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Moody's: Merlin acquisition is risky business

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Credit ratings agency Moody's Investor Service has reacted negatively to the Wells Fargo Securities acquisition of Merlin Securities, a prime brokerage and technology provider based in San Francisco and New York.

In a note that was sent to clients, Moody's analyst Sean Jones called the acquisition of the prime brokerage firm, which serves more than 500 single- and multi-primed managers, "credit negative" because it shows that Wells Fargo Securities "intends to expand its capital market operations".

Wells Fargo agreed to buy Merlin for an undisclosed sum in late April.

The prime brokerage firm has a suite of integrated solutions consisting of its MerlinPrime and Merlin-SHARP products, and it provides open architecture technology, custody and clearing services, operational support and securities trading to clients in the asset management industry.

Merlin's team will join Wells Fargo, and its managing partners, Stephan Vermut and Aaron Vermut, will continue to lead its prime services offering.

Announcing the deal, John Shrewsberry, head of Wells Fargo Securities, said that the acquisition of Merlin is a "logical extension of our offering to the investment industry", adding that it is "increasingly focused on tools to enhance risk management and improve capital efficiency".

He said: "This transaction enhances our ability to meet customer needs and generate earnings for our shareholders, all while adhering to our disciplines of prudent risk management and controlled growth."

It is the fact that Wells Fargo is expanding into prime brokerage that is the problem for Moody's. Jones said that although Merlin is "small and has a limited balance sheet, we expect that Wells Fargo will build this business and seek to expand its products and services."

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NEWSINBRIEF

Pirum automates RQV processing

Pirum will start phase 1 of its new Tri-party required value processing service (RQV).

This new functionality offers a single solution covering the calculation, agreement, and processing of daily RQVs for all tri-party agents and across all counterparties, regardless of whether they use Pirum.

Daily RQVs for securities lending portfolios will be calculated by Pirum using clients' own data and rounding rules. The new service seeks to improve intraday visibility of proposed RQVs, and provides a single unified process for operations teams to use when agreeing and communicating RQVs to individual tri-party agents.

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Clearstream announces April 2012 GSF figures

Post-trading services provider Clearstream of the Deutsche Börse Group has released its April 2012 global securities financing (GSF) services figures.

For GSF services, the monthly average outstanding reached €570.7 billion.

The combined services, which include tri-party repo, securities lending and collateral management, collectively experienced a rise of 5 percent during April 2011 to €542.5 billion.

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Moody's: Merlin acquisition is risky business

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He added: "Prime brokerage is typically a balance-sheet and operations-intensive business, which requires robust collateral management capabilities. We do not believe that this is a traditional area of expertise for Wells Fargo's management."

Wells Fargo's traditional area of expertise, according to Moody's, is in the consumer and commercial banking sector as a mortgage provider, which "contributes the great majority of the bank's earnings".

Prime brokerage requires "different risk monitoring, management and governance skills than are the traditional expertise of this company", said Jones.

In a statement, Wells Fargo said it disagreed with Moody's assessment. It said: "This is a modest acquisition and a measured approach to entering the prime services market. It is a natural extension of the capital markets solutions we currently provide to our corporate and institutional customers and does not represent a material change to the risk profile for Wells Fargo Securities or Wells Fargo & Company."

Ratings agency Fitch Ratings does not think that the deal is that risky, according to its own assessment of the Merlin acquisition.

It said: "Wells Fargo is adding prime brokerage services under an open architecture framework to its suite of customer offerings. While Wells Fargo may use Merlin as a platform for further expansion, the transaction is still viewed as relatively small in nature."

Wells Fargo said it had "successfully grown" its investment banking and capital markets business through "thoughtful and measured" expansion, adding that this is based on "serving our customers' needs and by continuing our long-standing record of prudent risk management".

The acquisition of Merlin, which is subject to regulatory approval, is expected to conclude during the third quarter of 2012.

Pirum automates RQV processing

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Rupert Perry, chief executive of Pirum, said: "The new service automates an operational process which today requires significant manual work whilst simultaneously improving control in ensuring exposures are correctly collateralised".

Additional releases are planned over the coming months that will further extend automation of RQV processing via direct interfaces with both BNY Mellon and J.P. Morgan.

Sweden's NASDAQ collateral management shakeup

Sweden-based exchange and clearing company NASDAQ OMX Stockholm (OMX STO) set up three clearing funds to mutualise risk, and revised its collateral management structure so as not to rely too heavily on custodians that are also clearing members.

After these changes in March, S&P revised its outlook of the company to stable from negative.

S&P's statement said: "We are revising our outlook on the long-term issuer credit rating on the company to stable from negative and affirming the long- and short-term ratings at 'A+/A-1'."

"The outlook reflects our expectation that the company will complete the overhaul of its collateral management framework and that its cash flow will remain strong due to its leading position in the Nordic region's cash and derivatives markets."

Within the new framework, clearing members will directly pledge margin collateral in cash or securities accounts in the name of OMX STO in lieu of accounts in the name of Swedish custodians, as is currently the case.

S&P remarked that this should ensure that margins are immediately and directly available to OMX STO for liquidation in the event that any clearing member defaults.

The complete overhaul of the collateral management framework is expected to be completed by the end of 2012.

FinTuition launches new sec lending course

Training company FinTuition has launched a new securities lending education programme for professionals who want to develop an understanding of the industry.

The basics of securities lending course will be taught online and will include more than two hours of lessons.

Topics that the course will cover include supply and demand, trading, collateral and electronic execution.

Singapore's 2012 sec lending activity shows April increase

The Singapore Exchange (SGX) has released its securities lending activity figures for April.

SGX's figures show that the daily average outstanding loans under the securities borrowing and lending programme totalled S$26.9 million, which represents a 39 percent rise on the previous year.

Markit continues expansion with Cadis purchase

Financial information services company Markit has agreed to purchase Cadis, an enterprise data management provider.

The deal follows Markit's acquisition of securities lending data provider Data Explorers in April.

Cadis was established in 2007. Its customers include investment banks, central banks, insurance companies, regulators, asset managers and hedge funds.

Its enterprise data management (EDM) platform consolidates data from multiple sources within a centralised hub, providing users with reliable, transparent and auditable data.

The platform addresses data management needs such as front-to-back office integration and data frameworks for trading, pricing, and risk and compliance management.

The acquisition comes at a time when financial institutions are becoming increasingly reliant on EDM platforms to manage their data challenges and comply with new regulations, including Dodd-Frank, Basel III and Solvency II.

Markit's acquisition of Data Explorers in April also came in response to changing regulatory conditions in securities financing markets. The company is positioning itself to capitalise on new data management needs.

Of the Cadis deal, Lance Uggla, CEO of Markit, said: "Data management is top of our customers' agenda; the scale and sophistication of the data they are managing have never been greater. Following this acquisition, we will be able to provide our customers with Cadis' market-leading data management solution which has a fantastic track record for successful implementation."

Daniel Simpson, who is Cadis's current CEO, will continue to run the business once the acquisition is complete. The financial details of the deal were not disclosed.

Simpson said: "Data is increasingly at the heart of financial institutions. Our EDM platform ensures our clients have the data they require to drive sound decision-making. By combining our expertise with Markit's distribution and customer network, we will be able to help more firms meet increased regulatory pressures and risk management demands."

Scrabbling for collateral

Moody's are considering industry-wide downgrades, with Morgan Stanley taking a potential $9.6 billion hit.

After US financial stocks fell, the bank stated that counterparties may call $7.21 billion in additional collateral or termination payments if its rating is cut three levels by Moody's, and two grades by Standard & Poor's.

Though banks are counting on the shift towards central clearing to help mitigate the impact of a downgrade, Morgan Stanley would also have to post $2.4 billion in collateral to certain exchanges and clearinghouses, it said in a quarterly report filed with the SEC. Total additional payments are up from the estimated $6.52 billion recorded in the last quarter of 2011.

Citigroup is in a similar, though less severe predicament, foretelling that $4.7 billion cash would be needed to cover collateral for derivatives contracts and exchange margin requirements should its credit be downgraded by two levels.

Bank of America was the third bank that could suffer under a downgrade, reporting in a quarterly filing that it may be required to post $5.1 billion in collateral if it is downgraded two notches.

In a recent interview, CEO of Morgan Stanley James Gorman defended the company, saying that he would be surprised if Moody's made these changes.

"We've had two years of potential ratings action now coming out of the crisis. I think they remain an important input, but not the only input. I think Moody's is on a mission, but this would be a late

change—obviously, a lot closer to 2008 would have intuitively made more sense. Whether they end up moving to the more extreme ratings, I don't know. Look at the US corporations. We've all come through the stress test quite strongly."

Moody's is reviewing 17 financial institutions with global capital markets operations.

EquiLend and BNY Mellon team up to automate RQV communication

Trading and post-trade service provider EquiLend will work with BNY Mellon to migrate the communication of Triparty Required Value (RQV) figures from email to an automated process using the company's triparty automated deal matching (ADM) platform.

BNY Mellon needs a fully authenticated RQV instruction to collateralise the outstanding stock lending deals that are transmitted electronically or through a browser. This enhancement will allow EquiLend and BondLend users to increase the post-trade efficiencies in securities lending trades and to reduce operational risk by automating the service.

EquiLend will leverage BNY Mellon's automated securities finance platform, which will reduce systematic risks, to enhance this service and assist client requests for RQV communication.

The service will be offered to existing clients of EquiLend and BNY Mellon by the end of 2012.

Brian Lamb, CEO of EquiLend, said: "We are looking forward to a long and fruitful relationship with BNY Mellon's triparty collateral management business, particularly the opportunities and solutions that this partnership will create for the market."

"We are pleased to be partnering with EquiLend to automate an end-to-end collateral management solution for our clients and the market," added James Malgieri, head of global collateral Management and securities clearance at BNY Mellon.

Eurex reports sizeable growth for Euro repo market

In April 2012, the international derivatives exchanges of Eurex Group recorded an average daily volume of 10.9 million contracts, a 0.4 million increase year-on-year.

Of those, 8.3 million were Eurex Exchange contracts and 2.6 million contracts were traded at the US-based International Securities Exchange (ISE). In total, 156.9 million contracts were traded at Eurex Exchange and 52 million at ISE, making April the best month in terms of trading volumes of 2012.

Eurex Repo, which operates Swiss Franc Repo, Euro Repo and GC Pooling markets, reported for all Eurex Repo markets an average outstanding volume of €235.6 billion, a €39.9 million increase year-on-year. The Euro repo market reached an average outstanding volume of €166.2 billion in April, an increase of 42 per cent year-on-year.

The electronic trading platform Eurex Bonds, which rounds out Eurex's fixed-income product range, traded €10 billion in April, an increase of 12 percent compared to €8.95 billion in April 2011.

OneChicago releases April 2012 trading volumes

A total of 228,685 security futures contracts were traded in the month of April 2012, according to OneChicago (OCX), an equity finance exchange.

More than 200,000 exchange futures for physicals (EFPs) and blocks were traded. April 2012 EFPs and blocks activity represented more than $1.2 billion in notional value.

More than 65,000 of April 2012 futures, which were valued at more than $351 million, were taken to delivery, emphasising the use of single stock futures as an equity finance product.

David Downey, CEO of OneChicago, spoke at a US IRS public hearing, in response to the proposed new tax withholding rules under 871(m) of the 2010 HIRE Act, recommending that the IRS should exempt SSFs from the proposed rules.

34 percent rise in securities lending for OCC

Cleared contract volume reached 321.9 million contracts in April, a 5 percent decrease from the April 2011 volume of 338.6 million contracts, according to OCC.

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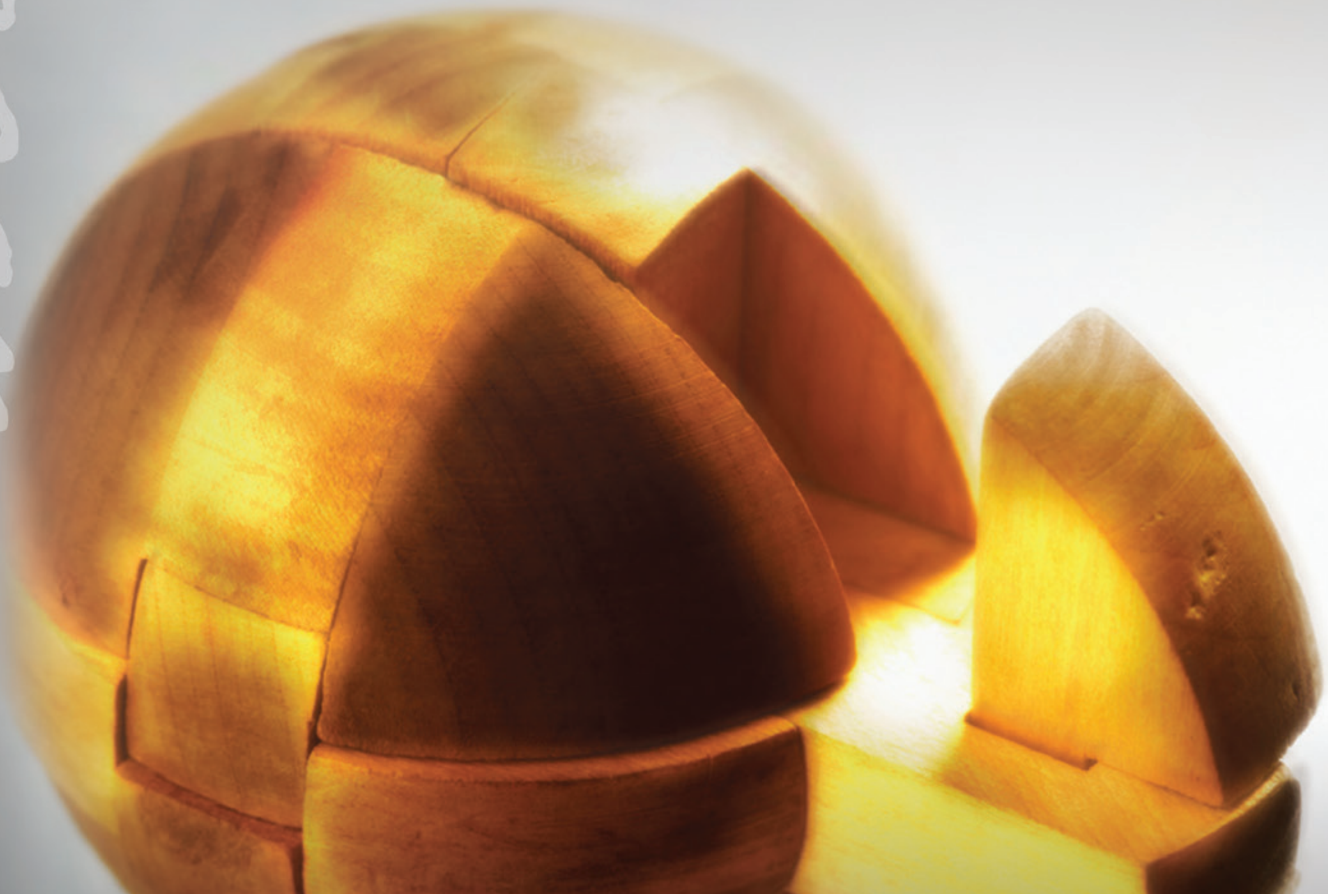

Based on Futures Industry Association data released in April, OCC's first quarter cleared volume of 1.07 billion contracts accounted for 57 percent of all listed derivatives contracts cleared in the US during that period.

Options trading volume and equity futures were both down by seven and 31 percent respectively year-to-year.

However, OCC's stock loan programme, including OTC and AQS, saw a 34 percent increase in new loan activity over April 2011 with 79,826 new loan transactions in April. Year-to-date securities lending activity is up 11 percent from 2011 with 295,150 new loan transactions in 2012.

BNY Mellon updates collateral management platform

BNY Mellon is renovating its collateral management platform for institutional clients by introducing an online central messaging service allowing market participants to transmit margin calls, substitution instructions and interest statements electronically.

BNY Mellon will be using AcadiaSoft's electronic margin call system MarginSphere.

"We recognise the need to help streamline the margin process in a way that is compliant with emerging risk management infrastructures," said James Malgieri, head of global collateral management and securities clearance at BNY Mellon.

"A wave of new regulations is reshaping the over-the-counter derivatives market and our new messaging platform is just one way we are helping our clients prepare," said Scott Linden, managing director of BNY Mellon's global collateral management services business.

NICE to detect securities fraud

NICE Actimize is to provide a hedge fund trading compliance solution designed to monitor the activities of hedge funds across all cash market and derivative asset classes (exchange-traded and OTC).

The solution includes a broad range of analytical models designed to detect illicit or behaviour such as insider trading, market manipulation, securities fraud, and deceptive practices.

Amir Orad, president and CEO, NICE Actimize, said Dodd-Frank will mean more controls will be needed for hedge funds. "To accomplish this, they must effectively partner with a solutions provider whose approach supports a comprehensive compliance risk management strategy that provides quick assessment of company policies and procedures to combat improper and/or unauthorised dealings."

Miranda Mizen, director of equities research for the TABB Group, a strategic advisory and research firm focused on capital markets, said: "As a heterogeneous group, hedge funds need quality products and custom solutions that fit the size and nature of their individual businesses to ensure they can balance regulatory compliance with the cost of doing business."

Hong Kong stock exchange tightens short selling rules

The Stock Exchange of Hong Kong has tightened the rules that regulate the short selling of designated securities after it conducted a review earlier this year.

Short selling has come under fire in the wake of the financial crisis as politicians and regulators attempt to stabilise financial markets.

The move to tighten restrictions for short selling in Hong Kong follows the enactment of similar legislation in the US and Europe.

The Stock Exchange of Hong Kong plans to increase the eligibility criteria for market capitalisation and turnover velocity from HKD$1 billion to $3 billion and 40 percent to 50 percent respectively.

In a statement, the exchange said: “The change reflects the fact that the average market capitalisation of listed companies in Hong Kong has grown by around three times and the market turnover velocity has increased from around 40 percent to over 50 percent in the past decade.”

“Had the new short selling eligibility criteria been adopted in the last quarterly review in April this year, 82 out of the existing 646 designated securities would have become ineligible for short selling.”

The Hong Kong Securities and Futures Commission has approved the new short selling rules.

They will come into effect on 3 July.

Deutsche Bank roasts coffee mogul

Company founder of Green Mountain Coffee Roasters Robert Stiller was forced by his bankers to sell $125.5 million of stock after borrowing against his own shares.

After the company’s stock fell 48 percent, lenders started to demand more collateral on outstanding loans.

The sale cut Stiller’s stake to 5.4 percent from nearly 10 percent in March, with the company’s board removing the 68-year-old of as chairman and publicly condemning the transaction, saying it was inconsistent with the company’s internal trading policies.

Stiller bought a coffee shop in a Vermont ski town in 1981, which grew into Green Mountain Coffee Roasters, with Forbes estimating his wealth to be $1.3 billion as of September 2011.

He resigned as chief executive in 2007, and just a year later pledged 46 percent of his stock as collateral for loans.

Stiller later sold his 12 percent stake in Krispy Kreme Doughnuts, raising close to $50 million.

He blamed his bankers at Deutsche Bank for the sales, who he said slashed how much he could borrow against his stock, and then required him to put up more cash after tumbling share prices following a discouraging earnings report.

Stiller denies any wrongdoing and claims that he did not break any regulations or laws.

Conference roundup

The CASLA annual conference in Canada was about more than the cocktails on offer

JUSTIN LAWSON REPORTS

Canada, much like London, may be going through something of a cocktail craze. Some of Toronto's talented cocktail mixologists are creating specialty cocktails by leaving them to mature in oak casks for added flavour, while some are turning their cocktails into works of art. The Vanilla Infused Manhattan is served inside a large bell-shaped glass that is filled with smoke. The cocktail is a mix of rye, homemade cherry vanilla bitters, hickory-smoked syrup and vanilla cognac, and costs CAD$45.00.

A conference is much like a cocktail. If the ingredients—the subject matter, delegates, sponsors and location—are not combined effectively, the result can be a disaster. However, much like the Vanilla Infused Manhattan, the 2nd annual CASLA conference was spot on.

The conference location was ideal, the subject matter was solid, and overall, it was a well-presented and well-delivered conference. This was all the more impressive considering that it was organised by a team of volunteers. Special praise goes out to Rob Ferguson of CIBC Mellon, Jori Horn of Northern Trust and Michelle Lindenberger of EquiLend.

Robert Chiuch, president of CASLA, dived straight in with an update on CASLA and what the association has been doing during the last 12 months. The association has performed well; memberships are staying solid at 21 current members and there has been productive dialogue with the industry. Chiuch's current term as president is coming to an end and the role will be taken over later this year by Reeve Serman of RBC Dexia. Two new panel members will also join the board—Tony Venditti of BMO Capital Markets and Nathalie Bockler of Societe Generale.

Closing his update, Chiuch said: "There are 31 rules recently introduced globally that impact our business". This is a scary thought for the industry.

Following hot on the heels of the CASLA update was an overview of the Canadian securities lending market from Melissa Gow of Data Explorers. The overview ran through a series of slides highlighting current trends and how Canada has moved on since the financial crisis. With supply returning to pre-crisis levels and demand steadily increasing, all is looking good for the industry.

One of the more interesting slides was how the energy sector is performing. It has the highest revenue contribution and the highest fee and balance out of any sector in the Canadian market.

What is clear from Gow's presentation is that the market is focused on the "intrinsic" lending fee, as there are low interest rates and a low risk appetite for cash reinvestment.

Up next was a panel moderated by CIBC Mellon's Phil Zywot covering the Canadian market's trends, challenges and risks. Stephen Novo of State Street, Andrew Thornhill of RBC Capital Markets, Scott Reed of Scotiabank and Michael Schleich of National Bank Financial were on the panel.

The Canadian economy was the first topic of discussion. The consensus was that, although the economy has done well, there are fears of a possible "condo bubble". National newspapers such as The Globe have recently reported that the number of condos being built in Toronto is outstripping New York and other major markets. Despite the possibility of a bubble that could burst, Reed said that "we are selling stability" in Canada.

On the securities lending market in Canada, the "2008 drop-off from hedge funds activity is coming back and the ETF (exchange-trade fund) explosion has been interesting to watch", added Schleich.

The stability of the market and how well its banks coped with the economic crisis has attracted lots of outside interest. "The markets are in pretty good shape, volumes are up and there is a lot of interest in the Canadian market place," emphasised Thornhill. Agreeing with this, Reed added: "We are trying to do more with less". Although there is new interest from mutual funds and pension funds, overall spreads are more compressed and many are working with 5 and 10 basis points. It is looking to be a quiet summer.

The afternoon saw three panel discussions tackling tax, demand and the future. Before this, Reeve Serman, the president of CASLA in-waiting, tackled the international market and shared an update that highlighted how negative some regulators and politicians are about the industry. Recent dialog on 'shadow banking' and publicised attacks on securities lending and repo highlight the industry's need to create a positive profile.

Serman moved onto CCPs and views from the G20. It looks like the securities lending industry is still not ready or looking forward to CCPs, but regulators are likely to continue their push towards the model.

The panel moderated by Tim Smith of SunGard looked at the demand side and echoed many of the points raised in charts from Gow earlier in the day. On the panel were Jack Huber of Citi, Paul Larkin of CIBC World Markets, Michele Sonier of J.P. Morgan and Rob Dias of Bank of America Merrill Lynch. The panel seemed to agree that hedge funds are still not really playing ball with the securities lending industry. Although the size of the hedge fund market is back to pre-crisis levels, their involvement is not as active. There is "no conviction to put money to work", added Dias.

The tax and regulatory panel was probably the most important. An area that surprised many is the extent to which FATCA could affect the securities lending market. But, as Chiuch pointed out during his talk, 31 rules have been introduced globally that have an impact on securities lending. The FATCA effect should not be a surprise.

The future of the market was the concluding subject of the days discussions. A panel of industry veterans moderated by Roy Zimmerhansl of Fin-Tuition and supported by Brian Lamb of EquiLend, Tony Venditti of BMO Capital Markets, James Malgieri of BNY Mellon and Jean-Paul Musico of Trading Apps, shared their experiences.

Zimmerhansl began emphatically: "Change is no longer an option; it is being thrust upon us".

Pension funds have returned to the market, supply is up, and they have been increasing their allocation to alternatives, which is a trend that looks set to continue. The question is will the increased monies flowing back into hedge funds lead them to short more and bring back demand levels? Presently, the answer is no, as many hedge funds are not shorting. Instead, they are taking up long positions and holding more cash positions.

The regulatory uncertainty has not helped. Predicting the future is not a science but with more support from regulators it could become a little easier. "We are not getting any clear direction from the regulators," said Lamb. **SLT**

Conversations with...

Greg Korte of Korte Consulting talks trends in lending programmes, and striking out on his own in the market

GEORGINA LAVERS REPORTS

How did setting up Korte Consulting come about?

I spent the first part of my career in the mutual fund accounting and administration portion of the investment business. For the next part of my career, I was a senior manager responsible for a wide variety of investment services, compliance, vendor management, technology services and institutional separate accounts. I developed and managed a comprehensive securities lending programme that grew to involve three vendors across $60 billion in AUM. I also founded a global lending oversight committee that was responsible for lending in five global locations covering close to $200 billion. As part of that varied role I provided operational consulting to investment consulting clients with over $1.3 trillion in AUM. It was from there that I moved into a full time role as a senior consultant providing operational services and working with the institutional sales team. That's where the idea to start my own consulting group focused on the operational needs of the industry emanated.

Could you explain your role in sec lending programme analysis?

Korte & Associates Consulting has worked with many clients to review their current vendor and associated contracts. We have also provided clients with projects that involve RFP and RFI work as a means to provide due diligence and documentation on a clients current securities lending vendor selection. I have provided customised client project work where I was utilised as sort of an expert witness in determining contract boundaries, limitations and financial exposures. We have also provided customised research projects for several industry participants.

Does transparency need improving?

I believe that there is transparency in the securities lending industry today. If on behalf of one of my clients I request any piece of information related directly to securities lending, I have the confidence and expectation that every major lending provider will provide me with the requested information. In my mind that's transparency.

It is then up to me or a client to understand the information that has been provided to them. There is still a knowledge gap across the industry about how to use the information available. That is, how to distill a large pile of reports and data available and to understand what the data is telling you. Where are your risk exposures? Where are your earnings opportunities? What are the implications and trade offs of making various policy decisions?

There are essentially three choices for clients.

1. They can choose to rely on internal staff to figure out what all the lending information is telling them and to learn the business and to stay current on what is happening to their lending activities and to the broader industry.
2. They can utilise the outsource model and ask a firm like ours to provide periodic oversight services of their lending program.
3. They can determine that securities lending is not worth the effort of either option 1 or 2, and stop lending altogether.

Do you think there are there any regulatory gaps in the marketplace?

I think there could be tighter rules governing separate accounts that are widely used in the lending industry in place of the very highly regulated SEC 40 act Money Market Funds.

Are you seeing any particular trends in lending programmes?

The trends that I see are:

- Continued risk reduction of collateral management by clients
- A near decimation of the general collateral trade
- Securities lending is still a dirty word for many clients and their board of directors
- Most clients have seen a sizeable drop off in the revenue that lending was providing just a couple of years ago, therefore it is not the source of alpha that once kept many clients and money managers interested
- That drop off in revenue is a double-edged sword. Many custody contracts were also based on higher lending revenue to support lower fees in other service areas. With the loss of lending revenue, the custody banks are now being forced to reach out to many clients and ask for fee increases on traditional custody services.
- Lastly, as I mentioned above regarding the oversight provided by internal staff, we have seen a noticeable shift of client oversight being provided by the front office investment staff rather than the back office operations staff. This is a very positive development for the future of the industry.

How important is education of beneficial owners when it comes to encouraging market participation?

Education is critical if a client wants to enter or remain involved in securities lending. I believe that some of the lawsuits, not all, but some of the suits by clients against their providers, were directly related to a lack of education and knowledge on what was going on inside of the clients lending programme and the risks associated with those client choices.

Given today's availability of specific lending programme information a client can operate an effective and risk controlled lending programme with the investment of time and education, as long as they have assets that the market wants to borrow.

What is holding back more beneficial owners from setting up programmes?

- Fear that something bad might happen based on prior bad experience
- Having an asset mix that will not provide enough income for the effort needed
- Still have a few clients that think that lending is 'feeding the shorts' and that engaging in lending is therefore counterproductive to their underlying long asset pools, even though many independent academic research studies have proved that there is no correlation between shorts and lending
- The low interest rate environment is absolutely a barrier to entry at the moment, because there are a lot of loans that are not being made due to said ultra low rates.

Does the new regulatory regime provide an added level of comfort to beneficial owners?

The SEC instituted a tightening of duration on the 1940 Act Money Market Funds that many lending clients utilise to manage their collateral. That helps clients reduce risk.

All of the other US regulations involved in lending have not been finalised at this time. Only time will tell whether they reduce client risk.

What areas, if any, are in need of additional SEC action to enhance investor protection?

The main area of risk currently in lending is not on the lending side of the business, which performed extremely well during the crisis resulting in no client losses. The current area of risk that I am focused on is the collateral that is accepted, held, and in the case of cash, reinvested. Making sure that a client can provide proper oversight of this key function is critical in my opinion. Utilising internal credit staff to monitor the collateral is a great option for many clients.

I am not sure if further SEC regulations are warranted at this time. It may be prudent to let the current new regulations take hold before adding any more new ones.

What do you believe are alternatives to cash collateral and lending practices that could perhaps have mitigated the recent crisis?

The atmosphere in lending prior to the crisis was that agents and clients were both pushing the limits on collateral reinvestment to raise earnings as high as possible. In several cases across most of the industry particular securities reinvested in collateral accounts lost almost all value, which drove client losses.

To mitigate this risk tighter controls and disclosures on collateral reinvestments is key. Moreover, clients have to be willing to do their parts in an oversight function. It has been noted before that the collateral account for many plans is their single largest allocation to one manager. If clients treat the collateral account in this light, the industry will be much better served.

In 2008 Canada and Europe lending programmes allocated a much higher portion of their collateral in non-cash form. In general both groups experienced far fewer problems than we did here in the US, where cash is king and non-cash collateral made up only a small portion of collateral portfolios (the US non-cash collateral has grown dramatically since 2008 levels).

Client education on lending and the lending industry is a key component of a well run programme along with periodic third party due diligence.

Have you any current projects of interest?

We have several projects that are interesting. One is a market study for a client whose large portfolio is being lent by their custodian. The client wants us to provide due diligence that this arrangement is still more advantageous than adding a third party lending agent. We are also looking at a project that is more industry based, trying to provide research on various industry lending agent programmes. **SLT**

Switzerland

SLT talks to Oliver Madden of RBC Dexia Investor Services to get his take on Switzerland's securities lending market and how it has evolved since the 2008 credit crisis

MARK DUGDALE REPORTS

The credit crisis of 2008 will influence popular opinion on financial institutions and the ways they do business for a long time to come. But many jurisdictions have been trying to learn their lessons from the disaster. Europe is awash with regulation, such as the Alternative Investment Fund Managers Directive and Basel III, that are aimed at tightening the rules and regulations that govern the continent's financial institutions, regardless of their shape or size.

Switzerland has not bucked the trend in this regard. The jurisdiction has looked to tighten the securities lending industry with regulation, and this has affected the ways in which market players do business. Oliver Madden, who is the director of technical sales and market products and services at RBC Dexia Investor Services, explains.

How does the Swiss securities lending market differ from other European markets?

Historically, the predominance of principal lending models existed to a much greater extent than other markets but today in most respects it is no different to any other major market—well structured with a choice of routes to market available and with knowledgeable market participants and beneficial owners.

What is the regulatory landscape like in Switzerland at the moment?

In relation to securities lending, what we saw following the credit crisis in 2008 was a measured consultation and review of the market through 2009 that ultimately led to the implementation of FINMA (the Swiss Financial Market Supervisory Authority) Circular 10/2 in 2010. The circular details the rules pertaining to securities lending transactions with clients. Whilst conservative they also provide a transparent, consistent and robust framework for market participants, which are very much positives and all one can ask for—from a regulation and a regulator.

How will Basel III affect business in Switzerland?

Basel III is one of a number of global regulatory initiatives that is having a significant impact on securities lending for all participants, not just in Switzerland. Basel III is changing the way banks manage their liquidity and has driven demand from borrowers for quality assets (in particular government bonds) and for term trades.

We're spending a lot of time talking with our clients about these trades, educating them about the key points to be considering, walking them through the underlying motivation and outlining how their returns may be enhanced.

Once clients understand the requirements and returns of the trades, and how we support them through it, they're in a position to make an informed decision. It's a trade where borrowers are willing to pay a healthy premium for certainty of supply of the right assets. It's an important conversation to be having.

Who are the big beneficial owners involved in securities lending in Switzerland and why does it appeal to them?

Given the depth and breadth of assets held, Switzerland has always had a diverse pool of beneficial owners, from pension funds, insurance companies and fund management companies through to private clients. Historically, they may not always have been visible given the principal lending model that has prevailed. Today, however, Swiss beneficial owners access the market in a number of different ways.

Securities lending appeals to Swiss clients because they see the benefits to fund performance or reducing costs that the revenue from securities lending provides. Swiss clients, as a rule, are conservative; however, they are also knowledgeable about the product. They appreciate the strong regulatory framework that exists and value the returns they can earn. What we see are informed beneficial owners selecting their route to market based on what best fits their risk, operational and reward requirements.

How have collateral type choices changed in recent years?

What we've seen in the last five years is beneficial owners taking the time to revisit and assess their programme parameters and make adjustments necessary to ensure the continued viability of their programmes—but all within prudent and tolerable risk frameworks. The type of collateral accepted is one of these parameters and, generally, we witnessed in the immediate aftermath of the credit crisis a shift away from cash collateral and towards more conservative non-cash collateral options. In the last two years, we've seen an increasing recognition of the value of collateral liquidity as well as quality plus correlating the loan and collateral sides of the trade. For these reasons, main index equities in particular have become more widely accepted.

How has the securities lending industry handled the negative press that it has received?

Securities lending has faced its own particular challenges. It's to its credit that the various trade associations that represent the industry have worked collaboratively and proactively, and continue to do so, to address those issues, to engage the media, and most importantly, to raise awareness with, and educate, beneficial owners. SLT

Conversations with...

Quadriserv's Pat Cestaro and Bruce Turner talk to SLT about how AQS is helping firms to successfully adapt to regulatory and economical uncertainties

MARK DUGDALE REPORTS

The securities lending industry, like most areas of financial services, is facing increased pressure to make changes. Proposed legislation in both the US and Europe, recently implemented rules and global economic uncertainties have coalesced to create an environment ripe for altering the traditional ways of conducting business.

Quadriserv, the firm behind the AQS platform that offers automated lending and borrowing of securities through a central counterparty, has been riding these turbulent waves of change as well. Since the platform was launched in the middle of the financial crisis, the firm has had to double its efforts to meet the sometimes-competing desires of market participants. As a result, activity in the AQS marketplace has more than doubled compared to a year ago. Quadriserv believes that stronger partnerships that have been developed with industry participants will enable them to further accelerate the growth momentum. SLT talks to recently appointed co-CEOs Pat Cestaro and Bruce Turner about how AQS is working with firms to successfully adapt to some of these complex changes.

SLT: Attitudes in the industry have evolved quite a bit since you first launched AQS in 2009. What's changed?

Bruce Turner: Since I arrived more than five years ago to run operations at Quadriserv, our conversations with customers and what they have been telling us has shifted. We've gone from a market that favored manual processes to one that is asking for automation. And there is a much more tangible emphasis on cost efficiencies. When talking to customers about their needs, collateral optimisation is at the top of their lists. They are under considerable pressure to get the highest and best use out of their assets. And they want to do it in a way that mitigates both counterparty and collateral risk, which is why the use of a central counterparty has emerged as a viable solution. OCC (Options Clearing Corp) is our central counterparty clearer and OCC's hedge programme laid the groundwork on which we've been able to build.

SLT: So how have these shifts affected you?

Pat Cestaro: We have had to modify our way of doing business just like everyone else in the industry. I've been in this business for over 30 years and the one constant has always been change. The scope and direction of that change is not always so clear. Thus, any leader in the industry needs to follow new developments, notice the trends, and anticipate the next shift. Quadriserv, which was started by a talented group of people that wanted to add efficiency and transparency to the securities lending industry, has been on my radar for years. When I joined the firm almost two years ago, my focus was to use long standing relationships to bring other industry leaders into the fold. As we continued to get feedback from our customers and started listening better and making market participants a more inclusive part of our business model, our focus became more apparent.

We now have a more practical approach to understanding what our broker-dealers, agent lenders and hedge funds need from an automated trading platform and a healthier respect for the role each participant plays in the industry.

SLT: Your automated marketplace, AQS, launched in January 2009. Specifically, what have you done to change?

Cestaro: Since our focus has been listening to customers, I can break it down in terms of what we are doing with each client segment. For our broker-dealers—especially the large prime brokers—they had a keen interest in having a more automated way to finance their GC (general collateral) inventory. So based on their feedback we launched AQS Direct this past fall, our broker-to-broker venue. Since adding this second platform, overall AQS securities lending volume has doubled. We are now working with our broker-dealers, helping them to better understand OCC's collateral process and how to optimise their margin collateral at OCC.

For agent lenders, the feedback is that our platform offers a wider distribution network than perhaps what they now have available to them. AQS is also a real-time price discovery mechanism for them. Since agent lenders are not OCC members, we are working with our strategic OCC member partners and helping them through the integration process with a sponsoring OCC member. As a result of this expanded sponsorship, further liquidity will flow into the AQS marketplace, which brings me to hedge funds. The value proposition for hedge funds will become evident once the agent lenders and their liquidity are more fully on board and we have a larger, more stable supply of HTB (hard-to-borrow).

SLT: So where do you see changes in the market going forward?

Cestaro: As a result of regulatory pressures, counterparty risk will continue to be an important topic. A CCP-based platform helps participants minimise direct exposure to potential default scenarios and mitigates risk. Hand-in-hand with that is the focus on more efficient collateral management. The more sophisticated broker-dealers are putting significant time and resources into optimising their OCC collateral requirements. For example, some firms have found that by shifting open borrows and loans onto our AQS platform, they're able to offset options risk that they already have on the books at OCC. The end result is a lower collateral obligation.

SLT: Where does automation fit into the discussion on regulatory reform?

Turner: It's not a regulatory mandate as much as it is a mandate to capitalise on any and all available technology. We'll remain in an environment where banks and other market participants can benefit from automation for a long time.

Cestaro: But the part of automation that does pertain to regulatory reforms is transparency. Legislators talk a lot about what they see as the need for transparency in the markets, although they haven't always done a great job of defining it. As financial securities professionals, we shouldn't fear transparency. There was an initial reluctance to a transparent market. It's almost a selfish motivation in that we think we have some knowledge that puts us in a superior position that no one else has. We want to keep that. And we also fear automation and efficiency will cut into the bottom line or our P&L. However, in market after market, it has shown that as more automation and transparency are introduced into a marketplace, volumes increase exponentially. We believe that in time we can expect the same to happen in the equity finance arena, whether it be securities lending or equity repo. **SLT**

Single stock futures... a new dawn

Saratoga Capital's Thomas Halikias looks at single stock futures usage in securities financing

INDUSTRY OPINION

In our work, promoting exchange listed single stock futures as a financing or stock lending facility, Saratoga Capital's success in introducing the product has been predicated on our ability to clarify clients' misconceptions regarding the single stock futures market. Initial responses include:

- "Futures? We don't trade futures."
- "Single stock futures? They don't seem very liquid."
- "How do single stock futures minimise our US withholding tax?"

The product's unfortunate association with speculative trading strategies often found in illiquid commodities has been a significant barrier to extolling the many virtues of this sophisticated financing and stock lending instrument. While customers can and do trade single stock futures in a speculative manner, the more subtle uses of single stock futures can be easily overlooked. Additionally, trading single stock futures does not specifically require Commodity Future Trading Commission (CFTC) registration—exemptions are available for most equity based strategies.

Single stock futures can be packaged against the underlying equity to either finance a long equity position or to lend the underlying equity to parties interested in obtaining the long shares for an extended period of time. For example, if an institution wishes to finance a specific equity position, they would sell the underlying equity simultaneously with the purchase of the equity's single stock future. This simultaneous transaction is called an exchange for physical (EFP) and bears absolutely no directional market risk. The pricing differential is based solely on market financing rates. For a lending transaction, the institution would perform a similar simultaneous equity for future EFP, but in this case the pricing differential would be based on the market rate for borrowing the stock. In both transactions, the institution would select the appropriate future expiration cycle to match their desired time frame for financing or lending the security.

While transactional volume on the OneChicago continues to grow; the exchange saw record volume this March—the 'shadow liquidity' in the financing or lending market is extraordinary. Saratoga Capital has direct access to billions of dollars of balance sheet for financings, and foresees the size of capital available for these transactions to swell in the coming months. As the market develops, the notional volume of lending transactions should also continue to grow. In the three years of trading single stock futures, we have seldom experienced an issue finding liquidity for our client's trades.

Once Saratoga Capital's staff has clarified these future and liquidity concerns, we are then able to discuss why single stock futures are a viable alternative to products already available in the security financing or stock lending market. The two major attributes of single stock futures are the listed nature of the product, fortified by the AAA rated Option Clearing Corporation's (OCC) explicit delivery guarantee, and the wide diversity of market participants able to transact via the OneChicago exchange. The diversity of participants and their accompanying institutional strengths creates for an extremely efficient market framework. The OCC guarantee enables large institutional cash managers to seamlessly fund small or poor credit quality entities or for large position holders to monetise equity holdings for an extended period of time without concern for counterparty credit lines or documentation requirements. Additionally, the opportunity to pair up naturals—two counterparties with offsetting exposures—further improves market pricing. An example of a natural transaction would be the financing of an equity that is involved in the purchase of another listed company. Under such a scenario, a merger arbitrageur would actually receive payment for borrowing the security he needs to short for the arbitrage. The joining of the financing and lending function in one market improves the pricing for all participants.

Another significant virtue for international holders of US equities is that utilising single stock futures can dramatically reduce a firm's US dividend withholding tax exposure. Portfolio managers can finance high yielding US equities and improve net equity and portfolio retentions considerably. The US Treasury's 19 January 2012 proposed legislation regarding dividend equivalents implies that single stock futures 1C contracts, priced with an implied estimated dividend, will not be withheld as a dividend equivalents. We believe this ruling leaves single stock futures as the most efficient tool for optimising off-shore US equity portfolios. Saratoga Capital has seen significant interest in this aspect of the market and we expect to see more large European, Canadian and Asian institutions transacting single stock futures shortly.

In our conversations with clients, we tend to focus on the quantifiable attributes of single stock futures for front line traders or position managers. These individuals tend to focus on pricing, counter-party risk and group or desk profits. However, single stock futures offer an array of organizational benefits that might not be a priority to desk heads or portfolio managers. These benefits include improved Basel capital reporting due to the superior credit rating of the OCC compared to traditional OTC counterparts and exchange listed price transparency that is easily incorporated into standard risk metrics and allows organisational risk managers to properly identify and calibrate the exposures inherent in their equity finance and stock loan activities. Utilising single stock futures also conforms to the intent of Congress' 2010 Dodd-Frank Act.

Once clients understand the many virtues of single stock futures, they almost universally want to learn more about the product. Like most new products, implementing a single stock futures trading platform takes some time and internal organisational approval and support. However, once all in-house requirements have been satisfied, the actual trading and clearing of single stock futures is relatively simple. **SLT**

Thomas Halikias
Managing director
Saratoga Capital

Conversations with...

SunGard's Jane Milner reveals the ins and outs of collateral management to SLT

BEN WILKIE REPORTS

Following the launch of SunGard's cross-enterprise collateral management and optimisation solution, Apex Collateral, SLT speaks to Jane Milner, head of strategy for securities finance and collateral management for SunGard's capital markets business, about the changing collateral demands the industry is facing

SLT: How has the focus on collateral management changed in the wake of the financial crisis?

Jane Milner: There is no doubt that post crisis there has been an increased focus on collateral management as unsecured lending has disappeared. And I would say that in relation to securities finance, this has had a positive effect, as the demand for collateral transformations bring an increase in demand for securities financing transactions, at a time when many of the other drivers of demand have reduced.

During more recent times, say the last 12 to 18 months, there has been a change in what firms are looking for in a collateral management solution. It's not just an operations function anymore; the discipline of collateral management has become an important tool in an institutions' balance sheet and liquidity management armory.

The move towards central the clearing of OTC derivatives under new regulations will increase, still further, pressure on all types of collateral—there's a collateral squeeze, with more requirements for collateral and demand for higher quality assets at a time when liquid assets are under pressure from a regulatory capital perspective

SLT: Is it a case that there's less high quality collateral available?

Milner: High quality liquid assets are certainly more in demand now than ever before. Collateral can no longer be looked at as individual silos if it is to be efficiently managed—collateral management applies across a broad range of products: derivatives, securities lending, repo and others. And there are further silos within those pools of collateral, some directly controlled, while other parts may be under the control of third-party agents. You have to look across the pools; you can't make best use of your assets without having the big picture.

So a centralised collateral inventory is key—and it's also about being much more intelligent about how you deploy the collateral assets.

Our solution adds the components of inventory and trading capabilities so that clients can 'morph' one type of collateral into another—collateral upgrade trades are something that many firms are looking to do more actively, either on their own account or on behalf of clients.

SLT: How advanced are companies when it comes to the development of their collateral solutions?

Milner: Being a solution provider and developing a cross-enterprise solution is one thing, but being an organisation trying to re-organise in order to get all your disparate collateral groups into one more effective unit is quite another.

Some firms are further advanced than others, and I'd say the sell side has done much more in this regard than the buy side. Historically, SunGard produced solutions for different asset classes and some customers will still use those point solutions. Now, some clients want to proactively manage multiple types of liquid assets and are forming enterprise collateral groups that require a more comprehensive solution to support their needs.

SLT: So this new product is not intended to be a replacement for the existing solutions that clients are using?

Milner: This will depend upon a firm's needs, short, mid and longer term. Some of our clients will be happy to continue with their existing point solutions for many years to come. But for those that seek the cost benefits that enterprise collateral management and optimisation can bring, then we have the new product, Apex Collateral, which handles cross-product requirements and optimal allocation of assets to underlying requirements in an automated way.

This is not a solution that we started from scratch; the capabilities have been built off our acquisition of Finace. Finace already provided a strong cross asset solution that gave us a very good starting point from which to build out further using our extensive experience from multiple individual collateral solutions.

SLT: How much demand are you seeing for Apex Collateral?

Milner: We have known for some time that there would be significant demand for enterprise collateral management. We've been working on this for two or three years and had already recognised the drivers—regulation and cost reduction being key. We've never been busier in this space.

SLT: How much is optimisation a part of what you're working on?

Milner: It is a very important part of the Apex Collateral suite. This part of the solution was developed from scratch, using the analytics and complex modelling expertise from the risk side of our business. Simplistically, this solution is a calculation engine, with user-defined constraints and variables that can be plugged into a SunGard or a client's own collateral system.

Optimisation is becoming increasingly advanced—we're using mathematical algorithms for the most effective optimisation. If you know what the demand is and what the constraints are, it becomes a question of how you approach the problem of deciding which collateral should be applied to which exposures—the point is to minimise the cost of the collateral. SunGard's team of capital market quants have helped us to deliver an optimisation engine to generate optimal collateral movements, saving expensive resources, time and cost.

SLT: So do you think that collateral optimisation will become a black box operation?

Milner: There will always be a role for collateral managers, but if you want to proactively manage more collateral more effectively then you have to have automation—an intelligent solution that can propose collateral movements. Ultimately, the market is moving towards a more hands off approach and greater STP.

In many ways, it's like the history of securities finance. At the start it was a cost centre. But over time it became a profit centre, a front office product, earning revenue from acting as a specialist intermediary. We're seeing this now with collateral management.

SLT: So is the phrase collateral management now one for the history books, replaced by collateral optimisation?

Milner: Communication is an art! You can't always know what people mean by these terms, you have to drill down into their challenges and needs. Collateral optimisation means different things to different people, it could simply mean exception management and STP operations, or it could be about algorithmically calculated optimal allocation of assets. I'd like to say that it's now all about the latter, but we still have some way to go. **SLT**

Collateral conversations

SLT speaks with Rule Financial's Jonathan Philp and Chris DeBrusk about collateral, CCPs and US versus EU regulation

Chris DeBrusk: I originally trained as a software engineer and I was an early employee at Sapient, and ran a number of groups there over the years. Most recently I founded a strategic consulting firm which was acquired by Rule Financial. I've spent the entirety of my career working with large companies in a consulting capacity and helping clients navigate the intersection between business and technology. Much of that time has been spent working with large buyside and sellside firms on regulatory based initiatives. In most cases these types of programmes all come back to sorting through the core data that runs the firm, so I've spent a lot of time helping clients get their house in order as it relates to trading flow and reference data.

Having spent seven years doing nothing but regulation, we were certainly calling it a flood. But the majority of it was in the listed securities business, a lot of it was equities that were really highly regulated and always have been. When the disaster happened it was centred around derivatives, which to be honest were not regulated at all. That is of course now changing. There's a lot of increased focus on collateral; exposure and market risk. To what degree is the system protected after the failure of a large institution? From 2000-2009 we were focusing on bad guys doing bad things; rogue traders and the like.

Jonathan Philp: In my current role a lot of the work is in response to regulatory change, like Chris. A lot of the focus has been with the main derivatives dealers, helping them adapt to the new world. Defending and building on their existing OTC books, helping them figure out additional services they can provide to the client, and helping them navigate the new cleared market model. If you are a dealer and have a number of buyside clients you have to help them access clearing. I'm currently involved with a global central counterparty (CCP). OTC derivatives were already cleared, but obviously the new Dodd-Frank and EMIR regulations mean additional changes. We're starting to see much more activity on the buyside front as they look to establish the infrastructure processes and the relationships that they need to continue using OTC derivatives.

Equities as collateral

DeBrusk: I would see that they want bonds and cash, but posting equities as collateral? I haven't seen it.

Philp: Obviously one of the things you've got is CCPs starting to compete with each other. You're starting to have a choice as to where you clear, and one of the things that CCPs are competing on is eligible collateral. I think Eurex at the moment are proposing a relatively broad set of eligible collateral for their new OTC offerings. If you do have the possibility to use equities as collateral for cleared derivatives, they will certainly have substantial haircuts on them.

DeBrusk: How much equities do the banks really own on their balance sheets? Given the elimination of prop trading from most investment banks, I don't see them really having equities available to play with.

Philp: That's certainly true for the banks, I guess I was thinking more of the buyside.

DeBrusk: How many buyside funds are going to have in their mandate both the clearing of equities and the clearing of derivatives? I can see a lot of challenges on the buyside and how they operate, as to actually being able to do it.

Hot tips for eligible collateral

Philp: I think the CCP's collateral eligibility policy will probably remain pretty restrictive. The question is, if you need to raise CCP eligible collateral for cash or government bonds, you probably need to do that outside the clearing process, maybe in the repo market or with your broker (if he's performing some kind of transformational service). So, anything can in theory be transformed into eligible collateral, but only after considering haircuts and the incremental counterparty credit risk they pick up on the way. That will determine the appetite of the more peripheral players. There's been some chatter about gold being accepted as collateral. The only areas where I've heard gold being discussed as particularly eligible was in a very specific context, so I'm not sure if it will become widespread. Managing the delivery and safekeeping would be highly problematic, I would imagine.

DeBrusk: The other challenge with alternative collateral is simply the volume needed. The amount is just so large. The gold markets and some of the physical commodities markets are big, but there are limits to them because of their very physical nature. Whereas the central banks or governments can create as much collateral as they want.

Recurring collateral challenges

Philp: What we've seen is the growing demand for collateral, and having to put up initial margin against your OTC counterparties, which was probably not done before. At the same time, you're also facing incremental Basel III liquidity capital and other liquidity requirements placing increased demands on your balance sheet. Some banks may still be fairly fragile, and therefore subject to substantial 'margin calls' if they were to suffer a credit downgrade, for example. To address that, what I've seen banks do is collect together collateral on a firm-wide basis, drawing together the different product silos, using the balance sheet, and using collateral as efficiently as they possibly can to get the maximum value out of the available assets.

DeBrusk: The other thing that I've seen is that the efficient use of collateral now becomes a decision around putting the trade on. It's not only a trader sitting at a desk deciding if they're going to a trade (especially if they're sitting opposite one of their customers), it's also the cost of collateral and what you clear. The collateral that you put up is different by CCP: a lot of CCPs will trade the same thing. One of the products we've been talking about is a margin calculator that will allow them to make a decision about whether they should put a trade on, but the impact on their overall collateral position (whether it is positive or negative, and also what kind of cost or haircut they are going to apply to the client). It's a whole bunch of decisions around cost of capital that traders aren't used to making.

Regulation

Philp: Dodd-Frank is much more advanced in terms of its completeness than EMIR, and there's been a lot of concern about the extra-territorial reach of the Dodd-Frank rules. Until it's clear exactly which institutions will be covered by each set of rules, banks will be concerned that they're going to become uncompetitive. US banks for example have expressed concerns over the viability of their business with non-US sovereign institutions. If dealing with a sovereign counterparty outside of the US, they don't want to become subject to the Dodd-Frank requirements, and so may look to select alternative counterparties.

DeBrusk: Exactly. As ever, it is highly unlikely that the US will allow their banks to become uncompetitive.

Philp: There are other rules and regulations that aren't Dodd-Frank or EMIR, which are also going to affect the banks. Things like the suggested Financial Transaction Tax (FTT) which is being kicked around in Europe, where there is talk of implementing this unilaterally, which seems an odd thing to want to do.

DeBrusk: The other big thing that is going to happen this year, and will likely have a dramatic effect, is the US election in November. I wouldn't underestimate the outcome of this on the potential implementation of some of the regulations. There are some very substantial differences between the parties. Saying that, it may actually have less to do with the presidential election than what happens in Congress. I would say that nothing substantial will happen either before November, or in the first term. But who knows? The US political system is fairly impenetrable in terms of predictions.

Philp: I would expect to see US and EU regulatory regimes converge. I think when you see Asian regulators in the Hong Kong and Singapore markets drawing on Dodd-Frank as a model (as it is the furthest advanced regulation of its type), there are definitely things from it that we can adopt. However, there's still a lot more to be done. What will be interesting is what happens outside the G20—will there be CCPs there as well? I don't think that derivatives will suddenly move away from London and New York, but there may be some movement towards Singapore and Hong Kong and to a lesser extent towards Europe. I hope that there is a decent degree of consensus about what the new model looks like.

DeBrusk: The other thing to think about is if you take a page from the listed markets and the more traditional cash markets, the US regulators tend to be much more prescriptive than anywhere else. I once had a client break down the cash rules, and there are 7,500 specific rules for trading a cash product in the US, while there are only about 100 in the UK. What I've seen traditionally is that the large European institutions that also trade in the US tend to align by the US rules. That's a style that may well translate from the cash world into the derivatives world.

Philp: I would agree. I think the principles-based approach wasn't necessarily as effective as it might have been. The EU is putting into place its regulatory infrastructure, and I think we can definitely expect European regulators to head along the road towards becoming much more prescriptive like their American counterparts. **SLT**

Rule Financial is a leading independent provider of advisory, business consulting, IT and software services to the investment banking community, and counts many of the world's foremost financial institutions amongst its clients.

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Considering mREITs?

SunGard Astec Analytics' Andrew Shinn assesses the yield potential and risks of residential mortgage mREITs

MARKET PERSPECTIVE

In the early 1980s, when interest rates rose to record levels, US savings and loans suffered huge losses as they paid depositors hundreds of basis points more than they received on their loans, including home mortgages. As a result, in 1981, US Congress passed the Economic Recovery Tax Act, which allowed savings and loans to sell their mortgage loans and deduct the losses from taxes paid up to ten years prior. It was a gift from the US government to the savings and loans via the Internal Revenue Service. An unintended consequence was the birth of the mortgage-backed securities market.

In 2012, as interest rates are at record-low levels, investors all over the world are forced to seek yield wherever they can find it, and many are focused on the high yields that are currently offered by many residential mortgage REITs (mREITs).

REITs have existed in the US since President Dwight Eisenhower signed the Real Estate Investment Trust Act on 14 September 1960. However, in the UK, they only came into existence in January 2007. The timing was not fortuitous, as that was near the top of the global real estate market. A majority of the eight British property companies that converted to REITs at the time are still down more than 50 percent from their peaks in early 2007, not including the value of dividends received over the past five years.

British REITs focus on investing in commercial property because they are prohibited from investing in owner-occupied properties, and as a result, they do not yield as much as US mREITs. US mREITs are able to generate high yields through leverage (anywhere from five to 12 times equity) by hypothecating their Fannie Mae- and Freddie Mac-guaranteed mortgage-backed securities in the repurchase market.
British REITs can't hypothecate their loan portfolios as easily as US mREITs can, and there are also leverage restrictions regarding REITs in the UK.

All REITs are attractive for tax reasons as they are not taxed at the corporate level as long as they pay out 90 percent of taxable income (among other requirements). Investors who purchase REITs as part of a diversified portfolio in a tax-deferred investment account, such as a self-invested personal pension in the UK or individual retirement account in the US, would only pay taxes when withdrawing income and gains at a presumably much-lower tax rate during retirement.

Upon hearing about a security such as an mREIT that pays a 17 percent yield, one's first reaction is skepticism; surely there must be risks that will either cause the yield to fall or the share price to suffer capital losses. In fact, such a security may even be a good short selling candidate. However, upon further examination, one realises that it's difficult to sell short a high-yielding stock because in addition to paying borrowing costs, a short seller must also write dividend checks. Indeed, mREITs and other high-yielding securities may offer compelling risk-adjusted returns.

Two of the biggest US mREITs are American Capital Agency Corp (NASDAQ:AGNC) and Annaly Capital Management (NYSE:NLY). AGNC has performed well over the last few years due to superior security selection, and its portfolio seems to be better protected than its peers against prepayment risk, especially if prepayment rates increase due to HARP (the Home Affordable Refinance Program) 2 in the US. Prepayment hurts mREITs because as homeowners refinance and prepay, mREITs must reinvest prepaid principal at lower prevailing market rates.

On the other hand, NLY is the largest mREIT and has the most experience—it launched in

Ticker	Name	Shares borrowed	Borrowing cost (bps)	Utilization rate
NLY	ANNALY CAP MGMT INC	36,615,513	9	11%
CIM	CHIMERA INVT CORP	19,324,327	8	14%
ARR	ARMOUR RESIDENTIAL REIT INC	10,872,301	68	72%
CYS	CYS INVTS INC	9,264,971	41	58%
TWO	TWO HBRS INVT CORP	3,611,441	9	13%
RWT	REDWOOD TR INC	3,526,463	15	15%
CMO	CAPSTEAD MTG CORP	3,297,907	10	17%
HTS	HATTERAS FINL CORP	3,013,511	6	9%
ANH	ANWORTH MORTGAGE ASSET CP	3,003,163	10	11%
AGNC	AMERICAN CAPITAL AGENCY CORP	2,675,275	1	12%
MFA	MFA FINANCIAL INC	1,795,526	9	2%
DX	DYNEX CAP INC	1,615,757	1	20%
IVR	INVESCO MORTGAGE CAPITAL INC	1,513,013	6	5%
MITT	AG MTG INVT TR INC	317,664	11	7%
AI	ARLINGTON ASSET INVT CORP	246,505	18	14%

October 1997. However, it has not positioned its portfolio well regarding prepayments. NLY tends to purchase TBA (to-be-announced) mortgage-backed securities, in which the seller may deliver a variety of different pools that meet PSA guidelines instead of specific MBS pools. On the other hand, one can't argue with NLY's 600+ percent total return since its IPO.

In 2011, AGNC earned an average asset yield of 3.19 percent and borrowed at an average cost of 0.89 percent (for a spread of 2.30 percent), but with leverage of 7.6:1 and other comprehensive income of $379 million, return on equity was 27.6 percent. NLY earned 3.70 percent and borrowed at 1.61 percent (for a spread of 2.09 percent) with leverage of 6.05:1 in 2011, but with an unrealised loss on interest rate swaps of $1.8 billion, return on equity was 2.51 percent. While NLY's net income is expected to rebound from $327 million in 2011 to roughly $2 billion in 2012 (because no loss on interest rate swaps is expected), the bigger difference between the two is that NLY's conditional prepayment rate (CPR) of 17 percent last year is much higher than AGNC's best-in-industry CPR of 10 percent. It is expected that AGNC's CPR will continue to outperform NLY's in 2012 as well.

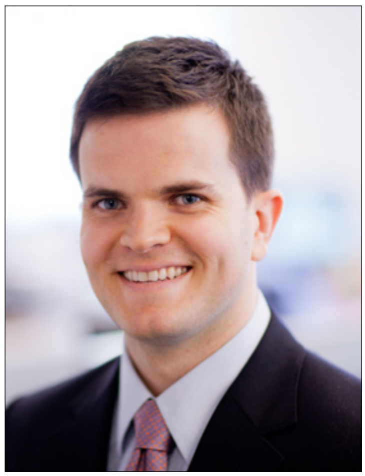
AGNC's strategy to limit prepayment risk (and achieve a low CPR) is to choose mortgage-backed securities that are less likely to be refinanced. Choosing the right securities is difficult, especially when AGNC is competing against other investors in the market. As we know from its 10K, AGNC specifically chooses securities with lower loan balances because homeowners with relatively small-sized loans will not find refinancing worth the cost. AGNC also chooses securities that already refinanced through HARP 1—so are less likely to refinance through HARP 2—and had a loan-to-value ratio of less than 125 percent. In addition, before HARP 2, AGNC sold its high-coupon, well-seasoned mortgage-backed securities because those would be the loans that would be more likely to refinance. It's important for AGNC to protect against prepayment risk because AGNC's portfolio's cost basis is 4.7 percent above par on average. In other words, AGNC's mortgages that prepay at par will result in an average loss of 4.7 percent. It must be noted that prepayment is not always a negative, however, because for those investors who purchase mortgage-backed securities at a discount, prepayment at par would result in a capital gain.

In addition to prepayments, another risk is a flattening of the yield curve since mREITs borrow short and lend long, benefitting from a steep yield curve. Despite the US Federal Reserve's third round of quantitative easing (Operation Twist), which attempted to flatten it, the yield curve is still relatively steep when compared to the average difference between 2-year and 10-year Treasury bonds over the past 20 years. As of 8 May 2012, the difference between 2s and 10s was 161 basis points versus a 20-year average of 116 basis points.

While the Federal Reserve's Operation Twist hurt MBS investors, the mortgage market overall in the US was helped immensely when Fannie Mae and Freddie Mac were placed into conservatorship (at a cost of $180bn and counting) and the Federal Reserve and US Treasury purchased almost $1.5 trillion in agency mortgage-backed securities. The Federal Reserve will most likely not sell these securities soon, and it may simply hold them until maturity. But if the Federal Reserve does sell, the value of other MBSs will decline. For instance, when the Federal Reserve announced that as part of Operation Twist it would reinvest its agency mortgage-backed securities' dividend proceeds, spreads on MBS fell 20 basis points. If spreads moved this much based on the Federal Reserve's dividend proceeds, they will increase much more if the Federal Reserve sells the underlying securities.

A final risk that must be mentioned is another tightening of the repo market. Similar to how counterparties in the repo market lost confidence in Lehman Brothers, mREITs must ensure that they're able to meet margin calls. Leverage helps increase returns in good times, but leverage can also force an investor to sell at inopportune times.

While there are many risks with mREITs, it seems that the high yields may sufficiently compensate investors. If investors are looking for a pairs trade to take advantage of the discrepancy between various mREITs' current portfolios, the table opposite shows the current number of shares borrowed and borrowing costs for 15 mREITs. As with all long positions, investors should monitor the securities lending market through services like SunGard's Lending Pit in order to be prepared if and when short sellers begin to take sizeable positions. **SLT**



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Repos and Securities Lending provides a comprehensive and practical programme explaining the legal, regulatory and documentary issues involved in repo and securities lending transactions.

Industry appointments

US independent regulator the Financial Industry Regulatory Authority (FINRA) has hired **Robert Colby** as its chief legal officer.

He will join FINRA on 18 June from Davis Polk & Wardwell LLP, where he is a partner in its Washington, DC, office.

Colby will oversee the corporate and regulatory functions of his new office, as well as the regulatory policy group, which is responsible for implementing FINRA's Corporate Financing and Advertising rules.

His current practice encompasses complex regulatory and compliance matters involving securities and derivatives for broker-dealers, financial institutions and markets, and clearing organisations.

Before joining Davis Polk, Colby spent 28 years at the US Securities and Exchange Commission (SEC). During his time at the SEC, he served as the deputy director of the division of trading and markets, chief counsel of trading and markets and chief of the division's branch of market structure.

"Colby is a perfect match for this key position and an excellent addition to our management team," said Richard Ketchum, chairman and CEO of FINRA. "[His] unparalleled expertise in both regulatory and corporate law makes him uniquely suited to be FINRA's first chief legal officer."

FINRA's general counsel, **Grant Callery**, who joined FINRA in 1979, will retire on October 1. **Marc Menchel**, general counsel for regulation, is leaving FINRA on June 1 to move into private practice.

Pauline Parker has recently joined as head of Rule Financial's application managed services division.

Parker formerly worked as a business consultant for core banking vendor, Temenos, and will lead Rule's application managed services team who work globally supporting clients' vendor and proprietary systems.

Parker also held roles at both Misys and SunGard, where she was heavily involved in evolving fully customer-centric product lifecycle modelling.

J.P. Morgan has reportedly made two redundancies in its prime brokerage division, while Securities Lending Times has been told that there has been another cut in its equity finance division.

Keith Pulsifer, head of prime brokerage services, and **Arthur Roby**, a senior-level stock loan employee, are among those reported as having been let go, alongside **Andrew Jamieson**, managing director of the equity finance business in EMEA.

Both Pulsifer and Jamieson held prior positions at Bear Stearns; the latter acting as European head of equity finance from 2007-2008.

A spokesperson for J.P. Morgan declined to comment.

John Clifford Jones has been appointed international sales director for Tullip Tree Advisors.

Formally head of international securities lending for Bear Stearns London, and subsequent contracting roles at State Street, Barclays Capital and Kellner Di Leo, he has joined Mike Frazier to market their cloud based global securities lending trading and settlement solution.

Deutsche Bank has hired former Brown Brothers Harriman network chief **Andrew Rand** as regional head of direct securities services (DSS) in EMEA within its global transaction banking division.

Based in Frankfurt, Rand was responsible for managing the global sub-custodian banks for BBH and has more than 20 years' industry experience. Rand will report to Thibaud de Maintenant, global head of direct securities services.

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Maintenant said: "His appointment reinforces our commitment to the EMEA region where we currently operate in 16 markets. Andrew will represent DSS in national and international markets."

Satvinder Singh, global head of trust & securities services and cash management for financial institutions at Deutsche Bank, said: "With Andrew's appointment we are further strengthening our DSS team and franchise in continental Europe. Andrew's proven track record will prove invaluable and his decision to join Deutsche Bank reinforces the excellent reputation of our securities services business." **SLT**

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