The International Securities Lending Association
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ESMA
CS 60747
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19 February 2015

Consultation on ESMA's Technical Advice under the CSD Regulation

Dear Sirs,

We are pleased to provide a response to the above consultation paper on behalf of the International Securities Lending Association ("ISLA"). Given the focus of our association on the securities lending market we have restricted our comments to specific questions which apply to provisions that are relevant to our members. We have separately responded to the consultation on ESMA's Technical Standards.

Executive Summary

Securities lending is a technique employed by long term investors such as pension funds, insurance companies and mutual funds as a means of generating incremental returns on portfolios. Securities loans are fully collateralised and conducted within a well-established legal framework. Banks and prudentially regulated broker dealers provide the market for securities lending by acting as principal intermediaries, borrowing securities from long term investors and using or on-lending them for a variety of purposes, including facilitating market making and trading strategies such as covered short selling. Securities lending activity is acknowledged as adding to secondary market efficiency which benefits all users of the capital markets.

In relation to the CSDR, securities lending also plays an important role in ensuring that transactions settle in a timely fashion, as investors and intermediaries borrow securities to enable them to fulfil their delivery obligations. Our interest in the CSDR is to try and ensure that implementing measures achieve the desired market settlement benefits without inadvertently discouraging investors from participating in securities lending. Investors consider securities lending to be an ancillary investment activity and there is evidence that applying costly settlement penalty regimes can actually serve to deter them from lending their securities. This will have negative consequences for overall settlement efficiency and market liquidity.

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This is because the investor can become exposed to a settlement penalty by virtue of lending their securities (for example if they are late settling a sale because securities have failed to be returned from loan on the intended settlement date). Whilst they may receive a penalty themselves (for the late return of the loan), which should negate the penalty they suffer, they still consider that some exposure exists. This can simply be avoided by not engaging in securities lending. The risk will be considered greatest for less liquid securities where it is more likely that a settlement failure will occur, and this will ultimately reduce liquidity further.

We realise that CSDR itself requires the application of settlement penalties and that ESMA has been asked to provide advice as to the appropriate levels of the penalties and in this regard we believe that:-

- it makes sense to consider securities borrowing costs when setting the level of penalties as this is a common mechanism for ensuring that transactions settle on time;
- the penalty levels proposed are high relative to the cost of borrowing and that the fine levels should be reduced to lessen the risk that investors decide to stop lending;
- although a simple model with few different penalty rates is generally desirable, we believe that this approach has drawbacks. ESMA should consider at least one additional category for less liquid securities which may prove difficult to borrow. This category should attract a low (or even zero) penalty rate to reduce the risk that market makers stop offering prices for securities.

We hope that this response is helpful to ESMA in its ongoing work and look forward to working further with you on this matter.

Yours sincerely,

Kevin McNulty

Chief Executive

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Answers to Specific Questions in the Consultation Document

Q1: What are your views on the proposed basis for the cash penalty calculation?

We believe that ESMA has considered carefully the issues relating to the basis on which the cash penalty should be calculated. We note that the penalties are meant to act as a deterrent to fails which should lead to improved levels of settlement efficiency, and that the penalties should take into account the specificities of different asset types, liquidity and category of transactions. We also note and would agree with the views expressed by stakeholders that the parameters and mechanisms for the penalties should not be overly complex.

Balancing these sometimes conflicting objectives however poses large challenges. Where our members perceive the greatest risk is that the settlement penalties deter investors from lending their securities which in turn would have a negative effect on overall settlement efficiency (given that securities lending is used to settle transactions that would otherwise fail). This risk derives mainly from the choice of categories of securities and levels of penalties and we expand on this in our answer to Q2.

We note that the CSDR will impose settlement penalties on all categories of transactions. Whilst settlement penalties are applied in some markets around the world today it is not common for these to apply directly to securities lending transactions. If a penalty is applied to a cash market transaction that is dependent on a securities lending transaction to settle, the cost of the penalty (on the cash market transaction) may be passed on to the parties under the terms of the securities lending master agreement. This is important as whilst many securities loan transactions are driven by demand to settle another transaction (in which case it may be appropriate to pass on a cost), in others, for example where the loan may be to create a collateral transfer and does not support a market transaction, it may not. In the latter case today there will not be a settlement penalty as there is no underlying cash market transaction.

By way of example:-

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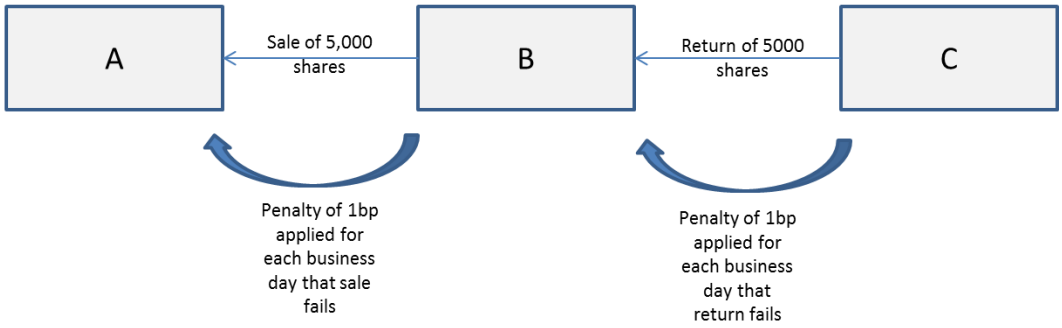
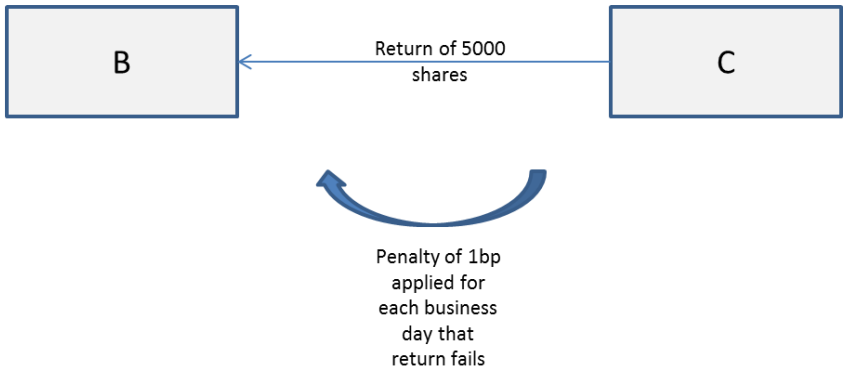
Example: Loan recalled by investor in order to settle a sale



In this example the lender (B) recalls shares in order to settle a sale in the market (to A). If the shares are not returned by the borrower (C). Under CSDR the borrower is charged a penalty on the failing return, and the lender is charged the same penalty on its failing sale. In markets today, where a penalty is applied to the failing sale, the lender may pass this cost on to the borrower.

The situation is different where the return is initiated by the borrower and there is no market sale by the lender. In markets today there is no fail penalty applied and the loan continues until such time as the borrower returns the securities. The lender continues to be collateralised and to receive the agreed lending fee. Under CSDR however this will be different as the failing return will attract a penalty:-

Example: Loan returned (terminated) by borrower



We point this out mainly as an example of how securities lending practice will change as a result of the CSDR and to support the observations in our response to the consultation on Regulatory Technical Standards that considerable time be given for implementation to enable these complexes changes to be managed by all parties.

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Q2: What are your views on the proposed approach regarding the categories of financial instruments and the penalty rates? In particular, do you consider that these penalty rates could dis-incentivise trading in small caps? Please provide evidence to support your views.

We agree that there is logic in relating the level of penalties to the cost of borrowing securities as this is an obvious way for market participants to remedy failing transactions. We also note the difficulties in attempting to establish simple rates for broad categories of securities as rates for borrowing will vary according to demand and supply factors. The dispersion of rates can in fact be very wide so picking a "one size fits all" penalty rate that has some bearing on borrowing costs is challenging.

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Comments on the proposed settlement penalty rates

In considering whether the proposed settlement penalty rates are appropriate we have considered data from two commercial data companies that collect data from securities lending market participants globally (DataLend and Markit Securities Finance). The analysis in this response uses data from Markit however we would point out that the two data sets are broadly consistent.

Based upon this data we believe that the suggested levels of penalties appear high relative to the average cost of borrowing. Whilst a high penalty rate may be considered as a good incentive for participants to borrow securities to cure a failing transaction, we believe that setting the costs too high will have the perverse effect of dis-incentivising institutions from lending.

Investors engage in securities lending as a discretionary activity in order to earn a modest, but risk-compensated return. Like most market participants they will generally wish to avoid being exposed to settlement fails. However engaging in securities lending can actually increase the risk that they may fail, for example when they wish to sell a security that is on loan and need it to be returned from loan in order to make the delivery. Where this happens, in most cases the securities will be returned and settlement of the sale occurs by the intended settlement date, however with shortened settlement timeframes and always the potential for some problem with the delivery, they may find themselves in the position of temporarily failing on their sale transaction. Whilst the investor may be entitled to receive a corresponding penalty from the borrower, this may not always be the case (perhaps because the lenders settlement instructions were submitted late). The investor is only exposed to this risk as a result of lending the securities in the first place. In other words investors will consider that they face a potential new risk (settlement penalty cost) when engaging in securities lending. This, combined with the imposition of mandatory buy-ins, will cause them to consider in which circumstances they are happy to continue lending and in which circumstances they are not.

Our members note that the negative effects will be greatest for less liquid securities where the risk of a settlement problem will be perceived as being greatest.

Below we provide analysis to summarise our thoughts on the proposed settlement penalties and how these relate to the costs of borrowing for each of the categories proposed by ESMA:-

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Equities

The table below shows aggregate data from Markit for all securities lending activity from their database for 2014.

Equity

Fee Bucket (% pa)	Value on loan (GBP)	Duration	Average fee	Total return
<0.00	31,434,678,745	80	-0.193%	-0.043%
>0.00 < 0.05	45,911,742,233	86	0.018%	0.004%
>0.05 < 0.08	40,668,849,483	94	0.064%	0.017%
>0.08 < 0.10	104,128,349,345	73	0.092%	0.019%
>0.10 < 0.15	133,384,180,411	84	0.108%	0.025%
>0.15 < 0.20	105,160,844,897	70	0.156%	0.030%
>0.20 < 0.25	40,444,184,325	68	0.208%	0.039%
>0.25 < 0.30	55,857,207,173	71	0.252%	0.050%
>0.30 < 0.35	26,431,654,133	52	0.318%	0.046%
>0.35	164,089,684,811	67	3.663%	0.682%

Cumulative Bucket	Value on loan (GBP)	Duration	Average fee	Total return
All loans	747,511,375,555	74	0.896%	0.185%

Proposed ESMA penalty charge (all in BP)	
Equity (annualised)	**252**
Daily fail penalty	**1**
Annualised loan rate	**89**
Daily loan accural (bp)	**0.25**
Assumed trading days accural needed to cover one day fail	**4 days**

The top section of the table shows all loans broken down by fee buckets. The first column shows fee buckets (all loans transacted in 2014 at given fee intervals in basis points per annum), the second column shows the aggregate value of loans for that bucket, the third column is the average duration of the loans, the fourth is the average fee in basis points per annum and the last column is the absolute return on the loan in basis points (for example a loan that is transacted at 10bps pa and has a duration of 180 days would create an absolute return of 5 bps).

The lower section of the table shows the same data organised cumulatively.

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What can be determined from this data is that the overall average loan rate for equities is 89 bps pa. This number can be compared against the annualised penalty rate proposed for equities, which equates to 252bps (1bps per day x 252 business days).

Another way to look at this is to consider the average absolute return that an investor makes from lending equities and compare this to the 1 bps per day proposed penalty charge. Looking at it this way the investor generates approximately 0.25bps per day from lending and therefore the penalty charge equates to 4 days' worth of revenues on an average equity loan.

Corporate Bonds

Corporate/Emerging Market bonds

Fee Bucket (% pa)	Value on loan (GBP)	duration	Average fee	Total return
<0.00	4,677,123,248	114	-0.048%	-0.015%
>0.00 < 0.05	8,065,650,489	80	0.025%	0.006%
>0.05 < 0.08	17,206,650,331	83	0.068%	0.016%
>0.08 < 0.10	27,751,156,556	156	0.092%	0.040%
>0.10 < 0.15	19,777,434,401	88	0.113%	0.028%
>0.15 < 0.20	10,264,168,772	70	0.162%	0.032%
>0.20 < 0.25	11,556,391,017	75	0.208%	0.043%
>0.25 < 0.30	5,606,744,544	79	0.258%	0.057%
>0.30 < 0.35	5,044,553,319	124	0.318%	0.110%
>0.35	16,941,293,803	88	0.985%	0.242%

Cumulative Bucket	Value on loan (GBP)	Duration	Average fee	Total return
All loans	126,891,166,479	101	0.234%	0.066%

Proposed ESMA penalty charge (all in BP)	
Corporate/Emerging Market bonds (annualised)	**126**
Daily fail penalty	**0.5**
Annualised loan rate	**23.4**
Daily loan accural	**0.07**
Assumed trading days accural needed to cover one day fail	**7 days**

Using the same approach as for equities, we note that average loan rate for corporate bonds is 23.4bps pa compared to an annualised penalty rate of 126bps (0.5bps per day x 252 business days), and the daily loan accrual is on average 0.07bps compared to a daily penalty of 0.5bps. In other words a single days penalty equates to approximately 7 days' worth of revenue.

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Government Bonds

Euro Government bonds

Fee Bucket (% pa)	Value on loan (GBP)	duration	Average fee	Total return
<0.00	15,402,862,889	103	-0.060%	-0.017%
>0.00 < 0.05	18,867,940,507	66	0.026%	0.005%
>0.05 < 0.08	93,428,510,665	137	0.059%	0.022%
>0.08 < 0.10	26,345,549,038	169	0.082%	0.039%
>0.10 < 0.15	54,882,035,887	163	0.115%	0.052%
>0.15 < 0.20	23,204,226,424	164	0.163%	0.074%
>0.20 < 0.25	14,448,166,951	145	0.212%	0.085%
>0.25 < 0.30	9,205,320,265	182	0.259%	0.131%
>0.30 < 0.35	3,439,714,667	163	0.307%	0.139%
>0.35	12,033,610,585	146	0.506%	0.205%

Cumulative Bucket	Value on loan (GBP)	Duration	Average fee	Total return
All loans	271,257,937,878	143	0.110%	0.044%

Proposed ESMA penalty charge (all in BP)	
Euro Government bonds (annualised)	**63**
Daily fail penalty	**0.25**
Annualised loan rate	**11**
Daily loan accural	**0.03**
Assumed trading days accural needed to cover one day fail	**8 days**

And finally for government bonds we see generally lower average loan rates at 11bps pa compared to an annualised penalty rate of 63bps (0.25bps per day x 252 business days), and the daily loan accrual is on average 0.03bps compared to a daily penalty of 0.25bps. It would take on average, 8 days of revenue to cover a one day penalty charge.

At this stage we do not have a strong view on the appropriate level of penalty except to state that we believe the proposed levels to be too high and we would encourage ESMA to recalibrate the levels nearer to the average costs for borrowing to avoid the risk that investors withdraw supply from the lending markets whilst still incentivising participants to cure failing transactions.

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Comments on the categories of asset classes.

Generally we consider that the categories are very broad and that ESMA should consider some additional categories. We would particularly point out that whilst the equity category will encompass securities that are not problematic to source on the market (as stated in the consultation paper), it will also include securities, such as smaller cap shares and less liquid securities (such as investment trusts and ETFs), that are in practice very difficult to source.

We believe that ESMA should conduct further analysis into this area and consider creating a separate category for illiquid shares that should be subject to very low or zero penalty rates to avoid a situation where market makers will no longer be able to economically make markets in these securities.

To illustrate the diverse nature of the equity category we considered a small sample of 10 securities from the smaller cap market making book of a specialist firm.

Isin		Name	Market cap (GBP mm)		MSF Lendable (GBP)	% of Market Cap available for lending	Average Utilisation	Average fee
GB0006683238		Communisis plc	114.00		20.40	18	11%	67bp
GB00B3CMRN66		Emerging Market Minerals PLC	25.60		No data	0		
GB00BBPV5329		Science in Sport PLC	18.10		No data	0		
GB00B073G363		Trading Emissions plc	12.10		No data	0		
GB00B1VCP282		Omega Diagnostics	16.00		2.25	14	nil	zero
GB00B0WHW246		Optos plc	189.00		33.50	18	2%	141bp
GB00BLZH7X42		River and Mercantile Group	176.00		4.40	3	2%	800bp
GB00B1318J18		Churchill Mining plc	17.00		0.08	0	nil	zero
GB00B7FD9168		Alpha Returns Group PLC	24.30		No data	0		
GB00BH0WFH67		Martinco PLC	25.20		No data	0		

Comparing these securities with Markit data we note that half show no availability in the securities lending market and the availability shown for the other five ranges from 3 to 18% of the market capitalisation for these securities. The scarcity value of these securities can be further seen in the average rates being charged for those where some supply exists (67 – 800 bps pa). These figures compare to an average of more than 27% of availability, and a lending rate of just 23 bps for an average FTSE 100 security.

Q3: What are your views on the proposed approach regarding the increase and reduction of the basic penalty amount?

We agree that it is better to avoid situations where the basic penalty may be different for the same types of securities. We would reiterate our concerns however that the imposition of penalties may have some negative effects on liquidity of some less liquid instruments and that having rates that are too high relative to the cost of borrowing may deter some lenders. In the circumstances we would encourage ESMA to consider adding at least one further category for less liquid shares and other securities, and consider reducing the penalty rates to be closer to the average borrowing costs. It should then be possible to consider after sufficient time has elapsed following implementation of the regime whether the basic penalty rates should be increased or decreased.