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Keynote Speech

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Ladies and Gentlemen,

I am delighted to have been given the chance to speak at today's conference in Prague. The fact that this is ISLA's 22nd Annual Securities Lending Conference proves how important an activity this is in today's financial markets and the amount of interest it rightly generates.

As you will understand, my remarks today will go a little bit beyond the specific topic of securities lending. Indeed, I will start with some general remarks on the issue of shadow banking, before focusing on the specific topics as the recent UCITS guidelines, short selling and collateral.

I know shadow banking is of great interest to you. I will outline some of the risks arising from shadow banking activities then discuss briefly the potential for shadow banking to be of benefit to the financial system and the real economy.

First of all turning to the risks, I believe these can be categorised under four broad headings. The first – and to some extent natural given the name ‘shadow banking’ – is the complexity and opacity of the activities. Not only are there a wide range of actors involved, e.g. money market funds, SPVs, banks, hedge funds etc., but the different ways in which they interact are many and varied – for example, through securitisation, short-term funding, repo funding, securities lending, tranching, and prime brokerage.

The second aspect that could be a cause for concern is the interlinkages with the financial system. As we know, shadow banking does not exist in a separate ring-fenced area of the financial markets, rather it is fully interwoven with our financial system. This means that problems that develop in one part of the system can be quickly transmitted to another part – and we know that in times of stress the problems may even be reinforced.

A further element of the shadow banking system that should be given due consideration is its size. Even if there has been a fall since the peak of 2010, it is still a significant component of the financial markets, about one-third of the conventional banking sector, and deserves regulatory and supervisory attention.

The final risk arises from the challenge of deciding how best to regulate shadow banking. Although there is broad consensus that more transparency is desirable, further discussion is needed on the precise regulatory and supervisory approach to this complex area.

Before I leave the shadow banking area, allow me to stress that shadow banking could have a more positive role to play in the financial system. As we are all too aware, the banking sector is facing a number of difficulties at present and there are concerns about the financing gap between what the EU's real economy needs and what the banks are able to deliver.

Shadow banking could constitute an alternative source of lending, and our view is that some channels may indeed contribute to final financing, such as securitised assets. However, there is some evidence that much of the financing provided by shadow banking remains within the financial system, meaning that the impact of the activity on the real economy is limited. Taking into account the additional regulatory requirements that may soon be applied to shadow banking activities, we should remain realistic about the extent to which it could become a replacement for traditional bank financing.

Let me now turn my attention to some specific areas of work that are of direct relevance to the securities lending industry. ESMA published its final guidelines on ETFs and other UCITS issues in December 2012. It is important to stress that these guidelines cover a wide range of topics and were conceived with two key objectives in mind: strengthening investor protection and reducing systemic risk, objectives which I believe to be complementary. I will not speak about all of the issues addressed by the guidelines but will concentrate on a few that may be of particular interest.

For example, the guidelines set out strict requirements on the financial indices to which UCITS may gain exposure. We took this action as we had become aware of an increasing number of UCITS that were obtaining exposure to indices which were, to all intents and purposes, investment strategies wrapped in an index. ESMA took a clear view that this type of activity was against the letter and spirit of the UCITS rules.

The guidelines also tackle issues that are particularly close to the hearts of attendees here today, namely securities lending and collateral management. For instance, the guidelines require the UCITS to provide details to investors of the risks associated with securities lending activities and full disclosure of the amount of fees deducted from revenues arising from these operations. The guidelines also strengthen the liquidity of UCITS by recommending that UCITS should be able to recall, at any time, assets subject to securities lending agreements or repo agreements.

I would like to stress that the inclusion of these provisions in the guidelines should not be taken as a criticism of securities lending or repo activity by UCITS per se. We recognise that these activities represent a means of managing portfolios in a more efficient manner, and that they potentially increase the revenues of the fund. However, we identified a need to put in place additional safeguards, taking into account the retail focus of UCITS funds and the need to ensure liquidity. We were also of the view that fees arising from securities lending, net of direct and indirect operational costs, should be returned to the UCITS. Although that particular reform was met with surprise by some stakeholders, we believe it is a key principle that is in the interests of UCITS investors. Indeed, there may be merit in carrying out further work in this area in order to monitor the application of the principle *on the ground*.

In this context, I would like to underline the valuable role played by ISLA with respect to the development of master agreements for securities lending, which have been adopted as an industry standard. Such initiatives are crucial in providing a sound basis for securities lending activity in today's highly complex, globalised and interconnected securities markets. However, I would like to stress that the existence of such agreements should not lead firms to reduce their own due diligence or to pay less attention to their back office controls. We have seen numerous real-life examples of problems arising from lax controls within financial firms, thereby making it difficult to reconstruct transactions or establish the proper ownership of assets *a posteriori*. As with any activity of this nature, risk management is crucial and firms should pay due attention to their own particular contracts and counterparties.

Let me now turn my attention to another important area of ESMA's work in recent months, namely our evaluation of the impacts and review of the Short Selling Regulation. We carried out this review in response to a request for advice from the European Commission. The review was published at the beginning of this month and covers many aspects of the Short Selling Regulation. ESMA's main recommendations cover such issues as the transparency and reporting requirements, the restrictions on uncovered short sales in shares and sovereign debt, the ban on uncovered sovereign CDS transactions and the emergency measures in case of a significant fall in price.

On the specific issue of securities lending, ESMA sought feedback, in its call for evidence, on the impact on the cost or availability of securities lending in the period since the Regulation has applied. This is relevant in the context of the conditions imposed by the Regulation on short selling of shares and sovereign debt. The views of market participants were fairly evenly split on this point. Some reported little or no observed effect, while others, including some securities lenders, commented that more conservative approaches to stock lending had been adopted, such as smaller sizes of loans offered and shorter lending periods. A number of respondents also thought that lending costs, particularly for less liquid/small cap stocks, either had increased or were expected to do so soon.

It is important to note that we did not rely solely on responses to the call for the purposes of developing our technical advice; we also carried out our own quantitative analysis. Part of the analysis was aimed at testing the hypothesis that the imposition of a mandatory *locate rule* could hamper securities lending activity. The evidence shows that activity in securities lending markets has been lower since the entry into force of the Regulation, compared to the previous period. The effect has been more pronounced for stocks that are not in the main equity indices, which can be explained by more stringent locate rules, such as the *put on hold* obligation. These conclusions are valid for all the countries in our sample as well as at the EU level as a whole.

Overall, our analysis shows that the entry into force of the Regulation was followed by a decline in quantities available to borrow on the securities lending market, though it has recovered since January of this year, and in quantities on loan for all countries in the sample. However, while it was expected that the utilisation rate would increase after the entry into force of the Regulation, given the relative scarcity of lendable stocks, the empirical evidence is mixed.

Taking stakeholders' feedback and our quantitative analysis into account, our advice to the Commission contains some recommendations that will be of interest to this audience. In particular, we see a case for introducing changes to Articles 12 and 13 of the Regulation to enable short sellers to obtain the confirmations necessary to undertake a short sale from parties within the same legal entity, provided those parties meet the necessary conditions. We see no clear reason why the ability to obtain confirmations from such parties should pose an increased risk to settlement discipline than requiring the seller to go to a different legal entity for this purpose. However, such a change should be accompanied by additional safeguards – in cases where a securities lending desk is situated within the same legal entity as the person seeking to undertake the short sale, it should also be a condition that the lending desk and the trading desk be segregated and operate on an arms-length basis from each other.

On a related point, we also recognise that, as regards the detailed measures to ensure a reasonable expectation that settlement can be effected when it is due, the definition of *liquid share* in the Short Selling Regulation does not take into account the ease with which borrowing of the share can take place. In our advice to the Commission, we consider that this issue might be revisited when possible, while noting that the current lack of regulatory data on securities lending transactions, their prices and the availability of shares for borrowing represents an obstacle. We therefore recommend revisiting this topic when such data becomes available.

To conclude on short selling, I would like to say that, even though our review had to be conducted shortly after the application of the Short Selling Regulation, I expect it will be of assistance to the Commission in view of its obligation to report to the European Parliament and the Council by 30 June 2013 on the appropriateness of the various requirements of the Regulation.

I will now turn my attention to my final topic. As you are no doubt already aware, the development of a single rulebook is only one of ESMA's objectives. Indeed, we have a much broader range of tasks that includes monitoring and assessing market developments and informing the EU institutions about the relevant micro-prudential trends, potential risks and vulnerabilities or TRV. One issue that we looked at in more detail as part of our recent TRV report was the supply of collateral in the securities lending, repo and OTC derivative markets.

We began by assessing the supply of collateral. Working on the basis that collateral should take the form of high-quality liquid assets, our analysis shows that high-quality collateral represented around €10.74tn in 2012 and semi-high-quality collateral around €1.64tn. We estimate the increase in supply for 2013 and 2014 at €0.85tn.

Turning to the demand for collateral, we looked at the likely trends in the main sectors of the market. Our view is that the repo market is likely to grow steadily to reach €4.1tn in 2014, implying additional demand of €700bn in 2013 and €300bn in 2014, or €1tn overall.

For securities lending, meanwhile, we expect the size of the market to remain constant. The more significant changes are likely to be with respect to OTC derivatives. While the size of the market itself will not change, the impact of EMIR in the EU and Dodd-Frank in the US is expected to create additional demand for collateral of around €610bn internationally, and around €240bn in Europe.

Overall, we believe that collateral supply will be significantly higher than demand throughout 2013 and 2014. Although we do not expect a shortage of collateral, there is likely to be a relative scarcity of collateral. This scarcity could heighten risks for the financial system. The extent of asset encumbrance, as well as the use of lower-quality assets as collateral and greater reuse, are potentially important drivers in this context.

The main conclusion of our analysis is that the availability and use of collateral needs to be monitored, particularly in view of the potential financial stability risks linked to relative collateral scarcity. It will also be important to separate trends that are due to regulatory changes, such as OTC derivatives regulation or Basel III, from those that are indicators of increased risk perception or a weakening of unsecured markets. We will keep this on our radar as part of our ongoing monitoring of developments in financial markets.

Thank you for your attention.