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UMR: A sheep in wolf's clothing?

Collateral panel discussion | State Street reveals details of P2P platform | The changing perceptions of data

Deutsche Bank suffers agency lending exodus

Several senior figures from across Deutsche Bank's agency lending business are set to leave the bank, amid wide-spread layoffs and a radical restructuring of its distressed investment business model. The departures known so far include:

- Tim Smollen, global head for agency securities lending
- Jay Schreyer, head of agency lending for Europe, the Middle East and Africa (EMEA), and Asia Pacific (APAC)
- Anthony Toscano, co-head of agency lending for North America and head of US trading and risk
- Mark Tisi, a director in the bank's agency lending business

A spokesperson for the bank declined to comment on the specific details of the recent departures or their potential replacements but did add that the bank remains committed to its securities finance business going forward.

A source close to the bank indicated that Jim Aris, Deutsche Bank's head of agency securities lending for EMEA equity trading, will take a leading role in the new agency lending business, although further details are as yet unknown.

All four joined the bank in 2009, with Smollen and Toscano, based in New York and Schreyer and Tisi operating out of London.

Schreyer originally served as regional co-head, but went on to become the sole head of agency lending for EMEA and APAC in February 2017.

Toscano first joined Deutsche Bank in 1997 as a director before leaving to join Commerzbank in 2002, also as a director, where he stayed until he re-joined Deutsche Bank in his latest role in 2009.

Meanwhile, Tisi also moved back to the bank in 2009 after leaving in 2002 to become head of client services and global business manager at Dresdner Kleinwort.

The departures come at a difficult time for the bank, which is seeking to radically restructure its investment businesses in order to rebuff market concerns around its ability to turn a profit.

Deutsche Bank is also thought to be attempting to right the ship after a series of costly penalties by global regulators for business mismanagement and compliance failures.

As part of the restructure, Deutsche Bank is expected to cut as many as 18,000 jobs across its global offices; although most are expected to occur in its German locations.

A steady stream of Deutsche Bank traders and bankers have been moving to other institutions since the German bank's financial concerns first became apparent late last year.

The recent agency lending departures also follow the start of Deutsche Bank's sell-off of its global prime finance and electronic equities business to BNP Paribas, which was formalised in September.

As part of the agreement, Deutsche Bank said it will continue to operate the equities platform until clients can be migrated to BNP Paribas to ensure continuity of service. Following this, Deutsche Bank has said it will maintain a focused equity capital markets operation.

The major restructuring plan will see the bank significantly downsize its investment banking business and cut costs by a quarter by 2022.

Inside SLT

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LCH completes clearing of its first €STR swaps

LCH has cleared its first euro interest rate swaps referencing the euro short-term rate (€STR), making it one of the first clearing houses to offer the swaps benchmarked to the new reference rate.

Morgan Stanley and LBBW, the parent company of three commercial banks, were among the first participants to clear derivatives using the new rate, which was first published on 2 October.

According to LCH, it introduced clearing of €STR swaps as the industry adopts new interest rate benchmarks.

The move follows LCH's launch of clearing for swaps with the secured overnight financing rate in July 2018, Sterling overnight index average futures in April 2018, and Swiss average rate overnight swaps in October 2017.

Thilo Rossberg, head of fixed income, currencies and commodities markets at LBBW, said: "We're encouraged by the swift introduction of clearing for this product, as it's a vital step for the development of a vibrant market. €STR is taking over, and we aim to be a reliable partner and liquidity provider in €STR swaps."

"Besides underlining our ambitions of being a reliable liquidity provider for our clients, this €STR-trade was moreover helpful in managing our overall risk position."

Meanwhile, Andrew Millward, European head of macro trading at Morgan Stanley, added: "We anticipate that €STR swaps will inherit much of the pre-existing liquidity from the euro overnight index average swaps market and are expecting strong investor demand from the out-set."

"As an active participant in the global derivatives market, we are delighted to offer this cleared product to our clients."

US Treasury and RMA join forces on new securities lending tax guidance

The Risk Management Association (RMA) is hopeful that a recent meeting with senior figures at the US Department of the Treasury will result in new guidance on the current interpretation of historic tax laws that are at odds with the aims of the market's post-crisis regulations.

The RMA's Tax Committee sent a letter to the US Treasury and the Internal Revenue Service in August to highlight its concerns that a lack of clear and up-to-date guidance on Section 1058 of the Internal Revenue Code is causing friction with the regulatory push towards term trades.

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

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

Since the liquidity coverage ratio was fully implemented in 2015 as part of Basel III's bundle of new regulatory requirements for banks, the RMA has observed that it is driving borrowers into longer-term securities lending transactions, meaning terms that go from 30 days to up to a year.

However, the move away from short-term funding is seen in stark contrast with the current interpretation of the tax rules under Section 1058, which does not include fixed-term lending.

Speaking at the Risk Management Association's conference in Miami, George Rapalje, the association's Tax Committee chair and head of tax for securities finance at State Street, told delegates that the US Treasury had responded to the letter by inviting the committee to Washington to meet senior figures and discuss the issue in more detail.

Rapalje explained that following the meeting the US Treasury fully understood the issue and the significance of it.

However, Rapalje added that the Treasury was also candid in outlining the myriad other issues currently on its docket, of which drafting new guidance on Section 1058 was not a top priority.

As a result, Rapalje said he is hopeful that he will see movement on the issue within the next six to 12 months but doesn't expect the desired guidance to be produced earlier than 18 to 24 months from now.

"It's a long-term project and we won't fix 40 years of tax law in a few months," he concluded.

OCC revamps regulatory oversight committee following SEC fine

The Options Clearing Corporation (OCC) is seeking to establish a new regulatory board-level committee in order to demonstrate its commitment to regulatory compliance in the wake of its recent run-in with the US Securities and Exchange Commission (SEC) for risk management failures.

The new committee, which will meet quarterly, will replace the OCC's current regulatory oversight working group and will offer guidance in relation to the conduct of OCC's core clearance and settlement activities.

The working group will be disbanded once the new group is in place.

In its filing to the US SEC to request a rule change to its charter to allow for the formation of the committee, the OCC noted that the committee would operate separately from its current audit committee and would complement the work done by independent consultants on regulatory compliance matters.

David Prosperi, senior vice president, communications for the OCC, explained that the SEC had not required it to create the new committee until 2020 but that the OCC "chose to proactively move it forward now to demonstrate our continued strong commitment to compliance with applicable regulations in the conduct of our core clearance and settlement activities".

In October, the OCC was handed $20 million fine by regulators for failing to manage certain market risks.

The SEC and the Commodity Futures Trading Commission (CFTC) found the OCC to have "failed to establish and enforce policies and procedures involving financial risk management, operational requirements, and information-systems security".

The SEC's investigation also found that OCC changed policies on core risk management issues without obtaining the required approvals.

IHS Markit expands their dividend forecasting services

IHS Markit is building out its analytics to more than double the number of companies covered by its dividend forecasting service.

The model uses machine learning to apply the methodologies of the dividend forecasting team to process a range of inputs and proxies, including company guidance, historical patterns, industry and peer group trends, consensus forecasts and other datasets from IHS Markit.

The model, enabling the expanded dividend coverage, was developed in partnership with the data science team at IHS Markit.

The expanded global service covers 28,000 stocks in more than 90 markets, providing up to five years of dividend forecast data for each stock covered.

Alessandro Ferretti, head of dividend products at IHS Markit, said: "Combining cutting edge analytics with our more than 15 years of dividend forecasting expertise offers index providers, derivatives desks, asset managers and hedge funds access to the broadest set of dividend forecasts available for large-, mid- and small-cap stocks globally, including frontier markets."

Yaacov Mutnikas, chief data scientist and chief technology officer at IHS Markit, added: "Using machine learning, advanced statistical modelling and time series analysis techniques to uncover patterns in multiple datasets helps us dramatically expand coverage and also retain the analytical rigour our dividend forecasting team has developed over many years."

SFTR opens door to corporate actions reform, says ISLA

The Securities Financing Transactions Regulation (SFTR) represents an opportunity for the securities lending industry to resolve long-running challenges around the handling of corporate actions, according to Andrew Dyson, CEO of the International Securities Lending Association (ISLA).

"Corporate actions have been problematic for many years but SFTR is forcing us to finally look at this," he told audience members

during the association update panel at the Risk Management Association's conference in Miami in October.

Dyson outlined after the session that previous work undertaken by ISLA suggests that around 50 percent of all corporate actions relate directly to securities lending activities.

"Not surprisingly, corporate actions relating to returns and additional on-loan securities figure heavily," he explained.

"Consequently, it is vitally important that all market participants deal with specific corporate actions in a consistent way across the market."

Dyson added that failing to do this or to set the necessary standards will mean that the market will find it difficult to reconcile and report trades under SFTR.

ISLA is embracing the opportunity that SFTR provides and has set out four steps with which to provide value for its members around corporate actions.

ISLA will start its work in this area by defining the corporate actions universe and then group corporate actions by securities financing transactions/booking model outcome, Dyson explained.

It will then look to work with its members to agree SFTR best practices for each corporate actions group.

According to Dyson, ISLA will aim to have this project completed before SFTR goes live in April 2020.

Elsewhere, Dyson noted that the level three SFTR guidance is expected to be released in Q4 and that industry participants will have to work hard to finalise their reporting solutions ahead of the go-live.

The remaining uncertainty around SFTR that will be clarified in the final guidance relates to article four, which includes reporting obligations and safeguarding for securities financing transactions.

CMF: "Data is the new gold"

The rise of machine learning (ML) tools has meant the value of data has grown exponentially, according to one speaker at the Fleming Collateral Management Forum.

"Data is the new gold," exclaimed Trevor Negus, collateral management product manager at Smartstream, during a presentation on the benefits of automation. "If you can harness data then you can use it to have machines learn patterns in that data allowing you to more effectively automate," he added.

Negus explained that to access the full potential of ML and artificial intelligence (AI) algorithms, firms must harness vast amounts of data.

SmartStream has an innovation lab that looks at how it can use ML to automate processes.

Negus told conference delegates that SmartStream has released 'SmartStream Air', which uses AI in reconciliations. Users can upload two files with different formats and complicated data sets that will still be understood and matched by the system for reconciliation.

"This is something that is normally done manually but is now something machines can do," Negus explained. "The more times the software runs, the more it learns and the more accurate it becomes."

Negus went on to warn audience members not to simply follow the trend of investing in AI for AI's sake. It has to deliver high-value innovation and solve specific use cases, he stated.

The goal is to eliminate or reduce manual, inefficient or costly processes, Negus concluded.

According to Negus, the data already exists in the capital markets, but it must be standardised and connected to flexible architecture, such as in a cloud-based infrastructure.

CMF: 'SaaS solutions are key for reducing costs' speaker says

Software-as-a-service solutions (SaaS) can provide operational and economical workflow optimisation, which will be a vital piece of the puzzle for reducing costs for regulations such as the Securities Financing Transactions Regulation (SFTR), says a Fleming Collateral Management Forum banking panellist.

Massimo Salerno, director of treasury and risk services centre at Cecabank, gave a presentation on global collateral management and SFTR and provided a holistic point of view on collateral management for securities finance and derivatives transactions.

SaaS is a method of software delivery and licensing which allows participants to access the software online via a subscription as opposed to being bought and installed on individual computers.

Salerno said that as well as reducing costs, SaaS can free up business units to invest in higher-value tasks. "This allows users to concentrate on their core business," he told conference delegates.

Additionally, Salerno noted that SaaS can help achieve economies of scale, which is important from a cost and knowledge perspective.

"We are under a regulatory tsunami and we don't want the user to have to put a lot of effort into the operational compliance," he continued. "This is why SaaS is important as it can also standardise processes, promote specialisation, improve control and increase efficiency and effectiveness of service."

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Year-end repo dislocation and liquidity deterioration

Much ink has been spent attempting to isolate the precise cause of the recent spike in the US overnight repo market with scientific precision. This is an exercise in futility. Equally futile is seeking to establish whether this portends a recession.

With year-end just over the brow of the hill, market participants remain jittery, seeking to establish whether the year-end US repo spike of 2018 will be eclipsed by a liquidity crunch of far greater magnitude. Memories of the disorderly 2016 turn have yet to fade. Anticipated liquidity and collateral requirements are being analysed with decisions being taken whether to absorb the premium hit by locking in early.

What is SOFR and what happened?

According to The New York Fed, "[t]he secured overnight financing rate (SOFR) is a broad measure of the cost of borrowing cash overnight collateralised by treasury securities. The SOFR includes all trades in the broad general collateral rate plus bilateral Treasury repurchase agreement (repo) transactions cleared through the delivery-versus-payment (DVP)..."

It typically stays close to the target the Fed's funds rate. On 17 September, a short-term liquidity squeeze pushed SOFR up significantly. According to my calculations, when the elevated three days are removed, the average 99th centile rate for 13 September to 19 October was 2.14 percent. On 16,17 and 18 September it was 4.6 percent, 9 percent and 5 percent respectively, peaking at an alarming 10 percent. The Fed responded on 18 September by injecting liquidity in temporary open market operations via repo transactions. Their repo desk offered 14-day repos of aggregate $30 billion according to a schedule in addition to overnight repos of aggregate $75 billion. This intervention returned the rate to close to the target federal funds rate.

The precise cause will be debated, more beneficial is to consider potential factors.

Bank holding too much reserve capital?

My recent memos have explored Basel III reforms from different angles. Readers will be familiar with the increased capital tied up on balance sheets that is, by definition, unavailable for lending or trading. The Fed currently holds $1.4 trillion in bank reserves, much of which is held due to regulatory and liquidity capital requirements.

J.P. Morgan?

The effect of J.P. Morgan's $2.7 trillion balance sheet hoovering up liquidity has been cited as a potential cause. Publicly available data reveals J.P. Morgan reduced the cash it has on deposit with the Fed by $158 billion in the year through June 2019. A natural link is formed with the previous point on reserve capital. As SOFR rose, J.P. Morgan and others would likely have stepped in to lend at higher rates, but were likely restrained by capital and liquidity ratios requirements.

The trifecta effect

Participants have highlighted a unique confluence of events:

- Corporate tax payments were due on 15 September leading to high $35 billion in money market fund redemptions
- The US' general account increased by $83 billion, thereby soaking up liquidity
- Dealers needed an additional $20 billion funding to finance the settlement of expiring US Treasury debt

Analysts remain divided over whether the spike was due to a unique confluence of events or whether this portends the deterioration of market liquidity going into year-end. Regardless of one's view, the market risk profile remains elevated and defensive strategies – to varying degrees – are bound to be activated.

If I were forced to proffer an opinion, I would state that recent liquidity deterioration events are driven by underlying structural problems. Automatic market correction mechanisms failed due to banks' inability to freely deploy capital.

The trifecta argument sounds plausible as an explanation of the trigger. The question remains why the market was unable to react to prevent a disorderly spike. This analysis will likely disappoint those seeking instantly tradable information. But, similar to how climate change cannot predict daily weather fluctuations, it does establish the increased probability of tail risk events.

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A Pandora's box of opportunities and challenges

Alan Sheehan of Calypso discusses the current landscape of collateral management and touches upon how technology can come into play in unlocking opportunities

Maddie Saghir reports

New regulatios have opened up a Pandora's box of opportunities and challenges. What effects are we seeing on the market?

There has been a lot of discussion around regulations, especially around the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) Uncleared Margin Rules (UMR) and mandatory clearing, which have vastly increased the daily number of margin calls. The industry has gone from a world where firms potentially had a single daily margin call for their variation margin (VM), to having as many as four margin calls, in the shape of the legacy VM call, a regulatory VM call, plus the two-way regulatory initial margin (IM) calls.

We have also seen the new regulations change the composition and financial accounting of the collateral that is being moved. Historically, VM was predominantly moved in cash and that remains the case today for both legacy and regulatory VM. Regulatory IM, however, mainly involves the movement of security collateral. We have seen this through the first four phases of UMR up to September 2019, with the movement almost entirely within the triparty agents. The fact that regulations have mandated the quality of the collateral and obliged firms to segregate the collateral so they cannot re-use it, has led to a considerable amount of high-quality collateral, and therefore liquidity, being removed from the market.

To give an idea of this impact on liquidity, the International Swaps and Derivatives Association (ISDA) margin survey conducted at the end of 2018 found that the 20 largest market participants (phase-one firms) collected and posted approximately $167 billion of regulatory IM for their non-cleared derivatives transactions at year-end 2018. Of the posted collateral, 88.4 percent was in government securities, which if consistent across the collected collateral, means that approaching $150 billion of high-quality liquid assets (HQLA) have been removed from the liquidity supply. This will obviously increase as the future phases of UMR impact more financial institutions.

What impact are these challenges having on collateral operations?

There is no way that the mainly manual collateral management processes could cope with a potential fourfold increase in margin call volumes. Nor could they handle the increased complexity of managing disputes in IM calculations, which are far more complex than the simple trade-level net present value required for VM, or with moving securities as collateral. This has created both an opportunity and a necessity for systemic solutions to solve some of these problems. For example, as firms are now moving securities for regulatory IM, they will almost certainly need interfaces to multiple triparty agents, who provide the regulatory segregation models. This is why Calypso has made a significant investment in connectivity to triparty agents and market infrastructure providers. In addition, there is the increased funding cost and the requirement to source the collateral, which means that collateral management needs to be integral to the front office processes. Front offices are now obliged to identify the true cost of the trading, funding costs included. But they must also look at where they should perform the trades; and whether/where they are going to clear the transactions, based on the information that is held within their collateral management systems.

The front office really must understand their costs and, from an opportunity point of view, have visibility and transparency. This is where systems like Calypso come in, offering an integrated front-to-back solution rather than a stand-alone collateral management system. Information that is normally stored in back-office systems needs to be accessible within collateral and inventory management systems.

How is the new regulation driving banks to integration and consolidation?

Regulation is providing opportunities because the collateral impact on both cleared and over-the-counter (OTC) derivatives trading means front-office users need to have much more information from the collateral agreement integrated into their decision-making tools to allow them to make execution decisions at the time of trading. For example, they need to know the details of the threshold in the CSA, what portion of that threshold has been utilised, and what is available. They must also understand the terms of the collateral schedule is having that information is essential for traders to make the correct decisions.

Then, given the increase in the amount of collateral that is required to cover regulatory IM, and also the quality constraints, banks need to have a more holistic view of the full inventory of their assets because they are using those assets to cover liquidity for the general financing of their repo and securities lending, as well as for collateral management exposures.

And let’s not forget that while we have been talking about the drivers from UMR, we have another set of regulations coming along: the Securities Financing Transactions Regulation (SFTR), the first phase of which comes into place from April 2020. SFTR will oblige banks and investment firms to report all the details of their securities financing transactions and lifecycle events, as well as the assets being used to collateralise them. This is where the combination of collateral, financing and liquidity comes into play. With the additional SFTR requirement to report collateral re-use, banks absolutely need a holistic view of financing and collateral management. And for collateral re-use, they need to know their trading positions in those securities. So, it is even more important to be able to access all that information together, rather than having to aggregate from disjointed systems.

What real-life use-cases are you seeing for new technologies to automate manual processes and cut down on inefficiencies today?

The whole collateral management process is relatively new. The first ISDA credit support annex was negotiated in 1994, so we have only been ‘doing’ collateral management for 25 years, and there was very little investment in the market infrastructure to support the process before the recent regulations. Collateral management was something new – and belonged in the depths of the back office. We know anecdotally, for example, that Excel and Email remain two of the most frequently used collateral management tools. The financial crisis and the UMR requirements that followed have changed this, particularly with the growth of the utilities. In the course of the first four phases of UMR up until September 2019, which brought into scope just over 200 of the world’s largest banks and investment firms, we saw utilities emerging as market standards for messaging and reconciliation of the standard initial margin model (SIMM) calculations. This has increased automation significantly. As these utilities have become the standard, of course you need to connect to them. But this is only part of the story. Providers like Calypso can add real value in the automation and the validation of these processes.

For example, Calypso has automated not only the sending and receiving of the messages but also the processing required upon receipt. We can add rules for checking eligibility when collateral is pledged, and for checking the settlement date is correct. We can automate the process to automatically accept the call, dispute the call, accept or reject the collateral.

How far can automation really go in the collateral space? Will there always be a need for people?

In the past, a collateral team would be moving mainly cash, with a small number of calls and using largely manual processes. Multiply the volume of work they were doing fourfold potentially, and there is no way that financial institutions are going to quadruple their collateral team. Having said that, automation won't replace people altogether.

We will always need people to manage exceptions in the collateral management process. We talked earlier about the complexity of the SIMM calculation, a much more complex value-at-risk-based calculation than the simpler VM, and in the event of disputes, far more difficult to identify the cause of dispute. I think the value is in automating the processing and communication so that the collateral team can concentrate on managing exceptions and on identifying where the real risks exist in the process, rather than sending and answering emails, and checking the pledge that has been sent is correct. The systems can do all that.

How important is the cloud for collateral management?

We are seeing a move towards cloud technology because of the cost benefits of not having to host software. But, at Calypso, we don't believe that cloud is the answer to every question; cloud doesn't work for some firms. That is why we have a 'deployment agnostic' approach, so firms can deploy on-premise, or we can host the software, or it can be deployed purely in the cloud. Cloud is here to stay. We have seen that from the increase in investment from companies like AWS, who are also breaking down some of the regulatory barriers related to the geography of data hosting. We are seeing more of an interest in the cloud to reduce the cost of hardware. But from a Calypso point of view, we believe that on-premise deployment is still something that many of our clients want—so we prefer to offer a mix of deployment options.

What is Calypso doing to innovate and how is it prioritising investment in new technologies?

As I said, we are making sure that our technology can be deployed in the cloud or can be hosted. We are making a major investment in microservices. We are creating an ecosystem of microservices that will be available to our clients, who can decide which of those services they want to use, and these will be deployed independently as part of their infrastructure. A microservices-based approach will reduce the need for clients to have major upgrades of their Calypso implementation; they will just need to upgrade the appropriate microservices. It is a popular concept as it offers firms entry level access to a system like Calypso. Naturally, these microservices can be deployed in the cloud.

A microservices-based approach also enables firms to consolidate their infrastructure. The new regulations have driven a need for greater visibility into banking systems–and for those different systems to connect. Microservices allow financial institutions to consolidate in an incremental way to provide the essential visibility and information.

What are your predictions of how collateral management will look in five to 10 years?

This is difficult to answer. Not least because of the rate of change that we have seen in the past three to five years and the huge change in collateral processing, technology and infrastructure in the past couple.

From a processing point of view, we will continue to see a move towards automation, combined with exception-based management. This will be driven partly by the need to reduce costs, and as a result of the increased number of calls that firms must make and the additional controls that they will need.

We will also see an increase in triparty services to further automate the collateral allocation process and could potentially see additional triparty agents emerging to add competition and to unlock additional sources of liquidity. I also expect a move towards interoperability between those providers.

Finally, I anticipate greater system consolidation as firms need to have more of the information held traditionally in the back-office and collateral systems available to users at the time of making the trading decision. So we will see consolidation from a systems infrastructure perspective, to enable banks to achieve that overall view.

Alan Sheehan
Director product management
Calypso


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Peer-to-peer securities lending and State Street's solution: Direct Access Lending

State Street's Michael Freundlich sits down with SLT to outline the bank's new peer-to-peer platform

Overview of peer-to-peer market/product

As the securities lending market continues to evolve, a constant theme that beneficial owners and alternative funds have broached with providers is peer-to-peer securities lending. Beneficial owners are seeking new avenues to increase distribution to boost securities lending revenue, while alternative funds are looking for ways to expand access to supply and to unlock the economic benefits of decreasing reliance on bank or broker-dealer balance sheets.

Over the years, different market participants have sought to enable bespoke exclusive trades between a single beneficial owner and an alternative fund. However, the structures that have been brought to market have failed to maintain the fundamental protections and service levels to which beneficial owners and alternative funds have become accustomed. Thus, no single scalable structure has been embraced by the broader market for mainstream client consumption. When approaching the opportunity to facilitate peer-to-peer securities lending, State Street started with the knowledge gained from operating both an agency lending programme on behalf of beneficial owners and a prime brokerage-like business, called Enhanced Custody, on behalf of alternative funds. The result is Direct Access Lending, a managed peer-to-peer service model, that is facilitated by State Street and leverages its securities lending programmes, providing transparency and economic benefit for those involved entities without further operational burden to clients. The product offers a seamless peer-to-peer model, supported by the operational efficiency and expertise of a managed securities lending programme.

Implications for agency lending clients

Agency lending clients generally choose providers that can offer three key functions:

- The distribution or utilisation of securities loans required to maximise earnings
- Credit and risk protections, such as borrower default indemnification
- Operational and trading excellence

First, the most liquid and largest securities lending market is in the US, and many alternative strategies maintain large, US equity stock borrow components. Consequently, the best opportunity to pair significant volumes of peer-to-peer loans is with US equities. Focusing on this market will both allow for improved agency lending utilisation of general collateral (GC) while ensuring liquidity of loans in the programme for both lenders and borrowers. Also, because these portfolios generally have low utilisation for most beneficial owners, the peer-to-peer transactions should be incremental to a participating agency lending client.

Second, any peer-to-peer securities lending relationship involves the introduction of new counterparty types to the beneficial owner community. Generally, the largest borrowers of securities are hedge funds operating different varieties of long/short equity strategies. These clients make up the bulk of most prime broker clients forming a large portion of the enhanced custody client base, but they are new borrower types for the beneficial owner community and most agency lending programmes. In order to mitigate some beneficial owners' concerns about this new borrower type, State Street is utilising a portfolio margining approach to establish collateral levels and will maintain counterparty default indemnification for these peer-to-peer transactions.

Third, beneficial owners require trading support to ensure distribution of securities at appropriate rates, and operational support to manage activities like corporate actions, collateral receipt and returns, and settlements. This lack of support has been one of the core issues with other peer-to-peer securities lending models proposed. State Street's Direct Access programme flows through the agency lending structure, meaning all loans through the platform will receive the operational and trading support provided today to beneficial owners, and no operational changes are required of the beneficial owners to participate in peer-to-peer loans.

Implications for Enhanced Custody clients

Prime brokerage clients generally choose providers who can offer access to a stable supply of securities at an agreeable fee, operational support required to manage a securities borrowing program and a stable credit counterparty. Direct Access Lending, through the utilisation of the infrastructure built for the Enhanced Custody business, offers all three components while maintaining the benefits of peer-to-peer lending.

First, the main reason an alternative fund would be interested in a peer-to-peer securities lending model is to trim the borrowing and financing costs associated with securities borrowing. By focusing on the liquid US equity market, Direct Access Lending offers a large, stable pool of supply from which to borrow, and by borrowing directly from the beneficial owner, a fee more similar to the rate in the securities lending wholesale market.

State Street has found that the potential for lower borrow fees is not sufficient to garner alternative funds' interest in a peer-to-peer securities lending product. Alternative funds do not have the operational and technical infrastructure in place to borrow from a typical agency lending programme. Agency lending borrowers must review and process daily recalls, mark to markets, corporate actions, and contract compare files amongst other daily tasks. If an alternative fund was required to build their own support to manage a peer-to-peer borrow, it's likely the costs associated would outweigh the economic benefit. For this reason, State Street is offering the trading and operational support provided by Enhanced Custody personnel to serve in an administrative role on behalf of the alternative funds. Beyond operational support, all Direct Access borrowers will also be Enhanced Custody clients, meaning State Street can step in to help ensure loan stability.

Finally, State Street's Agency Lending programme forms the ideal base of supply for a peer-to-peer lending programme; broad in scope and depth of holdings and committed to securities lending. Direct Access Lending provides borrowers the opportunity to borrow securities only from beneficial owners they are comfortable with, and full transparency into the underlying lender for the purposes of credit and risk monitoring.

Closing

When approaching a peer-to-peer securities lending model, State Street surveyed market participants offering competing products, beneficial owners as well as alternative funds to assess what would constitute a successful securities finance product for this market. Speaking with clients helped sharpen the focus on a product that accomplished the headline goal of peer-to-peer exposure.

Technology platforms exist that can easily match a security that a beneficial owner holds with an alternative fund seeking to borrow it, but don't have the trading, operational support, and scale required for both sets of clientele to participate. The goal with Direct Access Lending was to solve for both sets of client concerns, while delivering to market a unique, managed peer-to-peer securities finance product. As the securities lending market and State Street's various securities finance products continue to evolve, Direct Access Lending should be seen as an avenue to allow prudent peer-to-peer lending across a variety of markets and asset classes where participants trade.

UMR: A sheep in wolf's clothing?

The Uncleared Margin Rules are often painted just another burden to be managed, but will they also drive more firms into the securities lending market to access assets for use as initial margin? Industry experts debate the opportunities.

Ted Allen, business development director, securities finance and collateral, FIS

Todd Crowther, business development and head of client innovation, Pirum

Richard Gomm, head of EMEA banking industry, VERMEG

Shaun Murray, managing partner, Margin Reform

Mike Reece, head of EMEA sales, banks, platform sales, Securities Services, J.P. Morgan

Discuss the key trends within the collateral space right now.

Ted Allen: Clearly, preparations for waves five and six of the Uncleared Margin Rules (UMR) for bilateral over-the-counter (OTC) derivatives are front of mind for many firms. The impact on collateral usage will be significant for many as it is a catalyst to centralise collateral management and securities finance in the front office. UMR will increase the demand for high-quality liquid assets (HQLA) to meet initial margin (IM) calls, which will have a consequential knock-on impact for securities lending and treasury management. It will also create opportunities for some sitting on pools of HQLA that will be in higher demand. Centralised optimisation of inventory allocations will result and firms will also look to optimise trading decisions to minimise the margin impacts.

Mike Reece: The convergence of several themes and requirements makes this a very interesting time for collateral managers. In recent years we've been discussing requirements for more data standardisation and interoperability across markets; the need for firms to view collateral holistically and mobilise effectively across instruments, venues and regions; and finally, the evolution of sell-side optimisation from an outsourced, cheapest-to-deliver algorithm to more flexible, interactive user tools and better communication between triparty agents and borrowers. This change in triparty providers' optimisation capability is essential to enable each borrower's ability to optimise in-house and allocate versus their binding constraints – noting that this all needs to operate effectively alongside traditional triparty allocation solutions.

Buy-side optimisation is also emerging as a core requirement and potential opportunity, primarily in response to the final stages of UMR. Buy-side firms now face decisions on how to support complex margin management requirements, alongside other liquidity constraints and opportunities.

Beyond regulatory considerations, a renewed focus on environmental, social and corporate governance (ESG) investment parameters will add further complexity into the mix of general collateral challenges for both buy and sell side. The buy side will need to balance the requirement to widen collateral providers to improve attractiveness in securities lending versus a potentially narrower ESG policy and collateral acceptance, while the sell side may be restricted in posting collateral in reverse. At a minimum, this will require careful eligibility management and monitoring.

Finally, we can't ignore the potential for new technology to enable more efficiency within the collateral system, plus the role of new entrants focusing on data solutions and tokenisation, for example. We are starting to see some much more tangible initiatives around data solutions and tokenisation that could have huge potential for future application. Within this fast-changing environment, collateral managers, and particularly triparty agents, have a central role to play in enabling effective optimisation and mobilisation within an increasingly complex and interconnected ecosystem.

Richard Gomm: Automation, connectivity and both pre- and post-trade optimisation are without a doubt the three key trends in the collateral space right now. The need for greater automation is prevalent due to the increase in margin call volumes and potential disputes created by UMR. Via automation of the margin workflow via straight-through processing rules, the collateral management process becomes one of exception management. Automation enables margin managers to concentrate on the issues at hand rather than time-consuming manual processes and thus eases the burden on capacity and mitigates operational risk.

Direct connectivity to central counterparties (CCPs), triparty agents and third-party custodians are, as we know, a key pain-point within the industry due to the complexity of message formats and lack of standardised interfaces. Firms should seek technology or platform providers that have full triparty and CCP connectivity. There has been a significant increase in client appetite pertaining to the validation of valuations and eligibility checking of third-party access and CCP allocations. Since the Lehman Brother's collapse in 2008, customer relationship management teams now look to de-risk all processes and, as a result, gone is the antiquated view that firms just accept that requirements have been covered in full by eligible assets that adhere to both concentration limit and haircut parameters.

Pre- and post-trade optimisation are now also fundamental to market liquidity. Technology providers should be able to offer both. As the cost of collateral rises due to UMR, more and more firms are looking to reduce the cost per trade. This can be done via the use of pre-trade analytics. Firms should be able to reduce their cost of cleared trades via value-at-risk and Monte Carlo simulated calculations ensuring that all cleared trades are given up to the CCP. Post-trade optimisation needs to be across products to break down the institutional siloed approach. It should also be flexible in terms of algorithms and rules to be applied. Firms need to be able to build their own rules as optimisation doesn't always mean the cheapest to deliver and means many different things to different firms – five out-of-the-box rules may not satisfy this requirement. Firms also need the ability to periodically reassess collateral posting to ensure that all held and pledged positions are always the most optimal.

Shaun Murray: At Margin Reform, collateral breaks down into six key areas: strategy, technology, optimisation, risk and regulation, training and communications and legal and compliance. Each area means different things to different firms dependant on their starting point and where they want to end. The largest firms with the biggest budgets and the deepest expertise will have a different focus to firms who are now having to understand the regulatory dynamics, technology options and costs associated with either investing for the future or doing the best with what they have to meet and attain compliance.

No journey is the same and while evolution continues in the collateral space at a pace, all of the trends are functionally caught in the six key areas. Being a trendsetter is one thing, getting the basics correct, building the foundations in the right way and ensuring you future proof yourself are more important.

Todd Crowther: Firms are seeking:

Visibility: Consolidated view of margin requirements and collateralised transactions across various underlying products (securities financing transactions and UMR) and multiple collateral venues where real-time, network data is utilised to monitor and process the coverage of exposures in an accurate, efficient and timely manner.

Connectivity: Establishing better connectivity across the collateral ecosystem and more easily enable networking between market participants, triparty and third-party custodians, CCPs, outsource collateral agents, trade repositories, etc.

Interoperability: Leverage network to streamline and automate the full margin lifecycle by turning complex, manually intensive tasks into efficient, scalable and controlled workflow processes that are shared between counterparts.

Cost-effectiveness: Outsourced solutions are more cost-effective than in-house, hosted systems. A service fee replaces initial development costs; a single instance means that upgrades are more easily deployed; professional services are no longer required to maintain, support, user test nor update solutions as this becomes the responsibility of the service provider. Outsourced services also reduce development and integration timeframes as well as enable better controls from continually evolving security controls and infrastructure.

What is collateral trading and what is the main purpose of these trades?

Crowther: Collateral trading is undertaken to fulfil a collateralised exposure in the most efficient manner. These trades are undertaken to either raise, distribute or transform collateral to fulfil or enable the fulfilment of a margin requirement.

Allen: We are expecting UMR phase five and six and the extension of the clearing mandate for category three and four firms to increase the demand for HQLA to meet IM calls. This will drive collateral trading as those entities that are not naturally holders of these assets enter the securities lending market to access them.

Murray: The answer to this depends on the type of organisation you are speaking to and the role of the person. For some this is about P&L generation, servicing the client base and managing risk. On the treasury side, I may be looking for a collateral upgrade or downgrade to manage my balance sheet, or I could be a buy-side entity looking to optimise my collateral posting. In all events, there are factors everyone is considering such as the regulatory overheads, HQLA, balance sheet pressures and capital efficiency. The evolution of collateral trading to longer-dated, cross-asset, cross-geography client servicing and optimisation, plus the use of different legal structures such as 'pledge', will keep the market on its toes for the foreseeable future.

How will UMR affect the collateral marketplace?

Murray: UMR has already had a major affect on the industry. The first 4 phases are exchanging two-way regulatory IM, $170 billion across phase ones according to ISDA's 2018 year-end survey. Everyone has developed or implemented an IM model, mainly ISDA SIMM, and all have new processes, procedures, governance and regulatory oversight to contend with. Phases five and six are estimated to be much larger in terms of the number of impacted counterparty groups and they have to now decipher what they need to comply with, how they have to comply and whether they are able to utilise the monitoring aspects that the Basel Committee on Banking Supervision and International Organization of Securities Commissions (BCBS-IOSCO) statement alluded to by acting diligently.

The business as usual day-to-day processing is critical to get right. It varies from the management of your liquidity and funding requirements, the servicing of the long box for regulatory IM purposes, the external relationships with the custodial agents through triparty or third-party and dispute management, which will span operations and risk teams. In the longer term, we should expect to see all organisations focusing on the collateral dynamic, putting more emphasis on pre-trade analytics, moving to step-change technological improvements and enhancing internal connectivity across front office teams and their support areas in risk, legal and operations to increase efficiency and garner a better understanding of costs and the subsequent allocation of those costs to the correct place.

Gomm: Since the 2008 financial crisis, regulators have made huge strides towards stabilising the global financial system via regulatory reform. The US Dodd-Frank Act, Basel III, the European Market Infrastructure Regulation (EMIR) and other global equivalents have provided a tidal wave of regulatory change which, in the current economic climate coupled with stressed market conditions, has exasperate institutions' antiquated IT infrastructures, the lack of regulatory compliance, increased margin and dispute volumes, added to the adverse operational capacity, selection of IM calculation methodology and the subsequent squeeze on high grade collateral. However, institutions that were due to be impacted by UMR phase five, are now breathing a huge sigh of relief after the Basel Committee on Banking Supervision (BCBS) and IOSCO announced a one-year extension. Firms with an average aggregate notional amount of greater than €8 billion, but lower than the interim €50 billion threshold, will now be required to exchange IM in September 2021; 12-months later than the original mandated date. Many phase VI firms, particularly those domiciled in the US, will no longer be required to physically exchange daily IM with a large subsection being required to provide the underlying calculation of IM requirements only. However, streamlining IM requirements is much greater than purely choosing between schedule-based (GRID) IM and SIMM calculation methodology. Firms need to take a strategic, rather than tactical approach, thereby maximising automation, connectivity to triparty agents and CCPs, optimisation and efficient inventory management. This will ensure regulatory compliance, collateral mobilisation giving rise to competitive edge.

Allen: UMR will add complexity to firms in the over-the-counter derivatives market as they and their counterparties work to become compliant. This impacts legal, risk, treasury, front office and operations given the scope of the requirements. Those firms that have centralised collateral management and securities finance onto a single platform, such as Apex which supports the regulations, will be in an advantageous position. UMR will drive many firms into the securities lending market to access and use the assets needed for IM. Firms will be using systems that provide a central platform for securities finance and collateral, more and more. The decision to centralise these disciplines is both an organisational and an infrastructure question. We are all concerned about how regulations stop people getting on and doing their business. However, this regulation could paradoxically have a positive effect on securities finance.

Reece: I think the immediate impact, especially from the final phases, will be the significant time, effort and resources required across the industry to implement the rules efficiently. Given the scope and scale of participants in phases five and six, all industry participants will need to work together effectively. One of the longer-term benefits is likely to be increased interoperability between collateral providers, especially triparty agents, venues and vendors. As noted earlier, the final rule phases will also prompt a decision for buy-side firms. They can choose to implement a tactical solution to meet the requirements, or they can opt for future-proofing with a robust, end-to-end collateral optimisation solution across margin, liquidity and portfolio performance. Given ongoing pressures on spreads and shifting demand for liquidity, as well as the new margin obligations, choosing to work with firms who specialise in collateral, agency financing and lending solutions, with the expertise, scale and access they bring, is an increasingly attractive option. With the 2020 deadline fast approaching, buy-side firms should be deciding on their partners now.

Why should the firms aim for a centralised collateral management infrastructure?

Reece: Whatever the collateral obligation or opportunity firms are aiming to execute against, it's important to have the broadest possible

view and access across their portfolio. From a sell-side perspective, allocating collateral efficiently is now so much more complex, given the various capital, funding and liquidity constraints they are managing to - it's not just a case of prioritising lower-quality collateral.

Considerations related to counterparty, house-versus-client activity and duration are all critical in allocating collateral efficiently versus a firm's binding constraints. Being able to view a broad portfolio is key, but firms also need to be able to mobilise across business lines and time zones to access the collateral and then be able to allocate and lock into trades effectively. It's impossible to manage this process efficiently in traditional product and business silos.

Allen: Centralising collateral management, securities lending and treasury management can greatly improve efficiency. A given pool of assets can be used in the repo market to gain cash for variation margin, it can be used to raise revenue in the securities lending market or it can be transformed to access the securities needed. Only if these decisions around allocations are centralised, can firms avoid the spreads of going externally to access what is needed and to ensure the inventory is allocated optimally across all requirements.

Gomm: Many organisations still operate separate collateral pools to manage margin. Often this means the structure does not enable margin netting and compression to realise collateral and cost efficiencies for revenue-generation opportunities and can result in sub-optimal use of collateral inventory. If you include bilateral margin calls and settlement liquidity, then there is potential to utilise your triparty collateral arrangements to service a wider pool of business needs. The ability to break-down product silos and provide a holistic, cross-product view of risk to optimise firm-wide collateral inventories gives rise to competitive advantages which are not only proving to be critical to the success of any institution but for the financial industry as a whole. Therefore, the belief is that a centralised collateral management infrastructure is critical and should be at the forefront of any solution provided by fintech companies.

Murray: There is a multitude of reasons all firms should be looking to centralise when they consider collateral; the two most important are connectivity and simplicity. The embedded and increased risk and costs of the collateral regulatory environment needs management. Being joined up internally and externally, understanding the impact that a particular role has upstream and downstream leads to a more open and transparent approach to the collateral chain, which automatically brings a more efficient way of operating. In turn, being efficient leads to reduced costs. From a connectivity perspective, you should be working on a real-time basis, which is far more conducive to risk and liquidity management and ultimately can improve the top-line metrics through better balance sheet and risk-weighted assets management.

Crowther: Consolidated, enterprise-wide solutions can offer better cost-effectiveness, improved business returns and a more controlled, scalable solution in terms of a firm's target operating model.

What are the key challenges that organisations would face with this?

Crowther: The key to this is a firm's ability to have the visibility and connectivity needed to view and action coverage, agree or dispute exposures and effect collateral mobilisation to cover margin calls and this relies on the ability to collaborate not only a firm's counterparts but also its different infrastructure providers across different technologies.

The ecosystem is becoming much more complex – more products, more counterparties, more venues, more regulations – but standardised, automated technology should make the process of managing that growing spider web of complexity much easier.

The key points to enterprise-wide solutions are connectivity and real-time visibility – whether that be connecting with counterparties, infrastructure providers or utilities - firms should make sure they connect into that network to efficiently mobilise assets and agree on collateral. No firm can do that by themselves, they need to be outward-looking.

Allen: Building a business case for a budget for centralisation is a challenge. There is also an opportunity in regulatory deadlines for UMR and the Securities Financing Transactions Regulation (SFTR), which do require firms to look at their collateral infrastructure. I would urge firms to use this opportunity not to just do the minimum for compliance but to look at their collateral and securities finance infrastructure and invest to realise the benefits of centralising and optimising across front middle and back office.

Murray: There are multiple challenges to a centralised infrastructure which starts with the investment of those scarce resources, time and money, both of which need to be supported by their friend, expertise. The first and most crucial stage is to define the problem statement: what problem are you solving? Who is going to be responsible for the centralised infrastructure, is there a 'collateral owner' with the autonomy to bring success to the organisation? Are they backed by multiple stakeholders supporting them across product, functional and geographical footprints? Which (whose) problems do you solve first? What do you want the end-point to look like? Will the scare resources stretch far enough? There are several ways to break this down into manageable chunks and that should be a key consideration for all, as we've already recognised, collateral is rapidly evolving, some parts of the infrastructure are more important than others. Ultimately, organisations have the same challenges but they have a different priority weighting which needs to be understood at the outset.

Gomm: For years many firms have considered the move away from siloed processes. However, often such implementations can be costly, time-consuming and turn into multi-year projects. Many institutions still have antiquated infrastructures and internal data issues. Data quality and availability are a real issue throughout the industry and often represent the greatest risk to an organisation's ability to operate a centralised collateral management infrastructure. Fortunately, there are fintech companies in the market place that are offering truly


Counterparts
Tripary Agents
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Market Depositories
Regulatory Reporting
Central Counterparts
Data Providers
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Pirum is the world leader in post-trade automation and collateral management. Our real time network spans the breadth of securities finance, and our powerful connectivity hub gives institutions complete visibility of their assets and a bird's eye view of the entire financial eco-system.
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cross-product solutions. These solutions are geared towards both sell and buy-side organisations, providing hosted or a cloud-based infrastructure that removes the technical burdens and enables real cost and efficiency benefits.

Reece: For most firms, the main challenge is changing working practices and processes that developed over multiple years and have previously worked effectively. Aside from considerations around the front office, in terms of competing strategies, profit and loss (P&L) and balancing firm and individual desk priorities, the key challenge is often managing operations and heritage technology stacks.

Technology can pose a particular problem: for example, when we look at fixed income and equities business lines, the technology and associated downstream processing has often grown up in completely separate business lines. Realigning back, middle and front offices priorities within an already challenging market environment is a big decision, although the long term benefits are clear. To be effective, the role and responsibility for centralised collateral management infrastructure generally needs to be mandated from the top of the house. The full benefits from optimisation and mobilisation solutions through triparty agents and the broader ecosystem are magnified as firms move to a centralised collateral management infrastructure, through both scale and efficiency.

What other regulations do firms have to contend with in this space?

Reece: SFTR and the Central Securities Depositories Regulation (CSDR) are both significant requirements that firms need to prepare for ahead of 2020. We shouldn't underestimate the amount of work required or the impact of not being properly prepared, but there are clearly longer-term benefits to consider. I referenced the industry's growing focus on consistent data standards, harmonised markets and interoperability, but the reality is it's often very difficult to drive this purely as an industry initiative.

Regulation is often the catalyst for firms to prioritise funding and resources to an initiative, and so requirements from SFTR and CSDR will almost certainly deliver significant advances in data consistency, standardised reporting and harmonised markets. The timing of the International Securities Lending Association's 'Agenda for Change' whitepaper and suggested 'common domain model' are also well placed to help maximise benefits in this area.

Crowther: The European Securities and Markets Authority/EMIR are creating greater complexity by requiring collateral segregation and enforcing stricter eligibility requirements, BCBS is mandating improved liquidity profiles, greater capital buffers, more cleared products and higher-margin thresholds, SFTR and CSDR will affect collateral liquidity and widen market spreads whilst various government programmes such as quantitative easing and UCITS IV continues to impact availability of HQLA.

Murray: In Europe, you have SFTR, which has been front-and-centre of industry and media discussions for well over 12-months, unfortunately, that doesn't seem to have materialised in an advanced state of readiness across the industry when you consider planning and execution. CSDR regulation hasn't had the same fanfare that we have seen for SFTR or UMR, but firms who underestimate its impact, in particular, the settlement discipline regime which is due in 2020 could be in for a shock.

Additionally, in the EU we await clarification on the EMIR Refit and the requirements for IM model approval which are expected to be proportionate to the size of the firm, the larger you are the more onerous it will get.

For the Interbank Offered Rate purposes BCBS-IOSCO recently stated that if you're amending legacy derivative contracts solely to address interest rate benchmark reforms then you are not required to apply margin requirements for UMR. Assuming this position receives regulatory support, it means firms will have to have a systematic and automated way of ensuring such trades do not pollute their IM calculations. Documentation wise, credit support annexe or central securities depositories referencing the London Interbank Offered Rate or equivalent rates will need to be identified and have some form of an amendment or ISDA protocol executed.

Does liquidity scarcity exist or do you just have to know where to look?

Reece: While there are always conversations about liquidity, market feedback suggests that you just need to know where to look and/or have the capability to transform assets as required.

Gomm: It certainly exists as UMR represents a regulatory landscape, the likes of which have never been seen before, which has the collateral pool shuddering at the concept of an unprecedented demand for collateral comprised of high-grade assets and an increase in haircut provisions. While it is noted that increased collateral requirement in the market means greater safeguards against default, conversely, the ever-increasing demand for high-grade collateral also has an inherent destabilising market factor. Buy-side institutions have limited access to large inventories of high-grade collateral which gives rise to the phenomenon known as a "collateral scarcity". However, historically back off domiciled processes are now becoming key drivers of P&L. Sell-side firms can capitalise on the need for transformation and Secured financing services.

Secured finance transactions and post-trade optimisation techniques are fundamental to the provision of an untapped global inventory of high-grade collateral to smaller institutions and buy-side clients, while simultaneously providing sell-side institutions with further profitable business and revenue streams. Therefore, access to high-quality collateral positions via secured finance transactions and post-trade optimisation strategies coupled with competitive edge gained from technological efficiencies, are vital to market liquidity and thus the elimination or easing of the collateral scarcity phenomenon.

Expanding the toolkit

Harris Bock, CEO of Dynamex Trading, Brandon Neer, co-founder of Delta One, and Jason Lefkowitz, Dynamex VP and Delta One co-founder, talk about bringing transparency to the stock lending marketplace and the need to maintain human interaction

Tell us a little about Dynamex.

Jason Lefkowitz: Dynamex is a US-based agency only broker-dealer that specialises in equity, exchange-traded funds and index options trading. Specifically, we specialise in the trading of conversions, the listed options proxy for a stock loan transaction. Our high-touch brokerage services include hard-to-borrow trading, corporate actions, and balance sheet optimisation trades. Our client base is fairly diverse and includes many different types of firms including asset managers, market makers, family offices, agent lenders, prime brokers, and investment banks. Our footprint in the market is significant. A recent analysis of an active corporate action situation showed that we were 18 percent of all volume that traded across every exchange.

As a small firm, we are adaptable to changing market conditions and always at the forefront of innovation while constantly growing and protecting our clients and their trading needs.

Dynamex launched the equity finance marketplace Delta One in July of this year, how has it gone?

Lefkowitz: We have been getting overwhelmingly positive feedback on the platform and the improvement to workflows that it allows. On the first day following our wide release, we had over $3.4 billion worth of conversion and reversal interests in the system available for matching. Our near term goals in driving user engagement that centres around taking feedback from users to add new features to the platform that people find useful and help facilitate the matching of trade interests.

Is it only accessible for Dynamex clients or the whole of the wider market?

Brandon Neer: Delta One is only accessible to Dynamex Clients, but Dynamex deals with clients in every market segment. Beneficial holders, agent lenders, hedge funds, and investment banks are among our clients.

The Dynamex footprint in the industry is substantial and lines up nicely with the target user base for the Delta One platform. The goal from our first day of operation was to create a counterparty-neutral, open and transparent marketplace that would be available to all market players.

Do you see yourself as competing with platforms or complementary? Who are your target users?

Neer: Delta One's goal is to enhance traditional stock loan channels, not replace them. It gives investors access to rates that might not otherwise be available through traditional channels. The modern equity finance landscape is a tapestry of disparate markets that can be used to augment traditional channels for lending equities. Options, repo, swaps and futures can and should be part of every equity finance trader's toolbox to complement direct lending.

The options market is the oldest, and arguably the most complex of these alternatives. It's also by far the biggest. As of 8 October, there was $2.3 trillion notional outstanding in equity options alone in the US; ignoring this market seems crazy to us. Yet in 2019, we think the majority of stock loan players do not have adequate visibility or ability to trade options. Our goal is to change that.

Delta One was created to reduce the complexity of the options market as it pertains to stock loan participants. The platform allows for various levels of options trading knowledge, and the technology was created to help bridge the gap to investors who could benefit from trading borrows through options but might not be comfortable doing so on their own. To that end, Dynamex has the expertise and is willing to lend it to their clients.

As far as target users, Delta One was designed to benefit all levels of the stock loan market, from the small family office that seeks to improve their finance rates to the multinational money centre banks that want to provide their clients access to borrows and rates that might not otherwise be available.

Although we have users all around the world, we are only offering the platform for trading in US markets at this time. However, as we are perfecting the model here, we think the next natural step will be to scale into Europe and then Asia. The demand for transparency and liquidity in securities lending seems universal across the globe.

With balance sheet optimisation so critical in today's market, where does Delta One fit in?

Neer: There are two primary use cases for Delta One: stock lending and balance sheet management. Often the two use cases intersect. We see stock lenders and borrowers pair off regularly against balance sheet managers. Delta One was created to serve that need. People have used options to manage their balance sheet for a long time, but it has never been easy. Delta One assembles all the relevant information, displays it in a user-friendly interface, and allows participants to find matching interests that best suits their needs.

Whereas most systems aim to remove and replace humans, you want a human layer of protection between users and the marketplace, why is this?

Harris Bock: There are a few reasons for this. The first being that many current stock loan market participants do not trade options. Our team has a combined 50 years of experience trading options and we want to make people as comfortable as possible with the product. I think having humans involved with real experience is the only way to do this.

Secondly, existing low-touch matching solutions for these types of trades are fairly unforgiving. A single keystroke error can cause massive, instantaneous losses which is why I think those solutions have failed in the past. We don't see a lot of people that want that type of risk in exchange for faster match to tape executions. The time lag isn't an issue in this type of product. The human layer protects users from making unintentional mistakes.

Lastly, the equity finance marketplace is fragmented across many different instruments. Swaps, futures, options, repo, and direct lending can all be used to accomplish the same thing. The human check helps to prevent against over-executing across different markets. If times change and people seem comfortable removing this aspect of the system, that is something we can change in the future as Delta One evolves.

How do you see the platform developing over the next five years?

Bock: As a start-up, we are extremely nimble in how and where we can develop. Ultimately, we will listen to our users to guide platform development and product mix. Delta One already contains an extremely robust trade repository that includes most every execution relating to securities lending in the options space since the beginning of 2018, but we plan to enhance this to include other asset classes over time.

We have added numerous features to the platform that users requested during our 18-month beta testing period, and continue to take feedback as more users join the platform. Right now we see the most demand in listed options, but we are certainly not restricted from adding other instruments. We will continue to listen to our users and are willing and able to add other products as we see fit, but in our minds, the next logical step would be to incorporate total return swaps. As technology advances in general, we also hope to make enhancements and user interface improvements to improve the workflow even further.

How important is transparency to Delta One's offering?

Bock: The transparency available in Delta One is real-time. We are not a dark pool, all users receive information equally and at the same time. Delta One provides real-time information on actionable trade interests. A client can identify a better rate in the system and act upon it. Paired interests print to exchanges that disseminate trade information in real-time. Both sides of every transaction know exactly how much they are being charged.

Time for take-off?

Perceptions of data and market 'transparency' in the securities finance industry has shifted dramatically over the years from a nice-to-have to essential rocket fuel for space age artificial intelligence and automation technologies

Maddie Saghir reports

In years gone, by the collection of data in the securities finance industry was treated by some with suspicion and as a potential threat to revenue by bringing unwanted price transparency to a market that's value could be linked to its opacity. Nowadays, however, mostly thanks to the rise of new technologies that require huge quantities of data to operate, those previously sceptical of the need for more data have changed their tune.

Growing buy-side demands quantify the their lending/borrowing programmes has in turn brought the sell-side round to the idea that the creation and sharing of data is here to stay. As well as this, people are seeing the art of creating, capturing and utilising data as a top priority as it can open up all kinds of revenue opportunities and empower decision making. The opportunities afforded by increasing the utilisation of relevant data, according to Broadridge's marketing director, securities finance and collateral management, Martin Seagroatt, include trade pricing and electronic market aggregation, global inventory management and collateral optimisation through to post trade analytics. "Clear, centralised data can help traders take advantage of short-lived trading opportunities and allows risk managers to gain a more holistic view of risk," he explains.

Additionally, Kabin George, global head of product management for securities finance at IHS Markit, one of the securities finance industry's major data providers, says that data can be used to measure securities lending performance, comparing a lender or borrower against the market average. It is this comparison against industry peers that many in the industry once wanted to avoid but now the benefits of wider market transparency are being realised. For the individual trader, data transparency leads to more effective control of a lending programme through features such as post-trade benchmarking, as well as the ability to find additional alpha through accurate pricing of securities.

In terms of technology powered by data, Tim Smith, managing director of business and development at Hazeltree, says that data combined with technology solutions can empower market participants to get full transparency into their operations and get better informed decision to get the best-execution financing rates. "As the amounts of and analytics surrounding data increase so too does the requirement to find ways to use that data efficiently and effectively," Smith explains.

Today, increased use of data is being embraced across the entire spectrum of market participants. For example, beneficial owners are looking to benchmark and make effective use of data. Despite securities lending only accounting for a small section of most beneficial owners' investment strategy, a recent beneficial owner survey by DataLend conducted in conjunction with Funds Europe, found that 81 percent of beneficial owners are using securities lending data.

Harvesting the juicy fruit

A significant driver for the increasing demand for data is due to the securities finance desire to embrace artificial intelligence (AI) and machine learning (ML) to automate as much of their day-to-day processes as possible in order to focus on the more lucrative, and complex, trade opportunities; and these tools are insatiably hungry for data in order to operate as required.

Data is the juicy fruit that people want to sink their teeth into but harvesting the whole data field is simply not enough. Firms must utilise data correctly and pick up upon the 'right' data in order to reap the rewards. And while technology can be the key to unlocking success, AI and ML are only as good as the data fed into it.

Beyond the practical restrictions of cost and build-time, the biggest barrier to industry players leveraging these space-age technologies is that market data still suffers from a chronic problem of fragmentation, and a lack of standardisation; which is essential for AIs and ML solutions to process and correctly read the data they are fueled by. Simply, tackling the problem of fragmentation is crucial to harnessing the advantages of data - the data must be the same and it must be correct.

Alexandra Foster, director insurance, wealth management, financial services at BT, emphasises the importance of getting the data right and outlines that first and foremost, all of the different pieces of data must come together to form a single view. "Once that has been achieved, you can then start to use robotic process automation/AI to look for actionable insights from that data. When the data is fragmented, it is very hard to overlay anything on top of that to be able to get insight," she says.

Foster explains how BT is focused on internally mapping out where organisations are taking data from and helping them achieve a consolidated view of this data through BT's Radianz cloud, to try and help firms overcome data fragmentation.

Shiny bells and whistles

Removing data silos across organisations and standardising data across the entire securities lending industry will be a key focus for many market participants going forward. To this end, the International Securities Lending Association has gathered the market's biggest data providers into a working group to tackle the issue. Moreover, incoming regulations such as the Securities Financing Transactions Regulation, which will demand huge quantities of transaction data to be reported from April next year, is also serving to keep people's minds on the task at hand. But, regulatory requirements aside, why should firms on a tight budget, commit itself to an emerging technology that is yet to truly prove its worth? What can AI offer the securities finance market today or in the years ahead?

According to Seagroatt, AI can improve matching algorithms for trading in more illiquid markets and there are areas of front office decision-making where AI could process large volumes of data much quicker than is currently possible.

"These solutions would then enable robot-assisted traders to take advantage of short-lived trading opportunities before the wider market can react," he explains. "A future AI-driven system could also suggest sophisticated integrated transaction combinations to meet trading goals that are more complex than a basic single trade approach. AI can be used in a wide variety of areas and we've seen some announcements around use cases in areas such as trade pricing. There are also applications for predictive analytics to help with settlement fails or reconciliations," he adds.

Over at EquiLend, Nancy Allen, global product owner, DataLend, comments: "ML and AI are very real for us. We are actively working on using ML and AI across the lifecycle of the loan and have recently undergone a proof of concept with clients in our Post-Trade Suite."

From a purely data perspective, Allen explains that EquiLend are working on developing more predictive analytics and have recently brought on board a dedicated data science team.

The pie in the sky

Indeed, the opportunities that can sprout from these technologies are plentiful, but is technology still just the pie in the sky in this respect, and is the broader industry ready for AI and ML?

Some industry experts say that there are simpler solutions have out there for accessing these data opportunities for the short term. George highlights that firms are always looking for solutions to identify unrealised revenue and new opportunities, and while AI and ML are notable buzzwords, they have not yet delivered concrete results.

Mark Steadman European head of product development and change management at DTCC, reinforces this. "We are still in an early adoption phase with a lot of new technologies," he argues.

"Nevertheless, while technologies such as AI and ML hold a lot of promise, proven technology exists today that can enable more efficient and high-quality data processing in the short term."

Broadridge's Seagroatt also notes that a lot of things can be analysed using simple statistical analysis like regression, such as looking into the probability that a trade will fail based on certain characteristics. "AI does not always need to be employed," he explains.

Seagroatt recommends firms to create the fundamental building blocks of their data strategy before trying to launch AI solutions, and explains that without an accurate data model, it is difficult to implement AI solutions.

Seemingly, the ideas of what the technology can do are there but, for securities lending at least, it's the rocket that hasn't really taken off … yet. **SLT**

Growth in S&P 500 lendable assets

Sam Pierson, director at IHS Markit looks at the total lendable value of S&P 500 companies in recent years

There has been notable growth in lendable assets in recent years, with the supply generally exceeding borrow demand growth. The outpacing of demand growth has in turn pushed down on utilisation and return to lendable for beneficial owners. We have broken the growth in S&P 500 lendable assets by increases in market value and increases in shares being added to lending programmes.

Total lendable value across S&P 500 firms has grown from $2.3 trillion to $7.5 trillion since the start of 2010. To determine the contribution of share price appreciation relative to shares being added to lending programmes we compare the constituent level change in shares at the current price with the change in price at the initial number of shares (see Figure 1).

We'll use Microsoft Corporation (MSFT) as an example of the process for decomposing the source of lendable asset growth. At the start of 2010, there were 1.8 billion MSFT shares reported as lendable assets, which increased to 2.1 billion shares at the end of Q3 2019. That 239 million increase in lendable shares represents $33 billion at present, i.e. the contribution to current lendable value from the addition of new shares to lending programmes. Looking at the impact of appreciation, the 1.8 billion shares already in lending programmes at the start of 2010 were worth $56 billion at the time. After the 356 percent appreciation through the end of September, the value of those shares increased by $200 billion, reflecting the contribution to current lendable value from appreciation. Putting the pieces together, the value of MSFT shares in lending programmes has increased by $233 billion since the start of 2010. Moreover, a 86 percent of the increase ($200 billion) came from appreciation while 14 percent of the increase ($33 billion) was the result of shares being added to lending programmes (see Figure 2).

Looking at the constituent level there is a wide distribution of the lendable growth ratio. For example, Verizon only had 31 percent of the increase in lendable value as the result of share price appreciation, with the shares in lending programmes more than doubling while the share price only increased by 82 percent. In contrast, General Electric saw a $13 billion decline in lendable assets since the start of 2010, with a $14.5 billion decline owing to share price decline set against a $1.4 billion increase resulting from shares being added to lending programmes.

Aggregating up to the index level we see total S&P 500 assets increased by $5.3 trillion since the start of 2010, with 75 percent ($4 trillion) coming as the result of appreciation of assets already in lending programmes at the start of 2010, while 25 percent ($1.3 trillion) was the result of shares being added to lending programmes. There are many drivers of the increase in lendable assets, from lenders who had dropped out in the immediate aftermath of the 2008 financial crisis, to those who had never lent considering the practice for the first time. In the US there has been the suggestion that the '40 Act lending disclosures have spurred new interest in lending assets, given the increased visibility of revenues to non-participants. There are also broader applications of the product in risk, collateral and funding for beneficial owners which have also introduced new supply to the market. While the marginal decision to lend has an impact on aggregate supply, the larger force over the last decade has been share price appreciation.

If the drivers of increasing lendable remain in place it is fair to assume there will be further increases in the fee for hard-to-borrow shares. With utilisation and return to lendable assets falling, increasing fees where possible is the available offset for lenders. For the S&P 500, utilisation of lendable assets has decreased by 45 percent since the start of 2010.

Figure 1

S&P 500 constituent lendable & SPY price

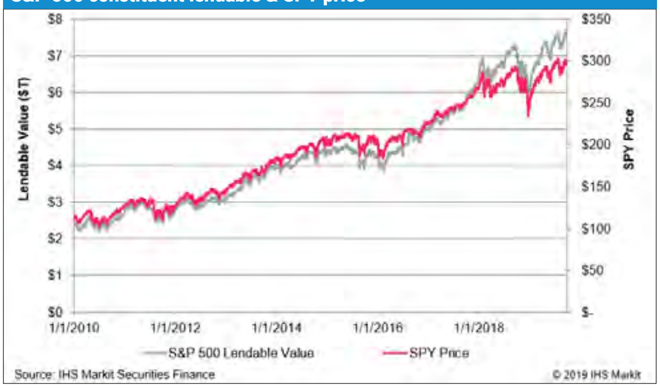

Figure 2

Microsoft shares in lending programs & share price

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Comings and goings at Deutsche Boerse, EquiLend and more

Deutsche Boerse's Marcel Naas and Marcus Addison have taken on new responsibilities for the build and launch of the exchange's new buy-in agent service that is billed to solve the requirements of the in-coming Central Securities Depositories Regulation (CSDR).

Naas has headed Eurex Repo since 2001, but will now move to the management board of the recently founded Eurex Securities Transactions Services, which will host the buy-in service once it launches in the second half of 2020.

Naas is joined in establishing the company by Addison, who previously served as head of default-management at Eurex Clearing.

According to Eurex, the buy-in agent service will offer market participants an automated and standardised solution to meet the settlement discipline rules of CSDR that enter force on 14 September 2020.

The new regulation on settlement discipline for securities trading transactions obliges the buyer in a securities transaction to initiate a buy-in process against the seller should the settlement fail.

Elsewhere, Matthias Graulich will take over Naas' leadership role at Eurex Repo, which he will now manage alongside Frank Gast, who has served as Eurex Repo's head of funding and financing since 2013.

Zirpolo leaves EquiLend

Rory Zirpolo has left his role as a consultant at EquiLend.

Zirpolo joined the trading and post-trade services provider in May 2018 and was based in its New York office. Prior to EquiLend, Zirpolo was managing director at WallachBeth Capital, a US provider of institutional execution services, for just under a year. He also held roles as managing director and COO for securities lending at Cantor Fitzgerald from 2015 to 2017 and as global head of equity finance for Cowen Group between 2012 and 2015.

Before that, Zirpolo spent just under 20 years at Credit Suisse, which he joined in 1991 as managing director. While at the bank, Zirpolo also spent four years as a board member for EquiLend with responsibility for equity trading post-trade processing for securities lending.

Commenting on his market experience, Zirpolo said that his time as a consultant for EquiLend, along with his fintech, buy- and sell-side knowledge, means that he has been able to identify "tremendous opportunities to increase revenues while simultaneously reducing expenses".

Zirpolo confirmed he is currently seeking new opportunities in the securities finance space and is currently in discussions with several sell-side firms and fintechs.

Former Societe Generale managing director, Thomas Kaczan, has joined Velocity Capital's securities lending trading team after taking a year out of the securities finance industry.

Velocity Capital provides securities lending services to institutions worldwide.

Kaczan, who has worked in various roles in the industry since 1993 and is based in New York, temporarily departed the industry last year after working as an investment adviser representative at Caserta & de Jongh, between 2017 and 2018.

Prior to Caserta & de Jongh, Kaczan worked as a managing director tri-head of US EFI trading at Societe Generale for just over eight years. Before that, he was a vice president senior equity trader at Santander Bank for four years.

Between 1999 and 2003, Kaczan worked as a senior associate in equity financing services in the middle office and before this, from 1993 and 1999, he was the associate of equity financing services trading at Morgan Stanley.