ISLA SECURITIES LENDING MARKET REPORT

ISLA
INTERNATIONAL
SECURITIES
LENDING
ASSOCIATION

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INTRODUCTION

It is now two years since the publication of our first ISLA Securities Lending Market Report in October 2014. As we now consider this, our 5th such report, we remain mindful of the original objectives that we laid out in 2014 around creating and promoting greater and more consistent transparency across securities lending markets. As we have developed the theme of transparency, we have also been able to see the impact of the changing regulatory landscape on the various facets of the securities lending markets. Over the past two years, we have seen significant changes in the shape of supply and demand in these markets as borrowers in particular respond to new and often challenging regulatory regimes. This in turn has led to noticeable shifts in how institutional investors are able to engage in these markets with some groups; most notably UCITS seeing historically low levels of demand to borrow their securities when compared with other institutional investors.

When publishing its Standards and Processes for Global Securities Financing Data Collection and Aggregation[1] on 18th November 2015, the FSB stated that 'Securities Financing Transactions (SFTs) such as securities lending and repurchase agreements (repos) play a crucial role in supporting price discovery and secondary market liquidity for a wide variety of securities'. Set against this backdrop and in the context of the broader Capital Markets Union, we believe that the role of securities lending is an integral part of the wider capital markets agenda. As such, it is increasingly important to better understand how securities lending can support those broad objectives.

The now well established reporting and analytical framework seen in our previous reports is used again. This allows for our current findings to be assessed in their proper historical context and makes trend analysis more relevant. In line with previous reports, we concentrate predominately on the traditional securities lending markets which operate between institutional investors (beneficial owners) who lend their securities either directly or via agents (custodial banks, asset managers or specialist firms etc.) to prime brokers and other principal borrowers. We also 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 evolving.

One significant political event that occurred just prior to the collation date for this report was the UK's electorate's decision on 23rd June to leave the European Union. The ramifications of that decision are both wide ranging and far reaching and to an extent fall outside of the remit of this market report. However, it is important to stress that the so called Brexit decision does not fundamentally change any of the legal constructs that govern our industry so day to day business continues uninterrupted.

We have however seen some pre and post vote impacts within our markets and these, as appropriate, are discussed in more detail within the body of this report. As the eventual path that the UK may take becomes clearer over the coming months, we will of course monitor this topic closely and how it may impact on both our member firms and the overall securities lending markets.

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

1 http://www.fsb.org/2015/11/standards-and-processes-for-global-securities-financing-data-collection-and-aggregation-3/

EXECUTIVE SUMMARY

This is our fifth ISLA Securities Lending Market Report and we now able to review this latest data set against the backdrop of over two years of comparable data. Our independent ISLA Global Securities Lending Aggregate[2] now looks back over an extended time horizon and provides an increasingly visible, important and independent 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 aware and fully supportive 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 in the next 18 months. In the meantime, we believe that this report continues to provide a valuable interim step as the regulatory reporting regimes develop.

Using data as at 30th June 2016, the following represent the key highlights and themes:

- **As at 30th June 2016, there were €1.9 trillion of securities on-loan which represented an increase of 4% from 6 months earlier.** The value of equities on- loan continued to increase in the first half of the year powered by increasing demand from Asia and North America. The value of government bonds on loan fell marginally for the second consecutive period.
- **We did see some contraction of lending activity around the UK Brexit vote on 23rd June.** We observed that European equity loans were returned ahead of the vote, suggesting investors had closed down open risk positions. Furthermore, a sharp fall in available lendable securities in Europe suggests that investors were selling in the cash market ahead of the vote.
- **Mutual funds and pension plans continue to dominate the global lending pool.** Together they again account for 66% of the reported €14 trillion of securities that institutional investors make available for lending.
- **Although mutual funds account for 44% of all securities made available for lending, they now only account for 17% of total on-loan balances.** The increasingly harsh regulatory environment facing many retail funds, notably UCITS, has led to a permanent shift in borrowers behaviour as they look to borrow securities from entities that better match their own regulatory requirements.

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

- **As at 30th June government bonds accounted for 35% of all securities on-loan.** This is the second consecutive period that we saw a fall in government bond lending ahead of the regulatory reporting date. This is probably an indication of active balance sheet management ahead of the half year end rather than a reversal of the trends seen over the past two years.
- **As a percentage of all government bonds on-loan, European government bonds fell from 38% as at 31st December to 36% at 30th June.** This drop could reflect the rolling impact of PSPP's that are pulling bonds from the market.
- **At the 30th June 38% of all government bonds on-loan came from government and sovereign wealth entities, up from 34% 6 months earlier.** Most of that proportional growth would appear to be at the expense of mutual/retail funds including UCITS which fell to 15% of all loans of government bonds from 18% at the 31st December.
- **Globally, equities represent 53% (€1.1 trillion) of all securities on loan as at 30th June 2016.** Of securities made available for lending by institutional investors, equities account for just under €9 trillion of the €14 trillion of securities held in lending programmes globally. This remains unchanged from 6 months earlier.
- **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 for the second consecutive reporting period to 48% from 51% 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 half year-end. As prime brokers and banks have deleveraged their balance sheets, they now hold fewer equities as part of trading inventory and as such will have to look for alternative assets to post as collateral. From the data, banks appear to have replaced equity collateral with government bonds as these as a proportion of total non-cash collateral increased from 38% at the 31st December to 48% as at 30th June.
- **Contraction of balance sheet and the high capital charges associated with equities means that banks appear to be holding less equities as inventory for trading and client facilitation purposes.** The apparent shift back towards using government bonds as collateral in the securities lending markets could put pressure on the availability of HQLA, as these are also sought after by market participants for broader collateral requirements. Any increase in the demand to use government bonds as collateral may be further undermined by PSPP's which in turn could pull further HQLA supply from the market.
- **As regulation progressively moves from legislation into implementation, market behaviour is clearly changing.** 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. Although the incremental growth in this market appears to have plateaued, we now see this as a permanent feature of our markets.
- **Further regulatory pressure could continue to 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.

GLOBAL MARKET OVERVIEW AND TRENDS

As at the mid-year point (30th June 2016), the ISLA Global Securities Lending Aggregate shows there was in excess of €1.9 trillion of securities on loan globally against reported inventory of circa €14 trillion. Although the value of the lendable pool of assets remained somewhat constant over the previous 6 months, we have observed a more noticeable change in the on-loan balances once again, which have increased by 4% over the review period.

Source: ISLA

Notwithstanding the increase in global on-loan balances however, it is worth noting that from a regional perspective we did see a fall in European equity values from the third week of May until the end of June. Although seasonality may have been a contributing factor here, banks did see noticeable hedge fund de-risking in balances going into the Brexit vote. Changes in tax regimes, notably in Germany also lead to a reduction in activity in this market.

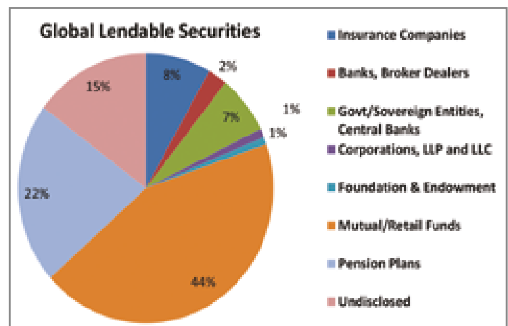
Part of this change may also be explained by simple FX, given data inputs are reported values as opposed to quantities with most of our data partners using US Dollars as their base reporting currency. ISLA is working on possible solutions with our data partners for future publications in order to eliminate these anomalies.

On-loan balances in government bonds fell in the first half of 2016 to 35% of all outstanding loans, versus 37% 6 months earlier.

Even at their peak of €720 billion of securities on-loan over the 6 months, this value was lower than that observed at the same point in the previous period (€765 billion). Further to that, notable reductions were observed at March and June quarter ends (€682 billion at June 2016). This trend is probably explained by banks continuing to actively manage their balance sheets for compliance with internal capital and leverage targets.

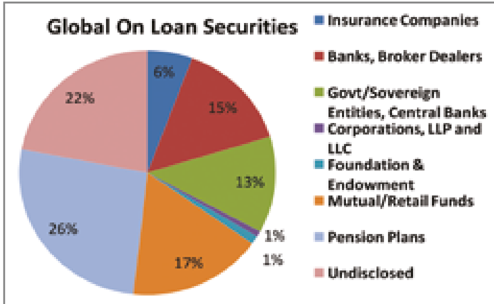
Our analysis also suggests that the growth in the term lending of government bonds has reached something of a ceiling. We have discussed previously the growth in the lending of HQLA as banks have looked to actively manage compliance with the Liquidity Coverage Ratio (LCR). This market that did not exist three years ago represents some 24% of all government bond loans today. The level of 3 month or longer transactions has remained constant now for several reporting periods and discussions with member firms suggest that the market has reached capacity for incremental business at the present time.

As at the 30th June 2016, the reportable pool of securities made available for lending predominantly by long term institutional investors was €14 trillion. This was once again broadly in line with the value 6 months earlier and only a marginal increase over the value a year ago. In terms of the composition of those lending assets, not surprisingly mutual funds and pension plans continue to dominate those institutions who participate in securities lending, with these two groups still accounting for 66% of all securities made available for lending. This is unchanged from the distributions seen as at the 30th June 2015 and the 31st December 2015. If we look more closely at the smaller components of the pie however, there has been a small decrease in some percentages such as Government /Sovereign Entities/Central Banks which fell marginally from 8% to 7% of the total.



Source: Markit Securities Finance

Institutional investors once again continue to dominate both the composition of lendable assets as well as the on-loan of balance. Mutual funds and pension plans represent 43% of the total



Source: Markit Securities Finance

balance. However the disconnect between the dominance of mutual funds in terms of lendable securities (recent figures show they represent 44% of all securities that are available for lending) and their proportion of on loan balances (they only represent 17% of all securities on-loan) continues. We would conclude this is still for the most part due to the restrictive regulatory environment that UCITS[3] face in Europe. As predicted, on-loan balances from UCITS have declined marginally since the last report, as asset segregation rules previously applied under the Alternative Investment Fund Managers Directive (AIFMD) begin to be more broadly applied to UCITS.

Whilst Sovereign Wealth Funds only comprise 7% of lendable securities, and although this has fallen marginally from 8% 6 months earlier, they continue to report a disproportionately high 13% of all securities on-loan. With the continued regulatory restrictions on retail funds, 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 their own regulatory requirements. The small fall in available lendable assets is interesting and may reflect some liquidation of underlying government positions by this investor group to service other internal liquidity requirements. Historically low oil prices could also be a factor here. We will continue to monitor this data point in future reports.

As at 30th June 2016, the overall percentage split between non cash and cash collateral[4] appears unchanged from 6 months earlier at 60/40. Low or negative interest rate environments make the redeployment of cash collateral in the short term money markets increasingly problematic. This in turn draws lenders toward a preference for non-cash collateral. Having said that, we continue to observe an apparent ceiling in North America that restricts various types of institutional clients from accepting non-cash collateral. ISLA will continue to monitor and report any updates on this during subsequent reports.

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. As at the 30th June 2016 that number is some 11% of all trades. As we will review in more detail in subsequent sections, the growth of term lending market was most pronounced in the government bond sector where the LCR[5] would appear to be driving this market.

Source: DataLend

The marginal fall in government bond lending and the increase in demand for North American and Asian equities saw a subtle shift in the debt/equity mix from 49%/51% as at 31st December to 48%/52% as at 30th June respectively.

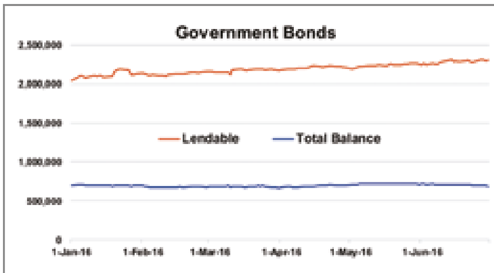
[3] For example UCITS are unable to engage in term securities lending.

[4] 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.

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

GLOBAL GOVERNMENT BONDS

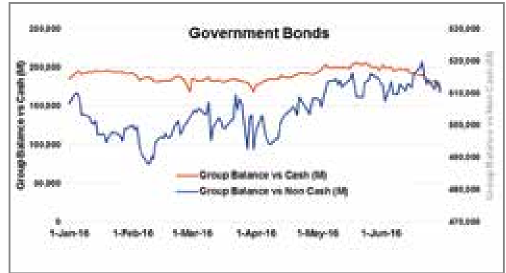
As at the 30th June 2016 government bond lending represented some 35% of all outstanding loans down from a reported 37% at the 31st December. This in turn was down from the reported 39% as at 30th June 2014. During the period, on-loan balances peaked at €720 billion towards the end of May, compared with a high point of €765 billion seen in November 2015. As was seen before in previous reporting periods, we observed a 5% reduction in on-loan balances in the final weeks of the reporting period (they closed at €682bn). However the fall in on-loan balances was not, as seen in previous reporting periods, accompanied by a reduction in the value of government bonds being made available for lending (lendable). During the period, government bonds made available for lending remained fairly constant at between €2.0 and €2.3 trillion.



Source: Markit Securities Finance

Patterns seen in previous reporting periods are seen again in this latest data set. As banks actively managed their balance sheets ahead of the half year end reporting date, on-loan balances have fallen with cash collateralised loans appearing to be returned first. This again, supports the view that non-cash collateralised loans are likely to be HQLA LCR driven terms trades and as such banks will be reluctant to unwind these positions unless absolutely necessary. The following chart highlights this clear trend with cash collateralised loans falling by circa 14% in the final month of the quarter.

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.



Source: Markit Securities Finance

This latest data set confirms that securities lending programmes continue to play a crucial role in both the recycling of HQLA into the market and providing a pool of available securities to support secondary market making in government bond markets.

This highlights in part the continued balance sheet pressure over key reporting dates driven by compliance with the Liquidity Coverage Ratio (especially relevant to EMEA). More generally, as bonds borrowed versus cash are balance sheet intensive & bonds borrowed versus non-cash collateral are balance sheet neutral, we would expect the trend towards borrowing government bonds versus non-cash collateral to continue.

As we think further about this sector, the data we are seeing also poses a number of further questions behind what is driving this market. If we assume that non cash collateral trades are part of a broader capital and balance sheet management process within banks, the relatively static nature in terms of volumes of this business during the review period would suggest that further demand for these structures will not materialise until the existing transactions either roll or mature. It is also possible that we are seeing a much broader impact of regulation reflected in these numbers. Review of the data and subsequent discussions with our member firms confirmed that as balance sheets were actively managed ahead of the 30th June, any securities including some HQLA that were not needed were returned. Better and more efficient use of collateral assets including HQLA is a theme that we are seeing across our member firms and these numbers tend to support that process.

We may also be seeing some anomalies between the securities lending markets and the broader government bond repo markets. Market

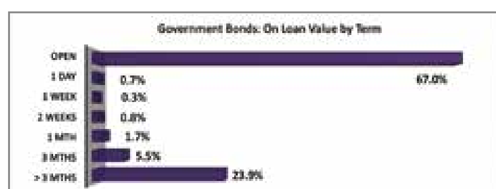
participants could be choosing to return government bonds in the lending markets when alternative potentially cheaper supply is available through the repo markets. We also believe that Quantitative Easing (QE) and Public Sector Purchase Programmes (PSPP) could also be factors in either pulling supply from the markets or pushing underlying investors to sell positions for their own liquidity requirements.

Notwithstanding the current trading patterns in the government bond lending markets, we remain very mindful of the longer term collateral fluidity objectives that the securities lending markets support. Although we have seen significant growth in the lending of HQLA over the past two years, the overall level of government bonds on loan still only represents circa 30% of the government bonds made available for lending by institutional investors. Although prudential lending thresholds, credit limits and the availability of balance sheet and capital within the system will act as a natural limit on the amount of securities that any particular client may want to lend, it is clear that there is still considerable capacity in the system to be unlocked in the future.

The broader issue of collateral mobilisation and the increasing requirement for market participants to migrate to a cleared world will progressively increase the demand for collateral. Whilst we believe that in an environment where there is less leverage in the system due to the natural constraints caused by regimes such as Basel III, we still take the view that there is sufficient collateral in the system. Much of it is in the wrong place however and whilst it is acknowledged widely that the SFT market has a role to play in mobilising and moving collateral around the system, we are also conscious that some regulation appears to be inconsistent with that broad Capital Markets Union agenda. We have highlighted before that certain institutional investors face restrictions on their ability to use the securities lending markets efficiently against a requirement to source and use collateral in respect of cleared transactions within the EMIR regime. Primarily our concern here is the increasing restrictions on UCITS[6] funds that make their lendable supply progressively less attractive to borrowers and further restrictions around asset segregation that may compound this further. The progressive inability of investor groups such as UCITS to fully engage in securities lending will see a loss of lending revenues for these clients as well as making it potentially more expensive for these funds to access collateral that they may need in the context of EMIR and similar regimes.

Since we started tracking these markets, we have seen a steady migration away from cash collateral towards the use of non-cash collateral. Figures for the 30th June (see previous chart) once again highlight the dominance of non-cash collateral in this market. Of the €682 billion of securities on loan as at the 30th June, €510 billion or 75% was undertaken against non-cash collateral. This is marginally up from the 73% reported at the end of 2015 and considerably higher than the 61% reported in June 2014.

As this part of the securities lending market contracted up to the 30th June, open[7] transactions fell disproportionately for the second consecutive period down from 68% of all loans in government bonds at the 31st December, to 67% at 30th June. Loans with a final maturity of three months or more remained constant in both absolute and percentage terms at €150 billion and 24% respectively. This tends to support our view outlined earlier that this market has reached something of a peak or saturation with banks reaching required levels of term funding to comply with LCR ratio thresholds.

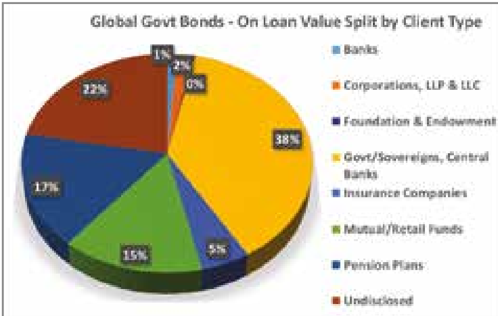


Source: DataLend

Looking at the distribution of on-loan balances for government bonds at the 30th June, trends seen in previous reviews are seen again with the proportion of loans of government bonds coming from government and sovereign wealth entities increasing to 38%, up from 34% six months earlier. Most of that proportional growth

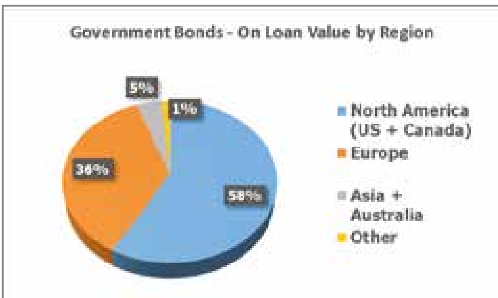
[6] For example UCITS are unable to engage in term securities lending.
[7] An open transaction is typically one with no specific end date but either party has immediate right to either recall or return the securities concerned.

would appear to be at the expense of mutual/retail funds including UCITS which fell to 15% of all loans of government bonds from 18% at the 31st December. This fall is consistent with the increasingly difficult regulatory environment surrounding UCITS and their inability to effectively engage in these markets.



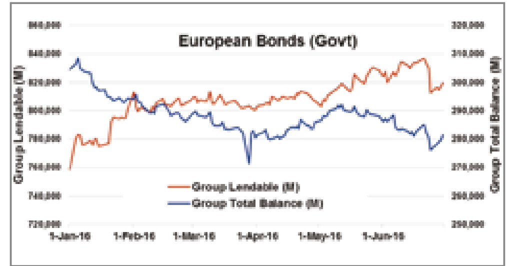
Source: DataLend

The distribution of government bonds on-loan by region has remained fairly constant over the two years of these reports. However as at the 30th June, we did observe some subtle shifts in the distribution of government bonds on loan. We have noted a small but clear fall in the percentage of European government bonds on loan which fell from 38% to 36%. Although one data point is insufficient to draw too many conclusions, this drop could reflect the rolling impact of PSPP's that are pulling bonds from the market. We will continue to monitor this particular statistic in subsequent reports.



Source: DataLend

The picture in Europe, although consistent with some of the broad themes seen at the global level did highlight some important differences that reflect the way in which the markets in Europe appear to be developing. The following chart highlights the apparent sell off in government bonds during the final weeks of the half year. We did not see any evidence of this sell off at the global level and indicates some movement away from European government bonds by investors in the final weeks of the period.



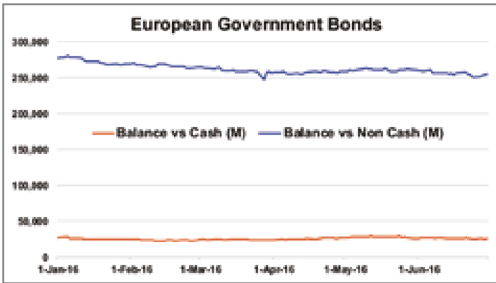
Source: Markit Securities Finance

Notwithstanding the fall in available lendable securities in the final weeks of the half year, supply actually increased over the six month period by some 7% whilst on loan balances declined again by circa 7%. This led to a fall in overall utilisation levels from 40% at the start of the year to 34% at 30th June. Reasons for these falls are likely to be varied but are most likely to centre around more effective balance sheet and collateral management by banks as they look to reduce borrowing ahead of the reporting half year end. Due to the very high concentration of non-cash collateral underlying this market (91% as at 30th June), any returns are likely to include high levels of non-cash collateral business. This was in fact the case with non-cash collateralised loans of European government bonds falling in line with overall balances.

As we have seen in previous reports, non-cash collateral continues to dominate this market with over 91% of the €281bn of European government bonds on-loan being reported as being against non-cash collateral. This continues 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.

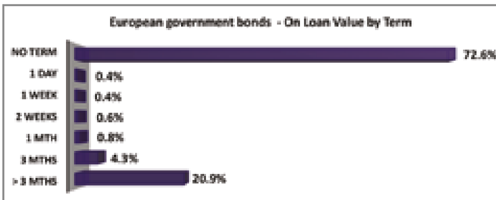
In this latest data set, we have seen a marginal shift in the proportion of open[8] business and term transactions, with the former increasing from 70% of all trades as at the 31st December to

73% at the 30th June. Trades with a reported maturity of 3 months or more fell from 23% to 21% at 31st December and 30th June respectively.



Source: Markit Securities Finance

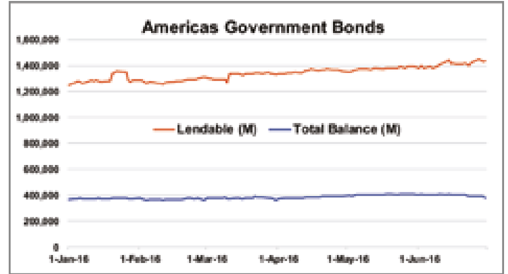
Term loans involving European government bonds fell from 25% to 21% of all reported transactions. This was part of a shift towards shorter dated transactions with reported open transactions increasing from 68% of all reported transactions as at 31st December to 73% as at 30th June.



Source: DataLend

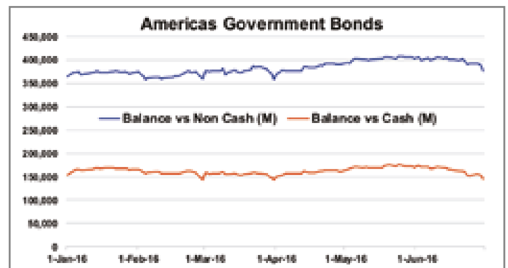
Patterns seen globally were very much representative of the trends also seen in North America. The following chart highlights how on loan balances fell by over 7% ahead of the half year reporting point. As we did not see any apparent fall in lendable securities during the same period, it is unlikely that institutional investors recalled these securities for their own liquidity purposes and the data underlines our pervious comments that this is likely to be banks actively managing their balance sheets for reporting purposes.

[8] 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.



Source: Markit Securities Finance

We have observed a gradual but clear shift towards the use of non-cash collateral in respect of government bond lending over the two years of these surveys. In North America where many lending clients have been unable to contemplate non-cash collateral for regulatory reasons, the shift has been less pronounced but the direction of travel is clear. As at the 30th June, 61% of all loans of North American Government bonds were reported against non-cash collateral up from 57% at the 31st December. This may change over time as interest rates and the yield environment return to positive territory making cash collateral more attractive. It is important to recognise however that non cash collateral is now the most important driver of these markets from a collateral perspective.



Source: Markit Securities Finance

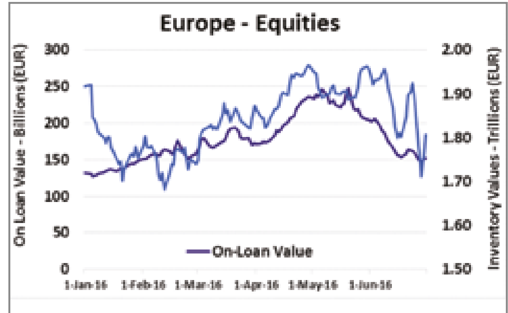
EQUITIES

At the global level, equities still dominate representing 53% (Euro 1.1 trillion) of all securities on loan as at 30th June 2016. Of securities made available for lending by institutional investors, equities continue to account for just under €9 trillion of the €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[9] with the average amount of equity securities on-loan being circa 9% to 12% of available lendable assets. Whilst there is some seasonality in these numbers especially in Europe during the spring, specific securities can at times see much higher levels of demand. Consequently, equities generally see lower levels of utilisation than government bonds which will see utilisation levels normally in excess of 30%.

From the data available, the value of equities on-loan increased by some 14% during the first six month of the year and this follows a reported 20% increase during 2015. We remain mindful that 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. We are working with our data partners to better understand this dynamic and we are looking at ways to dampen down any foreign exchange movements in future reports. We are seeing however an increasing demand to borrow securities as part of the various active asset management strategies.

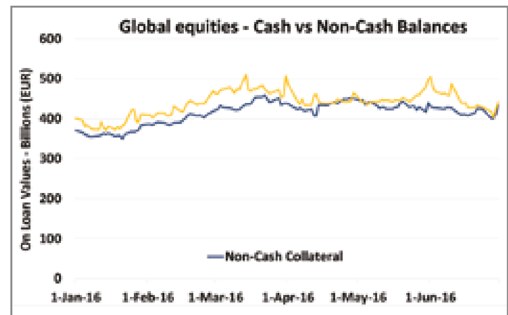
Set against this backdrop, we did note some contrasting outputs from the various regions. In both Asia and North America, we saw sustained growth in equity lending over the period which suggests strong corporate activity is driving demand to borrow securities for various trading and hedging strategies. However the picture in Europe was somewhat different. As the following chart highlights, both available securities to lend and on-loan balances fell sharply around the Brexit vote.



Source: DataLend

Discussion with our member firms and the broader investment community confirms the view that many investment managers closed down open positions ahead of the vote and the apparent sell off by institutional investors tends to support the view that some investors sold European equites at this time. We will of course monitor developments as Brexit continues to evolve and discuss any further implications or trends in future reports.

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 contemplating non cash collateral from a regulatory perspective, driving this market. Changes in regulation and the ability of US funds to accept non-cash collateral will change this dynamic over time.



Source: DataLend

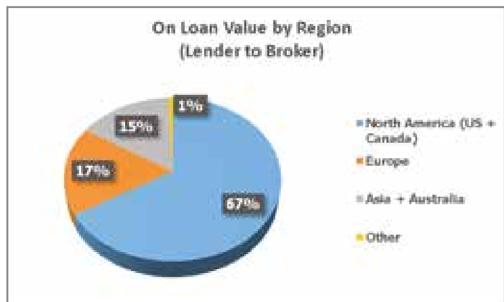
As we have monitored the relationship between cash and non-cash collateral, we have seen a progressive narrowing of the gap between

[9] 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.

both, with a steady drift towards non-cash collateral. As at the 30th June the split is 50/50. Whilst we continue to monitor this dynamic and would expect further inroads to be made by non-cash lending over time as the regulatory landscape enabling all lenders to accept non-cash collateral evolves.

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 trades within the equity lending markets has not changed, with less than 4% of all equity trades being reported as being for periods in excess of three months. This low level of term business is little changed from previous reports although 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 67% of all equities on loan as at the 30th June. This is again 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 in 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

COLLATERAL

As at the 30th June 2016, it is estimated that there were approximately €1.9 trillion[10] of securities on loan globally. Of this circa 60% or €1.1 trillion were loans that were collateralised with non-cash collateral.

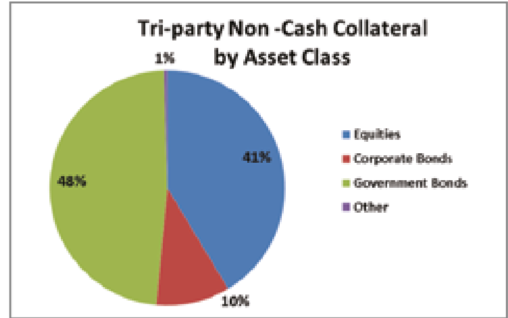
The patterns of non-cash collateral seen in previous reports especially in Europe in respect of government bond lending (almost exclusively undertaken only against non-cash collateral) were observed again. This greater use of non-cash collateral reflects the ongoing impact of the strong regulatory push 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 may 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[11] who holds the collateral on behalf of the lender.

Over the past two years whilst working with member firms active in this area, we have been able to combine information from the four principal tri-party service providers operating in Europe today[12]. Between June 2014 and June 2015, we saw steady growth in the proportion of equities being pledged by borrowers within tri-party. As at 30th June 2015 equities represented 57% of all securities held in tri-party in respect of securities lending activities. However and somewhat surprisingly the proportion of securities held as collateral in tri-party actually fell back to 51% as at the 31st December and fell again to 41% as at 30th June 2016.

The reasons behind these changes may reflect a number of different factors that are in play here. From our analysis we do not think collateral schedules that are agreed between lenders and borrowers have fundamentally changed within the past 6 months, so the decrease in equities being used by borrowers as collateral must reflect other structural changes.

[10] **ISLA Global Securities Lending Aggregate**
[11] **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.
[12] **Data provided by BNY Mellon, Clearstream, Euroclear and JP Morgan**



Source: BNY Mellon, Clearstream, Euroclear, JP Morgan

We think that as prime brokers and banks have deleveraged their balance sheets, they now hold fewer equities as part of trading inventory. As such, they will have to look for alternative assets to post as collateral. The position as at the 30th June 2016 may have also been compounded here in Europe by the pre Brexit contraction in business volumes particularly in the equities markets. From the data, banks appear to have moved to replace equity collateral with government bonds as these as a proportion of total non-cash collateral increased from 38% at the 31st December to 48% as at 30th June. Although the specific source of these additional government bonds being used as collateral cannot be conclusively identified within the remit of this report, our data would suggest that these bonds were most likely sourced from the government bond repo market.

Whilst an individual data point cannot point to a permanent shift in the market, it is interesting to consider that as banks appear to have less equities to use as collateral in the securities lending markets, they are using other mainly HQLA securities. The apparent shift back towards using government bonds as collateral in the securities lending markets could put pressure on the availability of HQLA which are also sought after by market participants for broader collateral and balance sheet ratio management requirements. Any increase in the demand to use government bonds as collateral may be further undermined by PSPP's which could pull further supply from the market.

Corporate bonds as a collateral class still appears to be out of favour with most lenders, representing only 10% of all non-cash collateral.

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 industry-standard 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 is a trade association which represents the interests of participants within the securities lending and borrowing markets.

Formed in 1989, ISLA has 121 members comprising of asset managers, banks, insurance companies, pension funds, securities dealers and service providers.

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

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

DISCLAIMER

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