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Warning: Change ahead

Industry experts break down the US market's challenges andopportunities for the year ahead

MUFG Evolves

The Japanese bank wants to become the preeminent Asian bank in the global securities financing market

US Repo

After much-unwanted drama last year, can the US repo market resolve its issues and stay out of the spotlight in 2020?

Data Analysis

IHS Markit reviews the data behind cannabis-related equities' meteoric rise to prominence for short sellers

Deutsche Bank unveils new securities lending team

Deutsche Bank has named its new Securities Services and Agency Securities Lending team, with Rebekah Flohr stepping up to become the bank's first female global head of agency securities lending.

Flohr, who is based in New York, will take on her new role in addition to her existing roles managing global sales and securities services in the Americas.

In a memo to staff, seen by SLT, says Michaela Ludbrook, global head of Securities Services and America's head of corporate banking said Flohr "will be instrumental in driving the next generation of agency securities lending product and cross-divisional solutions".

Flohr joined the German bank in her lead sales role in 2012 from J.P. Morgan.

"With the skillful and capable team we have in place, I feel great about achieving continued performance for our clients as well as shaping enhanced delivery and client experience going forward," Flohr says.

Flohr fills the gap left by Tim Smollen, who left to join MUFG in a similar capacity, along with two other senior members of Deutsche Bank agency lending team.

Elsewhere, Steven Hondelink will join Deutsche Bank's corporate arm to become head of securities services and agency lending for Europe, the Middle East and Africa (EMEA).

His new titles come in addition to his current duties at the bank's head of capital release group (CRG) for Germany.

Hondelink has 25 years of industry experience and, since joining Deutsche Bank in 2001, has held various senior positions in global equities and the CRG. According to Deutsche Bank, Hondelink, who is based in Frankfurt, will focus on the strategic positioning of the business in EMEA.

The memo also confirmed that Iain Macara and Peter Liberatore have been appointed COOs for the securities services business.

Macara will focus on strategy, governance and client analytics, while Liberatore will be responsible for resource management and administration.

Those taking on new roles will all also join the bank's Securities Services and Agency Securities Lending executive council.

Flohr and Hondelink will report to Ludbrook, while Macara and Liberatore will report to Paul Maley, head of Corporate Bank (UK and Ireland).

Inside this issue

Latest News
Trade bodies unite to call for CSDR buy-in delay 6

Malik's Memo
The state of EU shadow banking 18

Programme Overhaul
New horizons 20
MUFG is set to build out its global securities financing programme

US Panel
Warning: Change ahead 24
Industry experts offer a run-down of everything to be cognisant of in the US market for 2020

Equity Collateral
Changes to Rule 15c3-3 36
J.P. Morgan offers a glimpse into triparty adoption for non-cash collateral in US agency securities lending

Future Proofing
Everything is not awesome 40
After much-unwanted drama last year, can the US repo market stay out of the spotlight in 2020?

Responsible Investing
Going green 42
Broadridge investigates the practical implications of ESG for securities finance and collateral management

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Trade bodies unite to call for CSDR buy-in delay

The European Commission is expected to respond imminently to a joint letter sent by 14 trade associations regarding their major concerns around the impact of the Central Securities Depositories Regulation's (CSDR) settlement discipline regime, which is due to enter force in September.

The letter, which was signed by ISLA, ICMA and AFME, along with other trade bodies representing the European banking and financial communities, was sent on 22 January but the commission has been unable to respond until after the European Securities and Markets Authority's (ESMA) board of supervisors meeting on the 29 January.

The associations' aim was to highlight the scale of unease coming from affected parties that CSDR's mandatory buy-in regime and cash penalties for settlement fails will significantly damage market liquidity and stability.

"We [the associations] are extremely concerned that if the buy-in regime is implemented as it stands, there will be a significant negative impact on market liquidity, operational processes, and ultimately, end investors," the letter reads.

The associations also highlighted a lack of detailed technical specifications available to market participants, which is presenting significant challenges to those building solutions to meet the current timetable.

Other signatories include: the Association Française des Professionnels des Titres; the Association of Global Custodians; the Association française des marchés financiers; Assogestioni; Assosim; the German Investment Funds Association (BVI); the European Banking Federation; the Electronic Debt Markets Association; and Dutch Advisory Committee Securities Industry.

What are the concerns?

Although the letter opens with the associations reinforcing their support for the EU's mission to improve settlement efficiency and the introduction of a penalty regime, several issues were raised regarding CSDR's current model for achieving these aims.

The letter warns that the costs for in-scope market participants that will come directly or indirectly from the settlement regime's have not been satisfactorily modelled by ESMA or the commission and not enough time has been taken to ensure the market is comfortable and ready for the framework to be implemented.

Elsewhere, the letter's key concern relates to the buy-in feature. The associations note that although buy-in rules already exist in the clearing space, the mandatory nature of CSDR's version for over-the-counter trades sets it apart and potentially makes it not fit-for-purpose.

The letter explains that the primary issue is that this creates an asymmetrical dynamic between counterparties that could see potentially uncapped costs for the failing party, as well as other affected parties in the settlement process.

What do they want?

The letter includes a comprehensive list of reforms that the associations say must be made in order to avoid major market upheaval in September. It includes:

A delay to the mandatory buy-in regime until the effects of penalties and other measures to promote settlement efficiency are implemented, as well as an in-depth impact analysis is undertaken on the potential effects of a mandatory buy-in.

Moreover, the mandatory nature of the buy-in should be amended to become an optional right of the receiving trading party, underpinned by law, to allow a buy-in of a non-delivering counterparty.

Additionally, the asymmetrical issues relating to buy-in costs should be amended so that each party is restored to its original position. The topic of cash compensation should be thoroughly reassessed.

For cash penalties, the associations ask for fines to only be introduced once market infrastructures, banks and their clients have built the technology required to process them, and not before the market has had an opportunity to test the required new messaging and technology.

The letter adds that regulators should consider conducting a ‘live testing’ period, in which penalties are calculated and reported but not charged to participants, should be considered to ensure a successful implementation of the penalty regime.

Finally, the associations say they would welcome a monitoring process to measure the impact of the penalty regime on settlement efficiency going forward.

To support their requests, the associations refer to the “extensive consultation process and market engagement” ESMA undertook ahead of the post-trade transparency framework of the Markets in Financial Instruments Directive and encouraged a similar approach to be taken now.

Where’s the evidence?

To back up their claims, the associations’ letter leans on market research conducted by the International Captial Market Association (ICMA) in 2019 which showed that, with respect to bond markets, 100 percent of sell-side responders and 80 percent of buy-side responders expect mandatory buy-ins to negatively impact overall efficiency and liquidity.

Moreover, the impact study shows that market makers expect to widen bid-ask spreads by at least 100 percent, with a greater impact expected on illiquid asset classes, and full withdrawal from market making in some instances.

Elsewhere, traditional lenders are expected to hold more buffers, or even withdraw inventory, thus limiting liquidity for short covers. Finally, ICMA’s study included a comment from sell-side practitioners stating that “there will be no choice but to widen pricing in the High Yield and illiquid spaces to the detriment of investors”.

What next?

Many of the concerns raised in the letter have already been highlighted repeatedly by the associations and their members. But, the significance of such a comprehensive collaboration by industry bodies is the major step forward in gaining the regulators’ attention towards this problem.

The commission itself acknowledged that a delay was all but certain, for an entirely unrelated reason, as far back as November last year.

Although the commission is yet to publically confirm the delay, SLT understands that technical updates are required for the buy-in regime that will not come until SWIFT’s regular November update, meaning a delay of at least a month is already widely expected.

The letter did not offer a fixed alternative timetable but did reference the need for a push-back until at least November as a starting point for negotiations if they are offered by the commission and ESMA.

LCH wades into CSDR buy-in delay debate

Global clearing house LCH is the latest market participant to acknowledge the likelihood of a delay to the Central Securities Depositories Regulation’s (CSDR) settlement regime, currently due to go live on 13 September.

CSDR aims to improve settlement discipline by the imposition of daily financial penalties for failed settlements and mandatory buy-in provisions.

In a recent whitepaper on the incoming regulation, LCH notes that full implementation of the settlement discipline regime is “widely expected to occur once modifications to the TARGET2-Securities settlement system run by the European Central Bank are tested and complete”.

The clearing house explains that these amendments are necessary to enable the financial penalties introduced by the settlement discipline regime to be processed. According to LCH, a further extension, to early 2021, has been proposed, although the European Commission is yet to publicly comment on the matter.

For the securities finance market, the costs and challenges of CSDR will likely come indirectly, as short-dated (less than 30 days) transactions, such as repos, are excluded from buy-ins.

However, securities financing transactions without a fixed maturity date may not be exempt from the settlement discipline regime in the same way as repo transactions of less than 30 days in duration are.

In its whitepaper, LCH states that two consequences that may come from the settlement regime are that asset owners and their agent lenders may be less willing to lend securities, raising the cost of borrowing stock to cover short sales and settlements.

Additionally, the risks of short selling are increased by a lack of supply of securities available to borrow, greater recall risk and an increased possibility of being bought in. LCH also notes that, on the flip side, the risk of being bought in might increase demand to borrow securities to avoid settlement fails. The clearing house's comments on focus largely on the technical requirements for a delay which were highlighted last year by the International Capital Market Association (ICMA), among others.

Other market observers have raised several concerns around what has been described as fundamental flaws with the mandatory nature of the buy-in rules and lack of research around the impact of cash penalties.

The buy-in rules are expected to significantly increase the number of buy-ins instigated in the market, with an analysis by the European Central Securities Depositories Association using 2014 data from 11 European CSDs estimating as many as 1.8 million buy-ins a year, worth more than €2.5 trillion, could be seen.

Commenting on the research, LCH says that "while the actual outcome is unlikely to be as high as this, since market participants will adjust their behaviour, as is the intent of the settlement discipline regime, a significant increase from present levels of buy-ins is almost certain".

J.P. Morgan becomes Eurex GC Pooling's first balance sheet netting pilot

J.P. Morgan has stepped up to be the first pilot client for a new balance sheet netting tool offered through Eurex GC Pooling, a joint offering from Eurex Repo and Clearstream.

GC Pooling is a highly-liquid market for secured funding and offers the possibility of reusing received collateral for further money market transactions.

Balance sheet netting allows market participants to offset certain securities finance transactions against one another and, as such, is an important way to reduce balance sheet consumption.

In a statement on the project, Deutsche Boerse, which owns Eurex and Clearstream, says onboarding the US' largest bank marks a major step in rolling out of additional balance sheet netting opportunities between the GC Pooling and Repo (general collateral and special) market for Eurex Repo clients.


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A spokesperson for Deutsche Boerse confirms to SLT that J.P. Morgan is currently the only pilot, but the German exchange is in talks with five other "major clients" about on-boarding in the coming weeks and months.

J.P. Morgan is one of the Eurex Partnership Program design partners and member of the new Repo Board Advisory Committee, which had its first meeting in November 2019.

Lav Lukic, global head of rates repo trading at J.P. Morgan, says: "The established volumes of GC Pooling, when combined with the possibility of more efficient netting, should be a positive driver on the overall repo specials market volumes on the Eurex platform."

Lukic adds that the new tool closes the loop on the ability to net balance sheet between GC Pooling and specials.

Frank Gast, managing director at Eurex repo and head of sales Europe – fixed income, funding and financing, notes: "We greatly appreciate J.P. Morgan's support for initiatives such as our Partnership Program and onboarding them as a client for Eurex GC Pooling with balance sheet netting is just the latest successful cooperation between us.

"Together with Clearstream, we are looking forward to onboarding and setting up more clients on this service in the coming weeks."

Elsewhere, Eurex GC Pooling, which first launched in 2005, recorded its third consecutive month of double-digit volumes growth in its GC Pooling in December 2019.

In 2019 as a whole compared to the year before, GC Pooling's average outstanding volumes rose 20.5 percent to €44.6 billion, while the Repo Market average volumes rose 1.8 percent to €57.1 billion.

Wematch unveils ETF matching protocol

Wematch has launched a matching protocol dedicated to securities lending on exchange-traded funds (ETF).

Wematch is a global multi-asset-class, web-based matching and negotiation platform that aims to provide software-as-a-service technology to transform how traders match, negotiate and manage trades.

The new feature is addressing the complexity of the European ETF market, where one single international securities identification number can be associated with multiple stock exchange daily official list and can be custodied in multiple locations.

Wematch aims to provide lenders and borrowers with the most granular information as soon as the match is identified and will help them in their decision-making process before confirming any trade, with a view to optimise the workflow and to minimise all settlement risks and costs.

The new product, Wematch says, is in response to its clients' demands for more efficient ways to manage risks and streamlining their trading processes across this asset class.

The Wematch platform was first launched in 2017 by David Raccat and his team as a platform aimed at disrupting the dealing process of securities financing markets. It has steadily built out its offering since then with new products and senior hires, as well as becoming available in new markets.

Elsewhere, Wematch has also secured a number of key partnerships in the securities finance market, including with Pirum Systems and J.P. Morgan.

Clearstream's CSD gains CSDR licence

Clearstream Banking, the German central securities depository, has been granted a licence to operate under the Central Securities Depositories Regulation (CSDR) by the German market regulator.

The German Federal Financial Services Authority (BaFin) authorised the licence to the Deutsche Boerse subsidiary, effective as of 21 January, pursuant to

article 16 of CSDR, which covers EU-based CSDs.

Mathias Papenfuss, head of regulatory implementation at Clearstream, commented: “Receiving this licence is an important achievement; it is proof of our continuous efforts to ensure that we are in the best position to support the safety and stability of financial markets and offer services aligned with European standards to all market participants.”

CSDR aims to increase the safety and efficiency of securities settlement across the EU and to establish an enhanced level playing field among CSDs.

The regulation primarily aims to improve settlement rates via the implementation of mandatory buy-in rules and cash penalties for fails.

CSDR’s settlement discipline rules are currently officially slated to come into force in September but ESMA has acknowledged a delay is likely as there are fundamental technical issues with its implementation that won’t be addressed until SWIFT’s annual November update.

Deutsche Bundesbank and Deutsche Boerse back collateral management DLT

Deutsche Bundesbank and Deutsche Boerse have presented the results of a joint study on the use of distributed ledger technology (DLT) for collateral management, which outlines opportunities for cost-cutting and increased asset mobility.

Using DLT for collateral management purposes can provide significant additional opportunities to improve collateral optimisation and overcoming existing process deficiencies, the entites’ report states.

The study is based upon two joint research projects on securities settlement on DLT, known as project BLOCKBASTER. According to the report, the two prototypes support the settlement of securities transactions, payments, interest payments and redemptions.

“Even though considerable challenges exist, DLT has the potential to significantly change the current post-trade environment,” the report states.

“Using DLT for collateral management has important advantages for the collateral taker and the collateral giver as the underlying operating model no longer requires securities to be moved across custodians, thus enabling 24/7 availability of collateral and improving collateral fluidity.”

The report goes on to argue that the main challenge lies in designing DLT solutions which fit seamlessly in the current regulatory, process and system landscape and provide instant benefits for market participants. This is largely due to the fact that most market participants are unlikely to abandon the existing post-trade infrastructure in favour of a DLT solution.

“From the perspective of the Deutsche Bundesbank, collateral management is fundamentally important for the operational management of monetary policy. DLT-based solutions for collateral management have the potential to increase efficiency in this area by improving the availability of collateral,” says Burkhard Balz, executive board member at the Deutsche Bundesbank.

Based on the positive initial results, both entities have confirmed they will be continuing their venture in researching the capabilities offered by securities settlement based on DLT technology.

SEC approves OCC capital management policy

The Options Clearing Corporation (OCC) has been given the green light for its capital management policy from the US Securities and Exchange Commission (US SEC).

The core elements of the Chicago-based equity derivatives clearinghouse’s policy provide OCC’s approach to determining clearing fees inclusive of an operating margin based on the variance in daily volume.

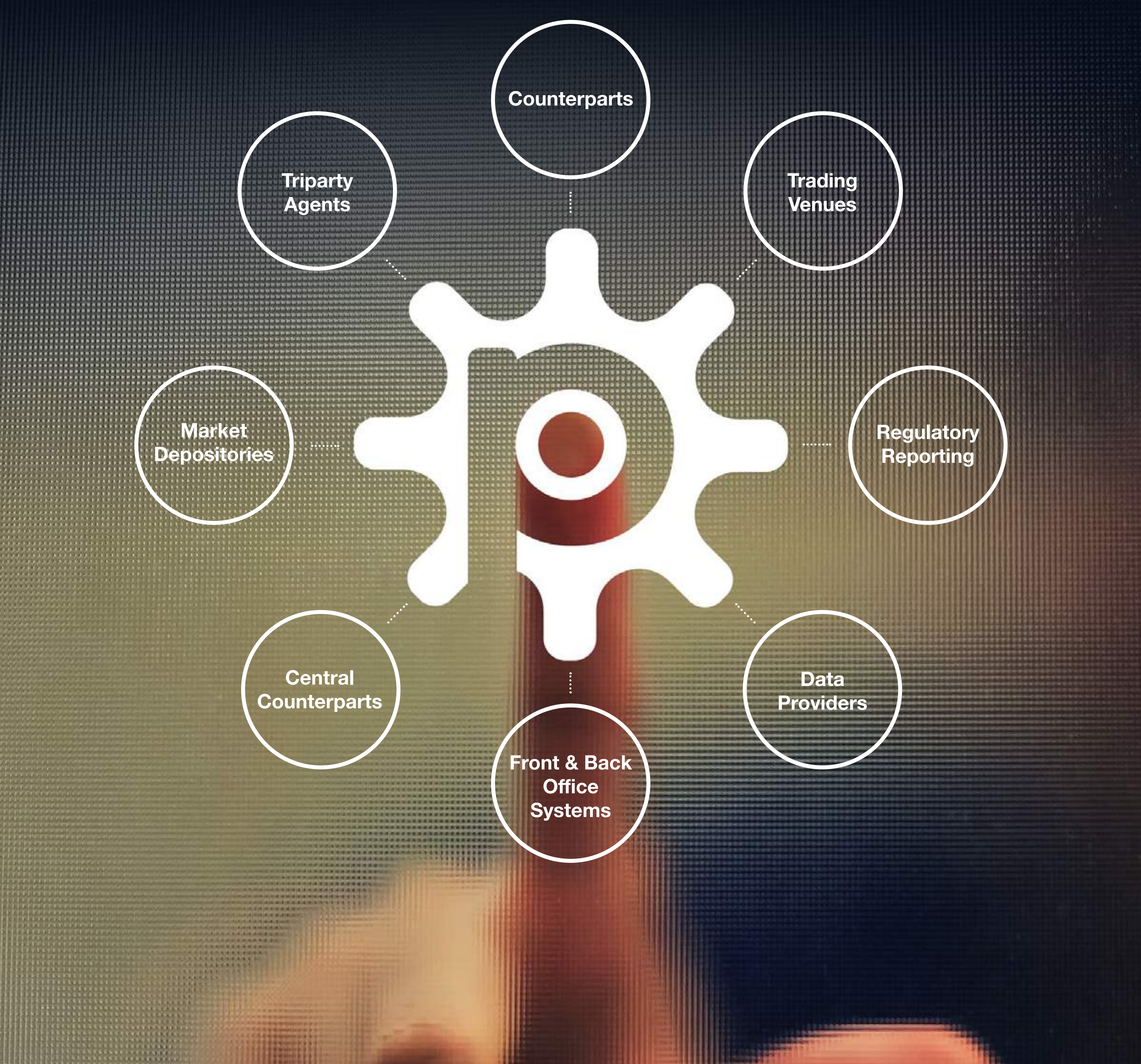
It also identifies the considerations made in determining OCC’s level of target capital on an annual basis and to monitor its capital levels to identify whether capital has fallen or is in danger of falling.

If this were to be the case, the policy also includes a contingency plan of replenishing additional capital if it falls below defined thresholds.

According to Craig Donohue, OCC’s executive chairman, the capitalisation will help to “increase market transparency, and provide capital and operational efficiencies for the participants in the US exchange-listed options, futures and securities lending markets.”

In the event of a clearing member default, OCC explains, the amount of equity capital above 110 percent of the target capital requirement will be available to offset the loss after utilising the margin and clearing fund contributions of the default clearing member.

OCC’s chief operating officer Scot Warren thanked clearing members for their feedback during the approvals process.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State of EU Shadow Banking

The Financial Stability Board (FSB) recently released its annual report on the global shadow banking sector (or Non-Bank Financial Intermediation (NBFI) as it now prefers to call it). The report covers data up to end-2018 from 29 jurisdictions, which together represent over 80 percent of global GDP.

The risk posed by the shadow banking sector is what the Securities Financing Transactions Regulation (SFTR) seeks to understand in granular detail via daily transaction reporting: "…the crisis has also highlighted the need to improve transparency and monitoring not only in the traditional banking sector but also in areas where bank-like credit intermediation known as 'shadow banking', takes place, the scale of which is alarming, having already been estimated to amount to close to half of the regulated banking system".

The industry is sparing no effort to meet the April 2020 go-live date. Many firms both privately and publicly in consultations have criticised SFTR, seeing it as an unnecessary burden in times where profit margins are already razor-thin. This report thus serves as a timely reminder of the relevance and necessity of the SFTR package of measures. it is worth taking a step back and considering the current state of NBFI.

Data shows that lending by other financial intermediaries (OFIs) continued to grow, increasing by 3 percent in 2018, largely in the euro area and largely comprising fixed income funds. In comparison, bank loans grew by 5.9 percent. On the key measure of interconnectedness between banks and OFIs, the level remained largely unchanged since 2016, after declining from its 2009 levels.

NBFIs grew by 1.7 percent to $50.9 trillion, representing 13.6 percent of total global financial assets, although the rate of growth is slowing. A sector that represents 13.6 percent of total global financial assets which is not subject to banking capital and liquidity requirements can only be a major concern and in need of much-needed transparency.

I have long cautioned market participants that SFTR is but a regime to bring about transparency. Depending on what subsequent data analysis reveals, mitigating steps and changes could come.

Recent innovations in NBFI

Of the 26 jurisdictions that replied to the FSB, 23 reported peer-to-peer (P2P) lending as a major growth area. Securities Lending Times reported on State Street's P2P lending system on 29 October last year. Collateralised loan obligations exist and nine jurisdictions reported some involvement of NBFI (investment funds, SPVs, pension funds and insurers) in leveraged loan markets.

The other innovations were crowdfunding to raise mortgage down payments. To this effect, amendments are forthcoming to bring crowdfunding into the second Markets in Financial Instruments Directive. Finally, five jurisdictions reported crypto-asset based lending.

The stand out innovation in the report was "one jurisdiction mentioned the licensing of a Securities Token Offering (STO). The offering was for the issuance of unsecuritised qualified subordinated token-based bonds with a maximum total nominal amount of €100 million and a term of June 2029."

Lessons from the report

The report is heavy on data and charts but the take-away message appears to be a stabilisation in assets and interconnectedness of the shadow banking sector with the formal banking sector. The rapid growth in the former in the post-financial crisis seems to be over, yet the levels of interconnectedness and absolute values of assets remain dangerously high.

In the coming years, regulators will gain a detailed insight into credit intermediation within the European Union (and the UK which is implementing a UK SFTR post Brexit). This data will reveal whether there are concentrated lines of credit and the danger, if any, that these pose.

If nothing else, this report highlights the backdrop and rationale for SFTR. What remains to be seen is when and if the remaining FSB/G20 countries implement FSB recommendations in their own versions of SFTR. Only then will the FSB have truly accurate aggregations.The US Treasury Department's Office of Financial Research has signalled its desire to collect data from the US repo market but so far nothing approaches the scale and ambition of its European counterpart.

New horizons

Tim Smollen
Global head securities lending solutions
MUFG Investor Services

Dan McNamara
Chief strategy officer
MUFG Investor Services

MUFG has set itself the mission of becoming the preeminent Asian bank in the global securities financing market. It has begun with a series of senior hires and plans for a brand new technology framework to reinforce its global growth plans. Drew Nicol reports

This year, MUFG Investor Services declared its aim is to focus on building out its securities lending offering. Why now and what are you looking to achieve?

Dan McNamara: MUFG Group has put a huge focus on its investor services franchise in recent years and there's a genuine commitment to growing this area. We've already seen it in our fund administration and fund financing solutions and we see the enhancement of our securities lending proposition as a continuation of that mission. Clients and the industry know that MUFG is committed to this space, we have a longer investment and commitment horizon than many other banks, so a move like this has resonated with the market.

We are the fifth-largest bank in the world by balance sheet, we have a stable brand and we see agency securities lending sitting very well alongside our portfolio of products. You could say we were a little underweight in this area even though we have been here for 20 years, but now it is an area where we can grow dramatically.

We are making this move at a point in time where a lot of regulatory change has been introduced and bedded down; yes changes will continue but we are in a prime position to build a platform for the future that already incorporates many of the post-crisis regulatory requirements in its core DNA. In this sense it's the perfect time to re-start with our new programme.

What opportunities are you looking to leverage to jump-start your new lending offering?

McNamara: First of all, we're really excited about the team we have built, including Tim Smollen as the global head of securities lending solutions. This is a team that has a lot of experience with managing clients who have large portfolios and expect a very high-end service in terms of the provision of necessary information, transparency, data and adapting to regulations and clients' changing needs.

We also believe that buy-side clients are looking for another option in this market and we see a space for another truly global programme, especially one run by an Asian bank. The actors in the industry we've spoken to are very interested in what we've showcased so far and given the current market environment we see now as the right time to do this.

Tim Smollen: The new regulatory environment also creates opportunities and not every programme out there can take advantage of that. We look to be nimble and responsive to changing market dynamics.

Crucially, we are not going to be a programme that's struggling with what to do with general collateral. That said, we want to be selective in our marketing and work with clients where we can offer value and something they aren't getting elsewhere.

Where are you starting on this mission? How will the new global programme be structured and where is your team based?

Smollen: So far we have Jay Schreyer, based in London, who will focus on Europe, the Middle East and Africa, along with Asia Pacific.

Additionally, we now have Anthony Toscano, in New York, who is responsible for building out the business in North America.

Both these gentlemen have experience in working with custodial and non-custodial programmes. They are both traders and risk managers, and client-focused as well, so they have the perfect skill set for our new model.

This is a global business and our clients need and demand continuity when interacting with each of our desks, so the fact that Jay and Tony have worked together before and understand each other is going to be critical.

McNamara: Asia is obviously an important market for us as well and we plan to set up a desk there the future. In the meantime, we will continue to engage with Asian clients, but it's just a matter of building that physical presence.

We are satisfied with the team we have right now and we're not planning any further hires for the moment. We have very high expectations for how this business will grow in the coming years and we will take on new hires to support that as needed.

Becoming arguably the first Asian bank to take a leading role in this space would be a major accolade, Tim, is that what drew you and your team's attention to MUFG?

Smollen: Yes. We love a challenge and we love to build. This business requires long-term commitment and not every bank out there is ready to do that – MUFG is. When I get a client I expect them to be with me for 10 to 20 years, and that's our goal. There's also obviously something to be said for working with the fifth-largest bank in the world. We have a strong capital base and a great credit rating and that resonates with clients. I could build the best mousetrap in the world, but, in the end, clients buy the bank, so it's important to have that rock-solid foundation.

The world's best mouse trap will require some heavyweight technology to back it up. Can we expect to see some investment in this area for MUFG Investor Services?

McNamara: Technology is at the core of our proposition. Our wider investor services franchise made some acquisitions in 2019. These include Point Nine, a post-trade start-up now re-branded as MUFG Investor Services FinTech, and certain divisions of the fund administration business of Maitland, a global advisory, administration and family office firm.

We've done this because we need to own and develop our key technology functions, such as client interface and data management and analytics to continue being a provider of choice.

The acceleration of our agency lending programme will follow a similar strategy. We will take inputs and feeds from market data sources and leverage some other in-house data systems but it will always be in a way that fits within our existing ecosystems. Tim and the team have always been major users of data and data analytics and so our aim now is to take that to the next level. You'll hear more about all this in the next six to 12 months.

In terms of our in-house builds, we have an opportunity to focus on new market trends such as environmental, social and corporate governance, which we know our clients care about and work with them during the process to know what they needed.

Speaking of clients, where are you going first in search of new lending clients?

Smollen: Primarily, we are hoping to tap into additional supply in Japan by offering a new programme which helps those clients get more comfortable. A number of large clients already lend—and have for years—but most really limit what they do and others have remained on the sideline for years.

Elsewhere, we also fully expect to win business from clients who are already with other lending agents by offering a better option.

We are looking for clients that have large, global portfolios that are diversified across asset types. In turn, we are avoiding clients that only have large general collateral holdings such as corporate bonds or only UK stocks. In terms of clients, generally we are looking to partner with asset gathers. Not surprisingly, that means asset managers and sovereign wealth funds that are chasing yields and own assets that tend to be more attractive in the securities lending markets.

MUFG also has a long history of working with central banks and even though the asset classes they tend to buy are not always the most exciting we can always find value in high-quality liquid assets such as US, German and French government bonds.

Clients who come to us tend to be the ones who want information, who want to be engaged with our traders and our desks on a regular basis.

They are looking for more than a behind-the-scenes programme that generates some alpha and covers costs – they want a proactive management tool where they can find innovation.

And what feedback have you got from the borrowers?

Smollen: It's actually from the borrowers that we've seen the most excitement so far because they have their own challenges and we're solutions-oriented. We have worked with counterparts on capital and regulatory solutions for many years and we've had great feedback when they've heard our plans to expand our service for both sides of the trade.

This year's Pan Asian Securities Lending Association conference is in Tokyo and we're viewing that as our coming-out party. We know borrowers that will be attending that are especially keen to hear more about what we have planned.

Are you concerned by the fact that the biggest Japanese lender partially pulled out of the market last year?

Smollen: If a client like Japan's Government Pension Investment Fund was in our programme, I am pretty confident that we would have been able to build a solution to meet their needs and keep them lending. And that's one of the opportunities we are looking to tap into. Those big, sophisticated investors that need and crave more transparency and information, and a more client-focused service that we can provide. I was disappointed to read about the fund's decision but I also see it as an opportunity.

It's undeniable that Asia is the future. There are huge opportunities there and we will be ready to take advantage of them.

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Warning: Change ahead

Industry experts offer a run-down of everything to be cognisant of in the US market for 2020, from fixing the repo market and possible collateral rule changes, to revenue predictions and much more

The US repo market caused waves in September 2019 when a range of issues coalesced to cause a significant rate spike over quarter-end that required a major (and on-going) intervention by the Fed to stabilise things. How did year-end compare?

Joseph Santoro: Compared to the 17 September rate spike, year-end turned out to be a non-event. The combination of the US Federal Reserve's temporary market operations (overnight and term repos) and outright treasury bill purchases to replenish bank reserves smoothed the repo market to an extent that overnight roll rates were only around 10 to 15 basis points above the overnight bank funding rate.

Joseph Gillingwater: Year-end in the repo market was well managed. The Fed's actions throughout the quarter, and the eventual year-end market utilisation of $256 billion in Fed repo, along with the Fed's bill purchases totaling $158 billion, appeared to succeed as the market saw only a small bump in repo rates at year end. However, structural concerns about adequate reserves in the system remain an ongoing issue.

Securities lending markets also did not show meaningful signs of stress at year-end. The concern is that market events put upward pressure on rebates, resulting in downward pressure on the overall spreads. With respect to lending rebates, year-end increases were well contained. In early December, secured financing rates rose sharply, trading at 4 percent for year-end, from normal day-to-day market levels of 1.60 percent. That was short lived, however, as the Fed's liquidity injections were increased through the month, even leading to undersubscribed repo operations towards the end of the month. In the end, on 31 December, there was only a minimal increase from normal day-to-day market levels, which was a positive to clients versus had there been a larger increase. This sequence of events largely played out how Northern Trust had expected, and our positioning of the portfolio with a focus on normal year-end liquidity needs, in addition to our focus on high quality investments, worked well in conjunction with our structure of securities on loan.

Michael McAuley: The Fed's operations at year-end produced an orderly funding market to close out 2019. Markets remained calm and traded near the Fed target range. There was some interesting forward market activity but that could have been driven by dealers working client orders or others looking to lock in funding with banks happy to invest at those higher levels.

Michael Saunders: Despite the temporary dislocation in the US treasury financing markets in mid-September, the Fed's intervention proved impactful. The reaction from the Fed through a combination of open market operations (OMO), term market operations (TMO) and US treasury bill purchases assisted in formulating an orderly financing market over the year-end turn. Of course, financing rates were elevated, which is typical as the market adjusted for the critically important reporting date of year-end, but nothing substantial relative to the period in mid-September. Certainly, the aggregate amount of approximately $400 billion in liquidity offered through both OMO and TMO facilities, combined with the announcement of $60 billion of US treasury bill purchases per month through April, provided the stability market participants desperately needed to engage in financing positions.

Panel participants

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Market participants have been suggesting a permanent, formal validation of a standing repo facility for quite some time

While there remains a difference of opinion as to the cause of the repo-spike, it can be confirmed that mid-September was not the first time coupon settlement, quarter-end and coupon refunding settlement coincided. The Fed should be applauded for their swift actions in restoring liquidity and stability. Their efforts removed a substantial amount of trepidation and nervousness heading into year-end. Further assisting the normalisation was the deleveraging of agent lenders – meaning those able to unwind US treasury financing positions were well-served. The challenge will remain for market participants to continue to operate as the Fed removes or scales back the daily operations.

Jarrod Polseno: In comparison to the volatility we experienced in September, year-end was mild and composed despite forward start trades indicating a significant rate premium even into later December. The liquidity injected by the Federal Reserve repo operations and increased treasury bill purchases throughout the fourth quarter, both term and overnight, have helped greatly. As opposed to mid-September where the market was caught off guard, year-end funding was one of the most prepared for and talked about events in recent memory. Market participants on both sides of the trade had ample time to analyse and adjust their books accordingly in order to ensure a smooth transition into the new year.

George Rennick: The Fed's actions muted the year-end turn, and unlike September 2019, allowed the year to end quietly. Market participants also contributed to the calm, reducing anxieties by diligently managing their balance sheets for the period. That is not to say that the market is fully settled, since the Fed has had ongoing operations since the mid-September spikes, and they injected more than $400 billion of liquidity into the markets ($250 billion in temporary open market operations in addition to over $150 billion through treasury bill purchases) for year-end to avoid cash shortages. Entering 2020, the Fed will now need to gradually decline overnight and term repo operations in an uneventful manner to avoid further liquidity spikes.

A standing repo facility is widely expected to be created this year as one solution to the rate flux, but concerns have been raised that this creates an artificial market dynamic and ignores the issue of over-regulation that also contributed to the spike. What do you think should be done?

Santoro: A repo facility has been discussed during the past meetings of the Federal Open Market Committee. The Federal Reserve is a deliberate institution and a decision is expected this year. A rule change in liquidity requirements would ease some of restrictions faced by large institutions, therefore reducing the need for Fed interventions.

Gillingwater: The Fed is currently operating in an environment where their target rate is achieved via prescribed rates such as interest on excess reserves (IOER), as well as a series of funding facilities (foreign repo facility and the overnight reverse repo facility) that are intended to channel overnight rates. The lower end of this range is managed by the existing programmes theoretically creating a floor for short term rates, but the top end of the range was intended to be contained by market forces. In other words, as rates climbed, banks would be motivated to lend their extra cash into the market, which would have the effect of slowing the rate ascent. The Fed is now focused on expanding its balance sheet broadly to accomplish its goal of 'ample reserves.' A standing repo facility could simultaneously be created to theoretically create a ceiling on overnight rates, but the construction is not likely to occur in the immediate future.

The longer-term solution will likely be a combination of efforts to both right-size the excess reserves in the system and address the regulatory need for capital at the banks, as the main intermediaries of the short term funding markets. The intra-day overdraft regulations in particular are being discussed as a possible avenue for regulatory adjustment. We do expect creation of a standing repo facility over time, but don't see it as an immediate or near term tool. The temporary operations have sufficed for the time being, so the urgency for the facility should remain more muted, especially as the balance sheet is expanded over time.

Saunders: Market participants have been suggesting a permanent, formal validation of a standing repo facility for quite some time. The OMO and TMO facilities are the first steps in this process. These operations have provided the framework for what many participants are seeking in terms of a permanent financing facility. Many in the market are eagerly watching the developments from the Fed, as the OMO and TMO auction schedules are announced, for any insights the Fed may be foreshadowing regarding the deployment of a permanent facility.

The impact of regulation has changed the manner in which market participants operate. This is nothing new and certainly poses new challenges, while adding new dynamics to the financing markets. Regardless, the market has adjusted and will continue to evolve as additional measures are implemented on the regulatory front. As

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A standing repo facility is widely believed to be a key mechanism to controlling interest rates and volatility in money markets, providing overall funding stability

it relates to a standing repo facility, the assistance from the Fed is certainly welcomed by most. The challenge will remain, enticing those with access to the Fed's facilities to distribute the access to liquidity to other market participants. Expanding the access to liquidity from the Fed will remain a challenge.

Rennick: A standing repo facility is widely believed to be a key mechanism to controlling interest rates and volatility in money markets, providing overall funding stability. A standing facility would release current bank reserves allowing a reallocation into the market and would provide ongoing liquidity to non-primary dealers especially at times of stress. Although not a certainty, it is very likely the Fed will implement a standing facility during 2020, perhaps as a mechanism to offset their short-term injections, such as those required to calm the markets at year end.

However, as with most policies, there are pros, cons and, often, unintended consequences. While stability may outweigh most concerns, a standing facility should not be viewed as removing all risk from the repo markets. The standing facility is certain to tighten specific spreads which could lead to an acceptance and increase in other risks while searching for yield. It is also unlikely that the standing repo facility would be open for all market participants, so those parties not eligible should not view the Fed as a lender of last resort.

McAuley: If the Fed goes forward with implementing a standing repo facility, commentators have suggested that they price liquidity in a way that moves them back to their traditional role as a backstop rather than being the lender of first resort. Another consideration may be expanding eligible participants to include, for example, securities lending cash collateral accounts.

Polseno: A standing repo facility open to a larger subset of market participants than the current operations could give the Fed a relativity easy-to-operate construct that they could use to increase and decrease the amount of liquidity they inject with less friction than current tools. This could be used to create a ceiling on funding rates (possibly a floor as well when needed) and overall would be welcomed by the market.

There are benefits to this whether it is in conjunction with, or in the absence of, regulatory changes. The financial resource impact of funding government debt securities should be reviewed as well, and this should not distract from that. Domestically, we have been running significantly greater deficits and increasing the overall debt burden, but at the same time making it more expensive and difficult to carry for financial firms over the last decade. We should look at sensible changes to regulation that eases this, whether it is in the repo markets for funding purposes or it is simply the cost to hold them on balance sheet. The notion that we can have an ever-increasing US treasury issuance but diminished capacity to fund and carry that debt seems to oppose one another.

In December last year, the SEC said it was looking into refining its exemption relief for their affiliated securities lending programmes. One suggestion offered was to only allow a mix of affiliated and unaffiliated

agents to be used. What impact would this have on the market and what else should the SEC be looking at on this topic?

Polseno: This would force some market participants to use multiple lenders, but to what extent remains to be seen. It would potentially create an interesting prospect for those funds looking to take securities lending in-house, where they would be forced to keep portions with other lenders. The benefits of doing that would need to be weighed against the burden of having to oversee multiple programmes and providers. If the true benefit could not be shown to the underlying investors, then the change may be doubtful.

Santoro: The US Securities and Exchange Commission (SEC) last issued an exemptive order with this relief in 2004, so change is welcome. Requiring affiliated securities lending programmes to adopt a multi-agent strategy may prove very beneficial in terms of relationship pricing, as well as net returns as a result of benchmarking the performance of each provider. More broadly, we think all mutual fund boards would benefit from an SEC requirement that they issue a formal, publicly available request for proposal (RFP) every few years. This is how the US public fund industry operates. RFPs are issued on a predictive schedule. Typically, all qualified agents are welcome to participate, both custodial and non-custodial, and relationship pricing is requested on a bundled and unbundled basis. As a result, US public funds enjoy leading edge pricing and service. Given the sheer number of mutual funds and exchange-traded funds (ETFs), one would expect there to be much more RFP activity than there is currently.

McAuley: In her keynote address at the 2019 ICI Securities law Developments Conference, Dalia Blass, Director of the Division of Investment Management at the SEC, indicated that affiliated securities lending was an area that the regulator “needs to tackle” due to the disparate treatment of market participants. This disparate treatment stems from the fact that the SEC last provided exemptive no action relief in this area back in 2004 so some fund complexes have relief and others do not. This would suggest that the SEC may be looking to codify no-action positions similar to what they have previously done with respect to cash sweep no-action letters.

Blass indicated the SEC would welcome comments on how best to address potential conflicts of interest inherent in those arrangements. Mixing affiliated and unaffiliated lenders was just one suggestion. However, the real focus was on transparency and providing boards with independent information in order to be able to assess the performance of lending agents. The recently implemented investment company modernisation final rule introduced reporting and data collection with respect to securities lending that should go a long way in keeping boards better informed and providing transparency into performance and fees. Mixing lending agents could have some unintended consequences and may not be necessary given increased transparency and the availability of market data.

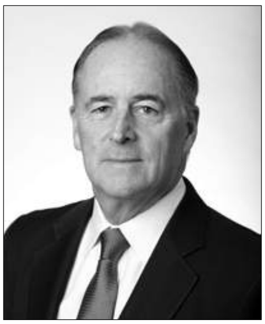
Rennick: Securities lending continues to play a vital role in the global markets, providing liquidity, efficiency and capital. For investors and other lenders, securities lending offers the opportunity to add an incremental return on idle assets in the form of income that can be used to offset fees and improve performance.

For registered investment companies regulated by the SEC under the Investment Company Act of 1940, the use of an affiliated entity as a securities lending agent is often not viable, absent exemptive relief. Since the early 1990s, many investment companies have filed for and been granted the specific exemptive relief necessary to efficiently enter into a securities lending programme with an affiliated lending agent. The time and resource investment required to gain this exemptive relief is quite significant. In December of 2019 the SEC recognised that the current existence of this relief for some, but not all, investment companies with affiliates capable of serving as their securities lending agent has effectively resulted in a divide of "haves" and "have-nots".

The SEC should continue to seek ways to ensure that the market is balanced, and that Investment companies and their investors have access to a broad array of potential securities lending agents. Levelling the playing field for all would increase competition and provide opportunities for all investment companies to partner with best securities lending agent for their funds and investors.

Changes to the US 15c3-3 rule for equities as collateral is expected to see progress this summer. How hopeful are you that this change will finally occur and how significant would this be for the US securities lending market?

Rennick: The SEC has started 2020 by soliciting feedback on the most recent interpretation version in early January, a potential sign that the equities as collateral changes are getting closer. However, given past history it is difficult to say this will be the year, but we certainly seem closer to the goal-line. Allowing broker-dealers to pledge equities as collateral will have a significant impact to all parties in the securities lending value chain. More than ever before, lenders with expansive collateral schedules that permit equities and equity repo will benefit over those with more restrictive schedules



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The recently implemented investment company modernisation final rule introduced reporting and data collection that should go a long way in keeping boards better informed that exclude equities, either by regulation or internal tolerance. Since the borrowers gain significant benefits by posting equities over cash, we can expect a continual decline of cash collateral posted versus non-cash collateral which would drive ancillary impacts to securities lending returns generated from cash reinvestment.

McAuley: The addition of equity collateral to 15c3-3 for loans of equity securities is expected to eventually become reality. The question is not if, but rather when. When really depends on the process. The change involves two separate actions. The first part is fairly straightforward: the addition of equity collateral to the list of permissible collateral. The second element involves how the equity collateral is treated in the reserve formula. This second part is very complicated and has been the reason the change has been so long in the discussion and drafting phase.

The eventual impact of the change on the US lending market will to some degree be determined by how the trades are priced. Equity-for-equity general collateral trades outside of the US do not command premium pricing. This is in large part due to the fact that those markets evolved dependent on securities collateral as a result of a lack of – or fragmentation in – money markets. If equity collateral is expected to displace cash, then the transaction pricing will need to reflect the balance sheet benefit to the borrower and the loss of investment return by the lender. One potential benefit to lenders is that the change may incent borrowers to transition some of their broker-to-broker activity to agent lending programmes, which would represent new demand.

Santoro: Regulatory reforms are having a meaningful impact on agents, counterparties and beneficial owners. Trade flexibility in particular has come to the forefront in response to counterparties seeking less balance sheet intensive loan structures. Counterparties want to pledge equities and seek to transact with beneficial owners willing to accept them. We think it will happen soon and it will be significant in the public fund space where we have a number of large funds who are less constrained and can benefit fairly quickly.

Polseno: This change has been debated for years now with little change, although it feels as if it is gaining some traction, it is hard to say it will actually come to pass. There are also other changes such as the Department of Labor's rules for 1940's Act funds that would need to happen along with the SEC change to truly have a market impact. Over the years, changes in borrowing locations have allowed beneficial owners that accept equities as collateral to accept it from a robust set of counterparties. This change may in some ways serve to move the borrow from one entity, most likely a non-domestic one, back onshore. To say that overall demand or loan balance increases is a difficult one, global borrowers may already be using entities that can give equities as collateral and would not have significant upside. There could be an argument made that smaller domestic-only borrowers would be able to use this change to their advantage though. It also remains to be seen how robust the approved equities set is, if it is quite narrow, say SP500 only, it could be less interesting to the market and hence lower demand.

Gillingwater: There is no doubt this would be a significant change to the US securities lending market. Given the balance sheet benefits, it is expected US broker dealers would leverage their long equities to finance their borrows, which could potentially reduce loan volumes versus cash or sovereign debt loan volume.

For agent lenders, equity collateral for loans with broker dealers would be more punitive from a capital perspective than when pledged by EMEA bank entities. The related softening in cash collateral volumes could have an impact on cash reinvestment returns.

Additionally, clients with equity collateral in their guidelines could see a strengthening in their portfolio utilisation compared to clients who only accept cash and government debt collateral.

Saunders: The market has been closely monitoring developments to any changes related to US 15c3-3. The benefits are rather clear and the market is certainly optimistic that the initiative progresses in the near term. However, the expansion of permissible collateral would still require amendments to many lenders throughout the beneficial owner community. So while beneficial, the proposed changes are not the magic solution. Regardless of the timing of the proposed changes to 15c3-3, lenders, agents and borrowers willing to engage in capital-friendly transactions through Central Counterparties, noncash loans and pledge structures are well-positioned to increase utilisation.

Last year saw a major beneficial owner partially withdraw from the market on the grounds that lending facilitated short selling, which was counter to its ESG goals. Has this had any impact on the market in practical terms of global liquidity? Are you aware of, or do you foresee, other lenders having similar concerns?

Saunders: The subject of environmental, social and governance (ESG) is first and foremost among the beneficial owner community. It is on the agenda of every board meeting, client review and part of every RFP as of late. ESG is only going to grow in importance and cannot be ignored.

It is imperative that the market implement ESG mandates into the management of a securities lending programme. Agent lenders will be required to facilitate the ESG mandates of the beneficial owner community into the management of lending programmes. While several of the largest, most sophisticated lenders have recently implemented changes to their lending policies to reflect the heightened focus on ESG, many agent-lending programmes are more than capable to support the requests of lenders. For example, the subject of proxy voting is often cited as the rationale for supporting an ESG-compliant lending programme. Our experience with beneficial owners around ESG has been positive as it relates to proxy voting. Here at BNP Paribas it is a priority to implement and apply our client's ESG mandates into our lending programme. As a bank, BNP Paribas is committed to implementing our own ESG policies, while supporting clients pursuing their own ESG mandates.

Santoro: It may be that some beneficial owners are conflating abusive short selling or perhaps empty voting with securities lending, which would be a mistake, in our view. We have not seen any impact on the market in practical terms and we've not encountered beneficial owners with similar concerns. Securities lending and ESG are fully compatible, in our case. We can accommodate ESG across the key facets of the service from approved counterparties, restrictions, collateral filtering, reinvestment, reporting, and recalling for proxy voting.

At Deutsche Bank, we're partnered with DWS, our affiliated professional asset manager who is a recognised leader in ESG, which adds another dimension. DWS offers an ESG themed money fund, as well as separately managed accounts with an ESG overlay. We think these capabilities will grow in importance as US-based investors embrace ESG.

McAuley: Securities lending is in general an oversupplied market so the cessation of lending by a few large entities should not have a material impact. In spite of the reviews underway by those large plans, a broad community of market participants agree that short selling provides a range of benefits to the market, not least is acting as a countervailing force against overvalued securities. Regulatory bodies are generally in agreement. In December 2019, the European Securities and Markets Authority (ESMA) issued a report analyzing short-term pressures facing corporations. The body considered arguments concerning the impact of short-selling and securities lending practices and their potential link with short-termism. ESMA pointed out that short-selling and securities lending are key for price discovery and market liquidity. ESMA also indicated that it is not aware of concrete evidence pointing to a cause-effect connection between these practices and the existence of undue short-term market pressures and that securities lending, if done in a controlled way, is an opportunity to add value for fund investors and is compatible with long-term investment strategies.

ISLA announced the formation of a new Council for Sustainable Finance, which will introduce a series of principles for sustainable securities lending in the first quarter of this year aimed to promote and embed ESG values into securities lending.

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Global head of fixed income securities lending trading
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To put it in perspective, 2018 was a record-breaking year for securities lending revenue, and 2019 was the second highest revenue generating year in the past decade

These are just the latest developments in a long sequence of industry improvements to enhance market transparency and provide reassurance that strong corporate governance frameworks support responsible securities lending programmes.

Polseno: There has been no discernable impact on liquidity in the market based on some beneficial owners withdrawing from the market. The trend has been for those not lending to come back into the market for some time now (and continues to be), which has muted any impacts of those exiting.

Gillingwater: To put it in perspective, 2018 was a record-breaking year for securities lending revenue, and 2019 was the second highest revenue generating year in the past decade, according to IHS Markit. Looking ahead in fixed income lending markets, the first phase of a US/China trade agreement and greater certainty around Brexit have taken risk off the table and led to improved sentiment amongst our counterparts. With stock markets rallying to fresh highs, banks may have more risk appetite and capital to deploy into 2020. In this respect, we expect to see continued strong demand to collateralise with equities, particularly benefiting buy-to-hold clients who are able to utilise high-quality sovereign bond inventory in term maturity tenor exposures. With the cross-currency basis swap market more opaque in nature, it is challenging to predict how cross-currency collateral swap trades will perform. However, it is unlikely we will see a material shift in demand to source US dollars, thus the appetite to borrow US treasuries should be maintained, albeit with a threat of narrower lending fees.

Additionally, the general outlook for credit market performance is expected to remain robust with expectations of moderate global growth replacing fears of recession. Moreover, with central banks seemingly in no rush to raise interest rates, corporate bonds should remain in demand as the hunt for yield continues. If the global economic outlook improves significantly ahead of expectations, government bond yields could rise in anticipation of an interest rate increase. This may motivate investors to switch out of credit, thus adding some upward pressure on lending fees.

Rennick: The subject of stewardship and ESG is attracting increased industry focus, with growing discussion about how lenders can meet their individual governance objectives whilst successfully participating in securities lending.

As lenders' ESG principles can vary across different portfolios, jurisdictions and client types, it is important for the agent lender to engage in ongoing dialogue with lending clients to understand their specific ESG goals. Once a lenders' specific goals have been understood, we believe that through adherence to existing industry best practices, development of operating protocols and inclusion of ESG criteria, solutions can be developed affording lenders the ability to continue to participate in a securities lending programme which enhances fund performance and contributes to improved liquidity in the market, whilst achieving their ESG principles.

Securities lending is incorrectly associated with facilitating short selling. Various industry studies, including one conducted by the U.S. Federal Reserve, have concluded that short selling does not systematically drive down asset prices. In fact, by facilitating corrections in overvalued securities, short selling can help identify poor behavior by companies, and this knowledge benefits all investors in the long run. Therefore, by participating in securities lending in a responsible way, one is able to contribute to better governance and oversight across the financial system.

We expect ESG to remain a key topic across all client segments at the highest levels. We welcome opportunities to partner with and educate clients, about the ability for ESG principles and securities lending not only to co-exist, but to remain aligned in delivering the same goals.

Last year failed to live up to highs of 2018's global revenue intake. Are there any indicators of how 2020 will fare?

Rennick: Looking forward to 2020 we may see a similar pattern to 2019, with a slow start followed by pockets of opportunity as volatility increases from factors such as an economic slowdown and the official start of the US presidential election cycle. While the US economy remains strong, it is not immune to the constant geopolitical tensions, global growth slowdowns or other type of shock events such as a global health scare. The new coronavirus emerging in China is already expected to impact growth and is bringing back memories of the deadly SARS virus, which was not only a public health problem but also impacted economies and drove a mass exodus of ex-patriots from places like Hong Kong, contributing to an immediate recession. While most analysts see the impact of the virus as short-lived, it remains to be seen if the recent market sell off was an opportunity to sell long or if short interest begins to increase.

Hedge funds are cautious as the stellar returns in the US equity market in 2019 made short exposure a dangerous proposition. Overall, 2020 may be an eventful year starting with events in China, progressing with merger activity in Europe, the Middle East and Africa and ending with the outcome of a US presidential election and the ancillary policies.

Saunders: Performance in 2019 was certainly driven by a combination of factors led by the attribution of specials from initial public offerings. Market data supports this concept. However, returns for lenders holding general collateral and high-quality liquid assets (HQLA) fared well throughout the year. Demand remains insatiable for HQLA and clients permitted to engage in non-cash collateral transactions with a broadened collateral set experienced solid performance. Despite the increased participation from historically idle lenders and thus increase in supply, opportunities continued to be present in the market. Lenders willing to be patient and engage in capital-friendly transactions, and transact via alternate trade structures and various market infrastructures, will be at the forefront of revenue opportunities regardless of the portfolio composition.

Polseno: It is early days but this should be an interesting year. There are a lot of factors at play that can affect broader market performance, political, trade, central bank actions, etc., that could curb the steady and robust equity appreciation that we have seen in the last few years. If we transition into a market that is friendlier to active management strategies, then it could prove to increase lending performance and become more interesting. The demand side of securities finance has been challenged as relative performance of hedge funds and long/short equity funds in many cases has lagged and fee structures questioned as investors compare to passive mandates. This has decreased overall demand as well as put pressure on borrowing fees as prime brokers offer concessions to their clients to retain or grow their market share. To the extent that these themes continue in 2020, the overall performance of 2019 could carry forward again.

Santoro: It's hard to predict 2020 revenues, but thus far January has proved to be a good month for us and we expect to report increases month-over-month for nearly all of our US-based clients.

McAuley: The lending market in 2019 was characterised by low volatility and very few specials. Much of the revenue was concentrated in a few initial public offerings and a couple of corporate events. While it is very early in 2020, we are expecting to see some renewed demand for HQLA. In addition, there is some expectation that corporate activity will trend in a positive direction.

What other trends and developments should the market be aware of in the US for this year?

McAuley: As the securities lending market moves forward the focus is on innovation designed to preserve indemnification, while also creating capacity to meet demand. Another focus of innovation is on creating new distribution channels that provide capital efficiency to borrowers, thereby stimulating new demand. One of the newest

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In terms of the market, continued US treasury supply will keep spreads in current ranges. Fed fund futures are pricing in one rate cut in Q4 2020

distribution channels is clearing. Last year, BNY Mellon became the first agent lender to clear a lending transaction through Eurex Clearing's securities lending structure. While BNY Mellon remains the only agent lender currently providing this distribution channel to lenders, we have seen demand for clearing continue to grow. Lenders that embrace clearing may see increased distribution opportunities as well as premium pricing. As with anything new, the onboarding process can be tedious. However, we have been working together to streamline this process and to make clearing more accessible for all lenders.

Santoro: We expect investor interest in ESG will continue to grow in the US, which will lead to increasing engagement relative to incorporating ESG into programme guidelines and service delivery. As a general matter, we expect to maintain a high level of client engagement on programme optimisation, including collateral expansion, trade ideas, and providing client PMs with useful information and analysis to assist with their long investing. In addition, the Securities Financing Transactions Regulation (SFTR) is on the near horizon for US beneficial owners. In terms of the market, continued US treasury supply will keep spreads in current ranges. Fed fund futures are pricing in one rate cut in Q4 2020.

Saunders: Efficiency and capital-friendly transactions remain at the forefront for many agent lenders in 2020. The implementation of automation to distribute increased supply, along with the leveraging of technology to discover pockets of liquidity, remain a priority for most participants. As BNP Paribas continues to evolve our lending programme, we are cognisant that a combination of technology and alternative trade structure be utilised to expand our distribution, while adequately pricing risk.

Polseno: In terms of aspects of the business that can be controlled by agent lenders, the themes of this year are not so different than past years – collateral and trade structure flexibility will be important for continued growth. We are seeing more interest in ETFs and convertible bonds – emerging market sovereign and corporate bonds. With regards to structures this could mean a few things, examples would be term trades, pledge collateral arrangements, central counterparty clearings (CCPs) and shift to triparty collateral from bilateral.

The overall theme of differentiation in the lending market from one beneficial owner versus another based upon the choices they make for their programme will continue. As some aspects of stock loan flow becomes further commoditised and technology enhancements are leveling the playing field, alpha tends to be generated through uniqueness.

Rennick: We spoke about potential changes to 15c3-3 and the SEC's review of affiliated lending programmes, but the two critical regulatory changes expected to significantly impact securities lending in 2020 are SFTR and the Central Securities Depositories Regulation (CSDR). Both of these topics have been discussed and addressed numerous times before; however, 2020 is the year each of these regulations come into effect. So expect further discussion and even more questions, especially around CSDR, general operating principles and how mandatory buy-ins will be treated.

What happens when SEC Rule 15c3-3 changes?

Ed Corral
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J.P. Morgan offers a glimpse into triparty adoption for non-cash collateral in US agency securities lending

In US securities lending, a significant portion of the market can only post US treasurys and certain agencies (Fed collateral) as non-cash collateral, for reasons that include regulatory constraints such as those imposed by Rule 15c3-3.

Additionally, in the US non-cash collateralisation of securities lending transactions has traditionally been managed bilaterally, whereas triparty has become the norm for these transactions in most other global locations.

The bilateral collateralisation process for cash and Fed collateral is relatively manageable due to their straightforward nature. However, if equities collateral becomes eligible and widely used, the US market may follow other major markets and see both a significant increase in non-cash collateral (vs cash) and a significant shift from traditionally-used Fed collateral to equities.

The opportunity is sizable

- Globally, approximately 60 percent of equity stock-loans and 72 percent of government bond borrows are versus non-cash collateral.
- In North America today, 47 percent of equity stock loans are collateralized with non-cash.
- In the secured financing markets outside of the US about $1

trillion in equity securities is being used to collateralize triparty activity. Furthermore, today more than $125 billion of equities are used to collateralize US triparty repo.

This demonstrates both the adoption rate of equities as collateral for stock borrows in Europe and the ability to support equity collateral via the triparty model in the US. The numbers clearly illustrate the opportunity to do more equities-based collateralisation if and when the 15c3-3 rule changes.

Adoption of equities as collateral has clear challenges. Specifically, managing equities collateral bilaterally can become operationally cumbersome and inefficient for both the borrower and lender, making it difficult to scale.

A different model could make a difference

Triparty collateral management addresses those operational inefficiencies, offering sophisticated eligibility tests that are automated, dynamic and provide efficient processing. It's a proven model as other global markets primarily use tri-party to collateralise using equities with considerable scale.

Indicating the increasing comfort with this model, we are seeing more interest from US participants in using triparty to collateralise stock borrow activity with Fed-eligible securities and have seen migrations from bilateral to triparty as a result. Once equities can be used in US securities lending, the proven efficiencies of triparty will be available to market participants.

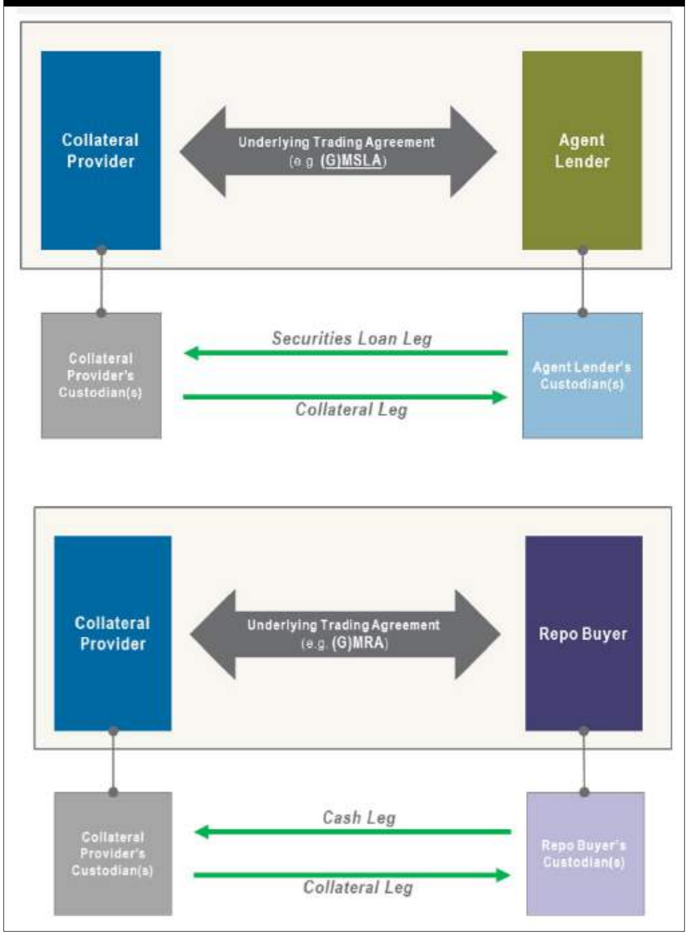
Getting ready

Ahead of any potential regulatory change, it's best to understand your options. Some of the key features of triparty are outlined here so that impacted market participants can become more familiar with the structure and consider how triparty could be integrated into existing operating models.

If you currently manage any of your collateral activity bilaterally, you know that you have to independently optimise and deliver eligible collateral (with haircuts) to each counterparty (figure 1). During the life of the trade, assets need to be revalued, and further deliveries/receives to/from counterparties need to be managed. The added complexity of managing equities – if and when the rule changes – which have intricate eligibility requirements (typically using indices, issuer limits, trading volume tests as well as other concentration limits) makes supporting equities collateral bilaterally a cumbersome process.

In triparty (figure 2, overleaf), assets are held in a central long box (across asset classes and markets) governed by a master collateral services agreement. Securities can be deployed from that long box as collateral against a variety of different collateral obligations – repo, securities lending, cleared/over-the-counter margin, and collateralised commercial paper programmes to name a few – all through book transfer movements at the triparty agent, which are not subject to market cut-offs. Collateral is ring-fenced in accounts at the triparty agent governed by the program

Figure 1:
Bilateral securities lending transaction(s)



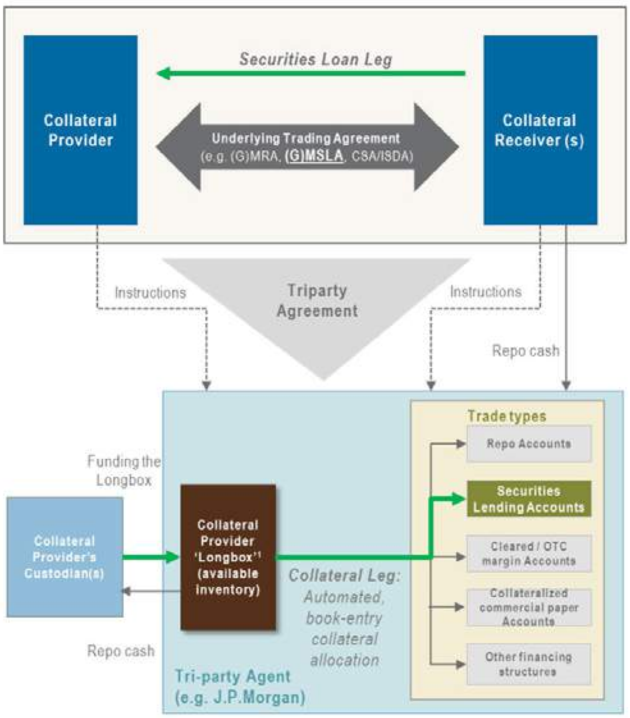
agreement between the trading counterparties and the agent. Once the collateral provider delivers available assets to the long box, the agent ensures the optimal allocation of their collateral across the trading portfolio, adherence to complex counterparty eligibility requirements and top-up of short accounts using available long box assets. This frees the collateral provider to focus on their client needs and trading book and allows the collateral taker to deliver the loaned securities. In the event, there is insufficient collateral in the long box, the triparty agent will reach out to the collateral provider. Triparty agents also support the re-use (not pictured) of received collateral against other counterparties.

Integrating US and global activity

As mentioned earlier, many global institutions are already using triparty to manage equity collateralisation in other parts of the world. For those firms, integrating the US book is simple. At J.P. Morgan, Collateral Central is a single, global platform that provides one user interface, long box and underlying operating model. That means that US and international triparty activity are managed holistically, allowing institutions to optimise the use of securities across the entire portfolio. Significant efficiencies and scalability allow market participants to concentrate on managing their firm's financing and liquidity demands.

Firms that are new to triparty can benefit from a model that mitigates counterparty and credit risk while delivering those same operational benefits and scalability. Since securities lending is only one of the many transaction types that can be supported by triparty, the benefits only increase as and when your activity broadens or increases.

Figure 2: Triparty securities lending transaction(s) with centralised long box for all collateral



Ed Corral
Managing director - collateral management
J.P. Morgan

Sagar Patel
Vice president - collateral management
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Pradeep Sreekumar
Associate - collateral management
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Everything is not awesome

Feature
Natalie Turner Reports

After much-unwanted drama last year, can the US repo market stay out of the spotlight in 2020?

The US repo market shook up Wall Street last September and since then market participants, regulators and even politicians have rushed to zero-in on the causes of the problem and produce solutions more nuanced than simply throwing money at it.

The interest rate spike – which lasted several days and peaked briefly at around 9 percent on 17 September 2019 – was a rude awakening for the New York Federal Reserve. The Fed was accused of miscalculating the consequences of the Basel III's rules on banks' ability to lend to each other, especially when combined with other market events, and then not acting quickly enough to cap the spikes as they intensified each day in the lead-up to the end of Q3.

Once the Fed did turn on the hoses and drench the smouldering engine room of the financial markets with much-needed cash, the issues quickly died away, but concerns remained as to how the market would function at year-end, which is traditionally more volatile than a quarter-end.

The Fed's answer was to simply stay in the market. It continued to offer cash injections in the lead-up to and over year-end to the tune of $75 billion in daily repos in September and then $35 billion in long-term repo twice per week from then on.

According to the International Capital Market Association (ICMA) report, published earlier this month, the Fed's continued presence was successful in avoiding anything near a repeat of September over year-end.

In its report, ICMA states that the Fed's attempts to keep bank reserves comfortably above the $1.5 trillion mark through its open market operations and bill purchases, has proved successful in stabilising money rates, and was further aided by an injection of increased liquidity over year-end.

"This also seems to have prompted a transfer of balance sheet by US banks from their European business to the US," it notes.

With the threat of year-end now over, all those involved must now answer the questions of what the future of repo will look like and whether the traditionally out-of-sight-out-of-mind funding market will be able to stay out of the spotlight in 2020.

So far, discussions around relaxing certain bank regulations and reducing the Fed's involvement in the overnight funding market are all being debated, even as opinions conflict over what caused the disaster in the first place and what the best course of action going forward should be.

"You don't really want the central bank propping up the repo market," argues Andrew Hill, senior director at ICMA. "When there is a great demand for cash in the repo market, you take it out of the central bank and you will get a better return. But there's a point, which we found in September, where the banks stopped doing that and they leave their money at the Federal Reserve." But why?

Jeff Kidwell, former-Morgan Stanley executive director and market commentator, explains: "The bottom line is that the repo market globally has fundamentally changed or moved on. The hundreds of new regulations imposed by global regulators, inspired by the 2007/08 financial crisis, have changed the way that businesses who use the repo market look at the use of capital and the return they require on that capital."

Although many welcomed the Fed's enlarged operations at the time, questions are now being raised as to the long-term viability of such activities, according to Michael Cyrus, head of short term products, equity finance and foreign exchange at Deka Investment, a Frankfurt-based investment manager.

"There are many implications with recent central bank interventions and most recently even the European Central Bank admitted that there are negative impacts with some aspect of how central banks interact with current markets," he explains.

"Central banks are an important player in the money markets and money markets are an essential part of the monetary transmission mechanism for central banks. Hence, it is hardly comprehensible to imagine money markets without central banks. However, in our view central banks have to (re-) learn that there should be some degree of volatility, some dispersion of prices and more granular pricing for risky assets."

Cyrus suggests that the actions of central banks are simply "papering over all kinds of risk nuisances in the market and are distorting market prices".

"Whether this is a price to be paid for financial stability or whether this makes markets inefficient to the extent that these inefficiencies become a threat to the market is an open question that needs to be looked into," he concludes.

ICMA's Hill predicts that whatever comes next, increased volatility is the new normal. "Volatility in the repo market should respond to demand and supply to have a functioning market, but it is these dislocations and panic to find cash and panic to place cash and the lack of access to markets," he says.

What's to be done?

Hill states that unless the market can address some of the imbalance or come up with a more proportionate regulatory framework that balances the importance that banks conduct, (plus having a safe resilient banking system), banks are going to have to get used to what happened in September.

There has been talk about the Federal Open Market Committee including a standing repo facility as part of the new framework for banks, this tool would allow banks that owned risk-free Treasurys to hand them in to the Fed on demand in exchange for fast liquidity in the form of bank reserves.

To this Hill says that there is a solid case for a standing repo facility. "As it becomes more difficult to estimate the 'sweet spot' for reserve balances as a result of prudential regulation, this would help get around the reliance on primary dealers to intermediate liquidity injections and provide a pressure valve for the money-markets".

However, Kidwell is of the opinion that a standing repo facility would harken back to the several standing repo facilities that the Fed had to employ during the financial crisis, which was an extraordinary measure and might make the public and the market think that we were on the verge of another crisis".

Despite animated discussions by those that felt the pain most acutely in September, market consensus is that the Fed is unlikely to commit itself to create such a facility in the near future. Moreover, despite the overt perception from the Trump administration that an axe would be taken to the carefully constructed post-crisis regulations, significant reforms are unlikely given the distraction of the upcoming election.

Year-end may have passed uneventfully, but the first quarter-end of 2020 is already on the horizon and it's unclear how many more body blows the market will be able to take before a permanent solution is found.

Going green

Martin Walker
Head of Product Management
Broadridge

Broadridge investigates the practical implications of ESG for securities finance and collateral management

Socially responsible strategies now account for 26 percent of UK's assets under management. The total value of global assets invested according to the criteria coming from the environmental, social and governance (ESG) movement is soon likely to reach trillions of dollars. While ESG is already having a major impact on investment decisions in both primary and secondary investment markets, areas coming under greater spotlight now include securities finance and collateral management.

This article examines the practical impact of ESG on the securities finance trade lifecycle and discusses the technology implications of managing ESG in a way that minimises operational workload.

While ESG as a concept has gained most of its momentum in the past decade, ethical investment, more commonly called "social impact investing", dates back hundreds of years. One of the first targets of ethical investment policies was the slave trade. Quaker businessmen in England and America not only refused to invest in businesses that profitted from the slave trade but ultimately provided much of the funding for the abolitionist movement.

One of the simplifying aspects of ethical investment strategies was that they typically involved avoiding investment in very specific types of business such as tobacco and armaments of firms trading with Apartheid-era South Africa. Another class of ethical investment were those that targetted types of businesses that positively worked to protect the environment or to increase diversity in the workforce.

Why ESG?

The growth in ESG came from some different perspectives to purely ethical investment. One of those insights was that an investment strategy to achieve socially worthwhile objectives did not have to be done at the expense of returns to investors. What is the point of enhanced returns over the short term if they come at the expense of fundamental environment or social destruction? Many of the new technologies such as renewable energy or more sustainable farming combine both a concern for the environment and the creation of businesses that may be commercially successful in the long term.

There was also the realisation that increasing the overall welfare of society did not just depend on the binary choice of whether to invest or not but on the overall ethos of a company. Including both the business areas in which a firm operated and the manner in which they did business, bringing together both the social and governance aspects of ESG.

ESG is also looked at by some providers of ESG-related services as a form of risk management. For any firm, ESG concerns can be looked at in terms of risks that can damage the performance of a firm if not managed correctly. Environmental impacts including climate change may have a major impact on the bottom line, governance concerns can have an impact on the quality of management (ultimately impacting performance) and public perceptions of firms' overall policies in ESG can have a direct impact on the willingness of customers to buy their goods and services.

The net result was the identification of a whole range of considerations related to ESG. The table below shows a small subset of the areas that can be grouped under the main dimensions of ESG.

Implications for securities finance and collateral management

Here are some key factors that make ESG relevant to securities finance:

- The receipt of securities as collateral in relation to securities lending transactions, derivatives or other business areas means that firms or funds may potentially end up as the legal owner of securities that do not meet their ESG requirements. Even if their legal ownership is transitory and may not represent a real economic stake in the issuer of the securities the ownership may be visible in a public access medium such as share registrars.
- One of the key mechanisms for influencing both the business direction and governance of corporations is exercising the right as a shareholder to vote on key issues. If shares are on loan it means the lender cannot vote since they are not at that point the legal owner.
- Where securities are lent out, according to some ESG criteria, it is important who the securities are lent to and for what purpose. There have been multiple actions taken by regulators and/or tax authorities against those borrowing of shares over the dividend season to exploit grey areas in tax law.

However, trying to make decisions based on more general concepts of ESG can be much more problematic. The fundamental problem is that there is a huge range of definitions of ESG and the more granular factors considered in creating ESG ratings. Including or excluding specific securities from investment/trading activity based on the preferences of investors or the criteria of a mandate is relatively straightforward. However, for ESG there are a great many overlapping or even conflicting definitions with different sets of criteria. Analysis on the ESG characteristics may also be represented in terms of an overall ESG rating, a set of ESG risks/opportunities or the exclusion of securities from a portfolio. One analysis may recommend excluding all companies involved in the extraction of fossil fuel, but another may allow investment in energy companies that have a lower carbon footprint resulting from more efficient extraction processes or efforts to offset their contribution to the production of greenhouse gasses.

Fundamentally there is no true “golden source” of ESG data and what is valid depends as much on the investors attitude to ESG issues as the quality of the data they purchase or collect.

Once investors have reached a view on both their own policies and the most suitable sources of data at the system level firms need to record the data required to automate trading, lending and collateral processes. This includes storing reference data about counterparties, issuers, securities and legal agreements such as credit support annexes. Supporting ESG policies can be challenging but to do so in a supportable way requires thought to be given to business processes, systems and reference data.

Environmental	Social	Governance
Climate change	Diversity	Ownership and control
Sustainability	Human rights	Tax transparency
Pollution and waste	Consumer protection	Executive compensation
Environmental opportunities	Animal welfare	Business ethics including corruption

The practical challenges

At the most basic level, systems and processes need to be modified to exclude or give preference to securities issued by specific parties. This can be relatively straightforward depending on how mature a firm’s processes are for managing reference data and the number of securities/issuers involved.

As ESG grows in significance, market practitioners should define an operating model and technology strategy that ensures adherence to the firm’s ESG policy, while also maximising automation and minimising operational workload.

Where are we now?

Nick Bruce
Business development manager,
REGIS-TR

European trade repository REGIS-TR is part of Deutsche Boerse Group and the TR of choice for group companies Clearstream and Eurex. With only weeks to go until SFTR, Nick Bruce takes a look at the final countdown

Finally, we have the last missing chunks of the Securities Financing Transactions Regulation (SFTR): the ISO 20022 schemas, the updated reporting guidelines and the amended validation rules. At the very least – and as the industry gets to grips with this and other regulations, it may well be that they need the odd fix – they are not going to change right now; everyone can be pretty certain what they're dealing with. That said, first-wave firms heading towards 13 April have been given only 14 weeks to analyse 300-odd pages of guidelines, define the changes, assess their impact, implement them in their systems and complete extensive testing. Hardly relaxing.

At the time of writing, it is only a few days since SFTR's final guidelines were released on 6 January and, like most of the industry, we are combing through the fine detail. The main question, of course, is – after years of guidelines,evaluations, debates and updates – how well is this all going to work?

In June last year, Neil Davies, Clearstream product guru and a long-time member of SFTR industry working groups for the International Capital Market Association (ICMA) and the International Securities Lending Association (ISLA), highlighted 10 of the more obscure potential issues (see this magazine's 2019-20 SFTR Annual for a recap).

Some of these remain ongoing (still no sign of a quick, efficient and inexpensive unique trade identifier (UTI) sharer gaining market traction, for example), and others – dealing with XML, doing your own reuse data reporting, possible counterparty issues with coordinated universal time (UTC) – are mainly, to be fair, down to awareness and planning. Others, such as the issue of data sharing with non-EU agent lenders, may simply be things that no-one can do much about.

In its 6 January statement on legal entity Identifiers (LEI), the European Securities and Markets Authority (ESMA) suspended the LEI requirement for third-country (non-EU) securities issuers until April 2021. This put a more-than-welcome hold on a problem which, if left unaddressed, would have left up to 70 percent of third-country securities unusable as soon as SFTR kicked in, with a massive impact on their liquidity.

However, there remains the conundrum of the 12 percent or so of instruments with issuers in the EU that don't have LEIs. As of 13 April, in terms of SFTR reporting, these securities will be ineligible. Do firms simply not trade in them? Might national competent authorities stretch a point on under-reporting for a while? There could be 100 international securities identification numbers (ISINs) in a single collateral report, but if just one of those had no LEI, the report would be rejected. There is no practical and viable solution to this one. Watch out for this in your backloading list, too.

Speaking of backloading, this has also been a bit up-and-down. The initial 180-190-day requirement had its downsides, as did a subsequent industry proposal to simply upload all outstanding transactions on the first reporting date. The updated guidelines say that so long as the 190-day deadline is met, reporting firms can make their own decisions about backloading dates. Sounds good, but what if you have already programmed your systems for 180-day backloading but your counterparties plan to frontload on, say, day one? Interestingly, the guidelines say: "In case both counterparties are covered by the relevant reporting start date, to minimise reconciliation breaks, they should agree on which day they backload the SFTs". It's not clear if this is a) helpful advice or b) a firm instruction to report on the same day, in which case it'll be a heavy load for firms that had been counting on another few months to deal with the backloading issue.

Probably inevitably now that the regulation is nailed down, the odd blip is coming up in the ISO messages. One is in the auth.031 status advice, the trade repository's (TR) feedback on each file of transaction reports. The auth.031 goes to the entity that submitted the file and also to the counterparty and responsible entity, assuming they a) exist and b) have an account with the same repository. As things stand, if the feedback contains, say, rejections, only the submitting entity, which has the original report, can see which SFTs are affected, and why. Until this issue is resolved, the other two parties will be aware of the problem, but have no details to work from.

Another small thing that may need firms' attention is how the fields in the regulation are reflected in the schemas. Take 2.83, collateral quantity or nominal amount. One field, you might think. But in the schemas, there are two: quantity for equities and nominal for bonds. Now, for net exposure reporting, the new guidelines say that the collateral giver reports the quantity or nominal amount as a negative number. For quantity, this is straightforward; you put a minus sign before the number. However, you can't use a minus sign for the nominal amount; instead, you enter the number of bonds and populate the ISO <Sgn> element with 'true'. It's doable, but fidgety. Also bear in mind that this is a reconcilable field and the two legs need to show the same number: one positive and one not.

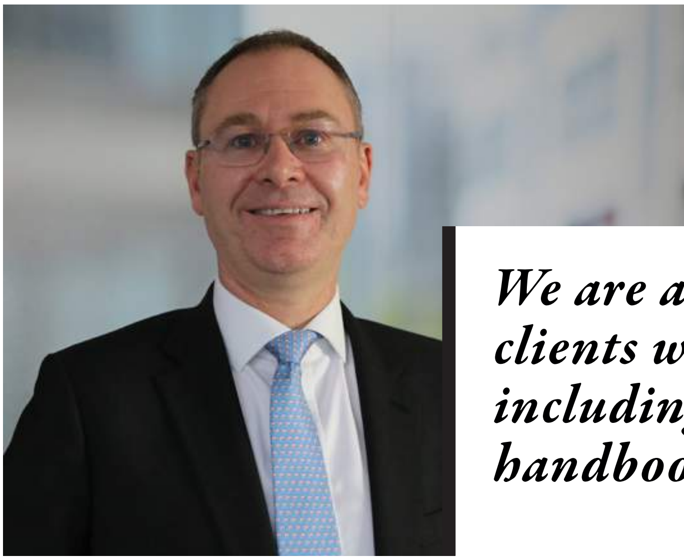
Far more cheerfully, SFTR has done a great deal for cooperation across the industry. Much of this comes down to the various expert groups, notably ICMA's SFTR task force (collateral and repo), ISLA's SteerCo (securities lending and borrowing) and the ISO evaluation team (SWIFT standards). These forums have brought together reporting firms, infrastructure providers, vendors, regulators - especially ESMA - and TRs to interpret the regulations, define issues, provide solutions and define best practice and guidance. Separately, the trade repositories have formed an inter-TR group to ensure maximum coordination, with a strong focus on reconciliation and the processes for switching to another TR.

REGIS-TR has been very much part of this co-operative effort throughout the development of SFTR, providing feedback to ESMA on standards and policy and as members of the inter-TR group, industry expert forums and wider industry groups such as the Association of the Luxembourg Fund Industry. Our vice-president Tomas Bremin was convenor of the ISO evaluation team, which worked with ESMA to define a set of standard, registered ISO 20022 messages for each SFT data-related reporting communication. This is a huge step and the use of these messages will not only hugely improve the quality and consistency of the data, particularly where reconciliation is concerned, but also create a much more level playing field in TR terms, with firms able to select or change repositories on the basis of price and performance and without the hassle and expense of adapting to different proprietary formats.

REGIS-TR was the first TR to provide a client testing environment for basic XML schema validation. Our current user acceptance testing (UAT), based on the most recent (20 December) ISO 20022 schemas, is up and running and in use both by our clients and by other firms looking to test our SFTR and other solutions. We are adding to this UAT environment gradually and are aiming for full SFTR UAT reporting functionality in February.

We are also providing various tools to assist clients with the new reporting regime, including a clear and comprehensive handbook, early onboarding and access to governing documents, various training modules offered by Market FinReg, which can be held on client sites, and a planned UAT demo video in English, French, German or Spanish.

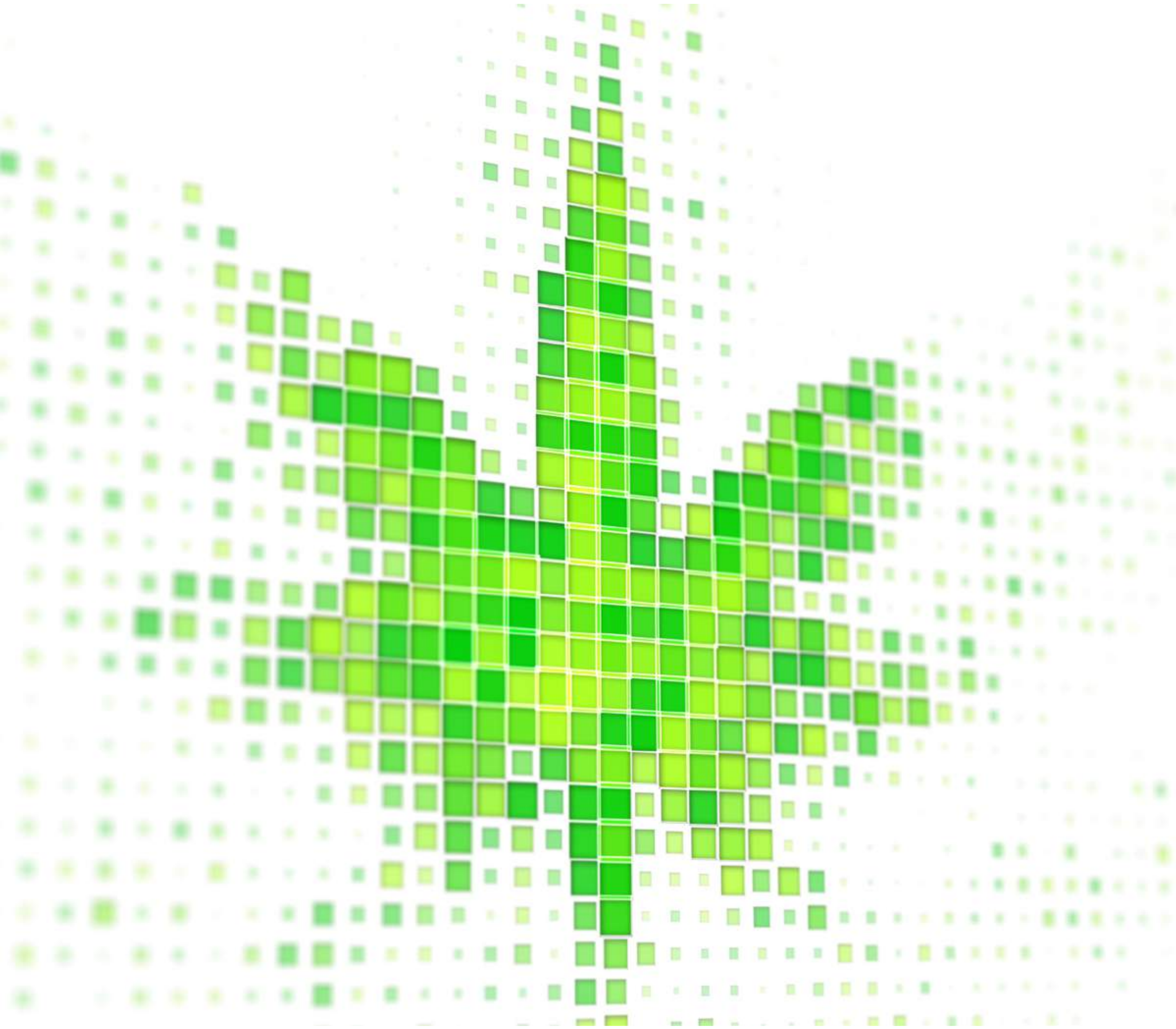
SFTR is a specialised, complex niche, and all firms should report to a TR that can provide both expert market knowledge and swift, responsive service support. We stay very close to our clients to help them through the entire lifecycle of regulatory reporting and, while we cannot provide legal or regulatory guidance, if you have an exception management problem, or a technical issue, we will find you the right person to provide technical advice.



We are also providing tools to assist clients with the new reporting regime, including a clear and comprehensive handbook and early onboarding

Nick Bruce, business development manager, REGIS-TR

Our support network, which is free of charge to our clients, offers fluency in all the main European languages in addition to several others. We have a proactive client services team with profound expertise in technical systems and reporting regulation, with a response time averaging three hours. We work with our clients if an issue proves complex, constantly stress-test our systems and contact a client directly if our monitoring tools detect an unexpected change in reporting patterns. Our relationship managers, who can be contacted directly for assistance with all aspects of our regulatory services, also hold regular user groups throughout Europe to discuss current issues and regulatory developments.



Lend 'em if you got 'em!

Sam Pierson
Director
IHS Markit

IHS Markit walks through the data behind cannabis-related equities' meteoric rise to prominence in the short world to uncover the reality of this new market sector

The cannabis sector has delivered uneven returns, with positive developments in some areas being offset by challenges elsewhere. It seems fair to say that to this point the sector has rewarded those who invested early, however it has generally frustrated efforts by investors to get involved more recently. With significant volatility in share prices, there is more to the returns of the sector for investors, namely the revenues from lending shares to short sellers.

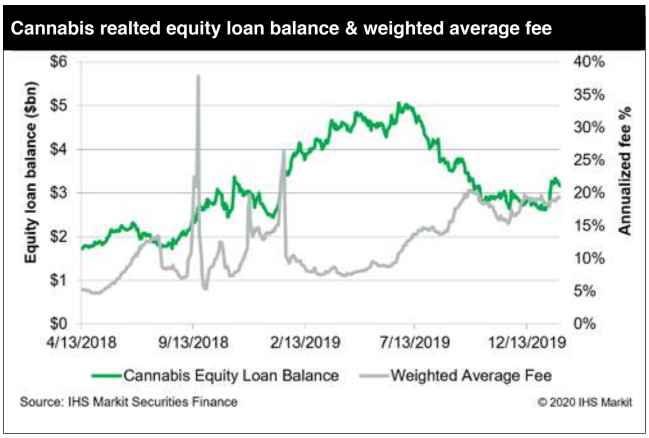
One of the best examples is Tilray, which has been one of the highest revenue-generating US equities since its initial public offering (IPO) in July 2018. Since going public, shares of TLRY have generated $148 million in revenue, contributing 2.9 percent of all North American equity lending revenue. That's impressive considering that the returns were generated on 0.04 percent of NA equity loan balances. From the perspective of an investor who purchased shares on the first day of public trading, the share price as of 27 January reflects a decline of just over $11. Making reasonable assumptions around fee split and utilisation, that investor could have earned $36 in lending revenue. The price of the security, and its value to investors, is therefore fundamentally altered by the consideration of lending revenues. Similarly, while shorting TLRY from the peak valuation has been a fruitful venture for short sellers, their profit has been meaningfully impacted by the borrow cost paid. Tilray is an extreme example, reflecting as much the dynamics of lending fees for low-float IPOs as the cannabis industry, but it is instructive for thinking about the lending fee and borrow cost as critical inputs to the investment process.

Canopy Growth, one of the market leaders in the sector, has seen consistent demand from short sellers in the years since going public. 2019 was exceptional, however, in the scale of borrow balances and related revenues, totalling $153 million in revenue, or just over 4 percent of NA equity total. Year-to-date revenues of just over $23 million equate to 8.7 percent of NA equity revenues, suggesting this year could deliver an even higher total. While the fees are unlikely to ever reach the eye-popping levels observed for TLRY shares in the period between the IPO and lockup expiry in January 2019, an early investor in Canopy Growth could have fully recouped their investment in the firm via lending fees by this point.

UK-based GW Pharmaceuticals, which trades via GWPH ADR in the US on the NASDAQ, is certainly a firm apart from most firms whose business is related to cannabis, with its focus on cannabinoid-related medicines. It too has been a target for short sellers, however, and short interest in the stock has reached a new all-time high in terms of shares and market valuation in 2020. An abundance of GWPH shares available for borrow has kept a lid on lending fees to this point, though it's worth noting the utilisation of the shares in lending programmes has increased from a low point of 25 percent in August 2019 to just over 40 percent at present. A further increase in borrow demand could start to push up on fees going forward.

The combined market cap for cannabis-related equities peaked in October of 2018 (see figure 1) at nearly $70 billion, however, that's a bit misleading given that it was only for one day and Tilray represented $15 billion of the total. Excluding Tilray, the combined market cap peaked just below $61 billion in April 2019, on the eve of Canadian legalisation in June. Loan balances for cannabis-related equities peaked in the weeks after CA legalisation at just over $5 billion.

Figure 1 *Source: IHS Markit Securities Finance*



Taken together, cannabis-related equities contributed 13.6 percent of all NA equity lending revenue in 2019, totalling more $484 million; That's up from $355 million in 2018, which was 12.3 percent of the total. Through 27 January the revenue contribution is 15.3 percent, with cannabis-related equities on pace to have the greatest influence on record. The increase in market valuations for cannabis-related equities, from the low point in Q4, may reflect a starting point for a broader recovery or a lower-risk entry point for short positions, in either case, a consideration of lending fees and borrow costs are critical for all investors.

Upcoming Securities Finance Training

Securities Finance Fundamentals

7 February 2020
London

Perfect for new starters or satellite services that need an overview of the industry process and practices. Designed for delegates with little or no understanding of securities finance

Securities Operations Foundation Qualification (SOFQ)

4-6 May 2020
London

The Securities Operations Foundation Qualification (SOFQ) is an introductory level programme intended for anyone entering a career in the securities operations area of the financial markets

Securities Lending & Borrowing - Operational Challenges

2-3 April 2020
London

Securities Lending & Borrowing has been an important activity within the securities marketplace for many years. This course will tackle common operational challenges

Collateral Management

30-31 March 2020
London

The use of collateral, for many years associated mainly with repo and securities lending transactions, has seen a rapid growth within the financial marketplace

Comings and goings at Eurex, ENSO and more

Morgan Stanley's Richard Portogallo is set to hand over the reins of its prime brokerage business after 34 years with the bank.

Portogallo joined the bank in 1986, one year after its prime brokerage was created.

He rose through the ranks to become managing director in 1994, before taking on his most recent role as global head of institutional equities clients and services.

Prior to Morgan Stanley, Portogallo worked at Dean Witter Reynolds before joining Morgan Stanley.

In an internal memo to staff, Morgan Stanley's head of institutional securities, Ted Pick, commented that "when the firm looked to rebuild institutional equities after the crisis, Portogallo helped lead the resurgence of an integrated, client-focused franchise".

Pick added that Morgan Stanley was grateful for Portogallo's dedication and commitment to the equity division.

"Rich's retirement is both a cause for celebration and a meaningful loss for the many of us who seek out his wisdom and admire his singular style of humility and calm in the storm," he wrote.

Morgan Stanley was unable to share details on who will take on Portogallo's role.

Eurex Exchange Council has re-elected Carola von Schmettow, CEO of HSBC Germany, as chairperson.

Meanwhile, Lutz Johanning, WHU – Otto Beisheim School of Management, was re-elected as deputy chair.

The constituent meeting was preceded by the regular elections at the end of November.

Newly elected to the exchange council were Jonathan Aucamp of OSTC, Robbert Booij of ABN AMRO Clearing Bank N.V., Jörg Hessenmüller of Commerzbank AG and Hans-Dieter Kemler of Landesbank Hessen-Thüringen.

The Exchange Council of Eurex Deutschland consists of 18 members who are elected for a term of three years.

According to Eurex, it is an important control and supervisory body of Eurex, and primary duties include appointing and monitoring the management of the exchange as well as issuing the exchange rules, fee regulations and the conditions for trading at the exchange

FIS is understood to have promoted several senior figures to new roles in a rejig aimed at a stronger alignment of its pre- and post-trade solutions.

The financial services giant has promoted Andrew Murray to become head of sales for post-trade solutions in Europe.

In his new role, Murray will oversee securities processing, derivatives processing, reconciliation, matching and asset servicing.

Murray is joined by Jonathan Hodder, who became FIS' European head of sales for its securities finance and collateral management business earlier this month.

Hodder, who reports directly to Murray, joined FIS from EquiLend in April 2019 as a senior sales executive, before officially taking on his new role earlier this month.

FIS is also understood to be welcoming Lee Bernini from IHS Markit where he had served as head of client relationships for Europe, the Middle East and Africa since March 2018.

Bernini is now set to become a senior member of the sales team as of 27 January and will report to Hodder in London.

Elsewhere, Igor Salzgeber, based in Switzerland, has stepped up to become head of product for FIS securities finance and collateral products, including Astec Analytics.

Salzgeber, formerly managing director of enterprise collateral, reports to Edouard Lacarriere, FIS' group executive, securities finance and processing, based in Boston.

FIS were unavailable for comment on the hires.

ISLA has appointed Jamila Jeffcoate to the newly created roles of head of finance and administration and chief of staff.

Jeffcoate will assume day-to-day responsibilities for the business that are currently being managed by ISLA CEO Andrew Dyson, among others, as of 10 February.

ISLA says the hire represents the first of a number of key hires planned for 2020 that will allow the association to successfully deliver on its “ambitious priorities and objectives in the near to medium term”.

A spokesperson for the association tells SLT that additional hires are likely in ISLA’s regulatory and technical areas as well as its communications and events team.

Jeffcoate has worked within the securities lending industry for more than 20 years in a variety of front-office trading and business management roles.

She also brings experience from senior positions at Deutsche Bank and State Street.

Jeffcoate joined State Street as senior vice president and head of custody for Europe, the Middle East and Africa (EMEA) in 2003, before becoming a senior vice president in February 2019.

“Her knowledge and experience within the industry are unrivalled, and she will, therefore, be able to add considerable value to all aspects of the work we do,” says Dyson.

Jeffcoate comments: ‘’I’m delighted and excited to be joining the team at ISLA in February and look forward to supporting them in representing the best interests of our members and the securities lending industry across EMEA.”

Transcend hires former ENSO CTO

Transcend, a provider of real-time collateral and liquidity optimisation technology, has hired Kayur Parekh from ENSO Financial to lead the expansion of its cloud-based technology for the buy-side.

Transcend aims to offer integration of over-the-counter derivatives functions with other business silos to manage margining across the enterprise.

A spokesperson for Transcend tells SLT that Parekh, who started as a senior technology manager this month, will contribute to the firm’s plans to accelerate its derivatives margining strategy to meet the unique needs of the buy-side participants, including pension funds, asset managers, alternatives.

Transcend is also focused on helping the buy-side prepare for their Uncleared Margin Rules deadlines in 2021, which will require more margining and add to operational complexity and impacting collateral assets and liquidity.

The firm’s technology will enable the buy-side to optimise collateral and liquidity while meeting UMR requirements, the spokesperson adds.

Parekh brings more than 18 years of technology and financial markets experience, including most recently serving as chief technology officer at ENSO for just over year.

At ENSO, Parekh spearheaded the technology transformation of the next generation of its solutions focused on cloud and microservices-based architecture.

The new role marks Parekh’s return to Transcend, as he previously served as a senior solutions architect of the initial technology platform for the firm between 2013 and 2017.

He also brings experience from roles at NEX (now part of CME Group) and Citi.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