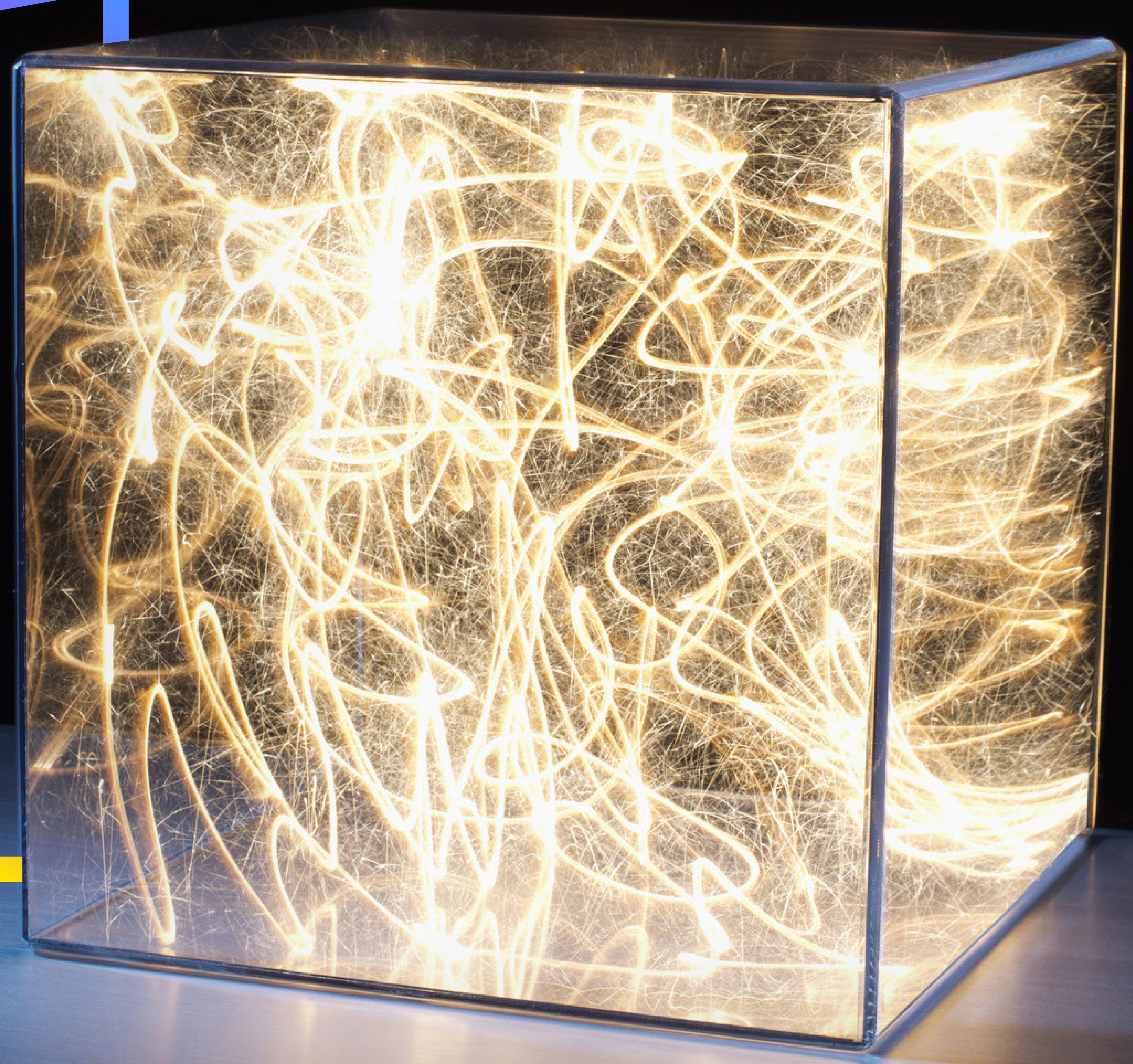
From boom to bust: considerations for the securities lending industry

The future of securities lending: disruption, transformation, and survival in the digital age



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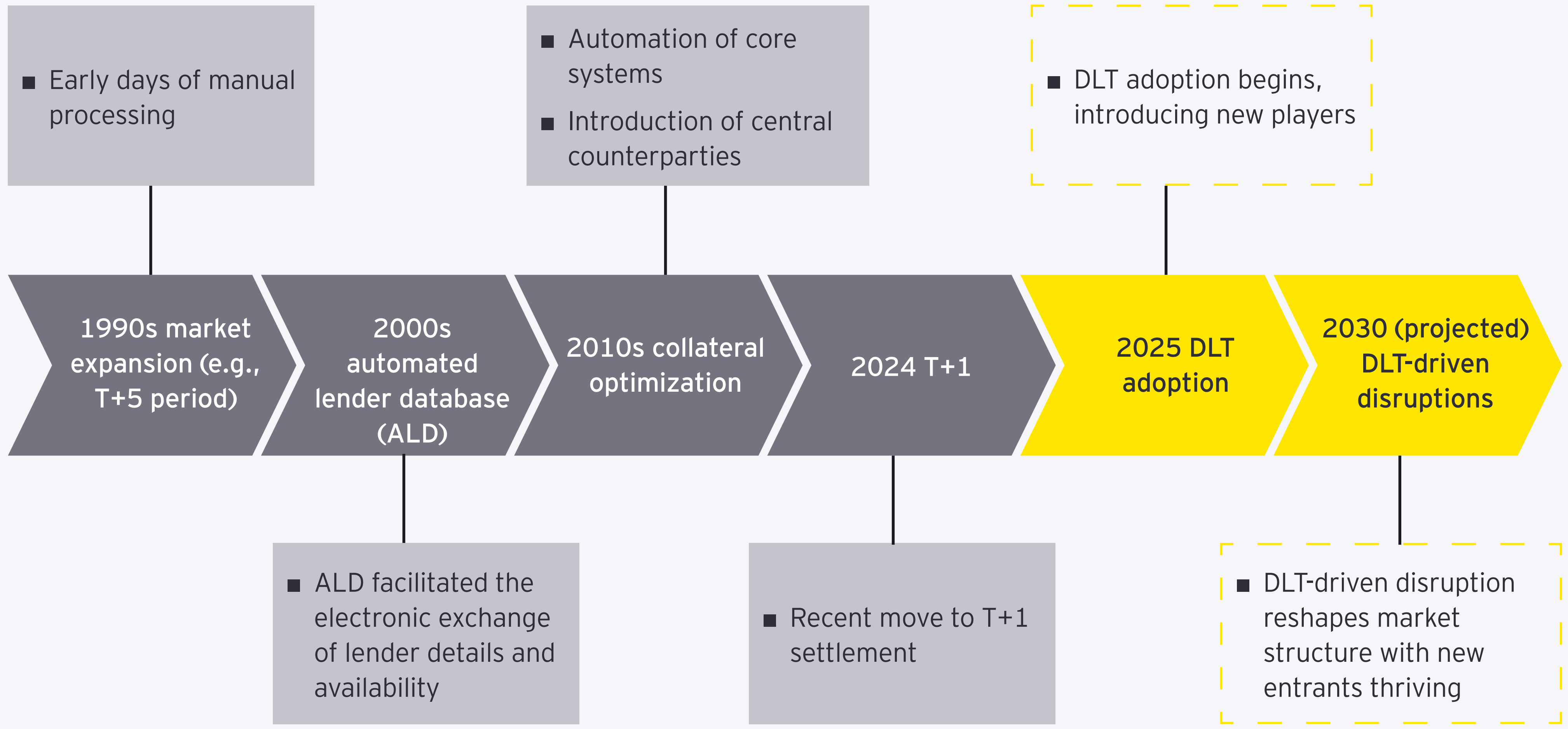
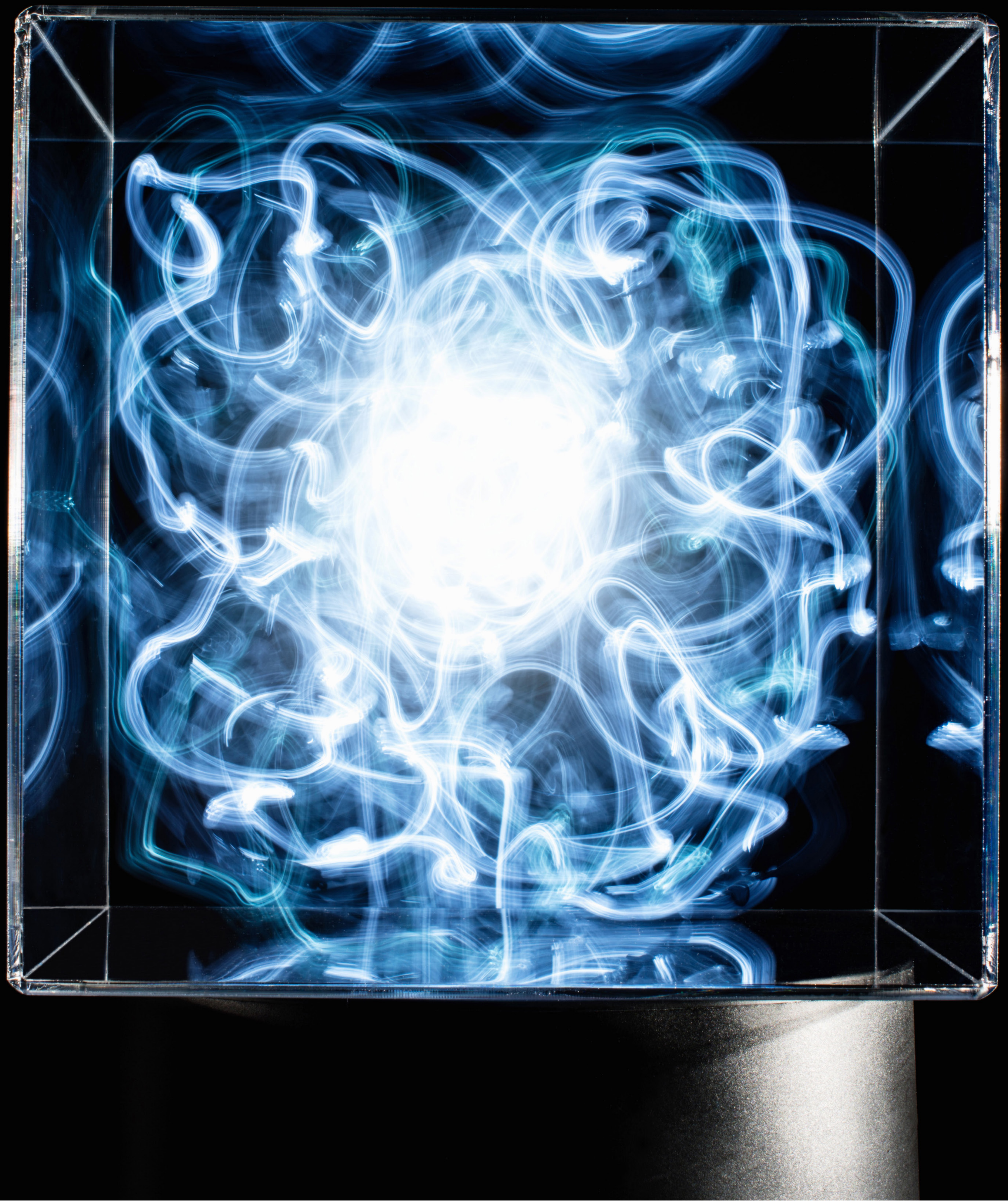
> “For financial markets, we are now at a crossroads where liquidity can move at the speed of light and protocols can offer alternatives to traditional intermediaries to instantaneously clear transactions.

Disruption of incumbents has accelerated in recent decades as a secular trend across all sectors of the economy. This trend is evident in the average tenure of companies in the S&P 500 Index. The average lifespan of a US S&P 500 company used to be 67 years. Now it's 15 and expected to shorten further.[1] Additionally, information technology companies in 1969 made up a small portion of the S&P 500, only 16 firms, but now tech firms dominate the sector. This shift portends even more disruption in the future as artificial intelligence (AI), blockchain and quantum computing have the potential to remake markets and reshape operating models. For financial markets, we are now at a crossroads where liquidity can move at the speed of light and protocols can offer alternatives to traditional intermediaries to instantaneously clear transactions. At this pivotal moment, the recent advancements in the adoption of distributed ledger technology (DLT) and tokenization poses opportunities and threats for securities lending market participants. We recently collaborated with the International Securities Lending Association (ISLA) Americas to analyze DLT and tokenization trends in securities lending markets and published this article to advance the discussion of continued adoption. The developments we observed indicate that the securities lending space is poised for transformation from DLT and tokenization, opening the door for incumbents to re-evaluate strategies to incorporate this new technology into their approach and products.





Why now?

The securities markets have undergone notable phases, transitioning from manual processes in the 1990s to automated lender databases in the 2000s. The 2010s saw the introduction of automation and central counterparties, marking a shift toward greater efficiency. DLT adoption is expected to significantly reshape the market structure of the securities lending industry going forward, paving the way for new entrants and innovation.

A variety of factors contribute to the current landscape, often described as a "perfect storm" for disruption. Key drivers include clearer legislative and regulatory frameworks, accelerating technological adoption, an influx of new markets and competitors and the recognition by incumbents of the risks associated with delayed transformation. These factors highlight the need to define a strategy to seize opportunities and maintain market share.

01 Increasing regulatory clarity in the US

- Clear legislative path
- Improved public sentiment

02 Accelerating technological adoption

- Include tokenized assets in portfolio
- Leap in trading volume for DLT-based projects

03 Revenue and cost opportunities

- New entrants and rising costs squeezing margins
- Enhanced capital deployment

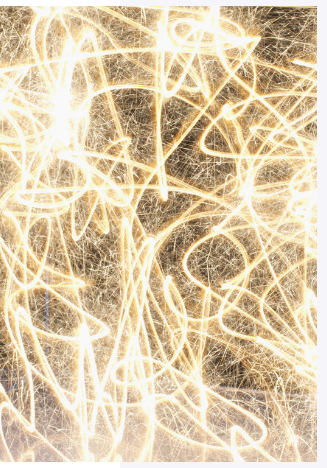
04 Risks of disintermediation

- Disruption risk can impact existing players
- Market share loss from delayed adoption

What's different?

The future securities lending market may bring near real-time settlement, automated collateral management and a variety of new players, counterparties and assets.

Today		Potential future
T+1 at best, semi-automated, delays due to processing by multiple intermediaries	Settlement speed	Near real-time on and across centralized exchanges as well as on-chain, 24/7
Opaque, relationship-driven, manual negotiations and adjustments	Price discovery and liquidity	Live order books and algorithmic matching, automated market makers (AMMs), transparent
Manual via voice or electronic order, multiple layers of trusted intermediaries	Trade execution	AMMs or smart contracts, flexible, trustless if done peer-to-peer
Margining managed by prime brokers and custodians, periodic marking-to-market	Margin and collateral management	Automated or smart contract-based intraday margining, real-time price feeds, oracles
Mandatory reliance on trusted third-party custodians	Custody and recordkeeping	Option to self-custody and other new custody models without losing asset mobility, publicly verifiable records
Batch processing, time-consuming, error-prone	Reconciliation, auditability and reporting	Publicly verifiable immutable audit trails with little need for reconciliation



What's at risk?

There can be risks associated with this transformation. Disruptive challengers and changing market structures threaten to erode roles and revenue streams of existing intermediaries.

Disintermediation

- DLT streamlines securities lending, potentially disintermediating those institutions who do not embrace new custody models and atomic settlement protocols.
- Prime brokers and agent lenders could also see their traditional roles in trade facilitation and collateral management evolve based on these new technologies.

Increased competition

- DLT lowers the barriers to entry for new market participants.
- This increased competition could pressure traditional securities lending firms to innovate and reduce costs to maintain market share and profitability.

Demanding operating models

- The DLT lifecycle demands coordination across digital-native and legacy systems, complicating 24/7 operation.
- Real-time risk management and compliance are added constraints to operating models as the market transitions to continuous 24/7 operation.

What's possible?

Tokenized assets, fractional ownership, 24/7 markets and automated corporate actions are just the tip of the iceberg of disruption possibilities.

Innovations such as digital-native securities and the tokenization of real-world assets could revolutionize how lending and margin pools operate. Moreover, advancements that enable 24/7 trading and automation via smart contracts and decentralized autonomous organizations (DAOs) signal a framework within which compliance and risk management can be managed in real-time.

1 New assets and tokenization

- **Digital-native securities:** What if money market funds (MMFs) were tokenized for collateral management, enabling fractionalization and split rights for lending, voting and dividends?
- **Tokenized real-world assets (RWA):** What if private equity, real estate and other illiquid assets were tokenized, creating new opportunities for lending and margin pools?
- **Stablecoins and digital cash:** What if stablecoins enabled instant, universal margin top-ups across asset classes, streamlining collateral processes?

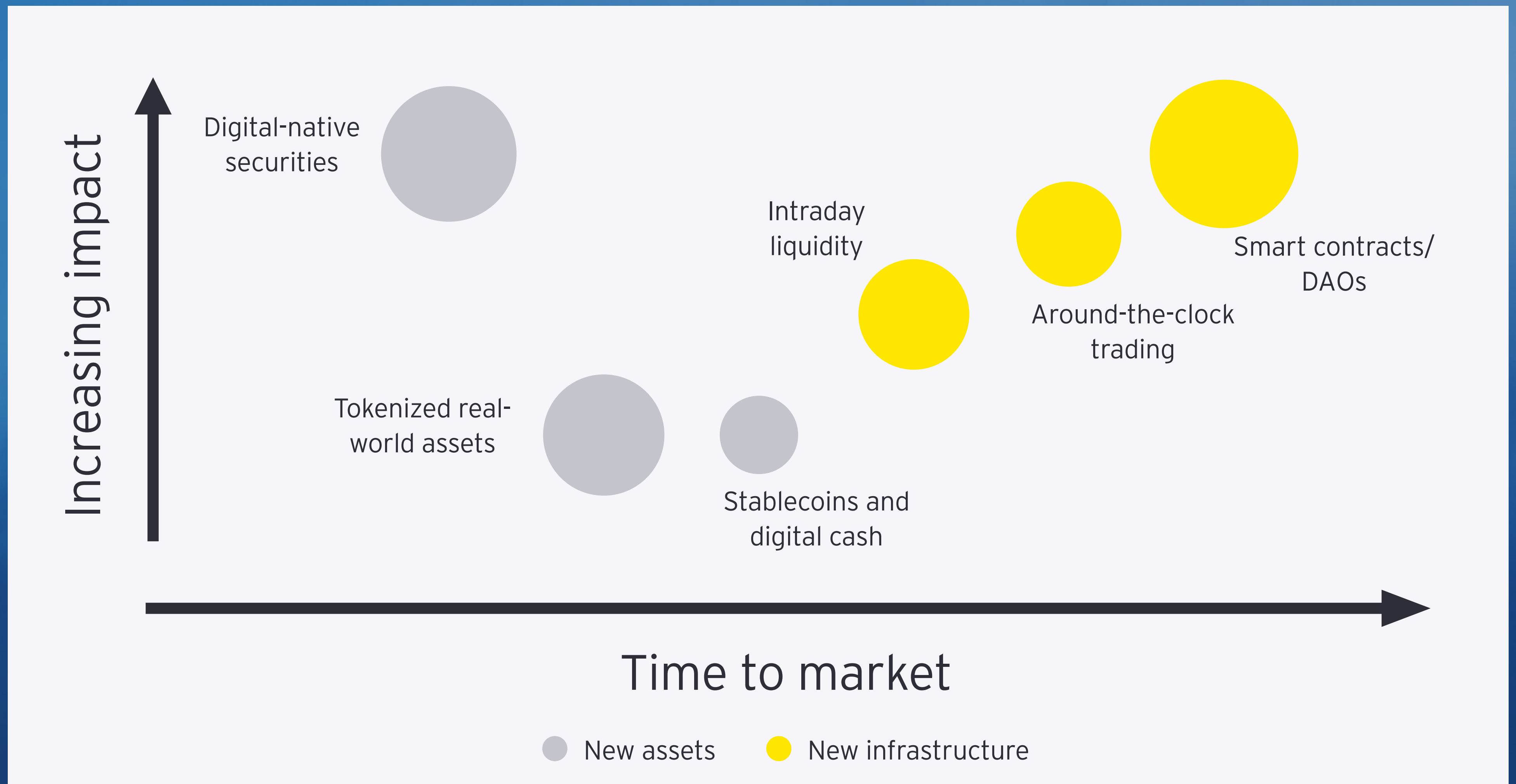
2 New infrastructure and automation

- **Intraday liquidity:** What if repo transactions could be settled same-day using DLT and digital twin securities, enhancing liquidity management?
- **Around-the-clock trading:** What if 24/7 markets enabled continuous lending and borrowing across time zones with real-time fees collection and intraday margining?
- **Automation with smart contracts and DAOs:** What if smart contracts and DAOs automated operations, compliance and risk management, resolving disputes and checking regulatory adherence in real time?

Transition on the horizon

The securities lending markets are in the early stages of transformation, driven by DLT and tokenization, introducing innovations like digital-native securities, tokenized real-world assets, intraday liquidity and around-the-clock trading in the near to mid-term, alongside the use of stablecoins and digital cash. Over the mid-to-long term, smart contracts and DAOs can further revolutionize operations, risk management and compliance.

- Digital-native securities: Fractionalized ownership could split shares into separate tokens for voting, dividends and principal, enabling new markets and trading strategies. This innovation may unlock greater liquidity and flexibility for investors in the near to mid-term.
- Tokenized real-world assets: Real-world assets can be securitized and moved on-chain with composable features, potentially enabling greater liquidity.
- Intraday liquidity: Cross-border margin offsets can enable collateral posted in one region to automatically balance exposures elsewhere in real time. This would enhance intraday liquidity by reducing friction in global securities lending.
- Around-the-clock trading: A 24/7 lending marketplace can enable continuous global lending and borrowing with live auctions and real-time fees.
- Stablecoins and digital cash: Universal collateral tokens could simplify complex collateral processes, allowing instant margin top-ups using stablecoins and digital cash. This would streamline operations and improve efficiency across lending platforms.
- Smart contracts/DAOs: Smart contracts and DAOs can enable automation to continuously monitor exposures in real time, enforce margin calls or unwinds without manual oversight, reducing operational risks and enhancing compliance functions in the mid-to-long term.



Note: Size of bubble indicative of relative size of addressable market.

Emerging use cases

Solutions are developing across diverse categories like tokenization, custody, lending and compliance, enhancing market efficiency and accessibility, shaping the future of securities and lending markets.

Tokenization platforms

Tokenization platforms enable the creation and management of digital securities on blockchain networks.

Custody

Custody providers secure tokenized assets, safeguarding storage and regulatory compliance.

Securities lending

Securities lending facilitates the borrowing and lending of tokenized assets to enhance market liquidity.

Tokenized cash

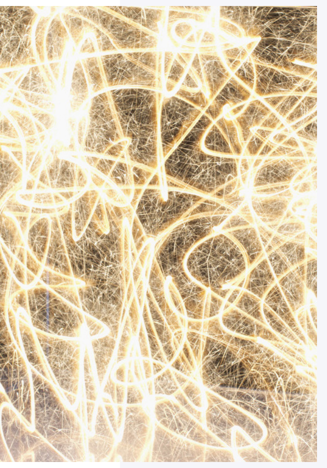
Tokenized cash provides digital representations of fiat currency for seamless transactions in tokenized markets.

Tokenized funds

Tokenized funds digitize investment vehicles, enabling fractional ownership and broader access.

Collateral management

Collateral management optimizes the use of tokenized assets as collateral in lending and trading.



New assets

These examples showcase how tokenized assets on blockchain technology are transforming securities markets, enabling faster settlement, enhanced transparency and broader accessibility for institutions and investors.

	Tokenized collateral management, bond issuance, repo trading/settlement	**Tokenized US Money Market Fund (MMF)**
Key features	▪ **Margin and collateral:** Optimizes margin efficiency ▪ **Custody and recordkeeping:** Blockchain records ownership ▪ **Settlement speed:** Programmable smart contracts enable precise settlement times and interest accruals	▪ **Price discovery and liquidity:** Backed by cash, treasuries and stable pricing ▪ **Custody and recordkeeping:** Blockchain facilitates accuracy ▪ **Reconciliation:** Interoperability across blockchains

New infrastructure

These examples highlight how DLT and automation streamline securities lending and repo trades post-trade processes with faster settlements, shared ledgers and cost efficiencies.

	Collateral mobility using DLT	**DLT platform to agree, execute and settle repo transactions**	**Post-trade automation with single data source**
Key features	▪ **Margin and collateral:** Enhances collateral mobility via DLT, removing intraday credit and collateral risk ▪ **Custody and recordkeeping:** Allows banks to fulfill collateral obligations in tri-party without needing to deliver securities out of their home custodian's accounts ▪ **Reconciliation:** DLT serves as the single source of truth to validate the ownership of the securities at any given point in time	▪ **Settlement speed:** Intraday repo settlement ▪ **Margin and collateral:** Smart contracts manage collateral ▪ **Custody and recordkeeping:** Tokenizes securities in custody	▪ **Recordkeeping:** A shared ledger with a record of agreements made between parties ▪ **Automation:** Contracts with rebate rates tied to benchmarks changed automatically ▪ **Reconciliation:** Provides mark price for all contracts on platform, maintaining that values are in sync for both counterparts at all times

The way forward

To navigate this transformative phase, a comprehensive roadmap is essential. Organizations building their DLT foundations should consider their solutions' ability to facilitate instant settlements, scale tokenization across multiple asset classes, enhance interoperability for ecosystem growth and implement real-time data and automation to enhance operations. Ultimately, achieving standardized interoperability is necessary for widespread adoption of new technologies and practices in the global financial markets.

As companies consider their next steps, collaboration, ongoing investment and innovation remain critical for survival and success in the evolving digital landscape. Embracing change will not only position them competitively but also unlock new opportunities and capabilities as the market continues to transition.

Building DLT foundations for instant settlement:

- T+0: Sets up DLT for T+0 (i.e., same day) settlement, enabling instant repo trade finality.
- Tokenization: Pilots tokenizing cash equivalents (e.g., Treasury bills).
- Collaboration and interoperability: Links DLT with legacy and other DLT systems for basic data sharing.

Scaling tokenization across asset classes:

- T+0: Extends T+0 to tokenized equities and money market funds (MMFs), reducing risk.
- Tokenization: Tokens equities, bonds and MMFs for digital trading.
- Collaboration and interoperability: Introduces standardized token formats.

Enhancing interoperability for ecosystem growth:

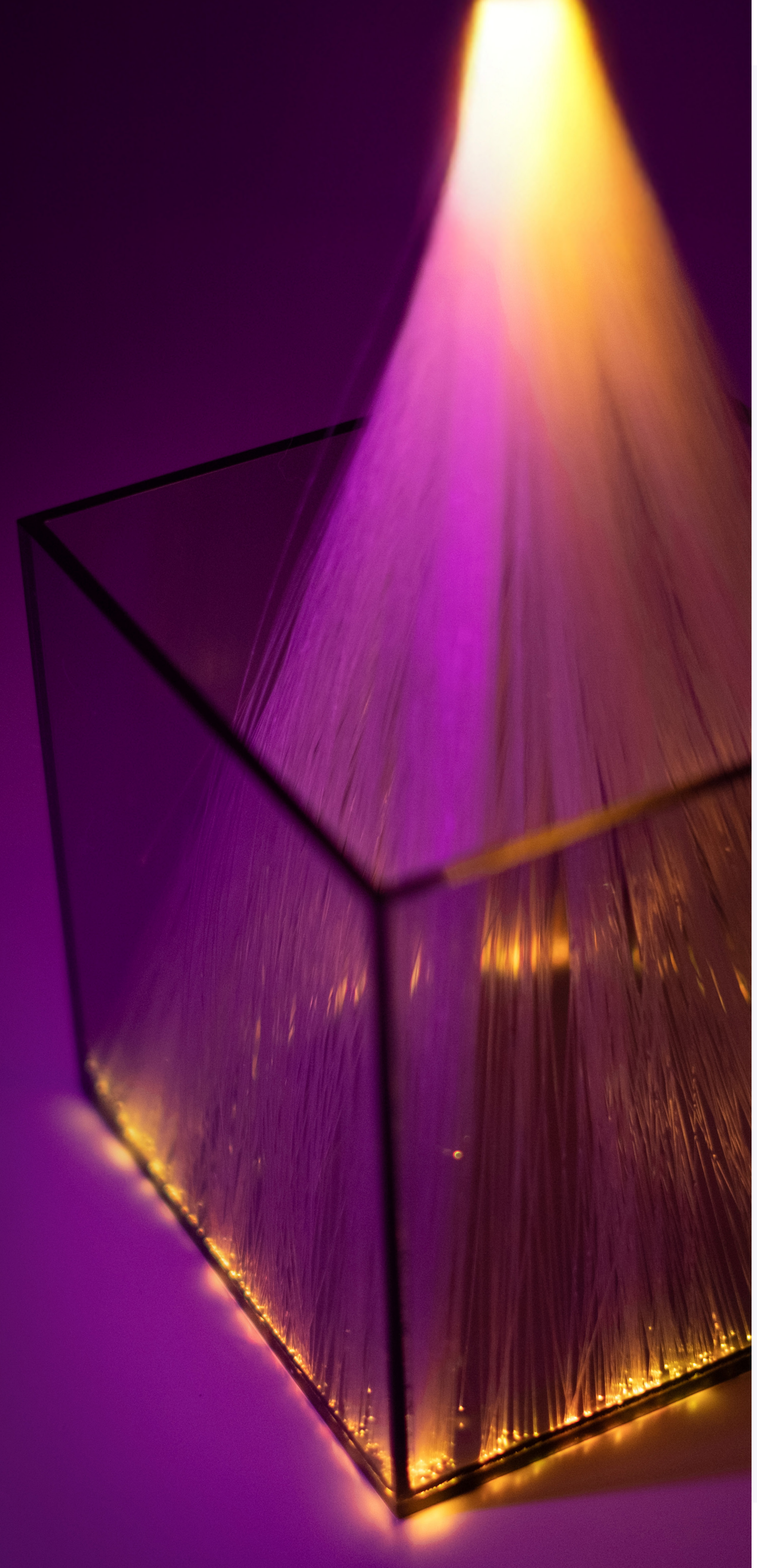
- T+0: Enables T+0 across blockchains.
- Tokenization: Adds smart contracts for collateral management.
- Collaboration and interoperability: Develops common data standards, e.g., International Swaps and Derivatives Association (ISDA), Common Domain Model (CDM).

Optimizing operations with real-time data and automation:

- T+0: Supports real-time margin adjustments via T+0 settlement.
- Tokenization: Integrates tokenized collateral into lending.
- Collaboration and interoperability: Enables cross-chain bridges for data sharing.

Achieving interoperability standards and market-wide adoption:

- T+0: Standardizes T+0 as the global settlement norm.
- Tokenization: Universally tokenizes all financial instruments.
- Collaboration and interoperability: Finalizes a global DLT protocol standard.



The future of securities lending is not merely about adopting new technologies; it's about fundamentally rethinking and restructuring securities lending markets to thrive amidst rapid changes.

Businesses should heed the lessons of past failures, adapt proactively and engage in collaborative efforts to ensure they are not left behind as the industry evolves. Collaboration, investment and adopting interoperable solutions in their digital journeys can position incumbents as well as new entrants to survive and thrive in the new reality.

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www.islaamericas.org

[1] "How businesses can stand the test of time," EY website, https://www.ey.com/en_gl/insights/consulting/how-businesses-can-stand-the-test-of-time, 16 June 2023.