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India strengthens SBL framework

Authorised intermediaries can now enter into securities borrowing and lending agreements with clearing members in India, following market calls for the change.

The Securities and Exchange Board (SEBI) of India confirmed on 3 June that the country's framework had been modified to allow authorised intermediaries such as agent lenders and prime brokers to directly enter into agreements with clearing members for the purpose of facilitating lending and borrowing of securities.

Under the new rules, an agreement must specify rights, responsibilities and obligations, and include basic conditions for lending and borrowing.

The agreement must also detail the "exact role" of authorised intermediaries and clearing members in relation to their clients.

Authorised intermediaries have to ensure that there will be no direct agreement between lender and borrower, despite market participants expressing a desire to move away from the country's stock exchange settlement system to a bilateral format.

The move follows SEBI's decision to create a unified and simplified regulatory framework for foreign portfolio investments.

A new investor class, foreign portfolio investor (FPI), has been created, merging the three existing classes.

"It was envisaged that dispensing with the mandatory requirement of direct registration with SEBI and adopting [a] risk-based know-your-customer approach in [an] FPI regime would smoothen the entry process and on-boarding experience of FPIs which desire to invest in the Indian securities market," said SEBI in a statement. The new FPI regime took effect on 1 June.

Designated depository participant Citi Securities Services India was among the first firms to register an FPI following implementation of the regime.

"The inherent attractiveness of the Indian markets, has kept India as a focal point of our securities business and we are pleased to roll out this new framework for our global clients," commented Aashish Mishra, head of securities services at Citi in India.

"We have been continuously involved with the development of the securities markets here from being the first to enable securities lending and borrowing for our clients to facilitating the largest QFI investment to being the first custodian to offer e-voting facility for company board meetings for our clients," added Mishra.

BlackRock 'bites back at asset manager claims'

BlackRock has reportedly hit back at the Financial Stability Oversight Council (FSOC) for claiming that asset managers' practice of providing indemnification to securities lenders creates potential for enhanced risks.

The FSOC, which is mandated to identify risks and respond to emerging threats to financial stability, warned against the practice in its 2014 report, despite acknowledging the likely benefits for asset managers from combining indemnification with securities lending.

"Unlike banks, asset managers are not required to set aside capital when they provide indemnification. Also, although asset managers have access to management fees, they do not have access to banks' stable deposit funding base."

"Consequently, the indemnification that asset managers provide may be a source of stress on their own balance sheets, while at the same time resulting in lower protection for the lenders relative to indemnities provided by banks."

A BlackRock report sent to the FSOC in response denied the claims, arguing that it holds enough liquidity and its clients are required to

SLTINBRIEF

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hold sufficient capital, according to reports.

A vice chairman of the firm also reportedly argued that the report overstated the risks, because it did not take into account the fact that indemnification is only used when a borrower defaults.

Onwards and upwards for securities lending

Securities lending deal activity picked up substantially during April, especially in the pharmaceuticals sector, according to research by Deutsche Bank.

Despite a difficult month in the equities market, offers for AstraZeneca and Meda were of particular notice to the wider market.

Merger activity was complemented by strong convertible issuance throughout the month. Recent tech-related IPO names saw strong short interest in April including Twitter, Japan Display and Hitachi Maxell.

It was a challenging month for hedge funds with the median fund flat (0 percent) over the period.

There was an unusually wide dispersion of returns among equity long/short strategies in particular. Credit (+0.81 percent), CTA/managed futures (+0.51 percent) and multi-strategy funds (+0.42 percent) led global gains in April.

Regionally, credit strategies continue to perform well gaining 4.32 percent in the US and 3.10 percent in Europe year-to-date.

In the US, the Securities and Exchange Commission (SEC) announced its intention to examine around 25 funds over the course of six months to review whether certain alternative mutual funds that follow riskier hedge-fund strategies are complying with leverage and liquidity rules.

The SEC also issued a risk alert on cyber security and plans to examine more than 50 investment advisers and broker-dealers regarding their level of preparedness.

In the UK, the Financial Conduct Authority published survey results on the composition of the UK hedge fund industry, finding that the UK's top 20 firms control more than 80 percent of assets under management.

Wells Fargo to pay $62.5 million to end class action

Wells Fargo and a group of institutional investors have agreed to settle their class action litigation over the bank's alleged misrepresentation of its securities lending programme.

The bank has reportedly agreed to pay $62.5 million to the group of approximately 100 investors, led by the City of Farmington Hills Employees Retirement System, to end the class action case in the US District Court for the District of Minnesota.

In agreeing to settle the case, Wells Fargo admitted no wrongdoing.

The investors brought the case against Wells Fargo in late 2010, accusing the bank of touting its securities lending programme "as a highly secure way for … institutional clients

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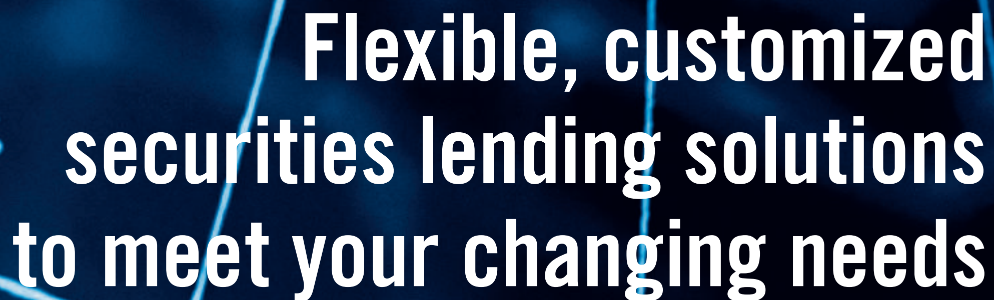

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to maximise portfolio returns and offset fees", only to violate its fiduciary duty when it "ultimately invested collateral into risky and illiquid securities that have declined greatly in value".

Wells Fargo plans to close the temporary securities lending programme in 2015, after selling this area of its business to CitiBank in 2011. Thirteen class action members, including the Arizona State Carpenters Defined Contribution Trust Fund, Goose Creek and ABC Retirement, remain in the programme, according to court documents.

"[A]ll remaining participants—whether class members or not and regardless of whether the settlement agreement is ultimately approved—will be exiting the programme in 2015 as the programme is wound down. That cessation is the culmination of a process that began in 2011 with the transfer of some participants to CitiBank and the continuation of a limited Wells Fargo programme for a temporary period."

The bank has not issued a public statement on the settlement, although it did cut the amount of losses it expects to suffer as a result of litigation earlier in May, according to a regulatory filing.

Wells Fargo said that the high end of possible losses due to litigation was $911 million at the end of Q1 2014, down from $951 million at the end of the previous year.

Fed must watch Reverse Repo Facility closely

The Federal Reserve Bank of New York's Reverse Repo Facility could encourage further development of the shadow banking system, according to president and CEO William Dudley.

Dudley warned the New York Association for Business Economics in a speech on 20 May that setting the facility's overnight rate close or equal to the interest rate on excess reserves (IOER), without caps, could lead to a shift of funds out of banks into money market funds.

The Reverse Repo Facility was tested between 23 September 2013 and the end of January of this year. It saw 139 counterparties, including money market funds and banks, exchange cash with the Fed for securities, overnight at a fixed rate.

The Fed has varied the Reverse Repo Facility rate from 1 to 5 basis points during testing and the usage cap has gradually been increased to $10 billion. "As expected, narrower spreads to comparable money market rates and larger caps have led to greater usage," said Dudley.

"Although the testing process is still ongoing, early results suggest that the overnight Reverse Repo Facility will set a floor under money market rates. Treasury repo rates have generally traded no more than a basis point or two below the overnight Reverse Repo Facility rate. Thus, the early evidence suggests that this facility would help strengthen our control over money market rates."

But the Fed is worried about the effect that the facility could have on the flow of money into money market funds, which regulators are watching closely as they assess the 'shadow' banking system.

Dudley said in his speech: "To the extent that the overnight Reverse Repo Facility rate were set very close or equal to the IOER without caps, then this might result in a large amount of disintermediation out of banks through money market funds and other financial intermediaries into the facility."

"This could encourage further development of the shadow banking system. If this were deemed undesirable, this would argue for a wider spread between the overnight Reverse Repo Facility and the IOER in order to reduce the volume of flows into the facility."

Considerable testing, analysis and discussion will be necessary to reach firm conclusions about the appropriate course of action, said Dudley. "My goal would be to clarify our intentions later this year, long before we begin to contemplate raising short-term rates."

Bond ETFs aren't cheap to borrow, finds Markit

Bond exchange-traded funds ETFs are among the most expensive to borrow in the US ETF market, according to Markit Securities Finance.

Markit analyst Andrew Laird charted the top 20 most expensive-to-borrow ETFs, with the top six including Vanguard Intermediate Term Corporate Bond ETF and Market Vectors Emerging Markets Local Currency Bond ETF.

Laird said: "As interest rates remain at historic lows, some investors will no doubt see ETFs as a conduit to take a view on rising rates, especially given the logistical issues around shorting bonds."

Investors are also willing to pay a premium for short exposure to emerging markets, especially Russia and China, according to Laird.

"It is no accident that these are market areas that structurally impede or prohibit short selling. Paying 7 percent a year to borrow an Indonesian basket in a relatively liquid market starts to make sense when looking at the logistics needed to borrow the constituents in the domestic market whose borrow fees often do not match that of the ETF."

Laird also stated that ETFs are one the few "success stories" in securities lending over the last couple of years.

"Fees generated through lending out ETF assets have generally held up despite the fact that the available pool of ETF assets to borrow from stands at an all-time high. Currently, return to lendable of US listed ETFs is five times higher than equities in the same market."

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Asia, according to the results of a poll conducted at the 5th Global Securities Financing Conference Asia.

Singapore Exchange (SGX) and Clearstream recorded a number of trends in the global collateral industry, following the poll of conference attendees. The conference is one of the first initiatives to come from the pair since they agreed last September to jointly develop collateral management services in Asia.

More than 150 delegates attended the conference, which focused on the recent developments around collateral management, securities lending and OTC derivatives in the Asia Pacific and worldwide.

At the conference, 93 percent of delegates agreed that sourcing the most appropriate collateral to cover global exposures is a priority, while 6 percent disagreed.

The poll results showed half of the respondents believed there would be a shortfall of eligible collateral over the next 12 to 24 months; 28.4 percent did not think so; 17.3 percent did not know and 4.9 assumed there would be a "significant shortfall".

More than 80 percent believe they have more work to do in the move towards a more efficient collateral management solution, with 14.1 percent having "little" and 2 percent stating they have no work to undertake.

An efficient collateral management solution would be important for 44 percent of delegates, for them to hold their assets in Singapore as collateral. Competitive pricing, a trusted management provider and global connectivity were also drivers.

For 84 percent of the delegates, triparty repos will become increasingly attractive to corporates as a replacement to cash deposits, but 15 percent of delegates disagreed.

Stefan Lepp, head of global securities financing at Clearstream, said: "Our discussions with industry delegates in the Asia-Pacific region confirmed that we are on the right track with our SGX partnership and the execution of our recently announced joint collateral management service."

Nico Torchetti, head of post trade at SGX, added: "Customers are increasingly concerned about the impact of the regulatory changes occurring outside of Asia and their ripple effect across the region. We look forward to offering a collateral management solution for the Singapore market and the wider Asian region."

OCC CCP activity in May down 18 percent

OCC's securities lending central counterparty activity was down 18 percent in new loans from May 2013, with 99,782 transactions recorded last month.

Year-to-date stock loan activity is down 8 percent from 2013, with 485,722 new loan transactions in 2014.

The average daily loan value at OCC in May was $117,951,459,426.

Total cleared contract volume reached 319,742,239 in May, an 18 percent decrease from the May 2013 volume of 391,347,069 contracts. Its year-to-date cleared contract volume remains up for 2014, with 1,789,079,351 contracts, 1 percent higher than the same point in 2013.

OCC's year-to-date average daily contract volume is up 2 percent at 17,369,702 contracts.

Futures cleared by OCC reached 4,112,004 contracts in May, a 16 percent decrease from the same month in 2013.

Its average daily cleared futures volume in 2014 is up 18 percent with 265,500 contracts. OCC's

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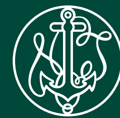

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year-to-date total cleared futures volume is up 16 percent with 27,346,548 contracts in 2014.

Markit launches new iNAV service

Markit has launched an enhanced intraday net asset value (iNAV) service for exchange-traded products (ETPs).

In addition to drawing on securities pricing data from global exchanges, the iNAV is underpinned by Markit's fixed income evaluated pricing and fair value services.

The Markit iNAV is a fair value calculation that can be applied to more than 5100 global ETPs tracked by Markit. It is produced every 15 seconds and published to the major stock exchanges and market data platforms.

Mark Schaedel, managing director and head of data services at Markit, said: "Our new iNAV service helps issuers provide greater pricing transparency amid increased regulatory scrutiny of ETPs."

"The integration of our evaluated pricing and fair value services provide the fuel necessary to enable continuous iNAV updates even when the underlying securities are illiquid or not trading."

Markit's fixed income evaluated pricing services are created using dealer contributions that provide independent pricing, transparency and liquidity data for more than 2.3 million instruments. These include almost 90,000 corporate and sovereign bonds, 1.1 million municipal bonds as well as more than 9000 European and 1.2 million US securitised products.

Markit's fair value pricing data provides an independent, fully outsourced service that calculates the fair value of an exchange-traded fund outside active trading hours using the correlation between 40,000 global equities, 80,000 global bond prices and more than 30 market factors.

Issuers use iNAVs to provide investors with a reference value that enables them to compare the tradable price against an evaluated fair value. Exchanges use iNAVs to ensure ETPs trade in line with the fair value of their underlying constituents.

As the ETP market becomes increasingly sophisticated with products often featuring constituents that do not trade during market hours, iNAVs help bring transparency to ETP pricing.

Front office the way forward

Evolution towards the front office has been identified as one of the main trends for efficient collateral management across global market participants in a survey by Sapient Global Markets.

The research, conducted throughout March to ascertain how firms are managing and processing collateral, also named the efficiency gains required to deliver increased automation and the support systems needed as being important.

While 66 percent of the firms polled still view collateral management as a cost centre, 39 percent plan to make collateral a profit centre and use it to generate additional revenue.

According to the survey, the increasing focus on collateral as an additional revenue stream is prompting a migration of optimisation functions to the front office.

This will require significant changes to established processes and systems to enable firms to manage margin and risk calculations within compressed timeframes across all available collateral inventory pools.

The survey also states that cost efficiency is one of the main drivers of change in collateral management, requiring more effective client communication, responses to margin calls,

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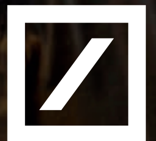

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dispute management and settlement of non-cash collateral.

However, most survey participants did not consider their dispute management processes to be efficient enough and regard their counterparties' processes as an area for improvement.

Collateral booking, for example, is performed manually in more than 60 percent of firms due to the lack of standardisation and automation in client communication.

Sapient recommends that increasing automation would lead to cost reduction in these functions and allow knowledgeable staff to be re-deployed.

Average outstanding volume down at Eurex Repo

Eurex Repo recorded an average outstanding volume of €216.5 billion across the Swiss Franc, Euro Repo and GC Pooling markets in May, down from €228.5 billion in the same month in 2013.

GC Pooling, the secured money market, recorded an average outstanding volume of €151.8 billion, up from €156.6 billion in May 2013.

The Euro Repo market, meanwhile, grew by 18 percent and reached an average outstanding volume of €43.5 billion, while the Swiss Franc Repo market achieved €21.2 billion.

ConvergEx and Liquid team up

Liquid Holdings Group has signed a joint marketing agreement with ConvergEx Prime Services, the prime services division of ConvergEx Group.

Under the terms of the agreement, ConvergEx Prime Services will offer the Liquid platform as an option to its broad portfolio of prime brokerage clients including hedge funds, family offices, mutual funds and registered advisors, and Liquid will refer its clients to ConvergEx for prime brokerage services.

"We are thrilled to work with ConvergEx Prime Services, one of the leading names in the prime brokerage industry, because we share a common commitment—empowering hedge funds to build more successful, long-term businesses through smarter solutions," said Brian Storms, CEO of Liquid.

"We look forward to providing their clients with the kind of superior technology and service they would expect of a ConvergEx partner."

ConvergEx claims that the Liquid platform allows fund managers to free up their time to manage investments by eliminating unnecessary and outdated infrastructure and time-consuming middle-office processes.

The platform is purpose-built for alternative asset managers, powered by a proprietary cloud and backed by managed services.

Regulatory uncertainty threatens systems

The unclear regulatory landscape is the biggest challenge cited by banks in implementing their counterparty risk and credit valuation adjustment (CVA) platforms, according to a whitepaper by InteDelta and Murex.

The respondents cited data issues as the second biggest challenge.

The paper presents the results of a survey that looks to establish the management processes, measurement and systems that banks use to control counterparty risk, paying particular focus on two important metrics in counterparty risk: potential future exposure (PFE) and CVA.

Half of the surveyed banks have already established a CVA desk while the remainder said they have plans to do so. Just under half of surveyed banks carry out some form of CVA hedging.

The paper claims that advances in counterparty risk/CVA require major investment in systems

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platforms. Despite the synergies between CVA and counterparty exposure, only 17 percent of the banks surveyed use the same platform.

Another finding in the paper stated that the new standardised approach for measuring counterparty risk recently issued by the Bank for International Settlements will force banks off more simplistic measures of regulatory capital measurement and may prompt more banks to move directly to the Internal Model Method.

Michael Bryant, managing director of InteDelta, said: "Banks have had to adapt to enormous changes in the area of counterparty risk and that change is still ongoing."

"It was not therefore surprising that our survey uncovered wide areas of differences in practices amongst the surveyed banks. Whilst it is generally true that the largest western banks have the most sophisticated practices, we identified many smaller institutions with well developed practices and some larger banks which did not have the controls and practices that might have been expected."

"I doubt that we are heading for a completely homogenised set of practices around counterparty risk and CVA—each institution needs to choose the practices that are most appropriate to its business and risk culture."

Alexandre Bon, head of enterprise risk management research at Murex, said: "Six years after the global financial crisis, counterparty risk management still is at the top of the agenda for most financial institutions, regardless of their size, geography and business model."

"As firms are grappling with the implications of an unprecedented regulatory overhaul and the accompanying transformations of OTC derivatives markets, we have been working very closely with our customers to help them address the joint challenges of Basel III compliance, CVA management, XVA management, risk control and collateral management."

"As the survey clearly highlights, there is no 'one size fits all' solution, but some common themes emerge. Building up a holistic yet evolutive system infrastructure will certainly help address the most pressing concerns respondents voiced around data management, risk modeling and developing new business processes that span over traditional business silos."

Nineteen banks participated in the survey from a broad spread of geographies and sizes, ranging from some of the largest investment banks to small regional players.

Dip in volume for OneChicago

OneChicago saw a 52 percent year-on-year dip in volume in May 2014, as the total stood at 521,746.

Open interest stood at 557,781 contracts on the equity finance exchange at close-of-market on 30 May 2014.

Some 513,118 exchange futures for physicals and blocks were traded in May 2014. This activity represented $2.9 billion in notional value.

Half of the May 2014 month-end open interest was in OCX.NoDivRisk products.

APAC-wide study shows automation processes vary

A new study has revealed the disparities in post-trade processes across the Asia Pacific region.

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ried out a study across Asia Pacific and China on post-trade processes for equity and fixed income trades, which was commissioned by Omgeo, a post-trade provider.

Interviews with 100 senior operations executives from domestic broker-dealers, investment managers, custodian banks and other financial service firms across the region showed that 95 percent participants believe improvements are required in post-trade automation.

Fund flow across the region is increasing, as Asia Pacific cements itself as an important economic hub, according to Matthew Chan, regional director of strategy at Omgeo.

"Yet, according to this landmark study, the region's financial markets feature varying levels of maturity in post-trade automation, which can have a direct impact on their ability to manage higher trade volumes and satisfy compliance requirements."

"Managing operational risk associated with the trade matching process is essential to ensuring financial market safety and integrity."

The survey revealed that overall, middle office automation in the Asia Pacific and China region is rated at 71 percent for equities and 55 percent for fixed income.

There are variations between countries, with Australia exhibiting the highest automation levels at 88 percent for equities and 69 percent for fixed income trades.

India, Hong Kong, Singapore, Japan, Korea and mainland China were among the highly automated markets, which scored around 70 to 80 percent for equities and 50 to 70 percent for fixed income.

The study found that Taiwan, the Philippines and Vietnam have the lowest levels of automation.

Reputational risk, increasing regulation and cost reduction are key factors for lifting automation levels, according to Omgeo.

One in three respondents of the study said reputational risk concerns with trade settlement failure as a reason for increasing middle office automation.

More than half of brokers and 67 percent of investment managers rated regulatory compliance as a key driver for pursuing greater levels of automation in the middle office.

A focus on regulation

BCBS239: a colossal opportunity?

Since the financial crisis of 2008, a paradigm shift appears to have taken place, whereby regulation breeds regulation. Just when you thought you had grasped the European Market Infrastructure Regulation (EMIR) and the early stages of the Markets in Financial Instruments Directive II, the Bank of International Settlements (BIS) ramps up its BCBS239 directive.

This new regulation's origins lie in the analysis of the causes of the financial meltdown, and the subsequent report uncovered shocking inadequacies in institutional risk management, including the widespread absence of consolidated views of risk across organisations, and the inability of firms to produce the required aggregation and reports in a timely manner.

The deadline for all global systemically important banks (GSIBs) to comply with the principles for effective risk data aggregation and risk reporting is January 2016, but only two thirds of the 30 listed firms anticipate that they will be ready. There are 14 principles set out by the document, of which 11 relate directly to GSIBs' capabilities: governance and structure, risk data aggregation, and risk reporting.

In reality, the directive will affect the day-to-day operations across departments (and silos), and in many cases this has exposed and exacerbated organisational and cultural limitations within firms. The need for an integrated, firm-wide compliance and governance structure stands in stark contrast to the traditional, embedded and departmentalised approach to risk management commonly found in the majority of banks.

In its December 2013 progress report, the Basel Committee for Banking Supervision (BCBS) highlighted the scale of the challenge ahead, citing "large, ongoing, multi-year IT and data-related projects" as a primary factor. Historically, the infrastructure of banks has been built up over decades and in that time it has expanded and evolved to accommodate mergers and acquisitions, new business and product lines, and geographic expansions. The resultant patchwork of accumulated systems will certainly not meet the requirements of BCBS239, without significant and costly re-engineering.

On the positive side, the survey highlights that firms judge themselves to be almost fully compliant with principles 8, 9 and 11, also known as comprehensiveness, clarity and usefulness, and distribution. The more challenging areas are undoubtedly data architecture, IT infrastructure and adaptability, which continue to give cause for concern. Unfortunately, and somewhat predictably, these are more time-consuming elements to transform and therefore a proactive approach implemented early seems the only remedy in the reputational and legal race to comply.

While it is obviously a well-intentioned and sound directive, an enduring problem with BCBS239 is that it does not offer a prescriptive formula of specific requirements. In essence then, unlike other regulatory strictures, BCBS239 is not just another box-ticking exercise. However, those firms that embrace the opportunity to transform their business could reap the considerable rewards arising from dramatic efficiency gains.

John Barclay
Market and credit risk specialist
Rule Financial

The Sector Specialists

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UBS restricts ETF lending

UBS has limited the amount of securities that its equity exchange-traded funds (ETFs) can lend out.

The Swiss bank issued a statement saying: "According to the European fund UCITS directive, securities lending may be up to 100 percent."

"Actual lending rates for UBS ETFs have been considerably lower. To provide our clients with more security we have decided to limit securities lending for all UBS equity ETFs to 50 percent."

The decision was announced on 12 May but became effective on 1 April.

BlackRock made a similar move in 2012, limiting securities lending in its iShares ETFs to 50 percent following clients' concerns about exposure to counterparty risk.

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The next-gen meeting

ISLA has rebranded its annual conference to better reflect business today. Co-chairs Ed Oliver and Mark Barnard discuss what to expect from the Securities Finance and Collateral Management Conference

MARK DUGDALE REPORTS

Why has ISLA decided to rebrand its annual conference?

Ed Oliver: The industry and where securities lending sits within it has changed in the past few years. Organisations have rebranded their securities lending business around collateral management—it's a definite trend. In our day-to-day work, we're not just talking about securities lending, but repo and collateral management, too. We have to help clients with how they handle their collateral associated with the move towards centrally cleared derivatives. Securities lending is the proverbial cog in a machine. It's a part of a bigger business and we wanted to reflect that in the title of the conference and the content.

Mark Barnard: The market has evolved. Managing the asset side of your balance sheet with regards to securities lending has changed. The use and management of a balance sheet is much more of a securities finance/collateral management function than ever before. Ultimately, the options and practices available to best manage the long and short side of your book have never been greater.

Arguably, we are a business in transition. As we continue to move forward and add more products to the securities finance world, we are probably going to find that a more derivatives-based ethos is going to come into play in the near future. This reflects the step forward in the market and in the behaviours and the underlying business drivers that now exist within the old school, stock lending world.

How is the rebranding going to be reflected in the conference's content?

Barnard: On a personal level, I've taken a very specific view of not researching the conference agenda from prior years. That doesn't reflect that the content was wrong in the past, the 2014 agenda should reflect what is salient in the market today, and what I think is going to be salient in the market over the next eighteen months to two years.

With the subject matter and the topics, we've looked at what are presently the key themes

within securities finance/collateral management. Financing, collateral management, securities lending, beneficial owners' awareness, and a regulatory awareness—they are key areas of focus. We want to have an array of debates that touch on those key topics. Our objective is to try to make the conference more multi-asset class, too. Yes, equity is still clearly the driver, but the challenges we face are more asset-broad.

Oliver: I've been asked why we're not doing a regulatory panel, for example. The reality is that regulation touches upon everything that we have on the agenda, and it isn't coverable in a single, 40-minute session. We instead have sub-sets of content that will reflect their own regulatory impact. Whether it's repo or securities lending, bank or asset manager, each will have its own regulatory effects.

How is the conference organised?

Oliver: We've moved the roundtables, which were traditionally during one of the main conference afternoons, to Tuesday, after the regulatory updates from ISLA. We wanted to shorten the two main conference days to maintain the core of the delegates, so that once the conference sessions finish on those two mornings, delegates can network.

Barnard: One of the things we have worked hard on this year is that the audience must be connected to the subject matter. We don't want the content to be so granular that we lose delegates—it has to be digestible.

To achieve this we have structured the daily agenda in two sets of two panels. Those pairs will be connected in their subject matter, so there is fluidity between the first and second conference debate. Hopefully that means that people who have a specific interest in one topic can see both panels without changing their business day too much. It also makes things a lot more interesting because the audience can hear one aspect of the debate, then can hear an alternative perspective.

This year, are there any 'educational' roundtables aimed at filling gaps in knowledge?

Oliver: If you look at the cash debate, which is the second pair of panels on the first morning, the first part of that is talking about central bank versus bank policies and how central bank policies have affected the money markets. I know, for me, that's something I'm very conscious has had an impact, but I'm not necessarily sure what it is about what the central banks have been doing that has had that impact and how banks have responded to it.

Therefore, before we get into the more obvious question—how do you make money in a low yield environment—we needed to to put some educational framework into place about how we got here. We hope we have achieved that on the cash debate.

We've also done that on the collateral debate, which is the first set of panels on the second day. Bill Hodgson, who is an independent industry expert in the collateral space, is moderating a panel that is going to talk about how regulators have been mandating central counterparties (CCPs) for OTC derivatives, and what the challenges are that result and how the buy side has had to react to those challenges. It's useful for our industry to have the background as to why we're talking about CCPs and the requirements for more collateral.

In the cash and collateral debates, we've tried to set up a couple of panels that describe why we're here and then the second panels focus more on why securities finance is key, practically, to providing the solution to those issues.

What else will be different about this year's conference?

Oliver: We've deliberately put a beneficial owner perspective right at the very end of the two days. We've started with the demand side, because we want to see what hedge funds and banks are saying, and then go into intermediary subjects, such as cash and collateral, where we'll have practitioners talking about the reality of the new environment that we're in. Within these panels we expect panellists to come up with suggestions about how beneficial owners can benefit from some of these new trends. So we've left beneficial owners to the end, so they can react to everything they hear over the two days.

Barnard: We also want the moderators to keep the conference moving quickly. Instead of picking someone who is a market practitioner, who might have a spin on a particular subject, we have asked practitioners to moderate who are passive in regards to the subject matter.

They are clearly experts in their fields, and they are connected or indirectly connected to the business, so I believe they are well positioned to ask the questions, and more importantly, ask the challenging questions that follow up as a consequence. We've chosen punchy moderators who aren't afraid to go off-piste. If they hear a comment that they are not happy with, they need to let panelists know. I don't think anyone wants to hear similar ideas—we want to get both sides of the story.

A good example of this will be the repo versus central banks debate. Instead of having all banks talking about their positions and views, we have two central banks and two banks. Hopefully, there will be an instance of challenging and readdressing some of the debates that are coming through.

Finally, what is the thinking behind the keynote speakers?

Oliver: Dr Levin Holle of the German finance ministry is delivering the keynote speech that will open the conference. He's very well regarded within German financial circles.

Barnard: Holle has an active role in policy setting across the EU. Having someone like Holle discussing how central banks have historically set policy will definitely help us with how we see our business forming over the coming years.

Oliver: Former Italian football referee Pierluigi Collina, who is speaking at the end of conference, is clearly a non-traditional keynote speaker, and from my perspective, someone pan-European is critical. More than half of delegates will be non-English, so we need to reflect that. Everyone is aware of Collina—he also has a financial background.

It's always instructive to hear how people in other businesses deal with issues that we come across. He'll talk about taking responsibility and decision making in pressurised situations, which he is qualified to do, given that he's refereed a World Cup final. It is also World Cup year and I think it gives an extra buzz to what Collina can present on. **SLT**

Ed Oliver
Conference co-chair
ISLA

Mark Barnard
Conference co-chair
ISLA

All paths lead to collateral

Asset owners can achieve collateral efficiencies in a centrally cleared OTC derivatives environment, say Sunil Daswani and Anthony Stevens of Northern Trust

Northern Trust is an important strategic partner for its clients and understands the complexities and challenges facing asset owners driven by regulatory changes globally. With the introduction of the Dodd-Frank Act in the US and the European Market Infrastructure Regulation (EMIR) in Europe, market participants will require greater amounts of eligible collateral and will see increased demand for liquidity. Both regulations require increased transparency in the derivatives financial markets. They also demand that sufficient high-grade liquid securities and/or cash be provided by both sides of the derivative trades to ensure that the trades are suitably collateralised.

These regulations, coupled with capital-related changes such as Basel III and the Capital Requirements Directive IV, are leading to industry predictions of a potential collateral shortfall, with securities lending seen as a possible conduit to providing the eligible assets to meet this. This may present additional revenue opportunities for many asset owners that hold large amounts of high-quality liquid assets. While global regulatory timelines are still a moving target as shown in Figure 1, investors need to prepare and understand these impacts on their investment strategies.

Mind the collateral gap

Northern Trust is actively monitoring the ongoing potential impacts of these global regulatory developments. In early 2013, many industry experts were predicting a large collateral shortfall once the move to central clearing had completed, with some studies reporting that as much as $11 trillion of high-grade government assets would be required to fill the gap between currently available and required assets. However, some of the more recent studies have narrowed the shortfall to $3 to $4 trillion, which is still a very sizable shortfall.

These high-quality liquid assets would, among others, be required by financial institutions to ensure they could meet the Basel III rules covering capital funding requirements and by any owner of rate swaps that would be forced to move from a bilateral (with no or little initial margin required) to a cleared derivative environment under EMIR and Dodd-Frank (where initial margin is mandatory). It is the combination of regulatory changes that will cause financial institutions to hold additional (or to have access to) high-grade liquid assets, driving predictions of a collateral shortfall.

Some institutions may be forced to increase their percentage of holdings in government bonds to ensure that they have sufficient eligible collateral to meet initial margin requirements, or to improve their capital ratios by adding these high-quality assets to their organisation's balance sheet. They may also need to hold liquid cash to enable them to meet the variation margin of cleared derivative trades.

However, holding these additional government bonds and cash within the fund may not naturally fit with these groups' investment strategies and act as a drag on overall performance. Some market participants will perceive this increased cost as prohibitive given their strategy and might opt for the futures route, resulting in potentially not-so-well constructed hedging strategies.

It is this expectation that has led to more common usage of the term 'collateral transformation', which essentially means an upgrade/

Figure 1

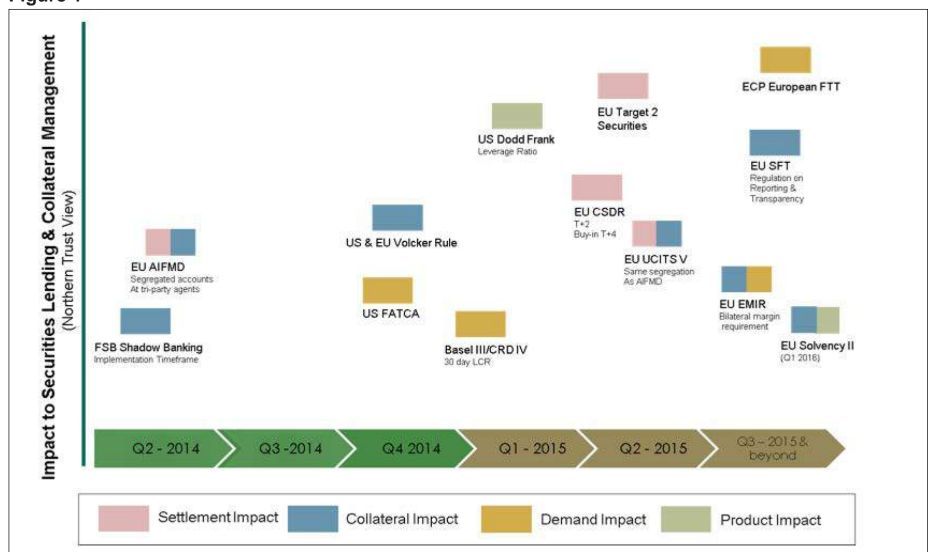

Figure 2

downgrade trade (depending on which side of the transaction you are on). The transformation trade allows a holder of a lower quality asset, such as an equity, to use it as collateral against the loan of a higher quality and more liquid asset, such as a government bond, with an appropriate haircut and associated fee. This transformation can be easily handled by the existing and firmly established securities lending desks.

Northern Trust currently effects such transactions for clients with the current securities lending infrastructure in place. There are a growing number of market participants that hold high-quality liquid assets to want to lend them and be prepared to accept a lower and less liquid asset as collateral in return. No matter the haircut and fee, some groups would just not entertain this type of trade, and therefore it is unlikely that the full collateral shortfall would be covered by the simple 'transformation' of assets.

With challenge comes opportunity

The institutions most likely to gain are those that hold large amounts of high-quality liquid assets and on which regulations such as Basel III and EMIR will have little or no direct impact. This is particularly true for asset owners such as sovereign wealth funds, pension funds and insurance companies, which generally hold these types of assets to maturity and could make additional revenue by lending them to the wider market.

Institutions will be able to enhance the long-term return of the funds they own by making the eligible government bonds available to a lending programme. The shortfall will make lending these government bonds attractive, especially if the institution can ensure that the assets are held in a fully segregated and transparent account structure. But return will also be able to be made by institutions willing to lend liquid cash for variation margin use, perhaps a peer-to-peer loan agreement or a term repo agreement.

There is no doubt that securities lending provides the type of framework that will help locate and provide eligible collateral. Securities lenders will therefore continue to be a central part of the process as they facilitate the collateral supply as well as find new sources of eligible assets to support the potential collateral shortfall. They will also be able to continue to increase the return generated by lending high-quality liquid assets for those institutions willing to lend them. This will be particularly true when assets' lending value increases when the collateral shortfall is big enough to force up the gross margin received from these types of lending trades.

However, some securities lending businesses are also beginning to think differently as they recognise they will need to execute trades in a way that will further protect the original asset owner (even more so than today), and provide transparency into the location of the assets at all points during the trade. Understanding where the loaned asset resides and having sight of it at all times will be essential, especially outside of the custody network and at the global clearing member or the central clearinghouse. Securities lenders will therefore need to be able to offer downsteam asset segregation all the way to, and including, the central clearinghouse as part of the loan deal.

They will also be required to recall and substitute assets intraday and ensure that the process is 100 percent settlement failure-free so they can guarantee access to their own highly liquid and high-quality assets when they need them most.

At Northern Trust, we recognise the need to provide further flexibility to support clients globally to meet the differing appetite of asset owners for securities lending in a centrally cleared environment.We have launched a suite of collateral and liquidity solutions, as depicted in Figure 2, which builds on our existing collateral management capabilities.

This structure would give asset owners increased security and transparency, allowing them to lend assets for use in the clearing lifecycle with confidence that those assets are retained within their incumbent custodian and agent lender. This could drive asset owners to gain approval from investment committees to re-approach lending of assets.

All paths emerging from the current regulatory environment are leading to collateral. Asset owners such as sovereign wealth and pension funds have an excellent opportunity to use their assets for revenue generation. And this is a win-win situation for clients with lendable assets and for those that need to borrow them to meet the new regulatory requirements, using securities lending as the conduit.

Northern Trust is working closely with clients to model and understand impacts on their investment strategies. The end result of this ongoing analysis is identifying collateral and liquidity shortfalls within clients' fund structures and implementing solutions that will provide access to the required collateral. The second goal is opening paths for clients to safely and transparently lend available assets and enhance the fund return.

Inventory management is critical here to assess the eligible collateral the fund owns and then use optimisation techniques to ensure that assets are generating the highest return while maintaining asset safety and protection in the new collateral-hungry environment. **SLT**

Anthony Stevens
Head of product solutions group, EMEA
Northern Trust

Sunil Daswani
Head of client relations, capital markets, Asia Pacific and EMEA
Northern Trust

A Finnish firm to ponder

Jarkko Järvitalo of Lago Kapital reveals why his Finnish securities finance boutique is an important fish in ponds big and small

MARK DUGDALE REPORTS

Can you tell us a bit more about the firm, Lago Kapital?

Lago Kapital is a Finnish securities finance broker focusing on the European markets with a Russian twist. Tier II fund and investment companies comprise the majority of our client base. The other founding partner, Jani Koskell, and I, both having a long history of the securities finance markets in the Nordics, started playing around with the idea of setting up our business in 2011. We applied for the Finacial Services Authority licence in 2012 and received approval in early 2013. Despite 2014 being the first full year of operation, we have already reached a break-even result in the beginning of this year.

How did you come up with the idea of starting your own company?

While both Jani and I were working at some of the major banks in the Nordics, it became evident that the few firms dominating the market were focusing only on Tier I clients, giving no attention to the Tier II clients. There was a clear market opportunity for a firm offering flexible and tailored services for the smaller firms that were becoming more and more interested in the equity finance field. We tested the idea with a couple of industry professionals and the feedback was very encouraging.

What services do you offer to your clients?

We started with basic securities lending products and have recently seen an increasing demand for financing transactions. We have a clear focus on specials instead of low-margin flow business, and we are focusing on non-traditional markets such as Russia and Turkey, where we are already trading actively. Furthermore, we are investigating the possibility of launching a single stock futures offering to provide more flexibility in terms of product structures to our clients. The more challenging the name and the market, the more you can rely on us delivering.

As a rather small player, your risk management processes must be robust?

Yes, we have made extensive efforts to minimise our counterparties' exposures to all relevant risks. For instance, all collateral is handled off-balance. Moreover, we only accept cash collateral, which is kept in a segregated client account. We acknowledge that, being a small player, we need to put extraordinary efforts in risk management to be credible in the marketplace. Managing risks, both ours and our clients', is at the core of our business.

What makes you stand out from the crowd?

As mentioned above, we are smaller than the major players in the market, which gives us the possibility to focus solely on equity finance products. So we can provide our clients with flexible and tailored services, run the extra mile to satisfy our clients' needs. In addition, our pool of lenders consists mainly of investment firms with stable, long-term positions, which means fewer recalls. Moreover, we have a clear focus on specials with a proven track record: for instance, we were one of the major providers of supply in Talvivaara and Outokumpu in 2013. Finally, we aim to include more non-traditional markets in our palette, for instance Poland and the major markets of the Middle East.

Could you elaborate on your plans in Russia?

We see Russia as a highly interesting market that offers considerable potential in securities lending. The Russian equities market is maturing, with the adoption of a T+2 settlement cycle and recent exchange mergers. Equity repos are still dominating the market, but we see a clear tendency towards securities lending.

"We see Russia as a highly interesting market that offers considerable potential in securities lending. The Russian equities market is maturing, with the adoption of a T+2 settlement cycle and recent exchange mergers"

Traditionally, Russian investors have focused only on Russian equities, but interest towards global equities has been increasing recently. Also, Finland has typically had close relations to and a lot of competence in Russian markets. We already have access to a nice inventory of Russian equities as there are plenty of Finland-based funds investing in Russia. Actually, after having a lot of dialogue with different players in Russia, we've been surprised how knowledgeable the people are and how modern the infrastructure is.

To strengthen our presence in Russia, we have recently hired a sales manager with a wide local contact network, who spends most of her time in Russia.

What about the risks of operating in Russia?

We execute prudent risk management in Russia, like in all other markets. In Russia, the fact that all loans are settled delivery versus payment reduces the risk as such. The same applies for equity repos, in case that is the transaction of choice. Further, we have ordered a legal opinion from the Russian subsidiary of one of the leading Finnish law firms, which concludes that our way of operating is in accordance with all rules and regulations.

Finally, we conduct background checks for all counterparties, leveraging on our contact network. We feel that given our pragmatic approach and long-term planning for establishing our presence in Russia, the risks are effectively mitigated.

Finally, where does the name 'Lago Kapital' come from?

Well, Finland is the country of thousand lakes, hence Lago ('lake' in Italian). Originally, 'Kapital' was supposed to be spelled with a 'C', but since we learned that there was already a company with that name in the US, we decided to adopt the Swedish spelling of 'capital' with a 'K' (Swedish is Jani's mother tongue and the second official language in Finland). Therefore, even our name reflects the international focus of our firm. **SLT**

Jarkko Järvitalo
CEO
Lago Kapital

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FIX it quick

What's next for technology, asks Rob Sammons of Anetics

Before internet browsing, arranging air travel was best handled by a local travel agent. He or she had access to all of the schedules and fares. With knowledge of the customer's profile and preferences, this person could set an itinerary and deliver travel documents. When you think about it, travel agents were a bit like finders in the stock loan industry. In some regards, it's a good thing times have changed.

I'm ever intrigued by how sophisticated booking air travel has become. It seems that you can go to any airline website and discover schedules, fares, and seat availability. Or you can go to an intermediary site to see the same information for many airlines all at once. Generally, the information available in both cases is the same.

I like arranging my own air travel, so that I can personally select the options that work best for me. I may go to one of the intermediaries to get the big picture, but I always book directly with the airline. I favour a bilateral contract with the service provider, and no intermediary. I find that it's best to execute quickly once you find your deal. Hover too long, or make the same inquiry too many times, and you may see the fare increase.

With air travel, sets of XML messaging standards have evolved for open communication between the airlines and booking agencies that even today continue to coalesce as the industry strives for better integration and a common protocol. Some 20 years ago we, in the equities industry, had the same need for communication, and lucky for us the FIX messaging protocol emerged. I say lucky because it has generated almost universal adoption, is easy to work with, and is an open-standard, freely available to any participant that wishes to use it. FIX messaging has been so successful for equities that it is now also used with fixed-income, foreign exchange, and certain other products.

The interesting thing here is, so far as I know, Anetics may be the only technology firm that uses FIX for anything related to securities lending. And we use it not by having created custom message formats, but by using standard messages, having them represent borrow/loan, supply/demand, or locate put/hold, depending on the context. There are an adequate number of standard fields to define most any attribute of a deal.

The stock loan desk

A day in the life of a stock loan desker starts early and seems to be getting longer, as fewer people are tasked with more to do. There are platforms to manage, phones to answer, and the constant flow of email and Bloomberg messages that can't be ignored. Many of these emails and messages, whether addressed manually one-by-one or collated by the Anetics Twill platform, offer a treasure trove of information about available securities, from or needed by the marketplace.

More dealing today is done through auto-borrow/auto-loan than ever before. This is often only beneficial if you are wired up to same hub as your counterpart. Even then it is usually just a fill-or-kill order request, perhaps with rate requirements. If a transaction is concluded you may even have to pay a fee, depending upon the hub you are on.

With email and telephone dealings you have unrestricted reach to and from all your counterparts with no supplemental transaction costs. This message flow is constant: everything from loan returns and requests for colour to pricing on new loans, with rate changes and myriad other tasks smattered in. Stock loan deskers take this all in stride, cutting and pasting, parsing and typing, in and out of whatever trading system he or she may be using, always striving to get back to the customer with a good answer or confirmation in a timely manner.

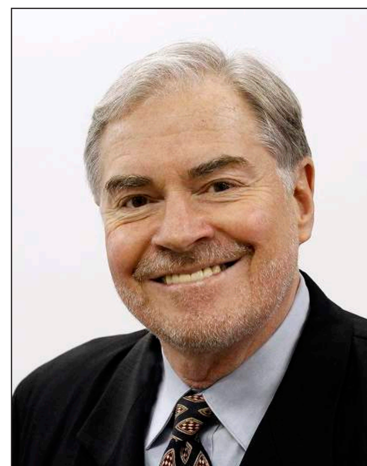
The future

Consider this: what if such flow of activity went directly from trading partner to trading partner, and not by email or voice over telephone, person to person, but as an electronic message, system to system? Most of the cutting and pasting, parsing and typing of lists is no longer necessary. The raw underlying data will have gone directly into the user's stock loan system. In some instances, the work related to the message can be completed without dealer intervention. In cases where dealer action is required, it happens on-screen, with no manual transfer of data, one system to another.

The underlying FIX messaging protocol is all transparent to the desk user. Think of FIX as system-oriented email—electronic documents that allow any one system to talk to any other system, and receive responses with updates and changes. Negotiated dealing with counterparts becomes key-strokes and mouse-clicks. If a loan request is received by your system at a rate you don't like, don't just accept or decline it. Kick it back with a rate you do like, add a comment, and wait for your borrower to respond.

Lest this all seem like magic, because it isn't. It's already the practice in other industries and the FIX messaging protocol is the perfect enabler for securities lending. Anetics has been using FIX messaging in customer communication for years. It is just a matter of time before you will wish to wire it up to your desk.

We at Anetics would be curious to hear from any industry participant that is also using FIX and if there is interest in collaborating on FIX standards for securities lending. It's just a matter of time. **SLT**



Rob Sammons
Director
Anetics

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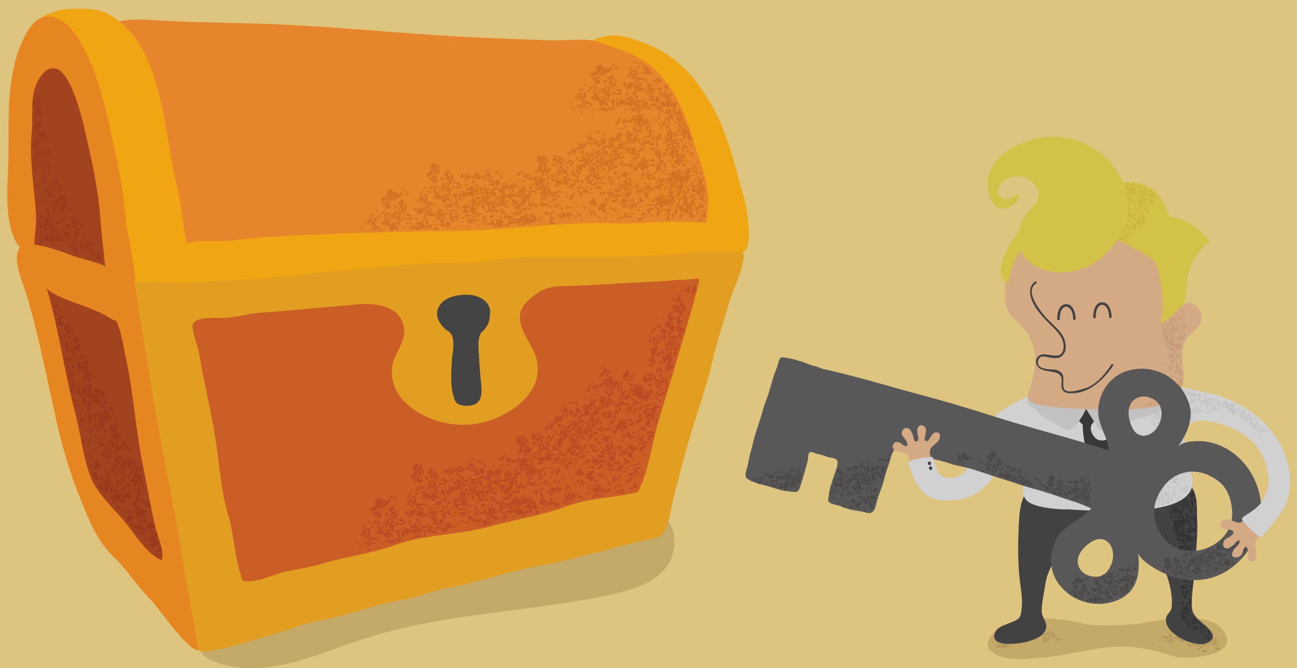

Unlocking liquidity

Regulation is creating new opportunities for securities lenders

MARK DUGDALE REPORTS

As new regulations such as the European Market Infrastructure Regulation (EMIR) and Basel III force financial institutions and intermediaries to look more closely at how and where they manage their collateral, questions continue to be raised around whether a 'collateral crunch' will start to materialise in 2014, or whether the global financial infrastructure is able to support the fluidity of collateral that markets and participants desire.

Securities lending activities have traditionally played a significant role in this process and new capital and liquidity requirements are encouraging institutions to look at the ways that they access inventory and collateral in a different light.

"It has been a very busy year for us so far," comments Alexandre Roques, head of ASLplus sales at Clearstream Banking.

"Despite spreads continuing to tighten across the board, we have seen a significant increase in lent balances during the first half of 2014. Demand for corporate bonds, in particular for euro-denominated issues, and emerging market debt continues to increase but we have seen the biggest changes resulting from the increasing demand for AAA- and AA-rated government bonds, in particular German bunds."

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Clearstream feels that this is being driven more and more by the need for firms to satiate regulatory concerns as borrowers prepare themselves for the roll-out of the Basel III framework, and in particular adherence to the liquidity coverage ratio (LCR) that will be introduced in 2015.

The LCR has been designed by regulators as a measure of financial stability in times of stress. Specifically, it represents the value of unencumbered high quality liquid assets (HQLA) that a financial institution needs to have access to cover its total net cash outflows for a prolonged stress period of at least 30 days.

"In broad terms, assets that qualify as HQLA need to be liquid, central bank eligible and easily monetised in times of stress," says Roques.

The requirements stipulate that at least 60 percent of HQLA should be met using the highest quality 'Level 1' assets, which includes cash, and specific high-grade sovereign debt, and no more than 40 percent of 'Level 2' assets, which includes specific lower-grade liquid grade sovereign debt, certain corporate and covered bonds, as well as some equities.

"As a large number of AAA and AA government bonds have generally fallen under the Level 1 categorisation, access to a stable and reliable source of top quality HQLA, in particular German bunds, will be essential for any financial institutions that want to manage their LCR efficiently. This is precisely an area of the market that Clearstream's Global Liquidity Hub and in particular its ASLplus product has been designed to support," says Roques.

"As we represent the central securities depository in Germany and the international central securities depository in Luxembourg, we have a large natural franchise in European government bonds and Bunds in particular and we are strategically best placed to mobilize them for collateral transformation purposes via our low-risk securities lending products," comments Roques.

Clearstream's ASLplus product was launched in 2006 as a complementary service to its existing ASL fails borrowing service, and was designed to unlock stable pools of high-quality assets that it holds as custodian for clients that are happy to lend them. After eight years of development and distribution, independent vendor league tables now rank Clearstream as one of the largest and most important lenders of bunds in the world.

Roques adds: "As an infrastructure provider, it is important for us to ensure that we can provide efficient solutions to facilitate the distribution of liquidity and collateral where it is needed most. We have access to a plentiful supply of bunds as well as other high-grade 'Level 1' qualifying assets, and the fact that our balances are generally stable in nature creates an attractive value proposition for our clients. It is the smooth reliable, nature of our business that makes us a reliable and trustworthy source of key liquidity in the current environment."

In fact, trust has always been an attribute on which Clearstream places great emphasis when developing its securities financing products, and also its relationships with its lenders and borrowers.

"The combination of a secure legal set up where Clearstream acts as sole borrower to its lenders and as sole lender to specific approved borrowers is the starting point. We use the industry standard Global Master Securities Lending Agreement together with our collateral management agreement under Luxembourg law and only accept specific liquid collateral with full title transfer. This makes us attractive to risk-averse lenders," confirms Roques.

"We have also optimised our distribution through a combination of proprietary desks in London and in Singapore as well as key distribution partners. This gives us the opportunity to negotiate the best possible rates on behalf of our lenders. In addition, our award-winning collateral management products have been used by the wider financial community for over 20 years and allow borrowers to streamline their collateral processes with us accordingly."

The demand for high-quality assets is likely to increase unabated in particular with the onset of the mandatory clearing requirements in the OTC derivative space later this year.

Roques says: "Challenges remain and easing measures enforced by central banks over the past few years have put substantial pressure on yields. Capital usage needs be managed efficiently and banks will need to look at the ways that they can manage their LCR ratio most effectively. Central clearing opens new doors but it is a firm's ability to mobilise its long balances, whether these are at a local or group level, and to unlock any liquidity that might be used to fulfill their regulatory obligation without impacting revenue, that will be critical."

"Through our Global Liquidity Hub initiatives not only in Europe but also the partnerships that we have developed through the Liquidity Alliance, we strive to ensure that the market place has the right tools as its disposal and the increasing demand for our supply and the use of our collateral management products is an encouraging sign that our vision is the right one." **SLT**

Alexandre Roques
Head of ASLplus sales
Clearstream Banking

"Central clearing opens new doors but it is a firm's ability to mobilise its long balances, whether these are at a local or group level, and to unlock any liquidity that might be used to fulfill their regulatory obligation without impacting revenue, that will be critical"

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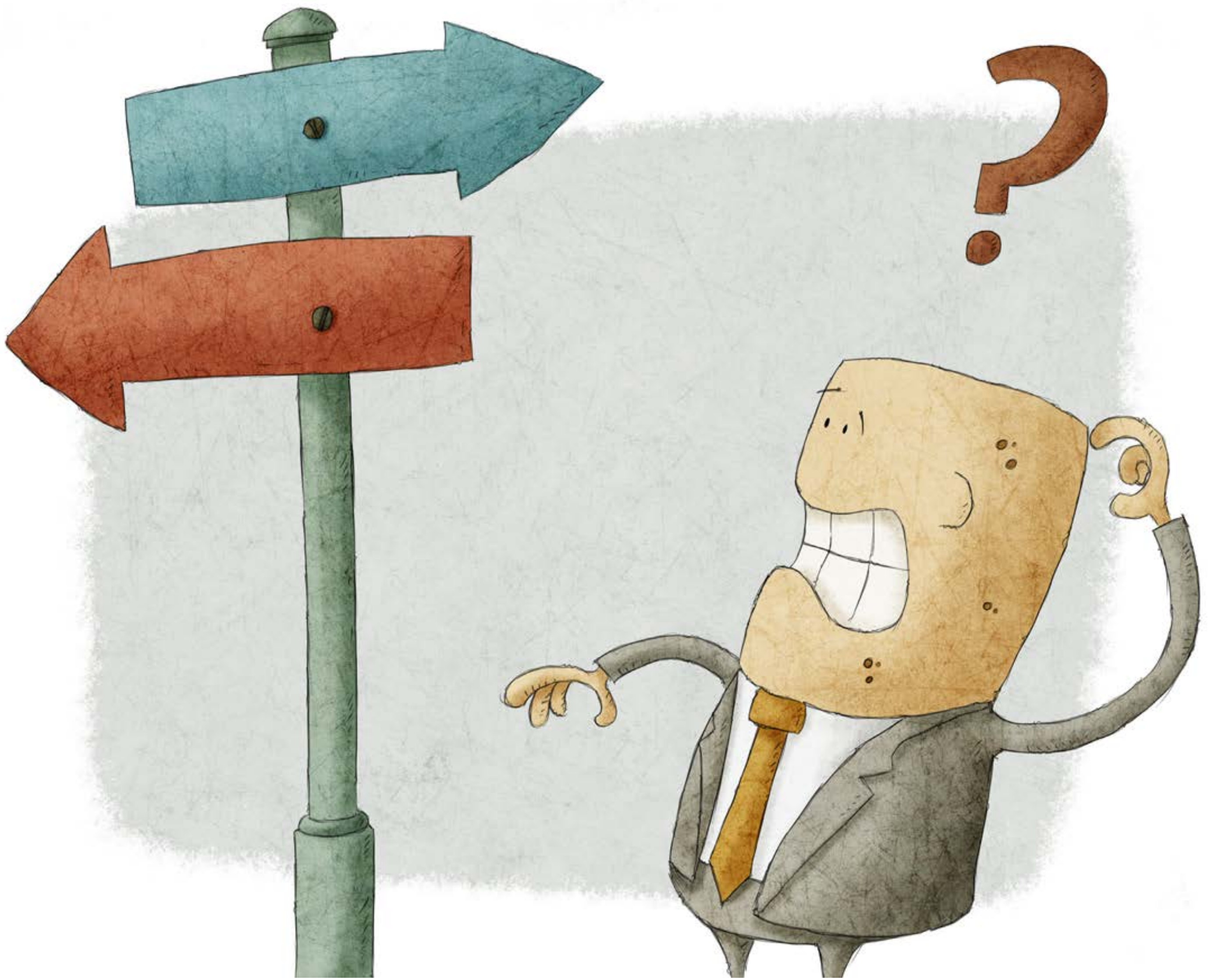

The collateral conundrum: burden or opportunity?

For those that have yet to decide on a comprehensive strategy, the risks are becoming even greater for operating with a substandard non-optimal system, says David Field of Rule Financial

The passing of the European Market Infrastructure Regulation (EMIR) 12 February trade reporting deadline was perhaps not as smooth as many market participants would have liked, but it may have provided invaluable lessons ahead of the impending collateral reporting deadline this August. Different firms' self-assessments range from confident claims of complete preparedness to those who are yet to mobilise, leaving the majority somewhere in between, aware of the implications of not complying but uncertain of how best to transform their current systems.

The current pace of regulatory change can seem overwhelming to those trading derivatives and the move to centrally clearing some OTC products has raised a number of new challenges around the collateral management process that firms must wrestle with.

Traditionally, collateral management was a credit mitigation process run by operations, margining was less frequent and collateral processing was largely supported via spreadsheets. This article will consider the impact of changing approaches to collateral usage, as firms must define their target operating models and leverage available technological benefits, most notably software as a service (SaaS). Regardless of whether you see opportunities or challenges in this changing landscape, proactive collateral management and optimisation will be a competitive differentiator, a method of reducing costs and performance drag.

The possibility of a collateral crunch in the coming years will depend largely on supply and demand, but at this early stage the data suggests that there will be sufficient collateral in the market. The main challenge lies in creating a market infrastructure that gets the right collateral to the right place at the right time, which is a highly complex task.

Under normal market conditions, an estimated $2 trillion of additional collateral is likely to be required. However, in less certain times, say

during a major default, volatility could cause collateral demand to jump as high as $11 trillion. Bilateral counterparties will require more initial margin as counterparty ratings drop and central counterparty (CCP) value at risk (VaR) models generate higher PFEs (potential future exposure). Variation margin requirements will also increase as a consequence of market volatility.

While a collateral crunch may not occur, a client onboarding crunch for clearing services and collateral technology could result in real problems, particularly for the buy side as it rushes to meet the requirements.

Managing risk

The benefits of strong collateral management capabilities are numerous but the adoption of new practices should also be viewed as an exercise in risk mitigation. In the situation of a counterparty default or market crisis, the collateral system must provide a clear view of all margin calls and pledges to every CCP and bilateral counterparty in one place. In addition, the visibility of allocated and unencumbered collateral across all funds (own, outsourced and third party), dynamic management of margin calls, substitution and pledging, and the ability to meet sudden variation margin calls quickly with eligible collateral should all be provided.

Delivering all of this while minimising headcount costs and performance drag by allocating cheapest to deliver (eligible) assets and using collateral transformation services efficiently, gives some idea of the challenges ahead.

In our opinion, an automated solution from one of the main technology vendors is likely to be needed. Should another Lehman Brothers occur or even worse, a CCP fail, then the cost of a leading edge collateral management system will be money well spent. Moreover, firms may also want to verify CCP/broker margin calls by replicating the CCP's initial margin calculations. This will help when forecasting collateral requirements on a forward-looking basis, thus creating the valuable time needed to source suitable collateral at a reasonable cost.

Stress testing the collateral portfolio can also be a valuable exercise, enabling risk managers to analyse the effect on collateral requirements and funding costs in scenarios such as a self-downgrade or major market movement.

The new collateral function and processes

Previously, margining was relatively simple with portfolio managers seeking alpha through cash instruments and hedging with derivatives. Typically, firms would post collateral in cash and manage margin with spreadsheets. The buy side, for example, posted one-way independent amounts to counterparties that were marked-to-market on a relatively infrequent basis.

In the post-crisis landscape as collateral demands grow, funds may no longer hold enough cash to meet the increase in margin requirements. This will result in a drive towards non-cash collateral to reduce the impact on fund performance. Non-cash collateral requires more intensive processing, leading to a step change in complexity for the buy side. Inventory management therefore becomes a core function and firms will need a clear view of inventory by fund in order to source collateral for initial and variation margin in an efficient way.

Secondly, a margining engine is essential for processing more frequent calls in an automated way with minimal strain on operations or headcount. A third key component is management of eligibility, concentration, haircut and reference data schedules and ensuring that the firm remains compliant with its mandate and risk guidelines. Finally, the use of margin messaging tools and reconciliation solutions would improve straight through processing and reduce operational risk.

Selecting your CCPs, clearing brokers and FCMs

Settling on the most appropriate CCP, clearing brokers and futures commission merchants (FCMs) can be one of the most time-consuming aspects of moving to a cleared environment. The majority of firms will connect to at least two clearing brokers and CCPs in order to diversify risk. However, this will result in a need for connectivity to many different venues, potentially fragmented order flow and reduced netting benefits. This increased complexity results in more margin calls, more widely dispersed collateral (thus reducing concentration risk), but at the expense of increased operational risk.

Firms must consider portability agreements that allow them to port positions and collateral over to another broker/FCM in the event of a default. Therefore, when assessing a CCP and performing due diligence, firms need to consider a wide range of both quantitative and qualitative factors including: margining methodologies, the credit quality of the CCP's clearing members, default and resolution procedures, and transparency of the CCP's risk management procedures.

It is also worth considering the likelihood of a central bank backstop, although as yet few central banks have explicitly agreed to backstop a CCP. This, and a lack of transparency around risk management methodologies, makes it hard to compare like-for-like when evaluating one CCP against another.

What has helped is that technology providers are constantly innovating in the area of CCP optimisation, simplifying previously complex calculations that consider the CCP's initial margin methodology, collateral eligibility criteria and netting options.

Sourcing and transforming collateral

The extent of the growing demand for high-quality assets remains uncertain but the effects of central clearing, two-way exchange of margin for bilateral trades and Basel III liquidity coverage ratios will all add to it. Movement of collateral around the financial system may also slow due to reduced rehypothecation and CCP account segregation. However, new supply of high quality collateral assets coming back into the market through the winding down of quantitative easing in the UK and the tapering of the US Federal Reserve system support may balance this.

Holding cash for CCP variation margin calls is likely to be expensive, creating a drag on fund performance. There are indications that leading FCMs will soon be charging 50 basis points for lodging cash collateral. Where some lead, others will follow, especially as some markets move into negative interest rate territory. Conversely, many funds will not be holding enough high-quality liquid assets to meet CCP margin calls.

The widely accepted solution lies in the collateral transformation trade that upgrades lower quality assets into CCP eligible collateral via the securities lending or repo markets. A broker can take non-CCP eligible collateral assets from the buy-side firm and then upgrade them for CCP eligible securities in the securities finance markets, charging an upgrade fee to do so.

Matching the maturity of collateral with the derivative portfolios it is underpinning is a key consideration and there are potential maturity mismatches in collateral upgrades. Short-term repo markets can of course provide a source of collateral when clearing a long dated swap at a CCP, but this can expose the derivatives end user to rollover risk. Collateral transformation may also be prohibitively expensive for many on the buy side, and sell-side firms are facing balance sheet constraints in the new regulatory environment.

As ever, in solving the collateral conundrum, there is no substitute for mobilising as soon as possible. For those that have yet to decide on a comprehensive collateral management strategy, the risks are becoming even greater for operating with a substandard non-optimal system, incurring high costs associated with non-compliance and inefficient tactical solutions. **SLT**

This is an abridged article from the new whitepaper by David Field of Rule Financial and Paul Wilson and Martin Seagroatt of 4sight

David Field
Specialist in clearing and collateral management
Rule Financial

Straight to the core

Experts assemble to discuss the machinations of the European markets, the FTT, the need for a CCP, and technology as a solution

John Schreyer
Co-head of agency securities lending EMEA & Asia, global transaction banking
Deutsche Bank

Jonathan Lombardo
Head of global sales
Pirum Systems

Jonathan Lacey
International head of equity trading, securities lending
Northern Trust

Mark Jones
Head of securities lending product management
Northern Trust

Guy Knepper
Head of securities lending
CACEIS

Laurence Marshall
Managing director
EquiLend Europe

Maurice Leo
Senior managing director and head of relationship management, EMEA
State Street

Simon Colvin
Research analyst
Markit Securities Finance

Paul Wilson
Managing director and global head of agent lending product and portfolio advisory
J.P. Morgan Investor Services

Mark Dugdale
Editor
Securities Lending Times

How are European securities lending markets doing at the as we enter the mid-point of the year?

Simon Colvin: Both equity and fixed income securities lending revenues have been relatively flat across Europe over the last couple of years. This is driven by the fact that average fees and loan balances have held relatively steady over this timeframe.

Things are looking healthy on the supply side, as inventories have increased by more than a third over the last 24 months to $4.5 trillion for all European securities. However, this surge in inventory has ensured that utilisation and return to lendable both stand near new lows.

Paul Wilson: From a beneficial owner perspective, the European lending market is very robust, with a strong appetite for lending with new beneficial owners coming to the market and existing lenders keen to grow revenues/maintain existing revenues.

The challenge remains on the demand side, where adjusting to new capital, liquidity and leverage rules are having the effect of impacting capacity and volume of business that borrowers are able to transact. This year's dividend season has transpired to be very challenging, with some borrowers pulling back on the amount of business they are doing and there being an absence of end users.

There were significant variances in the all-in levels and true differentiation could be achieved by having the right trading strategy. We feel very positive about our overall performance given the trading strategy we utilised.

John Schreyer: Overall, it has been a very solid year so far in both fixed income and equities. On the fixed income side we continue to see considerable demand for high quality collateral in various structured lending trades as well as need for financing against various collateral types and tenors. The market has also been experiencing steady growth in the lending of corporate bonds with an increase in special value. In terms of equities, while there has also been sustained growth, there has been a reduction of leverage in the market as a whole. Two of the main drivers have been greater demand due to a rise in convertible bond issuance and a clear boost in the fees generated on specials.

Jonathan Lombardo: We have seen a steady, albeit small, increase in overall balances year on year since the sharp decline witnessed post-crisis. That trend has continued into this year, although the impact of future regulatory changes may influence this growth as the industry begins to adjust to the increased capital and risk-weighted asset allocations directly to securities lending profit and loss.

Laurence Marshall: European markets have been strong all year across all major markets, according to DataLend data. As for securities finance trading, the EquiLend and BondLend platforms so far in 2014 have seen a 20 percent increase in volumes in Europe, year over year. It has been a busy year so far for the securities finance markets in Europe.

Maurice Leo: European equities lending has been improving over the past year as macro credit concerns have waned and capital has been redeployed into the region. In terms of traditional asset allocation percentages, many

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investors have been underweight the European region for several years. As this reverses and assets resume trading on fundamentals, the market should continue to produce opportunities to lend shares.

Despite a general long bias in the region, we have seen an increase in the demand to borrow. Many of the most interesting lending opportunities are a result of capital raisings, where we can lend shares against a new offering of securities, and a growing number of corporate distributions with an option to elect scrip, which drives demand for shares over record date.

> Lacey: The heightened bank-leverage standards imposed by the regulators will likely increase the capital for some banks causing further shrinkage in the securities lending and repo market.

Jonathan Lacey: The changing regulatory landscape continues to remain an increasing focus for the region, whether it relates to Basel III capital rules, the European Financial Transaction tax, or Basel III large exposure and leverage ratio proposals. As a consequent of these changes, borrowers continue to face increased scrutiny around capital costs and balance sheet usage and as such are changing the way they source their supply needs. Increasingly, when sourcing liquid securities, borrowers are looking to pledge equity collateral on a term basis in order to derive funding benefits. The heightened bank-leverage standards imposed by the regulators will likely increase the capital for some banks causing further shrinkage in the securities lending and repo market. We expect these themes to continue.

European securities lending markets have benefitted from a stabilising macro-economic environment in the region, however, political risk became a key concern as the world focused on protests in the Ukraine, followed by the overthrow of the exiting Ukrainian government and Russia's annexation of Crimea. Political tensions in Turkey, Thailand and Venezuela were also in the spotlight.

During the heightened tensions in Ukraine, the securities lending and repo markets continued to function normally without any significant disruptions. On the fixed income side, there was increased demand and higher spreads across almost every Ukrainian government bond issue. Targeted Ukrainian issues traded at even higher spread levels as funds executed directional trades.

On the equity lending side, European indices have maintained the positive momentum they had gathered through the second half of 2013. This rise in economic optimism in the region has been a catalyst for hedge funds to rotate capital out of the US and into Europe, which has started to bleed through to growing short balances in the region.

Additionally, Europe's low interest rate environment, coupled with ongoing regulatory pressure, continued to be a catalyst for capital raising. Rights issues and convertible bond issuance have been a key source of wider lending spread opportunities in 2014 as borrowers look to exploit inherent arbitrage opportunities.

A stabling macro-economic picture has also resulted in an increase in deal making. Global M&A activity totalled an estimated $1.2 trillion for the first five months of 2014, the highest level since 2007 and an estimated 42 percent up on a year ago with an increasing number of deals being financed through a mixture of stock and cash versus previous years. While not all M&A activity will not necessarily translate into increased securities lending loan volume, the higher levels of deal activity in the first half of the year creates optimism for the second half of 2014.

Which assets are attracting the most interest in the major European markets? What about the minor ones?

Marshall: Securities finance trading in major markets has been active this year, particularly in France, where stocks such as Peugeot, Gemalto and Total have been top earners across all of Europe late last year and in 2014. Trading on EquiLend and BondLend has seen strong growth in emerging markets such as Greece and Czech Republic, each recording triple-digit growth over last year, indicating a growing interest in these markets.

Schreyer: Almost all asset classes in the major markets continue to generate substantial opportunities. For fixed income assets in these markets, much of the interest depends on the ability to structure the trades in an efficient manner to meet the requirements of the borrower. This includes adjusting the duration or matching against collateral, and is true for both government and corporate debt.

For the major European markets the demand for equities continues to grow, but the structure of the trade and the type of collateral one accepts has become increasingly important.

The market is different in non-core Europe for both asset classes. There are opportunities to provide financing against these assets but only sporadic demand to borrow these assets.

Leo: Core markets have been the most active, with France, Germany and the UK producing the highest utilisations. The peripherals have produced specific stock trades with high spreads for periods of time, but these markets tend to lack the liquidity to produce substantial portfolio-level performance. Generally, and not unlike the sector interest we've seen in other regions, European financial, consumer discretionary and energy names have drawn the greatest interest.

Wilson: In the first part of the year, there has been strong demand for yield enhancement trades on high dividend paying equities. There was a fair amount of capital raising by European banks driven by upcoming European Central Bank (ECB) stress tests, so banks took the opportunity to strengthen their balance sheets.

> Marshall: Trading on EquiLend and BondLend has seen strong growth in emerging markets such as Greece and Czech Republic, each recording triple-digit growth over last year

Balances in international fixed income have risen steadily from the start of the year, reaching

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levels not seen since September 2012. Spreads were also very steady with demand for German government bonds particularly strong. After the quarter's end, we saw demand for government bonds drop off as volatility returned to overnight rates, as a result of excess liquidity in the system being paid back to the ECB.

> Colvin: Despite the rather static fee and balance picture, we've seen a nice pickup in revenues generated by rights issues, especially financials. Currently, there are 21 financials trading special across Europe, twice the number that was seen at the start of the year

Spain and Italy traded very close to AAA issuers for the first quarter but have widened as excess liquidity declines. Corporate bond demand remained stable throughout the quarter, though lower than the all-time highs seen in Q3 2013. Since dealers are holding less inventory, there is concern that liquidity will be affected, but we are still seeing very few long-term fails.

Lacey: As is typical in the first and second quarters of the year, structured trading activity linked to European company's dividend distributions has been a key source of demand in Europe's major markets. However, as referred to above, balance sheet constraints and increased collateral funding costs led to a slight softening of lending spreads versus 2013, with Germany and Italy most affected. In Italy, the financial transaction tax continues to negatively affect demand.

Elsewhere, demand for higher intrinsic value securities remained robust. The highest lending spread opportunities continue to be focused around specific long-term, fundamental lead directional demand across tough sectors that remain negatively affected by lower levels of global growth. These include mining, basic materials, consumer discretionary and information technology.

In terms of more minor markets, Europe's emerging market sector has continued to attract increased interest.

On the fixed income side, the demand for high-grade sovereign debt versus alternative collateral (ie, equities or corporate debt) remains high as the global regulatory environment continues to put pressure on borrowers to efficiently manage liquidity. This trade is usually done under a term or evergreen structure in order for the borrower to obtain beneficial treatment from a liquidity coverage ratio perspective. Regulators are also requiring market participants to pledge more high-grade sovereign debt as collateral against derivative and other transactions, further fuelling the demand for this asset class.

Colvin: Despite the rather static fee and balance picture, we've seen a nice pickup in revenues generated by rights issues, especially financials. Currently, there are 21 financials trading special across Europe, twice the number that was seen at the start of the year. The demand to borrow these names is driven by recent corporate actions led by Banco Espirito Santo, which recently announced a €1.05 billion capital raising effort.

While the current spate of deals revolves around smaller periphery names, the ever growing pressure on bank balance sheets could make rights issues, and the associated securities lending revenue, a bright spot for the industry in the near term.

How many lenders and borrowers exist in Europe today compared to before the financial crisis, and at what level are they doing business?

Lombardo: We have recently seen some consolidation on the broker-dealer side, which we believe is being driven by non-domiciled banks moving business lines back to their domestic hubs as a result of pending regulation and their impact on capital requirements. In terms of balance on loan, we are still below pre-2008 levels, which based on the data we receive is around 10 percent lower.

Overall, Europe remains vitally important for borrowers and lenders while we have seen strong demand for our bespoke post-trade services in newer markets such as Brazil and South Korea, which is indicative of participants looking at revenue streams away from the established European markets.

Guy Knepper: As a custodian acting on a principal basis for many of our clients (UCITS and insurance companies), the picture we have of the securities lending market is not representative of the industry as a whole. Other than the obvious disappearance of Lehman Brothers in the wake of the financial crisis, we do not feel that there has been a significant contraction in the number of lenders and borrowers in the market.

Indeed, from our point of view, the business is growing organically and clients still see the strong business case for joining a securities lending programme when the impact on profit and loss figures is demonstrated. In terms of new securities lending market entrants, we believe that barriers to entry are very high, which will exclude many smaller players, despite the availability of off-the-shelf technology platforms.

In terms of location, CACEIS has its securities lending hub in its Luxembourg-based dealing room, and is capable of acting for clients from any of the group's entities worldwide.

Schreyer: The number of lenders and borrowers at the wholesale level seems to have remained fairly constant since the financial crisis. The main change has been the size and mix of the business that each is doing. Certainly, the overall volumes are less than they were before the crisis. We have seen firms sharpen their focus to those sectors of the lending market where they see the greatest ability to generate spread or to facilitate other business that is important to them.

> Lombardo: Europe remains vitally important for borrowers and lenders while we have seen strong demand for our bespoke post-trade services in newer markets such as Brazil and South Korea

Europe is certainly a key region for Deutsche Bank with opportunities across both the equity

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and fixed income markets. It is also important to point out that the US remains a key focus for us with significant new client wins over the past two years and is a region where we continue to invest. Finally, the Far East also keeps on growing in both the number of lending clients entering the securities lending space, and the development of markets such as India, Taiwan and South Korea.

Wilson: Since the global financial crisis, the number of lenders across Europe has increased. We have seen significant increased demand and appetite since August, when European rates were reduced to zero and beneficial owners sought increased yields. European lenders on the whole do remain more cautious than counterparts in either Asia or the Americas, with a bias towards non-cash programmes focused on yield enhancement and specials activity.

Programsme do remain varied with high degrees of customisations. Beneficial owners are heavily engaged. They have a real desire to be actively involved and informed about lending activities and opportunities to increase returns. We have a highly focused business strategy with key segments across all regions that we have identified as a priority for us and of course this includes many across Europe. However, with demand suppressed and the prospect of overall volumes growing over the next two to three years being quite small, our targeted and focused approach has the right balance of matching supply to demand.

> Wilson: Beneficial owners are heavily engaged. They have a real desire to be actively involved and informed about lending activities and opportunities to increase returns

Leo: The number of market participants in the region has remained consistent over time, but the depth of demand for some of the traditional players has shifted. With regulatory changes exerting pressure on many borrowers, they have necessarily become more selective in allocating their resources. This has produced greater variability in terms of interest by products and by countries. Europe continues to be a very important and core product offering for both agent lenders and prime brokers. While the product mix and client make-up may continue to evolve, presence in the region is a must for any firms servicing clients on a global basis.

Colvin: This is a bit of a tough question as many securities lending providers do not have the luxury of choosing which markets they operate in. European equities securities lending still represents 55 percent of global revenue recorded this year, which is roughly the same portion as seen last year. With customers increasingly operating internationally and focused on universal offerings, ignoring parts of the European market makes little business sense.

Lacey: In general over the last few years Northern Trust has seen an increase in the number of beneficial owners joining our programme. Most of our client base invests in global assets so the domicile of the lender is not driving the volume of activity we see in the securities lending markets. Northern Trust continues to envisage Europe as an important location to operate business from and we will certainly continue to increase our global footprint in many key counties in the region.

Marshall: Our client base continues to expand. We now have 93 lenders and brokers worldwide using a combination of our trading, post-trade and data services, with all indications suggesting that client participation in the securities finance market remains strong. Europe in particular is and has always been a major hub for all global business due to the time zone and client management from Europe.

The EU 11 are pressing ahead with the Financial Transaction Tax—are European players and those that could be affected indirectly preparing for the worst?

Leo: The main concerns and real damaging effects of the proposed directive are caused by: (i) the establishment principle within Article 4 creating an extraterritorial and global tax charge; and (ii) the fact that both buyer and seller become liable to pay the tax with joint and several liability, thereby creating a tax multiplication or cascading effect on a global basis.

However, the European industry and professional advisors widely speculate that the proposed draft directive to implement an EU Financial Transaction Tax (FTT) between the present 11 participating member states will likely be similar to either the French and Italian iterations or the UK Stamp Duty Reserve Tax (SDRT) regimes. They impose a transfer tax on the purchaser and work on an issuance-based principle only.

> Leo: Without an established consultation period, market participants are concerned that the damaging effects of the directive may become a reality for which there is no plan B

Based on this speculation, ongoing jurisdictional political division and lack of agreement among the 11 participating member states, the industry is currently taking little action. Many believe the worst-case scenario—complete implementation of the directive as drafted into EU law—remains highly unlikely.

However, this remains a highly political process. Without an established consultation period, market participants are concerned that the damaging effects of the directive may become a reality for which there is no plan B.

Lacey: There is a level of apprehension around the implementation of the EU FTT and the potential implications for the securities lending market. It is widely hoped that as the exact details of the implementation emerge we will see exemptions adopted for securities lending and repo transactions, although we believe it likely that there will be a reporting requirement for lenders and borrowers.

Should lending transactions become taxable under the final legislation, it will undoubtedly make some of the existing transaction flow economi-

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cally unviable and would have ramifications for market liquidity and the revenue that beneficial owners are able to generate from lending their assets. The hope is that the implementation will eventually follow the lead of the markets that have already implemented a tax (France and Italy), and after reviewing the impact of capturing securities lending transactions in the scope of the FTT, an exemption will be granted.

In terms of preparation, I believe the market in general is well equipped to deal with any reporting requirement that may emerge, but preparing for a tax liability is more problematic. Lenders and borrowers will need to factor in the additional cost of executing a transaction at point of trade—systemically, this is something that most will be able to manage but as mentioned, there will be a dramatic impact on the volume of transactions actually being executed.

> Schreyer: The agency securities lending business operates on behalf of lenders and transacts with the borrowing market, so it is critical to continue to facilitate this connection in a profitable manner while addressing the new regulation

Schreyer: At Deutsche Bank we are constantly tracking the potential outcome of the transaction tax and other regulatory changes and the impact that they may have on various businesses, including the transaction bank. We have been preparing for the likely ramifications of the FTT, such as the potential cost to the agency securities lending business, as well as an evaluation of the trade structures that might emerge once the details of the tax are finalised. The agency securities lending business operates on behalf of lenders and transacts with the borrowing market, so it is critical to continue to facilitate this connection in a profitable manner while addressing the new regulation.

Lombardo: Although the impact to securities lending of the FTT has not yet been realised, there has already been a great deal of analysis of some of the expected effects. At first, this will be seen within the primary markets of the countries that impose the tax, potentially in the shape of a decline in the values of domestic securities and increased expense when fund-raising through capital markets.

Ultimately, these effects will indirectly flow into the securities lending market, which when combined with the direct impact of the tax that currently has securities lending transactions within scope, would lead to at least 65 percent of the current European securities lending market being rendered uneconomic based on analysis by the International Securities Lending Association. Given the scale of the changes, as an industry we must continue to lobby as the EU 11 have yet to finalise how they will implement the new provisions.

Knepper: The impacts of the FTT could well be severe, and may have a major impact on the securities lending business' ability to generate a profit. Low margin business would likely be killed off by the FTT, which would mean the cost of borrowing securities to hedge positions would rise considerably, and in turn lead to an undesirable reduction in market efficiency.

In terms of the FTT, the negatives clearly outweigh the positives. However, FTT related discussions are in progress, and as yet, no official decision has been made that put securities lending transactions in scope. Furthermore, should securities lending business fall within the FTT's scope, it is unclear as how the various players in the chain would be taxed. For CACEIS, a custodian acting as principal for its clients, that is a key point to address.

As more central counterparty offerings emerge, are you or your clients taking more of an interest in the CCP model for securities lending?

Wilson: Central counterparties (CCPs) on the face of it do offer a potentially supplementary means to transact. We can definitely see advantages where a robust, fully functioning CPP could be useful and we continue to monitor closely developments in this area.

Ultimately, market dynamics and economics will dictate whether these venues attract any material volume—if borrowers feel they will get reduced capital or more efficiency of capital by utilising a CPP, then there will inevitably be some pick up in volumes. In any event, we don't foresee a market that is all or nothing. We see a CCP as just another venue or mechanism to extract the best risk adjusted value in certain instances for clients.

> Knepper: Should securities lending business fall within the FTT's scope, it is unclear as how the various players in the chain would be taxed. For CACEIS, a custodian acting as principal for its clients, that is a key point to address

Mark Jones: CCPs for securities lending is still a hot topic and one that generates a lot of discussion, particularly with the upcoming implementation of the European Market Infrastructure Regulation and mandatory central clearing for derivative transactions, which has led to beneficial owners becoming more familiar with the CCP model in general and therefore better equipped to question if and how it could be used more broadly in the securities lending market.

There are still obstacles for the CCPs to overcome in terms of providing a workable and scalable model to support securities lending, not least cost and post-trade activities, and we feel that these issues are likely to limit the volume of activity that will trade through CCPs in the very near future.

We do feel that the regulatory focus on mitigating systemic risk through the use of CCPs and the increasing familiarity that certain beneficial owners have with the CCP model will keep this topic high on the agenda moving forward, and that there may be an inevitable increase in the number of securities lending transactions that are centrally cleared. The scale will be determined by how hard regulators push the market and the CCP provider's ability to address the concerns of market participants.

Leo: With the market evolving and adjusting to changes brought about by regulation and other events, I think lending market participants must

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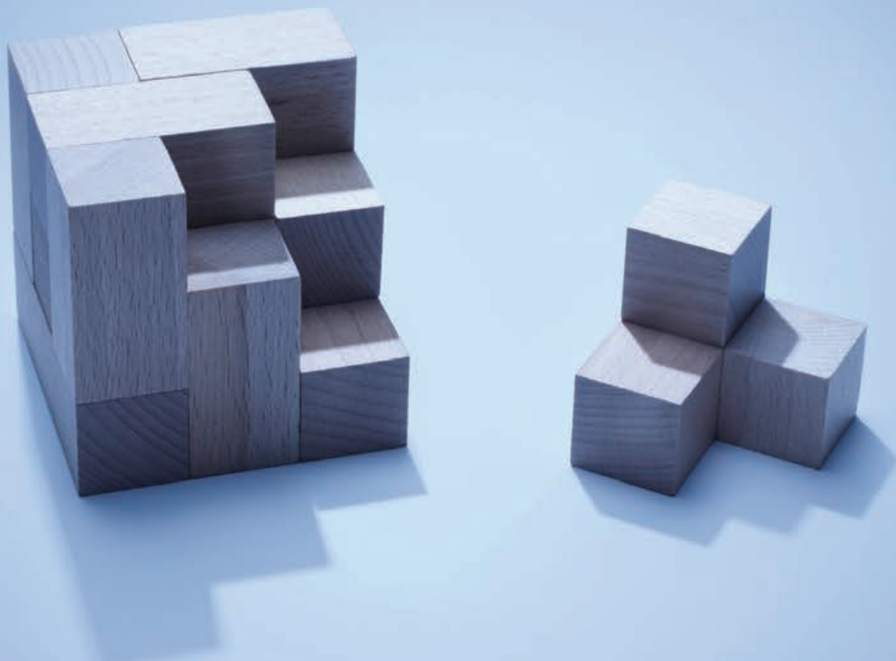

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continually evaluate options to optimally manage the product. The emergence of alternative models may provide certain benefits, and CCPs are likely to be one tool used in the future by many market participants.

Marshall: The securities finance industry currently operates almost entirely on a bilateral trading model, with much of that activity taking place via our global trading platform. The CCP discussion has been ongoing for years, but it hasn't changed the status quo much, although there has been some renewed interest in CCPs more recently given certain regulatory pressures on firms. We have been discussing this with our clients regularly and have committed to implementing CCP connectivity if client demand for it exists. Currently, we have not seen that demand yet.

Schreyer: We have been looking at the CCP model for quite a while. The model offers some real benefits in terms of risk and capital treatment. However, there are still some potential issues with combining the CCP model with the agency trade structure. Provided these issues can be resolved, some business will move into the CCPs but it is too early to determine how much.

Lombardo: We have been experiencing a surge in interest and take up of our CCP Gateway offering, which links into Eurex Clearing's Lending CCP. With several clients already live, in excess of €125 million of trades already being executed during May and an incredibly strong pipeline of clients in integration. we feel that the 'ocean liner' has finally turned. Increased risk-weighted asset and capital requirements have become a reality and the industry has embraced the benefits of a CCP in dealing with these issues. This is evident through the creation of ISLA's CCP working group.

We believe that the majority of organisations will, over the next few years, allocate a percentage of their business to be traded via a CCP. We believe this percentage allocation will range from between 5 to 20 percent of their total business and will be comprised of strategic but capital intensive trades that better suit novation to a CCP with its reduced capital requirements, as opposed to the higher capital requirement when trading bilaterally.

Finally, how are technology offerings streamlining business in Europe and making it more efficient? What more do vendors need to do in the next few years?

Marshall: Market participants want to be as efficient as possible with both their time and their budgets. We have responded to those calls by building Next Generation Trading (NGT), a consolidated, screen-based platform that combines trading of general collateral, warm and hot securities integrated with market data. Ultimately, NGT will eliminate the need for schedules, enabling real-time communication and trading of securities from general collateral through specials. This will truly change the way the securities finance industry trades.

The input from the industry on the ongoing build and rollout of NGT is truly unprecedented in the securities finance market. We have worked alongside dozens of traders, developers and relationship managers from lenders and brokers across North America, Europe and Asia-Pacific to ensure this platform encapsulates everything that they need in their daily trading activity, in the most intuitive and efficient way possible.

Wilson: Technology and operational efficiency are more important than ever. We are investing heavily in our core technology and particularly in our client facing technology, providing more fingertip information and analytics to our clients. We prefer to undertake technology developments in-house, but connect to industry applications such as EquiLend where possible.

Knepper: One of the principal benefits of technology is trading systems' ability to provide front- to back-office integration, which greatly increases the efficiency and data transfers for reporting purposes for custody clients on in securities lending programme. Today, there is no need to book tickets for transactions. Trading platforms and IT systems automatically import and book the transactions with no manual input. Furthermore, the STP nature enables us to absorb transaction volume spikes with ease.

Lombardo: Strategic alignments are critical for future growth and for the evolution of the market. Aversion to any infrastructural change and limited technology resources prohibit participants from building to match the ever changing dynamic of the fluid marketplace in a timely fashion. By utilising Pirum's central hub structure, participants technically outsource a portion of their development work, reducing overall cost, technology risk and implementation timelines. Customers further benefit from the 'network' effect where one connection, via a single portal, enables connectivity into all partnership structures developed by Pirum.

Flexibility, nimbleness, and 'light touch' implementation are key differentials that will separate successful models from those that require individual pipes or highly customised development. The latter models will ultimately struggle in today's present environment of cost reductions and technology resource restraints.

Jones: Technology is a key focus for Northern Trust and the continuing development of trading platforms such as Equilend and Bondlend are key factors in maximising trading efficiency for market participants. In addition, post-trade activities such as contract compare and collateral requirement matching continue to offer operational efficiencies and risk mitigation to the participants.

The demand and trend of increasing automation is unlikely to abate and vendors will need to adapt to the changing market infrastructure and regulation across Europe to ensure their offerings remain up-to-date. Transparency and reporting requirements across the securities lending market will undoubtedly increase as a result of increased regulatory focus and the need to have immediate access to data will be key.

> Jones: Infrastructure developments such as TARGET-2 Securities will have a major impact on how market participants interact with the settlement mechanisms in Europe

There is also an opportunity for vendors to help the market respond to this requirement from regulators by being able to provide such regulatory reporting 'off the shelf' and minimising the impact on in-house technology teams. Vendors that store vast quantities of data on lending activity will clearly be well placed to help the market respond to this push for market transparency.

Finally, infrastructure developments such as TARGET-2 Securities will have a major impact on how market participants interact with the settlement mechanisms in Europe and vendors will need to be mindful of the evolving needs of their clients in respect of these changes. **SLT**

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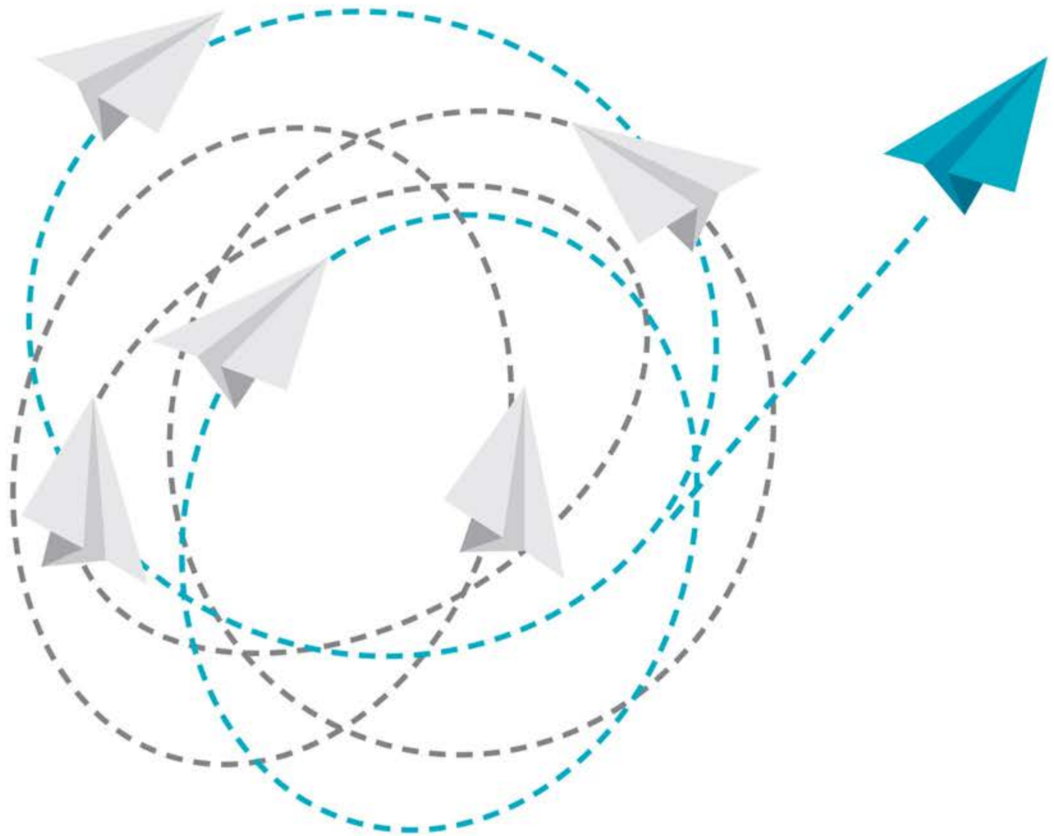

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Market focus on the Lending CCP

Eurex Clearing recently announced a number of new participants as well as some additional service extensions and enhancements of its Lending CCP service, the first CCP for the bilateral securities lending market in Europe. Three leading market participants discuss the benefits of a CCP for their securities lending business

As committed clients to Eurex Clearing's Lending CCP, can you describe the key business drivers that influenced your decision to use the Lending CCP?

Andy Krangel: We see the central counterparty (CCP) cleared segment of the market growing over the next few years as the focus on capital costs increases. This will force borrowers and agent lenders to focus on counterparty exposure and the resulting balance sheet impact, therefore structures such as CCPs that reduce this will be of greater benefit.

The opportunities for an agent lender are twofold. Firstly it will enable them to maintain balances, or even increase them, with existing counterparties, and secondly, enable loans to be transacted with counterparties that may not currently generate enough revenue to justify the internal risks and credit reviews. The drivers will also come from borrowers, which will almost certainly push towards CCP clearing in order to reduce exposure and therefore capital costs incurred when transacting with certain beneficial owners.

Richard Deroulede: The first objective is to have the option to transfer some of the OTC stock loan trades we have onto the Eurex Clearing platform and benefit from a reduction in the cost of capital as well as in the consumption of balance sheet, thanks to the netting effect on the cash legs. We also expect additional netting benefits on the entire portfolio of products that we have with each CCP.

The second objective is to realise operational gains by reducing the number of clients and counterparties with which we are clearing stock loan trades. Gains will be not only on the day-to-day operations that will be simplified, but also in the on-boarding of new counterparties.

Paul Bradford: There were a number of drivers for ING. Firstly, we believe that the changes in the regulatory environment will make it either mandatory to trade at least some of the securities financing transactions through a CCP, or from a capital usage and risk-weighted assets savings perspective, it will make a compelling argument at some point.

As a result of these, we decided that ING should be in as early as possible in order to have some input into shaping the best model. We also looked at this from a credit perspective. A CCP clearly reduces reliance on individual lines with counterparties.

CCPs for securities lending have been discussed by the industry for many years. Why has Eurex Clearing's Lending CCP model been successful in achieving the recognition and commitment from market participants?

Bradford: We think that the Eurex Clearing model fits very closely to the current business model used in our market today, in that it allows us to maintain bilateral relationships with counterparties, but give them up to the CCP for clearing, credit and risk. It effectively gives the best of both worlds. Maintaining bilateral relationships is a crucial part of the offering for us at ING.

The ease of integration via Pirum was also a big selling point. As ING are real-time users of Pirum already, the CCP flow follows a very similar pattern for us as our normal business, so very few changes needed to be made to our systems infrastructure in order for us to trade on the platform.

Krangel: The key challenge for beneficial owners with previous CCP structures has always been the lack of collateral passed back to the beneficial owners. They are used to holding collateral directly or through their agent lender. For many beneficial owners regulations such as UCITS or internal rules require collateral to be held. Eurex Clearing's model is the first CCP to provide a solution to this need.

Deroulede: The securities lending market is about covering liquidity and short positions, which are simple but extremely important functions for the financial industry. It requires that market participants know each other and more importantly trust each other. Eurex Clearing has understood this key aspect and put in place a set up that preserves relationships while enabling to clear transactions in an efficient manner.

Where do you see opportunity for revenue/pricing for your business by using the Lending CCP as a borrower/lender?

Deroulede: The new regulatory environment is increasingly putting pressure for higher returns on balance sheet, threatening the sustainability of several trades. We view the business through CCP more as a way to maintain current stock loan balances and manage more efficiently the overall collateral posted to CCPs, rather than an a pure opportunity to capture more business.

Krangel: This remains to be seen. There may be an opportunity for an expansion of

> "The securities lending market is about covering liquidity and short positions, which are simple but extremely important functions for the financial industry. It requires that market participants know each other and more importantly trust each other"

Richard Deroulede, head of equity finance Europe
Société Générale Corporate and Investment Banking

> The number of markets that CCPs can clear for should be expanded, because this will make the operational benefits of a CCP more obvious

Andy Krangel, director, agency securities finance, and EMEA head of business management
Citi Investor Services

borrowers for the CCP markets without the need to go through a documentation process and internal credit review. Whether this gives a significant revenue opportunity, however, is debateable.

More important may be revenue protection. In the future borrowers may push for a certain proportion of business to be routed through CCPs to reduce capital charges. They may even target loans with certain lenders. Without a CCP some of this business may become uneconomical in the future.

Bradford: There is still a lot of work to be done here on the financial benefits of trading on a CCP, as there is still a lot of debate around whether the specified savings from an risk weighted assets and capital charge perspective will outweigh the costs introduced. There is also more work to be done to understand a CCP's impact in the context of the new liquidity ratios and capital rules under Basel III. Once this is all understood and clearly documented, I think the correct pricing for use of a CCP will swiftly follow, or there just won't be enough pick-up of users.

What are the main regulatory topics leading the market towards greater use of CCPs for securities lending?

Deroulede: Most of the drivers are coming from the Basel III regulation, and in particular the introduction of: (i) the leverage exposure ratio, which creates negative bias on business with high balance sheet consumptions but low risk weighted assets such as stock loan and repo transactions; and (ii) the increased cost of credit for OTC transactions through the change in weights and the introduction of value at risk on credit valuation adjustments. The aim of the regulator is clear: it wants more centrally cleared transactions.

Bradford: I think a lot depends on whether the use of a CCP will at some stage become mandatory for parts of the business. The other big driver for ING is the impact that using a CCP will have in terms of real savings on balance sheet and leverage ratios, especially as we move into the world of Basel III. Some banks are further ahead in the adoption of Basel III metrics and therefore are being more proactive in reducing the impact. Those that are making the changes now, such as ING, should see the benefits materialise much quicker.

Krangel: The regulatory drivers continue to be Basel III and the impact it will have on capital availability and deal profitability. For US agent lenders, the Dodd-Frank Act will have an impact on the allowable exposure level with other banks and financial institutions, which will include indemnification risk.

These combined will potentially lead to greater use of CCP for securities lending.

What should CCPs focus on for the medium to long term so that they can assist the market further?

Krangel: There are two key areas the CCPs should focus on. Firstly, the number of markets that CCPs can clear for should be expanded, because this will make the operational benefits of a CCP more obvious. While the number of cleared markets is limited, the use of CCP will by its nature remain limited. Focus should be on the large markets where the bulk of lending occurs and should not be limited to Europe, the Middle East and Africa.

Secondly, the cost of using CCP services needs to be driven down over time, though CCPs will probably only be able to achieve this if volumes of CCP-cleared transactions grow significantly. Without this, CCP activity may be limited to loans that generate a higher basis points return. Typically, beneficial owners are used to their agents absorbing transaction costs and it will be a challenge to convince beneficial owners to absorb expense unless returns justify this.

For CCP volumes to increase, either beneficial owners will have to accept some of the costs or loan rates for trades in the general collateral/warm space may have to increase to offset the costs.

Deroulede: The main issue is on the cost of the CCP, especially with regards to the haircuts that will be charged. It will all depend on what will be the overall margin required by the CCP for the different products cleared. The key differentiation factor between CCPs will probably become sooner or later the efficiency offered by their cross-margining model.

Bradford: Helping people to understand their real costs now in terms of capital, how that will change under Basel III, and how a CCP will change things in real terms. The analysis to date has been based around average costs and we think that these will differ greatly from firm to firm. Once this can be ascertained, more firms will be likely to join the platform. Understanding all of the costs involved in trading on a CCP is also imperative because clearly, if the costs outweigh the benefits, or are very similar, it's going to be a hard sell.

We do, however, believe that as the product matures the costs should become much more of a secondary issue. **SLT**

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Paul Bradford, head of European equity financing
ING Commercial Banking, Financial Markets - Global Securities Finance

On the rebound

Robert Lees of Brown Brothers Harriman & Co on markets as they stand, borrower demand, 2014 as a turning point and what benificial owners can do with an upswing

MARK DUGDALE REPORTS

What goes up must come down—how will a reduction in monetary stimulus change the securities lending market?

There is no doubt that the past few years have been challenging from a securities lending perspective, as broader economic factors just did not cooperate. But looking ahead, short and long term, we are confident things are changing—as central banks begin to reduce their stimulus measures, equity markets should begin to normalise and create a better platform for stronger returns.

To elaborate a bit more, we expect that normalised market conditions should lead to decreased correlations between stocks, and increased volatility. This would create more opportunities for the long/short strategies that generate borrowing activity. As individual stocks begin to move more in line with their underlying fundamentals, it should trigger greater conviction from investors, with a long and short bias.

We also feel that the different rates at which central banks taper their stimulus measures could result in a period of divergence among global economies, potentially skewering asset valuations. This could lead to increased mispricing and importantly, volatility.

Which region will rebound first?

In our view, the US equity markets will offer the most short-term opportunity for our clients. Strong corporate activity, including IPOs and M&A, along with increased volatility, present great opportunities for growth. US corporations are arguably holding record amounts of cash and shareholders want to see firms take action and focus on making strategic decisions, not just those about balance sheet operations such as buybacks and dividend distribution. Separately, conditions that generally support M&A activity are improving as concerns around near-term fiscal and monetary policy start to subside in the market.

In Europe, our outlook is much longer term and although sentiment is improving on a fundamental level in terms of the stability and integrity of the eurozone, there is still a great deal of uncertainty around the impact of ongoing regulatory reform.

That said, Europe has had its fair share of M&A activity, though ultimately it has not been the kind that creates securities lending demand. On a brighter note, Q2 2014 did provide some interesting opportunities for our clients around rights issuances, where we were able to optimise returns for our clients.

In Asia, the highly anticipated mutual recognition scheme between Hong Kong and mainland China could present the potential for significant growth in the region in the medium to long-term. Shorter term, we expect Hong Kong and South Korea to continue driving demand and overall, Asia will continue to represent the largest opportunity in terms of revenue growth.

Although we are encouraged by new markets such as China and Indonesia developing their infrastructure, we remain cautious in terms of material opportunities in the near future.

On regulation, what's the latest and how is it affecting borrowing demand?

It's been a long time coming, but regulatory reforms are moving into an implementation stage. Pretty much all of the major financial markets regulation will affect the profitability of securities lending for both agent lenders and borrowers, meaning industry participants will need to focus on prioritising resources towards higher-margin activity. This means the shift to intrinsic value lending is likely here to stay as the profitability of general collateral lending stands to be most negatively affected by the cumulative impact of tax and regulatory change. Now more than ever, this is causing beneficial owners to evaluate their lending parameters in line with their risk appetite and focus on higher margin activity.

Collateral flexibility is also an area that remains high on the agenda for borrowers, although less of a concern for intrinsic-value lending programmes. Concerns over a collateral shortfall following the introduction of OTC derivatives regulations appear to have faded somewhat as the consensus indicates that collateral requirements will be met in the short-to-medium term. Central counterparties and the potential capital efficiencies they may provide is an area of interest for the industry at the moment.

Separately, we have seen the borrower environment become increasingly competitive as we continue to see new entrants to the market, further driving the need for borrowers to differentiate their offerings and demonstrate value, whether it is by the markets they operate in, trading strategies, or access to demand. From an agent lender perspective, it is more important than ever to maintain strong relationships with counterparties to ensure that strategies are well aligned.

So, will 2014 mark the turning point for securities lending?

As we approach the mid-year point, we are encouraged by the improvement in the conditions required to generate securities lending demand. The quieter markets of the past few years are, in our opinion, cyclical and 2014 should be a year where we can look back and note real momentum and strong progress toward a full-scale rebound.

We expect deal activity to remain elevated as animal spirits in the corporate world continue to build. The normalisation of equity markets following the ultra-loose monetary policy employed by central banks will lead to a decreased correlation in stock prices and create opportunities for hedging strategies.

Finally, regulation, while still challenging, is beginning to crystallise, and will provide a level of certainty investors require in order to feel confident in putting assets to work and increasing their risk appetite.

Do you have any advice to beneficial owners looking to take advantage of an upswing?

Despite the cyclical lows we have seen in recent years, securities lending is still strategically important to a broad set of asset managers because it still generates significant returns and can really improve fund performance. Those that have kept lending over the past few years will already be well positioned if they are working with the right provider, but that right provider is key.

And it's different for everyone—it's really all about finding the provider who is aligned with your investment and lending philosophy—that is what matters most in the long run. Innovation and engagement will become key battlegrounds where providers seek to remain relevant. Devoting the necessary resources and discipline to these areas will become critical in order to continue driving the evolution of the industry. **SLT**

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Listen and learn

Managed services is difficult to pinpoint, but securities finance and collateral management professionals should take note, says SunGard's David Selwood

MARK DUGDALE REPORTS

What is a managed service?

This really is the key question. Managed services is a catch-all term that encompasses a framework of services constructed around our clients' needs.

Let me give an example. When talking about infrastructure managed services, you are talking about creating a solution that allows you to plug directly into something that SunGard is hosting, with crossover also available on to application expertise and services. With application managed services, you are plugging into SunGard's expertise and ability to deliver services, support and development tools.

Managed services can be the best of both worlds, in that firms that operate in the securities finance and collateral management space can work with a vendor that understands how the business works. A solution can be customised to fit a need. If a firm wants an application managed service, where staff work with specific people and deliver services around the particular area of a business, that is an option. That same firm, if it expresses the desire, can expand into development services, with the option of acquiring hardware or plugging into a hosted solution.

One size does not fit all because no two clients are the same. Perhaps someone is not interested in having a hosted solution, but that does not preclude them from the discussion with SunGard about managed services. It just opens up a different avenue of managed services. SunGard's role is to deliver the managed services that the client really needs.

The beauty is that these services can easily be combined and delivered, added to or adapted according to each client need in an ongoing, changing business environment.

Does this suit a firm of a particular size?

SunGard works with all sizes of clients in all types of markets. On the smaller end of the spectrum, a firm looking at managed services often wants a complete solution, because its core focus is the business and it does not want the overheads that come with large applications and information technology infrastructure. SunGard wants to talk to those firms as much as the opposite end of the scale, such as large Tier 1s whose primary driver is a desire to bring multiple vendor relationships into one line item on the balance sheet, but know exactly what each is providing.

As a vendor SunGard wants to talk to all of the different types of market participants, as it is interested in, and capable of, offering solutions to all. We tailor solutions towards what the client wants. This includes clients looking at new installations or considering the suitability of new services and applications as part of a re-examination of an established relationship with SunGard.

SunGard is invigorating the services available to the market and helping our long-standing and new clients do as well as they can, in a supporting role so that we can share in the bigger story. It's not about treading water—it's about helping clients to advance and being the steady rock that they know they can rely on to build their business upon.

How can managed services help to combat the dreaded legacy system?

In our experience, we find that a multitude of systems can sometimes grow around a firm's existing environment. Decisions are made to create special additional applications to address certain business needs. As a managed service provider, SunGard will examine whether that particular job can be done within a broader application, and if not, why not? There must be a market need to adapt the core application and, with the client's help, the reduction in the proliferation of supporting environments can be achieved.

When considering managed services, SunGard, even as a vendor, makes a holistic assessment of securities finance. We take an overall view of the client ecosystem that is securities finance, or collateral management, within a firm and build a managed service to support it. These areas can be broader than a single application, so the discussion must often be had as to whether a certain legacy system needs to be incorporated, because there is no-one else to support it. If so, our wide market expertise allows us to manage that need and incorporate this across the managed service delivery.

Legacy systems build up for a number of reasons and clients sometimes do not talk to vendors about their needs. Building relationships through services can enable the collective benefit to be global, as what one client in one location is doing will directly influence the application going forward and what each of those applications do. SunGard is keen to listen and enable clients to help influence and drive the application. When you work closely in a managed services model, that conversation happens by default as information is always flowing back and forth, and that in turn helps our clients achieve their goals. **SLT**

David Selwood
Head of managed services for securities finance and collateral management
SunGard

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The ghost of securities finance's future

Is a collateral squeeze coming? Experts discuss the possibility

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SIX Securities Services

Where and how are securities finances businesses optimising their use of collateral?

Mark Trivedi: Regulations from various jurisdictions across the globe now require collateral to be posted across an ever increasing array of transaction types. This is forcing institutions to mobilise collateral within their own organisations more efficiently before going outside the organization and sourcing it externally. As a result, we are beginning to see the long-predicted breakdown of internal silos actually come to fruition.

Martin Seagroatt: Firstly, optimisation is, by its nature, very bespoke to each institution. There is no one-size-fits-all approach. The firm's trading strategy and its constraints are key components of the way the firm needs to approach the problem of optimisation.

It is important to think about this carefully before starting an optimisation project. For example, a sell-side institution's trading activities may be constrained by capital costs. It may therefore make sense to pledge out collateral assets that have a high risk weighting under Basel III in order to reduce capital consumption.

For a buy-side firm trading derivatives or servicing clients, that is short central counterparty (CCP)-eligible collateral, it makes sense to look at optimisation from the point of view of freeing up the CCP-eligible assets that it does have. This allows the firm to collateralise its hedges, while reducing the amount of cash collateral pledged out and lessening the drag on fund performance from holding large supplies of cash or low yielding bonds.

Optimising also allows the firm to minimise the use of expensive and possibly unreliable collateral transformation services.

The buy side now needs to think carefully about how it can secure stable sources of these CCP-eligible assets and match the maturity of its collateral with that of its derivatives as closely as possible. Securities finance plays an important role in all of this.

The other side of the coin is a buy-side institution that is long CCP-eligible assets, for example, a sovereign wealth fund. For this firm, optimisation could look at identifying surplus assets to lend out once it has met its own collateral needs.

The Basel III liquidity coverage ratio (LCR) is also one of the main concerns coming up for banks and will be a large driver of the demand for high-quality liquid assets, starting in January 2015. This is very much an optimisation problem.

It makes sense to prioritise the LCR as the de-facto 'hardest to please' counterparty. The optimisation algorithm must be able to identify collateral assets that are eligible for the LCR and allocate assets to it before satisfying other market counterparties.

As the list of LCR-eligible international securities identification numbers changes frequently, this requires data feeds with regular updates to ensure the LCR pool remains compliant. This is a large headache for banks and something they need to start working on immediately, as the compliance deadline is not far off.

Many of our clients are therefore now starting to organise their securities financing and collateral desks around bringing in LCR-eligible assets. It makes sense to utilise internal inventory or to structure the natural flow of assets from securities finance activities to bring in LCR collateral rather than going to the street to source.

As always, this comes back to the fundamental basic starting point of optimisation; a single consolidated view of collateral inventory across the firm's business lines and geographical locations.

Finally, there is also a lot of work going on around the infrastructure required to move collateral around. While there is enough collateral to prevent a collateral crunch, the main challenge for firms is to mobilise it and move it to the right place, at the right time.

Optimisation is largely about intelligent placement of collateral. However, a large part of effective collateral use revolves around automating the process of mobilising collateral, both within the firm and across the market infrastructure or collateral 'plumbing'.

Initiatives such as TARGET2-Securities (T2S) should help with this. For this reason, firms need to make sure they have the technology in place to move collateral at high velocity with a minimal amount of manual processing and operational risk to support these improvements in market infrastructure.

Jeannine Lehman: Before we can talk about optimisation we have to consider aggregation and reporting on collateral at the holistic firm level. In some cases, we see the market moving securities financing desks up a level to create central 'collateral treasuries' that look at the overall collateral needs of the firm. The combined view then allows desks to optimise the wider pool of assets for financing and perhaps direct exposure coverage needs, leveraging the tools they have available to them, such as BNY Mellon's triparty collateral platform.

We certainly see this as a global change for broker-dealers, and have started to see the larger buy-side firms also entering this space, looking for a collateral agent that can help them finance but more broadly, allocate and process collateral in a number of ways.

Jerry Friedhoff: Securities finance desks have traditionally looked at collateral optimisation as part of their daily financing activity. Whether trading in the specials market on an individual security basis or sweeping general collateral pools into best fit triparty shells, financing desks utilise optimisation techniques to source the cheapest-to-deliver outlets for financing both firm and customer assets.

Moving forward, these desks will continue to fine tune their optimisation techniques in support of the anticipated increased collateral demands associated with regulatory change, deliver more effective collateral cost allocation models to their trading desks and seek out areas of opportunity with regards to collateral transformation.

Saheed Awan: At our recent collateral conference in Brussels this May, this was a well-debated theme. A large consensus felt that more needs to be done to unlock silos of assets, across geographical locations, in a seamless and efficient manner. Many agreed that collateral velocity, ie, the speed and re-usage possibilities for collateral, are to increase significantly in the post-regulatory business domain.

One area of immediate optimisation that firms are encouraging is the use of third-party collateral management agents.

Elaine MacAllan: The huge amount of cash still being used as collateral (global estimates range from 70 to 85 percent of all collateral posted is cash) shows that while optimisation has been the industry buzz-word for some time, and appears in most firms top three strategic priorities, in reality it is still in it's infancy in terms of market implementation.

Various optimisation methods are being considered while firms get to grips with how to deal with the both the intended and unintended consequences of regulatory reforms on global collateral management practices. These can be broadly categorised, but in reality firms are considering a combination of internal solutions, outsourcing services and vendor technology solutions.

Large firms are quickly establishing collateral optimisation programmes, and smaller institutions are watching with interest, ready to learn from their successes and mistakes. Ultimate responsibility for collateral is moving to the front office, but the operational processes needed to support effective collateral management are remaining in the back office—so a new dynamic is appearing. There is a noticeable scramble to create optimisation solutions from both a calculation and technical perspective. The realisation of the complexity involved is forcing many firms to turn to vendor solutions.

Vendors tend to be able to develop and deliver technology solutions faster than in-house teams, and offer functional roadmaps to support optimisation programmes as they expand and mature. Early adopters are wisely putting a focus on maximising asset availability and access to quality data. Unless you can hold and apply accurate agreement, asset, cost and eligibility data, and establish a firm-wide view of inventory, the quality of the resulting solution will be compromised. Some vendor solutions impose optimisation calculations, in an attempt to identify universal 'cheapest to deliver'.

We see this as a risky strategy with a short shelf-life—what is cheapest to one firm will not be for another as different proprietary cost models play an important part. Any vendor solution offering longevity must provide configuration

and data flexibility, whilst empowering users to define and adapt their own definition of 'optimal'.

Firms are also turning to triparty services or outsourcing providers as a quick way to optimise their use of available collateral assets. This is an effective method, but can be costly, with the drawback that firms often do not internally have either the process capability or technical solutions to validate the optimisation or justify the cost/benefits.

Robert Almanas: With the inception, under the European Market Infrastructure Regulation (EMIR), of mandatory clearing for OTC derivatives in Europe early next year, demand for collateral across the financial industry, and particularly within securities finance businesses, is becoming substantial. This is because of its role as a "modern money creation process" (as the Bank of England described it).

Estimates of the collateral required still vary but it is clear that buy-side firms are under pressure to optimise their use of collateral. Therefore, firms across the value chain are working with global custodian banks as well as post-trade service providers such as SIX Securities Services to prepare for the regulatory changes. One key challenge they face as they plan how they will manage their collateral and where they will need to pledge cash or assets for multiple collateral calls in the future, is the fragmented and inaccessible nature of their collateral. As such, mobilisation of collateral is a key concern.

This fragmentation has been making it extremely difficult for market participants to access and understand their collateral efficiently, and continues to demonstrate the need for effective mobilisation tools to support collateral management efforts.

Ted Allen: We see a consistent trend in the market for consolidation of collateral management functions across silos, and securities finance is one of the silos affected. The driver is regulation and resultant increase in capital and collateral requirements. Most firms now recognise the need for a holistic view of the inventory of assets available for deployment over and above the silo level. This holistic inventory is the first step to achieving collateral optimisation. It is only if you can see the whole picture that you can make the strategic decisions about how to allocate your collateral.

One important aspect in the optimisation question is that each firm has different views of what is optimal. This means that they need flexible tools that can be easily configured to meet their business priorities and economic outlook. Specifically in the securities finance space, there are some clients that use have historically used triparty agents for collateral optimisation. However, increasingly they view the rather simplistic approach taken as inadequate and potentially inefficient. More and more firms want to use optimisation techniques that reflect their business rules.

How do you do it in your own business—and why do you do it that way? If you're a vendor, how is the best you've seen it done, and why?

Awan: As an industry collateral management utility, we play a specific role. We are constantly evolving our service offer to meet the needs of our 1500 clients from around the world. Our collateral management business is about building an infrastructure for mobilising and allocating collateral globally.

Our priorities in collateral management are primarily to grow the connectivity that we have on the Collateral Highway, in terms of both sourcing and delivering both bonds and equities from around the world on behalf of our clients. Equally, we have to be able to allocate such securities collateral to an ever-expanding ecosystem of collateral receivers, liquidity providers and risk mitigators. They are exit or delivery points on the Collateral Highway.

In practice, the targets and markets segments are tightly focused, particularly on central banks as one of the key exit points for collateral and for providers of liquidity. However, we also connect with all the world's principal CCPs. Our day-to-day business involves bringing more liquidity providers and CSA counterparts onto the Highway, whether they are corporate cash providers, insurance companies, securities lenders or commercial banks.

Almanas: At SIX Securities Services, we are progressively deploying a collateral management service that will provide our clients with access to a pool of collateral, reaching across markets, currencies and time zones, which mobilises their collateral.

Crucially, once rolled out, this will enable clients to have a consolidated view of their collateral across multiple infrastructures, and will instruct collateral movements accordingly between locations. This is important, as collateral held in a final place of settlement or central securities depository (CSD) is far more likely to be fragmented across markets. Even though these locations are extremely safe places to hold assets, many clients understandably don't want to risk holding all of their collateral in one place.

Allen: An interesting case study for this question relates to one of our clients that has taken a holistic approach to collateral optimisation and liquidity management. Using a single linear optimisation run, we are able to help them minimise the cost of the collateral required to support their trading activity across all of their counterparties and at the same time, maximise the second line of liquidity left available to them after these assets are deployed. This kind of advanced analysis using a sophisticated and flexible vendor tool translates into substantial and measurable cost benefits.

Trivedi: J.P. Morgan has been a collateral agent for more than four decades. In our role as a global agent, we help clients have a better view of their balance sheets across business lines, linking them to additional sources of demand/liquidity such as OTC derivatives clearinghouses and affiliated lending programmes. We provide clients with sophisticated algorithms that help optimise their collateral allocation decisions.

We believe the best approach to efficiently optimising collateral requires holistic/timely data that's organised in a manner that allows the institution to apply economic logic integrated with settlements infrastructure. Given the complexity of the data and processing requirements, a robust technology infrastructure is mandatory. J.P. Morgan's focus is on providing an integrated set of tools, technology and services to our clients.

Seagroatt: We find the firms that are ahead of the curve have completed the initial steps of consolidating inventory and exposures and mapping reference data. From there, they are pledging basic 'cheapest to deliver' assets to meet individual margin calls and in some cases, making cheapest to deliver substitutions and reallocations. The vast majority of market participants are either at this stage, actively implementing it, or thinking about it.

The most forward-thinking firms, which are even further ahead, are responding to the cost pressures facing the industry by arriving at a much more fine-grained transaction cost analysis. This involves funds transfer pricing, collateral opportunity costs, and streamlining which counterparties the firm trades with based on the profit and loss per unit of capital consumed, balance sheet usage, netting benefits and collateral costs. They are using big data analytics tools to perform complex multi-factor optimisation runs.

The industry is becoming more commoditised and industrialised. Banks now need to make tough decisions around which business lines and geographical markets to remain in. It is impossible to do this without an accurate view profit and loss for a given trading strategy or business unit.

The firms that will come out of all this in a strong competitive position will be those that can

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consolidate accurate data to support decision-making using a holistic approach to optimisation, taking into account all of the constraints imposed by the new regulatory environment.

Friedhoff: Optimisation techniques are not 'one size fits all'. These techniques remain tailored to an individual firm's own collateral pools across both cash and securities. Current technology solutions have focused on more refined inventory management criteria that bring individual product silos into a more holistic view while supporting optimisation benefits via a series of choice algorithms.

MacAllan: We think the best solution is a rules-based approach that allows users to configure their own definition(s) of 'optimal' and run algorithmic optimisation calculations on a real-time basis to identify the 'best' assets to be used 'now', reflecting individual and changing priorities. An optimisation solution should be adaptable and extendable to also consider future asset needs and optimisations. In this way the technology should enable an institution to identify their preferred allocations for use within principal bilateral and cleared margin obligations, but should also enable service providers and asset managers to provide bespoke optimisation services for their clients.

Alongside configuration, the best optimisation solution enables an enterprise view of collateral availability. After all, if you can only consider a portion of available assets, your calculation results won't be truly optimal. An enterprise inventory manager should be capable of providing a real-time view of all asset positions and values, of any asset type, and from any source. This may include external availabilities—it may be more optimal to consider a wider asset pool than only internal sources. Unless the inventory and optimisation engine can access and consider this data, the optimisation result will be compromised.

Lastly, the best optimisation solution will be able to consider cost as an element in the calculation, but that cost value must be configurable or provide plug-in capabilities—any solution that imposes a cost or value calculation on the user will ultimately fail. Large institutions in particular want to use their own proprietary cost models in the optimisation calculations.

The ghost of securities finance's future, a collateral squeeze, is always there—what are you seeing right now, in the current regulatory environment? Vendors, how are your securities finance clients reacting to the prospect of having to scramble for collateral? Are they panicking, or is it all in someone's head?

Lehman: The so-called collateral squeeze/shortfall/'sky-is-falling' scenario is yet to materialise—and nor do we expect it. At the moment, we don't see a great panic for better quality collateral. Our securities finance clients have implemented measures within their own firms to manage new regulatory requirements and are efficiently financing where they need to and at levels that are not outlandish. Upgrade trades are facilitating the use of equities as collateral and allowing brokers to source in higher quality inventory for their clients. So for now, and in the near future, we believe things are under control.

Having said that, many of the new regulations—Solvency II, Basel III, EMIR, central clearing—have yet to really bite. Our sense is that there is still a widespread 'when it hits', 'wait and see' mentality. These regulations will cascade through many levels across the global markets, and it is only when market participants experience first-hand the likely pain coming their way that we can really start to gauge the true impact on collateral.

MacAllan: The anticipated collateral squeeze is a dawning reality, however, optimisation processes are beginning to emerge, as firms seek new ways to better manage risk and collateral assets in response. A single point-in-time crunch is looking unlikely, as long as firms find and adapt solutions and maintain a pace of technology and process change in time to react to the market impacts of regulatory reform. Doing nothing may be a risky strategy.

It is widely accepted that increasing margin obligations imposed under new terms (mandated clearing, gross investment management, obligatory investment management, etc) will mean that global collateral requirements will vastly increase, though estimates vary as to the final impact as the regulations roll out over the coming few years. It certainly isn't all in someone's head.

Panic levels are rising as regulatory deadlines approach, although are broadly in line with dawning deadlines. Those with more distant deadlines are less worried and adopting a 'wait and see' approach to see how the early adopters fare in the new environment.

We are seeing a number of reactions to the anticipated collateral squeeze:

- A review and renegotiation of agreements—widening of asset acceptability;
- Creation of optimisation functions;
- Assessments of alternative collateral sources and analysis of cost implications; and
- Business moving to alternative product lines that are less collateral greedy.

Of course, others are turning this challenge into a business opportunity to create and provide entirely new frameworks that deal with the complexities and demands of the collateralised securities financing business. Service providers are beginning to inter-operate and integrate to

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Almanas: In a major change to common opinion last year, the consensus among most market participants today is that we do now have enough collateral in the system to meet these heightened requirements. Unfortunately, it is also agreed that the collateral required is currently both inaccessible and fragmented in a number of collateral pools, locked away in different geographic locations, time zones and entities.

Rather than solving this problem by diluting the notion of what constitutes acceptable collateral, securities service providers are in a unique position to support effective collateral management by providing firms with access to these pools, freeing up much needed liquidity in the market. Through the creation of a virtual collateral pool spanning the markets, these providers can enable collateral to be valued across multiple time zones, systems and currencies, helping to eliminate the inefficiencies inherent in having to transfer securities through these systems.

As a securities service provider, we are working hard to ensure the flow of collateral is as fluid as possible across the markets. While it is key that collateral be high-quality, liquid and simple to drive this, effective mobilisation will be integral in making this happen.

Awan: Again, feedback from our collateral conference showed that clients, and their balance sheets, are coming under increased pressures as a direct result of the pending regulatory environment. But it depends from what angle you are approaching and where your organisation sits in the secured financing domain. For example, for the securities lending segment, the US Dodd-Frank Act, EMIR and Basel III could very well lead to beneficial owners lending their securities. I'd say that 'panic' is the wrong word. More relevant is the lack of education at the buy side in terms of what is ahead. There is still a concerted effort needed by global custodians to educate their buy-side clients.

Mandatory clearing is a huge headache for the buy side. Insurance companies (solid insurance companies) that previously never had encountered such problems, are now being lumped in the same bucket as highly-leveraged hedge funds. They naturally ask: why are we paying the price for having to put up initial margins where we didn't have to do it before? They all lived off variation margin until now and now also initial margin, which is not low, but more like 10 or 12 percent depending on the time left to maturity of, for example, a gilt. Then, these buy-side firms have to set up new processes to manage their margin calls.

Add these together and you can see why it is a nightmare. We are talking to one of these Scottish insurance companies and they say they remain concerned about the implications around the level of margin calls that are expected, post regulation, when mandatory clearing is in place in Europe.

Allen: We are seeing the market adapt to the reality of the liquidity impact of the increase in collateral requirements through the deployment of collateral optimisation techniques. More sophisticated tools will identify opportunities for collateral upgrade trades that may lower the overall cost of collateral. We are also seeing a loosening of collateral eligibility rules in some cases (for example Eurex now accepting equities) and the joined up offerings from the CSDs are an interesting play on the problem.

Overall, our view is that the market is adjusting and that improvements in infrastructure, automation and the optimisation tools available to firms mean that collateral velocity is increasing. It will be interesting to see how this plays out when the Basel Committee on Banking Supervision/International Organization of Securities Commissions rules start to affect participants in the bilateral OTC derivatives market from 2015 with the requirement for greater amounts of collateral and significantly for the restrictions on rehypothecation.

Trivedi: We have seen a varied client reaction to increased collateral requirements, largely related to the industry and level of sophistication prior to these regulatory changes. In general, our clients don't view there being a shortage of collateral.

However, in many cases the assets simply are not available to the relevant entities with increased collateral obligations. Acquiring those assets may affect their underlying businesses given financing costs and balance sheet pressures. Many firms have found tactical means to cope with these changes but do realise these mechanisms may not be sufficiently scalable or economically efficient.

Metaphorically, we're only a few miles into the marathon. Scalability and efficiency will only continue to become more important as pressures on acceptable collateral increase: eg, EMIR's implementation, a continually evolving regulatory landscape, eligibility requirements becoming more proscriptive, more transactions requiring collateral, and longer-dated or grandfathered contracts expiring, among others.

Friedhoff: There has been a tremendous amount of discussion on the potential collateral squeeze associated with regulatory change to date. The consensus seems to be that the demand for high-quality collateral—the frequency and amount of margin call activity—will only increase in the coming years. Firms remain focused on the potential costs (collateral, capital) and benefits (optimisation, transformation) associated with ongoing regulatory change as they position themselves for the future. We are seeing that collateral management can be additive and have a real impact on the bottom line when incorporated in an effective way.

Seagroatt: We aren't really seeing a scramble or panic as such, although interest in optimisation tools has surged in the past year. But the demand for larger amounts of collateral will really start to take effect in 2015 when trading via CCPs in Europe begins, bilateral margin standards come into play and Basel III starts to bite.

However, rather than posing an existential threat to securities finance, a collateral crunch could actually benefit the business. If collateral is the lubricant to the financial system, then the securities finance markets are the plumbing.

It is essential that this 'plumbing' works efficiently to ensure that the financial system remains resilient to stress in a future crisis. Regulators seem to understand this on the whole. There is a real danger though that the combined impact of the various regulatory streams creates unintended consequences that cause blockages in the system.

From a supply and demand point of view, any major increase in the cost of collateral should provide an incentive for holders of supply to lend it out. This would unlock a lot of the collateral currently sitting idle in the system.

Central banks will presumably also be ready to fine-tune the impact of new collateral demands by adding liquidity if necessary, acting as the collateral transformers of last resort. So my personal view is there won't be a collateral crisis as such, it will be more of a market adjustment.

Trivedi: We see clients viewing collateral as an asset unto itself. Increasingly, their focus is on managing that collateral in accordance with economic decisions, in parallel with financing decisions, to fully utilize all available assets.

Are new asset classes opening up to meet increasing demand for new types of collateral? If so, what and why? If you're a vendor, how are you connecting borrowers and lenders with new asset classes, if they are demanding any at all?

Allen: Although the logical assumption when hearing of a collateral squeeze might be that

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lenders are opening up their collateral acceptability schedules, we are not seeing a great deal of evidence for this. What we are seeing, however, is greater emphasis on firms being able to maximise the use of their available inventory (for example, equities) in order to transform them into the type of high-quality liquid assets that are most commonly accepted as collateral by CCPs.

Awan: It is a correct assumption that demand for high-grade collateral is increasing. But it is incorrect to draw the conclusion that there is a collateral shortage. Industry observers would say that the forecast of new collateral required as a result of Dodd-Frank, EMIR and Basel III is somewhere between $3.5 and $6 trillion. That's the demand side.

The supply side is, in theory, less worrying. The International Monetary Fund reported in early 2013, that there is around $44 trillion from the G20 of sovereign debt, of which $33 trillion is governmental debt from OECD members. Then there is also about $2.5 to $3 trillion held in lending pools.

Markit Securities Finance says it reports on some $14 trillion in securities lending programmes, of which about a third, or certainly a quarter, is in high quality liquid assets. Then there is ourselves and the other three large triparty service providers, which account for roughly $950 billion to $1.2 trillion of cash available from the repo market. Repo is considered a collateral upgrade trade in that sense. So there is, on paper, sufficient ample supply.

And indeed, there is a growing appetite for different types of assets as eligible collateral as the markets recover from the global financial crisis. At Euroclear, we are noticing a trend for more of our clients to accept equities as collateral, especially major index equities.

MacAllan: Certainly one of the market responses to the collateral squeeze is that agreement terms are being closely reviewed—in particular those agreements that have very tightly defined eligibility criteria—triparty, lending, clearing agreements, etc. Clearinghouses are continually looking to widen collateral acceptability criteria, although new asset types tend to attract higher haircuts and so the optimisation programme/calculation must be able to consider the final haircut cost of using the collateral asset according to the posted venue.

Bilateral agreements are also being scrutinised—many older agreements may not have eligibility criteria clearly defined—collateral acceptability may be documented as 'like for like' (difficult to define in a diverse portfolio that is margined on a net basis) or 'as agreed between the parties' (difficult to impose and historically negotiated precedent plays a significant part here).

For many institutions it is often the case that although their documented terms allow them to use a wide asset selection (including equities, commodities, low-rated sovereigns and corporate assets, etc) they are technically incapable of automatically validating eligibilities/concentration limits/haircuts within the asset booking process, so they fall back on using high quality, universally eligible assets, even though they are not optimal and may be costly.

In order to support an efficient optimisation process, technology is required to both hold complex collateral acceptance criteria, and to utilise these terms in the calculation of 'optimal'.

From a vendor technology perspective, COLLINE enables a significant improvement of the collateral allocation and optimisation process. It can consider the enterprise inventory of assets, and support a rules-based calculation of the best assets to use from a cost/availability perspective, always consistent with the documented eligibility and concentration criteria. If the asset pool available widens (eg, if externally available assets are fed into the platform) COLLINE can simulate a sweep of existing allocations to identify potential substitution opportunities to improve the overall allocations at enterprise level and reduce the cost of the collateral programme.

In order to do this the platform enables configuration and mapping of the following data elements, for use within the real-time optimisation calculation, so meeting the needs of both lenders and borrowers, and sell- and buy-side users:

- Exposures/margin requirements;
- Inventory, including segregation and rehypothecation constraints;
- Agreement terms, such as eligibilities, concentration limits and haircuts;
- Asset data; and
- Market data.

Lehman: We haven't yet seen the predicted collateral squeeze, but there has nonetheless been an increased appetite for looking at a wider set of collateral types. There is no increased demand for collateral per se, rather counterparties are simply looking to optimise the collateral they already have at their disposal, rather than looking to transform it.

At present there is a big focus on exploring the feasibility of adding new collateral types and assessing the number of participants that might wish to utilise them. The key here is to ensure that those new types of collateral are being extended in line with current and emerging demand—there is no point increasing your pool of a particular collateral type that you already hold in abundance if no one else wants or needs it.

Friedhoff: The securities industry continues to lobby CCPs to accept additional collateral types in support of margin obligations. As the migration continues from a bilateral to cleared trade environment, the increased collateral disparity from one exchange to the other will only heighten the need for pre-trade tools that offer best execution technology to support these demands. Our focus, from a technology standpoint, will be to create these seamless integration points across our securities finance and collateral management product suites for our clients.

Seagroatt: There is no real evidence of a move from cash collateral to non-cash yet. In the current low interest rate environment, the system is awash with cash and there are lower incentives for the market to move to non-cash collateral.

However, as central banks taper quantitative easing and mop up excess liquidity, we should see the supply of high quality government debt come back into the market. CCP collateral eligibility schedules also accept a reasonably wide range of asset classes, although these are subject to concentration limits.

The use of non-cash collateral therefore presents a huge opportunity for market participants, particularly derivatives end-users on the buy side that want to maintain asset allocation strategies rather than hold large amounts of cash for margin. Managing non-cash collateral does add complexity though and this is where technology solutions add a lot of value. Many firms previously using spreadsheets for collateral management will find that they are no longer sufficient.

Almanas: With regulators increasingly viewing mandatory clearing and enhanced collateral requirements as effective risk management tools, the next asset class to be impacted will be OTC derivatives in Europe early next year. In addition, from December 2016 uncleared trades will also start to require collateralisation.

Adding to these collateral woes, the so-called 'killer clause' 47.3 of EMIR states that the billions in collateral being held by clearinghouses for initial margin calls must be locked up in securities settlement systems, to ensure adequate protection. Once instigated, this will mean that the market will require its full draw of collateral—currently estimated at a staggering €11 trillion. To meet the demands of this pending collateral lock-down, a fundamental shift in

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the market's current collateral infrastructure is therefore required.

Trivedi: We see clients viewing collateral as an asset unto itself. Increasingly, their focus is on managing that collateral in accordance with economic decisions, in parallel with financing decisions, to fully utilise all available assets.

What is needed technologically to optimise collateral use within securities finance businesses in the current regulatory environment, and how can technology be upgraded for future upheaval?

Trivedi: Efficiently optimising collateral demands a holistic approach. Optimisation requires a complex technological infrastructure that supports the aggregation, view and analysis of obligations with sophisticated tools to mobilise collateral across the franchise. You need comprehensive and timely data, the ability to apply economic logic and the means to integrate with the settlements infrastructure. J.P. Morgan provides all these components as part of an end-to-end service that supports our clients in managing collateral as an asset and making economically-impactful decisions.

Allen: Collateral optimisation is the key driver for change in the collateral management infrastructure within many institutions. To minimise the cost of doing business and to overcome the shortage of collateral, it is paramount to optimally allocate the assets available within the firm to meet the firm-wide requirements. To find the best allocation of inventory across requirements you must satisfy all of the requirements in a single allocation step.

Collateral optimisation is not merely a cheapest to deliver view for each collateral requirement in turn. What is needed is to deploy numerical optimisation techniques to determine true optimal allocation considering all requirements and their constraints of eligibility, haircuts etc. in a single calculation. This is a complex problem that requires specialist technology. The second aspect is one of scale. Collateral optimisation increases the velocity of collateral movements and to avoid strain on infrastructure, it must be accompanied by automation in the allocation and booking process.

MacAllan: This in large part depends on the existing technical infrastructure—firms face various technical hurdles in the implementation of an optimisation programme—not least access to, and normalisation of quality data.

As an ultimate goal, firms need to be able to access and process data in a real-time and global environment. Optimisation results can only be as accurate as the quality of data available.

There are two main elements to this challenge: Quality of data—real-time, global, cross-product and enterprise-wide;

- Quality of function—technical flexibility, user-configuration and extendable functionality capable of consuming and applying the data;
- In terms of technical upgrade requirements to implement a fully functioning optimisation process, a firm needs to access or provide the data elements outlined above—exposure, inventory, eligibility, market and asset, including costs and any proprietary cost models.

It is often the case that existing technologies fall short and that vendor solutions are required to support these features. There are three broad technical upgrade options that can be considered:

- Full cross-product implementation onto a single platform: some firms focus on rolling out a strategic replacement of existing legacy systems, silos, functions and processes that are no longer fit for purpose and do not meet either their corporate goals or regulatory obligations. This is the fastest way to implement true cross-product optimisation and centralised inventory management. Successful technical integration is key here, and so therefore is a dedicated and capable team.
- Gradual modular implementation: some firms are strategically focused on single platform, but do not have the appetite for a 'big bang' approach for integration and implementation—they may prefer a more phased approach, existing software licences have some time to expire but do not offer the enhanced functionality required, or the complexities involved in re-structuring the existing architecture encourage a more prudent step-by-step approach. The benefit of this approach is that gradual change is often more palatable, and implementation can be more tightly controlled. However, it will take longer to achieve the ultimate benefits offered by an enterprise optimisation function.
- Integrate enhanced modules with existing infrastructure: there is also a demand for optimisation and inventory technology as a standalone platform, capable of direct integration with multiple technologies within the existing infrastructure, and dealing with the complexities of data formats and transfer mechanisms that are inevitably involved. The standalone platform must be able to 'normalise' the data from disparate systems, in order to properly assess 'optimal' according to individual data models. The benefit of the standalone solution is that it is independent and can sit on top of the firm's existing infrastructure. The disadvantage is that the solution can only be as successful as the constituent data elements or framework.

Seagroatt: The basic component of optimisation is establishing a single global view of inventory and exposures across the firm. This is a fairly complex undertaking for most financial institutions. However, it offers a good return on investment.

Another key starting point is accurate mapping of eligibility, concentration and haircut schedules. Furthermore, technology solutions now need to incorporate collateral costs, risk-weighted assets and liquidity coverage ratios to support effective optimisation. All of this data is changing on a daily or even intraday basis. This means systems need to consume and process this data in real time with minimal manual intervention.

Collateral management solutions must also be able to move collateral efficiently in an automated way. This includes the ability to instruct movements in multiple formats to deliver collateral into the correct depositories. The number of collateral movements will increase dramatically in the coming years so maintaining control of settlement costs and mitigating operational risk is going to be a big challenge.

Finally, systems must support new services such as collateral transformation and offer tools that can help to price these services, based on factors such their balance sheet consumption.

While it is possible to use multiple technology solutions for all of this, a single system approach makes sense. There are major benefits in seeing all of this data in one place, from front to back office and across the firm's business lines.

A phased approach to optimisation is often best. Once basic optimisation is in place, the firm can assess the cost/benefit trade off from implementing more advanced techniques that require greater investment.

We will continue to see a lot of innovation in the collateral space in response to the upheaval facing the industry over the coming years. As hardware and processing costs come down, the more advanced techniques should also become available for a wider range of market participants. **SLT**

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Russian securities lending heats up

Chris Benedict, vice president and lead analyst of DataLend, takes a look at how geopolitical instability has affected securities lending activity in Russian stocks and ETFs

After years of government corruption and mismanagement, a dearth of employment opportunities, a weak currency and a steadily growing crime rate, the citizens of Ukraine staged a series of widespread protests later called "the Ukrainian revolution of 2014", erupting in January and escalating in February. Then-President Viktor Yanukovych fled Kiev to Russia in late February, and a new interim Ukrainian government was installed in the aftermath. This new government was immediately denounced by Russia President Vladimir Putin as a "coup d'etat".

With authorisation from the Russian Parliament, Putin sent Russian troops into the Crimean region, taking control by early March. Within a few weeks, Crimea held a referendum to secede from Ukraine and join Russia. Amid widespread allegations of voter fraud, the US and Europe responded with economic sanctions and threats of military action.

Government instability is never welcomed by capital markets, and Russia's incursion into Ukraine is no exception. We reviewed top Russian exchange-traded funds (ETFs) and stocks across various sectors to see how both the cash and securities lending markets reacted to these geopolitical events.

Market Vectors Russia ETF (RSX), for example, sold off by more than 20 percent during the onset of the Ukraine crisis in January and February. But it wasn't until Russian troops entered Crimea that the short sellers really got involved. Volume weighted average fees (VWAF) to borrow the ETF spiked considerably to reach a high of almost 550 basis points (bps) on 6 March. Utilisation reached a high of 98 percent during that same timeframe. Fees to borrow have dropped recently in conjunction with the ETF's sell-off, although utilisation in the name remains very high.

Market Vectors Russia Small Cap ETF (RSXJ) followed a similar pattern, although it exhibited more volatility than RSX prior to the crisis. Fees to borrow the ETF were around 300 bps before Russia entered Crimea and rose to 500 bps immediately after. Unlike RSX, fees to borrow RSXJ have continued to climb even higher more recently. Utilisation is also very high at 98 percent.

In the energy sector, Russian giant Gazprom also saw significant volatility in the aftermath of the situation in Crimea. Prior to the Ukrainian revolution, the stock was trading at very general collateral levels of around 16 bps. But by the end of March, fees had shot up to 600 bps and still traded in a hot range more recently. Lukoil followed a similar pattern: very little securities lending trading going on in the name before March, then fees to borrow skyrocketed from a general collateral 10 bps to 500 bps as the stock cratered. This stock also traded in a volatile warm/hot range more recently.

But it was more than just Russian energy firms feeling the wrath of the short market: Russian financial services firms were also adversely affected by the situation in Crimea. Sberbank, for example, traded sporadically in a general collateral to warm range prior to the Russian occupation. Share prices fell by 30 percent while fees to borrow jumped to 100 bps in the weeks thereafter. JSC VTB Bank also slumped in the wake of the crisis (down more than 20 percent), with fees rising from 28 bps to around 135 bps.

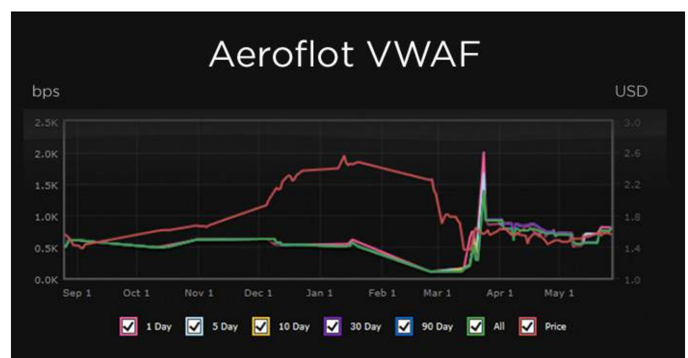
Shares of Aeroflot airlines fell as the company announced it would reroute its flights to avoid flying over Ukraine. The stock price plunged by almost 40 percent while fees to borrow soared from a warm 100 bps to a red-hot 2000 bps. Although borrowing fees have eased since then, utilisation in the name remains at almost 100 percent.

In the Russian consumer staples industry, Dixy Group saw its share price collapse as fees to borrow the stock soared to 765 bps in March. For competitor Magnit, fees to borrow jumped from a warm 200-to-400 bps range with utilisation staying north of 80 percent.

In the mining industry, the share price of AK Alrosa was not as badly affected (and actually rebounded amid the crisis), though fees to borrow the stock increased to more than 700 bps and utilisation reached a high of 70 percent.

Even Russia's nascent telecommunications sector could not escape the brutal sell-off as investors fled the country. Shares of AFK Sistema plummeted by more than 30 percent after Russia entered Crimea, and fees to borrow jumped from general collateral levels to 400 bps immediately after as short sellers borrowed any shares they could get their hands on. MegaFon also traded in the hot range for some time, although it has not sold off in the cash markets as badly as other Russian stocks.

There is an old saying that "Wall Street climbs a wall of worry", implying that although times may be tough or uncertain, investors remain confident that the problems will be resolved in the long run. Red Square is not Wall Street. If the situation in the Ukraine intensifies, fees to borrow Russian ETFs and thinly traded Russian equities could continue to climb as share prices remain stagnant or drop to new lows as a result of higher capital outflows, additional economic sanctions and growing condemnation of Russia's tactics.



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Short sellers' positions improve in Europe

Heavily shorted shares have underperformed the rest of the universe in Europe for the second month running in May. Simon Colvin of Markit Securities Finance reviews the shares currently targeted by short sellers

The fee charged in order to short a specific security incorporates multiple sentiment indicators that may be considered esoteric to non-securities lending market participants.

It includes both the demand to borrow as well as the availability. This single number represents, as an annual percentage, what investors are willing to pay in order to gain short exposure to a security. It is fair to say the most expensive stocks to borrow are often those with the most negative sentiment. This was reviewed in our recent review of the performance of the most expensive shorts in North America and Asia over the last few months.

Our focus on Europe finds that the most expensive shorts have also underperformed over the last couple of years, although the signal is not nearly as strong or consistent in this region compared to the rest of the world.

Expensive to short shares underperform, but not consistently

We compared the performance of 10 percent most heavily borrowed stocks against the broader Markit Developed Europe Universe, using Markit's Implied Loan Rate factor. This is based on the Markit Securities Finance indicative loan fee, which measures the cost charged to hedge funds to sell a share short.

The top 10 percent most expensive shares to short in the Markit Developed Europe Universe have underperformed the market by a cumulative 8 percent in the 24 months leading to the end of May.

But this underperformance could be misleading as most of the underperformance occurred in the first three months of the observation period. The subsequent 18 months have proved to be inconclusive for European short sellers, as the most shorted shares alternated between outperforming and underperforming the market. This inconsistent performance of the most shorted shares in Europe makes a stark contrast to the consistency seen in the cost to borrow Asian and North American shares.

However, the last couple of months have brought some respite for European short sellers, as the most shorted shares underperformed the market in successive months for the first time since summer 2012. The 0.6 percent and 1.2 percent underperformances recorded in April and March, respectively, have ensured that the most expensive European shorts have underperformed the rest of the market by nearly 2 percent since the start of the year.

Banks among the most shorted

Currently, among the shares commanding a high fee and strong utilisation are four banks, making banking the best represented sector within the 10 percent most expensive group with a utilisation rate above 50 percent. These companies are all peripheral names, which are currently in the process of recapitalising after the recent eurozone crisis.

Of those four firms, Italian bank Banca de Monte Dei Paschi has the largest proportion of its shares outstanding out on loan with 10.8 percent. The firm is going through a €5 billion rights issue, so it's safe to assume much of the current demand to borrow is driven by desire to play the rights issue as opposed to directional short selling.

Also seeing high demand to borrow in this space are National Bank of Greece and Liberbank, which are also busy raising capital from shareholders.

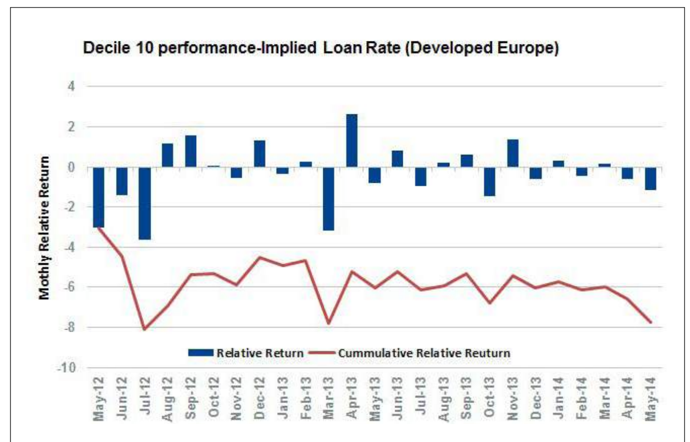
Airline wars

Transportation firms also see high demand to borrow with three firms among the shares seeing high utilisation. An ongoing directional story is in the airline space with Scandinavian airlines SAS and NAS currently battling for top regional spot in the region.

While NAS was seen as the hot short a year ago, the attrition tide seems to have turned in its favour after it was able to beat analyst expectations over the last couple of quarters. These developments have seen shorts cover a quarter of their positions since the start of the year.

SAS is currently seen as the potential loser by short sellers in the duel between the two firms after it has seen short interest double since the start of the year. While the firm has a lower proportion of its shares out on loan, the shorts are currently paying more to borrow SAS shares than NAS ones, showing a greater commitment in the short. **SLT**

Simon Colvin
Analyst
Markit Securities Finance



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Industry appointments

Deutsche Bank has appointed **Jens Reubbert** as head of global transaction banking in Vietnam and chief country officer.

Reubbert will take the role immediately.

He will report to Gunit Chada and Alan Cloete, co-CEOs of the Asia Pacific and members of the group executive committee of Deutsche Bank.

He joins from Deutsche Bank China where he served as managing director and COO. He has previously worked across Germany, Hong Kong, Singapore, Turkey and China.

As head of global transaction banking for Vietnam, he will report to Lisa Robins, the Asia Pacific and Deutsche Bank head of global transaction banking.

Chada said: "Reubbert's appointment clearly underlines our commitment to developing a successful franchise in Vietnam which is a growth market for both our clients and the Bank. [He] brings significant global and client management experience to this important role."

Robins added: "Reubbert's focus will be to bring his extensive experience and that of our team in Vietnam to serve the needs of both global and local clients and to expand Deutsche Bank's presence in the market."

Cowen Equity Finance Group has recruited **Christopher Masse**.

Masse will report to Rory Zirpolo, the head of securities lending at Cowen, who also serves as managing director and head of the equity finance group.

Masse joins after accruing three years of experience at Gleacher & Company Securities, where he served as director of equity derivatives sales and trading.

Prior to his time at Gleacher, Masse was also director of equity derivatives sales and trading at Saratoga Capital. Masse was employed at Saratoga between 2009 and 2010.

Masse also spent a year as vice president of equity derivatives trading at Garwood Securities.

BCS Financial Group (BCS) has appointed **Vladimir Tikhomirov** as its new chief economist.

The new chief economist role will help drive strategic decisions in the BCS Financial Group and will lend his economic weight to helping to grow the business.

Tikhomirov joins BCS from Otkritie Financial Corporation where he has worked as chief economist since 2010.

Other positions include the same role at URALSIB Financial Corporation and NIKOIL Brokerage, which he joined in 2001.

Joseph Dayan, executive director and head of markets at BCS Financial Group, commented: "As BCS continues to expand we have made a number of strategic hires that will help develop our offering and provide direction for the business."

"Tikhomirov is one of these who brings a huge wealth of knowledge about Russian and CIS markets, he will be a great asset to the team and lend his weight to helping BCS grow and mature its research capabilities."

OTAS Technologies has expanded its US sales team with the addition of **Jennifer Martyn**.

Her hire follows the appointment of Nick Lieder earlier this year as head of US sales.

Martyn joins from Thomas Reuters, where she served in the pan-European equity research division and prior to that, at StarMine in the European sales office.

She will work with the North American team, including Courtenay Kane and Noah Levin. Together, the team will integrate OTAS and TradeShaper into the workflow of new and existing institutional investments.

"Martyn's expertise and experience will bring a new dimension to the US team and its sales efforts. Her dynamic and client-centric approach to the fintech sales process has proven in the past to be a great recipe for success," said Nick Lieder, head of US sales of OTAS Technologies.

Martyn added: "I'm looking forward to working with the team in the US and on a global level to increase the OTAS footprint and grow the business".

The hire is part of a period of growth at OTAS. Alex Wild and Kim Zhang recently joined the global product specialist team in London and Hong Kong, respectively.

Nixon Peabody has expanded its government investigations and white-collar defence practice in New York City with the arrival of **Bradley Mirkin**, former senior litigation counsel at the Financial Industry Regulatory Authority (FINRA).

FINRA is the US's largest independent securities regulator providing oversight to more than 4000 securities firms and their registered representatives.

At FINRA, Mirkin served as lead counsel in some of its largest and most challenging cases. He also consulted on significant enforcement, member regulation and market regulation investigations, examinations and disciplinary actions.

"As the Securities & Exchange Commission (SEC), FINRA and other regulators step up their enforcement, [Mirkin] will be a terrific asset to our clients in the securities industry," said David Vicinanzo, leader of Nixon Peabody's government investigations and white-collar defence practice.

"As a skilled trial lawyer experienced in representing FINRA as well as prominent financial institutions who also served as a broker-dealer's COO and chief compliance officer, [Mirkin] offers clients a unique understanding of compliance programs, the securities laws, rules and regulations and FINRA and SEC enforcement."

Mirkin, who joins Nixon Peabody as counsel, will focus on strategic counselling, responding to and defending FINRA, SEC and Financial Crimes Enforcement Network investigations and enforcement proceedings; advising on compliance programmes, risk analyses and best practices; and handling commercial litigation involving federal and state securities laws.

Jonathan Eliot has joined the board of directors of LCH.Clearnet.

Eliot joins as a non-director, effective immediately in the group's UK central counterparty.

Eliot currently holds the chief risk officer role at Man Group, where he has worked since 2011. He manages the introduction of a new risk management framework.

He previously served as a market risk director at Barclays Bank, Deutsche Bank and prior to that, J.P. Morgan as head of Asia corporate risk management.

Jacques Aigrain, chairman of LCH.Clearnet Group, said: "We welcome Jonathan Eliot as a non-executive director of LCH.Clearnet. Eliot has an extensive track record in risk management, having worked in senior positions in both buy-side and sell-side operations. **SLT**

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