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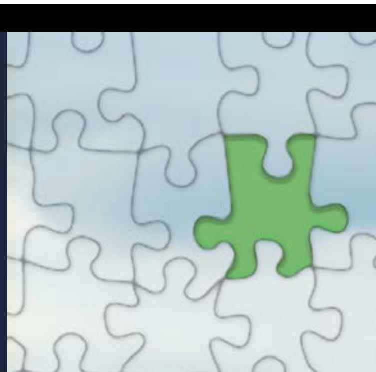


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Deadline looms to claim LACERA lending mandate

The deadline for agent lenders and custodians to manage the lending programme of America's biggest county retirement system is weeks away.

The Los Angeles County Employees Retirement Association (LACERA) is encouraging new suiters to apply for the chance to manage its securities lending programme ahead of predictions that its lendable asset pool is set to more than double.

The fund will begin reviewing applications in September with the semi-finalists to be announced in October. The mandate winner(s) will be chosen by February 2020.

LACERA, which has operated a securities lending programme for more than 20 years, instigated a 'request for proposal' to custodians and lending agents for its entire portfolio in June to review its overall programme design and compare its current service providers with the competition.

In the minutes from its July meeting, the fund's board noted that "such a review is timely because the current lendable asset size could potentially double as LACERA's global equity portfolio moves from commingled fund structures to separately managed accounts custodied at State Street".

LACERA's total lendable base was approximately $9.3 billion, as of April, but it is anticipated to balloon by approximately $14.5 billion once global equity-indexed assets transition from commingled funds to separate accounts.

By asset category, the lending pool is made up of domestic equity ($3.2 billion), corporate bonds ($3.6 billion), international equities ($1.2 billion), US treasuries ($1.1 billion) and US agency securities ($200 million).

LACERA's securities lending programme is managed by State Street Bank and Trust, which acts as a custodian, while Goldman Sachs Agency Lending (GSLA) is the current lending agent. Both are able to re-bid for the mandate.

State Street Bank and Trust lends LACERA's non-US equities, US treasury and US agency securities. GSLA lends LACERA's US equities and corporate bonds. Both offer indemnifications to mitigate borrower defaults.

Continued on page 6

Inside SLT

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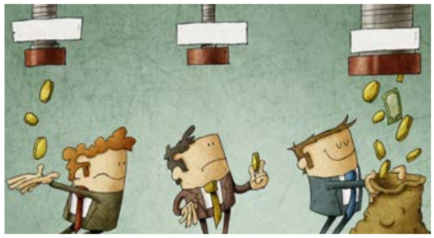

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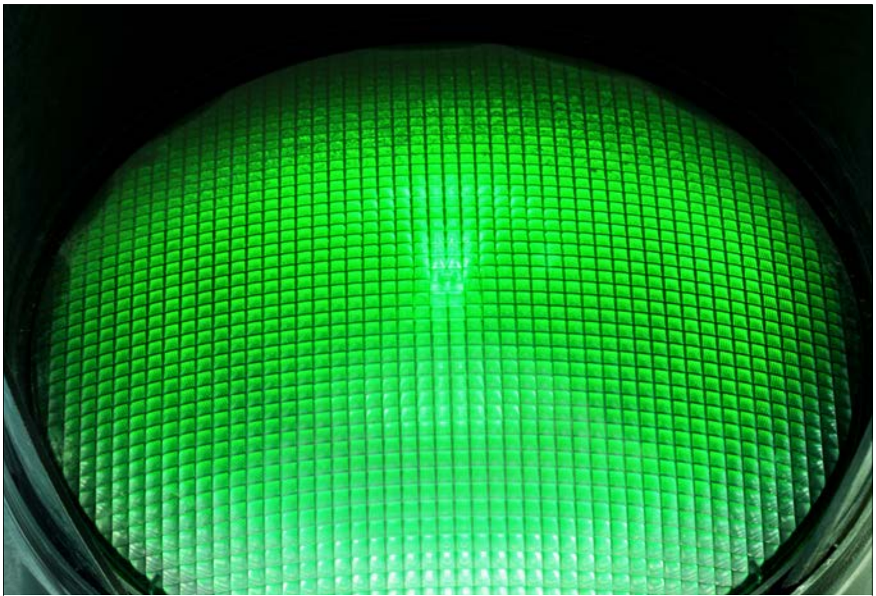

Euroclear Finland gets CSDR trading green light

Euroclear Finland can now operate under the EU's Central Securities Depositories Regulation (CSDR) following authorisation from the Finnish Ministry of Finance.

Since coming into force in September 2014, CSDR aims to create a consistent regulatory framework and a level playing field for CSDs and support competition between depositories in Europe.

As of Q1 2019, CSDs and their participants had to comply with CSDR requirements upon receipt of their authorisation.

In order to obtain the licence, Euroclear Finland and other CSDs had to submit applications for authorisation to their national competent authorities by September 2017 and then extensively review their entire CSD Core system.

Euroclear Finland clients will now benefit from streamlined processes and gain easy access to the Target2-Securities platform.

A spokesperson for Euroclear Finland said: "We have consolidated the different legacy systems into one single CSD system, which is standards-based and is a project we have done together with market participants."

Deadline looms to claim LACERA lending mandate

Collateralisation is set on non-US loans at 105 percent and on US loans at 102 percent of the market value of securities on loan.

State Street Global Advisors invests the collateral received from both lending programmes in short-term highly liquid instruments.

LACERA's 2018 financial report outlined that its gross securities lending income for the year was $18.8 million, compared to $11.6 million in 2017.

However, its income, net of expenses, was $5.7 million in 2018, down from $6.4 million the year before.

The revenue difference was mostly caused by a significant uptick in borrower rebates from 2017 to 2018, which increased from $3.7 million to $11.8 million.

In order to be eligible for the mandate, the fund's board has stated that securities lending providers must meet a series of requirements.

This includes having a minimum 15-year track record performing the duties of a custodial lending agent, third-party lending agent, or principal borrower, serving public pension plan clients as of 30 June 2019.

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Bond lending drop-off drives H1 revenue shortfall, says ISLA

The International Securities Lending Association's (ISLA's) latest report has confirmed fears of a market-wide revenue drop-off in the first half of the year.

The report highlighted the need for market participants to adapt to the new regulatory frameworks and new demands of counterparties in order to course-correct as more changes are yet to come.

IHS Markit data found that, while global on-loan volumes have stayed "broadly unchanged" at €2.2 trillion since its last report in March, revenues from securities lending overall fell 15 percent in the first six months of the year compared with the same period in 2018.

By asset class, ISLA noted that government bond lending saw the largest drop-off of 24 percent in reported fees, compared to the same period in 2018.

The report stated that the decline was caused by the growth in available supply combined with the slowdown in demand for high-quality liquid assets (HQLA) in Europe.

In a statement on drivers behind the disappointing revenue results, ISLA noted that there was a fall-off in demand to borrow HQLA just as the European Central Bank's quantitative easing stimulus programme came to an end.

Commenting on the results, ISLA explained that the spike in Europe into the half-year end "may have been owing to borrowers who were long equity securities and were looking to effectively swap them for government bonds via the securities lending markets for balance sheet and reportable risk-weighted asset purposes".

The results are in stark contrast to last year, when the industry saw the highest annual revenue for securities lending since the financial crisis in 2008.

Industry experts suggested that this was driven primarily by emerging markets, global credit uncertainty, and central bank tightening.

Meanwhile, government bonds being made available for lending did appear to show new supply coming into the market, increasing by 13 percent to €2.8 trillion, ISLA revealed.

"As insurers take advantage of all-time record low yields, these securities are finding their way into lending programmes as holders look to maximise returns," ISLA said.

"Government bond lending represented circa 43 percent of all securities on-loan globally, highlighting its continued importance to overall secondary-market liquidity."

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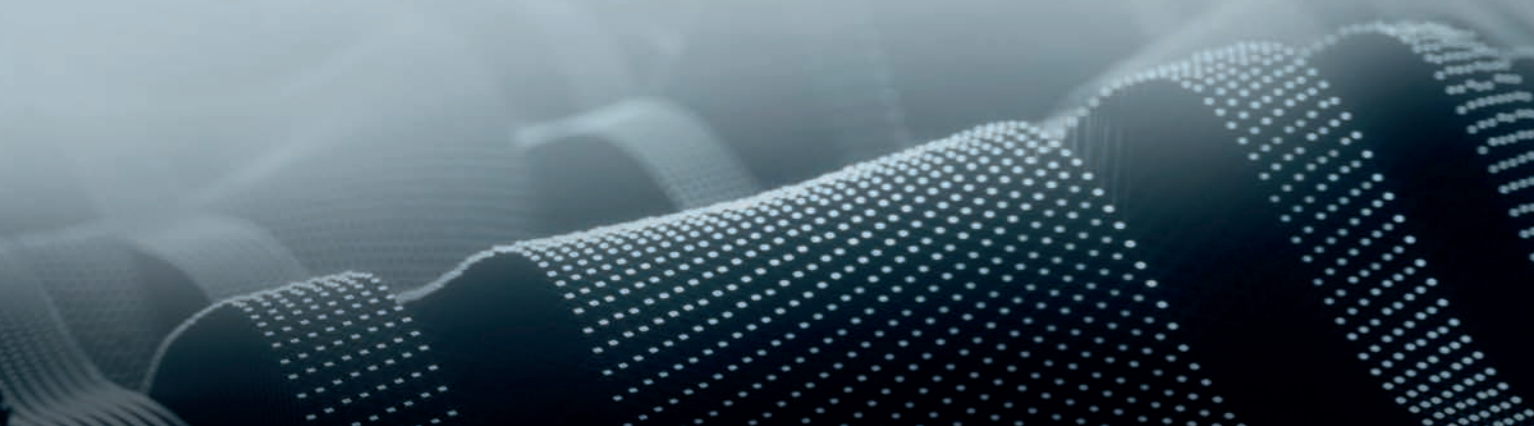

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Lyft shorters pick up earnings

Many shorters of Lyft, a ride-sharing app that went public in March, have banked significant profits in recent weeks, following the announcement that a pre-IPO share lockup would expire a month early, according to US data provider S3 Partners.

In a research note on the recent market movements, Ihor Dusaniwsky, managing director predictive analytics for S3 Partners, explained that, on 7 August, Lyft surprised the market by announcing that its pre-IPO lockup for 258 million shares would expire on 19 August, instead of a month later.

"The market braced for a wave of long selling that would negatively affect Lyft's stock price. In actuality, the effect was minimal, with Lyft's stock price only falling by 2.40 percent, although the stock is down 12.76 percent since the 7 August announcement date," explained Dusaniwsky.

In the weeks that followed the revised expiry dated announcement, Lyft shares shorted has decreased by 37.42 percent, representing 8.94 million shares and has further fallen by 43.97 percent (11.73 million shares) since the actual lockup expired.

Of this, Dusaniwsky said: "Even though there were expectations of price weakness after the announcement, short sellers were covering their open positions in size both ahead and after the lockup expiry."

Overall, shorts are up 26.48 percent ($311.5 million) in year-to-date, mark-to-market profits with almost 60 percent of those profits ($182.7 million), occurring after the lockup expiry announcement.

Recent short interest for Lyft stands at $765 million, with 14.95 million shares being shorted, representing 7.66 percent of its float and a 0.30 percent stock borrow fee.

Dusaniwsky said that, even with the buying pressure of over 11 million shares of short covering occurring over the past week, Lyft's stock price continued to slide under the onslaught of massive long selling.

He noted: "It looks that short covering has now leveled off, and if long selling continues to hit the tape, we should see continued Lyft price weakness as there will be no short-side based offsetting buying pressure on the stock."

Dusaniwsky concluded: "With just over 60 million in total trading volume since the lockup expiry and nearly 258 million of liberated shares on the street there may be sizable insider holders still waiting to offload their still profitable positions. If they are not proficient in

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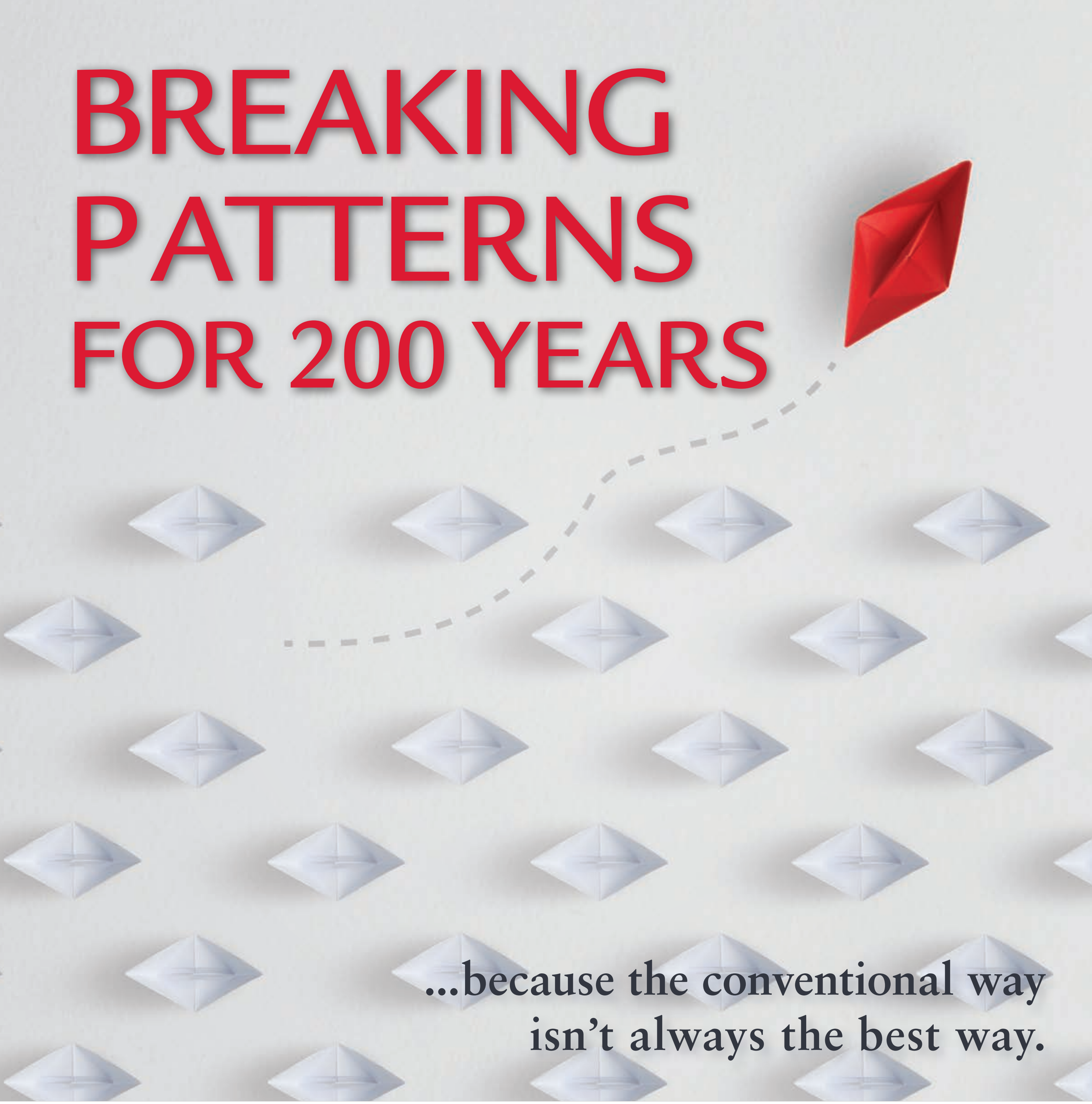

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their trading activity, we may see this confluent selling pressure push down Lyft's share price past its year-to-date lows."

Lyft is currently the third most shorted stock in the domestic trucking sector and has had the largest drop in short interest over the last month in the sector, according to S3.

Rival ride-sharing app, Uber, is the current shorter's favourite with short interest worth $1.3 billion, as of 27 August.

State Street sees record-breaking repo investment volumes

State Street has sponsored a record $140 billion in repo investment volumes as a result of its partnership with the Fixed Income Clearing Corporation (FICC).

State Street partnered with FICC in 2005 to launch its sponsoring/sponsored member repo programme whereby a bank netting member of the clearing house can sponsor eligible US mutual funds to clear their repos with FICC.

The sponsorship model via a central counterparty permits banks and broker dealers to offer clients more repo investing and financing opportunities in an efficient manner, according to Gino Timperio, head of funding and collateral transformation at State Street.

Timperio explained that this efficiency allows sponsors to intermediate credit limitations of peer-to-peer activity, while helping to realise the benefits of peers' supply with demand. It also allows sponsors to serve more clients and to do so throughout the calendar cycle, including historically volatile month and quarter ends.

Malaysia mulls repo reform

The Central Bank of Malaysia has proposed revisions to the country's rules framework for repos and reverse repos.

Bank Negara Malaysia published an exposure draft on 20 August and is inviting feedback on the new requirements and expectations for market participants engaged in repos involving ringgit or non-ringgit repo and reverse repos.

The bank said the changes would also affect any outright sale or purchase of repo securities.

The proposed policy revisions include an extension of the maximum tenor of a repo to five years, up from the current limit of 365 days.

The bank is also considering expanding the list of eligible securities to accord flexibility to market participants and the repo market.

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World's first blockchain lending platform launches

Lendingblock, the first blockchain securities lending exchange, went live on 3 September.

It is fully-automated end-to-end and will offer loans for several cryptocurrencies, including Bitcoin, Etherium, Paxos Standard Token and Tether, which can be loaned on one-, seven-, 14- or 30-day terms.

More marketplaces are expected to follow.

As part of its unique offering, the platform will offer anonymised data on the borrowing and lending activities of other users, such as the rates others are matching on, across all assets and terms.

According to Kelly Pettersen, Lendingblock's chief marketing officer and head of business development, the exchange is seeking to do for the burgeoning crypto world of tomorrow what securities lending does for traditional markets today.

Despite blockchain-based innovations often being billed as 'market disruptors', Pettersen believes this platform will be more complementary than competitive with the traditional securities lending market.

"Our team has come together to build out what we're calling a scalable, commoditised borrowing and lending marketplace to allow institutional-type players in the crypto economy to be able to access digital assets in a new way," she explained. "As my CEO likes to put it: there's not many times in your life you get an opportunity to re-invent something and make it your own."

The story so far

Lendingblock was founded in 2017 by its CEO Steve Swain, a former partner at Deloitte, and Linda Wang, who also brings experience from Deloitte as a technical consultant, as well as being the CEO and co-founder of LENDR, a digital mortgage adviser.

The Gibraltar-based company has spent the past 18 months on-boarding institutional clients, including hedge funds that are moving into crypto and other crypto-focused funds, along with exchanges that are sitting on digital assets that could be earning additional revenue from lending.

New digital custodians are also emerging and seeking to move from simply being a wallet for digital assets to offering services similar to traditional securities lending or hypothecation that Lendingblock is targeting as users of its trading platform.

According to Pettersen, Lendingblock has a comprehensive onboarding process that includes a new legal contract that has been customised for the digital economy and is based on the Global Master Securities Lending Agreement, known as a Global Digital Assets Lending Agreement.

Following several announcements on technology-milestone achievements and new partnerships with the likes of Caspian and Chainalysis, among others, over the past year, Lendingblock secured its full licence as a distributed ledger technology provider from the Gibraltar Financial Services Commission earlier this month.

With its first licence inked, Pettersen said that Lendingblock is now focused on gaining licences in the US and the UK, where the majority of its current clients are based.

Day one and beyond

Lendingblock has on-boarded 30 clients ahead of its launch, including what Pettersen describes as "some of the bigger over-the-counter players in the crypto market". Pettersen says that half of these are in the US, with another 30 percent in Asia and the remainder in Europe.

Beyond its initial launch, Pettersen outlined that users can expect new assets to be added, including the ability to execute rolling loans and new partnerships with custodians to better service their clients.

Into the weeds

The Lendingblock business model will see it take a basis point fee from the borrower and lending for origination. At the same time, Pettersen explains that as these loans are considered peer-to-peer, Lendingblock will sit in the middle of each loan to act as a trustee and take responsibility for managing any collateral, for which there will also be a percentage-based fee.

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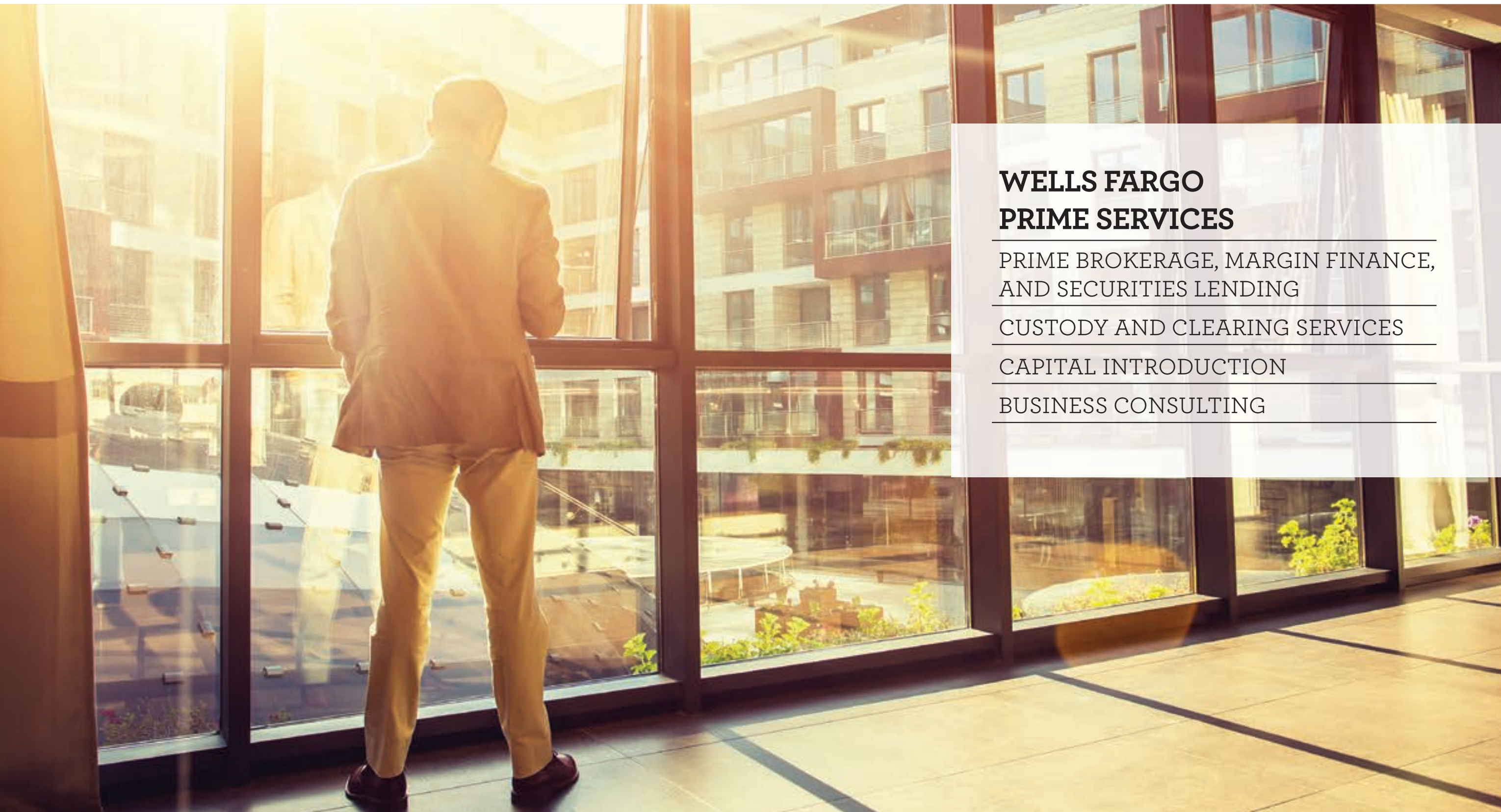

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Responses to ESMA's SFTR Consultation

The quality and breadth of the submissions that the European Securities and Markets Authority (ESMA) released following its market consultation on the Securities Financing Transactions Regulation (SFTR) varied significantly. Some responses replied to small subset of questions that concerned their membership, others were comprehensive. For those with limited time, I would recommend the International Capital Markets Association's (ICMA's) submission due to its thoroughness and originality.

While the submissions and topics are numerous, a summary of some of the salient points follows.

Scope: German investment fund management companies (Kapitalverwaltungsgesellschaft) act on the behalf of investment funds (Sondervermögen), which are established in accordance with contract law. It remains unclear whether such companies are in scope and the BVI, a German asset management industry organisation, is requesting regulatory alignment with the European Market Infrastructure Regulation (EMIR) by bringing such companies into scope.

Regarding what is considered 'concluded' by a branch, ICMA highlights the inconsistency of ESMA's approach with that of EMIR.

Margin lending: The Association for Financial Markets in Europe (AFME) asks if a 'COLU' update is required for a margin lending transaction even if there is no margin loan on a particular day. ESMA's consultation paper (CP) proposes: "When the margin loan is at zero, i.e. no credit is being extended, then the [loan cannot] be reported with action type 'ETRM', but rather with action type 'MODI'. It might, therefore, seem reasonable that no COLU update would be required in such a scenario.

Clearing: In its response, the BVI encourages ESMA "to evaluate if it should be sufficient to report only the cleared transaction at least if the clearing takes place promptly after the initial transaction". Such a facility already exists where trades are conducted on a traded venue and subsequently cleared the same day, only the cleared transactions need to be reported.

Perhaps the BVI wish to additionally include over-the-counter (OTC) bilateral trades, thereby removing the transaction on a trading venue limb.

Separately, ICMA states the view that, in reality, position level reporting for centrally cleared repos is unfeasible due to precise alignment of all contract details being unrealistic, thereby rendering them infungible. If it is used, then it is unclear why a 'POSC' report is restricted to an error or correction action. Most clearing houses will report on a transaction level.

Separate reports per currency: ICMA questions the wisdom of splitting a transaction into multiple reports for the sole reason that it involves multiple currencies.

FX: The BVI requested a small 0.0005 percent tolerance be introduced in the reconciliation of loan market value to allow for FX conversions. Other firms have requested realistic tolerances to avoid breaks.

Partial or full reporting of modifications: The Investment Association (IA), the Association of the Luxembourg Fund Industry and ICMA all suggest full reporting would be less burdensome than a delta. This will likely be adopted by ESMA.

Trading Venue: The IA notes the divergence in approach in reporting a trading venue, stating: "We believe it would be helpful to add a note to table 54 that the approach to reporting trades that are concluded OTC but under the rules of a venue differs from that in Markets in Financial Instruments Regulation transaction reporting, where the venue would be identified".

General vs Specific Collateral: Confusion persists as to when general collateral and specific collateral is to be reported.

Non-centrally counterparty (non-CCP) variation margin: While COLU is the action type to be used, it remains unclear how to differentiate and report this margin and handle scenarios of net exposure versus individually margined and ensuring this is correctly distinguished from underlying collateral flows.

Collateral baskets: Confusion remains on how to populate field 2.96 (collateral basket identifier). The IA suggests: "There are four situations that determine the population of field 2.96: (a) ISIN where a collateral basket is used, which has an ISIN; (b) NTAV where a collateral basket is used that does not have an ISIN; (c) NTAV where a collateral basket is used, for which the ISIN is not known at the time of reporting (to be updated when the information becomes available); (d) [blank] collateral basket not used".

As numerous respondents have noted, ESMA only intends to release its guidance in Q4. Given the complexity of the reporting regime and that large swathes of fundamental reporting questions remain in a state of flux, the industry is left with less than six months to build to fixed standards. This situation is wholly unsatisfactory.

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Head of financial law
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Let’s talk tax

The RMA is seeking new guidance from the US government to end a long-running conflict between new regulation and historic tax rules that is crippling market liquidity for fixed-term loans

Drew Nicol reports

Against the backdrop of growing borrower demand for longer-term loans, driven by regulatory incentives, the Risk Management Association (RMA) has waded into the murky waters of US tax law to resolve a four-decade-long dispute on whether fixed-term loans should be exempt from capital gains tax.

The RMA's tax committee has sent a letter to the US Department of the Treasury and the Internal Revenue Service to highlight its concerns that a lack of clear and up-to-date guidance on Section 1058 of the Internal Revenue Code is causing friction with the adoption of post-crisis regulatory requirements.

In the letter, the RMA notes that "the current uncertainty with respect to the Section 1058 eligibility of fixed-term securities loans generally results in many securities lenders refraining from such lending activity, thereby diminishing liquidity in a segment of the capital markets encouraged by the financial regulations discussed above".

It is this drain on market liquidity that the RMA is ideally seeking to resolve as it patently runs against the aims of US and international regulators to create a more stable market environment. But let's start at the beginning.

How did we get here?

Since the 2008 financial crisis, regulators have been dissecting the victims of the crash in order to discover the causes of death and are now applying those lessons to create new regulatory frameworks that mitigate those risks. For the securities lending market this has largely come in the form of a slew of reforms designed to encourage a move towards term lending and improved balance sheet managment.

In this vein, the Basel Committee on Banking Supervision drafted the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR) as part of a comprehensive package of regulatory requirements known as Basel III.

The LCR is a form of stress test for banks that aims to ensure that they are always holding enough high-quality liquid assets (HQLA) to meet their financial obligations for the next 30 days.

Meanwhile, the NSFR was scheduled to be effective on 1 January 2018 but is currently pending finalisation. It aims to promote market resilience over a longer time horizon by creating incentives for banks to fund their activities with more stable sources of funding on an ongoing basis.

George Rapalje, vice president and securities finance tax manager at State Street and chair of the RMA's tax committee, explains: "There has been a clear regulatory push coming out of the 2008 financial crisis to change the way financial institutions (covered banks) fund their operations."

"It was identified that much of what caused the crash was an extreme reliance on short-term funding coupled with the fact that that funding was used to finance illiquid longer-term investments."

Since the LCR was fully implemented in 2015, the RMA has observed that it is driving borrowers into longer-term securities lending transactions, meaning terms that go from 30 days to up to a year. In isolation this trend is entirely within the market's ability to adapt to, however, in the spider's web of rules and red tape that now exists, nothing new can be overlaid without interacting and reacting with the existing framework—and herein lies the problem.

The problem

In the US, an ambition to move the market away from short-term funding is in stark contrast with the current interpretation of the tax rules under Section 1058, which does not include fixed-term lending. Section 1058 was originally enacted in 1978 to give US taxable lenders confidence that when they engaged in securities lending transactions they would not generate capital gains income.

According to Rapalje, the issue centres on a lack of recent guidance on Section 1058, which has meant that for decades the market has been making do with an out-dated understanding of its application for term trades.

"The US Treasury really hasn't issued much guidance under Section 1058. It proposed some regulations back in the early 1980s that were never finalised," says Rapalje. "That is about the most formal guidance it has ever issued on the subject, which is astonishing given the nominal value of securities lending transactions that are conducted every day in the US market."

The key feature of these proposals outlined that, in order to be Section 1058 compliant for securities lending transactions, the lender must always have the right to recall with no more than five business days notice.

Rapalje notes that, back in the early 1980s, that was a settlement cycle, so the general interpretation today is that the lender must always have the right to recall, on-demand, and get all the securities returned in time to settle a sale.

However, although the proposed laws were never pursued, the lack of other formal guidance has meant that most lenders must rely on these draft regulations as their only guidance.

As a result, the commonly accepted reading of the law largely part puts fixed-term lending outside of the scope of Section 1058.

In its letter to the US Treasury, the RMA also noted that case law in intervening years has added further uncertainty around the application of the proposed regulations and the so-called five day rule to securities lending.

This reading of the tax code means that market participants are now caught between choosing to be eligible for tax on their term trades or taking the hit on their balance sheet to comply with LCR and NSFR for their short loans.

The situation is problematic for many, but especially so for some of the market's biggest lenders, namely Sovereign Wealth Funds (SWFs), that rely on this interpretation to inform their tax positions in other areas.

The law of unintended consequences

On top of the problems with existing and incoming regulations clashing with Section 1058, there are also other sections of the tax code that indirectly reference Section 1058. The most significant being the one that grants SWFs tax immunity in the US.

Broadly speaking, SWFs are exempt from tax in the US, which is an extension of the sovereign immunity principle that exists in international law. However, this immunity is revoked if the fund conducts commercial activities, such as starting a business in the US to enjoy tax-free profit by virtue of being owned by a SWF. The relationship between this and securities lending is that the US Treasury's regulations issued under the sovereign immunity principles specifically reference income from Section 1058 transactions as being exempt.

Rapalje explains: "This raises the question of, if you conduct a securities lending transaction that may not be Section 1058 compliant, such as a term trade, are you violating those sovereign immunity principles?"

The ambiguity around this issue, coupled with the heavy penalty that falling foul of the rules, means that many SWFs stay well clear of term trades to avoid the danger altogether. For agent lenders this means that a large portion of their lendable assets is closed off from being used to meet the growing demand for longer-term trades that new regulations, such as the LCR, have created.

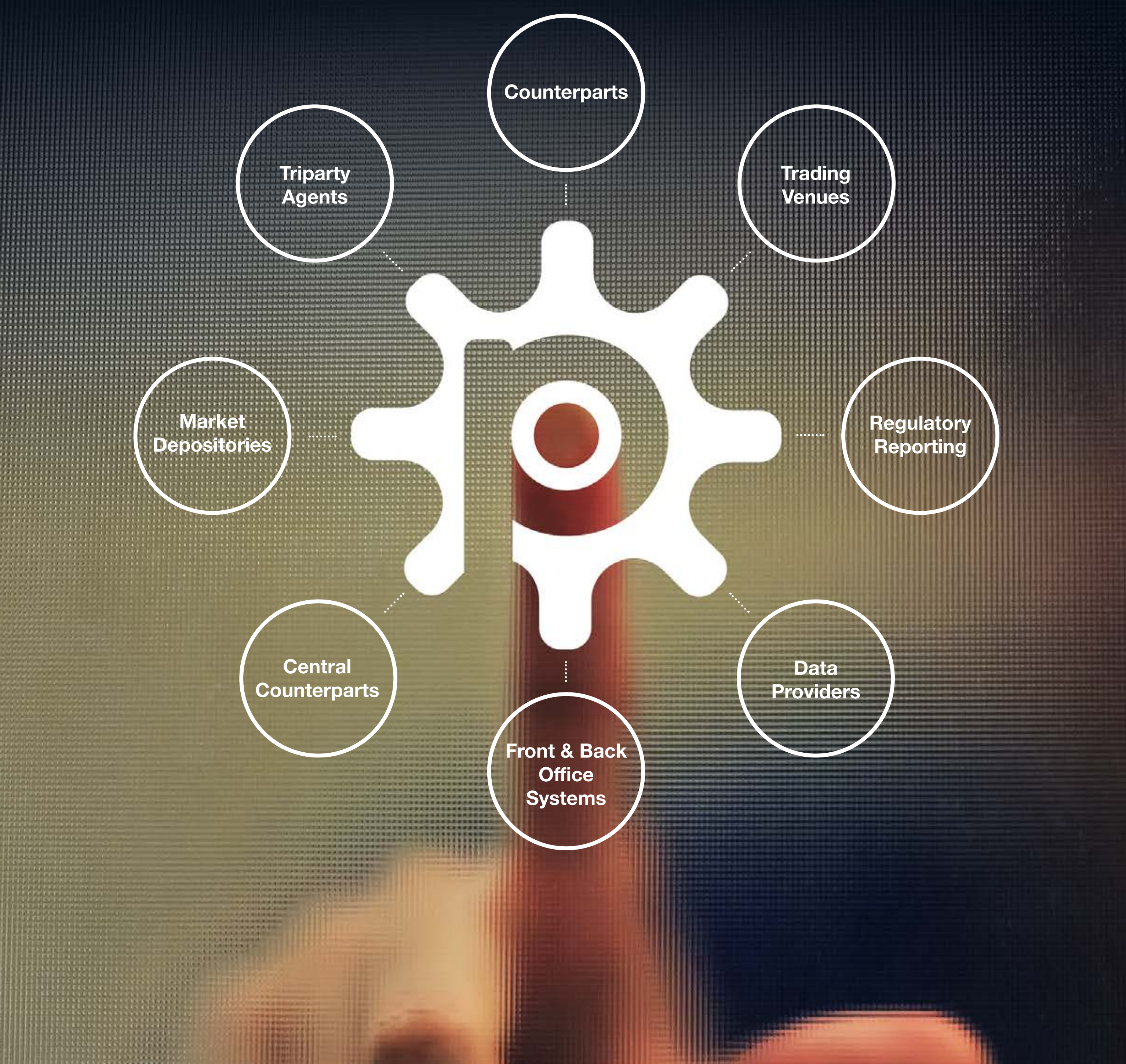
"This [duality] creates a pretty strong tension between what certain financial regulators are pushing and tax law that simply hasn't kept up. To an extent, there is certainly an effect on the liquidity in the space of the market that has been pushed by the Basel Committee and the Federal Reserve after 2008," Rapalje concludes.

A solution to this thorny issue is far from obvious and may still be a long way off, but the RMA hopes to open a dialogue with the powers that could lead to some form of resolution for the market and end this long-running deadlock between new and old once and for all. **SLT**

Section 1058 cheat sheet

Section 1058 of the Internal Revenue Code was enacted by Congress in 1978. It provides that no gain or loss is recognised by the transferor of securities when such securities are transferred to a borrower under a contractual agreement that satisfies the following requirements:

(1) The agreement provides for the return of securities identical to the securities transferred;
(2) The agreement requires payments to be made to the transferor of amounts equivalent to all interest, dividends and other distributions which the owner of the securities is entitled to receive during the period where the loan is outstanding;
(3) The agreement does not reduce the risk or loss or opportunity for gain of the transferor with respect to the transferred securities;
(4) The agreement must meet 'such other requirements as the Secretary may by regulation prescribe'.



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The changing dynamics of outsourced trading services

Ben Challice of J.P. Morgan discusses the advantages of outsourcing services

As the industry continues to respond to changing market conditions and the implementation of additional regulation—such as the final phases of uncleared margin rules (UMR), the Securities Financing Transactions Regulation (SFTR) and the Central Securities Depositories Regulation (CSDR)—we are seeing record interest in outsourced services such as securities financing and collateral management. The ability to look across standalone services, or integrate them operationally, is a major topic with both the buy and sell side.

What does the term 'trading services' mean as it relates to securities services, collateral management and agency lending?

Trading services businesses, in the context of securities services, are those with a transactional nature or that have a trading bias to them, but where the provider acts as agent for the client. While they complement the activities that are post-trade in nature—such as custody or fund services—they can also be undertaken independently.

Securities lending and collateral management have been outsourced to agents for many years, but now firms are increasingly looking to agents for help in managing other activities such as repo/reverse repo, middle-office functions and even cash trade execution. A heavier regulatory burden on the buy-side, narrowing margins and rapid technological developments are fueling this expansion.

Similarly, in securities financing, regulatory and market changes in the last decade have been the primary drivers of this evolution. With heightened demands for collateral and the need to mobilise inventory across borders and entities to make sure that it's in the right place or of the right type, securities financing and collateral management are increasingly two sides of the same coin. As UMR nears the final phases of implementation, the need to deploy an integrated approach to financing and an end-to-end approach to managing collateral will be critical for clients needing to meet their new margin requirements.

How does this relate to securities financing?

First, securities financing is experiencing extraordinary interest, mostly driven by industry evolution in response to regulation. However, the experience of market participants can be quite different based on where they sit.

The buy side is coping with well-publicised pressure on fees, especially in the passive/exchange-traded funds space. With the search for yield high on everyone's agenda, the alpha that lending securities can provide can no longer be ignored—even by those who have traditionally been anti-short selling. Furthermore, the need to think about and mobilise collateral is ever more pertinent in the face of uncleared margin rules. Securities financing transactions provide an important mechanism to achieve readiness and maintain compliance.

Meanwhile, sell-side activity is continuing to demonstrate shifts in demand and banks and broker dealers are becoming ever more sophisticated in managing their different, variable constraints, such as balance sheet, liquidity and capital. While these manifest themselves in changing types and sizes of demand, these firms are simultaneously focused intently on other parameters such as counterparty type, collateral eligibility and tenure, etc. As a result, sell-side firms are demanding an ever-increasing range of solutions, such as collateral pledge and central clearing, in order to meet their evolving needs.

Second, the conundrum of expanding supply versus more sophisticated, targeted demand, whilst the markets lack conviction and there is a dearth of corporate activity, means that spreads, and thus lending revenues, are compressed.

Third, technology and data continue to change the way business gets done. While often beneficial, this could also be disruptive—and this is just as true in securities financing as it is in our daily lives. Specifically, the need for better automation and improved data analytics are in great demand across the board. These services will become even more important as the industry grapples with the transaction reporting that comes with SFTR for the first time. Although that starts in Europe, it's evident that the effects will not only be felt globally but will also be compounded once the increased burden of settlement efficiency through CSDR ultimately begins.

How are these trends affecting client behaviour?

The increased complexity that market participants are dealing with across the board has meant that the role played by securities lending has moved upstream in clients' investment and collateral decision-making process and framework. The old approach of an operational 'turn my programme on and let it run' approach to lending is waning. Now client dialogue is focused on how securities financing and its associated data can be incorporated into pre-trade decision making, and agent lenders are constantly challenged to service an ever-expanding list of client requirements.

More firms are also evaluating their outsourcing options and thinking through those decisions much earlier. They are focused on whether and how a service provider can provide front-to-back, pre- and post-trade turnkey solutions, rather than carry the immense operational burdens associated with building and managing a sophisticated financing function in-house. Moreover, with additional regulations such as SFTR, CSDR and UMR coming into force, the demand for outsourced and unified agent lending and collateral management solutions is likely to increase.

As the interplay between financing and collateral becomes more complex, how is that relationship changing?

Over recent years, banks and broker dealers have become much more efficient in managing their inventory, or collateral, and thus their financing needs, in the face of the various financial resource constraints. They do this by constantly evaluating the sources and uses of their pools of long and short inventory and using SFTs or derivatives to ensure the inventory is being utilised in the most efficient manner, i.e. by moving it around or transforming it.

The buy-side is now having to think about this, perhaps for the first time, as their activities fall in-scope for phases four, five, and now six, of the uncleared margin rules. They will need to post segregated initial margin, likely in the form of securities (as opposed to their variation margin which is mostly in the form of cash). Therefore, the traditional premise of a buy and hold asset manager — who lends securities but doesn't expect that process to interfere with his investment process — now has an additional driver of demand for that same pool of securities if they intend to use them to meet their margin obligations. In that case, the asset manager, or their agent, needs to understand the dynamic between alpha generation from lending securities and the cheapest-to-deliver requirements for posting collateral. This dynamic is constantly evolving, so real-time data, analytics and a mobilisation mechanism are essential.

A simple example is one where a security posted as collateral becomes hard to borrow. In this instance one would clearly want to replace it as a collateral asset and lend it into the market for a fee. This becomes very difficult if there is not clear visibility into where your assets are at all times. Additionally, if you have different actors involved, such as an agent lender, agent collateral manager or an in-house repo trading desk, as well as multiple custodians, then further complexity arises. They could easily begin 'bumping' into one another by having different demands over the same pool of inventory; failing on a stock loan or repo is very bad, but failing on a margin call would be substantially worse.

The ideal solution for a buy-side firm would be to have the ability to view and manage the pool of assets holistically, like many banks and broker dealers do today, to determine the optimal use. If a firm doesn't have the appetite to manage this increasingly burdensome process in-house, whether that be from an expertise or cost point of view, then utilising an agent who has the appropriate product set across lending, financing and collateral should be its goal.

As an agent, how are you addressing these demands?

At J.P. Morgan, we've made significant investments in creating a fully flexible, custody-agnostic platform which allows us to handle a range of pre- and post-trade activities on behalf of our clients, helping them achieve their individual financing, collateral and middle-office objectives.

In addition, we are creating a collateral transport layer that offers for the most efficient use of asset allocation across lending and collateral, including a fully automated post-trade lifecycle. This gives institutions the flexibility they need to manage a variety of securities financing requirements, singly or in combination, based on their specific needs.

Mark Jones
Head of securities lending (EMEA)
Northern Trust

The securities finance industry today

Mark Jones, head of securities lending, EMEA, at Northern Trust reviews the major talking points of the securities finance industry in 2019

After a strong and successful 2018, this year has been more challenging for the securities lending market thus far. Political and economic uncertainty driven by Brexit and global trade tensions, among other factors, has had a major impact on broader capital markets, and the securities lending industry has not been immune to that.

At a high level, this uncertainty has contributed to a general lack of conviction across the market. Hedge fund flows are lower as long strategies are generally outperforming traditional hedge fund short strategies–and this has manifested as reduced demand, particularly in the equity space. While demand to borrow high-quality liquid assets remains robust, pressure continues to exist on spreads. This can be particularly the case when lending versus cash in US dollars, following declines in the US yield curve amid dovish central bank actions.

In addition, regulations continues to have an impact, specifically on the capacity of borrowers to generate demand for lenders. For now, this is the 'new normal' and as such our focus is on how we capture as much as possible of the more limited demand that exists in the marketplace.

There are a number of tools being employed across the industry to maximise the attractiveness of lendable assets and make the most of the resources borrowers have available to commit to loan balances. Many of these have been in play for the past 12-18 months and continue to develop. The adoption of pledged collateral structures in Europe is something we have had success with and we expect balances to continue to grow as more counterparties complete their implementation and legal work.

Capital-efficient lending, whereby borrowers seek to borrow from specific types of beneficial owners who present a more favorable capital treatment, has grown in prominence and we expect that it will remain important well into the future. Securities lending activity via central counterparties is increasing and has the potential to support increases in demand through more favorable capital treatment, much like what we have seen with the pledged collateral solution.

Perhaps less in the spotlight than some of the newer trade structures, efficiency and automation, from the front office through to the back office, remains hugely important to us. Northern Trust has invested heavily in integrating with platforms such as EquiLend's Next Generation Trading platform, which allows us to broadcast available positions to borrowers in a targeted fashion, making it easier for borrowers to identify and initiate transactions with little manual intervention. In an environment where the growth in quantitative-based trading strategies remains strong, being able to meet high-volume demand in an efficient manner puts us in a strong position to capture balance.

In summary, we can't control market forces, the macro-economic environment, or regulation, so our focus is very much on the things we can control. We are constantly looking to enhance our lending programme in ways that put us in the best position to capture existing and future demand.

What can we expect to see going forward?

There has been no shortage of comment and discussion on the impact of regulation on the industry, specifically the Securities Financing Transactions Regulation (SFTR) and more recently the Central Securities Depositories Regulation (CSDR). There are obvious effects of SFTR that the industry has largely addressed in respect of the technical challenges of creating, reconciling and delivering huge quantities of data. Vendors will play a key role in this process and have developed good solutions that address the majority of the industry's needs. We're now entering a phase of bilateral conversations with our borrowers to iron out challenges at a much more granular level, as well as being very engaged with the industry best practice work.

The result will hopefully be a standardisation of approaches to lifecycle events across the bulk of the market, but indications are that there are still areas that will prove challenging and will require attention over the coming months. This theme continues through to CSDR, with industry best practice groups leading the charge on standardising approaches that aim to reduce the impact of the settlement discipline regime being imposed in 2020.

The development of innovative, market-leading technology is a key priority for our business. We are investing heavily in our proprietary lending platform by taking advantage of new and emerging technologies. We recently implemented our securities lending pricing engine that utilises machine learning and statistical analysis to more effectively forecast market rates for a wide range of securities. This is a development we are particularly excited about, not only for its immediate benefits, but also for its potential expansion to other applications over time.

Another area of focus for us is on meeting the ever increasing demand for data and analytics from our beneficial owner client base. Requirements vary significantly across beneficial owners based on factors like size, location, and structure of the beneficial owner's programme, just as we are investing in our data and platform capabilities, so are our clients. The ability to interface directly with our clients via application programming interfaces and other mechanisms will be the key to success in the future. In addition, the consumption and analysis of data will ensure full transparency and strong risk management as we all consume and utilise more and more data than ever before.

The rise of ESG

A highly-visible trend across financial markets is the rise of environmental, social and governance (ESG) investing. While examples of attention to ESG investing emerged sporadically as early as the 1950s, expansion of the concept as a driving factor really took hold around the turn of the century, growing to the point where investors now almost inevitably have a carefully considered policy. Solution providers have designed a similarly wide range of investment options to meet their needs.

Most institutions are operating a more active ESG agenda than ever before, although we find huge variety of approaches across our client base as to how these are being implemented.

There are a number of ways ESG investment principles may affect a securities lending programme. Firstly, it will impact the securities an investor will hold, which in and of itself does not present an issue. ESG portfolios are still capable of generating sustainable returns in a securities lending programme.

The second impact is corporate governance. A key pillar of certain ESG approaches is to ensure investors are exercising their right to vote and influence the direction of companies in which they own a stake. Investors approach this in a variety of ways, from voting all proxies across their portfolio through to more selective methods such as focusing on particular markets or voting only on contentious issues.

As the right to vote passes in a securities lending transaction, lenders must recall securities from a borrower to ensure that the right to vote is maintained. We believe it is essential for beneficial owners to have a clear policy on their approach to voting and to discuss that with their lending provider to ensure their needs can be met. At Northern Trust we recognise the importance of strong corporate governance and as such have developed a range of solutions to support corporate governance objectives for beneficial owners in our programme.

Lastly, we have seen an increased focus on the collateral that beneficial owners deem acceptable to receive. In the same way that attention is given to what securities an investor holds in their portfolio, some beneficial owners take the view that the same principles should apply to the collateral they accept.

This brings to the fore one of the interesting challenges with ESG principles: that there are a multitude of different approaches. Despite the emergence of ESG benchmarks, indices and the development of principles for the assessment of companies and responsible investment, each individual investor decides which principles matter most to them. For example, some institutions may have a particular focus on low-carbon footprint investing, whereas others may view this through an explicitly more 'ethical' lens and focus on the exclusion of controversial weapons, gambling, or tobacco based companies.

Whatever the approach adopted, we believe it is important for us to support our client's requirements in this space, and the core principles of responsible investing more broadly.

Final thoughts

Securities lending remains a relatively low-risk product that can generate significant returns for beneficial owners through a well-managed programme. In an environment where cost pressure is increasing and returns are more difficult to generate, securities lending can make a difference to asset owners and asset managers by offsetting those costs and providing a useful source of income that contributes to portfolio performance. We are encouraged that we continue to see new entrants to the securities lending market as beneficial owners continue to recognise value in our product.

Securities lending remains a key product in the broader financial markets, supporting liquidity and generating valuable returns for investors. Whilst further evolution is inevitable, this industry has demonstrated time and again that it is well equipped to adapt and respond to the changing circumstances and requirements of market participants.

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New captain, same mission

REGIS-TR'S new CEO, Thomas Steimann, outlines the trade repository's preparations for Brexit, whenever it happens, and what's to come regarding SFTR

You have a clearing and custody background. How does this compare to the new challenges in the trade depository environment?

Before I joined REGIS-TR I was with the Spanish Central Securities Depository, Iberclear, executing strategic projects in domestic and cross-border post-trade securities services. Before that, I worked for more than 20 years in the custody business at Deutsche Bank SAE in Madrid, where I was responsible for securities clearing, custody and depository bank services for all our institutional clients. So, having spent a good part of my career on the client side of the desk, as it were, I'm now seeing the familiar trade depository/repository world from this new perspective. This is incredibly helpful because it means that, although I'm relatively new in the role, I truly understand the needs of our clients. Being on the trade repository side of the business is very gratifying because I'm working in a highly professional and respected environment, and have the opportunity of adding the value of my past experiences to the goals I and my colleagues have set ourselves and which, ultimately, are for the benefit of our clients.

How are you getting ready for Brexit?

The sword of Damocles, dangling over all our heads! I must say, that we truly live in exciting times. Like a lot of affected firms, we see it as a case of having to expect the unexpected and brace for the worst outcome. In that vein, it's reassuring to know that REGIS-

TR has been preparing for this event for a long time; we launched our new UK trade repository in London back in April. It's worth mentioning that we are the only TR which is domiciled in the EU and has set up shop in the UK; other TRs are located in the UK and are establishing operations in the EU now. REGIS-TR will need to provide full UK regulatory reporting services under the European Market Infrastructure Regulation (EMIR) from Brexit+1, no matter when exactly Brexit takes place, and irrespective of whether it is hard, soft, or even somewhere in between. Seriously, though, it's a given that the UK will continue to be a major player in European and global finance. Naturally, our aim is that our UK clients receive seamless continuity of service when supervision is transferred to the UK. To that end, the UK's Financial Conduct Authority has been very supportive and helpful throughout the registration process, and this makes things a whole lot easier – we're looking forward to this new collaboration with them.

What's the next big thing on your agenda?

Naturally, the Securities Financing Transactions Regulation (SFTR) is one of the biggest topics for our clients and for the industry right now. At the moment, we're fully engaged with the regulator, working to complete our SFTR trade repository application and responding to consultation papers and other regulatory outreach. We are also planning to apply to be an SFTR trade repository in the UK in due course.

Following on from EMIR and the second Markets in Financial Instruments Directive/Regulation (MiFID II/MiFIR), SFTR is really the last piece in the EU regulatory reporting jigsaw. Its high-level aim is to increase the levels of transparency and better equip regulatory bodies with greater levels of data to monitor systemic risk.

From talking to clients, we know that the sheer amount of data required is one of the biggest challenges with, in some cases, up to 153 fields being required to be reported per trade.

Getting your data to the repository is really only the first part of the challenge. Once it's there, it needs to pass various levels of format, content and logical validations and even then your transaction is required to match with your counterparty's report. This is really something unprecedented in the SFT world.

Trade repositories have to receive a fully formed set of data and in a pre-defined format, but SFT data is highly fragmented, so firms will have to either pull data together in an 'internal repository' or use a service provider that can do that for them.

Thinking about our own pedigree in this space, REGIS-TR is a joint-venture between Clearstream, a subsidiary of Deutsche Boerse Group, and Iberclear, part of BME Group. Within Deutsche Boerse Group we have a broad range of expertise in the SFT space, which helps us to understand the clients' challenges throughout the process.

Are you expecting an 11th-hour dash for SFTR, as happened with the start of EMIR?

What we saw with EMIR was a very last-minute rush, whereby we've got 1,500 accounts today but the vast majority of those had to be opened in the last couple of weeks before EMIR went live because the market was so late in getting itself organised. We expect that the SFTR go-live will be quite different. Whenever I or a member of my team meets with clients and prospects, we always encourage engagement with both ourselves and our partners in order to firstly understand the requirements and, secondly, gain early sign-up to our test environment. This is so that firms can really start working with their data. It's a complex reporting requirement and opening accounts is really only one aspect of regulatory readiness. We certainly see a good level of engagement and increasing readiness among the tier-one firms and we're keen to see that spread to all sizes of firms and all actors participating in SFT trading.

You have recently chosen several new partners. Is this key to your strategy going forward?

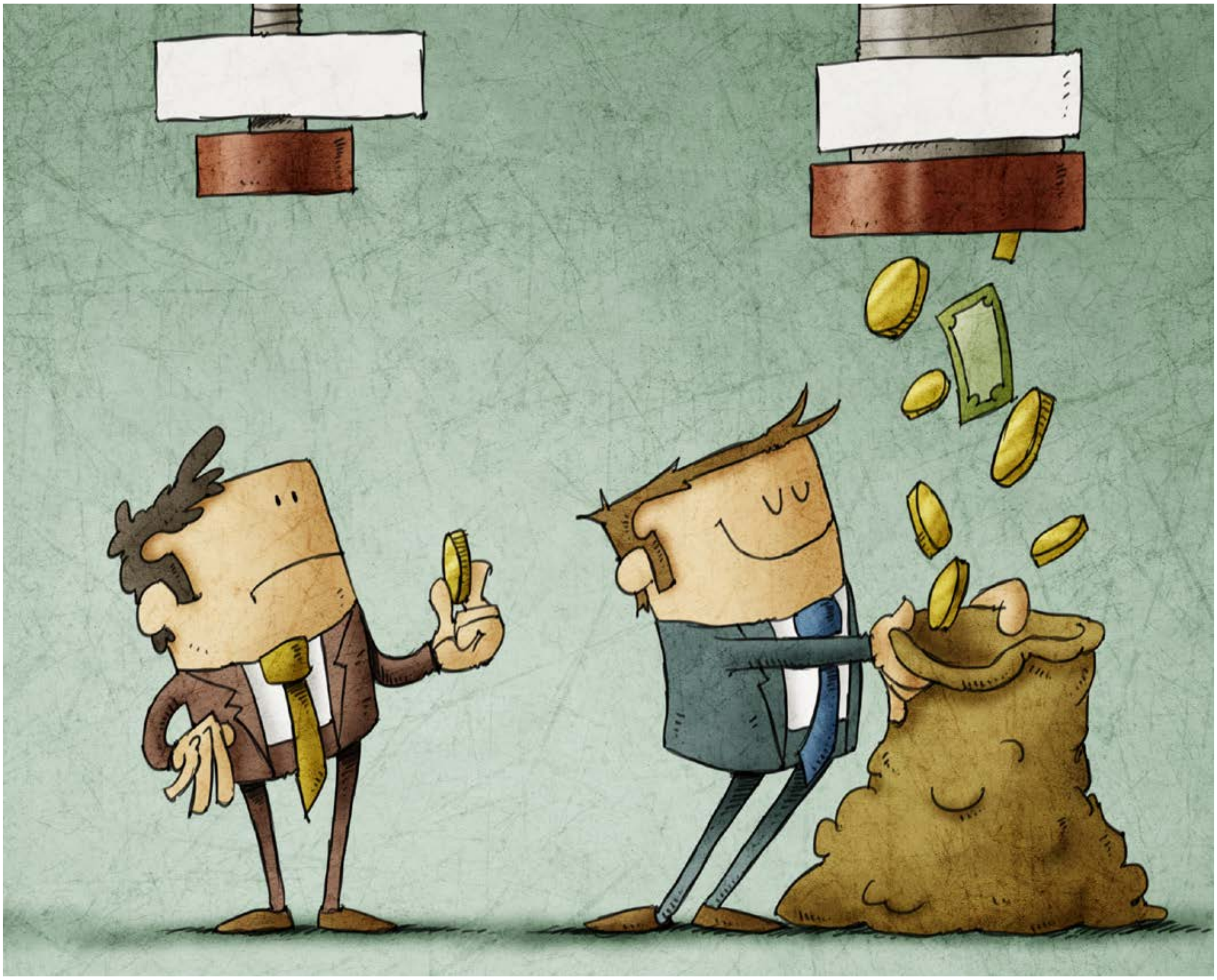
Yes, it is. We are constantly improving our client services and in that sense partnerships make a lot of sense. I'll give you a couple of examples which are helping us achieve our aim of providing an end-to-end reporting solution for SFTR requirements.

We can achieve this by collaborating with EquiLend, one of the leading providers of trading and post-trade services, and Trax, a leading provider of data and regulatory reporting services to the global securities market. These two partners offer a joint solution that helps firms meet their SFTR requirements. When clients book a trade on EquiLend's Next Generation Trading platform, EquiLend and Trax will derive additional SFTR-required data. Trax will match the information in a centralised booking process and then route the required information to the trade repository.

We are also collaborating with IHS Markit and Pirum. Together, they are working with industry leaders to design an SFTR reporting solution that can ease the complexity of routing data to trade repositories. Their data management and augmentation service, plus pre-matching, together with our flexible account model and cost-effective solution, provide market participants with a robust framework for SFTR compliance.

By leveraging these joint solutions, our aim is to ensure our clients can benefit from both a rapid reporting submission process, and REGIS-TR's intraday reconciliation capability, which will, within minutes of trade reporting, assist with SFTR compliance.

All-in-all, excellent partners help us to better serve our clients and this will always be our highest aspiration going forward. I am very excited about what the future in the trade repository space will look like. We will definitely take an active role and shape this future.



Why central banks need securities lending

BNP Paribas' Benoit Uhlen explores how central banks are becoming increasingly attracted to the proposition of low-risk, incremental income

Central banks have long recognised the value of securities lending as a mechanism for managing market liquidity. It has a vital and growing role to play in central bank operations and provides an important mechanism for enhancing liquidity, which helps central banks facilitate the smooth and efficient functioning of markets.

Securities lending offers valuable commercial benefits too. By monetising their holdings, central banks can add significant incremental income to their portfolios without substantially raising their risk profile–a proposition that many central banks are finding increasingly attractive.

Helping markets function

Central banks have long used securities finance transactions–including securities lending and repos–to support monetary policy and financial market stability.

When a central bank lends securities or uses repos to sell bonds to commercial banks, it removes cash from the market and tightens the money supply. This reduces competition for assets and keeps prices down. Buying debt instruments from commercial banks boosts the money supply by increasing banks' cash reserves.

Securities lending also promotes healthy functioning markets by enabling borrowers to access securities for short selling, balance sheet management, or to facilitate orderly transaction settlement. The increased market liquidity results in tighter bid/offer spreads and elevated activity levels.

The regulatory imperative and demand for HQLA

Post-crisis, central banks' securities finance activities have an even bigger role to play.

Regulatory initiatives such as the Basel III liquidity coverage and net stable funding ratios, along with the European Market Infrastructure Regulation's (EMIR's) clearing obligations, have created an enduring demand among market participants for high-quality liquid assets (HQLAs). At the same time, central banks' HQLA portfolios (i.e. debt issued by G7 countries) have increased significantly in certain cases, owing to the trillions of dollars' worth of securities bought under their quantitative easing programmes.

By initiating or expanding their securities lending activities, central banks can become important suppliers of much-needed HQLAs to meet borrower demand. Financing facilities offered by central banks, such as the Federal Reserve's Reverse Repurchase Facility and System Open Market Account (SOMA) programme, highlight the importance of securities financing in the capital markets. Such central bank intermediation plays a vital role in the healthy functioning of capital markets.

Moreover, securities lending provides central banks with opportunities to optimise the performance of their HQLA holdings by generating a return on what is an often untapped-income source.

The benefits of securities lending

Securities lending is a prudent and proven strategy for asset holders to diversify their revenue and extract additional value from their portfolios of idle assets–a goal of heightened importance in the current low interest rate environment.

Historically, elevated volatility levels have benefitted securities lending programme participants. With an end to quantitative easing and changes to monetary policy in sight, higher volatility seems set to continue, bringing further demand for certain asset classes and sectors.

Revenue opportunities from securities lending participation can be substantial, depending on the portfolio of available assets. Non-cash collateral transactions can easily generate stable and predictable returns on a portfolio of G7 government debt, with a highly risk-averse approach that takes investment grade fixed income as collateral and allows for transactions to be closed on a daily basis.

Beneficial owners willing to expand the tenor and permissible collateral-set to include cross-currency assets or lower-rated securities (for example, European Central Bank eligible debt, or even equities from the main indices) can boost returns to 25 bps or more, while likely increasing utilisation rates. Employing trade structures that minimise the capital impact for borrowers, such as a pledge structure, can provide an additional return.

Augmenting revenue streams through securities lending can then provide a significant contribution to meeting central banks' administration expenses and custody fees.

Well-managed risks

Many central banks have traditionally been wary of participating in securities lending. This hesitancy stems in large part from the risks brought about by the use of cash collateral and the losses that could result when that cash was reinvested in other, higher-yielding instruments.

However, the way programmes are structured has changed, bringing extra layers of protection for market participants.

Non-cash collateral transactions — which remove the interest rate mismatch, credit and liquidity risk associated with cash collateral, while providing equivalent returns — are increasingly the norm. In the US, more than half of all transactions now comprise non-cash collateral, compared to less than 20 percent three years ago. DataLend figures show that across the rest of the world, approximately 85 percent of all outstanding loans employ non-cash collateral.

> ***With an end to quantitative easing and changes to monetary policy in sight, higher volatility seems set to continue, bringing further demand for certain asset classes and sectors.***

Central banks can further reduce their risks by using an agency lender. Many agency programmes have introduced robust indemnification policies that protect investors against borrower credit risk in case of a counterparty default. Agency indemnification guarantees are often buttressed by the use of over-collateralised transactions and a careful selection of borrowers to ensure exposure to only high-quality counterparties. Together, these safeguards provide central banks with important risk mitigation assurances.

What to look for in an agency lender

Central banks' revenue opportunities and risk exposures will be determined to a large extent by the type of lending programme in which they participate. Capabilities to look for in an agent include:

Risk management: An indemnification policy is only as valuable as the agent's ability to backstop it. Agents need to be well-capitalised and possess excess liquidity to meet potential demands. They should also use a diversified counterparties list to minimise concentration exposures.

Sophisticated technology tools—including the use of robotics and artificial intelligence where possible—enable agent lenders to automate the majority of transactions and respond to locates faster

Collateral transformation experience: Borrowers are increasingly keen to place more varied types of non-cash collateral. This can be seen in industry lobbying for changes to the US Securities and Exchange Commission's Rule 15c3-3, to expand the permissible collateral a counterparty can pledge to include equities, and so make more efficient use of their balance sheets and capital.

Central banks willing to participate in collateral transformation transactions—in which HQLAs are exchanged for non-HQLA assets—can profit from substantially higher revenue opportunities. But, it requires a lending agent experienced in managing those transactions. An agent's willingness and ability to expand the set of permissible collateral, and provide indemnification against borrower default is critical.

Utilisation rates: How many similar lenders with the same types of assets does the agency programme contain? Each will have to take turns lending their securities to the marketplace, so the greater the number of clients, the longer the lending queue.

Shorter lending queues, along with bigger borrowing pools, ensure beneficial owners have more of their available assets out on loan at any one time. Maximising this utilisation rate will in turn maximise the revenue the owner can earn.

Borrower monitoring: Borrowers' creditworthiness must be monitored closely and continually to reduce credit risk. Agents should mark-to-market the borrowers' collateral on a daily basis and manage margin payments to minimise potential losses in the event of default. Independent risk management is also critical in monitoring a programme's activity, in addition to an experienced operational network to facilitate the settlement and maintenance of a lending programme.

Transparency: A clear view into how a securities lending programme is performing can provide central banks with important controls and comfort. Online access to real-time data will allow lenders to see which securities are on loan, the collateral received and rate at which they have been transacted.

Efficiency: Securities lending is a relatively low-margin, high-volume activity. Efficiency is critical, both for the viability of the agent's business and profitability for the beneficial owners.

Product development: An agent's ability to remain abreast of market infrastructure and regulatory developments is vital. Trade structures such as central counterparties and the pledge structure offer two new routes to market that balance the needs of lenders and borrowers, and minimise the capital impact for all participants involved.

Meanwhile, sophisticated technology tools—including the use of robotics and artificial intelligence where possible—enable agent lenders to automate the majority of transactions and respond to locates faster. This frees them to focus on developing counterparty relationships and trading strategies that extract maximum value from a clients' lending portfolio with the minimum risk, thereby generating more revenue for the beneficial owner.

All gain and no pain

Central banks have long recognised the value of securities lending as a mechanism for managing market liquidity. Fewer have taken advantage of the significant and stable revenue streams an active lending programme can deliver for participating asset owners. But that is changing. And with the robust risk mitigation measures that the best agency lenders now provide, the risk-reward calculations have never looked so compelling.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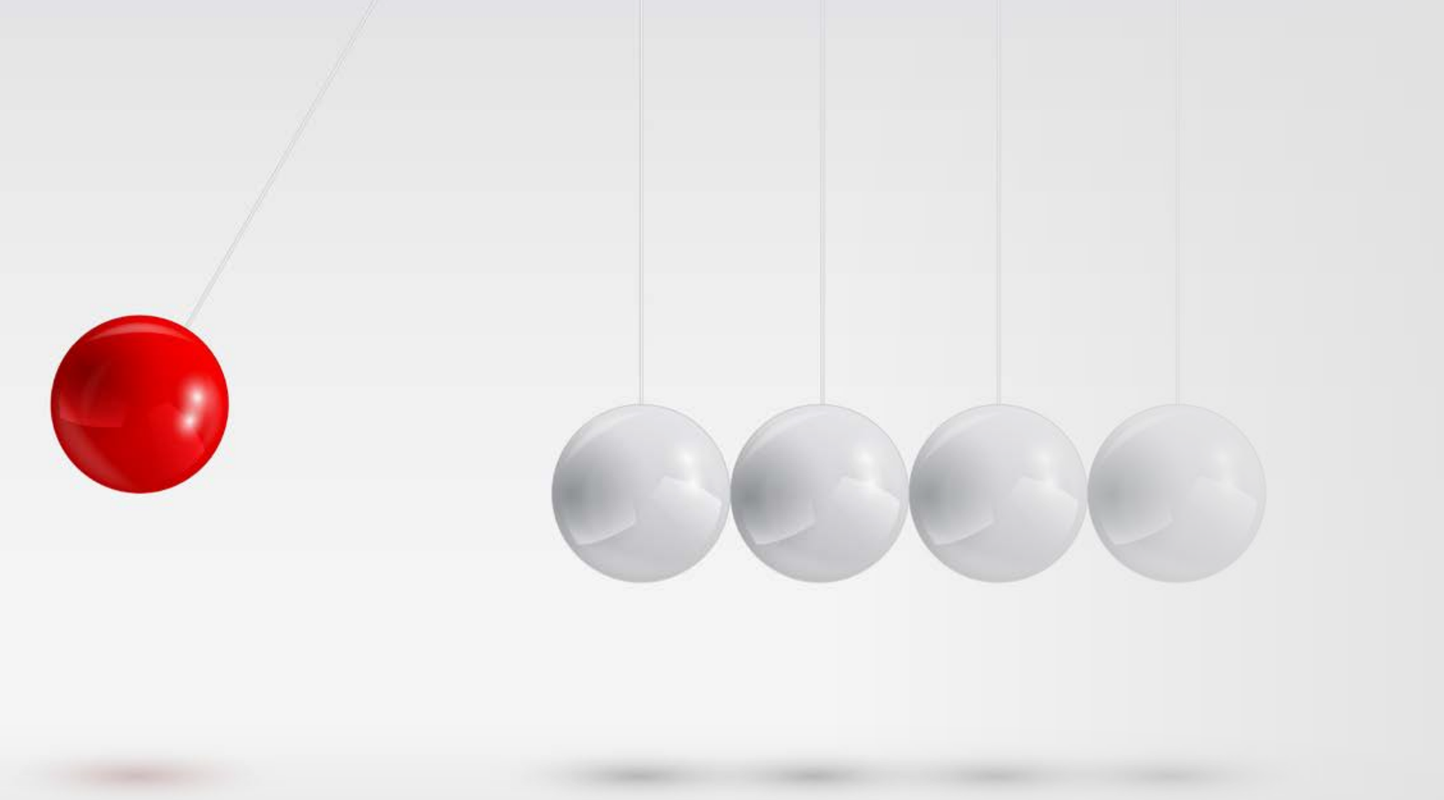


The impact of CSDR on securities lending

Bijal Shah and Tom Poppey, of Brown Brothers Harriman, discuss how CSDR differs from previous attempts to improve standards of market settlements and how to prepare for its 2020 implementation

One goal of the European Securities and Markets Authority's (ESMA) Central Securities Depositories Regulation (CSDR) is to increase settlement efficiency across the EU. Currently, European firms are less likely to tap the capital markets than their US counterparts and prefer to borrow directly from banks. This is not a new concept.

The drive for reduced settlement cycles and associated sanctions has been gaining momentum for many years. Where CSDR departs from these historical attempts is with the scope and scale of measures to be implemented over multiple years, while attributing responsibility to police the activity to those closest to the process: central securities depositories (CSDs). CSDR adopts an extensive arsenal of 'incentives' to motivate market participants to elevate their back- and middle-office activities in order to avoid penalties.

This, in turn, could have wide-ranging implications for market participants, particularly in the debt securities market. These regulations could dampen much needed liquidity in this asset class by making it more difficult for borrowers and lenders to efficiently trade bonds — a crucial component for bond market liquidity.

While CSDR will likely achieve improved levels of overall market settlement, invariably fails will occur. As a result, CSDs, custodians, and both buy- and sell-side market participants will expend significant effort and investment to develop systems and processes that determine liability and ensure cost is attributed to the responsible party. This is not an insignificant undertaking and is actively ramping up across EU capital markets.

With the reduction of the settlement cycle phase of CSDR under way, assisted with the pan-European Target2-Securities initiative and dematerialisation, now a household concept, the most significant overhaul of securities settlement will be the new mandatory settlement discipline regime.

The unique impact on securities lending

CSDR cash penalties and mandatory buy-ins have piqued the interest of the securities lending industry as the market has generally recorded lower settlement efficiency rates than traditional custody. In preparing for CSDR, the International Securities Lending Association (ISLA) conducted a survey which estimated that in 2018, the settlement rates of their membership were between 80 percent to 90 percent with the majority of fails being in the return leg of loan. Under CSDR, each of these fails could come with additional reporting, a mandatory buy-in, or even a cash penalty. As a result, increasing settlement efficiency across the chain of securities lending has come under increased focus.

While cash penalties, mandatory partial settlements, and buy-ins under CSDR on equity and fixed income cash market transactions have been included in other regulations, the inclusion of securities lending transactions as covered transactions is new to the industry. For the first time in any market, timely settlement of securities loans will be subject to enforcement mechanisms. New loans and loan returns will incur penalties if not consummated on the 'intended settlement date'. However, there is an exception from the mandatory buy-in regime for loans with a term of less than 30 days, presumably included in the final rule to recognise the importance of securities lending to trading liquidity. As a largely over-the-counter, bilaterally traded product, the securities lending industry may be prone to higher levels of settlement failure and therefore require more extensive remediation than cash market transactions.

CSDR will also bring focus to another area of securities lending operations: the process of recalling loans back from borrowers. In the event the timely settlement of a cash market transaction is reliant on the prompt termination of a securities loan, regulators and market participants will apply greater scrutiny. Ultimately, the alignment of loan return time frames with intended trade settlement dates will be key in ensuring that securities lending does not contribute to sell fails and associated penalties.

With respect to debt securities, CSDR has the potential to reduce market participation both from the lender and borrower perspective. Generally, trading liquidity on corporate bonds is lower than equity shares and therefore they may be subject to higher settlement failure rates. This dynamic, combined with the prospect of cash penalties and mandatory buy ins, may result in borrowers deciding to pull back from lending, reducing demand for borrowed bonds and eliminating a revenue source relied upon by beneficial owners. Lower participation in securities lending could further reduce market liquidity and exacerbate failure rates, which would be an unintended and ironic consequence given the goal of the regulation. This outcome is by no means certain but is also not unrealistic should penalties exceed the aggregate benefits provided by the lending of corporate bonds.

What is the impact on the middle office?

Ahead of implementation, many securities lending operations teams are bracing themselves for the day-to-day reporting requirement changes, voicing potential pitfalls and advocating for industry best practices.

As the imposition of cash penalties by CSDs will become the norm, the management of the identification, reconciliation and allocation will become the responsibility of each market participant. Given the prevalence of multiple stakeholders in the lending industry such as the lending agent, borrower, and custodian; the identification of the 'offending' participant will not be obvious to a CSD. The ultimate application of penalties and costs will encourage participants to enhance operational processes and ensure systems and data are accurate to ensure that trades do not fail for the most basic of reasons. It is for this reason that many industry participants are advocating for industry best practices to include pre-matching of trades. The use of third-party vendors for such pre-matching services in a consistent manner could address needed standardisation to close some settlement gaps that exist today.

Securities lending market participants are also currently reviewing timing of trade bookings, time zone issues and collateral management efficiency. This is driving many to review their current operating models to ensure they are efficient and don't fall foul of delays or errors.

More to come

No doubt there will be extensive consideration and consternation over the next year regarding CSDR, given the broad impact of the regulation – all of which takes effect in about a year. The key is to start planning early for the application of these settlement discipline rules well ahead of September 2020. The coming months contain a full implementation agenda including research and analysis on current levels of settlement efficiency, codifying new processes, clarifying responsibilities and documenting expectations, not to mention any investments in technology that firms may need to consider.

> ***Ahead of implementation, many securities lending operations teams are bracing themselves for the day-to-day reporting requirement changes, voicing potential pitfalls and advocating for industry best practices***

The impact is global and, as key milestones and deliverables approach, the market may start to adjust itself to prepare for increased buy-in activity as participants brace themselves for unexpected discipline costs. The good news is CSDR is on the front of minds for most market participants and trade associations who are actively working towards the regulatory intention of more efficient market operation.

2020 Vision

As market participants gear up for the traditionally busy fourth quarter and planning for next year, eSecLending's Simon Lee looks at the key talking points and considerations for beneficial owners to examine

Revenue Optimisation

One of the main themes in 2019 when beneficial owners consider the optimisation of their programme revenue is for more emphasis to be placed on improvements in meeting borrower demand. Those lenders whose programmes were closer to a broad 'ideal' would inevitably outperform those lenders at the other end of the spectrum. Undeniably, while portfolio composition (quality and quantity) is the primary driver in determining the revenue opportunities available to an individual lender, increasingly, decisions concerning route-to-market, acceptable collateral, and the ability to enter term trades are affecting programme performance to an ever-greater degree.

With regulatory expenditure growing across the industry, cost-management is an even more important feature of the business in 2019 and into 2020, thus driving this focus on optimising the supply/demand dynamic for beneficial owners. The differential in borrower demand for lendable supply deemed of higher quality continues to increase, providing an opportunity to enhance performance for those lenders that can develop their programmes accordingly. Moreover, this trend is hindering those lenders whose programmes are deemed less attractive due to portfolio composition, collateral requirements or otherwise.

For beneficial owners, the name of the game remains constant: structuring their securities lending programmes within a robust governance framework, ensuring their service providers are delivering on their goals and objectives and that the risk/reward equation is appropriately managed.

New entrants/new supply

In 2018 and 2019 we saw several new beneficial owners coming to market, either lending for the first time, or re-entering after a hiatus. Many absences even stretched back to the financial crisis in 2008. The reasons behind this are relatively consistent: an increasingly competitive fund management sector that recognises the boost to fund performance that securities lending revenue can provide, and for other asset owners a greater appreciation of the revenue opportunity that may be being left on the table by sitting on the side-lines.

This scenario is expected to continue through 2020, supported by a combination of factors. These include the continued downward pressure on fund management fees and consequential impact on profitability and further growth in the passive and exchange-traded funds sector (funds for whom securities lending is often an integral strategic component). Moreover, the level of comfort investors have around securities lending is seemingly rising every year we are removed from 2008, helped by the increase in regulation, education and transparency in the industry.

With new lenders there is new lendable supply, which could dilute effect on the performance of individual lenders in the more liquid asset classes and markets. While it is true that the sector evolves and identifies new opportunities from lending in new markets to enhance operational efficiencies through automation, beneficial owners should be cognisant of any potential impact to their individual programme. This may be more the case for those lenders that participate in a pooled programme structure, for whom programme performance is oftentimes relative to other lenders in the pool, and therefore more obviously influenced by the dilutive effect of increased lendable supply within the pool. Going back to previous comments on revenue optimisation, we see further benefits for beneficial owners in considering how programmes may be enhanced to push to the front of the pack. For new entrants, another factor to take into the decision-making process when deciding how to best access the market.

Regulation

No article that looks at how the coming year is shaping up is complete without the mention of regulation, though for our purposes in this article, we will limit our discussion to observations of how beneficial owners are dealing with regulatory change, the potential impact to lending programmes that beneficial owners should be mindful of, and the questions to be asked of service providers in 2020.

Securities Financing Transactions Regulation (SFTR) is the four-letter acronym that is getting the most airtime from market participants in 2019, with the requirement to report finally being with us in 2020.

A great many words have been written on the subject, with no doubt many more to come, so we will exercise brevity here and suggest the following questions beneficial owners that use agent lenders may wish to address:

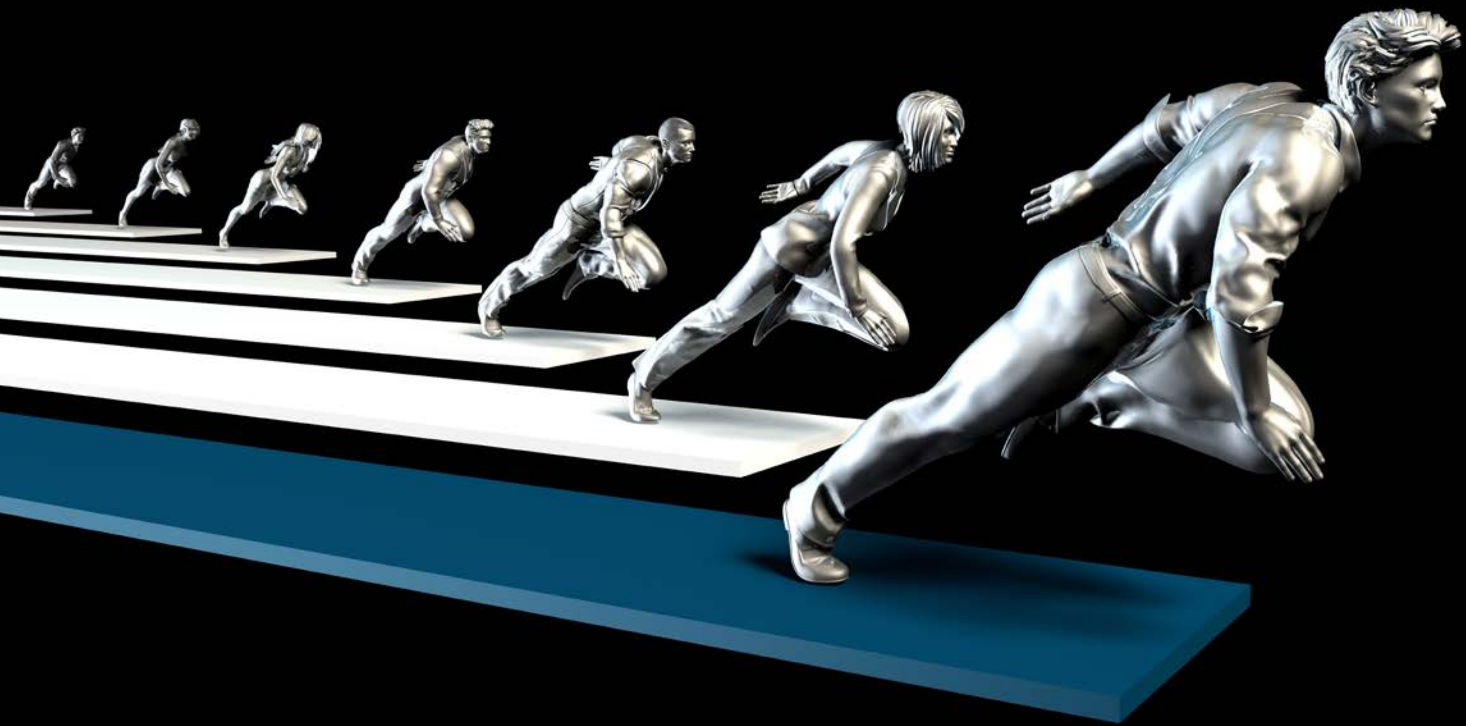
- What does the lending agent's SFTR solution look like and what is the roadmap for delivery including user acceptance testing, etc?
- How will the agent interact with, and deliver data to, the beneficial owner's preferred trade repository (if the beneficial owner specifies one)?
- Will SFTR change the way the agent interacts with borrowers and what will this mean for the beneficial owner?

For those beneficial owners domiciled outside of the EU that may not have a reporting requirement per se, their borrowing counterparties and agent lenders will likely be impacted to varying degrees, which for many organisations will require significant human and financial resources. Those beneficial owners not directly impacted by SFTR requirements should still be aware of how their service providers and counterparties may be effected to avoid any consequential negative impact on their individual programme provision and performance.

Another piece of European regulation, the Central Securities Depositories Regulation (CSDR), will be receiving attention from securities lending market participants this year and next, for the impact that delayed settlement of securities lending transactions in the EU may have on the costs associated with this piece of regulation. The focus for lenders will be on settlement efficiency for new loans, recalled loans, and, most importantly for beneficial owners, ensuring timely settlement of sales trades of securities that were on-loan at the point of trade and necessitate a market recall. While market participants lending in emerging and Asian markets are well-versed in the risks associated with failed settlements in these markets and associated costs, operational efficiency, which should be the cornerstone of every securities lending programme, will come under increasing scrutiny thanks to CSDR.

To finish, although no longer a topic that is considered new, the cost of regulatory capital on the business remains as relevant today as it ever was, even as the impact on securities lending programmes continues to develop. As we noted at the outset, beneficial owners that best meet the evolving borrower demand dynamic will stand to profit most from enhanced programme performance. These shifts in demand are in part a product of the regulatory costs faced by borrowers. So, to comprehensively examine this topic, we need to look at the key regulatory costs facing agent lenders and most importantly indemnification costs, which is potentially the biggest impact on beneficial owners.

Again, while the topic is one that has been a talking point among agent lenders and beneficial owners for some time, the discussion does not stand still. As other regulatory costs come to the forefront, existing costs like indemnification provision must get reviewed in a new context, and programmes may be adapted accordingly. Revised fee splits, limitations on scope of indemnities, and restrictions on lending activity are all potential adaptations open to agent lenders to manage these costs. Given the relevance of these considerations to individual programme performance, staying current to the circumstances of their indemnification policy should be on every beneficial owner's agenda in 2020.



Repo - is it time for a centre of excellence?

Pirum Systems' Scott Brown explores why the securities lending market has enjoyed wide-spread adoption of automation but the post-trade space for repo has been much slower, and explains how you can benefit from the vast automation opportunities available

The securities finance market has heard many times how securities lending has led the way in post-trade automation and how real-time visibility on economic differences leads to improved accuracy in profit-and-loss and a reduction in month-end issues and corrections.

Within capital markets there are many centres of excellence around the world at an institutional level, but how much of this occurs at the industry level and what benefits can this provide?

At Pirum, we provide a centralised automation hub for the securities finance market that brings together industry practitioners, and we have seen how crucial this has been to the growth and evolution of the market. The level of participation varies greatly between securities lending and repo, where the story differs somewhat: 71 percent for securities lending versus 29 percent for repo (by USD value). For the majority of sell-side firms, the adoption of electronic trading (or automatic trading system) is a growing trend (see figure 1) and where the resulting trade is cleared or collateralised via triparty (broker-to-broker) the straight-through processing (STP) flow post execution is at times very efficient. Where a trade is not cleared, or the collateral is managed bilaterally, the STP flow post-execution is varied.

One of the contributing factors to the STP rates could be the disparate nature of the repo market as a source of liquidity. Unlike securities lending, the source of liquidity is not finite. Because of this, some of the market reconcile and manage their trades on a central vendor solution and some do not. This leads to banks and brokers using multiple platforms and solutions, often with varying degrees of efficiency and cost, which adds considerable complexity. If this is to change then the market needs a place to begin, such as with something similiar to what Pirum brought to the securities lending market 18 years ago. A natural selection for automation that brings all sides of a repo transaction together. Introduce a regulatory paradigm shift such as Securities Financing Transactions Regulation (SFTR) and suddenly the current model appears clunky.

Many of the counterparts to the sell side are hedge funds or mutual funds, who historically have in-house solutions for processing and reconciling their repo deals, due largely to volumes being low and the fact that the vendor solutions are often priced with volume bandings, making some solutions too expensive. However, this means that those firms don't take advantage of central reconciliation or benefit from economies of scale.

SFTR brings additional challenges to the repo business, that until now have not been a focal point for firms. In particular, unique trade identifier (UTI) creation and distribution where clients are not using a post-trade platform or where a platform does not have counterparty critical mass will be hard to solve for. Pirum and IHS Markit provide a facility to create and share UTIs for our clients. It has the ability to absorb UTIs provided to us by our clients and potentially from another platform. However, for structured or non-vanilla repos the industry has challenges to overcome, such as how multiple substitutions are treated and where pledge arrangements are being utilised.

One thing is for certain: legacy trade booking practices will need to adapt to suit the requirements of the regulation, meaning trades booked under a global master repurchase agreement will need a common industry approach to how firms treat lifecycle events (or modifications). For example, repo trades reconciled with rebate style securities lending trades will no longer qualify a match once the trade is submitted to the trade repository.

All of this considered, there are solutions that are readily available to repo practitioners today that provide automation for existing processes. These include the following:

- Real-time confirmations and affirmation of trades
- Real-time pre-matching of key economics and SSIs
- Real-time reconciliation of life-cycle events e.g. rate changes
- Real-time fails management
- Auto-returns for processing borrow returns in an STP manner
- Triparty required value automation and real-time visibility of allocations
- Central counterparty connectivity (for deals novated post execution)

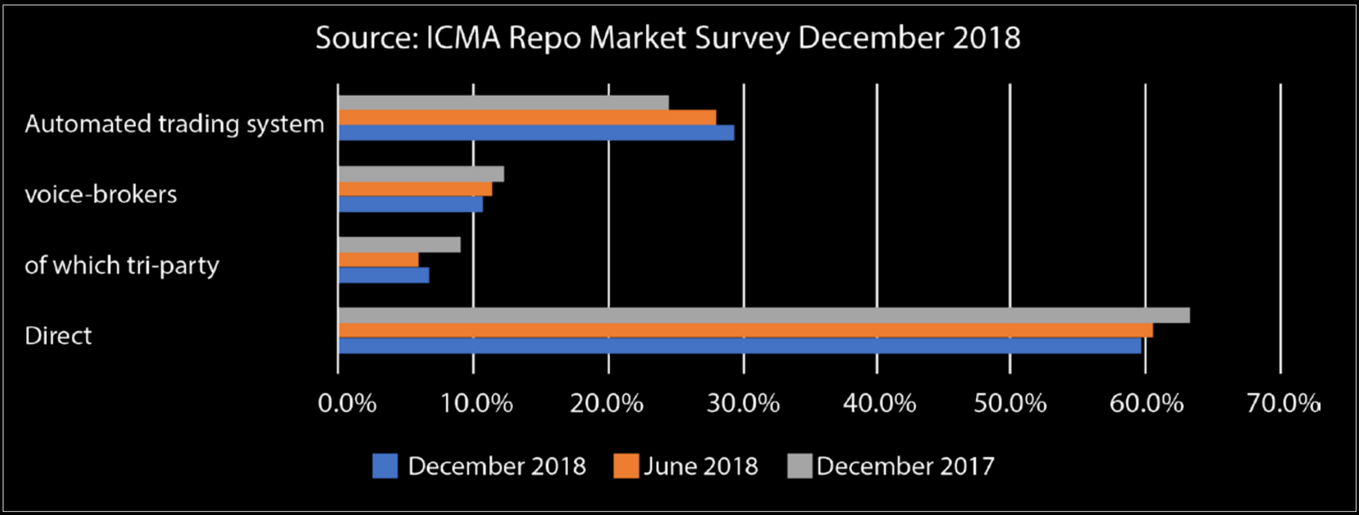
Given many repo desks also have a component part of their flow business that are bond borrow trades, providers such as Pirum can offer full-lifecycle automation and STP rates for mark-to-markets and returns in the 99 percent and 97 percent range respectively.

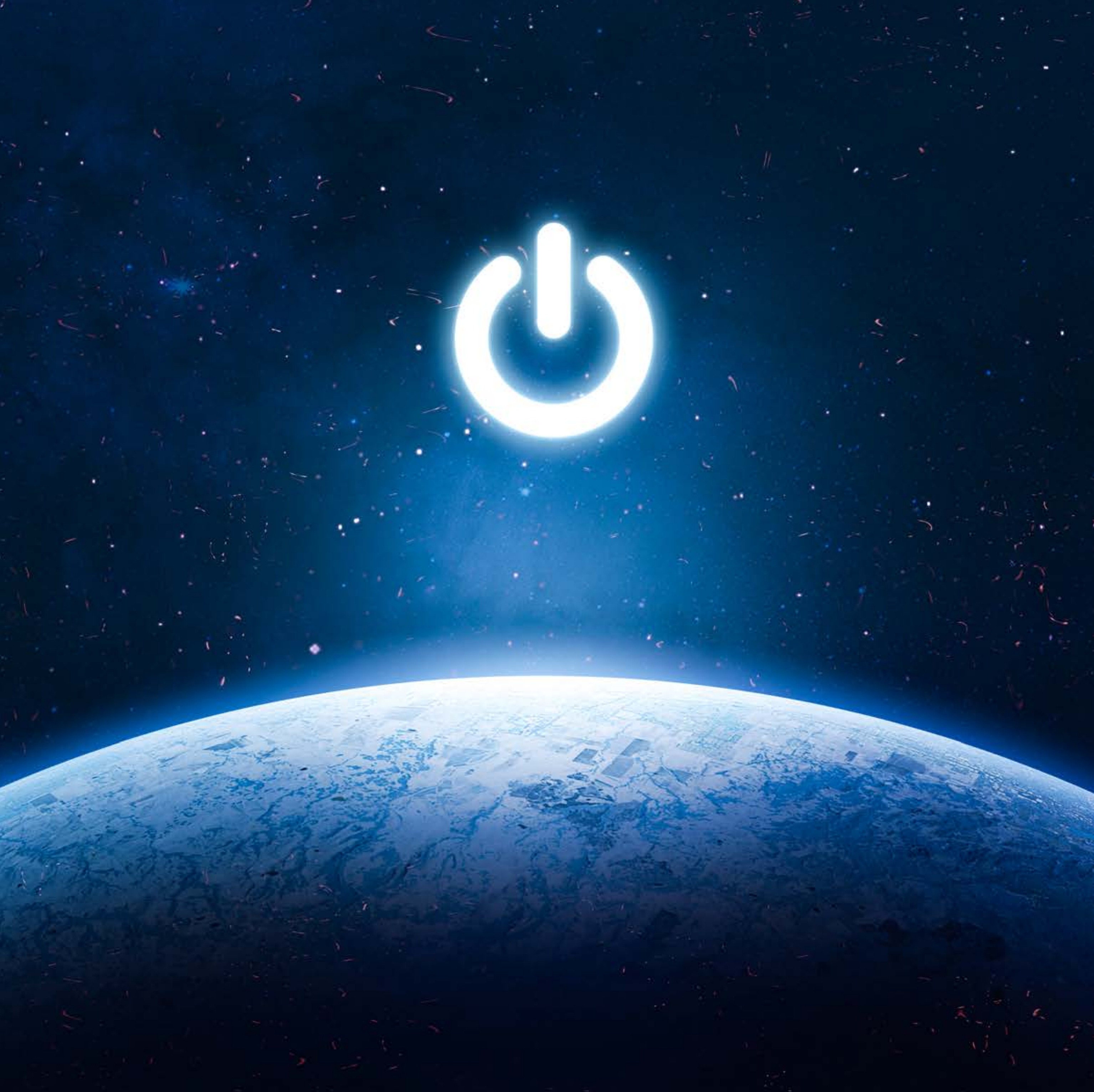
Achieving standardisation and process automation will become of paramount importance in 2020, not only when SFTR takes effect but also the introduction of the Central Securities Depository Regulation (CSDR), which will put a greater emphasis on firms ensuring that they monitor and manage fails in a timely fashion. If you are not entirely familiar with the scope of CSDR, Pirum wrote a detailed CSDR overview in the International Securities Lending Association's March securities lending report, which gives a detailed look into what firms can expect from the regulation.

Along with process automation, clients can also benefit from enhanced visibility on their collateral usage/potential usage. Clients can identify where assets can be deployed quickly, allowing for faster trading decisions and an improved use of inventory while managing usage with digitised collateral schedules.

In a marketplace where costs, spreads and resources remain squeezed, firms require strong partners to act as industry utilities and help clients achieve efficiencies and economies of scale that only a centralised solution can offer.

As we have seen in other products such as cleared derivatives and securities lending that standardisation has been achieved with the help of vendors who have taken steps to manage commoditised functions across the market, allowing firms to focus on alpha generation. Securities lending has largely achieved this, and the repo market would benefit from a similar approach. In a world that is sharing more than ever, now is the time for the repo market to draw lines where there are dots, and make sure that more of the market is connected in the post-trade space. At Pirum we're working closely with the repo market to assist clients on this journey.





Switch now to Comyno’s C-ONE platform

The Comyno team outlines the capabilities of the C-One platform with its new SFTR module and explains why the best time to switch is now

Comyno released its innovative securities finance software solution to the market, now incorporating a complete Securities Financing Transactions Regulation (SFTR) module, alongside the most complete front-middle-and-back-office functionality and internal/external connectivity options.

The C-ONE Securities Finance suite offers a complete solution for trading and collateral management, covering the entire value chain of the corresponding transactions.

It is built as a 'hybrid platform', incorporating features for an in-house trading and collateral management system and a multi-entity, multi-product trading platform across asset classes.

This enables our clients to not only manage their whole securities finance business with C-ONE, but also grants online access to and for their clients and counterparts including white-labeling potential via the web.This provides seamless possibilities for position sharing, locates management and affirmation processes.

Furthermore, clients and counterparts can see their side of the trading activity the collateral and exposure management. Even the profit and loss features can be used by all entities with access to the platform.

If the word existed (maybe it does from now on), we would call C-ONE a 'tribrid platform' because it incorporates total connectivity to every internal and external system or third-party entity which might be imagined. This includes the possibility to connect with various distributed ledger technology platforms as well.

Now, SFTR is at everyone's door. Since the timeline is set by the regulators, discussions are progressing and the first customer projects have kicked off. Comyno intends to follow its unique strategy for getting the maximum returns out of the new reporting regulations for our clients and how it correlates with the company goal of supporting the market with best-of-breed software and services.

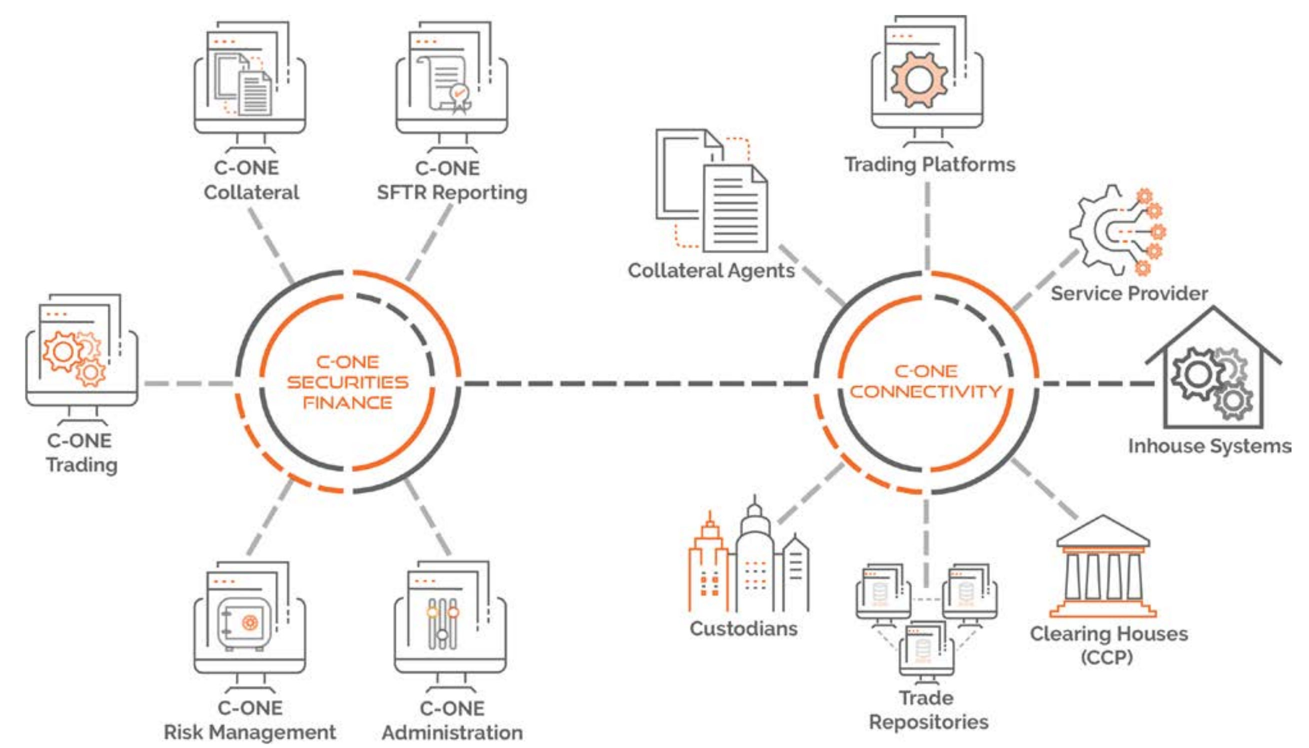
What is the key for us when we think of SFTR?

As experts for all business and technical matters in securities finance, we have one simple message:

Do not implement SFTR with a sole view on the reporting requirements, but have a second thought about the synergies for the business it can create if you do it right.

From our point of view, there is huge potential in turning the cost you are forced to bear for SFTR into real benefits for your business. Therefore, it is essential that traders and collateral managers jump on the SFTR train at an early stage of the project to better understand what it is about and to add their business

Figure 1



ideas to the project and make use of potential synergies the reporting has to offer.

Why we are convinced that there are such synergies?

This has a lot to do with the many projects we already did in the securities finance arena in general and specifically in the area of collateral optimisation. Clearly, we see that firms that have put effort into a collateral optimisation strategy will have torn down their internal (product) silos already. It will have a consolidated view on the firm-wide collateral portfolio and will have implemented the necessary infrastructure to efficiently manage liquidity and risk while increasing their revenues at the same time.

If your firm has invested in such an infrastructure environment already, the implementation of the new reporting will be an easier task because SFTR is requiring exactly that consolidated data for all your securities finance transactions across asset classes and business units, along with a full view on the firm-wide collateral portfolio.

If your firm has not yet invested in such a consolidated infrastructure, SFTR will force you to do so at some point further down in the value chain.

This is exactly the point when Comyno comes in to help to define how to bring all of the collected and required data into the right place and format. As a result, your company will be able to report SFTs properly and will increase the efficiency of collateral allocation at the same time.

This business-driven approach led us to implement and offer a full-scale SFTR system solution to the market instead of just providing a tool to collect the required data and fill the fields in the reports.

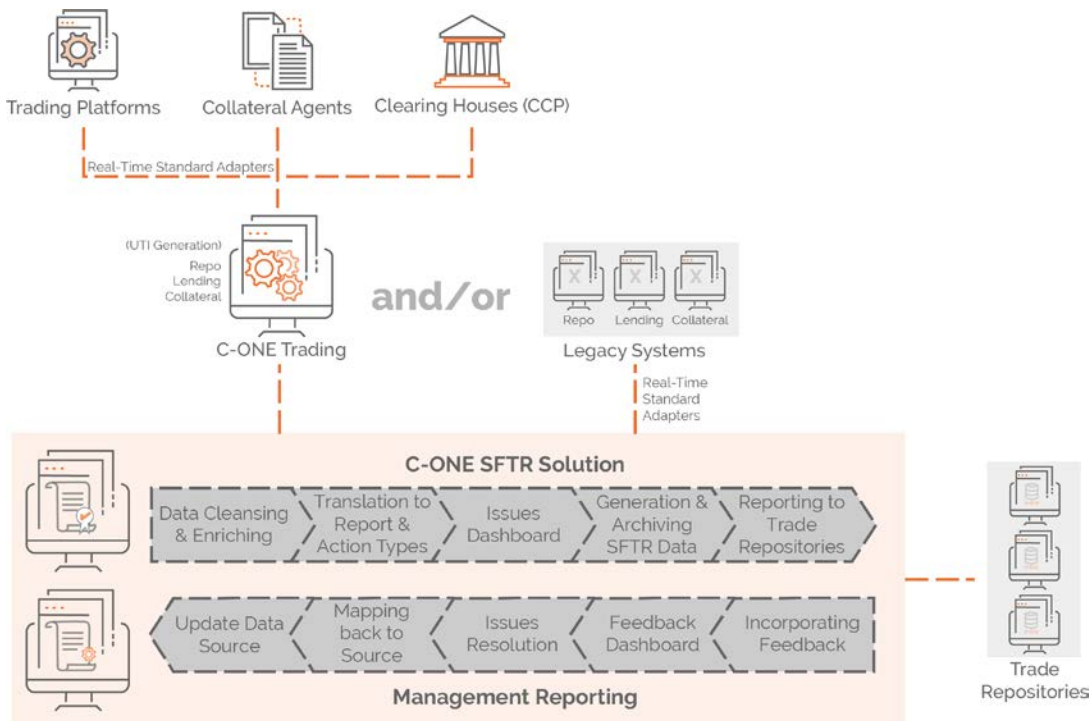
Our C-ONE Trading/Collateral Management and C-ONE Connectivity/Reporting platforms have initially been built by embedding the SFTR requirements as their core data structure. Now we are continuing by adding the missing pieces to deliver SFTR reporting fully in line with the regulator's requirements.

To stick to our word of the 'one-stop shop' slogan, the next logical step was to include SFTR into our product suite to keep our other promise: to be able to provide all system features as single modules as well. In other words: the SFTR functionality can also be used as a stand-alone tool for reporting from your legacy SFT in-house systems, or as an out-of-the-box service for firms already using our full C-ONE Securities Finance suite.

To wrap it all up:

One of the biggest cost drivers for the industry is the multitude of internal and external parties involved in SFTs and the variety of

Figure 2



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software systems, IT components and a big number of manual workarounds and interfaces which are necessary to fill the gaps in the underlying systems.

Comyno is tackling this industry challenge for the benefit of our market with its solution. C-ONE Securities Finance, with all its different modules, is now covering the whole value chain, both from a business and technical perspective.

Just imagine for a second:

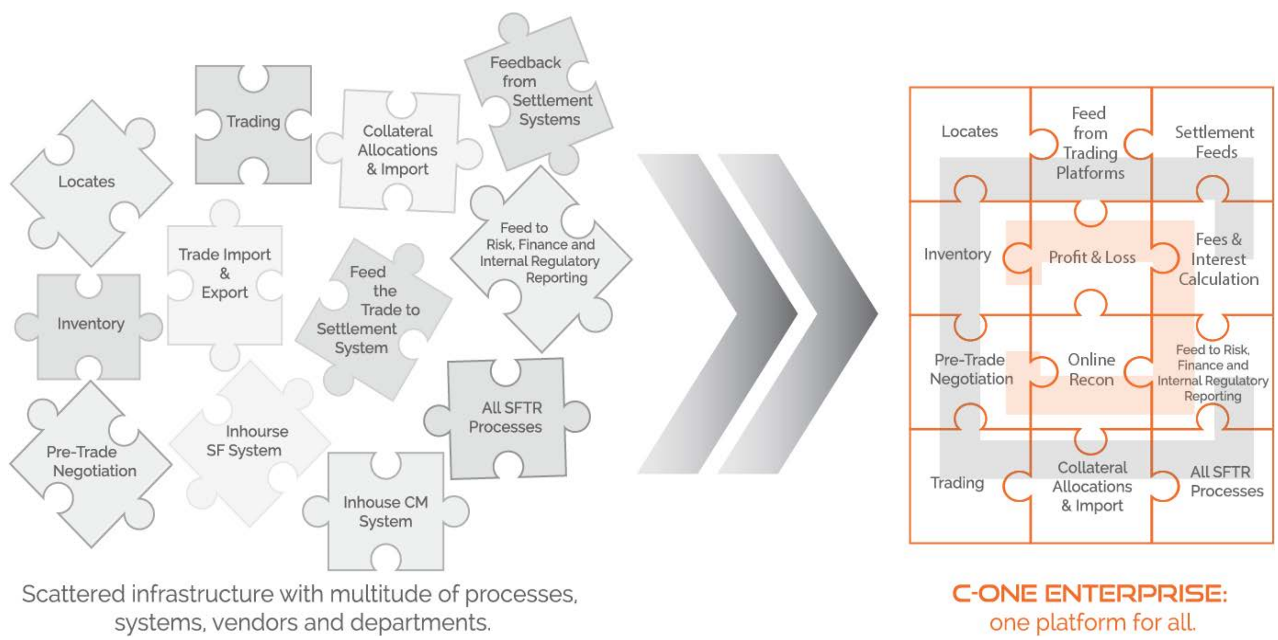
From generating the trade idea, finding your counterparty, online-negotiation, affirmation and trade booking, unique trade identifier generation, collateral allocation or triparty import, reconciliations and feeding the trade to your in-house systems, settlement and SFTR reporting–all this now can be performed on one platform: our C-ONE Securities Finance.

Of course, a firm can't jump from a scattered IT landscape to a single platform in one go. But the good news is: C-ONE, either as a whole or just some of its modules can be added at any point and expanded and migrated step-by-step over time. We would evaluate your existing infrastructure carefully to start with and put together a road map with all the necessary steps and processes and prioritise them according to their value add, cost impact and pain points.

The idea of then starting to implement the most crucial steps then brings us back to the topic of SFTR. Its implementation through C-ONE would subsequently not only solve your reporting obligations but also be the first step and basis towards modernising and fully digitising your securities finance infrastructure and gaining various business benefits at a lower cost.

> ***A firm can't jump from a scattered IT landscape to a single platform in one go***

Figure 3



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The lender's perspective

Mick Chadwick, of Aviva Investors, discusses the current securities lending market and talks through the likely hot topics for this year's IMN conference in London

Maddie Saghir reports

Can you outline your securities lending programme and how it has performed in the past 12 months?

Aviva Investors has around £350 billion-worth of assets under management worldwide, on behalf of both the Aviva Group and external institutional clients. The objective of the securities lending programme is to generate low-risk incremental revenue for our clients' securities portfolios, leading to improved investment performance. Our broader securities finance mandate encompasses a range of collateralised financing solutions, including repo/reverse repo trade execution and, increasingly, collateral management solutions for our derivatives franchise.

Securities lending programme revenue during 2019 so far is down slightly compared with last year. This is largely an industry-wide phenomenon, although changing some of our fund structures has also led to some 'frictional' revenue decline. The good news is that we anticipate increased revenue over the coming six to 12 months as we onboard additional, previously untapped, supply into the lending programme.

From a beneficial owner's perspective, what are the main industry trends impacting you today?

The industry trends impacting us are the same as for most of the beneficial owner and asset management community. There's a focus on improved efficiency and market transparency, plus much more granular transaction reporting, as exemplified by the pending Securities Financing Transactions Regulation (SFTR) reporting obligation. At the same time, there's a much greater awareness of the importance of the securities lending revenue stream given the ongoing cost pressures faced by the asset management industry. In addition, given the significance of securities lending as part of the broader collateral ecosystem, the ability to leverage our collateral management expertise and infrastructure to meet our clients' needs is increasingly acknowledged and appreciated by our clients and colleagues.

How are today's economic challenges affecting the approach and revenue streams of beneficial owners and what could new routes to market be?

We continue to explore all possible trade ideas and routes to market in order to maximise opportunities for our clients. In terms of new trading structures, in the short term the initiative where we're seeing the most traction is the use of collateral pledge arrangements as an alternative to the traditional title transfer structure. While pledge isn't a solution for every beneficial owner, it is an option for the largest, most engaged and sophisticated clients who account for the majority of our programme supply. In the wake of the introduction of more standardised documentation in this area, as sponsored by the International Securities Lending Association, we've seen an acceleration of the dialogue with various borrowing counterparty banks keen to explore this solution.

It has been said that securities lending is no longer just a way to cover operational costs and has emerged as a vehicle to capture alpha. Do you agree?

Absolutely! We've always regarded securities lending as a source of alpha as opposed to being primarily an operational discipline. This difference in approach, coupled with our ability to leverage the institutional heft of the broader Aviva Group, goes a long way towards explaining our track record of significant investment outperformance in this product over the years. Having said this, operational excellence is still a critical success factor; the fact that we have a dedicated securities finance operations team sitting right next to the trading desk continues to be a strong positive differentiator for our lending programme.

Do you feel that historic concerns around the need for HQLA collateral and indemnification have shifted at all?

Obviously there's a positive correlation between collateral flexibility and lending revenue potential. The Aviva Investors lending programme has the flexibility to allow our institutional clients to determine their specific collateral eligibility criteria, based on their risk appetite and liquidity profile. Given that securities lending is something of a peripheral activity for most beneficial owners, they tend to be understandably reluctant to dial up their risk appetite in pursuit of some arbitrary revenue target.

As far as indemnification is concerned, our more sophisticated clients regard this as 'nice-to-have' rather than 'need-to-have'. The quantum of risk in our programme is already very small, given the other risk mitigants in place, plus our track record and credentials in this area. No client of the Aviva Investors lending programme has ever lost any money from this activity in the more than 50-year history of the programme.

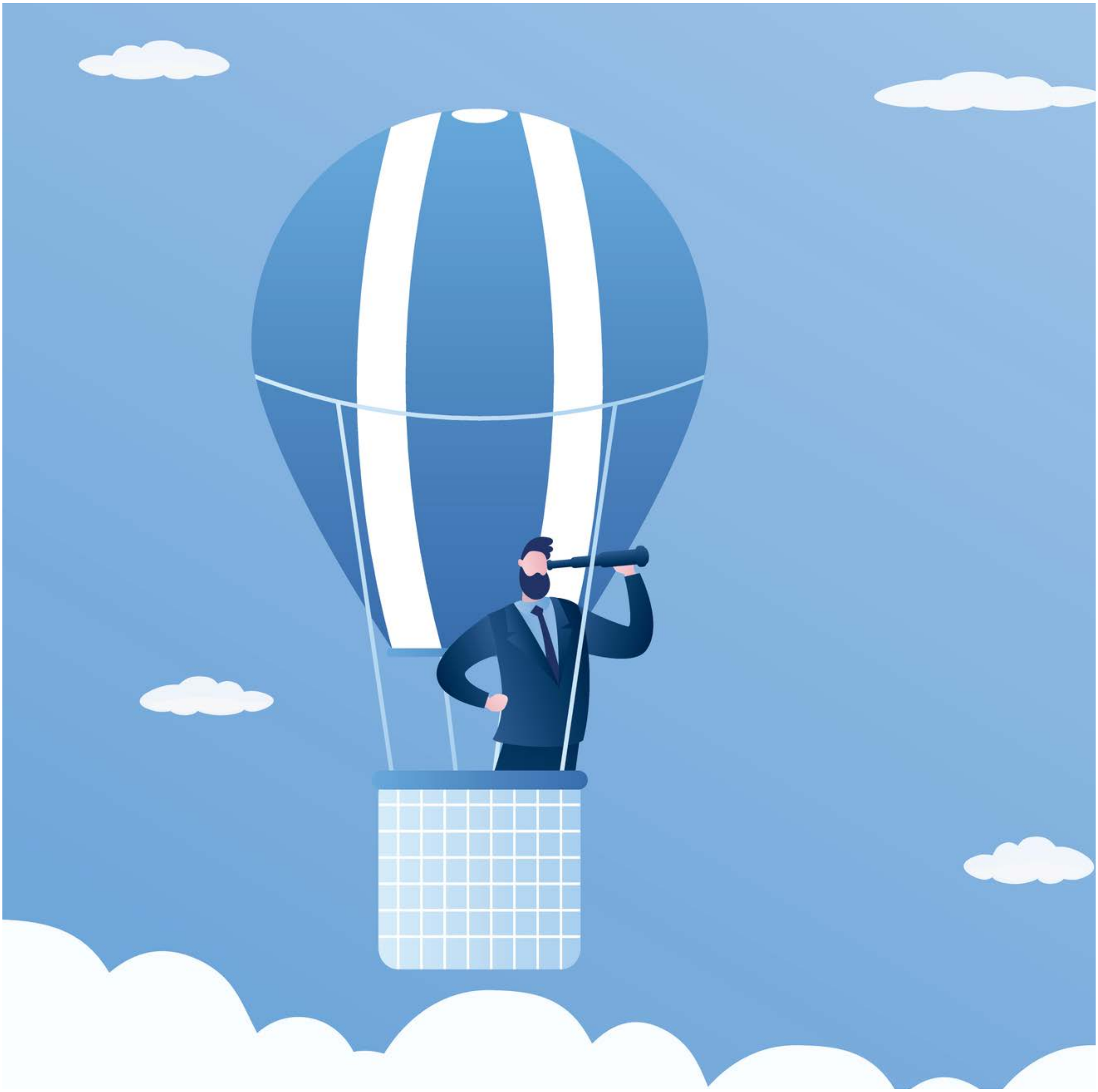
At a previous IMN conference, one panellist said that the industry could be heading towards a non-cash environment, what are your thoughts on this?

Cash collateral/cash reinvestment has always been less of a feature in Europe compared with the US domestic market. This is certainly the case for the Aviva Investors lending programme, given that our clients are predominantly long-only investors who don't require leverage, cash collateral can be regarded as a headache as much as an opportunity; especially when one considers the losses incurred from cash reinvestment by some beneficial owners during the 2008 financial crisis. In the post-crisis environment, regulators are justifiably alert to any activity that can be categorised as 'shadow banking'. As a result, even though we have the mandate to utilise cash collateral/cash reinvestment strategies for some of our larger and more sophisticated underlying clients, the nucleus of our lending programme is likely to consist of non-cash collateral for the foreseeable future.

What topics are you expecting to be discussed at the IMN Beneficial Owners' Conference this year? Will they differ from previous years?

Some of the 'usual suspect' topics will doubtless get another airing at the IMN conference, such as new routes to market, including central counterparties and peer-to-peer. Regulation, especially SFTR, collateral flexibility/optimisation, and blockchain/distributed ledger technology will very likely be discussed as well. One topic that will probably see more focus this year, and rightly so, is environmental social and governance (ESG).

ESG considerations increasingly permeate all aspects of the asset management decision-making process, especially in Europe, and securities lending is no exception. It's important that we dispel any myths that securities lending is somehow incompatible with ESG and good stewardship, particularly given the importance of an orderly and efficient securities financing market as part of the broader sustainable capital market's agenda. Aviva Investors is a prime example of this and we occupy a position of market leadership in both ESG and securities lending and the two businesses work closely together for the benefit of our clients. **SLT**



Emerging trends in securities finance

As summer comes to a close, DataLend's product specialists, Keith Min and Matthew Ross, outline the trends that are currently emerging to see if the securities lending industry heated up along with the temperatures

While overall revenue generated in the securities lending market continued its downward swing through June and July, a few areas bucked the trend in DataLend's findings:

Hot securities back in focus

The first half of summer 2019 was not great for European and North American equity lending revenue, which dropped in June and July by 19 percent and 3 percent respectively, compared to the same period last year. However, the hard-to-borrow equities space, trading at 500+ basis points, experienced increases almost across the board, with loan balances and fees in European hard-to-borrows increasing by 19 percent and 13 percent respectively. That resulted in revenue returns of $116 million, which accounted for 40 percent of all equity revenue in the region over the period, up from 26 percent the previous year. North America saw an increase in hard-to-borrow loan balances and fees by 6 percent and 27 percent respectively. That led to revenue returns of $351 million, accounting for more than half of all equity revenue in the region (62 percent), up from 44 percent the previous year.

Asian ETFs gaining traction

June and July were not particularly good months for Asian equities either with a 23 percent revenue decrease, but not all instruments experienced the same downturn. In this period year over year, exchange traded funds (ETFs) in the region saw increases in the number of securities lent (up 54 percent), average on-loan value (up 52 percent) and revenue generated (up 50 percent). Japan and Hong Kong led the bulk of the activity, with index ETFs for the NIKKEI 225, FTSE A50, CSI 300 and TOPIX all trading within the 50 to 250 basis point (bps) fee range.

Sector highlights

With Applied Optoelectronics, Sunpower and Ubiquiti Networks all cooling from their 2018 peaks, the IT sector saw a substantial dip in average fee from 82 bps to 51 bps in the same period in 2019. However, loan balances in the sector increased by 19 percent year-on-year, leading up to pending acquisitions by both Fiserv and Fidelity National Information Services. The Energy sector also cooled dramatically, from 73 bps to 38 bps, with Tecnicas Reunidas and Diamond Offshore Drilling more recently trading just outside the general collateral range. For higher fees, one would have had to look at the Consumer Staples sector, where average fees doubled over the same period to 140 bps, led by newcomer Beyond Meat.

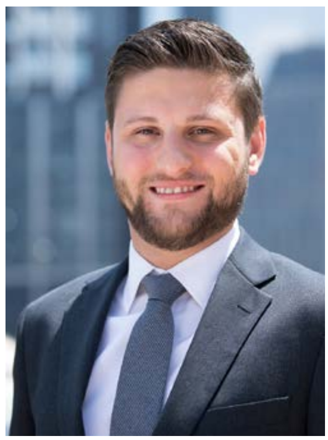
Sovereign debt update

While June and July 2019 witnessed slowing lending activity in global sovereign debt, resulting in revenue decreasing by 23 percent compared to the same period last year, Australian sovereign debt lending increased considerably. Balances rose 25 percent in those months amid rate cuts, leading to a 274 percent increase in lending revenue in this asset. Coincidentally, a similar trend seems to be emerging in US treasurys as balances have increased by 9 percent in the first three weeks of August, following the recent Federal Reserve rate cut.

The first half of summer 2019 was not great for European and North American equity lending revenue, which dropped in June and July by 19 percent and 3 percent respectively

The securities lending industry is showing progress in key areas, and with autumn just on the horizon, DataLend will continue to monitor where these trends lead and no doubt discover new ones along the way.

Keith Min
Product specialist
DataLend



Matthew Ross
Product specialist
DataLend

US retailing stocks deliver significant Q3 revenues

Sam Pierson, director of securities finance at IHS Markit, breaks down the recent big market movements in Overstock.com and the retail sector

The challenges facing retailers are well known, with the shift to online shopping and changing consumer preferences weighing on legacy bricks-and-mortar shopping outlets. This has been a global phenomenon, though the denizens of US shopping malls have been particularly hard hit. Around 2010 Sears was the poster child for the perennially in-demand retail equity, delivering significant lending revenue that helped to offset the terminal decline in share price. More recently Overstock.com and Dillard's have seen increasing borrow demand, which has put pressure on the supply of lendable shares and driven significant increases in lending fees.

In early July the fee for new Overstock.com (OSTK) borrows briefly exceeded 100 percent, the highest level since at least 2006. Then, as lending fees are wont to do, the marginal fee for new borrows declined from the peak, but only so much as required to meet the average fee for all borrows in the 50 percent area, the latter having increased on the back of re-rates as well. As shareholders and short sellers anticipate the digital token dividend (record date 23 September) and contemplate a Patrick Byrne-less OSTK, it's no surprise the borrow availability is still tight and fees remain elevated.

Dillard's (DDS) was a general borrow as recently as June, however, when active utilisation reached 85 percent on 7 June lenders were able to start pushing out new loans at higher fees. The ratio of the NYSE reported short interest to the number of borrowed shares reported to IHS Markit increased from 75 percent in mid-April to 100 percent on 11 June, reflecting a decline in prime broker's ability to internally source shares for short sellers to borrow. The increased utilisation and perceived decline in prime brokerage internal supply, along with increasing borrow demand from short sellers, was the perfect recipe

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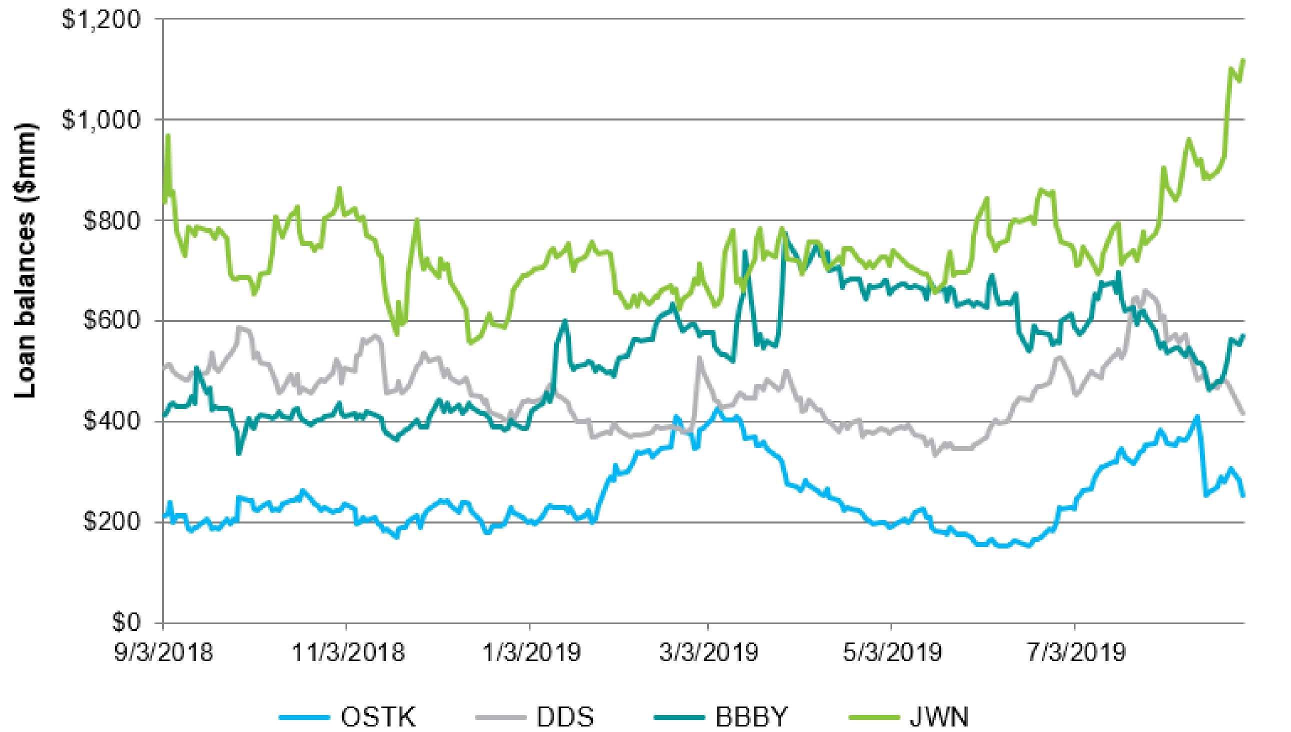
to drive special fees. The average fee for Q3 is 22 percent, suggesting shareholders could realise a gross return above 5 percent over just Q3, roughly equivalent to the quarter-to-date decline in share price.

Bed, Bath and Beyond (BBBY) has some lending characteristics in common with Dillard's in that the ratio of borrows to exchange SI has increased from 80-100 percent since mid-June and active utilisation is greater than 80 percent. The average fee for BBBY shares moved outside general collateral in early June, however, remains in the single digits at the end of August. The absence of a significant increase in fees may be partly explained by an overhang of lendable shares which aren't being made available at current fee levels. Some view on that can be gained by comparing the impact of the 'active' filter which removes inventory lending accounts which haven't recently made loans. For BBBY there are 14 million shares currently being removed based on the lender not having made recent loans, compared with DDS where there are only 360,000 shares being filtered out.

Share price volatility has created trading opportunities on the long and short side in the US retailing industry group. The elevated borrow demand from short sellers has pushed up on lending fees, particularly for some of the stocks with fewer free-floating shares. Stocks in the US retailing industry group have returned $71 million in Q3 loan revenues, already the most for any quarter since Q3 2017, with September still ahead. Upcoming dividends for OSTK, BBBY and DDS could all see increased borrow demand in the securities lending market as broker dealers seek the most efficient means to borrow shares over record dates. With the retailing sector has underperforming broad US equity indices year-to-date, the uptick in lending revenue is a most welcome offset for shareholders.

Sam Pierson
Director
IHS Markit

US Retailing value on loan for popular shorts



Source: IHS Markit Securities Finance

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Comings and goings at ISLA, Northern Trust and SEB

The International Securities Lending Association (ISLA) has hired Farrah Mahmood from JPMorgan Chase as a regulatory and data analyst.

Mahmood started her new role on 2 September and reports to Adrian Dale, director of regulation and market practice.

She joins from JPMorgan Chase where she was a traders assistant manager for securities lending since January 2018.

During her time at JPMorgan Chase, which began in 2015, Mahmood also occupied client service and analyst roles within asset servicing, broker dealer operations and swap middle office.

Dale commented: "We are delighted to welcome Farrah Mahmood at such an important and busy developmental period for our industry. Her skills and experience will bring some new and interesting perspectives to much of the ongoing work we are doing, as well as future projects."

In a statement on the hire, ISLA said it continues to focus on a number of key advocacy and regulatory streams across Europe with its members, regulators, policymakers and other industry stakeholders.

The association added that the latest hire will further bolster these efforts and provide the necessary support to do more.

Vermeg, a regulatory compliance software provider, has brought on AxiomSL's Paul Thomas as UK general manager.

Based in London, Thomas will be part of the Vermeg executive committee and responsible for sales, pre-sales, professional services and local client support for all industries and product lines in the UK.

Thomas has more than 20 years' experience in the fintech and regtech industry and was most recently part of the business development team at AxiomSL from 2016 to 2019.

At AxiomSL, Thomas oversaw its business development for new products in Europe, while also leading the global team for shareholding disclosure monitoring and reporting.

Thomas has also served at Misys and ION Trading.

Commenting on his new role, Thomas said: "I am delighted to join Vermeg at this point in its development. This is a new start for both me and the UK operation, as we move to new offices in Bevis Marks, and I look forward to leading the highly experienced team here in London with a strong portfolio of specialist financial software products."

In March 2018, Vermeg completed its acquisition of Lombard Risk, a leading global provider of integrated regulatory reporting and collateral management solutions.

Vermeg also has recently opened new offices in Brazil and Mexico to meet growing global demand for its specialist software products.

Northern Trust names global head of fixed income

Northern Trust has promoted Joseph Gillingwater to global head of fixed income securities lending trading and senior vice president, based in London.

Gillingwater, who assumed his new role in July, joined Northern Trust in 2016, where he initially served as head of international fixed income trading, securities lending and senior vice president.

From 2003 to 2016, Gillingwater was at State Street Global Advisors (SSGA) in a senior portfolio manager role.

During his tenure with SSGA he held the role of a money market portfolio manager investing in commercial paper, certificates of deposit, fixed and floating rate notes/medium term notes, treasury bills, repo and cash deposits across held in euro, British pounds and US dollars.

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Nordic corporate bank SEB has welcomed Jonas Örn as its new senior equity finance trader as part of its strategy to expand its securities finance team.

SEB's equity finance desk offers securities lending, equity repos, margin financing and synthetic financing, which includes products such as total return swaps and single stock futures.

Örn, who will continue to be based in Stockholm, makes the move from Nordea Markets where he had served as equity finance chief dealer since 2008.

Dan Murphy, head of equity finance at SEB, said: "Jonas Örn will play a key role in further developing and enhancing primarily our financing trading capabilities, but will also add additional trading experience to the desk as we look to grow both the breadth of our product offering and the client base of our business."

Northern Trust has promoted Grace Hayman to senior relationship manager for its securities lending business in Australia and New Zealand.

Now based in Sydney, Hayman will be responsible for leading the securities lending business development activities across the region.

Previously, Hayman worked out of the bank's Singapore office as a relationship manager in charge of the multifaceted Southeast Asian securities lending client base.

Hayman joined Northern Trust in 2011 as part of the GOLD Programme, which provides experience in a number of key business lines through an 18 month rotational programme. Her first role at Northern Trust was in 2013 as securities lending associate product specialist.

Since then, she has worked in a number of securities lending product and client management roles in Northern Trust's London office before moving to Singapore in 2016.

Mark Snowdon, head of capital markets for Asia Pacific at Northern Trust, commented: "Northern Trust continues to build its in-market support and expertise to meet the increased demand for innovative securities lending solutions from asset managers and asset owners."

"Grace Hayman's experience will be instrumental in further strengthening our relationships with clients in Australia and New Zealand and providing technical insights and expertise to this sophisticated market."

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