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The primary source of global securities finance news and analysis
ISSUE192 12 December 2017

Final leverage ratio rule a boon for CCPs

The final version of Basel III's leverage ratio rules are providing an early Christmas present for central counterparties (CCPs) due to a re-orientation towards risk weighted assets (RWA) over minimum capital requirement.

The Basel Committee on Banking Supervision (BCBS) released its final judgement on the major regulatory framework, stating that the revisions will help restore credibility in the calculation of RWAs by "enhancing the robustness and risk sensitivity of the standardised approaches for credit risk and operational risk, which will facilitate the comparability of banks' capital ratios".

Basel III will also constrain the use of internally-modelled approaches and complement the risk weighted capital ratio with a finalised leverage ratio and a revised capital floor.

Commenting on the finalised leverage ratio rules' effect on CCPs, Jonathan Lombardo, of Eurex, said: "Based on the 14.5 percent increase (weighted average increase of all banks) in the risk weighted minimum capital requirement (MRC), the overall MRC therefore decreases by 1.9 percent in the leverage ratio."

"Leverage ratio based MRC is in fact not CCP friendly as the calculation is not based on the counterparty risk weight. Risk weighted assets based MRC is very CCP friendly as this RMC can be lowered by moving your portfolio to a qualifying CCP where the counterparty risk weight is 2 percent."

"Therefore, the 14.5 percent increase in the RWA RMC is, on first sight at least, good news for CCPs as the Basel III reforms will help banks to realise the full capital efficiency a CCP brings due to its QCCP status through the adjusted RWA impact."

As part of its high-level summary of Basel III reforms, the BCBS has also allowed jurisdictions to excuse central banks from the leverage ratio exposure measure in "periods of exceptional macroeconomic circumstances".

BCBS will continue to monitor the leverage ratio's treatment of client-cleared derivative transactions. It will review the effect of the leverage ratio on banks' provision of clearing services and any consequent impact on the resilience of CCPs.

Jurisdictions employing this power must recalibrate the minimum leverage ratio requirement commensurately to offset the impact of excluding central bank reserves, and require their banks to disclose the impact of this exemption on their leverage ratios.

The reforms were also welcomed by the European Banking Authority (EBA).

"Strong international standards are an essential common yardstick that will support a safe and sound cross-border banking on a global scale," said EBA chair Andrea Enria. "The EBA is committed to engaging with competent authorities and European co-legislators to ensure a successful implementation of the standards in the EU."

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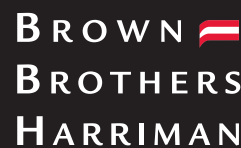

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ECB green lights collateral harmonisation project

07 December 2017 | Frankfurt | Reporter: Drew Nicol

The creation of a Eurosystem Collateral Management System (ECMS) has been approved by the European Central Bank as the next phase of the its market harmonisation campaign, with an initial launch date of November 2022.

Eurosystem-wide collateral management system will merge 19 national systems into a single platform will replace the existing systems in an effort to increase overall efficiency.

The ECMS will allow changes to the existing collateral framework to be implemented in a harmonised way across the euro area.

The collateral project follows hot on the heels of the completion of the final phases of the Target2-Securities and Target2 settlement initiatives.

Alongside the approval of the ECMS, the European Central Bank also signed off on plans to consolidate the two platforms by November 2021.

The central banks of Germany, France, Spain, and Italy will act as service providers for both projects.

Ocado delivers for short sellers

Ocado's recent bounces in share price have failed to shake off short sellers in recent weeks, according to FIS Astec Analytics.

The British online supermarket was FIS's top pick for a second consecutive week as part of its hot stocks list for Europe, the Middle East, and Africa, as short interest volume fell 22 percent in the third week of November.

"Such changes can precede an upward movement in the value of company shares as short sellers seek to minimise their exposure, but the drop was not followed by a correlated drop in utilisation, suggesting that some large institutional funds were also selling out of Ocado as the shares fell to £2.39—within a few pence of a new 12-month low," FIS explained.

Last week saw a further 7 percent drop in short interest with utilisation falling almost twice as fast.

According to FIS, this suggests that short sellers and long investors were both expecting a positive event, which in this case was signing of a deal with Groupe Casino of France, a major European supermarket.

Ocardo's share price has since rebounded, closing the week up 52 percent to sit at £3.64, a new 24-month high.

"Not everyone appears to be convinced, however, as 68 percent of the available shares remain borrowed by short sellers," FIS added.

BIS: CCPs could reduce segmentation in repo pricing

Central clearing for repo trades could reduce market segmentation and lead to convergence in pricing, according to the Bank for International Settlements Quarterly Review.

The report centres on a recent rule change from the Depository Trust & Clearing Corporation (DTCC), approved by the US Securities and

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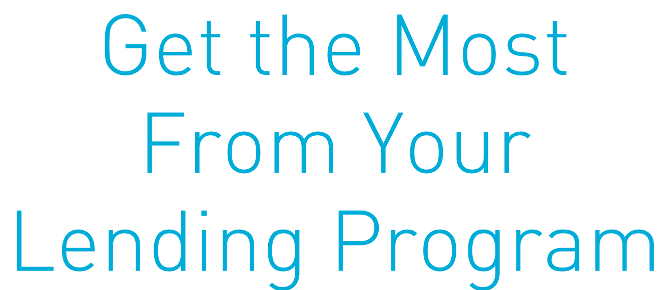

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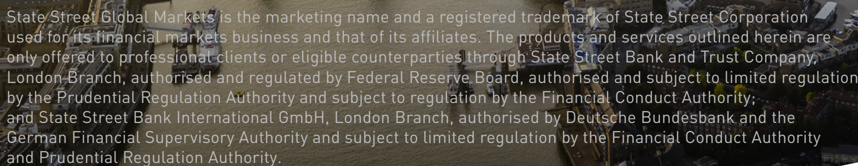

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Exchange Commission in May, allowing DTCC subsidiary the Fixed Income Clearing Corporation (FICC) to expand the availability of clearing in the repo market for more institutional investors.

This change means money market funds (MMFs) can provide cash or securities in the delivery-versus-payment markets, through a dealer sponsor.

Some MMFs have already started clearing repo through the FICC, and at the end of October, centrally cleared repo amounted to $13 billion. Although, according to BIS, the volumes are relatively small, they have been growing.

Centrally cleared repo made up almost 6 percent of the total repo volumes of the three fund families that cleared repo through the FICC in October 2017.

According to BIS, the initial reaction of MMFs suggests that central clearing has the potential to reduce market segmentation. There are also signs of convergence of prices, with centrally cleared repo trades earning up to 12 basis points more than the triparty rate index.

Further, funds that cleared trades through FICC reduced their end-of-quarter take-up of the overnight reverse repo compared with their peer funds.

Because of the netting and risk-weighted asset benefits, among others, of CCP trading, volumes of reverse repo with the Fed stood at $21 billion, for CCP funds, for Q3 2017.

The BIS report speculated that, if the funds had increased their reverse repo with the Fed at the same rate as their peers, this figure would have been around $35 billion.

CSD Prague opens a direct account in Euroclear Bank SA/NV

CSD Prague has opened a direct account with Euroclear Bank SA/NV and initiated the corresponding settlement link as of 1 December. The account will allow the central securities depositary to access a wider range of services and to have access to many additional foreign markets, according to Euroclear.

Euroclear Bank provides settlement and related securities services for cross-border transactions involving domestic and international bonds, equities, derivatives and investment funds.

Petr Koblic, CEO of Prague Stock Exchange and chairman of CSD Prague, said: “Capital markets are facing multiple challenges in the field of legislation, technology and innovation in general. Euroclear is a leading company which explores new technology solutions and implements them together with its participants.”

“I am glad that we are a member of such a group and that our market can benefit from working with Euroclear.”

Helena Čacká, CEO of CSD Prague, added: “This relationship with Euroclear will provide us with a safe and efficient settlement link permitting us to use all services related to corporate events and the potential to further develop services related to foreign securities.”

Frederic Hannequart, chief business officer of Euroclear group, commented: “We are delighted to welcome CSD Prague as a client of Euroclear Bank. CSD Prague’s decision reinforces the excellent long-term relationship between Euroclear Bank and the Czech market.”

Eurex Clearing secures five signups for its OTC partnership programme

BGC Partners, Bloomberg, TP ICAP Group subsidiary i-Swap, Tradeweb and, Tradition’s Trad-X are on track to become approved platforms as part of the Eurex Clearing partnership programme.

All firms are execution platforms for over-the-counter (OTC) interest rate swaps that will enhance price transparency, price discovery and liquidity for Eurex through the partnership.

As part of Deutsche Boerse, Eurex Clearing’s programme promises to reward interest rate swap price makers for providing competitive Eurex prices to both the interbank and end-user market, via execution platforms.

The approved platforms will support various execution formats including Central Limit Order Book, disclosed streaming and Request-for-Quote.

According to Eurex Clearing, utilising existing infrastructure and relationships for price makers will maximise market efficiency and significantly improve price discovery for clients.

“Price transparency and competitive prices are key to further strengthen our liquidity in interest rate swaps,” said Eurex Clearing’s chief strategy officer, Matthias Graulich.

“Therefore, cooperation with major execution venues is a key milestone in successfully rolling out our new partnership programme to establish a liquid alternative for clearing interest rate swaps in Europe.”

Dean Berry, global head of electronic and hybrid markets at BGC Partners, said: “We welcome the Eurex Clearing Partnership programme. This market led initiative will enable BGC Partners to provide greater liquidity and transparency to its clients for Eurex cleared products.”

Don McClumpha, CEO at i-Swap, added: “Initiatives which broadens the range of trading options available to the current participant group on the i-Swap platform, are something we are happy to be associated with.”

Nex sees EU and US repo boost

Nex Group reported a 25 percent increase to its European repo activity, which now stands at €240.4 billion year to date, up from €193 billion over the same period in 2016.

EU repo activity for November reached €241.1 billion, matching its volumes for the month before.

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Nex Group also recorded a 5 percent increase to its US repo activity year on year for November, which now stands at $252.6 billion, up from $240.1 billion.

Last month's US repo activity increased by 2 percent month on month, up from $247.5 billion in October.

Nex's positive market volume results come after Nex Regulatory Reporting received approval from the European Securities and Markets Authority to become a trade repository under the European Market Infrastructure Regulation.

The trade repository, which will be based in Stockholm, Sweden, will prepare Nex for its trade operations post-Brexit.

OneChicago sees lending volume drops

The securities finance exchange OneChicago's securities lending monthly volume dropped by 6 percent in November, compared to the same time last year.

OneChicago recorded 866,510 trades for the month.

The downturn marks a change of fortune for the exchange, which achieved a strong increase in cleared securities lending activity in September.

That month, OneChicago reported a 34 percent year-over-year growth, with 1.4 million transactions.

US Securities Markets Coalition opposes MODA reform

The US Securities Markets Coalition has opposed an amendment to the Modernisation of Derivatives Tax Act of 2017 (MODA) proposed by US Senator Ron Wyden.

Wyden's proposed changes to the act in May as he believed it's current form was "hopelessly antiquated, needlessly complex, and riddled with loopholes".

He added: "As a result, sophisticated taxpayers may manipulate the timing or character of underlying investments or the derivative contracts themselves."

In his proposed reform, Wyden claimed his changes to the US Securities Markets Coalition's tax regime would make derivatives contracts simpler if there was just one timing rule, one character rule and, one sourcing rule.

Wyden argued that his amendment would "[Strike] nine code sections and streamline many others in the process. The bill would also introduce a general rule for capital hedging whilst scaling back in the current, complex straddle rules".

In a statement released this week, the coalition said that the tax treatment of exchange-traded options is "governed by well-established rules that are relatively simple and easy to understand".

"The fact that the rules are old, is no argument for replacing them. Broad-brush reform of the nature represented by MODA 2017 will create new, untold complexities."

It added: "While we applaud Senator Wyden's stated interest in 'radically simplifying' the tax code to create 'a simpler, more straightforward tax regime,' we respectfully believe that MODA 2017 would not advance this objective, but instead would create results that are neither simple, nor straightforward, nor fair, as applied to exchange-traded options."

OCC secures securities lending gains in November

OCC's securities lending central counterparty (CCP) activity was up 34 percent in new loans in November from last year with 214,606 transactions.

January to November securities lending activity was up 22 percent with 2.1 million new loan transactions, compared to 2016.

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The average daily loan value cleared by OCC in November was $150.96 billion.

Cleared futures volume up 6 percent last month, with 10.8 million transactions, compared to the same period in 2016.

OCC's year-to-date average daily cleared futures volume was up 35 percent with 554,036 contracts.

OCC has secured consistent growth for its CCP throughout 2017, outdoing its 2016 monthly figures every month so far this year.

SLR and SCCL changes on the horizon, says BNY Mellon

Adjustments are expected on the Supplemental Leverage Ratio (SLR) and Single Counterparty Credit Limits (SCCL) in the near future, following industry concerns.

Questions around the future of the securities lending regulatory landscape dominated the BNY Mellon Markets' Securities Finance Regulatory Update webinar, held in New York on 24 October.

The SLR remains in contention as the US Treasury is to set SLR at 5 percent of Tier One capital, while the Basel Committee has recommended 3 percent.

In the case of insured depository institutions, the target level would be 6 percent.

The recommendations were designed as a backup capital measure to ensure banks do not take on an undue risk that was not captured by the risk-based capital rules.

The problem with the current implementation is that puts US banks at a competitive disadvantage against overseas rivals that are only obliged to hold half as much capital against the same risk positions.

Market participants have urged banking supervisors to revise the SLR and provide exemptions for certain low-risk activities—from holding treasuries on the balance sheet to placing cash on deposit at central banks—that are currently included as assets in the denominator of the ratio.

Eli Peterson, managing director at BNY Mellon's office of public policy and regulatory affairs, said: "We expect that the Fed will undertake a review. We know that they're already working on sort of a fundamental review of the supplementary leverage ratio."

Peterson added: "We really do believe that the Fed, in conjunction with the other banking agencies, is likely to propose some changes to the SLR over the next few quarters."

The Treasury also plans to place a limit on credit exposure one bank could have to another.

As it stands now, globally systemically important banks (G-SIBs) will be prohibited from having a direct counterparty exposure to another G-SIB in excess of 15 percent of that entity's Tier One capital.

The regulation is yet to be finalised but the securities financing sector has already called for change.

The biggest concern is the methodology used to calculate securities finance exposures overstates the actual risk in lending transactions between G-SIBs.

The securities lending sector is in favour of the Basel Committee's new calculation method, which proposes an alternative method for calculating securities finance exposures.

The revised calculation way is expected to be adopted as a standard in the US jurisdiction in the near future.

Michael McAuley, global head of product and strategy for BNY Mellon's securities finance business, said: "Without the revised calculation methodology, [SCCL] could have a significant impact on agent lenders' ability to provide indemnification."

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And for my Nex trick

SFTR is bringing significant changes to the securities lending landscape, but Nex is creating and collaborating to help clients through. Colin Murphy and Matthew Bernard explain

Nex Regulatory Reporting is set to apply to become a Securities Financing Transactions Regulation (SFTR) trade repository. What opportunities does this create?

Colin Murphy: We have a substantial client base through our market share for the European Markets Infrastructure Regulation (EMIR) and the second Markets in Financial Instruments Directive (MiFID II), and by becoming a trade repository for SFTR, we will be giving our clients a solution for what's going to be a pretty substantial regulatory change going forward. I think trade repository approval will uniquely position us as an endpoint to report directly to the trade repository.

What are the main challenges for securities financing participants regarding SFTR?

Murphy: This will be the first time that this segment of the market has had a regulatory light shone on it. Until now, the securities lending repo market has been untouched from a regulatory reporting perspective. The SFTR reporting requirements will have a big impact on participants, much in the same way that EMIR has on the over-the-counter derivatives market.

An important challenge for clients is the fact that, in order for them to comply with the regulations, they are going to have to extract data

In order for firms to adhere to SFTR they will need to, by definition, transfer their reportable trade data through a trade repository

Colin Murphy
Head of sales
Nex optimisation

from a large number of disparate systems. That process will, in itself, be onerous.

As is the case with other regulatory regimes we cover, we are able to ingest data from our clients in whatever file format they have it, we are very flexible in how we consume their information. Our existing infrastructure for MiFID II and for EMIR enables us to provide a comprehensive end-to-end solution from one vendor.

Also, in order for firms to adhere to SFTR they will need to, by definition, transfer their reportable trade data through a trade repository. That's an absolutely necessary process. The challenge for them will be getting information from a number of different sources and then transferring it.

How does Nex fit into the SFTR space?

Murphy: Our collaboration with other Nex Group companies, such as hedge treasury platform ENSO, and BrokerTec's repo business, uniquely positions us to capture significant market share of SFTR transactions. These businesses, and our cloud-based trade repository technology, give us a strong point of leverage to win SFTR reporting business.

This gives us a natural point of leverage for SFTR business. SFTR is going to have a significant impact for both the buy and sell side. Giving ourselves time for the implementation is going to be key.

Nex TR will be a cloud-based trade repository—it's cutting-edge technology. From a Brexit perspective, we're also future-proofing ourselves, hence why it will be based in Sweden.

Nex's Pivot programme promises to optimise clients' financial resources and reduce their costs. Why is this important?

Matthew Bernard: It's important because it's where the world is going. Banks have been focused on this for years, working to make significant improvements in internal technology to better optimise across clients and inventory.

Our buy-side clients are dealing with similar constraints and we're in a time of transformation. Fees are being tightened and re-worked and our core clients have a heightened focus on efficiencies to maintain the right operating margin in their business.

Our clients are being smarter, regarding the way they interact with their financing counterparties as a result, and technology continues to play a major role in this business.

Why is it so important for hedge funds to execute cash payments directly through a portal? How secure is this?

Bernard: In a world where human beings can order pretty much any product they want directly through their phone and have it paid for and delivered the very next day, I don't see why our industry participants would need to log into multiple sites to instruct or execute treasury- and operations-related orders and have it be so labour intensive. People want to do things faster, smarter and be more efficient and in a scalable way—Pivot allows for all those things.

The platform is extremely secure and reliable. It is built in partnership with Nex Markets, whose backbone has been providing these types of services to Fortune 500 customers globally for over a decade, and we are using the most advanced security protocols across the platform. **SLT**

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Matthew Bernard
CEO of Enso Financial Analytics
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New year, new tax

The German securities lending market is weeks away from the introduction of a new tax on dividend income that may drive participants out the market

For most people, the new year brings hope and a sense of opportunity and optimism. For Germany, 1 January 2018 brings the German Investment Tax Act (GITA 2018), which, among other things, will introduce the taxation of manufactured dividends and lending fees on German equities.

The rule has been described as murky, inconsistent and unnecessary—and industry leaders fear the worst about its negative effects on the market.

The Manufactured Dividend Rule renders securities lending and repo income subject to a 15 percent German taxation in the hands of a lender and repo seller, respectively, when such lender or repo seller is an investment fund.

The reform essentially modifies the taxation on investment income by creating two distinct tax regimes for non-tax transparent investment funds on the one hand, and transparent special funds, on the other.

The category of 'investment funds' includes UCITS funds, alternative investment funds, hedge funds and single investor funds, and these are the ones that will be hit hardest by GITA 2018.

Under the new regulation, German-sourced income, including revenue from securities lending and repo, are taxable at 15 percent withholding tax for non-resident funds, while some 15 percent corporate tax will also be imposed on German resident funds. Payment of the withholding tax on German-sourced dividends by non-German resident funds discharges the corporate tax at fund level, in order to ensure no double taxation takes place.

Primarily, these investment funds and their investors will be subject to tax. Fund level taxation will take place for the first time either in the form of corporate tax, or withholding tax. The key indicator is where the fund is domiciled.

Fran Garritt, director of securities lending and market risk at the Risk Management Association, offers further insights on the German tax law. He says: "GITA 2018 will treat manufactured dividend payments, repo interest and related fee income as German-sourced participation income, subject to potential German withholding tax if the payments are associated with a securities lending or repo transaction involving in-scope German securities."

Securities lending on the radar

The German market regulator is committed to putting a stop to dividend stripping and boosting compliance with EU laws on anti-discrimination. This will lead to equal treatment for German-domiciled and foreign funds on German-sourced income.

Local authorities have been strengthening tax regulation in securities lending in recent years. Ali Kazimi, managing director of London-based tax advisory firm Hansuke, explains: "The aim of the authorities is to stop abuse on trades between foreign and German resident shareholders around the dividend date of the shares."

The first step was to tax cum/ex transactions, followed by a levy imposed on cum/cum transactions this summer, according to Kazimi.

He adds: "The third piece of the jigsaw is to tax manufactured payments and lending fees that have a German origin. Now, all of these, including fund taxation and anti-tax avoidance packages have come together under the new framework."

Insecurity and liquidity challenges around GITA

As Germany aims to impose heavier taxes on securities finance moving forward, the industry raises fears of liquidity disruption in the German market.

As another concerned industry representative, the International Securities Lending Association (ISLA) submitted a letter on 5 December to the German Ministry of Finance asking for further clarification and expressing industry concerns around GITA.

ISLA explains: "Due to a lack of clear understanding across the industry, lenders may determine that the risk of lending securities is no longer low and therefore will withdraw from the market, rather than accept a higher level of risk or uncertainty."

"A number of members have indicated that they may have to cease securities lending activity in German equities mid-December in order for positions to be fully returned by borrowers before 1 January 2018. It should be noted that a wholesale withdrawal of liquidity over the typically lightly-traded Christmas period, could have an unpredictable and outsized impact on equity markets."

Garritt also warns that, in such an investment climate, most lenders and their agents may stop lending German securities. If a number of foreign investors decide to withdraw their supply from the market, there will be a negative impact on liquidity.

Garritt adds: "In fact, we are already seeing a number of agents and their clients decide to stop lending their German equities altogether, in preparation for the 1 January 2018 effective date."

"The liquidity challenge could be exacerbated around the holidays," Garritt adds. "Since the rule goes into effect on 1 January 2018, some institutions may decide to cease securities lending activity in German equity markets by mid-December in order to close out positions by the start date of the rule."

According to Garritt, the shortage of liquidity can affect the German market severely, "as volumes are typically low during this time period". Similarly, Kazimi predicts that 30 percent of the liquidity could be taken out from the German market as a result of the uncertainty around new regulation.

While Germany will likely remain a significant player in the financial market, demand could wane for German securities in the face of uncertainty and ever-stricter regulation. **SLT**

Deutsche Boerse's Michael Port examines GITA 2018 from a German perspective

How is the taxation on income changing?

Among other amendments, the main changes of the German investment tax reform are in the taxation on fund level. In the case that the lender is an investment fund which is subject to the new German Investment Tax Act 2018 (GITA 2018), a fundamental change of the tax regime is to be considered. Chapter six of GITA 2018 foresees a withholding tax:

- On income from German shareholdings
- On payments on securities financing transactions (SFT) in German equities (for example, lending fees)
- On income from property
- On other income that is subject to limited tax liability

This withholding tax compensates further tax obligations on the level of investors. Additionally, there is less complexity in the declaration of the earnings figures from a tax perspective.

What tax requirements will be set out for resident and non-resident investors as of 1 January 2018?

In the case that the lender is an investment fund that is subject to the GITA 2018, the borrower will be obliged to deduct the withholding tax on payments in the context of a securities lending transaction, such as the lending fee. These rules are valid for both German and foreign investors.

How should investors and asset managers prepare?

If it has not already been done, they should contact their tax advisor. In addition, ISLA is also working on this topic.

Which investment funds will be in scope?

The affected funds are outlined in chapter one of the GITA 2018, which refers to chapter one of the German Investment Code (Kapitalanlagegesetzbuch).

Where will GITA 2018 not be applicable?

The investment tax act is only applicable in the case that an investment fund is involved. In all cases where no investment fund is involved in the SFTs the GITA 2018 won't be applicable. For example, in the case that a foreign bank is borrowing German equities from a German bank.

Can you explain the difference between an investment fund and a special investment fund?

To be qualified as a special investment fund for tax purposes, various requirements have to be fulfilled by the funds. The investment terms and criteria are listed in chapter 26 of GITA 2018. They include the provisions that:

- The fund is limited to 100 investors
- No private investors are allowed
- The fund is not subject to German trade tax

Public investment funds only need to fulfill the criteria of chapter one GITA 2018.

Is it possible to change from an investment fund to special investment fund?

Only in the case that the special investment fund no longer fulfills the requirements of chapter 26 of GITA 2018, can a special investment fund be changed into an investment fund.

Will there be any punitive measures if market participants react too late? Or will transitional rules be implemented?

The new investment tax rules come in force on 1 January 2018. There are no transitional rules in place.

All questions have been answered with a main focus on securities lending transactions. Please be aware that the answers represent Deutsche Boerse's interpretation of the new rules, especially in the cases that are still in discussion. These responses are not to be construed as tax advice.

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A swing of the risk pendulum

Now is the opportune time to increase revenue on assets that have traditionally remained idle, says Michael Saunders, head of investments and trading for securities lending, North America of BNP Paribas

Many beneficial owners participating in securities lending programmes in 2017 experienced rather lackluster performance. The absence of volatility in global markets and the predominantly one-directional movement of both domestic and international markets resulted in limited opportunities, leaving many participants with lower revenue on a year-over-year comparison basis.

However, despite the relatively weak performance of securities finance revenues linked to hard-to-borrow securities or 'specials', participants with a diversified lending strategy and higher risk tolerance appear to have debunked this trend of disappointing revenues, ending the year with above-average returns, relative to the market.

The success of such beneficial owners can be attributed to a combination of factors, particularly an increased appetite to engage in non-traditional strategies, such as collateral transformation transactions, and an expansion of their programme's risk appetite to include alternative cash collateral reinvestment structures.

If the risk profile of beneficial owners were to be equated to a pendulum, in 2017, the risk pendulum has started to swing away from the equilibrium point of intrinsic lending and accelerate towards an increased risk appetite to include longer dated transactions and alternative reinvestment strategies. This shift in risk mentality has a direct correlation on programme performance, resulting in higher revenues for beneficial owners adopting such a strategy and enabling their programmes to outperform their lending peers.

Securities lending participants would be well served to reevaluate their risk tolerance in order to take advantage of current conditions with their non-cash and cash-collateral reinvestment strategies heading into 2018. Beneficial owners have, understandably, maintained a more risk-averse posture in the wake of the 2008 financial crisis, which witnessed losses attributed to cash collateral reinvestment. At the time, a strategic shift toward intrinsic-based lending, with a focus on indemnified reinvestment products, was considered a prudent approach for beneficial owners who committed to participating in securities lending. As this risk aversion subsides, however, sophisticated participants are increasingly shifting from intrinsic-only lending and conservative reinvestment strategies to increased credit and duration exposures as a means of capturing greater yields.

While the exact timing and frequency of the Federal Reserve's rate-tightening regime—which, at present, includes, almost certainly, one more rate hike this year and likely three or four additional hikes in 2018—has yet to be determined. What is certain is that the market is already pricing in higher rates over the next couple of years. Within this context, beneficial owners can certainly capitalise on the market opportunities by increasing their exposure to credit-sensitive instruments in the cash collateral market.

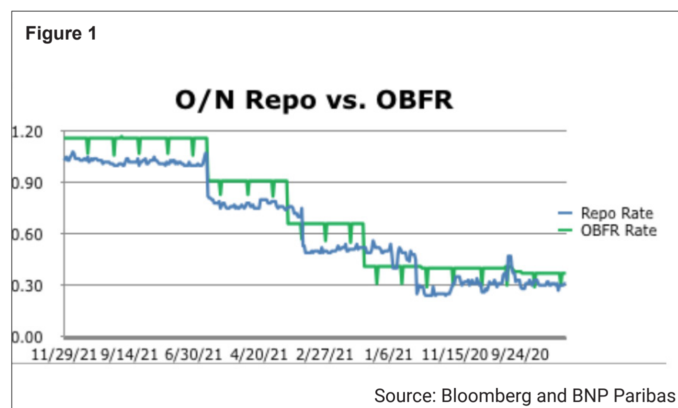
A shift in strategy

To date, a majority of securities lending portfolios have adopted an overnight-only lending strategy, combined with cash collateral investments limited to government money market funds or US Treasury collateralised reverse repurchase agreements. However, a trend has emerged among

beneficial owners to broaden their risk profile in an effort to capture incremental yield while utilising their portfolios of idle assets. This shift is predominantly driven by depressed yields on these reinvestment products.

The Overnight Bank Funding Rate (OBFR) has become the securities finance industry's main benchmark for pricing rebate rates on loans, as well as a proxy for the risk-free rate. A majority of lenders will loan securities at a rate linked to OBFR, usually at a spread of 5 to 10 basis points (bps) below the daily published rate, which currently stands at 1.16 percent. Assuming a financing rate of around 1.06 percent (OBFR less 10 bps), reinvestment yields of a portfolio would need to surpass 1.06 percent to maintain a positive spread. With government money funds yielding approximately 0.95 percent and US Treasury collateralised repurchase agreements hovering around 1.05 percent, the opportunity to lend securities linked to OBFR at a rate of less 10 bps is limited, at best, to an intrinsic-based or hard-to-borrow strategy. Figure one illustrates this current conundrum.

Figure 1



Source: Bloomberg and BNP Paribas

Despite the negative spread or inversion of rates between OBFR and traditional risk-free reinvestment products such as government money market funds and US Treasury reverse repo, investors can nonetheless achieve higher returns by allocating a portion of their cash collateral to prime money market funds, private funds or short-term bond funds, as well as through adopting a broader collateral schedule for their reverse repurchase agreements.

The implementation of the US Securities and Exchange Commission's (SEC) Money Market Reform in October 2016, and the subsequent shift of nearly $1 trillion of assets from prime funds to a stable net asset value of government funds, has created a nearly-35 bps spread between these two types of funds. Yields on traditional money market products, such as commercial papers, certificates of deposits, corporate bonds and even asset-backed securities, have widened, presenting opportunities for those with a higher risk tolerance. As an example, these short-dated instruments offer yields in excess of 1.25 percent, presenting ample spread between the OBFR funding rate of 1.06 percent, for limited risk.

Of course, such changes in strategy can lead to heightened market liquidity risk, interest rate risk as well as duration risk. However, all of these can be mitigated using fairly straightforward portfolio risk-management techniques, such as limiting the weighted average maturity of the portfolio as well as implementing a duration-matched lending program. Applying minimum levels of overnight liquidity to a portfolio as well as concentration limits on an issuer or asset class basis may also help reduce portfolio risk.

Finding an agent capable of properly managing a credit-sensitive portfolio is paramount for institutional investors. For those with in-house capabilities, the option also exists to self-manage cash collateral in order to maximise the portfolio's total investment return.

Opportunities to monetise current market spreads are not only limited to cash collateral reinvestment strategies. Participants engaged in a non-cash collateral program also have the ability to substantially increase their returns through the expansion of their permissible collateral and through extending the tenor of their loans. Equivalent opportunities exist for lending participants to increase their programme's yield through the acceptance of non-traditional repo assets, such as high yield bonds, equities and even securitised assets. Several lending agents are willing to indemnify these transactions with customised haircuts and tenors to offer substantial increases in interest rate spread.

A representative of a large insurance company said: "Our participation in a securities lending programme is designed to maximise our return while adhering to the risk tolerance of our institution. The ability to monetise market opportunities through the expansion of our permissible collateral and engage in longer-tenor transactions, while maintaining ample levels of liquidity under a fully indemnified programme, is prudent and in the best interest of our shareholders."

Whether a firm opts to participate in the growing trend of adding credit exposure to its cash collateral portfolio, or expanding the scope of its indemnified collateral schedule outside of government debt, guidelines should be implemented that adhere to the institution's risk profile.

One solution to capturing current market opportunities through an allocation of credit sensitive instruments, while adhering to a unique risk profile, would include implementing a hybrid approach to collateral strategy. This is similar to the analogy of a checking or savings account, where the checking account is the government money market fund or overnight US Treasury collateralised repurchase agreement, while the savings account allocation is the equivalent of a credit-sensitive portfolio with longer tenors and credit-sensitive instruments. A combination of both strategies is considered prudent, while adding potentially significant returns.

Ensuring proper portfolio protections

Despite the opportunity to boost incremental securities lending returns through broader collateral guidelines and credit-sensitive instruments, any changes to existing portfolio strategy should be discussed with a lending agent to ensure the appropriateness of these portfolio management approaches. Using proper risk controls to determine an acceptable allocation between the 'checking and savings accounts' is prudent, as is defining concentration limits, liquidity parameters, collateral liquidation procedures, interest rate mismatch and indemnification policies. Taking these steps, while also adopting a customised, tailored approach to programme management, can in turn lead to substantial value for the beneficial owner.

Heading into 2018

Regardless of risk appetite, the final weeks of 2017 are an opportune time to begin conversations with your lending agent to discuss your options. It is prudent to reassess your current programme and understand the capabilities and willingness of your lending agent to provide a customised, bespoke lending programme suited to your risk profile.

It is imperative that beneficial owners understand the capabilities of their provider to offer alternative solutions to their current lending programme. Providers exist in today's market that are willing to accommodate your risk appetite, offering a plethora of strategies to maximise revenue, while protecting the capital of beneficial owners.

As the pendulum continues to swing away from the equilibrium point, be ready to monetise the opportunities. Finally, as a beneficial owner, have the conversation with your lending agent, challenge your lending agent and engage with a provider to best serve your portfolio of assets. Opportunities exist to increase revenue on traditionally idle assets—so be engaged, educate your management and implement strategies to monetise these market opportunities. **SLT**

Won't get fooled again? Earnings for RH and other US retailers

Short sellers have been actively shifting their positions in several beleaguered retailers ahead of imminent earnings announcements. IHS Markit's Sam Pierson explains

With more than 200 percent year-to-date share appreciation, the short demand for shares of furniture seller Restoration Hardware has continued to trail off. The dramatic share buy-back disclosed in July caused metrics for shares outstanding and float to spike–as highlighted by the red line in the chart below.

This may have been interpreted as an increase in short demand, but it was purely the result of the denominator changing, meaning the number of shares on loan has been in decline since April. When the firm last reported earnings in September, a massive top line and EPS beat caused shares to rally more than 40 percent. Short demand halved in the subsequent three months, but shorts still represent 15 percent of outstanding shares ahead of today's earnings announcement.

Fred's, which operates more than 600 pharmacy and general merchandise stores, has been one of the highest shorted US retail names in 2017. With the share price having lost more than two-thirds of its value year to date, short sellers are sticking with a winner, though they've taken some profits during the quarter.

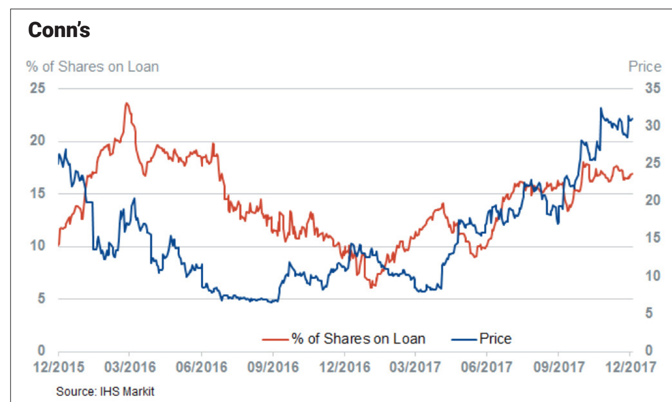
Over 35 percent of the firm's shares are still on loan–but that's down from the 2017 peak of 50 percent observed in July.

When the firm last reported earnings in September, the small top line and EPS beat, along with the appointment of a new chairman, led shares to spike more than 15 percent. Though the shares soon gave up that advance, it highlights the risk of incremental positive news for highly shorted stocks.

With utilisation of the lendable supply and borrow fees declining from the mid-year peak in demand, this position is less costly to carry. But, with current borrows equivalent to 15-days of trading volume, there could still be a rush to the exit on positive news. Despite a significant paper profit on the position in 2017, short sellers seem to be holding off throwing in the towel until they've wrung a bit more from it.

Short demand for Conn's increased during the quarter, despite a 60 percent rally in share price following the last earnings report in September. While short demand only increased marginally, it's worth comparing to the decline in shorts following the release of Q1 results in April. This also led to a sharp move higher in price.

Utilisation is down in the 70s and borrow fees are only a little outside of general collateral, making Conn's an easier short to carry relative to earlier this year. Regardless, with the short position still greater than 10-days trading volume, there could be additional upward pressure on prices following any positive results from the firm. **SLT**



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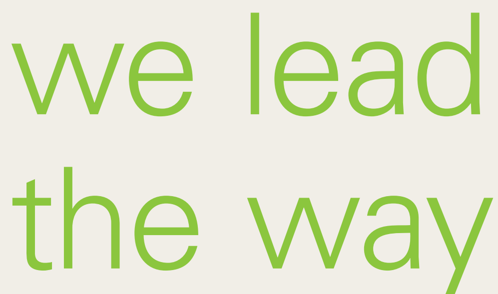

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Comings and goings at EuroCCP, Citi and Ceres Securities

John Jones has taken on a role as senior trader at Ceres Securities, a London-based boutique financial services firm.

Jones will join the firm's equity finance team and report to managing director and co-founder Charlie McSwiggan.

Alongside the trading role at Ceres, Jones brings experience as owner of JCJ Consulting, an independent securities financing product development company offering consulting and portfolio funding advice.

JCJ Consulting was founded in May 2010 and will continue to operate.

Ceres Securities was created in 2013 and offers securities lending, equity finance and electronic brokerage services.

For securities lending, Ceres covers equities and fixed income across all major markets.

Alongside McSwiggan, Ceres Securities was founded by John Brimmer and Alan Roggen.

Citi has appointed Brian Ovaert as managing director and global head of securities services and issuer services operations.

In his new role, Ovaert will be responsible for overall strategic direction of the securities services operations function, as well as the day-to-day activities of the business.

Based in New York, he will report to Stuart Riley, global head of markets and securities services operations and technology, and Okan Pekin, global head of prime, futures and securities services.

Previously, Ovaert worked at Northern Trust for more than 25 years.

He was most recently executive vice president and head of enterprise operations across asset servicing, asset management and banking.

Riley said: "This is a significant leadership role for the securities services business and it's a pleasure to have someone of Brian Ovaert's caliber join our team."

"He has a strong track record and a wealth of experience that will have an immediate impact on our growing franchise."

Pekin added: "The securities services platform is of critical importance to the bank as we continue to expand our global capabilities."

"Ovaert will complement our existing strengths and help build upon the momentum we have achieved."

Diana Chan, CEO of EuroCCP, is stepping down to become senior advisor to the chairman of the supervisory board.

As a senior advisor, Chan will assist the chairman on initiatives and represent EuroCCP in its engagement with senior industry members and regulators.

As well as being CEO of EuroCCP since 2007, Chan has also been CEO of EuroCCP NV, a clearing house based in the Netherlands for equity trades, since 2013.

EuroCCP said that as CEO Chan firmly established EuroCCP NV as the leading pan-European equities central counterparty.

In a statement on Chan's departure, EuroCCP said: "During her tenure, EuroCCP NV gained access to the trade feeds of London Stock Exchange, SIX Swiss Exchange and Euronext, extending the company's access to over 80 percent of equities trade flows in Europe."

Her replacement as CEO has not yet been disclosed.**SLT**

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