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2010 - 2015

International Securities Services Roundtable

Securities Financing

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Richard Deroulede
Head of Trading
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Joseph Omansky
Chief Investment Officer
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Securities Financing

Brian Bollen and a cross-section of representatives from the full chain of securities lending gathered together virtually to exchange thoughts on a range of issues affecting the securities lending market and participants therein.

ISS Magazine: What are the main trends that are leading the market towards greater use of CCPs for securities lending?

Gerard Denham, senior vice president at Eurex Clearing: The main trends are extensive capital requirements for capital ratio, exposure and risk weight calculations. Additionally, there is the introduction over time of CVA VaR capital charges as well as the framework for the leverage ratio. At the same time, the indication is also that the market will experience an increase in demand for collateral, impacting the supply and liquidity of the marketplace. In the longer term, this will be driven by margin requirements on OTC derivatives and haircut floors for securities finance transactions and the limited ability to re-use and re-hypothecate collateral along with stricter standards on eligible collateral - all will apply pressure on the market's ability to finance assets – in particular those classified as HQLA. All of these trends point towards a higher cost for doing business on a bilateral basis.

ISS Magazine: What should CCPs focus on for the medium and long term so that they can assist the market further?

Gerard Denham: The main focus for Eurex Clearing is on clients, collateral and markets. The ability to attract and extend the range and type of clients is essential, this is why the direct model for buy-side clients, the Specific Lender License, was integrated into the CCP service. Additionally, Eurex Clearing will increase the capability for users of this type of licence with the ability to allow for the title transfer on non-cash collateral and allowing cash to be utilised, too. This enables a broader range of Beneficial Owners and their Agent Lenders to participate directly with the CCP while maintaining their existing relationships to continue to transact business. For collateral, the key focus is flexibility and fluidity - being able to offer a broader range of collateral across different transaction types in multiple settlement locations will assist the market further as the liquidity of collateral becomes crucial for the market. Our clients also want to be able to transact in a wider range of markets and asset types; that's why Eurex Clearing is looking to expand the range of eligible equities across markets in Europe and North America.

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> - Gerard Denham, Eurex Clearing

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ISS Magazine: What do you think will be the effect of more CCP involvement in the Securities lending market?

Iain Mackay, post-trade services product owner, EquiLend & BondLend: On the positive side there are potentially a number of benefits for participants. From a business perspective there is the opportunity to extract real cost savings in terms of liquidity management through capital requirement reductions. With CCPs, there is the opportunity to fundamentally change the post-trade operating model within securities financing. It would ensure that the process becomes more structured and regimented with overall better governance. Examples of this can be seen with centralised pricing and advantageous agreed and confirmed pay dates for dividends and billing. Hopefully this practice would spill over into bilaterally agreed trades, which would help automation further, providing cost savings and appease regulatory bodies.

On the challenging side there are few open questions around the CCP business model which need to be addressed. Until a number of participants get comfortable around asset servicing and legal entitlement, the take-up will likely remain lower than hoped for. CCPs may also create fragmentation within the market. CCPs are an additional intermediary to the lifecycle of the trade, and the business will need to be managed separately, for example, from a collateral perspective. This fragmentation comes with additional costs, and participants need to evaluate this before embarking with the product. Whatever route the industry takes with regard to CCPs, EquiLend intends to support that transaction flow.

Richard Deroulede, head of trading, equity finance, Societe Generale,

Richard Deroulede
Head of Trading
Societe Generale CIB

Richard Deroulede joined SGCIB in 2005 to develop the Structured Equity Finance business; he took over the responsibility of the team in 2006 and further expanded it to structured and flow equity financing solutions. He became head of the Equity Finance Trading team for Europe in 2009 and has since developed the flow and structured business, adding Market Intelligence and Collateral Trading functions to the group.

Richard is a graduate from Ecole Normale Superieure and ENSAE.

> *Securities Financing is still very much an OTC activity but market participants have been working for the past decade or so to improve efficiency and short coverage.*
>
> \- Richard Deroulede, Societe Generale CIB

Prime Services: My first thought is that this will push us towards greater standardisation of trades. Securities financing is still very much an OTC activity but market participants have been working for the past decade or so to improve efficiency and short coverage. My second thought is that it will increase market transparency. As areas of the market can be quite dark and as certain market participants have derived great benefit from that darkness, heightened transparency will be in itself a good thing.

Joseph Omansky, chief investment officer and portfolio manager, Sky Fund LLC: More participants in securities lending provides more efficient markets and liquidity. CCPs are at the centre of OTC transactions connecting to multiple players. It is a natural fit for CCPs to become more involved in securities lending and this will provide greater access to lending at more efficient prices for all participants.

SG CIB assists corporates, financial institutions, public sector institutions and family offices, meeting their needs in terms of investments, strategic advisory services, capital raising and capital structure optimisation.

Relying on its internationally recognised expertise in structured finance (acquisitions, exports, natural resources, infrastructure and assets, media and telecom, real estate and lodging, etc.), SG CIB can offer a truly global set of financing solutions to its clients.

In addition, SG CIB offers global access to market via solutions in equities, fixed income and currencies, commodities and alternative investments. SG CIB develops advisory, investment and risk management solutions for the specific needs of each investor, supported by its number one worldwide equity derivatives franchise and leading positions in euro fixed income markets and cross-asset solutions.

Gerard Denham: The move towards CCPs for securities lending will have a certain positive impact for all market participants throughout the chain; from beneficial owners and agent lenders to banks, prime brokers and hedge funds. The reason being that a full-service Lending CCP brings capital efficiencies, broadens participants' distribution channels as well as delivering operational efficiencies.

Interest in CCPs for securities finance gathers pace as the capital cost savings and the credit risk benefits of transacting via a CCP become apparent. Eurex Clearing's lending CCP has been established to meet the new demands of the securities financing markets, reducing credit and systemic risk and further increasing operational efficiencies while maintaining important bilateral market characteristics.

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ISS Magazine: What issues have you seen emerge as companies have been required to gather more data?

Richard Deroulede: The main thing I see is the need for an upgrade of IT systems. We are all working with in-house or vendor systems developed years ago which don't provide the flexibility needed today as we are required to collect, manipulate and otherwise process data. Our sector has still to adapt to the growing realities of 'Big Data'.

Iain Mackay: EquiLend is in a unique position as we have a robust set of data ranging from market data through to different components of the lifecycle of the trade. Whilst we collate this in a standardised format, we are able to provide flexible reporting depending on clients' requirements.

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ISS Magazine: Does the current technology on offer meet the regulators demands in terms of data collection, analysis and benchmarking?

Richard Deroulede: My answer to that is a very short one. More development is required to standardise information and upgrade systems.

Iain Mackay: We are seeing regulators getting more involved and engaged in the securities finance business, and we expect this to grow in the future. We collect a wide range of data, which we are able to transform to produce the relevant reporting clients need to meet regulatory demands. We expect further requirements to come and believe we are in a strong position to support these.

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ISS Magazine: Do you agree with Mary Jo-White (chair of the SEC)'s recent comments that there is a need for greater controls on liquidity management?

Joseph Omansky: Yes I do agree that greater controls should exist on liquidity management. Liquidity, or ensuring that a fund is able to meet the liquidity needs of its investors is among the most important factors contributing to risk in the global financial markets. By monitoring and requiring fund managers to meet certain liquidity requirements, market participants are able to lower risks associated with return of capital when needed. We have seen growth in liquid alternatives globally due to increased requirements on maintaining liquidity and such practices should continue to be uniformly adopted.

Gerard Denham: A CCP for the securities finance market can facilitate the use of a cost-effective structure to improve and optimise securities finance activity through enhanced efficiency and safety for the entire market place. As well as helping to deliver an increase in supply to the market and improve liquidity, the CCP introduces standardised and transparent risk and collateral management methods.

The CCP's integrated cross-product service offers netting of regulatory capital across all cleared products, while being able to deliver collateral efficiency through a wide range of customised choice on collateral eligibility paired with re-use capabilities. The CCP is an extremely efficient tool for enhanced liquidity management.

Richard Deroulede: I believe that regulators have moved towards more transparency from market participants, and this is a move in the right direction.

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ISS Magazine: How do you see securities lending developing in the next year?

Iain Mackay: We expect organisations to further embrace technology to find

Joseph Omansky
Chief Investment Officer
SkyFund LLC

Joseph Omansky is the Chief Investment Officer and portfolio manager at Sky Fund LLC, a hedge fund firm and SEC Registered Investment Adviser. Sky Fund LLC is the investment adviser on a low volatility index of alternative UCITS in partnership with a European bank that has issued a principal protected note linked to the index.

Before Sky Fund, Joseph was a portfolio manager at Tradelink LLC where he managed an equity options volatility arbitrage fund. Previous to Tradelink, he was an equity options market maker with Lakota Trading Inc. where he managed an options book on the floor of the Chicago Board Options Exchange.

Joseph received his Masters in International Economics and Finance from Brandeis University and his Bachelors in Economics from Clark University. He resides in New Jersey and works in New York City.

Sky Fund LLC is a financial technology and investment advisory business utilizing proprietary ranking algorithms, intelligent data, and related intellectual property to help clients achieve their goals. Sky Fund LLC advises its clients on allocation to highly rated alternative investment fund managers including hedge funds, alternative UCITs and liquid alternative funds.

Sky Fund LLC, through the SkyRank System of Hedge Fund Ratings has applied its rating to tens of thousands of alternative fund managers on behalf of hundreds of high net worth and institutional investors over the past decade. Sky Fund LLC holds a patent on a System of Hedge Fund Ratings, Patent #7,536,333 and is a Registered Investment Advisor, CRD#126954.

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>
> - Joseph Omansky, SkyFund LLC

In 2000, a group of 10 global financial institutions joined together, looking for ways to optimize efficiency in the securities finance industry by developing a standardized and centralized global platform for trading and post-trade services. EquiLend Holdings LLC was formed in 2001, and the platform went live in 2002.

Since our launch, we have increased our network to more than 100 clients, released a number of new functions and enhancements, introduced the platform to the global fixed income securities finance community (BondLend) and launched a global securities finance market data service (DataLend).

Owners include BlackRock, Credit Suisse, Goldman Sachs, J.P. Morgan Clearing, J.P. Morgan Chase, Bank of America Merrill Lynch, Morgan Stanley, Northern Trust, State Street and UBS.

Iain MacKay
Post-Trade Services Product Owner
EquiLend & BondLend

Iain Mackay is Global Product Owner for Post-Trade Services at EquiLend and BondLend. He joined the company in 2014 from the Royal Bank of Scotland, where most recently he was Global Head of Network Management.

Before that, he was the European Head of Securities Operations at the firm, overseeing operations for cash equities, equity finance, fixed income and equity derivatives products. Prior to RBS, Mackay was the European Department Manager for Prime Services at Deutsche Bank, Section Head for Finance Operations at Citigroup International and Securities Lending Collateral Manager at Nomura. He has 20 years of experience in the securities finance industry.

automated solutions both in pre- and post-trade to reduce costs, find solutions to regulatory requirements and reduce risk exposure within their business models. We also think that T2S will start to play a part in how firms manage their inventory and could potentially have an impact on trading activity of organisations.

There could also be a change in how organisations manage their vendor relationships, with consolidation expected, and deeper partnerships built and managed with their strategic choices.

Alexandre Roques, head of securities lending, Clearstream Banking S.A: In a market environment where liquidity access has become more strategic, getting access to key security lenders has become an essential infrastructural choice over the last five years. This trend continued as a result of recent central bank intervention through programmes like the SMP or more recently the introduction of QE in Europe.

So far this year, we have seen an increase in our own securities lending balances as a result of a significant increase in spreads. This shows how important we have become to our borrowers and highlights the importance of providing them with the liquidity that they need in the most flexible way.

There are still challenges to come; collateral is very expensive and is putting pressure on the economic justification of each and every loan. Borrowers are also calling for more flexibility around term trades in a business which has been traditionally traded on open. This is mainly due to the Liquidity Coverage Ratio requirements imposed by regulators under Basel III / CRD IV.

We are confident that the securities lending business will continue to develop positively in the next year as the demand for liquidity remains high due to the recent QE intervention or more generally following an increased appetite for higher quality collateral. Market infrastructures like CCPs will significantly reduce risks both on the collateral and on the counterparty side and will also contribute to the development of this industry.

Joseph Omansky: Even with low interest rates, I have been encouraged to see a multitude of new methodologies around securities lending including peer to peer lending, collateralised lending, and direct lending from banks and other financial companies. I expect this trend to continue. We are seeing innovations in areas around lending and in other areas of the financial markets like Central Clearing Counterparty Platforms and other related areas also. Securities lending will continue to develop in this area.

Gerard Denham: The new regulatory paradigm will impact costs for both sell-side and buy-side institutions. Increased capital requirements and costs will particularly have a large impact on bilateral transactions and exposures that all lead to higher costs of bilateral business to account for declining sell-side economics. The high cost of maintaining existing business levels for borrowers engaged in securities financing activities leads to worsening terms for securities lending arrangements for beneficial owners.

For collateral and liquidity, demand will lead to increased margin and collateral requirements across bilateral and cleared business. On the supply side, there will be reduced availability, fluidity and liquidity of collateral due to new regulations. The move towards central clearing by all market participants can achieve capital, collateral and margin efficiencies for the market.

Richard Deroulede: The Lehman bankruptcy has pushed market participants to favour secured financing versus traditional unsecured financing, which has strongly increased the role played by securities lending business in interbank financing activity. The securities lending business has therefore evolved toward collateral trading and is being utilised (i) by a wider scope of clients and (ii) on various asset class.

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ISS Magazine: Has there been significant change in investment strategies that use securities lending? If so, why?

Alexandre Roques: Borrowers are using securities lenders for mainly two reasons. One, to cover shorts. This type of business is fairly straightforward, especially when using screens like Bondlend to distribute portfolios. Here, strategies haven't changed dramatically. When spreads are bigger and average sizes are smaller, the quality of the collateral that the borrower gives becomes less important.

Two, to borrow government bonds, usually in more significant clips (above 100 million), to play the specials (like the cheapest to deliver), or for a collateral upgrade. In the current environment there are fewer specials, meaning less spreads to cover the additional cost of haircuts. Consequently, borrowers are entering into these types of trades to a lesser extent. Concerning collateral upgrades, a number of lenders have been hit by the downgrades of key countries that were used significantly (like the European peripherals e.g. Spain, Italy, etc) as collateral over the past few years.

For government bond trades, strategies have had to change. There is very little value in borrowing against expensive collateral, so borrowers now need to go down the quality curve in terms of the collateral quality they can provide and/or term the trade for the longest time they can.

Some lenders can accommodate such strategies while others don't have such a risk appetite. This is also where infrastructure providers such as CCPs could play a major role in the future.

Gerard Denham: There are many different topics that are driving different strategies currently; the use of cash collateral versus non-cash collateral, re-use or not to re-use collateral and any subsequent regulation that may impact this strategy and the central banks buying bonds through quantitative easing. All of these are playing an important role in the ever-evolving world of securities finance and investors and end users all need to monitor developments in order to make their businesses more effective and efficient.

"The more transparency exists in the market, the more encouraged beneficial owners may be to increase their lendable inventory."

- Iain MacKay, Equilend

Richard Deroulede: Yes. We have seen the development of collateral trading, coming from the development of secured financing in interbank financing.

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ISS Magazine: Are we likely to see an increase in third-party lending?

Alexandre Roques
Head of Securities Lending
Clearstream Banking S.A

Alexandre Roques is the head of the securities lending desk of Clearstream Banking S.A. Based in London, he is responsible for the distribution of assets to borrowers under our ASLplus programme and co-ordinates the lending / borrowing strategy for the lending desks based in EMEA and Asia. Alexandre joined Clearstream in Luxembourg in 2009 relocating to the UK in 2010. Prior to this, Alexandre spent 10 years at BP2S in Paris and London, working in the Market and Financing Services Division as collateral manager, agency lending Sales, as well as two years at Landsbanki in London as Associate Director on the Equity Finance desk.

Alexandre holds a Master in International Finance from ESLSCA Business School in Paris.

Joseph Omansky: Yes, we are likely to see third-party lending continue to increase with new entrants to the market. With a need for direct lenders, like mutual fund companies to increase yield to investors through lending and effectively identify borrowers, they will continue to seek out relationships with intermediaries via third-party lenders. The primary lender should be careful regarding fees paid to the third-party lending entity, cash forecasting of yields and rebate levels to ensure that the rebate remains lower than the cash yield.

Richard Deroulede: Yes, as already referred to, the securities lending business has become more complex

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Clearstream is a global leader in post-trade securities services with more than EUR 12.2 trillion in assets under custody, making us one of the world's largest settlement and custody firms for domestic and international securities.

As an international central securities depository (ICSD) headquartered in Luxembourg, Clearstream provides the post-trade infrastructure for the Eurobond market and services for securities from 54 domestic markets worldwide – for approximately 2,500 financial institutions in more than 110 countries.

As a central securities depository (CSD) based in Frankfurt, Clearstream also provides the post-trade infrastructure for the German securities industry, offering access to a growing number of markets in Europe.

Clearstream also offers such services for the Luxembourgish market via LuxCSD, a CSD which is jointly operated by Clearstream and the Banque centrale du Luxembourg (BCL). Clearstream has consistently high credit ratings (AA) which testify to its robustness and reliability.

> *So far this year, we have seen an increase in our own securities lending balances as a result of a significant increase in spreads. This shows how important we have become to our borrowers and highlights the importance of providing them with the liquidity that they need in the most flexible way.*
>
> - Alexandre Roques, Clearstream

because it's being utilised for various purposes, by a wider scope of clients and on various asset classes. With this growing complexity we see clients more willing to delegate this activity to experts, typically third-party lending business. This is also driven by reduced revenues in many business areas pushing for cost reduction and the outsourcing of non-core business.

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ISS Magazine: How do you think increased transparency and a move away from shadow banking might impact the landscape?

Joseph Omansky: The increased transparency will be beneficial in the form of reduced spreads, fees, and increased volume for securities lending.

Whenever there is more information in the marketplace, it increases volume and decreases spreads or fees associated with the transaction.

Gerard Denham: The aim of the regulatory reporting directive is to assist regulators in being able to identify activities and participants across all securities financing transactions. Only once the reporting is in place can regulators truly evaluate the extent of non-bank involvement and how they affect and impact the market.

Richard Deroulede: Positively. There has been a great misunderstanding of how this business works and its embedded risks, focusing on the multiple re-use of the same collateral, or the risk of receiving totally illiquid collateral; I'm optimistic that many investors will come to value first the advantages of securing financing transaction by collateral and the flexibility that can be applied on the collateral.

Iain Mackay: We don't necessarily see a move away from shadow banking per se. The FSB classifies securities lending as a type of shadow banking, and the securities lending market remains robust. The FSB is currently advising on increased transparency in the securities lending market—discussions we are actively involved in—and believe this will have a positive impact on the securities finance industry. The more transparency exists in the market, the more encouraged beneficial owners may be to increase their lendable inventory.

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ISS Magazine: Is there truly still any money to be made from securities lending? If so, by whom? The asset owners or their service suppliers? Or both? If not, why not?

Joseph Omansky: I do believe that there is money to be made in securities lending, despite low interest rates. I believe there is money to be made by both primary lenders and third-party lenders.

Gerard Denham: New clearing models being developed for buy-side participants for derivatives and existing specific or direct member roles for beneficial owners transacting securities lending and repo help banks involved as borrowers to reduce trade exposures of counterparties subject to Basel III. These will help reduce risk-weighted asset and leverage ratio capital requirements for the sell-side resulting in more beneficial terms for the buy-side, particularly for beneficial owners and their securities lending programmes.

Additionally, the broader range of eligible collateral managed at the CCP will increase flexibility, enable cleared Securities Lending and repo as efficient collateral transformation and

eurex

Eurex Clearing's Lending CCP covers both bilateral OTC transactions and electronic trading markets for bonds, equities and Exchange Traded Funds for the European marketplace. The service developed in conjunction with market participants, achieves an increase in capital efficiency and reduces counterparty risk whilst retaining the characteristics of the bilateral market and reducing the operational burden for all market participants.

Eurex Clearing is one of the world's leading clearing houses and an innovator in risk management, with a proven track record and market expertise within secured funding and securities financing with its services for repo, GC pooling, securities lending and collateral management.

Gerard Denham
Senior Vice President
Eurex Clearing

Gerard Denham is responsible for the business development, sales and relationship management for Eurex Clearing's Lending CCP – its Central Counterparty (CCP) service for the Securities Lending market.

Denham has 20 years' global experience of Securities Financing and Collateral Management gained within the Asset Management, Global Custody, Investment Banking, and IT sectors having previously been based in Chicago, Frankfurt, London and Zurich.

yield enhancement tools, as well as providing participants the opportunity to raise eligible collateral and/or create additional yields on assets and lower financing costs and enhanced terms due to reduced counterparty risks and exposures on a CCP.

Richard Deroulede: Mostly from collateral upgrade trades. Securities financing has emerged as a truly solid business playing a key role in the market, but short coverage is a business that has seen revenues in Europe fall sharply as short sellers have reduced positions.

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ISS Magazine: Are we any closer to genuine price discovery than we were five to 10 years ago? If so, how? If not, why not?

Iain Mackay: We believe that the market is closer to true price discovery than ever before. On our EquiLend and BondLend platforms, we have seen an increase in clients and transactions year on year since inception. Clients can broadcast an indication of interest (IOI) on our platform and receive a near-immediate response and make a trade, all the while informed with aggregated pricing data from DataLend in a seamless workflow. That provides a level of transparency in price discovery that the industry has never before enjoyed.

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ISS Magazine: Finally, are there any burning issues which we should have covered but have missed out? If so we would value your feedback.

Richard Deroulede: There is a great need to improve the image of securities lending by displaying the risk/reward of the transactions taking place and the benefits of this business for the market as a whole. The more we show how the business works, and the more information we provide on everyday matters, the better it will be for our business.

Gerard Denham: The future of Agent Lender indemnification and how will this impact Beneficial Owners? As part of the core service offered, Eurex Clearing's Lending CCP - after novation - becomes the guarantor of the loan and collateral securities, offering the protection from counterparty default - the exact same purpose of the current indemnification against the borrower defaulting offered by Agent Lenders. The lessening of such an indemnification over time will enable the Agent Lenders to offer a more efficient and cost-effective service to Beneficial Owners, in combination with the enhanced collateral and risk management provided by Eurex Clearing acting as the central counterparty.

Brian Bollen
Consulting Editor
International Securities Services Magazine

Brian Bollen is a vastly experienced financial journalist, who has spent his entire professional life observing and writing about the international institutional finance industry, on subjects ranging from the Latin American debt crises of the mid-1980s to the emergence of direct debt as an asset class.

He has been a full-time freelance journalist since January 22 1993, when he left the Financial Times building at Number One Southwark Bridge for the last time, after more than eight years as a full-time writer, executive editor and editor within the FT Group.

He passed his banking exams and was elected an Associate of the Institute of Bankers in July 1983, towards the end of his five-year spell on the Midland Bank International graduate programme and was invested as a Fellow of the ifs School of Finance, since upgraded to ifs University College, in March 2007

Brian Bollen MA (Hons), Fellow of ifs University College

Freelance Journalist: Writer, Editor, Media Consultant & Media Trainer

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