

Enhancing Profitability

A Single Integrated Solution for
Securities Lending

ABOUT THE AUTHOR

An IT veteran who started her career as a mainframe programmer, Jane Milner quickly switched focus to the area of solution delivery, and has spent many years working closely with customers to implement a wide range of applications in markets as diverse as accounting systems, order processing, stock control, job costing and incomplete records.

Jane started working in financial markets IT some fifteen years ago, and since then has been involved with many different aspects of service delivery in the specialist area of securities finance. Her roles have incorporated training, documentation, account management, business development and marketing. She is currently global product marketing manager for SunGard's range of market leading solutions for securities finance, including Global One, Martini, Loanet and Astec Analytics.



INTRODUCTION

The securities lending market is expected to continue to grow by 5% in US and 10% in Europe according to the most recent reports¹. In this expanding market the need to improve efficiency and drive down costs is never far from the mind of the business manager. Securities lending is an area in which there is still considerable scope for efficiency improvement as it is one of the last areas to have fully embraced automated processing. The lack of automation, evident in front, middle and back office activities, is largely due to the variable nature of the trades and the complexity of the operational lifecycle. This is particularly true in international lending, where the cross market complexities make automation even more challenging.

While securities lending volumes and values continue to grow, there is the danger that revenue increases can be outstripped by increases in cost, resulting in a compression in overall profitability. Empirical evidence suggests that there are still countless efficiencies that could be realised to hold down costs. This involves two distinct areas for improvement; enhanced processing and integration of IT solutions within an organization, and also increased efficiency of communication between counterparties during the many lifecycle events that occur. With a securities lending trade duration, ranging anywhere from one day to weeks, months or years before a trade is complete, maximizing efficiency is clearly of paramount importance.

Technology has already assisted by putting into place a collection of small, distinct innovations, such as order routing and contract compare. But what will lead to real transformation and greater profitability in the industry is the closer integration to allow the entire process to be managed end-to-end. Not only will this deliver reduced costs and increased efficiencies, it will also build in the scalability required to support ongoing increases in volume and business expansion.

The danger with automation of isolated parts of the process is that a bottleneck is simply moved further down in the processing cycle, or even worse, a new bottleneck is introduced within the trade management lifecycle. Ideally, a solution needs to cater for straight-through processing (STP) from order entry, through each stage of the trade lifecycle, to maintenance of a firm's core books and records. Integration in its simplest form eliminates the repetition of tasks on multiple systems. It also gives greater sophistication and synchronisation to a total solution.

AUTOMATING THE LIFECYCLE

To date, STP has been focused around areas such as electronic settlement, however there is still great scope for further integration to improve efficiency in many more of the front, middle and back office processes.

Technology can deliver automation of manual, time consuming and error prone processes

avoiding duplication of effort and allowing practitioners to get on with the more interesting, added value tasks. Extending this further, integration between systems that are each efficient in their own right, leads to even greater opportunities to reduce costs and enhance profitability from securities lending.

Looking at the potential improvements throughout the entire trade lifecycle process, we can see that the benefits of automation and integration touch a considerable number of different areas.

FRONT OFFICE

The benefits of automation are not only appreciated by those managing the labour-intensive back office tasks, but also by the traders in the front office. Securities financing is no longer a 'service' to other trading functions, and securities finance traders need to become more proactive and opportunistic in their approach. To be more efficient, this requires more sophisticated decision support tools for price discovery, visibility of market volumes and trends, and a clear awareness of consolidated borrow requirements and securities availability.

Improved pre-trade support

Having a real-time consolidated, global positions management system, from which the trader can see long and short positions at a glance, puts the trader firmly in the driving seat. Combining this with market data analytics, such as trends in market pricing and volumes, further strengthens the trader's ability to do the right trade at the right price and at the right time. In many trading environments this data is readily available; however, in the opaque world of securities lending, such data is more difficult to access and it can only be obtained from a very limited number of sources.

Gaining efficiencies in supporting the higher volume, lower margin business is not enough. Automation is also needed to help generate new business and to free up time for chasing the lucrative specials, exclusives and other more sophisticated trading strategies including yield enhancement trades. Automation of general collateral trades does, however, enable traders to

spend more of their time identify the borrowing and lending opportunities that best suit their unique strategies.

Easier access to a wider audience

According to the most recent TowerGroup report on securities lending, borrowing needs will continue to outstrip supply, fuelling the demand for more sources of liquidity and greater automation. Electronically generated loan transactions still only represent 10% of the on loan balances, however TowerGroup and Celent² anticipate that this will rise to 20% by 2009.

Electronic marketplaces and order routing systems provide efficient access to a wider range of counterparties than is possible with one-to-one communications. In addition to helping lenders improve their distribution networks and giving borrowers easier access to supply, this automation increases the visibility and transparency of the securities lending industry. While the stock lending business still relies heavily on relationships to facilitate negotiation of the many factors influencing the profitability of a trade, general collateral business is now becoming the exception to this rule. These "vanilla" trades typically use a pre-agreed standard fee rate and require little negotiation.

When a trade has been agreed in an order routing system, efficiencies can be extended further through close integration with the middle and back office systems. This helps to avoid potential bottlenecks caused by the need to re-key, or further validate, these trades. Through such integration, limits and availability checking, along with trade defaults enrichment, can be done automatically. In an agency lending environment, a fairness allocation algorithm built into the security allocation routine will ensure that all underlying principals have a fair share of the new trades being written.

Standing out from the competition

The characteristics that have always differentiated one firm from another include the ability to provide fast, quality service, access to a wide range of securities, and flexibility of collateral acceptability. All of these factors help lenders get the best returns on the securities they manage.

More than ever before, owners of assets are demanding that such claims of quality service are substantiated. This can be done through reporting and trade analytics that benchmark the performance of an individual lender against the market. Once again, such data is not readily available, however specialist services can be found to independently carry out this function on behalf of a market player.

This risk and performance reporting goes hand-in-hand with the need to provide on-demand customer reporting, particularly in an environment in which a firm is acting as a lender on behalf of other participants, such as a global custodian or third party lender. The need to generate client specific reports for regular distribution, or for ad-hoc queries, is more and more in demand. The preferred solution is commonly the use of an industry standard report generator in which the firm already has expertise. The need to build a universe to allow the reporting tool to understand the stock loan data pool is a substantial task which is imperative if this route is to be effective.

Flexibility of collateral acceptability

The ability to take a broad range of collateral makes a lender more attractive to the borrowing community. Accepting both cash and non-cash collateral is now crucial, along with the ability to take a broad spectrum of non-cash collateral, including equities in addition to bonds. Use of third party collateral management services such as those provided by JPMC, BNY Mellon and Euroclear allows the outsourcing of expertise required to carry out more sophisticated collateral management. This can ensure best use of available collateral from a borrowers perspective, and strict adherence to the collateral mandate from a lenders point of view.

While these services provide effort reduction and timing benefits in their own right, the efficiency is compounded by implementing real-time integration with an in-house securities lending system that can manage all collateral types. Coupled with the requirement for daily disclosure of stock loans and associated collateral, both for US Agency Lending Disclosure (ALD) and Basel II, there is a need to hold detailed collateral data

in a company's core record keeping system in order to fulfil regulatory reporting requirements. Once again, this is a case in which enhanced "specialist" processing needs to be accompanied by associated integration into the core system in order to be used to best effect and avoid shifting the bottleneck.

Increased front office automation, and the associated benefit of increased trading volumes, brings with it a range of issues for operations teams, as trade agreement is only the start of a potentially long and complex lifecycle.

BACK OFFICE

With the front office equipped with more sophisticated tools to gain efficiencies and increase business, the back office must keep pace and maintain high levels of service. Not only is back office automation required to manage this activity, but it must be carried out ever more efficiently and cost effectively. High volumes present significant challenges in manually intensive processes. Increased automation of efficient business processing and increased STP is a fundamental requirement rather than a 'nice to have'.

STP in settlement

Settlement management, incorporating the generation of confirmation documents, settlement messages and the status response from clearers, is likely to have been one of the first areas targeted for automation with STP between firms and their settlement agents. Where faxing and re-keying of information is still carried out, this can be replaced by automation using standard settlement messages, such as SWIFT, to link to clearer and settlement systems.

Links may have already been established with in-house settlement systems, whilst these are acceptable in a buy/sell trading environment, they may not be sufficient to meet the more challenging response times demanded by securities lending. By generating securities and cash settlement messages to be sent to the settlement gateway directly from the securities lending system, timing issues can be alleviated and true STP achieved.

Diverse collateral type processing

The ability to take a broad range of collateral brings with it the need for additional functionality in the operational trade lifecycle. In the US market "cash is king" in terms of collateral, and most US market participants are well positioned to manage any associated cash re-investment. In Europe, however, the opposite is true with high quality, non-cash collateral such as government bonds being the preferred option. This means that a global securities lending system needs to be able to handle both types of collateral, not only from a risk and exposure management perspective, but also from the re-investment and, where allowed, re-hypothecation perspective. It is therefore important to avoid potential restrictions and ensure that all types of collateral can be managed effectively within a securities lending solution.

Automating daily marks

Daily marking for exposure management is largely a manually intensive task that presents major challenges for the back office. In international trading, with the complication of multiple pricing sources and varying exchange rates, every trade has the potential to vary in value between the two counterparties on the trade on a daily basis. This causes the need for daily checking and renegotiation of loan values. Some form of accepted standardisation of the marks process would benefit all market participants as this activity is one of the most resource hungry operational activities. The fact that marking needs to be done to mitigate risk on stock loan trades means that each firm is reluctant, or unable, to accept standard prices and standard foreign exchange rates. Acceptance of a standard, centrally generated mark value to both parties on a trade would greatly reduce the operational costs to all. Once this mark was applied, each firm would have the potential to show its exposure against its own in-house accepted price and exchange rates, with the option to follow up individually on anything outside an acceptable limit.

In today's world a flexible automark capability is an important standard feature of a securities lending system, but just as important is some way of communicating the proposed mark to the other party. This should be supported by a reconciliation process to ensure that the value of the trade as

held by both parties remains the same. If it does not billing problems with ensue.

Contract comparison

Technology solutions are available to carry out contract compare, fee compare and mark compare on a daily basis. These systems highlight exceptions, or "breaks" and help to save valuable time and reduce risk. Corrections are typically entered on the comparison web portal, and also on the core record keeping system. Integrating the two provides significant opportunity to reduce effort and improve accuracy by automatically updating trades as compare breaks are corrected.

Recalls/returns management

The requirement to carry out a recall is something that lenders, and borrowers, would prefer not to have to do. However, in the real world this happens and the effort involved for a large lender can be extensive, and time sensitive. Point-to-point communication is time consuming, but the use of a central hub for lender recalls and borrower returns brings operational efficiencies. To gain maximum benefit there needs to be integration between the hub and the securities lending solution so that these transactions are automatically reflected in the securities lending system without the need for manual booking.

Month-end billing

Billing presents a bottleneck in most back offices. This is due in large part to issues with trade value difference as a result of marks and also because of other changes that may be carried out on an individual trade by one party only. The time taken to investigate and communicate differences with the other counterparties can make it a tedious and lengthy exercise. A practical inability to carry out the work necessary sometimes leads to the need to agree on a fee difference, which clearly works to the advantage of one of the parties, however it is not necessarily good for the bottom line of the other.

Following the production and distribution of fee statements, the exercise of fee collection is sometimes managed by other areas outside securities lending; in many firms it also falls to the securities lending department. Software solutions are available to manage the fee collection process

and generate SWIFT payments for the fees due. If this process is an integral part of the securities lending system, the impact of any retrospective changes to trade values that affect the fee can be reflected automatically.

Effective corporate actions and entitlement management

The impact of corporate actions during a trade can make or break its profitability. Alerts to upcoming corporate events can greatly aid a trader in determining the relative merits of a proposed trade, and similar warnings on collateral booking and the return of a trade are just as important. The operations team must ensure that corporate actions are resolved effectively and in a timely manner. Once again, this is a hugely time-consuming and largely manual process for many organisations. With both mandatory and elective actions to take care of, complexity is further increased with variations in legislation and tax structures from country to country. Technology can help, particularly with the processing of actions with a known outcome. The impact on the quantity of a stock loan trade as a result of certain common types of corporate actions, such as splits and bonus issues, can be automated based on a rules matrix to determine the outcome. Where this is not done by an IT solution, corporate actions trades need to be posted manually to reflect quantity changes, which involves effort and provides the opportunity for error. The generation of claim forms and the collection or payment of cash dividends can also be managed by technology, with generation of cash SWIFTS automating the payment process.

The incorporation of effective dividends and corporate actions processing within an IT solution, along with the associated integration with settlement services, can have a dramatic impact on the reduction of manual, error prone effort when managing these events outside the core securities lending system.

Regulatory reporting

Two major initiatives for enhanced capital adequacy reporting have recently added further to the burden of the securities lending trade operational effort. These are Agency Lending Disclosure (ALD) in the US and Basel II capital

adequacy reporting in Europe and further afield. Although not directly a stock loan ops requirement, the desire to be a preferred lender to a wide range of borrowers, means that the provision of the necessary additional information is a given. The need for a borrower to report exposure by underlying principal requires the borrower to receive positional data from each of the lenders they deal with on a daily basis. Although in some regions there is currently a relaxation in the reporting frequency, the requirement for daily reporting is generally accepted as being desirable. Where file exchange has to take place on a point-to-point basis between borrowers and their lenders, achieving this will involve considerable IT effort.

In the US there are three inter-connected 'hubs' that have been established to allow a lender to send files to one central location for distribution to the relevant borrowers. One of these services also carries out contract reconciliation on behalf of the borrowers to confirm that the details received from the lender correspond with those held on their own books and records. Once again, there is a need to interface these services with the daily trade and collateral details. Where a solution provider can supply both the core record keeping system and the ALD hub, no additional data configuration or data communication effort is needed.

Handling higher volumes

Recent market volatility, along with the push for business expansion, has resulted in increased volumes for securities finance. IT solutions need to be capable of handling these ever increasing numbers of transactions in a reliable way. Systems that used to be able to handle 50,000 open positions at any time now need to be capable of handling double, triple and quadruple the previous volumes. Systems scalability is therefore important, and there may be a breaking point at which the speed necessary to run the business effectively can no longer be achieved. The fewer the layers and potential points of failure in the technical architecture, the easier it is to manage scalability at all points.

SYSTEM INTEGRATION

As previously described, there are a number of potential efficiencies that can be driven from the functionality incorporated within a securities lending solution. Having these challenges addressed by disparate, non-integrated IT systems can bring its own set of issues, and possibly result in moving bottlenecks to other stages within the business process. Close integration between systems is needed to fully reap the benefits of improved efficiency of process and support scalability, while helping to control risk and cost.

There are numerous ways in which integration between different systems can reduce inefficiencies and errors, here are a few examples:

- When a trade has been agreed in an order routing system, trades can be created automatically in the core record keeping and lifecycle management system
- For trade reconciliation, any corrections carried out on the contract comparison component can automatically be updated in the record keeping system, thereby eliminating the need to manually post the changes in two places
- Centrally generating marks to the trades of both participants ensures the trade remains in step, while at the same time the mark values can automatically update the recorded loan values
- Recalls can be centrally routed and recalls and return activities can be booked to the trades automatically

An integrated solution can become an enormous asset for managing an institution's own record-keeping commitments as well as trading activity with other market participants, while eliminating the repetition of tasks on multiple systems.

However, anyone who has been involved with integration of systems, whether manual or IT related, knows that the devil is in the detail. What sometimes appears on the surface to be a relatively simple task can build in complexity as the scope and subtleties of each system become apparent.

Integration is commonly one of the most costly, and least predictable elements of cost in an IT project's budget, often eating up what can seem to be a disproportionate percentage of the overall budgeted cost.

SINGLE SOURCE SOLUTION

An integrated front-to-back office solution sourced through one vendor relationship can deliver many of the advantages previously discussed with less of the complexity of multiple system integration. This is particularly important in the recognised niche business of securities lending where integration resource is particularly scarce. A single source solution can also best leverage the processing workflow and synergies between individual specialist components.

While many of the issues previously described apply globally, the US domestic market, which it is fair to say is more mature and less complex, has a far more efficient operational environment and there may be lessons to be learned. One major difference in this environment is that great efficiencies are already achieved through the use of a central system provider.

The shopping list for a single source solution is formidable, as in addition to the record keeping system at the core, there are a large number of other areas previously identified which need to be combined to provide an integrated STP system for the front, middle and back offices. These include:

- Price discovery and market analytics
- Consolidated positions management
- Trade capture and order routing
- Links with auto-borrowing and electronic marketplace solutions
- Collateral management, including links to tri-party agents
- Settlement management, including generation of market standard messages
- Automated marking
- Recalls management
- Billing management
- Corporate actions and entitlement management
- Contract and fee comparison
- Standard operational reports alongside report generation capabilities for ad-hoc and tailored reporting
- Trade analysis and performance reporting
- Regulatory compliance support for ALD and Basel II
- Communication hub for order routing, contract compare, marking, recalls management and ALD

Although it may seem a utopian state, the incorporation of all of this functionality in a single source solution is available. Brian Traquair, head of Capital Markets and Investment Banking at SunGard, is well versed with these challenges as he has spent the last twenty years dedicated to providing solutions for securities lending. "How often can a single point of responsibility be identified when working with a multitude of different systems? Working with a single supplier allows the customer to gain end-to-end efficiencies by transferring much of the responsibility for complex integration to the supplier. Customers get greater leverage from their IT investment by working in close partnership with a minimum number of points of contact, and therefore streamline and simplify their vendor relationships with solution providers.

The breadth and depth of SunGard's single source solution offering for securities finance is unsurpassed. In other walks of life, the benefits of single-sourcing have long been recognized. If carrying out a building project, particularly if not just a standard building but a rather quirky, specialist building, how many of us would favour a sole contractor over employing individual trades independently? The ability to have one responsible party mitigates risk and enables the most effective orchestration of all necessary resources in order to achieve maximum effectiveness."

CONCLUSION

Participants in the securities lending industry have choices when it comes to automation. They can choose to implement a standard system, or those with deep pockets and generous timelines may opt to invest in in-house developed systems. While the industry has progressed technologically at a measured pace to deliver innovations to specific business functions, disparate systems can pose problems with gaps in processes and overall accountability.

Up until now, securities lending has often existed in isolation in relation to many other departments within financial institutions. However, institutions are increasingly realising the benefits of enterprise-wide efficiency and improved workflow gained by a consistent approach to technology and systems. One clear premise that arises from this realisation is that the more integration there is between systems, the greater the benefits these systems can offer. The most effective integration can be achieved with a total solution sourced from a single supplier.

Closer integration between the front, middle and back offices, and amongst inter-market participants, is the next important step in technology innovation within the securities lending industry.

¹ TOWER GROUP JAN 2008 'THE SECURITIES LENDING MARKET: PERCEPTION OF REVENUE OPPORTUNITY AND THE TOOLS TO MAKE IT A REALITY'

² CELENT NOV 2006 'SECURITIES LENDING: TOPIC, TECHNOLOGY AND TRENDS'

ABOUT SUNGARD'S SOLUTIONS FOR SECURITIES FINANCE

SunGard is a recognised leader in supplying solutions to the specialized world of securities lending. Eight out of the worlds Top Ten Banks (as ranked by The Banker 2007) use a SunGard solution for securities finance. In 2007 the ISF (International Securities Finance) magazine surveyed its readers and SunGard was identified as the leading supplier of IT solutions in this marketplace, with the closest challenger being in-house solutions, and the sum of the other vendor supplied solutions not being equal to SunGard's market share. SunGard solutions have been dominating the market for the latest fifteen years, and although other suppliers of financial market solutions have attempted to expand their solutions to meet these niche market requirements, it has been demonstrated that the unique challenges of securities finance operations require a dedicated solution to handle volume trading.

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