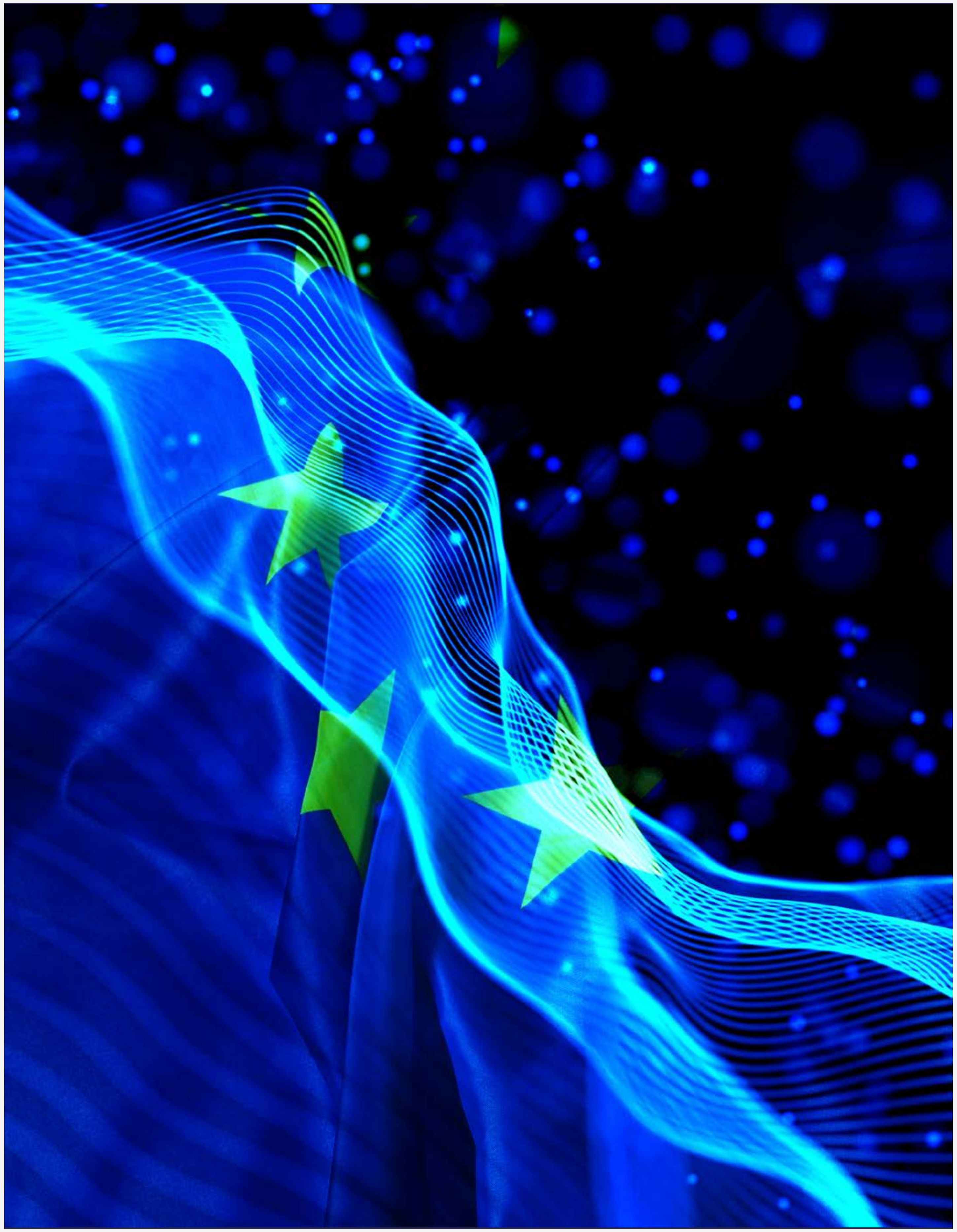
ISLA™

MAY 2024

How to Boost Europe's Capital Markets by Empowering Securities Lending & Borrowing

EXECUTIVE SUMMARY & RECOMMENDATIONS



Executive Summary

There is widespread political and industry consensus that stronger, deeper and more integrated European capital markets are needed to address the many diverse and significant funding challenges that Europe faces. The International Securities Lending Association (ISLA) is delighted to share its views and recommendations on how its members and the market it represents, can support European Union (EU) policy makers and regulators in achieving this objective. As an organisation, representing the majority of securities lending and borrowing activity in Europe, and with over 40% of our membership based in the EU, we are committed to ensuring our sector contributes to a successful and vibrant European economy.

Despite the extensive legislative initiatives of the last ten years, European capital markets remain under-developed, heavily reliant on bank funding, and are losing market share globally.

Meanwhile, Europe's funding needs have grown exponentially vis-à-vis not only the green and digital transitions, but also the financial needs of an ageing EU population and, more recently, the need for Europe to increase its defence capabilities – at a time of limited fiscal capacity.

Building more liquid EU capital markets is crucial to support the flow of private investments needed to address these funding challenges. This requires unlocking the substantial liquidity available among institutional investors. Securities lending and borrowing (SLB) is one of the core channels that can deliver exactly that, as one of the most efficient mechanisms to facilitate the flow of securities between supply and demand.

What this calls for is greater political focus and a European strategy to prioritise safeguarding and empowering core funding market channels such as SLB, to ensure securities can be mobilised quickly, and in sufficient quality and quantity. There is however significant untapped potential of securities supply held in portfolios of EU-based lenders such as UCITS, pension funds and insurance companies. If fully mobilised, it can be a key tool to unlock capital, enhance market liquidity and support investment across the EU – the foundations for competitive capital markets.

Outlined below are the strategic priorities and recommendations put forward by ISLA for the new legislative term.

Click here to read the full paper

The strategy should focus on the following four key themes:

1. Securing & Expanding Supply Channels

- Data shows there is a very significant gap between assets made available for lending and assets actually lent (i.e. between supply available for lending and the supply that is actually on loan). As a combined average only 7% (approximately) of securities held in UCITS and EU pension fund portfolios that is available for lending, are actually being lent into the EU market.
- A significant pool of untapped securities therefore exists within UCITS and EU pension funds that that could generate additional returns for investors and crucially underpin significant liquidity into the market– if fully deployed.
- EU policy makers should take action to address the reasons for this significant gap: some arise from conflicts between UCITS and Capital Requirements Regulation (CRR) requirements, others from inconsistent interpretations of key terms (e.g. use of pledge, beneficial ownership), while some are due to a lack of regulatory clarity on the compatibility of SLB with long-term, sustainable investing (which could hamper the ability to provide liquidity in new green asset classes such as green bonds).

2. Optimising & Enhancing Demand Channels

- Banks and brokers require timely access to a broad range of lenders to fulfil many essential functions in the market. This includes covering client short positions, facilitating market-making, meeting capital and liquidity coverage ratio requirements, facilitating delivery of securities to avoid operational fails and hedging of derivative positions.
- Of these, the cover of short positions probably constitutes the main reason to borrow securities. Some of the most stringent requirements of the EU short selling regulation (when compared to the US and the UK) should be reviewed to reduce the operational burden for market participants executing short sales, whilst maintaining proper supervision.

3. Advancing EU Infrastructure to Further Drive Forward Market Efficiency & Digitisation

- In order to maintain EU competitiveness while ensuring efficiency and deeper liquidity, the new CSDR framework should be allowed to bed in for SLB to play its role helping reduce settlement fails. Imposing additional (or progressive) penalties on this type of transaction would be counterproductive.
- Accelerating the current settlement cycle (from T+2 to T+1) would be a significant step to modernise EU capital markets and maintain global alignment, which policy makers should pursue, after proper cost-benefit analysis. It would enhance the attractiveness to invest in Europe as investors can free up capital faster and re-invest sooner, generating additional returns.
- Efforts to embrace and adjust to technology advancements will bring considerable reductions in the cost of trading, especially for retail investors. Greater use of Distributed Ledger Technology (DLT) in financial services and increased tokenisation of financial assets could make the EU more liquid, more competitive and even more accessible. EU policy makers should assess how fit for purpose the current DLT Pilot Regime and broader financial services rulebook is to support the wider uptake of those developments and make adjustments where necessary.
- For technology to thrive, it is also imperative that financial markets adopt not just the technology, but also a unifying and therefore frictionless standard, such as the Common Domain Model (CDM) developed by the industry. Policy makers should strongly encourage the wider adoption of the CDM that will benefit both EU markets and supervisors also ensuring direct access to more reliable and high-quality market data and crucially at a lower cost for market participants.

4. Improving the Data Reporting Framework for SLB to Ensure Market Resiliency & Financial Stability

- A resilient EU capital market is the foundation for a competitive EU capital market. The Securities Financing Transaction Regulation (SFTR) that came into effect in 2020 provides a robust financial stability framework to ensure that SLB transactions are conducted in a safe and sound manner.
- The implementation of SFTR has yielded a number of valuable lessons which EU policy makers should take stock of to update and further strengthen this framework, notably around data quality and reporting granularity.
- The review should be based on a thorough cost-benefit analysis using the enhanced SFTR data, so as to properly assess the impact of certain SFTs and their overall contribution to a build-up of leverage in the financial system, before imposing further prudential requirements such as minimum haircuts on non-centrally cleared SFTs.

Recommendations

Securing & Expanding Supply Channels

Europe should take a consistent and pragmatic view across legal financial frameworks that may impact market liquidity, both addressing regulatory conflicts and utilising consistent definitions and concepts across jurisdictions, to mobilise and facilitate the growth of supply channels of securities across all investor groups.

I. Review the UCITS framework (Efficient Portfolio Management techniques) to improve consistency of interpretation of the Directive across EU Member states and remove regulatory obstacles to further facilitate the participation of funds in securities lending. This includes the consistent use of pledge mechanisms as an acceptable form of collateral arrangement.

II. Ensure the upcoming European Banking Authority's (EBA) technical standards resulting from CRR do not unduly penalise banks when engaging in securities lending and borrowing transactions with unrated entities such as UCITS in particular.

III. As part of the local implementation of the EU FASTER Directive, promote clear, unambiguous and forward-looking legislation, including a harmonised EU-wide definition of beneficial ownership, taking into account widely accepted international standards, such as the OECD guidelines and sure consistency of interpretation between Member states.

IV. Considering the increased use of securities lending through online retail platforms, investor protection efforts should include raising awareness and transparency about the benefits/risks of securities lending.

V. Provide explicit recognition of activities such as securities lending and borrowing within defined legislation, such as the Sustainable Finance Disclosure Regulation (SFDR), whereby EU regulators officially acknowledge that engagement in the activity, so long as it complies with an institutions overall responsible investment policy, does not negatively impact a firms overall sustainability objective.

VI. Ensure that the upcoming review of the PEPP framework enables and incentivises EU pension funds to make more of their assets available for securities lending. Encourage additional Member states to drive forward the consistent introduction of capital markets based personal pension schemes, as recently took place in Germany.

Optimising & Enhancing Demand Channels

Europe should support the demand for the borrowing of securities through effective and pragmatic regulation and review the SSR accordingly. Key aspects of the EU SSR review should include:

I. Revising the public disclosure of individual net short positions with aggregated net short position reporting to reduce imitative behaviour.

II. Increasing the disclosure threshold for net short position reporting from 0.1% to 0.2% to reduce administrative burden for firms, with the option to reduce to 0.1% in particular market circumstances through ESMA's supervisory powers.

Advancing EU Infrastructure to Further Drive Forward Market Efficiency & Digitisation

For the purposes of encouraging cross-border investment and innovation in the EU, whilst also acknowledging the fragmentation across national markets – ISLA would recommend the following:

I. Complete a full cost-benefit analysis on the current CSDR penalty regime implemented in February 2022 in order to fully comprehend and analyse its effectiveness in improving settlement efficiency across EU capital markets. Adjust (increase) penalty rates accordingly for instrument types that have not demonstrated a sustainable improvement over time.

II. Consider securities borrowing transactions as the primary tool to aid and improve settlement efficiency and refrain from imposing any additional regulatory burdens, such as progressive penalties, from these types of transactions to ensure that they remain viable to be used for operational efficiency and increasing liquidity.

III. Complete full cost-benefit analysis, working with the financial services industry, to evaluate the pros and cons of accelerating the settlement cycle to T+1 in Europe, carefully assessing its impact on liquidity vs competitiveness vis-à-vis third countries.

IV. Provide political support for the uptake of the Common Domain Model (CDM) for SFTs, Bonds and Derivatives markets, to reduce the regulatory burden and cost for regulators in the EU, whilst promoting a level of standardisation across markets for lifecycle events, thus improving interoperability and communication across the EU capital markets.

V. Continue to focus on developing a sturdy legislative framework to embolden participation in the market for digital assets including, MiCA, MiFID II and the DLT Pilot Regime for Market Infrastructures based on DLT to create harmonisation and remove uncertainty for businesses by outlining clear and concise definitions and use cases.

Improving the Data Reporting Framework for SLB to Ensure Market Resiliency & Financial Stability

The EU must ensure that the regulatory burden imposed by SFTR is balanced against the benefits of improved financial stability and risk mitigation.

I. The Commission should proceed with updating SFTR and address outstanding challenges that will allow policy makers to have more accurate data surrounding securities lending and borrowing activity.

II. The review regarding minimum haircuts should be based on a thorough cost-benefit analysis using the enhanced SFTR data, post the initial review, in order to properly assess the impact of certain SFTs and their overall contribution to a build-up of leverage in the financial system before imposing further prudential requirements such as minimum haircut floors on non-centrally cleared SFTs.

2024

About ISLA

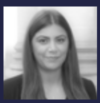
The International Securities Lending Association (ISLA) is a leading non-profit industry association, representing the common interests of securities financing market participants across Europe, Middle East, and Africa (focusing primarily on securities lending and borrowing (SLB) activity). Its geographically diverse membership of over 180 firms includes institutional investors, asset managers, custodial banks, prime brokers and service providers.

Working closely with the industry, as well as national, regional, and global regulators and policy makers, ISLA advocates for, amongst other things, the importance of securities lending to the broader financial services industry. It supports both the Global Master Securities Lending Agreement (GMSLA) legal framework, including the Title Transfer and Securities Interest over Collateral variants, as well as the periodical enforceability and security enforcement across global jurisdictions.

Through member working groups, industry guidance, consultations and first-class events, ISLA plays a pivotal role in the creation and promotion of market best practices and processes, thought leadership, standards for legal frameworks, and securities lending guides and related documents.

www.islaemea.org/about-isla

Contacts



Farrah Mahmood
Director - Regulatory Affairs
Farrah.Mahmood@islaemea.org

Fredrik Carstens
Public Affairs Advisor
Fredrik.Carstens@islaemea.org

Disclaimer

General Enquiries

Email: support@islaemea.org | www.islaemea.org