Stronger Than Before: A New Era for Securities Lending

Ten years on from the financial crisis, securities lending is more relevant than ever

It is hard to believe that we are ten years beyond the beginning of the 2008 financial crisis. Most of us can remember exactly where we were when Lehman Brothers filed for Chapter 11, but as shocking as it was at the time, nobody could have imagined just how serious the repercussions would be. In fact, the 2008 IMN in Edinburgh, just a few days later, was full of uncertainty. I remember attending the conference, but many had understandably cancelled their trips. At the time, we did not know what the future would bring or that the impacts would still be being felt a decade later.

For example, the quantitative easing programs implemented by central banks in the aftermath of the crisis in order to get economies back on their feet are only now winding down and remarkably, some of the regulations designed to prevent a repeat are still to take effect. For the securities lending market specifically, the crisis hit hard and had both direct and indirect impacts.

Directly, the supply of lendable assets initially shrank as some investors decided to take a temporary or extended hiatus in the face of credit risk concerns. Others continued and where necessary reigned in credit risk particularly with respect to collateral reinvestment guidelines. Intrinsic value lending shifted from a specialized activity to mainstream.

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Indirectly, demand slumped as the Volcker Rule forced investment banks to wind down their proprietary trading desks and Basel III regulations reduced the amount of leverage they could provide to clients. While regulations like these chilled demand, it was the implementation of near-zero interest rate environments and quantitative easing policies that arguably had greater and more sustained impact. As was intended, these programs stimulated equity markets, distorting valuations, and creating a challenging environment for hedge funds to sell short. Amidst a period of poor performance and redemptions, many hedge funds found the best strategy to keep investors was to adjust fees and ride a multi-year rally, which suppressed equity borrowing demand. The only bright spot in an otherwise benign environment was the increased appetite for fixed income assets, itself the result of regulation as capital and central clearing rules created a clamor for high-quality liquid assets.

However, at the tenth anniversary of the crisis, there are distinct signs that across all dimensions, the conditions for securities lending are improving and that the industry can pivot from restructuring and rationalisation towards growth and innovation.

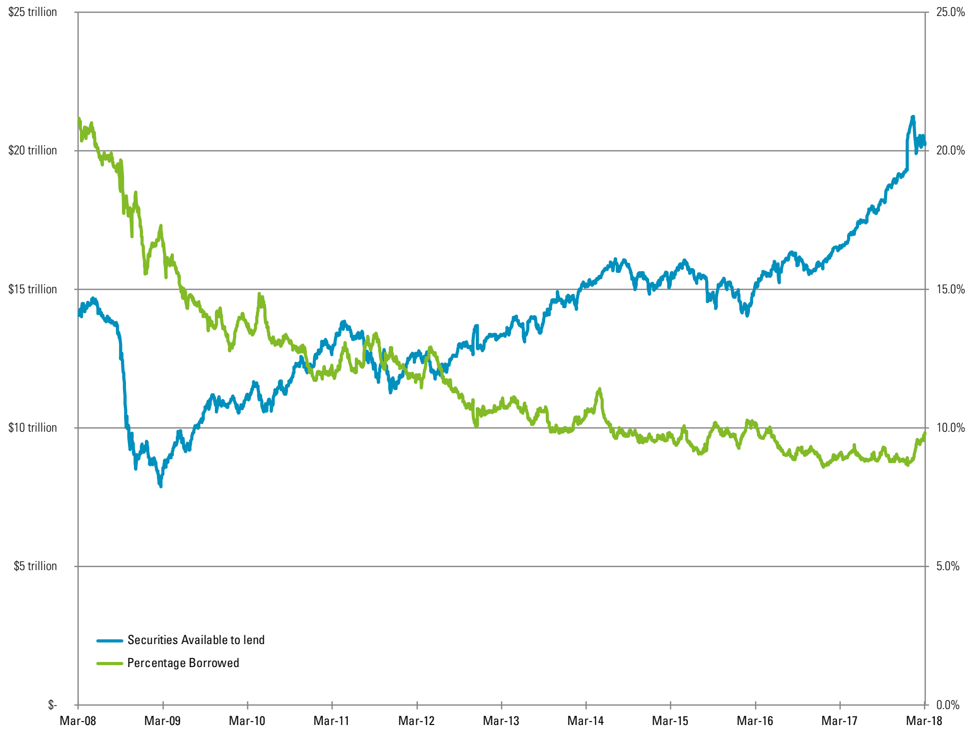
THE IMPACT OF PASSIVE INVESTING

According to industry data providers, the amount of available assets to lend is at an all-time high, in excess of $22 trillion. This reflects not only that confidence in the business has returned since the crisis, but also that its relevance has arguably never been greater. Low yield environments globally and the need to plug pension deficits are both driving increased interest in the returns securities lending can provide, but in the asset management sector specifically, it is the exponential growth of passive investing which is having the most impact and bringing securities lending closer to the core.

For a low-cost passive fund like an ETF, additional basis points (bps) offered by securities lending are key to more closely tracking its index by offsetting the impact of the annual management fee. By our account, of the managers representing 95% of AUM in ETFs, only two are not lending, demonstrating how ubiquitous securities lending has become for these products.

The passive investing phenomenon has in turn prompted all investment managers, including active managers, to evaluate the role securities lending can play in helping to mitigate the impact of their comparatively higher fees on performance. In the current environment, 5 or 10 bps are more meaningful in 2018 than they were in 2008. Today, by our account, 16 of the top 20 global managers by net new sales lend and we expect that number to only increase given the competitive pressures at play.

SECURITIES LENDING SUPPLY AND DEMAND 2008-2018



While the supply of available assets to lend has rebounded from the crisis to reach record levels in Q1 2018, demand has only begun to recover from a multi-year rally and the dampening effects of regulation (Source: Markit).

THE RETURN OF STOCK PICKING

Although at different stages, the unwinding of quantitative easing by the Federal Reserve, European Central Bank, and Bank of Japan is gradually creating a market where stock prices are becoming more dispersed, less correlated, and more likely to reflect their fundamentals. This improved environment for investors – both long and short – is also coinciding with assets flowing into hedge funds in 2018 at levels not seen since before the financial crisis – with equity long short strategies receiving 40% of the allocation. With some investors fearing a correction, hedge funds are well placed to continue benefiting from the requirement for downside protection which should be positive for lending returns given most of these strategies require securities borrowing.

THE REGULATORY AGENDA

A further tailwind for demand may be a more benign regulatory environment. At a minimum, the Trump administration is unlikely to increase the regulatory burden on banks and may even reduce it. The Crapo Bill was recently signed into law easing regulation on certain banks , and the Basel Committee on Banking Supervision announced changes in December, including changes to the calculation of credit risk in the original Basel III rules. If accepted by local home regulators, these could free up balance sheet capacity for the prime brokerage divisions of banks, further stimulating hedge fund activity, and perhaps even leading to a reemergence of proprietary trading. In the US, the SEC is reviewing potential changes to the longstanding customer protection rule 15c3-3 which would allow borrowers to pledge equity collateral for the first time alongside cash and Treasuries. By reducing their financing costs, this change will likely also stimulate demand from borrowers although there are other regulatory and commercial hurdles to clear before lenders can accept this expanded collateral set.

When discussing regulation, it can be easy to view all of it as a burden; however, it can only be positive that regulators have forced more transparency into the securities lending market. This enables regulators to identify future liquidity crises earlier and better inform end investors whose assets are engaged in securities lending. In 2018, market participants are doing a lot of work in both areas to help clients comply with ESMA's mandatory Securities Finance Transaction Reporting regime (SFTR) and in the US, the SEC Reporting Modernization initiative.

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THE ROLE OF EMERGING TECHNOLOGIES

Aside from the regulatory imperative to do so, it is important that the industry provides more transparency and control to help lenders engage in the market in a way in which they are comfortable. While competitive pressures may have brought them towards securities lending, the concerns of some of the more reluctant lenders haven't disappeared either. New digital technologies can play an important role in helping managers balance their need for additional performance with their corporate governance responsibilities and to better understand the potential impacts of lending on their portfolio.

The potential to utilize emerging technologies also extends into the trading discipline. Although securities lending remains an OTC market, a significant and growing portion of securities loans are already on automated platforms. Machine-based learning and algorithmic trading techniques offer possibilities to further enhance this process.

LOOKING FORWARD

It is said that what doesn't kill you makes you stronger. Perhaps this over dramatizes the impact that the events of 2008 had on securities lending but the industry has proved itself as resilient, adaptable, and arguably more integral than ever to asset owners and the broader capital markets. The industry has done a significant amount of work in the last decade to restructure the business model to comply with the raft of regulations imposed upon it, resulting in a stronger industry where all stakeholders have more visibility into each step of the process. Now is the time resources can begin to pivot toward growth and innovation. With demand recovering and relevance with asset owners increasing, the next decade promises to be an exciting one for securities lending.

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