

Q&A

The Transformation of Securities Finance

At the recent IMN Beneficial Owners conference in London, September 22/23rd, the concept of a “new market order” for the securities finance industry thrived in conversations in both the formal sessions and associated networking activities. The events of the last year have been transformational, and the change is still in progress. In the following discussion, SunGard’s Jane Milner considers the key forces and drivers of change in the industry, and the potential impact of these changes on the market dynamic.



Is the securities finance industry going through a transformation?

Yes, along with many other areas within the financial markets. The question is: How much of this is natural evolution versus forced by recent events? The industry’s dynamic has changed considerably for stakeholders. In particular, all of the market ups and downs have had an impact on both the hedge fund to prime broker relationship, and the global custodian to beneficial owner relationship.

In what ways has the industry changed?

There has been industry contraction, new competition, greater focus on risk, increased regulation, and a shift in market practices. The volume of securities finance transactions in the market is down between 30 and 40 percent. A small part of this change is due to a reduction in supply as funds have either fully or partially withdrawn from lending, but the main impact is a reduction in demand by hedge funds and other borrowers.

How have the dynamics of borrowing changed?

In the past, broker-dealers would access easy-to-borrow securities from the lenders and their agents so as to get penetration of hot stocks when these were needed, leading to large balances with lending institutions. Over the last year, this dynamic has broken down as brokers can no longer afford to have their balance sheets tied up with general collateral securities when there is little demand for them. There is some good news for lenders in that aggregate rates have increased, since special securities attract higher rates. Lenders themselves are becoming more aligned to the new dynamic, by focusing on quality and working smaller but smarter. Hedge funds’ primary concern is still about survival, and they remain wary of what the market is going to do. As a result, the demand to borrow securities is still subdued.

How will firms survive in the new competitive landscape?

As the industry continues to consolidate, there is also diversification taking place with smaller regional firms getting into the action. Hedge funds have begun acting as lenders as well as borrowers, and the prime broker model is evolving. Hedge funds will be more likely to have multiple prime brokers in order to spread their risk, as post-Lehman, they are more aware of the complexities regarding access to their assets in the case of default. There is an even greater need for prime brokers to differentiate themselves based on the range of services they can provide. Rightly or wrongly, there has also been damage to relationships between beneficial

owners and global custodians. Weakened relationships were the result of beneficial owners' perceived lack of risk within the cash collateral reinvestment programs, and whether or not their agents were fully 'up front' in drawing their attention to risks – not of securities finance per se, but rather those associated with cash reinvestment.

What does the increased focus on risk mean for cash reinvestment?

Recent events have particularly highlighted the risk impact on cash collateral and its reinvestment. Some lenders have pulled out of the industry altogether, and all are reviewing their practices with a specific focus on collateral. In some quarters it is being considered whether the best people for the job of cash re-investment are the institutional investors themselves, rather than leaving this up to their securities lending agents. In addition to updating cash re-investment guidelines, many are looking at their policies regarding the use of non-cash alternatives, including reviewing methods of better correlating loans and collateral. There is also more emphasis on the use of tri-party agents to help manage more sophisticated collateral requirements.

What are the challenges of measuring risk in securities lending?

There are two areas to consider regarding risk measurement. The first is that it is necessary to include a risk measurement aspect of securities lending in a corporate-wide risk model. Secondly, within the securities lending area itself it is difficult to quantify risk as there are so many variables including mark-to-market, indemnification, and the concept of correlating different collateral types, while cash collateral re-investment also adds to confusion. Right now, individual aspects can be viewed and analyzed over time to establish trends, as well as measuring the risk of counterparties. However, quantifying the risk remains a challenge.

Are exchanges in electronic markets and central counterparties coming for securities finance?

A route which some think may offer the potential to reduce counterparty risk is the use of a central counterparty, which until now has been absent from the securities lending market. However, there are now a number of options available, such as QuadriServ AQS where the OCC acts as the central counterparty, which might give a boost to the electronic marketplaces that have traditionally been a relationship-based business. This comes at a time when greater strain has been placed on relationships and the initial model focuses on not trying to take on too much by being all things to all participants.

How will new regulations play a role going forward?

The US market is by far the most regulated market at the present time, with relatively new regulation being added including the SEC Rule 204. In the UK, the interim solution for Basel II Capital Adequacy agreed by the FSA comes to an end in January, and the FSA Liquidity ruling becomes permanent regulation, designed to protect the investor and remove some of the risks in the market. As with Basel II (ALD in Europe), the European model has been based on the successful ALD reporting mechanism in the US, and it is likely that a similar thing may happen with further legislation. There's no doubt there will be more regulation on the way; what this might require of the industry is still to be defined.

What happens next in securities finance?

Hedge funds are returning carefully to the market, and short selling will continue to increase as alternative investors become more active. Clearly, the agile and efficient will gain an edge as strength and reliability becomes paramount. Institutions will continue to look for ways to better manage their risk and return tolerances.

The greatest shift in securities lending will be an increased emphasis on higher returns and lower volumes, with greater consideration to risk adjusted returns. More conservative collateral management will take hold, with focus on quality, liquidity risk and issuer diversification, and less attention on returns from cash reinvestment. All institutions will demand more from their service providers and counterparties. Cost efficiencies will become critical and the use of electronic marketplaces, consolidation of equity and fixed income areas, and the streamlining of operational processes will be ever more important.

Securities lending has not lost its place as a necessary lubricant in efficient financial operations. Indeed, governments have been undertaking it in Treasury markets to ensure orderly flows. While not reaching its historical highs any time soon, it is fair to say that it will be returning to its roots with more regulation and definitely more transparency.