



The year of preparation

SFTR will continue to be a hot topic this year as the deadline date draws closer, as well as CSDR and Brexit, meanwhile, a cautious eye should be kept on flows in and out of hedge funds which experienced performance challenges in 2018

Maddie Saghir reports

The hot topics for 2019 include Securities Financing Transactions Regulation (SFTR) preparation, legal challenges around Brexit, Central Securities Depository Regulation (CSDR), macro and geo-political factors leading to market volatility, new entries of participants into securities, as well as challenges around creating innovation.

The securities finance industry kicked off last year with the introduction of the second Markets in Financial Instruments Directive (MiFID II) implementation. The securities lending market was largely ready for MiFID II but perhaps the same cannot be said for the imminent, and most important regulation for the securities finance industry, SFTR. There was much discussion last year on the complexity of SFTR, however, some industry participants have argued that this is in fact a blessing in disguise, which will encourage better practices.

Market participants provide their predictions on hot topics, opportunities and challenges for the year ahead.

What are your predictions for the securities lending market this year? And what do you think the hot topics will be?

Paul Wilson: This year will inevitably be dominated by the build up to the implementation of SFTR in Europe. This regulation is having a fundamental impact on market participants, but it is also a catalyst for change and the way participants think about their business and activities. SFTR is arguably one of the most complex (and technologically difficult) challenges that the industry has faced since the financial crisis, and so it is difficult to see beyond this being anything other than front and centre for all impacted market participants.

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Paul Wilson
Managing director, securities finance
IHS Markit

This will inevitably lead to drop outs from some lenders where the additional overhead outweighs revenue generation. We think this will lead many participants, especially beneficial owners, to review their lending framework and parameters in order to validate that lending activities are consistent with their investment objectives, and to

ensure they are optimising revenue generation. This is considered best practice in any event, but we think especially so this year.

We are hearing a lot of talk and discussion around best execution and transaction cost analysis for securities finance, and while this may have been addressed to some degree with the advent of MiFID II, our sense is that the thought process and approach are continuing to evolve.

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Matthias Graulich
Member of the Eurex Clearing
executive board

Lastly, it is inevitable that macro and geo-political factors will be dominant this year, which will lead to continued market volatility that creates an uplift in borrow demand. This also translates into the continued positive income generation and profitability from securities finance experienced last year, especially in emerging markets with trade tensions, and also from corporate bonds (partly driven by exchange traded funds creation needs as concerns about the credit markets continues and have been voiced by many senior market participants). A cautious eye should be kept on flows in and out of hedge funds that experienced performance challenges last year.

Matthias Graulich: I believe last years' topics will still be hot. These include everything that drives and impacts the transformation of the securities lending market from a non-standard, bilateral over the counter model towards a more progressive and sustainable operating model.

All items shaping the market globally this year will be centred around the four key areas: legal, legislation, regulatory, as well as infrastructure and technology. More precisely, collateral optimisation, the legal challenges surrounding Brexit, the introduction of central securities depository and SFTR as well as the demand for the enhanced use of technology solutions across the entire securities lending process.

Furthermore, central clearing will continue its onward march and become even more important to the market. Central clearing leads to greater safety and integrity in the financial markets. As safety and integrity are also objectives that buy-side and sell-side market participants have in common, I think demand for the Lending Central Counterparty (CCP) service of Eurex Clearing will also continue.

The challenge is to bring committed participants together to identify and form the next steps towards building an improved securities lending market

Marcel Naas
Head of product design, funding and financing
Eurex

Mark Steadman: We will see the securities lending market spend this year ramping up preparations for SFTR implementation. A significant number of industry participants have already started to mobilise efforts by addressing the regulation's data requirements, which are far more demanding than firms have previously experienced. As such, this year we will see firms continuing to examine their workflows to ascertain how that data will be obtained and sourced, if not already available, in order to comply with the reporting mandate.

Walter Kraushaar: Continuing a trend which can be followed already since 2017, there will be an increased return and new entries of participants into the securities lending market.

This upsurge in interest in lending may be driven by a more passive asset management, where an add on of a lending programme will provide significant bottom line alpha to the fund performance without a parallel increase of inherent market risks.

At the same time, digitalisation helps even smaller asset managers, banks, beneficial owners and other lenders to build a robust infrastructure for their business at a cost which guarantees

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Mark Steadman
Executive director, European head of product
development and change management for
global trade repository
DTCC

a decent profitability of their securities finance activities even in a low margin environment.

Flexible digital IT platform strategies with high connectivity to other competing systems are key to support this trend, and guarantee a true low cost straight through processing and trade matching between all market participants and market service providers (for example, CCPs, tri-party agents).

In terms of products, the trend away from event driven lending activities towards general financing transactions in high-quality liquid assets (HQLA) securities will continue. There is also a clear shift towards term transactions such as 'evergreen' and 'pledge' structures for balance sheet and liquidity management purposes as well as collateral upgrades in every market.

A special market situation is about to occur in Spain, where—after a decade of debate—a law change is on the way to allow Spanish mutual and pension funds to conduct securities lending transactions other than for short cover purposes only. This will create a significant amount of supply of mainly European assets available for securities lending.

Finally, the upcoming of Brexit will move business in general away from London into various continental European financial hubs such as Frankfurt, Paris and Amsterdam.

What are the main challenges and opportunities for the year ahead?

Marcel Naas: The challenge is to bring committed participants together to identify and form the next steps towards building an improved securities lending market. At the end of last year, Eurex Clearing initiated a lending CCP think tank group to encourage dialogue, strategy and initiatives to drive the delivery of a new phase of market access for securities lending with the aim of shaping the growth of Lending CCP utilisation.

A key focus for this year will be to continue our collaboration with clients to bring innovation to the market. At Eurex Clearing, we believe that our clients and key market players are fundamental to drive the growth and transformation of central clearing for the securities lending market.

As far as the Lending CCP is concerned, Eurex Clearing looks forward to maintaining its role as a leading market infrastructure provider and partner to our clients. The Lending CCP signed up a number of major buy-side clients and agent lenders last year. This year we will have the opportunity to extend the range of clients, markets, and assets into our offering. As a result, we expect the daily average on-loan volume to steadily increase over the next year for both equity and fixed income segments.

Steadman: SFTR's data reporting requirements are more stringent than previous mandates and firms will need to report significantly more data than they have done in the past. In addition, inter-trade repository

reconciliation will present a challenge for market participants this year as it did under European Markets Infrastructure Regulation (EMIR). To overcome this, firms should prioritise the four fields required to pair a trade: unique trade identifiers (UTIs), reporting counterparty, other counterparty and master agreement type. Ensuring consistency will at a minimum allow matching to take place.

While a large number of firms are already putting preparations in place, many others, such as tier two banks and buy-side firms, have adopted a 'wait and see' approach to the regulation to gain clarity on the technical standards which have only just been published, however delaying preparations will create challenges in achieving compliance.

If SFTR preparations are approached correctly, the regulation will deliver multiple benefits such as data transparency which, in turn, will result in more accurate pricing, as well as contributing to the creation of greater transparency in the global financial system overall and the mitigation of systemic risk.

Kraushaar: Combined with the immense infrastructural efforts which have to be made by those market participants which will be affected by Brexit, the main challenges this year will most probably not be driven by market events but by significant (IT-) infrastructural challenges caused by those events and regulatory requirements. However, the mentioned challenges are a great opportunity at the same time as they push all market participants towards market transparency and to radically rethink their business strategy. This provides a big opportunity to upgrade and/or change the current aging IT infrastructure into modern digital platform technology, which will allow tailor-made solutions for every market participant at a significant lower cost basis. It will also help especially smaller and more specialised market participants to enter or re-enter the securities lending markets.

James Moroney: The industry challenges this year will be similar to the challenges faced in last year, however, we anticipate the market will yield an improved environment for generating revenue through lending securities. Market participants will need to focus on collateral transformation and regulatory compliance, which will once again drain resources. Last year these hurdles, along with low volatility and steady upward trending equity markets, contributed to annual returns that were well-below historic averages for asset owners.

Hard to borrow securities, as a percentage of overall on-loan securities in the marketplace, has steadily declined over the last 12 months as short-side participants appeared to throw in the towel and ride the 'long wave'. Tax harmonisation also muted securities lending performance last year and we expect it will continue to have an impact on the market this year. Poland, Belgium and possibly France are markets that are considering tax changes that could have similar outcomes to the rule changes seen in Germany early last year.

If asset owners are willing to broaden their acceptable collateral sets, they should continue to maintain as well as grow their slice of market share in securities lending. However, for lenders not able to accept

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Walter Kraushaar
Head of advisory services, Frankfurt
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alternative collateral types (for example, main index equities), they could see a continued deterioration in both market share and lending revenue. Market demand for many borrowers is shifting from USD cash collateral to non-cash collateral, and we anticipate this trend will especially be pronounced for general collateral loans going forward.

Optimistically, the markets are setting up for sustained volatility and wildly fluctuating equity market values. Trade wars, Brexit, credit pressures and other global macro uncertainties are beginning to build a 'base' in Q4 that could lead to more two-way risk in the markets for this year.

We are starting to see green shoots that could be indicative of better days ahead for short players and thus securities lenders. Initial public offerings are again trading special for many weeks at a time and single name shorting and borrowing is beginning to pick up around the globe. Similarly, mergers and acquisitions arbitrage has been more active of late, which gives further hope to lenders looking for a shift in momentum next year.

Lastly, there are also significant opportunities for lenders looking to expand lending into emerging markets such as Taiwan, South Korea and Russia, as well as anticipated new lending markets, such as the Philippines, which is poised to open for lending late in 2019. **SLT**

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James Moroney
Managing director, head of global equities
and corporate bonds trading
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