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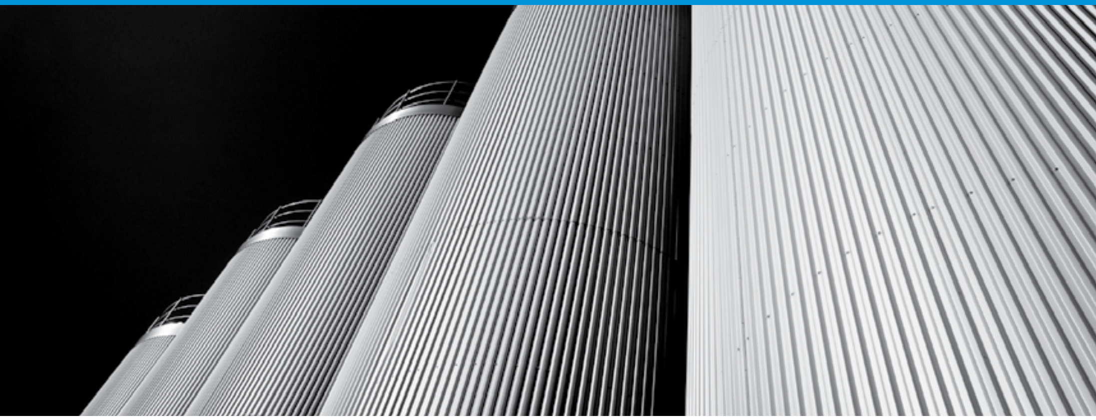

Collateral comes to the fore

BARCELONA 07.10.2011

The understanding and use of collateral, as well as the implications of the push to clearing were the focus of the 5th annual collateral management conference in Barcelona, which took place on 5 – 6 October.

Though the industry continues to debate the wisdom of multiple global regulations, participants agreed collateral will become scarcer and managing it more expensive.

"For the collateral management world, it is their time in the spotlight. Collateral is a hot topic in the front office and is intimately tied in to the bank's funding processes – it is no longer a purely back office function," said Jonathan Philp, managing consultant at InteDelta.

While the financial services industry seeks to find ways to optimise, standardise and come to terms with enterprise-wide solutions, firms making those offerings are looking to maximise the investment as well, shaking up the securities lending market.

"From a lending perspective, there is a clear opportunity to exploit the infrastructure investment getting made because of OTC regulations to offer additional services" said Philp.

For example, he noted, asset servicing banks which help clients address higher collateral burdens imposed by the central clearing rules will have a material competitive advantage by stitching in their lending and repo services to offer collateral transformation or financing.

In addition, lending represents a substantial revenue opportunity for those funds with long-dated government debt, like pension funds. But there is an immense amount of documentation, a concern that Philp thinks the industry is not paying enough attention to.

"The buy-side is looking to clearing brokers to figure out these services. The real bottleneck is that many legal considerations need to be in place, a comprehensive set of documentation for clearing and tri-party custodial relationships is not the kind of process that can be done at the last minute. So, outsourcing begins to look very compelling if participants do not want to get locked out of these [derivatives] markets," Philp said.

Asset managers at the conference affirmed that they are waiting to see how the clearing market, and costs of services, develop, although Paul Lahaijo of ING Investment Management did note that transformation services is part of the criteria in choice of clearers.

NEWS**IN**BRIEF

HazelTree to expand North American operations

HazelTree Fund Services will be expanding its operations westward with the opening of its newest office in the San Francisco Bay area.

The office wil be headed by Daniel Osborne, former partner, COO and CTO of Conifer Securities, LLC.

read**more** p3

European short selling bans extended

Temporary short selling bans imposed after a dramatic sell off in global markets during the summer have been extended in Belgium, France, Italy and Spain.

The extensions are made while the eurozone debt crisis grips market commentary and European officials scramble to buy time before a Greek default by boosting the leveraging power of the EFSF from €440 billion to some €2 trillion, among other measures according to various media reports.

Italy and France extended the short selling ban until 11 November, with the French regulator, AMF, stating that it "will continue to monitor, in coordination with the European regulators concerned, the markets and their developments. [The AMF] may decide to lift the ban if market conditions allow it".

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HazelTree to expand North American operations

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“HazelTree launched in January of this year and already we are servicing clients with a combined AUM in excess of $30 billion,” announced the company’s CEO Stephen Casner. “Given our success in New York, coupled with increasing demand from the Pacific Rim, it was a natural next step to expand our operations to the West in order to better serve our clients within this region.” Casner added, “HazelTree knows how to deliver that special edge hedge fund executives need today in order to stay at the top of their game, and Dan and our new West Coast team are further proof of that.”

Operating well ahead of business plan projections, HazelTree’s success has been driven by client demand for Treasury Suite, its treasury management solution, as well as what the firm describes as its unique business model.

“The approach we are taking is very different from your standard technology model in that it allows hedge fund executives to improve performance through Operational Alpha, a solution that is strictly value-added,” said Osborne. He attributed the success of HazelTree’s platform to the fact that it was built by a hedge fund for use by other hedge funds, with a performance that has been proven over time.

“HazelTree is leading the charge in creating innovative tech solutions for a rapidly changing financial environment,” Osborne added, “and I am confident that we will quickly establish HazelTree as a critical resource for fund services in the West.”

European short selling bans extended

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Belgium extended its ban indefinitely. Bloomberg reports the Spanish regulator confirming the ban will remain in place “until the market conditions allow it to be lifted”. Greece has extended its ban on short selling until 9 December.

Many market participants, frustrated by fragmentation of rules across European nations, question the wisdom of such bans, pointing to research suggesting the move reduces liquidity during times of stress and does little to achieve price stability.

Data Explorers securities lending data available from Direct Edge

Data Explorers daily securities lending information has been integrated into the Direct Edge market data distribution platform, allowing customers to subscribe via their existing connectivity to Direct Edge.

Data Explorers is one of the leading providers of securities lending data, tracking short selling and institutional fund activity across all global market sectors. The company provides security level information and analytics for supply, demand and borrow costs collated daily from the securities lending market. The comprehensive data feed delivers securities lending information covering $12 trillion of securities in the lending programmes of over 20,000 institutional funds. This data allows subscribers to create, back-test and optimise trading strategies.

Donal Smith, CEO of Data Explorers, commented: “We are pleased that our data is now available as part of the Direct Edge market data and analytics offering in the US It provides broker-dealers with a valuable source of differentiated investment ideas.”

Kevin Carrai, head of member and connectivity services at Direct Edge, added: “Our agreement with Data Explorers will allow Direct Edge to provide firms with valuable insights into the securities lending market and an important resource for optimising their trading strategies.”

4sight enhances collateral management system

4sight Financial Software has recently added new functionality to its Xpose Collateral Management system. The software is currently used by many of 4sight’s clients worldwide and provides a multi-product collateral management system for securities lending, repo, exchange traded and OTC derivatives collateral.

The new features include:

- Additional collateral optimisation and allocation tools
- Global trading and collateral inventory management with a single user-driven view of all global exposures
- Ability to net and margin call exposures by multiple criteria across multiple asset classes
- Optimised, schedule-driven booking of collateral trades in bulk, based on collateral concentration and cost
- Bulk settlement of collateral trades
- Full SSI management, with automated netting and packaging of all stock and cash SWIFT instructions
- Full service CREST, SWIFT, Loanet and DTC engines

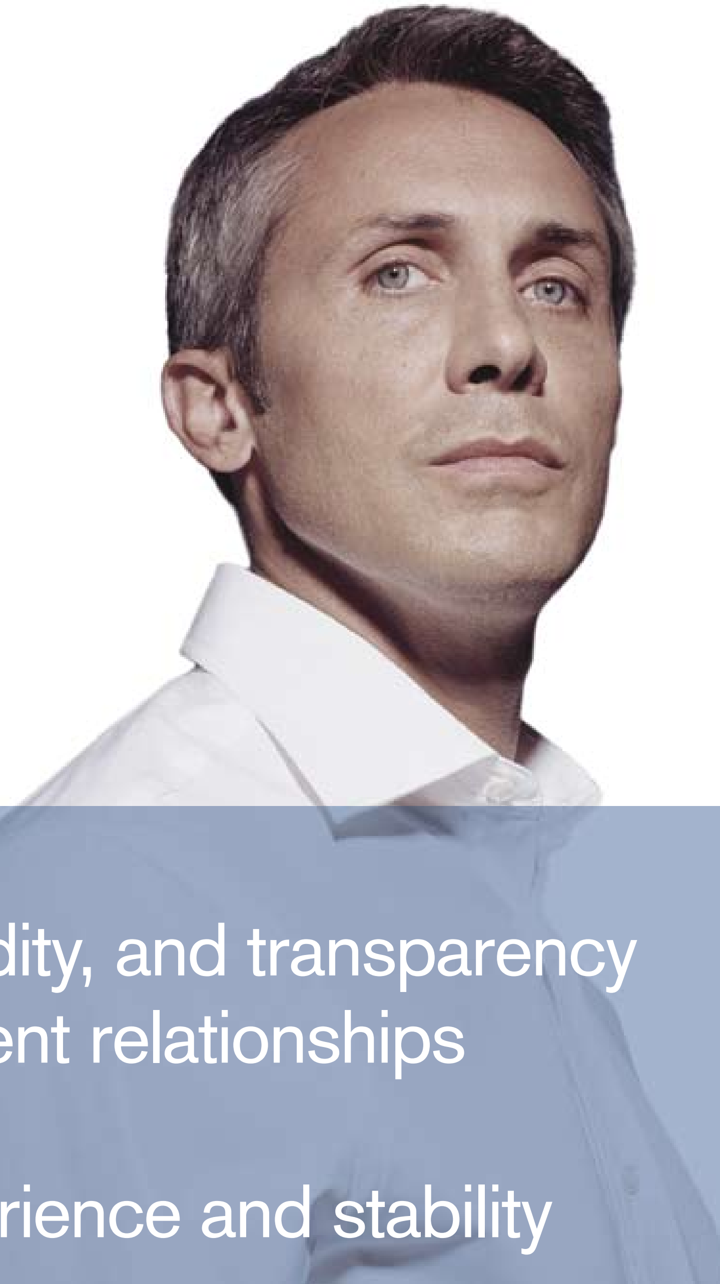
“We have enhanced the Xpose collateral management system to meet the surge in demand from our customers for cross product collateral optimisation and control”, commented Judith McKelvey, 4sight sales director. “The new features are scheduled to go live at three more client sites and we are also currently working on further enhancements to help customers respond to the evolving regulatory landscape. This includes further collateral optimization, balance sheet utilisation, CCP margining and regulatory reporting. We are also developing features to manage exposures resulting from FX trading and ETF Creation.”

OneChicago security futures dip, SSFs up in September

OneChicago has announced that a total of 182,157 security futures contracts were traded in September, down from over 500,000 the previous month.

Open interest stood just shy of 350,000 contracts in September, of which 32 per cent was in OneChicago’s equity finance tool which removes dividend risk from security futures, OCX. NoDivRisk.

However, single stock futures taken to delivery rose, at some 124,500 in September, valued



at more than $670 million compared to almost 100,000 August futures valued at more than $480 million the previous month.

OCC's stock loan programme drops slightly

OCC's stock loan programme, including OTC and AQS, saw new loan activity fall one per cent in September compared to the same month last year with 58,614 new loan transactions. However, year-to-date securities lending activity is up 47 per cent from 2010 at just over 585,000 new loan transactions. The average daily notional value reached over $15.5 billion.

Exchange-listed options trading increased 30 per cent over September 2010 and included the ninth and tenth highest trading volume days on record. Total options volume year-to-date through September was 3.5 billion contracts, nearly 23 per cent higher than at the same point last year.

Futures cleared by OCC reached almost three million contracts in September, up 63 percent from September 2010. Year-to-date OCC has cleared 31.4 million contracts, already 18 percent higher than the total number of futures contracts cleared in 2010.

Industry bends ESMA's ear on ETFs - Morningstar

The funds industry is weighing in on proposed guidelines for transparency by the European Securities and Markets Authority (ESMA) on ETF securities lending transactions, reported Morningstar.

ESMA has proposed guidelines for additional transparency on subjects such as collateral, index constituents and securities lending.

"On the topic of securities lending, it was argued that this is a very common practice within the financial industry and is not an ETF specific risk," reported Morningstar.

It added: "Stakeholders pointed out that mutual funds, like ETFs, also use derivatives and engage in securities lending. These funds tend to be far less transparent than most ETFs but no one is complaining about these practices, some [stakeholders] highlighted."

But securities lending markets are on the radar for regulatory scrutiny. In September, the Financial Stability Board (FSB) announced it would be looking into regulation of activities related to securities lending and repos, including possible measures on margins and haircuts. Policy recommendations are expected at the end of 2012.

The most pressing need expressed by the stakeholders present at the ESMA hearing, reports Morningstar, was clearer, more uniform definitions and regulations to help level the playing field for ETF providers and investors alike.

ESMA will now analyse feedback from the industry.

Eurex reports September volumes

In September 2011, the international derivatives exchanges of Eurex Group recorded an average daily volume of 12.4 million contracts (Sep 2010: 9.9 million).

Of those, 9.1 million were Eurex Exchange contracts (Sep 2010: 7.3 million), and 3.3 million contracts (Sep 2010: 2.6 million) were traded at the US-based International Securities Exchange (ISE).

The growth of 25 per cent y-o-y is due to the stronger hedging needs of market participants driven by uncertainty resulting from the European sovereign debt crisis, which led to an increasing use of exchange-traded and centrally cleared derivatives in the current market environment. In total, 201.1 million contracts were traded at Eurex Exchange and 68.8 million at ISE.

At Eurex Exchange, equity index derivatives as the largest segment recorded 112.6 million contracts (Sep 2010: 69.4 million), an increase of 62 per cent y-o-y and the second-best month in 2011. The future on the EURO STOXX 50 Index totaled 51.0 million contracts, its best monthly result year-to-date. The option on this blue chip index totaled 41.3 million contracts. Futures on the DAX index recorded 5.5 million contracts, also a monthly record in 2011.

The DAX options reached another 6.5 million contracts. The Eurex KOSPI Product achieved its second-best monthly result with 2.2 million contracts, an ADV of 101,000 contracts.

The equity derivatives (equity options and single stock futures) segment at Eurex Exchange reached 27.1 million contracts (Sep 2010: 30.0 million).

Thereof, equity options totaled 21.8 million contracts and single stock futures equaled 5.3 million contracts. Equity derivatives volume y-o-y is influenced by the change of contract specifications: In Q1/2011, Eurex Exchange increased the contract size of most equity options and single stock futures to match international standards, with the effect of potentially lower turnover in these products. The adjusted figure of monthly volume in the equity derivatives segment in August would have been approximately close to 32 million contracts based on an extrapolation.

Merlin upgrades Compass

Merlin Securities has released the next generation of Merlin Compass. Merlin Compass 2.0 is a real-time portfolio analytics application that incorporates the latest trading and risk tools and provides hedge fund managers with intraday performance, exposure and risk analytics across multiple custodians, prime brokers and accounts asset classes.

Merlin Compass 2.0 incorporates major improvements including the integration of trading, positions and risk information, increased customisation, robust filtering, and multiple workspaces. Other enhancements include the introduction of dynamic watch lists and benchmark tracking. In addition, more than 100 new data elements give users the ability to break out key

metrics by long, short, gross and net values, in multiple currencies across most asset classes. "We are continually working to expand Merlin's capabilities on the technology front," said Bob Garrett, senior partner and chief technology officer of Merlin. "Our vision is to combine the best automation and decision support found on the sell side with the best of the buy-side desks in a way that is viable for our client base. Intraday capability like that offered by Merlin Compass 2.0 is the cornerstone of this approach."

As with prior versions, Merlin Compass 2.0 integrates seamlessly with the MerlinPRIME and MerlinSHARP portfolio management and trading platforms to provide real-time portfolio updates and to integrate with fund managers' unique workflow and practices.

Merlin Compass, launched in January 2009, is a market-leading, real-time P&L and risk platform that provides intraday performance attribution and exposure, as well as portfolio activity and allocations tracking and reporting. It integrates with any trading platform using the FIX protocol.

"Merlin has built its business by focusing on our clients' technology needs, and we understand that fund managers need the best information systems possible in order to effectively generate returns for their limited partners," said Aaron Vermut, senior partner and chief operating officer of Merlin. "The release of Merlin Compass 2.0 further demonstrates our commitment to bring the latest technologies to the desktop of the fund manager."

ReadQ converts Zion

ReadQ Systems, Inc. has signed Salt Lake City broker-dealer and longtime client Zions First National Bank on to their QTIX trading system.

Zions Bank has been using ReadQ for clearing its fixed-income securities since 1995 and recently upgraded to their new QTIX clearing system. The new system provides significantly improved functionality and productivity to Zions Bank. The upgrade to QTIX was performed swiftly and efficiently with on-site support provided by ReadQ. Zions Bank is pleased with the expanded technology QTIX provides and is looking forward to their continued long-term relationship with ReadQ Systems.

According to Rob Cardone, president of ReadQ Systems, Inc., "QTIX, our latest technology product, was designed to help financial institutions reduce their operational overhead and technology costs and succeed in their automation objectives, while providing a user-friendly solution. We're looking forward to continuing to work with Zions Bank to support their growing business."

BarCap suspended for short selling glitch in Japan

Barclays Capital faces administrative sanctions from the Japanese financial regulator following the firm's report of a technical glitch with its system connecting to the Osaka Securities Exchange (OSE).

In a released statement, Japan's Financial Services Authority (FSA) wrote that the violation was a result of inadequate management of the electronic data processing systems by BarCap's affiliate in Japan (BJCL).

"The short-selling in breach...was due to BCJL's error in designing the system through which BCJL ordered equity trades to the Osaka Securities Exchange. This error was related to the indication of the fact of short-selling. BCJL started the operation of the system without checking for such an error...it continued the operation of the system without the appropriate system check for a year and a half...In addition, BCJL conducted short sales at a price equal to or lower than the latest published price immediately prior to the short sale." the FSA wrote.

In a statement released by BarCap, the firm states that upon discovering the error, it immediately reported the error to the regulators and suspended all transactions in cash equities which used the conversion system to place orders to the OSE.

"[The error] was caused by an IT system coding error and an internal review concluded that there was no deliberate intention to manipulate the market and derive a benefit...[the internal review] also concluded that the technical error was only in the system connecting to the OSE...No clients were impacted by the IT coding error," wrote BarCap.

Administrative action by the FSA include a business suspension order between the 11 and 24 October and business improvement orders.

Eurex Repo signs on Portugal

Eurex Repo has announced its further expansion in Europe with its first Portuguese member, Banco de Investimento Global. The bank has entered its first transactions via the Euro Repo and the GC Pooling markets.

"We welcome Banco de Investimento Global, and we are pleased that this Portuguese bank recognises the advantages of our business model, which comprises anonymous electronic trading, central clearing and efficient collateral management via Clearstream", said Marcel Naas, managing director of Eurex Repo. "The option to gain liquidity in and out of the market in an efficient way is especially important in turbulent market conditions."

Despite a severe austerity budget following Portugal's €78 billion bailout, government officials are warning that any defaults in the eurozone would make the country "vulnerable" and under such a circumstance "we cannot exclude that Portugal's assistance plan would have to be reinforced", according to the Financial Times.

Securities lending key to "new finance" - Data Explorers

In the global race for high quality government debt, the collateral upgrade trade is taking off and securities lending is "at the fulcrum of the new finance", says Data Explorers.

"In this 'new economy' life is upside down - asset managers have cash and banks don't," writes the analytics firm. "Treasury departments are busier than ever and exist in any company that handles large amounts of cash."

And the government bond lending market to upgrade collateral is cheap, between 15 to 20 basis points compared to 50 basis points in the overnight repo market. Moreover, banks are under pressure from capital requirements under Basel III regulations and regulators such as the Financial Services Authority (FSA) to avoid asset-liability mismatch by getting guaranteed or so called 'term' or 'evergreen' funding in place, which translates into borrowing G7 (US, France, Germany, Italy, Japan, United Kingdom, Canada) debt under a quasi lock-up, according to Data Explorers.

The people who will help a bank swap equities and corporate bonds for coveted G7 government bonds, it adds, are the big asset managers and the mechanism is the securities lending market and tri-party collateral management services.

"The Financial Stability Board is quite right, securities lending is a key component of shadow banking," writes Data Explorers.

Equilend sees jump in securities lending

EquiLend has announced a 16 per cent jump in the number of borrowing and lending transactions on its platform since the start of 2011.

Backed by some of the largest global firms, the platform has grown to facilitate 28,000 transactions in a single day valued at $21.3 billion.

This year, Equilend has signed on more clients than in any other year - RBC Dexia, ZKB, Prudential Investment Management, among them - and celebrates a decade in operation.

Laurence Marshall, managing director and COO of Equilend, says, "Our ability to be flexible and to adapt to the rapidly changing international regulatory environment enables us to innovate and create the appropriate technology to meet our clients' needs."

Deutsche Bank wins Kentucky mandate

Deutsche Bank has announced that its Trust and Securities Services division has won a mandate to provide securities lending services for the Office of Financial Management(OFM) of the government of Kentucky.

Tim Smollen, global head of agency lending, Global Transaction Banking at Deutsche Bank says, "We look forward to an enduring partnership with OFM. Our approach addresses the evolving needs of investors who are demanding greater sophistication and transparency from their providers."

BNY Mellon provides securities lending to Teucrium funds

BNY Mellon Asset Servicing has been selected to provide exchange-traded fund (ETF) services, fund accounting, fund administration, global custody, securities lending and transfer agency services for three Teucrium commodity funds: The Teucrium Soybean Fund (NYSE: SOYB), The Teucrium Sugar Fund (NYSE: CANE), and The Teucrium Wheat Fund (NYSE: WEAT).

"We have extended our relationship with BNY Mellon, which now provides ETF services to six of our funds," said Sal Gilbertie, president of Teucrium Trading LLC. "As an ETF service provider, BNY Mellon has proven its ability to provide the sophisticated services required for increasingly complex products such as those based on commodities."

"The ETF business has been rapidly evolving to provide investors with an increasing array of investment opportunities, such as the ability to invest in a broad range of commodities," said Joseph Keenan, managing director and global head of exchange-traded fund services at BNY Mellon Asset Servicing. "We will continue to enhance our industry leading capabilities so we can provide the services that these innovative and diverse funds require for success."

Absa upgrades stock lending capabilities

Absa Capital has upgraded its versions of SunGard's Global One, a suite of securities finance solutions for trade processing, operations and reporting. Absa Capital uses Global One interfaced with STRATE, South Africa's electronic settlement system, for processing transactions on the Johannesburg Stock Exchange and off market trades.

Chris Edwards, head of prime services at Absa Capital, said, "SunGard's Global One provides Absa Capital with a sound securities lending system that helps increase our competitiveness. It is also helping us achieve our objective of straight- through processing, thereby making our offerings more attractive to our clients. Support from SunGard and its commitment to deliver on time further assist our business in our quest for continued growth and maintaining that competitive advantage."

A multi-currency system for international securities lending, Global One supports both brokers and lenders. Organisations use Global One and its real-time communications capabilities for the administration and management of international and domestic securities lending activities.

Data Explorers expands IQ

Data Explorers has announced that its securities lending data, tracking short selling and institutional fund activity, is available to its subscribers over Capital IQ, a Standard & Poor's (S&P) business and platform for financial information.

"We are committed to providing the most complete data, research and analytics offering for asset managers so that we can support their evolving investment processes," says Peter de Boer, executive managing director of S&P Capital IQ. "The addition of Data Explorers content will enable subscriber clients to integrate this unique information into their Capital IQ workflow to quickly monitor market changes and identify new sources of alpha."

Data Explorers has enhanced its short interest page, for use with Screening, Excel and Charting functionalities, as well as via its Xpressfeed data management solution for sophisticated quantitative research and modelling. "This data adds a valuable new layer of criteria, especially for the buy side, for generating investment ideas, optimising portfolio positions, managing risks, and finessing deal timing," wrote Data Explorers.

Content is sourced directly from market participants including prime brokers, custodians, asset managers and hedge funds.

Going global

SLT speaks to BMO Capital Markets' global head of equity finance about the integration of Paloma and his views on the market

BEN WILKIE REPORTS

SLT: Could you tell us a bit about BMO Capital Markets?

Tony Venditti: BMO Capital Markets is a fully integrated North American investment bank with nearly 2,000 employees around the world, operating in 15 North American offices and 27 worldwide. As of July 31, 2011 BMO Financial Group had US$499 billion total assets. BMO Capital Markets has extensive expertise in providing financial advisory, securitisation, leveraged finance, market risk management, M&A, private placements, institutional brokerage, equity underwriting, treasury services, research and lending.

SLT: How has the integration of Paloma to BMO Capital Markets worked out?

Venditti: It has been almost two years since BMO acquired the securities lending book of business and team from Paloma. The integration of the Paloma business into BMO was a total success! We seamlessly integrated our front end systems, our operational infrastructure, our risk and credit reporting capabilities, and our globalised approach to executing multiple strategies with our very strong counterparty base. There were some minor issues during the first six months, mainly around novating some bespoke agreements and residual positions from Paloma to BMO – particularly as we decided not to novate any securities lending agreements associated with Paloma's UK broker dealer. BMO was comfortable with our counterparty base and the way we wanted to grow our business; understanding BMO London Ltd's capitalisation was an important part of the credit evaluations from a counterparty perspective. BMO acted quickly in supplementing additional capital to both the US and UK broker dealers which really helped in obtaining the credit lines we needed to help grow our business quickly. BMO has also been very supportive in providing us an ample amount of balance sheet and liquidity (if we were to need it). The additional benefit of the acquisition is that we have a very strong credit rating and area top ranked financial institution that has an impeccable reputation, as well as numerous global relationships that we can now tap into. I could not have found a better home for the team than BMO and senior management has done an incredible job in supporting our growth as well as being very enthused about our long term prospects for success.

SLT: How has securities lending changed as a result of the market crisis?

Venditti: There has been a noticeable change since the financial crisis. The two concerns that stick out are based around liquidity. Liquidity around funding of assets has been most evident. Now, almost all the large firms are looking for secured term funding in order to get their assets to match up with their liabilities. For years, many firms relied on liquidity from raising cash due to their ability to use short term commercial paper and money markets, and many firms would sit on many illiquid assets which led to some of the problems we had in 2008 when refinancing dried up. The other thing that has changed is how firms are looking much more closely at the liquidity of the securities they borrow/lend/pledge. We have seen haircuts increase and funding spreads increase. That being said, I think this is only the beginning of a gradual increase in cost due to changes in our regulatory environment that will not only affect our industry, but many others - especially when the true cost of long term funding gets passed on directly to the business units. That will find its way to any client that is entering into a trade that uses balance sheet or has some risk associated with it.

SLT: During your time in the industry, how automated has the business become? How much more automated could it get?

Venditti: The equity finance business has changed over the years due to automation but not as quickly as I had expected. I believe many firms have limited resources in which to spend on large IT projects, upgrades, or front end systems, which in some ways holds back our industries overall growth. That being said, there is a big advantage to the larger well capitalised firms that have the resources and the capabilities to use automation to build market share and increase efficiency. I still believe our industry needs to devote a fair amount of time and capital to help automate and build out e-type businesses that help increase order flow and efficiency.

SLT: Has the use of collateral changed in recent years? Does collateral optimisation mean that this part of the business is now considered a profit centre?

Venditti: I would say it hasn't changed. But what has changed is how people use it. I also think this has always been one of the most overlooked parts of a firm's strategy (when it is used properly that is), and as I said before, many firms sat on assets that where just a tad harder to fund. There was very little optimisation of collateral until the credit crisis. I now see many firms trying to fund all types of collateral (for fixed term as well). I have always viewed the funding book as a profit centre – this perhaps comes from working for a Japanese firm, with a high cost of capital, for as many years as I did and through multiple market crises. If you have a good team that manages collateral well, you can really increase spreads and help a firm improve liquidity. Since it is not hard to track the benefit, why shouldn't it be tracked as revenue?

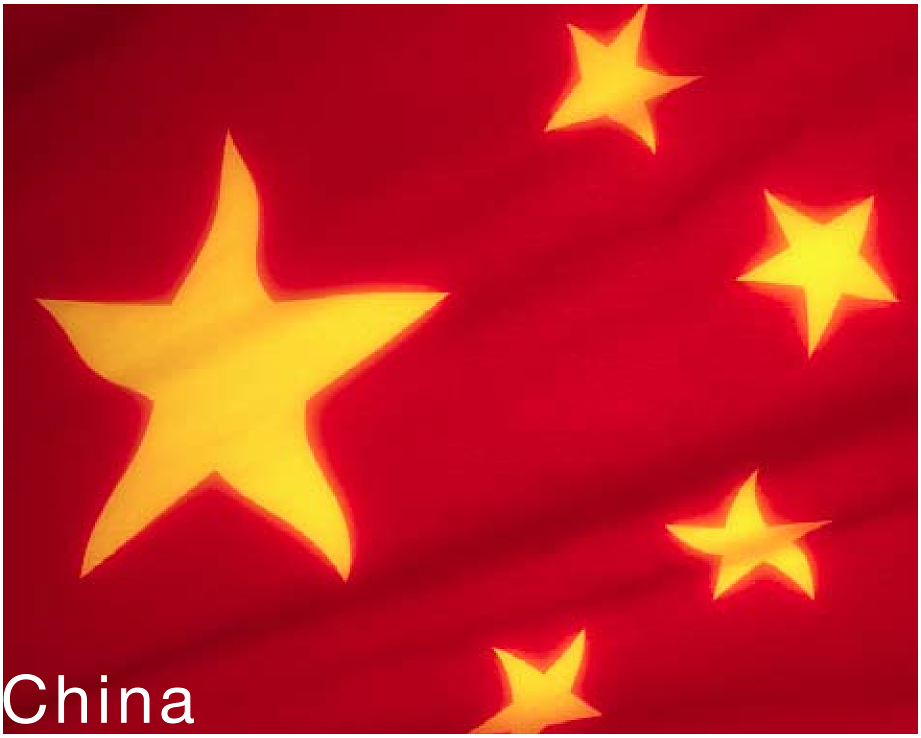
SLT: What are your views now on CCPs? Are there better alternatives?

Venditti: In theory, and in practice, especially during challenging credit times, CCPs are essential. The main issue that I see with CCPs is when we are not in a stressed environment the margin and costs to do business via a CCP could be prohibitive. I have seen how margins can change almost at a drop of a hat and almost make it destructive to deal with them. I think there is a place for CCPs, but depending on the product or market they do not always work. But I am sure that over time they will get the model right.

SLT: Do you have plans for further international expansion?

Venditti: The main areas of growth for our group and BMO CM is equity trading, derivatives, and prime brokerage in the US. We are very strong in these areas. With the infrastructure, counterparties, and talent we brought over from Paloma, coupled with BMO's strong balance sheet and credit rating, I can see BMO expanding first into Europe and then slowly into Asia. We already have a strong asset management footprint in China and we have been rapidly expanding in that space globally. I also think there are good opportunities in Delta 1 trading globally - mostly revolving around futures and options in which we have had a lot of experience trading. There is also a strong potential in growing more secured finance driven businesses around hedge funds and other investment banks. **SLT**

Tony Venditti
Global head of equity finance
BMO Capital Markets



China

China has been the economic powerhouse over the past decade, but are the cracks starting to show?

ANNA REITMAN REPORTS

China might be headed for trouble during a time of global economic uncertainty because of its "shadow banking" system - will the country's regulators continue down the path of reforms intended to increase market liquidity?

After travelling to China, Nomura analysts Lucy Feng and Donger Wang concluded that China's banks are showing signs of strain.

"[The] shadow-banking credit situation has worsened since our June visit…We have seen a continued expansion of shadow-banking credit and a decline in its quality since our most recent visit in June this year. We believe the situation is worsening, as shown by the rapid growth, 28.8 per cent year on year and of outstanding trust funds, compared to 15.2 per cent by the end of the first half of this year, as well as a 119.4 per cent year on year surge in new entrusted loans in the first half," said Feng and Wang in the joint report.

The duo estimates that total shadow-banking credit increased to CNY 10.4 trillion at the end of the first half, up by 10.5 per cent compared to the same period the year previous and representing 20.3 per cent of total bank loans.

One of the more jarring figures is a skyrocketing debt to GDP ratio of above 135 per cent under adverse scenarios, such as a government bailout amid accumulation systemic risks.

"Although China's government debt to GDP ratio of 43.6 per cent stood well below the international dividing line of 60 per cent as of end 2010, we are worried that it may climb substantially if the boom-bust of shadow-banking credit forces the government to assume not only central and local government debt but also underground credit in a deleveraging environment," write Feng and Wang.

News headlines have recently highlighted the growth of SME bankruptcy, particularly in Wenzhou, a city in the south-eastern Zhejiang province known for entrepreneurism and private lending, while public discourse focuses on the urgent necessity to bail out a large number of SMEs amid a backdrop of appreciating local currencies, rising labour costs, softening economic conditions and, in particular, tight liquidity.

"Given tight liquidity conditions and a tougher operating environment, many entrepreneurs in Wenzhou have suddenly "disappeared" as a result of breaks in their financing chain. It seems that the situation is becoming even worse now, as more entrepreneurs seem to have run away because they cannot pay back the money that they owe," report Feng and Wang.

According to Nomura's economics team, China's CPI inflation will remain elevated at 6.3 per cent year on year and 5.4 per cent in the third and fourth quarters this year respectively, while the forecast for real GDP growth (accounting for inflation) is at 9.4 per cent in the fourth quarter. "As such, we think there should be limited room for monetary policy loosening on the interest-rate front before the first quarter of 2012. In our view, any directional changes in China's monetary policy would require either real GDP growth to slow significantly to below nine per cent year on year, or CPI inflation to ease to between four and five per cent to mitigate the negative real deposit interest rate," they write.

So, while global growth hopes have been pinned on China's juggernaut economy, news that its balance sheet could take a big hit from the shadow banking system in an era of central banks with limited policy tools is sure to hit global stock markets. This, past the damage already inflicted by a worsening eurozone debt crisis and while regulators continue to navigate the OTC markets.

Shadow banking, also known as market-based financing, is on the radar of supranational regulators, notably the Financial Stability Board (FSB), which is setting up working groups to recommend regulation of activities associated with credit intermediation outside the official banking system. And China's securities regulator is also paying attention considering developments within the country.

Speaking at the Pan-Asian Regulatory Summit in Singapore at the end of September, Dr Eddy Fong, chairman of the Securities and Futures Commission (SFC), the capital markets regulator, stated that for Asia to have an impact on the shaping global regulatory reforms, Asian nations must continue to actively engage their counterparts in the West through participation in various standard setting bodies and international organisations, such as the FSB.

The SFC declined requests for an interview, however, experts have stated that international regulations are not likely to have a material impact on China's regulators any time soon.

Still, with liquidity concerns running high in an uneven, uncertain global economic recovery, the natural question arises – will market reforms intended to increase market liquidity continue down the development path or might heightened fears of introducing new mechanisms stall it?

Legal eagles

Development of the securities lending markets is slow but observers are seeing sign posts of advancement from the China Securities Regulatory Commission (CSRC).

Patrick Phua, partner at law firm Mallesons, says that since China's State Council approved a package of measures for securities lending and futures index and margin trading in January 2010, progress has been made.

"What is really encouraging is that reform is taking place and the direction is clear, regulators are still progressing down the path of convergence with overseas market practice. They are adopting best practices from overseas jurisdictions and lessons from the 2008 market turmoil. But the progress has taken time," says Phua, currently based in Beijing.

After a hiatus of nearly two years with little movement, a recent consultation draft from CSRC indicates that the two-year government-run pilot programme will be extended to allow a larger pool of brokerages access to securities lending practices, as well as making entry thresholds lower.

But there is still some way to go towards providing depth to the market. Phua explains that securities brokerages do not have a substantial amount of proprietary inventory for lending, and, combined with existing barriers to participants outside of the securities brokerages, the government-run pilot programme has been “a controlled experiment”.

In March 2011, Martin Chen, vice president of Corporate Trust department at the Chinatrust Commercial Bank (CTCB) provided an overview of the securities lending market in China and the pilot programme which began approving brokers between the end of March and December 2010. In total 25 pilot-run brokers with 2200 branches can operate margin trading and short selling business in China, accounting for more than 50 per cent of the total number of branches of all securities firms in China.

There are currently 50 eligible stocks in Shanghai Stock Exchange and another 40 eligible stocks in Shenzhen Stock Exchange, while eligible collateral includes cash, government bonds, ETFs, listed fund and bonds and listed shares, each with varying levels of haircuts.

In addition, short selling fees are high - at 10.35 per cent per annum compared to margin trading at 8.35 per cent, while initial margin stands at 150 per cent and maintenance margin is 130 per cent.

Moreover, there is an anticipated learning curve as short selling is a relatively new concept for China.

Some headway is being made on this front - Global Times reports that at the end of September this year, the government provided training for 75 securities companies on margin trading and short selling. Something that Phua thinks is a sign of things to come, although any development will remain sensitive to the macroenvironment.

Phua notes that Chinese regulators viewed complex financial products with strong disfavour after the Lehman crash, and the fact that a host of European regulators are imposing short selling bans during the current eurozone debt crisis may affect ongoing reforms.

“It is unfortunate that just when the second phase of the securities lending pilot is starting, we are running into what could be the second phase of market turmoil,” says Phua. “At the same time, Chinese regulators are commendable, in that they recognise the benefits of securities lending and short selling but are intent on a conservative approach to implementation.”

Although disputed among officials, a timeline of five years for easing of capital controls has been put forward by the regulator, State Administration of Foreign Exchange (SAFE). Whatever the timeline may end up being, there is wide spread consensus among international experts and analysts that China intends to internationalise the RMB.

“Just greater partial convertibility would result in an explosion of cross-border activity,” says Phua. “The impact on the global economy cannot be underestimated.”

It begs the question – once the flood has come through, does it make sense to erect any one section of the dyke?

“Although it is just a matter of time before other restrictions come down, many things are dependent on macroeconomic and political developments, both globally and within China,” Phua notes.

Tie Cheng Yang, a partner in the Beijing office of law firm Clifford Chance says he expects that the securities lending market will continue to be liberalised, noting the regulator encourages financial innovation, albeit that, in China, every financial innovation is originated by the regulators and not by market players.

“For foreign institutions, in order to get access to domestic securities lending business, they may have to set up a securities company in China first. In the future, CSRC may permit domestic securities companies to provide securities lending business to [Qualified Foreign Institutional Investors] QFIIs,” says Yang. “So far, only big domestic-funded securities companies are licensed for the pilot stage – this may be expanded to all securities companies in China, including securities companies with foreign investment.”

Seclending rumblings

There are, however, some rumblings of what those securities companies might look like. After a consultation with large funds, the Chinese regulator is considering implementing a non-profit securities finance company that would act as a third party securities lending provider between institutional investors and borrowers. The idea just might be the beginnings of a third party lending environment with a dedicated pool of securities, solving some of the issues associated with a thin market, albeit with a “firewall” between securities brokerages and a non-profit securities finance company.

It is highly unlikely, says a source familiar with the situation, that the scheme would include retail investors, however, which comprise some two-thirds of the market.

“The retail investor is critical to the Chinese stock market and regulators in China are very conservative, the last thing regulators want is to introduce innovation that blows up badly, like a securities finance company that becomes insolvent,” the source notes.

Hong Kong favouritism?

Hong Kong generally gets preferential treatment from China. And the tie that binds is getting stronger, through the Mainland Hong Kong Closer Economic Partnership Arrangement (CEPA). At the moment, however, there is no preferential proposal put forward for Hong Kong companies to engage in securities lending.

“There isn’t anything in place that allows [Hong Kong] companies to come in and participate in securities lending or securities finance arena, so there is no agreement to assist Hong Kong companies right now,” an analyst familiar with both markets says.

In fact, dual-listed shares between mainland China and Hong Kong do not have a mechanism for arbitrage, as attempts to allow the practice saw the mainland premium instantly drop, while QFIIs, such as BlackRock and Amundi, have quotas limiting investment in China’s equity markets.

“All things said and done with respect of any offshore market development in securities lending, the reality is there isn’t a functioning model just yet,” the analyst says. **SLT**

Risk and reward

Lombard Risk's product consultant speaks to SLT about the growing profile of collateral within the securities lending market

ANNA REITMAN REPORTS

Elaine MacAllan, who has over 10 years' experience managing repo and securities lending and OTC collateral, prime brokerage margin and portfolio reconciliation, joins from Credit Suisse where she held a senior VP role in the collateral department.

Elaine joined the team to direct the further development of repo and securities lending functionality in the Lombard Risk COLLINE solution.

The solution addresses an industry trend of firms looking to optimise their collateral management processes and improve risk management by replacing silo solutions, while gaining oversight across business lines.

SLT: Where does Lombard fit into the securities lending market?

Elaine MacAllan: Lombard Risk is a solution provider to the financial services market, specialising in collateral management and regulatory reporting.

The securities lending market uses collateral substantially to securitise its trades, and the COLLINE product from Lombard Risk meets their requirements to proactively manage it on a real-time and global basis.

Post-trade execution, COLLINE is a front-to-back provider of margin call processing, collateral management, and risk and client reporting solutions - supporting multiple financial products. Sophisticated technology supporting OTC derivatives margining is being leveraged and expanded to provide a real-time solution for the securities lending and repo markets, to include mark- to-market transaction pricing and valuation.

SLT: Your role is to "find solutions and improve risk management by replacing silo solutions and gain oversight across business lines" - how does that apply to securities lending?

MacAllan: Technology has always played an important role in bringing new products to market and, over the years that financial services firms have expanded, most of them have either bought or built systems in-house to meet each department's needs as they arise. The result? A plethora of 'silo' systems managing each department's requirements exceptionally well and presenting reports that summarise the department's activities and progress well. However, when management is faced with a report from *each* department, it is difficult for them to gain an oversight into how one department's operations impacts another - and to gain a consolidated view. From an operational perspective silo'd business lines can be costly to support and functionally inefficient; opportunities to leverage synergies of process and technology are often missed.

The answer? Is it more technology - this time an infrastructure approach that attempts to combine each department's data into a central (database) repository/warehouse from which consolidated reports can be generated? It's an ideal which firms have invested in significantly, however - data from one system is rarely 'compatible' with data from another and much time and effort has been expended on morphing data from various systems and creating the much-sought after 'golden source'.

A better solution - do away with the silo business systems wherever possible - and collateral management is an area where this is particularly effective. Collateral management in one department (eg, securities lending) is very likely separate from repos and OTC derivatives in most firms right now, which means that collateral may be under-utilised in one department when it could be improving liquidity when put in the overall non-silo picture.

COLLINE offers a single platform providing multi-product margining, addressing the particular calculation and workflow needs by business line (where operational processes differ), while offering the user the option to view and manage their risk and collateral portfolio on a consolidated basis. This eliminates the technical barrier to being able to consolidate margin requirements and obligations across business lines. So, where a firm may currently be simultaneously supporting multiple product-silo'd operational processes (and as many individual margin calls) on a daily basis, this could be reduced to a single call per master agreement. Thus increasing efficiency, reducing operational risk, reducing costs and minimising collateral sourcing requirements.

SLT: There is a push for more transparency globally and some retail fund managers would like more disclosures on, for example, the kind of collateral held for loaned out securities - can you comment on your viewpoint?

MacAllan: Clients and regulators are both demanding improved reporting transparency, for disclosure purposes, but also to facilitate and encourage proactive management and optimisation of collateral balances. With the increasing need to provide higher quality, and higher levels of collateral, there is a need to ensure (and continually re-evaluate) best use of available assets on a daily basis, both in terms of availability and cost. A centralised source of firm collateral positions and eligibilities provides an effective tool to manage the collateral inventory, both within and across agreements and business lines.

SLT: Which regulations do you see as most pertinent to this market?

MacAllan: There are two key areas of regulation that impact collateral divisions. The drive by regulators to force OTC derivative trades to be cleared through a central counterparty clearing house, and new regulations pertaining to the amount and availability of capital and liquidity.

We are witnessing a continuing squeeze on collateral - in terms of quality, availability and cost. A struggle to source and maintain suitable levels of high grade collateral is anticipated. Alternative forms of securing credit exposure will become more attractive, where the agreement terms allow. Therefore introducing methods of reducing (offsetting) collateral sourcing requirements, and allowing a flexible approach to margin methods (for example, optimising collateral inventories and supporting an efficient re-pricing process), can help address the increasing regulatory demands.

SLT: How do you see the future of collateral management in the securities lending industry from your vantage point?

MacAllan: Firms are responding in different ways to the demands of the market, their clients, and the regulators. But clear themes are emerging:

- A relentless focus on the cost and availability of collateral, and the need to proactively manage it.
- Increased transparency of reporting and consolidation of margin process across business lines
- Real-time (intra-day) valuation and margining
- A continuing drive towards maximising the efficiency of the margin process - introducing STP where at all possible
- The use of CCPs and/or tri-party agents to support and manage collateral. **SLT**

Elaine MacAllan
Product consultant
Lombard Risk

Training and Education

Date	Location	Course	Provider
Open Courses	London New York Singapore Sydney	**Hedge Funds: A Credit Perspective** A two-day intensive workshop offering an in depth structured approach to the analysis of hedge funds and alternative investment strategies. The workshop takes a credit focus for bankers and analysts but is also appropriate for a wider audience who need to understand the key risk issues of the hedge fund industry.	Fitch Training
Open Courses	Frankfurt Hong Kong London New York	**Basel II & III: Bank Capital Adequacy** A two day case study based workshop for financial market professionals, focusing on the capital raising, funding, investment and risk management needs of banks in the context of changing markets, Basel III and other regulations.	Fitch Training
26-27 Oct	London	**The Repo Market** The repo market is the lubricant that keeps the financial engine running. It serves as the link between the money and capital markets, and is vital to the well functioning of the financial markets. The turmoil in the market over the past two-years has further enhanced the importance of the repo market.	Eureka Financial
9 Nov	New York	**Repurchase Agreements (Repos) and Securities Lending** By the end of the course participant will be able to: Describe the features and characteristics of secured financing: - Repo agreements - Securities lending programmes	Financial Markets World
9-10 Nov	London	**International Securities Settlements & Custodial Services** This training programme is designed to provide delegates with practical knowledge about the key concepts, systems, processes and procedures in international securities settlement and custodial services as well as operational risks involved. Participants will have a chance to gain skills necessary to facilitate day-to-day transactions and communication processes between all parties involved	Eureka Financial
16–17 Nov	London	**Collateral Management** This course looks at collateral management in OTC derivatives in particular as well as repos and securities lending and borrowing. Risk identification, control, documentation, types of collateral, gross and net exposure and other practical aspects are covered as well as the conceptual framework and practical problems egg the treatment of corporate actions on a borrowed/lent position.	Investment Education PLC
23-25 Nov	London	**Global Master Agreements for Repo and Securities Lending Workshop** The International Capital Market Association (ICMA) and the International Securities Lending Association (ISLA) will be holding a workshop on the Global Master Repurchase Agreement (GMRA) and the Global Master Securities Lending Agreement (GMSLA).	ICMA and ISLA

A wake up call?

Data Explorers' Will Duff Gordon examines how US short sellers reacted in the third quarter

MARKET PERSPECTIVE

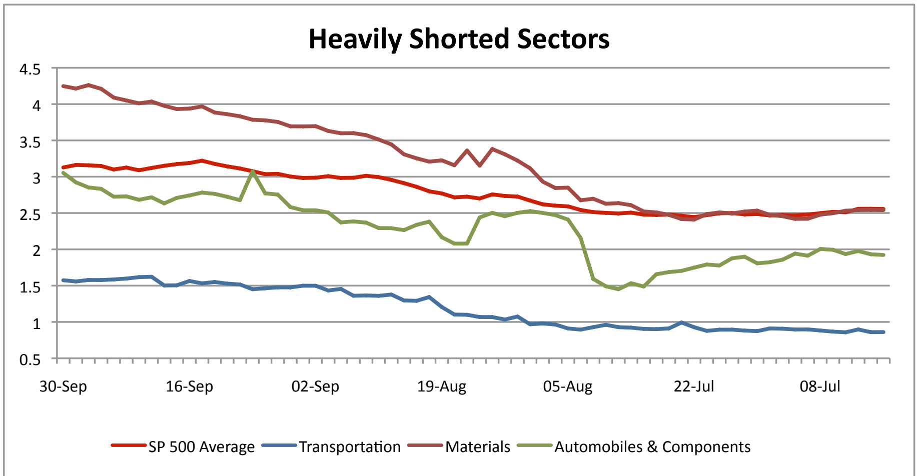
Hot on the heels of what can easily be described as the most turbulent quarter since the height of the credit crunch, US hedge funds are aligning their strategies by increasing their short bets on aggregate and switching their focus to sectors they believe are likely to be affected by the shifting situation. A recent Financial Times article encapsulated the negative outlook of many macroeconomic hedge fund managers. We use securities lending flow to assess which sectors across the S&P 500 have been impacted the most and least over the past quarter. In summary, we see the semiconductors, commercial & professional services and food & staples sectors have been subject to the most negative sentiment while the pharmaceutical, food & beverage and household & personal products sectors have been the least affected. Only the latter saw positive investor sentiment in this period.

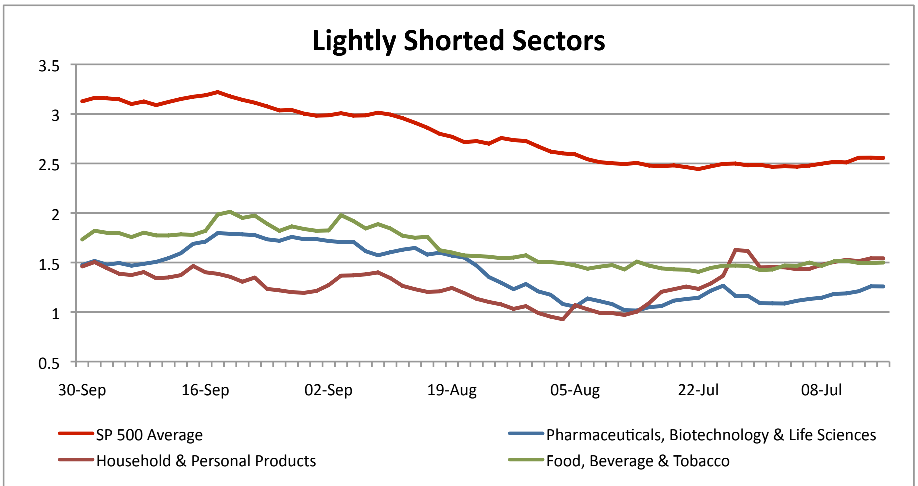
Short interest in the S&P 500 stands at 3.13 per cent of the total market capitalization - an increase of 22 per cent since the start of the third quarter, mostly coming from a steady rise in August. Of the sectors which make up the Index, the semiconductors sector is the most shorted with 6.1 per cent of shares out on loan, followed by the commercial & professional services and food & staples retailing sectors, with short interest at 5.8 per cent and 5.2 per cent respectively. It is worth noting that food & staples retailing is skewed heavily by a high 25 per cent short interest in Supervalu Inc, (NYSE:SVU) without which the sector would have a below average short interest of 2.6 per cent.

Looking at changes in short interest over the quarter, the transportation sector recorded the largest increase of 83 per cent, with the percentage of shares on loan having jumped to 1.6 per cent from 0.9 per cent, although it still remains the third least shorted sector in the index. Other sectors with large increases in short interest include the material sector with a 67 per cent increase to 4.2 per cent of shares shorted on average and automobiles & components with an increase of almost 60 per cent to three per cent of the total market cap.

Of all 24 GICS level 2 sectors which make up the S&P 500, only one sector, household & personal products saw a decrease in short interest, recording a five per cent drop in shares out on loan to 1.45 per cent of the total capitalisation. This also makes it the least shorted sector. The companies which make up the sector focus on basic consumer needs, including bleach producer Clorox (NYSE:CLX), consumer goods maker Colgate Palmolive (NYSE:CL) and fast moving consumer goods giant Procter and Gamble (NYSE:PG). These shares are typically referred to as non-cyclical for their ability to outperform the market in the event of an economic downturn – and that is what investors are clearly hoping.

Other sectors which recorded relatively low levels of short interest include pharmaceuticals and the food, beverage & tobacco sectors with 1.5 per cent and 1.7 per cent of their respective market cap out on loan. Both of these also focus on consumer needs rather than discretionary wants.





Bottom line

The market turmoil in August marked a wake-up call for short sellers in the US as they reacted to the macro-economic challenges. A review of the quarter highlighted that US short sellers have steadily increased their bets as the economic outlook deteriorated, yet they have been selective in avoiding sectors which are insulated from the worst of the economic headwinds. **SLT**

Will Duff Gordon
Research director
Data Explorers

Industry appointments

Trading Apps has appointed **Darren Johns** as non-executive director. Johns joins Jean-Paul Musicco, Matthew Harrison and Jeff Lloyd onto the board. Darren was most recently COO of prime brokerage at UBS. Prior to that he was COO of securities finance at Deutsche Bank. Since 2009 he has been building a portfolio of investments and non-executive roles.

Matthew Harrison, CEO, said "We are delighted that Darren has decided to join us. Right from our first meeting, Darren saw the value in Trading Apps. As COO he had been frustrated by the lack of vendor technology, which addressed business issues without having to change his entire platform at vast expense. And with budget pressures the availability of experienced in-house IT resources to work alongside business users to develop solutions was also very limited. The Trading Apps approach solves both these issues by providing easy to install applications solving specific business issues drawing information from whatever platform you currently have. Darren brings a wealth of knowledge about the market as well as practical experience on running a global business."

Ilicia Silverman has joined WTP Advisors' Capital Markets practice to head business development efforts. Silverman was most recently a vice president at Credit Suisse where she served as a senior member of the prime consulting team within Prime Services, providing best practice consulting, assisting startups, spinouts and existing clients to build out all aspects of their operational infrastructure.

WTP Capital Markets provides operational support, and tailored solutions for hedge funds in start-up, transition and growth phases, helping clients improve their operations through a full suite of CFO and COO services - including full third party service provider assessment and selection, including fund administration and prime brokerage platforms, interim back and middle office staffing, and business process reengineering.

Sue Crosby has joined Mercer's Investment Consulting business as partner based in New York. In this role, Crosby will focus on growing Mercer's Implemented Consulting business and will support the firm's growing Endowment and Foundation Consulting practice.

Prior to joining Mercer, Crosby initiated the Endowment & Foundation Relationship management effort at Merrill Lynch. Most recently she led business development for Perella Weinberg, an investment outsourcing provider.

As part of its business growth in this area, Mercer recently acquired Hammond Associates in St Louis and Evaluation Associates of Norwalk, Connecticut.

Cormac Sheedy has joined RBC Dexia Investor Services as senior executive officer for Middle East and Africa based in Dubai.

Sheedy has over 20 years' experience in financial services, spending the last eight working in the United Arab Emirates (UAE) where he was most recently head of sales at SHUAA Capital, a UAE Investment Bank.

"On-the-ground presence in Dubai is crucial for providing locally-based clients with a full suite of custody, administration and value-added services. Cormac's experience on the buyside gives him extensive insight into what asset managers need in order to operate effectively, and we look forward to having him on board," said Simon Shapland, managing director of UK, Ireland and Middle East at RBC Dexia, to whom Sheedy will report.

SEB Bank has announced that **Gatis Simsons** will be taking over as head of custody services in Latvia. Simsons makes the move from Swedbank Latvia and has experience in payments, custody and correspondent banking services. The announcement comes as SEB's former custody head for the region, Andis Artmanis, leaves after 17 years with SEB.

NorthPoint, the prime services business of ConvergEx, has launched a new division dedicated to the formation, performance and management of alternative mutual funds. The new Alternative Mutual Fund Services division will work with traditional mutual funds and hedge funds that are interested in launching alternative mutual funds. The offering will combine ConvergEx's investment technologies and investment services to enable customers to raise assets, optimise performance and manage funds in compliance with 1940 act regulations.

Jay Jacobs has been hired to lead this new division. An industry veteran with almost 30 years of experience, Jacobs was most recently a partner at Merlin Securities.

HSBC Securities Services (HSS) has appointed **Dan Massey** as head of Client Management Group, Asia Pacific.

Based in Hong Kong, he will be responsible for all client management and business development activity for HSS across the Asia Pacific region.

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Mike Martin, global head of the client management Group at HSS says, "[Dan's] knowledge of the Asia Pacific region and securities industry experience positions him well to lead the Client Management Group in the region."

Massey has an extensive securities services background and most recently held the role of global head of business development and regional head of Southeast Asia for HSBC's Sub-Custody and Clearing business.

He has 23 years' experience in the financial services industry and has been with HSBC since 1994 during which time he has held senior management roles in South Korea, Hong Kong, Jersey and the United Kingdom. **SLT**