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# Deloitte: ‘Shadow banking’ is worth $9.53 trillion

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The ‘shadow banking’ system in the US may not be as large as regulators and market participants fear, but its size could increase as regulatory changes and financial innovation take hold, according to a new quarterly index from the Deloitte Center for Financial Services.

The Shadow Banking Index defines shadow banking to include components that make up a market-funded, credit intermediation system of maturity and liquidity transformation through securitisation and secured-funding mechanisms.

To some extent, it exists outside of the traditional banking system and does not have government guarantees, according to Deloitte.

The index shows that the shadow banking system totalled $9.53 trillion at the end of 2011, which is more than 50 percent below its peak in 2008, and a figure that is considerably lower than many estimates.

“With other size estimates ranging from $10 to $60 trillion, we think shadow banking is a concept continuing to look for a better definition,” said Adam Schneider, executive director of the Deloitte Center for Financial Services.

Don Ogilvie, who is its independent chairman, added: “We expect that the components in the index will increase or decrease as new laws and regulations are adopted and new financial products are created.”

The index counts securities lending as an activity of the shadow banking system. Other entities and activities include collateralised debt obligations and repo agreements.

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## SLT**INBRIEF**



## Spain’s CNMV wants short selling back

Spain’s stock market regulator the CNMV said that it is lifting a ban on short selling of financial stocks that had been in force since August, saying market volatility had eased in recent weeks.

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## Kellner rebrands and launches new fund

Hedge fund manager Kellner DiLeo & Company has been reorganised and renamed as Kellner Capital. It has also launched a new event-driven investment fund.

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## Spain's CNMV wants short selling back

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The lifting of the ban became effective on 7 June, and affects shares in 16 financial companies that are traded on the Spanish stock exchange.

It comes after France and Belgium eased their restrictions, and the UK's Chancellor of the Exchequer, George Osborne sued the EU over its plans to ban short selling.

The CNMV added that investors taking significant short positions must disclose these positions to the regulator.

## Kellner rebrands and launches new fund

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George Kellner, the founder and CEO of Kellner Capital, said: "The firm has experienced exciting changes and we thought it appropriate to rebrand the organisation."

Kellner Capital's new fund launched with more than $50 million in assets.

"We believe our investment process which combines rigorous fundamental research with volatility trading provides an edge as we focus on niche opportunities which are less followed and undiscovered," said Kellner.

He added that the firm continues in its matched book securities lending partnership and that it is exploring opportunities in the alternative mutual fund space.

## Deloitte: 'Shadow banking' is worth $9.53 trillion

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The index found that securities lending is the only activity to have doubled in volume since the index's baseline in 2004, adding that securities lending is "vital to the functioning of the modern financial system".

In an emailed statement, Pat Cestaro, the co-CEO of Quadriserv, which runs the AQS securities lending platform, said: "Securities lending has done well as an industry and I foresee it continuing to grow in the future."

"With the increased importance of collateral optimisation, firms, banks and funds are increasingly reluctant to let the securities they're holding just sit there and not provide additional value. Also, when the economy does show signs of significant strength and participants come back to the markets with conviction, securities lending will expand further."

He added that both financial innovation and new regulations would have a large effect on securities lending, as they both go hand-in-hand.

He said: "We are seeing increased interest in our AQS securities lending platform in part because of its trading automation. That goes back to the trend of more efficient use of capital, which includes employees. At the same time, our model with OCC as the central counterparty to every transaction on the AQS platform is attracting more participants because it mitigates counterparty risk."

"Regulatory changes now being considered have made counterparty risk a priority. Even if securities lending doesn't have mandates for central counterparty clearing, many firms will be using CCPs for trading and other financial activities. And for those that focus on collateral optimisation, our securities lending platform will factor into those calculations as many firms have large collateral requirements at OCC. AQS could be a tool used to help optimise the use of their collateral, so there will be a cross-over effect, if you will."

## UK sues EU over plans to ban short selling

It has been reported that the UK's Chancellor of the Exchequer, George Osborne, has filed a lawsuit against the EU in a bid to stop it giving the European Securities and Markets Authority (ESMA) the power to limit or ban short selling in an emergency.

The lawsuit was reportedly filed with the Court of Justice for the EU on 30 May.

ESMA was established in January 2011 to act as an independent EU authority to help to safeguard the stability of the EU's financial system.

In the UK's lawsuit against the EU, its lawyers will argue that that the short selling powers are illegal because ESMA has wide discretionary powers that are outside of the scope of EU treaties, according to reports.

## Paladyne helps clients to meet Hong Kong SFC's short requirements

Investment management solutions provider Paladyne Systems has added capabilities to its order and portfolio management solution, Paladyne Portfolio Master, to help clients to meet the Hong Kong Securities and Futures Commission's (SFC's) requirements for fund managers to disclose net short positions.

The SFC rules come into effect on 18 June. The first reporting day will be 22 June and the reporting deadline will be 26 June.

All fund managers that are holding short positions in Hong Kong stocks will be required to comply.

Paladyne Portfolio Master can streamline these reporting requirements, according to Paladyne. The solution automatically imports the SFC's

database of companies that must disclose short sale positions and allows clients to generate daily monitoring reports.

It also generates a weekly disclosure to the SFC on relevant short positions that fulfill the prescribed thresholds.

"Paladyne has built an institutional framework that positions investment firms to be able to respond to global rule changes and other regulatory and compliance requirements rapidly and on time," said Sameer Shalaby, who is Paladyne's president.

"As a result, fund managers and service providers can fulfill their reporting obligations, including internal compliance and approvals checks, in a timely manner with minimal manual intervention."

## SGX's SBL programme totals $20.3 million

Daily average outstanding loans under the securities borrowing and lending programme at the Singapore Exchange (SGX) totalled $20.29 million (S$26.1 million), up 31 percent from a year earlier.

The total volume transferred for SBL increased 113 percent in May from April.

SGX also found that the volume of its derivatives business and OTC clearing continued to see growth in May.

Securities daily average value (SDAV) fell 20 percent year-on-year and 0.5 percent month-on-month. However, the total number of securities trades went up to 3.9 billion in May, a 34 percent annual increase and 8.5 percent monthly increase.

Derivatives volume rose almost 40 percent year-on-year to 6.9 million contracts, and daily average volume grew 31 percent to 320,715 contracts.

## OCC scores May 2012 clearing increase

OCC cleared 5 percent more contracts in May 2012 than it did in the same period in 2011.

It cleared 380,417,938 contracts in May 2012, compared to 362,653,311 in May 2011.

The equity derivatives clearing organisation operates under the jurisdiction of both the US SEC as a registered clearing agency and the US CFTC as a derivatives clearing organisation.

It provides CCP clearing and settlement services to 15 exchanges and trading platforms for options, financial and commodity futures, security futures and securities lending transactions.

Securities lending, options and futures contracts make up OCC's total statistics for May.

OCC's stock loan programmme, which includes OTC and AQS (a securities lending platform that is operated by Quadriserv), saw 83,144 new loan transactions in May, a 30 percent increase on the same period in 2011.

Year-to-date securities lending activity increased by 14 percent from 2011 with 378,294 new loan transactions in 2012. OCC's stock loan programme had an average daily notional value of $32,519,734,680.

## Fox River adds equity algorithm to solutions suite

SunGard's Fox River has enhanced its algorithm suite with a US equity 'dollar certain' algorithm, which is used when traders want to execute a trade in dollars rather than shares.

Trader who want to trade dollar amounts must manually convert the figures into specific numbers of shares and then enter those numbers into their trading systems. Fox River's algorithm automates this manual process.

The new algorithm helps traders to avoid calculation errors and reduce operational risk, according to SunGard.

Bob Santella, the chief operating officer for SunGard's Fox River and Valdi trading solutions in the US, said: "Fox River's dollar certain algorithm was driven by customer requests and designed to help them become more efficient, which is one of their key challenges."

"This new algorithm helps turn a purely manual process into an automated one, helping to save a trader's valuable time, increase efficiency and reduce operational risk."

## Algorithmics launches pension risk management solution

Algorithmics, an IBM Company, has launched a new edition of its existing solution, Portfolio Construction and Risk Management for Pension Funds, to help pension funds better manage their funding status.

Algorithmics has recently signed the Alberta Teachers' Retirement Fund Board (ATRF) as a client for the new edition of the solution. Derek Brodersen, chief investment officer of ATRF, said: "Pension funds are increasingly being required to meet higher standards for risk management."

"With Algorithmics we have a solution that helps us address our fiduciary requirements. Our former risk advisory service used Algorithmics as its technology platform so we are familiar with the software and the quality of risk analytics to help set and monitor our performance against agreed risk targets and limits."

Dr Andrew Aziz, the executive vice president of buy-side risk solutions at Algorithmics, commented: "Pension funds are facing more complex and volatile markets. While this requires sophisticated understanding of invest-

ments and risk, many smaller funds lack specialised staff, data and infrastructure to meet evolving needs."

## Finadium releases counterparty default indemnification report

Securities and investment research firm Finadium has released a research report on the future of counterparty default indemnification in securities lending programmes as new regulations in the US and Europe threaten indemnification's position as a free offering.

Beneficial owners, such as pension plans and mutual funds, consider counterparty default or borrower indemnification to be an important part of their securities lending programmes, according to Finadium.

But regulatory initiatives that are designed to reduce risk in the banking sector are threating the future of counterparty default indemnification.

Finadium said that Basel III's recommendations on leverage and capital usage could negatively affect the indemnification practice if accounting for indemnification pushes banks above required ratio levels.

Similarly, provisions of the US Dodd-Frank Act could constrain indemnification if accounting standards are set unfavourably, according to Finadium.

Finadium's research report evaluates regulatory changes that could affect indemnification for US, European and global agency securities lending providers.

It concludes with ideas on quantifying the value of indemnification for both service providers and beneficial owners.

The research report is aimed at asset holders participating in the securities lending market and their legal advisors, and securities lending agents, prime brokers, regulators and hedge funds that rely on short selling.

## SimCorp: Dodd-Frank is a catalyst for change

Investment management software and services provider SimCorp has released a white paper examining credit risk exposures and how buy-side firms can use the US Dodd-Frank Act to assess their readiness for credit risk reforms and implement risk management.

The white paper, which is authored by Else Braathen, the head of the risk management domain at SimCorp, looks at the Dodd-Frank definition of credit risk exposures and the obligations and opportunities that this presents to buy-side firms, assessing a firm's readiness for credit risk reforms, and credit default management.

The white paper's release comes as 30 percent of respondents to a SimCorp poll, which surveyed approximately 100 executives from 50 buy-side firms in the US, admitted that it would take days or weeks to estimate the profit and loss of a potential default of the companies to which they are exposed.

Dodd-Frank outlines that credit exposures need to be measured across all transactions and holdings to limit the ripple effects of company defaults, explained SimCorp.

"While Dodd-Frank is a good start for credit reforms, definitions are limited and overlook the potential default of the issuers of the derivatives' underlying assets, which can have a significant impact on a firm's exposure," said Braathen.

The white paper goes on to identify eight aspects of an effective credit default risk solution.

These include: consolidating position-keeping across all holdings for an accurate view of exposure; identifying exposures for all issuer and counterparty risks; showing underlying issuer risks derived from the underlying assets of derivatives and funds; including collateral to view mitigated counterparty risk exposures; and aggregating all of these to gain a complete view of exposure in case of a default.

David Kubersky, the managing director for SimCorp North America, said: "While OTC derivatives have come under fire for being risky products, they can also provide great returns if managed with a 360 degree view into both exposure and performance."

"Many of our clients who chose to leverage technology to facilitate transparency in the trade

# MXCorner

## Moving towards a Solvency II solution

There has been a lot of talk in the broader market about Solvency II, the new capital and risk regime that is currently aimed at insurance companies, but it is likely to end up affecting pension funds too, although not so much in securities lending. The implementation dates keep moving and there is a real push from insurance companies for EOPIA (European Insurance and Occupational Pensions Authority) to reduce the complex approach and requirements, but it is coming and it will, in whatever form that it ends up taking, require some attention from lending agents.

Like Basel II, Solvency II is based on three pillars with the third, Supervisory Reporting and Public Disclosure, being the biggest issue for agent lenders. In their current form, the reporting requirements require daily analysis of loan and collateral positions on a security-by-security basis. This includes any underlying cash investments, even if they are made via money market funds. If agent lenders are lucky, their clients will only require the detailed daily reporting of these outstanding positions, but, given that there are specific requirements for lending activity, it is more likely that they will require the completion of the regulatory reporting templates (known as Quantitative Reporting Templates, or QRT).

These templates require a significant and detailed enrichment of each security, whether it's lent or held as collateral, and the complexities that are involved in gathering, mapping and enriching the data mean that existing in-house reporting packages are unlikely to give beneficial owners the information that they need. Additional attributes that are not otherwise required in the business or for client reporting mean that agent lenders will need to find a way to source the additional data, either from internal securities databases or from vendors such as Bloomberg or Reuters.

In the last MX Corner, I talked about transparency and that lenders have often relied on tactical solutions for the delivery of regulatory reporting. For Solvency II, the complexities and frequency mean that it is impossible to think that a tactical or manual process will be acceptable. Although Solvency II implementation dates remain uncertain and the requirements still have some ambiguity, many lenders have already started to look at the requirements and are realising that delivery is complex and requires significant thought, planning and development.

But it's not all doom and gloom: once the numbers are crunched (via Pillar One—Quantitative Capital Requirements), securities lending seems very attractive when compared to many other asset management strategies. If agent lenders can understand this and present the business to clients using a Solvency II analysis, insurance companies should become more enthusiastic towards lending activities and be prepared to consider lending proposals and strategies more favourably.

**Sarah Nicholson, senior partner**
**MX Consulting Services**

lifecycle were among those least impacted by the 2008 financial crisis."

## CalPERS awards Citi $28 billion in assets

Citi was granted access to $28 billion of securities lending assets held by CalPERS in an auction conducted by eSecLending.

The lending auction was of $43 billion in US equities, with the remaining assets awarded to other participating bidders and to eSecLending's discretionary lending programme.

"We are thrilled to have won these assets and deepen our relationship with CalPERS," said Alan Pace, head of prime finance in the Americas at Citi.

"This win is a testament to the growth we have experienced in our prime finance franchise as well as our continued commitment to provide our clients with access to the highest quality borrow."

## Newedge calls it a day in Greece

Prime brokerage firm Newedge is pulling out of the Greek market.

The broker, which is a joint venture between two banks, Société Générale and Crédit Agricole, is purportedly Europe's seventh largest hedge fund prime brokerage business with more than $30 billion in client assets.

It has been reported that Newedge told its clients that it will cease extending margin loans for existing positions in Greek securities, and will only process sell orders.

The securities that are reportedly subject to the new restrictions include foreign-listed shares and American depositary receipts for Greek companies such as Alpha Bank, Coca-Cola Hellenic Bottling and Paragon Shipping.

The broker said that the decision to pull out of Greece is a part of its ordinary risk practices, which are aimed at minimising potential exposures proactively when the broker is concerned about potential issues.

## Clearstream's sec lending rises 5 percent

For Global Securities Financing (GSF) services, the monthly average outstanding at Clearstream in May 2012 reached €579.2 billion. The combined services, which include triparty repo, securities lending and collateral management, collectively experienced a rise of five percent over May 2011 (€552.7 billion).

3.4 million international settlement transactions were also processed in the month, a four percent increase year-on-year. Of all international transactions, 82 percent were OTC transactions, and 18 percent were registered as stock exchange transactions.

## Judge approves J.P. Morgan's settlement with AFTRA

A Manhattan judge has approved J.P. Morgan's $150 million settlement of a lawsuit over losses from the bank's securities lending programme.

Pension funds American Federation of Television and Radio Artists (AFTRA) Retirement Fund, the Imperial County Employees' Retirement System, and the Investment Committee of the Manhattan and Bronx Surface Transit Operating System brought the suit against J.P. Morgan in 2009.

The case was brought against J.P. Morgan because it invested in pension plans' and other entities' cash collateral in medium-term notes of Sigma Finance, while at the same time extending repurchasing financing to the company.

Staunton's View

# Doing the splits: is the practice perfect?

During the early 1990s, securities lending was in its infancy, at least in Europe anyway. Networked PCs were only just being introduced, and Blend, which was the UK sec lending system of the time, was used to input and match trades. There were separate legal agreements for UK equities and gilts, and there were different agreements for overseas securities. All in all, it was quite a formidable exercise for a new lender to enter the market when it was faced with this mountain of legal paperwork. Back then, securities lending was almost exclusively done by custodial banks that had custody of the assets, and so they were in the best position to offer the service on behalf of their clients.

In today's environment, much has changed to make it a less onerous task for new lenders to sign up: legal agreements are more streamlined and there are less of them; CCPs have emerged, along with trading platforms, third-party agent lenders, benchmarking services and reconciliation systems; and there have been huge advances in technology that have made some of the above changes possible.

But something hasn't changed; the dreaded fee split. You know the one: that singular page in an RFP that lenders quickly turn to, so that they can see how much they will make from the estimated revenue. The ratios have changed quite significantly. I remember 50:50 and 60:40 fee splits as common. Nowadays, 90:10 is common, and the split can be even less if you are a big enough lender. So my question is this: why has this part of securities lending failed to change, and when, if ever, should it change?

I believe that change here is long overdue. The business is more sophisticated than it was and this alone should trigger changes to fee splits. Applying a straightforward ratio against all loans falls short of the mark in the current securities lending environment.

As an example, should the fee split that is used when lending UK equities be the same as the fee split that is used when lending equities from an emerging market such as Taiwan? One is a very liquid, automated market where the costs of delivering a loan, as well as monitoring and reporting, are highly automated and cheap. The other carries additional risk, set up costs through research and development, and lower liquidity. Would a different fee split be appropriate in this example?

What about the practice of offering indemnifications to a beneficial owner against potential losses in the case of a default? This is a costly exercise for service providers that are now being charged internally for the use of capital that has to be set aside to cover risk. Those providers without a bank-size balance sheet to rely on have found that the costs of using an external provider to offer an indemnity have risen astronomically since Lehman Brothers went bust. There is a real cost to offering indemnification, but how is this being factored into the equation of revenue share between a provider and a beneficial owner?

If this wasn't enough, custodians that offered custody for free, or those that heavily discounted their fees to attract potential securities lenders, did so in the good times when it was inconceivable that markets would crash in the way that they did after the collapse of Lehman Brothers. Many lenders suspended lending and asset values fell, leaving agent lenders with clients paying little for the custody of idle assets that were not earning their keep. Did banks ensure that mechanisms were in place in any agreements to cover such eventualities? I imagine that many did not.
Ultimately, what could be the catalyst for change is the Financial Stability Board's review of shadow banking. It has already highlighted the indemnifications that are being offered and asked whether losses in cash collateral re-investment should be shared between agent and lender (which currently is not the case).

Whether this change is market or regulatory driven, it remains to be seen whether the business, and the systems that it relies on, can cope with replacing what is a simple method of calculating revenue share with a more sophisticated approach.

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# In the eye of the beholder: an association's POV

## SLT talks to the International Securities Lending Association's (ISLA's) Kevin McNulty about what lies ahead for securities lending

MARK DUGDALE REPORTS

### What do you make of the varying valuations of the shadow banking system?

There are a number of estimates of the size of the shadow banking system. This is partly due to the fact that the definitions of what constitutes shadow banking vary. The Financial Stability Board (FSB) has been helpful to clearly define what it is—"the system of credit intermediation that involves entities and activities outside the regular banking system"—but even with that definition there is considerable room for interpretation of what's included and what isn't. There has been some confusion about whether the system should be determined by the types of institutions involved, or by specific activities performed.

For securities lending, we think that it makes sense to consider activities rather than entities, and in particular, those that may be perceived to give rise to possible systemic risk. Arguably, some forms of securities lending don't fall within the FSB's definition at all, for example, where an institutional investor lends equities and accepts equities as collateral. I don't think that the precise size of the shadow banking system matters as much as being clear about what activities are supposed to be covered. Whether the system is $10, 20 or 50 trillion, the numbers are large enough for policymakers to be interested. The job of the markets that are covered is to help the policymakers focus their efforts on the right set of issues.

### What is supply and demand in securities lending like at the moment?

My perspective in this comes from my dealings with our members. The market is often considered to be over-supplied—this comes from a quick study of the aggregate supply and demand numbers that are provided by the data companies that cover the market. While this might be somewhat true at an aggregate level and overall returns have been subject to some downward pricing pressure, I hear that at a specific security level that this isn't the case. Lenders have confirmed that this has been a very good year so far in terms of returns, which is encouraging.

In terms of boosting supply, agents continue to do a good job of raising the awareness and understanding of this market with beneficial owners, and this is key. In the three years since taking this role, I have had the pleasure of participating in many events such as conferences, roundtables and webinars that were put on by our members and designed to educate end investors. Demand is perhaps trickier to develop as ultimately this will be driven by activity in the cash and derivatives markets (in turn driven by the conviction and risk appetite of active investors), but with prime brokers developing their services to make access to securities financing transactions easier this can only help when market conditions become more favourable.

### What challenges have ISLA and the industry faced since you became chief executive?

A trawl back through the inbox and calendar is all it takes to highlight the amount of time that we have been spending on regulation. Financial regulation is not new, but what distinguishes the past three years from the period before that is a more fundamental questioning of the role of the markets (something that we have generally taken for granted in the past), and the direct participation of a new set of actors in the process, the politicians. Until 2007, discussions about securities lending regulation were very focused on investor protection issues and were generally quite specific to such things as what types of collateral an investor could accept. These discussions took place with regulators who largely understood that securities lending was a positive activity and was to be encouraged (the same wasn't true however of some regulators' attitudes to short selling).

> We and others have appealed to the European Commission for future legislation to have more reasonable development timetables

Today the discussions are mostly focused on systemic risk and within this, a view that the market itself cannot see the dangers that might exist when all transactions and exposures across a wide range of activities are added up. This is a relatively new discussion for us and one which we have had to adapt to quickly.

ISLA has a wide range of issues on the table at the moment, but the most important is the review of shadow banking. But it's not all regulation, our tax, operations and corporate governance sub-groups have been very active, helping to stay ahead of issues that could affect our market and ensure that our members have the opportunity to stay abreast of them. Highlighting just two of many live issues are the UK tax authority's proposal to abolish the manufactured overseas dividend (MOD) regulations, and a review of the Stewardship Code by the UK Financial Reporting Council.

### How has ESMA worked to unify securities rules in the EU and what do you make of this work?

ESMA has certainly had its hands full since its formation last year. Our dealings with ESMA have been confined to the development of the Level II text for the short selling regulations due to come into force in November, as well as some proposals for new guidelines covering UCITS funds. In the case of short selling, we were not completely happy with the outcome of the Level II text, but to ESMA's credit, I believe that it took the time to listen to us and consider our concerns. At the end of the day, ESMA was given an incredibly difficult task of developing complex Level II text in an extremely tight timeframe and this wasn't helpful. We and others have appealed to the European Commission for future legislation to have more reasonable development timetables. At this stage, we are still awaiting the new guidelines for UCITS and hope that ESMA will take our concerns on board.

### How important is collateral reinvestment to an efficient and profitable securities lending industry in Europe?

Cash collateral is an extremely important form of collateral. Arguably, it is the most attractive form of collateral, but as everybody knows, taking cash collateral involves some form of investment risk. Estimates suggest that in Europe, much less than half of the business is against cash collateral, while in the US, the number is north of 90 percent.

Having said that, I believe that European investors should have the ability to take cash collateral and reinvest it with appropriate levels of risk. One of the proposals put forward for UCITS was that cash collateral should only be invested in risk free assets. If this were to happen, it would simply mean that UCITS funds would not be able to realistically use this option and would be deprived of one of the best forms of collateral available. I would think that regulators would prefer to see the lending market be as diversified as possible when it comes to aggregate collateral levels, and while rules that would help prevent the re-occurrence of well publicised cash reinvestment losses make sense, preventing cash collateral from being an option may result in higher concentrations of other collateral assets.

### What did ISLA make of the FSB's interim report?

We felt the report was actually quite good and that it's hard to argue with the core findings. Of course, at this stage the FSB has not published any policy recommendations and that's the stage where things will get most interesting. I know a lot of firms get quite excited by some of the statements that the FSB make, arguing that many of the risks that are considered are very theoretical and not reflective of current market practice. We have to remember that the FSB is focused on what might happen and it's in all of our interests to ensure that policymakers and regulators have the comfort that they need that there will not be future major risk situations arising in the future.

We have made it clear to the FSB that we support more discussion about making this market more transparent. While we know that a lot has happened in the area of transparency in recent years—be it the advent of Data Explorers and SunGard, the development of codes of practice governing disclosures by agents to beneficial owners, or the development of the agent lender disclosure framework—regulators do not necessarily have the data that they need to feel comfortable that there are no issues.

We have also said that we do not support some of the proposals being mooted by influential policymakers, such as the mandatory central clearing of all securities lending transactions or the imposition of a minimum margin (haircut) on collateral.

At this stage, we are open minded about where this will end up, but we feel that we have a good dialogue with the FSB and we will certainly be staying close to them over the next few weeks and months.

### What do you expect to be the hot topic at ISLA's Conference in Madrid?

Surprise surprise, shadow banking! It would be nice to think that the FSB might conclude in November that the securities lending market is in great shape and that there's no need for any new policy proposals, but I'm afraid that isn't going to happen. The conference will provide a good opportunity for attendees to hear from the FSB directly, as well as other senior regulators on this topic, and to get involved in roundtable discussions on this and other subjects.

I'm personally also looking forward to a new panel session this year that includes the heads of trading from lenders and borrowers on what they see happening in the markets.

We have two very significant keynote speeches that top and tail the conference: David Wright, the new director general of IOSCO; and Michael Portillo. With everything that's going on in Europe, I'm sure that they will have plenty to tell us about. Registrations are running ahead of our last two years, reflecting the interest in the market in meeting and discussing these issues, and I'm looking forward to a very productive conference. **SLT**

**Kevin McNulty**
Chief executive
International Securities Lending Association


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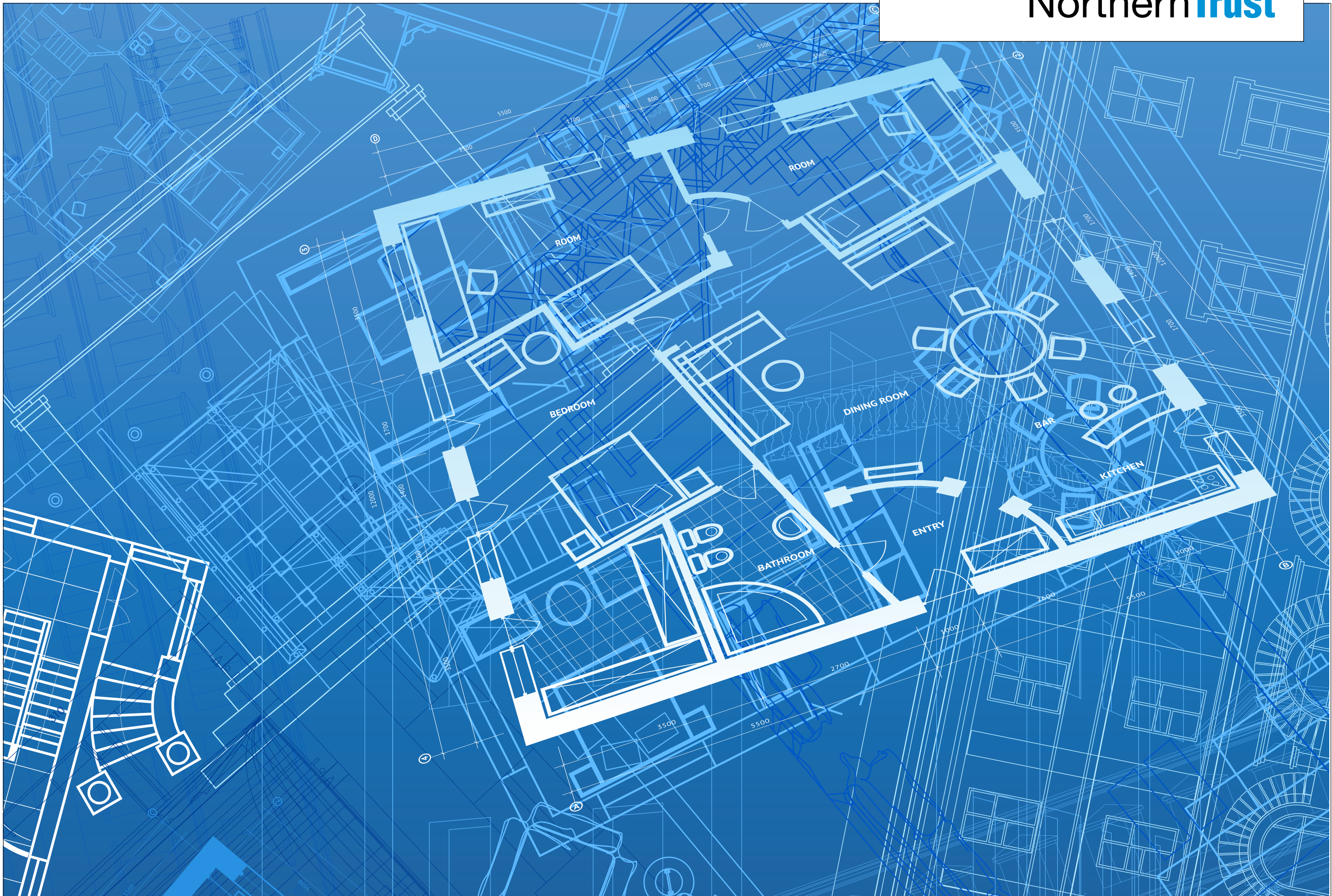


# Conversations with...

## SLT talks to Sunil Daswani and John Irwin of Northern Trust about agent lending, Asia and the particularities of supply and demand

MARK DUGDALE REPORTS

### How is business at Northern Trust the moment?

**Sunil Daswani:** Our securities lending business is doing well. Client interest in securities lending continues to grow with new participants joining securities lending programmes and current clients increasing their securities available to lend. Clients are interested in extracting incremental return from their portfolio so long as they have the ability to manage risk. It is a good time for clients to review potential securities lending opportunities and to establish a programme that fits their risk and return objectives, allowing them to capitalise on dynamic market opportunities going forward.

### How did the agent lending business in Asia change in the wake of the financial crisis?

**John Irwin:** The securities lending business in Asia, although not immune to the financial crisis, did show more resilience than other regions, which was largely supported by robust demand for the emerging market space. This demand continues, particularly in South Korea and Taiwan, as spreads and revenue prospects remain compelling.

Despite this trend, the regulatory environment has proven challenging at times amid the imposition of various short selling requirements. Complying with these requirements has demanded careful attention from industry participants, and in many cases, the requirements have been restrictive.

The cost of funding has become increasingly prominent and has driven some borrowers to internalise supply, contributing to lower overall general collateral balances in the market. Ultimately, this has driven lenders to focus even more on maximising incremental revenue from ‘hard to borrow’ securities. The desire from borrowers to pledge cheaper forms of collateral has required lenders to adopt a more flexible product offering to secure business, and this remains a major theme in the region.

For Northern Trust, Asia has increasingly become a more prominent market for clients in terms of incremental revenue as demand continues to outweigh supply, both in emerging and more developed markets, particularly Hong Kong, which has grown into one of the most important and active markets over the last year.

### What regulation do you think will change securities lending the most and why?

**Daswani:** The global regulatory environment is a prominent topic of 2012 with the roll-out of new rules from a multitude of regulations. In Europe, Solvency II, which is the EU directive that codifies and harmonises regulations applicable to insurance companies that are domiciled in the EU, may affect the securities lending industry. As an important investment tool for EU insurers, securities lending transactions and associated collateral fall within the scope of investments and holdings, so we are currently working to ensure that we are able to provide our EU insurance clients with the required granularity of reporting to ensure that they can meet their future regulatory obligations.

In the US, the Volcker Rule as part of the Dodd-Frank Act may have an impact on the industry. The Volcker Rule generally restricts banking entities from engaging in proprietary trading and investing in or sponsoring unregistered private equity funds and hedge funds. In theory, such a restriction should have little impact on securities lending. However, the Volcker Rule's broad definitions of 'hedge fund' and 'private equity fund' also encompass certain unregistered cash collateral reinvestment pools that are sponsored by agent lenders. As a result, lending agents may need to consider alternative investment strategies or structures for cash collateral reinvestment.

Northern Trust's securities lending experts are active in industry associations around the world, allowing us to provide valuable input to the various agencies that are responsible for drafting these new regulations. Our involvement also puts us at the forefront of regulatory and market changes, which ultimately benefits our clients.

## What is of particular concern to agent lending?

**Irwin:** At this time, I would say that there are two topics that most lending agents are focusing on. The first is attempting to anticipate changes in the regulatory environment and their impact given the large variety of rules being rolled out. The second is dealing with subdued levels of trading activity, mostly due to uncertainty surrounding the eurozone and the long bias that hedge funds continue to maintain.

## What are collateral demands like in Asia?

**Irwin:** The ability of a lender to be flexible and accept a variety of collateral provides a competitive advantage as borrowers increasingly look to manage their balance sheets more efficiently in this environment. The cost of pledging US cash and sovereign debt collateral has risen in Asia, as it has in Europe, and therefore, for the majority of borrowers, equity collateral on both a single and cross currency basis has remained a priority for some time. However, there are further flexible forms of collateral that have emerged in Asia, including corporate bonds, JGBs (Japanese government bonds) and yen cash collateral.

## What is more important to your clients: quality collateral or high quantities of collateral?

**Daswani:** Probably both! I would have to say higher quality of collateral given the continued uncertainty in the market. Our clients know that, at Northern Trust, we mark-to-market daily, and if necessary, collateral that is requested each morning is required the same day. We continue to expand the variety of collateral that we can accept on behalf of our clients and provide them with the opportunity to customise the collateral that they accept.

## Who are the traditional beneficial owners in Asia and what is their supply like at the moment?

**Daswani:** Generally, the beneficial owners that are domiciled in Asia and who are clients of Northern Trust are government entities and sovereign wealth funds. Their supply continues to be global across all asset classes and stable in nature.

## What about equity supplies?

**Irwin:** Global equity supply has substantially recovered to the levels that were seen prior to the financial crisis in 2008. This recovery has not only been driven by overall higher equity valuations since the crisis but also, notably, by lenders re-engaging in securities lending. We have seen beneficial owners that had either reduced exposures to the securities lending markets or exited the market entirely re-entering our securities lending programme, as they acknowledge the benefits of participation.

## How have hedge funds responded to equity supplies in terms of demand?

**Irwin:** In general, hedge fund demand has been lower for the last couple of years, as it has been affected by volatility in equity markets and global macroeconomic factors have contributed to uncertainty and a broad-based lack of conviction on the part of investors. Compounding these effects is the uncertainty around the final form of the global financial markets regulatory framework. Many hedge funds continue to be net-long holders of equities, employing possibly little leverage and holding excess levels of liquidity as compared to historical levels. A lack of merger and acquisition activity also contributes to lower demand from arbitrage trading opportunities arising from such events.

Despite overall lower levels of demand, we do continue to see strong interest for borrowing equities in a wide variety of market sectors that are affected by the ongoing global economic slowdown. In addition, ETFs have experienced an uptick in demand as they are generally very liquid and provide investors with relatively easy exposure to the market.

One area experiencing demand away from the hedge fund space is in broker/dealer funding. New regulations are requiring broker/dealers to fund more of their business on a term, rather than an overnight, basis. We have witnessed an increase in collateral-based trades, where borrowers are funding their long holdings by pledging those as collateral for borrows of highly rated sovereign debt or equities; the 'collateral upgrade' trade. In addition, regulations requiring that derivatives be collateralised will be a new source of demand in the near future.

## How important is technology to Northern Trust's agent lending business?

**Daswani:** Northern Trust consistently invests in its technology. We achieve efficiency in technology through our single, global proprietary trading platform. Organic growth enables us to develop and evolve our trading platform, which is a key technological advantage, allowing us to quickly capitalise on trades that others cannot. Our efficient technology and market expertise make us a more attractive partner for global borrowers, allowing us to lend more of our clients' securities.

Northern Trust's competitive advantage is gained via a distinctive global infrastructure. Our global presence and single system enable us to optimally connect our clients' supply with borrower demand around the world at all times. **SLT**

**Sunil Daswani**
Head of international client relations, securities lending
Northern Trust

**John Irwin**
Head of international trading
Northern Trust

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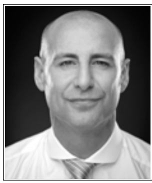
# A summer for European securities lending

## SLT's panel discusses bundling versus unbundling, new CCPs, and why summer has come for the industry

**Robert Chiuch**
managing director, global head of equities,
US head of corporates
**BNY Mellon**

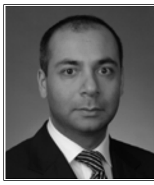
**Richard Glen**
head of global securities financing sales
UK, Ireland and the Americas
**Clearstream**



**Simon Lee**
senior vice president, EMEA
**eSecLending**

**Rory Zirpolo**
principal and head of securities lending
**Kellner Capital**

**Paul Wilson**
international head of financing & markets
products sales and relationship management
**J.P. Morgan Worldwide Securities Services**



**Sunil Daswani**
head of international client relations,
securities lending
**Northern Trust**

**Don D'Eramo**
senior managing director of securities
finance, EMEA and Canada
**State Street Corporation**

**Justin Lawson**
Look forward to seeing you in Madrid at
the ISLA Conference
**Securities Lending Times**

### How would you describe the European sec lending market at the moment?

**Robert Chiuch:** Given that securities lending markets take their cues from underlying markets, I would describe the environment as challenging. Market activity is impaired by macro conditions beyond our control. Systemic political and economic worries, reduced trading activity, significantly pared entitlements and corporate activity, growing regulatory and administrative burdens (globally), and growing collateral constraints, to name but a few, have negatively affected lenders and borrowers.

**Richard Glen:** It has been a busy year so far, despite increased challenges on the borrower side to provide eligible collateral, and outstanding balances have remained high.

Demand for liquidity on AAA government bonds has stayed extremely solid and very stable. We've also seen volumes on corporate bonds increase dramatically, especially on euro-denominated issues.

**Paul Wilson:** The first half of this year was quite positive. European dividend season was relatively good on the whole, with levels holding up well, from a demand perspective. But the Court of Justice for the EU ruling in May could negatively affect French yield enhancement for European funds going forward. We are monitoring how this developments. We have also found a fair amount of new interest from the supply side as new lenders enter the market, driven by an increased desire for additional yield.

**Don D'Eramo:** The industry backdrop has never been as demanding, specifically from a servicing perspective, with uncertainty in regulation, potential tax changes, and the European sovereign climate. However, the securities lending market continues to grow from a supply and demand perspective, and we have seen existing clients returning to the market as well as new mandates from first time lenders entering the market with very complex and specific goals. The key tenets that have been the cornerstone of our offering—transparency, tailored solutions, and optimising opportunities for clients within their risk parameters—make for a very exciting time in the industry and the value that State Street is able to add from a client's perspective is reflected in the trust that is awarded in this current environment. At this moment in time, we have an ability to help shape and position this important industry for all stakeholders.

**Sunil Daswani:** In Europe, the introduction of new legislation requiring financial institutions to hold higher levels of Tier One capital has resulted in wide spread capital raising, especially within Europe's peripheral banking sectors as firms have looked to strengthen their balance sheets. This has typically been achieved through the issuance of new share capital at a discounted price, typically via a rights issue. Natural price arbitrage opportunities created by these events has driven demand from borrowers with elevated spreads for securities within this sector. Europe has also seen arbitrage opportunities within the alternative energy companies, such as solar and wind.

**Simon Lee:** There are high levels of activity across a number of fronts in Europe at present. We're seeing increasing levels of engagement from both existing and prospective clients as they look to enhance their lending programmes, with an increasing focus on risk management, transparency, performance, and collateral optimisation. We're concluding a dividend season that has had the constant presence of tax legislation looming and it goes without saying that the evolving regulatory landscape continues to affect all lending agents.

### What regulation poses the greatest threat to how you conduct business and why?

**Glen:** The regulators have implemented a variety of directives, guidelines, reforms and rules that have been designed to bring additional stability to the global banking environment. These focus on aspects such as capital adequacy, liquidity, harmonisation and reform. Firstly, it means that sound collateral management practice is central to all efficient securities financing operations. A number of institutions in the past three years have actually created separate business units specifically to manage and understand exactly where collateral is being used and how it can be better optimised.

The second point is that collateral management is now a global reality. Historically, banks have focused on regional zones or local country assets and the regulators are now encouraging banks to take a global view and utilise all available assets as far as they can.

The third point is that access to liquidity guardians such as central banks and CCPs is crucial. Under the regulators' stress test scenarios, making sure that you have access to central bank facilities or alternatively that you have the ability to provide margin collateral to central counterparties is crucial for any business going forward.

The regulatory challenge is also creating financing opportunities for illiquid collateral. The interesting aspect here is that it is changing the way that the collateral management works from being strictly an interbank product to becoming a much wider used product. In fact, it is becoming a lot more like it is in the US in the sense that there are a number of non-financials that are now looking to gain access to securities financing. This allows banks to finance illiquid assets on a term basis.

**D'Eramo:** It is not so much about individual regulations, but rather the concert of regulations across the globe and how they may intersect and create any unintended consequences. Some of the regulations that we continue to focus on and welcome the opportunity to interact with regulators on are:

- The EU regulation on short selling, including the ongoing implementation work undertaken by ESMA (European Securities and Markets Authority). Specifically, how the technical standards may apply to existing markets and any changes that may affect liquidity
- ESMA guidelines on all UCITs funds, not just ETFs, and their effect on collateral requirements and transparency
- The FSB's (Financial Stability Board's) review of 'shadow banking' and its workstream on securities lending
- The EU's green paper on the same topic
- The US Dodd-Frank Act, Basel III and capital implications for current business models
- Solvency II and MiFID reviews
- The EU financial transaction tax.

There are many moving parts, but State Street supports the European and international efforts to ensure proper supervision and regulation of all financial activities, and we welcome the ongoing global debate. We do however remain concerned about overlapping regulatory mandates, which can result in unnecessary cost, and market disruption.

**Rory Zirpolo:** Regulations that affect the capital requirements for conducting OTC transactions are most troubling. With yields at near-zero (and in some countries below-zero) levels, collateral reinvestment feels like something from a time gone by. As a result, lending spreads are under more pressure than ever. Any changes that might take place with regard to balance sheet costs, whether in the lending business or in the swaps business, will add to this existing pressure and cause further problems for all parties involved in securities lending.

**Wilson:** There are numerous pieces of regulation or potential regulation that may directly or indirectly affect the lending industry. It remains to be seen how these pan out in terms of impact. We have seen papers from ESMA and the FSB and the impact from Basel III, Dodd-Frank and EMIR are also being considered. The cumulative effect is not yet known.

**Chiuch:** It's tough to pick only one since there's probably something close to 40 to choose from globally that could affect securities lending in some way. If I had to narrow it down, it would probably be the Dodd-Frank proposed regulations, and Basel III, regarding new capital burdens that would impose higher ratios and capital charges on counterparty-based exposures. I understand that more than 90 comment letters have been submitted, which are now being reviewed.

**Daswani:** Financial regulatory changes are underway globally as governments and regulators seek to manage systemic risk and provide additional protections to consumers and investors. Potential impacts on the securities lending marketplace arise in multiple venues such as Dodd-Frank in the US, the FSB global policy initiatives, capital requirements of Basel III and others. Securities lending is likely to be affected directly or indirectly by regulatory developments and related rules yet to be drafted or finalised.

At Northern Trust, we are actively tracking the progress of these developments and potential impacts on clients. In advance of rule-making or during comment periods, our experts engage with government agencies directly and through involvement with industry groups. We will continue to be actively engaged to assess the potential impacts of regulatory changes globally and work in the best interests of our clients.

## What are your views on the bundling versus unbundling of custody and securities lending services debate?

**Daswani:** Securities lending is not a one size fits all product. Traditionally, many beneficial owners find the bundling of custody and securities lending to be positive in nature. It provides the benefits of one relationship team, seamless technology flow through one bank's systems, and in some cases, better pricing due to the overall relationship. However, some beneficial owners prefer to keep the custody and securities lending businesses separate in an effort to diversify and build relationships with multiple providers. Northern Trust offers our clients both custodial as well as third-party lending, which are customised to their needs.

**Chiuch:** I would take the view that you have to differentiate between revenue/expense bundling versus services bundling. The bundling of services, or in other words, coordinating activities across an enterprise for maximum benefit to the client, is obviously optimal. Therefore, unbundling in that sense is less likely. Given the current business environment, I think that it's natural that pricing and revenues will, however, come under greater scrutiny at most firms.

**D'Eramo:** A key cornerstone and valued tenet from our clients is the focus on transparency and ability to provide optimal solutions to our clients. We've maintained a transparent approach and even in 'bundled bids', the costs of custody and the 'costs' of the securities lending programme (ie, the revenue sharing arrangement) have been clearly distinct. What is important from a servicing perspective is delivering on client goals regardless of the structure, and equally important is the valuation, focus on execution and ability to optimise a securities lending solution that does not differ from a client's perspective in any structure.

**Zirpolo:** This isn't so much of an issue of custody responsibilities versus securities lending responsibilities, but rather, the way that securities lending responsibilities are managed by lending and custody agents. Because of the degrees of separation between lending agents and end users, there is an inherent disconnect about the purpose for borrowing securities, which results in a lack of focus on what drives revenue generation in all parts of our ecosystem. The industry takes pride in the fact that the business is a straightforward yield business—one earns a certain rate of return on a certain amount of cash over a certain amount of time.

What is lost, I feel, is the way that each of those dimensions—rate, notional value, and duration—affects the other two. To me, the reason that the question about bundling lending and custody services comes up is because we recognise that there is an inadequate balance between the three sources of return. Each of these factors is over-managed, which results in a sub-optimal product for everyone in the securities lending business. For me, a lending agent—whether responsible for custody services or not—should be focused on maximising revenue. This is challenging because of the incomplete set of tools at our disposal. Performance measurement products only give a one-time snapshot of performance, which ignores the duration component to revenue generation. Lending agents should maximise revenue over three variables, not just two. If they can succeed in doing that, it will be irrelevant as to whether lending and custody services are bundled or not.

**Lee:** The subject has been over debated. The fact of the matter is that the number of securities lenders accessing the market through third-party agents is ever increasing, and that is likely to remain the case as more third-party agents refine their offerings, and more lenders demand the increased performance, transparency and customisation that is available through that route to market. The question is really one of transparency, and the unbundling of pricing to enable institutional investors to understand the true costs of the services thar they buy from their providers.

**Wilson:** This is a non-debate. Beneficial owners have the opportunity to pick the best agent lender, whether bundled or unbundled.

The key is for beneficial owners to focus on the rela-

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tive strengths of the agent lender and who can best meet their programme and risk requirements. At J.P. Morgan, we see good growth in both our custody and third-party business.

**Glen:** At Clearstream, securities lending is part of a fullly-integrated offering. It provides an added value for the beneficial owner that will allow it to offset custodian fees and add extra revenue. We believe that securities lending must be a flexible way of adding extra revenue without interfering in a portfolio strategy.

Being part of an integrated offering minimises the risk of failing recalls or missing corporate actions. Collateral management within a custodian like Clearstream, on the other hand, brings the safest environment for a lender to participate in a securities lending programme.

## The FSB is concerned that the ability to lend securities against cash collateral and to re-deploy that collateral allows any entity to act like a bank. What are your views on this?

**Glen:** The FSB has been reviewing securities lending and repo market practice in New York and London following the default of Lehman Brothers and AIG.

Some lenders were getting access to cash by simply accepting it as collateral. This cash turned out to be reinvested in illiquid assets and led to a maturity transformation outside of the banking system. Securities lending revenue should be generated by the intrinsic value of the trade; the cash is collateral, not an extra source of revenue.

**Daswani:** The FSB Shadow Banking Task Force recommendations are due by the end of 2012. One of the purposes of this regulatory review is to examine securities lending and repo agreements to generate policy recommendations as part of a wide-reaching review into improving the stability of the financial markets. The regulations as they stand at the moment—potentially affecting securities lending—will be a possible change to the minimum haircuts, greater rules around the reinvestment of cash collateral affecting returns, and while positively there may be greater transparency, we would also expect greater infrastructural changes to the market requiring a review of policies, procedures and systems.

**D'Eramo:** We welcome the FSB's efforts to develop policy recommendations to strengthen the global regulation of securities lending, and the opportunity to participate, where possible, as a collaborative approach, should yield positive changes.

Reinvestment of cash collateral is an essential feature of many securities lending transactions where the clients' risk appetite is commensurate with that return goal. Cash collateral is generally invested in short-term, liquid assets, either through commingled funds or separate accounts, under investment guidelines that are established by the client. Many of the clients participating in a securities lending mandate are subject to regulatory oversight of cash collateral reinvestment, major borrowers are increasingly regulated as banks, and agent lenders, like State Street, are typically banks under the supervision of relevant OECD regulators, so it is difficult to argue that these activities are somehow conducted outside of the supervisory system.

We agree with the FSB's observations that some principal models were intended to build leverage, and where these are identified, they warrant further regulatory examination. But a clear distinction between those models and an agent model such as that of State Street, where the agent lending market is already highly regulated, should be considered to ensure that this examination does not unintentionally capture legitimate and regulated securities lending practices.

**Wilson:** Overall, we found this report provided a good assessment and overview of the lending and repo market. While the FSB report was positive about the level of transparency that exists in the agent lending and triparty repo market, it wants to better understand how cash is re-invested and what the impact could be as market conditions change.

**Zirpolo:** Using the term "acting like a bank" misses the point. It ignores the fact that financial institutions serving many functions are necessarily interconnected. The fact that cash is re-deployed into markets is one of the mechanisms that financial services institutions have for keeping costs to customers low. Besides, a good number of institutions responsible for lending and custody explicitly call themselves banks. Indicting lending agents for performing this function is tautological and therefore silly.

## What is more important—quality collateral or high quantities of collateral?

**Daswani:** Probably both. I would have to say higher quality of collateral given the continued uncertainty in the market. Our clients know that, at Northern Trust, we mark-to-market daily, and if necessary, collateral requested each morning is required the same day. We continue to expand the variety of collateral we can accept on behalf of our clients and provide them with the opportunity to customise the collateral that they accept.

**Wilson:** Quality and quantity are both important. The type of collateral should be driven by the quality of counterparty, type of underlying loan and term of loan. The haircut should represent the liquidity risk of selling the collateral. Both are important, from a risk perspective, as well as looking at any correlation risk between loan, collateral and counterparty.

**Glen:** It has to be a combination of both. But before considering this, the first thing that you have to look at is the counterparty you are lending bonds to.

Revenues are under pressure and collateral is expensive; the more that you ask for, the less that the borrower will be able to pay. The lender must be educated and aware of this ratio risk/return.

**Lee:** Taking the subjectivity out of the question, it worth considering why collateral is taken in the first place—and the answer is to provide protection in the event that a borrower defaults. In such circumstances, the lender would wish to liquidate the collateral that is held, and buy back the lent securities. So, the quality of collateral, in the form of liquidity, would be more important than quantity; whatever the quantity of collateral that is held, it is of little use if that collateral cannot be traded.

**D'Eramo:** Collateral management is an important and dynamic process of our securities finance offering, so we cannot isolate any variable like quality and quantity in a vacuum. We approach collateral management from a perspective of an ongoing risk, rigour and reward assessment that captures types of collateral, margins, volatility, liquidity, counterpart and tenor, and pricing, among other variables. Ensuring that we have sufficient collateral for the types of transactions that we are undertaking on behalf of clients is of the utmost importance in our daily operation.

## Eurex Clearing is preparing to launch its new lending CCP service. After the closure of SecFinex, how do you feel that the industry will react to this new CCP?

**Daswani:** The same way as the industry has to the other potential CCP discussions that have taken place to date. Beneficial owners probably won't want to lend through CCPs. One of the biggest issues is that industry participants don't know what the charges associated with CCPs are going to be. Based on the charges, if CCPs were to go ahead, we will potentially see another layer of volume taken out of the industry where securities lending general collateral trades may become uneconomical. The general view is that beneficial owners may not bother to lend through a CCP in absence of the agent. We have had comments from beneficial owners such as "it's too much hassle for us" or "it's not really worth it". This is an area where our industry probably needs to ensure that any regulations forcing people down this route do not have the unintended consequence of losing liquidity in the market.

**Wilson**: Choice in the market is good. We are open-minded towards a CCP for the industry as a whole. But we are not convinced any can meet the needs of all stakeholders and/or bring tangible benefits.

**Lee:** In much the same way as it has reacted to the CCPs that have gone before; the product offering will be researched by market participants, and those participants will make a determination as to the relevance of the offering to their individual business, and the wider industry at large.

**Glen:** According to the market, this is the first CCP for OTC securities lending transactions. The way to access the CCP will be through flow providers such as Pirum Systems and Eurex Sec Lend Market, which load OTC securities lending trades onto the CCP.

Clearstream is going to support Eurex Clearing in its service offering as triparty collateral agent for the management of the collateral on behalf of the CCP. In the future, Clearstream will also intend to use this CCP for the distribution of some of the assets from its securities lending pool. The CCP will mitigate the counterparty risk and reduce the operational risk and therefore benefit our lenders.

## How would you describe the level of automation in the industry and what more needs to be done?

**Chiuch:** It's an interesting time for technology and providers of automated services. Clear leaders, such as EquiLend and the large triparty collateral service providers for instance, are pulling ahead. New entrants, such as Trading Apps, are clearly gaining traction. I believe that any service that improves productivity and operational efficiency, and reduces administrative burden and expense, while enabling incremental top-line and bottom-line revenue growth, will do well.

**Daswani:** The level of automation in the industry is quite high. In addition to the traditional Bloomberg information around specific securities and market news, data providers provide very comprehensive data around inventory, on loan statistics and pricing levels. The continued success of the EquiLend BondLend platform has increased standardisation of automation across securities lending markets.

Northern Trust consistently invests in our technology. We achieve efficiency in technology through our single, global proprietary trading platform. Organic growth enables us to develop and evolve our trading platform, a key technological advantage.

**D'Eramo:** Generally speaking, the industry continues to look for increased efficiencies, and certainly at State Street, automation continues to be a focus of our service offering. We currently have a highly automated process that allows our offering to be completely transparent to the beneficial owners' portfolio management process. We continue to support trading, reporting, matching and margining processes, and we are active participants with platforms that will continue to increase efficiencies for our client base.

**Glen:** The Clearstream securities lending products have been greatly developed with the market over the last couple of years. We have more than doubled our outstandings and diversified the counterparty risk by signing up an increasing number of high-grade borrowers.

The collateral has always been managed automatically by Clearstream as triparty collateral agent. Now it's time for more automation in the distribution of the principal securities. We therefore intend to sign up more borrowers to EquiLend and BondLend during 2012.

**Wilson:** The level of automation in the market is at a high level, and it is essential to keeping cost down, eliminating errors and reducing risk. Automation is no longer primarily focused on front-end trading, but also on downstream back-office functions such as reconciliations, billing and income collection.

## Outside of Europe, what are jurisdictions that interest you most?

**D'Eramo:** We continue to expand our product offering with a focus on South America, Eastern Europe, China and other parts of Asia.

**Wilson:** We have seen substantial growth and increased supply from Asia and Latin America. Markets such as Brazil, Taiwan, Malaysia, South Korea are key lending and revenue markets for us and our clients.

**Chiuch:** Generically, it's a bit of a cliché, but the BRIC nations' participation continues to evolve. Emerging markets account for roughly 40 percent of global GDP. It's natural to assume some of those markets are growing in importance to securities lending. Hedge funds have almost doubled in numbers in APAC (Asia Pacific), from 2,000 to 3,500 over the last 18 months or so. Reforms in India and China promoting capital markets activity continue to evolve favourably and Brazil is solidly on the radars of most major players.

**Glen:** We launched our securities lending desk in Singapore in August 2010. Today, we are distributing mainly emerging market bonds from Singapore while we continue to distribute most of our securities lending pool from London.

The desk in Singapore is a strong sign of Clearstream's commitment to develop further in the Asia Pacific region. This is one of the few growth areas in the world for securities lending and borrowing and Clearstream's service there is developing. Since the beginning of 2012, it is possible lend and borrow equities via Clearstream from both London and Singapore.

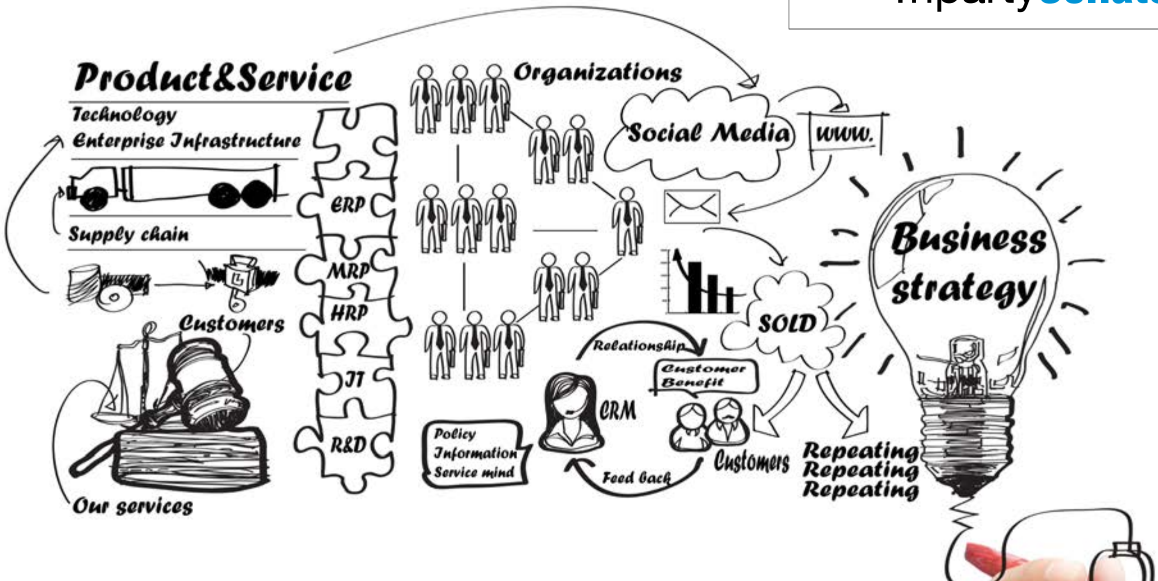
**Daswani:** The Taiwanese market remains the most compelling of emerging markets in Asia from a revenue standpoint, and despite recent regulatory constraints, it offers attractive spreads that are driven by a lack of supply. South Korea continues to remain attractive, particularly for high frequency-type trading that is focused on smaller cap securities. In Malaysia, recently amended securities lending rules have attracted lenders to the possibility of launching an offshore product.

Given the size of China, this market should continue to draw interest from offshore participants, although the lack of an offshore model continues to prevail. There has been progress with the onshore Chinese pilot securities lending programme that was launched officially last year, but substantial progress is not expected for some time.

There is also interest in exploring India, Indonesia and the Philippines. However, the lending infrastructure in these jurisdictions remains underdeveloped.

Russia represents one of the most exciting new frontiers with compelling spread opportunities potentially available. Russia represents the largest and most active of the MSCI emerging markets, with over US $2.0 billion of liquidity being traded across the MICEX exchange each day. The merger between MICEX and RTS, Russia's two main stock exchanges, will undoubtedly improve Russia's current financial infrastructure and is expected to result in the creation of a single operating platform for the trading of equities and other products. This should improve both efficiency and market access.

Turkey is another compelling emerging market from a revenue perspective, with robust hedge fund activity. Brazil continues to generate interest. However, some unique aspects of the market, such as the central counterparty holding the collateral, still make clients uncomfortable with lending their securities. **SLT**




# When liquidity matters: a new dawn in collateral management

## Olivier de Schaetzen of Euroclear looks at collateral and what can be done to make the most of it

COLLATERAL COMMENT

The global financial crisis has set off a seismic shift in the way that market participants view collateral management. Collateral has become an integral means of mitigating counterparty risk and a vital source of much-needed liquidity.

The move from unsecured to secured funding has become a reality worldwide. At the same time, tough new regulatory measures have greatly amplified demand for collateral from new market segments. Concerns over a global shortage of high-quality collateral continue to make the headlines.

In this increasingly risk-averse environment, it is little wonder that optimising collateral resources is high on the agenda of firms seeking to manage liquidity risks and minimise their overall cost of funding.

Achieving this goal presents a major operational headache to the industry as a whole. Indeed, many firms still hold separate collateral pools based on geography, asset type and business line. A prerequisite to portfolio optimisation is the efficient management of collateral across multiple asset types, counterparties and geographic borders. This is why it is important to work with an open collateral management model.

### Explosive collateral demand is set to continue

The ever-increasing demand for collateral is universal across all financial industry segments and will intensify in the future. At the same time, there is a real need for firms to fully exploit all options available to them to manage their liquidity and collateral requirements. As a consequence, market participants can no longer afford to keep precious collateral resources locked away.

**The current collateral demand landscape**


Firms operating in Europe have seen the steps taken to improve the stability of the banking system via fully collateralised credit operations. During recent months, the European Central Bank (ECB) injected approximately €1 trillion of cash into the eurozone. The ECB's monetary policy operations are not only boosting the demand for collateral, but they are forcing greater collateral diversification. A large portion of the collateral posted (up to 18 percent in 2010) is made up of non-marketable assets, such as credit claims. This trend is set to continue.

Additionally, the regulatory changes brought about by the EMIR and the Dodd–Frank Act mean that central counterparties (CCPs) will play a wider role in a number of markets, particularly OTC derivatives. These new regulations will apply pressure on those firms needing to comply with the new laws to harness the collateral they hold in different places worldwide. OTC derivatives margins alone are expected to grow from €1.6 trillion today to €2.6 trillion once the CCP arrangements are in place. In addition, the strong emphasis on high-quality collateral will increase the need for flexible ways of upgrading or transforming collateral.

The need to limit credit risk exposures is also leading to an increase in secured money market transactions in the interbank repo markets, with a growing prevalence of general collateral (GC) basket trades. As about 80 percent of repo-related collateral is EU government bonds, there will be an even greater need for easy access to high-quality securities collateral. Collateral transformations, including liquidity swaps, will also grow in importance in these markets.

The need to access new sources of collateral suggests new approaches are required to mobilise collateral from locations where assets are held in safekeeping, but are perhaps not fully leveraged as collateral resources.

## Managing complex operational tasks

There is a strong correlation between collateral optimisation and managing the operational complexities of moving the right amount of collateral to the right place at the right time. The main issues that create difficulties include:

- Multiple types of assets to be delivered and valued as collateral
- Various types of corporate actions that need to be processed on the collateral
- Different operational practices used in different market segments and companies.

In response to these important issues and market changes, Euroclear is opening its collateral management systems to interact with other settlement platforms within the Euroclear group and beyond.

For example, we recently delivered a comprehensive triparty collateral management service in some of the Euroclear group's central securities depositories (CSDs). Now, collateral may be transferred from collateral giver accounts to collateral taker accounts that are held in the same CSD. The service is fully operational in Euroclear France and in Euroclear UK & Ireland through the delivery by value (DBV) service. Similar collateral management services will be rolled out in other Euroclear CSDs.

Furthermore, Euroclear's collateral allocation interface enables our clients to deliver securities that are held in Euroclear Bank as collateral to other settlement platforms within and outside of the Euroclear group.

To further facilitate the cross-border movements of collateral, in June 2012, Euroclear Bank's triparty collateral management services will be complemented with a new collateral inventory management service. This will help market participants to keep track of their collateral in all locations and to mobilise these pools of assets, which are held with agents and CSDs, when necessary. By pooling these assets in a central location, they can more easily be sourced and used as collateral for multiple types of transactions.

BNP Paribas Securities Services and Euroclear Bank are the first to partner in this respect. Mutual clients of the two firms will be able to use fixed-income and equity assets that are held with BNP Paribas Securities Services as collateral in triparty managed transactions at Euroclear Bank. Client securities to be used as collateral will flow freely between the two firms while BNP Paribas Securities Services remains the local custodian of the assets. When client securities are no longer needed as collateral in Euroclear Bank, they will be returned to the main client account that is held at BNP Paribas Securities Services.

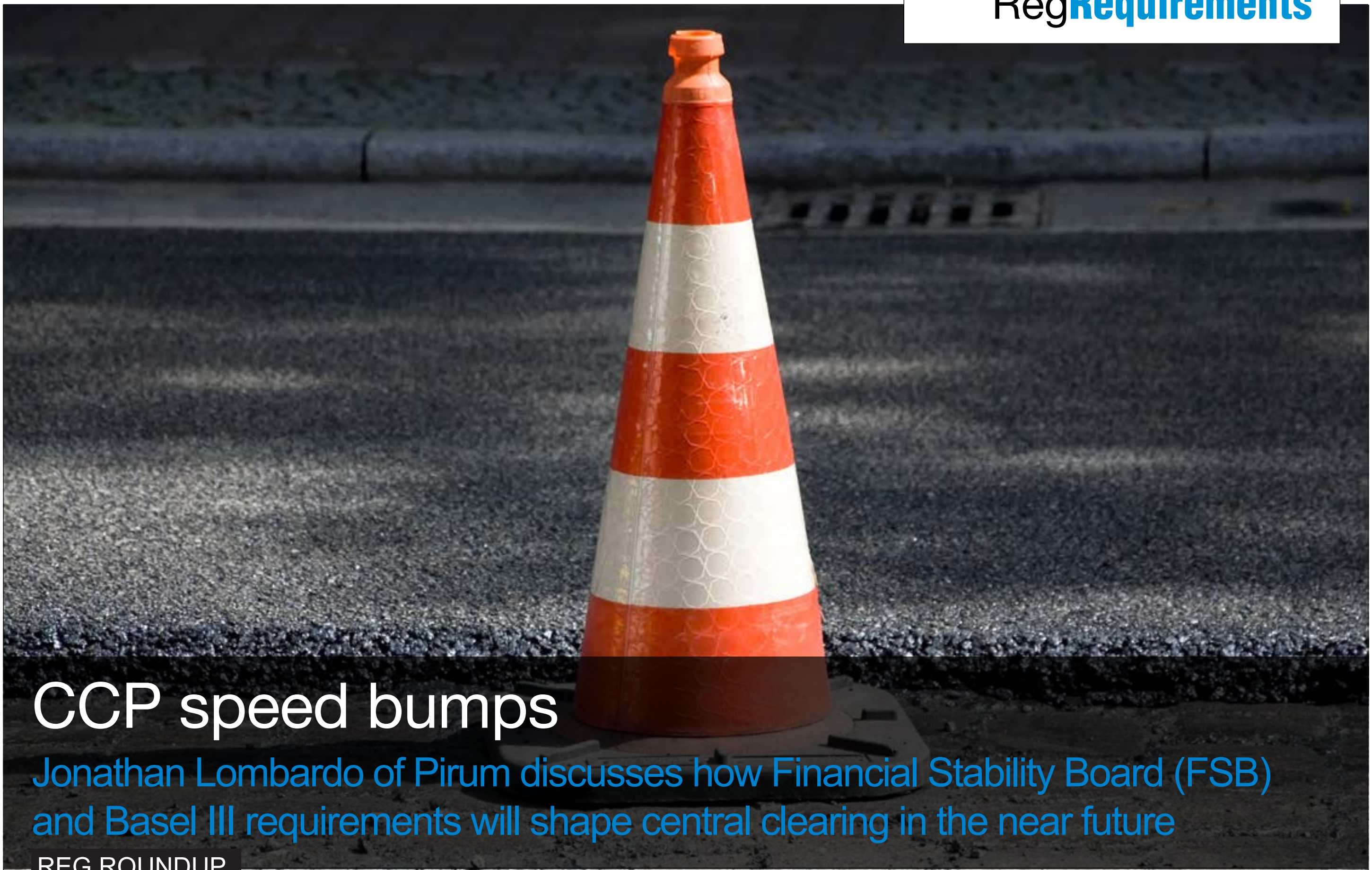
## Bridging existing liquidity gaps through triparty

By linking the triparty collateral management services of the Euroclear group infrastructures, we aim to optimise collateral pools. We will start by improving interoperability between Euroclear Bank and the three Euronext-zone CSDs in Belgium, France and the Netherlands.

Moreover, Euroclear Bank is involved in a market-driven initiative with the European Repo Council (ERC) to implement a full triparty interoperability model in Europe, which will be open to transaction feeds from any participating CCP. This will make GC basket repo trading independent of collateral pool locations and provide market participants with a choice of collateral service providers. A decision is expected by the ERC in June this year.

The growing need for collateral will continue across many domains. However, all recent market studies highlight the potential risk of collateral shortages. Therefore, it will be paramount that financial institutions develop the necessary expertise to manage their collateral resources smartly and efficiently. More and more collateral managers are turning to triparty collateral management providers, such as Euroclear Bank, to fully leverage the resilient and robust environment that has been developed by these providers for securities financing transactions.

Building on their securities financing experience, triparty agents are expanding their portfolio of services to include collateral management for exposures arising from derivatives trades, primarily in anticipation of new regulations. Triparty collateral management is becoming the cornerstone of global collateral management. **SLT**



# CCP speed bumps

## Jonathan Lombardo of Pirum discusses how Financial Stability Board (FSB) and Basel III requirements will shape central clearing in the near future

REG ROUNDUP

In recent months, the securities lending industry has been inundated with an unprecedented barrage of regulatory requirements that will redefine and reshape existing business models. FSB recommendations, Basel III capital requirements, FSA (UK Financial Services Authority) increased liquidity ratio standards, alongside stringent collateral and short selling guidelines, are set to dramatically alter today's playing field with the intention of bringing securities lending in line with the wider world of financial instruments.

With the FSB concentrating on the 'shadow banking' landscape, which includes securities lending and repo, an emphasis on disclosure and greater transparency strongly resonates in the tone of their recommendations. While securities lending data providers already exist today, a call for trade repositories seems priority number one, enabling greater visibility to a market place that has kept itself relatively under the radar.

Industry vendors are poised to assist in this data collection through the nature of their existing business models. Dissemination of the data can then be pushed via gateway solutions into a main depository hub for intended consumption by regulators on a granular basis and the general public on an anonymous aggregate basis. The data can then potentially be analysed for scenarios such as market imbalances or pricing inefficiencies.

The FSB have also identified potential issues with existing bi-lateral margin and haircut practices and may impose additional requirements. Recent comments have gone as far as suggesting empowering regulatory bodies with an ability to raise margin in times of volatility. Alternative solutions, such as central clearing, which can provide real time risk assessment and independent margining, may become the natural route to market for participants.

These potential new requirements, accompanied with Basel III capital requirements, begin to build a strong case for the development of a centrally cleared solution in the securities lending space. The topic of central clearing has been met with both applause and criticism from all sides, but recent developments in the OTC derivatives space as well as the previously mentioned regulatory initiatives, coupled with the launch of Eurex Clearing's CCP solution, have thrust this heated topic into the spotlight yet again.

One interesting development that has been brought to light is the possibility of a new requirement on agency lending programmes to set aside capital to cover indemnity for borrower default. Up until now, benefits resulting from the usage of a CCP have been heavily weighted in favour of the borrower, but the tables might be shifting slightly, creating need for participation from both sides.

Agent lenders have consistently raised concerns that speed bumps like margin and default fund contributions to a CCP would create too much 'noise', resulting in an exodus of beneficial owners from their programmes. Would the lack of an indemnity create a similar result? Would the CCP create an indemnity-like structure that guarantees the beneficial owners in the case of borrower default while not requiring the agent lender to post capital because of routing trades via a CCP structure? Food for thought, and surely worth investigating, it would seem. In times of market share and revenue protection, no alternative should be disregarded without thorough analysis.

As proposed liquidity standards are being finalised for Basel III, the FSA has opted to review its internal requirements for institutions that fall under its regulation. The anticipated result is a more stringent application that will require firms to extend the tenor of financing. Lack of term financing will require firms to retain liquidity buffers of unencumbered liquid collateral, predominantly G-10 debt, creating a greater necessity for the 'collateral upgrade' trade. With a flight to quality collateral and higher demand from the market, counterparty credit lines can be quickly exhausted leaving some organisations unable to comply, which may result in closures of business lines.

In summary, 2013 will be an evolutionary period for the securities lending industry shaped and defined by the enormous wave of pending regulatory changes. What shape and form washes up on our shores remains to be seen. **SLT**

**Jonathan Lombardo**
Head of global sales
Pirum

# Managing the legacy

## Rule Financial's Pauline Parker puts forward a way of dealing with the legacy that technology can leave behind

TALKING TECHNOLOGY

The banking software market has matured. Since the 1980s, there has been a surge of applications developed to support rapidly changing business needs. There has also been a flood of short-term and uncoordinated projects to add, automate and connect business processes. The result for current systems is a set of complex connections and interdependencies causing frustration when trying to manage the technology environment. Perhaps we should un-bundle, rip up and replace these monolithic systems?

The migration path to the future is lengthy, and in the meantime, it calls for co-existence. Often, the older, embedded systems use dated technology and methods, requiring very different skills to those now needed for business growth.

As we switch focus from legacy to future state, we choose to invest in and reskill for innovation. At the same time, we must continue to maintain and support the existing platform that is the lifeblood of current business. So how do we deal with it?

The key to successfully dealing with the legacy while driving value is to invest in new methods of delivery, not just technology. Application rationalisation and outsourcing will allow a CIO to prioritise resources, meeting demand more quickly and flexibly.

### Managing the legacy: a portfolio of services

Research that was published in 2010 by Cranfield University in the UK categorises the services providing rationalisation and outsourcing into four broad groups:

The **boutique service** tends to be highly customised, have a longer duration and be specific to a process. There is an expectation that the service team will be highly experienced in the right domain and will use their own judgment to meet needs. In addition, the service team will be closely engaged with bank technology staff and often embedded. Technology strategy formulation, consulting and planning services are also requested. A boutique service will address a number of critical management issues, including hiring the right staff, training, balancing workloads, scheduling work, ensuring quality and maintaining technology employee loyalty.

In a **shop service**, the short-term deliverable, for example, a software development or vendor evaluation, will often be performed away from the bank, out of sight. The service team will have limited interaction with the bank team, focusing on requirements and quality.

A **factory service** will be used to outsource well-defined processes such as PC installation, network maintenance, security management and so on.

The **mall service** has been the traditional outsource service and includes such things as first line helpdesk and system health checks. As with call centres, contact with users is high but the provider generally has a limited repertoire of responses to address their requests.

### Securities finance: an example

In the world of securities finance, there are a number of legacy vendor-supplied systems managing trade lifecycle. While necessary, these tools add no future value and take precious resources to manage. Nonetheless, the long-term benefits of replacing the systems are often outweighed by the short-term need to work on strategic or value-add programmes.

Rationalisation and outsourcing provide clear opportunities. A senior bank technologist explains: "With legacy systems we know that the factory approach does not work—there is clearly knowledge required to manage the system and add value to the bank. The sourcing of contractors is not a viable option as this means constant churn of personnel, in part due to regulatory factors such as recent co-employment legislation. There is also the added overhead of management administration and education of staff to consider. In my experience, the perfect option is to outsource to a company that has a core competence in our domain."

He adds that the independence of the service provider is fundamental, "as the business cannot be tied to a vendor strategy, it is important to retain flexibility on application, utilisation and direction". Research that was conducted by the London School of Economics adds weight to this argument, recognising that many clients are in their third or fourth generation of outsourcing relationship and have learned to discriminate in their outsourcing decisions. The quality of service needs to be recognised not just on a technical level but also on an emotional one, especially where there is client contact. A good boutique service recognises the importance of recruiting staff with a capability to deliver the service required, the right attitude and the ability to identify with the experiences of end users.

We have learned from prior attempts at outsourcing that there are different models of service delivery necessary to achieve the quality of work required, and that when it comes to legacy system management, a 'one size fits all' approach will simply not suffice. In order to drive value from the existing systems that run the bank, a pragmatic approach to balancing short-term needs with long-term business goals must be adopted. The boutique service approach offers a perfect opportunity to successfully manage applications by utilising specialist, outsourced services, thereby allowing the bank to concentrate efforts on maximising value from its own resources. In the drive to create value, mitigate risk and build a future-state strategy, the clear imperative is to manage the legacy. **SLT**

Pauline Parker is the head of application management at Rule Financial and is a specialist in software development and management, having worked in financial software solutions for more than 20 years. She has experience of all aspects of business systems consulting.

**Pauline Parker**
Head of application management
Rule Financial

# Location unknown: pinpointing short sale stock

## SLT talks to Rob Sammons of Anetics about automation, technology and future regulation

MARK DUGDALE REPORTS

### What's the most interesting thing that you heard at the CASLA conference?

It was interesting to hear that Canadian brokers may be required to provide an official short-sale locate prior to accepting a customer order to sell a stock short. This appears similar to be similar to Regulation SHO in the US, and other initiatives that are popping up globally. Though one would think that even in the absence of regulatory requirements, customers would favour some indication from their brokers that an intended short-sale could be covered—and at what cost.

Anetics has produced tools that are used in the US for just this purpose. We have a Short-Sale Locates module as part of our Argent suite of tools for securities lending. This is a desktop application that we host, and it connects the stock loan desk directly to the customer seeking to locate a stock to sell short. It eliminates phone calls and creates a documented audit trail on who asked for what, when, and how was it acted on.

### How do you enter a locate request?

The simplest approach is to copy a list of securities with quantity from a spreadsheet. Pasting the list into a locate-submit form gets the request into the system. The list immediately appears on the stock loan desk where broker personnel may take action. Any common security identifier can be used but ticker symbols seem to be most popular with equity traders.

### Isn't there ambiguity with ticker symbols across different regions, say for a customer that trades in two countries?

Yes, I'm sad to say. The same ticker can represent up to a half-dozen different securities. However, we require each locate request to include a country code to indicate where the security is to be delivered. The customer may also include an exchange code if necessary. We've found little to no ambiguity within a single country, and no ambiguity if we know the exchange.

### How do you support the customer that trades in multiple countries who requires support from more than one stock loan desk from within the same firm?

This is actually quite simple. From the customer perspective, the customer just enters the locate requests, in whatever region it intends to trade. Then, if the firm has say, two different stock loan desks, each covering a different region, each desk only sees the locate requests for the region that is covered by that desk. This allows for a high level of transparency and service to the customer, while segregating the locate process to the desk that is best prepared to act on it.

### What about the customer that requires a higher level of automation?

We support three different modes of machine-to-machine automation. FTP file-transfer, where the customer presents requests in a data file, and can monitor results by reading an output file. Next, we expose a series of web-services from which a customer system can make requests directly to our system, using similar methods to check on status. Lastly, we support FIX messaging that can be used on a two-way basis to handle the request and reply, or on a one-way basis to deliver current locate activity to a downstream system on a real-time basis (like an order management system).

### With this level of automation a firm could experience high volumes of locate requests. How does a firm cope with that?

For almost every firm that we support with a locate service, we also manage their available inventory. This represents the universe of supply that is known to the firm—all internal and external street availability. As the stock loan desk goes to act on each locate request, our system presents it with a summary of historical locate requests that have been granted, a summary of what's been granted to others, and the total supply that is available to the firm. This enables the desk to work quickly.

Alternatively, the system can be configured to automatically act on locate requests, based on the same rules that firm personnel would apply. This can cover 60 to 85 percent of all requests, leaving the more difficult items for desk personnel. We have one customer that processes more than 25,000 locates daily—and most of the decisions are actually made by the system.

### What about the concept of the firm charging a fee to provide a locate?

This is a question I hear frequently. Our platform supports the concept of customer billing—we have one customer doing it—but I cannot say that the practice has become widespread. There is no question that the customer is willing to pay for a locate on a hard-stock, particularly one that is difficult to get. And our platform supports rate negotiation and the pre-borrow requirement/approval process. But I'm not sure that the industry, or the customer in general, is ready for an up-front fee on the short sale. I'll look forward to having that discussion at a later time, once more of a pattern emerges. **SLT**

**Rob Sammons**
Managing partner
Anetics

# Q2 events: how will they affect shareholder remuneration?

## Dividend Outlook of dealReporter shows interesting results after an eventful Q2 2012

TOM MCKAY REPORTS

This article was written after the European markets closed on 29 May. The EuroStoxx 50 closed 0.6 percent up, but 6.71 percent down from the opening price of the year. This does not sound too bad when compared to the beginning of the quarter, which saw a 12.93 percent drop, but this is still somewhat off of the highest market price of the index this year. Compared to the index value of 2611.42, which is the highest value this year (seen in the middle of March), we have seen a 17.27 percent decrease. After an optimistic start to the year, these figures show that the situation has deteriorated.

The second quarter has seen an increase in market moving events, which have also caused a lot of volatility throughout all of the European indices. Some of these were expected, such as Greece almost dropping out of the eurozone, which created uncertainty about the future of the currency, and the UK returning to a double-dip recession. Other news was less predictable, such as Argentina nationalising the energy company YPF. The most significant event has been Nicolas Sarkozy losing the French presidency to socialist Francois Hollande, which is having a significant impact on corporations in France.

These events have had a significant effect in equities and some trends are replicating those that we saw in 2010 throughout Europe, where the average daily volume that was traded increased in the second quarter, while the index value decrease. This behaviour has come back in 2012, but only in selected markets. In France, the average trading volume of the CAC 40—France's Benchmark index—has increased by 21 percent, while the index value has decreased by more than 10 percent. In Spain, while the IBEX 35 average daily trading volume has increased by more 40 percent, it has recorded a 22.3 percent decrease in value. Unsurprisingly, a major index tracking the largest stocks in the eurozone—the EuroStoxx 50—has seen a 12 percent decrease in value, and a quarter of the constituents are Spanish or Italian.

In France, many large, dividend-yielding stocks are feeling pressure from the new government and the general public to decrease dividend payments. Large companies such as Total and Vivendi are expected, though, to prioritise protecting shareholder profit distribution policies, despite Hollande's dividend tax reform. France's new president is planning to impose a double rate of taxation: one lower rate for profits that a company reinvests in the business and another higher rate for profits that are distributed as dividends. This reform would only be implemented on profits made in France and so many companies with large international revenue streams will not be affected too much.

France Telecom has also faced pressure from employees and the government to cut its dividend. Recently, the group has increased tariff prices and made redundancies, and yet it is still paying out one of the highest dividend yields in the CAC 40. France Telecom is 25 percent owned by the French government, so it will be harder for the company to sidestep the new proposed dividend tax reform.

Even before Hollande was elected, France Telecom was already under from an employee shareholder group—ADEAS—pressure over its dividend policy. ADEAS submitted a resolution at France Telecom's AGM on 5 June to cut its final dividend by 50 percent. In a dealReporter exclusive article, we learnt that this proposal has very little chance of success.

Looking into the second half of the year and especially the third quarter, there is much uncertainty to be anticipated in the future of the euro and this is reflected in the lack of confidence in European equity markets.

### Effects on European equities and Dividend Outlook estimations

The EuroStoxx 50 has seen an even split of companies that have increased or decreased their last dividend payments year-on-year. There has been significant growth in the automotive sector, with BMW seeing a 77 percent increase, while three other sectors saw lower double-digit growth—computer software, consumer (other), and chemicals and materials. Looking at the other end of the spectrum, the consumer (retail) and media sectors have been hit the hardest, followed by real estate and financial services, both of which have already seen substantial cuts in previous years.

Looking at the same index by geography, Germany was the best performer with 10 percent growth, while Italy saw a decline of 24 percent. Finland had the largest decline overall, which was due to its only constituent, Nokia, cutting its 2011 dividend in half.

The significant cuts that we have seen throughout European stocks over recent years have set the base for companies to start increasing dividends on a regular basis again.

Looking into the second half of 2012, Dividend Outlook expects that the financial services and consumer (retail) sectors will see the largest growth in dividends, with 29 percent and 27 percent increases respectively. This is mainly down to the large decreases seen in the previous payments. The top six companies that are anticipated to see the largest increases have cut their last dividend payments.

The only sector that is expected to see a decline in dividends is the chemicals and materials sector, which is estimated to decrease by 1 percent. This is because Repsol is expected to decrease dividends by 22 percent due to the effect that the nationalisation of YPF will have on its future income. The only other company that Dividend Outlook expects will decrease dividends is France Telecom, which it is anticipating a 14 percent decrease for its 2012 dividend.

Societe Generale and Unicredit, which suspended their dividends in 2011, are expected to reinstate them this year, with the French bank estimated to pay €1.9 per share and the Italian bank to pay €0.1 per share. This will leave only ING Group not paying dividends in this index. The Dutch financial services group is not allowed to restart paying dividends until it completes the repayment of €3 billion of state aid that it owns to the Dutch state.

Italy is estimated to lead the recovery geographically, with a 35 percent increase in dividends, followed by France and Germany, both with 9 percent growth.

Many companies are starting to introduce SCRIP dividend options. This option allows a company to pay a higher cash value dividend, while not paying the equivalent in cash. This works well for companies with short-term financing problems, while they still need to maintain high dividend yields. Currently, there are seven companies in the index using this scheme. In recent years, Spanish companies have been heavy users of SCRIPs, however there has been controversy on whether the effectiveness of the SCRIP option could be reduced, thereby affecting the cash flow profile of the issuers.

Some companies have used this option effectively, such as Repsol, which after the nationalisation of YPF implemented a SCRIP dividend for its 2011 final dividend payment to maintain the same payout level as the previous year.

Companies are trying to maintain steady or progressive dividend payments, yet equity markets are falling so there are a lot of attractive yields. The EuroStoxx 50 has a yield of more than 5 percent (using the last-available annual dividend and latest-available share price) and there are five companies in this index that have yields of more than 10 percent. Three of these are Spanish, giving Spain an average yield of 10 percent. Telecommunications providers have always had particularly high dividend yields. In this index, this sector has an average yield of more than 11 percent. The highest yielding company is Telefonica with a 17.7 percent yield.

There are a lot of issues to play out for the rest of the year, but after the second quarter beginning that we have just had, how can things not get better? **SLT**

**Tom McKay**
Senior analyst
Dividend Outlook

JUNE 2012

**Dividend Outlook**
A dealReporter product

## CURRENT DIVIDEND YIELDS
USING LAST ANNUAL DIVIDEND AND CURRENT SHARE PRICE

| Sector | Yield |
|---|---|
| Telecommunications: Carriers | 10.85% |
| Telecommunications: Hardware | 8.78% |
| Energy | 8.55% |
| Utilities (other) | 6.78% |
| Services (other) | 5.30% |
| Financial Services | 4.86% |
| Other | 4.43% |
| Chemicals and materials | 4.37% |
| Construction | 4.13% |
| Medical: Pharmaceuticals | 4.02% |
| Industrial products and services | 3.93% |
| Automotive | 3.89% |
| Industrial automation | 3.86% |
| Consumer: Retail | 3.66% |
| Consumer: Other | 2.94% |
| Consumer: Foods | 2.66% |
| Computer software | 1.62% |

BY COUNTRY

| Country | Yield |
|---|---|
| Spain | 10.41% |
| Finland | 8.78% |
| Italy | 5.26% |
| France | 5.06% |
| Germany | 4.87% |
| Luxembourg | 4.83% |
| Ireland (Republic) | 4.38% |
| Netherlands | 2.91% |
| Belgium | 2.18% |

## COMPANIES IN EUROSTOXX 50
WITH CURRENT YIELDS OF OVER 10%

| Company | Yield |
|---|---|
| Telefonica, S.A. | 17.68% |
| Banco Santander, S.A. | 13.92% |
| France Telecom SA | 13.74% |
| Enel S.p.A. | 11.15% |
| Iberdrola SA | 10.43% |

Telefonica, S.A.(TEF)
17.68%

## ESTIMATED AVERAGE YoY % GROWTH
FOR THE NEXT DIVIDEND

| Sector | Estimated Growth | Last Reported |
|---|---|---|
| Financial Services | 29% | -16% |
| Consumer: Retail | 27% | -52% |
| Computer software | 20% | 25% |
| Automotive | 11% | 44% |
| Energy | 10% | -10% |
| Consumer: Other | 8% | 23% |
| Medical: Pharmaceuticals | 7% | 6% |
| Consumer: Foods | 6% | 7% |
| Construction | 5% | 5% |
| Real Estate | 5% | -17% |
| Industrial: Electronics | 4% | -8% |
| Industrial products and services | 0% | 0% |
| Media | 0% | -29% |
| Utilities (other) | 0% | -6% |
| Telecommunications: Carriers | 0% | -14% |
| Chemicals and materials | -1% | 10% |

BY COUNTRY

| Country | Estimated Growth | Last Reported |
|---|---|---|
| Italy | 35% | -24% |
| Germany | 9% | 10% |
| France | 9% | -4% |
| Belgium | 8% | 50% |
| UK/Netherlands | 4% | 8% |
| Ireland | 2% | 0% |
| Spain | 0% | 0% |
| Netherlands | 0% | 0% |
| Luxembourg | 0% | 0% |
| Finland | 0% | -50% |

## ESTIMATED DIVIDENDS
FOR COMPANIES THAT SUSPENDED THEIR LAST DIVIDEND

| Company/Action | Dividend |
|---|---|
| Societe Generale SA<br>Estimated to reinstate dividend | € 0.7 |
| Unicredit SpA<br>Estimated to reinstate dividend | € 0.1 |
| ING Groep N.V.<br>maintain 0 payment | € 0.0 |

## ESTIMATED DECREASES
IN NEXT DIVIDEND PAYMENT

France Telecom SA -13%

Repsol YPF S.A. -22%

## ESTIMATED LARGEST INCREASES
IN NEXT DIVIDEND PAYMENT

Assicurazioni Generali SpA 150%

BNP Paribas SA 33%

Carrefour SA 27%

# Sec lending in the headlines: Facebook and Europe's dividend season

## SunGard's David Lewis takes a look at the Facebook IPO and the European dividend season of 2012

DATA ANALYSIS

### Facebook: getting short on friends

The last dotcom boom gave us many new household names: some that were great success stories and some that we would all rather forget. Ten years later, the market has been buzzing about Facebook's IPO. But will this IPO be remembered as the end of the latest market bubble or just an endless source of 'friend'-based puns?

At present, it is hard to look into the future with a positive outlook for the future earnings potential of this record-breaking IPO, particularly when we are being bombarded with negative stories about how the IPO was managed. Critics cite an (arguably) inflated price range, alleged issues at Nasdaq on the first day of trading and class actions around rumours of concealed negative earnings forecasts. These issues will no doubt rumble on for some time. But looking at some of the initial statistics does not show a very pretty picture.

ing the launch. As the increasingly negative story emerged, those taking up short positions ahead of the first settlement date of 23 May had to pay fees pushing negative 40 percent rebate to ensure that they could meet their sales obligations.

As positions became available to borrow that first day, the increased availability of supply brought the intraday lending rates down by around 80 percent. Borrowers also began to re-rate their existing trades to make the most of the new market rates while those trading off stale data would have been left with conflicting information to deal with. As Figure 1 shows, the share price stabilised along with the borrowing rates following the highs of 22 May. SunGard's BAR value (borrower activity rating), which indicates borrowing difficulty (1 is general collateral and 10 is the hardest to borrow specials), also fell from the highest rating as soon as the intraday data began to show an easing in the market pressures.

Figure 1

| Date (May) | Volume on loan at close (million shares) | Weighted Average Rebate (% against USD) | Weighted Average Fee (%) | BAR | Closing Price | Change from issue price (%) |
|---|---|---|---|---|---|---|
| 22nd | 26 | -33 | 49 | 10 | 31 | -18% |
| 23rd | 54 | -7 | 7 | 9 | 31.99 | -16% |
| 24th | 59 | -5 | 4 | 8 | 32.545 | -14% |
| 25th | 41 | -2 | 3 | 6 | 31.75 | -16% |
| 28th | 41 | -2 | 2 | 5 | 32.9 | -13% |

Digging deeper into the statistics on Lending Pit, we can see that securities lending activity around Facebook, which is taken here as a proxy for short interest, is not that large. This indicates that the price drop post-launch was not necessarily triggered by excessive short selling in a low liquidity market; it is more likely to represent investors taking flight as the market 'support' came to an end.

Figure 1 shows the balances and rates that were achieved during the first five days of lending activity.

With such a high profile IPO in an uncertain market, it was clear from the outset that there would be a volatile few days immediately follow-

A wider issue with the Facebook IPO is the method by which such IPOs are launched and how they perform post-launch. Zynga and Facebook are linked by revenue generation—driving business to Zynga's gaming platform accounted for 12 percent of Facebook's revenues as of February 2012.

Zynga has seen its shares come under increasing pressure following both its own launch and that of its 'friend' Facebook.

The volume of shares on loan increased (see Figure 2) by just over 50 percent in the week after the Facebook IPO was announced (1 February to 8 February) despite the closing price trending upwards over the following weeks before turning downhill towards the end of the month. Loan balances continued to increase as short positions were taken up ahead of the Facebook IPO. As the Facebook IPO began to attract negative press, Zynga shares fell a further 30 percent to just over $5.70 (5 June), down from the post-IPO $14 peak. Over the first week of June, loan positions fell by around one-sixth as profit takers exited the trade, perhaps believing Zynga had no further to fall.

A more distant relation of Facebook is LinkedIn (LNKD). While not 'linked' to Facebook as directly, it is hard to ignore the more than 50 percent rise in loan positions in the week after the Facebook IPO. Fee rates did not change appreciably, which is symptomatic of a good supply of lendable shares. But the sentiment that is indicated is unmistakable, and with the closing price dropping from $99 to $93 over the same period, it was a sentiment that was well rewarded.

Feeling the chill for internet securities, Groupon fell a further $3.25 (around 25 percent) between the Facebook IPO on 18 May and 5 June. Short sellers over this period increased their positions by just over 20 percent to more than 18 million shares.

The Facebook fallout is not limited to previously launched companies. Future launches may also be affected by a reduction in the market values that they try to achieve or, at the very least, a suitable delay in timing of their plans. Spotify, Twitter and Rovio may all be watching how events unfold while they ponder their next move.

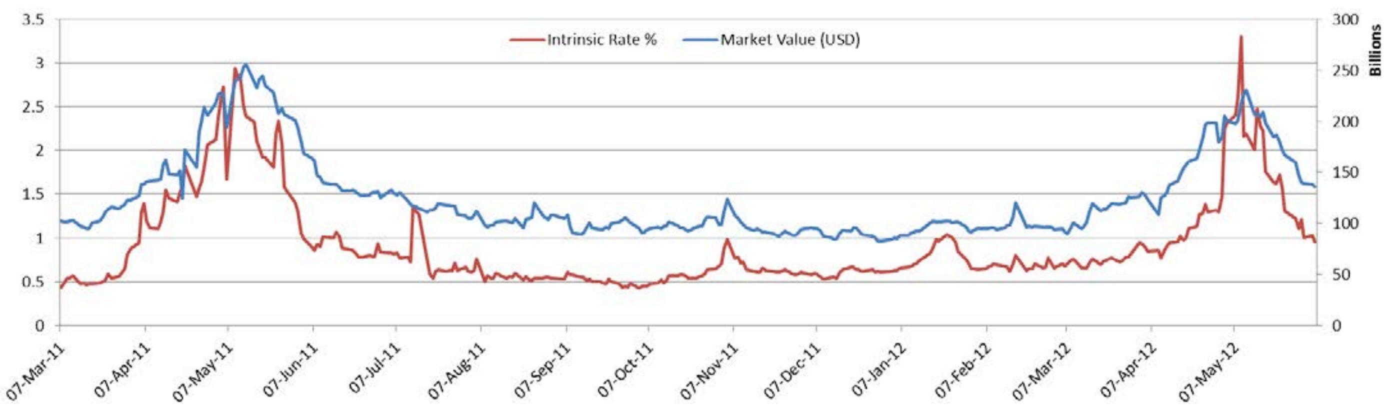
It is too early to claim that the latest internet boom is over. However, markets are wiser and are looking long and hard at these organisations to see if their promises of future income come true.

### European dividend season 2012

Regulations, capital requirements and short selling bans have all put pressure on the securities lending industry.

Figure 2

Figure 3




Yield enhancement, formerly known as dividend arbitrage, is closely tied to the long running threat of 'tax harmonisation'. Yield enhancement is a very significant contributor to the industry's annual income. Figure 3 shows the last 15 months of data and indicates just how great an impact the dividend season has on balances and fee levels.

Yield enhancement survives on the disparity between withholding tax levels across the region, allowing lenders to recover a greater proportion of the dividends due to them. The lack of tax harmonisation is discriminatory in the light of one of the four freedoms underpinning the EU: that of the free movement of capital. By treating domestic UCITS (Undertakings for Collective Investments in Transferable Securities) differently from those that are domiciled outside of France, the Court of Justice for the EU has determined that tax that is levied on non-French funds is discriminatory. Estimates of the tax liability on France range up to EUR20 billion, with potentially EUR5 billion alone due to cross the Channel to the UK.

The fight in France is far from over—it is likely that the next step for the French authorities will be to try and determine that non-domestic funds are not similar enough to their French counterparts to justify equal treatment. Alternatively, the French authorities could levy the equivalent withholding tax on their domestic funds, removing discrimination and avoiding the huge rebates that they may be liable to pay. Figure 4 shows the French equity market over the past 15 months. The dramatic impact of the dividend season on the securities lending market is clearly seen in the peak balance and fee levels shown, both for 2011 and 2012.

## Intrinsic value lending

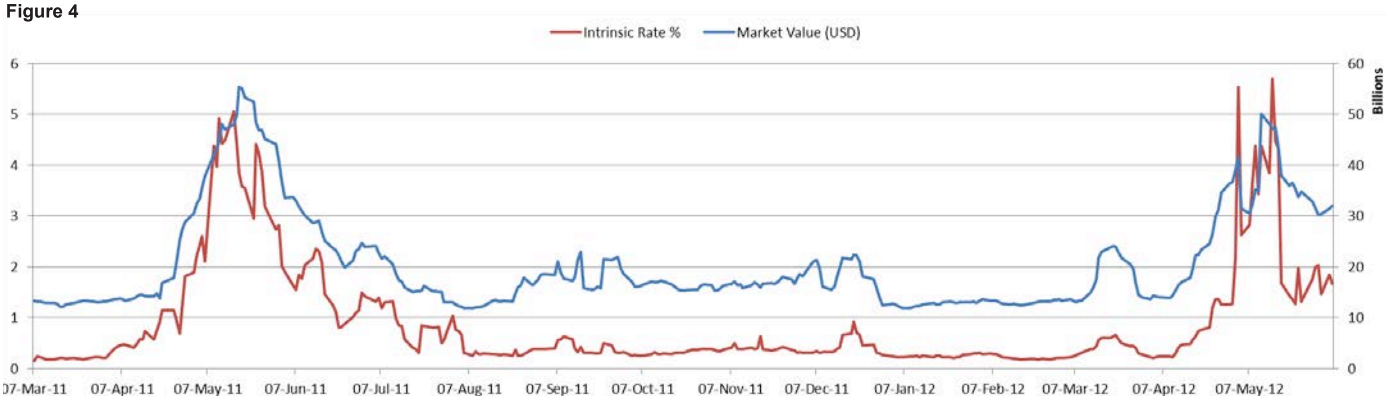
Intrinsic value lending has become increasingly popular since the financial crisis. Lenders focus on higher value loans while reducing their activity in cheaper, higher volume, 'general collateral' business where yields are much lower.

While general collateral business may grow again as the need for high quality collateral increases, Figures 3 and 4 also show us the impact of these strategies. Recent conversations with agent lenders have indicated that balances are down this year, but fees and overall income have risen when compared to last year. In Figures 3 and 4, the fee line (red) trends up slightly, surpassing last year's peak at the height of the dividend season. Contrast this with the lower market value (down around 25 percent) shown by the blue plot line. Not all of that decline can be accounted for by falls in the cash market.

With so many headwinds, securities lending is an industry under siege, but it is also one with a strong history of adaptation and resilience. SLT

**David Lewis**
Senior vice president
SunGard Astec Analytics

Figure 4



# Industry appointments

**Kevin Meehan**, the former head of prime services for Asia Pacific at Credit Suisse, will move to London from Hong Kong later this summer to act as global head of prime fund services.

A person close to the story confirmed to Securities Lending Times that Meehan will be replaced by Myo Schollum, formerly the head of prime services coverage in Japan for Credit Suisse.

After 16 years at Morgan Stanley, **Carl Davey**, who most recently served as head of prime brokerage sales for Singapore, will join Citigroup.

Davey will work in the Greater China division of Citi as head of prime brokerage sales.

**Brad Hunt** has replaced **Donal Smith** as CEO of Data Explorers.

Smith joined Data Explorers in March 2008 from Thomson Reuters where he was the CEO of Thomson Financial's businesses in Europe and Asia.

His departure signals the end of a transition period that began with financial information services company Markit's acquisition of Data Explorers in April.

Hunt, who was a managing director at Markit, now leads the Data Explorers business. He joined Markit last year from Goldman Sachs where he built and ran the firm's equity electronic trading business in Europe.

J.P. Morgan is replacing the head of its global prime brokerage business.

New York-based **Lou Lebedin** joined J.P. Morgan in 2008 as co-head of prime brokerage when the bank purchased Bear Stearns. He was named the sole head of prime brokerage just two months earlier, in March.
It has been reported that the London-based co-chief of J.P. Morgan's fixed-income prime brokerage unit, **Teresa Heitsenrether**, is replacing Lebedin.

She has been setting up the bank's prime brokerage business for the EMEA region from London. It is not clear what Lebedin's next role will be.

After **Andy Coyne** left Citigroup for Traiana, ICAP's post-trade FX network and processing technology vendor, Citigroup promoted internally to fill his role.

**Sanjay Madgavkar** will now be the global head of foreign-exchange prime brokerage, a bank spokesman confirmed.

Madgavkar has been with Citigroup for seven years, most recently as head of FX margin trading in New York.

He will now be based in London, reporting to **Jeff Feig**, global head of G-10 FX.

**Saheed Awan** has been appointed head of Euroclear's collateral management product management team.

Most recently a partner at GCMS LLC and DerivaTrust, Awan was also head of the global securities finance product team at Clearstream for 15 years, from 1993 to 2008. He is based in London.

Jo Van de Velde, managing director, head of product management at Euroclear, said of Awan's appointment:

"From our conversations with clients, regulators and other securities professionals, it is clear that collateralised transactions will become a cornerstone in building market stability and re-establishing trust in the years ahead."

"Towards this end, we have decided to bring in a well-respected and seasoned triparty expert. Awan has many years of market experience, much of which has been dedicated to the collateral management business."

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Pirum Systems has strengthened its London team with the appointment of **Tony Holland** as business development manager.

Holland moves to Pirum from Russell Investments. He will work with existing and prospective clients to highlight Pirum's suite of offerings. **SLT**