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ALWAYS BE CENTRALISING

Collateral supremo Staffan Ahlner discusses his new role shepherding State Street's Collateral+ suite into the digital era

HSBC to relaunch ETF lending programme, excluding ESG funds

HSBC Global Asset Management has become the latest firm to bar its exchange-traded funds (ETFs) that track sustainable indices from lending their assets.

From 1 March, the asset manager is set to relaunch a securities lending programme for 25 ETFs but will exclude all seven of its sustainable equity ETFs amid concerns it would not comply with HSBC's overall environmental, social and governance (ESG) policy.

Across all funds, HSBC Securities Services, acting as agent lender, will gain access to underlying securities across 38 equity and fixed income markets worth more than £2 billion.

The list of funds due to begin lending includes those tracking broad highly-liquid indices as well as several focused on emerging markets, Latin America or Asia Pacific, which are likely to generate the highest revenue.

HSBC Global Asset Management previously operated a lending programme until December 2013, upon which it "paused" the programme "due to the economic situation at the time and following discussions with clients".

The move came shortly after new rules were introduced in Europe requiring asset managers to pass all profits from lending back to underlying investors, less fees and costs for running the side business.

A HSBC spokesperson says the decision to restart the programme now reflects the "evolving global financial landscape with deleveraging and regulation changes".

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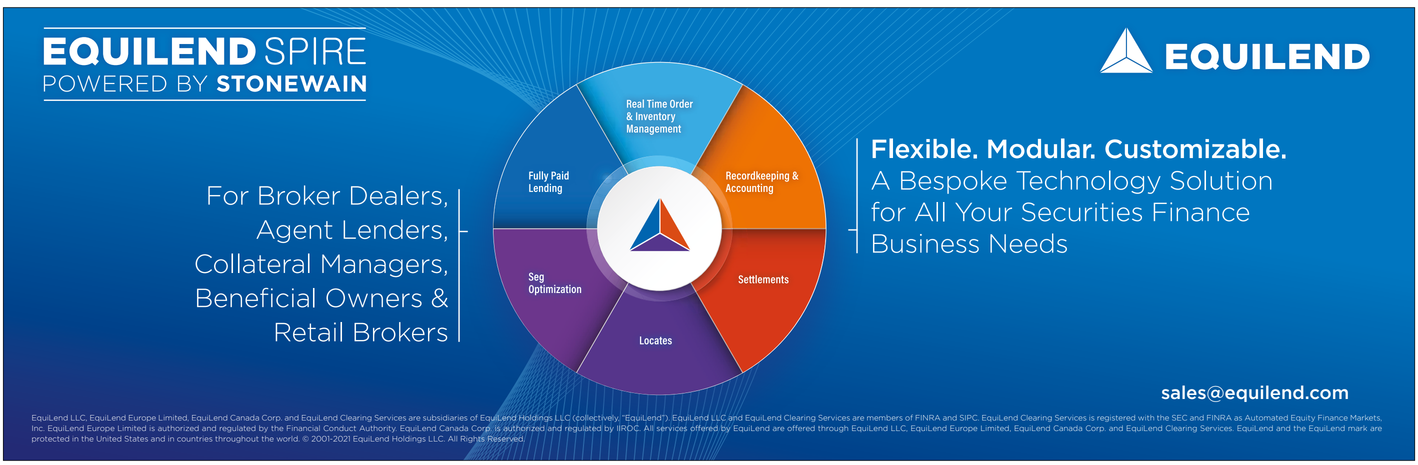

HSBC to relaunch ETF lending programme, excluding ESG funds

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"After careful review and taking into consideration the growth and focus of our ETF business, we feel it is the right time to begin this programme to further help our clients on their investment journey," the spokesperson explains.

Under the new programme, ESG ETF will not lend their assets until the "relevant framework" is in place "to ensure collateral and processes complement the ESG investment solutions and are aligned with the sustainable policy of the funds and the stewardship programme of HSBC Asset Management".

HSBC says there are currently no plans to create such a framework at the moment.

The exclusion of the ESG ETFs from the lending pool collectively only represents £285 million in assets under management (AUM) and so are unlikely to cause much of a ripple.

The funds range from the humble one-year-old HSBC UK Sustainable Equity UCITS ETF — which tracks the FTSE UK ESG Low Carbon Select index and accounts for £3 million AUM — through to the HSBC USA Sustainable Equity UCITS ETF USD (£118 million AUM) tracking the FTSE USA ESG Low Carbon Select index.

This last index is mostly made up of the world's largest financial institutions and technology providers and topped-up with constituents from the consumer goods and services sector such as Nestlé.

This compares to the HSBC MSCI World UCITS ETF (£1.87 billion AUM) and the HSBC Multi Factor Worldwide Equity UCITS ETF (£871 AUM), which will both begin lending next month.

Funds with relatively small AUM are sometimes considered to be not worth the hassle of onboarding into a lending programme but HSBC underscores that in this instance the decision to not include them was purely an ESG-driven call.

For sustainably-minded investors, the exclusion means they will not benefit from this additional revenue stream at a time when ESG assets are predicted to bring lucrative returns.

The programme will return 75 per cent of lending revenue to investors, with 25 per cent used to cover HSBC Securities Services fees as the agent lender and a further 10 per cent allocated to HSBC Investment Funds Luxembourg which will act as an ETF Management Company.

The typical collateral profile will consist of EUR, USD and GBP cash or high-quality and liquid equities and fixed income securities.

Where possible, any cash collateral will be invested into HSBC Asset Management's money market funds or, alternatively, in segregated accounts.

Speaking on SFT's recent APAC-focused roundtable, Brian Leung, regional trading head for APAC, agency securities lending at Deutsche Bank, said: "ESG will be driving appetite and sentiment for sustainability investors so one should expect more opportunities to lend and borrow in highly-rated ESG names."

The sustainable passive fund market has bloomed over the past year and soon the cumulative impact of their inability to lend will lead to a reckoning for the securities

finance community which must prove its ESG credentials to those outside the market.

ESG ETFs chalked-up an "incredible" 223 per cent growth over 2020 achieving a new record of $189 billion AUM, according to TrackInsight.

ESG ETFs captured $97 billion of inflows last year and nearly 200 new funds were brought to market during the same period, with ESG set to become "a key battleground" for issuers over 2021, the global ETF analysis platform states.

HSBC's decision follows that of DWS, a German asset manager majority-owned by Deutsche Bank, which closed the lending programme of one of its long-standing ETFs in December as part of its switch from tracking a traditional FTSE index to an ESG-friendly one.

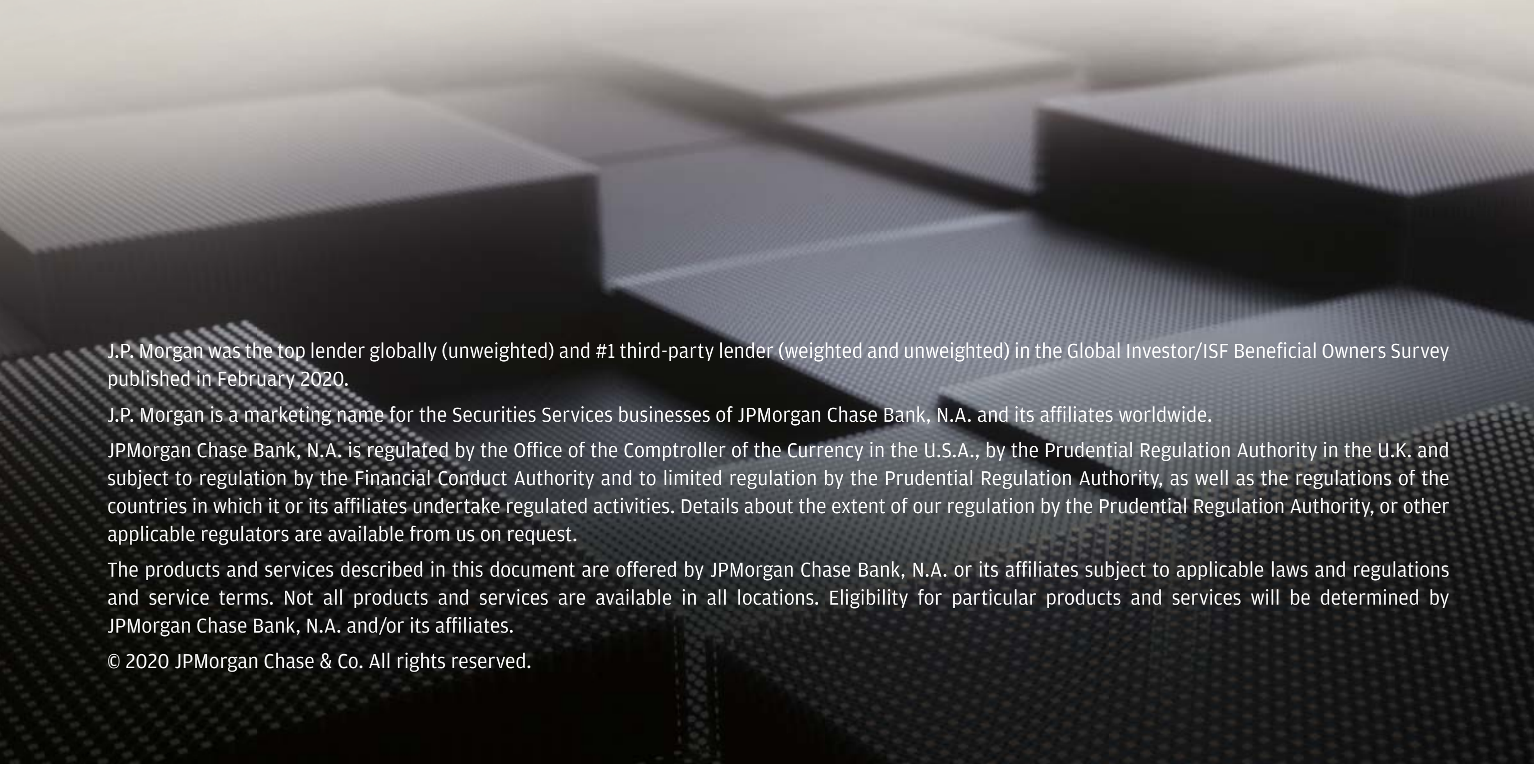
Similar to HSBC's concerns, DWS passive product specialist structurer Zeb Saeed told SFT at the time that the need for restrictive collateral parameters and regular recalls creates "a number of other challenges and alters the economics of the securities lending function to the extent that it effectively erodes much of the potential revenue from lending".

EC will not act on BaFin's Wirecard negligence in 2021

The European Commission (EC) says it is "carefully assessing" the implications of the Wirecard scandal on the supervision of EU capital markets going forward but does not plan to act on its financial market watchdog's findings in the near future.

Acting on the request of the commission, the European Securities and Market Authority (ESMA) published a report on German market supervisors' handling of the Wirecard case in November 2020 which concluded that BaFin and the Financial Reporting Enforcement Panel (FREP) disregarded warning signals from short sellers that the payment processing giant was fraudulent.

In its fast-tracked peer review, ESMA focused on whether EU guidelines on the enforcement of financial information published by listed companies were complied with, meaning it sidestepped the infamous 2019 short selling ban that was enacted by BaFin and endorsed by ESMA at the time.



A commission spokesperson tells SFT: “The report by ESMA is one piece of the puzzle. Investigations by various authorities in Germany are still ongoing.”

The spokesperson says the EC “will take stock of what has been achieved by the end of 2021, and consider proposing measures for stronger supervisory coordination or direct supervision by the European supervisory authorities”.

The spokesperson stresses that the onus for effective supervision of individual European markets lies with the relevant national competent authority and “market discipline, confidence and investor protection depend to a large extent on supervisors performing effective oversight of the activities of market players and listed companies”.

“We must ensure that in the future cases like Wirecard are detected and addressed at an early stage anywhere in Europe,” the spokesperson adds.

BaFin was unable to respond to questions on the type and scale of internal audits it was currently conducting related to the handling of Wirecard.

The EC additionally says that, under the Capital Markets Union Action Plan of 24 September, it will work towards an enhanced single rulebook for capital markets to assess the need for further harmonisation of EU rules and to monitor the progress towards supervisory convergence.

Elsewhere, ESMA’s ‘2021 work programme’ outlines ambitions to address concerns around market integrity through an assessment of the Short Selling Regulation (SSR), under which the Wirecard shorting ban was enacted, and the Market Abuse Regulation.

ESMA states it may also “take advantage of the lessons learnt in 2020” concerning short selling bans and related emergency measures after the COVID-19 outbreak and re-consider some aspects of the SSR framework at its own initiative. However, an ESMA spokesperson tells

SFT that although the authority can make suggestions on regulatory amendments, the provision of technical advice is only offered at the request of the commission.

Questions the commission may wish to ask include whether the unprecedented suppression of short activity into a highly-suspect tech firm was, in hindsight, a misstep by BaFin and ESMA.

Recent reports by the Financial Times suggest that BaFin was "selective" in the evidence it presented to ESMA when it requested the ban, and omitted several factors that would likely undermine its case. When ESMA receives a request to endorse a ban, it has 24 hours to respond and does not have any powers to review or query the evidence it is given by a national regulator.

Charles Schwab lending earnings soar after TD Ameritrade deal

Charles Schwab's securities lending revenue has boomed following the incorporation of retail broker TD Ameritrade, with earnings from this business alone accounting for more than 10 per cent of net interest revenue in Q4.

The US electronic trading platform was brought under the Charles Schwab umbrella on 6 October 2020 for $22 billion after a stellar year of client growth partly driven by national anti-pandemic lockdowns which saw millions of amateur investors turn to stock trading apps to supplement their incomes.

As of January 2021, the platform hosts roughly 13 million client accounts totalling approximately $1.5 trillion in assets.

The surge of retail trading activity, and the subsequent flood of lending revenue, has fundamentally changed Charles Schwab's revenue model, according to chief financial officer Peter Crawford.

Full-year 2020 securities lending revenue was $334 million in 2020, with $201 million coming in Q4.

By comparison, 2019 full-year revenue was $147 million, including $41 million in Q4.

Securities lending now accounted for more than 10 per cent of Charles Schwab's net interest revenue in Q4 and contributed 17 basis points towards net interest margin.

"Trading accounted for 20 per cent of our Q4 revenue and with margin lending and securities lending together at more than 10 per cent, we now have roughly a third of our revenue driven by, to varying extent, client engagement and trading activity," Crawford writes in the firm's full-year report.

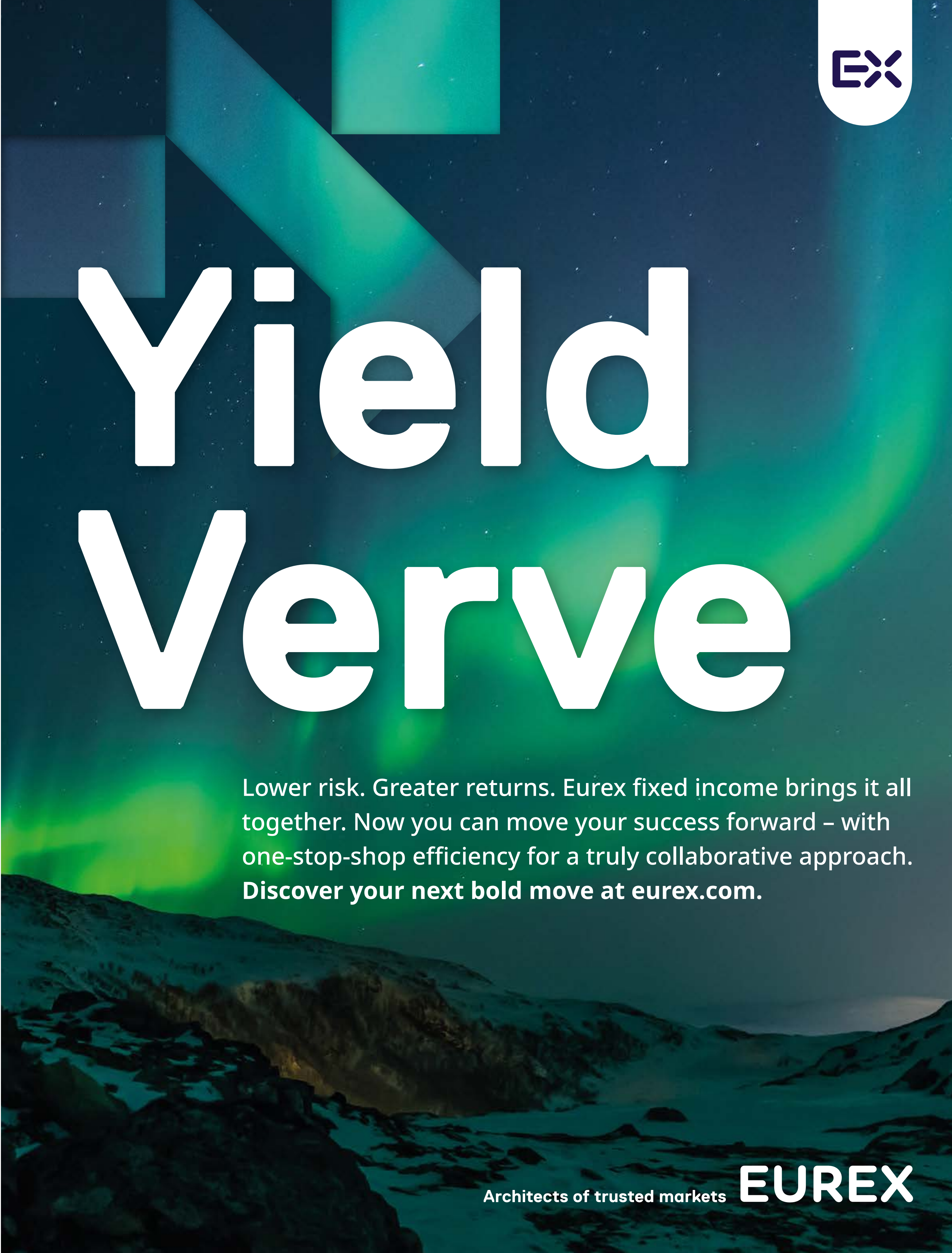
He adds: "We think there's a lot of opportunity long-term to capitalise on the combined strength of TD Ameritrade and Schwab and our securities lending operations.

As of December 31, total client assets reached a record $6.69 trillion spread across 29.6 million brokerage accounts, up 66 per cent and 140 per cent, respectively, in 2019.

The acquisition-driven boost went some way to offset the 6 per cent decrease in overall net interest revenue to $6.1 billion, caused by the extreme low-interest-rate environment created by the Federal Reserve to mitigate some of the financial challenges of the COVID-19 pandemic.

Overall, the firm's net income for Q4 2020 was $1.1 billion, compared with $698 million for the prior quarter, and $852 million for Q4 2019.

Charles Schwab CEO Walt Bettinger described the TD Ameritrade deal as "the largest brokerage acquisition in history" that represented "an extraordinary capstone to an extraordinary year".



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WFE: Market activity has 'swiftly' recovered from COVID-19

The World Federation of Exchanges, the global industry group for exchanges and central counterparties, suggests in its 2020 market highlights report that market activity swiftly recovered from the pandemic.

The COVID-19 pandemic, US presidential election, Brexit, the resignation of Japan's prime minister Shinzo Abe, and increased tension between the US and China all created economic uncertainty last year, WFE says.

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Cowen sees YoY securities finance earnings boost

Financial services firm Cowen's 2020 institutional services earnings, which includes its securities finance business, saw a substantial year-on-year (YoY) increase to $189.97 million in 2020.

The firm's full-year revenue from institutional services, which also include prime services, clearing, commission management and recapture, increased 29 per cent YoY from $135.18 million in 2019.

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Canadian pension fund CPP Investments joins GPFA

The Global Peer Financing Association, a trade body aimed at promoting collaboration between beneficial owners members in the securities finance market, has gained Canadian pension fund CPP Investments as a member.

CPP Investments brings $475.7 billion in assets under management to the peer-to-peer lending pool the association is forming, which already accounts for more than $6 trillion from 11 members, as of January.

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More SFTR news

ICMA publishes first update to SFTR guide post-Brexit

The International Capital Market Associationhas released a sixth version of its guide to reporting under the Securities Financing Transactions Regulation to reflect enhanced advice from EU regulators and the conclusion of Brexit, among other amendments.

Compared to the previous version, the updated edition defines the new dual regulatory environment created as of 1 January with guidance on both the UK and EU reporting regimes.

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Philippines inches closer to allowing short selling

The Philippines Stock Exchange will finally launch a short selling facility once three key final hurdles are overcome.

There are no more pending issues with regards to the short selling capabilities currently in the pipeline and the exchange is working to address concerns raised by foreign participants regarding the market's trading rules framework to make it viable for them to actively participate.

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Short seller takes one for the team

A US hedge fund's report on the allegedly shady activities of a healthcare company under investigation by the US Securities and Exchange Commission offers a timely reminder for the positive market force that activist short sellers provide.

Hindenburg Research has released its findings from an investigation into apparent misconduct by Clover Health but is not taking a short position to highlight the role activist bears play in uncovering fraud and malpractice.

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Always be centralising

Drew Nicol reports

Collateral supremo Staffan Ahlner discussing his new role shepherding State Street's Collateral+ suite into the digital era

You took over as global head of Collateral+ in late 2020. How was the transition after more than two decades with BNY Mellon?

It's exciting when you consider the remit because the collateral management industry has always been quite entrepreneurial in that it requires people to build and create innovative solutions.

The values of State Street align well with this market and our incredible client-focused approach means we can build something from a very strong foundation given our more than two decades of experience in this sector, with all the connectivity to the buy-side that this affords us.

As part of the State Street's Funding and Collateral Solutions division, we are effectively merging three collateral units into one to create something greater than the sum of its parts.

Beyond State Street's existing liquidity and collateral solutions, what's in the pipeline?

Primarily, we are setting up a triparty collateral platform that will operate as a pre and post-trade collateral optimisation engine. We're creating this in direct response to the Uncleared Margin Rules (UMR) and it will launch in May. This will come as part of the same platform as our other solutions to enable buy-side firms to easily pick up new tools down the road such as our peer-to-peer or securities lending facilities or access to sponsored repo. When we say we are modular we mean we can grow to fit our services to each client's specific needs.

How does State Street stand out in the increasingly crowded field of collateral solutions providers?

The main area where we excel is with our client community and outreach approach. Additionally, we've redefined what it means to offer 'scale', which used to be defined simply as assets under management. It's now much more about how well you're able to service your clients in a variety of specific areas and tailor your offerings to their sometimes complex requirements, while also bringing those under one roof in a holistic manner. This comes back to the breadth of our suite of services today, as well as the new tools in development, which is underpinned by our long experience in this space compared to some of our peers.

How far has the overall market come in its journey to establish collateral management as a feature in its own right and not just an afterthought?

You can approach that question in many different ways but broadly all the trends in this space are pointing towards greater centralisation of collateral to enable efficient management. We see this first-hand on the sell side where banks are merging various trading areas and centrally managing resources. More recently, we can see the buy-side adopting this approach, which is partly being driven by the need to meet the numerous requirements of post-financial crisis regulations. Today, collateral for the buy side is no longer a side business but has become a central pillar of their day-to-day activities.

Many opportunistic buy-side firms are using this regulatory push as a reason to reconsider their processes and seek greater efficiencies by looking at their business thoughtfully and holistically. As a result, centralisation is now happening on a large scale in the buy-side community.

Our advice to our buy-side clients is to take this as far as their resources allow and take the most holistic approach they can to review their collateral functions. This means including pre-trade and analytics, through the trade itself, and all the way to post-trade.

Although going beyond what is mandated in regulation will require more than the bare minimum of resources and attention, we believe gaining a holistic overview will pay dividends in the end.

How receptive are your buy-side clients to this advice?

It depends on the type of buy-side member and the horizon they are using to look at this problem. If they are viewing it as just achieving the compliance deadlines this year or next and simply getting over the hurdle they may be unable to take a more tactical approach.

But, if they are more long-sighted, then the conversation becomes a lot easier.

We aim to work with both categories. We are sympathetic to some entities with budgetary constraints that may hold them from looking for long-term solutions beyond what they need for compliance in 2021. That's why we've ensured Collateral+ suite offers a modular approach to allow firms to take on new capabilities as their situation allows.

This piecemeal approach extends beyond our collateral tools and also ties in with our holistic approach as some clients may benefit from our other liquidity products such as our managed peer-to-peer or access to cleared repo via the Fixed Income Clearing Corporation. As a group, we look beyond collateral to consider all ways that make trading possible for the buy-side community.

We aim to provide nothing less than a total end-to-end service through an enterprise-leading platform.

Although centralisation is good, how do you differentiate between the collateral requirements for various trade types?

It's important to say that just because we are putting everything together on one platform that does not mean we are taking a one-size-fits-all approach — far from it. We strive for maximum flexibility in the way we approach each trade's needs and in large part this comes down to effective data management.

You can't do collateral management on its own, it must be connected to efficient processing. Derivatives, as we know, are very data-heavy when it comes to making sure all the various requirements are met when it comes to settlement and reconciliation.

We mentioned regulation as a driver of change, and another way that's true is the unintended consequences of how frameworks such as the Securities Financing Transactions Regulation forced firms to become very well organised when it comes to data. Similarly, UMR has encouraged firms to bring their collateral management activities into the foreground of their business, especially if they have a longer view. Additionally, the Central Securities Depositories Regulation is enforcing settlement discipline. In all these cases there are opportunities for firms to go beyond the letter of the law and strive to make the best of the situation and claim the benefits of a more efficient business model.

> ***"SFTR, UMR and CSDR are opportunities for firms to go beyond the letter of the law and strive to make the best of the situation and claim the benefits of a more efficient business model"***

Going beyond the bare minimum of UMR requirements is a good aim, but a State Street survey from last year suggested a significant portion of phase five and six firms were not ready to go live. Has the situation improved?

There are still firms that are not as well prepared as we expect them to be. We can hope progress has been made since we conducted the survey. However, we are aware of many buy-side firms that are approaching UMR compliance from the view of threshold management rather than collateral management. By using the Average Aggregate Notional Amount for measuring initial margin, they aim to stay below the threshold to avoid UMR all together. The concern with this method is that a firm is capping the trades it can or can't do. It may seem like the path of least resistance now but there may be consequences further down the line. People may consider themselves 'ready' for UMR because they plan to stay below the threshold, and that's true today but it may not be tomorrow if the rules change and bring them into scope.

Beyond the pandemic for repo markets in 2021

Jeff Kidwell, president of Kidwell Consulting, offers his expert verdict on the state of the US repo market in 2021 and offers advice on what might be done to alleviate some of the pain points

After nearly 100 million people became infected with COVID-19 and more than 2 million of them died worldwide, it would be impossible to ignore the mortal, economic, and mental toll that the pandemic has brought to millions more people in the world. It is also hard to look ahead and 'assume' that the disease will come under control, aided by all of the precautions and the new vaccines.

Yet, I've been asked to look ahead to 2021 in my crystal ball, to see what other issues we will need to focus on in the repo market, and offer up some of my thoughts for discussion. Clearly, the pandemic forced the migration of workers in our industry from the office (and the money centers) to remote locations (some of them home offices). Along with the migration of schooling and other businesses to working remotely or virtually, this migration of the repo market is probably not a temporary thing, and certain benefits were unintentionally realised by the companies. There were tax, commercial real estate, technology, meeting efficiencies, and more benefits/issues that were realised during this almost forced business continuity plan. All of that has further implications for supervision, management, office leasing, employee compensation, home computer compliance, accounting, retention of documents, etc.

I would proffer that the first issues that the repo market in 2021 must address are: are these further implications identified and being dealt with for remote trading and sales, and is our technology up to the tasks of the benefits & issues highlighted by the remote migration?

We would have liked to have by now been able to say that technology can meet all of the trading and collateral optimisation needs of remote work. But the growth of the widely-assumed move to exchange-traded products, arbitrage trading programme, and central counterparties (CCPs), has been lackluster, driven mostly by sponsored repo and industry consolidation. Focusing just on the CCP side, it seems that their very existence, to reduce systemic risk, has actually led to less transparency, more concentration risk, and a self-limiting capital cap on volumes. Is there still a market trust issue in banks or is this because these were vendor-based initiatives and not community-based initiatives?

As we look at the technology needs for the repo market in this environment, do we have enough answers for remote users for elements of the repo trade cycle? The electronic platforms would be for the quotes, enquiries, and trading. But, where are we on the settlement of trades? I read that the European Central Bank and France think this is one of several areas in the trade cycle, during the massive transfer of assets to Europe from the UK, to take the opportunity to grow a more robust financial structure in Europe, including setting up its owner operations and clearing houses. Other parts of the repo trade cycle that we need to make sure there are appropriate technology solutions for are: counterparty know-your-customer, documentation, anti-money laundering, counterparty credit risk determination and monitoring, pricing of securities, trade processing, trade confirmation, and the monitoring and completion of trades (including coupon payments, dividends, proxies, substitutions, margin maintenance calls, maturing securities, early unwinds, etc.). Of course, the repo participants have to make sure that collateral and balance sheet are being optimised.

Then, there are the regulations. Not only do we need to see if the technology is sufficient to overlay the mountain of current regulations. In 2021, the repo market may also have to deal with the specter of Financial Stability Board and Financial Stability Oversight Council shadow banking reforms, European Commission-rumored hedge fund rules, new Best Interest rules, environmental, social and governance rules, short selling bans in some countries, potentially the Volcker Rule and the Federal Reserve finally addressing the Orderly Liquidation Authority for Firesale Risk. Not to mention the European Securities and Markets Authority's Securities Financing Transactions Regulation, Central Securities Depositories Regulation, the second Markets in Financial Instruments Directive, the European Markets Infrastructure Regulation, Rule 165, Basel III and IV, and the Financial Transaction Trax (in France and New Jersey), just to name a few.

I think another topic for 2021 that the repo market will have to deal with is the continuing imbalances of supply and liquidity, particularly in the US markets. This is somewhat due to the Fed's zero interest rate policy, but also the imbalance of collateral suppliers (broker/dealers) due to regulations and competing balance sheet products, as well as the Fed's own programmes, where it repos collateral to the primary dealers' cash providers and reverse repos collateral from the primary dealers. In effect, the Fed is running a mismatched repo book, while tinkering with the underlying rates of repo, reverse repo, Fed funds, and interest on excess reserves. I've argued that some of those imbalances could be alleviated by having both the buy-side collateral providers execute repo with the buy-side cash providers, bypassing the handcuffed broker-dealers and the need for the Fed to intervene, but I haven't seen the expected or potential growth in the recent figures that the overnight funding rate is reporting and that I am hearing from clients. Perhaps, it's because there hasn't been a community-based technological solution that makes it work better with remote trading. I think this overall supply/liquidity/counterparty diversification issue will be one of the most important for the repo market in 2021.

The last issue that comes to mind is the need for distanced continued learning, the need for distanced networking (particularly in like-minded communities), distanced tutorials and conference panels, and distanced basic training. With the pandemic forcing us from our three dozen annual conferences, because we can't have gatherings, and the non-specific panel discussions, and the need for more direct repo issue help desks, if you will, there is a technology needed here for the new networking.

I recently became a part of two of the solutions for this growing need in 2021. I have taught the 'fundamentals of repo' course for the Virtual Academy designed by Pierpoint Financial, which is an intense 11-week course from my 38-years of experience in the repo industry, and which accompanies other courses in collateral management, securities lending, and others to come, taught by other experts.

The second solution I am involved in is the very adaptable Pierpoint Alpha Community, which will provide the market with experts on call who can answer member questions on any number of topics, provide tutorials, develop question-and-answer discussions, and will allow for networking of like-minded institutions to discuss the most important topics of the day.

> ***A key topic for 2021 that the repo market will have to deal with is the continuing imbalances of supply and liquidity, particularly in the US markets***

Jeff Kidwell
President
Kidwell Consulting

SFTR to SFDR: The new, new regulatory frontier

Experts in securities lending, repo, regulation and law were brought together to navigate the unique challenges of moving from a regulatory world based on rules to one based on principles

Moderator:	Panellists:		
Ali Kazimi	**Danny Corrigan**	**Farrah Mahmood**	**Roy Zimmerhansl**
Managing director	CEO	Senior regulatory analyst	Practice lead
Hansuke Consulting	London Reporting House	ISLA	Pierpoint Financial Consulting

The Securities Financing Transactions Regulation (SFTR) and the Sustainable Finance Disclosure Regulation (SFDR) are vastly different in scope, aim, and design, but they do share one key trait. They represent a radically new rules framework, unlike anything the securities finance market has seen before.

For the securities finance market participants, after the harsh, direct gaze of regulators in SFTR, the incoming ESG rules are a return to form, bringing familiar challenges of being caught up in a broad-brush regulation not written for them or particularly well suited to their industry structure.

SFTR was an ambitious project by EU regulators to respond to the perceived market vulnerabilities laid bare by the global financial crisis, primarily targeted at the misleading moniker of shadow banking. Securities lending and the short selling it facilitates were already highly regulated markets before SFTR, with frameworks like Regulation SHO in the US all but eliminating naked shorting. But the actual dimensions of industry were a mystery to regulators. Hence the demand for granular transaction reporting to allow the scale of repo and securities lending markets to be comprehensively mapped out.

SFDR is different. ESG is an entirely new feature to capital markets and has taken even longer to trickle down throughout the securities finance world. The first phase of implementation on 10 March will be the EU regulator's first real attempt at standardising and crystallising the ethereal concept of sustainable financing in law.

The SFTR to SFDR webinar, hosted by Ali Kazimi, who operates as a tax integrity specialist for Hansuke Consulting, assessed the recent past of SFTR, which only fully came into force in January, while also pivoting to address the fast-approaching challenges of complying with the very different style of market governance SFDR presents.

The one-off webinar was hosted in partnership with the Chartered Institute of Securities and Investments and Securities Finance Times and is available to view on-demand in our multimedia hub.

SFTR's recipe for success

Look at your SFTR data and think of the Ottolenghi Cookbook, declared Danny Corrigan, simultaneously revealing his culinary and regulatory credentials. SFTR, he says, is much better than previous reporting frameworks such as the European Markets Infrastructure Regulation, and the data that's been available for almost a year now is "really good".

The vast variety of transaction data that's now available can be viewed as a recipe for knowing your own business better, Corrigan explained, adding: "It was designed for regulators but you can use it yourself."

Kazimi acknowledged that SFTR was widely considered a success but questioned the cost of compliance. The cost was "enormous", Corrigan conceded, but argued a firm can make the endeavour worthwhile if it utilises the new data to optimise their businesses.

Corrigan plans to practice what he preaches and his new venture, London Reporting House, will launch in April and offer to repurpose clients' SFTR data to help them develop their securities finance business, with a specific focus on environmental, social and governance (ESG) practices, such as green bonds.

Roy Zimmerhansl agreed that SFTR was largely a success and offered kudos to the trade associations, including the International Securities Lending Association (ISLA) and the International Capital Market Association (ICMA), for the central role they played in rallying various market participants into working groups that produced a lot of guidance for those in scope.

According to Zimmerhansl, there are two real winners of SFTR: those firms that use the new data for their own ends, and the people that sold the supercomputers to regulators trying to crunch the mountain of transaction reports they now receive every day.

Zimmerhansl added that it is less than clear what various regulators will do with all this data as there has never been a clear aim underpinning the broad reporting requirements beyond casting the widest possible net to capture the market's activity. Watch this space.

SFTR to SFDR: From rules to principles

At the centre of any conversation around the adoption of ESG across the global securities finance market is a single inescapable problem: the lack of standardisation. Today, financial institutions can make grand claims about their commitment to sustainability with very little scrutiny from either the market or regulators. For example, retail investors shopping around for ETFs to invest in may be presented with a fund's high ESG rating from MSCI, or indeed another agency, but there is precious little oversight of how these scores are calculated. The variety of opinions on how well securities lending and ESG coexist ranges from not at all — a view mostly held by ETF managers and pension funds — to completely (as argued by ISLA and most other market participants), and there is a lot of open water between those two poles.

According to Zimmerhansl, the main battlefield is collateral. Today, a beneficial owner may present a collateral exclusion list to its agent lender that will bar it from accepting any assets that do not comply with its ESG policy. Common offenders are businesses involved in fossil fuels, weapons manufacturers or other so-called 'vice stocks' such as tobacco.

Zimmerhansl called for a more nuanced approach to account for the shifting ESG landscape. For example, what should be done with energy companies seeking to transition to more sustainable models? That type of behaviour should be promoted not shunned, he argued, meaning a binary collateral lens of 'oil is bad, solar is good' is sub-optimal.

Service providers are craving conformity in the ESG space to escape managing the bespoke requirements of their clients, but in the global marketplace, this is unlikely to come soon. Zimmerhansl noted that SFDR is an attempt by the EU to bring general standardisation and oversight to the sustainability space but that doesn't take into account the rest of the world.

"Inevitably we're going to have to adjust and adapt our models so that it's much more about mass customisation, rather than mass standardisation. That's the challenge for the industry," he stated.

Among the issues of marrying ESG and securities lending, collateral is second only to the question of recalls of on-loan stocks to exercise voting rights. The issue of ensuring assets are recalled in time has been an ongoing sticking point for lenders and Zimmerhansl predicts that beneficial owners will be increasingly proactive in recalling stock despite the inevitable hit to revenues. Lenders will want to avoid being called out for taking small profit bumps instead of exercising their powers as investors.

"Any time an investor isn't voting their shares and someone else is, it's because that long investor has chosen not to vote those shares because shares are always recallable. So it's an active choice they're making to make their shares available for short sellers," Zimmerhansl explains.

Prepare to disclose ... something

Beyond the primary challenge of writing the rules of engagement for a market that no two participants can agree on, the hurdle for compliance is raised further still by the lack of granular detail on what the EU's market overseers want.

ISLA's Farrah Mahmood outlined the unusual situation of the market preparing for the go-live of the level-one SFDR text, which only outlines the requirements in the broadest terms, before the level-two regulatory technical standards (RTS), which provides more granular detail, are ratified by the European Parliament.

Last year, the European Commission published a consultation paper setting out proposals for the level-two RTS, which closed in September. The original timeline was for the final report to come out in December to allow time before the 10 March deadline, but COVID-19 put paid to that.

In November, the commission confirmed the RTS would be delayed but reiterated in-scope firms must be ready to comply with the level-one come March.

Then, in January, the level-two text appeared after all with a caveat that it would apply from January 2022.

So, is securities lending in scope? We don't know. ISLA members are waiting on the response to a letter sent by several EU authorities to the commission seeking clarification to key terminology that defines what activities are in-scope of SFDR.

The letter was sent in early January and a response is expected before 10 March, although it will not leave the securities lending industry much time to get their houses in order if, as is expected, the commission applies the broadest possible meaning of whether a product 'promotes' ESG and therefore falls under the SFDR disclosure rules.

Away from Brussels, ISLA's own working groups are also finding a lack of consensus of whether securities lending is in-scope due to the different areas that the business sits under with each member's structure. SFDR is relevant for 'portfolio management' activities as defined under the second Markets in Financial Instruments Directive (MiFID II). ISLA has since found its members received different external counsel on this and therefore they are split on where securities lending should sit, Mahmood explained. Some ISLA members were advised that only the cash reinvestment element of a securities lending business is considered a portfolio management activist while others disclose their entire programme under MiFID II, and will therefore have to do the same under SFDR.

ISLA's ESG steering group is attempting to square the circle and is standing by to act once the letter's response is available.

Kazimi asked for more details on whether ISLA was working with other trade bodies in the same successful way it had while tackling SFTR, to which Mahmood highlighted the work of ICMA and others that all contribute to the greater capital market understanding of what's required and how to get there.

Kazimi probed further, pitching an audience question that asked whether securities lending was meant to be swept up in SFDR in the first place. Mahmood suggested that it probably wasn't top-of-mind for those drafting the text. As is so often the case, securities lending is caught up in wider trends and must adapt accordingly regardless.

On this point, Zimmerhansl emphasised that ESG required a much broader-church approach than SFTR and called for all capital market participants to be included in discussions. Zimmerhansl also serves on the college of advisors for the Global Principles for Sustainable Securities Lending which focuses on gaining contributions from buy-side members (including pension funds and hedge funds), along with academics and other stakeholders as part of its mission to create a securities lending market that is indisputably ESG-compatible.

It'll all come out in the greenwash

The most controversial area in the ESG sphere is around 'greenwashing' — the act of disingenuously promoting your sustainable ideals in a superficial way to dupe clients. SFDR is a direct response to this issue but the vagaries of the initial requirements for website disclosures of ESG products fall far short of solving the problem.

Mahmood suggested progress will be made once the taxonomy is released, which will act as a list of activities and specific performance criteria for contributing to ESG objectives.

"That's going to create a common language for financial institutions, investors and policymakers," she explains. "Once you've got that standardisation and common ground everybody is going to be reporting to the same criteria."

Corrigan agrees and said an ESG-focused taxonomy for different securities will go a long way to cutting through the noise and allow investors to easily compare one asset's characteristics with another.

He added that central banks also have a part to play by dictating their collateral requirements for their primary repo market. If they were to only accept broadly ESG-friendly collateral then that would quickly influence the secondary market, he argued.

However, Zimmerhansl was unconvinced. He suggested the market needs to be better at self-policing by investigating a firm's green credentials, as well as regulatory oversight. It's here that the surge in retail investors, a major force behind the drive for ESG adoption by buy and sell-side institutions, may be at risk of undermining its aims, he suggested.

"Is the market better off with Citron Research not doing any more short reports because of the abuse that they've taken over GameStop," he questioned. "We will need more people checking greenwashing credentials rather than fewer. Partly that's because people will make mistakes and genuinely think that they're complying, as well as those people with more malevolent goals."

Turning to the recent past for examples, Zimmerhansl noted that both Wirecard and NMC health were members of mainstream indexes the FTSE 100 and the DAX 30, respectively. "I don't recall a lot of long investors or passive index holders calling out fraud and I don't recall regulators or auditors doing it, I saw journalists and short sellers doing it."

"I think there is a role for short sellers that's really valuable and I have a list of over 30 companies that have been spotted by short sellers and not regulators or long investors."

Commenting on the evolution of ESG as an industry hot topic, Kazimi observed that the first wave of ESG was vague enough to allow firms to talk loudly about their sustainability agenda without having to back that up with action. More recently, second-wave ESG brings more structure and definition to the conversation and will require firms to internalise that thought process and make changes.

Zimmerhansl said 2021 should be viewed as a year for "debate, challenge and engagement" to drive progress on practical issues such as ESG collateral. He also doubled down on calls for the conversation to not be limited to association working groups to agree on an industry-wide consensus on sustainable principles within securities finance for the future.

SFDR cheatsheet

- SFDR introduces transparency disclosure requirements for alternative investment firms, UCITS, credit institutions or investment firms that are subject to MiFID II reporting for portfolio management services in respect of how they integrate sustainability risks, into their investment decisions
- SFDR defines products in three categories: a vanilla product that's unrelated to ESG; a 'light green' product that is not an ESG-specific product but 'promotes' sustainable characteristics; and a 'dark green' product that is billed as an ESG product
- Dark green products are clearly in-scope of SFDR but most securities lending businesses full in the 'light green' category which is less clear but will likely mean disclosures are required
- In-scope firms will be required to publish written policies on the integration of sustainability risks in their investment decision making processes
- They will be required to meet contractual disclosures on how they operate these risks into their businesses or products, as well as publish an online description on their website on the methodologies used to assess and evaluate the effectiveness of investment

SFDR timeline

- The European Supervisory Authorities held an industry consultation on the regulatory technical standards which closed in September
- The requirements for sustainability disclosure outlined in the level-one text of SFDR comes into effect on 10 March
- The regulatory technical standards outlined in the level-two test were published in January and will go live in January 2022, after ratification by the European Parliament

The securities lending market in 2021: a fine balance between optimism and uncertainty

Andrew Geggus, global head of agency lending trading at BNP Paribas, offers an outlook for 2021 which strikes a fine balance between uncertainty and optimism

After the unforeseen shocks that dominated the world last year, any predictions for what 2021 will hold for the securities lending market come with a big caveat. Exogenous events still have considerable potential to surprise and disrupt. Yet there are also strong grounds for optimism.

What we got right about 2020

While initial projections for how the year would play out were quickly overtaken by the seismic spread of COVID-19, some of our predictions for 2020 have come to pass. One was the increasing importance of the Asia Pacific (APAC) region – where BNP Paribas Securities Services has continued to invest to support the securities lending market's growth, as with the recent addition of further trading capabilities in Hong Kong.

"Despite the temporary short selling bans in South Korea and Malaysia, the market continues to develop across the APAC region," notes Geggus. "This evolution is exemplified by the recent introduction of facilitated short selling and margin financing for global investors in China via the Qualified Foreign Institutional Investor scheme."

We also expected further robust borrower demand for eligible collateral securities and high-quality liquid assets (HQLA), primarily to meet industry participants' regulatory requirements. This trend played out through the year. There was increasing interest in collateral flexibility and optionality around tenors, with those beneficial owners able to accept a wide range of collateral on wide tenors proving best placed to benefit from demand for these asset types.

"It is a trend we do not see diminishing," says Geggus. "Collateral and tenor flexibility will become ever more important factors in the profitability of beneficial owners' portfolios."

The other major development we pointed to in 2020 was implementation of the EU's landmark Securities Financing Transactions Regulation (SFTR), which imposes extensive reporting and transparency requirements on lenders and borrowers. It is one of the largest regulatory undertakings the securities finance industry has faced in recent years and has required considerable resources to prepare.

"Successful implementation of such a complex piece of regulation is testament to the work performed across all market participants and between the industry working groups," notes Geggus.

What does 2021 hold?

So what can we expect from the year ahead? The outlook is for a fine balance between uncertainty and optimism.

COVID-19 impacts will linger

Vaccination programmes are rolling out apace. Yet rising infection rates, the spread of new variants and need for ongoing suppression through extended curtailment measures mean there is still no clear route out of the global health crisis. How long the impact of COVID-19 will be felt, and the full extent of the scarring it leaves behind, remains to be seen.

"Until that picture becomes clear, enormous doubt hangs over the global economy and the prospects for a normalisation of activity in the months and years to come," says Geggus. "In the meantime, central banks and governments will continue to pursue their extraordinary stimulus programmes – in turn exacerbating the questions around how countries can sustain and eventually address the current levels of debt, and whether the huge liquidity injections can be rolled back without impacting the economy and jobs," he adds.

As for the securities lending universe more specifically, the prospects through the current year and beyond are bright.

"We are seeing more asset owners and asset managers than ever engage in discussions about entering securities lending programmes," says Geggus. "New markets are opening up to securities lending and new routes to market continue to be explored. We are also seeing technological and efficiency developments that will help drive our business into the future."

A big focus in recent years has been on automation and straight-through processing and that will continue to grow, he explains. "More recently, we are seeing new developments in distributed ledger technology, artificial intelligence and machine learning, all of which promise exciting times ahead for the securities lending industry."

Regulation will test programmes' effectiveness

Regulation will be another major factor influencing the landscape and level of activity. Following the SFTR implementation, the industry's focus for the coming year is turning to the Central Securities Depositories Regulation (CSDR), with the market efficiencies it promises through mandatory buy-ins and late settlement penalties.

"With the regulation due to go live on 1 February 2022, the market continues to seek clarity on its final scope and to understand all the implications of the potential automatic buy-ins and punitive charges," says Geggus. "Operational efficiency with automated loan and recall processes will become ever more vital, and will be a key contributing factor when pricing loans."

Balancing ESG and securities lending priorities

A further trend coming to the fore is the focus on environmental, social and governance (ESG) issues, which in recent years have gone from a minor additional consideration to top of the agenda.

"Clients are much more actively engaged in conversations focused on ESG and how agent lenders can support them in pursuing their ESG goals," Geggus notes.

How this heightened focus will play out for the securities lending industry is not yet clear. But with no one-size-fits-all ESG solution, demand for service customisation is likely to increase.

"In an industry that has been working towards an omnibus structure, and bulking clients' assets together versus groups of pre-approved collateral sets, we can expect a needed shift to large scale customisation" says Geggus.

"The industry will need to develop customisable approved collateral and increase their recall capabilities to align with the clients' desire to vote more." Two areas where the bank stands ready to support its clients.

As with any change, incorporating ESG will be a test for the industry. "I believe ESG is a real driver for good and we will see a shift more broadly towards goals for sustainable finance," Geggus says.

Impact on lenders' programmes

How the events of 2021 play out will present challenges and opportunities for market participants. To what degree the challenges can be addressed and opportunities maximised will be determined to a large extent by lenders and their agents.

"The impact on programme revenues really depends on what clients are looking to achieve," says Geggus. "For example, agent lenders can support their clients' pursuit of ESG policies while offering ways to optimise the revenue generated. Clients wanting to vote will have to put in place recall programmes, a good agent lender can work with them to achieve that, all the while maintaining their programme's performance."

> ***The industry will need to develop customisable approved collateral and increase their recall capabilities to align with the clients' desire to vote more***

Geggus' suggestion for any prospective lender considering entering the securities lending market is to decide whether they want an agency or principal programme. Then discuss the programme goals with the lending provider and tap their expertise to increase revenue.

"Whether it is through greater flexibility of collateral or allowing term trades up to a specific tenor, there are many ways in which an experienced securities lending partner can help lenders maximise performance."

Changing with the times

Performance optimisation is a goal BNP Paribas Securities Services is constantly striving towards, as we adapt our securities lending service to accommodate market developments and our clients' priorities. Sustained investment in our technology and people is key to that focus.

"We continually seek to improve the efficiency of our business through technological advancements, along with ensuring we have the best people to support our clients across the globe," says Geggus. "This is not just a short-term investment. It is a long-term commitment. The industry is ever changing and being able to adapt to it is vital if we are to keep improving the benefits our clients gain from securities lending."

The aim for Geggus is to cement the bank's position as a technology market leader and to lead the way in partnering with clients to support their ESG goals and ambitions, all while taking a prudent approach to risk. "Our clients are at the forefront of all our business decisions and developments," he says. "When they succeed so do we."

GameStop: Now the dust has settled, what comes next?

Alex Pugh reports

An SEC investigation, hearings in Congress, murmurs of new regulations and Wall Street rattled; not bad for a Roaring Kitty

The first US federal hearing on the GameStop saga saw House members tangle with witnesses — and each other — over whether the events of January mean the country's financial mechanisms are working for ordinary Americans.

The apparent surge in retail trading in GameStop and subsequent short squeeze raised the spectre of reporting of short positions after House members described hedge funds as "bullies" guilty of market manipulation.

Whether an emboldened Biden administration will put out Trump's bonfire of regulations, looking to secure a big win against the financial giants, has yet to be determined — this was just the first of three GameStop hearings to be held by the US House Committee on Financial Services.

But, a House memorandum that details dormant sections of the 2011 Dodd-Frank Wall Street Reform and Consumer Protection Act, obliging firms to record and publicly disclose short selling data, gives an indication of the flavour of regulations that a Biden-led Deomocratic Congress may choose to implement.

Nonetheless, the hearing laid bare a partisan and polarised country, with one House member, Bill Huizenga of Michigan, calling the entire hearing pure "political theatre", for which he was subsequently chastised by chair and congresswoman Maxine Waters.

As the hearing, conducted remotely, ran for over five hours House members across the country probed witnesses on "short selling, online trading platforms, gamification and their systemic impact on our capital markets and retail investors".

The speakers called to testify — some faring better than others — were Robinhood CEO Vlad Tenev, hedge fund Citadel CEO Kenneth Griffin, Reddit CEO and co-founder Steve Huffman, Melvin Capital CEO

Gabriel Plotkin, Cato Institute director of financial regulation studies Jennifer Schulp and day trader Keith Gill who is credited with rallying the retail interest in GameStop through Reddit forum WallStreetBets.

Plotkin, in a statement released before the hearing, defended the short selling practices of the firm, emphasising the amount of research that had taken place before deciding to short the struggling bricks-and-mortar gaming retailer.

The trends Melvin Capital had identified — downloads are in, stores and trading games are out — were so entrenched that Plotkin said his firm had been short GameStop since its founding six years ago.

Plotkin also said the fund played absolutely "no role" in trading platform Robinhood's decision to limit trading in GameStop stock, referring to how the stock trading platform was forced to briefly ban buy orders on several volatile 'meme stocks', including GameStop, in order to allow the broker to refinance its collateral account with its central counterparty.

During the hearing, Cato Institute's Schulp emphasised that "the temporary volatility in these stocks did not represent a systemic risk to market function".

"Stock prices move in and out of alignment all the time and the market is no stranger to bubbles" and the market's mechanisms, Schulp added, including the "tool of short selling", generally work well to handle these circumstances.

Schulp said that the SEC's investigation into January's events has far more information at its disposal than the general public and may choose to introduce new legislation, but, Schulp told committee members, that "by no means should these events lead to more restrictions for retail investors".

As the hearing rolled on, fault lines in the House of Representatives were exposed as members grappled over who, if anyone, was to blame for the volatility.

Ed Perlmutter, of Colorado, zeroed-in on the inconsistency between Plotkin and Gill's views on whether the share price of GameStop was long or short after Gill told the representative that when he purchased the stock he believed that the price may eventually reach $25.

"Were you in a naked position?", Perlmutter subsequently asked Plotkin, to which the Melvin Capital founder replied that the system would not allow that sort of position.

Nydia Velazquez, a representative of New York, came down hard against the practice of short selling. "Too often, I have seen abuse [short selling] and it ends up hurting ordinary workers and families," she said. "I first saw it against the people of Puerto Rico, and now I am seeing it against GameStop."

In the same vein, Jim Himes, of Connecticut, likened hedge fund Citadel to a casino and accused Robinhood of making money from that casino. "As the house always wins, who loses?" In his view, it's the retail investors.

Himes said that although he supports the democratisation of finance he noted that on Wall Street retail investors are known as "dumb money" and he pressed an increasingly beleagured Tenev on whether, in the aggregate, users on the trading platform won or lost money as a result of shorting GameStop stock. Tenev was unable to answer.

California's Juan Vargas turned the screws on Tenev further, likening the platform to an anti-Robin Hood, stealing from the small retail investor and giving to the large investment fund.

Blaine Leutkemeyer, a representative of Missouri, said short interest in a stock of more than 100 per cent — 140 percent at its peak in GameStop — looks to an "outsider"like stock manipulation. "Don't you think there should be a limit on something like that?" he added.

Citadel's Griffin acknowledged the short interest in this instance was "exceptional" but advised against seeking a legal cap on the amount of times a share can be lent and short sold.

Georgia's Barry Loudermilk also spoke out against further regulations as a result of the GameStop saga.

"There seems to be a trend in Washington to never let a crisis go to waste," he mused, adding that there was no rush to introduce "big government" regulations.

Perhaps attempting to strike a balance, Lee Zeldin of New York felt the GameStop saga was a "perfect example" of how innovations in securities trading have brought increased access for retail investors, "for better or worse".

Making sense of round one

David Lewis, at financial services company FIS Global, spoke to SFT after the GameStop hearing and echoed Schulp's comments on how well the market infrastructure coped in these "extreme circumstances", noting that short squeezes, particularly ones as public as GameStop, are "relatively rare".

Regarding the perception of hedge funds as market bullies, Lewis says short selling is just one mechanism used by investors to make a profit on the falling price of an asset, but "when situations become as fractious as the GameStop episode fundamentals appear to be forgotten".

As the market price of a share is determined by the expectations of future income available to the holder, Lewis says, if every investor in the market was only ever allowed to take a positive position with regards to their expectations of future incomes, prices would rise and yields would fall.

"For every share sold at $X, there is, by definition, a buyer willing to buy that share at $X. Markets require balance and having some gain on unsustainably high asset prices does not provide that."

On whether short sellers should be required to report their positions under a resurrected regulation of Dodd-Frank, Lewis notes that short interest levels are already reported in the US, "so the practical requirement of this is already met".

"Adding names to those positions adds no value at all, unless it is an attempt at 'shaming' the holders of those positions, which is not a market serving objective at all."

Short interest provides "balance", Lewis explains, and identifies weak performing organisations, likening it to a "canary in a coal mine" which aids investors in identifying the best places to put their money.

Asked whether more transparency was needed in the US and to bring it more in line with the UK and the EU, Lewis suggests that although these two markets report short selling, there are "limits".

As the short position has to be greater than 0.5 per cent of the issued share capital of the company that is being shorted, a "great deal" of other positions remain unreported and "a potentially false sense of security is created", Lewis said.

Giving an extreme example, "it is certainly possible that there are 100 hedge funds, each with a short position of 0.4 per cent of the issued shares that would remain unreported". Therefore, any research and insight into that issuer is lost to the ordinary investor that might benefit from the red flags raised, Lewis said.

"Transparency is truly valuable, but when it is potentially badly out of focus, it can do more harm than good."

Also speaking after the hearing, Fran Garritt, director of securities lending and market risk at the Risk Management Association (RMA), tells SFT that none of the RMA's members experienced any settlement issues as a result of the GameStop short squeeze, "so yes, it appears the market structures worked".

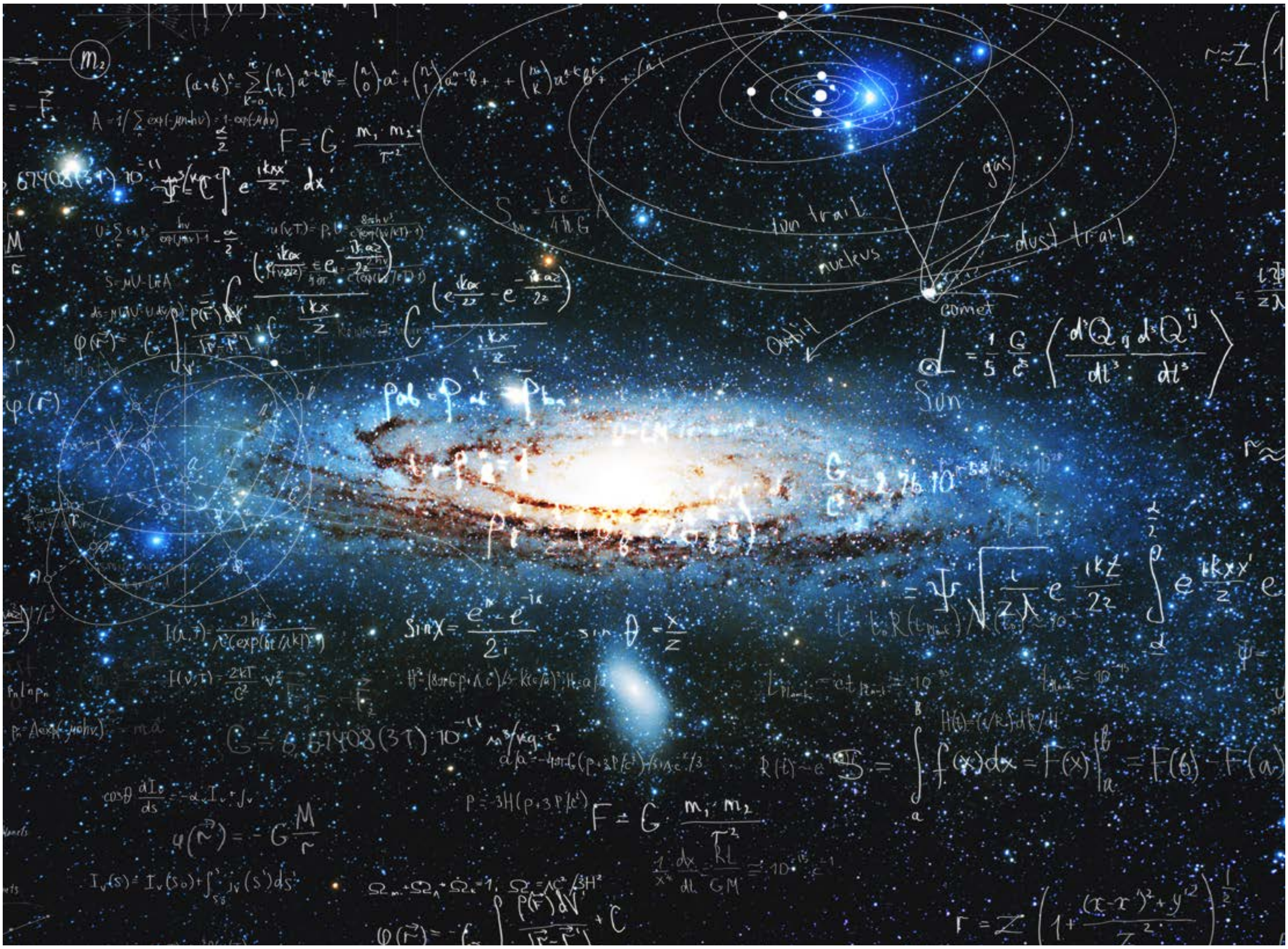
Moreover, despite speculation over a "broken market" and naked short selling, for crowded short positions like GME, "the metric short interest as a percentage of float can exceed 100 per cent", because no one is adding back the "new long position" created by the short sale.

In fact, Garritt notes, as Citadel's Griffin explained in his congressional testimony, a number of the buyers of the shares sold short were institutions.

Although what occurred in January was not a "new phenomenon", the size of this short squeeze put a "magnifying glass" on the event. "More than ever, stakeholders need to stress that if short selling was capped, it would remove liquidity from the market, and widen bid-ask spreads," Garrit tells SFT.

In terms of the exchange-traded fund (ETF) market, the ability of market-makers to provide liquidity via short selling helps ensure that prices are fair and reflective of the ETF's underlying securities, Garritt says. "Without the ability to short, this arbitrage mechanism would be broken, significantly impacting the ETF industry."

Garritt notes that the market manipulation surrounding GameStop stock "appeared to be more focused on long buyers that perpetuated the short squeeze" and that while it's not entirely clear who instigated the frenzy, the net losers were the short sellers and late rally buyers. "It is certainly hard to characterise someone as a bully when they are the ones that ultimately were the big losers from this episode," Garritt mused.



A pending shift in the balance of power?

FIS' David Lewis looks to the stars to show how the recent Perseverance rover landing on Mars should inspire a desire to remove friction and achieve greater data velocity

The laws of physics dictate the behaviour and reactions to almost everything we know and understand about the world around us. Recent achievements scored by the human race using their knowledge of physics include landing roving vehicles on Mars, a planet some 210 million kilometres or seven months away by spacecraft, and of course the production and distribution of hundreds of millions of doses of a vaccine for a virus few had heard of even 18 months ago. However, one of the defining statements that caveats many of the laws of physics confirms that the law applies "in the absence of friction".

Gravity, for example, will accelerate any matter towards the centre of the earth at 9.8 metres per second per second (m/s2); the speed of that object will increase by 9.8 metres per second, every second … if not for friction.

Eliminate friction, you get to go faster

The same applies for almost any situation, including financial markets. Blockchain is, effectively, the elimination of friction caused by the transmission of securities, replacing it with ledger entries instead of actual account movements. The electronification or dematerialisation of securities did the same for share and bond certificates many years ago, eliminating the need for physical delivery to effect settlement.

Cost is both a cause and a symptom of friction; costs create barriers to entry and unnecessary actions create costs. Therefore, it stands to reason that the removal of costs can also lower the barriers to entry. For example, the rise of budget airlines across the world brought some speculation that pricing power would shift from airports to airlines. Instead of having airlines compete for landing slots and pay ever increasing rates for space, the rise in airlines, passenger numbers and the diversion to smaller airfields might force the airport operators to have to pay airlines to bring passengers to them in order to defend the incomes from their retail and other services. As the barriers fell, more entrants joined the fray and the big airlines had to adapt to the lower cost scenarios. Could the same happen in financing?

The democratisation of finance

Transaction costs, like flight tickets, have fallen in the finance industry, right across the spectrum from fee-free investment funds and low or no-cost retail brokerages to the cloud delivery of lightweight securities finance systems that firms like FIS provide. This has led to the lowering of barriers to entry and, as some argue, the democratisation of finance. Nobody should be excluded from managing their own finances should they wish to. However, recent events that concerned shares in the high street retail outlet, GameStop (GME), can highlight issues or weaknesses in the system as it stands. Free trading and brokerage can indeed open the markets to many more participants and investors. Rational theory would suggest that the more participants, the better the marketplace in terms of efficiency, depth and price discovery. Rational theory, of course, relies on the balance of buyers and sellers, i.e. those willing to take a positive or a negative position. If the market is imbalanced, and there are more of one than the other, then the prices will respond until equilibrium is re-established.

What the GameStop frenzy has taught people, if they are open to that, is that a market can be pushed out of kilter by a disproportionately large single institutional player as easily as it can be by thousands acting together as one. Unfortunately, many of those individuals are also learning that "free" brokerage or trading is limited to the cost of entry to those markets but it does not apply to the consequences of the actions you take once inside. As the internet will attest, many fortunes were made over the few weeks that GameStop spent in the headlines, but just as many would have been ruined by the precipitous fall from the peak of around $347 to just under $45 at the time of writing.

Looking back a year or more, short interest in GameStop was at the maximum 100 percent utilisation as far back as March 2012, and repeatedly hitting that level many of the days since. Volumes moved as the price varied between $22 and $55, but rarely fell below 50 per cent. One year ago, the shares had fallen to under $4 apiece, highlighting the poor forward value investors had with regards to the future earnings of GameStop as a bricks-and-mortar provider in a socially distanced and internet-based world. Allegations of inappropriate actions are now flying of course, and changes may come as a result.

Adding friction harmed the market

Following the financial crisis of 2007 and the years that followed, the then chair of the US Securities and Exchange Commission (SEC), Christopher Cox, cited the temporary application of a short selling ban in the US as one of his biggest regrets and that he believed "on balance the commission would not do it again". They went further following more analysis and indicated that the "costs appear to outweigh the benefits" as spreads widened, and trading costs spiralled. It became clear to the SEC then that additional friction through increased costs harmed the market, indicating that the reverse would also be true. As a result, it is hoped by many that there will not be any irrational responses to these recent events that may harm the future of the financial markets, their efficiency and their increasing accessibility to all investors.

Short selling is a fundamental requirement of a balanced market and the economic allocation of limited capital, helping show that record high stock markets do not necessarily mean prosperity. Lower frictional costs allow more entrants, which in turn create better markets through increased depth and liquidity. As with space travel, the lack of friction between Earth and Mars undoubtedly helped the latest probes reach their destinations and land on the red planet. Hopefully, they are just as capable of surviving the volatile environment once they have arrived.

Upcoming Securities Finance Training

Securities Lending Fundamentals

Date: 13th Apr 2021
Location: Online
Provider: Consolo
This live on-demand training course is designed for new entrants to the industry who require an overview of the securities lending transaction and process involved in execution.

Non-Cash Collateral Fundamentals

Date: 14th Apr 2021
Location: Online
Provider: Consolo
This live on-line training course is delivered by an experienced market practitioner and designed for anyone who needs to understand non-cash collateral purpose, process and requirements.

Comings and goings at AIMA, Morgan Stanley and more

Morgan Stanley's head of bank resources management (BRM) Ciaran O'Flynn is vacating his role after five years as part of a planned "next phase" of the investment bank's revamp of its inner workings, SFT understands.

Tejash Patel will take over as head of BRM, reporting to Charles Smith, head of institutional securities business development, and John Ryan with respect to BRM's firm funding and collateral optimisation activities.

Patel will assume these responsibilities alongside his current role as co-head of delta one structured products, which he has held as part of a nearly 14 year tenure at Morgan Stanley. He gained his managing director status as part of the class of 2012.

O'Flynn will remain in BRM over the next several months during which he will serve as a 'senior resource' and continue to focus on the LIBOR transition in Europe, according to a memo from Smith to staff members seen by SFT.

Based in London, O'Flynn has spent the past half-decade reforming the BRM business with the changing demands and developing the next generation of BRM leadership.

SFT understands he is in discussions on assuming a new leadership role within the bank.

"Under Ciaran's leadership, we have made significant progress in evolving with changing business needs and in building a closer alignment with the rest of sales and trading and treasury," Smith writes. "I believe the change in reporting structure will further this alignment while continuing to create exciting growth opportunities for the BRM team."

The Alternative Investment Management Association (AIMA) has appointed Texas Alternative Investments Association (TAIA) CEO Sarah Riley as its new US director.

Riley, who is based in Austin, will continue to serve as a TAIA board member.

Riley brings nearly a decade of experience in both non-profit and financial services industries and has been a strategic advisor to non-profit organisations in both the UK and US, including serving as associate director of development for HTB Group in London for nearly five years until 2015.

Jack Inglis, CEO of AIMA, says: "Sarah's appointment and AIMA's collaboration with TAIA marks an important milestone for the continued growth of AIMA. We have the utmost respect for the important work of regional associations and look forward to further collaboration for the benefit of all market participants."

Thomas Trujillo, chair of the TAIA board of directors and audit partner with KPMG, adds: "I am delighted that Sarah will continue serving TAIA as a member of the board of directors.

"She will continue her leadership of local programs and key priorities for our Texas members. We look forward to working with AIMA globally to highlight Texas' important role as a center of investment excellence and innovation."

IS Prime, part of ISAM Capital Markets, an alternative investment manager specialising in quantitative investing, has expanded its institutional sales team with the appointments of Jodie Barrett and Daniel Lewis.

As a prime of prime, IS Prime provides aggregated pricing sourced from tier-one institutions, settled through the group's bank prime brokers. ISAM Capital Markets also includes IS Prime Hong Kong and risk management specialist, IS Risk Analytics.

Barrett joins from technology specialist Pirum where she was a business support specialist for just under a year. Prior to that she was client service associate at MarketAxess for a year.

Lewis joins the team from ATFX where he was a relationship manager specialising in spread betting.

Based in London, Barrett and Lewis will report to Paul Jackson, sales director. Jackson says IS Prime has invested in growing the sales team in order to facilitate the increased demand for its services and to maximise opportunities for further growth.

"Over the last financial year, as reported when we released our results, IS Prime virtually doubled its turnover in Europe and saw major growth in Asia and the Middle East. Since then, we have continued to expand across all regions," he says.