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EU's new short selling regulation could do with some fine-tuning

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The EU's new short selling regulation has had a positive effect on market transparency and reducing the risk of settlement failure in Europe, but adjustments do need to be made, the European Securities and Markets Authority (ESMA) has found.

ESMA was asked to carry out a review of the effects of the short selling regulation shortly after it was implemented in November 2012.

The authority looked at the effects of transparency requirements, uncovered short selling restrictions and any other temporary business restrictions.

It also assessed whether the regulation is fulfilling the needs of the market for transparency and regulators to carry out their supervisory mandates.

It had to deliver its findings by the end of this month, and did so in a report to the European Commission on 3 June.

The short selling regulation had "mixed effects" on the liquidity of EU stocks, "with a slight decline in volatility, a decrease in bid-ask spreads and no significant impact on traded volumes", according to an ESMA statement.

But price discovery speed "seems to have decreased compared to the period before the entry into force of the regulation", although "overall, settlement discipline has improved".

ESMA's report said: "Overall, it seems that market participants had a tendency to settle on one side or the other of the threshold and avoid crossing it. This would suggest that holders' behaviour is pre-determined, ie, over time a holder is sticking to its initial decision on whether to go public on a given position."

readmore p3

SLTINBRIEF

Mackenzie makes a beeline for Citi's services

Mackenzie Investments has selected Citi to provide a complete suite of fund administration, middle office, collateral management and transfer agent services to support its portfolio advisory and fund management activities in Asia.

readmore p3

May volume spikes for OneChicago

OneChicago, an equity finance exchange, announced May 2013 volume of 1,094,616, an increase of 322 percent compared with the same period in 2012.

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Short selling regulation needs some fine-tuning

Continued from page 1

"This would mean that the public disclosure threshold has an effect on short-selling activities, and even though no strict conclusion is to be drawn from the available data, it can be suspected that some actors prefer to stay below the 0.5 percent threshold and not to disclose information on their short-selling activity."

ESMA's statement added that the short selling regulation had "no compelling impact on the liquidity of EU single name CDS and on the related sovereign bonds markets ... except in a few countries".

"The liquidity in European sovereign CDS indices has been somewhat reduced."

Steven Maijoor, chair of ESMA, said: "[Our] review has found that the introduction of the short selling regulation has had some positive effects in terms of enhancing market transparency and reducing risks of settlement fails in EU financial markets."

"Due to the short period of operation of the regulation, ESMA was subject to severe limitations in terms of available data and practical experience in supervision under the regulation. However, ESMA is advising the European Commission to consider adjusting a number of aspects in the regulation that do not alter its main elements."

ESMA recommended changing the way that net short positions in shares are calculated, and revisiting the method of calculation of net short positions in sovereign debt, particularly the duration-adjusted approach, and reviewing the thresholds for notifications.

For restrictions on uncovered short sales in shares and sovereign debt, ESMA recommended considering some adjustments to the regime to allow internal locate arrangements within the same legal entity.

It also suggested revisiting the issue of the definition of 'liquid shares' for the purpose of locate arrangements at a later stage, when proper regulatory data on securities lending would be available.

The authority also looked at emergency short selling bans, such as the one that is in operation in Greece, recommending that they should be simplified and made more consistent in their application.

Mackenzie makes a beeline for Citi's services

Continued from page 1

Venkat Kannan, chief administrative officer of Mackenzie Investments, said: "As this is our first foray into direct portfolio advisory activities in Asia, outsourcing our middle office to Citi is a clear choice as Citi has a robust fund services platform in place, which can fully support our credit and macro investment strategy."

David Russell, Asia Pacific head of securities and fund services at Citi, added: "As global fund managers continue to expand their businesses in Asia, Citi is uniquely positioned with a strong local presence and a comprehensive range of information delivery and reporting technology and investment services solutions that let fund managers focus on building relationships and growing their business."

May volume spikes for OneChicago

Continued from page 1

"The continued growth of SSF volumes is directly related to customers locking in relatively low rates for their term trading now with the anticipation of interest rates rising," said David Downey, CEO of OneChicago.

"As firms and asset managers look to manage their costs of carrying positions, synthetic exposure to the US equity markets via SSF priced with a competitive broker dealer interest rate is a smart alternative."

Open interest stood at 746,943 contracts on the equity finance exchange at the end of May 2013. There were 1,064,741 exchange futures for physicals (EFPs) and blocks traded, and the month's EFPs and blocks activity represented $4.8 billion in notional value.

Sixty-one percent of May 2013 month-end open interest was in OCX.NoDivRisk products, an equity finance tool that removes dividend risk for customers carrying equity delta exposure.

OCC enjoys May increases

OCC's securities lending central counterparty activities saw a 46 percent increase in new loans over May 2012 with 121,016 transactions last month.

Year-to-date stock loan activity is up 40 percent from 2012 with 529,502 new loan transactions in 2013. The average daily loan value at OCC in May was $57,687,152,619.

The equity derivatives clearing organisation's total cleared contract volume in May reached 391,347,069 contracts, representing a 3 percent increase from the May 2012 volume of 380,417,938 contracts.

Its year-to-date cleared contract volume is up 0.2 percent from 2012 with 1,774,634,896 contracts.

OCC's exchange-listed options trading volume also experienced an increase, with it reaching 386,428,255 contracts in May, a 2 percent increase on the same month in 2012.

Average daily options trading volume for the month reached 17,564,921 contracts, which was 2 percent higher than May 2012. Year-to-date total options volume is down 0.41 percent with 1,751,155,921 contracts in 2013.

The total number of cleared futures reached 4,918,814 contracts in May, up 71 percent from the same month in 2012. OCC cleared an average of 223,582 contracts per day last month, an increase of 71 percent from May 2012.

Its year-to-date cleared futures volume is up 83 percent with 23,478,975 contracts in 2013.

BNY Mellon expands bilateral margining

BNY Mellon has ramped up its DM Edge product in the wake of recommendations from the Federal Reserve bank.

The bank has expanded its bilateral margining capabilities to include forward-settling mortgage-backed securities (MBS), as recommended to help reduce counterparty and systemic risk by the Treasury Market Practices Group (TMPG) sponsored by the Federal Reserve Bank of New York.

TMPG recommends two-way variation margin, exchanged regularly, because this type of trade settlement is often scheduled into the future at a date to be announced (TBA) with a 48-hour trade settlement window.

"The TBA market serves a critical function by allowing mortgage lenders to hedge risk and fund their loan origination pipelines," said a release from BNY Mellon.

It added that the TBA market facilitates the forward trading of mortgage-backed securities with defined settlement dates for each month in the future, and that the liquidity of this market also supports efficiencies, with cost savings for lenders that are passed on to borrowers in the form of lower rates.

"This enhancement to DM Edge helps clients manage their counterparty exposure," said Nadine Chakar, head of product and strategy for BNY Mellon's global collateral services business. "Through DM Edge, MBS trading counterparties can reduce the credit risk inherent in forward transactions by exchanging collateral, or margin, as protection against loss in the event of default."

"Unmargined, bilateral agency MBS trades can pose counterparty risk to market participants, which is why TMPG recommends that exposures from forward-settling transactions, inclusive of agency MBS transactions, be margined beginning in early June 2013 and substantially completed by the end of the year," said Chakar.

Given its volume and liquidity, the TBA market is the most important secondary market for mortgage loans and represents capital flow from a wide range of investors, said the bank.

Asset manager Dimensional chooses Citi

Global funds manager Dimensional has appointed Citi's securities and fund services as back office provider to its Australian funds.

Citi will provide custodial, fund accounting, unit registry and securities lending services to the Dimensional Australia funds, extending on existing middle office services which the firm has provided since 2006.

Dimensional Australia chairman and CEO, Glenn Crane, said the decision to award the contract to Citi followed an extensive global due diligence process, in which end-client benefit was the over-riding requirement.

"The market for back office services is a demanding one and client needs are changing." Crane said. "We need efficiency, responsiveness, technological sophistication, reliability and cost-effectiveness. And that means better services to our clients."

Citi's head of securities and fund services for Australia, Martin Carpenter, said: "In this complex and competitive environment, it's important that the Australian asset management sector partner with an organisation that has a premium product suite and global reach."

Citi already provides custodial services to US clients of Dimensional who invest in non-US funds.

Dimensional is a privately held global institutional asset management firm with approximately $300 billion in AUM globally, including more than $22 billion for clients in Australia and New Zealand.

Dimensional launched in the US in 1981. It opened its Sydney office in 1994 as an Asia Pacific trading hub and began offering strategies to Australian institutional and fee-only financial advisor clients from 1999.

Clearstream sidesteps GMRA with new repo agreement

Clearstream has designed a new legal master agreement for triparty repo transactions, with the aim of bypassing the difficulties of individual agreements.

The new master agreement hopes to speeds up counterparty marriage broking, enabling customers to sign just one document that is applicable for any number of counterparties.

"We're finding more new customers are keen to come into triparty repo—corporates, for example—but some are put off because of the delays in making individual agreements with each of their intended counterparties. Our aim was to provide a simplified framework to enable them to take advantage of triparty repo much quicker," said a spokesperson.

Clearstream has designed and paid for a master agreement that will cover all counterparties who sign it, avoiding individual negotiations. The agreement is under Luxembourg law, opposed to the Global Master Repo Agreement—first published in 1992 and governed by English law—and is posed as an alternative for newcomers to the market.

"Triparty repo's high level of security and efficiency make it a popular secured money market tool with many of our clients," said Pascal Morosini, global head of global securities financing sales and relationship management for Clearstream.

"However, some new market players are deterred by the existing contract process requiring them to negotiate bilateral master repurchase agreements with all their counterparties ... We fully understand the problem: who wants to wait a year to sign only two trading counterparties?"

Clearstream's repurchase conditions permit the participation of multiple counterparties within a few weeks.

The firm also announced that it is making available on demand and free-of-charge a number of legal opinions covering several jurisdictions addressing questions on netting and set-off provisions, enforceability, and insolvency proceedings.

Another attempted boost for India's SLB market

Indian regulator SEBI will increase the number of stocks allowed to be borrowed and lent, in efforts to ramp up the securities lending market in the country.

Stocks that fulfill certain criteria, such as an average monthly trading turnover of at least Rs 100 crores ($17.8 million), will now be allowed to be borrowed and lent out.

It is not the first time that the regulator has attempted to relax what some as seen as particularly severe rules. In November last year, the board stated in a circular that lenders and borrowers of shares could carry forward their positions up to three months, instead of one month as is the current norm.

The 'roll-over facility' states that any lender or borrower who wishes to extend an existing lent or borrow position shall be permitted to roll-over such positions for three months, although roll-over shall not permit netting of counter positions.

SEBI also indicated the introduction of liquid exchange traded funds as eligible for trading, with the ETF deemed liquid provided it has traded on at least 80 percent of the days over the past six months and its impact cost over the past six months is less than or equal to 1 percent.

The FTT: perverse and unacceptable

A recent paper has warned that current EU proposals for a Financial Transactions Tax (FTT) will drive business away from London and to New York.

In a foreword to a new Centre for Policy Studies paper by John Chown, a founder of the Institute for Fiscal Studies, Nigel Lawson wrote: "As John Chown demonstrates in this paper, the

coming EU Financial Transactions Tax is, if anything, even worse. Designed both to punish the bankers and to raise money for the EU budget, its principal effect will be to drive financial business away from the EU (including the UK) to more hospitable jurisdictions elsewhere."

"Belatedly conscious of this danger, the EU is now attempting to extend the FTT so that any transactions involving eurozone securities of any kind, wherever they are conducted, are caught by the tax. This extraterritoriality may well be illegal: it is clearly unenforceable. And the US has already made clear that it will have none of it."

"There are only two world-class financial centres: London and New York. That it should be considered in the interests of Europe to drive business away from London, to the benefit of New York is both perverse and unacceptable. John Chown and the CPS have performed a valuable service in drawing attention to this complex but important issue."

4sight updates collateral optimisation system

4sight Financial Software has added a range of new features to its collateral optimisation system. The updates will allow users to automate collateral recalls and substitutions based on: corporate actions; changes in collateral credit rating leading to it becoming ineligible; changes in counterparty and CCP eligibility criteria; recall requests by underlying clients leading to a short position.

The collateral management system can base all collateral substitutions on automated cheapest to deliver collateral algorithms.

The system can also help users to see when pledged collateral is no longer cheapest to deliver and can propose suitable reallocations.

Martin Seagroatt, 4sight's head of marketing, said: "Collateral substitution is one of the biggest operational headaches of the collateral management process."

"We developed new automation around this process to reduce the level of manual effort involved, while also minimising collateral costs through intelligent asset allocation."

'No evidence' of widespread collateral shortfall, says BIS

There is no evidence or expectation of any lasting or widespread scarcity of collateral in global financial markets, according to a Bank for International Settlements (BIS) report.

The Committee on the Global Financial System report looks at asset encumbrance, financial reform and the demand for collateral assets.

In his preface to the report, committee chairman and Federal Reserve Bank of New York president William Dudley said that while there is no evidence of a widespread collateral shortfall, there is evidence of banks' increased reliance on collateralised funding markets, particularly in Europe.

He added that regulatory reforms and the shift towards central clearing of derivatives transactions will also add to the demand for collateral assets.

"Temporary supply-demand imbalances, however, may arise in some cases, as the supply of collateral assets varies widely across jurisdictions and institutions."

Dudley said that "endogenous private sector responses" such as collateral transformation could help to address supply-demand imbalances if and when they emerge.

"While this will mitigate collateral scarcity, these activities are likely to come at the cost of increased interconnectedness, procyclicality and financial system opacity as well as higher operational, funding and rollover risks."

“Hence, monitoring these developments and designing measures that limit any resulting adverse market implications for financial market stability should be an important focus of policy.”

Naked short selling case could go to federal court

The US Court of Appeals for the Third Circuit will decide whether a case alleging Merrill Lynch & Co, Knight Capital Americas, UBS Securities and others engaged in manipulative naked short selling should be heard in state or federal court.

US district judge Jose Linares granted an interlocutory appeal on 23 May in a case that saw shareholders in Escala Group accuse the financial institutions of selling Escala stock that they did not own or borrow.

They filed the case in May 2012 in the Superior Court of New Jersey, but after they amended their complaint, the defendants removed it to the US District Court for the District of New Jersey in July.

The defendants argued that the change of jurisdiction was correct because the plaintiffs’ claims arise under US federal law.

The shareholders in Escala Group contested the change of jurisdiction, but their motion was denied in March, leading them to appeal against the decision.

In granting the Third Circuit appeal on 23 May, district judge Linares said that the case met the criteria for an interlocutory appeal, particularly because “an immediate appeal may ultimately advance the termination of the litigation”.

In his decision, judge Linares said: “There is little doubt that if the Court of Appeals determines that this court lacks jurisdiction, the case will be remanded to the Superior Court of New Jersey and the federal litigation will be terminated. On the other hand, denial of the instant motion could result in a needless waste of time and resources on the part of the court as well as the parties if this court lacks subject matter jurisdiction.”

The specific question that the Third Circuit must consider is: “Whether this court has subject matter jurisdiction over the instant matter by virtue of either of the following: (1) Section 27 of the Securities Exchange Act of 1934; and/or (2) plaintiffs’ claims raise, and arise under, federal law.”

A spokesperson for UBS Securities declined to comment.

Merrill Lynch & Co and Knight Capital Americas did not respond to requests for comment.

Aviva mandates BNP Paribas to develop repo

Aviva Investors France has mandated BNP Paribas Securities Services for the administration of collateral for its sale and repurchase agreements.

Under this new mandate, BNP Paribas will support Aviva to develop its repo activities in a constantly changing regulatory environment, an area where the custodian provides a complete line of service, said a release.

Hélène Virello, head of collateral management at BNP Paribas Securities Services, said: “This new mandate confirms our strategy of expanding our collateral management services for various underlying assets aside from bilateral OTC derivatives. These include repurchase agreements and cleared OTC derivatives.”

Christian Dormeau, CEO of Aviva Investors France, said: “Monitoring counterparty risk, which is a central topic of debate in the market, is also an essential component of our asset management strategy.”

“Given the strong growth of our repo activity, we wanted to outsource to an efficient, responsive service provider who would maintain Aviva Investors France’s high standards for

monitoring and managing the risks related to its commitments."

Aviva Investors France is the global asset management arm of Aviva Group. Founded in 2008, it operates in 15 countries, with AUM of £274 billion at 30 September 2012, making them one of the top 10 asset management firms in France.

Eurex makes securities lending CCP updates

Eurex Clearing is introducing changes to its central counterparty (CCP) solution for securities lending.

A processing solution for voluntary corporate actions is being implemented, and France, Belgium and the Netherlands are being introduced as settlement locations for eligible loan securities.

Eurex Clearing's executive board agreed to the changes on 22 May. They became effective on 7 June.

With the new processing solution for voluntary corporate actions, lenders and borrowers will be able to arrange bilaterally for all types of voluntary corporate actions, including the sale or execution of rights, while keeping the loan within the CCP.

Re-delivery obligations will be amended without loans closing, and cash compensation payments are to be agreed and executed on a bilateral basis.

Additionally, the CCP service for securities lending is being extended to include loans on blue chip equities in French, Dutch and Belgian markets.

These loans will be settled in the Euroclear France, Nederland or Belgium central securities depositories, depending on which one is the home market.

Eurex Clearing's new CCP service for securities went live on 22 November 2012. It was launched in partnership with Pirum Systems and Clearstream Banking.

KPMG selects SunGard's Adaptiv Analytics

KPMG in Germany has chosen SunGard's Adaptiv Analytics to help clients with assessments of credit valuation adjustments (CVA) under Basel III.

KPMG has integrated Adaptiv Analytics with its proprietary risk-weighted asset (RWA) calculator and related tools to create IMM-2-Go.

The IMM-2-Go framework will help firms implement an internal models method to calculate Basel III default risk and CVA risk charges with regards to derivatives exposures.

The internal models method can help to alleviate a firm's regulatory capital constraints that can help provide them with an important competitive advantage under Basel III.

Cubilla Ding, research director at Celent, said: "In today's increasingly competitive and unpredictable global markets, it is critical to efficiently use and manage capital, with Basel III RWA and CVA as areas of particular concern for many financial institutions."

"It is important for firms to prepare and equip

MXCorner

Future thoughts for smaller funds

There was an interesting survey reported in the last edition of SLT. I know, I know; 'interesting' and 'survey' don't belong in the same sentence—how many times have you turned on the news to be told an interesting survey has been published that reveals something banal and that your granny has always told you anyway? No, this one actually sounded interesting and although I haven't seen the detailed results, even just the two headline conclusions reported by SLT deserve a pause for thought.

The first was that 81 percent of defined benefit and defined contribution pension funds expect investment decisions to become more complex in the next 12 months because of the funding challenges they face and the changing regulatory landscape. The second was that 76 percent of smaller pension funds expect to outsource all aspects of fund management in the next five years.

I don't suppose that more complex investment strategy will come as a shock to many, but seeing it in black and white provides the opportunity to think about the knock on affect this may have. Historically, securities lending has struggled to get priority billing with pension fund trustees, as they always have more important things to focus on—despite what we in the industry may think, we are not the most important consideration! With the regulatory uncertainty and changes affecting all aspects of a pension fund (not just the securities lending activity), it may be easier for them to suspend discretionary activities such as lending and give the complex issues, such as investment strategy in the current changeable environment, the focus that they will require.

To avoid this happening, agents need to understand the broader implications of regulation and ensure that, as far as possible, they offer straightforward answers and solutions to the pension funds within the broader context of fund strategies. Understanding the bigger picture and providing good information with easy access to data will be key.

The second survey fact—that 76 percent of smaller funds will outsource all aspects of fund management in the next five years—also has potential implications. Adding more relationships to an already complex structure will complicate the requirement for controls and strong processes to manage asset flows, and client requirements. There will also be additional relationships to manage and a more complex reporting matrix. Although agents may already have the infrastructure in place to manage these multi-dimensional relationships, they will still need to consider the cost base of managing more clients in this way, and ensure that they have optimal automation. Equally, to ensure the right selection is made, pension funds will need to know what that want and what to ask about. Early planning and preparation on both sides will be vital.

Sarah Nicholson, senior partner
MX Consulting Services

themselves to perceive and discern risk more clearly to develop competitive advantage in our rapidly changing environment as new risks and regulatory realities emerge on the horizon."

Juerg Hunziker, president of trading and risk at SunGard's capital markets business, said: "Basel III is pressuring firms to rapidly adopt advanced simulation approaches to calculate measures like RWA and CVA for internal steering of credit risk."

"SunGard's Adaptiv Analytics can help firms and their clients to quickly respond to these requirements and support efficient management of counterparty exposure and CVA."

Real estate fund increases revolving credit facility to $60 million

RMR Real Estate Income Fund (RIF) increased its revolving credit facility with BNP Paribas Prime Brokerage by $10 million to $60 million.

The credit facility bears interest at LIBOR plus 95 basis points and it has a 270 day rolling term that resets daily.

The credit facility requires RIF to pledge portfolio securities as collateral with an aggregate value of up to 250 percent of the loan balance outstanding.

The credit facility also permits BNP Paribas to lend portfolio securities pledged by RIF with an aggregate value up to the loan balance outstanding, and RIF will receive a portion of the revenue earned by the bank in connection with RIF's lending of its portfolio securities.

RIF expects to use the credit facility to fund additional investments and for additional financial flexibility in managing its investment portfolio.

Lehman Brothers Holdings receives $1.9 billion in brokerage bids

Lehman Brothers Holdings announced that, following the conclusion of a "Dutch" auction process, it and certain of its controlled affiliates have agreed to sell $4.22 billion of their general unsecured claims against Lehman Brothers.

The claims will be sold for 44.5 percent of their face value, yielding an aggregate purchase price of $1.88 billion.

The sale of the claims is subject to certain closing conditions, including the effectiveness of the settlement agreement, which was reached on 21 February 2013 between Lehman and James Giddens, the trustee for the Securities Investor Protection Act's (SIPA) liquidation of Lehman Brothers.

Investors withdraw a little more from hedge funds

The SS&C GlobeOp Forward Redemption Indicator for May 2013, which indicates the volume of investors withdrawing from hedge funds, measured 3.77 percent, up 2.95 percent from April.

"Redemption requests are in line with the May historical averages," said Bill Stone, chairman and CEO of SS&C Technologies.

The SS&C GlobeOp Forward Redemption Indicator represents the amount of forward redemption notices received from investors in hedge funds administered by SS&C GlobeOp on the GlobeOp platform, divided by the AuA at the beginning of the month for SS&C GlobeOp fund administration clients on the platform.

Forward redemptions as a percentage of SS&C GlobeOp's assets under administration on the platform have trended significantly lower since reaching a high of 19.27 percent in November 2008. The next publication date is 21 June 2013.

Don't let the FTT be

What travails has the industry experienced since last year's International Securities Lending Association conference? SLT asks ISLA's Kevin McNulty

GEORGINA LAVERS REPORTS

How have topics covered in last year's ISLA conference progressed in the last year?

We started the conference last year with a workshop on the Financial Transaction Tax (FTT). At that time, the idea that all 27 countries in the EU were going to agree on an FTT had broken down, so temporarily it looked like we were off the hook. But John Billige, who gave the speech, said that on the horizon loomed the prospect of some of the member states doing something together, and that we might see some more unilateral action. Both of those things have happened.

The first keynote speaker last year was David Wright, the secretary general for the International Organisation of Securities Commissions. He spoke at a high level as to why we in the markets should expect regulators to be tough and gave us advice as to how to engage with them. It's fair to say that we've seen more regulation, and more talk of further regulation, and policymakers continuing to be tough on financial markets.

At the end of the conference, former MP Michael Portillo gave a closing speech, and he talked about the prospects for Europe at the time. One of the things he talked about was where the UK fits into Europe—at the time, the UK was still enjoying its triple A rating status. He predicted that it wouldn't last very long, and sure enough, we saw a downgrade happen. Within the conference, we had a good lively discussion with trading desk heads, who talked about the need for conventions in the markets around corporate actions pricing, and how they use data in their businesses. I think lenders and borrowers have been working those conventions out, and data continues to play an increasing role in supporting the role of the securities lending trading desks. We've seen announcements in the last year that EquiLend are providing a data service to compliment those already provided by SunGard and Markit Securities Finance.

Clearly, regulation played a big role last year, and our particular focus was on shadow banking. We are still seeing that story unfold. It's not getting the press it was six months ago, but attention will not fully go away until the Financial Stability Board has published its policy statement in September, and in Europe we know that the European Commission will be publishing a communication on shadow banking regulation shortly. The sooner we get something sensibly agreed the better and the market can move on.

For those who didn't read ISLA's response to ESMA regarding short selling and CDS, could you summarise what was in the letter?

There is a lot going on with the short selling regulation, but we're only focused on a couple of very specific issues. Our initial concern in the original regulation was about the procedures required to cover a short sale. At the highest level, these regulations say short selling is permitted, but that it must be covered. We were worried about what the true definition of "covering" was, because that's the bit that involves a securities loan.

We ended up with an okay outcome, and certainly better than feared—at one point it was looking like some European regulators wanted the system to be based on a pre-borrow type of arrangement, which would have cause tremendous liquidity issues. We managed to avert that, but nevertheless, ended up with a rather clumsy set of procedures involving differences between liquid and illiquid shares, and while not ideal, the market has found ways to work with the new rules in this particular area.

A recent development was that the European Commission was required to conduct a review of the short selling regulation six months after its implementation. That in itself was challenging, because half a year is not very long to consider how a new regulation is working in practice. It was especially difficult seeing as the definition of market making was still up in the air. We took the opportunity to focus on one issue, which was the regulations' requirement that a locate of securities that is made to support a short sale has to be done through a third party.

The legal view is that third party must be a separate legal entity. That means if you are a bank and have an internal securities lending and repo desk, you can't look to that desk to provide the locate to cover your short sale. We've been pretty unclear all along of what the policy objective of that requirement is, so have argued that it is unnecessary and doesn't achieve much in practice. Particularly as it looks like the market making exemption is going to be narrowed, and so some of the activity that should have been exempted from the short selling regulation may in fact now become covered, and that will create more volume of locates in the market.

What is ISLA's stance on the FTT and again, what recent developments have there been with the tax?

We are continuing to hear unofficially that the 11 member states have differences in opinion about the scope of the tax, among other issues. It's a little unclear as there's nothing much that's official out there, but nonetheless we know that there have been differences of opinion, judging from statements from the German finance minister Wolfgang Schäuble, for example, who said introducing the tax was not an urgent matter, and could take a long time to be finalised.

One thing we can predict is that it's looking unlikely that the 11 member states will agree on a consistent framework by 1 January next year.

As of now, we are not aware of any official move to change the scope of the original commission proposal. What we have been doing at the International Securities Lending Association is quite a lot of work to analyse the effects of the tax as it is currently proposed on the securities lending market, and we started talking to policymakers to give them some facts. Somewhat like the repo market, we are estimating 65 percent of the European securities lending market would essentially become uneconomic.

It's the same with the repo market. If you take an absolute 10 basis point charge and apply it to a transaction that generates revenues on a per annum basis in what is essentially a low risk/low return business—it becomes uneconomic extremely quickly.

The design of this tax is just not proportionate for this type of business. The important thing that we are stressing to policymakers is that long-term investors such as insurers and pension funds would immediately lose revenue as a result of that, and based on the last 12 months, it would be in the order of €2 billion.

Given things such as pension fund deficits and the need to encourage long-term savings and returns, that would seem to us to be contrary to those broad policy objectives. The second thing is that we believe, and know that this is broadly accepted by many market observers, that when securities are lent, they support the secondary markets in a fairly substantial way: through providing liquidity to markets; helping transactions to settle on time; ensuring that all trading activity is covered in the market; and that price formation works better.

It is hard to quantify these benefits, but if you accept these reasons, taking away the lending market would result in poorer secondary markets, which is not a good outcome for investors or issuers of securities.

Another interesting issue is that there seems to be conflict between what the FTT will do and what policymakers are generally trying to achieve in their post-crisis regulatory reforms. They are trying to reduce exposures in the markets, and reward collateralised businesses. If a bank has a collateralised exposure, it gets a much better collateral treatment because that business is deemed to be less risky. The market supervisors are pushing more and more transactions onto central counterparty platforms and even in OTC derivatives, regulators are pushing for OTC derivatives transactions that aren't centrally cleared to be margined using collateral.

This has led to a debate over the last 12 months whether there is enough collateral in the system to support all of these new requirements coming in. There is a bit of an argument about whether there is or there isn't—on the surface there appears to be, but the issue is, is the collateral in the right place to do the job? And the answer to that is clearly no, because a lot of the securities that would be deemed to be good collateral would be held by long-term investors such as insurers/pension funds, and they're not necessarily the ones that will need it for regulatory purposes. The only real mechanisms for moving this collateral around are securities lending and repo, so if you tax them out of existence, you're immobilising the collateral in the system, and that will mean that it will be harder and more expensive for institutions. **SLT**

Kevin McNulty
Chief executive
International Securities Lending Association

The A-Team

ABN AMRO's Valerie Rossi, executive director of securities financing, global markets Asia, and Jagdish Hirani, managing director and head of global markets Asia, tell SLT about the boost that Chinese A share ETFs have given to Hong Kong's market

GEORGINA LAVERS REPORTS

Hong Kong seemed to be a bright spot for global securities financing in late 2012—how are the markets faring currently?

Valerie Rossi: This year has again seen a change for the securities financing business. The first half of the year has proved challenging. A lack of specials and a reduction of volumes seems to have been the trend for the first half of the year. However, there is still strong growth in the capital markets for dollar bond issuance with Asia, excluding Australia and Japan, hitting record highs. We expect this to positively impact the repo activity in the region.

We have also seen a rise in borrowing demand as a result of several rights issues and new exchange-traded funds (ETFs). Chinese A share ETFs listed on Hong Kong markets issued either via the QFII (qualified foreign institutional investors) or RQFII (RMB) programmes have continued to be popular. The deregulation of the RQFII programme announced by the China Securities Regulatory Commission (CSRC) to include Hong Kong subsidiaries of Chinese mainland commercial banks and insurance companies, as well as financial institutions registered in Hong Kong, is opening the door for international firms. The RQFII programme is also going to expand to Taiwan, creating further opportunities including the potential creation of RQFII ETFs.

While we haven't seen the highs of 2012 in terms of volumes and fees, we believe that there is still good demand, commitment and a long-term interest from our clients in the local markets.

Is the amount of specials increasing in the market?

Rossi: We have seen more specials in some specific markets, for example Taiwan, but a decrease in other markets such as Hong Kong. On balance, there has probably been a decrease in the amount of specials regionally but still plenty of premium returns to be enjoyed.

Could you describe ABN AMRO's various offerings around securities lending in Hong Kong?

Jagdish Hirani: We have a unique approach to the business. Our coverage includes equity, bond and collateral financing. We have the ability to offer a wide array of products within our mandate satisfying demand via repo, securities lending or swaps. ABN AMRO is a niche player within the securities financing world. We look to understand our clients' needs and use our expertise to offer customised solutions to both internal and external clients. We also work closely with other business lines within the ABN AMRO group to provide broader product solutions through the same platform.

What are some of the collateral solutions used by the firm?

Hirani: Collateral management is an intrinsic part of the entire securities financing value chain. Our collateral management process is centralised (in Amsterdam) and this allows us to optimise the collateral flows and solutions we choose either bilaterally or through a triparty arrangement. At the ABN AMRO securities financing desk, we work closely with our asset/liability management/treasury department to provide solutions to optimise the bank's assets and provision of liquidity to our clients. The structure of our securities financing product encompassing equity, bond and collateral financing under one mandate allows us to achieve these goals more efficiently than if they were segregated.

How did the Hong Kong Stock Exchange's tightening of the rules that regulate the short selling of designated securities affect your firm, if at all?

Rossi We have not seen a specific adverse affect on our client activity following the change in eligibility criteria for designated securities for short selling by the Hong Kong Stock Exchange in 2012. In the meantime, additional securities have also become eligible based on their respective market capitalisation and turnover.

How are Hong Kong desks developing their in-house technology?

Hirani: Our securities financing desk in Hong Kong is a part of the international activities of ABN AMRO. We take a global technology approach to this business with our core infrastructure being hosted centrally from Amsterdam to optimise the synergies of scale. Within this framework, we customise where necessary to also cater for any local market nuances. **SLT**

CCP discussion

Sponsored by PIRUM

State of the central counterparty

Experts met in London to attend the SLT/Pirum roundtable on central clearing for securities lending. Here's what they had to say

Jonathan Lombardo: At this point, do we feel that the securities lending industry has done enough to not only educate itself about central counterparties (CCPs), but its underlying clients?

Charlie Manning: From a front-office perspective, there's a definite advantage and interest in making sure that Societe Generale is at the forefront of any CCP developments and initiatives. From a compliance and regulatory perspective, there needs to be more education.

The general perception is that internal teams, be it credit or compliance, are going to view a CCP solution more favourably than a bilateral setup, especially when considering a counterparty with which there is no existing relationship. I think that it's certainly a question of more education.

Ed Oliver: eSecLending has always been keen to be at the forefront of new initiatives—that's how the company began—but now it's a question of not being at the forefront of the CCP initiative just for the sake of it. It's about moving on to the next stage, and that goes back to the question of how to improve client engagement on this subject, so that we can move it from an initiative discussion to one about implementation.

I think that's where the industry is with the CCP. In the last few months, with some of the developments from Eurex Clearing in terms of adding new markets, there's now a more tangible product. It's just a question of how it can be marketed to clients in a way that they can easily interpret, understand and decide upon.

Lombardo: OTC derivatives are being pushed towards a central clearing solution. Does the fact that other parts of the business are moving towards a CCP model make it easier for the securities lending people to digest?

Andy Krangel: I think OTC derivatives and securities lending are completely different products. The products that are moving to a CCP, or are already on one, are priced in a completely different way. You go out to get the best price for an equity or a derivative transaction, so relationship probably isn't quite as important as it is in the stock loan environment.

From a lender's perspective, the challenge with education is proving what's in it for them, because there is no evidence out there. In the markets where CCPs are operating, such as Brazil or India, everything is through a CCP, so there's no room to compare it to the bilateral model. A lender's main concern—to some degree, if

they're already comfortable with the risk—is whether it is going to get a better rate. When an agent lender speaks to a borrower, there are no comments coming back about willingness to put trades through a CCP at a higher rate. I guess that's the challenge when we go out to lenders. I've been out to a few client service reviews where we've mentioned it, and that's the one of the key questions we're asked.

Ben Challice: I would disagree with Charlie Manning going back to the initial question here in terms of education needed internally. Speaking for Nomura, the need to optimise capital and liquidity is a major consideration across all trading activities, no matter, whether you sit in the front or back office. In addition, phrases such as 'enterprise collateral management' have become significant because we want to identify the best use of collateral when talking about margining any product, not just the silos of securities lending, repo or OTC derivatives

For exactly those reasons, the internal regulatory and control functions already encourage a closer look at CCPs, especially where balance sheet and capital efficiency and netting of transactions and payments are concerned. There are lots of synergies.

Manning: We are still waiting for a suitable solution to convince us that the majority of existing securities lending business can be managed via CCPs. But naturally, given Societe Generale's position in the OTC derivatives market, regulatory enforcement of clearing OTC derivatives is a massive part of Societe Generale's business at the moment. Our model on the equity finance side is cross-product, so if we see an effect on the OTC derivatives that we are trading, it will only be a matter of time before pressure will start to be applied. Then we will be asked more questions internally why we are not using CCPs and what our plan of action is.

Lombardo: To Andy Krangel's comment that lenders aren't feeling any pressure from borrowers to use CCPs, what do you think from the borrowing side of the business? Are you talking to lenders or beneficial owners about partnering for central clearing?

Challice: The short answer is no—those conversations haven't happened yet. I think there is generally some reticence from the lending side to entertain those conversations.

However, that leads us on to another point. Look at the repo market. That's mainly a bilateral market where huge volume—either by notional or by daily volume—goes through CCPs. Why is the equity market that different? We're seeing various other platforms looking at matching technology around borrower and funding needs, and so perhaps financing transactions should be the angle the securities lending industry should explore first, rather than continuing to discuss how to lead with the asset lenders? In addition, there has still not been a viable solution for the complexities of corporate actions via a CCP, so perhaps that's a push too far to start with, and we should lead with the inter-broker funding market.

Lombardo: If you look at the fixed income market, the last International Capital Market Association figures I saw said about 28 percent gets transacted through central clearing, and that's basically an inter-dealer market. Eurex Clearing's model for securities lending wanted to preserve the business model as it operates today. Not necessarily because that's right or wrong, but the position of the industry has always been, at least on the borrowing side, bring the lenders and we will participate.

Thomas Wißbach: Our goal at the outset was to listen to market participants and their demands. I think what we have delivered is what the market asked us to do. There is now a bespoke clearing model for the securities lending industry. It's not just a copy-and-paste model from other asset classes—it is a dedicated model with plenty of tailor-made functionalities for securities lending transactions. It also incorporates a solution for handling corporate actions. I think it's now required to make this message transparent to each and everybody in the whole market chain, ie, borrowers, direct lenders, agent lenders and beneficial owners. Eurex Clearing's offering is different to others available so far, and it delivers benefits to all involved in the lending chain. Our lending CCP gives the market the one and only opportunity to implement central clearing in a market-led, coordinated and smooth way well ahead of any particular regulatory mandate that we might face in the future.

Lombardo: The fact that securities lending is primarily a relationship business is a good example. In prior platforms—SecFinex being one of them—where the anonymous model was the driver, relationships were not an issue. But when you began to look deeper into day-to-day business, where it's not just general collateral, but

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Thomas Wißbach
Senior vice president—clearing product design
Eurex Clearing

specials or yield enhancement trades, relationship is really required. Whether that changes in the future remains to be seen.

As the industry becomes more comfortable dealing with central clearers, you'll possibly see a move back towards anonymous trading, because at the point when people are comfortable with it, concerns will be less focused on preservation of the relationship model. It's really the benefit that you gain from dealing with the central clearer that's essential, not knowing who's on the other side of the transaction. I think that's irrelevant, but because CCPs are at the infancy stage, the relationship aspect needs to stay intact.

Eurex Clearing has gone above and beyond understanding that concept, and asked what's deliverable first. It's a bilateral name give-up model that allows the relationships to stay intact. Whether we move or progress to something different is up to the market, at the end of the day. A few years down the line, the market might require both bilateral and anonymous platforms.

Wißbach: This topic reminds me a bit of the discussions that took place a few years ago within the markets for other asset classes. Whether bilateral or anonymous—I don't care. Our clearing model is flexible enough to cope with both, wherever the lending market wants to go to in the future.

Lombardo: It all stems back to the education process—it's getting both the buy and sell sides comfortable with another product for securities lending.

Krangel: From my perspective, there are three key things that the beneficial owner cares about: revenue, risk and service from the agent lender. Whatever it is, be it a new market or CCP, they're going to ask whether it's worth doing. A good example is new markets. You can sell them as much as you like, but if you say the new market is going to make $50,000 a year, the beneficial owner may tell you to come back when you can make $500,000 a year. They also care about the risk. You can sell a CCP as a risk mitigant, but when a beneficial owner has an agent lender indemnifying, and it has 105 percent in German government bonds as collateral as well, it will ask whether the CCP really reduces the risk. As for service, I'm not sure that even comes into it for a CCP, because that's really masked from the beneficial owner's perspective.

It really depends on the driver for that lender. As I say, ultimately, if you're asking a beneficial owner to become a member of a CCP, the collateral doesn't really change for them because it's collateral-based, the question the beneficial owner is going to ask is what's the benefit? Is there money to be made from it?

Challice: Isn't that a key point though? You talked about pricing, so even if the borrowers are not going to give higher rates, might they have a preference for borrowing from lenders that can transact through a CCP from a capital point of view? Due to the low counterparty risk weighting? It is at 0 percent now, and moving to 2 percent post-Capital Requirements Directive IV. Could there be a volume benefit perhaps?

Krangel: I'd argue that it isn't a volume business and it hasn't been for a long time. It's an intrinsic value business.

Challice: Okay, let's call it utilisation. What if you have better utilisation of funds that are more attractive to borrow from?

Krangel: Utilisation for us on intrinsic value lending hasn't been a problem in the past. I would say that things are changing a little in that even for the yield trade, borrowers tend to fill their books up a lot earlier, but even then, at the end of the day, we still seem to push things out last minute and fill our books.

I feel that we're at a point now where central clearing is probably at its most acceptable stage in securities lending

Jonathan Lombardo
Head of global sales
Pirum Systems

Challice: But there are still lenders out there that allocate on the back of balance and the associated leverage. I think that, with the world that we are in and have been in for some time, there is an increased appreciation of the capital required to face different clients, and costs are allocated accordingly.

Some banks are already there but some banks aren't. When the playing field is levelled, the price will change for clients that we would face with a lower capital outlay than others.

The agent lending model, in my view, is antiquated. In what other industry do you face a counterparty whose identity is unknown at the time of trading? Given that businesses such as ours are being measured on return on equity, it is incongruous to have to put up regulatory capital that we are unable to quantify at the time of trading. This is an unsustainable situation.

Krangel: That's where Citi is a little bit different, because many of our clients are fully disclosed, which is quite different from some of our peers where you don't know, until you get the ALD filing, who you're dealing with. I think one of the biggest changes that I've seen over the years is with counterparty approvals. In the old days, you'd send a new lender down to the borrower and they'd just tick the box and approve the lender. Now, it can take weeks, if not months, to get lenders approved because borrowers now don't always see some lenders as counterparties they want to deal with, or it's not a big enough account for them to prioritise.

Challice: But the approval process is also about checking netting opinions, constitutional documentation and capacity, and they are refreshed a lot more regularly than they were previously.

Lombardo: This goes back to the fact that a CCP does alleviate some of those pressures, and to go back to your conversation about what's in it for me, well there's plenty in it. There's increased distribution, less legal requirements, ALD relief, etc. I feel that we're at a point now where central clearing is probably at its most acceptable stage in securities lending.

Krangel: I've always been pro-CCP. I think the challenge is the change, the development requirement, it's spend you have to do and you have to prioritise that with your other projects. You can take the leap of faith and dive in, hoping other people will follow, but most people in our industry don't do that. They wait for someone else.

Oliver: What I think is the biggest issue here is putting an argument in front of the beneficial owners and getting their time to focus on this. Part of the challenge was being caught between two different sets of knowledge bases on the topic. Are we educating beneficial owners on bilateral securities lending versus what the CCP solution is and how they compare, or are we educating beneficial owners and securities lending professionals, who historically may not have been exposed to CCPs, on how a CCP works? You have two knowledge bases in this business—people who know securities lending and people who know CCPs.

We need to find the best route to present to the decision makers at the beneficial owner entity and then find the right board meeting that has securities lending on the agenda. With the best will in the world, securities lending is not high on beneficial owners' agendas right now. You often see it once or twice a year at an asset managers' board meeting and securities lending is fourth or fifth on the agenda with only 15 minutes allotted.

To be successful in this space, you need to put a very articulate business case in front of the right committee at the right time. You need to be thinking about the direction that committee is coming from, be it securities lending or deriva-

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Ed Oliver
Senior vice president—product development
eSecLending

tives or some other activity, and assess whether the committee is CCP savvy enough to immediately understand the risk benefit.

Challice: What is the proposal for a beneficial owner?

Krangel: The principal to the trade becomes the lender, but under the Eurex Clearing model, the beneficial owner isn't asked to put up margin because of the way that collateral has been structured. The challenge under a more traditional CCP was always that a clearing member had to be hired to gain access. Then the clearing member has risk against the lender, so it may want to margin the lender. In the traditional model, the collateral flowed all the way through, so the lender was margined, and if you look at most lenders, they want 105 percent of collateral held in their depositories or agent lenders in certain forms, and they don't want to give margin up.

That may seem odd because a lot of these guys trade in derivatives and equities for OTC, so they're experienced in doing a CCP model, but the people we deal with are completely different. They've usually been hired just to manage the lending programme, quite a lot of them are operational in nature, and it goes through a different risk process. Trying to tell them that they shouldn't actually be concerned is difficult because, when their fund trades derivatives, it gives margin up, and they say the two aren't connected.

Lombardo: With Eurex Clearing taking the securities lending model into consideration by applying the special lender's licence, enabling beneficial owners to become direct members, and so not requiring them to post margin or default fund contribution, really translates into business as usual. I think beneficial owners should look at the CCP as another counterparty, at the end of the day.

Wißbach: Yes, this is exactly where our lending CCP is unique. We offer beneficial owners the opportunity to continue their lending programme as of today. They keep their relationship with their agent lenders, which continue to operate their mandates, and at the end of the day the CCP is just another counterparty, but a top-quality counterparty. That's a real benefit for the beneficial owner. Another potential upside embedded in the CCP model is around indemnifications—and that's as well of relevance for the agent lender. Given various regulatory activities—for example, Dodd-Frank in the US—the current practice of indemnifications can become quite costly in the future. And it is an idea worth following up if these indemnities are still required once a CCP is guaranteeing a loan—you can imagine my view.

Krangel: That's the next leap of faith from a lender's perspective. If a beneficial owner is told that it no longer needs an indemnity because it is a member of the CCP, it will still ask why there is no protection from the agent lender. The answer is of course because it's a CCP and the risk is much lower, but, the beneficial owner will say, if the risk is much lower, why won't you provide an indemnity?

Lombardo: That goes back to your comment about dealing with people who are monitoring securities lending programmes and have no further market insight.

Krangel: But that's the reality of the situation. They're not the same guys. They've been hired just to manage the interface between our agency programme and the real beneficial owner, the fund. I can give you the example of Brazil. If you ask a lender about lending in Brazil, indemnification will come up, but we can't indemnify, because we'll have no collateral—we can't do that as an organisation. Brazil has a CCP, a CSD and an exchange all owned by the same company. All of a beneficial owner's assets are held in custody within that company. When it trades, that company

If a beneficial owner is told it no longer needs an indemnity because it's a CCP member, it will still ask why there is no agent lender protection

Andy Krangel
EMEA head of securities finance product management
Citi

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Ben Challice
Managing director and head of global equity finance
Nomura

manages the execution, settlement and custody, is therefore there any additional risk in lending through the CCP, because if that entity collapses, there is no accessible Brazilian market. But the securities lending people at beneficial owners don't care; they must have an indemnity.

Lombardo: Education is probably the most important aspect of getting central clearing realised in securities lending. What do you do as a lender to educate decision makers that this is something that you currently adhere to on a daily basis for other products and should therefore be utilised in the securities lending capacity, making it another tool in your arsenal for further distribution of assets in a market that is constricting daily?

Oliver: The market isn't there yet. As I said from the outset, there have been significant steps forward in the last few months. Eurex Clearing is adding new markets, adding fixed income securities and there's a more compelling case being built. But that's where I disagree that this is the best stage to be introducing CCPs, because it's still evolving and there will be a better stage in the future. It's only going to improve and as you get other CCPs coming in, that's going to provide more infrastructure and make people look at it.

From eSecLending's perspective, we're happy to look at this because we can't predict when there might be a distribution opportunity for one of our clients and we have to be ready. We can't predict if or when the borrowers are going to turn around and say "it's a CCP or nothing". We also can't predict if/when regulators might say that securities lending must be centrally cleared from a certain date. For those reasons, we can't bury our heads in the sand—we have to look at it.

But I think we're still at the point where we are trying to identify that 15-minute business pitch. That's something I'm keen to continue working on. It may be different entities that we work with, but that's what we're still trying to identify and there's still a little bit of work to be done before we get there.

Krangel: I agree. You can put forward a list of bullet points that says why it's a good idea, but you can't put that slide together to say what the numbers are. You can't educate to say if you do this, this is what the numbers are, or is this is the reduction in risk.

I'm not convinced this is something where first mover has an advantage, to be honest. I think with a new market, you can understand why first mover has an advantage, because the rates are always higher until it becomes over supplied. In markets like Taiwan, you're starting to see over supply. For these types of major market developments, does being the first really make a difference?

Challice: If a borrower needed to reduce its capital without affecting business, it would look at counterparties who would enable the same level of borrowing, but with a reduction in capital. A lender able to operate through a CCP would get an advantage.

Krangel: You're going to get an advantage for a very short period.

Oliver: I'd like that advantage! If you said come through me via the CCP, I'll give you an extra 50 basis points (bps) because I can lose that cost from my operation, then that's great. I'll be very happy to do that. That's why I think we need to be in these discussions because you need to ready for that opportunity and take advantage of it. We won't even go down the route of what that means for benchmarking, but I think in terms of that opportunity, I'm absolutely going to look at it and be tempted to put that in front of clients.

Lombardo: From a strategic and revenue protection point of view, this is a solution. Where do you think, from a trading point of view, you'll see an upside?

Manning: From our point of view, the benefits go back to the reduced cost of capital and credit to a borrower, and therefore the associated benefits. Certainly, the main benefit is seen going into a CCP model, but you need to achieve that critical mass or scale to really capture the benefits from netting. You're going to have lower capital charges, but if you're always trading in the CCP model in one direction as a borrower then your haircuts are going to be larger especially if you're posting non-cash. At the moment, they're significant.

That changes in an indirect way if imposed minimum haircuts are proposed for bilateral securities lending, for example. From our perspective and given our position in the market as a broker-dealer acting on both sides—inter-bank, and with lenders—the real benefit is in achieving that scale where we are positioning ourselves with trades in both directions against a CCP, and therefore really picking up efficiency benefits.

Wißbach: And that is exactly where it pays off to bring a broad portfolio of transactions into a single CCP counterparty—you will receive substantial netting and cross-margining benefits. Not only between lending transactions (lend versus borrow) but it offsets against transactions in other asset classes as well. Today, we already offer those for lending versus repo, cash equities and cash bond transactions. But this will be even further enhanced to various other transaction types within our upcoming Eurex Clearing Prisma margining tool. That makes it an even greater benefit for members.

Challice: In addition, I think the real value is around the funding side of the transaction. That's really where the volume remains.

I would also like to raise a point around the need for STP automation. Again, we're essentially getting to somewhere where you're doing a trade by voice and then novating it over. That's great and addresses the capital side of things, but we have no automation, still. Yes, we've got autoborrow-type functionality, but what about true trade matching? I would like to see automation for the more simple trades to focus on the high value transactions that really benefit everyone in the value chain. **SLT**

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Charlie Manning
Equity finance flow trader
Societe Generale


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On the back burner

Activity across the Czech Republic is low, but there is a security or three creating borrowing interest. SLT takes a look

GEORGINA LAVERS REPORTS

After the longest recession on record, the Czech Republic may be slowly eking its way out of an economic slump.

But the statistics office in Prague had some fairly dispiriting recent data on the country. Gross domestic product fell 1.1 percent from the previous quarter—and topped a preliminary estimate of a 0.8 percent contraction—and also fell 2.2 percent from a year ago, the worst performance in more than three years.

Lackluster exporters and a European debt crisis didn't help economic output, which declined the most in four years, as businesses curbed inventories.

The decline has caused the central bank to slash rates, leading policymakers to debate whether they should weaken the koruna currency with interventions, seeing as the Czech koruna recently weakened 0.3 percent to 25.8 to the euro.

But the head of the central bank's monetary and statistics department, Tomas Holub, was positive that higher April exports would indicate a light at the end of the tunnel.

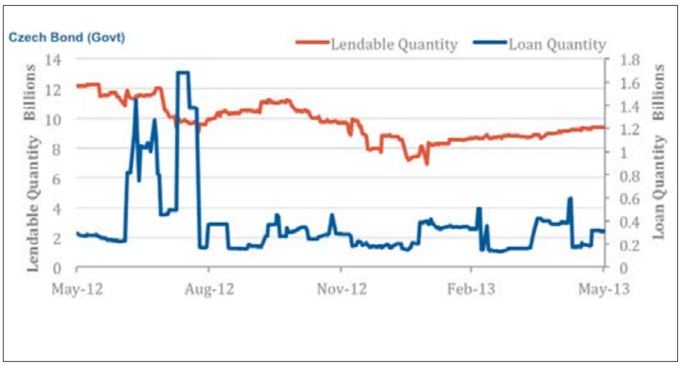
"There's some sort of hope that foreign trade might bottom out and help the economic activity to gradually recover in the rest of the year, which would be in line with our forecast," he told deputies from the Chamber of Deputies's budget committee.

Though opportunities for lending in the Czech Republic have been touted as early as 2007, six years down the line there has not been a huge demand for the sector.

"Activity across Poland, the Czech Republic and Turkey is relatively low, with minimal demand, few if any specials and just the odd yield enhancement trade from time to time," said Paul Wilson, managing director and global head of client management and sales at J.P. Morgan Investor Services, in a virtual roundtable discussion.

Jemma Finglas, the head of business development equity finance and repo, market and financing services for BNP Paribas Securities Services, remarked that Poland is undoubtedly the key growth market in the Central and Eastern European region, due to the size of its publicly-listed companies and available shares in the securities lending market.

"The WIG-20 names are generally liquid and easy to borrow … the Hungarian and Czech markets follow a similar pattern in terms of ease of trading, but the respective size of both markets means that focus is limited to the largest three or four securities that dominate the indices."



Saurabh Seth, the managing director of trading for eSecLending, said that with revenue opportunities in the more mature markets under stress, due to regulation and general market lethargy, market participants have been taking a much closer look at growth potential from previously unexplored markets.

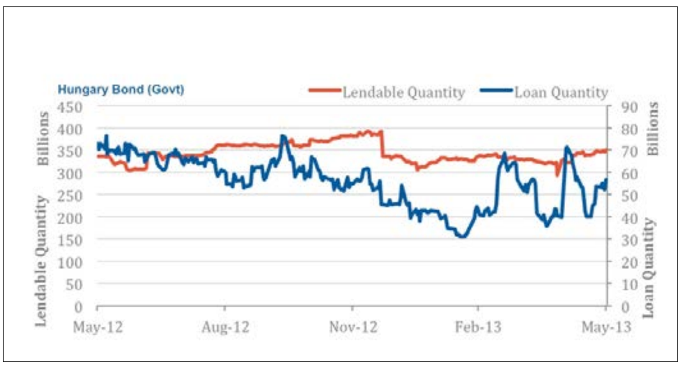
The Eastern European marketplace, he said, has benefitted from this interest—with the Czech Republic containing a handful of names that create periodic borrowing interest.

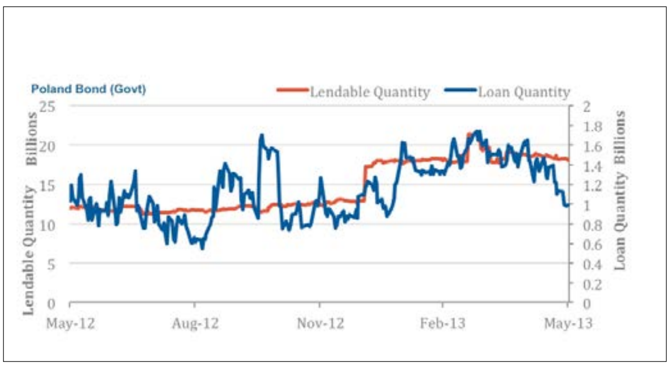
"Sectors such as energy are coming under pressure, which is typical of the European region rather than individually a Czech Republic issue," comments David Lewis, the senior vice president, for SunGard's Astec Analytics.

But he adds that New World Resources (NWR), a hard coal and coke producer based in the Czech Republic and Poland, is a security generating some special demand.

"The share price of NWR has dropped from its 2013 opening of around 337 down to 150 in May this year. During this time, shares on loan have more than tripled and the fees charged for borrowing this stock have almost doubled, placing it firmly into the 'special' category."

"Comparing this with the levels of borrowing increasing across the metals and mining sector indicates that this rise is middle of the road as far as similar companies elsewhere go, pointing to a systemic economic issue with miners and raw materials, rather than a specific Czech Republic issue." **SLT**





Source: Markit Securities Finance

Lending CCP: what do you believe?

Tobias Duchscherer of CofiNet and Markus Büttner of Comyno explain why central counterparties can be good for securities lending

'Cost sells a lending CCP', or even, 'cost kills a lending CCP'—this impression might be predominant to anybody following the recent discussions and articles around central counterparties for securities lending, but this simplistic approach obviously fails to put the topic in a broader context within securities financing. The CCP subsequently isn't seen as an opportunity to rise to the severe challenges that the industry currently faces.

In real life with market participants, we have experienced a slightly different approach; an extended decision making process, in which the ability to manage a variety of liquidity scenarios efficiently is considered as the deciding factor. Of course, the cost structure of a CCP matters and is of true importance, but it is treated from a trading rather than an operations point of view. In general, participants are looking to achieve economies of scale and therefore a lower cost structure achieved by adding additional liquidity to a standardised CCP environment. This is an environment in which the absolute cost levels of a CCP determine the transaction types suitable and the targeted volume intended for a CCP trading book.

As of today, a typical CCP evaluation is embedded within a scenario where market participants consider shifting liquidity for the standardised part of their trading activity from the established bilateral market to a CCP structure. With bilateral credit lines exhausted, expansion of liquidity access is of the same importance as any potential cost savings.

Therefore the resulting assessments cover all aspects of the value chain of trading, clearing, collateral management and settlement, and consider the related cost and risk structure in relation to the profit margins achievable by the intended trading and liquidity scenarios.

The issue of 'liquidity' opens the consideration of the implications of a CCP to the trading organisation and the processes to generate liquidity. While the bilateral market is characterised by a countless number of mini-liquidity pools, corresponding to a portfolio of one-to-one lending contracts, the one-to-multiple contract structure of a CCP-organised market provides a systematic advantage by pooling liquidity to a single credit relation. A CCP therefore creates the possibility of an advanced and efficient trading organisation, which might be characterised by price transparency, deep markets, best execution and anonymous trading patterns.

In addition, the development and maintenance of a bilateral individual contract structure requires a time- and cost-intensive credit assessment and legal approval process within the banks. A CCP structure ideally requires only one credit assessment to get connected to multiple counterparties, thereby providing significant time and setup cost savings within the pre-trading phase.

> Cost matters, but brightness of liquidity is what sells a lending CCP to the market

A CCP effectively takes over the credit assessment for the participants in the CCP-organised market. The corresponding contractual and credit line structure of the bilateral market is complex and that complexity itself is the source of potentially inefficient use of credit lines. This is of course a sin in the days of reduced balance sheets and internal competition for credit lines.

After the cost structure of the pre-trading and trading phase, participants consider the clearing costs related to liquidity and volume scenarios. In order to be able to scale unlimited liquidity, participants are looking for:

- Unlimited, direct access to the CCP rather than limited, indirect access via a clearing member;
- Delivery guarantees from the CCP for all outstanding transactions; and
- A principal trade-off between additional margin cost and capital relief.

Last but not least, participants consider one-time costs such as CCP connectivity and integration costs, and we have found that whenever the setup costs are cash-flow relevant, the availability of budget drives the timing of a CCP integration project.

Nevertheless, we expect the lending CCP to become a vital part of the flow-business within the securities lending market because each of the involved market participants (beneficial owners, agent lenders and broker-dealer) can realise economies of scale by using a CCP. Since most of the broker-dealers are already CCP and clearinghouse members, it will be very interesting to see which of the agent lenders in Europe will be the first to make a strategic step and open the door for its beneficial owners to access a lending CCP.

To summarise, cost matters, but brightness of liquidity is what sells a lending CCP to the market. **SLT**

Markus Büttner
CEO
Comyno

Tobias Duchscherer
Consultant
CofiNet

Working the angles

SLT's experts take a dim view of the European securities lending market, but predict a steadying of the ship if certain regulatory initiatives are blown off course

Saurabh Seth
Managing director, trading
eSecLending

Jemma Finglas
Head of business development equity finance and repo, market and financing services
BNP Paribas Securities Services

Paul Wilson
Global head of agent lending product
J.P. Morgan Investor Services

Sunil Daswani
International head of client relations for securities lending
Northern Trust

Laurence Marshall
COO
EquiLend

Georgina Lavers
Deputy editor
Securities Lending Times

BNP PARIBAS eSECLENDING SECURITIES FINANCE TRUST COMPANY Northern Trust J.P.Morgan EQUILEND

How are macro conditions in Europe affecting securities lending at the moment?

Jemma Finglas: Negative market sentiment has weighed heavily on the proprietary trading activity for which our industry is entirely dependent. This has been caused by the difficult economic, regulatory and political environments globally, not just in Europe. Good news, whether relating to regulation or economic data, remains patchy and, until we see some consistent improvement, we will not see the much longed-for and needed rise in trading activity that creates demand in the lending arena.

Marshall: Stronger credit markets and increased liquidity driven by central banks have helped to support a growth in the markets

Historically low levels of interest rates leave cash reinvestment at the short end of the curve a considerable challenge, and of course, have had the knock on effect of reducing general collateral business.

The areas of opportunity, the greatest being the need for high quality liquid assets to collateralise other trading activity and strengthen balance sheets, still holds its own in terms of revenue generation. However, the difficulty in generating quality returns within the clients' current risk/reward profiles and the borrowers' demands for longer duration and broader collateral acceptability are proving to be yet another challenge in this tough environment.

Sunil Daswani: During Q1 2013, global equity markets continued the broad rally that began in Q4 2012. Although many of the concerns related to Europe's sovereign debt situation have not been fully resolved, they appear to have been contained sufficiently to allay investor fears of a deepening crisis. Market volatility declined throughout Q1 as confidence increased and investors continued to put more cash to work, fearful of missing out on the rise in share prices. As a result, we will see increasing revenues in most markets where fees are based on values of loans for clients. Additionally, as hedge funds move from their long cash bias we will see a greater amount of demand come back into the securities lending marketplace.

Saurabh Seth: The European economies have been in the doldrums for some time now and this has had a negative impact on securities lending revenues. With no signs of near term growth in Europe and the European Central Bank using up most of its arsenal to combat this lethargy, we are in a market with little conviction. This lack of conviction, coupled with uncertainty and political interference, has created a risk-averse market place. We expect that market participants will start to filter back with conviction once there is more medium-term confidence in the state of the European economy.

Paul Wilson: Overall, market conditions remain challenging in the securities lending market across Europe. Low interest rates, central bank programmes and intervention have continued to keep pressure on spreads in the bond lending market. In equities, European yield enhancement season is coming to a close, which has been more challenging than in prior years, with all-in levels being quite volatile, driven by a decrease in the number of end users. With strong underlying equity markets (the German DAX hit a record high and peripheral markets rallied also) and hedge fund activity has been subdued, affecting the number of specials.

Laurence Marshall: So far, 2013 has seen a much-improved macro environment, which has had a positive impact on the industry. Euro concerns are currently lower than they were for most of last year, and the stock market surge has provided positive sentiment. The introduction of the EU short selling regulation in November 2012 has been managed well—and one less regulatory change to manage. Additionally, stronger credit markets and increased liquidity driven by central banks have helped to support a growth in the markets, which has helped to increase volumes in the securities financing market. Although better, there are still many challenges ahead that will put great pressure on the environment.

What are your feelings on ESMA's UCITS rules on securities lending, and short selling regulations?

Seth: Back in July 2012, the European Securities and Markets Authority (ESMA) published guidelines on a number of issues related to exchange-traded funds (ETFs) and UCITS. The guidelines that generated the most debate in the securities lending world were the interpretation of the provisions related to disclosure of all costs and the return of all revenues arising from efficient portfolio management (net of direct and indirect operational costs). When these were first released, they were vague and the initial interpretation was that no securities lending intermediary would be able to charge fees for their services.

However, in the March update the topic was further clarified to state that securities lending agents, which can be the ETF manager or the UCITS management company, are entitled to normal compensation for their services, so long as disclosure to investors is clear and deliberate. We believe this is a fair expectation and it creates more transparency in the market and helps alleviate concerns about fees and disclosures.

Finglas: The ESMA regulations are, for the most part, very clear and well set out. Their intention is to protect the underlying investor and ensure an increase in transparency in terms of activity and fees in addition to strict rules around collateral eligibility and cash reinvestment. This has been achieved. ESMA clearly recognises the importance of efficient portfolio management for the efficient running of the financial markets, but also highlights the need to protect the underlying lender via its guidelines.

However, some of the effects of these rules will be to squeeze supply, including, but not limited to, the high quality liquid assets that are in demand from borrowers. ESMA requires depository banks to take the role of oversight in terms of collateral management, which will in turn increase their costs and operational risk. The depository can delegate the custody of the collateral to a sub-custodian and it will remain liable for that collateral should it be lost by the sub-custodian.

This, coupled with increased transparency and justification of fees, seems to have deterred some participants, and we have seen indeed this manifest itself as some players have either announced their intention to leave the market or have already exited the business.

However, such oversight has legitimised securities lending as a practice and this has materialised in an increased number of prospects euroclear

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Wilson: Overall, the ESMA guidelines make sense and the sentiment behind them is positive. We support efforts for greater and more consistent disclosure and reporting, as we do in supporting collateral diversification.

Daswani: Additionally, we believe the EU's new short selling regulation has had a positive effect on market transparency and reducing the risk of settlement failure in Europe, but further review is required on the way short selling is defined and calculated by ESMA.

Also, it is important to have clear direction on what is defined as 'liquid shares' versus 'illiquid shares'. Positively, the consistency and operation of short selling bans would be welcomed going forward.

Eastern Europe is typically less mature than its more Westernised counterparts when it comes to lending, but in which of the region's countries are you seeing growth?

Wilson: Activity across Poland, the Czech Republic and Turkey is relatively low, with minimal demand, few if any specials and just the odd yield enhancement trade from time to time.

Finglas: Poland is undoubtedly the key growth market in the Central/Eastern European region. This market provides depth due to the size of its publicly-listed companies and available shares in the securities lending market. The WIG-20 names are generally liquid and easy to borrow. In addition, the Warsaw Stock Exchange has recently expressed interest in boosting liquidity and efficiency by: (i) backing a move to allow private local pension funds to lend shares for short sale transactions; and (ii) establishing a securities lending platform on the exchange. This should facilitate further interest and growth in the Polish market.

The Hungarian and Czech markets follow a similar pattern in terms of ease of trading, but the respective size of both markets means that focus is limited to the largest three or four securities that dominate the indices.

Turkey is an established market with levels remaining attractive although off highs of previous years.

For other markets in the region, there is a lack of demand currently but all are worth monitoring closely for future developments.

Seth: With revenue opportunities in the more mature markets under stress, due to regulation and general market lethargy, market participants have been taking a much closer look at growth potential from previously unexplored markets. The Eastern European marketplace has benefitted from this interest, notably in Hungary, Poland and the Czech Republic. Hungary, although currently quiet, has from time to time seen strong directional interest from short sellers. The Czech Republic has a handful of names that create periodic borrowing interest. Poland is the most active market in Eastern Europe for consistent borrowing demand.

What are the opportunities that arise from increasing use of collateral in the financial marketplace?

Daswani: The increasing use of collateral will have effects in the securities lending market place on both supply and demand. Having said that, impacts may not be as significant as some believe.

This is because, where securities need to be pledged as collateral, they may not be coming from securities lending pools of available assets. On the demand side, we will see an increase in demand for investment-grade securities and this will certainly have a positive effect on fees.

With the implementation of Basel III, in instances where corporate bonds would be treated as investment grade collateral, we will see this particular asset class benefit directly in ways that it does not necessarily today. These benefits will arise from increased demand and the subsequently higher fees arising from its increasing use as collateral.

Marshall: With the restructuring of the OTC markets, it is widely acknowledged that there will be greater impact on the availability and management of collateral. This should create additional financing revenue as demand and volumes continue to increase along with greater demand for transforming collateral, in particular equities and corporate bonds. Organisations that deliver flexibility and operational efficiency will be best placed to maximise this opportunity.

So expect the trend of collateral type influencing the trade decision process to continue and grow.

The potential risk is that organisations may change their attitudes toward the lending and rehypothecation of assets. With a broader use of collateral across organisations and an increase in their use of collateral optimisation, this could result in a major reduction of assets that are made available.

Seth: This creates more trading opportunities in the marketplace, which is expected to benefit securities lending agents, prime brokers, and most importantly, those asset owners that hold high quality collateral. The early adopters of the liquidity swap trades have been able to capture healthy spreads based on the increased demand for high quality collateral. As a lending agent, we review each one of these trades on a risk/return basis to quantify the relative return versus the counterparty and collateral risk on a fundamental basis and on a quantitative value at risk basis.

We look at each trade in a thoughtful risk adjusted manner. The area where we see risk is when participants look for yield in the 'collateral downgrade trade'. This is when you lend high quality collateral for lower quality without adjusting margin for the increased risk. Those chasing yield in that manner without a thoughtful risk management approach are likely taking on undue risk without full appreciation for what can go wrong with correlations, volatility, margins, etc, in a large negative market event.

Wilson: We support efforts for greater and more consistent disclosure and reporting, as we do in supporting collateral diversification

There is also some discussion that the increasing use of collateral could add to demand in the market, outpacing supply, which is positive for those holding the supply. However, we are not seeing that happen in the market as yet.

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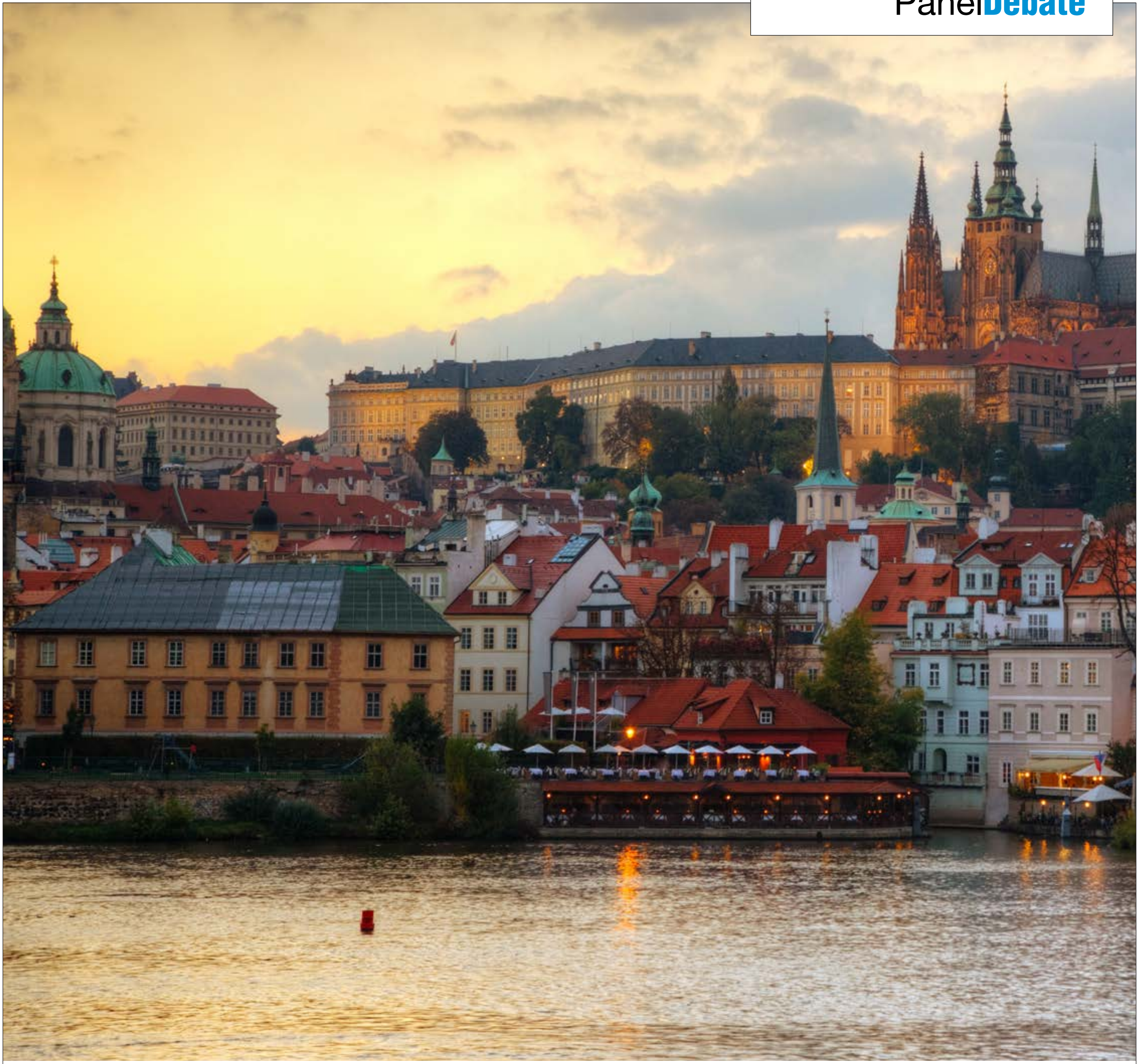


Finglas: The opportunities are plain to see in terms of increased utilisation of the high quality liquid assets that are now needed for:

- Collateralising derivative transactions; and
- Strengthening balance sheets via term trade structures.

Banks are under pressure to increase their long-term funding while lenders are under pressure to produce consistent and reasonable returns for their clients, which translates into longer trade duration and a broader range of collateral acceptability. The gap between both sides of this equation in terms of returns versus duration/collateral is proving difficult to bridge. In order to increase duration and solidify the value of the term trade, borrowers are asking for tighter controls and greater penalties for breaking term structures. While, at the same time, lenders are finding it difficult to commit their clients to such lengthy duration, stringent terms and penalty clauses despite the potential revenues available.

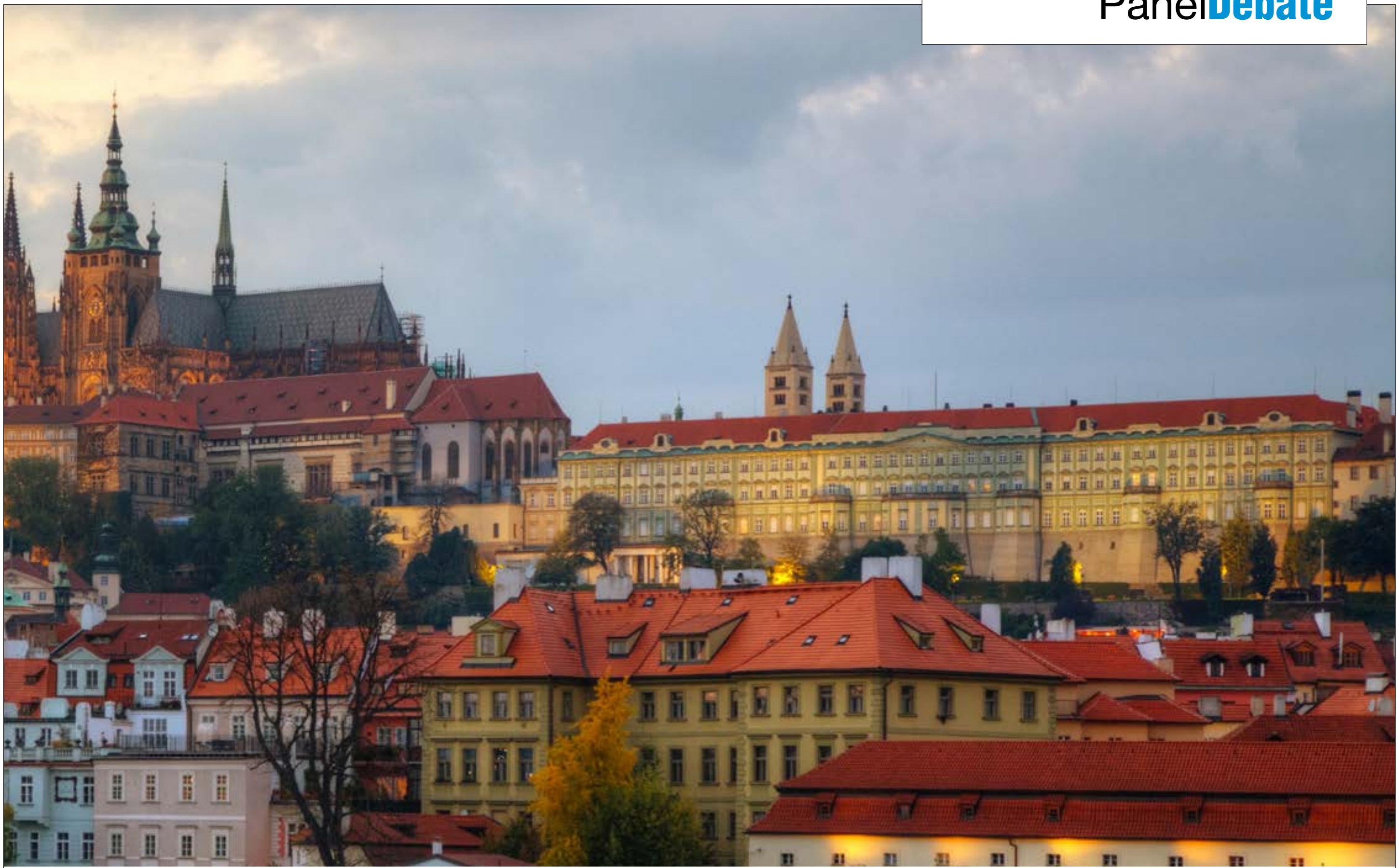
Fees generated on the back of these transactions, open and term, are providing consistent general collateral returns and higher, more lucrative revenue generation for those who can accept term structures, respectively. This has been welcomed by lenders and their clients during a difficult period where returns overall have suffered due to lack of demand, difficult regulatory conditions and changes to some withholding tax rates.

The issues faced by this sector are not yet tangible but can be more or less based on the current imposed regulations that will have a significant impact on:

- Supply (ESMA guidelines);
- Reduced mobility of collateral (Financial Stability Board); and
- Cost of transactions (Financial Transaction Tax)

The needs of the supplier of these high quality liquid assets in terms of risk are at odds with the needs of the borrower in terms of duration and collateral that it can employ to transform.

The current regulations, or guidelines as they stand, are creating a chasm that is proving difficult to bridge. While the need



for collateral is increasing, the supply and mobility of that collateral is being reduced. When fully implemented, the system could be put under significant stress and may buckle under the pressure.

It is only the very solid of partnerships, backed by the strength of the institution offering the indemnification, or a principal route to market, that are in a position to absorb this risk and generate the quality returns that are only available when we look further out the yield curve. Clients need to be very comfortable with their lender's ability to manage such trades from an operational, legal and credit/risk perspective before they decide to sign up to these trade structures.

Wilson: Over time, we do see that the increased usage of collateral in the financial marketplace is both a good thing in terms of market stability and will be positive in terms of increasing demand to borrow high-quality securities. That being said, we don't see the demand being at the upper levels often reported and there is still significant unlent inventory that is available to meet much of this potential demand should it materialise. With respect to collateral upgrade and transformation trades, we don't see any material volume as yet in these areas.

Any new form of potential demand is a positive for the securities lending industry. But we don't see that these types of trades as being for all lenders, especially as they will likely need a term commitment.

What will the consequences be for securities lending if the FTT is implemented in its current form?

Marshall: Massive! In its current form, the FTT is so broad and with so few exceptions that it is difficult to see how any activity will continue, particularly in the high-turnover transactions. Despite the very strong political force that is driving this, I would hope that the importance of financing and the disruption that this will cause on bank funding models will lead to material changes to the current draft.

Seth: In its current state, the enhanced co-operation FTT will have a general negative impact on the global financing markets. The ability to finance (cheaply) is something all in-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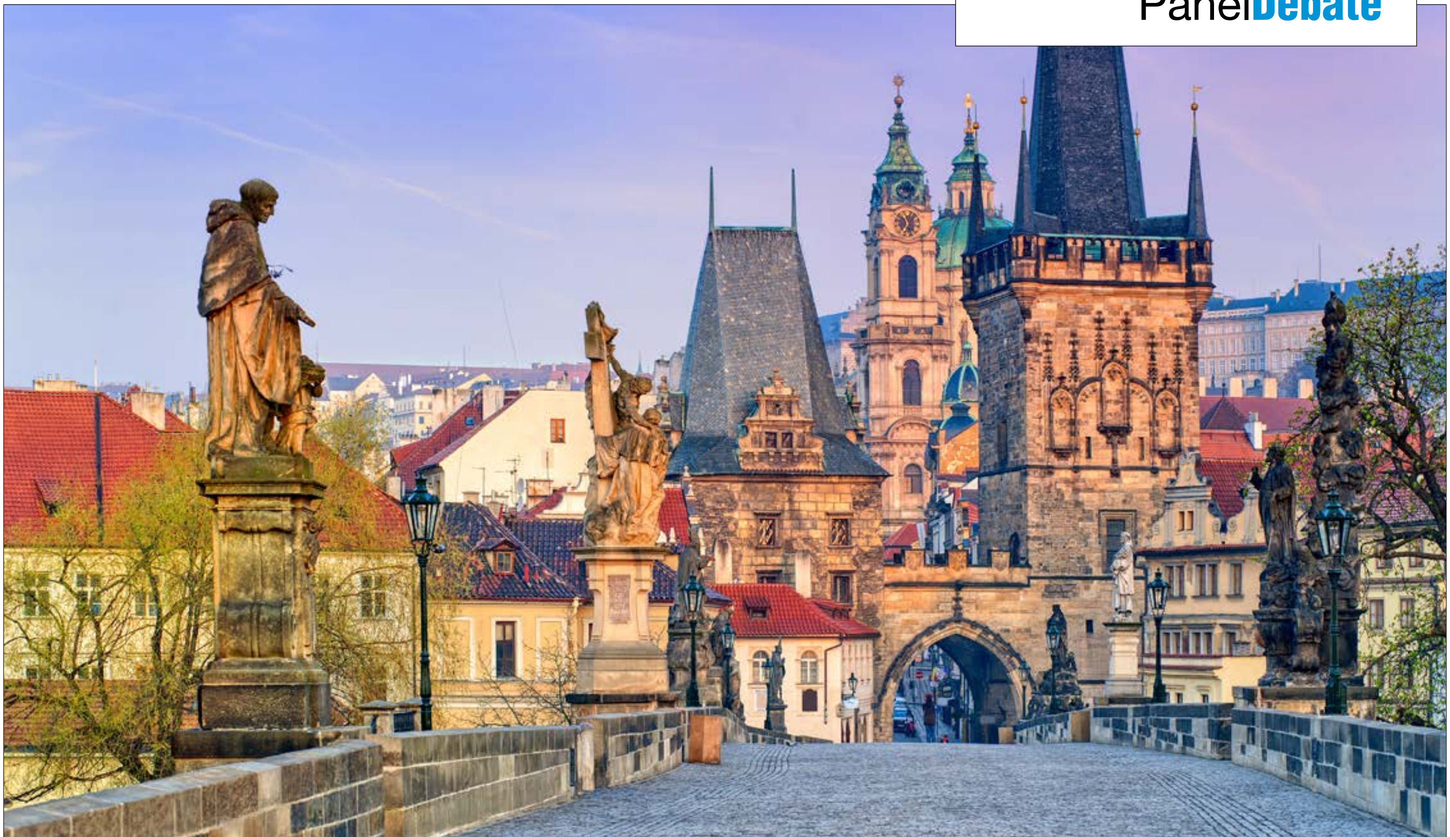


stitutions rely upon: including central banks, to manage their monetary targets; financial institutions, to meet their regulatory imposed capital targets; and pension funds, to enhance their returns and derivative users, to satisfy their collateralisation requirements.

Seth: The ability to finance (cheaply) is something all institutions rely upon including central banks, to manage their monetary targets

There are several reports illustrating the potentially crippling impact of the FTT, ie: increased funding costs for the US; effective interest rates in excess of 1 percent; and overnight general collateral repo costs rising in a market where bond yields are in the low double digits, etc. The securities lending and repo markets are a key source of liquidity for the financial markets. The proposed FTT, in its current form, could create a liquidity crunch more severe than what we experienced in 2008. That said, we believe and are hopeful that the proposal will be revised, if not rewritten, to exclude (at a minimum) repo and government bonds and assets traded under a repo and securities lending contract.

Finglas: The FTT has been a black cloud over the financial markets for a number of months now. The proposal to include securities lending and repo transactions has caused a lot of consternation. It was felt it would effectively eliminate low margin trades such as fail coverage and overnight repo transactions, thus significantly affecting the efficiency of the markets in terms of liquidity and settlement.

Its introduction would create an uneven playing field if implemented as suggested and in practical terms would almost be impossible to monitor in terms of implementation, oversight and collection of data. The responsibility of this oversight and collation of data would add further costs to an already over-burdened system and its market players. The practicality of implementing such a tax was also questioned at great length and it was believed this was almost impossible to do.

It was felt those who would ultimately pay for the tax would be the institutional investors in pension/mutual and insurance funds and UCITS. Therefore, the unintended consequences would be to increase taxes for the investors that the regulators were trying to protect. Momentum has grown to speak out against the tax and recently it was reported that the EU is looking to scale it back and potentially delay it for years.

The tax of 0.1 percent for equity and bond trade and 0.01 percent on every derivative trade could fall to 0.01 percent across the board generating €3.5 billion versus €35 billion. The implementation will be delayed until mid-2014, which will give the equity securities lending business some breathing space for the time being.

Daswani: We will see an increase in demand for investment-grade securities and this will certainly have a positive effect on fees

There is some momentum gathering to exempt repos from the tax to which the securities lending industry may also benefit on that back of this movement. The impracticality on imposing such a tax on each of the many movements that can occur, on both the loan and collateral leg, should be at the forefront of any decision on whether to impose this tax on the securities lending world, along with the drastic effects on settlement, liquidity and efficient functioning of the relevant markets. **SLT**

On their behalf

SLT speaks with Saheed Awan of Euroclear and Mark Jennis of DTCC about their plans to launch a joint collateral service

MARK DUGDALE REPORTS

What market benefits do you believe your joint initiative will deliver?

Mark Jennis: The Depository Trust & Clearing Corporation (DTCC)/Euroclear joint collateral processing service will significantly increase efficiency, reduce risk and support the growing collateral needs of industry participants.

The industry is focused on collateral management as a result of concerns over how to address operational and counterparty credit risk, while navigating the changing regulatory landscape. This proposed new service will be designed to address these concerns.

The Margin Transit Utility, currently under development, will help to mitigate risks, lower costs and create greater efficiencies by providing STP of OTC derivative margin delivery obligations.

The linking of our collateral services through the use of Open Inventory Sourcing and similar technologies will provide consolidated inventory management and optimal collateral allocation of assets held in DTCC, Euroclear and agent banks around the world.

What will market participants need to do to benefit from it?

Saheed Awan: The beauty of our initiative is that it requires very little action be taken by market participants. We will count on our clients' involvement in defining the specifications of the joint service and testing during the implementation period, but this is the only occasion where they would need to actively 'do' something specifically related to our initiative.

Euroclear and DTCC will deliver a common collateral infrastructure for market participants active on either or both sides of the Atlantic. We will offer centralised tracking of both securities and cash collateral, as well as a simplified means for optimising collateral inventories. The joint initiative will offer the market opportunities to benefit from efficiencies in margin management, collateral inventory management and collateral allocation and segregation.

Of course 'how' firms chose to make best use of the new infrastructure is a decision that we leave in their hands.

Why have you decided to join forces to accomplish this?

Jennis: The two firms have joined forces to leverage the collateral processing functionality and expertise from both institutions. This will enable us to deliver straight-through margin processing and to efficiently pool and allocate the substantial amounts of collateral held by both depositories against exposures globally.

How does this initiative complement Euroclear's global Collateral Highway?

Awan: The Collateral Highway has enjoyed considerable success in Europe and is catching on in Asia with agreements already signed with Citi, BNP Paribas, the Hong Kong Monetary Authority, the Korea Securities Depository and Standard Chartered Bank. To make it truly global, the Collateral Highway needs to extend its reach, notably into the Western hemisphere. This is what we are doing with the joint collateral management initiative with DTCC.

The service we plan to jointly develop will provide consolidated inventory management and optimal collateral allocation of assets held in DTCC, Euroclear and agent banks around the world. This will provide seamless repositioning of collateral between Europe, the US and Asia.

What is the role of the Margin Transit Utility and how will Euroclear fit into this initiative?

Jennis: The Margin Transit Utility is a margin processing solution designed to service dealers/future commission merchants (FCMs) and

their clients in the derivatives clearing markets, as well as to support the remaining bilateral relationships in the OTC markets. It provides STP, including the matching of margin calls between market participants, the netting of cash margin payments, the settling of US dollar and non-US dollar collateral, the safekeeping of collateral in segregated margin accounts, and the reporting and record-keeping of collateral.

The substantial benefits of the Margin Transit Utility include: (i) reduced personnel, settlement and funding costs; (ii) reduced systemic risk; (iii) increased scalability; (iv) greater transparency regarding collateral activity; and (v) the potential for linking collateral data with information reported to the Global Trade Repository, which will provide a complete view of risk exposures during a market crisis.

Euroclear will play a major role in providing this functionality for the processing of non-US collateral, including participating in the build and maintenance of this messaging hub for enrichment and routing of settlement instructions, as well as the settlement of cash and the segregation of securities.

When do you plan for this joint service to be launched?

Awan: It is still too soon to answer that question with any degree of certainty, especially as we are still scoping the services we plan to make available to the industry.

At present, DTCC's Margin Transit Utility service is scheduled for launch in 2014 with US dollar cash followed by euro cash and finally securities collateral.

We believe that the Collateral Highway will provide a ready mechanism for the transmission of margin calls from the buy side to a transit account at the clearing member and into segregated accounts at the CCP.

The timing for the roll out of the second major part of the joint initiative—the linking of our collateral services through the use of open inventory sourcing and similar technologies—will only be known once the scoping exercise has concluded.

What do you mean when you say the joint service will operate as an industry cooperative and will provide open access to all other collateral processing providers?

Jennis: The joint collateral processing service will employ an 'open architecture', affording access to and by global and local custodians, other central securities depositories (CSDs) and international CSDs that wish to become part of the initiative.

Why a MoU rather than an agreement to deliver?

Awan: Signing a memorandum of understanding gives us the time we need to complete our exclusive discussions with DTCC and together define the most important aspects of the planned service for the industry.

We are working on a delivery timeframe and how the joint collateral service will be managed and maintained, taking into consideration the different time zones. We are also discussing the ownership structure and the split in revenues and costs.

Our joint initiative has the potential to have major market impact, so we must take the time to clearly define our deliverables with the industry.

How will you manage the work streams involved in delivering such a large project?

Jennis: This initiative has been divided into a number of separate projects managed under a joint Euroclear/DTCC programme. These individual projects cover the legal and regulatory aspects, the extension of operating hours for the Collateral Highway, implementation of the inventory management and collateral allocation service, development and implementation of the Margin Transit Utility, and the roll-out with clients. The scoping of the work involved in these projects has already started and the definition of deliverables has begun. **SLT**

Saheed Awan
Global head of collateral services
Euroclear

Mark Jennis
Managing director, strategic initiatives
The Depository Trust & Clearing Corporation

A benefit of the Margin Transit Utility is the potential for linking collateral data with information reported to the Global Trade Repository, which will provide a complete view of risk exposures during a market crisis

European securities lending: utopia or dystopia?

DataLend's Ben Glicher, CIO, and Winston Victolee, data analyst, assess the state of the European market

Market values go up and down, but despite the different market conditions, securities lending utilisation trends have been pretty consistent over time. In Europe specifically, dividend season typically sees an increase on average of around 2 to 3 percent utilisation year over year.

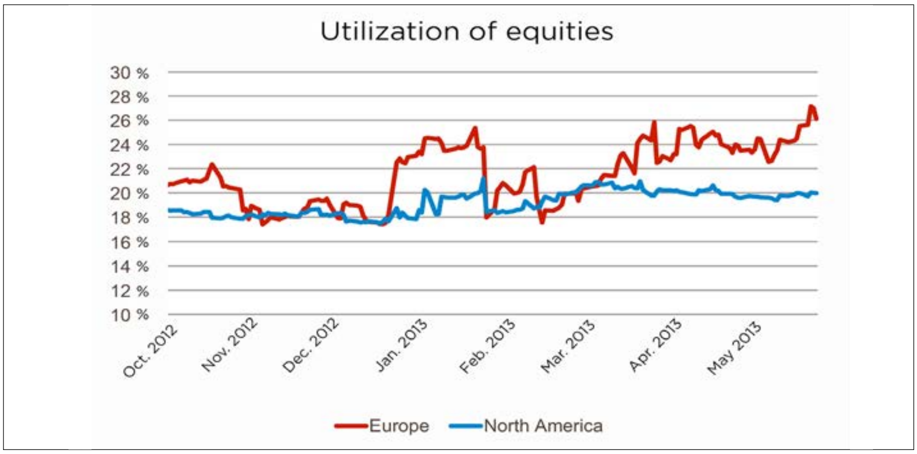
This year, however, things appear to be different. Almost nine months ago, $103 billion worth of European equities were on loan at a utilisation of 20 percent, with North America having $355 billion on loan and a utilisation of 18.5 percent.

That can imply that European equities utilisation is more active due to their supply being more available. Now the markets as a whole have changed, with the ebb and flow of value increases and decreases—and maybe even a loosening of the grip on cash—playing a role.

On-loan values of select regional securities (June 2013)

Belgium	DELHAIZE	$1,088,774,117
	SOLVAY	$667,453,371
	BELGACOM	$561,309,969
Germany	SAP	$12,523,068,129
	LINDE	$7,294,359,413
	DEUTSCHE BANK N	$4,065,814,559
Italy	ENI	$2,886,839,335
	UNICREDIT	$2,197,037,493
	ASSICURAZIONI GENERALI	$1,390,963,834
Poland	POLSKI KONCERN NAFTOWY ORLEN	$286,525,266
	KGHM POLSKA MIEDZ	$275,993,465
	PKO BANK POLSKI	$143,457,320
France	TOTAL	$4,189,307,211
	ESSILOR INTERNATIONAL	$3,264,046,707
	SOCIETE GENERALE	$2,967,255,698
Greece	ALPHA BANK AU	$4,097,371
	ALPHA BANK RTS	$3,458,936
	NAT BANK OF GREECE AU	$1,147,396
Luxembourg	ITC DR	$5,303,578
	SES GDR	$1,193,656
	EASYETF BRAZIL EUR ETF	$1,186,340
Portugal	PORTUGAL TELECOM SGPS	$548,409,183
	EDP	$304,777,085
	GALP ENERGIA (SGPS)	$180,072,310

Source: DataLend



Source: DataLend

Today's market for European equities seems to have received a substantial boost in the securities lending marketplace. European equity on-loan values grew to $260 billion toward the end of May with a utilisation of 26 percent and a high of $280 billion, while North American equities are now at $459 billion with a utilisation just shy of 20 percent and a high of $460 billion.

With utilisations having increased from 20 percent to 26 percent and on-loan values increasing by more than 2.5 times from $103 to $260 billion, the European securities lending market has definitely seen more activity. Comparing last year's highs at $220 billion on loan and 22 percent utilisation, there are other regional factors at play. The countries with the highest utilisation increases in descending order are Portugal, Greece, Luxembourg, Poland, Italy, France, Belgium and Germany.

Of the smaller on-loan amounts, Portugal leads the way with a 13.17 percent increase in utilisation and an on-loan value of $1.2 billion, just under half of which is Portugal Telecom. Poland had an increase of 9.64 percent with an on-loan value of $1.22 billion, and Belgium had a utilisation increase of 8.36 percent with a current on-loan value of $4.7 billion. Greece had a utilisation increase of 12.37 percent with an on-loan value of $12.1 million due, in major part, to Alpha Bank, which for some time has faced fears of being nationalised.

Italy's Eni has an on-loan value of $2.89 billion and has had some recent issues, with operations being suspended across Turkey. Eni, UniCredit and Assicurazioni Generali together account for more than a third of Italy's on loan, helping Italy to gain 9.4 percent in utilisation.

France leads all of the European countries as far as value increases. France has had an increase in utilisation of 9.3 percent and an on-loan value of $52.1 billion. The leaders in French securities seem to be names with recent and/or upcoming dividends, which may account for the large increase in utilisation.

Germany paves the way with most of their top securities having dividends recently, but Germany's utilisation only increased by 2.1 percent, further illustrating that the securities lending market in Europe is still quite active regardless of dividends.

All of which is evidence of this recent anomaly in the European securities lending space, where typically consistent utilisation rates have shown a significant spike in 2013.

But what does that mean for market participants?

How does one navigate the current marketplace, where stock prices have climbed and new highs have been reached? Noting the current trends, North American equities have remained relatively consistent, while European equities have received quite a boost. What that means comes down to perspective—there are always the bearish who believe there is money to be made when the market is up.

Oranges and lemons

When life gives you lemons, make lemonade. But that may be too tough a task for biotechnology short sellers, says David Lewis of SunGard Astec Anaylics

Economic history is peppered with booms and busts, from the original 'South Sea Bubble' right up to the more recent advances in technology, communications and social media. In the early 1990s, it was the turn of the biotechnology companies; a burst of excitement surrounded breakthroughs in pharmaceuticals and industrial chemistry. Like any other boom, there were winners and losers. Large companies seemed to balloon from small chemical labs almost overnight and some of them disappeared just as quickly. One such firm, Chiroscience, which was founded in the 1990s on the basis that oranges and lemons were mirror images of each other at the chemical level. They are made up of chiral molecules that can be scientifically described as non-superimposable mirror images, or more simply for people like me, being like a right and left hand. They are effectively mirror images, but you cannot superimpose one on the other, however you present them.

So what? You can tell oranges and lemons apart by sight, taste, and smell, right? But for science and medicine, it means a lot—chirality can make the difference between a molecule locking onto a disease and disabling it, or being completely useless—a kind of binary event if you like.

Investments in such industries, or kitchen table lab experiments as many were at their start, were also pretty binary—if it worked, fortunes were made, if not, investors' millions were wasted in research and development with no useful results. Jump forward to the present day and the pharmaceutical industry is once again on the rise, but what does that mean for the investor and indeed the securities lender?

This year alone, according to Dealogic, has seen 10 new biotech companies come to market, raising more than $720 million between them and there are indications of double that number of emerging companies waiting in the wings. Also, the NASDAQ Biotechnology Index has delivered double the dramatic rise (32 percent) seen in the S&P 500 over the year to-date. All good for investors so far? What about the binary results issues though?

Fewer than one in 10 new drugs passes clinical trials, and even fewer of those go on to become stellar performers solving major health issues or diseases across the globe, earning billions for their patent holders. Add a final layer of additional risk to the mix makes such investments even more volatile: a couple of decades ago pharmaceutical companies could only raise significant levels of investment once they had a successful clinical trial under their belts—not so anymore.

Some of those companies attracting investments now have no such pedigree, meaning investments are more speculative, but with potentially even greater returns for those investors who get into the deal at such an early stage. What does this mean for risk and what does it say about investor appetites in today's markets? With a hit rate for launching a drug that passes clinical trials of less than one in 10, it is perhaps better than playing roulette with your cash, but not by much. Some observers would also say that this increase in perceived risk taking is a reflection on the scarcity of yields available in more traditional investments.

So, if risks are high and the success rate is low, is this then a sure-fire play for the short sellers? A one in 10 success rate is the reverse of a nine in 10 chance that they will fail, so maybe it makes sense to short a spread of biotechnology stocks and enjoy a 90 percent success rate. Of course, it isn't that simple.

Looking at 17 IPOs over the last 12 months, 12 are up on their launch price, one is flat and only four are down. Looking more closely at some of the best performers, the short sellers appear to have cleverly stayed away: Omthera Pharmaceuticals (OMTH) has less than one fifth of the shares on loan compared with its launch and its share price has gained more than 50 percent; a similar price performance for Chimerix is reflected in a share on loan balance of zero; finally, shares on loan in Stemline Theraputics are less than one eighth the number on loan at their peak showing many made the right trade as the shares have risen more than 70 percent. But what happens when you take the wrong position?

Vertex (VRTX), a company working on a cystic fibrosis drug, jumped 60 percent in one day in April this year; and Pharmacyclics (PCYC) has risen 450 percent since the start of 2012 after various drugs trials. Both of these show that fingers can be burnt very badly if you get the bets wrong. Figure 1 shows an unrealised loss overnight of around $64 million for those more than 2 million shares out on loan over 18-19 April. Dwarfing that is PCYC, with an average on-loan balance of 2.75 million over the last two years. PCYC has seen its share price rise from $6 to $88, leaving an eye-watering loss for short sellers of more than $222 million over that period. Figure 2 shows the details over the last two years.

As a sector, biotechnology (with more than 320 stocks across the globe in the Astec Analytics grouping) shows more than 1 billion shares on loan at the time of writing, down a little below 3 percent in volume over during the month of May. Even with that drop, this is still a very large number of shares sold short representing a significant exposure to the pharmaceuticals market. If we narrow this sample down to US securities only, the shares on loan account for around 90 percent of the total, which shows just where the risk is concentrated. With a 32 percent rise year-to-date in the NASDAQ biotechnology sector, it is likely that many traders have had to swallow some bitter pills, much like having made the mistake of biting into a lemon rather than an orange. **SLT**

Figure 1: VRTX shares on loan and market closing price since 1 January 2013

Figure 2: PCYC shares on loan and market closing price since 1 June 2012

Figure Source: SunGard's Astec Analytics

Industry appointments

Citi's head of triparty collateral management **Russell Pudney** is joining J.P. Morgan.

J.P. Morgan declined to comment, but a source confirmed that Pudney, who recently oversaw the launch of a triparty collateral management solution at Citi that allows mutual clients to consolidate their equity and fixed income holdings into a single collateral pool, will join the bank.

Wells Fargo Securities, the capital markets and investment banking business of Wells Fargo & Company, has formed a new client trade services group within its securities markets division.

Client trade services will consist of prime services, OTC clearing, futures clearing and execution, and funding and liquidity management.

Dan Thomas, a senior leader at Wells Fargo, has been named head of client trade services. He will report to Tim Mullins and Walter Dolhare, co-heads of the markets division.

Thomas joined the bank in 2008, alongside its purchase of Wachovia Corp, and prior to this role, was head of interest-rate and commodities sales. His role will bring together clearing capabilities for OTC derivatives and futures, prime brokerage for hedge funds and other services such as securities lending and repos.

Dolhare said: "As the market structure for fixed income and equity products evolves, we have created a coordinated and product-agnostic approach to help our clients manage their funding, collateral and technology needs."

"Under Thomas's leadership, our new client trade services group will allow us to efficiently manage risk and compete successfully in an evolving marketplace."

Wells Fargo Securities has also named **Eamon McCooey** as head of prime services. He will be based in New York and report to Thomas.

McCooey previously spent 13 years at Deutsche Bank, serving most recently as head of US prime brokerage. He has also held senior financial positions at Canadian Imperial Bank of Commerce and Kidder, Peabody & Company.

His role was first held by Stephan Vermut, followed by his son Aaron Vermut. They sold Merlin Securities to Wells Fargo and resigned in 2013 to join Prosper Marketplace, a San Francisco-based peer-to-peer lender.

Commenting on the appointment, Thomas said: "McCooey's extensive knowledge of the prime brokerage industry combined with his proven ability to lead and grow a business makes him an ideal fit for our organisation."

"We are committed to our prime services business and look forward to the growth opportunities created by the addition of McCooey to our team."

As part of its client trade services group, Wells Fargo currently offers its clients full service OTC and futures clearing and is adding in-house securities clearing capabilities.

"Building out our clearing capabilities is an important component of the overall client trade services business strategy", said Wells Fargo veteran George Simonetti, head of markets clearing and futures execution.

"Our clients will continue to need access to clearing venues globally. We're providing them with a high quality service that allows them to efficiently manage their collateral, especially in light of mandatory regulatory clearing requirements'.

J.P. Morgan nabbed former Credit Suisse prime brokerage executive **David Leahy** in efforts to boost its Asia sales.

Leahy relocated from London to Hong Kong to become managing director and head of Asia-Pacific prime services sales.

Prior to this appointment, he was head of hedge fund and institutional coverage for prime services in Europe, Middle East and Africa at Credit Suisse, based in London. **SLT**

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