BANK OF ENGLAND

Minutes

Securities Lending Committee

17 May 2018

Location: 20 Moorgate, EC2R EDH

Attendees:	**Prudential**	Nina Moylett (Chair)
	Aberdeen Standard Investments	Matthew Chessum
	Aviva Investors	Mick Chadwick
	BlackRock	Tim McLeod
	BoNY Mellon	Simon Squire
	Citadel	Timothy Tomalin-Reeves
	Citi	Andy Krangel
	Clifford Chance	Habib Motani
	Goldman Sachs	Mark Short
	HSBC	Jamie Anderson
	ICMA/ERCC	Godfried De Vidts
	Morgan Stanley	Matt Collins
	Prudential	Simon Dunderdale
	State Street	Alex Lawton
	DMO (Observer)	Jessica Pulay
	FCA (Observer)	Wladimir Kraus
	BoE	Chukwuma Nwankwo (Secretary)
	BoE	Helen Ritson
Apologies:	**BoNY Mellon**	Staffan Ahlner
	Insight	Mark Stancombe
	ISLA	Andrew Dyson
	Lloyds	Jamie Smith
	Norges Bank Investment Management	Matthew Brunette
	BoE	Sarah John
	BoE	Jonathan Pyzer

Minute no.

1. Introductions

Nina Moylett (Chair) welcomed new members Jamie Anderson (HSBC) and Tim McLeod (BlackRock) to the Committee.

2. Pledge Structures

The Committee had discussed pledge structures at its May and November meetings.[1] ISLA's work with Clifford Chance on developing market-standard documentation around pledge structures continued and the Chair invited Andy Krangel (Citi) to provide a progress update.

[1] For further information see https://www.bankofengland.co.uk/minutes/2017/minutes-of-the-securities-lending-committee-meeting---november-2017.

ISLA's pledge working group had reached, or was close to, agreement on a number of outstanding issues. The working group had agreed that, from a UK perspective at least, a claim on pledged collateral constituted a floating (as opposed to fixed) charge, as borrowers would wish to retain the right to substitute and optimise collateral.

The final points of the Global Master Securities Lending Agreement (GMLSA) in relation to account control would soon be agreed following which it would be distributed to the working group for comment. The Committee noted that work was progressing on the basis of the current four triparty agents.

Cross-jurisdictional enforceability was also discussed with the Committee noting that it was usually determined by the location of the borrower or collateral. Related documentation for the UK, Luxembourg and Belgium would be distributed soon.

Regarding tax implications, pledge structures raised a question as to whether movement of collateral would be considered a disposal by tax authorities in certain jurisdictions. It was noted that ISLA's main role was to provide an overarching framework and explanation of pledge structures; individual users would have to gain comfort with the risks of pledge and retained the option to customise the provisions within the documentation to meet their own requirements.

The Chair invited Habib Motani (Clifford Chance) to recapitulate the legal implications of pledge structures, particularly in comparison to title transfer. He noted that whilst both structures delivered similar outcomes it was incumbent on market participants to conduct an in-depth review of each structure's nuances. Some members of the Committee noted that the limited size of the pledgor universe meant that such analysis had not been completed and it remained unclear how much of this work firms wished to leave to ISLA and/ or complete in advance of Brexit.

Firstly, there was potential for minor differences in the default timelines process for pledge structures due to a requirement for separate notices. He reiterated that pledge structures were not viable as a fixed charge and it would be necessary for market participants to reach a similar understanding. Finally, the suitability of pledge structures for third party creditors (for example, UCITs) had to be factored into the overall framework.

Members were in broad agreement that a pledge structure entailed a change in risk profile which could appeal to a subset of lenders. A custodian bank noted that it seemed counterintuitive for pledge structures to reduce the risk of securities lending transactions to one party, whilst being no riskier for the other party, simply by varying the documentation. Members agreed that although the transactions were economically equivalent there were nonetheless fundamental differences – for example, default under one structure may be managed differently to default under the other – and it was important that market participants appreciated the differences between the structures and the implications. Some members suggested that a clearer articulation of the risks by tri-party agents would aid broader market understanding.

Buy side Committee members noted that pledge structures would be a difficult sell to all but the most sophisticated clients who may see an opportunity to earn a better return. The Committee discussed the likelihood of pledges structures being restricted to an interbank market, given the driving force in their development so far has been a lower capital risk weighting. Members agreed that an interbank market was unlikely because pledged collateral could not be repurposed and as such would more likely appeal to investors such as sovereign wealth and insurance funds.

The Committee also discussed the longevity of the favourable capital treatment of pledge structures, noting that in future regulators could decide that such transactions should be consolidated with title transfer structures given the equivalent economic outcomes. Moreover, regulators may have differing interpretations of pledge structures and would be unlikely to provide the certainty (regarding the treatment of these transactions) that market participants desired.

Members agreed pledge structures were likely to remain a live issue in the medium term and that a further update at the next SLC meeting would be useful.

3. Developments in securities lending

Members noted that market participants did not face the same binding constraints due to differing business models/mixes and varying interpretations of the rules in different jurisdictions.

One member presented some statistics from IHS Markit's Security Finance Quarterly Review, which showed that 2018 saw the best Q1 securities lending revenues since 2008.[2] However, total return to lendable securities was only marginally higher than in 2017, partly due to increasing equity valuations.

Some prime broker members noted that it was now easier to on-board new lenders but suggested that demand may not have increased to a similar degree. Members from the buy side also noted an increasing supply of lenders to the market driven by an extremely competitive environment in asset management (particularly with the rise of passive strategies) where performance could be skewed by a matter of basis points. It was also noted that some of the concerns around the securities lending industry of a few years ago appeared to have abated.

On the demand side, a UK bank noted that equity hedge funds were operating at higher levels of leverage but most investor funds were flowing into vehicles such as UCITs (that have constraints on the use of collateral) which made it difficult to increase the utilisation rate of high RWA clients. A further inhibiting factor was the fact securities lending infrastructure in its current form did not cater to all the requirements of clients with Environmental, Social and Governance (ESG) criteria. An agent lender noted that some clients' policies may mean lenders are forced to develop bespoke collateral schedules because clients were selective about acceptable collateral.

A sell side member noted that although the bulk of High Quality Liquid Assets (HQLA) was in segregated accounts, most lenders were of the opinion that supply was not constrained. However, most banks had now shifted their focus away from the Liquidity Coverage Ratio (LCR) and to the Net Stable Funding Ratio (NSFR), a metric for which upgrading (less liquid) collateral (for HQLA) was less beneficial.

The Committee agreed that, in summary, the securities lending industry was facing a number of challenges and one of the most critical was devising the optimal way to trade given current and impending regulations.

4. Securities Financing Transactions Reporting (SFTR)

Members agreed that considerable resource had been dedicated to Markets in Financial Instruments Directive II (MiFID II) and attention was only now turning to SFTR. On the technology front, members noted that it was difficult to find a single solution that worked for all types of securities financing transactions.

An agent lender noted that the onerous reporting requirements and attendant cost of SFTR could exclude smaller beneficial owners from the market. Some prime broker members highlighted the additional complication of apportioning costs between clients whose trades were captured by or out of scope of SFTR. Some members questioned the value of the reported data more generally given it would only show a point-in-time snapshot. **Members agreed that the business model implications of SFTR would be discussed at a future SLC meeting.**

Some members noted that Central Securities Depositories Regulation (CSDR) could have a more significant impact on the securities lending industry because provisions like mandatory buy-ins (which force an entity failing on a trade to acquire the missing securities) may lead

[2] For further information see https://cdn.ihs.com/www/pdf/MSF-Q1-2018-Quarterly-Review.pdf.

some lenders to review the cost-effectiveness of their continued participation. **The Committee agreed that the trading implication of CSDR would be worth discussing at the next SLC meeting.**

5. SLC Forward Agenda

The Chair debriefed the Committee on the items on the Money Market Committee's (MMC's) forward agenda and invited suggestions for inclusion on the SLC's own forward agenda.

Members discussed how peer-to-peer (P2P) securities lending had become less prominent in light of increased balance sheet availability. As such there was now little appetite on the part of borrowers/ lenders to transact directly with new counterparties. The distinction between platforms and P2P clients was discussed with members noting that the former was merely an interface as opposed to trading venue.

Members also noted that platforms lacked the capabilities to handle other parts of the trade process. It was also noted that some market participants may be forced to connect with trading counterparties via platforms in order to demonstrate best execution. However, the proliferation of these platforms meant that only a select few with the highest concentration of liquidity were likely to survive in the long run.

The Committee agreed that the inefficiencies that were increasingly seeping through the securities lending transaction chain; potential solutions for these inefficiencies (for example smart buckets);[3] tools to demonstrate best execution; and Basel IV minimum haircuts should be included on the Committee's forward agenda.

6. AOB

The Committee had discussed an impending tax change in Germany in relation to securities lending at its November meeting. The Committee noted that a final circular had recently been released in German and an English translation would be available shortly. There was an expectation that lenders operating under German tax jurisdiction would declare to the (German) authorities the receipt of a manufactured dividend and the authorities would confirm if a tax return needed to be filed.

Some members noted that the impact of the tax change at an aggregate level was currently uncertain but there was some concern that uncertainty on the part of lenders (regarding their obligations) could mean a fall in supply of lendable securities putting pressure on borrowing mid-cap stock if those securities were recalled en masse.

The Committee discussed potential presenters at the July Committee meeting. The Chair highlighted the meeting date's proximity to ISLA's annual conference and noted a desire to avoid duplication of agendas. **The Committee agreed that, similar to last year, it would be useful to have presentations from technological solution providers and that it would be particularly useful to hear from firms offering front-end trading solutions. Trading Apps, HQLAx and R3, were flagged as potential candidates.**

[3] For further information see http://www.securitieslendingtimes.com/dataanalysis/dataanalysis.php?data_analysis_id=22.