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AIG's sec lending mess clearing up

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With the last of the Maiden Lane II (ML II) portfolio sold off, it seems there is further momentum in clearing up AIG's financial crisis securities lending woes. In this latest sale, the New York Fed sold assets with a current face amount of $6 billion through a competitive process to Credit Suisse Securities.

The five broker-dealers included in the competitive process were Barclays Capital, Credit Suisse Securities, Merrill Lynch, Pierce, Fenner & Smith, Morgan Stanley, and RBS Securities. In the end, ML II generated a net $2.8 billion gain, including $580 million in accrued interest on the loan and its sale will result in a full repayment of the $19.5 billion loan extended to AIG by the New York Fed.

William Dudley, president of the New York Fed, said, "The completion of the sale of the Maiden Lane II portfolio has resulted in significant gains for the public and marks an important milestone in the wind-down of the extraordinary interventions necessitated by the financial crisis."

Maiden Lane II was created in November 2008 in order to alleviate capital and liquidity pressures on AIG associated with the securities lending portfolio of several of the insurer's subsidiaries. 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.

In the third quarter of 2011, AIG returned to securities lending with arrangements in place to avoid a repeat disaster. 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 fourth quarter filings, AIG announced that there has also been headway on an outstanding dispute over securities lending losses with Transatlantic. The insurer has agreed to settle between $45 million to $125 million, with the final amount subject to the two parties reaching a resolution or being decided on by a mediator by June. "AIG has accrued an amount it believes is reasonable for this settlement," the insurer wrote in its 10-K filing.

NEWSINBRIEF

Clearstream and BNP Paribas team up

Clearstream and BNP Paribas Securities Services (BNP Paribas) have signed a letter of intent to intensify their cooperation on collateral management.

BNP Paribas customers will be able to consolidate their collateral holdings, via Clearstream's Global Liquidity Hub, to cover their global exposures from a single optimised collateral pool. Customers gain a double benefit: they will retain their asset portfolios within BNP Paribas' proven and established custody network while Clearstream's collateral management engine allocates, optimises and substitutes collateral on a fully automated basis across the books of BNP Paribas.

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OneChicago posts mixed February figures

OneChicago has announced that EFPs and blocks in February 2012 came in at 204,835 traded representing more than $1.3 billion in notional value. This is down from January's amounts, when 262,532 EFPs and blocks were traded representing more than $1.6 billion notional, however, looking year-on-year, blocks increased 187 per cent.

The equity exchange saw a total of 237,197 security futures contracts traded in February, compared to 301,804 in

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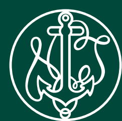

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Clearstream and BNP Paribas team up

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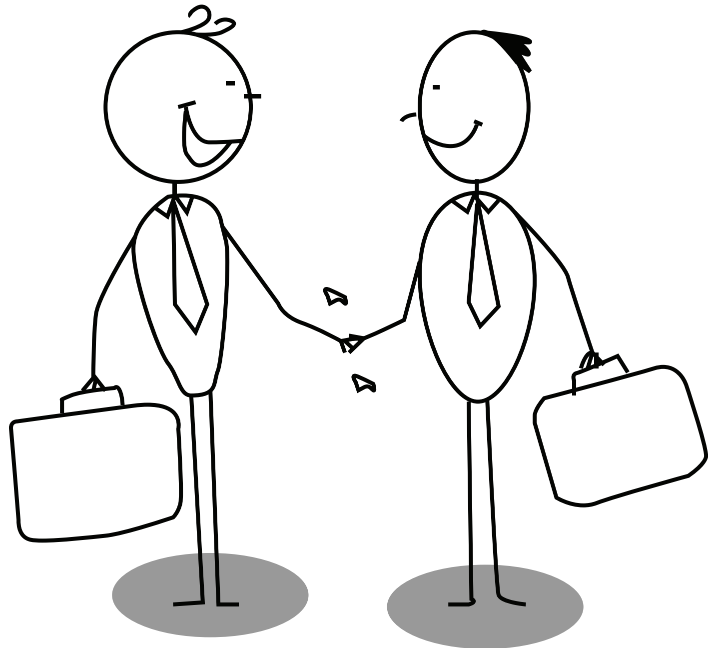
This partnership offers clients the advantage of Clearstream's collateral management service coupled with BNP Paribas' agent bank service. Pooling collateral across the globe in one central hub while allowing collateral to remain in its custody location – ie, agent banks or CSDs – brings cost savings and security to the client.

Collateral consolidation enables the financial industry, and in particular sell-side firms, to reduce operational risks, operational costs and opportunity cost resulting from collateral fragmentation. Additionally, mutual clients of BNP Paribas and Clearstream will benefit from pooling and optimising collateral positions held in custody across the two organisations against the rapidly expanding range of exposures covered by Clearstream's Global Liquidity Hub.

Jeffrey Tessler, CEO Clearstream, said: "We are delighted to extend our long-term partnership with BNP Paribas to add a fourth layer to our Global Liquidity Hub initiative: partnerships with agent banks. Liquidity Hub Connect builds on our established quad-party collateral management service established with them five years ago. This is a further example of Clearstream's commitment to strong partnership and we are expecting to add further agent banks to the model over the course of the coming months. We will also continue to grow the other pillars of the Global Liquidity Hub by entering further strategic partnerships with market infrastructures such as CSDs, accessing further CCPs and signing further agreements for central bank money access on a global basis."

Alain Pochet, head of clearing, settlement and custody at BNP Paribas Securities Services, said : "We are committed to providing our clients with maximum flexibility to manage their collateral requirements across key markets while delivering bespoke domestic and global settlement and custody services.

"Strategic partnerships, such as this first one with Clearstream, complement perfectly our collateral management offer as bilateral agent for buy side and sell side institutions."



OneChicago posts mixed February figures

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January. 56,170 February 2012 futures valued at more than $490 million were taken to delivery.

Open interest stood at 392,732 contracts on the exchange at the end of February 2012 and 37 per cent of month-end open interest was in OCX.NoDivRisk products.

New high for BondLend

BondLend has announced record trading for the month of February 2012. The 45 per cent year on year growth is attributed to increased participation across North America and Europe.

The platform now has 16 lenders and 29 dealers active daily. Oscar Huettner, BondLend global product manager, commented, "February's record volumes illustrate the value of BondLend's automated solution to fixed income securities financing. Since launching BondLend in 2011, we have expanded our borrower and lender client base and have consistently seen increases in trade volume from our existing clients. "

EU regulators adopt CDS short selling rules

The European Council has adopted rules which introduce common EU disclosure requirements and

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harmonise powers in "exceptional circumstances". The decision was taken without discussion at a meeting of the Economic and Financial Affairs Council meeting. The United Kingdom abstained, the European Council (EC) said in a statement.

"The regulation - which also had to be agreed by the European Parliament - covers all types of financial instruments, but given the potential risks posed by short selling this form of trading is a central element to be governed by the new rules," the EC said.

Transparency rules dictate that for significant net short positions in shares of EU listed companies, the regulation creates a two-tier reporting model. At a lower threshold, positions must be reported privately to regulators so that the latter can detect and investigate short sales that might constitute abuse or create systemic risks. At a higher threshold, positions must be disclosed to the market in order to provide useful information to other market participants.

For sovereign debt, significant net short positions relating to issuers in the EU will always require private disclosure to regulators.

EC said the regulation is intended to address issues arising from regulatory arbitrage which occurred in the wake of the 2008 financial crisis, when governments implemented a variety of national rules without pan-European coordination. At the same time, the regulation is also intended to acknowledge the role of short selling in ensuring the proper functioning of financial markets, in particular in providing liquidity and contributing to efficient pricing.

To tackle the increased risks posed by uncovered short sales, the proposal requires that anyone entering into a short sale must at the time of the sale have borrowed the instruments, entered into an agreement to borrow them or made other arrangements to ensure they can be borrowed in time to settle the deal.

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However, these restrictions don't apply to the short selling of sovereign debt if the transaction serves to hedge a long position in debt instruments of an issuer. Moreover, if the liquidity of sovereign debt falls below a specified threshold, the restrictions on uncovered short selling may be temporarily suspended by the competent authority.

ESMA's role as a coordinating body was affirmed as well. The EU financial markets regulator is currently in consultation with stakeholders on implementation of these rules. ESMA expects a final report and submission of the draft advice to the Commission by mid-April with regulations due to enter into force in November, which will then be binding across all EU member states.

Clearstream and ISS launch proxy voting services

Clearstream and Institutional Shareholder Services (ISS) have launched a service which will allow customers to manage meetings for assets in the securities lending programme and vote on positions pledged as collateral.

The new service was delivered in advance of the 2012 proxy voting season and covers all Clearstream proxy voting markets and eligible instrument types, including eurobonds and investment funds, for both the ICSD in Luxembourg and CSD in Germany.

The enhanced proxy services provides customers with extensive and timely information throughout the lifecycle of a meeting, with a range of options, including the ability to send and receive information via SWIFT and through ISS' online system, ProxyExchange.

Philip Brown, member of the executive board and head of client relations, Europe & Americas and head of product development at Clearstream said, "As the focus on corporate governance intensifies globally, investors increasingly need state-of-the-art asset services to support their active ownership initiatives. Our new enhanced proxy voting solution offers customers a superior quality service across the widest possible set of securities and markets."

Global market initiatives such as the United Nations Principles for Responsible Investment and recent regulatory developments such as the introduction of investor stewardship codes in various markets highlight the important governance role of investors in exercising their active ownership rights, including voting at company meetings. The implementation of the EU Shareholder Rights Directive is working to remove the practical impediments to voting, such as share blocking, in EU markets. Clearstream notes that the enhanced service addresses many of the "pain-points", ultimately making it easier for its customers to exercise their voting rights.

OCC securities lending up seven per cent in February

OCC's stock loan programme, including OTC and AQS, saw a seven per cent increase in new loan activity with 68,820 new loan transactions in February.

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Year-to-date securities lending activity is down three per cent from 2011 with 132,046 new loan transactions in 2012. OCC's stock loan programme had an average daily notional value of $21.9 billion.

Total cleared contract volume in February surpassed 351 million contracts, representing a two per cent decrease year-on-year. OCC's year-to-date total contract volume is down seven per cent from 2011 with almost 689 million contracts.

Greece taxes OTC securities lending transactions

The Greek parliament has voted a new tax of 0.2 per cent on OTC securities lending transactions that settle in the local CSD, HELEX.

The amount will be calculated as 0.2 per cent of the value against payment trades, or 0.2 per cent of the amount derived from the stock closing price on trade date.

The tax will only be payable by the lender and will be applicable to all investors, including those that are exempt from taxes or duties. It will be passed on as an out-of-pocket expense in the same way as the stock sales tax. The removal of the stock sales tax and the implementation of a Capital Gains Tax (CGT) instead are still scheduled to be effective as from 1 April 2012.

Euroclear Bank noted that tax is not due for OTC securities lending activity between two accounts in its facility.

NYSE and NASDAQ February short interest

Short interest was relatively flat for NYSE and NASDAQ though NYSE Amex saw an increase for the two-week period to 15 February.

NYSE's short interest rose to 12.6 billion shares from 12.5 billion shares. The short interest on 15 February was equal to 3.3 per cent of the total shares outstanding.

NASDAQ too was mostly flat staying at 6.8 billion shares across 2740 securities compared with the same across 2,742 securities in the previous reporting period. The short ratio, or the number of days' volume represented by outstanding share positions, was 4.9 days of average volume, compared with 5.4 days for the prior period.

NYSE Amex saw a slight lift in short interest to 404.9 million from 402.0 million. A short position of 5,000 or more shares existed in 340 issues. Some short position was shown in 501 issues.

Italy's short selling ban to expire - Bloomberg

Italy will not be extending a short selling ban due to expire last week, said the chairman of Consob speaking to press at the London Stock Exchange, reports Bloomberg.

"We will let it expire quietly," said Giuseppe Vegas as reported by Bloomberg. "We have no plans to extend it."

This does not come as a surprise to the market since it follows other European countries which allowed short selling bans to expire this month. Greece's short selling ban is in place until July this year.

Whether or not this moves countries like Korea to also reconsider policies to ban short selling adopted in August when markets plunged is in question, though some observers have said that there is likely to be a shift in attitude after presidential elections scheduled for the end of this year.

Eurex Group reports February trading volumes

In February 2012, the international derivatives markets of Eurex Group recorded an average daily volume of 8.7 million contracts (Feb 2011: 10.3 million).

Of those, 6.0 million were Eurex Exchange contracts (Feb 2011: 7.1 million), and 2.7 million contracts were at the US-based International Securities Exchange (ISE) (Feb 2011: 3.2 million). In total, 179.3 million contracts were traded, thereof 125.8 million at Eurex and 53.5 million at the ISE.

Eurex Exchange recorded in its equity index segment, the largest product segment, approximately 58.3 million contracts compared with 58.4 million contracts in February 2011. Futures on the EURO STOXX 50 Index stood at 21.4 million contracts while 23.9 million options on this index were traded.

Futures on the DAX totaled 3.0 million contracts while the DAX options reached another 5.2 million contracts. The Eurex KOSPI product reached 2.6 million contracts, compared to 138,000 contracts year-on-year.

The equity derivatives (equity options and single stock futures) segment at Eurex Exchange reached 30.0 million contracts (Feb 2011: 34.4 million). Thereof, equity options totaled 19.8 million contracts and single stock futures equaled 10.2 million contracts.

Equity derivatives volume y-o-y is influenced by the change of contract specifications: In the first quarter of 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 monthly volume figure in the equity derivatives segment in February 2012 would have been approximately 35.4 million contracts under the previous, old contract specifications.

The Eurex segment dividend-based derivatives totaled approximately 691,000 contracts; single stock dividend derivatives peaked at a new monthly record of around 266,000 contracts. Commodity derivatives reached around 80,000 contracts. Turnover of volatility derivatives grew by 76 per cent and achieved 243,000 contracts.

Eurex Repo, which operates Swiss Franc, Euro Repo and GC Pooling markets, recorded €236.4 billion average outstanding volume in all repo markets (Feb 2011: €282.3 billion). The euro repo market totaled an average outstanding volume of €160.7 billion, an increase of 36 per cent y-o-y.

The secured money market GC Pooling recorded an average outstanding volume of €129.5 billion, an increase of 40 per cent y-o-y (Feb 2011: €92.6 billion). The Swiss Franc Repo market reached €75.7 billion.

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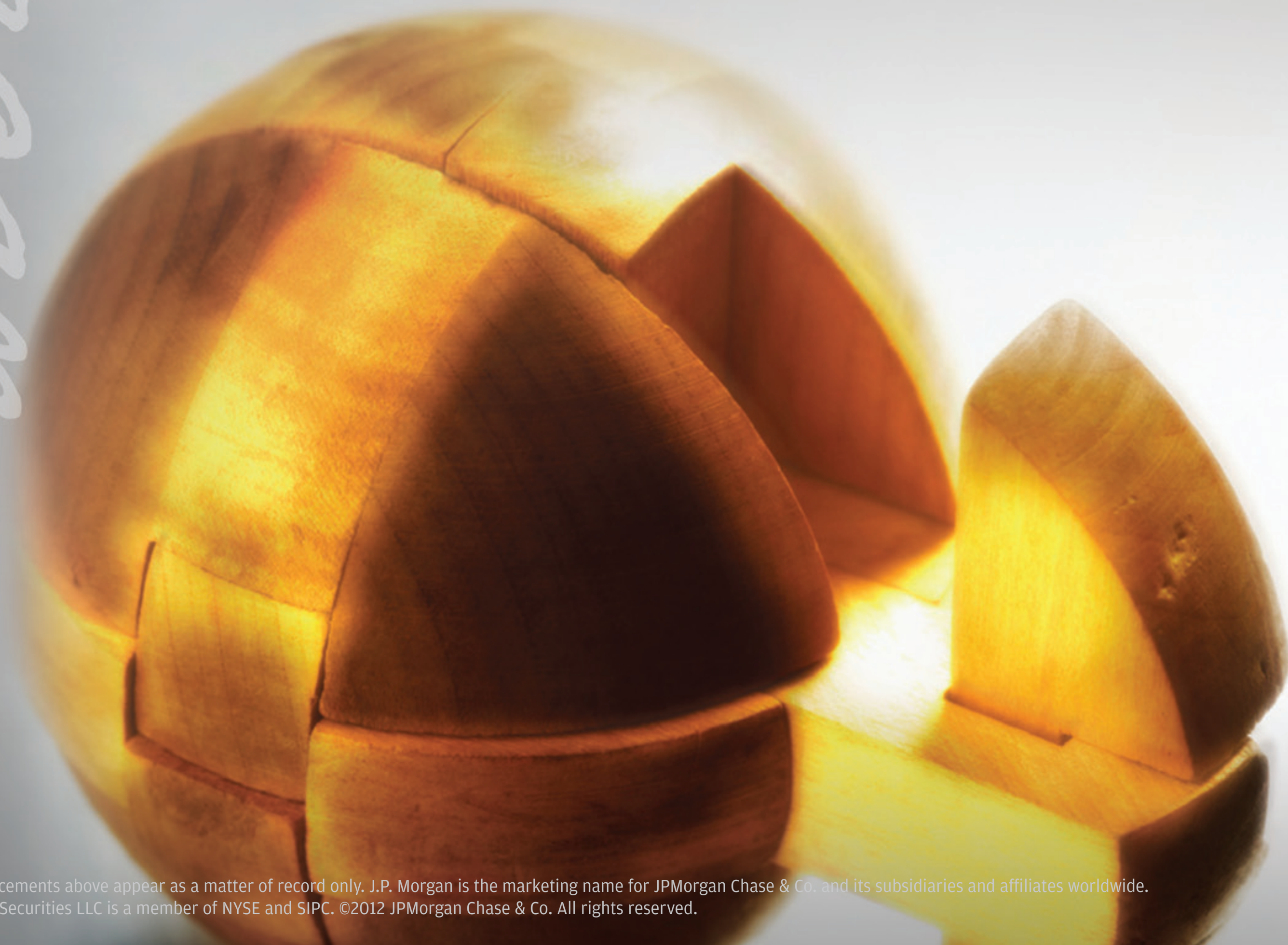

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All Shook Up

SLT talks to Jeffrey Kidwell about Direct Repo, the LTRO and singin' the blues

ANNA REITMAN REPORTS

What do the repo markets and an Elvis performance have in common? As it turns out, Jeff Kidwell. After a career in repo and securities lending spanning almost three decades in Manhattan, he moved to Florida to join AVM and co-found its direct repo business, where he focuses on connecting his cash provider clients directly with his collateral provider clients. And he still finds time to do Elvis.

SLT: Some of your Repo Commentary followers told me they wanted to know more about you on a personal level and what led you to this point in your career?

Jeffrey Kidwell: My education is actually in communication arts with a degree in English, along with some finance. I intended to be a journalist but instead managed to land a job at Morgan Stanley. Well, luckily I ended up at an investment bank rather than a newspaper, because it has given me the chance to do a lot of other things, like repo and securities lending for 29 years. I also get to write a daily market commentary, which entertains about 2150 people per day, including the Fed, the ECB and most of

the State Treasurers. I put in my time in Manhattan at Morgan Stanley and at Cantor Fitzgerald, cultivating sales and trading skills, and building client relationships, which led me to this new gig at AVM. When I left Wall Street in 2008, I wasn't sure what I wanted to do, and I had covered III Associates, which is the well-known hedge fund affiliate of AVM, and approached them with some ideas I had about a Direct Repo product. It was a way to utilise my client list and relationships with people on both sides of the market without necessarily reinventing myself or continuing to be a typical broker/dealer. I thought this was an exciting challenge and it reinvigorated me to be able to help the market move along its next evolutionary step in which cash providers and collateral providers could speak to each other. That is how I managed to end up in Florida, where I had to embrace the difficult lifestyle: golf, beautiful weather, fishing and boating. There are obviously a lot of things to do in this vacation destination paradise. I have also continued to be an Elvis tribute artist (since 1989) and I continue to travel and sing the National Anthem for major league baseball (since 2003). So, I even find some time to do my singing in Florida too.

SLT: Direct Repo is challenging the standard process in the market, how has this been accepted?

Kidwell: For somebody who had been in the market for a long time managing two huge broker dealer repo desks, you are not sure how a new idea is going to be accepted. After trading and selling for 26 years for a matched book repo desk, intermediating trades with clients on both sides and managing the risk for the broker/dealer, it becomes a very familiar comfort zone. It feels very different and initially unfamiliar, when you are talking about brand new ideas in the market and a new way of thinking, even if it is simply about augmenting the liquidity provided by the existing broker/dealer repo desks. It is not like the cash providers and collateral providers which I am speaking with now weren't actually trading with each other then, it is just that they had several intermediaries between them, but they have always ultimately been trading with each other.

Because broker-dealers' balance sheets have shrunk so much, the pipeline is tight - we think of it as a 'crimped pipeline' - everybody is under more pressure and there is less liquidity for the actual collateral provider or cash provider at either end of the pipeline. So, people are trying to create other pipelines.

SLT: Why not make the pipeline bigger?

Kidwell: Well, I think they would like to, but with all that has happened since Bear Stearns and Lehman Brothers, senior managers at a lot of broker dealers want to reduce the use of capital and reduce balance sheets, Basel III, Dodd-Frank, Volcker rule, and all these other reforms, financial taxes and so on, are going to actually reduce the pipeline again. Getting back to pre-Lehman levels is probably not going to happen right away, if ever again. But what is happening is that other pipelines are emerging. For instance, there was a pipeline in the news recently, corporate treasurers are now doing triparty repo directly with European banks, which is interesting because it followed an article which came out three months before showing that money funds had stopped doing as much triparty repo with European banks. Corporate treasurers don't commonly enter the repo market directly, they traditionally go through money funds, but because the money funds pipeline became crimped as they decided to pull back from European banks, a new pipeline emerged with those corporate treasurers who had invested in those money funds deciding to go directly to European banks. Now that new pipeline has gone from $2.5 million to $250 million, jumping 10-fold in one year. And there are other new pipelines forming - like prime custody. Custodians are offering this new product that allows the hedge fund borrower of securities to speak directly to the actual lender of securities, bypassing the traditional prime broker. It is another pipeline that custodians have decided to offer to augment liquidity. Where it used to be just money funds and prime brokers providing a pipeline, other pipelines are emerging.

Another important example is the new Fed pipeline, which they actually referred to as Direct Repo, despite the AVM trademark, in which the Fed chose to expand their cash counterparties. They normally only deal with primary dealers, but now have announced a connection with money market funds and government-sponsored entities (GSEs) such as Fannie Mae, Freddie Mac and Ginnie Mae. The Fed needed to expand their counterparty base to whom they could ultimately sell or repo securities because they recognised that the 21 primary dealers right now do not have sufficient balance sheets to take on all of those securities - ironically the $2.9 trillion of securities moved from the balance sheets of the primary dealers to the Fed's in the first place in their quantitative easing operations. On top of that, those primary dealers could be more balance sheet and capital constrained going forward, by upcoming regulations, such as Basel III, SEC guidelines, Federal Reserve reporting, new banking regulations, FDIC regulations, etc.

SLT: What support do these pipelines need, technological or otherwise?

Kidwell: The Direct Repo concept would use all the same technology that is already in place. To the extent that a state municipality has been doing repo with a broker dealer or doing cash re- investment with a securities lending agent or custodian, they can still be doing that, but now they will just have more counterparties. So the securities lending agent will show maybe six more counterparties, but the mechanics are the same. For example, if it's triparty repo, there is no additional technology needed because the securities lending agent already has it in place: If they are doing it for 10 broker dealers, then they can do it for 10 broker dealers and five REITs. To the extent that the cash provider or the beneficial owner are doing their own repo or cash re-investment, then I would be the one who would show them more counterparties.

But beneficial owners, who do their own re-investment or cash providers who do their own repo, may wind up doing some more, or different, counterparty credit work initially. Monitoring might actually be easier for them to check the credit of some of these new counterparties than it has been for checking their current counterparties. REITs, for example, produce quarterly reports and financial reports online. But doing the initial counterparty credit work, that is going to be a little bit more intensive because it is slightly different than what they are used to. They are slightly different animals. When you are studying a lion, you have become familiar with what a lion is – you know it has four paws, teeth, and a tail. Now, you may be analysing a panther, which may have different eating habits and habitat, but is still a similar animal.

SLT: Where is Direct Repo at right now and where is it going?

Kidwell: The nature of the repo market , in my experience over 29 years, despite our advances in technology and electronic trading, begins with people getting comfortable with each other. It starts as an OTC product, over the phone or emails, and then it can move down the road to an electronic form. But when you are talking about a new product, it has to start OTC. People need to get comfortable with new people that they are dealing with. Once they are comfortable with the players that are involved, it can eventually move to an electronic platform and that is probably where things will go down the road for this product, just as it has with derivatives and other OTC markets. You start out OTC, then move to electronic, then move to a centralised clearing counterparty (CCP).

Right now, we have clients on both sides of the fence sitting down at the table and talking to each other, which is a major milestone. We have asset managers sitting down with municipalities. Already the counterparties involved have realised that it makes sense, it is an evolution that could result in significantly better income for both sides, better protections from a haircut standpoint, and more client sector diversification. They are just now working out the mechanics of counterparty credit approval and the questions they should be asking to get their documentation in order.

SLT: Where would you like to be by the end of the year?

Kidwell: I am confident that by the end of the year, many more cash providers will be changing investment policies to include high quality collateral providers as counterparties and taking advantage of this pipeline. I would like them to get more interested in who the counterparties ultimately were

When you have more intermediaries in a market, you have less information about the other side and I think the market is moving towards more transparency and getting more comfortable with that

that were doing business on the other side with their broker dealers. When you have more intermediaries in a market, you have less information about the other side and I think the market is moving towards more transparency and getting more comfortable with that. I am sure that the Federal Reserve and other regulators probably welcome that too. Clients don't want surprise headlines and they want to know when they are doing business with a counterparty, who the ultimate counterparty is that they are dealing with. In Direct Repo, we are talking about ultimate counterparties, the owners of the collateral and owners of the cash. In the case of a broker-dealer as a counterparty, clients would like to know where the broker-dealer obtained those securities and how many counterparties are in that repo chain. This leads to the topic of shadow banking and rehypothecation, which is a big discussion for the market right now and regulators are figuring out how they should regulate that. Securities can be rehypothecated countless times, the actual rehypothecation market is some $16 trillion in the US, so securities have been repo'd and repo'd so many times, that the actual owner of the security may be seven clients removed. When there is a default situation and liquidation is necessary, it can be unclear how that path gets unravelled.

SLT: The ECB's attempts to pump in liquidity have most recently taken the form of the three-year LTRO, can you provide some of your thoughts on the operation?

Kidwell: The LTRO is good for the overall markets' liquidity for banks, broker dealers and especially European banks. I also think that most of the 523 banks, which took down a total €489 billion in December 2011, are gearing up to try and participate in the second LTRO [On 29 February, figures showed that 800 banks drew €529 billion in the ECB's second LTRO].

It is inexpensive money at one per cent for three years and the theory is that banks will then be able to use that money in investments, particularly in their sovereign debt, building up their own capital and ultimately their native economies.

SLT: How does it compare to the Fed's QE programme?

Kidwell: One positive is that the ECB has expanded all of the collateral it will take with the LTRO, all sovereigns, ABS, corporate bonds, a lot more higher-yielding securities than the Fed's QE took. But it is not that different from the $2.9 trillion balance sheet move by the Fed from broker dealers, which in turn gave the broker dealers and banks all that cash. There is a concern, however. Banks and broker dealers did not in turn necessarily use that money in the US market, but tended to dress up their own balance sheets, improved their own capital position, and went through cost cutting. I don't think they lent money out to the market or consumers in the way the Federal Reserve expected and there is a risk of the same thing happening with the ECB's LTROs. In fact, if you look at the first LTRO, almost all of the money that was borrowed by those banks is currently sitting deposited in the ECB in their overnight deposit. It is not being lent out to any other banks or clients. That is a concern, the ECB is trying to get money in the hands of banks to improve the financial conditions of the market and assuming those banks are now going to buy more sovereign debt to prop up those sovereign nations or that they will lend money to consumers or clients to get the market going. But the point of fact from this first LTRO, and from the Fed's QE programme for that matter, is that this is not happening.

SLT: What might this mean for the securities lending market?

Kidwell: That is another concern. The higher yielding products that the ECB is now vacuuming up in the LTRO will significantly decrease the amount of securities that are available for reinvestment for securities lenders. Securities lenders loan securities out of their portfolios directly or through their securities lending agents to broker dealers who are short the securities. Or, they trade with hedge funds or other clients who are short the securities. Securities lenders then take the proceeds or cash and reinvest or swap into those higher yielding products now moving to the ECB to create incremental income for the portfolio.

So, yes, the LTRO is a good thing from the side of liquidity for the market, but there is no guarantee that banks are going to use the money the way the ECB thinks and then there is this unintended consequence of reducing the amount of securities available for securities lending. On one of the panels I moderated at the IMN Beneficial Owners conference on 1 February 2012, one of the panellists representing a major securities lending firm very specifically noted that this could be a "game changer" for securities lenders. **SLT has left the building**

Jeffrey Kidwell
Co-founder and managing director, Direct Repo
AVM, LP and III Associates

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Forward focus

MX Consulting's new senior partner talks about her new role, and what she feels the securities lending industry needs to focus on

BEN WILKIE REPORTS

SLT: Can you talk about your experience in the market?

Sarah Nicholson: I have worked for Aviva Investors and its predecessor companies for over 20 years. After working in most securities lending roles I spent six years heading up the UK business before becoming the global director of securities finance for the last five years. In this time I sourced and implemented new lending and risk systems as well as helped develop the global business covering all elements of financing including lending, derivative collateral and secured funding.

SLT: So what are you doing now?

Nicholson: I decided last year it was time for a change and, after handing the reins over to Mick Chadwick, left Aviva Investors in November. I have always been interested in the broader industry as a whole and I started working with ISLA almost immediately - looking at some of the issues the industry as a whole faces. I have been involved with ISLA for over 10 years as a board member and I am enjoying having the time and the opportunity to get more hand on in representing the industry. I have now also decided to join MX Consulting as a senior partner.

SLT: What made you join MX Consulting?

Nicholson: I have always enjoyed identifying opportunities, working out what is needed to seize them and developing solutions to implement them, so a role in consultancy has always held some attraction. I have known MX Consulting for a long time and I have always recognised their focus on providing strategic solutions, enabling businesses to manage growth and maximise opportunities. The MX team all have extensive experience and expertise from working in the securities finance industry rather than coming from a more generic background, which is perhaps more common for consultancy firms. This has meant that MX has been able to design and build large scale system solutions across the industry, for both buy and sell sides, enabling greater automation, cost efficiencies and links between different businesses within the same firm. Importantly for me, they can add an immediate and relevant perspective as well as tangible value very quickly.

SLT: What will you be focusing on?

Nicholson: I will be overseeing the business consultancy side of the business. As I said before MX has a wealth of experience which can help firms maximise their business model and meet the challenges ahead.

The level of regulation that is impacting now, or will impact in the next 18 months or so, is unprecedented, and I want to focus on helping businesses prepare and meet this challenge, as well as help identify any potential opportunities that this may offer. Regulatory harmonisation across Europe will ultimately be a good thing for the industry but the journey may be difficult.

Regulatory and compliance departments are already at full stretch and the nuances of securities finance means that impacts are not always obvious to non-practitioners/specialists - and just keeping up with the sheer volume of regulatory change is challenging - let alone finding cost effective solutions. Understanding the regulatory change and ensuring that the impacts on securities finance activity are identified early enough to ensure compliance is critical.

One of the biggest issues will be in producing data for capital and risk analysis, at the granular level the regulators require. MX has already developed some product based solutions in this area which can easily be configured to any agent's programme or beneficial owners' requirements. Businesses that are in good shape to meet the requirements of the regulators will be in a better position to identify and maximise opportunities as they arise.

SLT: What do you think the future holds for securities lending?

Nicholson: There are so many moving parts and uncertainties at the moment it is difficult to see how the industry will look in the future. Understanding regulation and having the flexibility to meet the requirements is a must have whilst keeping costs down, but businesses also need to keep focused on growth and development.

The lines between securities finance and other investment strategies are fading and the disciplines ingrained in lending are in high demand in other areas. Regulation and difficult market conditions means that the demand for collateralisation is only going to continue to increase. This in turn drives the need for optimisation and efficient inventory management and financing skills.

With the buy-side now also focusing more on balance sheet considerations and risk management techniques, securities finance will increasingly be seen as of strategic importance in managing risk and generating all important additional yields. I think you will see more focus on specific transactions rather than flow business, especially as investors adjust their portfolios to become more capital efficient.

There are opportunities for lending desks to further align their businesses to the client needs and add real value but only if they can understand the changing landscape and their clients' changing needs. **SLT**

Sarah Nicholson
Senior partner
MX Consulting

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Securities lending siesta

Spain's securities lending market has dropped off the radar in the wake of short selling bans

ANNA REITMAN REPORTS

Spain's securities lending markets have been forgotten as the country's sovereign debt and banks' LTRO participation take centre stage. Meanwhile, low trading volumes after a six-month short selling ban are only just starting to become known.

In its financial results for 2011, Bolsas y Mercados Espanoles (BME), the stock operator of all markets and financial systems in Spain, writes that the ban on short selling in place since August and throughout the year "undermined cash equity market turnover and led to a liquidity squeeze in the order book, resulting in bid-offer spreads widening and an increase in implicit transaction costs for investors".

Revenue in the equity business unit during the year dropped 3.4 per cent versus 2010 to €133.3 million. The number of equity trades totalled 46.1 million with a turnover of €927.3 billion. These figures imply a 13.0 per cent increase in the number of trades and a 10.7 per cent reduction in turnover, year-on-year, reports BME.

The high levels of volatility and uncertainty seen in the third quarter which spurred regulators to impose the ban persisted in the final quarter of 2011. As a result, in the fourth quarter, trading value in equities was €206.6 billion, a year-on-year decline of 29.8 per cent, with trades down 9.5 per cent. The impact on derivative market volume was even bigger, with a 44.1 per cent slump in the notional value of index derivatives and a 30.1 per cent drop in equity derivatives compared with the same quarter the previous year.

Yet, equity investment flows channelled through the exchange in 2011, including shares already admitted to trading and new shares admitted, amounted to €37.7 billion. This reflects growth in investment flows in both newly-listed companies and companies already admitted to trading. The total implies a 35.1 per cent increase compared to investment flows channelled through the exchange in 2010, the fourth-highest figure in the history of the Spanish securities market.

In the context of investment flows in equities, €4.0 billion were instrumented via scrip dividends in 2011, a 91.9 percent increase versus 2010. Meanwhile, fixed income trading volume soared by 41.4 per cent to €5.6 trillion in 2011.

Size and structure

Though the ban was lifted in February, the market continues to become increasingly long. According to Data Explorers, the LongShort ratio for Spanish equities stands at 7.1, the highest it has been since mid-April of 2011. The value of stock on loan is $7.4 billion against a lendable supply of $53.2 billion.

Securities lending is common practice in Spain. Every loan executed on securities listed on the Spanish market must be communicated to Iberclear, the Spanish CSD, which keeps control of security loans outstanding in separate client accounts.

According to the Spanish markets regulator, Comision Nacional del Mercado de Valores (CNMV), legislation allows margin trading and provides two different systems for securities lending. The credito system is commonly used by retail investors dealing in Ibex35 stocks. The prestamo system is more commonly used by institutional investors and covers a broader range of securities, including ETFs and shares listed on Latibex, the only international market for Latin American securities. Margin trading using the prestamo system is the most important method for short selling on the spot market, notes CNMV.

But lately, interest has been diverted to the repo markets and the participation of Spain's financial industry in the LTRO. Money and risk managers in European banks will not be very much enthused with securities lending, said Jorge Vrljicak, analyst at Westside Consultants, instead, they will be watching FX markets closely amid criticisms that the ECB's intervention is causing currency debasement.

"The interest rate parity between the euro and the dollar has embedded an average spread of 50 basis points since before 2008. That spread is waning,w having reached 80 basis points during the worst days of the crisis and is now at 40 basis points. This is because banks are perceived less risky and all these contracts go through banks," Vrljicak explains, adding that he sees securities as taking a second or third row position in the eyes of investors.

He also sees a potential shift in the high quality government debt markets in an environment flush with the ECB's money, limited leverage and low interest rates.

"The LTRO displaces certain liabilities on a bank's balance sheet. Banks don't have unlimited leverage, so selling low yielding bonds and taking on second or third grade could become attractive. For example, it is not that you have a bund base and on top of it you pile Spanish bonds, because you don't have leverage wiggle room, it is that you sell bunds and buy Spanish

or Italian bonds. So there may be a shift in the market that will impact collateral" Vrljicak says.

Troubled economy?

Though unemployment in the country remains persistently high, hovering at around 20 per cent, commentators are noting that there have been positive signs that the government is getting control of public finances.

Vrljicak notes that the consolidation of "caxias", or domestic banks, is moving forward in a positive direction. Meanwhile, Mariano Rajoy, Spain's prime minister, is reigning in public finances. One of the more recent moves by the government has been to get municipalities' public debt out in the open. Still, a larger than expected deficit from the previous government, which was 8.5 per cent of GDP in 2011 compared to a target of six per cent, will make it hard to meet the EU-agreed deficit target of 4.4 per cent this year.

The Financial Times reports that Rajoy said Spain would do "everything we can" to cut the budget deficit because the public sector could not carry on spending €90 billion more than it earned each year, but that this statement was wrapped in a request for other eurozone leaders to soften deficit targets in the face of an imminent recession.

This may cause controversy within the EU, but for Spanish companies, it may have few implications. "Spain's economy is still not doing well and mortgages will continue to be a problem for a while, but Spanish companies diversify their investments globally. Telefonica, for example, has more investment in Latin America than in Spain and it is the same for renewables company Iberdrola in the US. Union Fenosa and Repsol also have large investments outside Spain" Vrljicak says.

Opening markets

Of all the criticisms levelled at Spain, perhaps the most heated discussions, with both trade and post-trade infrastructure market participants, are in response to the country's protectionist leanings.

BATS Chi-X Europe (BATS) recently bumped their market share to 3.4 per cent in January 2012 compared to 1.9 per cent in the same month the previous year. But BME still controls 95 per cent of trading. And in terms of post-trading, when BATS announced four-way CCP interoperability for the markets it trades within Europe, only Spain was excluded.

However there have been some signs that the country will move forward on opening up the market to competition.

When the crisis came to a head in the summer of 2011, Spain's reliance on domestic structures had caused risk to accumulate. Spanish banks were holding Spanish government bonds with all transactions going through the domestic clearing system.

As this risk reached thresholds of tolerance, some banks went to outside CCPs – Eurex Clearing in Germany and LCH.Clearnet in France and the UK. By September 2011, the Spanish bond government clearing services at LCH Clearnet cleared trades with a total notional value of more than €1.5 trillion. Nine Spanish banks were active as direct clearing members and a further two operated as repo dealers under a third-party clearing arrangement.

Since then, MEFF, the domestic CCP, has changed its model to be compatible with other CCPs in Europe.

Meanwhile, Spanish banks have been the biggest receivers of the ECB's three-year LTRO. The first round of the ECB's liquidity programme saw Spanish banks increase holdings of sovereign bonds by 29 per cent to €230 billion over the two-month period between December and January. The second liquidity injection shows that a further €530 billion has been tapped by some 800 banks, compared to €489 billion by 523 banks in December 2011, of which almost 50 per cent of the latter is attributed to Spanish and Italian banks.

"Aside from accessing this funding from central banks, the crisis has pushed domestic banks to avail of international liquidity funding through repo by using non-domestic CCPs, which has helped Spanish banks weather the storms," says Godfried De Vidts, chair of the European Repo Council of the International Capital Market Association (ICMA).

"I think this opening up is irreversible and particularly new regulations, such as EMIR and MiFID II, are going to further underpin this. ESMA has the powers to name and shame if national authorities don't apply new regulations within three months. In a way, domestic limitation of markets is over. In the last two years, Spain has realised that domestic barriers do not help the market, instead of resisting change, endorsing change is the strategy now and I think it will continue to be going forward," he adds.

CSD regulations from the European Commission, anticipated for publication in March, are expected to target cross-border charges in Europe and national favouritism. One of the goals of the single market is that the place of issue for securities will no longer be the determining factor for where investors hold them.

But De Vidts believes that there will be more opening up beforehand. Iberclear is part of the Link Up Markets initiative with Clearstream in Luxembourg, which will allow investors to keep securities with the ICSD instead of Spain for non-domestic banks.

"For an international client, like an insurance company which has equities across many countries, it makes sense to consolidate their holdings in one place, it is much cheaper administratively. So I see this interconnectivity as a sign that the market will open up before the regulation is final," he says.

It remains to be seen what that might mean for securities lending markets. SLT

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If stock is received from a loan on TD+3 but the sale is not settled before 15:00 i.e. T+3, then a short sale fine of one per thousand of the cash amount of the sale would be applied + late settlement fine.

If stock is received from a loan on TD+4 and the sale is settled on T+4, a fine of two per thousand of the cash amount of the sale would be applied + late settlement fine. If not settled before 15.00 on TD+4, the trade is bought in by the CSD.

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Dividend arbitrage crackdown

Some market participants think FATCA is throwing out the baby with the dividend bath water

ANNA REITMAN REPORTS

The tax fallout from the financial meltdown is settling on the securities lending markets. New temporary and proposed US Treasury regulations were issued in mid-January concerning withholding taxes imposed on cross-border securities lending and related transactions.

At the American Bar Association Section of Taxation meeting in San Diego, which took place from 16 to 18 February, tax lawyers were holed up in hotel conference rooms for the duration and, despite the gorgeous weather, even drew curtains closed to better view the slides, writes Lee Sheppard in Tax Analysts, noting that practitioners were "shocked and disappointed" at how the US Treasury had decided to go forward on these rules.

The most cynical observers see this set of regulations, which are an outcome of FATCA, as a politically motivated manoeuvre which taps into public anger at rich hedge funds escaping taxes by engaging in dividend arbitrage trades.

Hedge funds avoiding taxes makes for great headlines, but, in the complete absence of any cost benefit analysis, critics point out that the cost of compliance for companies caught in the net of the far reaching rules will greatly outweigh the amount of taxes collected. In addition, if a party really wants to avoid the withholding taxes, they will find some means of doing so.

The reaction from both sides underscores the polar divide between how the industry and government view securities lending and related transactions. Many people in industry believe the US government can have these rules or cross-border securities lending, but not both. The government is taking the stance that no transactions with the potential for abuse should be allowed and furthermore, will not water down the rules to help anybody "hide trades".

Securities Lending Times talks to John Taylor, US tax partner for King & Spalding based in London, to get his thoughts on the implications.

SLT: Equity swaps have been the synthetic answer to cross-border stock lending transactions, can you give an indication on the current status of both markets in terms of tax regulation?

John Taylor: Withholding on cross-border securities lending has been a hot topic for a number of years. Under the old rules it was possible to have a foreign to foreign securities loan over US equities where no related US withholding taxes applied. The old rules were effectively withdrawn in September 2010 when the new dividend equivalent withholding tax rules came into effect. Under the new regime substitute dividend payments relating to US equities are subject to withholding tax unless the payor can show that a US withholding tax has already been levied on the chain of transactions or is not otherwise due. The new regime is intended to ensure that at least one level of US withholding tax applies to a chain of securities loans. This regime also has procedures designed to minimise the possibility that multiple layers of withholding, so called cascading withholding, do not apply to a single chain of securities loans.

In contrast to securities loans, equity swaps under current rules allow someone to take a synthetic position in a US security without incurring US withholding taxes. This is in line with the general withholding rules for swaps. However, the current rules, also in effect since September 2010, do not apply if certain conditions are deemed abusive. These include a "cross in" or a "cross out" in connection with the transaction. These are the rules that are in effect for payments on swaps through the end of 2012. The newly issued guidance is much broader in scope and does not only target abusive transactions identified in the statute.

SLT: In a recent article, your team points out that this could be considered an "opening offer" by the US government, what do you mean by that?

Taylor: I think viewing the regulations as an opening offer to industry is the best way to look at them. At some point, the government's view on withholding on these types of transactions is going to have to be reconciled with industry realities, both in terms of how markets operate for non-US securities and in realising that rules that are too broad may foreclose abuse at the expense of non-tax motivated commercial activities. We are seeing more people look to move their US equities related activities into a US branch or subsidiary because of these concerns. That cannot be good long-term for US equities as I don't think other jurisdictions are, or will be, this restrictive. Everybody gets the point that the regulations should close down perceived abuses, but these rules go well beyond that and catch many non-abusive transactions.

SLT: Can you point out some of the rules that you think the industry should be paying attention to?

Taylor: The two biggest ones that come to mind are the "short term" and "in the market" filters, failing either one makes the equity swap subject to withholding. The short-term filter bites if the swap has a term of less than 90 days. That seems fair

until you learn that an unplanned early termination within the 90-day window taints the swap from the beginning. This means US withholding taxes apply even though the termination event was not intended and may have been totally unexpected at the outset. For example, if there is a triggering credit event or other objective termination event 80 days after the swap is entered into, withholding tax applies from the date the swap was entered into, not the date that the termination event occurs. So parties in the transaction can have ticked all the boxes to ensure no withholding applies (and priced accordingly), but due to a credit or similar event, which of course nobody in the market would want to happen, the transaction becomes caught by the rules.

The "in the market" filter is the other major rule to worry about. It applies if the long party is "in the market" on certain dates with respect to the underlying security, including pricing and termination dates. A tricky element to this filter is that it includes actions undertaken by affiliates and does not require that the market transactions are connected in any way to the swap. There is a 10 per cent de minimis rule, meaning total market transactions for less than 10 percent of the notional do not fail this filter, but this is practically meaningless if you cannot enforce trading restrictions internally across your affiliates.

SLT: What exactly under the "in the market" rule could make something a bad transaction?

Taylor: A simple example should illustrate some of the problems with the current formulation of this filter. Let's say you have a swap on Apple shares with a foreign long party. To avoid withholding on the swap the long party and its affiliates cannot sell Apple on the pricing day or buy Apple on the termination date unless such trades can satisfy the de minimis test in the aggregate. I am not sure that systems are available to monitor and police that. This may be particularly true for a fund with more than one asset manager.

A critical issue here is a lack of transparency on both sides. The lack of a connection between the "in the market" activity and the swaps means that a long party may not even know it has violated the rules. Neither party could know they have a bad swap. The US counterparty (which has potential liability as a withholding agent) does not have to be aware of these actions in order to be forced to withhold. Although IRS officials have said publicly that a party will not be held accountable for events it was unaware of, I am not sure that taxpayers are going to be willing to rely on that. The rules do not seem to provide for such an out and it is unclear whether representations will cover this situation. And can a long party even give representations in many circumstances due to the lack of sufficient internal controls?

In some ways, parties to swap transactions may have to presume they are in the wrong and withhold if the long party is not based in the US. This is why many people may move their trades onshore. However, I hope that some of the more problematic issues discussed above will be resolved in the final regulations.

SLT: How do you see this developing as the date for rules to take effect get closer?

Taylor: The proposed rules are supposed to take effect for payments on or after January 1, 2013. Because this includes payments under swaps entered into before that date people have to worry about these issues for any swap straddling next year. I think there will be efforts to convince the government that these proposed regulations are too broad and catch way too many non-abusive transactions. This process may mean a delay in the effective date for the regulations. More broadly, FATCA had tight timelines for implementation set by Congress and the Treasury extended them, in some cases to 2017, because compliance just wasn't reasonable until all the bugs had been worked out.

For equity swaps I believe government and industry both realise the challenges to getting something workable done. If there is no compromise on the dividend equivalent regulations by around October, there may be another extension of six months or another year to let the existing rules continue to apply until a solution can be worked out with the industry. I think we will have either a quick turnaround on the regulations or an extension of the current rules to allow people time to digest and implement the final rules when they come out. Hopefully the regulations will narrow their focus to apply only to genuinely abusive transactions. **SLT**

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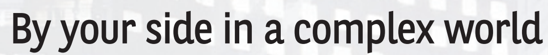

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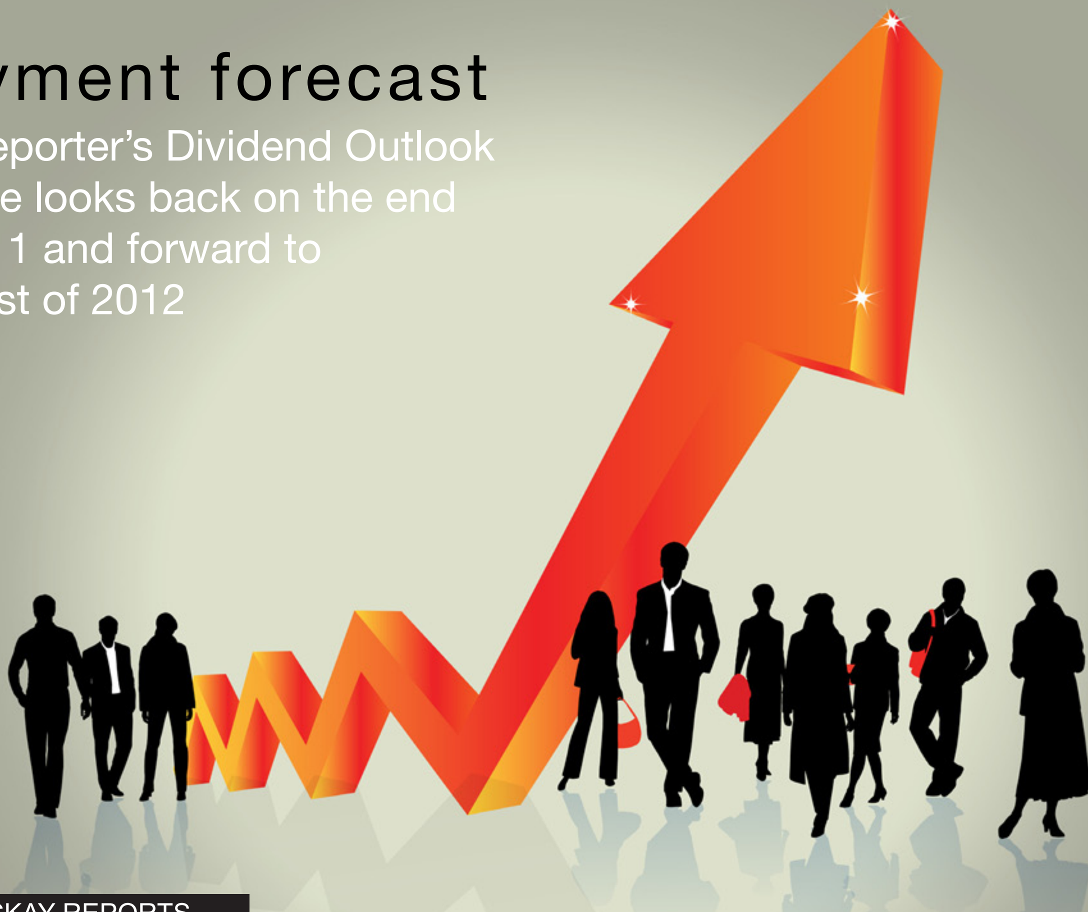
Payment forecast

Dealreporter's Dividend Outlook service looks back on the end of 2011 and forward to the rest of 2012



TOM MCKAY REPORTS

Q4 was a very turbulent time for European stocks following the Greek turmoil, which in August caused the stock markets to gain momentum in a negative dive. The worries that Greece would need more European help to refinance existing debt, as well as the haircut of about 50 per cent that bondholders would have to take was not the ideal start to the last quarter of the year. Despite the Greek events, which could potentially have catastrophic consequences for the majority of the stocks that Dividend Outlook covers, there has been a significant level of generosity in terms of dividends payments.

Q411 has shown 60 companies announcing dividend increases, with an average increase of 21.61 per cent. Seven companies have decreased their dividends, with an average decrease of 51 per cent while one company suspended its dividend with three companies having reinstated a dividend payment.

Not including companies that have suspended dividends completely, the largest decrease recorded was Portugal Telecom, which decreased its final dividend - due to be paid in January - from EUR 0.65 to EUR 0.215 for 2011. On the more optimistic side, Carnival Group increased its final dividend from USD 0.1 to USD 0.25. This higher level was maintained at each of the last four dividend payments. The average change of all dividends announced in this quarter was an increase of 10 per cent year on year.

The increase in dividend payments has been inflated by companies using equity to pay their dividends. In this way companies can maintain or increase large dividends payments without decreasing the cash on their balance sheets.

Out of all the dividends announced in Q411, companies that offered an equity option amounted to 32 in 2010. In 2011 this number increased to 38. Out of these increases, three were down to SCRIP issues and three to DRIPs. 30 companies maintained their current equity plans.

In term of special dividends announced, Q411 saw two special dividends paid compared to seven the in Q410.

In the last three months, the sector that reported the strongest dividend increases has been leisure, which has seen a 74 per cent rise in dividends year on year, followed by transportation and industrial: electronics, with 67 per cent and 43 per cent increase respectively. Three sectors had negative growth with two sectors seeing no year on year change. Defence was the worst affected with -21 per cent growth, while telecommunications and consumer:other both saw -2 per cent growth. Mining and media each did not report any changes. Despite the economic conditions, the 13 financial companies that announced dividends had an average increase of 10 per cent.

Geographically, Switzerland saw the biggest increase in dividends with an average increase of 43 per cent, followed by Ireland with 29 per cent. The UK had the biggest increase out of our major indices with an average increase of 14 per cent over the 52 companies that announced dividends. France followed with a six per cent increase with only eight companies announcing dividends. In this quarter, no companies in Germany's DAX index announced a dividend. The worst performing country was Portugal, with only one company announcing dividend, while Italy had the second biggest decrease, with six companies announcing dividends at an average decrease of four per cent in growth. Belgium and Luxembourg maintained the same level of dividends, with both having had only one company announcing dividends.

Dividend Outlook estimates for Q112

2012 is set to be a very volatile year, even in comparison to 2011. There are still many uncertainties that will be exposed more in the months to come, linked to Greece's future and how this will affect all European countries, as well as the fears about a double dip recession.

UK financial services company Hargreaves Lansdown is expected to report the largest in-

crease when it announces its final dividend for 2011 and Dividend Outlook is estimating a 211 per cent increase, to GBP 0.14 per share.

23 companies are expected to decrease their dividend, however only one of these is expected to cut its dividend completely - Credit Agricole SA -due to the political pressure French banks have been facing in recent months. The average dividend decrease for these companies will be 27 per cent. Not including companies cutting their dividend completely, the biggest decrease is estimated to be Schneider Electric SA with a 53 per cent cut to EUR 1.56.

16 companies are expected to maintain their current dividend payment. Out of these, five companies are estimated to maintain not paying a dividend: Alcatel-Lucent, ING Groep, Lloyds, Misys and RBS

122 companies are estimated to announce a dividend with an average increase of 27 per cent to their dividends. This is not including the companies that are estimated to reinstate their dividends, such as Edison International SpA, ITV plc and Jeronimo Martins SGPS SA. It is estimated that 72 of these companies will be increasing their dividend payments by more than 10 per cent

In Dividend Outlook's estimated data for 1Q 2012, the best performing country is expected to be Spain, with an estimated average increase of 37 per cent. From the major regional indices that we are tracking, the best estimated performer is expected to be the UK which has 72 companies announcing results and which will result in an average increase of 29 per cent. This is followed by Germany with a 14 per cent increase and France with 4 per cent decrease.

In our universe, there is only one Portuguese company announcing results - Jeronimo Martins SGPS SA - and Dividend Outlook estimates it will resume its dividend. Greece is the worst performer with a 25 per cent average decrease, followed by Finland with an eight per cent decrease.

Across the sectors, the best estimated sector is mining, with an average increase of 69 per cent, followed by real estate and then consumer, with 52 per cent and 45 per cent estimated growth respectively. At the lower end of growth there are three sectors which are estimated to see a decline in dividend values: Transportation, telecommunications and industrial sectors are all expected to see dividends decrease of around 5 per cent each.

Lately the financial services sector has been taking a hard hit with dividend payments, as many governments are trying to restrict any potential return to investors. The restrictions being enforced range from breaching covenants to being unethical to pay dividends. As result, many financial services companies are choosing to use equity payments, so that they can keep as much cash on the books as possible due to increased capital requirements. However, we are expecting an average increase in dividends payment of about 8 per cent across this sector.

Despite the leisure sector having the largest single estimated increase, the overall sector, which includes four companies, is estimated to see a 21 per cent increase.

It is estimated that there will be many opportunities for growth in dividend markets across Europe, however there are many events which could shut many potential areas of growth. Dividends in the past years have been increasingly significant for investors as volatile times have surrounded us, but 2012 looks to be more volatile for the market. This will mean dividends will have an important place in many investments over 2012 as European economic conditions change. **SLT**

dealReporter Dividend Outlook Europe is tracking a universe of over 400 companies from three major regional indices (FTSE 100, CAC 40, DAX) and two large Pan-European indices (FTSEuroFirst 300 and S&P 350) as well as a Dividend Outlook Ex-Index. Dividend Outlook started the 'Ex Index' to allow it to keep tracking companies unless they delist, as they could potentially have an impact on index arbitrage at a later date, when indices are adjusted. Dividend Outlook uses fundamental bottom-up analysis for its cash flow and dividend analysis and a statistical analysis model based on historical data to estimate dividend dates. All dividend changes represent year on year dividend change and do not include special dividends.

For more information on dealReporter Dividend Outlook call 020 7059 6237

Tom McKay
Senior analyst
Dividend Outlook

FEBRUARY 2012

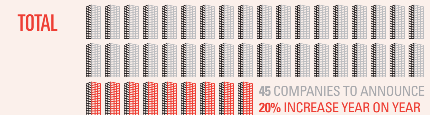
Dividend Outlook
A dealReporter product

PREDICTED DIVIDEND OUTLOOK FOR THE
NEXT 3 MONTHS

FTSE 100

CAC 40

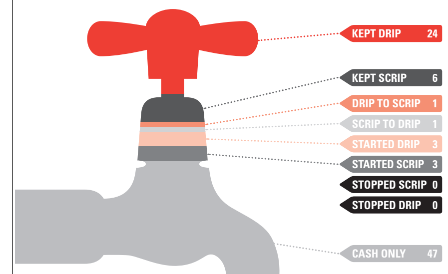
DAX
3 COMPANIES TO ANNOUNCE
10% INCREASE YEAR ON YEAR

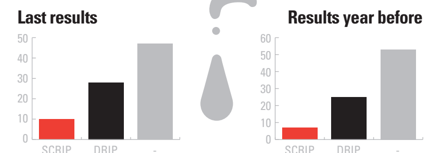
TOTAL


BIGGEST ESTIMATED INCREASE

ANNOUCEMENTS MADE IN THE
PAST 3 MONTHS

All historic numbers have taken out 3 companies that have not paid a compareable dividend before





BIGGEST HISTORICAL DECREASE (Q4)
- NOT INCLUDING SUSPENDED DIVIDENDS

BIGGEST HISTORICAL INCREASE

Dangerous Shorts?

Data Explorers' Will Duff Gordon looks at companies that appear to be ripe for takeover, yet still have significant short interest

MARKET PERSPECTIVE

With increasing momentum in the M&A market we have screened for companies that have seen their share prices take a battering that could make for potentially dangerous shorts should their underlying profitability make them attractive takeover targets.

Stocks covered include: Veeco Instruments Inc. (NASDAQ:VECO); First Solar, Inc. (NASDAQ:FSLR); GT Advanced Technologies Inc (NASDAQ:GTAT), Alpha Natural Resources, Inc. (NYSE:ANR), SUPERVALU INC. (NYSE:SVU); Safeway Inc. (NYSE:SWY), Best Buy Co., Inc. (NYSE:BBY), Home Retail Group Plc (LON:HOME), ITT Educational Services, Inc. (NYSE:ESI), Guangzhou R&F Properties Co., Ltd (HKG 2777) and Lonking Holdings Ltd.(HKG: 3339).

Companies are sitting on record amounts of cash and this is spurring a revival in the M&A market as companies take advantage of their stockpile of capital and a growing list of attractive takeover targets who have seen the value of their equity crippled by a harsh economic environment. Last quarter saw USD 876 billion of deals announced globally, the most in over three years according to S&P Capital IQ, and the USD 291 billion of deals announced so far this year have it on track to beat last year's levels. Against this backdrop, we have screened for firms which have seen their stock price drop significantly over the last year, potentially making them attractive takeover target and dangerous for those investors betting on the price continuing to fall.

Methodology

Whilst takeover targets are notoriously hard to predict, we have used S&P Capital IQ to screen for companies with low Enterprise Value to EBITDA ratios. This ratio measures a company's core profitability through EBITDA as well as the true cost of a company factoring in both equity and outstanding debt net of cash.

We looked at global companies with a market cap of greater than USD 1 billion that have a low and decreasing enterprise value to EBITDA meaning that their current valuation makes them potentially attractive to acquirers. Companies which have seen a fall in their share prices in the last year implies profits for short sellers, yet their low valuations could make them a potential acquisition target. Should this happen, a short seller would be exposed to any takeover premium offered by bidders.

Heavily shorted and cheap

The table below ranks the companies with the lowest Enterprise Vale to EBITDA ratios from our screening of 61 names that see heavy short interest above 10 per cent of the total shares.

Looking at the list of relatively cheap companies that also see high short interest, there are many shares with heavy exposure to consumer spending with retailers and consumer service providers making up a significant proportion of the list.

Solar firms feature prominently with component maker Veeco topping the list of most shorted names that could be attractive takeover targets. The company has the lowest enterprise value to EBITDA Ratio of only 2.0 and is subject to heavy short interest with 35.1 per cent of its total shares on loan. Also on the list is fellow PV component maker GT Advanced Solar, as well as perennial short favourite First Solar with short interest at 22.9 per cent and 18.6 per cent of shares respectively both with low Enterprise Value

Company Name	Exchange:Ticker	Price - % change over 1 Year	Enterprise Vale to EBITDA ratio	Short Interest as % of Shares Outstanding	Market Capitalization ($m)
Veeco Instruments Inc.	NasdaqGS:VECO	-43	**2.0**	35.1	1,048
Home Retail Group	LSE:HOME	-54	**2.2**	16.5	1,297
Vishay Intertechnology Inc.	NYSE:VSH	-30	**2.3**	14.2	1,777
ITT Educational Services Inc.	NYSE:ESI	-10	**2.9**	39.9	1,796
Fiat S.p.A.	BIT:F	-35	**3.0**	11.9	7,085
Best Buy Co. Inc.	NYSE:BBY	-23	**3.1**	10.3	8,653
GT Advanced Technologies Inc.	NasdaqGS:GTAT	-20	**3.4**	22.9	1,047
Alcatel-Lucent, S.A.	ENXTPA:ALU	-48	**4.0**	11.4	5,698
Transcontinental Inc.	TSX:TCL.A	-22	**4.1**	18.0	1,050
ASM International NV	ENXTAM:ASM	-4	**4.2**	12.4	2,081
SUPERVALU Inc.	NYSE:SVU	-24	**4.3**	38.8	1,386
Bill Barrett Corp.	NYSE:BBG	-25	**4.4**	15.5	1,373
Guangzhou R&F Properties Co., Ltd	SEHK:2777	-2	**4.5**	15.5	4,254
R.R. Donnelley & Sons Company	NasdaqGS:RRD	-26	**4.5**	36.1	2,467
Celestica Inc.	TSX:CLS	-19	**4.6**	20.9	1,995
Safeway Inc.	NYSE:SWY	-2	**4.6**	14.0	5,749
Trican Well Service Ltd.	TSX:TCW	-20	**4.6**	15.6	2,698
Janus Capital Group, Inc.	NYSE:JNS	-34	**4.6**	13.2	1,662
Bekaert SA	ENXTBR:BEKB	-68	**4.7**	10.5	1,975
First Solar, Inc.	NasdaqGS:FSLR	-78	**4.9**	18.6	2,793
Lonking Holdings Ltd.	SEHK:3339	-28	**4.9**	14.0	1,738

to EBITDA ratios. At these levels, it is worth asking whether they could be attractive takeover targets leading to shorts getting burned?

Retail companies in the screen are topped by the UK's much-maligned Home Retail Group, which sees the second lowest Enterprise Value to EBITDA ratio of 2.2 and short interest at 16.5 per cent against a backdrop of the shares having halved over the year. US names are led by electrical retail giant Best Buy, which has seen its share price fall by almost a quarter over the last year and has the sixth lowest Enterprise Value to EBITDA ratio of 3.1, with short interest at 10.3 per cent of the total shares. It is joined by other U.S. retail names including SuperValu and Safeway Inc, which see short interest at 39 per cent and 14 per cent respectively.

For profit degree programme provider, ITT Educational Services sees the greatest short interest in the screen, with almost 40 per cent of its total shares out on loan and an Enterprise Value to EBITDA ratio of 2.9, while the shares have only fallen 10 per cent over the year.

Asian names include Chinese real estate firm, Guangzhou R&F Properties Co, which sees an Enterprise Value to EBITDA ratio of 4.5 and short interest at 15.5 per cent of the total shares and construction specialist Lonking Holdings, an Enterprise Value to EBITDA ratio of 4.5 and short interest at 15.5 per cent. The shares in the latter have fallen a quarter over the last year.

Short covering

Looking at the shares in our screen which have seen the greatest amount of short covering is pertinent as it shows where shorts have decided to take profits. This could reflect a desire by short sellers to leave the scene before a potential takeover.

Alpha Natural Resources is the second name in our screen which has seen short sellers cover all positions over the last year. Alpha was also implicated in a potential tie-up in September last year.

Conclusion

Short sellers need to be wary of being exposed to a name in the face of a possible bid. Whilst it is hard to predict which companies are susceptible to takeovers, a good indicator is how profitable a company's core business would be to a potential purchaser. Cheap potential targets make for dangerous shorts as their profitability could make them attractive purchases. **SLT**

Potential Takeover Targets Seeing Short Covering

Company Name	Industry	Ticker	1 Year % Price Change	Entreprise Value to EBITDA	1 Year Change	Short Interest as % of Shares Outstanding	1 Year Change
Nyrstar NV	Metals and Mining	ENXTBR:NYR	-38	6.3	-1.4	**6.1**	- 16.4
Alpha Natural Resources, Inc.	Oil, Gas and Consumable Fuels	NYSE:ANR	-62	7.8	-0.2	**0.7**	- 15.5
Allegheny Technologies Inc.	Metals and Mining	NYSE:ATI	-32	9.8	-11.6	**0.8**	- 12.7
Thompson Creek Metals Company	Metals and Mining	TSX:TCM	-34	4.9	-3.7	**7.4**	- 11.4
TomTom NV	Household Durables	ENXTAM:TOM2	-31	5.4	-0.7	**7.1**	- 10.5
Covance Inc.	Life Sciences Tools and Services	NYSE:CVD	-14	8.2	-3.5	**5.0**	- 9.7
Logitech International SA	Computers and Peripherals	SWX:LOGN	-54	7.6	-4.1	**18.9**	- 9.6
JetBlue Airways Corporation	Airlines	NasdaqGS:JBLU	-15	5.8	-0.9	**18.0**	- 9.3
Con-way Inc.	Road and Rail	NYSE:CNW	-8	5.8	-2.9	**3.9**	- 8.4
CR Bard Inc.	Healthcare Equipment and Supplies	NYSE:BCR	-2	8.6	-1.4	**1.2**	- 8.0
Portfolio Recovery Associates Inc.	Commercial Services and Supplies	NasdaqGS:PRAA	-17	7.4	-4.4	**9.7**	- 7.9
SMA Solar Technology AG	Semiconductors and Semiconductor	XTRA:S92	-49	3.2	-0.8	**7.3**	- 7.8

Training and Education

Date	Location	Course	Provider
11-13 Apr	Singapore	**Dodd-Frank Act for Non-US Banks** The training course is aimed at helping banking, foreign corporations and professional practices understand the stakes involved and in this sense, offers an extremely valuable and unique perspective on how the Dodd-Frank may be interpreted for business, finance and the law.	Euromoney Training
17-18 May	London	**International Securities Settlements & Custodial Services** This training program 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
21 June	London	**The Repo Market** This 1 day course is designed for delegates who are new to the business of bond repurchase agreements (repos) and aims to explain how repos are priced, settled and why they are transacted by different participants in the market, including pension funds, hedge funds, market makers and derivatives users.	Eureka Financial
28-29 Jun	Hong Kong	**Repos and Securities Lending** Repos and Securities Lending provides a comprehensive and practical programme explaining the legal, regulatory and documentary issues involved in repo and securities lending transactions.	Euromoney Training
6-8 Aug	New York	**Repos and Securities Lending** This course will offer a start to finish discussion of the key terms of the Global Master Repurchase Agreement and the Global Master Securities Lending Agreement, as well as the agreements used in the U.S. domestic market. Attendees will be taken through the operative terms of the agreements, events of default, and the termination and close-out provisions.	Euromoney Training

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Industry appointments

Rule Financial has made a number of senior hires to support its growing business.

As part of the enhanced team in New York, **Ciaran Henry** joins Rule Financial, bringing his extensive experience of capital markets and applying these skills to a range of new clients. Henry, who reports into CEO Chris Potts, has over 25 years of experience in capital markets technology, gained at some of the world's leading investment banks; previously holding MD positions in the technology organisations of Merrill Lynch, JP Morgan Chase, and Credit Suisse.

Henry said: "Rule Financial has an industry-wide reputation for innovation and excellent project delivery and I'm delighted to be part of its expansion in the US market. The rapidly changing regulatory environment in the United States, fuelled by the ever evolving Dodd-Frank and the Volcker Rule, is creating significant challenges for global investment banking. As we support our clients in meeting these complex regulations, I anticipate further growth of the New York team."

In London, Rule Financial has appointed **Jim Warburton** as global head of the investment banking domain group, which will lead the development of client-focused propositions.

"Investment banks around the world rely on Rule Financial for support with projects in core areas such as OTC derivatives clearing, collateral management and optimisation, as well as multi-platform UX design and build for eTrading and risk reporting," said Warburton. "We have also witnessed a growing demand for application support and managed services that deliver cost savings and business efficiencies. I am keen to provide innovative new propositions that genuinely help our clients accelerate change and reap the benefits of leading business and IT innovation."

Reporting to Jim is new hire **Jeremy Taylor**, a specialist in operational processing and derivatives. Jeremy will be leading the delivery of Rule Financial's client offerings in the OTC derivatives area and related regulatory reforms.

Chris Potts, CEO, Rule Financial, said: "Growing the business in 2011 was a tremendous achievement for Rule Financial and a testament to the high quality work our specialists are performing within banks. Our consultants are the foundation of our business and we recruit and develop domain experts who truly innovate to solve the needs of the world's leading banks. We fully intend to develop these capabilities in 2012 with more investment in our domain experts and delivery teams, to offer world-class support to our growing client base."

Nicholas Pfaff has joined ICMA as a director in the Market Practice and Regulatory Policy department to strengthen the team in the association's Paris office.

Pfaff has significant knowledge of the public sector as a former senior banker at the European Bank for Reconstruction and Development. He also worked as an investment banker at BNP Paribas and Goldman Sachs and has extensive international experience.

Citi has appointed **Cheeping Yap** as head of fund services for Asia, excluding Australia, for its Securities and Fund Services business. In this new role, Yap, who will continue to be based in Hong Kong, will be responsible for growing Citi's fund services platform for the Asia Pacific region.

He will report to David Russell, head of Securities and Fund Services Asia Pacific and to Sanjiv Sawhney, global head of Fund Services.

David Russell said, "As our clients continue to look at investment opportunities in the region, they look to Citi as key enable for their business expansion. Cheeping's appointment underlines our focus to expand in a fast growing area of our business."

Yap joined Citi in Hong Kong in late 2006 as head of Securities and Fund Services for China, based in Shanghai. In July 2009, he assumed the role as head of Securities and Fund Services for Hong Kong where he was instrumental in expanding Citi's product offerings in exchange traded funds, Hong Kong and Cayman Unit Trust services, MPFA pension fund services and RMB fund services products in Hong Kong.

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HSBC Securities Services (HSS) has appointed **Dileep Venkatakrishan** as new head of client services for its Singapore team.

Venkatakrishan joins HSBC from J.P. Morgan's Treasury and Securities Services business in India, where he worked for over 14 years in a number of roles. Most recently, his role within J.P. Morgan was to lead the Client Service and Implementation teams within the Treasury and Securities Services business. **SLT**

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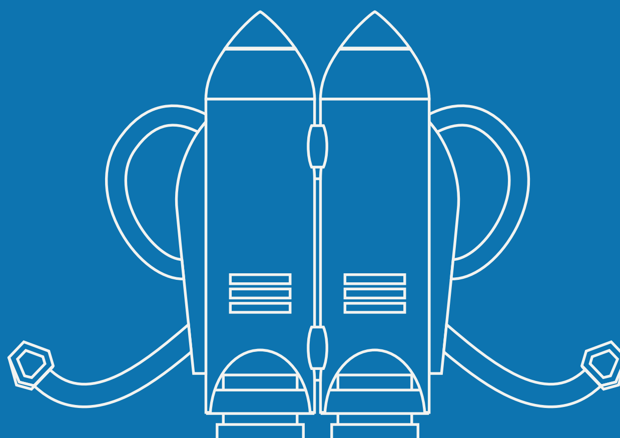

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