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Hedge fund assets for prime custody services surge

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Hedge fund assets that are available for prime custody services stood at $684 billion in August 2012, increasing by 40 percent since 2010, according to a new report.

The report from financial research and consulting firm Finadium—in conjunction with BNY Mellon—found that approximately half of all hedge funds with more than $1 billion in AUM have a prime custody agreement in place.

This is up from 15 percent in 2008, as funds increasingly seek to mitigate counterparty risk.

Prime custody refers to the servicing of unencumbered assets within alternative investment portfolios and is performed by prime brokers and custodians to provide greater transparency and risk mitigation.

But prime custody's definition has changed, and largely depends on the custodian servicing hedge fund assets.

In its report, Finadium said: "Most custodians now have dedicated service teams focused on their hedge fund clients. This is the new prime custody, with sales and service efforts that seek to recognise hedge funds as a distinct client base with a different set of needs than a pension plan or mutual fund."

The 40 percent increase in assets that could be a part of a prime custody service represents the assets of hedge funds—not including funds of hedge funds—"multiplied by an estimate of 38 percent of excess cash and securities in an average hedge fund's portfolio".

Assets that are available to prime custody services have "risen steadily over the years and are expected to grow further", according to Finadium.

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SLTINBRIEF

Riskbank cuts Sweden's repo rates

Riskbank's executive board has cut Sweden's repo rate to prevent inflation falling too low.

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Hong Kong shorting gets pricey

Markit Securities Finance has released a report that highlighted the high cost of short selling in Hong Kong.

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Hedge fund assets for prime custody services surge

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The upsurge of hedge funds assets is the result of increasing hedge fund AUM and lower levels of borrowing from prime brokers.

Finadium said: "More than ever, hedge funds are establishing triparty relationships with both their prime custodian and prime brokers. While initially this may force some price renegotiation on the use of leverage and trading commissions, overall hedge funds reported financially that maintaining a proportion of assets in prime custody is much more beneficial than leaving all the assets with a prime broker."

In a statement, Marina Lewin, managing director in BNY Mellon's alternative investment services business, said: "Hedge funds are putting far more emphasis on how they manage custody of their assets and increasingly looking to adopt best practices to ensure their counterparty risk profiles are optimised and meet investor requirements."

"BNY Mellon works in partnership with its extensive network of prime brokers, so clients maintain their current prime broker relationship but have the added benefit of holding their assets with an independent third-party custodian."

Riskbank cuts Sweden's repo rates

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The rate was cut by 0.25 percentage points, to 1.25 percent.

The reduced rate is expected to stay at this level until the middle of 2013, in the hope of supporting economic activity, and contributing to inflation rising toward a 2 percent target.

Growth in the Swedish economy this year has been stronger than predicted, with the summer seeing the krona appreciate faster than anticipated.

These factors indicate that inflationary pressures are now expected to be lower than forecast in July.

Economic growth slowed in June this year as activity in construction and private sector services fell dramatically. However, Swedish consumer confidence rose unexpectedly in July, with the indicator increasing to 5.6 from a level of 3.1.

Hong Kong shorting gets pricey

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In a blog post, Will Duff Gordon, research director at Markit Securities Finance, said: "If you thought, like me, that the cost of short selling in Hong Kong could not get any higher since a year ago then you are wrong."

He said that the number of shares on loan in Hong Kong for more than 500 basis points have increased from 13 percent of securities to 21 percent, compared to just 2 percent in Japan.

"Admittedly, this rise in the cost of borrowing plateaued over the last few months but this was after a continued rise for nine consecutive months."

Battery seller short-circuits the market

Battery manufacturer A123 Systems triggered the US market short-sale rule on 5 September when shares of its stock dropped below 10 percent of the previous day's closing price.

The market trigger was created in 2010 by the US SEC to prevent aggressive short selling.

Restrictions are now in place regulating short sales of A123 Systems.

The restriction gives precedence to long sellers over short sellers to sell their shares.

Security futures contracts fall at OneChicago

OneChicago traded 433,498 security futures contracts in August 2012, a dip compared to 507,238 traded in the same month a year earlier. However, August saw an increase from July 2012, where 369,694 contracts were traded.

More than 400,000 exchange futures for physicals (EFPs) and blocks were traded, with August 2012 EFPs and blocks activity representing $2.4 billion in notional value.

Half of August 2012 month-end open interest was in OCX.NoDivRisk products. The OCX.NoDivRisk product suite aims to remove dividend risk from security futures.

Some 80,200 of August 2012 futures valued at more than $489 million were taken to delivery, emphasising the use of single stock futures as an equity finance product.

Open interest stood at 525,995 contracts on the equity finance exchange at the end of August 2012.

Clearstream's GSF services drop in August

Clearstream has released its August 2012 figures, which reveal an increase in assets under custody, but a dip in the company's global securities financing services.

The value of customer assets that are held under custody has increased to €11.2 trillion, a year-on-year increase of 3 percent, and securities that are held under custody in international business rose 4 percent above August 2011 figures to €6 trillion.

For global securities financing services, the monthly average outstanding reached €557.7 billion. The combined services, including triparty repo, securities lending and collateral management, collectively decreased with a drop of 10 percent from August 2011.

The investment funds services saw an 18 percent from August 2011, with 0.59 million transactions processed.

Securities lending is at a high for OCC

OCC's securities lending central counterparty activities saw a 50 percent increase in new loans from August 2011, with 92,072 transactions in August.

Year-to-date stock loan activity is up 26 percent from 2011 with 663,934 new loan transactions in 2012. The average daily loan value at OCC in August was $32,844,809,346.

Cleared contract volume was down significantly; at 313,781,757 contracts in August—representing a 43 percent decrease from the all-time monthly volume record of 554,842,463 contracts that were posted in August 2011.

Futures that were cleared by OCC reached 2,844,837 contracts in August, down 41 percent from 2011.

BMO Global Asset Managment rebrands business lines

The three primary business lines of M&I Institutional Trust Services have been rebranded to reflect their integration into Canadian firm BMO Global Asset Management.

M&I Institutional Trust Services used to be a unit of BMO Harris Bank affiliate Marshall & Ilsley Trust Company.

The newly branded businesses are BMO Retirement Services, BMO Taft-Hartley Services and BMO Not-for-Profit Services.

A statement from BMO Global Asset Management said: "All include the services provided by the firm's retirement and trust and custody division and have access to the investment expertise of BMO Global Asset Management."

BMO Taft-Hartley Services provides recordkeeping, custody, securities lending and other financial services for single and multi-employer benefit plans, while BMO Retirement Services offers a platform of retirement, trust and custody services.

Barry McInerney, co-CEO at BMO Global Asset Management, said: "Rebranding these lines of businesses was the next step in our successful integration efforts and reflects the importance they play in our overall business strategy,"

"Our ability to provide clients with holistic asset management solutions and service excellence is at the core of our corporate principles. Our proven ability to deliver the results clients expect will continue to be the key to our North American growth strategy."

The rebranding follows moves earlier this year that saw Marshall Funds rebranded as BMO Funds, and M&I Investment Management Corp merged with Harris Investment Management and renamed BMO Asset Management Corp.

Eurex Clearing rolls out new OTC derivatives system

Eurex Clearing plans to introduce a new risk methodology for calculating initial margin for both listed and OTC derivatives called Eurex Clearing Prisma.

It will be launched on 12 November 2012.

"At Eurex Clearing, we are continuously shaping the standards of risk management," said a statement from the firm. "By raising the benchmark for an adequate risk calculation for our members, we are improving the safety and integrity of the marketplace."

Eurex is replacing its existing margin methodology (risk-based margining) with a new portfolio-based margin approach, which will allow for cross margining for listed derivatives business

and between listed and OTC derivatives business that is cleared through the firm.

The default management process (DMP) is the basis of the new portfolio-based margining method. Both the new margining method and the revised default management process will be implemented along a newly introduced 'liquidation group' set-up.

In this set-up, each product that is cleared by Eurex Clearing will be assigned to a liquidation group. The groups compile products that can be liquidated jointly at the same point in time.

For each of the groups a default management committee (DMC) will be implemented to assist the clearinghouse with any relevant matter of the default management process. Each DMC will consist of representatives of pre-selected clearing members with sufficient trading and risk expertise to manage the liquidation of a specific group.

DMCs will assist and advise Eurex Clearing in developing group specific hedging strategies, and executing the respective transactions.

The statement concludes that hedging is an important component of the DMP, as it "enables the clearing house to reduce the market risk and stabilise the defaulted clearing member's portfolio prior to and during the liquidation group specific auctioning process, which is considered to be the core component of the DMP."

Prospera goes live with Protegent Social Media Surveillance

Texas-based broker-dealer Prospera Financial Services has started using SunGard's Protegent Social Media Surveillance program to monitor its advisor's online activity on social media sites such as Facebook, LinkedIn and Twitter.

SunGard's Protegent Social Media Surveillance will also help Prospera to meet regulatory requirements, assisting the company with managing the supervisory, books and records requirements that are set forth by FINRA Regulatory Notice 10-06 in the US, which covers blogs and social networking sites.

The program will enable the company to use tools for moderation and pre-approval of content that may be considered to be advertisement under the FINRA regulation.

Marco Galavan, information technology manager at Prospera Financial Services, said: "SunGard's Protegent Social Media Surveillance gives our compliance officers greater confidence in allowing our advisors to participate on social media sites and run their own websites because Protegent helps them monitor that activity and protect the firm from regulatory breech and reputational risk."

Steve Sabin, COO of SunGard's Protegent business unit, said: "SunGard's Protegent Social Media Surveillance is helping customers like Prospera Financial Services establish and enforce internal social media usage policies, while also helping them mitigate risks and adhere to regulatory obligations."

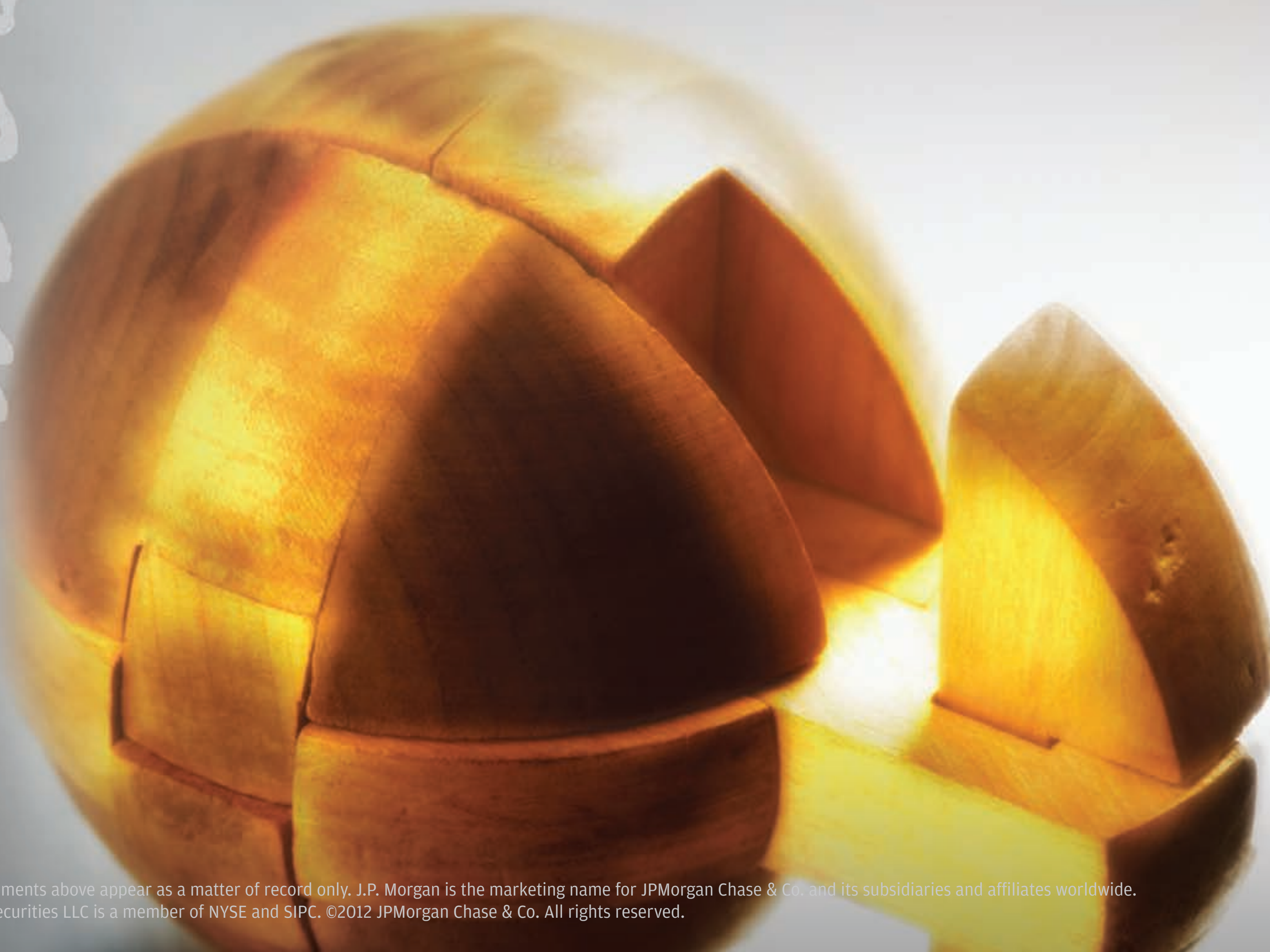
Advent launches collateral management toolkit

Advent Software has launched a new Interest Rate Swaps (IRS) package for the Syncova platform.

The IRS package is a set of collateral management tools that are designed to help buy- and sell-side firms to address new US and European regulations that are related to the OTC derivatives market.

Together, the tools aim to deliver more automation and control to firms facing managing multiple central counterparties (CCPs), and derivatives clearing members.

"The new regulations will have a lasting impact on how the buy side conducts business," said



Liam Huxley, vice president of business development at Advent Software.

"The new capabilities within Syncova will help firms be compliant with these regulations and manage their collateral more effectively while putting them in a stronger position to leverage the new transparency and competition among CCPs for the long-term."

Lombard Risk prepares for common reporting

Lombard Risk is releasing its Risk Reporter solution to clients in preparation for the European Banking Authority's (EBA's) Common Reporting requirements (COREP).

Lombard Risk has been providing COREP solutions to European firms since 2006, and stated in a release that: "The experience and knowledge gained in doing this has proved to be invaluable in helping us to gain a clearer and earlier understanding of the full implications of the regulator's definitions and process."

Lombard Risk Reporter was released to some customers in August and is being installed for data analysis and testing.

Functionality now being distributed includes all templates that are in consultation, including those for COREP, large exposures, liquidity coverage, net stable funding and leverage ratio requirements.

Legal understanding leads to Omgeo update

Omgeo has updated its Alert database, which deals with settlement and account instructions, with new legal entity data capture functionality.

With these enhancements, investment managers and broker-dealers can automatically view 23 new legal entity fields containing the names and identifiers of their counterparties, said a statement from Omgeo.

The functionality was added in response to requests from market participants that wanted to gain a better understanding of which legal entities they were trading with.

Avox, a subsidiary of DTCC, will maintain the legal entity data that populates the additional 23 data fields, including legal name, trading status, date updated, aliases, and registered and operating addresses.

Ahead of the proposed implementation of regulatory requirements for a global legal entity identifier (LEI) standard, a field has also been created to capture and populate LEIs in Alert.

Bill Meenaghan, global product manager for Alert at Omgeo, said: "While this is an independent initiative, in anticipation of a mandated LEI, we have added an LEI data field in accordance with regulatory requirements and in support of the LEI."

Rule Financial sees 15 percent revenue boost

Business and IT services provider Rule Financial has seen an advance in revenues of 15 percent year-on-year.

The firm has experienced growth in the UK, US and Canadian investment banking markets, as well in Poland and Spain. It has also recruited more banking domain specialists and technical experts.

The growth in revenue has seen Rule Financial grow its presence within nine of the top ten global investment banks.

In a statement, Rule Financial said that: "Regulatory pressure is a key driver for projects in capital markets; with the Dodd-Frank regulation in the US and EMIR in Europe requiring banks to completely overhaul OTC derivatives clearing systems."

Chris Potts, CEO, Rule Financial, said: "The wave of regulation which was triggered by the 2008 financial collapse is now being felt by the world's financial institutions, which is in turn driving IT strategies. Dodd-Frank, EMIR and Basel III are just a few of the regulations for which firms are turning to Rule Financial for guidance and consultancy."

"Our early move to open a development centre in Poland is not only supporting, but is also helping to drive our growth. We fully intend to use our success in the first part of the year as the platform from which we continue to drive for the recruitment of quality staff and continued financial success."

Rule Financial also owes its success to a number of recent key appointments to the OTC clearing and collateral management team.

James Tomkinson and Jonathan Philp have been recruited as specialists in OTC clearing and collateral management. Marina Potok also joined Rule Financial earlier this year as a specialist in OTC, structured and securitised products.

MXCorner

Conference calling

The end of September brings the annual IMN European Beneficial Owners' Securities Lending Conference. Now in its 17th year, it's always a good opportunity to speak to a number of beneficial owners that don't otherwise attend these events and the agenda itself often highlights the concerns of this all-important group. It also provides an opportunity to reassure as well as test out new theories and opportunities.

This year, the agenda—unsurprisingly—has a focus on regulatory change and how beneficial owners can manage their programmes to ensure that they stay compliant, and the closed door sessions each morning give beneficial owners the opportunity to make sure that the topics that are covered are those most critical to them. These breakfast sessions always bring some surprises, with beneficial owners often concerned about aspects of the market and lending models that are not necessarily the focus of market participants. It will be interesting to see which areas of new regulation beneficial owners are concerned with and think about how the industry can help to address them.

MX Consulting will be attending and I will be participating in the panel session that discusses what the market will look like going forward. With so much change, either just beginning to affect or still in the pipeline, it is difficult to see how the industry will look in 12 to 18 months.

There have been a few occasions over my career when something significant has happened and where I have heard people say, or have thought myself, that the industry will have to change exponentially and look very different very quickly. Looking back, I can't think of a time when it has ever actually happened. Instead, the industry slowly evolves to incorporate required changes and develop with the times. It's an industry that has an inherent ability to innovate and develop new opportunities. I don't think there has ever been a time when it hasn't been evolving and transforming.

I'm not sure—with all the change on the horizon—that a slow evolution will be possible this time, but I am sure that Basel III and Solvency II and all the other new regulations will be complied with and the industry will continue to develop and innovate, creating opportunities for beneficial owners to earn incremental revenue from their portfolios in a low risk environment. Let's hope that we can use the IMN conference as an opportunity to re-assure beneficial owners and retain their support.

Sarah Nicholson, senior partner
MX Consulting Services

A technical edge

SLT talks to Markus Büttner of German software and consulting firm Comyno about regulatory limitations on securities lending in Germany and the technological drive to overcome them

MARK DUGDALE REPORTS

How have German regulations driven securities lending market participants towards better technological solutions for supporting trade and post-trade processing?

From what we see in the market, budgets are moving back along the value chain, from the front office driving the introduction of new products to more of a focus on enhancing post-trade efficiency. The regulations on liquidity and capital requirements made numerous investments in technology necessary, so that market participants can make the entire process chain on trading and triparty platforms more transparent. Generally speaking, the regulations force firms to improve and enhance existing products and subsequent processes, and they therefore have to limit their resources to develop and pursue new business ideas.

The obvious need for more high-grade collateral on the other hand requires more sophisticated collateral management tools to fully support collateral trading activities. Banks that have not yet overcome their 'siloed' approaches are now being forced to get a bank-wide view of their collateral inventory, including assets that were not previously seen as relevant to the business. This subsequently requires, from a technological point of view, higher product flexibility and a clearer focus on easy integration into a bank's infrastructure. In the end, collateral trading systems have to not only provide a view of the collateral pool that is available, but they also have to extensively support analysis functions to automatically come up with collateral trading propositions.

What is the effect of the 10 percent lending limit that is placed on Germany funds, and how have technological solutions developed to accommodate and take advantage of this rule?

German funds are regulated, among others, by the Deutsche InvestmentGesetz (InvG). A major regulation within the InvG is the so-called 'lending limit', which forbids funds from lending out more than 10 percent of their net asset value to a single borrower. Additionally, beneficial owner have to keep their right to sell any assets without restrictions from lending activities.

Firms negotiate these hurdles in different ways. While being able to trade as a principle up to the 10 percent limit, a firm would have to access an agency lending and/or synthetics desk to get hold of the remaining 90 percent of the fund's assets.

Alternatively, a firm could make use of Clearstream's KAGplus lending programme. As the programme is categorised as an "organized system" under the InvG, the lending limit does not apply.

With standard front-office solutions out in the market not covering the full list of the requirements arising from the InvG, Comyno fills this gap with a variety of tools. For efficient utilisation of funds assets, the Allocation Engine merges the assets of similar type funds into pools. Traders at the lending desk do not have to worry about which security in which size is being held by which fund in particular. All they see is the real available position that they have, with all relevant limits already applied. Also, they only book the street-side trade, letting the engine do the legwork of pulling out the securities of the single funds. Naturally, the engine caters for respective limits that are not being breached while creating the tickets and applying fees respectively.

It even goes a few steps further. Should the net asset value not move proportionally to the value of open trades against a particular fund, a 'passive limit violation' could occur. The engine would detect such events intraday and not only alert the traders, but also re-allocate automatically to ensure that no limit is broken at end of the day.

To avoid the necessity of constant communication between trading and asset manager, the engine would also alert the trader of a fund going potentially short due to assets on loan being sold.

On top of these, what other solutions are you developing for your clients in Germany?

We have developed a variety of connectors—KAGplus is a good example. Others are trading platforms such as BrokerTec, EurexRepo and EquiLend. Recently, post-trade information flow for the triparty business has become critical due to regulations, which we have brought from end-of-day procedures to a more near-time infrastructure.

How do these solutions differ to those that you do for clients in other European markets?

As long as German funds are of interest for the client, it doesn't matter if its business is run out of Frankfurt or London or elsewhere—the limits that are specified within the German InvG have to be taken into account. In other instances, the full automation of allocating / re-allocation that has been described is a plus for any lending desk. Our work on connecting the desk straight-through and as real-time as possible to the outside world doesn't show many differences either—it's required throughout the whole industry.

What is happening in the CCP space in Germany?

The production readiness announcement from Eurex Clearing for its CCP for securities lending has definitely found its way to the business in Germany. Nowadays, you will not find any events or roundtable discussions where CCPs are not on the list of topics. Discussions evolve mainly around the cost of service and collateral that is accepted—but it is clear that a lot of banks do not yet have a close enough view of the offering.

Two things have to happen here. On the one hand, the market needs to be educated in more detail about what is possible today, while on the other market feedback has to be continuously taken into account at the providers' end. I'm convinced that several reasons will, slowly but surely, lead to many banks connecting up to the service. It's not only to do with capital requirements. More and more firms see the advantage of possibly growing a business that is seriously limited by credit lines on bilateral business today. We are currently working actively on both sides. We are helping to further enhance the CCP offering on the providers' side and also driving a project to make use of the lending CCP at a major German lender.

What can CCPs do from a technology point of view to make market participants more confident in them, in Germany and Europe as whole?

Honestly, I think given current state of discussions, technology can neither be the main driver nor is it seen as the main issue at the moment.

Nevertheless, CCPs that are active in the lending market are open to connect themselves to lending platforms, so banks can re-use existing infrastructures to get their trades through to the CCP. Today, to get a CCP up and running, firms need to talk to the variety of involved parties, such as flow providers, triparty agents, custodians and the CCP themselves. The integration has to be done by companies like ours, which is good for us, but if CCPs offered a more complete package, that would surely lower the entry barrier for clients. With near future releases of the CCP's offering, I'm sure that integration will be easier, making it also interesting for mid- and small-sized market participants. **SLT**

Markus Büttner
CEO
Comyno

Collateral management in Asia is on the rise

SLT talks to David Lewis of SunGard Capital Markets about how collateral management is changing in Asia

MARK DUGDALE REPORTS

What are the key trends that you have observed in collateral management?

There has been a huge increased focus on collateral management from all types of organisations. Sell-side institutions lead the way, seeking to better leverage all of the assets that are available to them, and this has also had an impact on buy-side institutions that need to make best use of the assets that they are holding in order to offset risk in other transactions.

Much of the interest is driven by the increased demand for greater risk mitigation. For example, in the OTC derivatives world, the mandated move to central clearing is generating a demand for central counterparty-eligible assets. Also, on a regulatory front, the need to maintain liquidity buffers to provide greater security to financial markets in times of stress is requiring firms to manage their use of all liquid assets far more effectively.

There is also a demand to reduce costs and work more efficiently across the board, so the standardisation of processes and IT solutions is a goal for many institutions.

The increased interest in collateral management, and the introduction of the collateral upgrade/downgrade trades, has benefited the securities finance world, as this is another motivation for demand for and supply of securities lending activity.

Have the practices for cash collateral investment changed in the last two years?

Post AIG, the importance of managing the re-investment of cash collateral that is received against loans with the same stringent criteria as any other investment became crystal clear. The tightening up of cash re-investment guidelines took place more than two years ago, and in the intervening period, beneficial owners have become far more informed about how their cash collateral is deployed. Although some of the guidelines may have returned from the original 'crisis management' levels, collateral re-investment schedules have become more granular and restrictive, and are reviewed with greater frequency.

Typically, what are the margins and what do you think the right margins should be?

From the data that we have seen, we are aware that margins vary regionally, and in general, they are somewhat, but not startlingly, higher now than they were historically. The highest margins are—unsurprisingly—most commonly found in emerging markets.

How will all the proposed capital regulations affect collateral for securities lending?

Though there is little direct impact on securities lending trades, the need to maintain greater control of all assets, and in particular liquid assets, is driving the need for increased asset optimisation, and securities lending can be used as a vehicle to transform one type of asset holding into another. One thing is for certain, since the cost of doing business is now significantly higher than it was before, firms pay far more attention to ensuring that they are in a position to allocate the cost of capital right down to the underlying trading activity in order to allow them to judge which areas of the business are the right ones to focus on.

Are securities lending transactions delivery versus payment, or is there always a settlement exposure risk?

The answer to this depends on the market in which the transaction is settling, and of course, whether the transaction is against cash or non-cash collateral. There are some major markets that are true cash delivery versus payment, but in international markets there is greater usage of non-cash. Although initial margin is not standard in the securities lending markets, there is sometimes an agreement to pre-collateralise in order to remove settlement risk for the lender, but this is in a minority of cases.

Regarding collateral in Asia, is the market using more cash or non-cash for collateral trades, and how are trends shifting?

Asia is pre-dominantly a non-cash market, but in certain regions the usage of central counterparties (CCPs) also facilitates the use of cash collateral. From the data that we see, we are not seeing a significant shift in the type of collateral that is used.

Asia has a number of CCPs that work in the stock borrowing and lending markets (India, Malaysia, Taiwan and South Korea are the key ones).

Have these models changed in 2012?

Asia is ahead in terms of the already established CCPs in the market. For some markets, the use of a CCP is put into place as a fundamental part of establishing a new market, due to the counterparty risk mitigation and transparency benefits that they bring. Although there have been relatively subtle changes (while some are planned) in the way in which these CCPs are used (methods of access, and so on), the fundamentals have not changed.

Would you expect CCPs to change structurally as a result of regulations?

It is unlikely that CCPs will structurally change as a result of broader regulation, because while in many regions new regulation are forcing the uptake of CCP usage, they are already well established in Asia. In effect, Asia is ahead of the game in this respect. **SLT**

David Lewis
Senior vice president, Astec Analytics
SunGard Capital Markets

euroclear

Post-trade made easy

Get on the Collateral Highway

Whatever your collateral destination

The right securities – at the right place – at the right time

Fasten your seatbelts

The risk of default is always there, but collateral management has evolved and is easing the burden, as SLT finds out

MARK DUGDALE REPORTS

The risk of counterparty default became a reality when Lehman Brothers collapsed in 2008. The adage 'too big to fail' was tested and ultimately proven wrong, teaching financial institutions some hard but important lessons about the risks that they take.

The risk of counterparty default is one that has always been there, but it became more pronounced when Lehman Brothers went into bankruptcy. James Tomkinson, who is a specialist in collateral management and OTC derivatives at Rule Financial, says that the failure of Lehman Brothers made other financial institutions realise that they needed to focus more on the solvency of their counterparties.

"When Lehman Brothers went down it all came into focus in one big, painful experience," he says. "Before the collapse the focus was about the return on capital, afterwards it was all about return of capital—as counterparty risk became the number one priority."

"Prior to the financial crisis, the relationships between financial institutions were relatively simple," according to Richard Glen, head of global securities financing sales for the UK, Ireland and the Americas at Clearstream.

He added: "Many financial and non-financial institutions were happy to place their cash directly with each other on an unsecured basis without receiving any collateral in exchange. This type of transaction generally rolled from one day to the next and if the receiving counterparty were to go into default, be placed in administration or go through insolvency, the unsecured cash would be gone with a claim against an administrator being the only hope of compensation."

A close shave

The collapse of Lehman Brothers and the financial crises that ensued underlined collateral management as a means of mitigating counterparty risk, according to Ted Leveroni, executive director of derivatives strategy and external relations at Omgeo. "Collateral management is the most effective process for managing a risk that often changes dramatically day-to-day," he says.

Leveroni likens collateral management to wearing a seatbelt in a car—"they are both 'measures of last resort". He explains: "You can manage collateral incorrectly for a long time and never get burnt by it, much like you can drive and never wear a seatbelt. When there's a problem, you want to be wearing a seatbelt and you want to be managing collateral correctly."

Collateral management has changed as financial institutions—most notably on the buy side—have increased their focus on it. Mark Higgins is managing director for Europe, Middle East and Africa business development at BNY Mellon Global Collateral Services, which was recently established to bring together BNY Mellon's global capabilities in segregating, allocating, financing and transforming collateral for its clients, and encompass the firm's broker-dealer collateral management, securities lending, collateral financing, liquidity and Derivatives360 businesses.

Higgins says that his firm's collateral management services are changing to meet the new demands of clients. "It's evolving. We're taking what we have on the shelf for a traditional problem and reapplying it to a new problem. In the case of a triparty model, which is traditionally there for repo and stock loan, we've now reapplied that as a way of allocating collateral into a clearinghouse from a broker or direct vendors. It's all about optimisation and efficiency, and rather than having a physical delivery of assets, it's about using triparty books and records. That's how we've evolved. We've taken something that we've done for more than 20 years, found a new need for it and twisted it to fit."

On the formation of Global Collateral Services, Higgins explains that the group has been established to give broker-dealers and institutional investors the operational control, comprehensive capabilities and added precision that they need to manage collateral more effectively and efficiently.

He says: "Segregation is a key part of that and can be done in multiple ways, depending on whether it's the buy side or the sell side. This is the same with the other pieces. What you're doing is trying to address the buy and the sell side in a sensible conversation. For example, the buy side could be required to post and receive initial margin for uncleared trades. Normally, I'd be talking to each side separately about themselves, but now I need to be talking to one side about both sides' obligations in the same conversation. It's all about gluing together all parts of the industry."

Collateral management also represents a method of increasing returns in a market that many say is yet to fully recover from challenging financial conditions. Saheed Awan, head of global collateral services at Euroclear, says that if an institution is placing cash into safe instruments, rates are currently negative, "so it makes sense to move to the securities collateral model."

"And there, the price setting of securities lending has shifted more to the borrower. Securities lending volumes are currently depressed and borrowers are looking at how to make a return. This is where collateral management comes in nicely. If you are able to have flexibility in the type of collateral that you can give, for example, equities indices or corporate bonds, and the lender finds it agreeable, you and the lender can generate more loans. The flexibility of eligible collateral is now the name of the game."

He adds: "A good triparty collateral management service provider should give you flexibility as well as safety. For example, as a collateral taker your triparty provider should allow you to take many different types of securities as collateral and diversify the risk of accepted collateral with concentration limits on the different types of assets and names that you will accept. It requires a very sophisticated and automated collateral management service to manage the collateral commitments during the entire life cycle of the loan." **SLT**

Destination unknown

What is having more of an effect on collateral management—regulatory change or market demand—and what are your thoughts on central counterparties and clearinghouses?

Justin Lawson
Publisher
Securities Lending Times

To a certain degree, the two are inextricably linked. The forced mandatory clearing of OTC derivatives, as a result of the US Dodd-Frank Act and European Market Infrastructure Regulation (EMIR), will increase exponentially the demand for collateral. It will also heighten the need for collateral transformations as market participants will need to meet more stringent collateral requirements imposed by central counterparties (CCPs).

Beyond OTC derivatives, there is a real need for firms to fully exploit all of the options that are available to them to manage their liquidity and banking capital requirements under EU legislation Basel III and the Capital Requirements Directive IV (CRD IV). As a consequence, it will no longer be acceptable for firms to have precious collateral resources 'locked away' in silos.

In addition to the regulatory drivers, the need to limit credit risk exposures has led to an increase in secured money market transactions in the interbank repo markets and there is a growing prevalence of general collateral basket trades. The result is ever-increasing demand for collateral to cover these exposures as well.

This surge in demand is universal across all industry segments and is set to intensify in the future.

CCPs are deemed to play a wider role in a number of markets, not least of which will be the OTC derivatives market. Indisputably, the benefits of CCPs are most welcome as a source of balance sheet relief as well as the orderly operational management of a default situation. The flip side of the increasingly central role of CCPs is that they too have become a *locus* of concentration risk for the markets.

However, CCPs also pose a challenge to market participants. Central clearing will require them to post initial margin and the collateral that is posted will have to meet more stringent collateral requirements, usually cash or government securities. The combination of having to post more collateral and only collateral of high quality undoubtedly puts a squeeze on collateral pools. The drive towards full segregation of collateral, as well as the intraday margining of CCPs, will significantly increase the focus on operational efficiency and STP.

Saheed Awan
Head of global collateral services
Euroclear

While both are important, regulatory change is the key driver in demand for new collateral solutions. Collateral processes have to be adjusted to meet aggressive market deadlines and comply with new regulatory requirements, such as stricter collateral segregation. However, regulation also provides a fair amount of optionality. For example, clients can choose between omnibus or individual client segregation under EMIR. Clients are exploring these alternatives and their choices will have a significant impact on the industry and the capacity planning of their providers.

As part of the present regulatory reform, CCPs are looking to improve their operational processes to manage collateral. This is in line with new international standards, such as the new CPSS-IOSCO Principles for Financial Market Infrastructures, which call for CCPs to use operationally flexible collateral management systems. Regulators are also debating further adjustments when it comes to concentration risk or the reinvestment risk of collateral that is posted to CCPs. As an agent supporting CCPs when it comes to their collateral needs, we are actively contributing to this discussion with the objective that regulation strikes the right balancing between operational efficiency and safety.

John Rivett
Managing director
and global head of collateral management
J.P. Morgan Worldwide Securities Services

Regulatory change is driving market demand, so the two are intertwined. Some regulation directly stimulates demand for collateral—central clearing is an obvious example. Other regulations, such as additional capital constraints, put pressure on banks' business models, and these indirectly drive demand for better collateral processes to squeeze out an extra few basis points of profit.

In principle, CCPs and clearinghouses are a good idea, but the challenge will be dealing with the proliferation of CCPs that you have to deal with. This creates operational complexity, but it also fragments your portfolio and so reduces the economic offsets that naturally occur in most banks' positions. There are also additional complexities where multiple margining approaches are allowed—for example, SPAN versus VaR-based margining. The best clearing location will be driven to a large extent by where the deal has the best margin offset effect. Figuring this out and agreeing on it with your counterparty will be a challenge for many.

Mat Newman
Senior vice president/general manager for the Apex Securities Finance and Collateral solution suite
SunGard Capital Markets

Rather like Doctor Doolittle's Push-me-Pull-me, it is difficult to work out which is leading the way—regulatory change or market demand.

Currently, market conditions, which are driven by credit and liquidity concerns, largely dictate how collateral gets used. There continues to be a strong demand for high quality collateral in the traded context, the repo market, and as variation margin. However, as the new regulations come in to effect, demand will not only be driven by market concerns, but also by what is now mandated within those regulations.

As we talk to our clients, their focus is on:

- Risk mitigation—counterparty risk has been central following on the credit crisis of 2008, while regulatory change has certainly appeared in discussions significantly over the last two years.
- Enterprise wide collateral management—in particular, there is an emerging sense of urgency to increase efficient use of collateral pools and embed collateral into the overall business model. While the potential business benefits seem clear, such initiatives seem to be driven largely by regulatory reforms and the need to achieve greater efficiency in a post Dodd-Frank/EMIR environment.
- The introduction of CCPs and how to meet new collateral requirements, including segregation and collateral eligibility limitations.

I think that it is fair to say that while we have a much better sense of what the post-CCP world will look like, it is not possible to predict with certainty what effect the increased collateral requirements will have going forward.

There are a few certainties:

- CCPs will increase the amount of collateral that firms require to do business. The reason is two-fold. Firstly, because of the loss of netting across full trading portfolios and secondly, because of the asymmetric nature of CCP collateralisation whereby they call both parties for initial margin which becomes 'locked up'.
- This extra collateral comes at a cost, both operationally and financially, so the world will be a more expensive place to do business and consequently less business might be done. Front offices are going to need to look more carefully than ever at the cost of doing business as the transparency around the cost of collateral improves.
- The extra cost of doing business will need justification through risk mitigation (ie, the probability of CCP default would need to be lower than that of a typical counterparty). This is why I don't expect the major CCPs to accept much aside from cash or very high quality collateral anytime soon.

Notwithstanding the above, after a period of uncertainty, it will be full steam ahead to clear swaps globally within CCPs. While the first step in central clearing will be with OTC swaps, I think that it is likely that other products (such as repo and securities lending) will also find themselves centrally cleared in the not too distant future.

As a service provider, the clearinghouse concept presents both challenges and opportunities. For example, we have had to change some of our operating procedures in order to support our clients' needs when facing clearing brokers. Similarly, we are building on infrastructure to support clearing broker collateralisation of CCPs themselves (in particular around legal segregation requirements). At BNY Mellon, we do expect business to grow and are anticipating an influx of collateral as the regulations begin to apply. When that happens, our triparty collateral management capabilities, specifically around the allocation of non-cash collateral from clearing broker to CCP, will become a critical part of market infrastructure.

Paul Harland
Managing director—EMEA sales director securities clearance and collateral management
BNY Mellon

Regulatory change and market demand are very difficult to separate because they are both born from the events in 2007 and 2008, and their goals are the same—to reduce risk in the system. In my opinion, I believe that market demand is the primary driver of changes simply because most of the new regulations have yet to be implemented. That said, as the regulatory push increases, we will see it drive changes even more quickly than we have seen in the past few years. The good news is that because regulation and market demand are both addressing the same challenges, many of the solutions are the same. The industry needs robust daily holistic collateral management and it is moving in that direction.

CCPs and clearinghouses are essential parts of the industry and play key roles in managing market and counterparty risk. To date, they have been very focused on adjusting their offerings to address issues that are raised by their new buy-side relationships, such as expanding the list of eligible collateral and supporting LSOC (legally segregated, operationally commingled) transactions. However, CCPs and clearinghouses are not the entire answer. Remember, they don't eliminate risk; they centralise it so that risk can more easily be monitored and managed. Further, the fact is that many instruments will not be cleared so it is up to the industry to implement risk management solutions for those non-cleared trades that are every bit as robust as a CCP applies to cleared trades.

This mixed clearing environment will present major challenges for market participants. Investment managers that use CCPs will need to prepare themselves to process significantly more margin calls than before, as well as communicate and oversee their clearing broker relationships if they currently use non-standard methods of communication. These challenges will necessitate closer relationships with their vendors and service providers.

Ted Leveroni
Executive director of derivatives strategy and external relations
Omgeo

The implications of regulatory change is currently having more of an effect, largely because of the lack of clarity of what the eventual global regulatory obligations will look like, and how they will interact, is creating concern over how firms will need to adapt to meet their obligations, and what timeframes they will need to operate within.

The notion that a reduction of global systemic risk is fairly sound—the banking crisis has identified a need for a focus on, and improved control over, global risk mitigation practices.

However there are doubts that mandated clearing for all is the solution, or the only solution:

- What is intended to provide a centralisation and reduction of credit risk actually provides a proliferation of operational and settlement risk—take for example (pre-regulation), one bilateral OTC derivatives margin call. Post-regulation, this single call may be split across multiple clearinghouses covering different products. Each of the clearinghouses may (currently) call in up to 17 currencies per portfolio, demanding initial and variation margin in each. In addition, it is likely that there will remain an uncleared portfolio of more exotic products. One bilateral net call of a single piece of collateral may reasonably become up to 20 to 50 collateral movements per day.
- There are unintended consequences of the increasing margin and capital requirements—a squeeze on global liquidity and increasing cost of and reduction in availability of collateral.
- It is as yet unclear what happens in the event of a clearinghouse default.
- What happens in the event of multiple clearinghouse defaults?
- Is anyone quantifying CCP concentration risk?
- A mandated approach to collateral management should have a more centralised framework for coming up with solutions—there are a multitude of clearing houses, all imposing different (and ever-changing) operational processes to provide what is essentially the same service. It is enormously difficult for firms to develop support systems and processes to be able to meet the various margin requirements of all the clearinghouses.
- The 'one size fits all' approach of mandated clearing regulations are not necessarily suitable for all products. What is suitable for OTC is not necessarily suitable for repo and securities borrowing lending markets. There is a danger of applying an inappropriate broad-brush approach to regulation.

Elaine MacAllan
Business matter expert and product consultant
Lombard Risk Management

From our perspective, in the past it was mainly market demand in the driving seat as firms looked at ways to enhance risk management in the wake of the financial crisis. However, the sheer volume and scope of regulatory change is now steering technology needs as the industry works to comply with new rules, many of which are still being finalised.

Once regulations begin to take shape, and financial firms have adapted to the new *modus operandi* there will then be a further wave of technological innovation. Vendors will shift from supporting new regulations through optimisation and the modelling of CCP margining requirements, for example, and look to further differentiate their solutions. The technology that is required to manage collateral successfully is rapidly becoming more complex as collateral management evolves into a far more sophisticated and dynamic discipline than was the case before the global financial crisis.

There are obvious benefits to trading via CCPs from a credit risk management point of view. From the regulators' perspective, they offer the advantages of increasing transparency and reducing systemic risk. However, the move to a CCP model also has the potential to concentrate risk with CCPs, creating a 'too big to fail' dilemma and resulting moral hazard. Without a doubt, the consequences of a CCP failing would not be a good thing.

In terms of CCPs for securities lending, the recent work that Eurex Clearing and Pirum have been doing to establish a CCP for the market looks interesting. There could be advantages for lenders, as it would allow them to expand the range of counterparties that they deal with. The CCP would act as principal to the trade, reducing the burden of counterparty credit risk, meaning lenders could trade with lower rated borrowers than before.

There would also be a reduction in regulatory capital charges due to the lower risk weighting that is assigned to cleared trades compared to bilateral trades. However, this would have to be weighed against the costs of transacting through a CCP, particularly for agent lenders. There are also issues around the lack of standardisation and often bespoke nature of securities lending and whether this would translate well to trading via a CCP.

Furthermore, the current bilateral model for securities lending/repo held up reasonably well during the financial crisis. Many market participants are therefore of the opinion that if it ain't broke…

However, shadow banking is definitely on the regulators' radar and at some point, they may mandate a move to central clearing to bring greater transparency to the market.

Antonio Neri
Executive director
4sight Financial Software

Although the topic of CCPs has been there for years, so far there has not been one CCP that has been very successful in our industry, but I still believe in the principle on which CCPs are based. It is a fact that Basel III will create capital incentives for banks, so the direct result in the near future will be the fact that banks will trade a certain part of their securities lending book to each other via CCPs. I am also convinced that there will not be one CCP dominating, but there will be multiple CCPs in the securities lending market.

The biggest challenges for these CCPs will be in creating transparent charging models, the possibility to novate trades and the operational efficiency and automation for the participants. This is required to get the participant onboard and actively trade on the platform. The participants also need to get used to the fact that the collateral will be handled differently and that their trading systems and reports need to be adjusted.

Another factor is the push of derivatives into CCPs, which will automatically result in collateral flow via the clearinghouses. The collateral from the derivatives can then, for example, be netted with the margin requirements for securities lending and then we can really talk about cross product collateral optimisation.

Sander Baauw
Managing director—continental Europe business
Synechron

In the short term for those institutions whose businesses are dependent on their funding capability, then the market demand is the key driver influencing collateral management developments. These are firms that simply need to source funding and generate smarter and longer-term trade financing activities. Obviously, central bank intervention has provided welcome funding support over the short-to-medium term, which has provided a breathing space for many banks. However, questions remain as to the consequences and effects on institutions and the market as a whole once central bank funding is eventually withdrawn.

The market is in the process of preparing for the impact of the regulatory changes, with various players at different stages of preparedness. For institutions that are not 'funding sensitive', then inevitably the regulatory changes are their prime focus.

On CCPs, the market is divided:

Positives

- I believe that there is a positive perception of CCPs in response to regulatory changes
- Because they centralise and standardise the margining activity related to swaps
- I would like to see increasing variety of products accepted by CCPs.

Negatives

- There are an increasing number of CCPs, which undermines the logic in using a single centralised location
- It also increases the complexity of market connectivity (as clients need to connect to more CCPs)
- More CCPs inevitably adds additional costs to the market
- Market activity is concentrated through a small number of lowly capitalised institutions
- Does not provide a solution for securities lending.

James Tomkinson
Specialist in collateral management and OTC derivatives
Rule Financial

Regulatory change is both directly and indirectly driving many firms, but not all changes are in collateral management. Dodd-Frank, EMIR, the pronouncements from various national and supranational legislators, plus the ramifications of the introduction of centrally-cleared OTC derivatives, bringing with it concepts that have been little-used until now in the OTC world (SPAN-type calculations for initial margin, intra-day margin calls, tighter restrictions on collateral eligibility, capital penalties for non-cleared derivatives), are causing vendors of collateral management solutions to develop significant extensions to already comprehensive, functionally rich systems.

However, not all is entirely clear or confirmed from the respective regulators, and this is causing confusion and uncertainty in the end-user marketplace. It is by no means certain that each CCP will offer identical services and methods, and differences here will most certainly be reflected and amplified downstream in terms of collateral and margin management.

Further to this, given that competitive advantage is at stake among those proposing themselves as derivatives clearing members, the details of levels, types, and costs of services to be offered to clients is largely unknown. This poses practical difficulties for vendors of collateral management solutions that would clearly like to conform to any developing standards and offer complementary features and functions, but without sufficient detail from CCPs and derivatives clearing members, what are being created tend to be flexible platforms.

Market demand is also driving certain aspects of and capabilities in current day collateral management. The focus on the global collateral inventory is not all down to the advent of CCPs. Issues of liquidity, cost of funding and optimisation are just as key for large brokers as for small asset managers. With extremely low interest rates, cash is no longer such an obvious choice of collateral, and with a squeeze on liquidity, firms are having to analyse and assess their collateral portfolios very closely, and need collateral management to offer support here, and to reflect the changing markets.

Reform has been most certainly required, but I would have preferred to see this accomplished through a suite of lesser measures that are already established or in progress: such as development, introduction of, and strict adherence to the International Swaps and Derivatives Association's Standard Credit Support Annex (or something similar); mandatory registration of and automatic reconciliation and confirmation of transactions in centralised trade repositories; more extensive use of third-party custodians of collateral; adoption of standard electronic-messaging; use of commonly-agreed reference and market data (such as legal entity identifications); continual monitoring and benchmarking of key collateral management processes across all firms so that firms large and small—buy side and sell side—can measure the effectiveness of their collateral management processes.

Simon Lillystone
Collateral management
IBM Algorithmics

Regulatory change is having a more profound impact on the way that collateral is managed and leading to changes in market behaviour. This is down to two fundamental aspects. Firstly, there is a continued flight to quality that has led to an increased demand for high grade assets, particularly AAA and AA-rated sovereign paper. This demand stems from financial institutions needing to meet liquidity and stress test requirements, to cover central bank funding needs as well as cater for margin call obligations from clearinghouses and OTC derivatives. The second aspect is that collateral management is now both a front and back office process.

From a cost perspective, pressure is being placed on financing desks to make efficient use of all all available inventory, no matter where it is held, and to optimise the use of this across all asset streams, whether this be repo, securities lending, OTC derivatives or securing central or commercial bank liquidity. This naturally places more emphasis on middle and back office teams to make their operational processes as robust and efficient as possible, something which is not always possible with the budgets available for development. Over the past 20 years, Clearstream has a developed a variety of tools within its Global Liquidity Hub offering that can help its clients address these specific issues.

Richard Glen
Head of global securities financing
UK, Ireland and the Americas
Clearstream

Developments in the current lending environment

SLT talks to Don D'Eramo of State Street about how agent lenders and custodians can best assist their clients in a rapidly changing environment

MARK DUGDALE REPORTS

The overall securities lending environment has benefited from buoyant dividend income in 2012, and there are attractive opportunities for securities lending in growing markets such as Asia.

The market is, however, fighting significant headwinds that have been brought about by a raft of regulatory developments, and lenders may be looking to recalibrate their approach going forward.

Are current dividend pay-outs supportive of the securities lending market?

The 2012 European dividend season went well with dividend yields in line with, or better than, expectations. One reason for this trend could be due to companies retaining more cash rather than deploying it for other reasons such as new investment. As a result, the first half of the year was fairly positive for our clients and the securities lending industry in terms of revenue generation.

Given potential headwinds, it is difficult to gauge future dividends, but regardless, we continue to believe that the market will continue to grow and will present opportunities for our clients. Our agent lending structure is such that we believe we will be able to optimise such opportunities for our clients going forward.

What are the key regulatory changes on the horizon?

Some of the activities that are encompassed by securities lending, including cash reinvestment, are deemed to fall within the work on shadow banking activities, or preferably "non-bank financial" activities, not only in the EU but internationally.

Important work is currently being undertaken by the Financial Stability Board (FSB), the Basel Committee of Banking Supervisors (BCBS) and the International Organization of Securities Commissions (IOSCO), and we support efforts to ensure the proper supervision and regulation of all financial activities, including activities conducted outside of the banking sector.

Accordingly, we support the work that is currently being undertaken in the EU. The FSB is due to deliver its recommendations in this area before the end of this year, and the EU has the potential to adopt them in full, with national regulators set to implement them in the early part of 2013. There is a lot of interest in this topic and some speculation as to what the measures may include, but it's probably too early to determine the impact that they may have on the industry.

Other regulatory reforms that may affect securities lending are the US Dodd-Frank Act, as well as Basel III. Both measures address, among other topics, issues of counterparty risk concentration and capital that may affect all stakeholders in securities lending, with potential unintended consequences, specifically concerning liquidity.

Of the other regulatory changes in the pipeline, what consequences may arise?

There has already been some industry discussion of how UCITS funds may be affected by 'The Guidelines on ETFs and other UCITS Issues', which was published by the European Securities Markets Authority (ESMA) on 25 July.

The guidelines cover issues such as collateral requirements, risk calculations, fee and revenue sharing arrangements—the area most fervently discussed—and the diversity of collateral. The guidelines set out by ESMA include quantitative and qualitative criteria for collateralised transactions such as securities lending that UCITS must follow.

It is likely that each UCITS manager will need to take these new rules into consideration during the process of their investment decision making. However, the impact of the guidelines will, to some extent, depend on the ways that individual regulators will interpret and implement them. The guidelines will affect all European UCITS funds from February 2013, although existing UCITS will have 12 months from February 2013 to apply them.

In addition, the EU Short Selling Regulation takes effect from 1 November 2012 and affects all European securities, regardless of who holds them and where they are domiciled. This regulation represents several potential challenges for the securities lending industry in terms of sales of lent securities from the client point of view, the locate and reserve requirements for hedge funds and brokers, and the role of agent lenders. The precise implications of the regulation are as yet uncertain.

Will the French Financial Transactions tax also make an impact?

The French Financial Transaction Tax took effect in August 2012, and although securities lending and repo transactions are exempted, the tax is still likely to have some effect along the financial transactions value chain should the end-purchaser of the in-scope French equity not be eligible for any of the specific tax exemptions. It is difficult to predict the final impact, as more changes to the existing law are expected in the future, but some compression of returns may be likely as the cost will have to be absorbed somewhere.

In addition, it is still not clear yet (specifically with regard to collateral movements) how the tax will actually work in terms of its administration and collection, and therefore this developing situation requires careful monitoring.

There is also the possibility that other European jurisdictions will follow France's lead and impose a similar tax of their own through an EU mechanism known as enhanced cooperation.

Will the regulations affect collateral arrangements?

The general collateral market continues to show signs of evolving, specifically, with the focus on more structured or term-related general collateral arrangements. Non-cash collateral flexibility is one of the key areas that clients continue to explore, ensuring any changes conform with their risk appetites.

We do not yet know whether the new regulations coming from ESMA and others will affect what is considered acceptable as collateral, although State Street continues to work with clients to ensure that acceptable opportunities that are related to collateral profiles evolve.

The low interest rate environment in the eurozone has meant investment opportunities for euro-based cash collateral do present challenges, so there is a move towards using non-cash collateral instead in these instances.

What are the prospects for exchange-traded fund lending?

We continue to see growth in demand for exchange-traded fund (ETF) lending with most opportunities resulting in strong revenue spreads for investors. We continually engage with our clients; assisting them in developing and shaping their securities lending programmes and ETFs are just one of the elements of this.

We welcome and support continuing development around transparency around ETFs and lending, we continue to monitor developments and discuss new opportunities with clients and how they would like to structure their lending programmes in the future.

Are there any specific areas where the market could see growth?

In addition to growing demand in Europe, we do see that demand for Asia-based securities is increasing and although this asset class does present some additional securities lending challenges, there are lending opportunities in quite a few of the Asian markets.

State Street's extensive securities trading and account management footprint in Hong Kong, Sydney and Tokyo, we believe, allows us to optimise on opportunities that arise in that region on behalf of our clients.

From talking to lenders, what are their concerns about the market?

Lenders are increasingly looking to structure their programmes carefully and are keen to look to new markets for opportunities, but they also want to ensure that they understand the overall environment, particularly given the large number of regulatory changes. We engage in ongoing discussions with clients around re-setting or adjusting their risk appetite, and potential changes to their programmes.

As a result, they are increasingly looking for a partner that can offer robust reporting and flexibility in a product offering that can meet their growing requirements; this would include dedicated resources around business development, tax, product development and legal resources to help them to manage their programmes optimally.

How is State Street helping clients to explore the opportunities in the current environment?

Lenders are keen to achieve greater transparency and more immediate reporting on their programmes, and we have upgraded and consolidated our online reporting via our client portal, my.statestreet.com, to better meet their needs in this area.

Ultimately, given the rapid rate of change in the market, it's becoming evident that working with a business of the scale of State Street can help clients to achieve their goals for their securities lending mandates. The global scope and reach allows State Street to identify opportunities, whether it's new markets, specific bespoke styles in lending, for example opportunistic or specials only, versus other non-cash or cash profiles.

Ultimately, although change in the securities lending environment is proceeding apace, we see this environment as an opportunity for us to work more closely alongside our clients, utilising our extensive resources, to move forward together. **SLT**

Don D'Eramo
Senior managing director and regional business head of securities finance, EMEA and Canada
State Street Global Markets

2014

Solvency II time: lenders prepare

Solvency II goes live on 1 January 2014, but the sell side still has work to do. MX Consulting's Adrian Morris reports

Beneficial owners that lend insurance funds are contending with Solvency II, which is driven by the European Insurance and Occupational Pensions Authority (EIOPA). Like Basel II for banks, Solvency II is pushing insurance companies to supply large quantities of information to the regulator, including securities lending, repo and collateral data. Recent events have meant that EIOPA and the UK FSA both currently state that the new regime will go live on 1 January 2014, a year later than originally intended. It will replace Solvency I requirements and the current regulatory regime for insurance supervision for firms in the UK.

There are three pillars of Solvency II: 'Quantitative Capital Requirements' (Pillar 1), 'Qualitative Supervisory Review' (Pillar 2) and 'Supervisory Reporting and Public Disclosure' (Pillar 3). Pillar 3 concerns market discipline and it contains a provision that means that any agent lending on behalf of insurance funds will need to supply the required information to the insurance companies. Agreement will need to be made on whose responsibility it is to put this data into the required Solvency II format. Ultimately, it is the insurance company that will report the data to EIOPA in the form of quantitative reporting templates (QRTs) for all securities on loan in QRT D5 and all types of collateral, including cash, in QRT D6.

It is fair to say that some of the information that is required is not standard to securities lending. Also, the provision of data between loan and collateral positions does not align itself well when compared to how it is used for current regulatory disclosures such as the agent lending disclosure (ALD) or normal day-to-day business management reporting. EIOPA has not ceded any changes in its July 2012 response to the International Securities Lending Association's concerns about the scale and types of data that are required.

Agent lenders will need to carefully analyse the meaning of the requirements and spend time educating those individuals working for insurance companies on the wider Solvency II data projects about their securities lending businesses. Clients may also demand additional data for their own internal risk models, which can further complicate matters. In the past, many agent lenders have relied on spreadsheets or tactical solutions to supply clients with regulatory data, or they have found current in-house reporting packages to be sufficient. The problem with Solvency II reporting for both insurers and their agent lenders is that it has unusual complexities involved in the gathering and mapping of data, and this is further complicated by the requirement to provide cumulative daily loan and repo positions for the entire year. Now that agent lenders face so much additional scrutiny from beneficial owners, it is up to them to ensure that the data that is supplied to insurance fund clients is correct in order to protect this discretionary activity and its income stream. If an insurance fund client has issues with the regulator because incorrect data is provided, the fund's first and most likely course of action will be to review its lending programme.

Beneficial owners have become very sensitive to any issues that arise with regulators.

The addition of attributes that are not normally required means that those managing Solvency II data delivery will need to find a way to source the data, either internally from in-house securities databases or externally from securities vendors such as Bloomberg or Reuters. Loan and collateral securities per trade and collateral positions also have to be mapped according to new Solvency II-defined identifiers that are known as complimentary identification codes. These do not exist outside of Solvency II and they are applied in a way that requires convoluted programming, as EIOPA's requirements consistently misunderstand the relationship between a single loan or repo and its collateral.

As a further example of these complications, Solvency II balance sheet codes must be applied within QRT D6. This means that for every line of collateral, the corresponding loans from the fund legal entity per counterparty are aggregated by security type to a balance sheet category and assigned as a string in a single cell!

In recent years, the majority of agent lending businesses have switched to using triparty agents to collateralise their daily loan positions. Many agent lenders only hold the total collateral value for each borrower and lending legal entity within their systems for exposure monitoring purposes. This is problematic for Solvency II reporting purposes as the underlying positions of the collateral will need to be communicated to the beneficial owner and regulator. Issues also arise as in-house securities databases will not necessarily be able to reference the required clean price for bonds because collateral securities that are allocated by the triparty agent each day will not always be part of the normal daily loan position pricing universe.

These are only some of the issues that Solvency II creates concerning the management and submission of securities loan and collateral data. The analysis and solution requirements for this regulatory regime require a high level of analysis and thought. Tactical solutions are unlikely to give the level of comfort that is required.

Given that insurance company beneficial owners are running large and complex programmes of work for Solvency II, they will be demanding the full attention of their agent lenders in the remainder of 2012 and in 2013 to help them to understand the challenges of Solvency II for the QRT D5 loan and D6 collateral submissions.

MX Consulting has been working with both insurers and agent lending clients to help them to understand the issues. It has also recently implemented its Securities Lending and Collateral Solvency II solution with a large UK-based agent lender and insurance client. The application can be white labelled for use via a client's intranet and it can manage the entire process from end-to-end. The system can work equally well for agent lenders wishing to submit the completed Solvency II QRTs to multiple underlying insurance clients or where the insurance client wants to take raw securities lending and collateral data from their agent lenders and manage the data and subsequent submissions themselves. **SLT**

Bandage bans

SLT looks at recent research into the effectiveness of short selling bans and asks whether they are worth implementing at all

MARK DUGDALE REPORTS

When a market or a stock takes a nasty turn, regulators work like doctors to treat the symptoms while assessing the source of the contamination. Regulators fear that short selling could drive stock prices down artificially and have looked to implement bans as a means of alleviating the problem and protecting markets in times of turmoil.

Economists from the Federal Reserve Bank of New York and the University of Notre Dame's Mendoza College of Business recently conducted a study that investigated the link between short selling and market downturns in the US, and asked what short selling bans really accomplish.

The study's authors—New York Fed economist Hamid Mehran and Notre Dame finance professors Robert Battalio and Paul Schultz—assessed evidence of the effectiveness of bans in limiting share price declines in 2008. They also looked at the market effects of short selling in August 2011, when ratings agency Standard and Poor's lowered the US sovereign long-term credit rating, prompting the S&P 500 to fall 6.66 percent on the next trading day. This particular time was chosen as a means of contrast—at the time, there was no short selling ban in place in the US.

The authors concluded that "not only do short-sale bans fail to limit share price declines during market downturns, but also that the bans have the unwanted effects of reducing market liquidity and driving up trading costs", according to Rob Ferguson, senior vice president, capital markets, at CIBC Mellon.

He says: "For example, the authors estimate that the inflated costs of liquidity attributable to the short sale bans applied to US equity and options markets over a three-week period in fall 2008 exceeded $1 billion. The research also points to bans as restricting the ability of short sellers to root out cases of fraud. All in all, the research shows that short selling enables price discovery, not price manipulation, which means that banning short selling during market downturns is essentially a case of shooting the messenger."

Research into the effects of short selling has "consistently shown" that it does not cause artificial stock declines, according to Ferguson. In fact, the practice "actually helps reduce volatility, enable efficient price discovery and a faster market reaction to emerging news".

Ferguson says: "Consider that when there's demand, short sellers have the inverse entry and exit points to a long holder, so their trading volume helps smooth out prices. In this way, short selling actually creates a natural buffer that can help stabilise the market. This may be borne out in the New York Fed research: financial stock prices that fell 12 percent during the 2008 short selling ban didn't stabilise until the bans were lifted."

"I also believe that short selling bans may have a counterproductive effect of decreasing investor confidence. Think about it this way: if security X is seeing a steep decline in price, some investors might see that as an opportunity to buy into that security at a 'discount'. But when a short selling ban is in place, some investors might conclude that the regulators' attempt to slow the decline in that stock means the stock will fall even further. After all, putting the brakes on as you drive down a hill doesn't make the valley any less deep."

Clean as a whistle

Short selling is not a Persil white practice, as the Wolfson brothers recently showed. The US SEC accused brothers Jeffrey and Robert Wolfson of naked short selling and they agreed to pay $14.5 million to settle the case against them.

"[They] attempted to game short-selling restrictions in order to win millions of dollars in illegal profits," said Andrew Calamari, acting director of the US SEC's New York regional office in a statement at the time.

Jeffrey Wolfson conducted naked short sales while working as a broker-dealer, and later as the principal trader at a Chicago-based brokerage firm that is no longer in business.

Robert Wolfson made illegal sales while trading in an account at New York-based broker-dealer Golden Anchor Trading II LLC, which was also charged by the SEC and agreed to the settlement. Jeffrey Wolfson generated approximately $8.8 million in net illicit trading profits, and Robert Wolfson and Golden Anchor made $700,000.

But Ferguson says that Battalio, Mehran and Schultz address concerns that short sellers would try to "game the system", weakening confidence in strong firms or otherwise pushing prices down below fundamental levels in their study.

He says: "[They point] out that short sellers actually have a limited upside and an unlimited downside—unlike other types of investors. An attempt to push prices below fundamental levels exposes short sellers to tremendous risk as managers of shorted firms work to rebuild confidence and smart value investors who correctly identify the targeted firm's fair value trade against them. Using false information to drive down prices also opens short sellers to criminal prosecution: hardly the returns they are seeking."

"Short sellers also provide revenue to long investors. The fees to borrow shorted securities can help long owners who participate in securities lending offset losses and produce additional returns. Take the solar energy sector as an example: if you are a long investor who believes that solar stocks have a bright future in the years ahead, a short- or medium-term dip in prices has little impact on your long strategy. By lending out the portfolio to short sellers seeking to profit from shorter-term dips, you benefit from the lending fees and would actually see greater returns on a successful long-term investment than you would without short sellers."

He concludes: "Perhaps most importantly: if something is overvalued, shorting helps bring it back to fundamental or appropriate levels. It's a means of price discovery that can actually help support an efficient market." **SLT**

Square peg, round hole

SLT asks Rob Ferguson of CIBC Mellon whether there are any alternatives to short selling bans

What are the alternatives to short selling bans?

The goal should not be to keep the market flat, because that's not going to happen; sometimes things go up, sometimes things go down. As the New York Fed research shows, bans on short selling don't work: they don't smooth the market—in fact, the artificial barriers actually seem to have the adverse effect of driving up costs, reducing liquidity and even reducing investor confidence in a way that can even prolong the problems. So, I think the first thing is to accept that there's not a way to smooth the market, and that it will rise and fall with new information. If in future there are market stakeholders calling for bans on short selling in the future, I would hope that the regulators will be able to point to the large body of research into the ineffectiveness of these bans—and the positive impacts of short selling.

Secondly, I think it's important that all stakeholders—regulators and participants—beware of people undertaking abusive short selling; it's important to ensure there are strong controls against insider trading or spreading disinformation.

The market could certainly benefit from ongoing efforts to improve disclosure to ensure that market decisions are made on accurate information. Regulators could also work to further improve the dissemination of that information: there is at least a perception that information is widely available to institutional investors, but retail investors can sometimes suffer from a lack of information. There are a lot of fingers being pointed over the performance of Facebook stock, for example, with some charging that certain institutions had access to better information that was not made public.

Lastly, I think one of the best steps we can take is among the simplest: for market stakeholders to acknowledge that short selling is not inherently bad—it's just an investment strategy, and it comes with its own set of risks and returns. Along the way—from fraud hunting to driving down trading costs—short sellers can provide a lot of value to the market.

Rob Ferguson
Senior vice president, capital markets
CIBC Mellon

As easy as that

What does the Euroean Central Bank's easing of eligible collateral for its long term refinancing operation mean for the securities finance market? Will Duff Gordon of Markit Securities Finance takes a look

The European Central Bank (ECB) has finally wrestled the Bundesbank to the ground. Stock markets were set on fire as ECB president Mario Draghi stated his readiness to buy unlimited amounts of government debt under the Outright Monetary Transactions (OMT) mechanism. As ever, the devil is in the detail.

Not betting against Europe

The ECB's president grinned widely when he said that there is no going back from the euro. France President Francois Hollande reiterated this triumphant point. But no one was betting against the euro break up anyway—or so our data shows. A year or two ago, there was great demand to short European Financial Stability Facility (EFSF) bonds. Borrowing and selling the closest things to euro bonds was seen as a good way to profit from the unravelling of the euro. But, today, demand to borrow these bonds is unremarkable. In fact, they are being used in financing trades such is their credit worthiness!

Don't forget Greece

The cost of borrowing Greek equities rose sharply over the past week (there is a short sale ban in place). There was also a very high rise in share price volatility. With all the focus on Spain and Italy, are markets quietly assuming that Greece will not be granted an extension of debt repayment and left to wither on the vine? The credit default swap market sees the monthly change in the cost of default protection fall for all eurozone countries with Portugal, Spain and Italy seeing the biggest tightening.

Application for EFSF/ESM is a pre-requisite

No surrender; no bond buying. OMTs in secondary bond markets are contingent on Spain and Italy signing up for the "EFSF/ESM [European Stability Mechanism] macroeconomic adjustment programme or precautionary programme" along with "primary market purchases".

So far, Italy's prime minister, Mario Monti, and Spain's prime minister, Mariano Rajoy, have said 'no thanks', paving the way for a stand off. However, the very fact that the ECB is prepared to intervene is the declaration of intent that investors needed to step off the sidelines, raising markets by 2 percent on the news.

OMT will buy bonds with maturity of one to three years

Prior to this policy, there has been a noticeable crowding of bond borrowing demand around the short-term debt maturities. Data shows that only German and UK debt is in demand beyond a 10-year maturity. One wonders whether this could be about to change. Why lend or borrow one-to-three year maturities when this means using up the ones that the ECB is happy to buy?

Another consequence could be a general shift, by asset managers, along the maturity curve. If you can sell your short-term eurozone debt to the ECB in the secondary market, why wouldn't you use that cash to buy long-dated bonds in return for the double bonus of higher yield and less short term re-investment risk?

Eligibility criteria for central government assets change

In the old days, the word 'eligible' might generally be followed by 'bachelor'. Nowadays, 'eligible collateral' is what you want to dance with in today's world. Draghi has relaxed the list of bonds that he will accept as part of the long-term refinancing operations (being the art of lending the ECB some bonds and getting back cash on very good terms).

On face value, this might ease the demand for German, UK and French sovereign debt, which, as the data shows, is not infinite. On the other hand, the scale of the haircut or 'over-collateralisation' that is required might mean that it remains cheaper to swap/borrow your way to bunds after all.

Mirroring the policy from late 2008, there will be an 8 percent haircut applied to non-euro bonds being pledged into the ECB and a further 5 percent haircut for instruments that are A-. This percentage rises further on a sliding scale if you pledge bonds below A-.

Saying no to non-euro bonds with coupons falling due

This must be a boon to the securities financing market. Those wishing to swap/replace a non-euro bond with an imminent coupon payment with one that doesn't are likely to give you a ring. This could lead to a steady stream of short-term government bond borrowing in what would be routine, and very welcome, business for the securities financing markets. **SLT**

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13th Annual Collateral Management

Location: London
Date: 20-21 September 2012
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Location: London
Date: 20-21 September 2012
www.imn.org

Dedicated to meeting the information and networking needs of beneficial owners for nearly 20 years.

6th Annual Collateral Managment

Location: Amsterdam
Date: 9-10 October 2012
www.finance.flemingeurope.com

Bringing together top experts from both the buy side and the sell side, this two-day conference will help experts to manage and optimise their collateral.

RMA's 29th Annual Conference on Securities Lending

Location: Miami
Date: 8–11 October 2012
www.rmahq.org/slconference

Join your peers in participating in timely industry discussions on the latest legal and regulatory requirements, including a triparty repo reform discussion.

Industry appointments

Zurcher Kantonalbank has snapped up **Raphael Zemp** as a vice president and trader for its prime finance team. He will work on the fixed income and financing side of the business.

Zemp reports to Roger Reist, head of repo and fixed income securities lending.

He joined Credit Suisse in March 2008 from UBS, where he worked in fixed income lending and financing. Zemp left Credit Suisse in May.

HazelTree has appointed **Tyler Gowen** to the position of managing director.

In his new position, Gowen will lead HazelTree's sales efforts to provide treasury, portfolio management and compliance services to a select group of multi-prime hedge funds. He will report to Stephen Casner, CEO of HazelTree.

BCS Global Markets and Investment Banking has made four senior appointments to its new London office.

Luis Saenz joins as head of equity and derivatives sales trading. Saenz previously worked at Otkritie as CEO of its New York office.

Tim Bevan has been recruited as head of international direct market access (DMA), sales and prime brokerage. Bevan also joins the firm from Otkritie, where he was director of DMA sales.

Joesph Dayan has been appointed as BSC London's head of markets. Dayan was previously an employee of UniCredit in New York, overseeing cash equity operations.

BSC's final appointment, **Mark Cleary**, has been hired as head of sales trading. Cleary has previously worked at VTB Capital, Otkritie, Walter Capital and SAC Capital Advisors.

William Vereker, the joint head of investment banking at Nomura Holdings, is stepping down from the role to become vice chairman of investment banking, according to an internal memo.

The other joint head, **Kentaro Okuda**, will assume sole leadership of the global investment banking at the brokerage with immediate effect.

The Royal Bank of Scotland (RBS) has recruited **William Egan** as head of mandate sales for prime services in Asia Pacific. Egan will be based in Singapore.

In the newly created role, Egan will be responsible for originating and delivering the bank's prime services platforms to clients. He will also focus on winning long-term prime broking mandates spanning across FX, rates, flow credit, and futures and options.

Egan's new appointment at RBS sees him leave Barclays after six years, where he was part of the bank's prime services team in New York. He most recently served as head of FX prime brokerage and OTC clearing in Singapore.

HSBC's global banking and markets division has recruited nine senior executives in its Asia Pacific equities and prime services units.

Jean-Paul Linschoten joins the bank as a director in prime services sales. The Hong-Kong based role sees Linschoten reporting to Matt Kiraly, head of prime services sales for Asia Pacific.

David Streatfield has been appointed as a director in equity finance delta one sales in Hong Kong. Streatfield was formerly a director in delta one, synthetics, swaps and stock lending sales at Deutsche bank in London.

Adrian Harrison will be joining HSBC as a director in prime services sales, and will also be based in Hong Kong.

Ted Langworthy joins as director in equity finance delta one sales. Langworthy will be based in New York, reporting to Warren McCornick, head of equity finance and delta one for the Americas.

In equities, the Asia Pacific team sees the appointment of five new senior executives.

Tim Franks has become head of hedge funds sales. Based in Hong Kong, Franks will be reporting to Brad Schwartz, head of equity sales, Hong Kong. Franks was formerly a managing director and head of hedge fund sales at Bank of China International.

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Jeffrey Tan has been appointed as a director in equity sales, based in Hong Kong, also reporting to Brad Schwartz.

Eric Ang joins as director in equity sales trading, and will also be based in Hong Kong. In his new role, Ang will be reporting to Jefferson Saunders, head of sales trading and customised execution services for Asia Pacific.

Russell Jacobsen has been recruited as director of equity sales trading. He will be based in Hong Kong, also reporting to Jefferson Saunders. Jacobsen joins from Samsung Securities where he was head of regional sales trading and execution.

Finally, **Edward Yen** has been appointed as a director in Taiwan equity sales. Yen was previously an equity analyst at Goldman Sachs. **SLT**