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AIG 'back in securities lending'

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AIG has begun a return to securities lending in a bid to boost income after a disappointing quarter, according to insiders. The company pulled out of the industry during the financial crisis.

This time, says AIG, things are going to be different. The disclosure that AIG is resuming securities lending activities came from the insurer's third-quarter regulatory filing, which showed a $4.1 billion net loss for the quarter, reported the Wall Street Journal.

AIG said that during the third quarter it lent $1.2 billion in municipal bonds to banks, brokerages and others in exchange for collateral such as treasuries or cash, also receiving interest payments and a fee. Its insurance units are likely to lend more securities to generate income or bolster liquidity, the company said.

The new lending activity is just a fraction of the $90 billion in corporate bonds and other securities that AIG's insurance units lent to banks and brokers before the last financial crisis, when the company ultimately realised a $20 billion loss from its securities lending activities.

This time around, AIG's filings indicate there are arrangements to avoid a repeat of what happened during the last crisis. The municipal bonds were lent by Chartis, AIG's property and casualty insurance business. Banks and brokers that borrowed the securities posted collateral amounting to at least 102 per cent of the securities' value. The collateral cannot be reinvested by Chartis and is being held on the insurer's behalf in a third-party custodial account.

In its assessment of the "shadow banking system", supranational regulator, the Financial Stability Board, noted that AIG's securities lending and cash collateral reinvestment programmes were a key contributor to its failure. Back in 2008, a division of AIG took much of the temporary cash it received for loaned out securities and invested the money in sub-prime mortgage bonds.

When credit markets froze during the housing downturn and AIG's trading partners returned the securities and asked for their money back, the insurer had difficulty coming up with the cash and had to be bailed out by taxpayers to meet its obligations.

NEWSINBRIEF

Pirum releases exposure management tool

Pirum Systems has released a new tool to end margin call disputes

Pirum's exposure tool is the industry's first fully automated solution to show in a single screen both borrower and lender views of their exposure to each other. Being able to easily review a continuously updated reconciliation which automatically matches every component contributing to overall exposure is crucial to understanding and resolving any disputes. All securities finance trade and collateral types are covered to maximise usability, eg, traditional stock loan, financing and repo trades with non-cash, cash, cash-pool and triparty collateral.

The root cause of all exposure differences are immediately and clearly highlighted avoiding the need for manual tick backs and bringing significant time savings. Automation of this process brings a greater level of visibility and control to the critically important exposure management process. By matching borrower and lender exposures together, both parties gain confidence that their exposures have been correctly calculated.

Pirum's CEO Rupert Perry commented: "Pirum's new real-time collateral management tool addresses an urgent need in today's risk climate within the industry bringing additional accuracy, visibility and efficiency to agreeing margin calls. Users of Pirum's new service will see immediate benefits in both improved risk control and reduced operational overheads".

INSIDE SECURITIESLENDINGTIMES

China indicates short selling ceiling lift

China's securities regulator has announced plans to raise the ceiling for short selling individual shares to 10 per cent of a stock's total market value, according to Bloomberg. The original proposal was for five per cent.

The Commission has not said when it will allow short selling and margin trading for individual stocks though there has been recent management reshuffling in key positions.

The ceiling for margin trading has been proposed at 15 per cent from a previously planned 10 per cent.

Shipping sector heavily shorted - Data Explorers

Though the Baltic Dry Index (BDI) has seen a revival, so too have heavy shorts in the shipping sector, according to Data Explorers.

"There is a real disconnect between market conditions and stock pricing in the shipping industry," noted the analytics firm, adding that the BDI has jumped 66 per cent over the third quarter and October and is up 14 per cent year-to-date, despite continued concerns about global growth, reduced earnings and excess shipping capacity.

Average short interest across the global ICB Marine Transportation sector, which is made up of 107 stocks, currently stands at 2.6 per cent of total shares.

The most shorted shipping stock with a market cap over $1 billion, China Cosco, had seen short interest climb to a 22 month high of 14.6 per cent of total shares by the end of the third quarter but as the stock price rebounded from annual lows, shorts have since covered positions to 11.6 per cent of total shares. Meanwhile, institutional investors have shown negative sentiment towards the stock and have reduced holdings to annual lows of 14 per cent of market cap.

The company has predicted a full-year loss and plans to idle container ships if falling rates in the dry-bulk shipping market do not improve.

The situation is not much better on the oil shipment side and Data Explorers notes that there is an even split between the most shorted companies being oil and dry shipment focused, which may indicate a sector wide problem rather than the nature of cargo.

Securities lending flow data for the most shorted companies or those with the largest increase in short interest analysed by Data Explorers show lendable supply out on loan at or near annual highs or a reduction in the holdings of institutional investors who lend.

Even ancillary companies are feeling the effects. Marine services company Bourbon has seen an increase in short interest to seven per cent in October even as the share price rebounded off annual lows and after some short covering in the third quarter. Almost all of the lendable supply remains out on loan, a trend seen over the year.

Russian CSD set to approve bilateral offering

National Settlement Depository (NSD) has announced its intention to conduct bilateral securities lending transactions.

"The company's Supervisory Board approved a tariff for information services provided by NSD to its clients in order to conduct securities lending transactions collateralised by other securities on basis of a bilateral agreement," NSD wrote. NSD is set to announce a date of the new service's launch in November 2011.

CSRC management shake-up - Business Week

China's government has announced that chairman Guo Shuqing will become head of China's securities watchdog as part of the biggest regulatory reshuffle in a decade, according to Business Week (BW).

Shuqing resigned from Construction Bank to replace Shang Fulin, who is appointed chairman of China Banking Regulatory Commission.

In addition, chairman Xiang Junbo will take the top job at the China Insurance Regulatory Commission (CIRC) after resigning from the Agricultural Bank of China.

Japan FSA extends short selling restrictions

The Japanese Financial Services Authority has extended restrictions on short selling to April 2012. The restrictions, which meant a ban on naked short selling, were due to come to an end on 31 October, but it was widely expected that the regulator would choose to continue the ban.

Market commentators say that this extension is likely to be the last time the rule will be continued, although the FSA has said it is looking at permanent restrictions on the practice.

FSB identifies risks of securities lending

Cash collateral reinvestment programmes will be scrutinised by the Financial Stability Board (FSB) among a package of recommendations aimed at addressing systemic risks posed by the shadow banking system.

The supra-national regulator will set up a "workstream" under its Task Force to focus on the regulation of these programmes as well as measures for repos and securities lending such as margins or haircuts.

This may include limits on the maturity of investments into which cash collateral is invested or on the types of instruments used. Limits on rehypothecation may also be reviewed.

Securities financing - repo and securities lending - has been identified as a key contributor to AIG's downfall during the global financial crisis, when it was discovered that the insurer had built up ultimately illiquid positions at extreme risk levels.

Speaking on the broader overhaul of market based financing, Adair Turner, chairman of the FSB Standing Committee on Supervisory and Regulatory Cooperation, said, "With regulation on banks tightened, it is important to address systemic risks – such as maturity transformation and leverage – arising from the shadow banking sector and its interaction with the regular banking system. The detailed recommendations that will be produced by the five workstreams during 2012 are thus fundamental to the stability of the global financial system."

Lansdowne picks Goldman as prime broker

Lansdowne Global Financials Fund has appointed Goldman Sachs as a prime broker and custodian.

In its capacity as prime broker, Goldman may execute purchase and sale orders and clear and settle such orders and orders executed by other brokers. In addition, it may enter into off-exchange contracts with the fund as principal and also provide the fund with financing lines and short selling facilities.

Other prime brokers of the fund include Morgan Stanley and UBS.

Securities lending "takes a hit" from liquidity buffers - Finadium

Liquidity buffer regulations may see securities lending take a hit since equities are not considered "high quality liquid assets" (HQLAs).

The liquidity coverage ratio (LCR) prescribes that HQLAs must, on the applicable reporting date, be equal to at least 100 per cent of net cash outflow over a 30-day time horizon, according to a recent Finadium report. The measures are intended to mitigate risks from both institutional and systemic shocks during any future banking crises.

Under Basel III, financials, high yield, equities, convertible bonds and emerging market paper are not considered HQLAs and cannot be used to improve a bank's LCR, while qualifying "level II" securities (government bonds rated between A- and A+, agencies and corporate or covered bonds rated greater than or equal to AA-) can-

not compose more than 40 per cent of the total pool of HQLA after a 15 per cent haircut.

Essentially, stock loans will need to offer attractive enough returns to make up for the low quality assets and broker-dealers and banks may be obliged to extract additional spread from clients for principal lending transactions, when these intermediaries behave as the sole counterparty.

The observation period for LCR implementation began this year to monitor the implications for financial markets, credit extension and growth with introduction including revisions in 2015.

BIA Funds picks Newedge UK for custody and PB

BIA Funds has announced that it has selected Newedge UK as its prime broker and custodian for two funds.

Newedge UK will provide prime brokerage services, in respect of all investments, margin financing, clearing, stock (securities) lending and borrowing facilities and custody services for the BIA Pacific Macro Master Fund and BIA Pacific Master Fund.

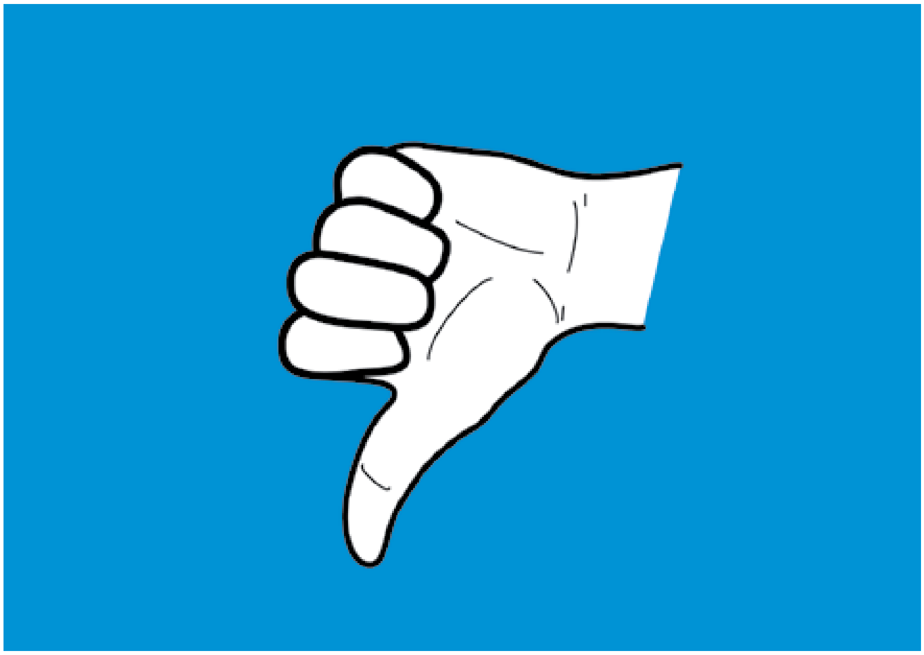
Newedge UK is a wholly-owned subsidiary of Newedge Group, which is joint-owned by Societe Generale and Credit Agricole.

Jupiter adds Deutsche Bank for hedge fund services

Jupiter Asset Management has appointed Deutsche Bank as an additional prime broker and custodian for its Financials hedge fund.

Deutsche Bank will provide custody, financing and reporting services regarding the purchase and sale of securities entered into by Jupiter.

Assets will be allocated between Deutsche Bank and Credit Suisse, the current prime broker and custodian, based on the nature and type of transaction.



IROs negative on short selling - BNY Mellon

Some 64 per cent of investor relations offices (IROs) within companies globally think short selling has a negative impact on the trading environment, according to a recent BNY Mellon survey.

In terms of equity trading, short selling is perceived to have a negative impact across the globe by 50 per cent of companies worldwide and 32 per cent believe that hedge funds adversely affect the markets.

Developed as a benchmarking tool for BNY Mellon's depositary receipt clients, the survey, *Global Trends in Investor Relations*, looks at how publicly traded companies are managing their investor relations practices and features input from 650 companies across 53 countries. Respondents cover the range of market cap and sectors, including financials, industrials, consumer, technology and healthcare.

The most vocal IROs who have a negative view of short selling on equity trading are in North America. Although fewer IROs in EEMEA, at 42 per cent, and Western Europea, at 45 per cent, share the same view, they are still critical while IR executives in frontier markets are less concerned, at 31 per cent.

A significant portion of IROs also have "definitive opinions" on the issue of regulatory oversight over short selling, at 57 per cent of respondents, even when they indicated the practice does not have a negative impact on markets.

In terms of regional breakdown, North America is where the highest number of IROs think there should be more regulatory oversight, followed by Asia Pacific, Western Europe and Latin America. On a market cap basis, a considerable majority of micro cap IROs, at 67 per cent, would like to see regulations placed on short selling.

At the same time, hedge funds remain an integral component of global IR activities with around 92 per cent of companies worldwide meeting with hedge funds, yet the percentage of a firm's meetings devoted to hedge funds (21 per cent) has declined slightly since 2010 (24 per cent) but remains above 2009 levels (16 per cent). Micro caps devote less time to meetings with hedge funds, at 12 per cent.

FINRA fines UBS Securities $12m

The Financial Industry Regulatory Authority (FINRA) has announced that it has fined UBS Securities $12 million for violating RegSHO and failing to properly supervise short sales of securities.

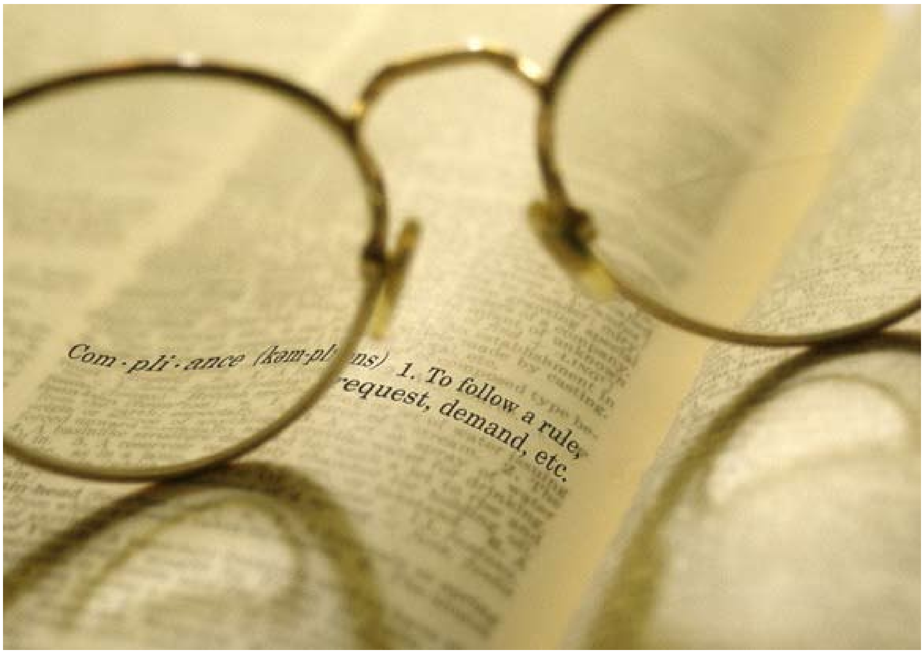
As a result of these violations, millions of short sale orders were either mismarked, placed to the market without reasonable grounds to believe that the securities could be borrowed and delivered or both.

Reg SHO requires a broker-dealer to have reasonable grounds to believe that the security could be borrowed and available for delivery before accepting or effecting a short sale order and requires a broker-dealer to mark sales of equity securities as long or short.

FINRA found that UBS' Reg SHO supervisory system regarding locates and the marking of sale orders was significantly flawed and resulted in a systemic supervisory failure that contributed to serious Reg SHO failures across its equities trading business.

Brad Bennett, FINRA executive vice president and chief of enforcement, said, "Firms must ensure their trading and supervisory systems are designed to prevent the release of short sale orders without valid locates, and properly mark sale orders, in order to prevent potentially abusive naked short selling. The duration, scope and volume of UBS' locate and order-marking violations created a potential for harm to the integrity of the market."

UBS neither admitted nor denied the charges but consented to the entry of FINRA's findings in concluding the settlement.



Primebroker begins ANZ lawsuit

Primebroker has begun its lawsuit against ANZ, accusing the bank of misleading and deceptive conduct.

Principals of Primebroker Securities, Sal Catalano and Ian Pattison, say that ANZ and its agent, the insolvency specialist KordaMentha, led them to believe that Primebroker would be supported with an investment of $55 million that never materialised.

However, in July 2008, ANZ retreated from the proposed capital injection at Primebroker that led to the firm closing its doors - a move Catalano and Pattison claim resulted in them losing a business, Chimaera Capital, that KordaMentha had valued at $100 million.

Catalano and Pattison want the court to declare that ANZ's move to appoint receivers to Primebroker, as well as to companies the pair controlled that had indemnified Primebroker, was invalid, wrote the Sydney Morning Herald, and are seeking damages, interest, costs, declarations, the removal of the receivers and managers: in short, they want the whole position back where they were in mid-2008.

Scandinavian industrial sector most shorted - Data Explorers

Short sellers have not been as aggressive in Scandinavia as in other markets, yet industrial sector stocks have seen significant short interest relative to their regional peers.

After analysing securities lending data flow across Denmark, Finland, Norway and Sweden, Data Explorers found that short sellers have focused their attentions on sectors with exposure to global economic troubles, despite the Nordic economies' resilience so far.

"On a macro level, we find that that capital goods shares feature most prominently on our screen. There are currently 19 Scandinavian capital goods companies with a short interest greater than two per cent. The next most shorted sector was energy with 11 stocks. Capital goods shares have also seen the greatest increase in short interest in the last three months," noted the analytics firm.

Demand in this sector, companies that manufacture machinery used for engineering and construction industries for example, is sensitive to economic conditions and, as a consequence, share prices rise during a boom or conversely drop when the economy contracts.

Looking at the overall level of short interest across the region, Data Explorers found it holding steady in the last three months at a relatively low 1.1 per cent of shares outstanding. Short sellers have avoided the banks, consumer durable, food retailing, insurance and utilities sectors, with no companies in these sectors having recorded short interest greater than two per cent.

Deutsche Bank wins US securities lending mandate

Deutsche Bank has announced it is the first third party agent selected to provide securities lending services for Employees Retirement System of Texas (ERS).

Jacqueline Johnson, deputy executive director of investments for ERS, said, "We believe the [Deutsche Bank] team can be a strong intrinsic value lender and a superior risk manager."

ERS provides a retirement and disability pension system for Texas state employees, law enforcement and custodial officers, elected state officials and two classes of judges.

Tim Smollen, global head of agency lending, Global Transaction Banking, Deutsche Bank, said, "We are delighted to serve ERS, one of the world's largest and most sophisticated retirement systems in the United States. We look forward to building a long-lasting relationship with the ERS team."

Eurex reports volumes

In October 2011, the international derivatives exchanges of Eurex Group recorded an average daily volume of 10.7 million contracts (October 2010: 9.2 million). Of those, 7.3 million were Eurex Exchange contracts (October 2010: 6.3 million), and 3.4 million contracts (October 2010: 2.9 million) were traded at the US-based International Securities Exchange (ISE).

The growth of 17 per cent y-o-y is due to stronger hedging need 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, 153.9 million contracts were traded at Eurex Exchange and 72.1 million at ISE.

At Eurex Exchange, equity index derivatives as the largest segment recorded 82.3 million contracts (October 2010: 57.7 million), an increase of 43 per cent y-o-y. The future on the EURO STOXX 50 Index totaled 31.3 million contracts, its best monthly result year-to-date. The option on this blue chip index totaled 36.4 million contracts.

Futures on the DAX index recorded 3.8 million contracts. The DAX options reached another 5.3 million contracts. The Eurex KOSPI product recorded 2.4 million contracts, an ADV of nearly 120,000 contracts – a new monthly record since product launch.

The equity derivatives (equity options and single stock futures) segment at Eurex Exchange reached 24.7 million contracts (October 2010: 28.0 million).

Thereof, equity options totaled 21.6 million contracts and single stock futures equaled 3.1 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 October would have been approximately close to 28.0 million contracts based on an extrapolation.

Eurex Exchange's interest rate derivatives segment totaled 46.0 million contracts (October2010: 45.7 million). The Euro-Bund-Future reached 18.4 million contracts, the Euro-Bobl-Future 9.3 million contracts and the Euro-Schatz-Future 11.0 million contracts. The Euro-BTP-Future totaled more than 144,000 contracts and the Short Term Euro-BTP-Future nearly 26,600 contracts.

The Eurex segment dividend-based derivatives increased by 84 per cent y-o-y and totaled approximately 706,000 contracts. Volatility derivatives achieved 259,000 contracts, four times higher compared to October 2010.

Eurex Repo, which operates Swiss Franc, Euro Repo and GC Pooling markets, achieved new records in the Euro Repo and GC Pooling market. The Euro Repo market totaled an average outstanding volume of 183.4 billion euros in October, an increase of 54 percent y-o-y. The secured money market GC Pooling recorded a new monthly peak with an average outstanding volume of 150.2 billion euros, an increase of 61 per cent y-o-y (October 2010: 93.0 billion euros). The Swiss Franc Repo market reached 82.8 billion euros. All Eurex Repo markets recorded 266.2 billion euros average outstanding volume (October 2010: 266.6 billion euros).

The electronic trading platform Eurex Bonds, which rounds out Eurex's fixed-income product range, traded 8.6 billion euros (single counting) in October, an increase of 39 per cent y-o-y (October 2010: 6.2 billion euros).

Hong Kong set to centralise short selling

Hong Kong's stock exchange is considering a centralised securities borrowing and lending facility.

The Hong Kong Financial Services and Treasury Bureau plans to introduce legislation soon to improve the reporting of securities short-selling according to emailed statements seen by Business Week, while China's regulator, the Securities and Futures Commission has indicated that it will not ban short-selling.

Market offers

Tim Smith tells SLT what the data is telling him with regards to the specials market three years after the crisis

ANNA REITMAN REPORTS

At the IMN Beneficial Owners conference in London this September, SunGard Analytics presented figures showing why there is a global trend towards specials, chiefly, the disproportionately larger revenues when compared to the size of the market.

SLT: What is the global picture for specials at the moment?

Tim Smith: Since the 2008 crisis, securities lending has become on a global basis more of a specials than a GC based industry, meaning people are looking at the intrinsic value of the securities being lent. However, there are important regional differences in terms of GC versus specials around the world and the reason behind that is usually to do with collateral.

The biggest market in the world is the US, where cash is king and the choice of collateral since revenue is generated through cash reinvestment. In North America, in terms of loan volume, the GC amount outstanding in early October was about 85 per cent of the total loan, with GC being defined as anything earning less than 25 basis points. In Europe, the split was lower, it is less than 70 per cent GC based, while in Asian markets excluding Japan, the actual loan volume of GC versus specials is 30 per cent.

That is quite a relevant metric to have in mind because intuitively it has always been the case that securities lending outside of North America has always been about the security being lent, consequently every security that is borrowed tends to be defined as "special".

SLT: What does the revenue picture look like?

Smith: That gets quite interesting as well because the revenues turn those percentages around. If you are looking at North America, GC accounted for less than 20 per cent of revenue, so it turns the whole dynamic on its head, similarly in Europe, where revenue from GC stands at just under 30 per cent, while in Asia [excluding Japan], it is around five per cent.

That tells you a lot about the relative maturity of the markets and the nature of the business, how it has been established and conducted. In the US market, participants take a holistic view of securities financing, the cash reinvestment is taken as part of the whole trade and transaction, so there is a whole lot of talk about yield, yield on the cash, and that is historically the way the market has matured.

Europe is a sort of halfway house, where, although there are mature markets, there is a desire to take GC balances down in order to lodge elsewhere as non-cash collateral. It is an inbuilt market outside of cash reinvestment. European players are not actually borrowing GC to get cash to reinvest, but borrowing GC names cheaply in order to use as collateral.

When you look at Asian markets [excluding Japan], participants are actually looking to perhaps move from more exotic type of derivatives transactions to put on positions to more mainstream securities lending, but they have to pay up for those rates - everything is extremely special, extremely new. When you throw Japan back into the mix, the dynamics tend to look more like Europe.

SLT: What opportunities and challenges do these dynamics present?

Smith: In terms of government debt, rates charged for borrowing when governments are under pressure is very much the same as the way a company's securities would trade on the securities lending market if that company was under pressure.

What we have seen though in the earlier days in the securities lending data was that the rates in the markets that were the first to have trouble, for example, Greece, Ireland and Portugal, seem to have spiked more quickly, subsequently as more markets became more troubled, such as Spain and Italy, their rates in terms of borrowing weren't quite so high as people got used to the fact that countries can be in trouble.

One cannot bank on there being specials every year, and that is one of the strange things about brokers bidding on borrowing a portfolio - it is very difficult because you don't know what M&A activity will be out there or what dividends are going to be charged.

In the emerging markets, there are usually access products by way of swaps or derivatives - the earliest methodology was American Depositary Receipts (ADRs) or Global Depositary Receipts (GDRs). Shorting the ADR is still a fairly big business. Exchange-traded funds (ETFs) are one method of shorting without borrowing and lending the underlying shares in those markets, but, as the emerging markets come on board, we have found that the rates for borrowing the securities in the emerging markets tend to come down from high fee rates to much lower rates more quickly than in the developed markets.

SLT: What does the data say with regards to specials management?

Smith: The data tells me that specials have taken over in importance, participants are focusing more on specials than GC lending. Behind that, if you look at the US charts for example, you see balances of volume on loan have gone down, but the rates overall in North American markets have just remained stable but gone up quite a bit, which implies that people are borrowing less but are paying more.

But what I want to stress in terms of the specials management, what we are seeing from all of the stakeholders in the securities financing process is that there is great demand for more hands on control and quicker rerating of outstanding transactions should they become more or less special.

That is one of the reasons why SunGard came out with an intraday service, participants want the rates now and we are finding that demand from both brokers and lending agents, but rather interestingly, from beneficial owner holders of securities as well. They want to have a bigger input to and control of their securities lending business.

SLT: How do you see this trend playing out?

Smith: One cannot bank on there being specials every year, and that is one of the strange things about brokers bidding on borrowing a portfolio - it is very difficult because you don't know what M&A activity will be out there or what dividends are going to be charged.

In 2009 in the US, the Citibank trade was the biggest of all time, it created $1.5 billion in income out of some $15 billion globally just on the one transaction. Obviously there are different areas to discuss about predicting company takeovers and that usually falls within the purview of areas outside of the securities financing desks. It is the latter that Astec Analytics supports through its price discovery and performance benchmarking technology. Whilst historical data analysis is good for establishing market signals and trends, predicting M&A activity is different and a more subjective business.

There are many variables in terms of managing a specials operation, so going forward it is very difficult to make hard and fast rules but certainly participants already feel the need for market information. For example, there is a large dispersion in the rates between borrowing for a longer period of time cheaply versus borrowing over a short period of time expensively - there is an overall potentially similar amount of generated income but in a different timescale.

Participants have to manage the rates, there was some "flirtation" on the asset management side in terms of looking to see what stocks were hot and buying those securities into a portfolio for the whole basis of lending those securities to generate income, but that is not a generally accepted tenet of investment management. It is probably not wise to buy and hold securities just in order to generate securities lending income, meaning, if there is a good economic sound investment reason for buying those securities then that should not be outweighed by anything earned from securities lending.

SLT: How do you see the specials market developing?

Smith: In terms of ebbs and flows of specials lending, as it is driven by market conditions, it is a very reactive business, which is why GC entered the picture. Now, with the problems that were encountered in cash collateral reinvestment, participants are looking much more at specials only.

I think the focus on specials lending, or a more pragmatic approach, is going to be prevalent globally in terms of overall balances, North America is still by far the biggest market in the world, Europe is still fairly seasonal in its nature while Asia-Pacific [excluding Japan] is very much a specials only market.

All eyes are on what potentially will happen in China and India once those markets really open up. Again there will be the opportunity to take advantage or maximise interest in specials activity in those two markets. And, not to forget Latin America , where Brazil particularly shows high levels of interest. I am seeing a continued focus on intrinsic lending, certainly for the next two or three years. Later down the road, as people become more comfortable with any controls in place with regards to different sorts of collateral, maybe GC will get back into flavour.

Also to take into consideration is that, in the past, borrowers used to guarantee a certain amount of GC balances with big lenders in order to get an allocation of specials and that whole dynamic has rather broken down over the last couple of years. We may get back to that dynamic but not soon.

SLT: How are regulations impacting the industry?

Smith: The trouble with the regulations, in terms of the desire for more transparency and control in the areas of short selling, is just as the securities lending business is different around the world so too regulators have different viewpoints.

Everyone has a different viewpoint in terms of what they want and feel they need to have out of securities lending and transparency, be it risk, return or reward. Sometimes, regulators will get hung up on associated activities, like cash collateral reinvestment, but securities lending itself is fairly well governanced right now, rules are usually coming out in the areas of short selling and cash collateral reinvestment. **SLT**

Tim Smith
Executive vice president
SunGard Astec Analytics

Japan

Japan's market is more 'relaxed' than some other regions as lessons learned from the Lehman collapse take hold

ANNA REITMAN REPORTS

Japan's economy has rebounded remarkably well after the devastating earthquake in March, considering the state of the global economy. Still, its fiscal policy will need to be expansionary to facilitate reconstruction efforts, says PIMCO's Asia-Pacific Portfolio Committee.

The investment manager's team notes that over the year ending in the third quarter 2011, the country's real GDP (accounting for inflation) took a hit, contracting a little over one per cent compared to world growth of 2.7 per cent. However, over the next year, the firm expects Japan's real GDP growth to fall between one and 1.5 per cent, a conservative estimate and in line with predictions for world economic growth.

No doubt the hot story is emerging Asia's growth, but developed markets such as Japan have been beneficiaries of the high single digit GDP figures. This is a welcome dynamic for a country that has faced two decades of stagnant growth after the Asian banking crisis in the 90s. One of the reasons why Tomoya Masanao, managing director in PIMCO's Tokyo office, believes that the country's economic growth will outperform other major developed economies this year is because the country's near-term policy focus will be on reconstruction from the March earthquake, leading to expansionary fiscal policies to facilitate them, in contrast to contraction in the US and Europe.

Masanao does not expect the Bank of Japan (BoJ) to implement aggressive quantitative easing in the near future as officials have publicly expressed concerns over central banks' ability (or inability) to control the government bond yield.

Still, the BoJ has intervened in FX markets three times this year to weaken the domestic currency. The last intervention on 27 October, immediately following Europe's announced haircuts on Greek bondholders, saw the domestic bond buying programme increase five trillion yen ($65 billion) while keeping interest rates at near zero.

In terms of the corporate outlook, Masanao identifies some risks. "We are worried about spillover effects of deteriorating external demand from both Western developed countries and emerging Asia...Japanese corporates generally maintain healthy capital expenditure plans, but those plans will likely be cut back if PIMCO's pessimistic outlook in the global economy materialises...We are also worried that political instability in Japan could further delay implementation of a large fiscal package for reconstruction."

In terms of securities lending trends, some market participants have noted that less stock is being loaned out but that corporate bonds, particularly domestic, are of increasing interest to clients. Since Japan's corporates have better standing, are more attractive than European corporates and are in a better position to raise cash, this could point to expectations of increasing activity in credit markets in anticipation of capital expenditures.

According to Data Explorers' third quarter review, the Japanese equities LongShort Ratio continued its downward trajectory fuelled by dividend trading and an element of directional short selling. The third quarter closed with over half of all securities falling within the 0-50 bps bucket and even fewer specials than before.

At end of September this year, lendable securities in Japan equity was at $348.1 billion and total balance out on loan was at $49.5 billion showing a securities lending fee of 36.95 bps and a securities lending return to lendable at 2.38 bps.

Notably, equity stocks in the Nikkei 225 showed returns of 1.48 bps with a lending fee of 18.93 bps and a utilisation rate of 5.11 per cent whereas Japan equity outside of the top firms by market cap showed a lending fee of 62.99 bps with a securities lending return of 4.82 bps and a utilisation rate of 9.9 per cent.

However, a spokesman at Data Explorers notes that as most Japanese companies which pay dividends do so at the end of the third quarter, the value of stock on loan tends to be inflated and more recent figures show it at $36.6 billion, slightly below the value before dividend season which was at $39 billion. Longs outnumber shorts by a factor of 10.

In terms of export growth, Japan has accelerated after several months of stagnation, while its merchandise trade balance returned to surplus in September, according to Standard Chartered.

“Foreign investors have ceased liquidating Japanese equities and most major life insurance companies plan to rotate into [the government’s bonds] and other domestic assets in [the second half of the 2011 fiscal year]...We continue to think that [the yen] will not weaken sustainably until the US economy finds its footing and the tensions facing Europe subside. In terms of domestic factors, however, we are monitoring the sales tax debate as a possible source of future [yen] weakness. Recent flooding in Thailand may introduce another supply-chain disruption that could hamper Japanese trade just as recovery from this year’s natural disasters begins to gain traction.”

Heard in the market

Sources familiar with the market say that Japanese investors tend to have strategic holdings and those that lend out stocks are keen to recall them to claim voting rights, resulting in a short squeeze just before the record date. In general, the market is a “callable” one though “noncallable” shares, which can be borrowed for as long as needed, are in high demand and can be lent out for higher premiums.

Lenders tend to be global custodians, insurance companies and corporate pension funds while public pension funds do not participate in stock lending in consideration of reputational risks associated with shorting holdings.

Regulations, however, are similar to other mature markets. Recently, Japan’s Financial Services Authority (FSA) extended a short selling ban to April 2012 which has been in place since the Lehman collapse. Naked short sales are restricted and disclosures are mandated for holders of positions of 0.25 per cent or more of outstanding issued stocks.

Other measures include banning short sales on allocated stocks on public offerings. This is a result of hedge fund practices, which drove share prices down before returning stock to borrowers. The bans, says a market participant at a major firm, have not impacted the trading side but rather just increased operational considerations. He adds that Japan’s regulators tend to pay attention to enacted measures in other mature markets, particularly the US and consider whether they might make sense domestically.

Although noting that Japan’s domestic lenders are relaxed, the eurozone crisis has caused some international participants to pull out of the securities lending market over counterparty default fears. In general though, domestic lenders have learned lessons from the Asian banking crisis in the 90s and the Lehman collapse. Procedures to liquidate collateral have been put in place and domestic vendors are more relaxed than before over potential default fallout.

Meanwhile, developments for the advent of CCPs into the securities lending market are advancing. The target is to have a centralised pool of collateral or DvP system in place – something which is “definitely going to happen” though not for one or two years.

DvP development

In an annual report, president and CEO of the Japan Securities Depository Centre (JASDEC), Haruhiko Kato, outlined some of those development plans.

At present, securities companies, trust banks and other players are able to conduct securities lending transactions using cash, negotiable securities and other forms of eligible collateral, yet still face settlement risk since there has been no DvP settlement system.

In general, there are two types of transactions: securities-driven and cash-driven. On the whole securities-driven transactions, in which the lent securities are specified and cash and/or other securities collateralised, are predominant in Japan. Common reasons for borrowing stocks are to cover borrower’s shortages, lend stocks to customers and prevent fails. However, the absence of a DvP system has exposed the transactions to settlement risks.

Following the Lehman bankruptcy in 2008, counterparties could not accept receivable collateral despite having already delivered the lending stocks. At that time, although settlement fails in the market continued to occur up until the end of October, the Japan Government Bond Clearing Corporation (JGBCC) by and large cleared up the settlement fails by the end of September, within just two weeks of the collapse of Lehman Brothers (Japan).

This reinforced the importance of mitigating settlement risk and in January 2010, the FSA, which oversees banking, securities and exchange and insurance, identified the strengthening of securities clearing and settlement systems as an “urgent issue”.

In a report in 2010 after consultations with market participants, the FSA recommended that “in order to reduce the settlement risk relating to stock lending transactions...possibly the parties should promptly prepare and publish a roadmap that includes the timing for the mandatory use of CCPs or the development of rules for DvP settlement.”

Following the regulator’s report, JASDEC set up a subcommittee for settlement with the participation of nine securities companies, five trust banks, one securities finance company as well as representatives from relevant regulatory bodies and associations.

The emerging model is a hybrid of collateral calculation and transactional DvP settlement methods expected to enter into service in 2014. **SLT**

Risk and reward

Risk appetites are coming back according to short interest data, says Data Explorers' Will Duff Gordon

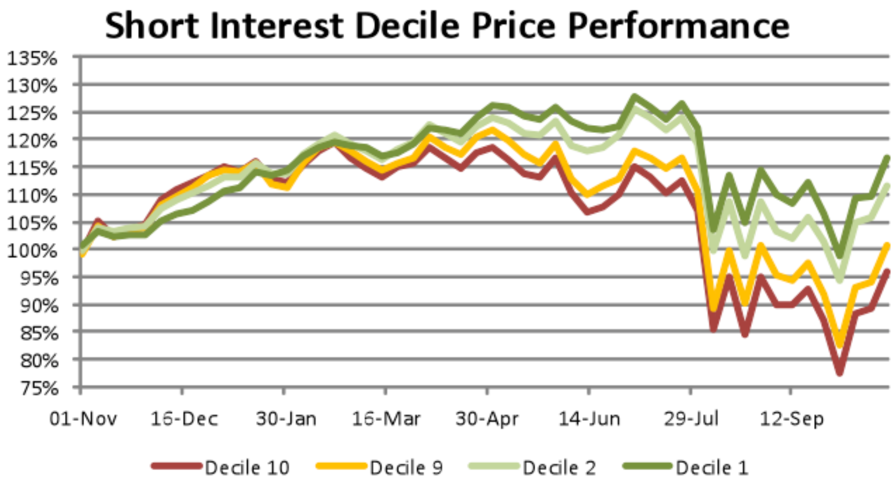
MARKET PERSPECTIVE

Fund managers shift their asset allocations in reaction to the ever unpredictable global tide of macroeconomic news, switching their level of risk exposure to avoid the worst of the market turmoil. Market commentary has recently focused on the 'Risk On Risk Off' trade. With this in mind, we looked at how US shares have reacted in the last year. Using short interest as a proxy for the level of risk in the US market, we analysed the performance of highly shorted shares compared to their less shorted counterparts. We found that shares with high short interest performed well in the first four months of the last year, only to reverse this performance from February. Yet this trend seems to be reversing in the last three weeks.

We looked at the constituents of the Russell 3000 to analyse the behavior of investors over the last year. This was done by grouping these constituents by deciles based on their level of short interest on a weekly basis. We then analysed the performance of these decile portfolios in the subsequent week, and then repeated the process weekly from the start of November 2010 to the week ending October 24th of this year. Positing that short interest is a proxy for risk, we expected that the different decile portfolios would react to global macroeconomic events as the market was gripped by tumultuous world events.

Short sellers on average focused on the small cap end of the Russell 3000 with the most shorted end of the index currently having an average market cap of USD 1.3 billion against an index average capitalisation of USD 5 billion. Large cap stocks were the least shorted, with an average market cap of USD 19 billion.

We also found that shorted shares on average tended to have higher volatility with a standard deviation of average weekly returns of 5.5 per cent as opposed to a 4.7 per cent for the whole index and 4.1 per cent for least shorted shares. This is in line with our premise of highly shorted shares having the greatest risk. Most of the volatility was observed in the second part of the year with the standard deviation of the most shorted shares jumping from 2.2 per cent in the first half to 7.4 per cent in the second. A similar jump in volatility observed across the wider Index.



Name	Ticker	Short Interest as % of Shares
LinkedIn Corporation	NYSE:LNKD	27.22
Alliance Data Systems Corporation	NYSE:ADS	25.25
Kinder Morgan, Inc.	NYSE:KMI	21.60
Microchip Technology Inc.	NasdaqGS:MCHP	19.08
Digital Realty Trust Inc.	NYSE:DLR	17.88
BorgWarner Inc.	NYSE:BWA	17.26
Ecolab Inc.	NYSE:ECL	15.32
Core Laboratories NV	NYSE:CLB	12.79
Fastenal Company	NasdaqGS:FAST	12.64
J. C. Penney Company, Inc.	NYSE:JCP	11.39

The chart below highlights the returns of the different portfolio. The highly shorted shares (Deciles 9 and 10) matched the returns of the least shorted shares (Deciles 1 and 2) until end of February. Since then, the highly shorted shares started to underperform the market. This is also the point at which the market started to turn volatile (See Chart).

As of October 28, the portfolio comprised of the least shorted shares performed the best on average with a cumulative return of 16.7 per cent over the year, whereas the portfolio with the most shorted shares performed the worst with a cumulative loss of four per cent over the year. On the whole, the most shorted shares tend to be contentious, either seeing the best or worst returns in 29 of the last 51 weeks.

It is also worth noting that the most shorted shares have seen a good run of form in the last three weeks as the markets recovered from recent lows, seeing an average return of 7.6 per cent, against 6.6 per cent for the market. This makes it best performing of the 10 decile portfolios. Shares currently featured in the most shorted decile include LinkedIn, Alliance Data Systems and Kinder Morgan with 27 per cent, 25 per cent and 21.6 per cent of their shares shorted respectively (See Table).

Conclusions

We have found that shares with the greatest short interest do have higher volatility and therefore risk. These shares have underperformed their less shorted counterparts throughout the worst of the market turmoil, yet this trend seems to be reversing in the last few weeks. **SLT**

Will Duff Gordon
Research director
Data Explorers

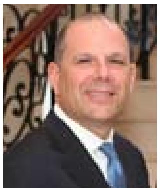
Industry appointments

State Street's global markets chief **David Puth** has left the bank after three years running the business.

Puth headed up the business at a time of market turbulence, and weathered a senior executive exodus as a core team of senior executives left the bank to start up the ill-fated Premiere Global Securities Lending. The departures led to a number of lawsuits, which were completed earlier this year with what was generally seen as a win for State Street.

Puth will be pursuing other opportunities within the financial services industry, said a spokesperson for State Street. He was appointed head of investment research, securities finance and trading activities at State Street in August 2008. He moved to State Street from Eriska Group, a consulting firm that he founded, and had previously worked at Chemical Bank.

Merlin Securities has announced the appointment of **Rick Bensignor** as chief market strategist.



Prior to joining Merlin, Bensignor worked at Morgan Stanley as a strategist and is a widely followed behavioural economist. As an adjunct instructor at New York University, he taught behavioral economics and finance theory as well as trading and technical analysis courses.

In his new role at Merlin based in New York, Bensignor will produce behavioral market strategy research focused on a wide variety of asset classes and macro-economic commentary.

Stephan Vermut, founder and managing partner of Merlin Securities, said, "Fund managers benefiting from our powerful reporting systems, risk analysis, and comprehensive fund workflow solutions will now also be able to take advantage of Rick's market analysis, trading strategies and investment acumen. Having this type of seasoned professional as a resource is an incredible value-add for our clients."

Mike Rogers, executive vice president and head of global services Americas, will assume leadership of the global markets business in addition to his current responsibilities. Rogers is a 30-year industry veteran who led Investor Financial's capital markets businesses before it was acquired by State Street in 2007.

Paladyne has confirmed the appointment of **Jason Meklinsky** as senior sales director for the US region.

Meklinsky will be based in New York and responsible for sales of Paladyne solutions and technology to buyside firms as well as Broadridge customers. Broadridge acquired Paladyne in September this year.

He joins Paladyne from Cantor Prime Services where he was most recently managing director of prime brokerage sales and has also held positions at Merlin Securities, UBS and Bear Stearns, according to HFMWeek.

Bank of America Merrill Lynch (BAML) has announced the appointment of **Peter Klein** as global head of FX Prime Brokerage. In this role, Klein will be responsible for further developing BAML's FX Prime brokerage business globally and ensuring that the firm is well placed to support FX services, including in prime brokerage and clearing.

He joins from a similar role at J.P. Morgan in London and was previously COO of a European hedge fund and earlier worked at Saxo Bank, where he established and led the bank's first overseas branch in London.

Peter Johnson also joins BAML at the end of this month as global head of Futures and OTC Clearing, based in Chicago, to whom Klein will report as well as to Chris Bae, co-head of Global FX trading and Kevin Connors, global head of FX Sales.

The Securities and Exchange Commission (SEC) has announced that **Peter Curley** has been named associate director for Clearance and Settlement in the US regulators trading and markets division.

In this role, Curley will oversee the Division's clearance and settlement program, which has been expanded significantly over the past two years.

Traditionally focused on securities clearing agencies and transfer agents, the Division's Office of Clearance and Settlement is now additionally responsible for implementing regulations under the Dodd-Frank Act for clearing agencies that clear security-based swaps and will be responsible for overseeing security-based swap data repositories.

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"I am pleased to welcome Peter to this important role," said Robert Cook, director of the SEC's Division of Trading and Markets.

"His significant expertise in both the securities and derivatives markets together with his senior management experience in the exchange industry makes him a tremendous asset for the clearing and settlement programme."

Prior to joining the SEC's Division of Trading and Markets in August 2010 as an attorney fellow, Curley was a senior executive with Hong Kong Exchanges and Clearing Limited, where he served as head of Corporate Strategy and head of IPO Regulation. **SLT**

Training and Education

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**
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**

Stephen Sheehan

SLT meets Stephen Sheehan, client relationship manager, Securities Finance at Citi's Global Transaction Services

Tell us about your career to date?

I started work at Citi Dublin in 1995 having completed an honours B.Comm degree at University College Dublin. I joined the securities team and was quickly involved in the daily operation of the business. I was involved in gilt and equity settlement, before the days of Crest and market dematerialisation and this gave me a really good understanding of the mechanics of the business. I also learned how to process Irish corporate and income events, which gave a thorough overview of the operational aspects of the industry. In 1998, I completed the Registered Representative programme of the Irish Stock Exchange and soon after transitioned to manage the Securities Client Services team.

I joined ABN Amro bank in 1999 and set about creating and managing a services team for its new Working Capital and Treasury group. Once in place there followed 18 months in the implementation team concluding with a further move into sales and relationship management where I spent a further three years. My focus was on structured cash management and treasury solutions for international corporations and subsidiaries. My time at ABN Amro provided me with exposure to a different corporate culture and the chance to drive client relationships and generate new business in the corporate banking industry in Europe.

In 2006, I returned to Citi joining the securities finance team. I was initially tasked with managing Irish-based securities finance relationships. My responsibilities soon broadened and I took on some relationships across EMEA. My current role combines relationship management and business development and I am now travelling more and working with Citi's local offices throughout Europe to further build the Securities Finance franchise. My role is varied and energising and I get to meet and work with decision makers across the asset management, banking, insurance and funds business on a daily basis across the region.

Securities finance is a compelling business to work in and my role is continually evolving, now one of business development. I see a bright future for the industry as it continues to provide an additional revenue stream for lenders despite the current headwinds across the financial markets.

How did you get into sec lending?

After six years working in International Cash and Treasury positions at ABN Amro I really wanted to get back into the securities industry and saw a position available at Citi as a securities finance product relationship manager. I already had a good, albeit basic, knowledge of securities lending and I was excited about the new role. I pursued my future manager for about four months, finally convincing him I was the right person for the job and started work in January 2006. I haven't looked back since.

I find securities lending a fast moving and dynamic industry and I feel fortunate that Citi provides a strong support structure for the team and more importantly for our clients.

Was it different to what you expected, if so how?

What really surprised me was the large number of dependencies and intricate relationships across the industry. Citi already has ties with all of our programme counterparties across a number of business lines and so dealing with and understanding the demand and supply sides of the business made it an enriching experience.

Has anyone helped or inspired you during your career?

We place a large emphasis on teamwork at Citi and when a problem needs solving we group together and work out the solution. I have found this approach invaluable.

On a personal level I have had a number of mentors throughout my career, people I have called upon from time to time. I found the one to one dialogue beneficial and have since turned mentor and now really enjoy helping colleagues in addressing the challenges that they face.

How did you find working through the industry's biggest ever crisis?

It was and continues to be an engaging experience. During the crisis the whole team dug deep to support each other and this approach has served us well in our ability to service our client base. We listened closely to the feedback from our lenders and have rolled out enhanced client reporting solutions as well as innovative revenue generating ideas.

What one thing would you change about the industry?

I'd like to see continued market transparency, so that all market participants are satisfied that the business can support its reporting and regulatory requirements efficiently and at industry level .

What are your ambitions?

I love the cut and thrust of the markets and the fast pace of global banking. I see myself running a global business with multiple lines of business across multiple jurisdictions. There would be a significant emphasis on IT and innovation and I'd be involved and hands on with all the team. It would be market driven with investment based activities, be fast paced and would require a diverse skills set across the team.

Outside of work what are your interests and pursuits?

Family time is precious, my wife and I have three boys, all under five. I'm an early riser so getting up with the lads is no problem. We usually head out to the park good and early and come back covered in muck ready for the day. I love cycling and I will often get up extra early to go up the Dublin mountains before the rest of the house wakes up, it really blows the cobwebs away! I took up Triathlons a few years ago and I really enjoy the excitement and build up at the start of a race. Golf is a huge passion of mine I've been playing since the age of 15 I especially relish matchplay when going head to head with someone else.

If you were given an unexpected USD / GBP 10 million bonus tomorrow what would you do?

First thing I'd do is get myself a vintage Piaggio Vespa. I like the convenience of motorbikes and the retro scooters also look great.

Then I'd book flights over to San Sebastian in Spain for my wife and I to try out some of their top michelin starred restaurants.

If you weren't working in securities lending what would you be doing?

I think I'd be a professional golfer playing the tours and the world's great courses. SLT

The views expressed in this article are of Mr Sheehan and not necessarily of Citi