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CSDs find new ally in Deutsche Börse for blockchain collateral scheme

Four international central securities depositories (CSDs) are collaborating with Deutsche Börse to build a blockchain-based prototype for cross-border collateral transfer.

The Canadian Depository for Securities Limited (CDS), Clearstream in Luxembourg, South Africa's Strate, and Norway's VPS are all members of the Liquidity Alliance, an international consortium of CSDs focused on collateral management.

They are partnering with Deutsche Börse to create the LA Ledger solution, intended to provide faster and more efficient mobilisation of security collateral and to overcome some of the challenges of moving collateral across jurisdictions.

Under the US Dodd-Frank Act and the European Markets Infrastructure Regulation, there is demand for high-quality collateral but limited access. Moving such collateral around is a regulatory requirement for mitigating risk in the financial system.

LA Ledger will use decentralised distributed ledger technology, allowing direct interaction between participants and thereby simplifying the collateral mobilisation process.

In theory, fragmented security positions will be allocated more efficiently, covering participants' financial obligations in different jurisdictions.

The solution will be implemented as a prototype, based on the Hyperledger Fabric blockchain.

Validation from market participants and regulatory authorities is scheduled to begin in Q2 2017.

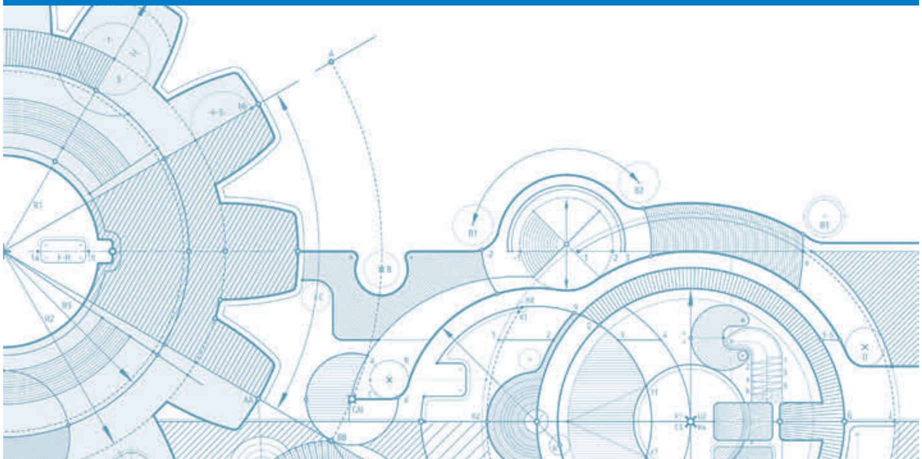
VPS CEO John-Arne Haugerud commented: "LA Ledger is designed to simplify cross-border collateralisation away from using multiple complex and non-standardised links towards smooth movement across various jurisdictions."

Inside securities lending times

ISSUE169 24 January 2017

SFTR regulatory technical standards expected in Q4

London | Reporter: Drew Nicol



The final draft of the regulatory technical standards (RTS) of the Securities Financing Transaction Regulation (SFTR) is not expected to be released until Q4 2017, according to the International Securities Lending Association (ISLA).

The European Securities and Markets Authority is expected to submit its final draft RTS to the European Commission in late March and with the full formal adoption procedure triggered thereafter.

With this timeline, ISLA described the chances of the SFTR RTS coming before Q4 as “unlikely”, meaning that phase-in is likely to begin in Q4 2018.

The latest prediction of SFTR’s development comes from a joint effort between the association and US-based public relations and marketing agency Fleishman Hillard and is based on a “smooth-sailing scenario”, which ISLA acknowledged is open to disruption and revision.

Despite a large number of remaining concerns with the RTS that were voiced at the November public hearing, ESMA is eager to close off the RTS without further delaying implementation, as it is already well behind the 13 January deadline mandated in the level one text.

In explaining its reasoning, ISLA laid out the foundation of its calculation, stating that, once the commission receives the draft RTS, it has three months to adopt the standards via delegated regulation.

The commission, in turn, then has to submit the delegated regulation to the European Parliament and Council for review for one month if the RTS is unamended, or three months if amended.

Once there is agreement on the RTS, it will be prepared for distribution and entered into the EU official journal, which should be completed by October.

ICMA: ECB lending must expand

The International Capital Market Association (ICMA) has reaffirmed its calls for the European Central Bank (ECB) to expand its securities lending facility in response to the extension of the central bank’s asset purchase programme (APP).

In its Q1 2017 report, ICMA noted that ECB’s public sector purchase programme (PSPP), which directly relates to the European repo market, is approximately 80 percent based on government bond collateral.

“Holding securities within the PSPP naturally removes them from the market and it is only through the arrangements for securities lending that these holdings can then be made available to assist the market in meeting its operational needs. In consequence, collateral availability could decline, at a time when collateral demands are increasing,” ICMA stated.

“In particular, new derivative margining requirements are starting to be imposed, and this comes at a time when there is already evidence that pressure on the collateral market has been increasing.”

Specifically, ICMA highlighted that collateral decomposition by issuers and type suggests a notable increase in the share of German and Italian government bonds.

In response to the ECB’s December announcement of its decision to extend its APP until December 2017, ICMA acknowledged the positive amendment to introduce cash collateral for PSPP securities lending facilities. ICMA added that this alone will not solve current concerns and there remains scope to further enhance the effectiveness of the securities lending arrangements.

The association also reaffirmed its commitment to being an active player in the arena in the coming year.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Bloomberg builds for collateral

Bloomberg's MARS Collateral Management solution has secured HSBC Private Bank and more than a dozen corporations and financial institutions as clients.

The MARS solution targets the new variation margin requirements for non-centrally cleared over-the-counter (OTC) derivatives for banks, investment firms and corporations, promising to facilitate the collateral management and reconciliation processes needed to adhere to these new requirements.

Bloomberg said: "These rules are intended to reduce systemic risk, but present costly operational challenges to investors who will need to calculate and post initial and variation margins for all non-cleared trades, classify eligible collateral to post and deal with an increase in margin calls and daily calculations."

The non-centrally cleared OTC derivatives market is currently valued at $200 trillion.

Bloomberg MARS Collateral Management allows customers to centralise their collateral management workflow and automate how they manage and monitor risk exposure and collateral positions. It provides cross-product, cross-asset support for US Dodd-Frank Act and European Market Infrastructure Regulation compliance, effective capture of legal documentation, automated messaging, risk analytics, and portfolio reconciliations.

Bloomberg also provides a data licence product and look-up feature on the Bloomberg Terminal that helps investors identify collateral eligible to post in different jurisdictions, as well as aggregation and eligibility checking services for bilateral and triparty repo agreements.

"It's a business imperative to trade these types of instruments, so compliance too becomes a business imperative," said Kpate Adjaoute of HSBC Private Bank.

"We anticipated that these reforms were coming. It helps to centralise the process and have access to the data we need, as well as the counterparties with whom we trade.

Phil McCabe, global product manager for collateral management at Bloomberg, added: "The challenges investors face in the OTC derivatives market cannot be addressed with software alone. Bloomberg provides the data and analytics to calculate and reconcile margin requirements. We go further by connecting a global network of corporations and investment firms, both large and small, to unify what can be a very laborious, risky and disjointed process."

Hong Kong trader spared jail

A Hong Kong-based trader has avoided jail after being reprimanded for uncovered short selling.

The Securities and Futures Commission (SFC) issued a fine of HKD 50,000 (USD 6,500) to a Core Pacific–Yamaichi International employee for breaching the code of conduct in relation to illegal short sales of shares of China Agri-Products Exchange.

The SFC found that Chang Chyi told a customer that shares allocated by China Agri-Products through a rights issue could be sold before 4:00pm on 21 March 2014, without violating short selling restrictions.

The customer placed an order to sell 320,000 rights shares and bonus shares that were subject to conditions until 4:00pm on 21 March 2014 and could not be sold at that time.

Illegal short selling is a criminal offence in Hong Kong. it carries a maximum penalty of a $100,000 fine and two years is in prison.

The SFC said: "Chang did not have an adequate understanding of the short selling restriction and had failed to take reasonable steps to verify the date on which the relevant rights issue would become unconditional."

Australia doubles down (under) on reporting

Perth | Reporter: Stephanie Palmer

The Australian Prudential Regulation Authority (APRA) is considering two new reporting standards for securities lending and repo transactions in order to maintain global regulatory parity.

The latest overhaul of the Australian market's reported data comes in response to the Financial Stability Board's recently published final recommendations on securities lending, as part of its review of risks threatening asset managers.

Of the two reporting forms being considered in APRA's discussion paper, the first option will collect transaction-level data on repos and securities lending activity for all positions outstanding at the end of the month, while the second collects aggregated data broken down along certain lines.

APRA noted that, during its industry consultations, most institutions indicated a strong preference for the first version, but, some reporting institutions are likely to find the second more straightforward.

For each repo, reverse repo, securities lending and borrowing position at the end of the month, entities with greater than a AUD 100 million (USD 75.4 million) of stock outstanding will be required to provide details on the characteristics of the loan and of the underlying collateral.

For securities lending activity, further aggregate information will be collected on the reinvestment of cash collateral, which cannot be reportable at a transaction level.

APRA has proposed an extended phasing in period for this new standard of reporting that will begin on 1 July 2018. Phase two and three will then begin on 1 January 2019 and 1 July 2019 respectively.

There will also be a parallel run period of 12 months where market participants will be required to report data on both the old and new forms in order to ensure continuity and data accuracy.

Under APRA's existing reporting system, institutions are already reporting some data on repos and securities lending. The data is published by the RBA, which also runs a quarterly bond and repo survey.

APRA is open to industry comment on the proposals until 18 April.

FSB issues final recommendations for asset management

The G20-backed Financial Stability Board (FSB) has issued new recommendations for securities lending as part of its review of risks threatening asset management.

The board's report included 14 policy recommendations to tackle "financial stability risk activities", like securities lending, pose to the market.

Specifically, the FSB has taken umbrage with asset managers' use of indemnification of the underlying lender's trades.

As part of its final recommendations, the FSB suggested that authorities should monitor indemnifications provided by agent lenders/ asset managers to clients in relation to their securities lending activities."

"Where these monitoring efforts detect the development of material risks or regulatory arbitrage that may adversely affect financial stability, authorities should verify and confirm asset managers adequately cover potential credit losses from the indemnification provided to their clients."

"The enhanced disclosure task force improve public disclosure for financial institutions on any indemnifications provided as agent to securities lending clients, including a maturity profile of those contingent liabilities where appropriate."

"However, such a recommendation does not exist for other types of financial institutions offering securities lending indemnities."

Previous versions of the FSB's securities lending recommendations attracted criticism from major industry players, such as BlackRock, which stated in 2015 that policymakers "misunderstood the lending practice".

BlackRock confirmed at the time that it has never had its indemnification agreements triggered

or had to use its own capital to repurchase a security on a lending client's behalf and, as a result, held $2 billion in unencumbered liquidity against potential indemnification exposure, with access to an additional $6 billion of liquidity.

Commenting on the final recommendations, Mark Carney, chair of the FSB, stated: "The growth in asset management activities provides new sources of credit and investment, and adds diversity to our financial system."

"The policy recommendations published today will enhance the resilience of asset management activities so that this form of market-based finance can help underpin strong, sustainable and balanced economic growth. This will be of lasting benefit to our collective economies," Carney said.

Daniel Tarullo of the standing committee on supervisory and regulatory cooperation, added: "The policy recommendations will better prepare asset managers and funds for future stress events."

"The recommendations should also significantly enhance the information available to authorities for understanding potential risks from the asset management sector within and across jurisdictions."

Turn to p16 for an in-depth look at the fallout from the FSB's recommendations.

DTCC advances DLT platform

The Depository Trust & Clearing Corporation (DTCC) has partnered with IBM to develop a "watershed moment" in the use of distributed ledger technology (DLT) for derivatives post-trade processing.

DTCC, which is also partnered with Axoni and the blockchain consortium R3, aims to use IBM's DLT through to re-platform its Trade Information Warehouse (TIW) to further automate and reduce the cost of derivatives processing by eliminating the need for disjointed, redundant processing capabilities and the associated reconciliation costs.

The TIW service currently automates the recordkeeping, lifecycle events, and payment management for more than $11 trillion of cleared and bilateral credit derivatives.

The new TIW platform, which begins development in January and is predicted to go live in early 2018, will be built on Axoni's AxCore distributed ledger protocol and submitted to Hyperledger upon completion.

Hyperledger is an open source collaboration project hosted by the Linux Foundation. IBM will lead the initiative, provide programme management, DLT expertise, and integration services, and offer the solution-as-a-service, with R3 acting as a solution adviser.

This new project follows the completion of a proof-of-concept for North American single name credit default swaps (CDS) last year by DTCC, Axoni, IHS Markit, and other participants.

The proof-of-concept demonstrated that complex post-trade events inherent to CDS can be managed efficiently with DLT in a permissioned, distributed, peer-to-peer network.

Chris Childs, CEO of DTCC Deriv/SERV, said: "IBM, Axoni and R3 offer valued DLT expertise as well as a strong commitment to the Hyperledger community and industry standards."

"We are pleased that they have chosen to leverage their collective expertise and collaborate with us on this initiative, which will allow us to build the best solution for the marketplace while minimising cost to the industry and expediting our speed to market."

Greg Schvey, CEO of Axoni, added: "Deploying distributed ledger technology in production at this scale is a watershed moment for the industry. The combination of technology and business expertise being contributed to this project from across the participating firms is unparalleled and the benefits are clear."

CME's peso IRS activity breaks record

Derivatives marketplace CME Group achieved a record-breaking January trading day by clearing more than MXN 1 trillion (USD 45.53 billion) interest rate swaps (IRS) in a single session.

On 12 January, CME Group's cleared notional surpassed the previous record of MXN 659 billion (USD 30 billion) set on 16 December 2016.

The firm began offering Mexican peso IRS clearing in 2013. Nearly 120 participants have cleared MXN swaps at CME, with a cleared notional of over MXN 57 trillion (USD 2.59 trillion).

CME offers over-the-counter (OTC) clearing for IRS products in 19 currencies in total.

Sean Tully, global head of financial and OTC products at CME Group, said: "We are pleased that global market participants continue to turn to our OTC cleared swaps solution as their preferred venue to clear Mexican peso TIIE swaps."

"We continue to strive to provide efficiencies to this important marketplace, including the first cleared Mexican peso compression cycle through TriOptima TriReduce, which removed more than 33,000 line items and reduced gross notional by MXN 6.23 trillion (USD 283 billion) on market participants' balance sheets."

BlackRock reports Q4 revenue rise

BlackRock earned securities lending revenue of $138 million in Q4 2016, securing a million-dollar increase over the same period in 2015.

The rise came as a part of a wider increase reported across investment advisory, administration fees and securities lending revenue, which produced $26 million more than they did in Q4 2015.

Quarter-over-quarter, BlackRock's securities lending revenue dipped from the $142 million earned in Q3 2016.

As of 31 December 2016, BlackRock held $177 billion in assets and collateral in separate accounts under securities lending agreements. This was down slightly from 2015, when it held $182 billion.

BlackRock saw record firm-wide net inflows of $202 billion in 2016, including $98 billion in Q4, of which cash management, thanks to momentum in iShares and institutional businesses, accounted for $18 billion.

Laurence Fink, chairman and CEO of BlackRock, commented: "While domestic equities rallied following the US election, the combination of a strengthening dollar, underperforming international equities and negative fixed income markets produced challenging outcomes for global investors."

"Investors are rethinking their approach to active management, asset allocation and portfolio construction, and we're seeing more clients use active and index strategies together to deliver returns."

"We have purposefully invested in our platform to provide clients with a full spectrum of offerings including cash, market cap-weighted indexes, smart beta and factor-based investment strategies, and high-conviction active products, whether fundamental, quantitative or illiquid."

Brazil builds volumes

BM&FBovespa's securities lending transaction volumes reached BRL 692.74 billion (USD 215.3 billion) in 2016, up from BRL 665.73 billion (USD 206.9 billion) the year before.

The total number of annual trades actually decreased between 2015 and 2016 to 1.38 million, down from 1.52 million.

The exchange ended the year on a high, with December's securities lending volume building positively on November's to sit at BRL 60.41 billion (USD 18.77 billion).

Deutsche AM expands lending

Deutsche Asset Management is expanding its securities lending activity through its sub-funds as part of an overhaul of its investment strategy.

In a note to investors, Deutsche Asset Management explained that its UCITS and exchange-traded fund (ETF) sub-funds will switch from an ‘indirect investment policy’ to a ‘direct investment policy’.

This will include “entering into securities lending transactions as more fully described in the prospectus”. Cash collateral gained from lending may be reinvested if possible.

Currently, each sub-fund is exposed to the performance of its relevant current reference index by way of derivatives transactions such as individually negotiated OTC swaps deals.

Under the new strategy, the sub-funds will direct buy a portfolio of debt securities that may comprise of the constituents of its new reference index, unrelated transferable securities or other eligible assets.

Deutsche Asset Management will also bring the management of these funds in-house. State Street Global Advisors currently acts as investment manager for the sub-funds.

ITG fined for sec lending violations

The US Securities and Exchange Commission (SEC) has fined broker ITG more than $24.4 million for securities lending violations relating to the facilitation of naked short selling.

ITG engaged in ‘pre-release’ transactions of American depository receipts (ADRs) without owning the foreign shares or taking the necessary steps to ensure they were custodied by the counterparty on whose behalf they were being obtained between 2011 and 2014.

According to the SEC, many of the obtained ADRs were ultimately used for short selling and dividend arbitrage, even though they may not have been backed by foreign shares.

ITG violated Section 17(a)(3) of the Securities Act of 1933 and failed reasonably to supervise its employees on its securities lending desk.

Without admitting or denying the findings, ITG agreed to pay more than $15 million in disgorgement.

It also agreed to pay more than $1.8 million in interest and a penalty of more than $7.5 million.

The SEC’s order acknowledged ITG’s cooperation in the investigation, which is ongoing.

Convergex efforts bear fruit

US broker Convergex attracted more than $1 billion in new assets for its prime brokerage business in 2016.

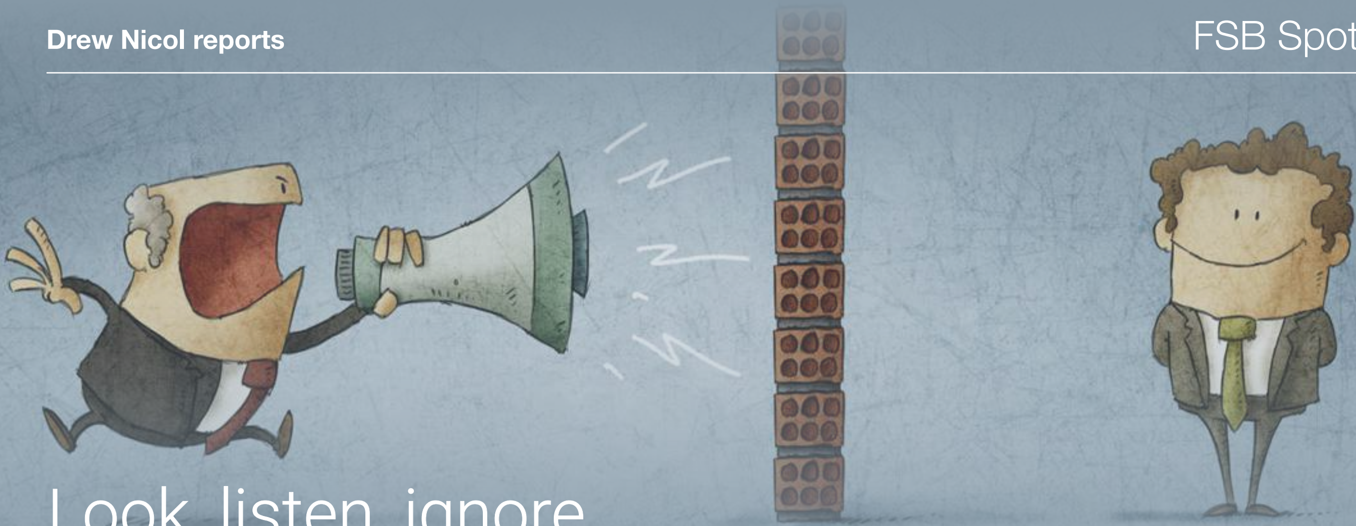
The new business, which came from both US and EU markets, was attributed to improvements to its product offerings, including expanding its futures execution and clearing services, and adding fully paid lending capabilities.

The broker also brought new products to market in 2016, including a ‘stealth’ small cap algorithm to maximise liquidity in traditionally illiquid stocks, which launched in June.

According to Convergex, the algorithm rests completely hidden in more than 15 alternative trading systems and is able to exit the market when it ‘senses’ that it is signalling its presence.

The algorithm then returns to the market when it determines that it is advisable to re-engage.

Doug Nelson, executive managing director and head of global clearing and prime services at Convergex, said: “Convergex has been seeing a steady increase in the number of European-based hedge funds looking for US prime brokers as they have found the full scope of our product offerings to be a safer and more cost-effective alternative.”



Look, listen, ignore

After an extensive review period, the securities lending industry's loud and repeated calls for change to the FSB's policy recommendation have fallen on deaf ears, much to the annoyance of everyone concerned

Inappropriate, unclear, lacking evidence, unfounded and based on an overemphasis of the risks—these just some of the descriptions offered by market participants on the draft of the G20-backed Financial Stability Board's (FSB) policy recommendation on securities lending.

Despite this, the FSB's final recommendation on securities lending, published on 12 January, remained identical to the initial draft that inspired more than 50 separate comment letters from market participants offering amendments.

As part of its extensive review into "structural vulnerabilities from asset management activities that could potentially present financial stability risks", the FSB categorised securities lending as one of four key risk areas that required closer monitoring.

Specifically, the FSB concluded that the practice of agent lenders offering indemnification wholesale to their clients could be a risk to the financial stability of those asset managers and, by extension, the wider financial market.

"Although very few asset managers seem to be currently involved in providing such indemnifications, the scale of exposures can be as large as that of some global systemically important banks," it said.

The multi-year fact-finding mission, which began in March 2015, resulted in 14 policy recommendations on a range of asset manager activities, from liquidity mismatch issues to handling operational risk.

Recommendation 14 proposed that regional market authorities "should monitor indemnifications provided by agent lenders/asset managers to clients in relation to their securities lending activities" in an effort to "detect the development of material risks or regulatory arbitrage that may adversely affect financial stability".

Authorities must then "verify and confirm asset managers adequately cover potential credit losses from the indemnification provided to their clients".

According to the FSB, the review was born out of a need to "assess the recent changes in the structure of asset management activities; identifying and prioritising potential structural sources of vulnerability that could affect the global financial system; evaluating the role that existing policy measures could play in mitigating potential risks; and making policy recommendations as necessary."

The majority of the comment letters endorsed and encouraged the FSB's mission to collect and distribute data on asset managers activities and perceived risks, but went on to comprehensively deconstruct the board's argument for focusing on the service of indemnification.

Stuck between a BlackRock and a hard place

Of all the market entities that waded into the debate on legitimacy of focusing on indemnification as a source of systemic risk, none were more vocal than BlackRock.

In its response to the first draft proposals, BlackRock simply stated: "Potential losses to a securities lending agent or its clients due to borrower default indemnification is not a systemic risk."

The firm said that the FSB should have considered whether data collection about borrower default indemnification provided by securities lending agents would be "additive to data reporting efforts".

It added: "Both the value of outstanding loans receiving borrower default indemnification and the value of collateral posted against those loans should be collected and considered in tandem. However, in many cases, the consultation fails to differentiate between market risks that could result in losses by investors from vulnerabilities that could produce or transmit systemic risk."

"For example … borrower default indemnification is a limited obligation, and any potential client losses are limited to the difference between the value of the lent security and the value of the collateral posted, and potential losses are further mitigated by various limits imposed by clients."

BlackRock's campaign on this particular set of recommendations began back in May 2015 when it released a whitepaper accusing policymakers of "misunderstanding the lending practice".

It claimed that there are many misunderstandings specific to its own involvement with securities lending, and these have "unfortunately" formed the foundation of recent policy discussions. Ultimately, BlackRock regarded the proposal as inappropriate and unnecessary.

Feel the concern

The view that further reporting requirements on securities lending transactions and asset managers would only place further burdens on those affected was echoed repeatedly by other market participants and industry bodies.

The International Securities Lending Association summarised the views of its members to the initial proposal in four concise points: (i) Asset manager are subject to regulatory oversight by local and European regulators and as such will be required to disclose liabilities and capital adequacy; (ii) the absence of a formal capital regime does not prevent them from ensuring liabilities are monitored and accounted for; (iii) given the diversity of indemnifications, standardised reporting will be exceptionally difficult to impose with any accuracy and risks misinterpretation; and (iv) regulators have oversight of all the relevant information to apply the FSB recommendations without further need of additional reporting or regulatory initiatives.

Since the unchanged final draft was published, ISLA has reiterated its concern.

"We continue to support the work of the FSB in terms of moving to a more transparent market that will enable regulators and policymakers to better understand the securities lending markets."

"Whist we note the focus on indemnification in the FSB's latest recommendations in respect of asset management sector, we would stress that any form of indemnification should only been seen as a backstop to a well run and managed lending programme where the risks associated with lending are clear and well understood by the parties involved," ISLA explained.

"It is also important to recognise that simply tracking indemnification may not reflect all of the risks involved as the nature and scope of indemnification may vary from programme to programme."

In a similar vein, the Risk Management Association said: "The fact that the FSB did not expand the scope of its recommendation beyond monitoring confirms what many in the industry already know: there is no evidence to suggest that asset managers' provision of borrower default indemnification contributes to systemic risk."

"Many asset managers have expressed concern regarding any expansion of data collection that would be required to implement the monitoring recommended by the FSB."

"They fear it could cause significant operational burdens for them and increase costs to investors—all to monitor an activity that has not been shown to contribute to systemic risk."

The International Capital Market Association (ICMA), along with others, including BlackRock, raised concern over an apparent misconception regarding differences between banks and asset managers acting as agent lenders. ICMA stated: "We have more concern about the claim that different regulation of banks and asset managers could lead to regulatory arbitrage in securities lending."

"There are important differences between banks and asset managers that are reflected in their regulatory frameworks."

"Most importantly, asset managers do not rely on government-insured deposits to support their liquidity and asset managers do not have access to central bank liquidity."

Simply, because asset managers are not a utilising taxpayers money for their balance sheet, unlike most banks, they should not be held to the same high level of capital requirements.

Finally, the Association of the Luxembourg Fund Industry, which is not a regular contributor to debates on niche markets such as securities lending, commented: "We agree with the focus on the risks identified, although we believe some risks are overemphasised, such as securities lending and transfer of accounts."

The FSB's decision to ignore these concerns bucks an emerging trend of stronger ties between market participants and regulators.

This trend recently saw the European Securities Markets Authority (ESMA) highly praised for its pragmatic handling of potential pitfalls in the Securities Financing Transaction Regulation (SFTR).

After receiving a deluge of industry comment, a well-informed ESMA smartly sidestepped one of the industry's worst fears of creating a major liquidity issue by revising its collateral reporting rules in its second-level consultation, published in October 2016.

It's worth bearing in mind that the FSB's recommendations are just that, and it will be up to individual market authorities to interpret them.

The vast majority of industry opinion seems sceptical, at best, as to their usefulness. **SLT**

The unfolding of events

March 2015: Review of structural vulnerabilities in asset management begins.

July 2015: FSB delays final assessment of methodologies for non-bank non-insurer global systemically important financial institutions in favour of focusing on asset management.

June 2016: FSB publishes a consultative document on proposed policy recommendations and receives more than 50 response letters from concerned market participants.

January 2017: Publication of the final version of the FSB's 14 policy recommendations, including an unedited securities lending market proposal.

December 2018: The FSB's global securities financing data collection and aggregation framework will begin implementation.

FSB's final recommendation on securities lending

Recommendation 14: Authorities should monitor indemnifications provided by agent lenders/asset managers to clients in relation to their securities lending activities.

Where these monitoring efforts detect the development of material risks or regulatory arbitrage that may adversely affect financial stability, authorities should verify and confirm asset managers adequately cover potential credit losses from the indemnification provided to their clients.

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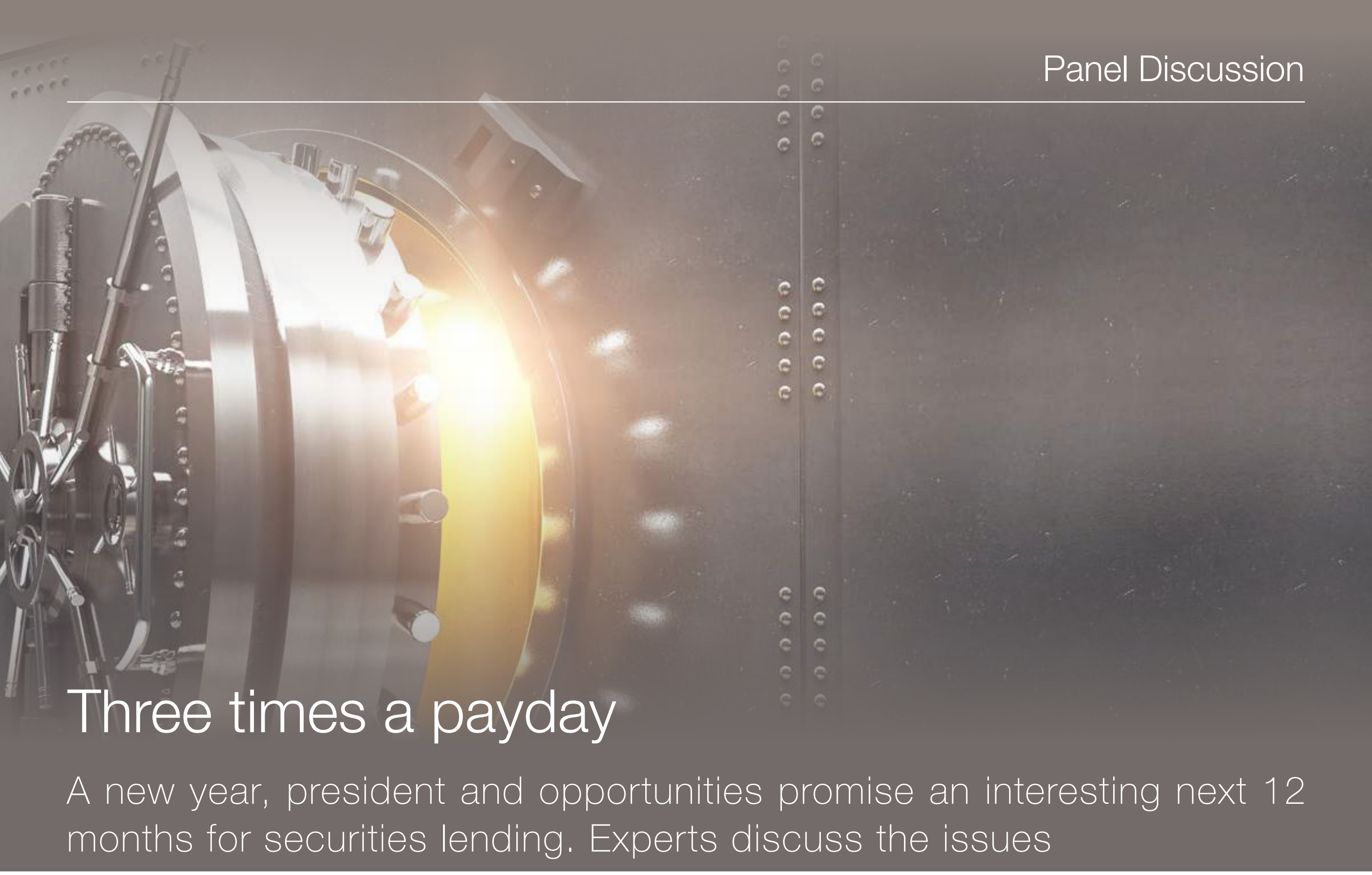

Three times a payday

A new year, president and opportunities promise an interesting next 12 months for securities lending. Experts discuss the issues

What should be on the top of a beneficial owner's to-do list for the coming year?

Paul Wilson: The market is more dynamic than ever as demand to borrow and/or finance securities evolves in response to regulatory change, capital/balance sheet constraints, the global economy and other macro events. Beneficial owners generally experienced a decent 2016 in terms of revenue generation, given increased demand for high-quality liquid assets (HQLAs) and a robust equity specials environment, most notably in the US. However, the underlying trend is one of gradually declining revenue on a like-for-like basis, as evidenced by continued erosion of European yield enhancement and lower demand for general collateral.

Therefore, beneficial owners will want to stay abreast of these trends and consider, within their individual risk profile, whether to make changes or think about additional approaches (to markets, collateral, structures or general parameters). For example, some beneficial owners have 'hold-back' requirements. If a beneficial owner reduced a 20 percent hold back to 10 percent, revenue on in-demand specials could increase by 12.5 percent.

Being proactive around scrip and corporate action opportunities is another simple, yet effective, option to increase revenues.

There are other, more complex opportunities materialising that won't be suitable for everyone. Either way, as the industry adjusts, beneficial owners should consider spending time on understanding and evaluating these options versus the overall goals of their securities lending programme.

Finally, the 'to-do' list of beneficial owners should include monitoring and adhering to new and evolving requirements regarding transparency (the Securities Financing Transactions Regulation (SFTR) in Europe and the US Securities and Exchange Commission's Investment Company Reporting Modernization Act, for example) and/or SFT reporting. Throughout 2017, and in future years, these requirements will become increasingly more commonplace and since failing to adhere is not an option for beneficial owners, this should be near the top of the list.

Lance Wargo: While the US securities lending market is dominated by cash collateral, with interest rates rising, it would be prudent to review cash collateral reinvestment strategies. Particularly, upon the implementation of money market reform in October last year, many investors took a back seat and moved into lower-yielding government money market funds.

As always, there is no one-size-fits-all approach. Beneficial owners need to consider their objectives as well as their unique risk tolerance in formulating a specific and feasible strategy.

Meanwhile, higher interest rates could potentially offer wider spreads. Yet, interest rate risk management would become more significantly important for beneficial owners as the Federal Reserve's tightening pace accelerates.

That said, beneficial owners should also review their agent bank relationships to ensure that the interest of their securities lending agents are aligned with their own. Beneficial owners rely upon agent banks' expertise to pursue higher returns and to manage risks, both financially and operationally.

Be it intrinsic lending or general collateral lending, the key is that agent banks need to have the capability and capacity to carry out a unique lending and investment strategy that is best suited for beneficial owners against the backdrop of new economic climates.

Since our programme at BNP Paribas was launched in the US, we have built our platform to offer customised solutions to our clients. We are in frequent dialogue with clients, such that they are fully engaged in the management of their securities lending programmes, and are fully informed of developments in the marketplace.

They are able to quickly implement a new lending and/or investment strategy—at their will—should market conditions evolve.

Joseph Santoro: 2017 should be a year of engagement. With an array of regulatory changes in effect, and more on the way, beneficial owners in the US and overseas would be well served to engage their agent as to how change affects them, their agent and counterparties. The new environment poses real challenges, but it also presents opportunities for those who are willing to invest time in optimising their strategy.

Deutsche Bank always puts the interests of beneficial owners first, and therefore seeks to make the best opportunities available to them by considering the challenges facing counterparties. Trading flexibility, such as collateral types and legal domicile, can provide counterparties with balance sheet relief and reward clients with measurable improvements in returns. Similarly, counterparties incur higher balance sheet costs trading with certain client types, so having flexibility in approving borrowers is increasingly important.

Finally, 2017 might be an ideal time for beneficial owners to re-examine the overall value proposition they receive from their agents. Some agents might be less constrained than others with respect to indemnification and relationship pricing, for example. Moreover, the needs of many beneficial owners are expanding beyond traditional yield enhancement, to include financing and collateral management, which is worth exploring.

George Trapp: Beneficial owners should review their programme parameters in 2017 to ensure they are prepared for a year that will likely experience changes in terms of the securities lending marketplace.

The last several years have provided relatively modest growth in the securities lending market. After a long period of extremely low interest rates globally, the US has increased the overnight fund rate twice in the past 12 months and will likely continue to increase rates during 2017.

Now would be a great time to review the terms of your securities lending programme and ensure they reflect the risk profile of your investment policy. Beneficial owners taking cash collateral would be wise to focus on investment guidelines and how the cash collateral portfolio is positioned relative to the expected increases in the overnight funding rate.

Cesco Squillacioti: Part of what an agent lender does is to review market activity constantly and to translate that activity into actionable suggestions for beneficial owner clients. Some suggestions could be revenue focused, such as engaging in lending in a new or different market; some suggestions could be around risk mitigation; sometimes both.

While we see this as an ongoing activity, the beginning of the year might be an opportune time for beneficial owner clients to take time to review and consider such suggestions in the context of their overall programme parameters and with a view to optimising them.

Chip Dempsey: Stock lending is becoming less profitable for the borrowing banks that facilitate transactions, which has diluted the incentive to provide clients with better service. There are three drivers to the benefits of a central counterparty (CCP):

- Clearing affords more favourable capital treatment (with the CCP as counterparty or trade performance guarantor);
- CCPs that accept non-cash collateral create opportunities to optimise collateral pledging, using securities that are otherwise un-utilised, further preserving balance sheet; and
- CCPs process listed instruments in highly automated ways, which can be leveraged to the cost-efficiency of the stock loan post-trade processing flows.

Our traditional clearing members, many of which are bank-owned broker-dealers, were early adopters of our securities finance clearing. Basel III has had a very direct effect on their need to preserve their balance sheet by switching to lower risk-weighted assets.

The competitive edge is always moving: the conversations we're having with agent lenders suggest that utilisation will reflect the borrowers' costs, and the borrowing banks are unequivocal about the relative costs of CCP versus higher risk-weighted counterparties.

Understanding how CCPs affect their competitive position is worthy of being on a beneficial owner's to-do list.

How will higher interest rates affect your trade choices?

Peter Economou: Higher interest rates add value to beneficial owners that lend securities in a number of ways. Beneficial owners that accept cash collateral and have investment guidelines that allow for a risk-adjusted return that incorporates duration risk can invest in opportunities as an upward sloping yield curve develops. Beneficial owners should carefully assess their liquidity needs to determine a desired liquidity threshold and, likewise, identify the portion of their cash collateral investment that could be extended by maturity to achieve higher returns.

In addition to the benefit for cash collateral, there is also an intrinsic lending benefit. Rising interest rates will continue to increase the securities lending benchmark as represented by the overnight bank funding rate (OBFR). As OBFR increases, there will be more spread between the benchmark and zero, allowing for more earnings to be generated from the opportunity cost of cash. Historical analysis shows that rebate spreads widen as cash opportunity cost spreads widen.

Trapp: Lower bond yields for the last several years have certainly had an impact on the shifting allocation from cash collateral to non-cash collateral. The trend, however, has other drivers as well, including the regulatory environment and the associated costs of utilisation of various types of collateral.

> Beneficial owners should carefully assess their liquidity needs to determine a desired threshold
>
> Peter Economou, Head of markets, risk, and operations
> **eSecLending**

> The recent shift higher in credit yields makes cash collateral more appealing

George Trapp, Head of North American client services
Northern Trust

If anything, the recent shift higher in credit yields (ie, prime fund-like returns) versus government funds makes cash collateral more appealing from a pure yield perspective. The regulatory environment remains a driver of collateral decisions, but as spreads widen on cash products, the conversation becomes more compelling to re-engage on the cash side.

Wargo: Prolonged low interest rates have offered limited options for lenders over the years. Higher interest rates, no doubt, open the door for beneficial owners to pursue different trading strategies given their unique objectives. On the other hand, higher interest rates will translate into higher capital costs for broker-dealers. As a result, they will look for alternatives, if any, to lower their funding costs.

We strive to capitalise on market opportunities and maximum client returns in a risk-controlled manner. Our customisable programme structure allows us to achieve these goals throughout business cycles by tailoring to clients' needs, while addressing borrower demand. In this context, we are designing various cash collateral reinvestment programmes with different asset types and maturity parameters to best capture market opportunities to maximise client returns, while keeping risks contained.

Wilson: By and large, transaction choices are driven by the borrower and the parameters established by the beneficial owner. Generally speaking, a higher interest rate environment will afford a broader range of cash re-investment options, including term. However, this is offset by continued decline in cash collateral provided by borrowers and volatility in cash balances around key reporting points such as quarter ends, which therefore require the need to keep robust levels of liquidity.

With the prospect of further rate rises during 2017, we favour floating rate securities as we feel they provide the best movement ahead of rate changes and we are able to capture the tightening environment. From a fixed rate standpoint, we are mindful of break-evens and interest rate expectations, but continue to be active there as well. Our approach is to try to remain flexible towards transaction choices, collateral, tenure, and so on in order to take advantage of opportunities as they materialise.

Dempsey: It is all about collateral optimisation. The opportunity cost of higher interest-bearing instruments is driving efforts to optimise the use of cash equities as collateral.

Santoro: Higher rates will not have a profound effect as we are focused on lending securities that are in highest demand. Also, we operate on a separate account basis and manage interest rate risk very closely. For us, it is more a matter of staying in close communication with counterparties and managing, or holding the line on, rebate rates as the Fed moves. We have the longest tenured team in the industry, so we've been through a number of interest rate cycles.

To what extent will the current low-yield bond environment affect the shift to non-cash collateral?

Squillacioti: We have seen a gradual shift towards non-cash collateral over the past few years, and it is becoming increasingly important. There would seem to be many factors at play to make this the case. The rate environment could certainly be viewed as a contributor to this shift in terms of influencing client preference or acceptance, but another factor has been working to be flexible enough to accept collateral from our counterparties that fosters balance sheet efficiency, under the various regulatory ratio requirements.

I mentioned client preference, but there are also situations where a beneficial owner lender may only accept non-cash collateral. As the number of those clients grows, it would also begin to have an impact on this shift.

Entering an environment where rate increases become more of a feature essentially provides additional flexibility to an agent lender,

> We favour floating rate securities as we feel they provide the best movement ahead of rate changes

Paul Wilson, Global head of agent lending product and portfolio advisory
J.P. Morgan

> There are situations where a beneficial owner lender may only accept non-cash collateral

Cesco Squillacioti, Global head of agency lending
State Street

and additional options in trading strategies. Ultimately, the driver has to be what combination of loan and collateral type works best for client guidelines and risk tolerance, and what provides a client a more attractive loan opportunity.

Economou: The current low-yield bond environment has been in place for some time now. Non-cash collateral has continued to increase based upon the borrower's regulatory requirements and the fact that beneficial owners have seen little opportunity to invest cash in a near-zero interest rate environment.

As interest rates rise, beneficial owners should demand to be paid more for taking non-cash collateral in order to be compensated for forfeiting the reinvestment value of cash collateral with an upward sloping yield curve. This, of course, is only one factor within the intrinsic value of lending securities and should be incorporated into the supply/demand pricing dynamic.

Santoro: In Europe, in keeping with client preferences and convention, the majority of our trades are already booked versus non-cash collateral, accounting for roughly 70 percent of our non-US fixed income book and 90 percent of our equity book.

In the US, until more recently, we did not feel compelled to move an appreciable portion of our book to non-cash, so our clients have been able to enjoy the added pick-up associated with cash collateral. With balance sheet restrictions becoming more of a concern among our counterparties, we would expect these percentages to grow in the US.

Dempsey: The most significant driver towards non-cash collateral is more desirable balance sheet treatment, versus cash collateral, on the part of the borrower. If the lender is sufficiently collateralised and comfortable with that collateral then it may find better pricing on non-cash loans, which can counterbalance shrinking returns under the current low-yield environment.

Wilson: While the low-yield bond environment may affect the buying behaviour of beneficial owners and could also affect the demand to short particular fixed income asset classes, it is not likely to be a material driver in a further shift to non-cash collateral.

We do anticipate the continuation of the shift to non-cash collateral. In the US and for many US beneficial owners, this still has a way to go, but is to some degree dependent upon rule changes that will make it more viable for US dealers to use equities as collateral.

Wargo: Certainly non-cash transactions have increased due to the regulatory and capital advantages. However, the rising rate environment in the US has created a tremendous opportunity for those clients engaging in a cash collateral transaction.

Money market reform, and the subsequent widening of LIBOR, created tremendous opportunities for programmes engaged in cash collateral strategies.

The anticipated interest rate increases in the US will continue to provide an opportunity to monetise rate movements, while current conditions in the credit markets make it an opportune time to engage in cash collateral reinvestment strategies.

Trapp: Lower bond yields for the last several years have certainly had an impact on the shifting allocation from cash collateral to non-cash collateral. The trend, however, has other drivers as well, including the regulatory environment and the associated costs of utilisation of various types of collateral. If anything, the recent shift higher in credit yields (ie, prime fund-like returns) versus government funds makes cash collateral more appealing from a pure yield perspective.

The regulatory environment remains a driver of collateral decisions but as spreads widen on cash products, the conversation becomes more compelling to re-engage on the cash side.

> In the US, our clients have been able to enjoy the added pick-up associated with cash collateral

Joseph Santoro, Head of product sales for the Americas—agency securities lending
Deutsche Bank

> Our focus on effective risk management aligns with Dodd-Frank to reduce systemic risk

Chip Dempsey, Senior vice president and chief commercial officer
OCC

Is President Trump and the economic/regulatory disruption he will likely bring be a good thing for the securities lending market?

Trapp: The outcome of the US presidential election is being felt across the marketplace. Whether it is the anticipation of increased growth or less regulation, the markets have reacted positively.

Although the optimistic sentiment has not necessarily resulted in a consistent improvement across all securities lending asset classes, beneficial owners may see a positive result in terms of portfolio returns, which would benefit performance and funding levels.

US treasuries are also seeing some interest, especially the benchmark and most recently issued securities.

There is increased activity with more general collateral securities and now a spread can be made on lending US treasuries for cash or non-cash collateral. This is a fairly dramatic change from where the US treasury market was a year ago.

At the same time, the current market environment has benefited from returns on the cash collateral for the US dollar. This has helped boost returns for beneficial owners taking cash collateral and will likely continue as rates move higher.

One exception to this has been experienced by Rule 2a-7 government cash-only investment vehicles, which continue to see relatively modest returns due to the demand for US treasury securities.

Economou: We expect more market volatility and better margins, which creates ‘space’ for hedge funds and those that borrow from/lend to them, which means good potential for the securities lending markets. Trump’s appointments to the Treasury and SEC, as well as congressional support, will likely influence various tactical moves that could lighten the regulatory burden on market players.

It is also reasonable to expect that the higher thresholds that have been established by the Fed on global systemically important banks will be scaled back—another potential benefit. As a beneficial owner, this would be positive.

Santoro: Some speculate that the top agenda items for President Donald Trump’s administration will be the ‘repeal’ of Affordable Care Act and tax reform, with the Dodd-Frank Act being addressed at a later date. We’ll have to wait and see with respect to specific growth-oriented economic policies that the new administration will promulgate, and whether post-crisis regulations might be repealed or rolled back in a meaningful way.

Market volatility will always provide opportunities in the securities lending market, so if the tone and content of the election campaign carries over into the next few years, a higher level of market volatility is possible.

Dempsey: OCC supports the idea of efficient and effective regulation that enables a diversity of investment strategies and innovation without increasing systemic risk.

Our focus on developing safe and secure markets through effective risk management aligns with the goals of Dodd-Frank to reduce systemic risk.

It is too early to tell whether there will be any economic or regulatory disruption for the securities lending market until Trump’s policies begin to take shape with his newly formed cabinet.

However, based on what we have seen and heard, his platform appears to be more focused on freeing up capital for small business loans.

Some of his potential nominees for the Fed and other relevant policy positions in his administration have been calling for higher liquidity ratios in lieu of tighter regulation. If such actions were to occur, that could portend tighter access to balance sheets, more expensive bilateral credit, and an enhanced need to reduce risk weightings.

This could pose a challenge to OCC’s clearing member firms and could cause us to provide novation for a wider range of the stock loan market in order to afford our member firms our 2 percent risk weighting, as opposed to 20 percent or 100 percent with other counterparties. OCC estimates, supported by industry research, a clearing model reduces a clearing firm’s cost of capital by 71 percent.

What are the possible ramifications of SFTR for your US businesses? And where are US regulators with their own reporting framework?

Wilson: SFTR regulations in Europe impose two obligations: greater disclosure of lending activity by entities and the reporting of SFTs themselves to designated trade repositories.

European Securities and Markets Authority (ESMA) guidelines had already established greater reporting/transparency for UCITS funds and, in October 2016, the US SEC voted to adopt rules, forms and amendments that are intended to modernise and enhance the reporting and disclosure of information by investment companies.

The new rules will enhance data reporting for mutual funds, exchange-traded funds and other registered investment companies.

They also require enhanced and standardised disclosures in financial statements and will add new disclosures in fund registration statements relating to a fund’s securities lending activities.

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US regulators collect data to help them get a better understanding on how the market functions

Lance Wargo, North America head of agency securities lending
BNP Paribas

The reporting of SFTs to trade repositories is still a work in progress with implementation in Europe scheduled for some time in 2018. While the finalised requirements have yet to be published, enough is known to be sure this regime will have a profound impact on entities and beneficial owners.

It is likely to require changes to well established procedures and protocols, especially agent lender disclosure.

For beneficial owners outside of Europe that transact (lend) with entities (borrowers) in Europe, it is believed the reporting requirements will fall on the Europe-based entity, although it is possible that certain information may be required from the non-European entity in order to assist the Europe-based entity in meeting their reporting requirements.

As the approach in Europe is in line with one of the Financial Stability Board's (FSB) recommendations from 2015, we anticipate that other jurisdictions will follow suit in due course.

Trapp: It's unlikely that the EU's SFTR initiative will affect the US business differently to the non-US business. In the near term, US lenders may not be obligated to directly report the loan side of the transaction, but it is anticipated that borrowers will still need confirmation from agent lenders on how their collateral has been allocated among its lending clients.

Generally, challenges are expected during the implementation period, specifically as related to efficient communications between systems for agent lenders and borrowers regarding timing and demands of the available data. Industry-wide discussions on the mechanics of implementation are ongoing.

Northern Trust is actively engaged in those efforts and intends to provide the necessary support to facilitate required reporting under SFTR.

Wargo: The US regulators, from time to time, collect data from the marketplace to help them get a better understanding on how the market functions. While the US securities lending market is the largest in the world, we, along with other market participants, are actively involved in discussions of US regulatory developments.

Economou: Since eSecLending runs a global programme, with EU-member entities as lending clients as well as counterparties, we have already begun complying with SFTR's requirements.

eSecLending's programme is managed on a segregated basis rather than a pooled one, which gives us inherent advantages in supporting SFTR, especially regarding upcoming trade reporting requirements.

Trapp: In various jurisdictions, including the US, regulators have been working on the appropriate reporting framework.

The Office of Financial Research (OFR) completed a pilot study to help identify data requirements that would be most well-suited to their transparency goals. We expect regulators to use the results of this study to help guide their input at the FSB level during 2017.

The OFR has also made a recommendation for permanent data collection.

Squillacioti: SFTR could have potential ramifications for any client that is dealing with a European counterpart, as it is a two-way trade repository. However, as the technical standards are expected to be released at the end of Q1, the mechanism for capturing non-European trade data has yet to be determined.

We understand that, from there, implementation would take place over an 18-month timeline.

In terms of the US, the OFR is still finishing work on a proposal for a final permanent data collection method and mechanism. The US will be done on an exposure basis rather than trade-by-trade basis, thereby making the execution considerably simpler.

Santoro: Clearly, there is a technology spend to comply with SFTR regulations. Specific to US regulators, Deutsche Bank participated in the OFR, US Treasury and SEC's pilot programmes in 2015, which collected lending agent data for three separate dates during the year to provide those regulators parameters in which the market operates.

Further, in October 2016, the SEC adopted reporting modernisation rules that will go into effect on 1 June 2018.

The rules will enhance data reporting for mutual funds, exchange-traded funds and other registered investment companies.

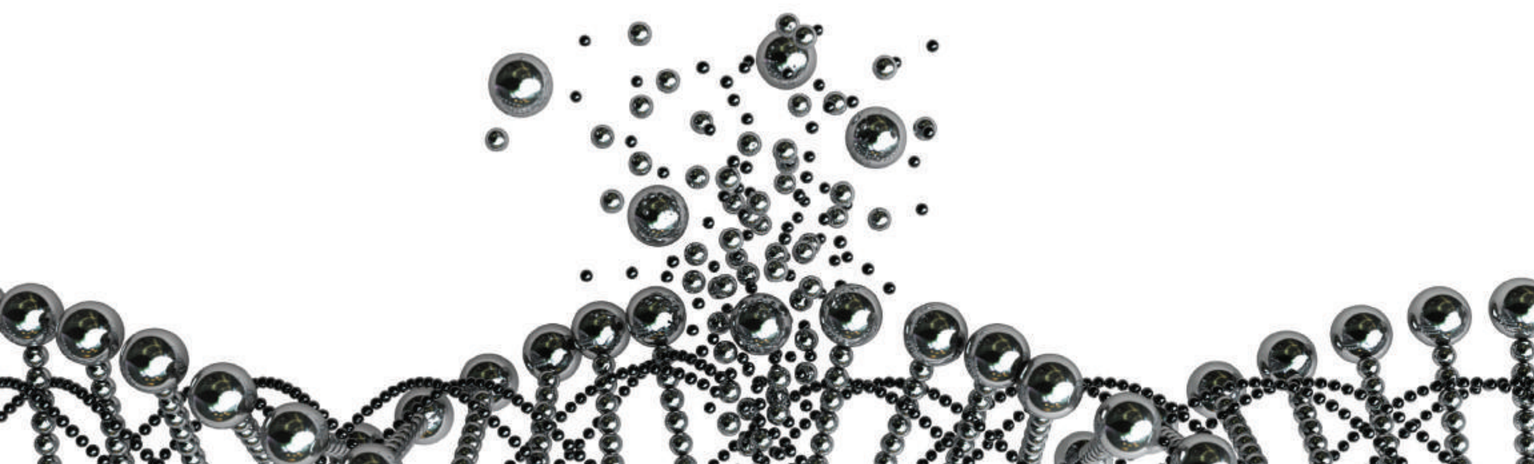
The rules call for new monthly and annual reporting forms, enhanced standardised disclosures and new disclosures in fund registration statements relating to a fund's securities lending activities.

We do not envision any difficulty meeting the new requirements given we operate on a real-time platform with a dedicated technology team that sits within the business. We've already had dialogue with our clients who will be subject to the new rules.

Given Deutsche Bank is a global institution, it is worth mentioning that we service global investors across multiple jurisdictions.

We are very active in the US and overseas in analysing new regulations, including reporting technical standards, in conjunction with our market advocacy, legal and compliance groups.

Where appropriate, we are working together with industry groups towards a consistent and efficient industry-level approach. **SLT**



The practical impact of uncertainty: The SFTR view

In the second of a two-part special, the new 'new normal' advanced by attorneys Michael Huertas and Kai Andreas Schaffelhuber of Allen & Overy is discussed in the context of the Securities Financing Transaction Regulation

It is important to recall that the Securities Financing Transaction Regulation (SFTR) aims to make SFT markets in the EU safe and resilient. Improving transparency by introducing regulatory reporting to trade repositories has seemed to be the preferred way forward in achieving that goal. Much of this is based on the 'legislative success' that policymakers advanced in taking the 2009 G-20 'Pittsburgh Commitments' on derivatives regulation through to implementation of the European Market Infrastructure Regulation (EMIR) in the EU.

Greater transparency, regulatory reporting and centralised clearing formed the ethos of that response, which also sought to reduce (perceived) threats from the nebulous terms 'shadow banking'. SFTR stems from similar regulatory thinking.

As a result, market participants should remain quite cognisant that, regardless of practical difficulties around sufficient data capture and quality, EU policymakers and supervisors tasked with safety of EU markets can use SFTR surveillance to improve resilience of markets. It is important to note that EU policymakers, notably the European Commission, in cooperation with the European Securities and Markets Authority (ESMA), are in the driving seat to determine 'equivalence' of third countries.

In a post-Brexit world, there are currently no assurances that SFTs governed by English law, booked in the third-country UK, would remain compatible with the legislative aims of SFTR and the priority of improving resilience.

Those EU policymakers are also, in a multi-speed EU, tasked with mandates to complete integration of the single market and the eurozone, including through the capital markets union (CMU)-driven reforms. As a result, it is conceivable that some third countries might be viewed less favourably than others.

Even if the UK and its regime are deemed SFTR-equivalent, key problems remain. ESMA and national supervisory authorities would still, in accordance with SFTR's provisions, need to conclude mutual agreements on information exchange, which are subject to the professional secrecy rules embedded in SFTR and generally go well beyond the scope of any high-level memorandum of understanding. These already take a long time for regulatory authorities to conclude. In addition to the supervisors, the same exercise is required of the respective central banks. Therefore, it is not just the private sector that will have to Brexit-proof itself for SFTR compliance (or other supervised areas), but also the public sector.

So what might this mean for SFT documentation?

Public sector-driven responses are also likely to coincide with and/or be shaped by private sector-driven changes, as was the case with EMIR, where industry associations played a leading role. It is conceivable that there is a probability that SFTs may be structured, documented, booked, (centrally) cleared and custodied in a very different manner as markets change. Again, this is further complicated as a result of Brexit or any renegotiated relationship of the UK as part of the EU.

While there is currently no immediate threat to the use of English law for financial market transactions, it might be wise to look at how these issues have been tackled in other jurisdictions that suffered legal uncertainty and use arbitration (possibly with the seat of arbitration located within the eurozone) as an appropriate forum for resolving disputes.

The issue of legal certainty can be summarised by the fact that the bulk of private international law rules (also known as conflict of law rules), as they apply in the UK to regulate commercial and financial market transactions (as well as collateral asset transactions and post-trade custody and servicing), rest on the UK's membership of the EU. In effect, this development could lead to a decoupling of the choice of English law, preferred for its flexibility, certainty and pro-business point of view, from the choice of English courts. The latter are chosen by counterparties, often with no connection to England, due to the 'neutral forum'.

The choice of English law will, following the UK's exit from the EU, be continued to be respected and applied by courts of law in the member states of the EU, subject to the same limited exceptions that exist as the law currently stands. Much of the mechanics will be driven by which EU laws the UK (politically) decides to keep, but that choice should not prevent a move from disputes determined by English courts in favour of arbitration. Parties to SFTs, including when using the majority of master agreement documentation, need to agree to apply English law, but are free to choose arbitration (including with seat outside of England) instead of English courts.

Are there any alternatives?

More generally, this assessment on certainty might also merit looking at whether alternatives to English law-governed SFT master agreement documentation suites might be suitable for use. Alternatively, whether these may offer suitable transactional documentation upon which improvements can be more easily made. That assessment might also factor in whether the alternative to an English law-governed SFT master agreement is easier to Brexit-proof.

As a result, market participants may want to consider the cost/benefits of using non-English law-governed documentation (with a hypothetical lower Brexit risk) that may have more amendments required to make it compliant with SFTR or a host of other regulatory requirements.

It is unlikely that, for example, the 2001 or 2004 edition of the European master agreement (which allow the parties to freely choose their governing law and forum, subject to defined fallbacks) might eschew agreements that are based on English law. However, if fully SFTR-proofed, the European master agreement, like the agreements in national jurisdictions, could still provide credible alternatives due to its 'jurisdiction agnostic' design. This is especially the case if the EU, as part of the CMU and integrating the eurozone, continues to push the necessary agenda of increased 'financialisation' of domestic markets as vital precursors to greater standardisation, calibration and integration.

The contribution that widely accepted standardised documentation yields to greater financialisation of markets is important. Transaction documentation that is perhaps rooted to a legal system whose courts might find themselves outside the EU does raise risks for counterparties, but also for EU policymakers, and so arbitration arrangements might be more attractive.

As a result, Brexit- and SFTR-driven changes merit early engagement from market participants. They also will likely require continued and deeper engagement in 2017 from those industry associations that act as gatekeepers of the master agreement suites and related industry documentation and the transnational private regulatory regime, ie, rules and procedures that underpin how these operate.

There are certainly some lessons to be learned from the move to EMIR compliance that are sensible and very capable of being replicated and applied to the SFTR-proofing of documentation, but also the amount of data that will need to be captured and reported as SFTR requires. Again, tackling fragmentation from the outset is key. Part of this will require benchmarking industry-developed compliance solutions to ensure that conceptual inconsistencies do not exist and are not 'hardwired' into the solution. EMIR provides many examples of how industry associations developed documentation design aimed at assisting users who developed very different means of upgrading existing as well as new documentation to comply with EMIR.

The format, content and degree of conceptual equivalence of, for example, the EMIR-relevant International Swaps and Derivatives Association documentation, differs from its nearest equivalent, the 'EMIR-Anhang', or 'EMIR Annex', which was used to make German 'DRV' master agreements for financial derivatives transactions compliant with EMIR.

EMIR, like SFTR, is jurisdiction agnostic and so, where gaps exist between the EU law- and the national law-governed documentation or between two sets of documentation (whether governed by the same legal system or otherwise), conceptual gaps may exacerbate risk and conceptual translation risk.

The same is true of other industry associations, including those that have joined up and which have dealt with SFTR disclosure obligations on reuse. The work of those associations still differs slightly from, say, the German equivalent. Is there a need for difference in content and concepts? Probably not. The same is true in terms of messaging formats in the post-trade environment. While the bulk of this work is being driven by the private sector, taking a leaf out of other EU regulatory projects, such as the single euro payments area or Target2-Securities has, despite challenges, advanced unification of national systems into standardised pan-continental formats.

> Harnessing available support will remain necessary in order to drive efficiency

Is more needed for the post-trade environment? If the regulatory authorities continue, especially since the birth of EMIR, to drive greater granularity of regulatory disclosure and reporting as a desired supervisory outcome? What is different now, and this is crucial, is that in the nearly five years that have passed since EMIR was implemented, digitisation has continued to take root and transform business and regulatory change processes.

Revising for the new 'new normal' using regtech solutions

That positive disruption has even begun to spill over into so-called 'regtech' solutions, which can assist in the more efficient delivery of pragmatic documentation and process solutions to complex legal and regulatory workstreams.

The role of regulatory lawyers (both external and internally) is still likely to be valuable in assisting governance, risk and control functions within market participants to set overall regulatory strategy and process manage implementation.

For market participants generally, and those in SFT markets in particular, harnessing available support will remain necessary in order to drive efficiency as SFTR compliance challenges move from data capture, disclosure, reporting and verification to operative workstreams that have their own compliance issues. These are driven by the actual text of the rulemaking instrument and the circumstances of the counterparties, but also increasingly by the impact of the new 'new normal' on how trades are conducted.

Next steps

A next immediate step should be ensuring that UCITS funds (and their management companies), as well as EU-authorised managers of funds that are regulated as alternative investment funds, periodically disclose to their investors their uses of SFTs and total return swaps. This must be an SFTR-compliance obligation that is phased in. As with the existing SFTR disclosure obligations (such as the reuse disclosure obligation) that have already entered into force, it is important to note that certain national regulatory frameworks, including that of the UK, may have provisions covering the same concepts that go beyond what SFTR requires, and other jurisdictions may have different obligations.

Minding those gaps is important, especially as ESMA works to, on the one hand, revise EMIR, but also to prepare and submit its report and new proposals on SFTR 'risk mitigation techniques' by 13 October 2017. This SFTR report will cover progress on international efforts to mitigate the risks associated with SFTs, including international recommendations, especially those of the Financial Stability Board on haircuts for non-centrally cleared SFTs, and whether this would be replicable for markets in the EU.

It remains to be seen whether the output will follow or (as more likely) diverge from the EMIR risk mitigation techniques for OTC non-central counterparty cleared transactions. Given the likely tall order of impact, early buy-side engagement to complement sell side-led discussions might be advisable.

In any event, the political and macroeconomic rollercoaster of 2016 that has given birth to this new 'new normal' is likely to keep policymakers, market participants, advisers and stakeholders very busy for 2017 and beyond, where Brexit remains a contributing factor but increasingly a sideshow to much more important priorities.

All of this will not negate or stop the very concentrated efforts that a number of market participants will need to continue to advance in order to make sure their SFT documentation, processes and operations remain fit for purpose and resilient. **SLT**

> Brexit- and SFTR-driven changes merit early engagement from market participants

Liquid launch

State Street's Sean Greaves examines liquidity in a post-crisis environment and explains why regulators must be cognisant of the law of unintended consequences when devising new frameworks

The securities finance market has undergone significant change as it has sought to adapt to readily available liquidity and low interest rates, as well as the introduction of more stringent global regulatory requirements. These changes have affected all participants in well-documented ways and are expected to continue to challenge markets for years to come.

Lenders and borrowers alike have noted a shift in market demand as a result of post-2008 regulation and deleveraging of the market. This has resulted in lower spreads and volumes on the demand-side, although the supply side has seen a recovery to pre-crisis levels.

Liquidity was a major concern during the credit crisis, but has become less worrisome for investors as central banks around the globe pursued quantitative easing measures, some of which are still in place today. By contrast, the issue for investors is not so much around liquidity as it is returns in a low interest rate environment.

Questions remain over liquidity management going forward, but, as interest rates are showing the green shoots of growth, governments are expected at some point to pull back on their quantitative easing measures. Financial institutions are also beginning to feel the effect of global regulation aimed at liquidity management. This last point is especially interesting, as the requirements of regulation aimed at liquidity, such as the liquidity coverage ratio and net stable funding ratio, are having a profound effect on how institutions are approaching their financing requirements in both the short and long term.

Assessing the problem

Given the importance of liquidity management to investors, State Street commissioned a survey titled Let's Talk Liquidity: Opportunities in a New Market Environment, in partnership with the Alternative Investment Management Association, the global representative of alternative investment managers. The results suggested that liquidity concerns are at the forefront of investors' minds.

The survey also found that the almost half (47 percent) of global institutional investors believe decreased market liquidity is a secular shift, requiring a new strategic approach in order to succeed in the new and complex environment. Many US and European banks feel constrained in their efforts to perform their traditional roles as market makers, which has affected broader market liquidity conditions.

Furthermore, more than three fifths of respondents say current market liquidity conditions have affected their investment management strategy, with 36 percent rating this impact as significant. Managers must now reassess how they manage risk in their investment portfolios. More broadly, they are adjusting to a new liquidity paradigm in which trading roles have been transformed, new market entrants are emerging, and electronic platforms and peer-to-peer lending are changing the way firms transact their business.

The trend for borrowers to service their liquidity requirements through term lending can be seen in the data. Market benchmarking services such as IHS Markit, DataLend and FIS Astec Analytics all point towards an increase in shorter duration trades on specials and longer duration trades to meet financing requirements. For example, IHS Markit's data shows that the average tenure of government bond loans climbed close to 200 days in September 2016, up from lower than 150 days as recent as June 2014.

So, what does the future hold for market participants? The questions that many participants continue to get to grips with are around data management and financial technology, as it becomes ever more apparent that managing liquidity in the modern environment is increasingly a question of 'automation of information', ie, how quickly market counterparties can react to market changes and mobilise their assets effectively.

State Street has long been at the forefront of big data and continues to build out its data management capabilities to set the pace for the industry. Where State Street has the advantage over many of its peers is its large client base and access to a larger pool of data. This will undoubtedly place State Street well in the global information race.

Fintech continues to be a topic of conversation in the industry, as firms seek to develop systems to help manage the data more accurately and quickly. Fintech development appears to be the most active area of investment and activity too, with the recent merger of IHS and Markit, as well as several institutions declaring their interest in developing blockchain technology, the whole industry could undergo some significant changes within the next few years.

Today, the market continues to face the pressing issues of how to simultaneously meet the needs of borrowers and lenders alike. This represents a difficult mismatch between borrowers seeking to finance inventories of low grade collateral versus lenders seeking to remain highly liquid in terms of their ability to recall loans and the collateral that they hold in lieu of securities on loan. Regulation aimed at preserving the integrity of funds, such as UCITS IV (and V), seems to occasionally be at odds with regulatory requirements aimed at increasing financial institutions' liquidity.

For example, UCITS regulations put strict limits on the amount of securities that can be lent, as well as the types of collateral that can be held. It has long been a concern of borrowers and lending agents alike that such restrictions could make lending for these funds untenable as borrowers make the assessment that such trades are uneconomic. Should such sources of liquidity be unavailable to the market on economic grounds, then regulations may achieve the very end they were aimed at avoiding.

Another threat to market liquidity comes in the form of governments imposing taxes on the market, a good example of which is the financial transaction tax currently being considered by 10 nations in the eurozone. It remains unclear whether such a tax would apply to securities lending transactions, but even a minimal tax could have severe consequences for the financing market if it had to be applied on each transaction. Typically repo transactions involve chains of participants and if each leg of a repo has a tax applied, the whole chain of transactions would become uneconomic.

The good news for securities lending market participants is that whilest regulations have resulted in some reduction in liquidity, they have sothus far shunned the extreme options touted in some political arenas. For example, calls for an outright ban on short selling in various markets have not been adopted and it is to be hoped that regulators will continue to engage with the market participants on this and other important themes for liquidity.

There is no quick remedy to ensure market liquidity, but securities lending still plays a vital role in enabling an increase in overall market liquidity and price stability, and provides a flexible financing option outside of the traditional market-makers during times of stress. We remain optimistic that new opportunities will present themselves to market participants who demonstrate the flexibility and nimbleness required to take advantage of the new market environment. **SLT**

> There is no quick remedy to market liquidity, but securities lending plays a vital role

Sean Greaves, Head of Asia Pacific securities lending
State Street

UK short sellers cover, defying Brexit anxiety

UK equities are enjoying their longest positive streak on record and investors are showing no desire to short the rally, says IHS Markit analyst Simon Colvin

The potential impact of the 'hard' Brexit plan has seen the pound sink further in 2017 despite a brief rally in the wake Theresa May's long awaited speech on the issue. However, anxiety has by and large been constrained to the sterling market as both large and midcap UK equities have managed to sustain the rally initiated in the closing weeks of last year.

This rally has not only pushed the FTSE 350 index to new highs, but has also tamed many UK equity skeptics as short sellers have actively been covering their positions in the index's constituents over recent weeks.

In fact, the average demand to borrow the constituents of the FTSE 350 constituents now stands to a three-month low of 2 percent of shares outstanding—12 percent lower than the average registered in early December last year. This covering marks the largest monthly fall in average UK short interest since the referendum back in June, underscoring the improving investor mood.

A further dig into the numbers shows that the covering has been led by the midcap FTSE 250 end of the index, whose relatively large UK exposure made them favourite short targets following the referendum. While these companies still see relatively more shorting activity than at the same time last year, the fact that domestically exposed equities see covering indicates that the market is choosing to focus its attention on buoyant economic indicators, such as the latest service and manufacturing UK PMI published by Markit Economics, rather than the possible impact of a falling pound.

High conviction shorts lead the covering

Short sellers have been just as eager to trim positions in their high conviction plays as the rest of the market, as 17 of the 20 most borrowed constituents of the FTSE 350 index that have been shared out on loan returned over the last four weeks.

Chief among the stocks experiencing covering is supermarket WM Morrison, whose demand to borrow has sunk by a fifth in the last month. This covering has been spurred on by its best performance over the Christmas trading period in over seven years, which has propelled its shares to the highest level in nearly three years.

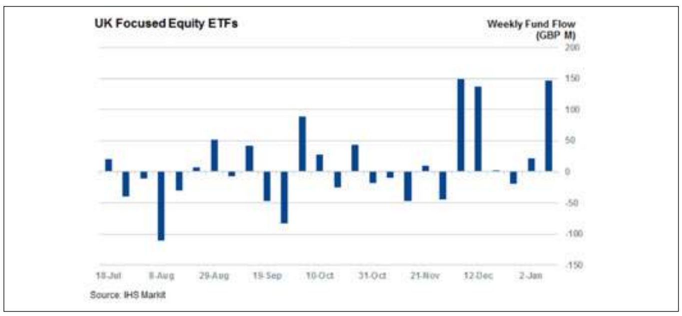
WM Morrison's peers, Ocado and Sainsbury's, which also feature among the high conviction short plays, have also experienced covering over the last month, with an 8 percent and 9 percent fall in demand to borrow, respectively.

Covering isn't confined to retailers, as engineering and automation firm Rotork has also experienced a significant fall in its short interest, with 19 percent of its loans returned in the last four weeks. The pound's crash is likely to disproportionately benefit the firm as it earns over 88 percent of its revenues from overseas.

ETF investors pile in

Exchange-traded fund (ETF) investors have also been keen to ride the surging trade as UK equity ETFs have seen more than £160 million of inflows year-to-date, with flows coming from both Europe- and overseas-listed funds. US investors have driven two thirds of the inflows after £117 million of new assets were parked into the iShares MSCI United Kingdom ETF.

Despite the falling pound, products that hedge against the further falls in the UK's currency have continued to see lukewarm demand from investors as these funds have only attracted £17 million of new assets over 2017 or 10 percent of year-to-date inflows. **SLT**



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Pirum, DTCC, Solium Capital, Gobal Prime Partners and The Field Effect

Pirum Systems has appointed Data Explorers founder Mark Faulkner to its board as a non-executive director.

Faulkner launched Data Explorers, one of the first securities lending data providers, in 2002. It was acquired by Markit in 2012.

He also co-founded Credit Benchmark, a credit risk data and analytics provider, in the same year, of which he is currently director.

Former Data Explorers CEO Donal Smith, who co-founded Credit Benchmark with Faulkner, was installed as non-executive chairman of Pirum in 2015, after two private equity firms invested in the post-trade provider.

Faulkner commented: "I have known and admired Pirum as a business for many years. I am very happy to be joining the board as the company develops its next phase of products and I look forward to reconnecting with the securities finance world after several years' absence from the market."

"Now is a time when financial markets participants more than ever need fintech providers to meet the dual challenges of developing their businesses and meeting regulatory requirements in this ever more interconnected world."

"Pirum is ideally placed to help meet these challenges. I look forward to working with the board and contributing to build on Pirum's success."

The Depository Trust & Clearing Corporation (DTCC) has bolstered its senior leadership team with the appointment of Derek West as chief compliance officer for its European global trade repository (GTR) business.

West will focus on ensuring DTCC's compliance with the European Market Infrastructure Regulation (EMIR), along with all other relevant regulatory regimes.

He will also coordinate EMIR supervisory activities and examinations, as well as work closely with GTR senior management and the European Securities and Markets Authority.

West was previously senior director of derivatives oversight at the Quebec Autorité des marchés financiers, the Canadian province's financial services regulator, where he was responsible for drafting and implementing Quebec's Derivatives Act and regulations.

He also managed eight national regulatory projects, including trade repository recognition and reporting rules and mandatory central counterparty clearing rules.

Australian financial software provider Solium Capital has appointed former Pershing Securities Australia COO Paul Le Roy as president of Solium Australia.

He replaces Scott Scobie, who left Solium Capital earlier in January.

At Pershing, Le Roy was responsible for securities lending, operational risk and support functions.

Solium Capital is a provider of software-as-a-service for equity administration, financial reporting and compliance.

Markus Ruetimann has joined the board of Global Prime Partners (GPP) as senior non-executive director.

He was previously group COO of Schroders for just under of 12 years, until June 2016.

Ruetimann, who is now based in London, boasts an international CV with more than 25 years of financial services experience, having served in Zurich, Geneva and New York.

Specialist consultancy firm The Field Effect has appointed Mark Barnard as a senior consultant.

Barnard previously served as managing director at RBS, where he led equity finance, liquidity management and derivatives, for just over four years.

Managing director David Field said: "I am delighted to welcome Mark Barnard to the company to extend our already established clearing and collateral consulting practice. Mark brings significant top-tier trading and financing experience to the team." **SLT**

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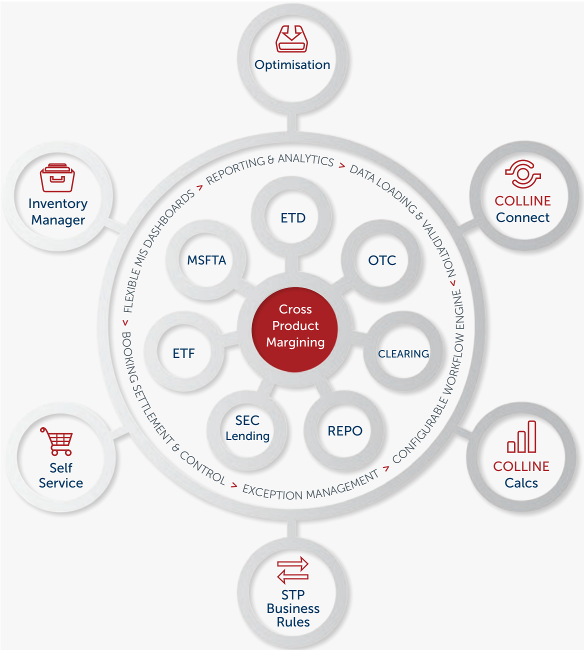

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