Dispelling the myths of securities lending for Irish UCITS funds

There is huge potential liquidity that could be released to the market and significant revenue that could be captured if more Irish UCITS funds engaged in securities lending, according to Ed Oliver of eSecLending

Securities lending is big business—€16 trillion of lendable assets earning €8.4 billion in revenue in 2016, according to DataLend. So, where do UCITS funds sit within this industry?

We often hear that regulatory pressures cause UCITS funds participating in securities lending programmes to be more penalised relative to other fund structures domiciled in the US and elsewhere. However, when you actually look at the data the good news is that this is not really the case—in some instances, they actually perform strongly.

In eSecLending's securities lending programme, the positive experience of our UCITS clients dispels the myth that securities lending is not worth engaging in given the current regulatory environment. One of the European UCITS clients for which we have acted as lending agent for 12 years earned more from its securities lending programme in 2016 than in any previous year.

Additionally, one of our other UCITS clients experienced the highest basis-point (bps) returns at a portfolio level compared to all of our other clients. In 2016, we doubled our UCITS client base, as UCITS funds that had not previously participated in securities lending re-entered the market.

When you examine independently produced data from IHS Markit, the numbers echo this. A simple check of annual securities lending returns for the year to 5 May 2017 shows UCITS funds earning average portfolio returns of 4.4 bps compared to the the entire securities lending client universe's 3.8 bps. A 16 percent outperformance isn't so bad.

So, is the perception that regulation is affecting UCITS funds' participation in securities lending inaccurate? Well, in a word, no.

UCITS funds are subject to European Securities and Markets Authority (ESMA) guidance on structuring securities lending programmes. These guidelines include, among other things, the requirement that UCITS funds should be able to terminate a loan at any time. This stops UCITS funds from participating in term trades, the trade where the fund lends some of its assets, typically the high-quality liquid assets (HQLA), to a borrower for a specified period.

Banks are currently required to have long-term funding of their balance sheets under the terms of the net stable funding ratio (NSFR), so in essence, the regulation limiting the UCITS fund term capabilities is in direct contrast to the regulations affecting banks.

Another regulation affecting UCITS funds that is also in opposition to the regulators' recent drive to put more transactions through central counterparties (CCPs) is that UCITS funds are required to accept collateral under title transfer arrangements only, whereas collateral provided to a CCP is usually in a pledge arrangement.

What can we do about these regulatory hurdles? The International Securities Lending Association has recently formed a UCITS working group to highlight points like these to regulators.

In addition, we also see the role of the depository as one that can complicate the securities lending programme due to their different interpretations of the ESMA guidance.

The working group aims to produce a guide of best practices to help all those in securities lending programmes manage to common industry standards.

In conclusion, although regulatory challenges do exist, UCITS funds should feel confident in their participation in a securities lending programme. Over time, regulatory change may actually improve matters, but ultimately the biggest opportunity for UCITS funds is to unlock assets that do not make their way into securities lending programmes today.

Of the €7 trillion of assets under management at UCITS funds, only approximately 10 percent of these participate in securities lending today. There is huge potential liquidity that could be released to the market and significant revenue that could be captured.

Ultimately the biggest opportunity for UCITS funds is to unlock assets that do not make their way into securities lending programmes today

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