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The end of the beginning

Jonathan Lee of Kaizen Reporting explains how his firm is bringing novel solutions to lingering reporting issues and how Brexit creates double jeopardy for regulatory compliance


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BMO exits agency lending

Mitsubishi UFJ Trust and Banking Corporation (MUTB) has inked a deal with Bank of Montreal (BMO) to take on its entire book of clients under its agency securities lending programme in a move designed to significantly enhance its North American footprint.

The Canadian bank is understood to be exiting businesses its senior management consider to be non-core.

Earlier this month, BMO Financial Group concluded a deal to hand over its asset management business covering clients in Europe, the Middle East and Africa to Ameriprise Financial.

The latest deal is thought to be mutually beneficial for both parties as BMO has been seeking to exit the agency lending business for the past year, while MUTB, which has been building out its third-party lending service since 2019 and is seeking to grow outside of its established Asian foundation, will welcome BMO's large, North American client base.

SFT understands that the agreement, which was concluded in February, will see MUTB, the trust banking arm of the Mitsubishi UFJ Financial Group, assume responsibility for trading on behalf of BMO's clients this month, with some operational services transitioning over later this year.

Most of BMO's securities lending team are not expected to be taken on by MUTB, with Christopher Kunkle, who served as head of agency lending since 2015, and Daniel Hoover, BMO's head of distribution/sales since 2014, having already parted ways with the bank.

Kunkle declined to comment on the deal other than to confirm he has left BMO and to say he is open to new opportunities in the coming months.

Meanwhile, MUTB has been on a hiring spree since Tim Smollen took the reins of the global agency lending solutions business in January 2020.

Most recently, the Japanese banking group's global securities lending solutions group (GSLS) gained Thomas Ryan from Deutsche Bank, as head of asset and liability management for the Americas and head of trading for the bolstered client base under the leadership of Anthony Toscano, who oversees the North American business.

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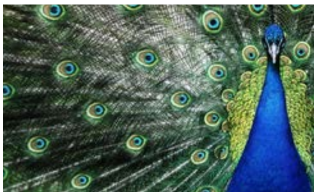

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BMO exits agency lending

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The acquisition of BMO's clients is a major step forward in MUFG's vision of becoming the first Asian bank to assume a leading position within the global securities financing marketplace.

The journey began with the appointment of Smollen and his team from Deutsche Bank.

Beyond the personnel, MUFG Investor Services, the global asset servicing arm of Mitsubishi UFJ Financial Group, selected EquiLend Spire's securities finance system as its core global platform to expand its front, middle and back-office securities lending systems.

EquiLend Spire is the product of a partnership between EquiLend and Stonewain Systems and offers a modular and scalable securities finance solution for compliance, reporting, risk analysis, accounting, positions and trading.

BMO and MUFG declined to comment on the deal.

Pass test to invest, South Korean regulator tells retail short sellers

The South Korean financial regulator says the measures, designed to protect and enhance opportunities for retail investors to engage in securities lending and short selling announced in February, will come into effect from 3 May.

The Financial Services Commission (FSC) says 17 securities firms will provide securities lending services worth between KRW 2 trillion (USD 1.78 billion) and KRW 3 trillion (USD 2.67 billion), up from only six offering these services today.

An additional 11 will join the market throughout the year. The regulator expects a total of KRW 2.4 trillion (USD 2.15 billion) in securities will become available to lend for KOSPI 200 and KOSDAQ 150 stocks as of 3 May.

Unlike institutional or foreign investors, retail investors will be guaranteed a maximum 60 day period of stock borrowing.

The FSC has placed several guardrails on the financing and short selling markets for retail investors and erected several educational barriers to entry, which the regulator hopes will protect them from "excessive loss".

Under the new rules, investors must have securities lending agreements with their trading firms and those without an account must create one.

Additionally, those with no investment experience must undertake mock trading programmes and educational exercises administered by the Korea Exchange (KRX) and the Korea Financial Investment Association, the FSC says.

How much cash retail investors can get their hands on will depend on their prior experience — total novices, for example, will be restricted to borrowing KRW 30 million (USD 26,936). The cap increases in line with an investor's experience and is then removed for investors with more than two years of experience or those who are considered professional investors.

Retail investors are also subject to the restrictions from participating in a company's capital increase via issuing new shares once the company has made such a plan public.

If an investor has shorted a company's stock within the period of one day after the

announcement of the company's capital increase plan until the determination of the issuing price, the investor is not allowed to participate in the company's capital increase.

A monetary penalty of up to 1.5 times the undue profit gained from violating this rule can be imposed.

Investors with net holding balance above a certain level due to short sale activities should report to the FSC and the KRX.

A monetary penalty of up to KRW 30 million (USD 26,936) can be imposed for violating this rule on each incident.

State Street to launch ESG securities lending collateral investment strategy

State Street intends to establish an environmental, social, and governance (ESG)-focused commingled cash collateral reinvestment strategy for its agency lending programme.

The agency lending team of State Street Global Markets has partnered with State Street's asset management business, Global Advisors (SSGA), to provide pension plan clients with new ESG tools informed by its Global Advisors' R-Factor — a proprietary scoring system for listed companies.

This tool is used to measure the performance of a company's business operations and governance as it relates to financially material ESG challenges facing the company's industry.

According to SSGA, the R-Factor is "the first ESG scoring system that offers companies a roadmap on how to manage and disclose their ESG practices, allowing them to take the action needed to enhance their scores".

SSGA says the R-Factor addresses the current challenges with data on sustainable financing by removing opaqueness around ESG materiality in the scoring process, by drawing on multiple data sources and leveraging transparent materiality frameworks from the Sustainability Accounting Standards Board — a non-profit organisation, founded in 2011 to develop sustainability accounting standards — and corporate governance codes.

State Street Global Markets' global head of client management — securities finance, Francesco Squillacioti, tells SFT the fund is "preparing to launch" and he anticipates a late May or early June rollout, "but that is subject to change".

On whether the underlying clients or State Street's traders will use the new ESG-focused cash strategy, Squillacioti says that securities loans — where the collateral is cash — generate cash collateral to be reinvested. "Based on a participating client's securities loan activity, cash will be invested using this strategy," Squillacioti adds.

Squillacioti also tells SFT that State Street is exploring plans to cover other client types, "but no timetables have been determined".

The new investment strategy, which will follow short-term investment guidelines to the extent consistent with applicable law, is currently available only to retirement plan clients that participate in State Street's agency lending programme, because pension plans are a large and important client base for State Street, Squillacioti says. However, the firm is looking into making this strategy available to other fund types in the future, Squillacioti adds.

Executive vice president and head of global markets at State Street Global Markets Nadine Chakar says: "The continued rise in interest in ESG principles across markets underscores client appetite for their securities lending strategies to work in synergy with their ESG strategies. This move builds on State Street's commitment to leadership and innovation in applying ESG principles to cash reinvestment for securities lending."

Senior managing director and global head of cash management at SSGA Pia McCusker says: "As a firm, State Street Global Advisors has firmly committed to ESG principles [and] partnering with State Street Global Markets, one of the largest securities lending cash collateral managers in the world, is a natural and logical combination and one that supports institutional investors' ESG goals."

Pirum adds bilateral trading module to CollateralConnect platform

Pirum Systems has built out its global CollateralConnect service to give clients the ability to manage all their bilateral secured financing activity, in addition to their triparty trades in a single platform.

CollateralConnect aims to address the challenge firms face in moving away from a siloed approach to collateral management towards a consolidated, holistic solution — an industry-wide trend driven by new regulatory requirements such as the Uncleared Margin Rules and the Central Securities Depositories Regulation.

The new bilateral trading functionality is offered as a stand-alone module under the established platform, enabling clients to manage securities lending, repo and derivatives margin relationships across multiple collateral venues globally, Pirum says.

Since launching in 2017, CollateralConnect now sees collateral volume valued at more than $1.5 trillion pass through the platform each day.

The product development is the latest step in Pirum's FutureTech Initiative which launched in January by CEO Phil Morgan, who took over from Rajen Sheth last year.

Todd Crowther, head of innovation and collateral services at Pirum, says: "Pirum's extensive connectivity to various collateral venues, coverage of all collateralised products and our turn-key integration with a client's books-and-records enables firms to connect quickly and easily to the broader collateral network and both accelerate the delivery of benefits while simultaneously lowering the execution risk of implementing such a far-reaching solution.

"For many clients, the appeal of CollateralConnect is not only what it delivers by way of functionality and associated benefits but additionally, where data and connectivity are consolidated, it also provides the basis for enhanced collateral optimisation, increasingly a key focus for both Pirum and the market at large."

BNY Mellon clients can now collateralise Chinese assets

For the first time, BNY Mellon's clients are able to use Chinese bonds as collateral for a variety of purposes via its triparty platform.

The service allows investors to better utilise their Chinese fixed-income assets by leveraging Hong Kong's Bond Connect, which allows international investors to access the $13.9 trillion China Interbank Bond Market.

BNY Mellon's new solution enables clients to begin utilising these assets as collateral.

According to BNY Mellon, until now, there has been no mechanism to allow participants to use Bond Connect assets as collateral.

The investment banking firm says that demand for an assets-as-collateral solution had been growing due to anticipated growth in the Chinese fixed income market.

Once the assets are within the triparty platform, clients can mobilise and optimise the securities as collateral in transactions with counterparties across the globe, the bank says.

Importantly, BNY Mellon says the new platform is entirely custody agnostic, so clients can use it as a triparty agent without custodying assets.

The first trade, printed the first week of April 2021, enabled a broker-dealer client to collateralise Chinese government securities through the new triparty solution, the bank says.

Under the transaction, it accessed the client's bonds, which were under custody at HSBC, and reflected the assets in BNY Mellon triparty, enabling the client to use the collateral for financing and other purposes.

Asia Pacific head of clearance and collateral management Natalie Wallder says: "Enabling clients to collateralise Chinese bonds through triparty is a service that has the potential to revolutionise the global collateral landscape.

"China is a hugely important market and one that will only become more integral to investors in the years ahead. Having the ability to utilise Chinese stocks, and now bonds, as collateral promises to be transformative for clients."

FSC finalises beefed-up short selling rules

The FSC has amended the Enforcement Decree of the Financial Investment Services and Capital Markets Act with stricter penalties for naked short selling in anticipation of lifting the short selling ban on 3 May.

The revisions have introduced new penalties on illegal short sale activities, record-keeping requirements on securities lending agreements and restrictions on short sellers' participation in capital increase.

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No-action period on 15c3-3 lending programmes ends

The grace period for US broker-dealers operating fully-paid lending programmes that do not comply with the requirement to physically transfer collateral expired last week.

In October, US SEC staff raised concerns that several broker-dealers were believed to be contravening Rule 15c3-3's customer protection requirements by retaining control over the collateral used to secure their borrowings of fully paid and excess margin securities.

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ESMA's first SFTR data quality report makes light reading

The European Securities and Markets Authority (ESMA) has published a report on the data integrity of both SFTR and EMIR — the first since the introduction of both reporting regimes.

Designed to assess the quality of data reported by trade repositories, the report gives an overview of actions taken by both ESMA and various national competent authorities to enhance both regulatory regimes.

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More industry news

ISLA publishes new GMSLA legal opinion for Belgium

The International Securities Lending Association has released the final bankruptcy remoteness opinion to support the global master securities lending agreement (GMSLA) written under Belgian Law by Freshfields Bruckhaus Deringer.

The second version of the GMSLA was released in 2019 to accommodate pledged collateral.

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BNY Mellon now offers FICC-sponsored repo

The bank says the addition of cleared repo to LiquidityDirectSM means it can provide a secure, centrally cleared solution that offers counterparty diversity and potentially enhances yields.

Since 2017 cleared repo through the Fixed Income Clearing Corporation has emerged as an important short-term investment option for liquidity providers, especially after changes in entry requirements increased the community of investors eligible to utilise the product.

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Sharegain and GVC Gaesco to bring SBL to Lux funds

Sharegain promises to provide access to the securities lending market to the likes of small-and-medium-sized asset managers, private banks, high-net worth individuals and online brokers.

Securities lending is a common practice among European asset managers but Spain is currently the only major European economy that restricts securities lending on funds domiciled in its territory.

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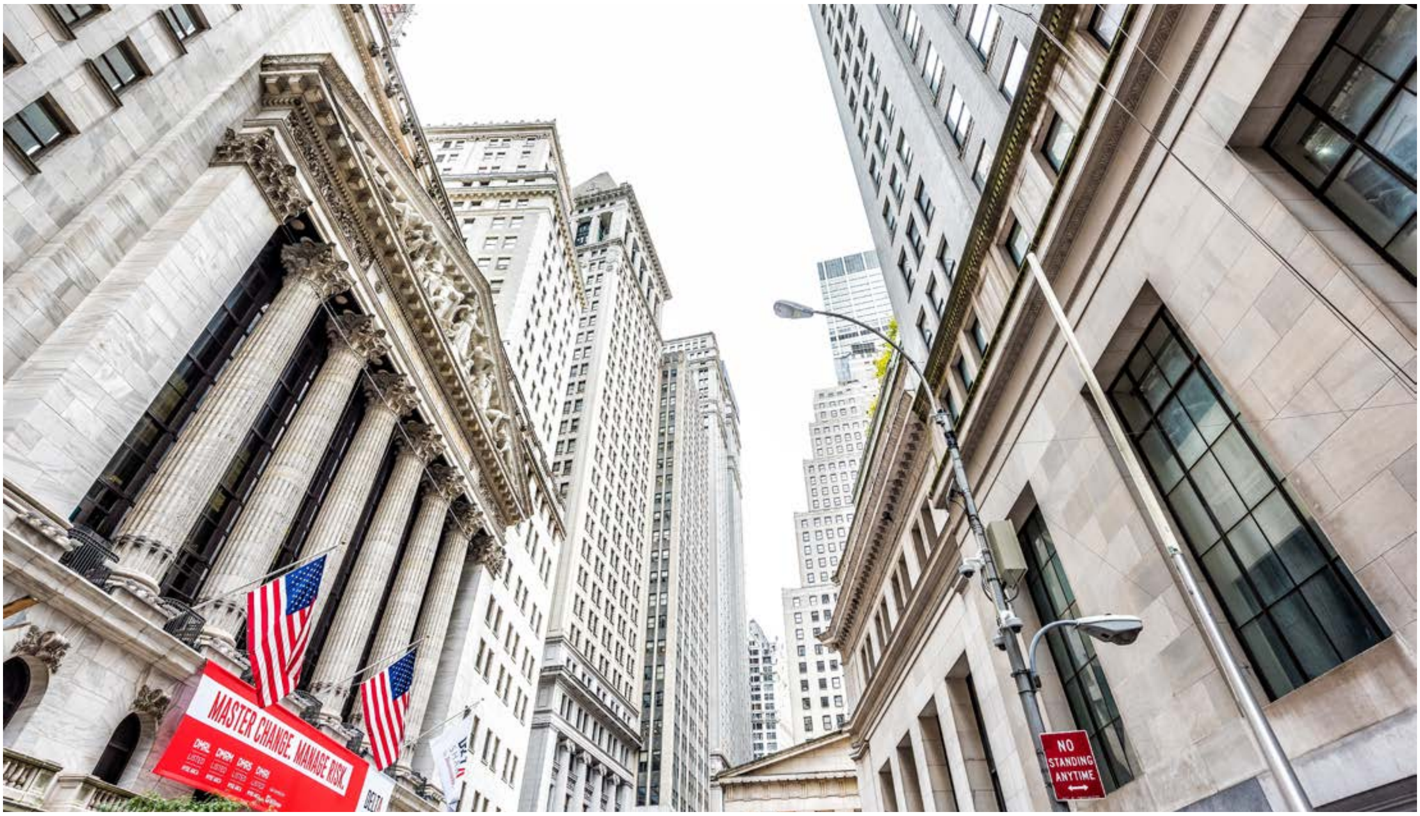

SFT reviews the performance of securities finance entities across the latest earnings reports

Although global securities finance revenues increased between 10 and 15 per cent in the first quarter of 2021 compared to the same period last year, according to the latest figures from industry data providers, Q1 was a mixed bag for individual market participants.

First quarter earning reports revealed how some performed better than the previous quarter, but several fell short in their reported Q1 revenues compared to the same period in 2020.

BlackRock

BlackRock reported its lowest quarterly securities lending earnings since 2015 in Q1, after achieving record-breaking full-year returns in 2020.

The asset management behemoth chalked up lending revenue of $127 million for the first three months of the year, down from $131 million and $158 million in Q4 and Q1 2020, respectively.

In its latest earnings statement, BlackRock attributed the downturn to lower spreads, partially offset by higher average balances of securities on loan.

The soft start to the year means BlackRock will be hard-pressed to recreate last year's total earnings, when it brought in $652 million, largely propped up by a stellar second quarter ($210 million), its best full-year performance since at least 2015.

BlackRock bundles its securities lending figures with its investment advisory and administration fees. The services group achieved collective earnings of $3.6 billion in Q1, up $537 million from the previous quarter.

This was primarily driven by the positive impact of market beta and foreign exchange movements on average assets under management and organic growth, and partially offset by the impact of yield-related fee waivers on certain money market funds and strategic pricing changes to certain products, lower securities lending revenue, and the effect of one less day in the quarter, BlackRock states.

State Street

State Street's securities finance like-for-like revenues in Q1 rose 8 per cent.

The bank reported Q1 revenue of $99 million in the opening months of the year, compared to Q1 2020's $91 million.

Earnings also increased sequentially by 13 per cent from Q4 2020's $88 million.

The latest earnings haul was greater than any quarter posted throughout 2020 and marks the first quarter where the bank broke the $90 million mark since Q2 last year, a threshold it had never failed to meet in any quarter since at least 2015.

Q1's securities finance revenues were primarily driven by higher agency lending and Enhanced Custody balances, State Street says.

BNY Mellon

BNY Mellon posted a decline in its securities lending revenue for Q1, compared to the same period in 2020.

Revenue for the bank's securities lending business, which sits under its investment services business, came in at $41 million in its first quarter, down 11 per cent from $46 million reported in Q1 2020.

But, Q1 revenue was up 14 per cent from 2020 Q4 which took in $36 million.

Elsewhere, BNY Mellon's clearance and collateral management business saw earnings drop from $300 million in Q1 2020 to $281 million Q1 2021.

But the bank's clearance and collateral management business increased between Q4 2020 to Q1 2021 — from $275 million to $281 million.

The bank attributed the year-over-year decrease to lower interest rates and intraday credit fees, while the sequential increase primarily reflects higher clearance volumes.

Charles Schwab

Charles Schwab has managed to maintain form on its securities lending revenue in Q1, following a major uptick in the closing month of 2020 caused by the internalisation of retail broker TD Ameritrade.

The US broker's securities lending earnings for the first three months of 2021 was $204 million, up from $201 million in the prior quarter, and just $37 in Q1 2020.

Beginning in the fourth quarter of 2020, Charles Schwab unbundled securities lending from broker-related receivables and other revenue immediately following the acquisition of the retail broker that caused its securities lending revenue to balloon.

Overall, the Charles Schwab Corporation reported a net income for Q1 of "a record" $1.5 billion, compared with $1.1 billion for Q4 2020, and $795 million for the first quarter of 2020.

The company's financial results are influenced by the TD Ameritrade deal which closed in October 2020, as well as "certain acquisition and integration-related costs and the amortisation of acquired intangibles".

Together these transaction-related expenses totaled $273 million pre-tax for the first quarter of 2021, Charles Schwab says.

CEO Walt Bettinger said, "The first three months of 2021 have in many ways been both the most successful and the most challenging in our history.

"As the US economic recovery advanced, supported by expanding COVID-19 vaccine rollouts and government aid packages, the equity markets continued to climb, with the S&P 500 rising 78 per cent between the pandemic-driven low in March 2020 and the end of this year's first quarter."

Bettinger further notes that market performance was influenced by interest rates beginning to lift as well, with the 10-year Treasury yield moving to

1.74 per cent by quarter-end — its highest level since January 2020.

"This environment contributed to another rise in client engagement and activity beyond the record levels of late last year," he adds.

"As investors turned to Schwab for help in navigating current conditions, they opened 3.2 million new brokerage accounts — a level that exceeds our reported total for all of 2020, excluding the accounts we acquired as part of our recent merger and acquisition activity."

Northern Trust

Northern Trust's securities lending revenue decreased in Q1, compared to the same period last year, due to lower spreads.

The Chicago-headquartered bank saw fees from its agency lending business reach $18.2 million in the first quarter of this year, up 4 per cent from the prior quarter but down 22 per cent from Q1 2020, when it earned $23.4 million.

The Q1 figures mark the third consecutive quarter Northern Trust has failed to achieve earnings north of $20 million, a threshold it has cleared in all prior quarters since 2016.

Northern Trust was among the agent lenders to make gains in full-year revenue from its securities lending business in 2020, compared to 2019, primarily thanks to above-average returns in Q2 last year.

The bank brought in $88 million in 2020, up from $87.2 million the prior year.

Northern Trust's securities lending business sits under its corporate and institutional services division which overall reported revenue of $620.5 million for Q1, up from $596.1 million in the previous quarter and $574.4 million in Q1 2020, a 4 per cent and 8 per cent increase, respectively.

Jonathan Lee
Senior regulatory reporting specialist (SFTR)
Kaizen Reporting

The end of the beginning

Once the final wave of SFTR went live in January, many operations teams stood down, but for Kaizen Reporting, the work was only just beginning. Jonathan Lee explains how his firm is bringing novel solutions to help financial firms tackle trade and transaction reporting data quality and how Brexit creates double jeopardy for regulatory compliance

The UK's Brexit transition period ended on 1 January. What has this final cut-off been like from a financial regulatory compliance perspective?

The pandemic was sufficiently distracting for people to not be focused on the end of the transition period. But, it's also fair to say that the regulators didn't provide a great deal of comments or detail around the expectations until quite late in the day.

For securities financing participants specifically, the main change came after the December deadline, on 11 January, when the EU enacted phase four of the Securities Financing Transactions Regulation (SFTR), for non-financial counterparties (NFCs), which the UK version did not onshore. This divergence was telegraphed much earlier in 2020 by the UK's Chancellor of the Exchequer and so was a smooth process.

The other more nuanced difference is that while the regulation was written into UK law, the Q&As, guidelines and other ancillary documents produced by the European Securities and Markets Authority were not. But, most parties that are following UK SFTR are still adhering to these guidelines, even though they have no legal standing in the UK. This will become a more important topic once the UK regulator begins to publish its own Q&As that may diverge from guidance under EU SFTR. The Financial Conduct Authority (FCA) has already issued guidance on one area of SFTR that ESMA is yet to address and these instances will add up over time and create two distinct reporting regimes.

Looking ahead, the main question is if the UK will be offered an equivalency deal for financial services, along with passporting rights into the single market. SFTR is a hugely detailed and comparatively complex regulatory regime and if the UK doesn't get what it wants then the FCA may be tempted to look at it and say it far exceeds the global requirements and standards as set out by the Financial Stability Board in 2015 and start stripping away some of the fields. The FCA may argue that a model looking at transactions on a settled position level and with less frequent reporting, more akin to the Japanese model, would still meet the international remit and allow the UK to monitor for any systemic risk, while also being a lot less onerous for firms to implement and operate.

If negotiations on passporting into the single market do fail, how likely is it that would result in a review of UK SFTR?

I think there's a high probability that they go for some level of regulatory arbitrage. Yes there is the issue of sunk costs and any divergence means new builds and it means new controls, but much of the pain around SFTR comes post trade, post report and in operations. The volume of transactions that must be reported in a dual reporting model means that a significant number may not pair, and even if they do the chances of them matching across this colossal swathe of fields is still almost zero. This issue is partially mitigated through delegated reporting but that undermines the whole exercise of a double-reporting regime. I imagine operations teams are currently deploying huge amounts of resources just to support this flow and the largest UK players will be very keen to encourage a review of the rules, in particular, the scope and level of detail required for reporting loan and collateral security reference data.

At inception, SFTR was meant to be a macro market overview and yet the EU's take on this idea was to make it micro-surveillance, anti-market manipulation regulation. If you ask for too much you get relatively low-quality data that doesn't pair or match, and therefore cannot be reconciled. Right now the regulator is probably struggling to see the wood from the trees with the data it has. If SFTR was streamlined and focused on settled positions it would be much more straightforward to identify where exactly the concentration risks are, which firms are overly using leverage, which firms may be under collateralised, and which pieces of collateral are potentially being overused.

Looking at the work Kaizen has done to help clients with each phase of SFTR's go-live, what has your experience been and what issues have you encountered?

As we approached the third and fourth phases of SFTR the entities in question became increasingly less inclined to report themselves. Not all, but most, buy-side firms and NFCs chose to delegate reporting to their broker-dealers as they are allowed to, but this negates any value to be had from double-sided reporting. Each buy-side firm may have up to 10 broker-dealers, each of whom are reporting their portion of the buy-side firm's trades, potentially to a different trade repository (TR). Remember, however, that although these entities can delegate their reporting obligations, under SFTR they retain the responsibility for the completeness, accuracy and timeliness of those reports. This can still be incredibly burdensome given the fragmented picture I laid out above.

Where you have the same security being used as collateral for loaned security with two or more of your counterparties, are they reporting the same classification data for that security? Are they reporting to the same TR? To put a controls layer in to oversee all your broker-dealers becomes more and more difficult. These are just a few of many examples of issues with providing accurate data. The complexity here creates a situation where many firms that are particularly worried about complying with the rules in the strictest sense will either need to take on the reporting themselves or divert all their trade reporting data via another vendor that can coordinate everything.

For Kaizen Reporting specifically, what's in your development pipeline and what are your key growth criteria for 2021 and beyond?

Our initial focus has been on our Accuracy Testing assurance product which is fast evolving. This isn't sample-based testing, we test the entire reporting universe for the reporting period, so every single activity that gets reported goes through our testing process, giving a full picture of the quality of reported data. We also deploy hundreds of validation rules because we want to be rigorous in ensuring the TRs are applying all of the validation rules themselves. We've seen transactions that we do not believe should have passed validation and yet they've been accepted by the TR.

More recently, we are looking at the reports more holistically, so beyond just reviewing the individual fields and how they fit together, we are modelling the loan and collateral equilibrium throughout the life of the trades and the reporting period.

In addition, we are having a big push to build out our Advanced Reconciliations service for SFTR. Kaizen's approach to reconciliation is a little bit different to some others in that we extract data from all of the respective golden sources as well as the firm's books and records. We then create their SFTR reports with our interpretation of the regulation and reconcile those reports against the ones submitted to the TR. In addition to all of the accuracy elements that would be further enhanced through this process, we're also looking for completeness, meaning any areas of under-reporting or over-reporting. In particular, in the collateral space, we have quite a strong inkling that the significant under-reporting of collateral occurs.

Thirdly, with the end of the Brexit transition period, there are a growing number of firms that are facing EU reporting obligations for the first time, particularly if they're operating in the Euro money markets by offering secured or unsecured lending in euros. In such cases, those firms will have obligations under the money market statistical reporting for the European Central Bank and the European system of central banks. Also, a lot of EU firms have been establishing entities in the UK and some of those are coming under the sterling money market data collection reporting rules that the Bank of England requires. As such, we are in the process of building out Accuracy Testing for reports under both those regimes.

A final thing to mention are our core training courses for compliance and operations staff on the fundamentals of SFTR reporting. The key to accurate reporting is a strong understanding of the obligations. We also provide courses for the European Market Infrastructure Regulation and the Markets in Financial Instruments Regulation transaction and post-trade reporting.

When SFTR finally came fully into effect many operations teams stood down, but for Kaizen it really was just the beginning. As concerns grow around regulatory compliance, coupled with the prospect of being publicly known as lacking a robust regulatory controls environment and not protecting the interest of your clients and investors, there are many entities out there that need our services.

Don D'Eramo
Head of securities finance
RBC Investor & Treasury Services

Securities lending: Setting the record straight. Let's address what may be holding you back

Don D'Eramo, head of securities finance at RBC Investor & Treasury Services, offers an overview of why a securities lending programme can offer low-risk returns and support capital market liquidity

Securities lending provides a valuable opportunity for asset owners and managers to earn incremental revenue on otherwise idle assets without disrupting their day-to-day investment activities. Moreover, the practice is relatively low-risk, given that it is usually indemnified by agent lenders and fully collateralised by counterparties, with tailored parameters that can be applied to align with a client's risk appetite.

According to the Bank of Canada, securities lending "plays an important role in Canadian financial markets" by promoting market liquidity, enhancing price discovery, preventing settlement failures, and supporting a variety of trading strategies — as well as providing security holders with access to funding.

Still, there may be misconceptions about securities lending that are influencing institutional investors' participation in this core market activity. These include topics such as risk levels, short positions, flexibility, and alignment with environmental, social, and governance (ESG) investing.

We address these concerns in more detail for beneficial owners considering adding securities lending to their investment strategy in order to generate new revenue streams, offset and/or reduce costs, and improve portfolio returns.

Key insights

- Securities lending is an important contributor to well-functioning capital markets by promoting liquidity, enhancing price discovery and providing access to funding for security holders
- Securities lending is often negatively associated with short selling; however, securities lending goes beyond short selling and includes other market facilities such as market making, funding, prime brokerage and collateral optimisation
- Portfolio managers and beneficial owners can participate in securities lending without impacting day-to-day operations and investment strategies. For example, many beneficial owners strike a balance between repo activity and securities lending. Flexibility in parameter setting and consultation with agent lenders is key to supporting simultaneous functioning of market activities
- Securities lending can coexist with ESG principles. A survey from The Risk Management Association shows 95 per cent of institutional investor respondents believe that securities lending activities can coexist with ESG principles

It is not high risk

The view that securities lending is a high-risk activity is an idea that developed in part from the losses incurred dating back to the 2008 global financial crisis.

At that time, securities lending was considered higher risk when cash-collateralised transactions involved a high degree of maturity or liquidity transformation, according to a report from the Bank of Canada. It cites the example of insurer AIG, which ran a large in-house securities lending programme. "AIG's strong credit rating combined with its large portfolio of in-demand securities made it an ideal counterparty for many borrowers," the bank stated in its report. It noted that AIG lent out its securities for cash collateral, much of which was reinvested in residential mortgage-backed securities and other asset-backed securities, with only a small cash buffer retained to meet redemptions.

In September 2008, there was a run on the program as borrowers demanded that US$24 billion in cash collateral be returned. The Federal Reserve Bank of New York ended up borrowing US$38 billion of securities from AIG and provided it with cash collateral to satisfy borrower demands.

Those losses were tied to cash collateral reinvestment, primarily driven by market stresses impacting the invested assets (i.e. defaulting instruments) as well as the duration mismatch of the reinvestment portfolio, and not the act of securities lending, says Donato D'Eramo, managing director and global head of securities finance at RBC Investor & Treasury Services (RBC I&TS). Also, since then, he says the industry has evolved. The practice of cash reinvestment has changed to mitigate against that scenario recurring, and there is greater transparency on reinvestment strategies.

Fast forward to today, and Canadian and European securities lending markets are predominantly undertaken without cash collateral. "Although it can be done in a very risk-averse way, if it aligns with a client's risk appetite," adds D'Eramo.

The multiple layers of protection that surround typical securities lending transactions include collateralisation and indemnification, making it a relatively low risk-adjusted return activity. With strong risk mitigation protocols, securities lending remains an important part of a diversified portfolio strategy and can be a powerful revenue driver.

It goes beyond short selling

Securities lending is often associated with trading strategies that rely on short selling, a sometimes controversial and polarising market activity that is based on the expectation that the price of a security will drop. While short selling certainly has its share of critics, it is also considered a vital market mechanism.

Academic research shows short selling enhances liquidity and price discovery and improves market efficiency. Furthermore, the strategy does not negatively impact long-term investment goals, with research suggesting that long sellers impact stocks more than short sellers.

"When investors have the ability to take both sides, the mechanism of price discovery is much more efficient," says Kyle Kolasingh, associate director of securities finance at RBC I&TS.

Short selling is not the main driver of securities lending, he adds. "That's a primary misconception. Short selling is one aspect of the industry but by no means the largest contributor."

The European Securities and Markets Authority (ESMA) considered the impact of short selling and securities lending practices and its potential link with short-termism in a 2019 report. The report stresses that short selling and securities lending "are key for price discovery and market liquidity".

The ESMA report further emphasises that it is "not aware of concrete evidence pointing to a cause-effect connection between these practices and the existence of undue short-term market pressures".

It stated that "securities lending, if done in a controlled way, is an opportunity to add value for fund investors and [is] compatible with long-term investment strategies".

It is not all or nothing

Securities lending does not require the commitment of an entire portfolio. In fact, portfolio managers and beneficial owners can restrict any security or asset classes they may not be comfortable lending. Recalls can also be initiated at the beneficial owner's discretion.

Agent lenders develop programmes that are customised to suit a client's particular requirements and preferences. For example, a client can opt to enroll its entire portfolio of assets but limit lending to a specific hurdle rate. This approach is referred to as an "intrinsic value" lending programme. In this model, clients can enter agreements that enable them to choose to lend only specific securities or "specials". While this is a more concentrated form of lending, it provides some exposure and insight into the mechanics of securities lending before proceeding to make a full portfolio lendable, and may be more conducive to some investment strategies.

While securities lending is about scale, it is not only larger portfolios that have the opportunity to benefit from lending, Kolasingh says. "You can have a smaller portfolio that is concentrated in a very attractive asset class. That can generate the same return profile as a portfolio that may be 10 times as large but may have an asset composition that is less desirable from a lending perspective." At RBC I&TS we have developed a tailored route to market where eligible beneficial owners can monetise securities lending opportunities on single securities, instead of lending their full portfolio. This can be advantageous for traditionally smaller portfolios, or simply a more suitable approach depending on risk appetite considerations.

It is ESG friendly

Another concern is that securities lending is incompatible with ESG investing, where investors seek to exercise governance responsibilities by screening companies considered to be more responsible in their corporate behaviour, or focusing on those where voting rights can be used to exert influence.

For example, investors may see short selling as inconsistent with ESG investing since sustainable investing is often viewed by some as a strictly long-term investment strategy. The Bank of Canada, through its opinion of price discovery and market liquidity, presents an alternative and broader view of what sustainable investing is by including factors such as price discovery.

Furthermore, beneficial owners do not need to give up their proxy vote when lending securities, as noted in a recent report from BlackRock.

“Questions have arisen regarding whether securities lending is additive to or detracts from sustainable objectives, particularly in relation to short selling and voting,” the report states, citing a common view that securities lending transfers the voting rights to the short seller. “The buyer of the security has the right to exercise proxy votes of the security not the short seller,” the report notes. “Additionally, brokers are prohibited from borrowing shares for the primary purposes of voting. Securities on-loan can also be recalled to vote.”

A recent survey from The Risk Management Association (RMA) shows 95 per cent of institutional investor respondents believe that securities lending activities can coexist with ESG principles. The survey says 18 per cent of respondents currently apply ESG factors to their programs, while 25 per cent said they did on a case-by-case basis. Another 18 per cent do not apply the principles but are planning to, while 39 per cent simply do not.

Canadian pension executives believe ESG issues are critical and eight of the country’s leading pension plan investment managers — representing approximately CA$1.6 trillion in assets under management — recently issued a statement calling on companies and investors to provide consistent and complete ESG information to strengthen investment decision-making and better assess and manage their collective ESG risk exposures. Interestingly, all of the pension plans that are part of the call to action participate in securities lending programs, further highlighting that securities lending can align with ESG principles.

Andrew Dyson, CEO of the International Securities Lending Association (ISLA), believes that “a well-run and prudentially managed securities lending programme can happily run alongside an ESG investment mandate”.

In a recent letter posted on the ISLA website, Dyson says many of the reasons cited for not lending securities in an ESG mandate “appear to fall away and not stand up to intellectual rigour”.

He notes that lending agents can help beneficial owners exercise their voting rights, while also highlighting the role securities lending can play in supporting short sellers.

“It has been confirmed time and time again through independent research and by the regulatory community that short selling in general is a force for good, allowing hedge funds and other short sellers to bring companies to account where their share price bears no relation to the facts behind that firm. As so-called ‘greener’ markets evolve, wouldn’t we expect that level of scrutiny from the buy-side of the investment spectrum?” writes Dyson.

He also discusses the market liquidity and efficient price discovery that comes with short selling. “Without the support of institutional investors for securities lending across ESG markets, these securities will trade less frequently and suffer from a lack of market liquidity which, in turn, will lead to a widening of bid-offer spreads,” writes Dyson, whose organisation is working on best practices and guidance to help institutional investors align their securities lending programmes with their ESG objectives.

He also underscores the argument that securities lending delivers relatively low-risk returns over time, “which can drive outperformance or lower fees where lending revenues are used to offset management costs”.

Securities lending as a viable investment strategy

Securities lending is a mature, resilient market activity that has persisted through macroeconomic events such as credit shocks, the sovereign bond crisis and now the pandemic. Furthermore, it is highly regulated and transparent, utilising risk mitigation tools that make it efficient and low risk.

The industry continues to evolve alongside the financial markets and the global economy. Participants benefit from digital innovation with tools and data that help them make more informed decisions and optimise results.

Overall, securities lending can provide beneficial owners with the opportunity to earn considerable low-risk adjusted returns. Given that interest rates are expected to remain low for longer, securities lending is an important market tool to help beneficial owners seek broader portfolio diversification to achieve sustainable future returns.

Looking beyond the ESG hype

Alex Pugh reports

ESG is a hot-button topic, but are agent lenders' and beneficial owners' priorities aligned?

Few trends have captured the market's attention in recent years more than environmental, social and governance (ESG). Agent lenders across the world are touting their sustainable credentials at every opportunity in order to capture what myriad media headlines and panel discussions suggest is the hottest topic of the moment for their clients. Barely a day goes by without a report, webinar, product or fund launch that puts ESG at its core.

Service providers, including agent lenders, are participating in a collective mania around ESG and are jostling to present a plume of

green feathers to what they perceive to be an increasingly socially conscious client base. But, are beneficial owners as concerned as the spin would suggest? And are agent lenders providing their existing, and importantly, their new clients, what they want?

eSecLending's US head of business development Peter Bassler says ESG is an "emerging topic" as it pertains to on-boarding conversations. But in most cases it is not yet at the stage where it is informing tactical securities lending parameters or decision making, outside of voting, "which has always been a key focus for many of our clients," Bassler says.

Northern Trust's head of client management, North America, securities lending, Lori Paris says that because each client may have a different view on what ESG means to their securities lending programme, the bank discusses with its clients how to customise their programme parameters, such as accepted collateral, participating assets, and proxy voting. "Interest level in ESG appears to vary as to whether the client is an asset owner or an asset manager, as well as by region," Paris says.

"As ESG permeates many discussions at investment firms and asset owners, the broad topic of how you implement ESG priorities within a securities lending programme is occurring as a strategic talking point," Bassler says.

While asset owners typically select investment managers that align with their ESG mandates — and don't focus heavily on ESG within securities lending specifically — asset manager clients that self-manage are more likely to desire alignment with proxy voting policies and ESG considerations of non-cash collateral acceptance.

"Enabled by regulations such as the EU's Action Plan on Sustainable Finance, ESG-related discussions are more prominent in Europe, Middle East and Africa and Asia Pacific, but are on the rise in North America," Paris observes. This is also the case at Northern Trust — ESG generally has been more of a focus in Europe but it is becoming a priority across the investment landscape in the US and other regions as well, according to Bassler.

Elsewhere, Standard Chartered's global head of agency securities lending Sunil Daswani says that ESG issues have become a priority among his clients. This is the result of changing attitudes on one hand, but also an awareness that well-managed companies, that operate responsibly and sustainably are more likely to be successful in the longer term and be more resilient in a crisis.

There's also a growing awareness of the impact of poor ESG performance on reputational risk, which can rapidly and materially affect the value of a company. However, Daswani adds, each client has different ESG priorities. Clients are looking for segregated securities lending solutions that are tailored to individual ESG priorities while seeking higher risk-adjusted returns and greater transparency than traditional, pool-based lending programmes, he explains.

Of the three areas of ESG, the 'E' and 'G' appear to be the most salient today. At eSecLending, the governance aspect has "always been present in our conversations", Bassler says, which historically has directly translated to proxy voting and how that coexists with securities lending. "As a security on-loan loses the right to vote, our clients take different approaches to managing recalling securities for instances where they want to vote a given proxy," he adds.

Helpfully, eSecLending offers a unique product with ISS — provider of proxy advisory and corporate governance solutions to financial market participants — to help lenders manage the competing interest of voting and earning revenue from securities lending. This partnership aims to overlay the 'E' and the 'S' to give lenders a more granular way to think about ESG within their proxy voting guidelines, Bassler explains.

Similarly, at Northern Trust, the majority of ESG questions relate to governance and, specifically, ensuring compliance with beneficial owners' proxy voting policy.

The second emphasis at Northern Trust is on ESG considerations of non-cash collateral acceptance, "as all loans must be fully collateralised and beneficial owners with ESG mandates want assurances that the accepted collateral does not breach their guidelines," Paris adds.

But, ultimately, at Northern Trust, each investor decides which principles matter most to them, "despite the emergence of ESG benchmarks, indices and the development of principles for the assessment of companies and responsible investment".

For some, the focus is low-carbon-footprint investing, whereas others may view this through a more ethical lens and focus on the exclusion of controversial companies, such as arms manufacturers. "Whatever the approach adopted, we believe it is important for us to support our client's requirements in this space, and the core principles of responsible investing more broadly," Paris concludes.

However, at Standard Chartered, the 'E' seems to be the most talked about priority. Daswani says there are several indices available, such as MSCI UK IMI Low Carbon SRI Leaders Select index which tracks small and mid-cap UK entities with high ESG scores. However, there is still a long way to go in establishing a consistent way of measuring and comparing fund performance at an industry level, Daswani says. Some investors will prioritise carbon emissions, others will look more at issues such as energy consumption, pollution, corporate governance diversity and inclusion will be more important.

Whether it's 'E', 'S' or 'G', sustainability concerns are more common than they used to be. "Right now, the question being asked is: is securities lending ESG-friendly and can the two coexist?", Bassler says. He says many industry papers have been written on the topic and when an agent manages customised lending programmes, a lender can tailor their strategy to address all investment concerns including ESG-related sensitivities.

Without a doubt, ESG is one of the newer phenomena, Daswani says. "It's an important one for all of us, and it's great to see institutions wanting to lead the way and do their bit to ensure ESG is the priority that it should be," he adds. Nearly every client looking at services wants to understand how Standard Chartered can integrate ESG — typically in securities lending this will be the ESG policies of clients that we need to adhere to or implement within our product, Daswani adds.

Paris says ESG discussions are much more common and most clients are interested in understanding the impact of any restrictions on securities lending revenue opportunities and this forms part of the ongoing performance dialogue as well.

The same goes for eSecLending. How agent lenders can adjust lending priorities to mirror ESG policies is an emerging topic, Bassler says. "This is something we are actively working on at eSecLending — to introduce additional tools that clients can use to manage their securities lending programs within their ESG priorities," he adds.

Now to get into some numbers. While ESG concerns are becoming increasingly common for new and existing beneficial owners alike, does the number of clients who are ESG-aware constitute a significant proportion of an agent lender's base? Interestingly, it seems that the majority are interested in ESG as it pertains to securities lending and want it to inform their portfolios.

For the ESG topic generally, at eSecLending, around half of beneficial owners are asking about how it relates to securities lending. But the question of 'how can I apply ESG principles to my lending structure?' constitutes a lower percentage, according to Bassler, "but the trend is emerging and we anticipate it will continue to be an increasing focus of conversation". The fact that lending agents need to be prepared to customise their offerings to match lenders emerging and growing ESG considerations is becoming increasingly prevalent.

While Northern Trust does not track the number of new or existing clients who are concerned or ask about ESG, the figures are similar to those of eSecLending for new clients. However, only a minority of existing clients ask, Paris observes, and again they are more heavily weighted to EMEA and APAC as well as asset managers globally.

Standard Chartered's Daswani says ESG issues are fast emerging as important priorities for institutional investors. He quotes research published by Edelman in November 2020, covering 600 investors in six key markets, that revealed that 87 per cent of institutional investors already actively invest in companies that have reduced their near-term return on capital in order to reallocate capital to ESG initiatives. And 91 per cent believe that companies with strong ESG performance are more resilient in a crisis.

"It's fair to say that nearly all beneficial owners if they don't have ESG policies now, feel that they should implement them — we can help them with such requirements," Daswani adds.

It's all very well that clients are asking for ESG and agent lenders want to provide it, but without metrics and credentials, it's impossible to adequately measure ESG credentials. All the agent lenders SFT spoke to had either existing platforms and tools to combat this or were working on developing such tools.

On a macro level, the level-one requirements of the Sustainable Finance Disclosure Regulation came into effect on 10 March, representing EU regulators' first attempt at standardising ESG principles, which demand high-level disclosures from financial institutions on any product they deem to be ESG-friendly.

But the regulation has much to be desired when it comes to crystallising various ESG concepts. Despite the regulation being live for more than a month, EU policy-makers are yet to respond to the well-documented market calls for clarity on several issues that will significantly affect the role of securities lending in the new sustainable market environment.

Northern Trust's platform allows the firm to support clients' voting needs in a number of ways depending on their governance policy and they can apply a wide range of restrictions across other lending parameters. But from a collateral perspective, "it can be challenging as every client has a different need depending on their specific view", Paris says.

eSecLending is also working on enhancing existing tools and creating new ones to create ESG filters across the securities lending transaction that include voting proxies, non-cash collateral screening and potentially filter for cash investments and securities borrowers as well.

Northern Trust is part of an industry working group affiliated with the Risk Management Association and the International Securities Lending Association to coordinate best practices and key considerations on implementing a lending programme within their ESG framework. "We expect some consolidation as ESG-based indices and benchmarks become more prevalent and widely used, but at present, we are focused on being able to provide the flexibility to manage a wide range of different client requirements that support their ESG mandate," Paris adds.

At Standard Chartered the securities lending product is operated through eSecLending's fully segregated programme which allows for specific client customisation. "This approach also enables better adherence to client-specific ESG requirements," Daswani says. Parameters can be set to tailor proxy voting requirements, collateral restriction or borrower restrictions based upon whatever the clients ESG policy may dictate.

"We are seeing various initiatives emerge to develop ESG measurement and comparison tools, both amongst individual providers and at a wider industry level," Daswani says. One of the most promising of these is the Global Principles for Sustainable Securities Lending initiative, which aims to create a global ESG market standard for owners, lenders, borrowers and impact creators, such as Standard Chartered.

However, market forces alone will not be able to bring the industry together on what ESG means and how important it is for the financing industry or others. Despite the novel challenges of writing rules based on principles rather than distinct market features, regulator input is essential to separate those with attractive window dressing from those who have structured their whole shop to embrace the modern, ESG world.

Comings and goings at CloudMargin, SEC, VERMEG and more

Gary Gensler — academic, former Goldman Sachs executive and Commodity Futures Trading Commission chair — has been confirmed by the US Senate as the new chair of the US Securities and Exchange Commission (SEC) after a 53-45 vote.

Gensler has spent his entire career in and around the financial markets; in the private sector, in state and federal government, and most recently in academia as Professor of Practice at MIT Sloan School of Management.

The 63-year-old Democrat's appointment, replacing acting chair Allison Herron Lee, represents a sea change in the way the US will approach and regulate financial markets going forward. With the Democrats in control of the House, the Senate and the White House, Gensler's confirmation draws a line under the Trump administration's laissez-faire approach to the markets.

In his nomination hearing at the Senate Committee on Banking, Housing and Urban Affairs on 2 March, Gensler affirmed the SEC's mission was to protect investors and to maintain fair, orderly, and efficient markets: "When there are clear rules of the road and a cop on the beat to enforce them — our economy grows and our nation prospers," he said.

"When we take our eyes off the ball — when we fail to root out wrongdoing, or to adapt to new technologies, or to really understand novel financial instruments — things can go very wrong," Gensler continued.

During that hearing, when asked by Massachusetts' Senator Elizabeth Warren, a longtime regulatory hardliner, whether he would use all the available "tools to make the markets function better", Gensler said that as SEC chair he would adopt a robust multi-agency holistic approach.

"Senator, if confirmed, I look forward to looking at all of the authorities. Not just this one. But all of the authorities to help protect investors, promote the capital formation and the efficient markets that we talked about."

Gensler, who teaches a class at MIT called Blockchain and Money, has his eyes firmly on the future, and he is not afraid to introduce new regulations in response to rapidly evolving markets and technology.

"Markets — and technology — are always changing," he said during his confirmation hearing. "Our rules have to change along with them. In my current role as a professor at MIT, I research and teach on the intersection of technology and finance. I believe financial technology can be a powerful force for good — but only if we continue to harness the core values of the SEC in service of investors, issuers, and the public," Gensler said.

The SEC welcomed the appointment of Gensler: "A warm congratulations to Gary Gensler on his Senate confirmation to become Chair of the SEC. We welcome him back to public service and look forward to working together to execute our vital mission."

The Depository Trust & Clearing Corporation (DTCC) was similarly effervescent: "Chair Gensler's confirmation underscores decades of accomplishments in both the public and private sector.

"His prior work at the CFTC and the Department of the Treasury, and ongoing efforts at MIT, have positioned him to take the helm as the 33rd SEC Chair. We look forward to working collaboratively with Chair Gensler on critical issues related to market transparency, safety and stability."

Gensler was sworn in on 17 April.

CloudMargin, a cloud-based collateral and margin management solution provider, has appointed Helen Nicol from VERMEG to the role of senior vice president, head of product.

Based in London, Nicol will be responsible for CloudMargin's benchmark product.

Now a member of the CloudMargin leadership team, Nicol reports to Stuart Connolly, CloudMargin's CEO.

Nicol has more than 20 years of experience in collateral management, financial markets and law, including senior positions at two global banks.

Nicol joins CloudMargin after serving for more than 14 years as global product director for Lombard Risk, which was acquired by VERMEG in 2018.


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In that role, she was responsible for the firm's collateral management, clearing and optimisation solution, managing teams in London, Singapore and New York.

Commenting on Nicol's appointment, Connolly says: "Her deep experience and expertise in collateral management — both as a service provider and a sell-side market participant — make her ideally suited to lead our product team and bring us to the next level as we continue to grow and enhance our offering.

"We are also very fortunate to add another strong woman with extensive management skills to our executive team, and we recognise that diversity in our organisation and managers make our company ever stronger."

Nicol says: "I am delighted to be joining CloudMargin at such an exciting time in the financial technology industry.

"CloudMargin has laid the foundation to enable standardisation of data parameters, creation of efficiencies through configurable workflows and enhanced connectivity to the market across all sectors, and I am looking forward to working with the team on the expansion of the CloudMargin product suite."

Prior to joining Lombard Risk in 2006, Nicol held several banking roles at both UBS and then Credit Suisse in London.

In her ultimate role, she was responsible for new business and derivative legal agreements, including day-to-day management of the bank's over-the-counter, repo and foreign exchange collateral legal agreements.

Eva Luterkort joins Pirum as general counsel

Pirum Systems has gained legal guru Eva Luterkort from Goldman Sachs to head up its new in-house legal team.

Luterkort has been a lead in regulatory matters as well as Brexit planning and implementation.

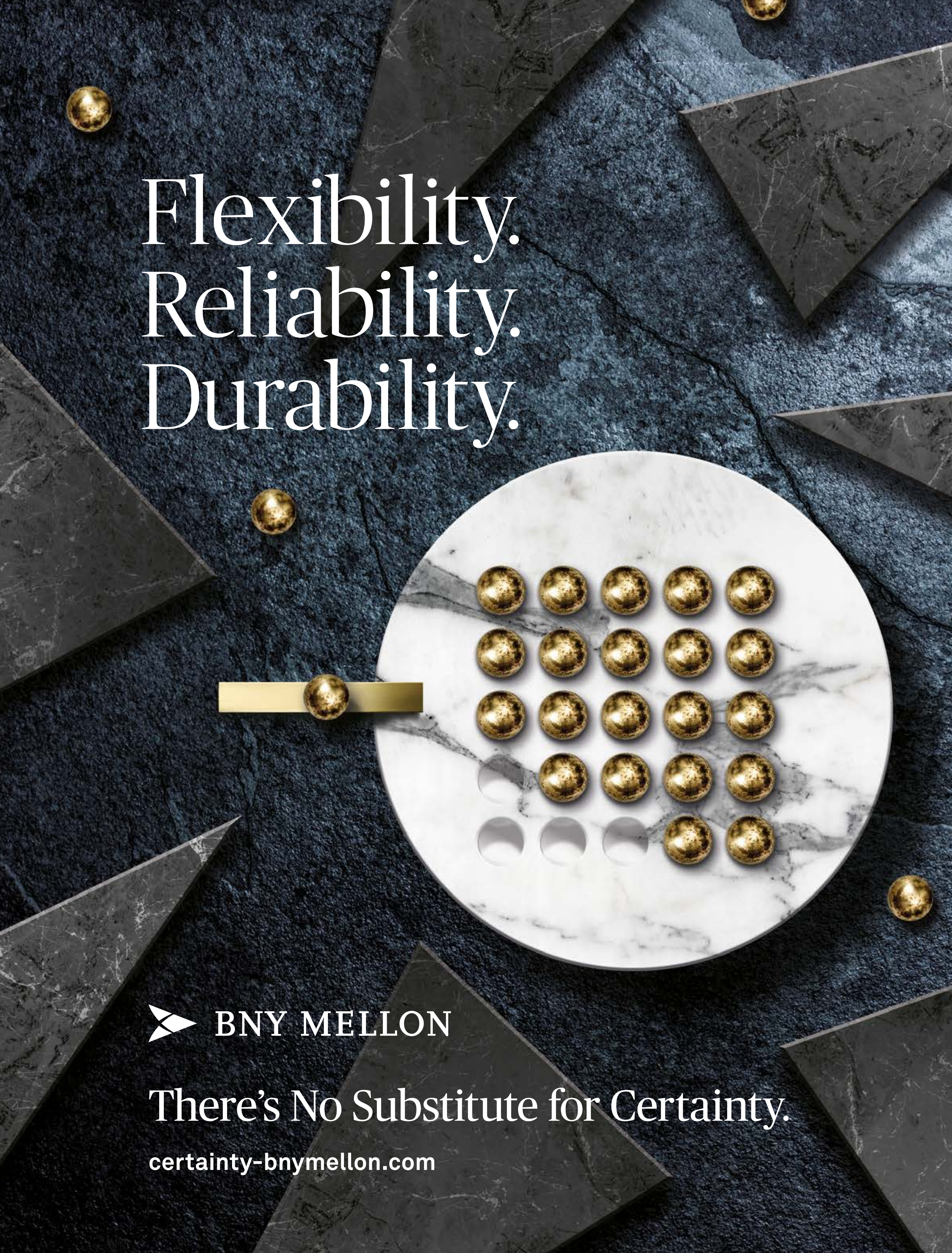
Given the growing complexity of the securities finance ecosystem, Pirum says it has created an in-house team to cover legal contracts, compliance, risk and regulations and appointed Eva Luterkort as general counsel.

Luterkort qualified at law firm Linklaters, as part of a six-year tenure, where she specialised in capital markets, investment management and banking, including two secondments at Nomura and Lehman Brothers.

From the end of 2013 until March this year, Luterkort worked at Goldman Sachs as executive director and senior counsel in the firm's prime services legal and securities financing transaction divisions.

There she supported the principal securities lending, agency lending, short-term interest rate market making and firm funding desks with respect to balance sheet and liquidity transactions.

"I am thrilled that Pirum has been able to attract someone of Eva's experience and capability. She will quickly help us improve customer experience, as well as industrialising our legal, risk and compliance functions," Pirum CEO Phil Morgan tells SFT.



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