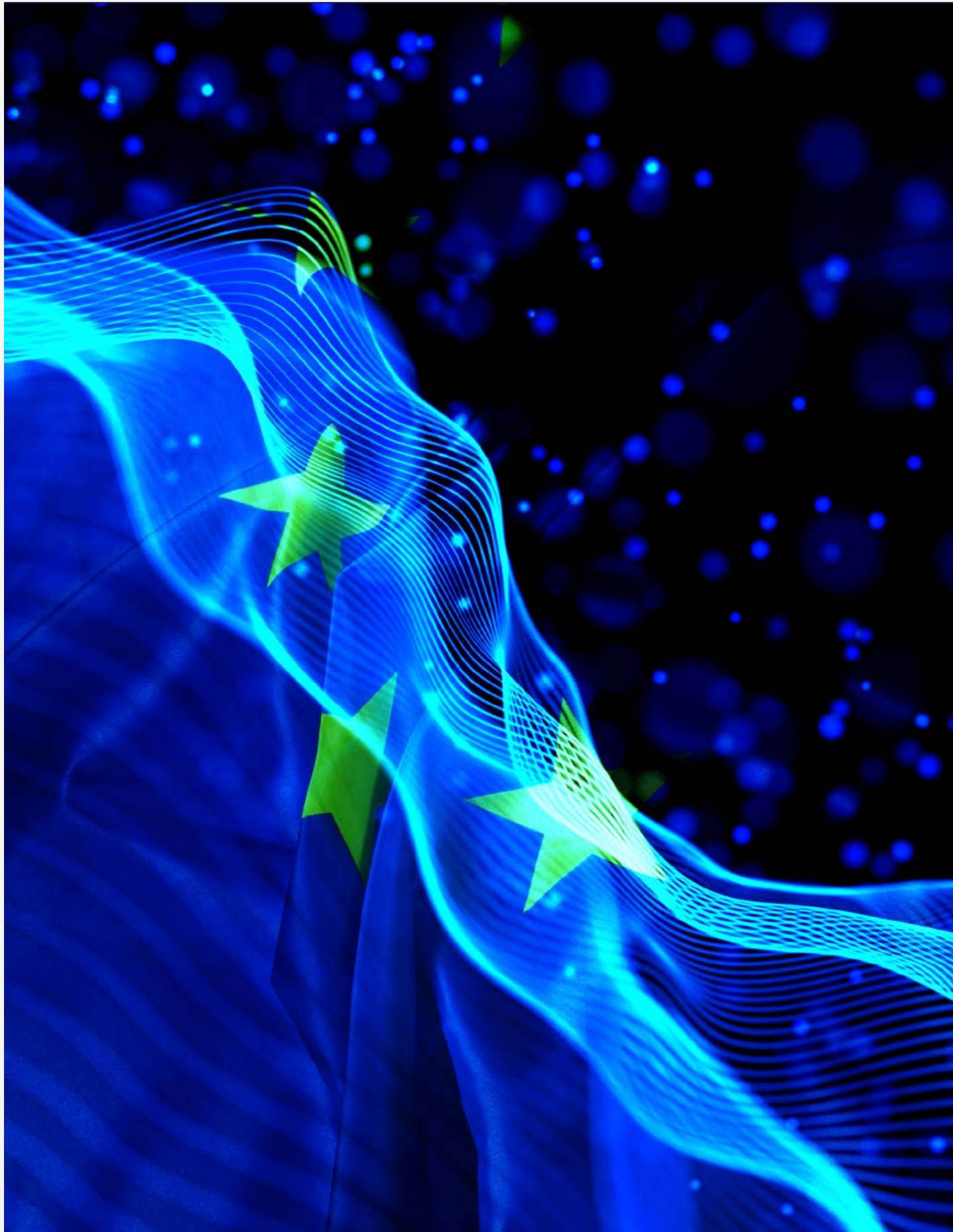


ISLA™

MAY 2024

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



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Introduction

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.¹ 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 (SLB) activity in Europe, and with over 40% of our members based in the EU, we are committed to ensuring our sector contributes to a successful and vibrant European economy.

Building more liquid EU capital markets is crucial to support the flow of private investments needed to address the funding challenges; this requires unlocking the substantial liquidity available among institutional investors. 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 Undertakings for Collective Investment in Transferable Securities (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.

The strategy should focus on the following four key themes:

- **Securing and expanding supply-side channels**
- **Optimising and enhancing demand-side channels**
- **Advancing EU infrastructure to further drive forward market efficiency and digitisation**
- **Improving the financial stability data reporting framework for SLB to ensure market resiliency**

Implementing this strategy will help the Capital Markets Union's (CMU's) long-term goals to balance competitiveness versus stability, enhance liquidity and efficiency, and create a deeper, more attractive destination for international investors, amidst a challenging environment.

After providing the context and a short description of what SLB is, including the benefits that it brings to well-functioning markets, this paper provides a number of recommendations for EU policy makers and regulators to consider, as they look for effective measures in which to enable this strategy.

For a summarised version including an overview of ISLA's recommendations please [click here](#).

¹ According to the Eurogroup Statement (11 March 2024): "to match the substantial financial needs of the future, market-based funding opportunities must urgently become more widely and readily available in Europe"; also Enrico Letta's report on the EU Single Market: "While the EU has boldly set forth an array of ambitious goals, a critical challenge remains unresolved: the funding of these aspirations." (p.26)

Context for Change

European Capital Markets Remain Under Developed

Nearly a decade has passed since the European Commission introduced its CMU Action Plan. Despite extensive legislative efforts and significant strides in enhancing efficiency and integration within primary and secondary markets, progress towards the objectives of the CMU has been slow:

Europe's reliance on bank versus capital market funding remains reasonably unchanged in the last decade (at circa 75% vs 25% respectively). This is despite the notable shift of investment, credit and funding activities from banks to non-banks.

EU capital markets remain a fraction of the size of US capital markets, with EU financial services continuing to lose market share in the past fifteen years. For example, among the largest 100 asset managers globally, the share of funds from Europe has dropped to 21.9% in 2022 from 47.1% in 2007.²

Meanwhile, Europe's Funding Needs Have Grown Exponentially

In less than six years, Europe has faced three major 'before and after' events namely, Brexit, the COVID-19 pandemic, and the conflict in Ukraine. These have tested the resilience of EU markets and in some cases, required significant injections of public money. Looking ahead, Europe is now confronted with how to mobilise significant amounts of investment to support the green and digital transition of its economy, and to do so at a time of fiscal repair. In tandem, an ageing EU population and the need for Europe to increase its defence capabilities, are adding to the immense funding pressures.³

² <https://www.luxembourgforfinance.com/en/publication-mag/competitiveness-of-european-financial-services-2024/#:~:text=Among%20the%20largest%20100%20asset,any%20region%20globally%20in%202007>. According to the Eurogroup Statement (11 March 2024)

³ Q&A on the European Commission's 2023 Foresight Report: "Overall, additional investments of about EUR 620 billion annually will be needed to meet the objectives of the Green Deal and of our REPowerEU plan, with an additional EUR 92 billion needed to address the objectives of the Net-Zero Industry Act over the 2023-2030 period";

Core Funding Markets, such as Securities Lending & Borrowing, Can Play a Vital Role in Supporting Competitive European Capital Markets

All of this places an onus on the importance of private sector capital to fill much of the investment gap, taking some of the pressure off the public purse. However, this shift also comes at a time of geopolitical fragmentation that itself threatens global investment flows. In such a context, it is crucial for EU policy makers to prioritise safeguarding and empowering all core funding market channels. Whilst perhaps currently not the most prominent consideration in policy maker's minds, securities lending and borrowing is one such channel, and can become a key tool to unlock capital, enhance market liquidity and support investment across the EU – the foundations for competitive capital markets.

Indeed, securities lending and borrowing is a vital mechanism for providing liquidity in both traditional asset classes (such as company shares, corporate and government bonds), as well as in emerging new asset classes (such as green bonds, digital assets, and perhaps in the future, defence bonds). A liquid secondary capital market is crucial, not only for the ability of companies and governments to fund themselves in the primary market, but also to the attractiveness (and therefore competitiveness) of Europe's capital markets. This is because more liquid secondary markets tend to lower the cost of funding.

The landmark Eurogroup statement on 18 March 2024 puts it well:

“An open, liquid capital market which is well integrated into global markets is important to support the flow of private investment into innovation, including in the green and digital sectors. With the limited fiscal space and multiple spending priorities, funds to build up production capacity and boost innovation in Europe, need to come primarily from the private sector.”⁴

Furthermore, former Italian Prime Minister Enrico Letta's recent report on the state of the Single Market, equally underlines this liquidity imperative:

“In the face of constrained public budgets, private capital can also be key to developing new green (transport, energy, etc), and digital infrastructures. This requires unlocking the substantial liquidity available among institutional investors, such as pension funds and life insurers.”⁵

Securities lending and borrowing's importance to market liquidity stems from its status as one of the most efficient mechanisms to facilitate the flow of securities between demand and supply, in a well-established and secure manner. Bolstering core funding markets like securities lending and borrowing will serve the needs of market participants across the entire financial services value chain.

A European Strategy to Bolster Core Funding Market Channels

What this calls for is a strategy to tap the potential of securities lending and borrowing, to help meet these needs. Such a strategy ensures that both securities and collateral can be mobilised at all times, and in sufficient quality and quantity between market participants. The upside is that there is significant untapped potential of securities supply held in portfolios of European-based lenders, such as UCITS, pension funds and insurance companies not yet mobilised for securities lending. This can truly further support liquidity and collateral availability, if fully deployed.

Getting to where we need to be requires a comprehensive, two-pronged approach focused on unlocking the funding potential from securities lending and borrowing (and other similar securities financing markets) that addresses both:

- (i) supply and demand challenges
- (ii) regulatory and operational challenges that limit the additional provision of liquidity

This needs to become an area of much greater political focus than it has been to date.



Given the global nature of financial markets...it is important that EU policy making takes account of the competitiveness of EU financial markets versus other jurisdictions⁶

⁴ Eurogroup statement (18 March 2024) <https://www.consilium.europa.eu/media/70782/peg-to-pec-letter-march-2024-final.pdf> (pg 6)

⁵ Enrico Letta report 'Much more than a market' <https://www.consilium.europa.eu/media/ny3j24sm/much-more-than-a-market-report-by-enrico-letta.pdf> (pg 31)

⁶ ESMA position paper 'Building more effective and attractive capital markets in the EU' https://www.esma.europa.eu/sites/default/files/2024-05/ESMA24-450544452-2130_Position_paper_Building_more_effective_and_attractive_capital_markets_in_the_EU.pdf

What is Securities Lending & Borrowing?

Securities lending and borrowing is a long-established and well-functioning market in Europe, where an investor temporarily lends securities to a borrower, in return for a fee. It is one of four different securities financing transaction (SFT) types, along with repurchase transactions (repos), buy-sell back transactions, and margin or commodity lending.⁷

Securities can be in the form of bonds issued by governments or corporates as well as equities and Exchange-Traded Funds (ETFs). In addition to the fee, the borrower provides the lender with collateral in the form of cash or other securities. This protects the lender from the risk of potential loss if the borrower becomes insolvent and is unable to return the lender's securities. The value of the collateral provided by the borrower is normally greater than the value of the borrowed securities, providing additional protection for the lender.

To further protect both parties from market fluctuations during the life of the transaction, securities and collateral on loan are revalued on a daily basis and adjusted if needed. At the end of the transaction the borrower and lender return their respective securities and collateral to one another. Securities are frequently lent on an open basis and as such, can be recalled if the lender requires the securities back. These requirements form part of market standard legal agreements and the processes are further supported by widely accepted best practices between market participants.

Lenders are usually investors such as pension funds, mutual funds including UCITS, insurance funds and Sovereign Wealth Funds (SWFs), that typically invest



[Click here to access the ISLA Securities Lending & Borrowing Hub](#)

with a medium to long-term horizon and thus do not need access to all of their securities on a daily basis.

By lending securities, they can receive additional income without losing the benefits attached to those securities, such as dividends and interest payments. The revenue generated can help reduce costs for investors, retail and pension plans in Europe.

The European Central Bank (ECB) and other national Central Banks (NCBs) also use securities lending as part of their monetary policy. This is vital for price stability, economic growth in the Eurozone, financial stability, as well as an autonomous EU capital market, which lessens external dependence and provides sufficient resources internally for European businesses.

Whilst only accounting for a relatively small part of the market, retail investors have also begun to utilise securities lending for incremental income via a range of trading platforms and aggregators (firms that combine small retail holdings into tradeable volumes).

From a legal and tax perspective, it is important to note that:

- Most transactions are carried out using 'outright transfer of title' meaning that legal title to both securities and collateral passes on to the borrower and the lender respectively.
- However, whilst legal ownership to the securities is transferred to the borrower throughout the duration of the transaction, the economic ownership remains with the lender. Whilst the borrower receives all dividends and/or interest coupons during the life of the transaction, these are then passed back to the lender, via what is called a manufactured payment.
- Most transactions take place under the Global Master Securities Lending Agreement (GMSLA) - Title Transfer and the Security Interest over Collateral (Pledge) Agreement both supported by legal opinions with regards to the enforceability of the agreement across jurisdictions.

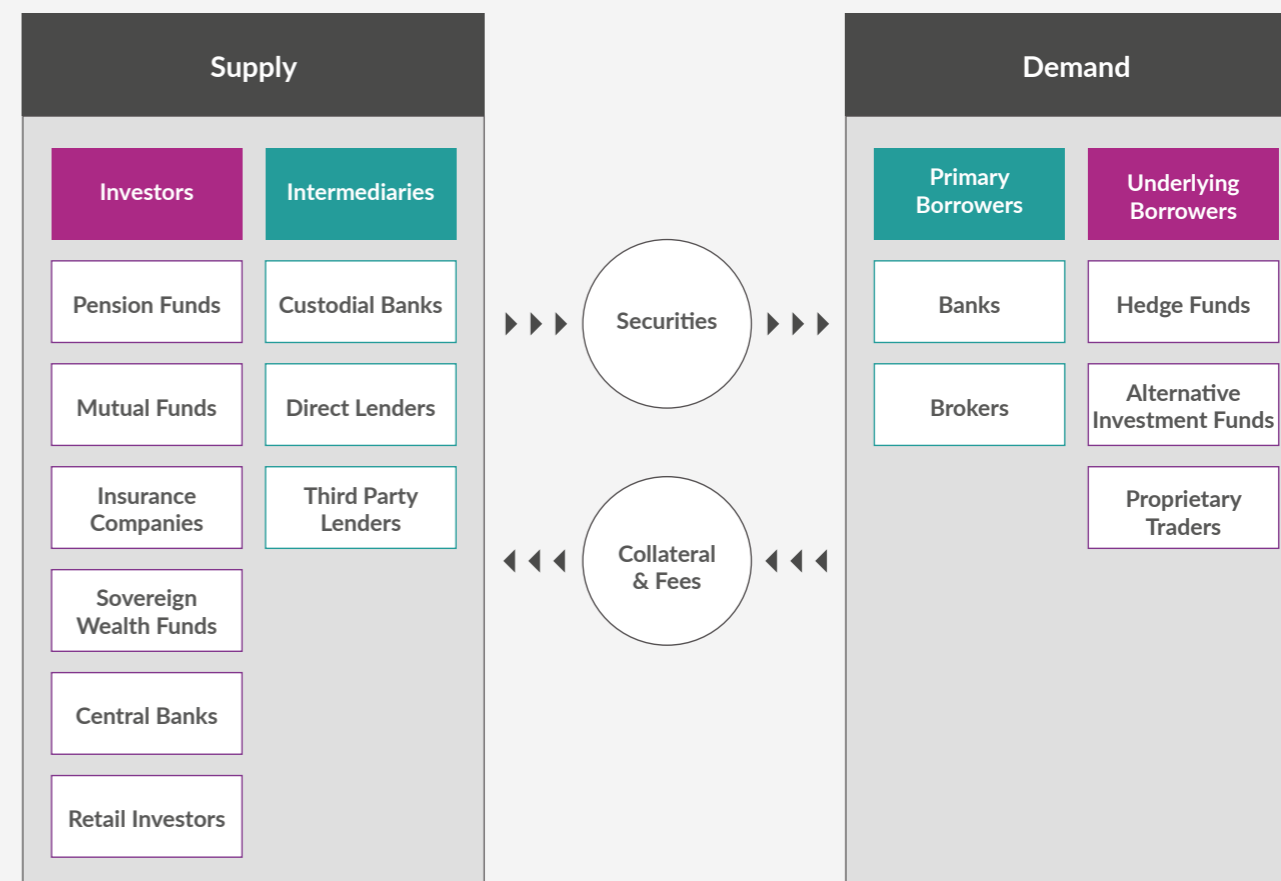


Diagram showing the trade flow between the supply-side and the demand-side

⁷ According to ESMA's report on "EU Securities Financing Transactions markets 2024", the total outstanding exposure of SFTs is EUR 9.8tn, as of September 2023. Repos account for EUR 6.7tn or 68% of the total, securities lending for EUR 2.3tn (23%), buy-sell back for EUR 743bn (8%), and margin lending for EUR 124bn (1%).

How Securities Lending & Borrowing Contributes to a Healthy Financial System

Makes financial markets more liquid and more efficient – providing access to securities for banks and brokers to meet their market-making commitments and obligations towards clients and EU governments.

Provides a low risk means for investors to generate additional portfolio income – lenders/owners of securities are the ultimate beneficiaries of the income generated from the securities they lend in return for a fee. The revenue can be used to offset operational costs thus improving the overall performance of the portfolio and increasing returns for long term investors.


Supports the increase of retail participation in capital markets - the emergence of low-cost retail investment products (e.g., tracker funds such as ETFs) is in part due to management costs being supported by revenue gained from securities lending. By making investing in the financial markets more appealing at a lower cost, securities lending stimulates retail investment flowing into the capital markets.

Reduces operational risk in the system – making securities available where they are needed, thus ensuring timely settlement of financial transactions, and ensuring market stability.

Is vital for the ability of EU financial institutions to meet their risk management regulatory capital requirements, thus reducing systemic risk in the system. EU legislation requires banks and other market participants to reduce risk by 'collateralising' their exposures to counterparties. Examples include:

- (i) Meeting margin requirements under derivatives regulation (EMIR), thus ensuring the stability of clearing houses.
- (ii) Meeting the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio requirement for banks to hold high quality securities under the Capital Requirements/Basel framework.

Is an important part of market operations of the ECB & NCBs – to implement EU monetary policy and promote financial stability. Central banks can use securities lending for quantitative easing to increase supply, by purchasing government bonds and other financial assets from banks and then lending them back into the market.



Securities lending and borrowing makes financial markets more liquid and more efficient

Priorities & Recommendations for the New Legislative Term

In the following, we provide several recommendations that ISLA believes would help to bolster the competitiveness of EU capital markets, whilst also strengthening Europe's market resiliency. These are grouped under four key themes that provide overall direction for a future strategy to optimise securities lending and borrowing as a core channel to support Europe's funding needs. Such a strategy should focus on:

- **Securing and expanding supply-side channels by mobilising significant additional securities in EU lenders' portfolios**
- **Optimising and enhancing demand-side channels - by better connecting the supply and demand for securities**
- **Advancing EU infrastructure to further drive forward market efficiency and digitisation**
- **Improving the financial stability data reporting framework for securities lending and borrowing to ensure market resiliency**

1. Securing & Expanding Supply Channels

One of the conditions for a deep and liquid financial market, is to ensure that securities can move freely between market participants. The mechanism enabling this flow is securities lending and borrowing. Yet, for securities lending and borrowing to be able to play its full role, asset owners must be further encouraged to lend their assets into the market which can be done by making the regulatory requirements more practical in line with market practice.

The supply of assets typically comes from long-only investors largely managing buy and hold portfolios such as pension funds, asset managers through UCITS, insurance companies, central banks and SWFs.

As the table below shows, there is a very significant gap between total assets, available supply and assets on loan.

Financial Assets held in EU (in Billion €) as of Q4 2023⁸

	Total Assets	Assets Available For Lending	Actual Assets On Loan	% On Loan
Total	82,000	3,630	326	9.0%
UCITS	8,400	2,490	194	7.8%
Pension funds	3,370	522	32	6.1%

- **Total securities held by EU-based investors is estimated at around €82 trillion (as of Q4 2023) of which approximately €3.6 trillion is currently available for lending.**
- **UCITS hold approximately €8.4 trillion in assets (10%), of which €2.5 trillion (27%) are available for loan; yet only €194 billion (7.8%) are actually out on loan.**
- **Pension fund assets have doubled to €3.37 trillion since 2008, according to the ECB, and make up some 4.1% of total assets held; yet only €32 billion (6.1%) of the lendable assets are actually lent out.**
- **A significant amount of euro-denominated securities available for securities lending comes from outside Europe with non-EU lenders making up some 75% of available supply and 63% of on-loan balances.⁹ These lenders include large SWFs and international asset managers as well as non-EU central banks with significant reserves also held in European government bonds.**

⁸ Data provided to ISLA by S&P Global Market Intelligence

⁹ Data provided to ISLA by S&P Global Market Intelligence



Therefore, there is a very significant gap between:

- (i) total assets held in the EU
- (ii) assets that are made available for lending
- (iii) assets that are actually lent in the EU market

Two important lessons can be drawn from these numbers:

- (i) A significant pool of untapped securities exists within, UCITS and EU pension funds for example. By making more securities held by these institutions available for lending, significant liquidity could be injected into the market, that would also generate additional returns for investors. Pension funds in particular potentially represent a significant additional source of supply in the future, especially as the plan structures in the EU become increasingly more capital markets-based.
- (ii) Non-EU investors are a major source (75%) of euro-denominated securities supply for European markets.

The reasons for the significant gaps between available supply & the amount of securities on loan, are manifold & vary among asset holders

Some arise from within the UCITS and pension funds regulatory frameworks, as well as from direct conflicts between different frameworks (e.g., UCITS and Capital Requirements Regulation (CRR)). Others stem from uncertainties resulting from inconsistent definitions, while some are due to the lack of regulatory clarity on the compatibility of securities lending with long-term, sustainable investing. We consider each one in turn, below.

Conflict between specific asset management & capital requirements regulatory frameworks

Whilst UCITS legislation has delivered a largely unified and successful investment vehicle for both institutional and retail investors, we believe there is scope to further facilitate the participation of UCITS assets in securities lending to benefit from additional returns whilst also strengthening the competitiveness of the UCITS brand as a global standard. There are aspects of the regulation as part of Efficient Portfolio Management (EPM) at the ESMA level, as well as specific variations existing on the local level, that make UCITS less attractive as a source for borrowing securities, such as:

- (i) A term limit of a maximum of seven days on UCITS' securities lending activities, which conflicts with the demand from banks and brokers looking for longer term funding under CRR (e.g., thirty days minimum under the LCR) – meaning banks can no longer borrow securities from UCITS for regulatory capital purposes.
- (ii) Under the current CRR, UCITS of high credit quality are deemed as unrated counterparts, thereby increasing capital costs for banks to borrow from UCITS due to the increased risk weight associated with unrated entities, which will reduce demand to borrow from UCITS even further, and in turn reduce market liquidity. This lowers potential returns for UCITS funds that ultimately serve investors, pensioners, and savers.

On the pension front, the introduction of a Pan-European Personal Pension (PEPP) product in 2022 was an important step in the ambition to establish a voluntary personal pension scheme. Designed as an additional saving option for EU citizens complementing the existing state-based pensions and occupational pensions offered by employers, its development across Member States and take-up has so far been slow across Europe. Some countries however such as the Netherlands, Sweden, Denmark, and Norway have for many years successfully offered effective capital market-based pension fund offerings, many of which engage in securities lending. As some of the larger economies are starting to implement their own capital market-based pension fund products such as Germany, EU-held pension assets are set to grow significantly, potentially boosting supply in the securities lending markets if utilised correctly. Any future review of the PEPP should ensure that the framework is an enabler of this potential.



Inconsistent interpretation of key terms that are core to securities to lending & borrowing activity

This includes, in particular, inconsistent interpretation across Member States, on the acceptability of a pledge (security interest over collateral) mechanism for transferring securities as collateral under a securities lending transaction with UCITS. Pledge is a well-established mechanism for transferring securities as collateral in, for example, in derivatives markets and crucially, enables borrowers of securities to benefit from a better treatment for regulatory capital, as the borrower retains a property interest in the collateral assets and is not exposed to the same risk of non-return of excess collateral by the lender. Therefore, the borrower may be considered to not be taking any exposure to the lender which potentially eliminates the associated risk weights and leverage exposure for the bank. In order for UCITS funds to compete fairly with other lenders, pledge-type mechanisms should explicitly be considered and made consistent with other UCITS regulation as an acceptable form of collateral arrangement in a future UCITS review.

Outside of core financial market regulation, the withholding tax landscape across Europe can also act as a significant barrier to entry for investment, and further reduce competitiveness. We commend Commissioner Mairead McGuinness, in her recent letter to Mario Draghi, where she highlights as a priority, greater harmonisation within the single market to iron out divergent national rules, mentioning barriers linked to differing taxation frameworks. The recently agreed FASTER Directive aims to make the administrative withholding tax procedures better fit for cross-border investment and combat the possibilities of abuse of taxation rules. However, without a clear and consistent definition of for 'beneficial ownership' of securities and a consistent interpretation of OECD guidelines, this can create obstacles for investors when allocating their investments across international markets thereby potentially limiting the growth of EU capital markets. Furthermore divergent anti-abuse legislation across EU member states, including retrospective changes of guidance and lack of clear and unambiguous regulation can result in investors withdrawing their supply of securities available for lending from the market altogether.



“Capital markets regulation in the EU is advanced and comprehensive. While there is scope for further harmonisation in those areas, fragmentation and obstacles to EU capital markets growth can often be driven by a lack of consistency and common approaches in other areas of law, particularly regarding issues such as taxation and insolvency that are in the remit of Member States.”¹⁰

Lack of clear regulatory acknowledgement of the positive alignment of securities lending & borrowing with sustainability

Securities lending and borrowing can actively support the EU's sustainable finance agenda. It provides vital liquidity and a secondary market for sustainable securities like green bonds for example. Transitioning to net-zero and achieving other sustainability goals requires significant capital, exceeding the capacity of public finance alone. Private funding for essential infrastructure and investments is crucial. Well-functioning capital markets, facilitated by securities lending, are key to generating this funding. Securities lending, along with short selling, can increase the supply of sustainable securities within these markets. This aligns with the CMU's wider goals and contributes to a more resilient European economy that empowers the EU to deliver on its objectives under the European Green Deal.

One concern that often arises for asset owners considering engagement in securities lending, is the temporary transfer of shares, including voting rights, to the borrower. This has raised questions about whether securities lending and short selling can align with a long-term sustainable investment strategy. The need to attenuate short-termism was one of the primary action points under the EU's 2018 Sustainable Finance Action Plan. The European Commission, at the time, was concerned that activities within capital markets are inducing companies to prioritise short-term profit at the expense of the long-term success of businesses, which requires consideration of threats such as climate change. It mandated the European Supervisory Authorities to review the evidence and report on whether practices within capital markets are generating undue short-term pressure in the real economy, including in relation to securities lending. ESMA did not find any concrete evidence

for a causal connection between securities lending and undue short-term market pressures and clearly stated that “short-selling and securities lending are key for price discovery and market liquidity”. They did not recommend any changes to policy in this area as a result of their findings. However, in the absence of clearly defined sustainability legislation targeting investment tools such as securities lending, both institutional and retail investors may take a stricter approach to engagement in the activity, which could ultimately hinder growth in EU markets, as well as hinder liquidity in sustainable securities.

Transitioning to net-zero and achieving other sustainability goals requires significant capital, exceeding the capacity of public finance alone.

Recognising that securities lending plays an important role in the market and provides investors with additional income, the UK Financial Conduct Authority (FCA) has, for example, usefully clarified “we do not consider securities lending as being incompatible with ESG, as securities lending arrangements can be tailored to meet the ESG objectives of the lending and borrowing parties”.

¹⁰ ESMA makes recommendations for more effective and attractive capital markets in the EU

Recommendations

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. The ambition should be to resolve those conflicts and develop a common approach within the EU towards securities lending and borrowing, facilitating its use among market participants, with clear and unambiguous rules and regulation. Stronger participation of EU-based investors in securities lending will reduce the current reliance of non-EU based supply coming from institutions outside of Europe and at the same time, increase the liquidity and competitiveness of EU markets.

- I Review the UCITS framework (EPM 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 EBA's 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 ensure 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 institution's overall responsible investment policy, does not negatively impact a firm's 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.

The European Commission should continue to propose legislation in the form of regulations rather than directives, to improve consistency of implementation and interpretation, and agility in making changes¹¹

¹¹ ESMA position paper 'Building more effective and attractive capital markets in the EU' https://www.esma.europa.eu/sites/default/files/2024-05/ESMA24-450544452-2130_Position_paper_Building_more_effective_and_attractive_capital_markets_in_the_EU.pdf

2. Optimising & Enhancing Demand Channels

The demand to borrow securities is primarily from banks and brokers to:

- (i) cover the short positions of their clients
- (ii) facilitate market making obligations
- (iii) manage collateral positions
- (iv) meet capital and LCR requirements
- (v) facilitate delivery of securities in a timely manner to avoid operational fails
- (vi) hedge derivative positions

To fulfil these roles effectively, borrowers require timely access to a broad range of lenders to secure the amount and type of securities required.

Of these, the cover of short positions probably constitutes the most significant reason for market participants to borrow securities. Despite its sometimes negative connotations, short selling constitutes a key component for any developed financial market.¹² It is generally accepted by global policy makers as vital for any developed financial market, providing important price discovery and liquidity to the financial ecosystem as outlined in ESMA's recent [report](#) on Securities Finance Transactions 2024. At the beginning of the year, ESMA also released a detailed [review](#) of the effects of short selling bans as a result of the pandemic in 2020 on financial markets which delivers a fact-based and balanced view, in effect confirming the significant role that short selling plays for efficient capital market functioning. A recent [report](#) from S&P Global Market Intelligence in March 2024, stated that short interest across EU equities had fallen to the lowest levels in a decade.

The current Short Selling Regulation (SSR) in the EU stands out as having some of the most stringent requirements when compared to the US and the UK. One way to enhance the competitiveness of the EU capital market, would be for EU lawmakers to carefully consider the most recent changes to SSR introduced in the [US](#) and the [UK](#).

Recommendations

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.

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

Allow the new CSDR Framework to bed in for securities lending & borrowing, to play its role helping to reduce settlement fails.

Europe now has a stronger, albeit fragmented, securities settlement framework Central Securities Depositories Regulation (CSDR), to build from and pave the way for a more integrated and competitive EU market; a framework within which securities lending can play its role to prevent settlement failure and thus increase efficiency and liquidity across the board.

In a recent consultation, ESMA [stated](#) that 'securities borrowing is usually the easier way to prevent or resolve a settlement fail caused by the lack of securities', and [also](#) 'one and a half years after the start of the application of cash penalties....settlement fails are occurring less frequently' due to the establishment of standardised rules pertaining to CSDs and their participants, thereby moving the EU closer towards its goal of maintaining a developed, integrated single market.

In order for the EU capital market to increase in size and liquidity, securities lending and borrowing must be proactively supported, as it is the obvious solution to secure settlement efficiency. Imposing additional (or progressive) penalties, as part of the upcoming review on this type of transaction, would be counterproductive.

Hence, new proposals emerging from policy makers to introduce progressive penalty rates under CSDR, without conclusive evidence to suggest that the current regime is not being effective, could potentially exacerbate liquidity concerns across the EU. The additional operational complexity and cost involved in investing in Europe may act as a barrier to entry when firms are considering investment here versus other jurisdictions. Especially if a new progressive penalty regime was to be rolled out in tandem with a focus on accelerating the settlement cycle.

Although Europe has made significant progress, its unique and diverse settlement infrastructures and legal frameworks will render the transition more complex than those of other jurisdictions. In addition, progressive penalties for settlement fails could make lenders more cautious of relinquishing their supply to assist with settlement failure. Most importantly, the complexities of managing progressive penalties would be a huge administrative burden and cost to both lenders and borrowers, potentially discouraging participation by smaller market participants and with uncertain benefits.

In order to maintain EU competitiveness while ensuring efficiency and deeper liquidity, further time is needed for the CSDR penalty regime to bed in, in order to accurately measure its effectiveness in the long term, and to better recalibrate the current penalty rates for instrument types with continuously high failure rates (such as ETFs), so long as this does not disrupt the flow of capital.

Subject to the above, the introduction of an accelerated settlement cycle in the EU, will certainly help to advance post-trade inefficiencies, but also reduce systemic risk in the financial system, by reducing exposures over the settlement period. It is a significant step to modernise capital markets in Europe and maintain global alignment. A shortened settlement cycle would enhance the attractiveness to invest in Europe; with trades settling the next day instead of the current T+2 standard, investors can free up their capital faster and re-invest sooner, allowing for the potential to generate additional returns.

¹² MSCI developed market classification 'Existence of a regulatory and practical framework allowing short selling.'

Advancing digitisation & the uptake of industry standards to support the transition

Capital markets in Europe are now more accessible than ever, and a lot of this can be attributed to technology advancements that have considerably reduced the cost of trading, especially for the individual retail investors. Support for development of new infrastructures such as Distributed Ledger Technology (DLT) can further:

- (i) **reduce settlement times, with the potential for 'real time' settlement finality, eliminating the delays caused by traditional intermediaries**
- (ii) **reduce operational costs by streamlining the often manual elements of the settlement process**
- (iii) **enhance transparency and auditability by creating a secure record of all activity reducing risk and potential fraud**
- (iv) **improve governance by providing a clear picture of ownership and transaction history with access to consistent and good quality data to help mitigate counterparty risk**

To encourage greater use of digital infrastructure, ISLA believes that the use of digital assets, such as tokenised traditional financial assets, could make the EU more competitive and even more accessible. Digital assets can make a significant positive impact on liquidity, as they allow for fractionalisation, meaning that market participants can gain ownership of assets in smaller digital units, which facilitates participation from a much wider range of investors, including those with less capital. New asset classes can also create additional avenues for funding and collateral purposes by removing geographical and operational barriers associated with traditional collateral management, leading to a more frictionless market.

The regulatory environment to facilitate movement of tokenised assets as well as the infrastructure, including custody solutions and trading platforms is still evolving, and ISLA is very supportive of these developments. A clear and structured framework will be necessary for widespread adoption and to mitigate any potential risks. Careful consideration must be given to the specific characteristics of the asset and the intended use cases.

For technology to thrive, it is imperative that financial markets adopt not just the technology, but also a unified and therefore frictionless standard. To further this outcome, ISLA has been working alongside the International Swaps & Derivatives Association (ISDA) and the International Capital Markets Association (ICMA) to develop the FINOS Common Domain Model (CDM). The CDM creates a single data standard that can be used to represent securities lending, repo and derivative transactions through common data points, transaction lifecycle events and product definitions. This common standard approach will support legal, KYC and static information that underpin market operations and therefore improve post-trade activities.

The improved data clarity realised by this approach not only improves market efficiency but also has been proven to significantly reduce costs, for both the market and regulators. In its April 2022 Machine Readable Executable Reporting (MRER) [feasibility study](#), the European Commission highlighted the benefits to both market participants and the supervisory community of a CDM. Combining this concept with the reality that regulatory compliance represents one of the largest operating costs, there are obvious benefits to adoption of these technologies and standards, further improving the attractiveness of operating in the EU.

Recommendations

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 FINOS 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.

4. Better Data for Greater Stability

ISLA has long supported the push by global and EU policy makers for more transparency in the securities financing market and proactively led the charge for the industry to adopt and create best practices with regards to the Securities Financing Transaction Regulation (SFTR) since long before the go-live in 2020.

ISLA fully supports Europe's goals to ensure that SFTs are conducted in a safe and sound manner to help protect from risks that exist, particularly outside of the traditional banking system. We therefore welcome the news of an upcoming consultation on SFTR announced as part of the European Commission's report on a macroprudential framework for Non-Banking Financial Intermediaries (NBFIs) as well as the full review of the SFTR reporting regime by the next Commission. ISLA supports the Commission's desire to make the regime fit for purpose, to help regulators to identify risk and to provide a fuller picture to trigger the relevant supervisory interventions where necessary.

The implementation of SFTR has yielded a number of valuable lessons for regulators and market participants including:

- (i) **Importance of standardised data collection. As advised above, the endorsement of policy makers for a CDM would help significantly to ensure consistency of data provided for analysis.**
- (ii) **Data quality and reporting granularity. Data lacks the necessary detail for effective risk assessment by regulators. Going forward, efforts to improve data quality and standardised reporting granularity can further enhance the usefulness of the data collected.**

Over the years, ISLA has maintained a log of outstanding issues and challenges related to SFTR's reporting obligations, that have been shared with the EU regulator. We welcome the opportunity to build out the framework to address these challenges, to allow policy makers to have accurate data surrounding securities lending and borrowing activity.

Although minimum haircuts for SFTs as part of the Basel III framework have generally not been implemented in several jurisdictions to date, we anticipate that they will be considered in the near future. Under the international Basel framework, non-centrally cleared SFTs with non-banks as well as collateral upgrade transactions will be captured under this framework. Although there is general acknowledgement that some SFTs may be used to take on leverage which may pose risks to financial stability, not all SFTs are entered into for this purpose. The FSB stated in a report titled 'Transforming Shadow Banking into Resilient Market-based Finance' in 2015 (updated in 2020), that the framework looks to "limit the build-up of excessive leverage outside the banking system, reduce the procyclicality of such leverage, guard against the risk of regulatory arbitrage, and maintain a level-playing field". However, there is no distinction made in the Basel framework between:

(i) specific transactions that are for the purpose of financing and thereby increase leverage.

AND

(ii) transactions such as securities lending and borrowing, that are mostly used to source a particular security.

Furthermore, a 2016 ESMA report states that "numerical haircut floors for non-centrally cleared transactions, such as those set out by the FSB, can only be introduced and calibrated following a thorough analysis using granular SFT data (which will become available after the full implementation of the SFTR, and following careful assessment of the scope)".

Recommendations

While SFTR has increased transparency in SFT activity, assessing its full impact on 'shadow banking' and the associated risks of contributing to a build-up of leverage requires further analysis. The EU must ensure that the regulatory burden imposed by SFTR is balanced against the benefits of improved financial stability and risk mitigation. With regards to the macroprudential framework for the NBFIs sector, ISLA understands the importance of appropriate counterparty credit risk management by banks given the high degree of interconnectedness with NBFIs.

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.

Compiled 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 EBA's 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, un-ambiguous 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 FINOS Common Domain Model 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

ISLA™

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

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General Enquiries

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