REGULATION ADDS MORE STRESS TO SEC LENDING

While the industry broadly supports stronger transparency measures, Europe's securities-lending participants worry that the imposition of some tough new regulatory regimes could help undermine market efficiency by reducing liquidity and price discovery while widening deal spreads. Does the opportunity still exist for some modification to take place? Dave Simons reports.

IN RECENT REMARKS, Lord Turner, head of the United Kingdom's Financial Services Authority (FSA), suggested that the $60bn shadow banking sector, of which securities lending is a part, was in need of greater attention. However, it has been left to the Financial Stability Board (FSB) regulatory task force to draft tougher new laws by year's end. While hardly earth-shattering news, the fact that the FSA considered securities lending to be a key component in this potential quagmire has raised concerns over the nature of forthcoming legislation.

Already a sector under siege due to the backlog of current legislation in various markets around the globe, in Europe securities lending supply and demand is likely to be affected by fresh restrictions within Basel III, the sec-lend/short-selling proposals issued by the European Securities and Markets Authority (ESMA), as well as the imposition of the Financial Transaction Tax. Though it is too early to tell which of these pieces of legislation could have the greatest impact, any kind of transaction tax would be bad news for sec-lending, given the relatively low levels of income derived from very large deal sizes. With demand for standardisation in sec-lending continuing to mount, the effective quantification and accurate monitoring of counterparty positions, along with the ability to extract and report on any relevant position at any given time, has become far more important from a risk perspective.

Faced with mounting regulatory pressure, France has already intimated it could cease sec-lending activity, even if others in Europe may not necessarily follow suit. Meanwhile, collateral is likely to play a much greater role in Basel III, in the process raising the cost for custodians needing to indemnify lending schemes.

Although the industry broadly supports measures aimed at introducing a more rigorous and transparent market regime, Europe's securities-lending specialist worry that incoming regulation could undermine market efficiency by reducing liquidity and price discovery while widening deal spreads. What might be the impact of upcoming legislation? Does the opportunity still exist for those in the industry to help modify these new rules?

At the behest of the European Central Bank (ECB), ESMA is attempting to rush release a restrictive new set of short-selling regulations that could re-shape the map for the securities lending industry as a whole. With a November 1st 2012 compliance deadline looming but nothing yet set in stone, industry participants are in the rather unenviable position of trying to prepare for what may happen, without knowing if in fact it actually will. "Given that many of these roads are still under construction, it's still too early to gauge the possible impact on the lending business," says James Slater, global head of securities lending, BNY Mellon. "This naturally makes it quite challenging to formulate a proper working plan."

In terms of quantifiable change, the imposition of new capital rules calling for better ratios covering leverage and stable funding have had the greatest impact on the securities lending markets to date. "In response, there has been a much wider use of securities as collateral on a global basis, and I believe we will see a continuation of that trend," underscores Slater.

However, most agree that ESMA seems bent on drafting some form of legislation that, while ostensibly aimed at de-railing naked-short selling, could have even farther-reaching consequences.

Separating liquid from illiquid

"ESMA is looking to separate liquid from illiquid instruments," explains Brian Lamb, chief executive officer of EquiLend, a global provider of trading and operations services for the securities-finance industry, "and for those that fall into the latter category there could likely be some kind of locate as well as hold requirement, though again it is hard to say for sure." Most troubling, says Lamb, is regulators' efforts to use the Markets in Financial Instruments Directive (MiFID) as the rubric by which "illiquidity" is defined. Though it may sound like a reasonable approach to some, "you're talking about two very distinct markets—that is, the cash market on the one hand, and the financing market on the other," notes Lamb. "While there is certainly some common ground, there are very substantial differences as well."

This has the potential to wreak havoc—or at the very least, create a lot of extra work—for those attempting to short stock that happens to wind up on the illiquid hit list. "First you'll have to locate that stock, but then you would also be required to hold the stock, thereby introducing a dynamic that doesn't currently exist within the market," says Lamb. This, in turn, raises a whole new set of questions, including who is paying to keep the stock on hold, the ability for participants to view "held" stock; not to mention how all of this might impact the economics of the transaction. Unfortunately, at this point concrete answers are hard to come by, says Lamb.

Also part of the effort to keep lenders on a tighter leash is ESMA's suggestion that income arising from certain sec-lending arrangements be returned to a fund in its entirety "as a general rule," rather than having a portion of the proceeds distributed to the fund manager. In the event that any sharing of fees takes place, such arrangements should be fully disclosed by the fund, contends ESMA. As expected, the proposal has had lending leaders from all corners up in arms, among them the International Securities Lending Association (ISLA) as well as the European Fund and Asset Management Association (EFAMA). Fee-sharing revenue allows managers to offset some of the costs associated with offering lending services, say proponents, and, if prohibited, could affect the livelihood of lending providers.

Calling securities lending a "costly activity" requiring "significant investment in research and technology" in order to generate incremental returns, ETF leader BlackRock claimed the ruling would present the industry with considerable operational challenges. Particularly in opaque sectors such as OTC derivatives, the application of research and analytics can have a direct impact on the investor base, suggested BlackRock. Furthermore, risk-management capabilities call for a steady stream of capital in order to properly monitor counterparties and collateral parameters. "Since it may be difficult to assign costs, such as risk oversight and trading tools to a specific fund, in our view a transparent revenue sharing agreement is the most appropriate way of ensuring a UCITS can benefit from securities lending," says the fund.

Other proposed rule changes have raised similarly strong objections. While agreeing that liquidity risk may rise in the absence of lending limits, the non-profit CFA Institute nevertheless argued against using a "bright-line rule" for all lending situations, suggesting instead a solution based on a combination of outstanding short volume and the total market float for each specific security. Such an approach said the group "would take into consideration the ability of share borrowers to unwind short positions."

Understanding lending

Though the sec-lending business has been a ripe target since the start of the financial crisis, if anything election season appears to have made the bull's eye that much bigger. Says Lamb: "It's a shame that these things have to become so overly politicised. It seems that somebody's always looking for a scapegoat, when instead they should just be looking out for the better interests of the public."

Slater agrees that there are a number of forces helping to shape the discussion around Europe's securities-lending markets at present, "and not all of it is about regulation—there are geopolitical and geo-economic concerns as well." Despite concerns over the unintended consequences of initiatives in the making, the belief that EU regulators understand the connection between the vitality of securities lending and the smooth functioning of the financial markets will ultimately enter into the conversation, says Slater.

James Slater, global head of securities lending, BNY Mellon. "It's still too early to gauge the possible impact on the lending business," says Slater, "Which naturally makes it quite challenging to formulate a proper working plan." Photograph kindly supplied by BNY Mellon, May 2012.

"Generally speaking, regulators seem satisfied with the level of transparency currently on offer from agent lenders," says Slater. If there is room for improvement, he adds, it is within the reinvestment segment. "There is still not enough information that is publicly available or easily accessible by regulators," he adds, explaining that it "helps explain the increased regulatory focus on shadow banking, as well as the FSB's and Bank of England's recent work stream on raising transparency."

In an effort to engage regulators more broadly, participants such as BNY Mellon have considered the possibility of creating a central transaction depository whereby information could be stored and subsequently accessed by regulators. "Just so that everyone can understand the facts," says Slater, "and decisions are not made that could lead to unintended consequences."

Just back from a round of sec-lend policy briefings in London, Lamb attempts to put a good spin on a potentially volatile situation. "Securities lending is a complex market, one that compels people to take the time to really think things through, lest they wind up with the wrong kind of legislation on their hands," he says, adding that this is why it is so important to take the time to be thoughtful about any changes that need to be made, to understand the consequences and not just throw the baby out with the bathwater, so to speak. Obviously there is a lot of good that can be derived from these markets. I think that EU regulators by and large understand this—and although they are committed to making substantial modifications in areas like repo and re-investment, I hope they will know where to draw the line". ■