

ISLA

INTERNATIONAL SECURITIES LENDING ASSOCIATION

The Institutional Investor Guide to Securities Lending

PRODUCED IN ASSOCIATION WITH FINADIUM

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Executive Summary

Securities lending plays an important role in today's global capital markets. It has long been a fundamental component of financial markets as a means of meeting settlement and collateral requirements, as well as providing vital liquidity to secondary markets. It supports important hedging and investment strategies and helps to facilitate timely settlement of securities.

Today, securities lending is being used as a key tool around the mobilisation of collateral including High Quality Liquid Assets (HQLA) within the financial ecosystem, as the demand for these assets has grown.

Securities lending, a fundamental component of capital markets activity, has been more influenced by regulation in the last ten years than any other factor, leading to deep seated changes in how the industry works and how external actors see the business. As new rules-making begins to subside and regulators engage in implementation and monitoring, regulators and policy makers have become an important part of the fabric of the securities lending industry.

Much of the current regulatory framework facing securities lending can be traced back to the period immediately after the Global Financial Crisis of 2008/9 and the work undertaken by the Financial Stability Board (FSB). Their paper entitled 'Strengthening Oversight and Regulation of Shadow Banking'* dated 29 September 2013 described the shadow banking sector and its importance - 'The "shadow banking system" can broadly be described as "credit intermediation involving entities and activities (fully or partially) outside the regular banking system" or non-bank credit intermediation in short. Such intermediation, appropriately conducted, provides a valuable alternative to bank funding that supports real economic activity.' Since then, the FSB has redefined its reference to the activity more broadly as 'market-based finance'. This is in recognition of the value it adds as an alternative to traditional bank funding.

As beneficial owners of securities, institutional investors form a central and important part of a marketplace that would not exist without their participation.

* Available at http://www.fsb.org/wp-content/uploads/r_130829c.pdf

2. Introducing Securities Lending

Securities lending is the temporary exchange of a security against receipt of collateral.

A lender will receive collateral from the borrower, generally in the form of either cash or other securities (see Exhibit 1). In Europe, in excess of 90% of securities lending transactions are backed by non-cash collateral. The exchange of collateral is an important means of risk reduction in the securities lending transaction, and therefore the level of overcollateralisation will reflect the characteristics of the trade (levels typically range from 2% - 5%, but can be as high as 50%). Collateral is marked to market daily, ensuring that both lender and borrower of securities have the right amount of protection and collateral outstanding.

In return for lending their securities, the lender receives a payment. This can be in the form of a simple fee in respect of non-cash collateralised transactions, or through an implied fee for cash collateralised loans.

Non-cash collateral such as government bonds or equities is delivered at the beginning of the transaction, adjusted daily to market prices, then returned when the transaction is closed out. A tri-party agent is often responsible for the safekeeping of these collateral assets, monitoring and rebalancing non-cash collateral on a lender's behalf. Non-cash collateral is less popular in other parts of the world: in the US, the split of non-cash vs. cash was roughly 50/50 in 2018.

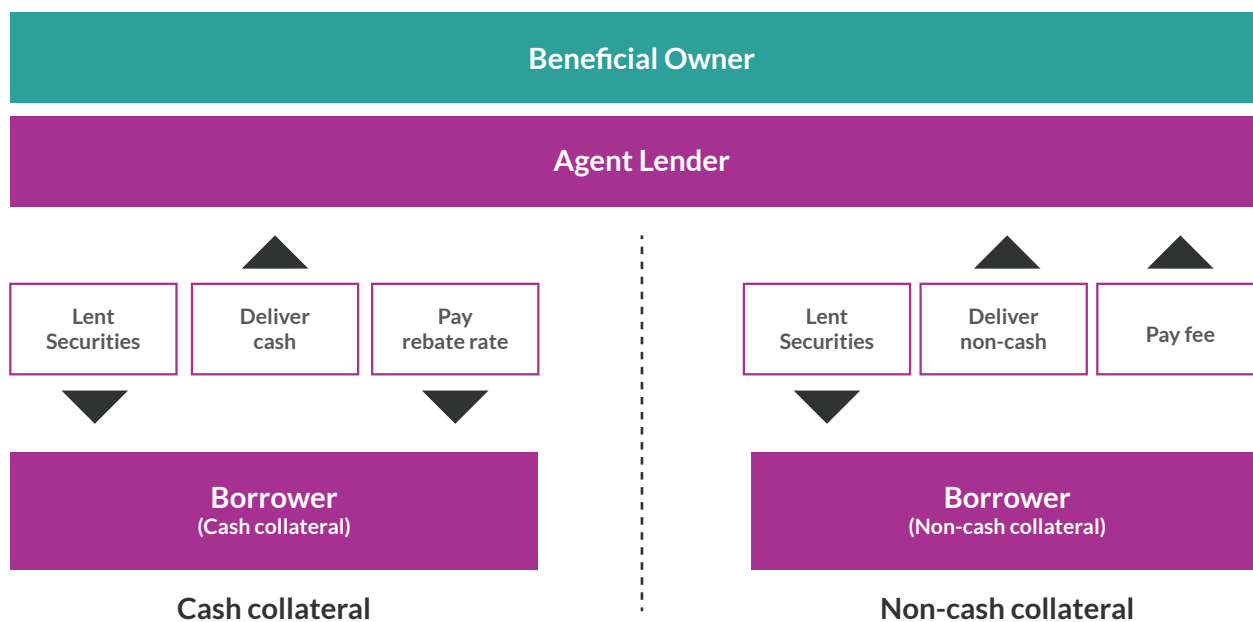
In a cash collateral transaction, a borrower delivers cash when the transaction is initiated. The lender invests the cash in approved financial vehicles that may produce additional revenues. A proportion of the cash reinvestment revenue earned is 'rebated' back to the borrower. In this case, the cost of the transaction is referred to as the rebate rate. The difference between the cash reinvestment earnings and the cash paid to the borrower is the 'implied' fee. For example, a lender may receive €1,000 in collateral, earn a return of 50 bps, and rebate 30 bps back to the borrower. The lender keeps the remaining 20 bps as income for the loan. In theory, the value of the non-cash fee and the implied fee from cash collateral earnings should be the same, although this is not often the case.

The level of fees earned by the lending institution for securities lending transactions can change depending on multiple factors; the type of collateral lenders will accept, restrictions placed upon the credit worthiness of the borrower, operational efficiency, the consistency of the lender/borrower relationship, any fixed term nature of the transaction, and any recall activity that may be demanded by the lender's corporate governance and oversight departments.

Internal buffers, also referred to as programme guidelines, can influence fees by permitting larger amounts of securities to be lent or by restricting the lending of securities over a specific time period.

Whether based on cash or non-cash collateral, adjustments in the borrowing rate can occur based on the ebb and flow of demand for the particular security borrowed. This rerating can occur at the behest of either the borrower or lender, and is typically initiated by the party in whose favour the market has moved. Billing statements and fees are normally produced, accrued and paid on a monthly basis.

Exhibit 1 - Cash v non-cash securities lending flows



Principal types of securities financing transactions (SFTs)

Type	Description	Master Agreement
Securities Lending	An agreement where one party lends a security to another party for a limited period. In exchange for either other securities or cash, the borrower pays a fee to the lender for the use of the loaned security.	Global Master Securities Lending Agreement (GMSLA)
Repurchase Agreement (repo)	A repurchase agreement (repo) is the sale of securities together with an agreement for the seller to buy back equivalent securities at a later date for a higher price, the difference representing interest or the "repo rate".	Global Master Repurchase Agreement (GMRA)
Sell-Buy Backs/ Buy-Sell Backs	A transaction by which a counterparty buys or sells securities, commodities or guaranteed rights, agreeing, respectively, to sell or to buy back securities, commodities or guaranteed rights at a future date, such transaction not being governed by a repurchase agreement.	Bespoke / Long Form Confirmations
Margin Lending	A transaction in which a counterparty extends credit in connection with the purchase, sale, carrying or trading of securities, but not other loans that are secured by collateral in the form of securities. Margin loans are part of the range of services that prime brokers offer to their clients (i.e. investment funds). The loans are collateralised by a portfolio of securities, or securities held in a margin account, that prime brokers manage as part of the other services they provide, including trading in repo, derivative and cash markets. A key difference with repos and securities lending is that margin loans typically do not require the use or pledge of any additional collateral.	Bespoke

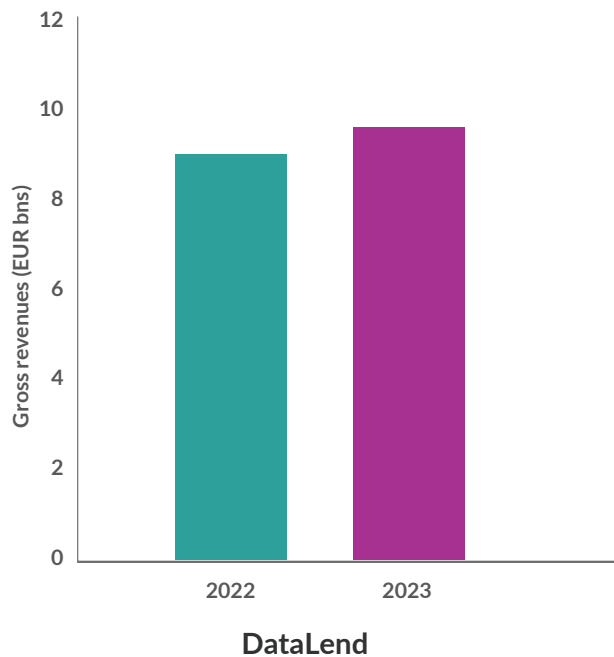
3. Who Uses Securities Lending & Why

At the global level, the value of outstanding securities lending transactions averages around €2.2 trillion at any one time*.

There are over €27 trillion of securities being made available in securities lending programmes today**. Securities lending produced around €9.7 billion in gross fees for institutional investors and their agent lender service providers in 2023, according to industry data providers. (See Exhibit 2).

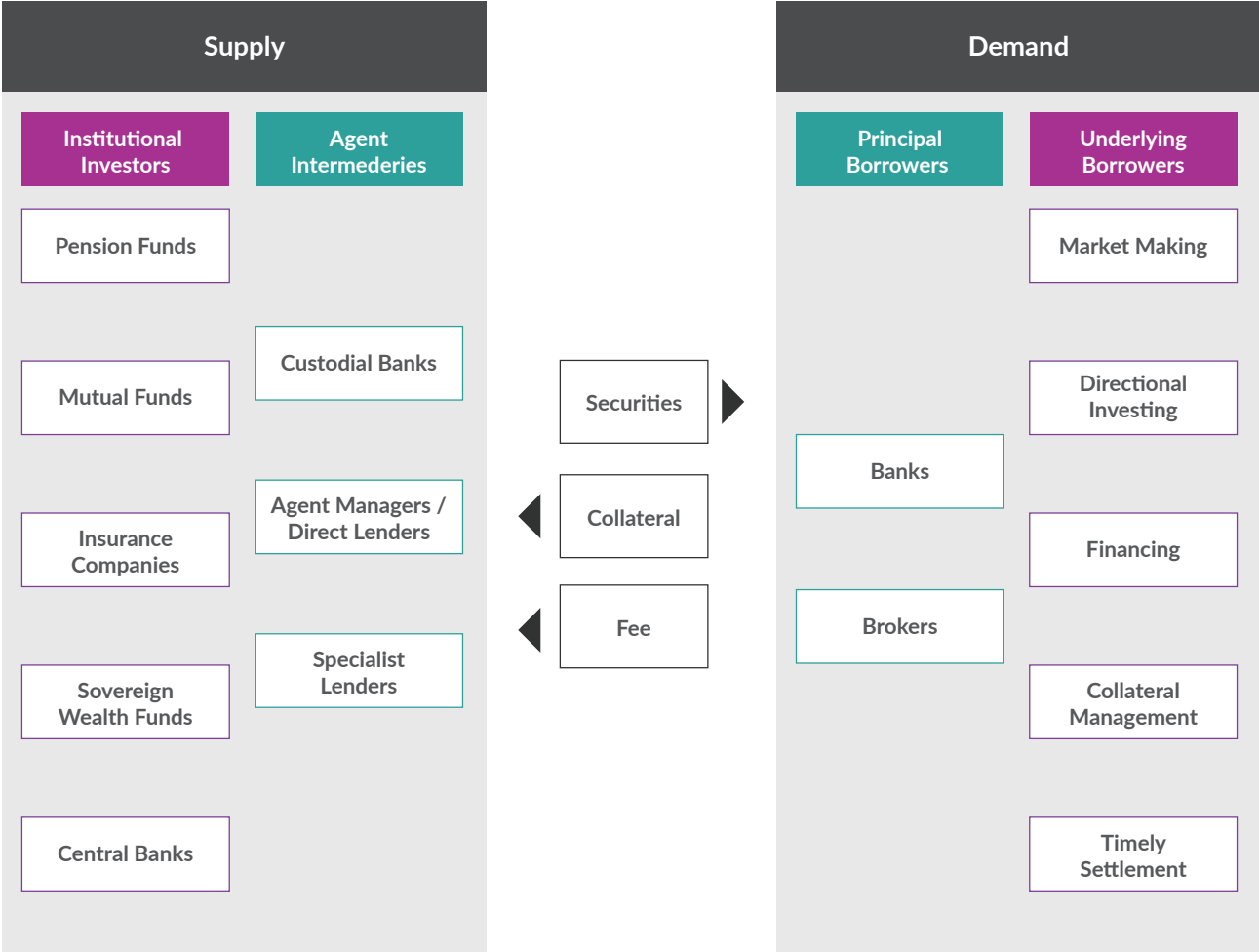
There are three to four counterparties in most securities lending transactions, with variations that may add or subtract actors based on the inclusion of service providers.

Exhibit 2 - Securities lending industry gross revenues (institutional investors and agent lenders)



* According to FIS Astec Analytics
** Data as at December 2023

Exhibit 3 - Securities lending value chain



Investors lend securities to generate 'risk adjusted' revenues which help pay pensions, reduce insurance costs, and contribute to reducing the overall costs of asset servicing.

Borrowers borrow securities for a wide range of reasons.

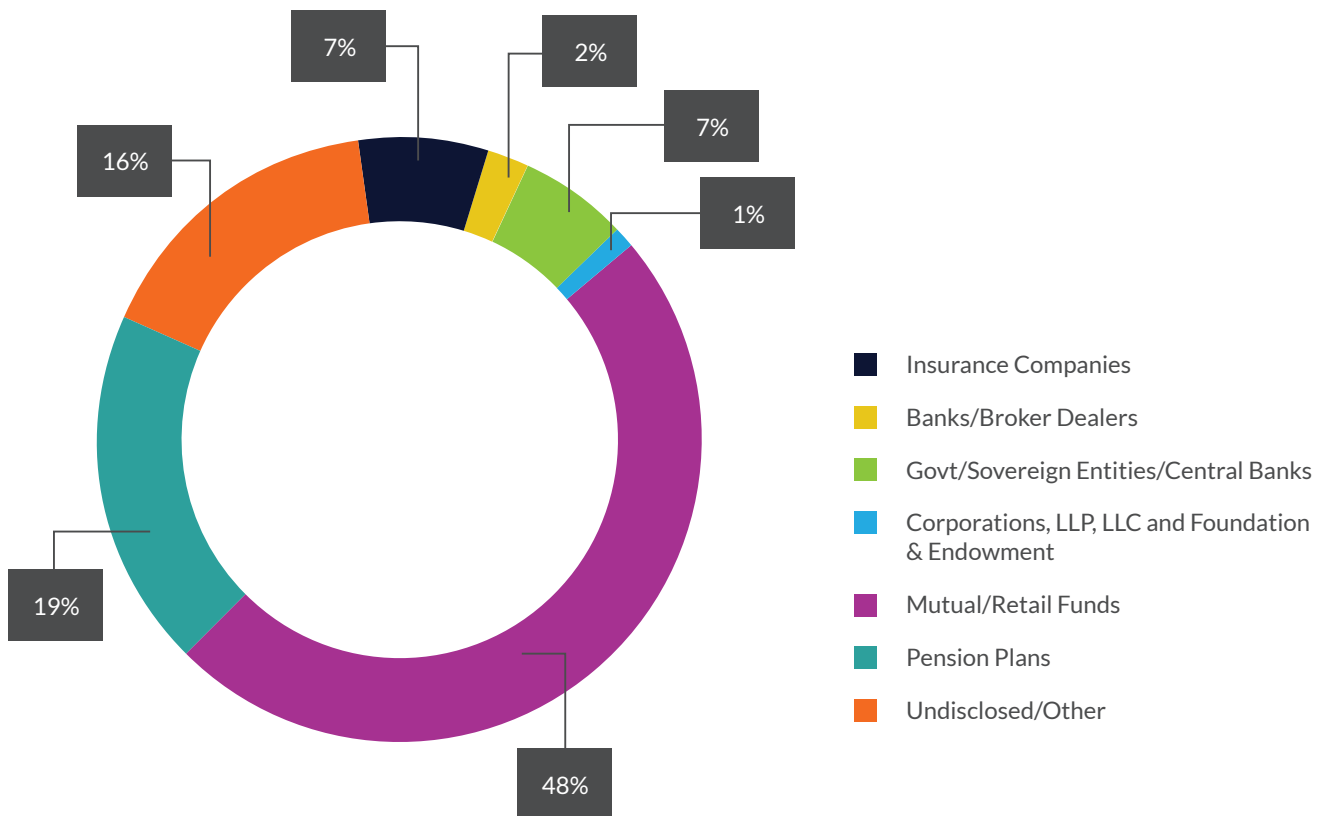
3.1 Institutional Investors

The basic value chain begins with the institutional investor, who as the beneficial owner of a security has the legal right to lend it. The institution is ultimately responsible for the risk in the transaction, with mitigations provided by the amount of collateral held and by protections offered by service providers. There are over 20,000 institutional funds of various types lending securities in today's market globally, including pensions, sovereign wealth funds (SWFs), corporations, insurance companies, UCITS and ETFs.

Nearly half of lendable assets come from mutual and retail funds around the world, with another 19% from pension plans (see Exhibit 4). This does not necessarily correspond to what types of firms lend the most assets however. Some institutional investors are active lenders with most of their portfolios available at any given time, whilst others are engaged more sporadically or for limited amounts of their portfolio. Notwithstanding this, others have regulatory limits on how much of their portfolio they can lend at any one time, or internal

policies that place restrictions on lending activity. In addition, legislation aimed at bolstering retail investor protection has led to constraints on the amount and type of securities lending that certain retail funds may engage in. Whilst ISLA continues to work with relevant policy makers and regulators, this theme has opened up opportunities for other institutional types, most notably SWFs, who have seen disproportionately high levels of demand to borrow their securities, particularly in certain fixed income markets.

Exhibit 4 - Lendable assets by fund type



3.2 Agent Lender Intermediaries

An institutional investor may lend its securities from an internal desk, or more likely will appoint an agent lender to lend on their behalf. The institution gives the agent lender an omnibus mandate (ongoing authority) to lend their securities, and the agent lender is responsible for lending at the best combination of rate, term and collateral available to the institution in the marketplace. The agent tracks

collateral holdings and valuation, oversees delivery of securities on-loan, and recalls for securities when needed (for example, to satisfy a cash market sale). Agent lenders may be part of a custodial bank (custodial agent lender) or may be affiliated with a separate bank, institution or specialist provider (third-party or non-custodian agent lender). The typical pricing mechanism of agent lenders is a fee

split. Although it is not the remit of this guide to discuss or recommend these split levels, current market norms suggest that a beneficial owner receives circa 80-90% of gross lending revenues. The fee split is based on various factors including the size of the lender, the value of their assets to the marketplace, and the potential balance sheet impacts of the client's business and portfolio to the agent.

Indemnification

An important service offered by agent lenders is counterparty default indemnification, a type of insurance policy. In the event of a counterparty default, the agent, acting on behalf of the lending client, will immediately take control of any collateral delivered by the defaulting counterparty. In the case of non-cash collateral, it will usually sell the collateral securities and use the cash proceeds to buy back equivalent on-loan securities. In the case of cash collateral, the agent will liquidate assets in the cash collateral reinvestment portfolio, again using the proceeds to purchase equivalent on-loan securities. In both cases, if the relevant cash proceeds are insufficient to cover the full cost of the purchase of the equivalent on-loan securities, the agent's indemnification may be called upon to cover any monetary shortfall.

Indemnification has often been bundled in to the agent lender's fee split, although Basel III and related regulatory costs mean that indemnification may now be quoted separately. Indemnification is not necessarily required to engage in securities lending, but most agency lending clients prefer to have it. In November 2018, consultancy firm Finadium found that 83% of pensions and SWFs said that indemnification was an important part of their securities lending programme.

It is important that institutional investors recognise that indemnification in most cases only applies to the counterparty default element, and not to the holding of some non-cash collateral nor the reinvestment of cash collateral. In some cases, agent lenders have also indemnified repurchase agreements (repo) in cash collateral accounts, although this should not be assumed. The lack of indemnification protection in cash collateral reinvestment accounts caught some institutions off guard during the Global Financial Crisis, and has resulted in greater focus around cash reinvestment guidelines going forward.

When utilising the services of an agent lender, the securities lending process should be seamless to the institution.

The agent is responsible for all trading and operations activities. Any sale of securities on-loan will generate a recall notice to the agent. All corporate actions and dividends are received and enacted on, as if the securities had not been lent out. The only right that cannot be guaranteed is the voting right. In order to undertake a vote, securities must be recalled in advance to ensure the lender is the holder of record at the record date.

3.3 Borrowers

Borrowers of securities are mostly large banks and broker-dealers, including many of the same banks that offer agency lending services to institutions. Institutional investors have traditionally preferred to lend to large banks and their affiliates only, since bank credit risk exposure is both low and well understood by the market. Some institutions are also willing to lend to smaller banks and brokers, although these firms represent a smaller percentage of the market. There are roughly 200 borrowers in the securities lending market globally.

The reasons to borrow securities fall into five main categories:

- To assist the settlement process to prevent or remediate a failed delivery. The delivery requirement can be created by short-sellers needing to borrow securities to deliver for settlement, or by market-makers obligated to quote two-way prices but who may not have securities on hand to deliver.

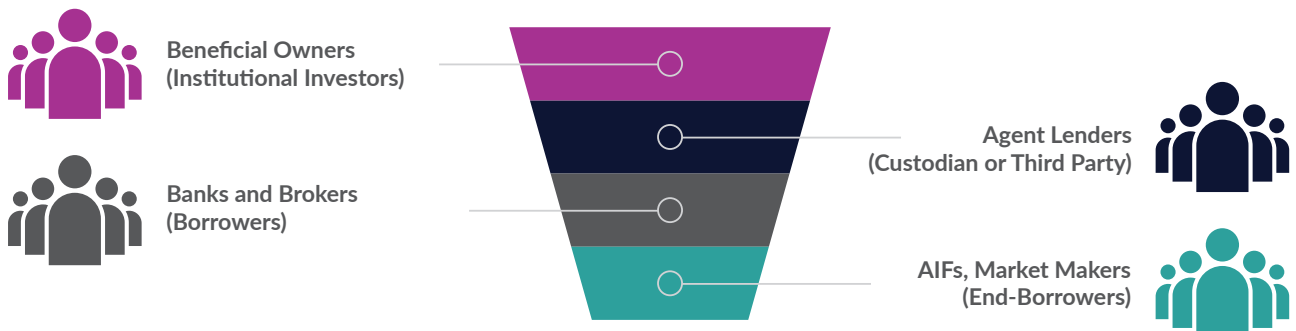
- To obtain securities that can be delivered as collateral for other types of transactions, and that are not currently in the borrower’s portfolio. Securities lending is a key component in the mobilisation of collateral including HQLA. This is an important component of facilitating overall financial stability, as banks and other prudentially regulated entities generally look to borrow low risk high quality assets.
- To obtain the rights to the security in the event of a corporate action, including scrip dividends and rights issues.
- To receive cash in order to re-invest in other short-term investments, whilst retaining market exposure of the lent securities.
- To support a bank’s balance sheet by obtaining HQLA in exchange for lower quality assets.

When borrowing on behalf of an Alternative Investment Fund (AIF) as a prime broker to meet settlement needs, banks act as principal

intermediary between the institutional lenders and the AIF. An important service prime brokers provide in this case is credit intermediation. Only recently have institutions considered lending based on the credit quality of an AIF, preferring instead the generally higher credit quality and ratings of a bank or broker. Also, many AIFs do not have identifiable independent credit ratings that many lenders look for as part of a due diligence process.

Securities lending is dependent on demand by the ultimate borrowers of securities, whether an AIF, a bank or a broker for its own purposes. If there was no requirement to cover a failed delivery either by mismatched market making activities, from a short sale, or to ensure adequate HQLA for balance sheet purposes, then no activity would take place. Lenders and their agent lenders must wait on market demand; this is a borrower driven market.

Exhibit 5 - Participants in the traditional securities lending market



4. Other Routes to Market

Lending between institutional investors, agent lenders and banks is not the only model for securities lending transactions.

4.1 Direct Lending including Peer to Peer

Due to regional variations in regulation, collateral policies and financial market structure, some parts of the European securities lending market have employed a direct lending model (there are many instances of institutions lending directly to borrowers without the services of an agent lender). The popularity of direct lending is unique to Europe; in North America and Asia, the model has been built around the use of agent lender services, with direct lending as an outlier.

Direct lending is developing further nuances with the growth of Direct, Peer to Peer and All to All marketplaces. These electronic venues provide opportunities for lenders of cash and securities to meet borrowers

with or without bank intermediation. Whilst the nature of the transaction has existed for decades, the business is seeing a new evolution, as major service providers enter the space with organised, structured product lines. These platforms challenge current ideas about who is a safe counterparty and provide opportunities for revenue generation and product expansion.

One key to the growth of Direct, Peer to Peer and All to All markets is the availability of borrower balance sheet, which in turn supports or limits credit intermediation. A plentiful supply of bank capital will augment the ability of banks to transact in the securities lending market, thereby reducing opportunities for non-bank borrowers. If banks can no longer borrow due to

balance sheet constraints or can do so only at a high fee, then lenders and non-bank borrowers may turn to each other directly. The idea of eliminating the credit intermediation function of a bank and retaining any incremental income may sound attractive, but getting there can require careful analysis. Lenders may also want to retain agent lender indemnification, and agents and their clients may have different opinions about acceptable counterparties. Agent lenders may also face hurdles in providing indemnification to a non-rated, small hedge fund counterparty. This too could limit the growth of the market or result in higher costs for institutions that wish to engage.

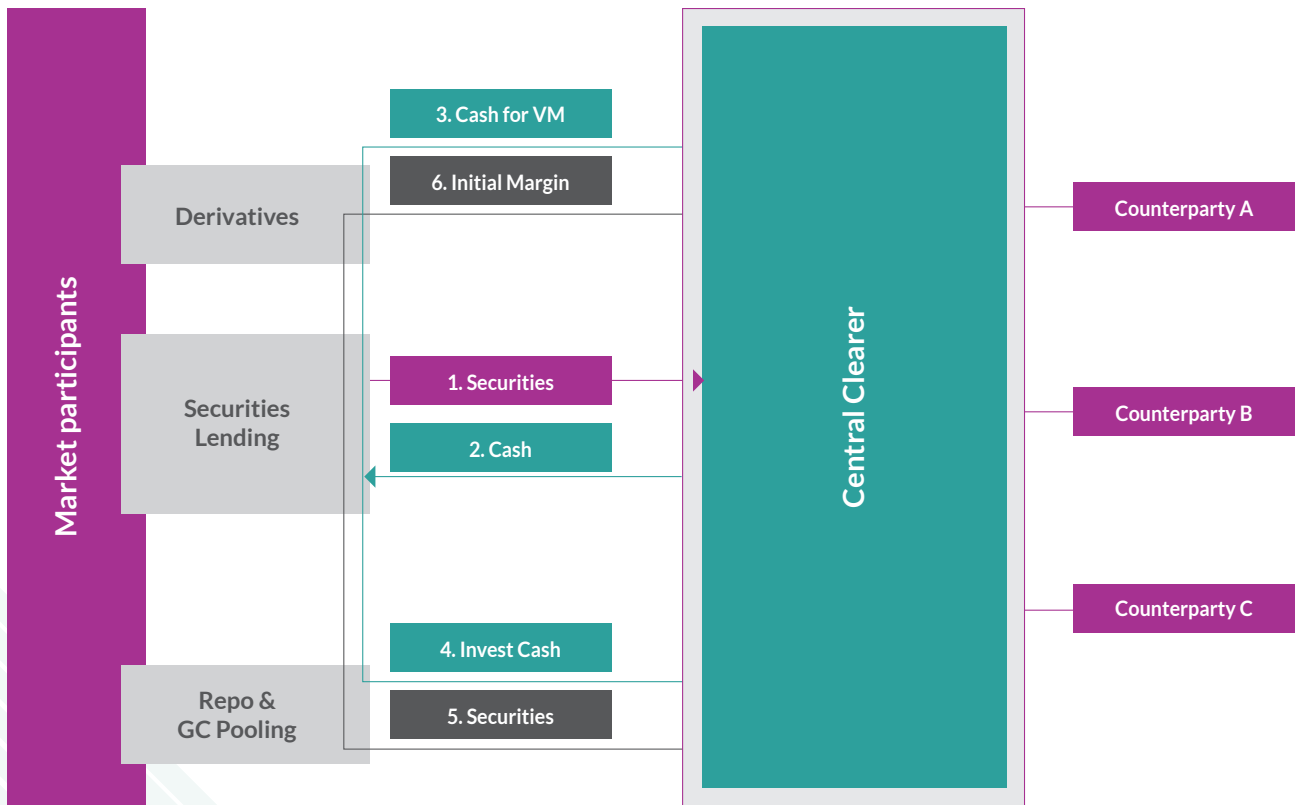
4.2 Central Clearing

The concept of a central counterparty (CCP) in securities lending has gained traction over the last decade due to regulatory pressure on bank balance sheets (see Exhibit 7). A CCP is market infrastructure that assumes responsibility for every trade through a process called novation: the CCP

becomes the buyer for every seller and the seller for every buyer. In a CCP transaction, borrowers are able to lower their balance sheet capital based on a combination of the CCP's 2% risk weight, and the potential for netting. Lenders may one day find that pricing is better on a CCP due to lower borrower

capital costs, but this has not happened as yet. It is expected that central clearing will become a feature of the securities lending market place, even if only applied to a subset of transactions.

Exhibit 7 - Integrated CCP cleared solutions for securities financing & collateral management



5. Benefits of Securities Lending to Lenders & the Capital Markets

Revenues are the main reason that beneficial owners including retirement plans and long-term savers lend securities. Securities lending is intended to produce a consistent, incremental return for asset holders. However, securities lending is not intended as a core alpha or beta asset class. It is an incremental revenue stream and is best classified as “additional alpha”.

It is appropriate that not all funds lend, and not all portfolios carry the same value in the securities lending market. Institutions and asset managers commit capital because they seek returns that are commensurate with the risk they

assume. Likewise, securities lending fits into the risk/reward profile of some firms but not others. However, those institutions that have elected to participate in securities lending can earn regular incremental returns.

There are also less immediately tangible benefits to the capital markets ecosystem that come from a fully functioning securities lending market.

5.1 Supporting Market Liquidity

From an altruistic point of view, securities lending helps the broader market by generating liquidity. In order for an AIF to make a short sale, there must be a securities lending transaction to guarantee delivery. Without this, the short sale would not occur, leading to reduced transactional activity in equity and fixed income markets. Globally, regulators around the world are supportive of both securities lending and short selling,

recognising it as an important part of market functionality. At the same time, they demand to see that any short position has an identifiable source of cover in the securities lending markets. Institutions that engage in securities lending help make markets efficient for everyone, including themselves.

As Europe moves towards a Capital Markets Union (CMU), a deep and diverse securities lending industry is an

important component to establishing a capital markets framework. Two primary objectives of the CMU are to strengthen the capacity of EU capital markets, and to make it easier for companies to enter and raise capital on public markets. Both regulators and industry associations agree that securities lending and borrowing are critical to both of these activities, not to mention building investor confidence for long-term participation.

5.2 Generating Market Data & Information

Over the last five years, the institutional view of securities lending has expanded to consider the data generated in the transaction. Securities lending data has become an important metric for a segment of long-only and long-short asset managers interested in receiving market sentiment feedback. The data is used in portfolio construction and

rebalancing, including when to choose to adjust a portfolio based on short selling and securities lending activity.

When long-only and long-short strategies exist at the same investment manager or pension, lenders find that they see both the rates they receive when lending to a bank and the rate that the AIF receives when borrowing from a bank.

The cost of credit intermediation becomes apparent. Capturing both segments of the trade is a valuable tool for creating a holistic view of the securities finance landscape, and hence building an investment thesis. There are also now instances of portfolios created solely for their ability to lend at high fees and cover other portfolio borrowing costs.

6. Regulatory Change

A consistent theme of the securities lending market in the last ten years has been the pace of regulatory change. Following the Global Financial Crisis, the FSB embarked on a sweeping review of Shadow Banking, including a workstream on securities lending and repo. This work continues today, and has led to regulatory change, notably in Europe.

This has led to directives for broad transparency in the markets, as well as haircut requirements, supervision for systemic risk monitoring and large scale data reporting. This work coincided

with the Basel Committee on Banking Supervision and IOSCO requirements for initial and variation margin for OTC derivatives. The impact of these directives have been felt in Europe,

with the introduction of the Markets in Financial Instruments Directive (MiFID II) and the Securities Financing Transaction Regulation (SFTR).

6.1 Securities Financing Transactions Regulation (SFTR)

Through SFTR, the EU aims to enhance transparency and enable regulators to better monitor risks by introducing reporting requirements for SFTs.

These requirements are similar to those already applicable to derivatives transactions under the European Market Infrastructure Regulation (EMIR). The regulation also introduces limitations on the reuse of collateral, not just in the securities financing markets but also in the wider collateral markets. The initial phases went live in July 2020, delayed from April 2020, due to COVID-19. The final phase went live in January 2021. An important component of the regulation is transaction reporting and record keeping requirements. The conclusion, modification or termination of an SFT must be reported to a Trade Repository (TR) that is registered or recognised in accordance with the SFTR.

Notwithstanding a few points of overlap with EMIR and MiFID II/ MiFIR, SFTR reporting requirements are distinct. The regulation includes

over 150 fields, not all of which are required for every transaction, but all of which must be considered and accounted for. Furthermore, some of these fields have not historically been captured by technology platforms in securities lending, repo or collateral trading. This has complicated efforts to build reporting tools and led to wide-spread industry cooperation in sorting out procedures for compliance.

Like the record keeping requirements in EMIR and MiFID II, counterparties subject to SFTR are required to keep a record of any SFT that they have concluded, modified or terminated for at least five years following the termination of a relevant transaction. The record keeping requirements applied from 12 January 2015. Market participants need to ensure they have appropriate processes in place for data retention, or risk being in breach of regulatory requirements.

SFTR sets out controls on the reuse of financial instruments received as collateral under a collateral arrangement. A 'collateral arrangement' is included by reference

to a security financial collateral arrangement or a title transfer financial collateral arrangement, in each case, as defined in the Financial Collateral Directive. A right of reuse of financial instruments received as collateral is subject to at least both the following conditions: (a) risks and consequences have been communicated in writing; and (b) prior express consent of the providing counterparty has been granted. The exercise of a right of reuse is subject to at least both the following conditions: (a) reuse is undertaken in accordance with the terms specified in the relevant collateral arrangement; and (b) financial instruments are transferred from the account of the providing counterparty. Again, participants to a SFT must recognise and account for these requirements.

SFTR was adopted into UK law under the European Union (Withdrawal) Act of 2018, and UK based institutions began reporting SFTs under a UK version of SFTR following the end of the Brexit transition period on 31 December 2020.

6.2. Securities Finance & MiFID II

The markets in Financial Instruments Directive (MiFID II) and the Markets in Financial Instruments Regulation (MiFIR) impact securities finance, even though there are few direct references to the activity. The regulations went live in early 2018, and further standardise market activity, codify best practices and increase transparency. The directive and regulation include any off-shore counterparty that transacts business with any EU entity, resulting in many non-EU institutional investors adopting MiFID II and MiFIR as their global regulatory standards.

MiFIR provides supervisors and regulators the right to intervene in markets under certain circumstances to suspend trading. One of the specific triggers that could create this scenario would be perceived unacceptable or unusual securities lending activity.

MiFID II has more immediate applications to securities finance. The requirement of best execution, as well as full disclosure of securities finance to underlying clients including the risks, is stressed. As securities lending is a market without a central limit order book like a stock exchange,

best execution must be measured in terms of counterparty, collateral, fee and length of transaction, where appropriate. This has created a range of policies at lending firms and agent lenders that define what best execution is and how it can be achieved under MiFID II.

6.3 Central Securities Depository Regulation (CSDR)

The CSDR was published in the Official Journal (OJ) of the EU on 28 September 2014, and its provisions generally came into effect on 17 September 2014. The regulatory technical standards for settlement discipline were adopted by the European Commission (EC) in May 2018, and after a period of scrutiny, the RTS was passed into law in September 2018. After a large number of industry bodies and associations advocated for a review of the settlement discipline element of the regulation, the European Commission recommended that the RTS for this element be delayed until April 2021. As a result of the pandemic in 2020, further delays to the RTS have been endorsed by the Parliament and of the Council.

The key issue of concern is around Mandatory buy-ins and their potential negative impact on market liquidity.

The CSDR settlement disciplines will apply to all market operators in the context of European securities settlement, and all European central securities depositories (CSDs). They will apply to all trading entities regardless of their domicile if they settle transactions on an EU CSD, either directly or via a settlement or clearing agent.

With regards to securities settlement, the requirements in the CSDR mainly apply to transferable securities as defined under MiFID II, money-market instruments, units in collective undertakings, and emission allowances which are admitted to trading or are traded on a trading venue or cleared by a CCP.

SFTs are captured by the scope of the CSDR whereby settlement disciplines and cash penalties will apply to all transactions. However, exemptions have been provided from the mandatory buy-in scheme for SFTs which are for less than 30 days term. The market requires further clarification for this exemption, specifically in respect to the scope and application of buy-ins. The ISLA membership advocates for SFTs to be excluded entirely from the buy-in element of the regime, arguing that securities lending is in itself a tool used to prevent fails in the cash market.

In 2020, the UK Government chose not to adopt the CSDR Settlement Discipline Regime which enters into force after the end of the transition period.

6.4 Short Selling Rules

The EU regulation on short selling and certain aspects of credit default swaps (CDS) came into force on 1 November 2012. The aim of the legislation was to provide greater transparency of short positions held by investors, reduce or eliminate settlement risks associated with uncovered or naked short positions, and give member states clear powers to intervene in exceptional situations to reduce systemic and market risks.

Under the legislation, all short sales of shares and government bonds must be covered by either a borrow, or an arrangement with a third party confirming their location (i.e. naked short selling in shares is banned). The regulation also sets mandatory transparency requirements with significant net short positions being reportable to the relevant National Competent Authority (NCA). As long ago as June 2009, IOSCO noted that

“short selling plays an important role in the market for a variety of reasons, such as providing more efficient price discovery, mitigating market bubbles, increasing market liquidity, facilitating hedging and other risk management activities”. Today, short selling supported by liquidity from securities lending markets is an integral part of the investment landscape, allowing investors to express sentiment in this way.

6.5 Securities Finance & Total Return Swaps (TRS)

Following 2008, securities lending and collateral management became part of the regulatory scrutiny around OTC derivatives. A further complicating matter for securities lending is the preferential treatment afforded to derivative transactions, under both the Basel Committee's Current Exposure Method (CEM) and Standardised Approach for measuring Counterparty Credit Risk (SA-CCR). These methodologies create incentives for market participants to substitute

securities lending transactions with economically equivalent derivative instruments (Total Return Swaps) to obtain better capital treatment.

Synthetic finance using swaps in place of physical securities lending transactions is now a recognised and established part of the overall prime brokerage service model.

However, a wider shift towards synthetic finance has not been seen in market-level securities lending transaction data, with most lenders

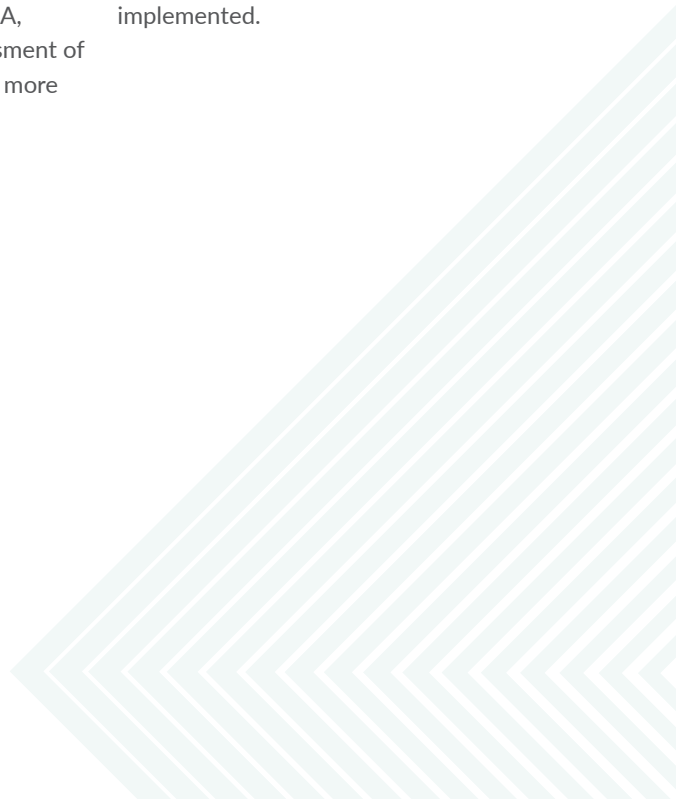
of securities still preferring the physically settled markets. Also and not withstanding the capital benefits associated with certain derivative transactions, some synthetic transactions still require a physical borrow to hedge the position. As the market grows, it is likely that synthetic transactions will increase exponentially until or unless the regulatory treatment of SFTs equalises between synthetic and physically settled transactions.

6.6 Mandatory Haircuts

The 2018 Basel III package included a standard to introduce mandatory haircuts to SFTs, including securities lending and borrowing in the bank capital framework. The EC is committed to implementing this within the Basel IV package in Europe in 2020. Advice from the European

Banking Authority in 2019, building on earlier analysis by the EC, ESMA, and the European Banking Authority (EBA), recommended to delay with the transposition of mandatory haircuts in the EU at this point. The EBA, similarly to the 2017 EC assessment of minimum haircuts, argued that more

data is needed to assess the impact of introducing minimum haircut floors in the EU, and that such a thorough data analysis might only be performed once the SFTR reporting regime is fully implemented.



6.7 Master Agreements

The EMEA model of securities lending is typically based around the delivery of collateral on a full title transfer basis, where the lender has legal ownership of securities that are received as collateral from the borrower. The pledge model, which is popular in other parts of the world, relies on a commitment by the borrower to deliver collateral in the event of a default, but does not transfer ownership of the collateral beforehand. Because full legal ownership of the collateral does not

pass between the borrower and the lender, pledge collateral arrangements are treated differently from a balance sheet and Risk-Weighted Assets (RWA) perspective than a title transfer (see Exhibit 7). Consequently, a borrower may receive a different outcome when looking at its key binding constraints.

In certain circumstances, both lenders and borrowers in securities lending appear to be in favour of the pledge model over transfer of title.

Borrowers appreciate the reduced balance sheet cost, which remains a driver of business decision making through the firm. For lenders, other benefits may accrue including better haircuts, lighter regulatory reporting requirements and potentially improved fees. ISLA has developed a new market standard GMSLA (Security Interest Over Collateral). This can be used by both parties entering into security interest arrangements.

The following table (Exhibit 7) summarises some of the main differences between the Pledge GMSLA and the 2010 GMSLA. This list is not intended to be exhaustive and should not be construed as legal advice. All market participants should take independent legal advice before entering into any form of contractual arrangements.

Exhibit 7 - Key differences between the Pledge GMSLA and 2010 GMSLA

Terms	Pledge GMSLA	2010 GMSLA
Parties' roles	One party is lender and the other is borrower.	Either party may be lender or borrower under any given transaction under the agreement.
Posting of collateral	Borrower provides collateral by transferring it to the secured account. Under ISLA's GMSLA security interest structure, the collateral is provided using a tri-party arrangement.	Borrower delivers collateral by title transfer to the lender.
Valuation of posted collateral	The value of the posted collateral is determined under the Control Agreement by adjusting the market value to take into account any specified haircut or margin percentage.	Collateral delivered by title transfer has its market value for the purpose of the margining calculation.
Collateral mechanics	The amount of any collateral transfer required is calculated on an aggregated basis across all transactions under the Pledge GMSLA.	The parties can choose to carry out margining on either an aggregated basis or a loan-by-loan basis.
Manufactured payments on collateral	There is no obligation on Lender to transfer interest or other distributions received on posted collateral because the collateral is in borrower's account, therefore borrower will receive the distributions directly.	Lender is required to make manufactured payments in respect of interest and other distributions received on posted collateral.
Manufactured payments on loaned securities	Borrower is required to make manufactured payments on loaned securities during the term of the relevant loan.	Borrower is required to make manufactured payments on loaned securities during the term of the relevant loan.
Termination	<p>If any event that constitutes an event of default occurs and is continuing, but the non-defaulting party does not declare an event of default by notice to the defaulting party, the lender has the right to accelerate all loans.</p> <p>The non-defaulting party may prefer to use this provision to trigger exchanges of securities and cash, rather than to effect a close-out and pay or receive the net termination amount.</p>	No equivalent provision as upon an event of default the lender has unrestricted rights to the collateral.
Borrower's warranties	Borrower represents that it has the power and authority to grant the security interest. It is the beneficial owner of all collateral to be credited to the secured account and Lender will obtain a valid and perfected first priority interest in such collateral, except to the extent subordinated to any lien which is routinely imposed on all securities in a clearing system.	No equivalent provisions because the representations relate to the security.

6.8 Regulatory Changes for Borrowers

Banks and their affiliates covered by Basel III and national regulations have experienced multiple waves of regulatory change since 2010. In each new regulation, market practitioners have worked to understand the impact to securities lending and have often worked to mitigate unintended consequences that would reduce their ability to conduct business. At this time, every large bank is safely within proscribed limits of their national Leverage Ratio (LR), Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), even when not

all ratios are yet required for official reporting. Banks experience continued constraints on their balance sheets however, and seek to find lower cost channels to conduct business. These include CCPs, synthetic trades, or by opening up their settlement platforms to the respective parties to a transaction. This latter activity assumes no balance sheet obligation as an agent lender or principal borrower and as such, there are few limits to the amount of business that can be conducted.

Borrowers will see additional regulation in the coming years, for example the introduction of Single Counterparty Credit Limits that will reduce the amount of business conducted between large agent lenders and large borrowers. If both firms are global systemically important banks (G-SIBs), US rules state that the maximum credit exposure can be 15% of tier 1 capital. This exposure includes securities lending, repo, OTC derivatives, deposit liabilities, lines of credit and other credit-related business.

6.9 Undertakings for Collective Investment in Transferable Securities (UCITS)

The Undertakings for Collective Investment in Transferable Securities (UCITS) Directive was adopted in 1985, and aimed to offer greater business and investment opportunities for both asset managers and investors by creating a single market for investment funds across Europe. The various UCITS Directives set out a harmonised regulatory framework

for investment funds that raise capital from the public, and invest it in certain asset classes, providing high levels of investor protection and a basis for the cross-border sale of these funds. The UCITS framework sets out some clear responsibilities in respect of securities lending. Fund prospectuses are required to outline the role of securities lending in the context of

the fund's investment strategies and portfolio optimisation techniques. Ongoing reporting of securities lending activities are also required as part of the fund's annual reporting outputs, and further scrutiny has also been sought by the EC regarding the level and proportion of securities lending fees retained by asset managers.

6.10 Alternative Investment Fund Managers Directive (AIFMD)

The Alternative Investment Fund Managers Directive (AIFMD) is a regulatory framework for Alternative Investment Managers (AIFs), including hedge fund managers, private equity firms and investment

trusts. The primary objective of the Directive is to implement a framework for the regulation and supervision of investment funds, to increase transparency and to ensure greater investor protection.

AIFMD requires certain operational structures, particularly around the role of depository banks that can have implications for asset segregation and the management of collateral received from borrowers.

6.11 Sustainable Investing

Set against a backdrop of increasing concerns around climate change and the wider impacts of economic activity on the planet, more and more investors are demanding that their investment strategies incorporate sustainability factors within the investment process. This has led to rapid and exponential growth in funds that seek positive returns and long-term benefits to society, the environment, and the performance of businesses. There are several different categories of sustainable investing, including impact investing, socially responsible investing (SRI), Environmental Social and Governance (ESG), and values-based investing.

When considering securities lending in the context of sustainable investing, it is important to recognise that the mechanics of lending ESG funds is no different from any other asset class, with the same operational and risk management frameworks supporting the business within a lending programme. However, due to the different requirements placed upon asset owners, particularly in the context of their enhanced responsibilities associated with key areas such as active shareholder engagement and governance, it is likely that the parameters of any lending programme will have to be adjusted accordingly.

It is therefore important that institutional investors engage directly with their lending agent or specialist provider to ensure that their programme is compatible with their ESG aims and objectives.

Whilst the regulatory environment is still developing, it is already clear that all actors in the lending chain will increasingly fall within the scope of various disclosure regimes that will promote greater ESG transparency. This will include requiring all financial institutions who promote products that have ESG attributes, to disclose their key features and the metrics and data sources they used in developing these products.

7. Institutional Risk Management & Programme Oversight

The collateralised nature of securities lending, combined with robust daily mark to market (MTM) procedures and tried and tested legal frameworks, make securities lending a relatively low risk activity. However, there are risks that market participants should be aware of when undertaking securities lending. These should be understood, quantified and mitigated wherever possible. As with all investment strategies and activities, securities lending can involve certain potential risks.

The following table describes the main types of risks involved with securities lending activity, together with ways in which each one can be managed or mitigated through effective oversight, including agreements, indemnification, collateral guidelines, and internal controls and audit, to name but a few.

Type	Description
<p>Borrower Risk The risk that the borrower defaults on the loan (for example, the borrower becomes insolvent and is unable to return the securities).</p>	<p>The lender must consider who they are willing to lend to and how much they are willing to lend.</p>
<p>Collateral Risk The risk that the value of the collateral falls below the replacement cost of the securities that are lent. If this happens AND the borrower defaults on the loan, then the lender will suffer a loss equal to the difference between the two.</p>	<p>Establishing rules governing collateral can be complex and lenders are advised to discuss this with their agent or adviser. A lender's collateral policy will affect the returns that are achievable (the riskier the policy, the higher the return). The main issue to be considered are:</p> <p>What is acceptable as collateral? Lenders must consider what types of collateral they are willing to accept.</p> <p>How much of any one type of collateral should be accepted? Lenders should place limits on the amount of any one bond or share that is received as collateral to avoid ending up with a concentration of one type of collateral that might prove more difficult to sell.</p> <p>What level of overcollateralisation is required? It is commonplace for a lender to require collateral that is worth more than the value of the loaned securities. The lender needs to decide what level of margin is required.</p> <p>In setting these policies, the lender and agent should take into account technical factors such as liquidity (i.e. the ease with which the collateral may be sold at a fair value), and price correlations between the loans and collateral (i.e. whether the price of the collateral is generally expected to move in line with the price of the lent securities).</p>

Type

Description

Cash Collateral Risk

The risk that the lender suffers a loss on the re-investment of the cash collateral.

Where a lender takes cash collateral, the cash must be reinvested to generate a return. The lender must ensure that the investment guidelines governing the investment of cash collateral are fully understood and provide an acceptable level of risk and return. Lenders should be aware of the liquidity risk inherent in the investment of cash collateral should investments need to be sold at short notice to return the collateral. This is likely to be a matter for consideration by someone with knowledge and responsibility for portfolio management decisions.

Intraday Settlement

The risk that the securities being lent are delivered to the borrower before the collateral is received.

Lenders should consider whether they wish to receive their collateral a day before the loan settles to avoid this risk. At the end of this loan, lenders should ensure that their shares are returned before or at the same time as collateral is released back to the borrower.

Operational Risk

This covers day-to-day operational risk matters, such as:

What happens if shares that are sold are recalled late?

What happens if the lender or its agent fails to claim for a dividend or other entitlement?

It is important that the lender understands if the agent takes responsibility for operational risks and in what circumstances, if any, they do not. If the lender is undertaking the lending activity directly then robust procedures need to be developed to protect against operational risks.

Legal Risk

The risk that the lender's legal agreement does not provide full protection in the event that the borrower defaults.

Lenders should review their legal agreements (typically a securities lending authorisation agreement signed with their agent, and the agreement that the agent signs with the borrower). That latter should conform to commonly used market standard documentation. In case of any doubt it is recommended that the lender seeks professional advice.

Effective oversight is a cornerstone of a successful securities lending programme. Whilst it is incumbent on institutional investors to implement best policies and procedures in order to monitor their programmes, there is no ‘one size fits all’ solution for every lender. The sophistication and comprehensiveness of programme guidelines and oversight will vary in proportion to the amount of revenues generated from the activity.

7.1 Performance Measurement

There are many ways to monitor performance whether lending directly or via an agent lender, including best execution, risk management, cash collateral performance and qualitative analysis of best practices. As a first step, lenders should ensure that the work of managing a securities lending programme is worth the revenues to be generated. This analysis can be conducted by an agent lender or consultant.

Several vendors offer desktop dashboards for trade supervision of agent lenders or internal lending

desks. These platforms enable daily analysis of all transactions and rolled up performance reports. These technologies are most suitable for self-lending firms and large institutions in the securities lending marketplace, often with multiple agent lenders themselves.

For lenders less concerned with daily performance measurement, agent lenders offer weekly, monthly or periodic reports on lending activity. These reports can also be available from independent suppliers that incorporate market data with the

analysis. Reports provide information on revenue earned, utilisation of the portfolios and peer group comparisons. Even an annual analysis of agent lender performance could provide appropriate oversight, when combined with periodic checks that risk and collateral guidelines are being adhered to. Whether daily, weekly, monthly or annually, best practice for institutions is to engage with their trading desk or agent lender at some level, so as to ensure their definitions of best execution and good governance are met.

7.2 Non-cash & Cash Collateral Guidelines

Investors deploy different strategies to generate securities lending returns. These will reflect their specific risk tolerances. In a non-cash collateral transaction, lenders receive a fee from borrowers for the right to borrow their securities. Institutions have a range of decision points regarding collateral acceptance. This can influence the attractiveness of their portfolio to

investors. A decision to receive only government bonds for example, will offer the lender the most protection but may be of least advantage to the borrower.

On the other hand, a willingness to accept equities as collateral may be of interest to borrowers, but expose a lender to more market risk than

they would like. These considerations of credit risk, along with collateral concentration (too much of any one security type) and wrong-way risk (collateral moving in the same direction as a securities lending transaction that could default) are important to managing the process.

The European model is in contrast to the US, where one strategy is to focus on intrinsic revenue, which is the value of a transaction in the marketplace without additional returns from cash collateral reinvestments. Before 2008, there appeared to be a desire to earn returns from what today may be perceived as risky cash investments. Now, investors have adopted a more targeted approach to reviewing the balance between risk and reward. This includes turning down transactions that fail to produce sufficient intrinsic

revenue, or where transactions would produce an unacceptable total return.

Institutional investors have investment criteria for any portfolio, and that practice should extend to non-cash and cash collateral received in securities lending. Every major agent lender has a suggested list of acceptable collateral or cash collateral reinvestments to provide to a lender, and will pare back or enlarge this list in accordance with the institution's requests if it does not transgress

either the institution's or the lending agent's own acceptable credit criteria. The more limited the type and quality of the collateral vehicles, the more reduced are revenue opportunities. On the other hand, more expansive collateral guidelines increase revenue generation but also the risk profile of the programme. Lenders must consider carefully what collateral they are willing to receive and, in the case of cash, how that collateral will be reinvested.

7.3 Oversight Committees & Levels of Supervision

An Oversight Committee is recommended for all securities lending programmes of over €1 million in securities lending revenues. If established, this Committee will be the primary internal mechanism for ensuring appropriate performance and risk management of a securities lending programme. The Committee is

responsible for reviewing performance and risk, making recommendations or decisions on lending and collateral guidelines, and ensuring the safe continuation of the programme. The Oversight Committee will typically report to the Fund Board or equivalent. Oversight Committees are often supported by an internal Subject

Matter Expert (SME) or point person to coordinate performance reports and ensure a level of awareness about the markets.

The activities of an Oversight Committee include:

- Mandate to receive performance reports on agent lenders
- Review of lending agent adherence to programme guidelines
- Review of relevant market or reputational risks
- Review proposed changes to collateral guidelines or borrower lists
- Initiate and conduct a Request for Proposal (RFP)
- Meet with the agent lender at least annually for a market and performance discussion
- Conduct a peer performance analysis, using data collected by a securities lending data provider, the agent lender or a consultant, to validate that the performance of the portfolios at the lending agent are generating reasonable revenues compared to a peer group
- Conduct a holistic, qualitative review at least every other year to ensure that the agent lender or trading desk is up to date with regulatory trends, technology, market data utilisation and routes to market

Commensurate with the scale and scope of a programme, institutional investors should also engage in regular oversight outside of Oversight Committee meetings. The intent of regular oversight is to ensure appropriate programme risk management. This level of supervision includes daily or weekly reviews of

agent lender or trading desk reports on lending revenues, volumes and collateral management holdings.

Other departments at institutional investors should also be involved in securities lending. Compliance departments should conduct a periodic risk-based review of securities lending guidelines. This should include a

review of internal procedures to ensure adherence to the processes identified. An internal audit should validate the securities lending policies and procedures document, summaries of quarterly supervision, programme changes and the qualitative review.

8. Selecting an Agent Lender

Nearly all institutional investors new to the market will select an agent lender to support their efforts. Agent lenders have become highly proficient at market tasks and understand the nuances of borrower requirements in ways that would be impractical for new institutions to learn quickly. Even institutions interested in lending their own securities will almost always partner with an agent lender for operation, valuation and collateral management purposes.

In initiating and selecting an agent lender, institutional investors should consider the following:

Approval to lend

Does your institution have the necessary powers to enter a lending programme? Do you have the skills in-house to manage a programme or do you require external support?

Risks

How have you researched and understood the various risks associated with securities lending? What level of risks are you prepared to accept? Have you assessed that the proposed or current securities lending activity will not inadvertently impact any other investment activity you undertake?

Programme supervision

How will you monitor your programme? What reports will your agent lender provide or do you need to create? Will your agent lender provide benchmarking or will you access that service elsewhere, and have you researched those services? What level of oversight is required for your size of engagement in securities lending?

Legal framework

What legal support do you require to initiate or continue your programme? What resources do you have available to evaluate modifications to agent lender or borrower agreements? How will you evaluate newer opportunities, for example engaging with CCPs? Do you understand the scope and applicability of the indemnification agreement offered by your agent lender?

Collateral guidelines and management

Do you understand the options, risks and revenue generation opportunities of cash and non-cash? If cash, do you prefer a segregated vs. pooled cash reinvestment vehicle? How will you periodically review your cash and non-cash collateral guidelines? Do you know what will happen to the collateral in the event of a default? How have you evaluated the diversification of the collateral?

Lending counterparties

Which counterparties will your securities be lent to? Are there limits of the amount lent per counterparty? If considering an “exclusive” arrangement with a single borrower, how have you assessed any additional risks involved?

Regulatory impact

How will the agent assist with the regulatory reporting? What controls can they provide to insulate against settlement costs (for example, CSDR penalties)?

Corporate governance and voting policies

If required, can you recall lent securities to allow voting? How and when do you inform your lending agent of your policy on voting? Do you understand the potential impact of voting on the lending programme? Do the requisite policy and procedures documentation for corporate voting exist and are they current?

Fees

How have you assessed the level of rewards you are expecting versus the level of risk you are taking? Do you understand how the lending agent will receive their fees for managing the lending programme? Is the income you are receiving what you are expecting or have been led to expect? If it has changed, do you understand the reasons for the change?

Training

Do you have appropriate resources in place to train one or more SMEs or point people for your firm? Who else requires training? What topics should the training cover, in what level of detail, and in what format should it be delivered? Do you attend periodic conferences for institutional investors in securities lending?

About ISLA

Who are we?

International Securities Lending Association (ISLA) is a leading industry association, representing the common interests of securities lending and financing market participants across Europe, Middle East and Africa. It's geographically diverse membership of over 200 firms, includes institutional investors, asset managers, custodial banks, prime brokers and service providers.

What do we do?

Working closely with the global industry as well as regulators and policymakers, ISLA advocates the importance of securities lending to the broader financial services industry. ISLA supports the development of a safe and efficient framework for the industry, by playing a pivotal role in promoting market best practice, amongst other things. ISLA sponsors the Global Market Securities Lending Agreement (GMSLA) and the annual enforceability review in over 20 jurisdictions globally.

How do we do it?

Through member working groups, industry guidance, consultations and first-class events and education, ISLA helps to steer the direction of the industry and is one of its most influential voices on the European and global stage.

About Finadium

Finadium is a consultancy focused on securities finance, collateral and derivatives in capital markets. In its research practice, the firm assists institutional investors, banks and service providers in maximizing the effectiveness of their resources. Finadium conducts consulting assignments on vendor selection, marketing, product development, operations and technology. For more information, please visit our website at www.finadium.com. Finadium publishes the daily news and opinion site Securities Finance Monitor.





Disclaimer

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