ISLA SECURITIES LENDING MARKET REPORT

ISLA INTERNATIONAL SECURITIES LENDING ASSOCIATION

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INTRODUCTION

Our first ISLA Securities Lending Report was published in October 2014 as part of our drive to promote greater and more consistent transparency across securities lending markets. In this, our fourth report, we continue to develop the theme of transparency as part of those original objectives but we have also begun to explore where the securities lending markets may change and evolve as many of the regulatory initiatives across Europe move into legislation. We believe that as part of a broader transparency debate it is important to recognise the role of securities lending in the context of the broader capital markets and real economy and we therefore welcome recent dialogue around the Capital Markets Union.

In order to provide proper context and make historical trend analysis relevant we have continued to follow the framework established in our previous reports and we therefore again concentrate predominately on the traditional securities lending markets which operate between institutional investors (beneficial owners) who lend their securities either directly or via agents, such as custodial banks, asset managers or specialist firms, to prime brokers and other principal borrowers. We review the depth and breadth of this market both regionally and from the perspective of the mix of asset classes which are lent and how the relationship with collateral and the borrowers is changing. Themes identified in our previous reports around apparent links between securities lending markets and the impact of regulation is reviewed again in light of another six months of new data. Better understanding of the cause and effect of regulatory changes on market behaviour is becoming increasingly important especially as we consider the broader topics such as collateral mobilisation and proper and effective liquidity for primary and secondary markets.

As ever we welcome all suggestions as to how this report may be developed for future publications.

EXECUTIVE SUMMARY

In this our fourth ISLA Securities Lending Market Report we are now able to review this latest data set against the backdrop of two years of comparable data. Although specific data sets are important, the development of a historical time series of data will allow us to identify trends and the fundamentals that are driving the development of this market. As this historical trend analysis develops, we hope to add to a greater understanding of these markets and how they are interconnected with other liquidity driven elements of the economy.

Our independent ISLA Global Securities Lending Aggregate[1] looks back over two years of data and provides an increasingly visible and important reference point for regulators and policy makers as they consider the developing dynamics of this market. As we continue to develop this report we remain mindful of the key objectives of regulators to create better and more consistent transparency in this market. This report is designed to complement concurrent work around the implementation of the European Commission's regulation on Securities Financing Transactions Reporting (SFTR) by ESMA which will lead to the detailed collection of large numbers of securities lending transactions in Europe over the next two years. In the meantime we believe that this report provides a valuable interim step as the regulatory reporting regimes develop.

Using data as at 31st December the following represent the key highlights and themes:

- **As 31st December 2015 there were Euro 1.8 trillion of securities on-loan which was broadly unchanged from 6 months earlier.** Although the value of equities on- loan continued to increase (albeit at a slower rate) in the second half of 2015, the value of government bonds on loan fell marginally by 4% ahead of the year-end.
- **Mutual funds and pension plans continue to dominate the global lending pool.** Together they again account for 66% of the reported Euro 14 trillion of securities that institutional investors make available for lending.

[1] ISLA Global Securities Lending Aggregate is compiled using data from DataLend, Markit Securities Financing (MSF) and FIS Global. Please also see Data methodologies section.

- **Although mutual funds account for 44% of all securities made available for lending they now only account for 18% of total on-loan balances.** This anomaly was identified in previous reports and now appears to be a permanent shift in market behaviour. It is increasingly likely that this reflects the restrictive regulatory environment applied to this sector in respect of securities lending.

- **Securities lending is still a very important revenue stream for institutional investors.** Figures recently released by Datalend[2] suggest that the securities lending industry globally generated Euro 8bn of revenues in 2015, with Europe accounting for circa Euro 2.6bn.

- **As at 31st December 2015 government bonds accounted for 37% of all securities on-loan.** Although the proportion of government bonds on-loan globally has increased steadily over the past 12 months we did see a marginal fall in on-loan balances towards the year-end. This probably is an indication of active balance sheet management ahead of the year end rather than a reversal of the trends seen over the past two years.

- **Globally, equities still dominate representing 51% (Euro 1.01 trillion) of all securities on loan as at 31st December 2015.** Of securities made available for lending by institutional investors, equities account for just under Euro 9 trillion of the Euro 14 trillion of securities held in lending programmes globally.

- **The mix between non-cash and cash collateral stabilised during the last six months of 2015 at 60/40 globally.** Europe continued to record much higher levels of non-cash collateral as banks and brokers repositioned their balance sheets to comply with new regulations. For example, in excess of 90% of all government bonds which are lent in Europe are now collateralised with non-cash collateral.

- **The proportion of equities held in tri-party services fell to 51% from 57% six months earlier.** The reasons for this reversal of previous trends may be a combination of more efficient collateral management within banks, reducing the reliance of external funding combined with a natural reduction in business volumes ahead of the year-end. This dynamic will be closely monitored in future reports.

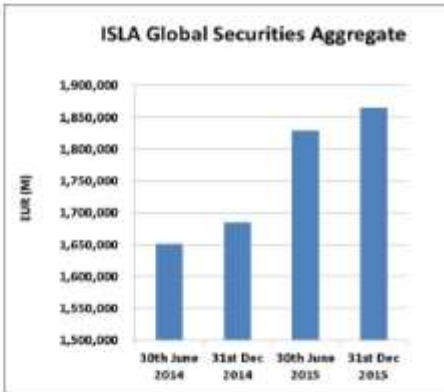
- **As regulation moves into legislation and implementation market behaviour has changed.** Basel III and the Liquidity Coverage Ratio (LCR) have effectively created a term market in HQLA that didn't exist two years ago. Today circa 25% of all government bonds are borrowed for three months or more.

- **Further regulatory pressure could push institutional lenders away from the securities lending market.** The combined and rolling impact of compliance with various regulatory regimes such as SFTR, the Bank Recovery and Resolution Directive (BRRD), the Central Securities Depository Regulation (CSDR) and further restrictions on UCITS may cause some lenders to withdraw from the market rather than comply with this array of new regulation. This in turn could lead to a loss of market liquidity and make it harder and more expensive for institutional investors to invest in equity markets and for government institutions to issue and manage existing government bond programmes.

[2] http://www.datalend.com/infographic/infographic2015.php

GLOBAL MARKET OVERVIEW AND TRENDS

As at the 31st December 2015 the ISLA Global Securities Lending Aggregate indicates that there was just over Euro 1.8 trillion of securities on-loan globally drawn from an available lending pool[3] of just under Euro 14 trillion. Both reported numbers are broadly comparable with 30th June 2015 with reported on-loan balances only 2% higher whilst the reported available ending lending pool actually fell by a marginal 1%.



Source: ISLA

The above chart highlights consistent growth in on-loan balances over the past two years although there was a clear slowdown in the second half of 2015.

Although growth in overall balances slowed in the latter part of 2015, a review of the various market segments did highlight some more varied changes. Equities at a global level showed further strong growth with a 6% increase over the period from Euro 1 trillion to Euro 1.1 trillion with much of the growth being recorded in North America. Asian equity markets also recorded a strong and consistent on-loan profile driven by strong profitability in that region during 2015.

[3] Available lending pool or lendable is the value of securities made available by institutional investors and other long term investors within securities lending programmes.

On-loan balances in government bonds actually fell in the second half of 2015 with a noticeable 4% fall over the period. Previously we have seen a strong and growing demand to access High Quality Liquid Assets (HQLA) as banks seek to source high quality collateral as part of a broader agenda to comply with Liquidity Coverage Ratio (LCR) requirements and to reduce the impact of balance sheet and capital charges for equity securities. The reasons behind this reversal may only be temporary and may simply reflect broader dislocations in the short term money markets. We will continue to monitor this dynamic in future reports, but it is clear that this sector of the market can be sensitive to changes in monetary policy and the regulatory agenda facing banks.

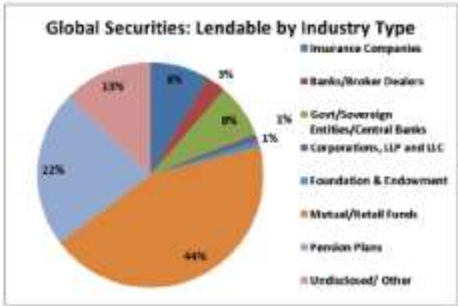
The idea that the reduction in government bond lending was temporary as opposed to a change in overall direction tends to be supported when it is noted that, as government bond loans contracted cash collateralised loans were returned first. This suggests that these were not balance sheet LCR driven transactions. This view is further supported by the proportion of term transactions (as defined as three months or more) which rose as proportion of all loans of government bond loans to 26%, up from 25% reported in June.

The changing debt/equity mix discussed above led to an overall slight shift towards equities with global on-loan balances shifting from 51/49 equity/debt as at 30th June to 53/47 respectively as at 31st December.

As at the 31st December 2015 the reportable pool of securities made available for lending predominantly by long term institutional investors was Euro 14 trillion. This was broadly unchanged from 6 months earlier but represents a circa Euro 2 trillion increase compared the Euro 12 trillion reported at the 31st December 2014. Although it is likely that some of the growth in securities that are made available for lending can be attributed to the continued strengthening of the US

Dollar against the Euro, it is clear that a broad and diverse pool of long term investors see value in participating in lending programmes.

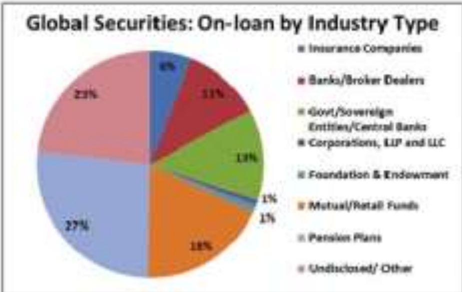
As we have reported previously, mutual funds and pension plans continue to dominate those institutions who participate in securities lending with these two groups accounting for 66% of all securities made available for lending. This is virtually unchanged from the distribution seen as at the 30th June 2015, but if we look back further to our first report in June 2014 we have seen a seven percentage point increase in the proportion of mutual/retail funds that comprise the global pool of securities lending assets. Part of this growth may reflect simple US Dollar/ Euro exchange rate appreciation as a large proportion of mutual funds hold US Dollar investments but it also supports the view that lending is still attractive to institutional beneficial owners. Figures recently released by Datalend[4] suggest that the securities lending industry globally generated Euro 8bn of revenues in 2015, with Europe accounting for Euro 2.6bn.



Source: Markit Securities Finance

As at the 31st December 2015 the distribution of on-loan balances was broadly unchanged from that seen at the 30th June with the key trends identified in earlier reports continuing in this latest date set.

Again, institutional investors comprise the largest lenders of securities with mutual funds and pension plans representing 45% of all securities on-loan. However the disconnect between the dominance of mutual in terms of lendable securities (they represent 43% of all securities that are available for lending)



Source: Markit Securities Finance

and their proportion of on loan balances (they only represent 18% of all securities on-loan) continues. The reasons for this apparent disparity may be varied but are likely to reflect, at least in part, the increasingly restrictive regulatory environment in respect of securities lending that is applied to UCITS[5] funds in Europe. Furthermore potentially we could see on-loan balances from UCITS continue to decline as asset segregation rules previously applied under the Alternative Investment Fund Managers Directive (AIFMD) are more broadly applied to UCITS.

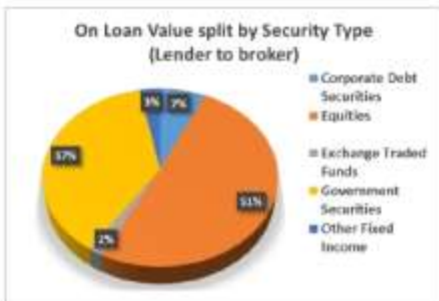
Again Sovereign Wealth Funds (who only comprise of 8% of lendable securities) report a disproportionately high 13% of all securities on-loan. We have noted the growing importance of this institutional lending group in this and previous reports. It reflects a shift in borrower demand away from less attractive and highly constrained retail funds towards counterparts who can contemplate lending transactions that match more closely match their own regulatory requirements.

The latest data set suggests that direct lending amongst banks and broker dealers is again around 12/13% of total securities on-loan. This is consistent with earlier data sets and appears to have settled at this level. We continue to monitor this particular metric as it can be a lead indicator of banks changing borrowing behaviour especially as regulations potentially restrict access to normal lending channels.

[4] http://www.datalend.com/infographic/infographic2015.php

[5] For example UCITS are unable to engage in term securities lending.

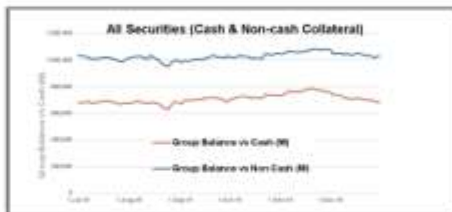
Reported securities on-loan by asset type shifted marginally in the second six months of the year. The combination of a strong demand to borrow equities particularly in North America and Asia combined with some reduction in government bond lending led to a rise in the overall proportion of equities on loan from 49% of all securities on-loan at 30th June to 51% as at the 31st December. Government bond lending fell for the first time since we started tracking these outputs from 39% to 37% of all securities on-loan as at 30th June and 31st December respectively. It is not clear at this point if the reduction in government bond lending is temporary and will return to its upward trend in future periods or if this market has reached a temporary ceiling in terms of both demand and available supply.



Source: DataLend

The steady move away from cash collateral across the industry appears to have slowed in the second half of 2015. Non-cash collateral[6] has levelled out at around now 60% of all collateral received by lenders. The following chart highlights the relatively consistent non-cash element of total on-loan balances globally with some evidence that as on-loan balances were reduced ahead of the year-end it would appear that cash collateral loans were returned first. This is perhaps explained by noting that many non-cash collateralised loans (especially those involving HQLA assets) are likely to be term LCR driven transactions which borrowers would likely prefer to retain. Another potential ceiling on the drift towards a wider use of non-cash collateral is existing restrictions in North America around the ability of various types of institutional clients to accept noncash collateral. We believe this dynamic will change over time but would expect the pace towards the use of non-cash collateral to slow somewhat although the direction of travel will remain constant.

The declining role of cash collateral is further compounded by the continued very low and negative interest rate environment and the absence of any real return in the cash collateral reinvestment markets, making cash collateral less attractive to lenders.



Source: Markit Securities Finance

In our first report published in September 2014 we were able to report that just over 8% of all transactions were reported to have a term of 3 months or more. That number has risen consistently over the past 18 months with 12% of all reported transactions being for 3 months or more as at 31st December 2015. As we will review in more detail in subsequent sections, the growth of a term securities lending market was most pronounced in the government bond sector where the LCR[7] would appear to be driving this market. Here we are seeing a quarter of this market operating on a term basis.

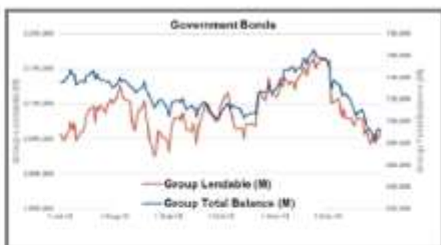
Source: DataLend

[6] Collateral may be in the form of cash or other securities and is given by the borrower of the securities to the lender to mitigate the risk of financial loss if the borrower is subsequently unable to return the borrowed securities.

[7] Liquidity Coverage Ratio (LCR) requires that banks hold HQLA that exceed their expected net cash outflow for the next 30 days

GLOBAL GOVERNMENT BONDS

As at 31st December government bond lending represented 37% of all outstanding loans, down from 39% six months earlier. On-loan balances for government bonds peaked at around Euro 765bn at the end of November but we then saw 10% and 5% falls in on-loan balances and lendable respectively up to the year end.



Source: Markit Securities Finance

The apparent sell-off of government bond positions in the final month of the year is interesting and reflects a number of factors that influence investor behaviour. Firstly, in certain markets there was some anticipation that the next move in interest rates would be up with investors looking to switch out of longer dated maturities into shorter dated bonds to capitalise on this change in sentiment. Secondly, we are seeing some evidence that the decline in on-loan balances is linked to a shortening of tenors in HQLA bonds due to the impact of negative interest rates and Quantitative Easing (QE). It is also possible Public Sector Purchase Programmes (PSPP) may well have sucked bonds and liquidity from the system.

Set against this backdrop it is still clear however that the link between the demand to borrow HQLA (as evidenced by growth in government bond lending over the past two years) and the implementation of regulations such as Basel III, EMIR and Dodd Frank (as noted in our previous reports) is driving this segment of the market. This latest data set confirms that securities lending programmes continues to play a crucial role in both recycling HQLA into the market and providing a pool of available securities to support secondary market making in government bond markets.

In our last report we referenced the European Commission's Green paper on Building a Capital Market Union (CMU) in Europe where they stated that *'The fluidity of collateral throughout the EU is currently restricted, preventing markets from operating efficiently.'*

Thinking further about this important dynamic and although we have seen significant growth in the lending of HQLA, from the data that we see it is clear that there is considerable potential for this part of the securities lending market to expand further. As at 31st December we estimate that of the Euro 2bn of HQLA that could be lent only Euro 690 bn or 33% was on loan. Whilst it would be wrong to suggest that all of the Euro 2 bn could be lent as prudential thresholds, client and credit limits would restrict what could actually be lent from the available pool of securities. Therefore we believe that (notwithstanding the normal parameters that govern the operation of a lending programme) there is considerable room for expansion.

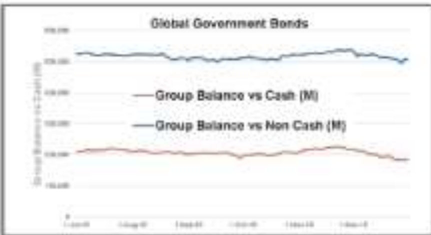
As we think about how the broader market may unlock these HQLA we are also mindful of regulation that potentially acts as constraint on the development of this market. We have already seen increasing restrictions on UCITS[8] funds

[8] For example UCITS are unable to engage in term securities lending.

make their lendable supply progressively less attractive to borrowers and further restrictions around asset segregation may compound this further. We therefore believe that it is increasingly important to recognise the crucial role that securities lending can play in unlocking these pools of HQLAs globally. Therefore attendant regulation should wherever possible encourage their mobilisation.

Figures for the 31st December once again highlight the continued drift towards non cash collateral in this market. Of the Euro 691bn of securities on loan as at the year-end, Euro 507bn or 73% was undertaken against non-cash collateral. This is marginally up from the 72% reported in June and considerably higher than the 61% reported in June 2014.

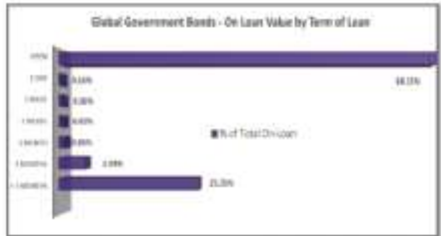
The following chart highlights the dominance of non-cash collateral and it also suggests that as onloan balances fell towards the year end (see previous comments) borrowers appear to have opted to return cash collateralised loans first. The reasons for this are complex but are likely to reflect that cash collateralised loans are unlikely to be term driven HQLA trades which are normally collateralised on a non-cash basis. It is these trades that borrowers are more likely to want to maintain as some lenders recall securities on the back of cash market sales.



Source: Markit Securities Finance

[9] An open transaction is typically one with no specific end date but either party has immediate right to either recall or return the securities concerned.

Not unexpectedly as this part of the securities lending market contracted up to the year-end open[9] transactions fell disproportionately from 71% of all loans in government bonds at the 30th June to 68% at the year end. Loans with a final maturity of three months or more actually increased in both absolute terms and as a proportion of the overall total outstanding from Euro 140bn to Euro 150 bn and from 24% to 25% as at 30th June and 31st December respectively. This underlines the importance of these predominantly LCR driven trades to the wider money markets.

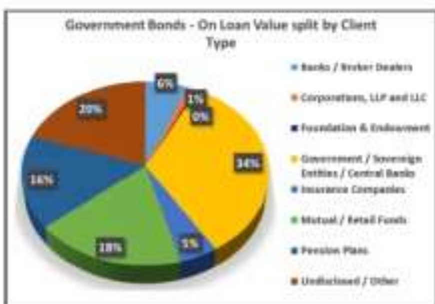


Source: DataLend

We have again considered the interaction between the traditional lender to borrow market and the much smaller bank to bank or broker dealer market. We have already highlighted that this latter markets accounts for circa 13% of all securities on loan with in the case of government bonds this direct or principal to principal activity accounts for 5% of total on-loan balances. However again we have noted that banks, not surprisingly, are evidently more prepared to undertake term transactions with each other with over 45% of loans in this smaller market being undertaken for periods of 3 months or more. This compares with the 25% seen in the broader traditional market. This is perhaps understandable when it is considered that banks trading with each other in a principal capacity will have a greater ability to undertake term business and assume the liquidity and pricing risks associated with these types of transactions. Conversely institutional investors may either not have the ability to undertake term transactions

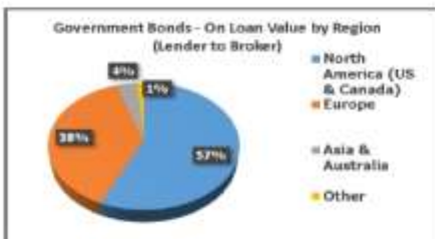
(e.g. UCITS) or would prefer not to manage such risks in the context of their lending programmes.

Looking at the distribution for on-loan balances for government bonds at the 31st December we would highlight the importance of government and sovereign entities which now account for 34% of all government bond loans. This is up from the 32% reported in June and may well reflect the appetite of these institutions to consider things like term transactions or alternatives forms of non-cash collateral that is more closely aligned with the regulatory driven needs of the borrowers.



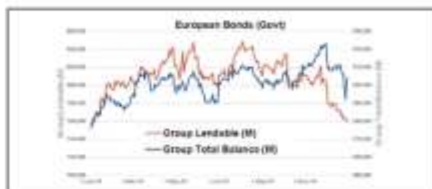
Source: DataLend

The distribution of government bonds on-loan remained little changed from six months earlier with North American government bonds representing 57% of all government bonds on-loan as at the 30th June and 31st December.



Source: DataLend

The picture in Europe is similar to that seen globally. The following chart highlights the apparent sell- off in government bonds during the final weeks of the year. It also highlights the knock-on impact to on loan balances with both falling to levels last seen in the middle of the year (although the reported year-end on-loan balance of Euro 304bn is still substantially higher than the Euro 278bn reported as at 31st December 2014). This reinforces the view that securities lending in Europe is a key conduit for the mobilisation of HQLA and shows a level of sensitivity of this market to short term market changes.



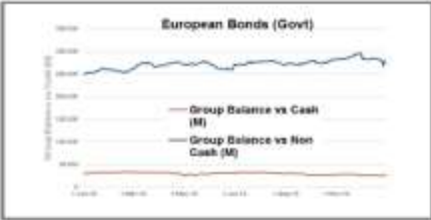
Source: Markit Securities Finance

This level of interconnectivity and increasing reliance on this source of HQLA can been seen when considering the utilisation[10] figures for European government bonds. At the start of the year Euro 277bn of European government bonds were on-loan against a reportable lendable inventory of Euro 752bn, creating an utilisation rate of 36%. By the end of the year this had risen to 40% with Euro 304bn of European government bond on-loan against a reported lendable base of Euro 759bn. This suggests that as lendable fell, especially at the end of the year, borrowers were keen to keep these trades on their books thereby squeezing supply, at least in the short term.

As we have seen in previous reports non-cash collateral dominates in this market with over 91% of the Euro 304bn of European government bonds on-loan as at 31st December being reported as being against non-cash collateral. This continues

[10] Utilisation is the proportion of any given security that is on-loan compared as a percentage to the available pool of lendable securities for that security.

to support the view that borrowers securing access to HQLA are almost exclusively optimising balance sheet and risk weighted assets by providing other assets (mainly equities as collateral) in these transactions.



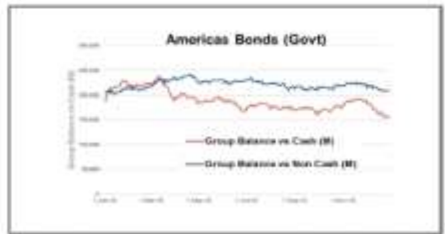
Source: Markit Securities Finance

Although we saw a small shift in the mix of term transactions with a slight increase in the proportion of open trades increasing from 68% to 70% over the last six month regulatory driven three month plus trades remained fairly constant at 23% of all reported trades. As at the 30th June 24% of trades were for three months or more.

Source: DataLend

Patterns seen at the global level in terms of the interbank/ broker-dealer market are seen here as well with circa 45% of all transactions between banks and broker-dealers being for periods of there months or more. However as this segment of the market represents only 7% of the reported volumes it is difficult to draw too many conclusions although we will continue to monitor this segment of the market.

Historically where non-cash has been very much part of the market structure for many years here in Europe, the market in North America developed around the cash collateral model. The combination of regulatory pressure making the non-cash collateral model progressively more attractive to brokers, combined with the absence of any real reinvestment yield in the cash collateral reinvestment markets has led to a slow discernible drift to the use of non-cash collateral in North America as well. The pace of this change will also depend on lenders ability to accept non-cash collateral and although this is changing, many underlying lending clients will need to regulatory changes before they can contemplate accepting non-cash collateral. Notwithstanding some of these natural market constraints the proportion of US government bonds lent against non-cash collateral is now typically 57% of all transactions. Furthermore, we noted that as the market headed towards the year end it can clearly been seen in the following chart that business undertaken against cash collateral appears to have fallen more steeply that non-cash collateral transactions. Again, reasons for this may be varied but as we have seen with other HQLA assets it is likely that borrowers were keen maintain non-cash transactions as these are most likely to be LCR driven transactions.



Source: Markit Securities Finance

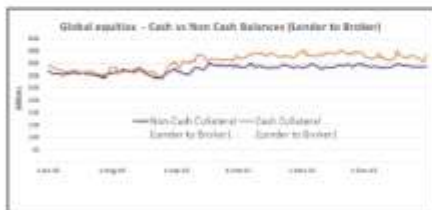
EQUITIES

Globally equities still dominate representing 51% (Euro 1.01 trillion) of all securities on loan as at 31st December 2015. Of securities made available for lending by institutional investors equities account for just under Euro 9 trillion of the Euro 14 trillion of securities held in lending programmes globally.

Unlike fixed income securities and particularly government bonds equities typically see much lower levels of utilisation[11] with the average amount of equity securities on-loan being circa 10% to 12% of available lendable assets over the past 12 months. Whilst there is some seasonality in these numbers, especially in Europe during the spring, specific securities can see much higher levels of demand. Therefore equities generally see lower levels of utilisation than government bonds which will see utilisation levels normally in excess of 35%.

From the data available the value of equities on-loan increased by some 20% during 2015 and reflects an increased level of demand to borrow equities globally. Some of this apparent increase could be the result of a steady strengthening of the US Dollar/Euro foreign exchange rate over the period that has led to some inflation of the predominantly Euro reported numbers that we use for this analysis. However it would also appear to reflect an increasing demand to borrow equity securities as part of various active asset management strategies. Data provided by Datalend[12] suggests that the equity lending markets generated average returns of 68 basis points in respect of on-loan securities during 2015.

The following chart highlights how equity lending globally is still a predominantly cash collateral driven business with, in part, the preponderance of North American investors, many of whom have historically been restricted from a regulatory perspective from accepting many forms of non-cashdriving this relationship. Changes in regulation and the ability of US funds to accept non-cash collateral will change this dynamic over time.



Source: DataLend

Although we saw the gap between cash collateral and non-cash collateral narrow in the earlier part of 2015, it would appear that much of the growth in equity lending seen in the second half of 2015 came in the form of cash collateralised lending. Whilst we continue to monitor this dynamic and would expect further inroads to be made by non-cash lending, very low interest rates to borrow cash and the perceived excess of liquidity in the system probably makes using cash a more compelling option for borrowers at the present time.

Whilst the exact details of the underlying reasons for the overall growth in equity lending are likely to be varied, typically such loans support trading and hedging strategies. The absence of any real term

[11] Utilisation represents the percentage of any given security or asset class that is on-loan as a percentage of the total value of that security or asset class that could be lent.
[12] http://www.datalend.com/infographic/infographic2015.php

trades within the equity lending markets has not changed, with less than 5% of all equity trades being reported as being for periods in excess of three months. This has little changed from the data that we analysed in previous reports. We will continue to monitor this particular dynamic as borrowers consider how they must adapt both trading and funding strategies to reflect the demands of the Net Stable Funding Ratio (NSFR).

Not un-expectedly, North American equites continue to dominate representing 69% of all equities on loan as at the 31st December. This is a reflection of the relative size and maturity of the equity markets in North America combined with the sheer number of US based institutional investors (who have high levels of domestic assets in their portfolios) and participate in lending programmes. Another factor driving the demand to borrow US equities is simply the higher level of corporate activity including merger and acquisitions that is seen in the US compared to Europe and to a lesser extent Asia. This underlines the importance of a functioning equity lending market to support broader capital markets activities and provide secondary market trading liquidity and more efficient price discovery for investors.

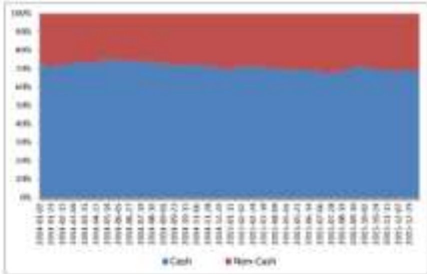
Source: DataLend

North American equities showed a similar growth pattern to that seen elsewhere, with on-loan balances at the year-end 20% higher than 31st December 2014.

Source: Markit Securities Finance

As already discussed is this and previous reports there is likely to be an element of foreign exchange translation in these numbers as the US dollar strengthened against the Euro over the period. However it is felt that there is also an overall increase in borrowing activity as banks borrow securities to support their clients' various trading and hedging strategies. It is also possible that the overall increase in demand seen across all equity classes in the past 12 months could reflect the premise that previously banks and brokers have been able to actively optimise internal flows and positions as part of a drive to improve funding and balance metrics. So in previous periods, particularly in 2014, some of the demand to borrow securities would have been met by better internal management of long and short positions within a given bank. With that process delivering essentially a one off dip in the demand to borrow securities externally it is possible that the demand is now driving the need to borrow securities again externally.

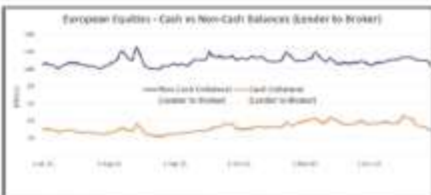
The pure North American equity lending market is one of the last major markets that we have seen where cash collateral still dominates.



Source: FIS Global

Although there has been some drift towards non-cash collateral in this market, approximately 70% of all loans are still collateralised with cash collateral. It is likely that the non-cash element of this market relates primarily to European beneficial owners who own these securities rather than a shift to non-cash collateral lending by US based beneficial owners. Whilst we would expect this number to drift towards non-cash over time, the previously discussed limitations on beneficial owners accepting non-cash collateral will only change this dynamic slowly and those restrictions are lifted.

In Europe we see the expected greater concentration of non-cash collateral lending with approximately 80% of all loans of European equities are collateralised with non-cash collateral.



Source: DataLend

This again underlines the important role of collateral in the context of the securities lending markets globally but particularly in Europe. The role of collateral is vital for the smooth running of the market, as well as the provision of market liquidity to support equity trading and settlement and mobilisation of HQLA in the government bond markets.

COLLATERAL

As at the 31st December 2015 it is estimated that there were approximately Euro 1.8 trillion of securities on loan globally[13]. Although this is marginally up on the volumes seen at the end of June, the growth in on-loan balances seen earlier in the year slowed toward the year end.

Of this circa 60% or Euro 1 trillion were loans that were collateralised with non-cash collateral. This is in line with the levels of non-cash collateral seen earlier in the year but the growth in non-cash collateral did slow in the second half of the year. This level of non-cash collateral may represent something of a regulatory driven ceiling due to constraints upon mainly North American institutional lenders who historically can only accept cash collateral.

The patterns of non-cash collateral seen in previous reports especially in Europe and more specifically in respect of the lending of government bonds are now almost undertaken only against non-cash collateral.

This greater use of non-cash collateral reflects the ongoing impact of the strong regulatory push behind new regulatory regimes such as EMIR and Basel III that are forcing borrowers to think about different forms of collateral particularly when they want to access and borrow HQLA assets.

Non-cash collateral securities are normally held and managed in one of two ways. First the lender can take delivery of the collateral securities directly from the borrower and hold them in a custody account. Alternatively the collateral securities are delivered to a specialist tri-party service provider who holds the collateral on behalf of the lender. Over the past 18 months we have been able to combine information from the four principal tri-party service providers active in Europe today.

Between June 2014 and June 2015 we saw steady growth in the proportion of equities being pledged by borrowers within tri-party with as at 30th June 57% of all securities held in tri-party in respect of securities lending activities being reported as equites. However and somewhat surprisingly the proportion[14] of equity securities held as collateral in tri-party actually fell back to 51% as at the 31st December.

Source: BNY Mellon, Clearstream, Euroclear, JP Morgan

The reasons for this apparent reversal in trend are interesting and may reflect a number of different factors: First it is possible that prime brokers and banks simply deleveraged their balance sheets ahead of the year end and as such that there were less equities in the system that could be used as collateral. This idea is supported by the clear fall off in equity lending ahead of the year end. A second possibility would appear to be that prime brokers and banks were holding higher levels of government bonds on their balance sheets as a proportion of collateral assets within tri party have increased compared to six months previously. Again this would tend to support the argument that we are seeing the reaction to year end balance sheet management within the markets rather than changes to the greater use of equities as collateral by market participants.

Corporate bonds being accepted as collateral remained flat at 9% of total try-party collateral over the period. Although it is hard to draw firm conclusions it is interesting to note that as equity collateral fell (as a proportion of overall collateral), borrowers appeared to prefer to use government bonds rather than corporate bonds. This may reflect a combination of an absence of these instruments being held by banks for trading and market making purposes but it may also reflect a continued lack of interest from lenders to take corporate bonds as collateral.

[13] **ISLA Global Securities Lending Aggregate**

[14] **Tri-party** collateral management is where the parties to a bi lateral non cash loan transaction pass responsibility for the management of the agreed collateral to a specialist collateral management service provider. The tri-party agent then maintains the value including any agreed haircut, quality and performance of the collateral over the life of the loan.

DATA METHODOLOGIES AND SOURCES USED

This ISLA Securities Lending Market Report has been compiled using a range of data contributors together with specific information provided directly by our members through surveys and questionnaires. We would like at this point to thank all of the various contributors for their efforts in assisting ISLA in the production of this report.

Loan information that includes details of securities on-loan across different asset and client types has been provided by three institutions that provide commercial data and benchmarking services for the securities financing industry. DataLend, Markit Securities Finance (MSF) and FIS Global all collect data from industry participants on a high frequency basis and provide a range of securities lending benchmarking analytics that allow firms and their clients to better understand and assess the relative performance of any given lending programme.

Whilst each of these data providers covers broadly the same market we have chosen to use data from each to reflect the fact that each has a slightly different business model and client mix and therefore provide different perspectives across certain asset classes or regions. By adopting this approach we have been able to develop and publish the **ISLA Global Securities Lending Aggregate.** This aggregate, that will be used to develop consistent trend indicators over time, has been compiled by combining information from each of the commercial data providers. The ISLA Global aggregate was compiled to provide the most representative global estimation of the size and scope of the securities lending markets. In compiling the aggregate we took the largest securities lending on loan balance provided by the three commercial data providers as a starting point for the calculation. This global on-loan balance was then adjusted to reflect incremental data from the other commercial data providers where their reported on-loan balances across different asset classes or regions created a more representative overall global number.

All regional and geographic analysis reflects the location of the issuer of the securities (as opposed to the location of the lender or borrower) as this is the basis on which the providers collect and analyse their data.

Data from the principal tri-party service providers active in Europe today is also incorporated within the report as part of our analysis of collateral.

ABOUT ISLA

The International Securities Lending Association (ISLA) is a trade association established in 1989 to represent the common interests of participants in the securities lending industry. ISLA works closely with European regulators and in the United Kingdom has representation on the Securities Lending and Repo Committee, a committee of market practitioners chaired by the Bank of England.

The Association has contributed to a number of major market initiatives, including the industrystandard lending agreement, the Global Master Securities Lending Agreement (GMSLA).

ISLA's aims include:

- Working with regulators to provide a safe and efficient framework for securities lending.
- Highlighting new market developments.
- Ensuring sound industry practices.
- Enhancing the public profile of the Securities Lending industry.
- Fostering good communication and co-operation with other trade associations.
- Promoting the use of the Global Master Securities Lending Agreement (GMSLA) as the market standard legal agreement.

ISLA has approximately 100 full and associate members comprising of insurance companies, pension funds, asset managers, banks, securities dealers and service providers representing more than 4,000 underlying clients. Based in London, ISLA represents members from more than twenty countries in Europe, the Middle East, Africa and North America.

ISLA has an elected Board of fourteen industry professionals representing firms from all parts of the industry.

Further details may be found at: www.isla.co.uk

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