Broadridge

The Shrinking Role of Financial Intermediation

The Buy-Side Trend to Bring Securities Lending In-House

Ready for Next

TABLE OF CONTENTS

Executive Overview 3

Background 4

What is Securities Lending? 4

Is the Buy-Side Prioritizing the Move to Bring Sec Lending In-House? 5

The 2008 Liquidity Crisis Enabled the Buy-Side: Is Covid Liquidity Crisis Different? 7

Why a Buy-Side Rush to Bring Sec Lending In-House Has Not Materialized 8

GPFA: A Tsunami About to Impact Securities Lending? 9

The Financial Intermediaries' Role is Vulnerable 10

Concluding Notes 12

About the Authors 12

EXECUTIVE OVERVIEW

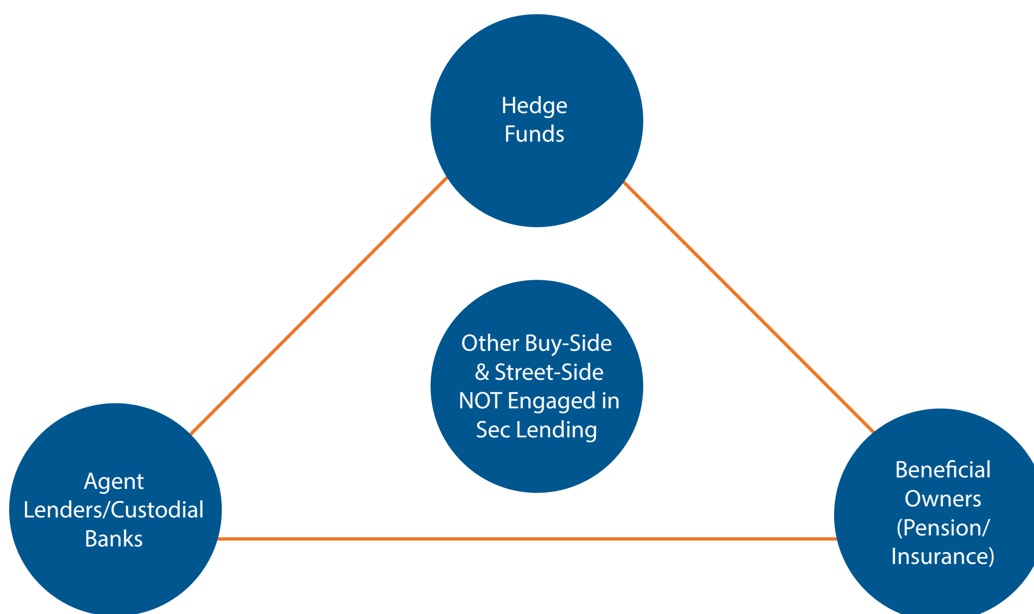
Fidelity grabbed headlines in May 2019 when it announced a material shift in its securities lending activities by moving them in-house and away from Goldman Sachs. While this is neither an isolated event nor a new phenomenon, the size of the shift did create a ripple in the industry and has been growing in momentum in recent years.

Securities finance is a big business, producing more than $9.9 billion of revenue globally for lenders last year, according to EquiLend. In the race to zero on fees/commissions, securities lending takes on a more important spotlight for revenue generation. According to regulatory filings in early 2019, Fidelity paid approximately 10% in fees to its agent, Goldman Sachs. Generally, these fee splits have been under pressure in recent years and will continue to experience a downward trend for financial intermediaries.

Acting as principal on securities lending transactions and cutting out the role of the agent lender has become easier with the adoption of technology in the last decade and with the greater connectivity between buy-side and sell-side institutions. Not all firms (buy-side or street side) participate in the securities lending business, but for those that do, transparency into the marketplace and availability for both supply and demand is on the rise.

There are three main reasons the buy-side may seek to bring securities lending in-house:

- **Pressure on fees/commission for financial products, thereby driving their revenue down;**
- **Diminishing street returns, driving pressure on asset liability management commitments;**
- **The technology available and transparency into availability/size on the street for both lenders and borrowers in the last 10 years has facilitated the buy-side to be able to make these moves.**



Approximately $2.3 trillion USD assets on loan of the estimated pool of $22 trillion USD in lendable institutional assets globally (IHS Markit, November 2019)

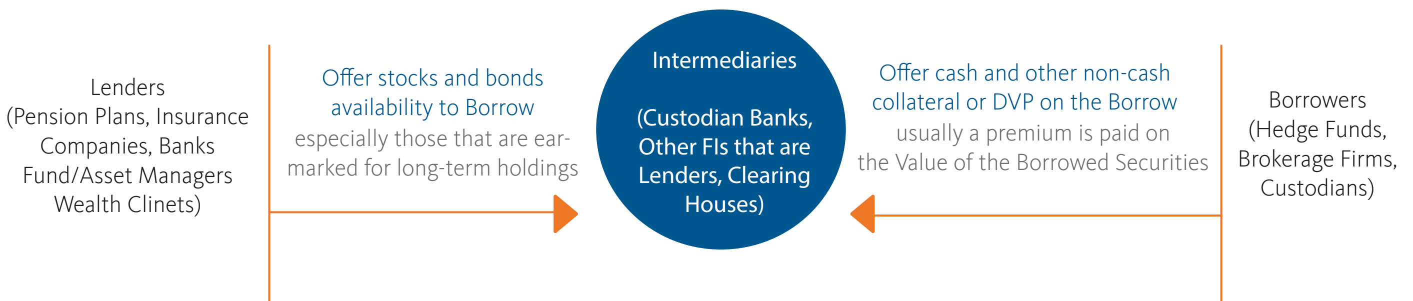
BACKGROUND

In financial services, securities lending has typically been associated with the custodial and sell-side, but a lot of the lending they do is on behalf of the buy-side firms. It is important to note that not all buy-side firms heavily involved in the securities lending aspect of finance are the same. The two major groups are hedge funds and beneficial owners (i.e., pension funds, asset managers and insurance firms). For many years, there was an individual or team in a buy-side institution whose core role was to liaise between what the portfolio managers/trading desk activity was doing and the custodial relationships to determine what they could loan and what they needed to pull back, substitute, etc.

As fee compression impacts both sides of the street, many buy-side firms are looking for methods to trim costs, generate alpha and increase rates of return. Some buy-side institutions have expanded more heavily into derivatives, non-exchange-traded securities (such as real estate, private equity and other private investments, which require longer-term capital tie-ups but generate attractive returns) and collateral management and securities lending spaces for opportunity to achieve revenue goals. The prioritization of bringing sec lending in-house as a revenue opportunity is often directly proportional to the size of this book, the potential lending value of the underlying collateral pools and how much buy-side firms are leaving on the table with their custodial and other street-side counterparts.

WHAT IS SECURITIES LENDING?

Securities lending is an activity that surprisingly many individuals in the financial services do not know much about unless they are directly involved with the activity for transactions or accounting. A quick explanation will help readers understand the domino effect this shift will have for all parties in financial markets.



IS THE BUY-SIDE PRIORITIZING THE MOVE TO BRING SEC LENDING IN-HOUSE?

Carol Penhale spearheaded a global strategy with a government pension fund in 2005 that had – in today's dollars – approximately $80 billion AUM. The portfolio was entirely in single currency, vanilla equities, treasury and fixed income. You just don't see any firms like this anymore. The question they wanted answered in the strategy was 'should we diversify and how should we approach diversification given our core competencies, operational capabilities and current technology as a starting point'.

Trading strategies for most asset management firms today have diverse global asset classes, instrument types and currencies. In addition, they have become more complex and more sophisticated to remain competitive and achieve acceptable rates of return through the years. With interest rates on the decline, the buy-side is looking at many options to make up the difference for sustainable rates of return.

Buy-side firms are looking for additional alpha and ways to cut costs and/or remain competitive. For those buy-side firms offering products, costs, such as fees and commissions are under tremendous pressure and they continue to search for areas to offset those revenue cuts – like fees they pay on securities lending activities. Pension and insurance firms also have asset liability management obligations creating a heightened pressure to improve returns

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Buy-side firms are looking to offset diminishing returns on exchange-traded securities to maintain rates of return. As they become more creative in seeking alpha, five big trends have emerged:

- Globalization for country coverage, asset exposure and – for some of the larger entities – offices.
- Economic, Social and Governance ("ESG") trends and investment/asset allocation restriction easements and asset/geographic/deal type exposure (especially for pension mandates).
- Over the last decade the asset allocation pie chart has shifted and private investments (real estate, private equity, infrastructure, etc.) have taken a more dominant role (especially for pension/insurance);
- More buy-side firms are immersed in derivatives, OTCs and overlay programs on their exchange-traded securities and many are dealing with the rollout of Uncleared Margin Rules ("UMR") adherence;
- Securities lending and collateral management skills, strategy, practices and sophisticated technology are being considered as a role to bring in house.

Globalization. As areas of interest for investment have popped up around the globe for many shops, optimizing the book of business for returns has become more challenging. While 'passing the book to follow the sun' is not new, looking to optimize the securities on the loan book globally is a new focus and a tall order for many firms. It is not as high a priority as global diversification, but optimizing the book is starting to garner more attention.

ESG & Investment/Asset Restriction Easements. ESG is picking up momentum for many jurisdictions and asset managers need to be mindful of the implications and/or opportunities it presents. Pension mandates in particular are benefiting from relaxing investment policies, especially related to direct foreign investing. This is enabling more interpretation for investment type, geographical location and strategy, and has added considerably to firms spreading their investment

wings and, hence, consolidation issues and synergy challenges. This is causing firms to build out expertise in asset classes and country-specific knowledge. Prioritizing securities lending is just one of the streams firms with broader mandates to achieve their returns are examining.

Asset Allocation to Private Investments. Before and after the sub-prime crisis, buy-side firms with asset liability management mandates like pension and insurance were more heavily weighting their asset allocation in private investments (such as real estate and private equity). It became attractive with the hope it was the 'panacea for rate of return' in exchange-trade markets with low returns to help service asset liabilities. While attractive in the long term for the promise of overall rates of return, in the short-term, they tie up capital and many have cash flow outlays before they become cash flow sources.

Derivatives Envelope is Pushed, UMR is Watching. For many buy-side firms, derivatives are net new in the last decade as part of their portfolio plays. New entrants to the space are typically looking for either/both hedging and yield enhancement plays. FX and interest rate swaps are typical. Some have investment strategies looking for portable alpha overlaps and/or combining fixed income instruments with equities for income plays. Directional strategies are achieved with hedging activities via derivatives and cash instruments. Some desks push their risk limit further with more exotic derivatives. While the pre-sub-prime crisis really pushed the envelope with deals like dispersion swaps, the pendulum has swung back to less exotic territory for most of these institutions.

UMR is a global program for firms that have derivatives portfolios exceeding $750 million USD. UMR arrived in 2016 under the European Market Infrastructure Regulation ("EMIR"). The inaugural introduction saw initial margin requirements proposed for bilateral, uncleared over the counter ("OTC") derivatives and it also requires firms to post collateral for transactions, including FX forwards, cross-currency swaps, exotics and equity options, either on a tri-party or third-party basis. UMR is relevant for a discussion on securities lending in general, but especially for the buy-side. UMR will increase the demand for high-quality liquid assets (HQLA) to meet initial margin calls.

UMR is a multi-phase program and the buy-side has some breathing room (thanks to Covid) with phases 2 and 3 postponed for one year into 2021, but derivatives strategy, systems and workflow to support need to be/are underway at present to be ready.

Securities Lending and Collateral Management. While this list was not prioritized, securities lending was intentionally put at the end as it is generally the last area of potential alpha-area relief explored by buy-side firms. There are many reasons (outlined in a section below) but size of the book of business and the amount of revenue being left on the table with third parties to manage the sec lending book are the biggest drivers to prioritize a review. For many firms, the above-noted steps across the stream (sophisticated derivatives desk, repo trading, collateral management optimization) start to lead to serious consideration of securities lending as the next natural step in their progression toward more self-sufficiency in financing activities.

THE 2008 LIQUIDITY CRISIS ENABLED THE BUY-SIDE: IS COVID LIQUIDITY CRISIS DIFFERENT?

We talk about the 'new norm' in many aspects of our lives both personally and professionally under Covid, but we forget this is not the first time even in recent memory we have had a 'new norm' for securities lending. In August 2007, the financial markets fell into a liquidity and credit crisis that resulted in several key impacts causing a downturn in securities lending:

- The supply from beneficial owners of securities decreased during the sub-prime crisis.
- The percentage allocation to alternative investments increased for many ALM-driven firms, contributing to the reduction in beneficial owner supply of securities for lending.
- As many borrowers (and lenders) had firm-driven risk tolerances increased, deal transparency became critical, and revamped counterparty policy, which hampered the trade environment, slowed demand while the industry adjusted.
- At and since that time, internal risk watch dogs and regulatory bodies globally have adopted or are still adopting reporting procedures to help remedy the cause and effect of the sub-prime crisis – high on that list is traceability in mandates, such as SFTR and CSDR.

Gradually since the sub-prime crisis, all firms have had to re-calibrate their systems, data, operational procedures and reporting to adhere to what became the 'new norm' for the financing marketplace. The deal making and deal execution changes slowed appetite for sec lending based on costs, mechanics or other prohibitive factors.

Ironically, the remediation for the sub-prime crisis and audit trail on deals that firms must file has made it easier for buy-side firms to enter the securities lending space. The sub-prime crisis reform reduced much of the opacity between pools of securities available/on loan for both sides of the street, and set up conditions ripe for the buy-side to have access to marketplace availability and expertise to hire in-house. In addition, software vendors adjusted their sights to target buy-side institutions with tools previously catered to sell-side constituents, making them most cost-effective and solving for the buy-side needs. All these factors have led to a reduced execution risk of bringing their sec lending book in-house.

Not in a hurry to relinquish the revenue streams with valued clients in securities lending, the sell-side and custodial firms are looking for ways to more closely align with their most valued clients in the financing space. Early accommodations were in renewed/revising master services agreements with more attractive fee structures for both securities lending and overall custodial services. More recent services look to offer access to pools of liquidity not available to them as buy-side firms, such as sponsored repo via FICC and securities finance transactions for equities via NSCC.

The pandemic has introduced an economic impact and liquidity crisis so there is little doubt kinks in the regulatory armor will be uncovered and more policy will follow.

Brexit and Covid have been good tests of a copious number of preventative measures established by regulatory policy in many jurisdictions for liquidity, securities lending and country banking policies in general. While it is still too early to tell the overarching impacts of both –particularly Covid – it appears banking policy and systems globally are capitalized better than during the sub-prime crisis, so capital markets in general are heading in the right direction

With prime interest rates in some federal banking policies at an unprecedented 0% and much of the treasury and fixed income world adjusting to (what appears to be) the possibility for negative interest rates, new factors are arising. The pandemic has introduced an economic impact and liquidity crisis so there is little doubt kinks in the regulatory armor will be uncovered and more policy will follow.

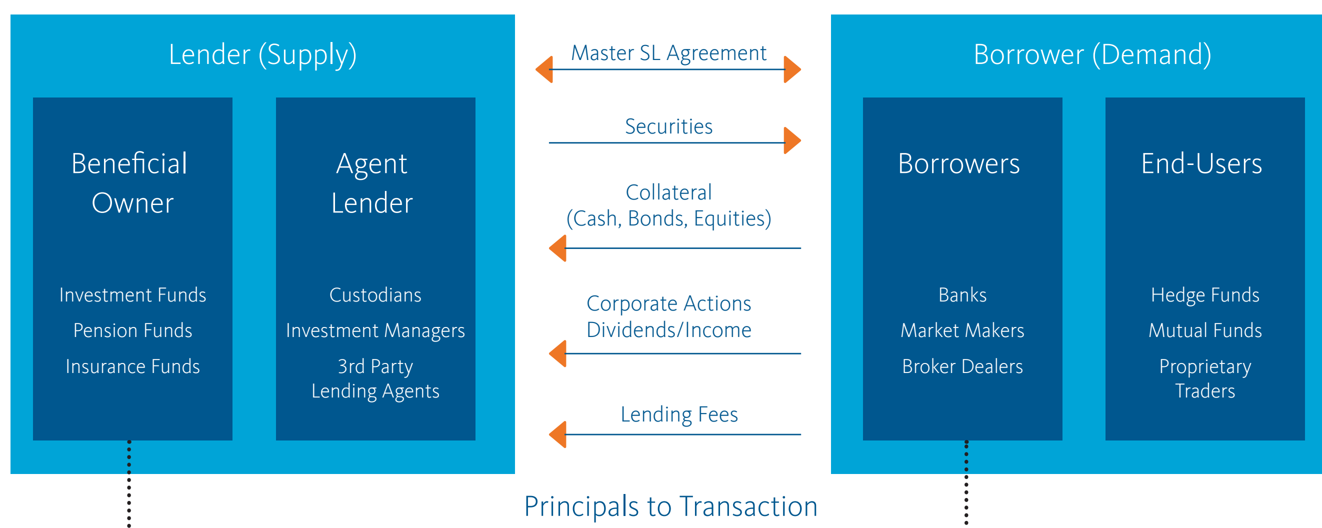
WHY A BUY-SIDE RUSH TO BRING SEC LENDING IN-HOUSE HAS NOT MATERIALIZED

The benefits to the buy-side seem very apparent and the market conditions driving the move in-house are deepening, so why is there not a stampede to make this move? There are several reasons for these types of initiatives being a slow burn:

- Measuring the impact of taking securities lending off the table for custodial and/or broker/dealer relationships for services (for example, custody services or trade services, respectively).
- Renegotiating custody and custodial MSAs is generally a slow process and renewals are infrequent, so many firms are driven by these milestones.
- Custody firms are wooing buy-side firms to stay with attractive offerings (such as sponsored repo), further slowing the business case development for buy-side firms to bring clarity to the risk/reward ratio.
- Firms need to ensure they have the skill sets and tools in-house to manage this book of business, including any of the functions their street-side partners enable for them as part of securities lending and (likely) collateral management and liquidity functions.

Traceability is the new barometer in finance space initiatives like STFR and CSDR, and is creating regulatory challenges.

- Internal risk watch dogs need to learn the vulnerabilities that bringing securities lending in-house presents and to make sure the risk/reward ratio is solid.
- Regulatory reporting globally is in the middle of a categorial shift from collection of data and reports to traceability of actions and workflow on trades. Traceability is the new barometer in finance space initiatives like STFR and CSDR, and is creating regulatory challenges. New entrants to the securities lending space are spending time examining these factors as part of their business case set-up, impacts to their workflows and data flows through their enterprise architecture. The rest of the established securities finance and collateral management industry, on the other hand, is in retrofit mode.
- Asset Management Liability (where applicable) and Investment Policies to permit securities lending (and collateral management) and any restrictions must be adopted and approved by senior management.



The migration for most buy-side firms to bring securities lending in house is a very slow burn for all the points noted above. In addition, most new adopters are not going cold turkey: the most attractive scenario for buy-side firms is a hybrid model where some of their securities lending remains with external partners and other pieces are brought in-house to mitigate business risk while they build a securities lending business, relationships and knowhow themselves.

Early adopters bringing this function in-house generally have an incremental approach to this shift, bringing more in-house at each review in areas where they see financial benefit to the firm without incurring business, execution or partner (especially custodial) risk.

GPFA: A TSUNAMI ABOUT TO IMPACT SECURITIES LENDING?

The recent formation of the Global Peer Financing Association could be a game changer for securities lending for both sides of the street. Four pension funds with assets trending towards $1 trillion USD have launched a peer-to-peer securities lending association for beneficial asset owners to help optimize efficiency and to supplement traditional banking counterparty trade opportunities.

While details are still emerging, the founding members (California Public Employees' Retirement System, Healthcare of Ontario Pension Plan, State of Wisconsin Investment Board (including Wisconsin Retirement System) and Ohio Public Employees Retirement System) hope to attract other beneficial asset owners to the association (such as other global pension funds, insurance companies and large asset managers). The GPFA is receiving inquires daily from firms around the globe and this seedling will likely expand very quickly. There is no question: buy-side peer-to-peer securities lending, collateral management and liquidity strategies will revolutionize financial intermediation.

Buy-side peer-to-peer securities lending, collateral management and liquidity strategies will revolutionize financial intermediation

Buy-side firms engaging in this peer-to-peer trading activity initiative who largely rely on agent lenders for this function, will need to step up with:

- Technology to facilitate securities lending/finance and collateral management (SFCM) optimization, adequate reporting (especially traceability under SFTR/CDSR) and functions performed by their current street-side partners. (For time to market considerations, Business Process Outsourcing should strongly be considered for more of the non-differentiating back/middle office functions).

- Front office tools to enable sophisticated SFCM strategies, coupled with a strong emphasis on transparency into real-time available pools and connectivity to the marketplace, should strongly be considered. This is an area their street-side counterparts are investing in and expedited trade decisions are key to optimizing the SFCM book of business and revenue stream.

- Transparency into the book of business on an intra-day basis to be agile enough to respond to market nuances and seize opportunities is a very strong 'nice to have' migrating to the 'must have' category for many firms.

- Adapt the end-to-end business and portfolio workflows to handle the self-sufficiency role they will take on for functions done by their agent lender collaborators in their current models. This includes right-sizing the technology, expertise and training/hiring for new functions.

Sell-side firms, custodians, hedge funds and agent lenders need to be aware of this pivotal shift for the securities lending space as beneficial owners move to act as financial intermediaries among themselves. The traditional banking counterparty firms and functions will need to re-invent themselves with offerings to retain business with firms entertaining GPFA-like consortiums. To remain competitive, agility will need to increase, revenue expectations will need to be right-sized and focus on other asset pools for opportunity may need to be ramped up. These firms will need to re-calibrate operational workflows and adopt technology to reduce costs with a mind to what they can offer the buy-side, which is not available in a peer-to-peer network (such as sponsored repo). They also need to consider other avenues for revenue and global pools to extend their footprint for lendable assets.

THE ROLE OF FINANCIAL INTERMEDIARIES IS VULNERABLE

This quiet shift of securities lending activities by lenders to a self-service buy-side is not happening unnoticed or without major consequences for the sell-side and custodial world. Initiatives like GPFA will be a big wakeup call for the street that the future of securities lending industry is already here. A major source of revenue is at risk for them with this migration as agent lenders are looking for ways to keep clients loyal and that revenue stream intact. Broker-dealers, prime brokerage, custodians and hedge funds are all vulnerable to the financial impact of the buy-side taking securities lending (and collateral management/liquidity) in-house.

Some street-side individuals have taken a Pollyanna view to this ramping up for securities lending by stating buy-side firms don't have the expertise or relationships/connections, so they so won't be able to establish a solid business. Given the pressure the street has seen over the last decade with cutbacks and layoffs, it is unrealistic to not extrapolate that some securities lending and collateral management expertise is crossing the street. For many custody firms, broker/dealers and prime brokers, the wakeup call comes from a time-honored client announcing it is making fundamental changes to its way of doing business in this space – the Fidelity move in May 2019 was very large but not unprecedented and similar and smaller shifts are happening regularly.

Understanding the role of the intermediary helps clarify the position of what is at stake:

Why Loan?

- Incremental return/alpha passive investment/idle holdings
- Provides cash liquidity to reinvest for the life of the loan

Why Act as Intermediary?

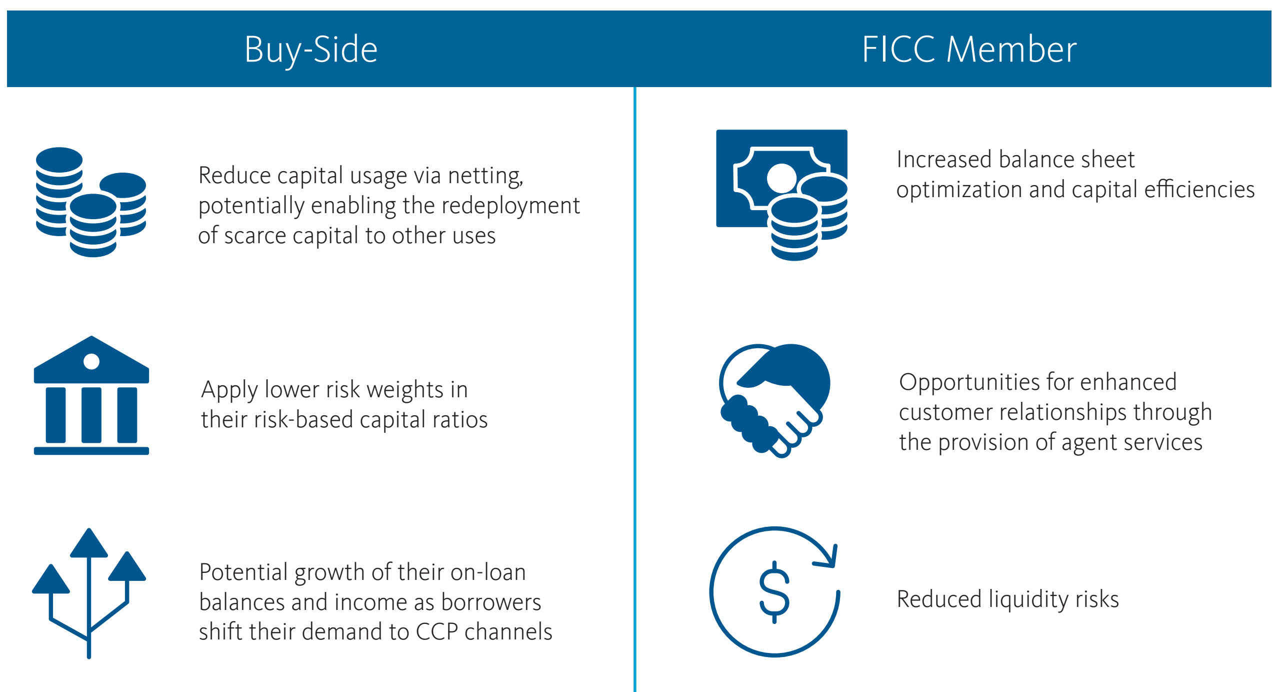
- Borrow and lend to reap benefits of market fragmentation/segmentation
- Extended offering of services for custody clients
- Offer counterparty and issuer credit analysis to Lenders
- May act as indemnification against borrower default

Why Borrow?

- As part of short sell strategy
- To offset settlement failure
- Capture an arbitrage opportunity (esp. cash and derivivatives)
- Market Making
- To be able to vote at an Annual Meeting (holder of the shares controls the vote)

Recognizing this seismic shift in a historically lucrative source of securities in and for its own lending business, custodians and sell-side firms alike are looking to entice buy-side firms and their assets with attractive offerings in an effort to woo them as never before. Unlike their capital markets and prime brokerage competitors, custodial players have been able to negotiate with attractive pricing on the custodial side for not only securities lending fees but also custodial services. This has helped over the last decade, but the game stakes are rising and street-side players not offering deep custodial services are starting to have a better hand at the table.

Programs like sponsored repo where FICC members can offer the privileges of their membership to their buy-side firms has skyrocketed in popularity in the last two years. The FICC is also offering a Centrally Cleared Institutional Triparty Service (CCIT) and, while this has not 'taken off' yet, it is poised to do so with early adopters in the marketplace. On the equity side of the house, new programs from FICC sibling NSCC under DTCC are positioning to enter the securities lending marketplace, allowing similar financing programs on equities that have been very popular on the fixed income side with sponsored repo. The NSCC offering is referred to as the Securities Financing Transaction (SFT) and, for those involved in sponsored repo on the fixed income side, SFT feels like déjà vu except it is for equities. The benefits of these programs (SFT and sponsored repo) to both sides of the street are compelling and help the custodial/prime brokerage/sell-side keep the buy-side 'sticky':



Programs like GPFA may force traditional agent lenders to look at further exploring opportunities in wealth account lendable assets and adapt their models in financial intermediation to compensate for the pull-back by institutional assets from the buy-side. For many global banks who have 'siloed' operations, this may provide new impetus for the capital markets and prime brokerage lines of business to look for synergies and opportunities with the asset management, wealth and retail lines of business for mutual benefit. This will, of course, also bring back the debate in such firms about 'who owns the client' that we have seen in the industry for well over a decade.

CONCLUSION

Economic factors and increased ease to enter the marketplace continue to drive compelling reasons for buy-side firms to bring part or all of their securities lending activities in-house. The number of firms that are making inquiries on assistance with a due diligence process to examine options/industry best practices/peer comparisons from asset management firms in the last year has increased substantially. This is especially true for firms looking for BPO options to leverage and accelerate the path/reduce the business and operational risk of startup.

The tide has turned in recent years, and it is becoming normal course to conduct a review of fees paid versus value received to ensure readiness in buy-side firms. It is often on the heels of expansion into areas such as derivatives mandates, expanding into repo pools or renewing custodial agreements. Examining the value proposition for any services renewal has become normal course.

The vendor community is stepping up to cater to buy-side firm budgets and specific securities lending/collateral management/liquidity needs in the wake of the industry shift for asset managers striving to achieve more self-sufficiency and more sophistication in financing activities. This is helping ease the transition for buy-side firms evaluating risk/reward ratios and business cases to bring activity in-house, especially for firms looking to start with a hybrid approach of in-house and traditional custody/agent lender partners as well.

The street side of the equation is working hard with competitive rates and new offerings/products to make this decision a tough one for the buy-side to become totally self-sufficient. It is anticipated this competitive marketplace and the shifting trends of securities lending players will continue to affect both sides of the street as the buy-side contemplates bringing sec lending activities in-house and everyone adapts to the changing securities financing and intermediary landscape.

As a Managing Director and a Practice Lead for Consulting at Broadridge, Carol brings three decades of experience to financial services mandates and helping firms achieve business goals and remain competitive. Carol has spearheaded many end-to-end transformational mandates by optimizing technology stacks, addressing data governance and migrating to more effective processes and workflows to service disruptive business impacts and demands. She has a BA from The University of Toronto, a Certificate in History from The University of Edinburgh and a Degree in Programming and Systems Analysis from The Institute for Computer Studies. Carol.Penhale@broadridge.com

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