is transaction reporting and record keeping requirements. The conclusion, modification or termination of an SFT must be reported to a Trade Repository (TR) that is registered or recognised in accordance with the SFTR.

Notwithstanding a few points of overlap with EMIR and MiFID II/ MiFIR, SFTR reporting requirements are distinct. The regulation includes over 150 fields, not all of which are required for every transaction, but all of which must be considered and accounted for. Furthermore, some of these fields have not historically been captured by technology platforms in securities lending, repo or collateral trading. This has complicated efforts to build reporting tools and led to wide-spread industry cooperation in sorting out procedures for compliance.

Like the record keeping requirements in EMIR and MiFID II, counterparties subject to SFTR are required to keep a record of any SFT that they have concluded, modified or terminated for at least five years following the termination of a relevant transaction. The record keeping requirements applied from 12 January 2015. Market participants need to ensure they have appropriate processes in place for data retention, or risk being in breach of regulatory requirements.

SFTR sets out controls on the reuse of financial instruments received as collateral under a collateral arrangement. A 'collateral arrangement' is included by reference to a security financial collateral arrangement or a title transfer financial collateral arrangement, in each case, as defined in the Financial Collateral Directive. A right of reuse of financial instruments received as collateral is subject to at least both the following conditions: (a) risks and consequences have been communicated in writing; and (b) prior express consent of the providing counterparty has been granted.
The exercise of a right of reuse is subject to at least both the following conditions: (a) reuse is undertaken in accordance with the terms specified in the relevant collateral arrangement; and (b) financial instruments are transferred from the account of the providing counterparty. Again, participants to a SFT must recognise and account for these requirements.

SFTR was adopted into UK law under the European Union (Withdrawal) Act of 2018, and UK based institutions began reporting SFTs under a UK version of SFTR following the end of the Brexit transition period on 31 December 2020.

9.2 Central Securities Depository Regulation (CSDR)

The CSDR was published in the Official Journal (OJ) of the EU on 28 September 2014, and its provisions generally came into effect on 17 September 2014. The regulatory technical standards for settlement discipline were adopted by the European Commission (EC) in May 2018, and after a period of scrutiny, the RTS was passed into law in September 2018. After a large number of industry bodies and associations advocated for a review of the settlement discipline element of the regulation, the European Commission recommended that the RTS for this element be delayed until February 2021. As a result of the pandemic in 2020, further delays to the RTS have been endorsed by the Parliament and of the Council.

The key issue of concern is around Mandatory buy-ins and their potential negative impact on market liquidity.

The CSDR settlement disciplines will apply to all market operators in the context of European securities settlement, and all European central securities depositories (CSDs). They will apply to all trading entities regardless of their domicile if they settle transactions on an EU CSD, either directly or via a settlement or clearing agent.

With regards to securities settlement, the requirements in the CSDR mainly apply to transferable securities as defined under MiFID II, money-market instruments, units in collective undertakings, and emission allowances which are admitted to trading or are traded on a trading venue or cleared by a CCP.

SFTs are captured by the scope of the CSDR whereby settlement disciplines and cash penalties will apply to all transactions, However, exemptions have been provided from the mandatory buy-in scheme for SFTs which are for less than 30 days term. The market requires further clarification for this exemption, specifically in respect to the scope and application of buy-ins. The ISLA membership advocates for SFTs to be excluded entirely form the buy-in element of the regime, arguing that securities lending is in itself a tool used to prevent fails in the cash market.

In 2020, the UK Government chose not to adopt the CSDR Settlement Discipline Regime which enters into force after the end of the transition period.

9.3 Securities Finance & MiFID II

The Markets in Financial Instruments Directive (MiFID II) and the Markets in Financial Instruments Regulation (MiFIR) impact securities finance, even though there are few direct references to the activity. The regulations went live in early 2018, and further codify best practices and increase transparency. The directive and regulation include any off-shore counterparty that transacts business with any EU entity, resulting in many non-EU institutional investors adopting MiFID II and MiFIR as their global regulatory standards.

MiFIR provides supervisors and regulators the right to intervene in markets under certain circumstances to suspend trading. One of the specific triggers that could create this scenario would be perceived unacceptable or unusual securities lending activity.

MiFID II has more immediate applications to securities finance. The requirement of best execution, as well as full disclosure of securities finance to underlying clients including the risks, is stressed. As securities lending is a market without a central limit order book like a stock exchange, best execution must be measured in terms of counterparty, collateral, fee and length of transaction, as appropriate. This has created a range of policies at lending firms and agent lenders that define what best execution is and how it can be achieved under MiFID II.

9.4 Short Selling Rules

The EU regulation on short selling and certain aspects of credit default swaps (CDS) came into force on 1 November 2012. The aim of the legislation was to provide greater transparency of short positions held by investors, reduce or eliminate settlement risks associated with uncovered or naked short positions, and give member states clear powers to intervene in exceptional situations to reduce systemic and market risks. Under the legislation, all short sales of shares and government bonds must be covered by either a borrow, or an arrangement with a third party confirming their location (i.e. naked short selling in shares is banned). The regulation also sets mandatory transparency requirements with significant net short positions being reportable to the relevant National Competent Authority (NCA). As long ago as June 2009, IOSCO noted that "short selling plays an important role in the market for a variety of reasons, such as providing more efficient price discovery, mitigating market bubbles, increasing market liquidity, facilitating hedging and other risk management activities". Today, short selling supported by liquidity from securities lending markets is an integral part of the investment landscape, allowing investors to express sentiment in this way.

Banking & Prudential Regulation

9.5 Basel Framework

Basel III is an internationally agreed set of measures developed by the Basel Committee on Banking Supervision in response to the financial crisis of 2007-09. The measures aim to strengthen the regulation, supervision and risk management of banks. Like all Basel Committee standards, Basel III standards are minimum requirements which apply to internationally active banks.

The Capital Requirements Directive IV (CRD IV) is an EU legislative package that contains prudential rules for banks, building societies and investment firms, and is intended to implement the Basel III agreement in the EU. This includes enhanced requirements for the quality and quantity of capital, a basis for new liquidity and leverage requirements, rules for counterparty risk and macroprudential standards including a countercyclical capital buffer and capital buffers for systemically important institutions.

The rolling impacts of Basel III/CRD IV have significantly changed how borrowers think about certain elements of their securities lending business, with new leverage hurdles, minimum liquidity requirements and more stringent counterparty risk parameters changing behaviour.

9.6 Leverage Ratio (LR)

Within the Basel regulatory framework, the Leverage Ratio (LR) is defined as Tier 1 capital divided by a non-risk-based measure of an institution's on and off-balance sheet items. In Europe, a bank's on and off-balance sheet items, that are also known as the exposure measure, must meet a minimum 3% leverage LR requirement at all times. SFTs, including securities lending transactions, fall within the scope of the LR which acts as a natural limiter to restrict the build-up of leverage in the banking sector. The LR also compliments the other risk based measures within the Basel framework, by providing an additional simple non-risk based 'backstop' measure.

The application of the LR combined with the incremental impact of other binding capital constraints, particularly on the borrower community, can at times have a significant impact on lending volumes and overall market liquidity. The market is continuing to adapt to absorb the impact of these pressures, and on a day-to-day basis is currently performing well. Nonetheless, there have been points in time, particularly on or around reporting dates (such as quarter-ends) where the market has been seen to be under some stress.

Given that the role of securities lending and collateral markets is at the heart of the financial system, it is important to monitor both the effectiveness of this measure as well as the ongoing and unintended consequences that it may have in terms of adverse impact on market liquidity.

9.7 Liquidity Coverage Ratio (LCR)

The Liquidity Coverage Ratio (LCR) measures whether a bank has sufficient HQLA to survive 30 days of a significant liquidity stress scenario, by which time it is assumed that appropriate corrective actions could be taken by the relevant parties. HQLA must be unencumbered, or 'not pledged to secure, collateralise or credit-enhance any transaction'. Securities lending and collateral management negatively impacts the LCR, although firms have generally found that the LR is the more stringent requirement. Still, the LCR requires additional reports for securities finance teams and occasional requests to alter counterparties to transactions, if credit exposure levels are too high. The implementation of the LCR has led to the active development of a term HQLA securities lending market where borrowers secure HQLA assets for periods in excess of 30 days, with these assets then eligible to be included within the banks LCR calculation. The requirements of the LCR and in particularly the minimum 30 day term of such trades, may in part explain the declining appetite to borrow HQLA from UCITS, who typically are unable to lend for periods in excess of seven days.

9.8 Net Stable Funding Ratio (NSFR)

The Net Stable Funding Ratio (NSFR) requires a minimum amount of stable sources of funding at a bank relative to how liquid the assets are, as well as taking into account off-balance sheet commitments, over a one-year period. The purpose of the NSFR is to encourage a more robust and focused assessment of liquidity risk across all on and off-balance sheet items. The NSFR adds costs based on specific counterparty types, and can create an extra asset/liability mismatch penalty when securities are borrowed from one type of counterparty with a set duration and loaned to another type with a different duration. Most banks are now factoring in the NSFR to their securities finance activities. Similar to the LCR, NSFR requirements may force a change of counterparties, but otherwise the LR remains the gating factor.

9.9 Large Exposures Regime

Under the large exposures regime within Basel III, banks worldwide are limited to how exposed they can be to other banks. As one example, a global agent lender may have a 15% total exposure limit to a prime broker borrower across all products. Indemnification would be one small part of the business, with FX, OTC derivatives and repo as potential candidates for other product relationships. The regulatory cost of indemnification and the profitability of securities lending must be considered across this product mix. If the profitability or importance of securities lending is not viewed as high as other products, then securities lending will see a reduction in credit line with the one counterparty. Business can still be conducted via intermediaries but that will increase costs for the original participating bank and their underlying clients.

9.10 Mandatory Haircuts

The 2018 Basel III package included a standard to introduce mandatory haircuts to SFTs, including securities lending and borrowing in the bank capital framework. The EC is committed to implementing this within the Basel IV package in Europe in 2020. Advice from the European Banking Authority in 2019, building on earlier analysis by the EC, ESMA, and the European Banking Authority (EBA), recommended to delay with the transposition of mandatory haircuts in the EU at this point. The EBA, similarly to the 2017 EC assessment of minimum haircuts, argued that more data is needed to assess the impact of introducing minimum haircut floors in the EU, and that such a thorough data analysis might only be performed once the SFTR reporting regime is fully implemented.

9.11 Bank Recovery and Resolution Directive (BRRD)

The Bank Recovery and Resolution Directive gives resolution authorities wide-ranging powers across Europe to manage failing financial institutions. These include powers to write down debts owed to creditors, convert debt to equity, or impose temporary 'stays' on termination rights. Cross-border recognition of such powers is built into the EU legislative framework.

However, there is no international law for the recognition of the exercise of foreign governmental powers. Various legislative measures and regulatory steps have been taken to address this potential impediment to the resolution of a regulated entity, including requiring regulated entities to provide for a clause in non-EU law governed contracts by which their creditors agree to and recognise the bail-in or temporary stay powers of the relevant resolution authority.

As part of a desire to eliminate close-out rights triggered by the potential cross-border resolution of G-SIBS, home authority regulators requested ISLA to amend the GMSLA master agreements with the addition of so-called 'stay' provisions.

9.12 Securities Finance & Total Return Swaps (TRS)

Following 2008, securities lending and collateral management became part of the regulatory scrutiny around OTC derivatives. A further complicating matter for securities lending is the preferential treatment afforded to derivative transactions, under both the Basel Committee's Current Exposure Method (CEM) and Standardised Approach for measuring Counterparty Credit Risk (SA-CCR). These methodologies create incentives for market participants to substitute securities lending transactions with economically equivalent derivative instruments (Total Return Swaps) to obtain better capital treatment.

Synthetic finance using swaps in place of physical securities lending transactions is now a recognised and established part of the overall prime brokerage service model.

However, a wider shift towards synthetic finance has not been seen in market-level securities lending transaction data, with most lenders of securities still preferring the physically settled markets. Also and not withstanding the capital benefits associated with certain derivative transactions, some synthetic transactions still require a physical borrow to hedge the position. As the market grows, it is likely that synthetic transactions will increase exponentially until or unless the regulatory treatment of SFTs equalises between synthetic and physically settled transactions.

Investor Protection Directives

9.13 Undertakings for Collective Investment in Transferable Securities (UCITS)

The Undertakings for Collective Investment in Transferable Securities (UCITS) Directive was adopted in 1985, and aimed to offer greater business and investment opportunities for both asset managers and investors by creating a single market for investment funds across Europe. The various UCITS Directives set out a harmonised regulatory framework for investment funds that raise capital from the public, and invest it in certain asset classes, providing high levels of investor protection and a basis for the cross-border sale of these funds. The UCITS framework sets out some clear responsibilities in respect of securities lending. Fund prospectuses are required to outline the role of securities lending in the context of the fund's investment strategies and portfolio optimisation techniques. Ongoing reporting of securities lending activities are also required as part of the fund's annual reporting outputs, and further scrutiny has also been sought by the EC regarding the level and proportion of securities lending fees retained by asset managers.

9.14 Alternative Investment Fund Managers Directive (AIFMD)

The Alternative Investment Fund Managers Directive (AIFMD) is a regulatory framework for Alternative Investment Managers (AIFs), including hedge fund managers, private equity firms and investment trusts. The primary objective of the Directive is to implement a framework for the regulation and supervision of investment funds, to increase transparency and to ensure greater investor protection. AiFMD requires certain operational structures, particularly around the role of depository banks that can have implications for asset segregation and the management of collateral received from borrowers.

10. Conduct & Governance

Following the global financial crisis of 2007/8, not surprisingly we saw governments move to bolster and develop the regulatory oversight of financial markets. In Europe, we saw the growth of groups such as the European Securities Markets Authority (ESMA), the various NCAs as well as the FSB at a global level. In turn, the work of the regulatory community has logically led to a specific legislative agenda, with MiFID and SFTR changing the regulatory landscape.

Set against this backdrop, we have seen the emergence of several binding mandatory frameworks that have been augmented with the development of various codes of conduct and best practice regimes. At the same time, we have also seen the rise of the shareholder engagement agenda that is formulating policy today. In the UK, that has been in the form of the Senior Managers Regime (SMR), that binds individuals with legal responsibility for their conduct and behaviour. ISLA was part of a market-wide group that developed the Bank of England (BoE) sponsored Money Markets Code (MMC). This code sets minimum standards for the securities lending markets in terms of conduct and business practices, and although not technically a regulation, its status as a recognised code under the UK's Financial Conduct Authority (FCA) SMR provides many of the same outcomes as formal legislation. The growing voice of sustainability within the investment community has led to the development of the Shareholders Rights Directive (SRD), that sets out clear principles for the behaviour of responsible investors in the context of the broader Economic Social Governance (ESG) debate.

11. What Can Regulators Do to Support Securities Lending?

There is a virtually complete acceptance by all participants in the securities finance industry that increasing levels of regulatory scrutiny and applied regulation are here to stay. Regulators can use this opportunity to effectively oversee securities lending while at the same time, ensure that capital markets receive as much benefit as possible from the business.

The mutual goal of the industry and supervisory bodies is the pragmatic, acceptable and successful implementation of proposed current and future legislation. A cooperative stance offers the greatest benefit for all participants. Four steps can help improve the dialogue and successful outcomes between regulators and market participants:

1.

Define the problem. Regulators distinguish between helpful behaviour in capital markets that support growth, and non-helpful behaviour that generates income without regard for the real economy. As regulators can best determine an ideal market and economic outcome, market practices can be traced back to find means of promoting supportive practices on securities lending desks.

2.

Engage market participants. Securities lending participants at all points of the value chain welcome the opportunity to speak with regulators about their business. When regulators have a more complete view of the industry, they in turn can target specific regulation, allow for exceptions where appropriate, and help craft strategies for practical implementation. Market participants can also be a source of ideas: nearly all agree for example that the LCR works as intended, but that the LR does not.

3.

Align implementation of specific regulations with end goals. If regulators want vibrant stock exchanges, and short selling is one component, then securities lending transactions that support short selling should be encouraged. A current dilemma is that regulations have inadvertently preferenced some OTC derivatives over physical securities lending transactions; regulation could be established that reverses this trend where supporting market liquidity is concerned. Creating regulation with specific end goals can also rely on data analytics, some or all of which can be completed by market participants themselves.

4.

4. Reduce conflicts across regulatory objectives. Diverse regulations impacting different types of market participants have created adverse reactions to participation in securities lending. For example, the LCR encourages market participants to conduct term trades yet UCITS rules prohibit trades in excess of seven days. A better mapping of regulatory requirements to support core directives would assist the industry with compliance while enabling more and diverse types of firms to participate.

ISLA and market participants welcome the opportunity to further engage with the regulatory and policymaking community. An ideal way to start the engagement is informal discussion about the state of the business and how that meets regulatory objectives in broader capital markets.

About ISLA

Who are we?
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's geographically diverse membership of over 155 firms, includes 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 policy makers, ISLA advocates the importance of securities lending to the broader financial services industry. 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 20 jurisdictions globally.

How do we do it?
Through member working groups, industry guidance, consultations and first-class events and education, ISLA helps to steer the direction of the industry and is one of its most influential voices on the European and global stage.

About Finadium

Finadium is a consultancy focused on securities finance, collateral and derivatives in capital markets. In its research practice, the firm assists institutional investors, banks and service providers in maximizing the effectiveness of their resources. Finadium conducts consulting assignments on vendor selection, marketing, product development, operations and technology. For more information, please visit our website at www.finadium.com. Finadium publishes the daily news and opinion site Securities Finance Monitor.

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