Insights
Multi-Asset Solutions

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Lending Returns Decline Along with Volatility

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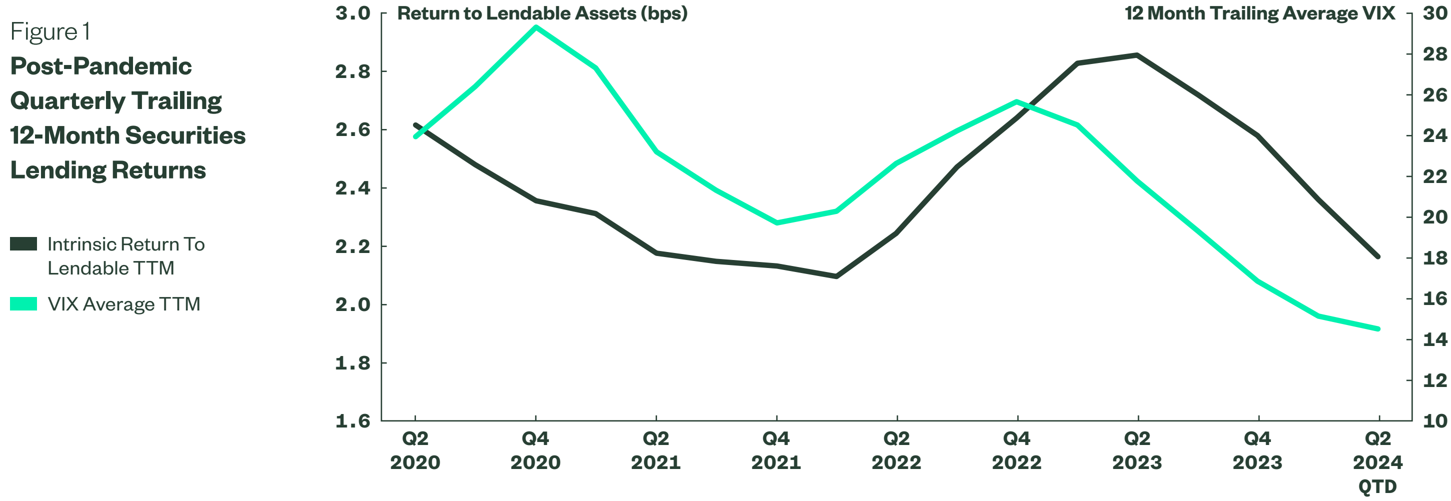
This semi-annual update discusses the current market dynamics impacting returns and risk in securities lending. We will also examine regulatory developments impacting securities lending, and State Street Global Advisors' approach.

Market Update

As referenced in our October 2023 update, we saw signs that securities lending earnings were beginning their turn downward. This trend has persisted, sending securities lending earnings to new lows in recent months (on a return to lendable basis). The Federal Reserve Board's effort to engineer a soft landing while fighting inflation has resulted in low volatility. Several of the potential events we noted in the last update have also been avoided — namely, a U.S. government shutdown, weakness in China impacting the global economy, and a commercial real estate meltdown. The CBOE VIX Index continues to set new post-pandemic lows with the most recent one on May 21, 2024 at 11.86. Other than a brief spike into the high teens in April, the VIX has largely stayed below 15 since November of 2023.

Securities lending returns thrive on market volatility due to the demand it creates to hedge and make directional market bets by shorting securities. Conversely, placid markets tend to reduce the demand to borrow securities, resulting in lower lending returns. As evidenced in Figure 1, securities lending returns have followed the VIX towards post-pandemic lows. On the brighter side, the VIX is approaching historic lows, not having closed below 9 since at least 1990, and averaging about 19.5 since that time. While the VIX is not the sole driver of lending returns, we will see how long it can stay near historic lows, depressing demand to borrow securities.

Figure 1
Post-Pandemic Quarterly Trailing 12-Month Securities Lending Returns



Source: S&P IHS Markit as of May 31, 2024, for lending returns and CBOE for VIX closing prices. Past performance is not a reliable indicator of future performance.
Note: Trailing twelve-month averages are used above to mitigate the influence of seasonal factors on lending returns. Further, demand side (intrinsic) returns are depicted to mitigate impacts of reinvestment spreads on the analysis.

Basel III Implications on Securities Lending

In this update, we look ahead at some regulatory changes on the horizon that are expected to impact securities lending. In response to the Global Financial Crisis of 2008, global bank regulators developed various measures to improve the stability of the global financial system. In the coming years the final aspects of these measures (known as Basel III) are expected to be formalized into regulation by the global central banks. Some of these measures are designed to increase resiliency in times of distress and limit risk for banks through the imposition of capital requirements for counterparty exposures. These will affect both the lending agents (through the indemnification provided in many securities lending programs) and typical intermediaries of securities loans (banks and broker dealers) for end borrowers. Effectively, it could become more expensive for the banks to conduct securities lending transactions.

There are ongoing discussions between industry participants and regulatory authorities as to the final form these regulations will take in the US. Industry participants are advocating for regulation that is intelligently designed to protect our banking system while limiting impacts on the efficient flow of capital. Securities lending markets are integral to global financial systems that support efficient markets and the allocation of capital. While we do not know the final form the regulations will take, we do expect it to drive change in the securities lending market.

State Street's Response to Basel III

As always, State Street Global Advisors seeks to hold our clients' interests first. State Street Global Advisors is working with State Street Bank and Trust, our lending agent, to advocate with the regulators for a considered approach to the regulatory changes. Securities lending not only provides revenues to our clients that can be used to offset fees, and provide incremental returns, but it also supports efficient markets that benefit our clients. There are several industry-driven innovations in development to mitigate potential regulatory impacts that State Street is researching and evaluating. State Street Global Advisors is also operating in conjunction with State Street Bank and Trust to develop innovative securities lending program designs to manage the risk of, and enhance revenue from, securities lending for our clients in light of regulatory changes. As the details of Basel III and its impacts become more clear, and State Street Global Advisors' evaluation of program enhancements develops, we will continue to keep our clients informed and confident that they have an industry-leading partner to navigate ever-evolving markets.

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world and help millions of people secure their financial futures. This takes each of our employees in 28 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's fourth-largest asset manager* with US $4.34 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2022.
† This figure is presented as of March 31, 2024 and includes ETF AUM of $1,360.89 billion USD of which approximately $65.87 billion USD is in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.