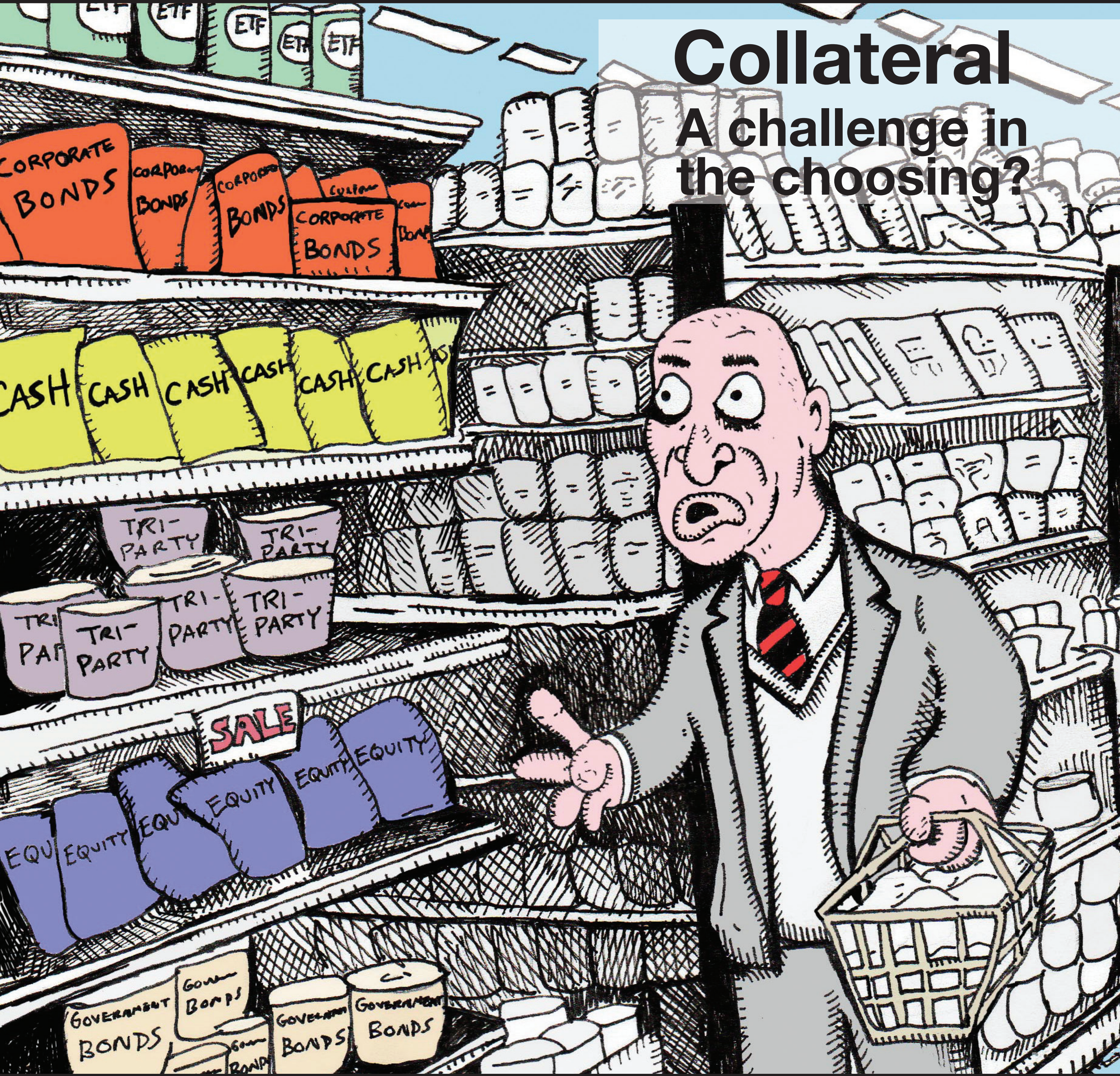
GSL
Global Securities Lending

GSL ISSUE 07 Q1 2010



Collateral
A challenge in the choosing?

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Lend an ear

After the market panic of 2007 and 2008, regulators spent much of last year researching short selling and securities lending.

The information they have gathered has a number of implications. Foremost among these is the acknowledgement that securities lending is a vital part of the capital markets.

Inevitably the increased attention will manifest itself in increased regulatory influence and our panel discussion with several key industry associations establishes where we are today and what the future holds.

Having weathered the first phase of the credit and liquidity crisis in 2007, the continuing challenges in the money market and the Lehman default in 2008 pushed some beneficial owners out of securities lending.

Yet some resisted this knee-jerk reaction and stayed the course. We profile two individuals from firms that not only continued lending but have also contributed to improving the wider beneficial owner community's and regulators' understanding.

Collateral management has always played a critical part of the business, but will be ever more important going forward. I have dubbed 2010 "The Year of Collateral" and this will remain central to our editorial focus going forward.

Three important countries are profiled in this issue. France retains its position as one of the largest and most active equity lending markets and with the launch of the first European central counterparty for securities lending, it carries an importance beyond simply its size.

Australia has arguably experienced more turmoil than any other active securities lending market. We look at the prospects in the aftermath of scandals and the tremendous scrutiny of market participants, regulators and media.

Spain stood out for many years as an active lending market without the benefit of substantial domestic participants, and there was much anticipation the necessary approvals would be given in 2008.

Then Lehman happened and the pen that was due to sign the orders was quickly put back down on the desk. We look at the situation in Spain today.

Roy Zimmerhansl, Editor-in-Chief

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ISSN 1759-0728 Printed in the UK

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“Apples and oranges"

Which market practitioner said comparing the first and fourth quarter of 2009 was like comparing these two fruits?

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News Round-up

Top industry stories at deadline.
For daily updates go to www.gsl.tv

Securities Lending

In January, China gave approval "in principle" to a number of financial reforms, which could aid the development of a securities lending market in the country. Investors in China will soon be able to sell stocks short, some believe, as well as have access to stock market index futures and margin trading.

Philippine Stock Exchange (PSE) CEO and president Francis Lim highlighted securities lending as an area where the exchange is likely to prosper in the new year. As part of the bourse's 'Level Up' plan, he said this year would see the activity of "the new trading system and the securities borrowing and lending programme that will enable short selling in the stock market".

The Securities and Exchange Board of India (SEBI) has announced a revised framework for the borrowing and lending of securities within the Indian market. A circular from the organisation revealed a number of modifications based on industry feedback to a previous circular released in October 2008. Under the new framework, securities lending contracts may last for a period of up to 12 months, stating that the approved intermediary (AI) in the transaction will decide the exact length. The circular also made provisions for allowing both the lender and borrower to recall or repay the shares early, with the AI stepping in if a recall takes place.

The Options Clearing Corporation saw the notional value of its stock loan contract top USD16 billion, according to its 2009 results. OCC expanded its securities lending programme last year and signed an agreement with Quadriserv to provide clearing house services and act as a central counterparty (CCP) to stock lends submitted via Quadriserv's AQS platform.

People Moves

Brian T Moynihan was elected CEO by the Bank of America board of director, replacing Ken Lewis on 31st December. Moynihan has been involved in a number of leadership roles at the bank and will move from his current position as president of consumer and small business banking.

HSBC Securities Services global head Tim Howell was named as the successor to Pierre Francotte as CEO of Euroclear, who announced his intention to leave the role last year.

On 8th December it was announced that Jeannine Lehman was appointed head of client relations within the securities lending division of Bank of New York Mellon. Lehman will be based in London and will take charge of securities lending client relationships in Asia and Europe as well as overall service delivery to non-US clients.

Dean Backer was appointed global head of prime brokerage and capital introduction at Goldman Sachs.

Collateral Management

The European Central Bank launched a paper for the market – "The collateral frameworks of the Eurosystem, the Federal Reserve System and the Bank of England and the financial market turmoil" – to outline the frameworks of the three institutions' participation in stabilising the financial markets. On 5th November the Bank of England's Monetary Policy Committee today voted to continue with its programme of asset purchases financed by the issuance of central bank reserves and to increase its size by GBP25 billion to GBP200 billion.

Wells Fargo responded to reports that it is facing a probe from the US Securities and Exchange Commission (SEC) by claiming that an information request it received from the regulator was part of a wider review of securities lending in general. A number of organisations in the US have launched a lawsuit against Wells Fargo, accusing it of making investments in "risky and/or illiquid securities" as part of its cash collateral reinvestment programme – an accusation the firm denies.

Technology

Securities lending participants using Quadriserv and SunGard's integrated platform now have access to straight-through processing of price discovery, central counterparty clearing, settlement and open loan contract maintenance, the firms announced in December. The new capabilities are the fruition of a partnership that was first announced in May 2009, which has seen Quadriserv's AQS platform integrated with SunGard's Loanet processing technology.

At the end of November J.P. Morgan Worldwide Securities Services upgraded its securities lending dashboard to allow clients to monitor their lending activities in a customised view with real-time information. The enhanced dashboard provides clients with snapshots of critical portfolio data and is available through J.P. Morgan ACCESSSM, the firm's web-based portal for treasury and securities services.

Omnify, the incubator for middle and front office software firms and provider of niche software and services to asset managers, launched a real-time surveillance and alerts module for 'Athena Aura' - the analytics, visualisation and business intelligence dashboard for hedge funds.

ELX Futures, L.P. , a new fully regulated electronic futures exchange, has selected Firm58, a financial management software provider, to automate billing processes and invoice delivery.

Using Firm58's billing solution, ELX Futures will provide an online portal for exchange participants to access daily balances, trade discounts and fees, and detailed reports. Firm58's software-as-a-service (SaaS) platform provides ELX Futures with additional business insights via summary-level views of trade activity, income analysis and profitability drivers.

Market Infrastructure

The UK Treasury devoted just 39 words to securities lending in its Pre-Budget Report, submitted to the House of Commons yesterday by Alastair Darling, Chancellor of the Exchequer.

In the chapter entitled 'Reforming incentives and governance in finance sector firms' - after summarised recommendations on corporate governance from Sir David Walker - article 3.39 states: "The FSA has been reviewing the governance and risk management of stock lending in the market. The Government welcomes this work and will work with the FSA and market participants as necessary to help develop thinking in this area."

The Investment Industry Association of Canada (IIAC) has selected the Canadian Derivatives Clearing Corporation (CDCC) to develop a central counterparty for the Canadian repo market, in a move welcomed by the country's central bank. Bank of Canada governor Mark Carney described the move as "a critical first step" and cited the effect of an efficient repo market in helping the country's core markets function continuously. "Developing a more effective central counterparty framework for repo transactions in Canada constitutes important progress, and the Bank of Canada is pleased to be working closely with industry on initiatives such as this," he said.

A review of the Australian superannuation system, the Super System Review, has called for "better disclosure" by trustees involved with securities lending. The review panel, chaired by Jeremy Cooper, former deputy chair of the country's securities regulator, suggested that there should be no restriction on the practice within the system. However, "the panel believes that there should be better disclosure to members about the trustee's policy on stock lending, the risks involved (if any) and the fees it derives from and pays for that practice", the report read. "Disclosure should also be made about who retains voting power over the securities."

Repo

Daiwa Securities SMBC Europe – a key repo market participant - was renamed as Daiwa Capital Markets on 1st January 2010.

Borrowers

Shane Norman, a leading fund adviser at ML Capital, told GSL that there was "no prima facie reason" why hedge funds should be required to contribute to a Systemic Resolution Fund being proposed by US lawmakers. The proposal forms part of the Financial Stability Improvement Act of 2009, which has just been approved by the House Committee on Financial Services, but has come in for criticism from global hedge fund body the Alternative Investment Management Association (AIMA).

Assets under management of hedge funds – a key stock borrowing community - passed USD 2 trillion in value for the first time in a year during November, according to new figures from HedgeFund.net.

The statistics showed that total assets increased by 3.39% to reach USD 2.037 trillion. Assets were last above the USD 2 trillion mark in November 2008.

More Nordic securities lenders are returning to the market and will find ongoing changes and new models in both prime brokerage and hedge funds, according to SEB Enskilda's head of prime brokerage. Magnus Ward, speaking to GSL.tv from the Swedish bank's London office, explained that first-time participants are joining lenders who had stopped their programmes during last year's turmoil as they return to the market.

On 18th December Credit Suisse announced that it was in exclusive talks with Fortis Bank Nederland with a view to buying the latter's alternative asset management services division, Prime Fund Solutions.

Deutsche Bank's Global Prime Finance division continued the market convergence between custody and prime brokerage with the launch of a hybrid of these services called DB Integrated Prime Custody. The platform allows funds to hold unencumbered assets that were typically held within their prime brokerage in a separate custody account held at BNY Mellon. It also enables unencumbered assets to be held within Deutsche Bank's separate custody division.

Galleon hedge fund founder Rajaratnam was accused in 2009 of trading on insider information about a number of big-name firms, including Google and Hilton, allegedly making around USD17 million in the process. In early January it was revealed that he is facing further charges in the US over claims that he paid an insider for information about the takeover of ATI Technologies by microchip giant AMD.

News Analysis

Market practitioners can hope for a steadier 2010 after a year of regulatory scrutiny and lower trading volumes.

Repo activity

With markets returning to stability, there is an even stronger case to be made for 2010 as the year for repo.

In the last issue GSL summarised the bounce in European repo transaction values in the first six months up to June, a rise from from EUR4,633 million to EUR4,868 million, or 5.1%. The average outstanding volume in December 2009 was EUR99.4 billion - EUR98.6 billion for the year as a whole.

This month saw a reflection of this increase on trading platforms. Eurex Repo – the electronic trading marketplace – and GC Pooling, the collateral service provided by Clearstream, together saw record levels of transaction activity. GC Pooling, which gives dealers the option of re-using collateral to generate refinancing capacity via the central bank, hit EUR73 billion average outstanding volumes – part of the annual growth rate (CAGR) of over 94% since its launch in 2005.

"Our business model comprising anonymous electronic trading, central clearing and efficient collateral management via Clearstream really proved itself last year," said Marcel Naas, managing director of Eurex Repo, said – music to the ears of supporters for a central counterparty model in securities lending.

Inter-broker dealer ICAP also had cause for celebration. Average daily electronic volume in US Treasury products on its BrokerTec platform in November 2009 increased 23% year-on-year to USD107.7 billion. Total average daily volume in fixed income products the platform - US Treasury products, US repo and EU repo - was USD506.1 billion for the month of November, an increase of 4% on the previous year, and USD452 billion for the 12 months ending 30 November. Volumes in European repo in November were solid at USD227.4 billion.

US Repo also had a strong month. Electronic volumes increasing 8% month-on-month to USD170.9 billion in November, up 3% on 2008.

Total electronic broking volumes on the EBS spot FX platform and the BrokerTec fixed income platform for the month of November 2009 was USD637.3 billion.

Onthe subject of the US, Eurex Repo, which plans to expand GC Pooling to secured financing in US dollars by the end of January.

Broker dealers also saw a swift return to activity after the Christmas break, according to comments to GSL. "The cash market has been active, it's not an immediate pick up in corporate repo market but that's a natural and logical conclusion," said a senior trader in a top Asian bank, who declined to be named. "Repo markets have been very quick to start up again - from December to January people lock up their liquidity and balance sheets and [activity] picks up very quickly afterwards."

An event, dear boy

On the 18th and 19th November, 2009 Data Explorers and eSecLending, in partnership with the Melbourne Centre for Financial Studies, hosted an educational securities lending seminar in Sydney and Melbourne.

The purpose was to discuss the increased focus on securities lending and its relationship to short selling both globally and in Australia.

"Australia is one of the largest and fastest growing superannuation/pension markets in the world," explained Giselle Awad, senior vice president of of eSecLending Asia Pacific. "The credit crisis has had a particularly profound effect in Australia, characterised by short selling bans, regulatory changes and negative press.

"This brought significant opportunity for education to funds about securities lending to help them make better informed decisions," she added Ms Awad.

The first panel one looking at the fundamentals of securities lending, and the major industry events which resulted in an increased focus on transparency and regulation.

No average Joe

Central counterparties (CCP) are arguably the hottest issue in securities lending currently and interest from broker/dealers in the model remains high – at least according to Joe Pellegrini, who heads up securities lending at the Options Clearing Corporation (OCC).

The OCC had a busy 2009 in terms of stock lending – in January it began operating as CCP for Quadriserv's AQS platform and ended the year with a stock loan contract notional value of more than USD16 billion.

Pellegrini believes that next year will bring in bigger numbers – thanks in part to the buzz around CCP in the industry.

"I can tell you that day in and day out I get phone calls from interested parties on our programme and our services, and all because CCP is such a hot issue," he says.

"They are all looking into it and I fully expect our membership for securities lending to grow."

Panel two explored regulatory motivation: Australian regulation compared to global regulation, and what regulatory changes can be expected. "An interesting result emerged here," said Ms Awad. "We found a lot of independent support for the practice of securities lending from the regulators who view it as an effective mechanism for bringing liquidity and efficiency for the market".

Panel three addressed demand drivers and trading strategies, including a summary of short selling studies addressing the impact of borrowing and the role of short selling in capital markets.

Olan Henry, an associate professor of the University of Melbourne Centre of Financial studies presented his research on short selling which postulated that short selling contains information which adds to the efficiency of markets, every short sale does not necessarily reflect a negative sentiment about a stock, and that during the ban on short selling, there was more volatility in the market.

Finally, panel four looked at the beneficial owner's perspective. It discussed the lessons learned from the events of 2008 and 2009, how the risk/reward profile of participants has changed and what 'best practice' in securities lending really means.

"While some Australian lenders endured challenges over the last several months, it seems that those who viewed lending as an investment function fared better during the turbulent time," Ms Awad said. "What became apparent is that securities lending should be treated with the same level of due diligence and understanding as any other investment mandate. Clients need to fully understand the risk and reward inherent in their programmes and feel confident about proper oversight and controls. With this shift in perception came both understanding and comfort in what funds were undertaking by participating in a securities lending programme".

From GSL.tv last quarter:

More Nordic securities lenders are returning to the market and will find ongoing changes and new models in both prime brokerage and hedge funds, according to SEB Enskilda's head of prime brokerage.

Magnus Ward (pictured), speaking to GSL.tv from the Swedish bank's London office, explained that first-time participants are joining lenders who had stopped their programmes during last year's turmoil as they return to the market.

"There were a lot of lenders that were part of the market that withdrew and have then come back again but there are also a lot of new lenders considering securities lending.

"Some really bad news last year was good news for some, as it opened their eyes to this as a potential income source - for them to lend their equities, particularly those who run more beta or index mandates," he said. "It's becoming more normal to split a portfolio between the alpha part and the beta part."

Such a rate of change is reflected in the stock borrow space, where some prime brokers are altering their service set up, driven mainly by new demands by hedge funds looking for growth and security as the markets ascend.

In particular, it has led to a rise in the convergence between prime brokerage – the historical destination for much of hedge fund cash and securities – and custody, which would provide segregated safekeeping of assets to diffuse the risk of loss in the case of broker default.

Ward explained that this model came into demand about four years ago when hedge funds were exposed to "full risk from leaving assets with their prime broker. People started asking questions: 'why should I have that risk on the prime brokers?'"

He adds that SEB runs prime brokerage on a purely custody model, where the clients' assets are always in segregated accounts from the bank's assets.

"A lot of our competitors are going in that direction - we see announcements from prime brokers that they are changing their models – [changing] to some kind of custody based model to give that extra security to hedge funds and their investors."

Ward believes that Swedish lenders have been more wary than some countries in engaging in securities lending based on the negative press that short selling attracted as they apparently drove down the share price of domestic companies.

He added, however, that some lenders were still willing to lend international securities.

Separately from the video, he told GSL that there would be a flight to quality for investors into hedge funds. "Most money is will be going into well-established hedge funds - most investors will want to find the right returns."

"I think a silver lining for the industry is that regulators - following consultation on their part - have a greater awareness of securities lending than two years ago"

ISLA comment: Kevin McNulty

The beginning of this year heralds two key areas of change regarding industry standards. On 1st January the deadline passed for firms subject to UK FSA regulatory capital requirements to fully adopt the Agent Lending Disclosure reporting framework. This follows the termination of the FSA's interim solution implemented in December 2007.

ISLA has engaged closely with the FSA around this issue, and has also worked hard with the member firms for the last few months. We believe that most firms are in pretty good shape to now adopt this standard.

Secondly, we are in the process of making a few minor changes to the GMSLA 2009 following industry feedback. The changes do not affect the improved post default provisions incorporated in the 2009 document but cover some issues that were felt not relective of market practice. The revised agreement (GMSLA 2010) will be issued very shortly and we'll be actively encouraging the market to adopt this standard.

Looking back over 2009, I think a silver lining for the industry is that regulators – following research and consultation on their part – have a greater awareness of securities lending than two years ago. This year we will continue to work with regulators to further enhance this communication and ensure that further requests made of the industry are based on the best information.

2010 also looks to be the year for a focus on controlled growth. Where the past two years saw a natural focus on sustaining business and communication with clients about the effects of the credit crisis, I get the impression from member firms that they now want to spend time on new business opportunities.

This year will also see ISLA developing educational strategy for securities lending, partly in response to the concerns from members around the negative perceptions of the industry in the market place and to continue to build the knowledge of beneficial owners.

In the last few months, we have seen significant initiatives from regulators and politicians internationally to address the wider landscape of banking regulation and financial markets stability. The UK Treasury's proposed resolution arrangements for investment banks, spearheaded by Paul Myners, and the US Financial Stability Bill, are two examples of this. I believe it is important that we are well versed in these over-arching initiatives that augur holistic changes in banking, and keep at the forefront of our considerations what effect they will have on securities finance.

"This year will see ISLA developing educational strategy for secutrities lending, partly in response to concerns from members"

Chris Hitchen, RPTC

The CEO of Railway Pensions Trustee Company tells Craig McGlashan he sticks by his endorsement of securities lending and sees new opportunities for market practitioners.

For a man who confesses that the first time he really heard of securities lending was in connection with the infamous Robert Maxwell and his Mirror Group pension fund revelations in the early 1990s, Chris Hitchen has a surprisingly warm attitude towards the borrowing and lending of stock by pension funds.

And he is exceptionally qualified to talk about the subject. As chief executive of pensions administrator RPMI and the Railways Pensions Trustee Company, which runs the industry-wide pension arrangement for the UK's railways, Hitchen is at the forefront of the UK pensions sector.

"Interest rate and inflation swaps will increasingly be used by pension funds and there must be some scope for lenders to get involved"

There was also the small task of being chairman of the National Association of Pension Funds (a role he no longer fills) during the financial crisis of the last two years – when, despite the negative press that securities lending received, he told the OPDU Annual Conference in January 2009: "Don't abandon your securities lending programmes. Having stock to lend and borrow is crucial for efficient markets."

Does he still stand by this statement? "Yes - I have always been of the view that securities lending is highly beneficial to institutions because what we want is liquid markets, which cannot happen without the lending of stock," he says. "We probably have more to fear from illiquid markets and inadequate price discovery than we have from short sellers."

Unlike many funds, the Railways Pension did not stop its securities lending programme during the turmoil of the past 18 months. Hitchen puts this down to good management. "At this fund, we were always very particular about the way we treated collateral and very particular about the indemnities we received, but that was probably not true more generally across the industry.

"We have thought quite carefully about relating collateral to the assets. If we were accepting a type of collateral that would not function in line with what we had lent out then we would ask for a higher haircut. That has meant that we have lent a lot less stock than we could have done, but we felt that was fine because it was the risk that was most important to us."

In his role as NAPF chairman Hitchen was able to hear the concerns and thoughts of the UK pensions industry. So how has its view on securities lending changed given recent events?

"Securities lending has always been taken seriously. It has never been a big money spinner, but it was a nice source of income and if nothing else it helped offset some of the custody and other costs," he says.

"It would be wrong to say that people are thinking about securities lending more than they are about the level of markets because we have had such a rollercoaster ride in that arena. But people are much more tuned in generally now to the fact that you can lose money – sometimes it is not just about the return on the money, it is about the return *of* the money.

"There has been a flight to quality in every respect and I think that has resulted in people dusting off their securities lending agreements and looking at what their safeguards are, in a way that they might not previously have worried about."

Hitchen thinks that some of the

funds that ceased lending did so "on ideological grounds".

He explains: "They worried that they were lending to hedge funds, for example, who were just going to sell the stock short and force prices down. We found little evidence that that was really happening inside the market."

In addition, he says that pension funds have a long view and any short term affect on a price "should not bother us too much" and if a premium can be obtained for lending the stock then "that fits with our longer term horizon".

Hitchen also reveals that not standing by his statement at the OPDU

"We probably have more to fear from illiquid markets and inadequate price discovery than we do from short sellers"

conference would be "hypocritical" – given that "we do invest with hedge funds as part of our wider portfolio". Hitchen explains that the fund chose hedge fund investment because it "delivered higher returns than cash generally but had much lower volatility than equities".

A report from US consultancy firm Agecroft Partners released at the start of 2010 suggested that pension funds will increase the allocation of their asset base to hedge funds from 2.5% to 15% over the next decade – does Hitchen see this as a possibility?

"We are increasingly using hedge funds in a more targeted way, treating them not just as an asset class. We are using them within our main equity portfolio as a way of managing the assets. When we are looking for alpha generation we won't necessarily only appoint long-only managers - we might appoint hedge fund managers and then use a future to complete the market exposure."

However, this diversification of investment strategy has potential pitfalls for the pension fund's lending programme, Hitchen suggests.

"It makes securities lending harder to do. Portfolios are increasingly not filled with real stocks, or are seen through the lens of some vehicle such as the hedge fund, making it harder to lend the stock because you do not have the direct line of ownership. We are getting increasingly complicated fund management arrangements and that makes lending harder to organise.

"Even in the long-only space we now have more specialist equity managers and fewer large, low-transactional portfolios, and that means that there are more parts moving and it is harder to be sure that a particular stock is going to be in one place and that it is going to stay there over the timeframe that makes it possible for someone to borrow it.

"It is still do-able but it is not so easy."

On a more positive note, Hitchen sees opportunity for lenders in a new trend developing in the pension fund space. "Over the next few years interest-rate and inflation swaps will increasingly be used by pension funds to try to match out their liabilities and there must be some scope for lenders to get involved in actually helping those swaps to be packaged. I think that is going to be a growing area."

However, he warns: "Trends take a long time in pension funds – things do not happen overnight. We could be talking about these issues in much the same way in three years time, I expect." So what will happen in these next three years? Hitchen's major worry is that the tentative recovery in the UK economy may not be sustained, with 2010 seeing growth but 2011 being more difficult.

He adds: "My concern for the foreseeable future is that we are in an environment where government bond yields, and in particular index-linked bond yields, are very low and that means that the cost of providing pensions looks very high."

Hitchen does think the government can help in this regard. "We know that the government has to issue more bonds but it would be good if they could issue more at the long end and more in particular of index-linked bonds. That is something that the NAPF have talked to the Treasury about on a regular basis and there is some evidence that they are now doing that."

While warning that he does not expect the environment for pension funds to "get much easier in future", Hitchen is not one to miss a silver lining on a cloud. Even the Maxwell scandal had its benefits, he thinks. "It was that event which led to increasing amounts of legislation to make pension funds safer, such as the Pensions Act 1995 and subsequent pieces of legislation. Strangely though, they did not focus on lending and the assets, they focused on funding levels and how trustees should be organised and things of that nature. But the original catalyst for a lot of it was the event with Maxwell and the Mirror Group pension fund."

Perhaps the global economic crisis of the last two years could have a similar effect, creating a better securities lending market and more beneficial owners like Chris Hitchen who understand the business and its positive effects.

Railway Pension Trustee Company: fund statistics

GBP17 billion in assets under management

350,000 beneficiaries including 90,000 active contributing members

All UK rail companies represented

Around 100 different sections for different employers

Collateral

Losses through cash collateral reinvestment struck a blow to the perception of securities lending - but all collateral types have their issues, finds Ben Roberts

The close of 2009 saw both global market performance and sentiment improve across the banking world, including securities finance.

Asset values were boosted to give a partial relief to investors across the board. The first week of January saw the biggest one-day corporate bond issuance in US history, partly as the most feasible option in raising funds and partly to capture the relatively low yields in the bond market before interest rates make their expected rise.

Improved sentiment has increased the volume of stock lending in some markets, some say, though issues around securities – type, supply and value - pledged as collateral still represent a complex and often divisive conversation in the marketplace.

Kelly Mathieson, global head of clearance and collateral management at JP Morgan, saw an increase in deal making in the run up to the end of 2009, and says comparing the last quarter of the year to the first is like

“We've been working with the broker dealers for them to be able to pledge ETFs as collateral and take other things on loan on the back of them"

Keshava Shastry, BGI

comparing “apples and oranges”.

The improved markets, she says, “had set a trend of market recovery and market strength – particularly from an asset value perspective – that have given people the sense that this wasn't an anomaly or bump, and what it has translated into is much more deal activity.”

Demand for loans overwhelmed supply for much of 2009, she adds. Borrowers sought securities but often did not have collateral that fit the acceptable criteria set out by lenders, criteria that for some had narrowed to only the highest quality assets – such as government bonds - since the milestone collapse of Lehman Brothers.

A senior trader in a French bank said this was the current outlook in a London market that has been relatively low in lending activity. In “an inverted supply and demand” the quality of collateral that people are still asking

Issues around securities - type supply and value - pledged as collateral still represent a complex and often divisive conversation in the marketplace

for is higher than the assets being lent. “That's the complete reverse of the normal securities lending environment.”

In stock loan escrow – a securities-for-securities transaction – Mathieson says that fixed income still dominates collateral-taking, although expects more equities will be used this year due

to their perceived liquidity and price transparency.

This point was partially echoed by Ed Oliver, head of consultancy at Data Explorers Consulting. In a presentation on collateral trends to delegates at the GSL Summit in London last November, he said that in analysing the market "one word is liquidity – far more important than the rating of collateral".

He added that equities – a collateral type often recommended by his firm – in securities lending generally could increase in usage this year. "Equities are attractive versus previously held collateral, such as corporate bonds. Bonds are more difficult to price and sell, but in equities there is constant pricing."

He continued by explaining how, in certain market circumstances, equities was a better collateral to take.

Despite the evidence, the mindset of the end lender is still crucial as they assess what collateral they take. Brian Staunton, managing director, securities finance, EMEA, Citi, says: "If you look at the statistical argument and the correlation between lending equities and taking equities as collateral, there is compelling evidence that in certain situations there is very good correlation, and in some situations you're better off with equities in the case of default. Emotionally, right now, I think if you are the beneficial owner accepting collateral, the preference is towards accepting government bonds, as the safest form of collateral."

Mainstream equities as collateral, Oliver said, is "a trade that makes sense from a risk perspective, providing you have the haircut".

He said equity-collateral transactions saw an average margin of 10%, rising to about 20% for some transactions. Though Mathieson also saw a rise in the margins demanded by lenders last year, they have yet to drop back in the US.

"Margins have not come off," she explains, "and I think they may not. Margins reflect the true price risk in the collateral type. Most of the margins mirror those set by the Fed, in which collateral must be pledged at a Primary Dealer Credit Facility (PDCF). Although PDCF is a temporary program I think there was a lot of thought that went into the margins for that and reflected the price volatility".

Where much of the European market has been dominated by government bond collateral, taking corporate bonds has been less accepted. This is frequently down to the ability to price the bonds. Unlike the equities and government debt, you wouldn't necessarily get a daily price from price feeds if it is infrequently traded. Without certain levels of liquidity, therefore, there would not be so much of an up-to-date price that is

"Emotionally, right now, if you are the beneficial owner accepting collateral, the preference is towards accepting government bonds "

Brian Staunton, Citi

integral to its worth as collateral and the margin that is applied.

Staunton believes this pricing challenge can apply across other asset classes, and he credits collateral managers and tri-party repo providers like Euroclear and Clearstream that provide a flexible solution. "If you take corporate bonds as an outright form of collateral, or even if you've brought in corporate bonds via a repo trade and you have then in your tri-party repo collateral mix, the tri-party repo providers give participants the opportunity to substitute after a certain amount of days of that price being old. Alternatively, if you continue to accept the collateral, it can be re-margined."

He adds that assessing corporate bonds as collateral is particularly pertinent for end lenders that take a ratings-based approach. "Clearly, triple A rated securities are harder to find than they were, as are double A rated securities," he says.

Regarding the assessment of credit quality, he stresses a distinction between lending equities and fixed income. "Since I can remember, lending equities have generally been loaned against government bonds – with a margin, as the preferred choice of collateral.," he says. "There has always been this mismatch in the credit quality of the asset you're lending to that which you are taking, which I believe is still very much the case, certainly for the equity business. I know equities as collateral were becoming more popular in 2008 and 2009, but since the default of Lehman Brothers there's a reluctance to accept stock, even though the academic arguments regarding the correlation are valid. Lenders, as demonstrated post Lehman wanted high quality, mostly government bonds with a margin as collateral.

"On the fixed income side, it's harder to lend government bonds and take government bonds as collateral. The two sides to that trade are at loggerheads as the borrowers seek high- quality government bonds to post as collateral for other trades. To give government bonds in return just won't work. So there's always been the mismatch, and in order to generate any meaningful revenue you've got to accept lower, but still highly rated forms of collateral."

As is universally accepted it seems, the default of Lehman Brothers hit markets, confidence and outlook to shake-up the price and liquidity of securities. He gives asset-backed securities – one time a popular form of collateral - as a key example.

"Until the default, the asset backed

Portfolio perspective:

Wayne Burlingham, global head of securities lending at HSBC, outlines a key concern around reinvestment

"An agent commits you as lending client as a principal to a transaction," he explains. "So if they run a cash reinvestment programme for you, it could be that they transform your primary portfolio into something else.

"For example, if you have USD100 million in Treasuries and they are lent against cash, and that cash is used to then buy some corporate debt, that means your portfolio has been transformed. But from a regulatory point of view, it's often the case that they're looking at you as if you still hold US Treasuries. So I think the regulations may occasionally miss something in terms of the risk point.

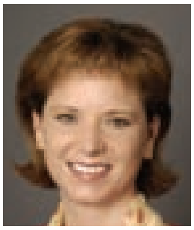
"Perhaps there is a need for strengthening in this area and in particular what is being done with the cash collateral."

market was very liquid. You could get very good prices. But the liquidity just dried up and made accepting asset backed either as outright form of collateral or as part of repurchase agreement more difficult." Mathieson also makes the case for the tri-party setup regarding price. "Part of what's driving the use of certain collateral types is the degree to which a lender can have confidence that what is being provided as collateral is valued at a level that represents the likely liquidation value rather than a market value that may be stale or represent trades days or months ago.

"The price transparency and price availability gives the lender greater confidence to receive collateral valued at a price that's most close to that liquidation level," she says. "I think there's a huge focus on the various market participants and remains some discussion.

"One of the more dramatic shifts in the market, as lenders sought to alter collateral types, was the challenge to providers to have more pricing sources. There were more robust pricing challenges, therefore, where the different market participants demanded live trades as an indication of price."

2009 also saw an increase in the use



"One of the more dramatic shifts in the market, as lenders sought to alter collateral types, was the challenge to providers to have more pricing sources"

Kelly Mathieson, JP Morgan

of exchange traded funds as collateral – the latest use for the index-tracking product that has continued its global boom and saw a host of new recent issuers, including HSBC. Keshava Shastry, markets manager at Barclays Global Investors, explained to delegates at the GSL Summit last November that discussions had gathered apace last year with the relevant colleagues in securities finance.

"We've been working with some of the broker dealers for them to be able to pledge ETFs as collateral and take other things on loan on the back of it," he explained.

Where much of the European market has been dominated by government bonds, taking corporate bonds has been less accepted

"One of things we've been working with the credit side of the things is to help them understand that it's a Delta One product, it's a basket of securities underneath which is backed by the underlying stocks. So you don't have to worry about the ETF volume but you can also look at the overall underlying liquidity. If you need to create an ETF, you buy the underlying stocks – say of the EuroStoxx 50, you just tap into the underlying liquidity of the 50 stocks and use that to create the ETF."

Jorge Soltaro at Bank of America Merrill Lynch added that his firm had also progressed in discussions with counterparts regarding ETFs. "One of the things we're telling our clients is that the liquidity of the ETF is more determined by the liquidity of the underlying stock, rather than necessarily the product," he said. "We're also saying that to our repo counterparties as well so they get more comfortable taking an ETF in a equity repo transaction so that it, overall, lowers our financing cost."

Staunton says that although Citi does not include ETFs in its roster of agent lending collateral, it is an asset class the bank is studying closely. "When you look at collateral you're applying certain rules: whether it's liquid, whether it can be priced, traded, and settled by a professional settlement depository. If the answer is yes, and it suits the brokers have that to finance or pledge as collateral, ETF's fit the model. Just like equites as collateral, we prefer to take these into a tri-party mechanism so provided it can be handled by the tri-party agents then we would accept ETFs as a valid form of collateral.

Australia

The market is stabilising down under, writes Kimberley Ferguson.

Securities lending in Australia experienced a tumultuous 2009, characterised by increased regulation, negative press and costly lawsuits.

Though the country avoided much of the global financial crisis and did not experience recession, wider market sentiment plus a short selling ban imposed by the Australian Securities and Investments Commission (ASIC), Australia's corporate markets and financial services regulator saw the demand for securities lending in Australia drop in early 2009. This did however start to pick up once the ban on the covered short selling of financial stocks was lifted on the 25th May, 2009.

Despite a large amount of scathing, and often erroneous press regarding short selling and securities lending in Australia, Stewart Cowan, head of securities lending at JP Morgan Australia, believes that ASIC has been successful in clarifying many of the misconceptions and communicating the vital liquidity role securities lending has in developed markets.

"This was helped by the evidence from the short selling ban, which demonstrated to the market that short selling did not affect share prices and in fact increased liquidity and reduced buy sell costs," he says.

Peter Martin, the Sydney based chair of the Australian Securities Lending Association (ASLA) adds that: "Since the lifting of the ban, we have seen the securities lending market in Australia move back into a more stable environment from a price discovery and volatility perspective".

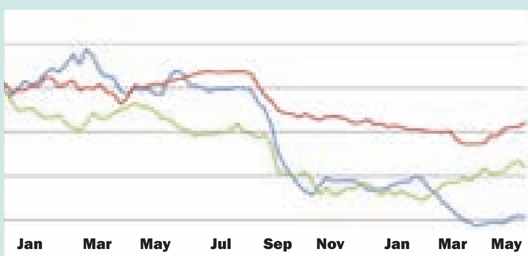
"The market is still over 30% down from the high of 2007, naturally reducing the net asset value of outstanding loans," Mr Martin said. "However, the supply of shares available to lend is still extremely healthy, with approximately AUD 200 billion available, consistent with the size of two years ago".

On 17th of December, 2009 the Australian Securities Exchange introduced the reporting of lending in an attempt to improve the overall functioning and stability of the market. The disclosure regime consists of both 'gross transactional flow' and 'outstanding loan positions' in each ASX listed security, along with additional data and settlement performance.

Mr Cowan explains that while cash collateral continues to dominate the Australian domestic lending market, the use of non-cash collateral is gaining momentum. "In late 2008, most if not all our clients reviewed their cash collateral guidelines to ensure they remained appropriate in the volatile market environment. Some clients decided to tighten them and of those clients who tightened we now see them relax or looking to relax them as they deem appropriate. JP Morgan is

"In late 2008, most if not all our clients reviewed their cash collateral guidelines to ensure they remained appropriate"
Stewart Cowan, JP Morgan Australia

The Australian market 2008-2009



DESLI (Short)
1 month % change +7.07

DESLI (Lendable)
1 month % change: +8.04

Price index
1 month % change +4.03
SOURCE: Data Explorers

"The supply of shares available to lend is still extremely healthy, with approximately AID200 billion available
Peter Martin, ASLA

looking to expand collateral options to include equity collateral in the New Year".

2009 also saw the final legal resolution of the scandal involving the broker Opes Prime.

Opes Prime was set up in 2003 by former ANZ executive, Laurie Emini, and former Ord Minnett Executive, Julian Smith. Its collapse in March 2008 shook the Australian finance industry, and like the default of Lehman Brothers in September 2008, the ramifications reverberated around the world.

Opes lent clients money to buy shares, and then acted as custodian of these shares until the borrowed amount was paid off. The stock was then used as collateral to borrow money, at a much lower rate, from ANZ. In addition, Opes lent some of the money to short sellers to borrow stocks.

Laurie Emini had six favoured clients, to whom Opes Prime lent huge sums of money. These people were using this money to buy stocks, and to increase the value of the portfolio of these favoured people, Opes was also transferring stock from other clients to bulk them up.

Alarm bells started going off in early March 2008, when Norman Seckold, a mining company chairman and customer of Opes Prime, decided to reclaim his stock. He had used the margin lending facility offered by Opes Prime to buy stock for AUD 15 million, which was valued in March 2008 at AUD 100 million. Mr Seckold went to Laurie Emini, cleared his loan, and expected to receive the stock back straight away.

However, he discovered that his stock had been 'double booked', and it took two weeks for it to be returned to him, in dribs and drabs.

Realising that volatile markets would spur more investors to claim back their stock, Emini borrowed AUD 95 million from ANZ.

By mid 2008, Opes Prime went bankrupt. ANZ (who were owed AUD 650 million) and Merrill Lynch (owed AUD 400 million), as secured creditors, began selling all the stock that they were given as collateral to recover their money.

About 1200 clients, as unsecured creditors, lost everything- totalling AUD 1 billion.

A law suit was filed by clients against the bankers. In July 2009 a settlement was reached and where they received about 37% of what they had invested in Opes Prime.

Julian Smith said the eruptions from Opes Prime in the Australian market continued to make a "tsunami in a puddle".

ASIC is now considering reclassifying stock loan programmes so that practitioners have to issue full product disclosure statements to prospective clients, at levels similar to a managed investment scheme. The securities lending and substantial holding disclosure consultation paper was put out for stakeholder consideration on 3rd July, 2009.

However, despite this crack down in disclosure, Sunil Daswani, the international head of client relations for securities lending at Northern Trust, explains that part of Australia's appeal is that it is a relatively low risk market from a regulatory perspective.

"There are also no existing short sale restrictions on demand," he adds.

Going forward, Mr Martin believes the securities lending market can only pick up, helped by further stability and arbitrage opportunities for borrowers. "Since the lifting of the ban we have seen the market move back to a more stable environment from a price discovery and volatility perspective. We are still to see a full recovery in the hedge fund and institutional fund manager space but there is progress being made. There is a strong level of optimism that we will see an increased allocation in 2010 to the Australian strategies of some of the large funds that may still be sitting on the sidelines, sitting long cash. Over AUD 90bn has been raised in 2009 so one would expect a significant amount of M&A activity in 2010 as companies seek opportunities to rebuild and grow".

Read all about it:
recently in the news

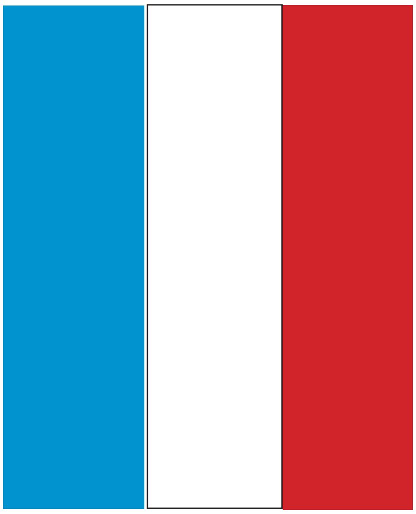
In December 2009, a review of the Australian superannuation system, the Super System Review, called for "better disclosure" by trustees involved with securities lending.
The review panel, chaired by Jeremy Cooper, the former deputy chair of ASIC, suggested that there should be no restriction on the practice within the system.

In addition to securities lending, the panel opted not to pursue other governance issues, including government-directed investing.

The paper is the first stage of the overall review process of the superannuation system, with the final report set to be delivered to the Australian government by 30th June 2010."

France

One of the debut markets for a central counterparty, volumes are steadily increasing in French securities lending, finds Kimberley Ferguson.



"Cash remains a legitimate option for lenders to consider as collateral - but it is just that, an option"

Blair McPherson, RBC Dexia

Over 2009, the French securities lending industry has experienced the tight imposition of short selling restrictions and the launch of the highly debated central counterparty in June of this year by SecFinex with LCH.Clearnet.

Down with the others

Like most western markets, Europe's second largest economy took a tumble in 2009, officially entering recession after its GDP decreased by 1.2% in quarter one.

François Cadario, director of business development, LCH.Clearnet, which serves as the clearing house for the CCP, confirmed that this trend was reflected in securities lending volumes. "I would say France has seen between 10-20 % in reductions compared to two years ago," he estimates.

Blair McPherson, head of technical sales in market products and services at RBC Dexia concurs. "Securities lending is a demand-driven product. The demand side has been impacted significantly as result of the credit crisis and consequently so have securities lending volumes."

The collateral profile has also changed. Guy Knepper, head of securities lending in Caceis's dealing room, explained that in France, takers of equities and corporate debt as collateral have either temporarily halted their lending programs or tightened their collateral schedule by switching to government bonds. "As most of our clients are very conservative and risk averse, their preferred collateral type remains government bonds," he said.

And what about cash? "At RBC Dexia, more than 97% of the collateral held is non-cash and almost all of the cash accepted is reinvested into overnight government bond repo," Mr McPherson explains. "It is a conservative risk profile but it's one our clients share. Cash remains a legitimate option for lenders to consider as collateral – but it is just that, an option, with its own specific risk-return profile that must be clearly appreciated and understood," he said.

According to Mr McPherson, as well as the decrease in demand during the credit crisis, the short selling ban also had an effect on French securities lending. "Short selling restrictions, and the general sentiment expressed by the regulator towards securities lending, is partly responsible for the dip in volumes," he said.

This ban was initially implemented by the French securities regulator, the Autorite des marches financiers (AMF) 19th September, 2008. This was then extended in December 2008, February 2009 and again on June 10th. Of the ban, AMF head Jean-Pierre Jouyet in a speech to the French parliament that the AMF plans to maintain the ban "whilst we await the decisions of our American and European partners on the matter."

Then, on the 16th June, SecFinex and LCH.Clearnet launched the first central counterparty which, along

with the other Euronext markets, was launched in France.

New model

A central counterparty acts as an intermediary between securities lending participants. The lender of a security lends to the central counterparty, which is then simultaneously borrowed by a broker.

This way, if one party defaults then the central counterparty will absorb the loss, thereby reducing the amount of counterparty risk for the participants.

The idea is that market practitioners will connect to SecFinex and LCH.Clearnet as either individual clearing members (ICMs) or as part of a pool of traders 'fronted' by a general clearing member (GCMs). GCMs are working not only with their individual clients, but also with LCH.Clearnet to add this asset class to their existing general clearing product mix.

> **"It does look as though we are slowly returning to levels seen prior [to Lehman Brothers crash]"**
>
> **Andrea Rutigliani, BNP Paribas**

SecFinex and LCH.Clearnet, the first organisations to introduce CCP services on stock borrowing and lending markets, argue that as well as reducing risk, a CCP service enhances market efficiency and transparency, increases market volumes and trading opportunities, reduces the capital required to support loan transactions, and reduces administrative costs associated with maintaining multiple credit arrangements.

So what do the French market practitioners make of this development? "Overall, I would say a large part of the market is reluctant to a CCP interposition, because securities lending is quite a relationship based market, and this would lost with a CCP," Mr Cadario believes. "But, things have changed from two or three years ago- there is now a real need for a risk counterparty opening, so as long as we can offer this we become more attractive."

Unfortunately, the first phase of the CCP in France was implemented with limited functionality, and could not cope with the full process of dividends or non cash collateral. "Certain features need to be upgraded. We are actively working with SecFinex at present, and these steps will be completed in 2010," admitted Mr Cadario.

Still, Andrea Rutigliani, global head of principal lending at BNP Paribas remains unconvinced. "I understand that for some of the small brokers or counterparties, who may have trouble getting to work with a big organisation, the CCP could be viewed as an advantage.

"But at BNP Paribas, we are solid in the market, we are well distributed in Europe- people like to work with us. I'm not against it as a principle, but I want to see first how the other counterparties react. If everyone else participants, of course we will consider it, but at the moment after speaking to several of our clients, I don't see a lot of enthusiasm yet".

Positive

Despite a difficult year for French securities lending, market practitioners are becoming more positive. "After the Lehman crash, there was a complete change in the stock lending industry," Mr Rutigliani said. "Now, however, it does look as though we are slowly coming back to levels seen prior to this event."

Keep up with central counterparty news at www.gsl.tv.
Look out for GSL's French Securities Lending Summit, scheduled April 2010

> **"France has seen between 10-20% in reductions compared to two years ago"**
>
> **Francois Cadario, LCH.Clearnet**

> **"As most of our clients are very conservative and risk averse, their preferred collateral types remains government bonds "**
>
> **Guy Knepper, CACEIS**

Asia

Anthony Harrington

explores the status, infrastructure developments and vast potential of rising Asian markets.

The Asia Pacific area remains a highly fragmented place as far as securities lending is concerned. "You have to take Asia country by country for there are tremendous variations and differences between them," one market specialist says.

Clearstream recently opened a Singapore branch with the aim of using that office as a hub to cover not just Singapore, but also China, Greater China and, indeed, the whole region. European and US companies are looking to place an expert in countries like Singapore to train up local relationship managers for the various country specific markets.

Once the fragmented nature of the market is grasped, the next point to be made is that securities lending is just one element of a whole basket of sophisticated practices, all hinging in one way or another around collateral management. Clearly without collateral management there is no securities lending, and the corollary also holds true, which is that if you have great collateral management capabilities in place, even if these are put in place initially and primarily for liquidity purposes, then it becomes very easy for people to take advantage of large portfolio holdings, be they of fixed income or securities, to generate additional revenue opportunities.

The name of the game at present is very much about educating the various institutions and banks across the region as to the benefits of having a collateral management infrastructure in place. For western players who take this point for granted, it will come as a surprise perhaps to find that collateral is not a big issue, for example, for Chinese bankers.

A moment's thought should be enough to provide an explanation for the attitude of Chinese bankers. They are dealing, day in and day out, with state sponsored entities of one sort or another. Since state sponsored entities are characterised, in the last analysis, by an implicit underwriting of their operations by the government, why bother to collateralise dealings with them? The government has a bottomless purse, so everyone feels pretty comfortable.

"You have to grasp that banking looks very different from a Chinese perspective. They can see, when we explain the full picture, that there are tremendous efficiency gains to be made by implementing proper liquidity and collateral management and that it dramatically reduces counterparty risk. They can see too, that once these things are in place, it is then much easier for them to go on to take advantage of additional revenue generating opportunities such as securities lending," the specialist comments.

"Banking looks very different from a Chinese perspective. They can see, when we explain the full picture, that there are tremendous efficiency gains to be made by implementing proper liquidity and collateral management"

It is not as easy a conversation to have as it is with, say, a western banker whom circumstances have made extremely sensitive to counterparty risk, but it is a possible conversation, and over time, it will bear fruit.

It is a bit frustrating, as well, to be told by some Chinese bankers from time to time that revenue generation and taking advantage of minor revenue generation opportunities is not the primary focus. Just being a bank and providing banking services is where a good part of banking attention in China is focused.

No one is denying that securities lending in China is going to be huge at some point in the future, but there is not exactly a scramble for it right now. At this point, the name of the game is education, focusing on efficiency and on what can be achieved when the right infrastructure is in place.

When the conversation moves to infrastructure, providers of post-trade and collateral services from Europe that espouse 'liquidity hubs' are getting a tremendous hearing from bankers across Asia. "Our approach is to hold up the idea of a liquidity hub, such as we have already established in Europe, and to some extend in the US," he says.

So what is a liquidity hub? Two of the key elements of a liquidity hub are the ability to hold a collateral pool for a client and the ability to trade unbroken across at least 20 of the 24 hours of the global day. With this in place, and provided your hub is neutral to the transaction type that needs to

be collateralised, so that it will work as easily for securities lending as for raising finance, you can provide your global clients with a very powerful system. A trading desk in London could draw on a segment of the collateral pool to support a transaction and when that transaction closed at the end of the day, the institution's Asian desk could draw on precisely the same pool of securities to collateralise its trade.

Within a single organisation, the move to a centralised liquidity management desk avoids situations that arise when, for example, the equities, fixed income and derivatives desk are each managing their own liquidity positions. In that situation, you may well have a position where the equities desk is cash long at the end of the day, while the derivatives desk is cash short. Since neither knows what the other is doing, the derivatives desk will go out to the market and borrow, at some expense, to cover its cash short position. Where there is a central desk managing liquidity setting off the one against the other is simplicity itself. Exactly the same story, writ large, pertains with an international liquidity hub service.

In September last year, Clearstream expanded its presence in Asia Pacific and now offers customers the opportunity to carry out real-time settlement throughout the Asia-Pacific working day.

Some say that, given that behind securities lending there is collateralisation, there is something of a chicken and egg situation. By providing the collateralisation pool approach, we simultanteously open the door to much greater participation in securities lending programmes.

In fact Clearstream is already "white labelling" securities lending for some Asian countries. The way this works is that banks who do not want their positions to be made public, can offer their portfolios anonymously to Clearstream. It does not run securities lending programmes itself because that would immediately put it in competition with many of its clients. Instead, it has signed up a number of borrowers who will borrow from these portfolios and then lend on to their clients in turn. In effect they act as distributors of the Asian portfolios and receive a share of the basis points for their pains.

Clearstream is already well advanced in discussions with a couple of Asian central banks with the idea of using its liquidity hub and the associated securities pool, to enable the rapid securitised flow of funds from the central banks to local banks in the country concerned.

Since Clearstream already be hold a large securities pool for those banks it would be very easy for them, if they had an urgent liquidity requirement, to provide their central bank with collateral and the funds could be released directly. We are in advanced talks with two Asian central banks.

The main requirement here is that we hold an account on the central bank's books, and it holds one on our books, so we can then automatically book out securities to the central bank to cover its funding of the local bank.

Clearstream is also extending its system to include a foreign currency capability, with US dollars coming on stream in the first quarter of 2010, and from there the technology is in place to add Asian currencies as required.

John Sweeney, Executive Director with Mizuho International, says that there is plenty of appetite among Japanese holders of European and US securities to make those securities available to securities lending programmes, and Mizuho runs these programmes for a number of Japanese clients.

"A lot of Japanese institutions hold very high quality securities portfolios that are of a great deal of interest to European borrowers. They have large, chunky positions of good quality assets that borrowers in Europe have a great appetite for," he comments.

At present there are some difficulties in the way of securities lending programmes targeting lending of Japanese securities. As Sweeney explains, determining the legal status of counterparties when what you are dealing with are commingled trusts, is particularly challenging.

You have to get a clear organisational and ownership structure out of that

Read all about it:

recently in the news

Philippine Stock Exchange (PSE) CEO and president Francis Lim said that securities lending formed part of its ambitious 'Level Up' plan which aims to boost the bourse's performance.

"2010 will be the year where we will start reaping the fruits of our efforts under the 'Level Up' strategic agenda like the full implementation of the Personal Equity and Retirement Account (PERA) law, the Real Estate Investment Trust (REIT) Act, the new trading system and the securities borrowing and lending programme that will enable short selling in the stock market, " he explained.

Securities lending in the Philippines has developed significantly over the last few years, with the country's finance regulator the Securities and Exchange Commission approving rules on the practice in June 2006 with further rules approved in 2007.

Reporting by Craig McGlashan

"A lot of Japanese institutions hold very high quality securities portfolios that are a great deal of interest to European borrowers"

John Sweeney, Mizhou

stream in the first quarter of 2010, and from there the technology is in place to add Asian currencies as required, he says.

Lepp points out that once collateral becomes readily available, it becomes much easier to sell Asian beneficial owners on the idea of engaging in securities lending programmes.

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You have to get a clear organisational and ownership structure out of that system before you can implement seclending. Not only must owners be rewarded, but, of course, you cannot actually lend an asset legally unless you have the owner's position – which is tricky if you do not know precisely who the owner is.

"We are working on some projects to create a visible structure that would facilitate the lending of Japanese securities for Japanese investors. We are looking at the best way for some of our clients to bring their portfolios to the lending market," he comments.

Cedric Gillerot, Director, Collateral Services at Euroclear points out that Euroclear now accepts securities from 10 Asian countries as part of its pooled collateral services. As recently as October 2009, Euroclear Bank brought Korean Government Bonds into its collateral system, so these can now be used as collateral by international counterparties who hold them in Euroclear Bank. It is also increasingly arranging triparty collateral management deals using Japanese Government Bonds (JGBs).
When managing Asian securities as collateral, by definition, the agent involved also has the responsibility to handle corporate events and to ensure that the right party gets the coupon payments, or is informed of the event in good time.

Gillerot says that Euroclear's Hong Kong office has been honed to provide a full range of custody and corporate event management services on Asian securities, providing a real "early bird" service that can inform Asian clients

"The critical aspect for collateral practitioners is to be able to use collateral in a seamless way"

Cedric Guillerot, Euroclear

at the start of their working day of all corporate actions relating to Asian securities that Euroclear Bank is holding for them.

Gillerot points out that there is no doubt that regulators worldwide are very keyed in to the importance of reducing risk. The collateralisation of transactions is a huge step forward in taking risk out of the system. "The move to an environment where investors are looking to collateralise all of their trading exposures takes time to come about. But once market practitioners make that move and regulators drive that process, there is no one who will say, "I'd rather go back to an uncollateralised way of transacting business," he says. And even if there was such an entity, they would struggle to find a counterparty to deal with them on the basis of trust alone. "The critical aspect for market practitioners is to be able to use collateral in a seamless way with counterparties across the world. Once you have the infrastructure in place to do this, then a whole range of transactions, including securities lending, becomes less risky to undertake," he says.

As an ICSD, Euroclear Bank has a lot of links with domestic markets around the world, including the 10 Asian markets already mentioned and 42 markets globally. Euroclear Bank recently extended its settlement processing cycle to facilitate overnight collateral management services for Asian clients using Asian securities as collateral to support collateralised transactions. "Basically, institutions with JGBs in their portfolio, for example, can pledge them at the end of their trading day, and have them available at the beginning of the next business day for trading purposes," Gillerot says.

One of the conditions for a specific country's domestic securities to be admitted to the service is that those securities can be freely held internationally. For this reason, Chinese securities, which still have a number of rules as to who can hold what and how much, are not part of a pooled collateral service that could be used by one party to collateralise a transaction with a second party anywhere across the world. India is in a similar position. "Right now we have MOUs with different parts of the Chinese and Indian infrastructure, preparing the way for us to work with them when we can include Chinese and Indian securities in our service," Gillerot says.

Will private initiatives such as those we have seen here, by the likes of Clearstream, Euroclear and Mizuho, eventually render redundant the multi-country led initiatives to introduce a pan-Asian clearing and settlement infrastructure for bonds and equities? That is probably impossible to call right now, particularly as Euroclear is one of the parties involved in planning such an initiative, but it is clear that impressive strides are being made to enable Asian securities to be used as collateral internationally.

Panel: Regulation

The contact between rule-makers and securities lending's industry bodies could be highly significant if this is the year of regulation. GSL questions three associations.

ISLA	RMA	PASLA
Kevin McNulty is CEO of the International Securities Lending Association	Mike McAuley is chairman of the Risk Management Association's securities lending committee	Dominick Falco is a consultant and former chairman of the Pan-Asian Securities Lending Association

1.Have there been any new restrictions or regulations on securities lending and/or short selling that have impacted your members?

McNulty: At the moment there is nothing new or definite in terms of regulations. Through 2009 we saw the temporary rules around short selling relaxed in most markets, and a plethora of consultations and policy initiatives that will likely herald new regulations in the coming months. In Europe most of the regulators have been waiting to see how the Committee of European Securities Regulators consultation exercise on short selling disclosure pans out, and we're expecting to hear back this or next month. On the securities lending side there is little change in the rules. In Australia the Stock Exchange and Reserve Bank recently issued a disclosure regime for securities lending transactions and we've been in conversation with ASLA about this.

McAuley: I think the most significant thing that will affect our members will be the two Basel papers that were just issued a couple of weeks ago on capital relating to counterparty credit risk, and liquidity risk. These papers are in addition to their paper issued in July that focused on capital related to risk within the trading books of banks. I think those three things combined – specifically 'when' and 'how' they're implemented in the United States - will have probably the largest impact on our industry of any regulation.

Falco: The impact to all the members had been significant at the start of the year. The gradual lifting has started to bring a number of issues. Basically, it's made the quality of business increase. Turnovers have increased, but also there have been a number of ancillary points that have come out that don't necessarily impact the trading aspect, but a number of new changes have gone into the markets. Clearly there have been changes in the settlements side in Australia that have impacted people but haven't demonstrably caused any problems – it's more the regulators wanting a little bit more transparency into the marketplace.

There have been other operational changes we've seen in Singapore that have impacted people; so again, it's not necessarily a specifically a ban on short selling or securities lending but some of the operational issues surrounding movements of securities have impacted us. The regulators threw some of the industry associations -the custody banks association and PASLA - have been listening to some of the issues we have and have been trying to recraft the system to accommodate some of the problems that the changes have created.

2.Have regulators been more engaged with you this year?

McNulty: Yes. In the five months I've been CEO I've spent a lot of time in discussion with the FSA, and the regulator in turn has spent a lot of time understanding securities lending and reviewing what it thinks is going on in the market on an informal basis.

This review started last spring run by the FSA's Markets Group following instructions from the UK Treasury to analyse the market. The contact with ISLA has helped the FSA to understand how the market runs and we've received some independent feedback. Its findings by and large have been very positive, though it would like the industry to address a few concerns it found when surveying the market. The principal concern is the varying degrees of understanding – particularly around risk – that beneficial owners have of securities lending. A large number of beneficial owners knew a lot, but some didn't know near enough. So the key point for us now is how we raise the level of awareness of these beneficial owners. ISLA be working with other trade associations to address how to solve that problem.

McAuley: Yes, absolutely. The RMA committee have instituted quarterly meetings with the New York Federal Reserve. The meetings are mostly attended by members of the New York Fed but members of Boston and Chicago Fed also participate. Recently we've had participation from the SEC and in the future other regulators may join those meetings. We've been substantially more engaged with the

regulators than we ever have.

The round table that the SEC held was another example of the regulators reaching out for information. The more regulators understand how our industry works the more it helps us. They understand securities lending, but how it works from not just the high level but down in the operational element is very important to us in helping them when they feel the need to craft regulation to prevent some of the unintended consequences we had to deal with during the crisis.

Falco: Not necessarily more engaged but continue to be engaged. PASLA's been fortunate in that many of the regulators are happy to listen to what we have to say, happy to attend the securities lending conferences – all of these things. So I think we've been lucky enough to enjoy a good relationship. And that continued, and it's a good thing.

3.Which areas have the regulators been focusing on?

McNulty: One area the FSA is looking into on a firm-by-firm basis – though not through the current review – is whether they should be looking into the cash collateral reinvestment practices of banks in the UK. There have been well publicised cases of cash reinvestment problems, particularly in the US and it is trying to assess whether anything needs to be done in Europe.

Another area looked at by the FSA was corporate governance. Despite the work we and others have done to highlight the practical issues of securities lending and voting, there are still lingering perceptions that empty voting, for example, still happens. The FSA didn't find any evidence of empty voting but have suggested that more needs to be done to deal with the perceptions.

McAuley: It's our goal to give them as much information as possible. . I wouldn't say regulators have been focused on one particular thing. What we've seen so far is a thirst for knowledge and information. The requests have been more to gather and share information, about the marketplace.

Falco: I think the biggest issue with securities lending – probably more the knock on effect to securities lending - is engagement, talking about some of the short selling issues. I would say a general desire to see a little bit more transparency, and I think that's definitely a general theme to say. That hasn't really changed significantly over the year. Regulators don't necessarily plan that. In many respects the broker dealer or lender are not residents in a local markets, so you really have to think about what they can concern themselves with. Their concern is really issues of generally speaking, things like pricing and transparency of pricing.

"We've been substantially more engaged with the regulators than ever"

Mike McAuley, RMA

Their concern is being able to capture information on short selling on a timely basis, increasing transparency and reporting on short selling; so in some markets like Australia, trying to understand the size of the borrow loan market is as well. Whereas the concern of the beneficial owners - things like the exposure to broker dealers - are very much UK and US-centric issues because in many respects it's the banks and broker dealer balance sheets impacted – we don't really have so much of that out here.

4.Where do you think regulators will be focusing their attention going forward?

McNulty: Aside from the bigger picture items of capital adequacy and financial markets stability I think that transparency will get some attention. The Transparency Directive in Europe is to be renegotiated at some point – that may be this year. I wouldn't be surprised if we saw some regulators in Europe looking to impose disclosure for securities lending. Whenever regulators find a part of the market that isn't particularly transparent they get a bit suspicious. Whilst we know that there is much greater transparency in the market today than ever before, they worry that not much is available publicly.

When we consider new regulation and rule changes, for either short selling or securities lending, we push hard for as much harmonisation across the jurisdictions as possible. The firms we represent are active in many markets, and complying with several different regulations can be costly.

McAuley: I don't know where the regulators may go in the future. I think the capital papers give a good idea of how the issues of liquidity and capital will be dealt with. I hope they would focus on the areas in which the issues arose. We always try to separate the transactions into its two component parts: the securities lending part and the cash reinvestment. The issues that we faced really arose in the cash collateral component of the transaction; so if they were going to focus on something, I would hope that this is where they focus.

Falco: I think generally the theme of increased transparency is something regulators continue to look at. That's probably the biggest theme we see out there. Interestingly, you can perhaps slice and dice the Asian markets into a couple of camps: Australia and Korea impose draconian bans on short selling; other markets, like Singapore, Hong Kong didn't feel the need to have any outright bans. I think what we're seeing in Australia and Korea is a return to normalcy with the desire to have more increased transparency. In Singapore, Hong Kong, I think it's just a question of working with the industry, what securities lending impacts there are in the marketplace. There was a task force earlier this year on short selling from IOSCO, and I think IOSCO has spearheaded a lot of these things within their remit. What we're finding probably is cross-industry bodies like IOSCO are helping to de-mystify the short selling and securities lending markets.

5.Are the regulators focusing on areas that have also been points of concern with your members?

McNulty: This is an interesting area. The question in some ways is: 'are regulators moving down the same path as the firms would like them to?' The answer is: not always! If you think about disclosure requirements for short selling, there's an implication that short selling has been partly responsible for some of the global market turmoil. Many parts of the market would not agree with that, and wouldn't see the case for spending money to disclose to regulators and others. That said, I think the industry is relatively pragmatic about these areas, and understand that regulators require transparency.

ISLA's role is to articulate on behalf of the market what the concerns are with proposed new regulation and perhaps offer alternatives. I think it's something the body has done effectively over the last few years, and I think regulators welcome the dialogue with trade associations.

However, I think at this point in time regulators may still be under pressure to act quickly and that might be at the expense of this consultation. So we might be in a situation where we have to work a bit harder to stay on the front foot for the regulators and find the right solution.

McAuley: I would say that the two sets of concerns don't align. The regulators are more focused on the systemic risk issues, the bigger picture in comparison to specific issues. Perhaps the one differential is that all the regulators are focused on disclosure – ie, what types of disclosure are made to what types of clients. That would align with participants in the marketplace, but I think overall their focus is on the larger issues.

Falco: I don't think there have been any particular points of concern specifically to the members. Again, we are dealing with probably more technical issues these days rather than overarching market issues.

Minor issues of changes in settlement cycles have actually impacted us in Singapore, and we've had some issues with the treatment and process surrounding certain tender offers in Korea. I think the members and their dialogue specifically with the regulators in many ways is back in the 2007 world where we're dealing with the day-to-day issues that come up as markets develop. We're not necessarily facing: 'the sky is falling and regulators are peering in and looking at us under a microscope'. It's definitely much more the day-to-day issues that come up within securities lending.

6.Do you think the work between regulators and industry bodies will be sufficient to change the perception of the industry among other areas of the market and the wider public, or are there other initiatives going forward that could make an additional contribution?

McNulty: I think there will be a need for more initiatives. I don't think the dialogue between the regulators and the industry is enough to deal with all the incomplete or ill-informed perceptions out there – though it certainly helps. One area that plagues securities lending is the perception of its impact on corporate governance. While there has been a lot of good documentation produced that explains how securities lending and corporate governance can reside happily together, there are still a lot of negative perceptions that they are incompatible. We will continue work with the ICGN this year to develop a common code for securities lending and corporate governance.

Also this year we will work harder to make sure people understand the risk and return profiles so beneficial owners can make informed judgements as to how much to engage. Short selling will always be part of the discussions. It's almost like a religion: people either believe it's good and may cite the academic evidence to support this belief, whilst others will refuse to accept it is a legitimate activity that adds, rather than detracts from the market.

McAuley: I think the capital changes is an example where the regulators are focused on preserving the integrity of the markets and making sure that we don't run into a situation like the recent crisis. The result of that could significantly change how the beneficial owners receive lending services, and from whom they receive them.

I think all of the industry bodies are doing as much as they can given their individual constraints and budgets to improve perception. The RMA is holding an academic forum that invites academics to present papers on securities lenders or short selling to the industry and we can provide feedback. That's all designed to make sure we have input and know what's coming down the pike.

As long as short selling is a demand driver of securities lending, which it obviously is, I think we'll always be dealing with the constituency who feel that short selling is not good. I would expect we will see empirical evidence provided by the academic world that proves once and for all that short selling is beneficial because we have this unique period to examine which is a period in which short selling was banned and can compare it to the periods where it was not.

Falco: In many respects I think we'd be remiss if we didn't go out there and try to contribute to the education process. To that end I would still say education will be the most important thing. It's something we as an industry body and member body try to do. We haven't been as vilified as others have been and I think the markets seem to be recovering reasonably well. I think a lot of companies are looking at this and helping it will help lead them out. It's nice we're not getting so many problems out here as had been seen last year in the US and UK.

Short Selling: Rules update

Belgium

The Banking Finance and Insurance Commission (CBFA) has kept intact the announced trading and disclosure rules relating to new and existing short positions on 22nd September 2008.

China

On 11th January China gave approval "in principle" to a number of financial reforms, which could aid the development of a securities lending market in the country. Investors in China will soon be able to sell stocks short, as well as have access to stock market index futures and margin trading. According to reports, the reforms – posted on the China Securities Regulatory Commission's website - had initially been approved by the Chinese government in 2008 but the effects of the global financial crisis stifled attempts to introduce them.

Dubai

Members of the NASDAQ Dubai stock exchange were required to obtain prior approval for naked short sale on behalf of a seller in respect of an Admitted Security (as defined in the exchange rules), but not for The requirement covered short sales. Further, the NASDAQ Dubai introduced a temporary requirement for members to disclose every gross short position in an admitted security at the start of trading on the business day after each day on which a short position is held.

France

A ban on covered positions was imposed by the Autorité des Marchés Financiers (AMF) as well as on the establishment of any derivative-based sale position. The AMF has also introduced a new disclosure requirement regarding net short positions. AMF information to short selling traders include the stipulation that investors should not use derivative instruments to establish a sale position in relation to one of the relevant entities.

Germany

At the end of this month, the Federal Financial Supervisory Authority (BaFin)'s decree prohibiting naked short sales of shares of key insurance and finance companies active in the financial and insurance sector, is released. It was first imposed mid September 2008. The ban will be continually reviewed.

Hong Kong

Reports and updates from the Securities and Futures Commission (SFC) were issued from October 2008 since issuing a warning on action against abusive shorting. The SFC carried out a consultation on increasing short position transparency, which closed in September 2009, and the consultation conclusions are awaited. Martin Wheatley, CEO credited the workings of market since imposing a ban on naked short selling eleven years ago.

Italy

Last July the regulator lifted its short selling ban which was extended in May 2009, first imposed on 22nd September 2008, following feedback from a consultation paper. The paper, issued 27th May 2009, outlined the possible options for regulating short selling.

Japan

On 27 October 2008, the Japanese Financial Services Agency (FSA) published new short selling rules which introduced a ban on naked short selling, and reporting requirement for short positions of 0.25% or more. The prohibition on naked short selling is effective from 30 October 2008 and is due to expire at the end of this month. The new rules apply to certain listed securities and some transactions on certain dealer established OTC markets.

Netherlands

It has been sux months since the AMF lifted its short selling ban. Disclosure is still required on companies such as Fortis, ING and Van Der Moolen to the extent that net short positions are 0.25% or more, but daily disclosure has been replaced by a requirement to disclose at every 0.10% interval.

Portugal

Portugal stands by the order approved by the CMVM on 22nd September 2008 prohibiting Euronext Lisbon and PEX market members from accepting naked short sales of shares and other related securities in financial institutions on Euronext Lisbon and PEX. The CMVM has since extended the deadline for reporting short selling transactions.

UK

Little news since the rescinding of the short selling ban on 15th January 2009. The UK Treasury devoted just 39 words to securities lending in its Pre-Budget Report.

US

The Securities and Exchange Commission (SEC) hosted a two-day seminar at the end of September 2009, which included industry leaders. Panel topics included discussions of securities lending practices, possible short sale pre-borrowing requirements and additional short sale disclosures.


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Spanish regulation

Stalling regulatory proposals and a negative market sentiment have made Spain a difficult environment for advocates of securities lending, writes Craig McGlashan.

The story of securities lending in Spain could not be any more different from that of the country's wider economy.

Since moving to democracy in the 1970s, the country has seen growth, recessions, bubbles and all the other features of a modern capitalist economy in a relatively short time. The development of securities lending, however, has been sluggish to say the least – although hope is growing in the country that this situation could be about to change.

Currently, pension funds are technically allowed to lend, but in Spain pensions have always followed the regulations set out for mutual funds – and they are subject to tight rules. Since 1991, mutual funds have only been allowed to lend for two purposes: market credit operations or through the centralised lending facility of Iberlear (Spain's central securities depositary).

On the market credit side, lending is limited to IBEX 35 [Spain's main index] shares and - according to Gabriel Padilla from SecFinConsulting, its "very rigid framework makes it of only limited interest to retail investors".

The system allows participants to sell shares they do not own and buy shares using credit. However, all trades that are executed between the first and 15th day of each month mature at the end of the month, with trades executed later in the month maturing the following month.

Trades may be renewed for a maximum of two 30-day periods, resulting in a maximum trade duration of 105 days.

In terms of Iberclear, the centralised lending system is only available for covering short selling at the CSD level and it does not resemble a typical stock loan made in other markets. The trade does not use collateral and is only used to avoid lack of delivery.

These rules have resulted in relatively low securities lending activity in Spain. Padilla says: "Despite the fact that it is probably cheaper and quicker and easier to understand if you go through securities lending, basically because it is taking so long to introduce, the market has taken the view that they have to find their own way, because there's a very intense equity derivative activity in Spain."

Those looking for a larger securities lending industry in Spain thought that they would have their moment in 2008, when the securities lending ministerial order for investment funds was sitting on the desk of the minister and was about to be signed – at least in the dramatic account of events - when news started appearing about a certain bank called Lehman Brothers encountering difficulty.

As a result, the order remained unsigned as politicians and regulators in Spain and the wider world came to terms with what had happened on Wall Street and its implications for the global financial system.

This was not the first time that securities lending in Spain has suffered a stumbling block, however.

In 1998, an amendment of the Securities Markets Act explicitly mentioned securities lending, indicating that Spanish mutual funds could "engage in securities lending operations" if they adhered to terms and conditions issued by Comisión Nacional del Mercado de Valores (CNMV) – Spain's market regulator.

However, these rules were never published. Why? "It was never the priority," according to Padilla. He cites a meeting with the CNMV around 10 years ago when "they did not have the resources and because of this, they were concentrating on things that they thought were more important at the time".

The next few years saw some positive developments. The Financial Act of 2002 allowed the netting of obligations under bilateral agreements, the classic structure of a stock loan. Prior to this law, Spanish firms had problems entering into agreements with international counterparties as outstanding obligations were considered to be part of the liabilities – making them subject to bankruptcy rules.

The following year, the UCITS Act expressively stated that "the securities and other assets that form the portfolio of a mutual fund may be subject of securities lending transactions according to limits and conditions to be issued by the Ministry of Finance", referring to the rules ready to be signed into law during the month of September 2008.

Despite the market still having to wait on these "limits and conditions", rules were outlined on securities lending in other areas. The Supplementary Budget Law in 2003 outlined the tax status of securities lending transactions in portfolios which were not subject to mark to market valuation, while the Financial Guarantees Regulation in 2005 regulated the use of collateral under bilateral agreements.

However, a change in government in 2004 meant that a law ruling to confirm the UCITS Act of 2003 only happened in 2005, and the conditions for the market were still not forthcoming. Since that point, the only official documentation on securities lending in Spain was a circular in 2008 modifying the accounting regulations for UCITS and expressively including how to record securities lending transactions by mutual funds.

However, now that the dust appears to be settling on the worldwide financial turmoil of the past two years, many in the Spanish finance industry are hopeful that 2010 could be the year that they finally get the terms and conditions that they have been expecting for so long.

Padilla organised a conference in Madrid in December 2009 that brought together interested parties to discuss the potential for securities lending in Spain. Attendees included both Spanish banks and some local representatives from the larger global custodians. The general view of the audience was that a securities lending market will open in Spain sooner rather than later, according to Padilla, who also feels confident that the regulation will be approved this year.

"The general feeling was most definitely 'yes'," he says. "We also had a few, maybe three or four in the audience, who came from investor relations and they were rather less supportive and more worried.

"From their point of view, the key of this game is to have information.

"It would be very naive to think that by introducing restrictions all your problems would be solved"

Gabriel Padilla, SecFinConsulting

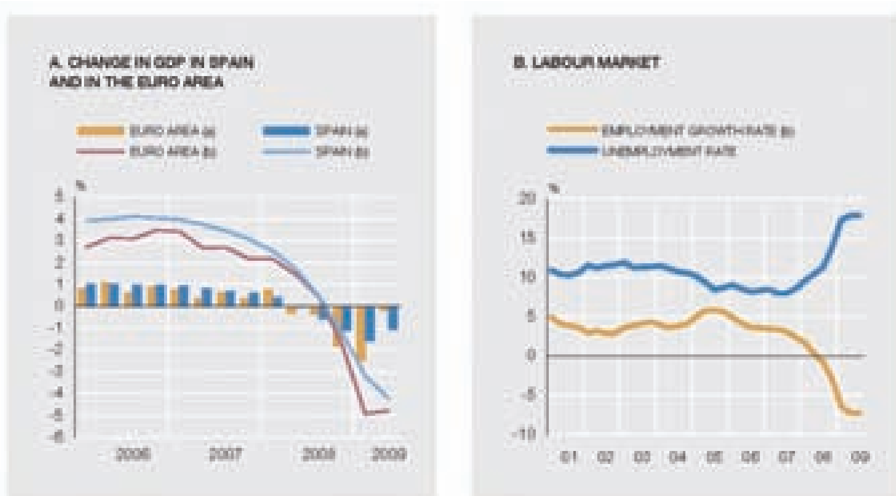
It would be very naive to think that by introducing restrictions all of your problems will be solved. I would say it is better to have information – that seemed to satisfy their concerns."

What other questions were the participants asking?

"They were definitely interested to see market trends, information on the regulations that are expected to be enacted, information in connection with international markets," he says. "There were also a lot of questions in connection with collateral. They were looking for information on new types of collateral being taken and also on tri-party collateral management and risk control."

However, many in Spain have concerns about the wider economy. After a construction boom in the late 1990s, the bubble burst and the economy of Spain is now in a rather weak position compared with other major European economies (see inset). There are other issues that may arise. While a change of government is unlikely to impact on the regulation given that a general election is not due this year, there has been a lack of interest in securities lending in Spain in the past that could hold things back.

Downturn: a bumpy ride for the Spanish



SOURCES: INE, Eurostat and Banco de España.

a. Quarter-on-quarter rate.
b. Year-on-year rate.

Padilla comments: “It is the fact that while securities lending activity is somehow limited there is a very intense activity in derivatives and other areas of securities finance, so basically my perception is that it has been taking so long to get the whole legal framework in place, that the market has just gone around during trades in other forms.” Many asset managers fail to see the benefits that securities lending could bring to their business, he adds.

“This is something that I am working intensively on as a consultant - the fact that asset managers don’t seem to realise that this is actually a source of revenue for them,” he says.

“I was having a chat with one of the largest asset managers in Spain a couple of weeks ago and they said, ‘This can mean a potential profit for the fund but it is only a cost for the asset manager. If it is not something we can incorporate into our revenue stream then we are not interested,’ which is wrong.

“Of course it’s going to be a revenue stream for the participants, but in the end you can also charge a fee for that, so it is also a source of income for the asset manager.

“There is a lack of understanding, there is a lack of knowledge, that goes together with limited interest.” Indeed, the main drive to get the regulation enacted in 2008 came from the industry, with both Santander and INVERCO [the Spanish Asset Management Association] taking a lead on promoting the draft.

While apathy by some may prove an obstacle to the growth of a securities lending market, there has been some active opposition to the move too. Gregorio Arranz, a Spanish state lawyer, explains that many listed companies in Spain feel threatened by the potential for securities lending to open up a new avenue for short selling among speculators.

“Since the Lehman collapse the authorities have been afraid of approving any kind of regulation that in some way can clearly facilitate short selling,” he explains.

“There are many Spanish listed companies, big and small, that are very concerned and very worried about short selling. There is a difference between the two but it is clear that if you facilitate any kind of institution to grant loans then it allows the shorting of securities.

“Another additional reason is that there has been a huge pressure from very important listed companies, including banks, warning that this can be another source of short selling and they have put pressure on the CNMV to stop the order.”

Other problems cited by Arranz include the tendency – not just typical to Spain – for regulators to be opposed to anything that will make their duties more complicated, and that mutual funds in Spain have typically run smoothly –there is a view that introducing a new operation to the mix could affect this record. Even some banks have been against the introduction of securities lending, with two large banks – Banco Popular and Banco Sabadell – actively lobbying against the move.

“There has been huge pressure from very important companies, including banks, warning that this can be a source of short selling, and they have put pressure on the CNMV”

Gregorio Arranz

What about the custodian banks? Larger firms support it, but others are unsure, according to Arranz. “As custodians there is a clear interest in approving this regulation, but at the same time these are listed companies and sometimes these organisations consider the value of the stock to be more important than any hypothetical new business.”

However, if the order is signed into law then what will the securities lending market in Spain look like?

“Practically all securities” will be available to lend,” Arranz explains, “with the rules governing collateral types equally wide – ironically, the Spanish market could be one of the more liberal markets worldwide, despite the difficult road it has had to take to get off the ground.

Neither Arranz nor Padilla believe that the order will undergo many major changes before it is enacted, although the two men disagree on how likely it is that it will come into law in 2010. “If what I’ve been hearing from both AMF [the Spanish Financial Markets Association] and ADEPO [the Spanish Depositary Banks Association] is true, they are definitely interested to put this forward,” says Padilla. “I would say it would be a bit strange if we don’t see the regulation enacted.

“The market seems to be a lot calmer than a year ago, and apart from that the push of local entities in having everything read. The state secretary of the economy said a month ago when he was asked about this issue that there was no further reasons to continue delaying it so I would say it would be very strange if it was not enacted within the next half year.”

However, Arranz says he is only 50% certain that 2010 will see the order signed. “I always ask the regulators on this and they have not given me any clear indication that it will be approved in a short time,” he adds. Whatever the likelihood of the new rules being enacted this year, few would argue that the tale of Spanish securities lending has a few more twists yet to come.

GSL End of Year Summit

London

'Top Ten for Twenty Ten', November

First panel (l-r): Marco Strimer, SIS X-clear; Maria Carina, Euroclear; David Little, Rule Financial; Ed Oliver, Data Explorers Consulting; Brian Staunton, Citi. Far right: Roy Zimmerhansl, GSL. Inset: Greg Hands, MP, Shadow Treasury

Collateral trends, central counterparty and exchange traded funds dominated the discussion at GSL's final Summit of 2009

Venue: Bank of America Merrill Lynch
Sponsors: Bank of America Merrill Lynch, SecFinex, 4sight Financial Software, Rule Financial.

GSL's fourth and final Summit of 2009 provided an astute summary of some of the most important issues facing the industry. Building on themes discussed in its previous London and Amsterdam events, it began with key coverage of the element that joins lenders and borrowers: collateral.

After opening comments from Roy Zimmerhansl, GSL editor-in-chief and Summit chairman, Ed Oliver, head of consultancy at Data Explorers Consulting, provided a presentation of the collateral trends this year.

This included an analysis of the 'correlation' of collateral to the securities lent – an issue that has divided the industry globally. Results from Data Explorers showed that there was a strong case for the pledging equities for a stock loan. For many lenders in the room this was against the climate of risk aversion that saw G10 debt as the main form of collateral.

> **"There needs to be a level of education of the science of collateral and the liquidity"**
>
> **Brian Staunton, Citi**

Later, Brian Staunton of Citi asked the audience to raise their hands: whether they would prefer to receive equities or fixed income as collateral. Despite a proven increase in correlation between equities and equities, the majority of the audience pledged for bonds.

'I think it's interesting because it demonstates that there needs to be a level of eduation of the science of collateral and the liquidity because, emotionally, you move to the path of least resistance which in your mind would be a government bond, it's the safest form of collateral. Post Lehman… lenders who were more diversified in their collateral acceptance moved from equities and other forms of collateral, despite the research that Ed pulled up of the correlation between prices."

Maria Carina, director of product management at Euroclear, followed with a presentation as to the collateral trends in Europe. In an overall flight to safety, sovereign bonds as collateral was increasing, corporate debt was less popular and asset-backed securities had almost disappeared.

Zimmerhansl then turned to central counterparty. Marco Strimer, CEO of SIX x-clear – whose company operation is wider than securities lending - provided an insight into the

"Stock lending is perhaps the sector in financing that is most underestimated or undervalued by market professionals "

Pedro Noronha, Noster Capital

workings of a CCP. This included an explanation on risk management.

He pointed out that "post-trade anonymity will prevail", and added that a CCP is exempt from the capital requirements prescribed by Basel II. Strimer added that general clearing members "shouldn't 'feel' the CCP", and it should be fully automated, with no counterparty risk against the CCP.

David Little of Rule Financial, the consultant, added to the collateral debate with an emphasis on liquidity – "liquidity will be a key issue for 2010… can I turn my collateral into cash?"

He gave an overview as to the two different types of liquidity outlined by the Bank of England. This has particular relevance regarding the paper released by the FSA in October, which requires "all banks and other financial organisations to manage liquidity differently". Stress tests around liquidity will be carried out over 30 days. "It won't be possible for banks to be able to show they can deal with this without bringing in collateral management," he commented.

The second panel tackled the underlying dynamic of the whole industry: supply and demand. Jane Milner, securities finance specialist at SunGard, referred to the technology company's statistics in giving an overview of lending trends. Since the highs of recent years, the industry is now growing again at around 2004 levels, she said. Industry focus was on quality, she added.

Face to face (l-r): GSL.tv gets reaction and comment from panellist Jane Milner of SunGard, Liam Huxley of Syncova Systems, and Rupert Perry of Pirum Systems

Pedro Noronha, managing partner at hedge fund Noster Capital, pointed out that the market was driven by short covering. However, he added that there was a trend to shift from shorting and stock borrowing to long CDS deals, despite a popularity for shorting of international names and special situations. Mr Noronha credited securities lending for providing such a vital part of the capital markets.

"I think stock lending is perhaps the sector in financing that is most underestimated or undervalued by market professionals, because they have no idea how important it is to the fluid functioning of the market," he said. "The options market would not exist without securities lending, I don't think some people are sophisticated enough to realise that to buy a put option someone needs to be shorting the delta in front of it to hedge it for you. I think you do a great contribution to the financial world."

Eddie Guillemette of Bank of America Merrill Lynch agreed that there was a focus on liquidity, with liquid strategies the preference for investors coming back into the industry. Lucinda Guthrie, of dealReporter, said this year has been "all about balance sheet repair", with M&A activity relatively weak, although May saw 19 rights issues.

The third panel focused on exchange traded funds, and featured Keshava Shastry, markets manager from BGI; Eddie Guillemette and Paul Amery of Index Universe. In a presentation, Shastry said ETFs made up more than a third of daily trading turnover in the US. He outlined the great liquidity of the product and said those in ETFs in the bank were working with brokers to help develop the product into a collateral tool.

Greg Hands, MP and Shadow Treasury Minister, closed the Summit with a summary of the UK Conservative Party's future approach to the financial industry, including a rebalancing of power in favour of the Bank of England, along with an explanation of his time in the City and on Wall Street. ✳

Watch the videos of the conference on www.GSL.tv

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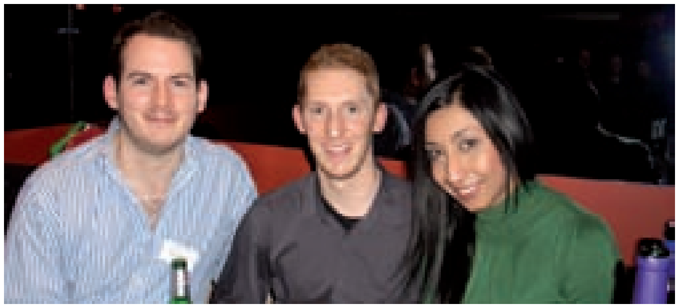
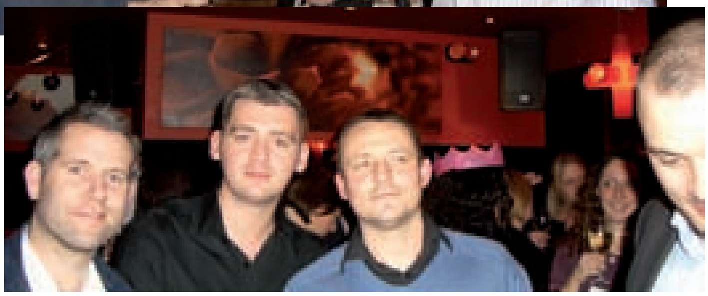
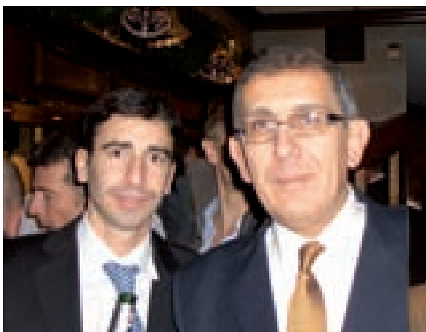
Securities Lending Operations and Middle Office Christmas event

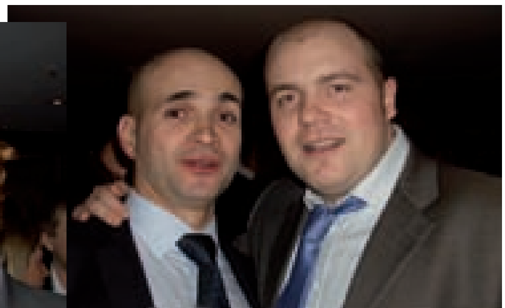




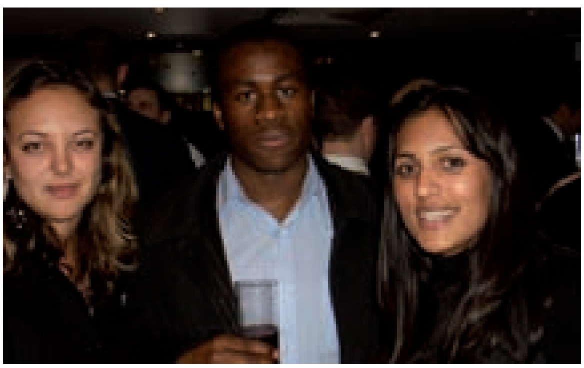
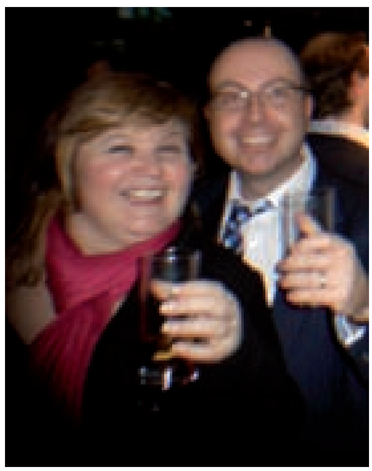

Winter wonderland

Banks and technology firms from across the securities lending spectrum enjoyed the festivities in the run-up to Christmas in the City of London

Fortis Christmas party





Operations up close

Ben Roberts catches up with Rupert Perry, director at Pirum Systems, to discuss the move towards billing automation, contract compare and ISLA's best practice paper.

1. Last year ISLA finalised its best practice paper for billing reporting. Does this support Pirum's promotion of automated standards in the post trade space?

It does. ISLA's best practices sub group includes some of the operations professionals who are most active in pushing the whole industry forward towards using processes that provide both more efficient processing and greater control. The most recent best practice paper essentially sets out a standardised data format for securities lending bills which permits the bills to be more easily transmitted electronically between participants and thus handled / reconciled automatically. When bills are reconciled automatically, they are processed more efficiently and this facilitates timely settlement of the bills.

2. What near term effect might best practice standards have on the market?

The best practice standards are aspirational in that they provide an agreed "best practice" for the topic in question. Whilst not everyone is able to operate in full compliance with all of the best practices today, the papers give good 'ammunition' to operations people – and indeed the management – to make the case for upgrading the systems that

"Accurate records around open contracts is particularly important when it comes to, for example, understanding your full exposure to Lehman Brothers at the time of the bank's collapse"


Rupert Perry

are processing their securities lending and borrowing, so that they do operate in accordance with best practice in future. The idea is that over time the whole industry's operational processes will converge on best practice, ultimately providing more efficient and controlled processing for everyone, with fewer exceptions to be handled / investigated by hand.

3. What are the key discrepancies between counterparties that have spurred the need for common standards?

Differences in positions (i.e. disagreements over exactly how many shares have been lent) are probably the most important discrepancy, as although genuine positional differences are rare, they are potentially extremely expensive.

Recently, we helped a borrower and lender resolve a positional difference where a borrower attempted to return shares which the lender did not believe they had on loan with them.

"Some securities lending firms are assessing counterparties along the lines of the standard of their automation"

It turned out that the lender had mistakenly booked a previous return by another borrower to the trade in question, which explained why the lender did not think the shares were still on loan.

In other words, the lender had no record of the shares on loan to the first borrower, whilst they thought they had shares on loan to the second Borrower, when in fact they had already returned them.

Automated contract compare was the key tool which enabled us to quickly identify what really happened in this case. Regular use of automated contract compare is probably ISLA's most important best practice recommendation.

This is because effective use of contract compare every day ensures your positions are correct, which is fundamental to calculating counterparty exposure correctly. Accurate positions are also the foundation to the smooth operation of all other downstream processes (e.g. billing, mark to market, returns, corporate actions etc.), as any positional differences will otherwise cause exceptions in each of these areas, requiring more manual intervention to deal with them.

Another example would be something like the mark to market best practice. You have to choose when prices on stocks are taken – whether, for example, it is the price at close of markets yesterday or today.

This is an issue commonly encountered in Europe when deciding what prices are appropriate to be used for valuing Asian securities. ISLA's mark to market best practice standard says it is today's close of business price that should be used for Asian securities.

It's important to have a common standard, as otherwise both parties will try to mark their positions to differing prices and this inevitably causes more exceptions which require manual investigation when the two parties try to agree the mark that will actually be processed.

4. Might clarity around standards and transparency improve regulator's understanding and view of securities lending?

Regulators want participants to operate in a controlled environment where they know and manage their exposures correctly. If you run your business in compliance with ISLA's best practice recommendations this undoubtedly helps demonstrate to them that operational risk is being properly controlled.

Having accurate records around open contracts is particularly important when it comes to, for example, understanding your full exposure to Lehman Brothers at the time of the bank's collapse.

5. How far is the industry towards automation?

It generally depends on the size of the firm and whether they are using a vendor package or an in-house developed solution for their books and records.

Market participants using vendor packages often find it easier to adopt industry automation, as the vendor will often develop the necessary file extracts and imports just once for all customers.

Those who are using in-house solutions (especially the older and more mature ones) often find it harder to use

"When bills are reconciled automatically, they are processed more efficiently and this facilitates timely settlement of the bills"

the available industry automation, as they have to develop the required data feeds themselves.

All other things being equal, generally the larger players use more industry automation than the smaller players. However, when that number of open loans is very small, it is possible to get by without using much automation, but it has to be put in place to allow volumes to rise.

One interesting development that we've seen is that some securities lending firms are assessing counterparties along the lines of the standard of their automation. It's a relationship-based business of course, but equally if a bank knows that their counterparty has automation for post trade systems such as billing and contract compare it is going to be a lot more attractive to do business with – particularly as minimising operational risk is top of the agenda right now. ✺

Consulting

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Data Explorers is the leading global provider of market information and consulting services to the securities financing industry and the largest provider of global short-side intelligence to investment managers.

Our products provide market professionals with quantitative measures of securities lending, performance and risk. We are based in New York and London and collect data from over 100 of the top security lending firms representing over 75% of the global securities lending market. On a daily basis we process more than 3 million transactions from over 22,000 funds. On 1 December 2008, this included over 220,000 fixed income and equity assets worth more than USD11 trillion in lendable value of which over USD3 trillion was out on loan.

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Securities Lending

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Lender Profile - Axa Investment Managers

Christophe Roupi, global head of trading and securities financing, AXA Investment Managers, talks to GSL.

"We fully appreciate how difficult it might be not to associate securities lending and short selling"

1. What is your fund's activity in securities lending?

We provide securities lending services to a wide range of funds, from Insurance mandates to third-party institutional clients in all major currencies. Our collateral policy is 100% non-cash, governed by the regulation of the funds and AXA IM's risk profiling, as well as dynamic changes to reflect market conditions and our clients' product development objectives.

2. What criteria does Axa set in order to decide the future of the securities lending?

The perception and understanding of securities lending's contribution to the financial markets does vary from one market event to the next financial crisis, and headlines over the last 16 months have shown the criticality of transparency and reporting.

Securities lending relies on strong risk management, appropriate controls and adequate reporting and monitoring. We also need to be flexible enough to adapt quickly to our clients wishes, for example changes in collateral profile or the possibility to add or remove guidelines to the program.

Ultimately we have to feel comfortable with the risk-return framework, this activity will always aim to maximise value of assets held within an active investment management strategy.

3. What is your collateral profile, and do you see this changing?

Being 100% non-cash implies we'll always have a strong appetite for better correlation between loan and collateral, the latter being made up of high quality and liquid assets.

My responsibilities also include cash and derivatives trading across all asset classes, meaning we have the capacity, if required, not only to provide instant market access or market colour, but to challenge price valuation or market impact.

My organisation encompasses two expertises: trading on one side and securities financing, headed by Jayne Forbes, on the other side. Clearly the ability to interract sensibly between the two adds value to the product, and ultimately benefits our clients.

4. How would you assess the overall contribution of securities lending to the fund?

The alpha generated by securities lending does capture the attention of the beneficiaries, albeit on a different scale depending on market conditions and fund performance. It does not drive or should not hinder our investment process, but if it can help the fund's performance through incremental returns then we should definitely provide this opportunity.

5. How do you perceive the challenges in the communication of securities lending's risks and opportunities?

As an agent lender embedded within a large investment management company, we fully appreciate how difficult it might be not to associate securities lending and short-selling for example.

The educational gaps are always going to be challenging, although we always ensure our clients are fully aware of the procedures and risk management framework surrounding the activity.

Capital markets rely on an efficient lend and borrow programme to access liquidity, it is therefore essential to ensure capacity is not constrained.

We've had some very interesting discussions and exchanges with regulators with a view to provide transparency on the industry, and maybe bring securities lending the credit it deserves. In the end we might want to take passion out of this debate once the markets have settled to ensure risk mitigation, control, transparency and reporting features higher on the agenda than just basis points returns or fees.

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You've got questions

Did securities lending participants remain in their programs throughout the financial crisis? Can risk factors be sufficiently mitigated? Is securities lending viable in today's dynamic market?

RBC Dexia can provide the information you need to help unravel the intricacies of securities lending.

For securities lending insights, access our essential guide, Demystifying Securities Lending and the results of our recent Quick Poll, Prudent Approach Prevails — available at **rbcdexia.com/sl**

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