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The securities finance industry today

Mark Jones, head of securities lending, EMEA, at Northern Trust reviews the major talking points of the securities finance industry in 2019

After a strong and successful 2018, this year has been more challenging for the securities lending market thus far. Political and economic uncertainty driven by Brexit and global trade tensions, among other factors, has had a major impact on broader capital markets, and the securities lending industry has not been immune to that.

At a high level, this uncertainty has contributed to a general lack of conviction across the market. Hedge fund flows are lower as long strategies are generally outperforming traditional hedge fund short strategies–and this has manifested as reduced demand, particularly in the equity space. While demand to borrow high-quality liquid assets remains robust, pressure continues to exist on spreads. This can be particularly the case when lending versus cash in US dollars, following declines in the US yield curve amid dovish central bank actions.

In addition, regulations continues to have an impact, specifically on the capacity of borrowers to generate demand for lenders. For now, this is the 'new normal' and as such our focus is on how we capture as much as possible of the more limited demand that exists in the marketplace.

There are a number of tools being employed across the industry to maximise the attractiveness of lendable assets and make the most of the resources borrowers have available to commit to loan balances. Many of these have been in play for the past 12-18 months and continue to develop. The adoption of pledged collateral structures in Europe is something we have had success with and we expect balances to continue to grow as more counterparties complete their implementation and legal work.

Capital-efficient lending, whereby borrowers seek to borrow from specific types of beneficial owners who present a more favorable capital treatment, has grown in prominence and we expect that it will remain important well into the future. Securities lending activity via central counterparties is increasing and has the potential to support increases in demand through more favorable capital treatment, much like what we have seen with the pledged collateral solution.

Perhaps less in the spotlight than some of the newer trade structures, efficiency and automation, from the front office through to the back office, remains hugely important to us. Northern Trust has invested heavily in integrating with platforms such as EquiLend's Next Generation Trading platform, which allows us to broadcast available positions to borrowers in a targeted fashion, making it easier for borrowers to identify and initiate transactions with little manual intervention. In an environment where the growth in quantitative-based trading strategies remains strong, being able to meet high-volume demand in an efficient manner puts us in a strong position to capture balance.

In summary, we can't control market forces, the macro-economic environment, or regulation, so our focus is very much on the things we can control. We are constantly looking to enhance our lending programme in ways that put us in the best position to capture existing and future demand.

What can we expect to see going forward?

There has been no shortage of comment and discussion on the impact of regulation on the industry, specifically the Securities Financing Transactions Regulation (SFTR) and more recently the Central Securities Depositories Regulation (CSDR). There are obvious effects of SFTR that the industry has largely addressed in respect of the technical challenges of creating, reconciling and delivering huge quantities of data. Vendors will play a key role in this process and have developed good solutions that address the majority of the industry's needs. We're now entering a phase of bilateral conversations with our borrowers to iron out challenges at a much more granular level, as well as being very engaged with the industry best practice work.

The result will hopefully be a standardisation of approaches to life-cycle events across the bulk of the market, but indications are that there are still areas that will prove challenging and will require attention over the coming months. This theme continues through to CSDR, with industry best practice groups leading the charge on standardising approaches that aim to reduce the impact of the settlement discipline regime being imposed in 2020.

The development of innovative, market-leading technology is a key priority for our business. We are investing heavily in our proprietary lending platform by taking advantage of new and emerging technologies. We recently implemented our securities lending pricing engine that utilises machine learning and statistical analysis to more effectively forecast market rates for a wide range of securities. This is a development we are particularly excited about, not only for its immediate benefits, but also for its potential expansion to other applications over time.

Another area of focus for us is on meeting the ever increasing demand for data and analytics from our beneficial owner client base. Requirements vary significantly across beneficial owners based on factors like size, location, and structure of the beneficial owner's programme, just as we are investing in our data and platform capabilities, so are our clients. The ability to interface directly with our clients via application programming interfaces and other mechanisms will be the key to success in the future. In addition, the consumption and analysis of data will ensure full transparency and strong risk management as we all consume and utilise more and more data than ever before.

The rise of ESG

A highly-visible trend across financial markets is the rise of environmental, social and governance (ESG) investing. While examples of attention to ESG investing emerged sporadically as early as the 1950s, expansion of the concept as a driving factor really took hold around the turn of the century, growing to the point where investors now almost inevitably have a carefully considered policy. Solution providers have designed a similarly wide range of investment options to meet their needs.

Most institutions are operating a more active ESG agenda than ever before, although we find huge variety of approaches across our client base as to how these are being implemented.

There are a number of ways ESG investment principles may affect a securities lending programme. Firstly, it will impact the securities an investor will hold, which in and of itself does not present an issue. ESG portfolios are still capable of generating sustainable returns in a securities lending programme.

The second impact is corporate governance. A key pillar of certain ESG approaches is to ensure investors are exercising their right to vote and influence the direction of companies in which they own a stake. Investors approach this in a variety of ways, from voting all proxies across their portfolio through to more selective methods such as focusing on particular markets or voting only on contentious issues.

As the right to vote passes in a securities lending transaction, lenders must recall securities from a borrower to ensure that the right to vote is maintained. We believe it is essential for beneficial owners to have a clear policy on their approach to voting and to discuss that with their lending provider to ensure their needs can be met. At Northern Trust we recognise the importance of strong corporate governance and as such have developed a range of solutions to support corporate governance objectives for beneficial owners in our programme.

Lastly, we have seen an increased focus on the collateral that beneficial owners deem acceptable to receive. In the same way that attention is given to what securities an investor holds in their portfolio, some beneficial owners take the view that the same principles should apply to the collateral they accept.

This brings to the fore one of the interesting challenges with ESG principles: that there are a multitude of different approaches. Despite the emergence of ESG benchmarks, indices and the development of principles for the assessment of companies and responsible investment, each individual investor decides which principles matter most to them. For example, some institutions may have a particular focus on low-carbon footprint investing, whereas others may view this through an explicitly more 'ethical' lens and focus on the exclusion of controversial weapons, gambling, or tobacco based companies.

Whatever the approach adopted, we believe it is important for us to support our client's requirements in this space, and the core principles of responsible investing more broadly.

Final thoughts

Securities lending remains a relatively low-risk product that can generate significant returns for beneficial owners through a well-managed programme. In an environment where cost pressure is increasing and returns are more difficult to generate, securities lending can make a difference to asset owners and asset managers by offsetting those costs and providing a useful source of income that contributes to portfolio performance. We are encouraged that we continue to see new entrants to the securities lending market as beneficial owners continue to recognise value in our product.

Securities lending remains a key product in the broader financial markets, supporting liquidity and generating valuable returns for investors. Whilst further evolution is inevitable, this industry has demonstrated time and again that it is well equipped to adapt and respond to the changing circumstances and requirements of market participants.