



In Vogue: Term and ETF lending

Clearstream's James Cherry, head of business development for Collateral, Lending and Liquidity Solutions, and Banu Apers, head of securities lending and borrowing, discuss two topics currently in focus for beneficial owners and borrowers around the globe

Term lending is an increasingly prominent tool in the toolkit of sophisticated lenders globally. Lending assets on term allows beneficial owners to take advantage of an additional yield uptick on their existing lendable pool and, in addition, increase asset utilisation rates.

At the same time, they continue to benefit from safety and security, perks which are provided by Clearstream's strategic lending

programme. From a borrower's perspective (a commercial bank), borrowing positions on term allows the institution to optimise their liquidity position, with respect to the capital regulation they are subject to, such as net stable funding ratio (NSFR) and liquidity coverage ratio (LCR).

Exchange traded funds (ETFs) have gained in popularity among investors over time as the asset class fulfils investor objectives

in terms of liquidity, low fees, transparency and portfolio diversification. Clearstream offers solutions for the ETF market which are designed to increase process efficiencies, as well as produce additional revenue generation opportunities benefitting issuers and investors alike.

Currently, the ETF market is estimated to be circa US\$12.3 trillion in size and is expected to grow to US\$30 trillion by 2033. The demand for ETFs is creating increased liquidity and lending opportunities in the market. With over €716 billion worth of ETFs in safe custody, Clearstream is well positioned to support the evolution of the ETF lending market.

Lenders and borrowers run into challenges

For many institutional investors, current market conditions mean that securities lending revenues have been compressed as volatile markets, high interest rates, inflationary pressures, and geopolitical tensions all take their toll on portfolio returns.

A number of institutions are also struggling to blunt the impact of rising costs, caused not just by inflation but also ongoing investments into technology and re-platforming, and dealing with market changes, such as the Central Securities Depositories Regulation's (CSDR) Settlement Discipline Regime (SDR) and T+1 settlement in North America.

On the borrower side, firms are scrambling to source high-quality liquid assets (HQLA) to meet various regulatory requirements.

"Under Basel III, commercial banks are subject to LCR and NSFR provisions. LCR requires that banks maintain an adequate level of unencumbered HQLA that can be easily converted into cash to meet their liquidity needs for a 30-day stress scenario. NSFR is designed to secure a more stable funding profile in relation to the composition of assets and off-balance sheet activities over a longer-term horizon, typically a one-year timeframe," says James Cherry, head of business development for Collateral, Lending and Liquidity Solutions at Clearstream.

Access to HQLA has become even more critical following post-global financial crisis reforms of off-exchange OTC derivatives markets.

The US Dodd-Frank Act and the European Market Infrastructure

Regulation (EMIR) both demand that certain OTC instruments be centrally cleared at a CCP, where they are subject to strict margining obligations. Similarly, uncleared OTCs traded bilaterally must also be fully collateralised under the rules, requiring the posting of initial margins as defined by the regulatory authorities.

As demand for yield and high-quality collateral has increased, so too has the market for securities lending with on loan balances increasing year on year.

Turning to term lending

Lenders (sovereigns) and borrowers (overwhelmingly commercial and investment banks) are embracing term lending, a type of transaction which can be structured in either one of two ways.

"A term loan is effectively a loan entered into between the lender and the borrower whereby both parties agree a future date at which equivalent securities will need to be returned by the borrower to the lender," explains Banu Apers, head of securities lending and borrowing at Clearstream. "The lender will agree to lend the position for 35 days at a fixed fee, at which point the security is then returned by the borrower to the lender."

Alternatively, firms can structure the loan on a so-called evergreen basis. This is defined as a loan entered into between a lender and a borrower with an extendable notice period to terminate the loan and to call for the delivery of equivalent securities.

Supporting lenders and borrowers

For lenders, term loans with higher rates can help them to supplement portfolio return with extra income, potentially mitigating some of the revenue and cost challenges facing them elsewhere.

"In the case of US Treasuries, term lending could help lenders net an additional 3bps — 5bps with higher utilisation — whereas European government bonds will likely accrue anywhere between 2-3bps with higher utilisation. Rates of course depend on the type of underlying assets and currency," adds Apers.

As rates rose in recent years, asset owners benefited from the buy-side's positioning, particularly with regard to European government bonds.

According to Cherry: “During the earlier rising interest rate environment, there was a lot of buy side positioning for the basis trade, whereby short activity in European government bonds created volatility and specialness within the securities lending market. This was a driver for strong incremental portfolio yield for beneficial owners holding specials. However, as rates have plateaued and the market moves to financing, this revenue driver is removed. Term lending is a way for beneficial owners to unlock additional value from their portfolio, as borrowers are willing to increase fees for liquidity that helps them to meet their regulatory capital ratios.”

On the bank borrower side, term lending means they can obtain HQLA, allowing them to comply with the LCR and NSFR provisions.

“Basel III capital adequacy requirements — such as LCR and NSFR — force banks to have access to certain types of liquidity over a prescribed period of time, so they need to hold onto HQLAs for a set duration,” Cherry highlights.

ETF lending is here to stay

The ETF market is going from strength to strength, and this is creating ample opportunities for ETF lending.

Owing to their liquidity, low fees, portfolio diversification and transparency benefits, ETFs are becoming increasingly popular among investors. In 2023, ETFs saw inflows of nearly US\$975 billion, bringing their total assets under management (AUM) up to US\$12.45 trillion according to recent analysis.

Despite the soaring AUM, ETFs out on loan accounted for less than 3 per cent of the total value of all ETF outstandings in 2023 — although this is a jump from 2017 when that figure stood closer to 2 per cent. “Given the market’s growth trajectory, we expect ETF lending to increase exponentially moving forward,” states Cherry.

An enabler for lenders and borrowers

As with term lending, ETF lending can provide institutions with an additional incremental source of revenue on top of their existing portfolio returns.

“Lending out ETFs can add further basis points to returns,” according to Apers. “The average loan fees are in the region of

75bps. However, specials can earn lenders many multiples of that. This ultimately benefits the investors.”

Through ETF lending, borrowers can access ETF securities for strategic trading and liquidity purposes. Along with facilitating short coverage, the added ETF supply can also support market making activities.

Significantly, ETF lending could help reduce the settlement risk of this asset class.

Settlement fail rates in ETFs as an asset class are much lower relative to other asset classes. Settlement efficiency, however, could be much improved if more ETFs are lent out, enabling firms to side-step any cash penalties for late or failed trades under SDR and meet their T+1 obligations.

“If you want to make a market on an ETF or take a position, this is only possible where securities are available, in the right place at the right time. Positions trapped in investor portfolios are not available to the secondary market and cannot be used to rectify blockages in the settlement chain, trades cannot settle and markets cannot be made until ETFs are available,” Cherry explains.

He continues to say that participants can “go back to the fund itself and create a new unit in the ETF to allow settlement to occur”, but this can be time consuming and costly. A far more efficient, economical option, according to Cherry, is to borrow the security, as is the “long established practice in equity and fixed income markets”.

Equally, ETFs can also be used by borrowers for collateralisation purposes when posting margin on their OTC trades at either CCPs or with bilateral counterparties.

With more borrowers and lenders recognising the benefits of ETF lending, the market is only going to get bigger.

Getting over the hurdles

For many sovereign lenders, access to on loan securities on a timely basis is paramount.

Apers illustrates: “Our lenders are mostly sovereigns, so the assets out on loan from them will either be their foreign reserves or their

monetary policy assets. If sovereigns want those assets back, then they want them back quickly.

“We have models to manage this. In other words, we could restrict lending to a certain percentage of a position. We also allow for substitutions across the pool of assets in our programme enabling a borrower to have stable access to liquidity whilst the lender can execute their trading strategy with no impact from securities out on loan.”

Regulation is also creating challenges in the securities lending market.

The ability to recall securities quickly has assumed an even greater importance following the rollout of SDR. With the shortened T+1 settlement cycle now bedded down, trade fail rates are expected to trend upwards, as borrowers and lenders have less time to process recalls. As a result, the cost of fails in securities lending trades is projected to increase.

New transparency obligations, coupled with regulatory reporting requirements, are also adding to the workloads of securities lending participants.

In the EU, the Securities Financing Transactions Regulation (SFTR) requires information about SFTs to be reported to trade repositories approved by the European Securities and Markets Authority (ESMA).

Elsewhere, the US is introducing the Securities and Exchange Commission (SEC) Rule 10c-1a, which stipulates that securities lending transactions data be disclosed to a registered national securities association.

How to maximise potential

Institutions need to think carefully when choosing a service provider to support them with their securities lending and collateral management activities, and the challenges that come with it.

Most critically, institutions should look for providers which are well-capitalised, prudently risk managed, and subject to robust regulatory oversight.

At the same time, institutions need to check that providers use

best-in-class technology and that their systems are fully automated.

A customised and bespoke service will be critical if borrowers and lenders are to truly maximise their term lending and ETF lending potential. ■

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