

Quarterly Securities Lending Market Commentary

JULY 2023

In collaboration with a range of agent lender and borrower member firms, ISLA Digest is a quarterly market commentary that looks at some of the recent trends and driving forces behind securities lending and financing market activity. ISLA would like to thank the contributing firms for their continued support*.

Macro Reflections & Market Drivers

The second quarter of 2023 in Europe has not been short on talking points. The Russia/Ukraine war continues to persist contributing to supply-side shortages adding fuel to the inflation fire. The financial sector went through another mini crisis as Silicon Valley Bank became insolvent, had to be bought out, and contagion spread across other US regional banks with further forced buyouts and support from the FDIC to guarantee retail deposits.

After multiple years of low interest rates, excess liquidity and low inflation, we fast-forward to find the global economy suffering high inflation, multi-year high interest rates and further excess liquidity. Central banks are in a precarious position as they need to get the balance right to avoid their domestic economies tipping into a deep recession.

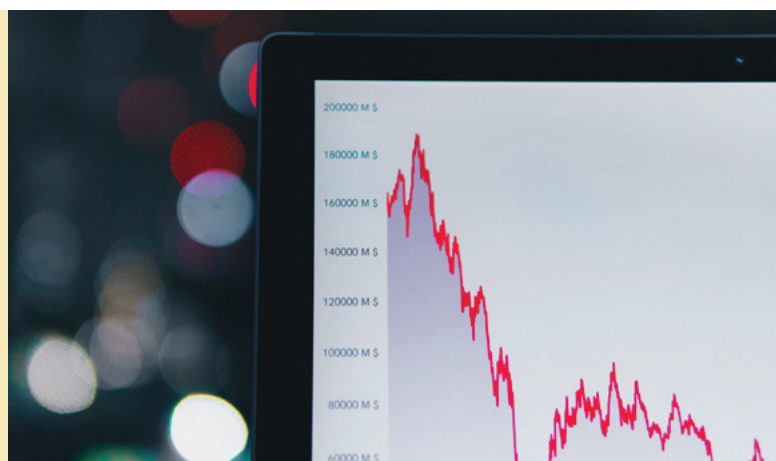
Central banks are mandated to control inflation hence the historic rate increases, but they need to avoid stagflation which is a period when slow economic growth, higher unemployment, and higher prices collide. The recent \$500bn European Central Bank (ECB) Targeted Longer Term Refinancing Operations (TLTRO) repayment in June has led to lower-grade collateral returning to the market. We've already started to see demand for High Quality Liquid Asset (HQLA) and collateral funding off the back of this which will contribute to a strong second half of the year.

Finally, we saw the usual uncertainty around the US debt-ceiling – would they or would they not approve an increase in spending – although the outcome was not unexpected, the late decision put pressure on borrowers to unwind US Treasury borrows that were due to mature or pay coupon whilst some Bills demanded over 200bps, multiple times their usual trading levels.

Trading

Hedge Fund positioning in Q2 was characterized by low conviction, shorts were mostly added around Utilities and IT, while covers were mostly driven by industrials and real estate, although real estate remains a focus in terms of potential shorts, and balance sheet repair. Earnings season also played a significant role in positioning, and the overall delta was slightly better to short over the quarter.

Overall, shorts reduced significantly in Europe compared to the last year, and so has borrow balances in Europe.



Once again market trends are mostly towards covering at the index level, with SX5E shorts decreasing materially across dealers, resulting in enhanced liquidity for main index equities over the past couple of months.

In contrast, demand for US equity specials was particularly strong. AMC Entertainment leading the way, GameStop, Beyond Meat and Lucid Group also generating solid revenue for lending clients.

In EMEA, the most shorted sector was real estate and property management, driven by elevated interest rates. SBBB SS in Sweden (Swedish real estate), Orpea (French nursing homes), HAPAG Lloyd (German shipping company) and Victoria PLC (flooring product manufacturer) were particularly strong revenue generators.

Looking further afield demand for Taiwanese equities has been a standout amongst the APAC equity markets.

In fixed income, demand for corporate bonds has been a highlight, driven by higher interest rates putting pressure on cash-starved companies. Demand for HQLA remains strong as always, particularly for Bunds, Gilts and United States Treasury (UST). We have also seen an increase in demand to finance corporate bonds since the ECB repaid \$500bn in TLTRO in June.

Financial Resource Management & Regulatory Developments

Capital optimisation has been a common talking point across all market participants the last couple of years but with Basel IV getting ever closer, the topic has taken centre-stage again.

Central Counterparty Clearing (CCP) is picking up pace, with several offerings in EMEA and the US on the horizon, and borrowers and lenders showing commitment to work together on a solution.

The 2% Risk Weighted Assets (RWA) for counterparts facing a CCP is appealing, as well as the simplicity of onboarding one counterpart, with one set of Standard Settlement Instructions (SSIs), as well as borrowers being able to access Undertakings for Collective Investment in Transferable Securities (UCITS) supply indirectly which would otherwise be capitally suboptimal if facing an agent lender directly.

Borrowers interest in Pledge collateral has had a recent resurgence, after having largely fallen off the radar the last couple of years. US borrowers are exploring Pledge-back structures whereas those in EMEA are revisiting Global Master Securities Lending Agreement (GMSLA) Security Interest ('Pledge').

More specifically on the dealer side it doesn't seem there is any particular binding constraints driving specific demand for structures at the present time. The liquidity in synthetic sourcing did increase post yield-season and collateral optimization is back in terms of optimizing short covering.

Also, borrowers continue to access lending clients through smart bucketing to face low-RWA clients, especially over quarter-ends.

In general, borrowers are still sensitive to Liquidity Coverage Ratio (LCR). There continues to be demand for 35 day plus funding, as well as an increase in demand for longer term funding, particularly USTs vs Japanese Government Bonds (JGBs) in the 6 months plus over year-end.

Infrastructure

The market is preparing for US and Canadian equity markets to move to a T+1 settlement cycle in May 2024.

One of the main concerns is the current market infrastructure to communicate sales from a client's investment manager to the end-user, via, at least, the agent lender and bank/broker borrower, is still hamstrung by communications delays having remained mostly unchanged for many years. Not only will T+1 put pressure on domestic counterparts, but there is also the added issue that a global marketplace with international counterparts brings to the equation. For example, a London-based borrower of US equities from a US domestic lender will receive recalls in their evening on T+0, meaning they will need to return recalls on settlement day if they are unable to leverage a US operations team to start to work on the recall on the day.

Depending on how successful implementation is, and what the regulators decide to do about buy-ins, there may be a need for lenders to reduce liquidity by maintaining greater buffers than they do today, to help minimise market fails. On a positive note, post-trade vendors are working with the market on solutions to message, track and process recalls in a much more efficient manner than today's process which largely relies on bilateral communications, such as email and Bloomberg messaging.

CCP for Securities Financing Transactions (SFT) is another challenge the market is working to solve. From an Agency lending perspective, we need to ensure we can onboard clients to the platform with as light a lift as possible, and that there is no friction added to processing collateral, recalls, billing etc. Managing events of default will also need to be robust to ensure clients are no less protected than they are today.

Environmental, Social & Governance (ESG)- Is screening of collateral becoming more common?

Client enquiries related to collateral screening for ESG remain concentrated to managers running ESG funds. Clients do need to consider the risk that, by screening out collateral assets, they could create concentration risk if they find themselves with a less diverse collateral pool. Most managers identify collateral primarily as a risk mitigation tool, not an investment tool. Clients have no economic interest in the performance of the collateral securities, however, the most important factor is the liquidity of the collateral.



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