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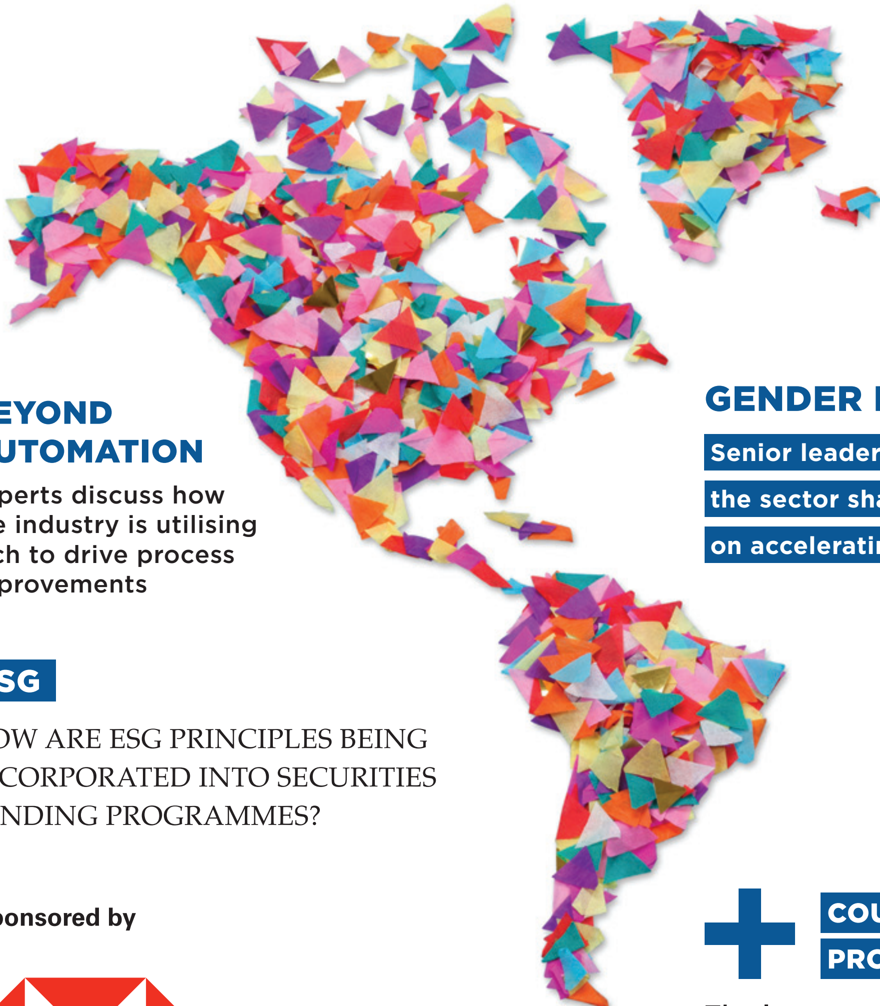
# Securities Finance Americas Guide 2019



## BEYOND AUTOMATION

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## GENDER DIVERSITY

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## + COUNTRY PROFILES

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GLOBAL INVESTOR GROUP | FOW | ISF

**General manager** Will Browne
Tel: +44 (0) 20 7779 8309
will.browne@globalinvestorgroup.com

**Managing editor** Luke Jeffs
Tel: +44 (0) 20 7779 8728
luke.jeffs@globalinvestorgroup.com

**Securities finance editor** Andrew Neil
Tel: +44 (0) 207 779 8858
andrew.neil@globalinvestorgroup.com

**Special reports editor** Louise Fordham
Tel: +44 (0) 207 779 8983
louise.fordham@globalinvestorgroup.com

**Contributors** Paul Golden, Ceri Jones, Cherry Reynard

**Design and production** Antony Parselle
aparselledesign@me.com

**Head of events** Yasmin Okolo
Tel: +44 (0) 20 7779 8109
yasmin.okolo@euromoneyplc.com

**Events manager** Velida Cajdin
Tel: +44 (0) 20 7779 8188
velida.cajdin@globalinvestorgroup.com

**Events assistant** Jacqueline Onyenze
Tel: +44 (0) 207 779 8061
jacqueline.onyenze@globalinvestorgroup.com

**Divisional director** Jeff Davis

**Chairman** Leslie Van de Walle

**Chief executive** Andrew Rashbass

**Directors** Jan Babiak, Kevin Beatty, Andrew Billingal, Tim Collier, Colin Day, Tristran Hillgarth, Imogen Joss, Wendy Pallot, Lorna Tilbian



**SUBSCRIPTIONS**
UK hotline (UK/ROW)
Tel: +44 (0)20 7779 8999
US hotline (Americas)
Tel: +1 212 224 3570
hotline@globalinvestorgroup.com

**RENEWALS**
Tel: +44 (0)20 7779 8938
renewals@globalinvestorgroup.com

**CUSTOMER SERVICES**
Tel: +44 (0)20 7779 8610
customerservices@globalinvestorgroup.com

**GLOBAL INVESTOR**
8 Bouverie Street, London, EC4Y 8AX, UK
globalinvestorgroup.com

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# Making moves in Mexico

Proposed changes to the structure of Mexico's pension system could pave the way to increased participation in securities lending transactions. **Ceri Jones** reports.

A new Retirement Savings Bill was proposed in January by Mexico's ruling National Regeneration Movement (MORENA) to liberalise the corporate governance of Pension Investment Companies (Siefores) and replace them with Pension Investment Funds (Fiefores). As well as some worker-friendly initiatives, and the abolition of the 20% investment cap on foreign securities, Fiefores will be allowed to invest in a broader range of financial instruments and enter into securities lending and repurchase agreements, including the ability to receive cash deposits for collateral purposes.

This is a major step forward for the nation's pension funds which are currently limited to securities issued by the Mexican Federal Government in their lending and repo operations.

Allowing the pension market to enter the securities lending market for stocks and bonds introduces a very large inventory of equities and bonds that should boost supply and increase the liquidity of the markets.

"Siefores and Afores, which manage worker contributions registered at the Mexican Institute of Social Security, are the major players in the Mexican economy with funds under management of up to MXN4.88 trillion," says José Ignacio Rivero Andere, a partner at Gonzalez Calvillo, one of Mexico's leading law firms. "These reforms are expected to materially incentivise economic activity in Mexico, as well as to improve profits for workers which in turn will boost their retirement funds."

### Securities supply

There is demand for borrowed securities, but relatively few institutions currently participate in the securities lending market, resulting in scant supply. One issue is the lack of hedge funds, as well as a dearth of broker-dealers with active short strategies. Most of the nation's hedge funds are domiciled outside of Mexico and transact business in the US, so creating a level playing field with the level of flexibility investors have become accustomed to is a tall order. However, the Bill has stoked interest and the recent revelation that Goldman Sachs is considering a stock-trading brokerage in Mexico demonstrates the developing interest in Latin America's second largest economy.

"Our discussions with beneficial owners indicate a general sense of optimism to participate in securities lending," says Andrea Cattaneo, head of securities services Brazil and head of sales LATAM at BNP Paribas Securities Services. "The difficulty remains similar to other markets in that the opportunity must become prioritised within each organisation. Certainly the high fees associated with lending equities in the local market are compelling. However, scalability continues to drive decisions for participants. This dilemma is no different for participants when examining entering new lending markets. Therefore, it will take increased volumes along with continued transparency for beneficial owners to become convinced of their participation. Inevitably this process will take time.

"While beneficial owners may become inclined to participate in securities lending in the local market, the demand must increase. The benefits to the beneficial owner and market infrastructure remain compelling to engage in securities lending. But until the demand increases through increased short interest the market will remain idle."

In the current investment conditions, asset managers and beneficial owners are keen to improve returns, and for Siefores the need is pressing as the new Bill will force them to reduce their charges. The reforms could therefore have a very positive impact on the mandatory pension system, given time.

"Currently, Afores are permitted to lend Mexican Government Bonds, which is the largest and most liquid market," says Juan Hernandez, head of Vanguard Mexico. "Some of them actively participate in this lending market but given the high liquidity and the fact that the Central Bank also participates as lender of last resource for market makers, the demand and lending rates are not that attractive. It is the expectation of Afores that lending equities and corporate bonds could be an attractive source of return for their funds.

"Specifically, the measures would enhance returns for investors, as current lending rates for Mexican equities are between 2-3%. In addition, it would improve liquidity and market depth in stock and bonds."

Academic research suggests that securities lending typically increased liquidity in the cash execution markets. Mexico's nascent market should also be bolstered by the presence of government agencies which have already gained experience in these activities.

"The participation of government and central bank entities throughout Mexico in securities lending should provide a great deal of comfort to potential participants," explains Cattaneo. "The experience of government entities and

**"Historically, the lending market in Mexico is heavily weighted towards fixed income and proposed regulation will seek to better align the lendable balance of equities."**

**– Andrea Cattaneo, head of securities services Brazil and head of sales LATAM at BNP Paribas Securities Services.**

> **It is the expectation of Afores that lending equities and corporate bonds could be an attractive source of return for their funds.**

**– Juan Hernandez, head of Vanguard Mexico.**

the Central Bank can be used as a case study for non-government entities to examine the process of implementing a risk-adverse securities lending program while focusing on generating incremental income through securities lending. Perhaps the greatest impact will be on the lendable balances of equities. Historically, the lending market in Mexico is heavily weighted towards fixed income and proposed regulation will seek to better align the lendable balance of equities."

### Market infrastructure

Appetite for liberalisation of the financial markets has also been stoked by other initiatives in recent years. For example, the second bourse, Bolsa Institucional de Valores (BIVA), has improved infrastructure which has significantly reduced the costs of securities trading.

However, when BIVA was launched in July last year, there was scepticism over its viability given that just 12 securities traditionally account for over 50% of Mexico's trading volumes. Backed by four pension funds with a $22 million investment through a private equity firm, BIVA struck a deal with Nasdaq X-Stream technology to access tech that could attract market participants. Transactions are now said to be faster than the Bolsa Mexicana de Valores (BMV), where for example delayed market data or bandwidth during rebalances forced the bourse to close to investors four times in 2016 while it dealt with the outages.

### Next steps

As things stand, the Fiefores regime will be determined by the National Retirement Savings System Commission (Consar), and securities lending and repurchase activities will be the subject of enabling regulation to be issued by Banxico.

However, the Bill, which has already been approved by the finance committee of the lower house of Congress, has yet to move through the full lower house to the senate, and may still be modified. Critics have warned that Lopez Obrador's leftist government might use freedoms to deploy workers' pensions to finance its planned infrastructure projects, which could result in the tabling of a range of amendments and modifications to protect funds from risk.

Opening up the securities lending market will also mean that Afores and Siefores, the principal local investor of securities issued by the Mexican Federal Government, will have a broader choice of securities and financial transactions in which they can participate. This could force the Mexican government to search for new investors in domestic and foreign markets, and to modify its paper to satisfy their profit appetite and to be more competitive.

"Furthermore, the reform is expected to provide companies and projects of all sizes with the necessary funds for their implementation and growth, and thus to incentivise these players to issue securities in the Mexican stock market," adds José Ignacio Rivero Andere. "The existence of new issuers on the market will increase the free-float capital and, consequently, the daily volume of operations."

Another recent initiative with a similar aim is the two-year fiscal incentive that will enable private companies to become public with a tax rate of 10% versus the current 30%, which should result in more IPOs and, subsequently, more listed companies and increased market depth. ■


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# Catalysing through collaboration

**Daniel Baeza,** VP Latin America at Frontclear, talks to *Global Investor's* **Louise Fordham** about the organisation's role in developing money markets in emerging and frontier economies, and its work in Latin America to date.

**Financial markets development organisation Frontclear was established in 2015 with a particular focus on catalysing repo and derivative markets across emerging and frontier economies. It has a two-pronged approach to achieving this aim: issuing guarantees to cover a lender's counterparty credit risk and facilitating money market knowledge, regulatory and infrastructure development through a technical assistance programme.**

The firm's activities span emerging and frontier markets in Latin America, Africa, Asia, the Middle East and CIS. "What we tend to see in these jurisdictions are multiple barriers that prevent local financial institutions from enjoying a stable and inclusive money market. There is a lack of connectivity in terms of liquidity, and there is no way of hedging risk locally," says Daniel Baeza, vice president for Latin America at Frontclear.

Smaller banks can encounter challenges accessing liquidity, he explains, which can create balance sheet issues and result in inefficient asset liability management. Frontclear helps these institutions to access local and global money markets through its guarantees.

Baeza says: "We facilitate the use of local currency and local securities as collateral, which opens up a pool of assets for local borrowers to use what would otherwise not have a lot of liquidity as the secondary markets tend to be quite shallow in these countries."

Eligible collateral includes government bills and bonds in hard or local currency for repo transactions, and USD cash, local currency cash, government bills and bonds for swaps. Frontclear guarantees up to 100% of the transaction exposure with a maximum notional value of $40 million.

The organisation originates trades based on the liquidity and hedging needs of local financial institutions. This includes drafting term sheets and initial discussions with beneficiary banks (lenders). Once the local institution has selected a lender and the terms and conditions of the deal have been agreed upon by the two entities, Frontclear will finalise the guarantee with the lender.

It also conducts this process on a bilateral basis upon the request of a lender. In both cases, Frontclear will open local custody accounts to support collateral management.

**"After we close the guarantee we have seen first-hand what the hurdles in the market are, not just theoretically but in practice."**

### Understanding the hurdles

The organisation's guarantee facility is complemented by its technical assistance programme. "After we close the guarantee we have seen first-hand what the hurdles in the market are, not just theoretically but in practice. That gives us a lot of leverage when it comes to setting up a technical assistance programme and tailoring it exactly to what that particular jurisdiction needs," says Baeza. "We will then sit down with the regulators, give them an assessment of the hurdles we faced when closing the deal, and explain how technical assistance can help bridge the gap between local regulation - which may not be working to its full potential - and international best practice."

Through the programme, Frontclear brings together local financial institutions, market infrastructure providers and regulators, as well as international associations and experts, with the objective of facilitating interbank activity and increasing market efficiency, inclusivity, and stability. It also runs educational initiatives to enhance understanding of derivatives and money markets.

### Latin American activities

In May 2019, the organisation held a Technical Assistance on Derivative and Money Market Development event in San José, Costa Rica. This was based on a tailored programme for the Costa Rican market, and drew on the firm's real-life experiences of a recently-executed non-deliverable forward (NDF) in the country.

The event comprised of a regulatory roundtable that brought together the Central Bank of Costa Rica, the Superintendence of Financial Institutions, the Securities Superintendence and Ministry of Finance with the International Swaps and Derivatives Association (ISDA), The Currency Exchange Fund (TCX), international law firm White & Case, and a local legal expert on the derivatives market. On the back of this, the organisation will work with regulators to develop an action plan to address challenges in the market.

In addition, more than 40 treasury, legal and credit team representatives from Costa Rica's regulated financial market took part in a one-day ISDA course, which was organised in partnership with the country's banking association.

"The roundtable was an eye-opening event, it allowed regulators to discuss and understand key structural, legal and operational building blocks necessary for a liquid derivatives and money market. Frontclear's initiative offers an opportunity to strengthen our financial market," commented Bernardo Alfaro, Superintendent of Financial Institutions, Costa Rica.

Elsewhere in the region, Frontclear hosted a roundtable with Honduran regulators in Tegucigalpa in February, with participation from the Central Bank of Honduras, Honduras Stock Exchange, and National Commission on Banking and Insurance. The discussion covered the role guarantees and technical assistance can play in the market, as well as exploring what steps need to be taken to expand from a largely overnight market to a longer-term money market.

Frontclear is also active in Ecuador, where it recently closed a repo transaction. Its technical assistance programme in the country centres round the efficiency of cross-border transactions and enforceability from an ISDA and GMRA perspective. These are also focal points for its efforts in the Dominican Republic, where it is partnering with the local banking association to support local outreach.

The organisation is in the early stages of its activities in El Salvador, with the aim of accelerating the development of the interbank market to enhance liquidity. "Regulators recently approved measures to allow banks to lend to each other. The interbank market was non-existent just a few months ago," says Baeza. "There's still a long way to go but we're building up the momentum that's already there, teaming up with the banking association, and looking to meet with market regulators."

**Sharing international best practice**

These activities are supported by the establishment of strong relationships with local market participants as well as partnerships with international organisations. "Partnerships are a very important part of our process," stresses Baeza. "For example, we have worked alongside ABN AMRO in Africa where they have shared their expertise on clearing and trading systems."

The organisation has also partnered with the Overseas Development Institute (ODI) Fellowship Scheme to post fellows in central banks and regulatory agencies in emerging and frontier markets.

In addition, it works closely with ISDA and the International Capital Market Association (ICMA), and has also worked alongside the International Monetary Fund (IMF). "As we focus on money markets, we're usually focused on the short-end of the curve whereas the IMF tends to focus on the long-end, so we complement each other," says Baeza.

**Moving towards onshore-onshore development**

To date, Frontclear has closed $355 million in issued guarantees, facilitating more than $600 million-worth of transactions. Recent transactions include a repo agreement between the European Bank for Reconstruction and Development (EBRD) and Armenian bank Armswissbank, a cross-currency total return swap transaction between Fidelity Bank Ghana and Société Générale, and cross-border, cross-currency swap transactions between Société Générale and the Development Bank of Mongolia.

The organisation is currently building up its capital base, which will enable it to support larger transactions and expand the number of countries in which it is operating. PROPARCO, TCX, Germany's Federal Ministry of Economic Cooperation and Development (BMZ), EBRD, Cardano Development, Dutch development bank FMO, FSDA Africa, and the UK's Department for International Development through UK Aid are among its current funding sources and investors. KfW, the German development bank, counter-guarantees Frontclear's guarantees.

Over the medium to longer term, Frontclear plans to broaden its focus from offshore-onshore transactions to onshore-onshore transactions. "Issuing guarantees to local players to lend out to other local players is very important to us because it is in the market's best interest that liquidity flows from one end to another. That will mean going from a bilateral transaction to more of a multi-party or umbrella guarantee structure, which we call TradeClear," says Baeza. ■

**"Issuing guarantees to local players to lend out to other local players is very important to us because it is in the market's best interest that liquidity flows from one end to another."**

# HSBC in emerging markets: Navigating complexities through customisation

**Matt Kiraly,** global head of origination sales, Prime Finance, and **Murat Demir,** head of emerging markets Americas, Equity Finance, talk to *Global Investor* about emerging market trends in Latin America and beyond. They outline how HSBC is structured to support institutional investors in accessing and navigating the distinct subtleties of emerging markets.

Emerging markets have always been integral to HSBC. Indeed, the bank has been present in one of the world's most prominent emerging markets – China – for more than 150 years. The Hongkong and Shanghai Banking Corporation, the founding member of today's global banking group, opened an office in Shanghai in April 1865, just one month after it was first established in Hong Kong.

As its deep-rooted experience in China and across Asia attests, the bank is accustomed to adapting its approach in order to help clients navigate the complexities unique to each developing market. This includes a strong focus on leveraging local expertise to support market access, as well as to deliver timely insights.

Connecting clients to developing, high growth markets is a core focus for HSBC not only in Asia, but also across Latin America. The global bank can trace its standing in the Argentine

**"Typically with any emerging market, as you see the market become more accessible you will see demand increase and a broader range of investors look to enter the market."**

**Murat Demir, head of emerging markets Americas, Equity Finance**

market, for example, back to 1998 and HSBC is today one of the country's largest private banking and financial services organisations in the country. The bank is also present in other LATAM countries such as Mexico, Chile, Peru, Colombia, and Uruguay. Furthermore, HSBC is poised to return to the Brazilian market. After the end of non-compete agreement with Banco Bradesco, HSBC has been able to freely operate again in the Brazilian market starting 2nd January 2019. The Bank currently serves hundreds of local and multinational clients and is working on expanding its operations in the country, with the aim of becoming a bank of choice for large and medium-sized multinationals.

### LATAM an important player in the EM growth story

The last few years have seen growth in both cash and listed derivative volumes, says Murat Demir, head of emerging markets Americas, Equity Finance, who points to the increase in open interest on not only global emerging market futures but also Latin American ones, as a key indicator of this trend. As an example, MSCI LATAM Index Future open interest doubled and MSCI Brazil Index open interest tripled since December 2016 to reach US$1.7bn and US$1.85bn respectively.

As volumes have increased, Demir explains that the cost of exposure has become more favourable and ease of access has improved. "Typically with any emerging market, as you see the market become more accessible you will see demand increase and a broader range of investors look to enter the market." The Brazilian cash market is a good illustration as volume doubled to US$4bn daily in the cash market since 2016.

At the same time, the addition of some key markets to the MSCI Emerging Markets Index is helping to drive interest while also spurring efforts for greater market transparency, access, and development. "Saudi Arabia and China are definitely two of the most significant market themes that we have been speaking about with our clients over the course of 2018/2019," says Kiraly. "However, Argentina is definitely another market where we are seeing demand as it transitions from a frontier to an emerging market." Despite the fact that the MSCI Argentina Index is made up of only ADRs currently, HSBC expects volume in the domestic market to increase as well, and is putting the final touches to its swap offering which should be ready toward end of June 2019.

While strengthened emerging market infrastructures and more market maturity could help drive deal flow and IPO activity, in turn further capturing investor interest, Demir points out that the increased weighting of emerging markets on the MSCI ACWI Index may also bring certain challenges. He says: "As the weight of EM countries will increase

**"Argentina is definitely another market where we are seeing demand as it transitions from a frontier to an emerging market."**

**Matt Kiraly, global head of origination sales, Prime Finance**


within MSCI ACWI, the amount of emerging market assets derivative will naturally increase. If some of the large EM countries do not put in place re-hypothecation processes, as we have in developed countries, this could ultimately reverse the trend of EM derivative products becoming less expensive."

### HSBC - A partner of choice for accessing LATAM

Matt Kiraly, global head of origination sales, Prime Finance, says: "We have extensive local markets expertise in LATAM and are able to offer a full suite of services to our clients: from execution through to custody and clearing, alongside meeting any financing requirements. Importantly, we are able to advise our clients on options available to access the market, bespoke execution requirements or trade settlement mechanics, and help them navigate future regulatory developments."

The bank's broad capabilities and extensive global presence – which includes Prime Finance operations spanning time zones across five continents - enables it to provide comprehensive support to international investors.

Demir continues: "HSBC's local presence and the way that our business is set up globally gives it easy access to emerging markets that are not as 'emerging' as they used to be but that still have complications in terms of market access or the funding of positions."

Seamless execution, around-the-clock coverage, wide scope of access products tailor-made to clients' needs, a good understanding of the very diverse local markets and regulatory landscape, have been at the centrepiece of HSBC Equity Finance LATAM offering. In turn, this makes HSBC the partner of choice for accessing Latin America. ■

# Progressing the conversation on ESG and sec lending

**Cherry Reynard** examines how environmental, social and governance (ESG) principles are being incorporated into securities lending programmes.

The concept of investing sustainably has moved from the side lines to the mainstream over the past 10 years. A perfect storm of regulatory intervention, pressure from investors and increasingly onerous consequences for poor corporate behaviour have seen the investment industry wake up and take note, examining their investments through a sustainability lens.

The Global Sustainable Investment Alliance's *Global Sustainable Investment Review 2018,* published this April, found that at the start of 2018, global sustainable, responsible and impact (SRI) investment assets reached $30.7 trillion, up 34% since 2016. This varies markedly across the world: responsible investment commands 18% of professionally managed assets in Japan, rising to 63% in Australia and New Zealand. Europe and the US are the two biggest markets, with €12.3 trillion ($14.1 trillion) in assets under management, and $12.0 trillion respectively.

A recent report from BNP Paribas Securities Services, *The ESG Global Survey 2019,* showed that ESG factors are increasingly embedded within asset owners' and managers' activities, with the aim of both increasing returns and managing risk. In 2019, BlackRock CEO Larry Fink said in his annual letter to CEOs: "Companies that fulfil their purpose and responsibilities to stakeholders reap rewards over the long term. Companies that ignore them stumble and fail. This dynamic is becoming increasingly apparent as the public holds companies to more exacting standards. And it will continue to accelerate as millennials – who today represent 35% of the workforce – express new expectations of the companies they work for, buy from, and invest in." It is not unrealistic to suggest that those asset managers that do not embrace sustainability in their security selection may not have a business in future.

### Voting rights and borrower purpose

How does this interact with securities lending? This is a huge business for many asset managers and allows them to offer cheaper fees to clients. It is clear that there is the potential for conflict in several areas. The first is voting rights. Xavier Bouthors, senior portfolio manager at NN Investment Partners (NN IP), says: "Our Responsible Investing team cannot engage with companies if the voting rights have been passed on to someone else. So, every security needs to be available for voting, which may sound simple and obvious, but it requires a solid process of monitoring record dates and issuing recalls when necessary."

Ryan Smith, head of ESG research at Kames Capital, says where voting rights are passed over it can spell trouble: "The trouble with stock lending is that you don't always know who you are lending it to and whether that person could be using it to advocate for something bad, or short termist."

This is 'empty voting' - where activist investors borrow from long-term shareholders to use their voting rights. The practice is generally condemned, but still goes on. The Bank of England's money market code is clear - "Securities should not be borrowed solely for the purpose of exercising voting rights." – but it is not legally binding. The most notorious case was in 2002 when activist investor Laxey Partners borrowed 42 million shares in British Land, including from governance champion Hermes Investment Management, and then used it to put pressure on the board. More recently, the Oasis hedge fund borrowed stock on Premier Foods, which it used to vote against the chief executive.

Guillaume Prache, managing director at Better Finance, says: "ESG investment managers must examine carefully what is the identity and business purpose of the securities borrowers. ESG managers should beware short sellers who try to influence the price of an issuer's securities for short or very short-term purposes. Helping those by lending them securities is not compatible in our view with at least the G part of ESG: governance." The same is true where borrowers are trying to use stock lending to improve their tax position. There can be short-term transactions around a dividend date, for example.

Knowing and understanding the nature of the borrower is also important in reducing the risk of a rogue or unethical counterparty, another challenge for securities lending programmes. Whereas previously a counterparty may only have been assessed on their creditworthiness, now they may need to fit certain ethical criteria as well. Lenders such as NN IP have dealt with this by creating internal ratings on counterparties. This will incorporate a review of counterparties' code of conduct and tax principles. It also stops any new loans being issued on securities within one week prior to the record date, to prevent stock lending being used for tax manipulation.

Lenders are adjusting their practices to meet these new requirements. Bouthors says: "We monitor the record dates and AGMs so that we can ensure our securities are back well in time to vote. Lenders should seek to automate this as much as possible. We are fortunate to be able to rely on our lending agent to take most of the burden of this, but we are aware that not all agents offer this.

**"A key step in incorporating ESG factors is the protection of voting rights. So we maintain the right to recall and restrict our securities at any time to engage in shareholder meetings."**

**– Xavier Bouthors, senior portfolio manager at NN Investment Partners.**

**"Securities lending can be compatible with ESG investment. ESG investment funds should be in a position to lend part of their portfolios of securities as ESG means long-term investments and therefore should also mean a lower turnover of their portfolio, thus allowing to lend part of the securities they hold for a short period."**

**– Guillaume Prache, managing director at Better Finance.**

"A key step in incorporating ESG factors is the protection of voting rights. So we maintain the right to recall and restrict our securities at any time to engage in shareholder meetings… We then recall the securities and restrict them from lending until voting is concluded." This approach is aligned with the UN's PRI Guidance on Securities Lending as well as EFAMA's Stewardship Code and Principles.

### Collateral considerations

Collateral can also be a problem. Does the collateral received meet the investment guidelines of the fund? It is no use if the collateral for lending on a responsible sustainable company is government bonds from a country with a poor human rights record, for example. In practice, collateral is increasingly posted in cash, so the problem does not necessarily arise, but investors need to bear it in mind.

Bouthors says this is becoming easier: "'Exclusion lists' were once tricky to incorporate but are now adopted by tri party collateral agents as part of a push from beneficial owners." Citi Agency Securities Lending, for example, says it allows clients to tailor cash collateral investment in accordance with the ESG factors that are most important to them. KAS Bank says its collateral programme can take full account of an investor's ESG policy, labelling it 'ESG proof'.

### The compatibility question

There is a broader question on whether facilitating shorting - as securities lending does - is unethical in itself. Shorting can be seen as going against the principles of long-term investment in good, ethical companies. However, Prache argues that the two are compatible: "Securities lending can be compatible with ESG investment. ESG investment funds should be in a position to lend part of their portfolios of securities as ESG means long-term investments and therefore should also mean a lower turnover of their portfolio, thus allowing to lend part of the securities they hold for a short period. It is also the duty of any asset manager to try to maximise the returns for their clients, and securities lending, if done in a controlled way, is an opportunity to add value for fund investors." There is also an argument that short selling facilitates price discovery and can help expose poor behaviour by companies. Short selling should play an important role in creating efficient markets.

In May 2019, the Alternative Investment Management Association (AIMA) published a *Responsible Investment Primer* which states that short selling is neither irresponsible nor unethical, and that it can form a critical tool in responsible investment: "For instance, a manager could short a company with poor environmental practices that were hidden from the public and which the market had failed to price in." The primer goes on to note, however, that "some of the most stringent responsible investors may prohibit short selling for a variety of reasons".

The move to incorporate ESG principles is a sea-change for asset managers and securities lending programmes must move with them. There is a growing realisation that securities lending programmes must be able to integrate these preferences. They are now moving with the times. ■

# Challenges to the sec finance status quo

Natixis' **Anthony Caserta,** executive director, global securities financing client strategies, and **Saverio Costa**, executive director global securities finance, head of securities optimization unit, Americas, outline the opportunities and pressures facing the industry as traditional securities finance models are increasingly challenged.

**What are the main pressure points facing the securities finance industry and how are firms adapting their strategies to mitigate these pressures?**

In addition to the pressure on spreads, the costs of doing business continue to increase as firms are faced with additional regulatory reporting requirements and the need for real-time, accurate market and credit risk assessment. And while firms are turning to technology as a major part of the solution, it is, unfortunately, also a part of the problem. Firms are faced with the daunting task of meeting the demands of an industry, which continues to evolve at an increasing pace, with aged and disconnected technology. The inefficiencies that need to be solved span from the back office to the front office of individual firms as well as through the entire securities finance market infrastructure. What will be the optimal way for participants to interact in the market place? How do individual firms deal with synchronizing old systems? Do they continue to add to the web of existing technology? Do they start from scratch with entirely new systems? Or do they perhaps consider the wide array of fintech solutions emerging in the market? These are the questions more and more firms are facing.

**How is the industry employing technology and data analytics? Where are these having the most significant impact now, and where do you expect them to be employed to greatest effect over the next 5-10 years?**

There is no question that technology and data analytics are playing an increasingly important role in our industry. This is the case on three levels: internally for banks, how they interact with clients, and how all participants interact in the marketplace. Internally, the focus is on optimal allocation of scarce resources, both physical and financial, to best meet client needs and maximize profitability. It is an absolute must that resources are optimally deployed to provide maximum value for the client in a highly efficient and economical structure. This needs to be accomplished in a marketplace where natural business evolution and regulatory requirements are changing the ways in which market participants operate internally and with each other. Although internal and client optimization are certainly not going away, the biggest changes going forward will center around how banks, their counterparties and clients transact with each other, especially given the trend toward new and innovative financing solutions.

**Have you seen a change in the type or number of firms engaging in securities finance transactions? How is this driving banks and brokers to develop their services?**

The good news is that while the securities finance business evolves, it continues to grow in scope. The maturing of the business, whether natural or in response to new regulations, is creating more and more opportunities. We are seeing more fintech entrants than ever in our industry - offering solutions that cover anything from operational and reporting tasks to collateral, resource and client optimization. Participants that exited the business following the crisis in 2008 continue to return. New entrants are increasing as firms realize the many solutions - from market exposure to balance sheet, collateral and yield optimization - that are available through securities finance.

Having the ability to provide both vanilla and more complex, innovative solutions to clients on a cross-asset basis is essential for banks. This is putting a high premium on the ability for banks to move away from the traditionally siloed approach to a true centralized securities financing model.

**What are the key considerations for firms seeking to optimize and obtain the most value from their collateral?**

At the core of collateral optimization is a centralized approach – a fairly simple concept, but difficult to implement. There are several factors that are key to being successful: the ability to identify and access collateral across asset types and geographical regions, the capability to accurately assess the value and market for each asset type, and the infrastructure to support the efficient deployment of the collateral to extract maximum value and minimize the associated credit, market and operational risks. Failure to address any of these areas will lead to inefficiencies. The obvious answer is technology. What's not so obvious is what type of technology. Securities finance is a critical component of financial firms and the financial markets in general. A technology solution needs to address not only the cross-asset financing needs, but it needs to connect throughout the firm's entire infrastructure and interact efficiently with the market.

**What do you believe the next 12 months has in store for the US securities finance industry, and how can firms position themselves to leverage opportunities that 2019-2020 may bring?**

An overriding theme going forward will be that traditional models, both firm specific and market wide, will be challenged. There are a number of factors underlying and driving this trend. Although regulatory uncertainty is easing from recent levels, it is still weighing heavily on the future of the business. The pressure on spreads, rising costs and strain on resources, including balance sheet, capital and collateral are forcing firms to re-evaluate business models in order to preserve profitability. Given the many benefits of CCPs, they will continue to play a larger role in the market as they expand across asset classes and evolve to include the buy-side as well. Asset managers, who in the past may have relied on agent lenders or prime brokers, may look to take on their own financing activity to maximize returns for their clients. Traditional structures like stock loan will continue to take a back seat to more balance sheet efficient non-cash trades. Banks will reassess resource allocations to best serve their clients, who are at the intersection of rising costs, contraction in spreads, and a technological conundrum. The status quo will always be challenged in a maturing business. With all the additional forces we see today in the securities finance market, firms must be nimble. Those that fail to evolve and find innovative solutions will be left far behind. ■

# How can we foster greater gender diversity in securities finance?

**Organizations in the financial sector have been intensifying their efforts to build a more balanced and inclusive industry. This ranges from awareness campaigns such as State Street's Fearless Girl and employer commitment to diversity promotion and reporting initiatives such as the UK's Women in Finance Charter, through to the launch of women's groups such as Women in Securities Finance as well as dedicated networking sessions at industry conferences. However, there is still significant work to be carried out to accelerate the pace of change and achieve full inclusivity and diversity in the financial sector. With this in mind, *Global Investor* asked senior leaders in the securities finance industry to share their views on what more can be done to encourage gender diversity.**



Global tri-chairs and founders of Women in Securities Finance: **Elaina Kim Benfield,** senior counsel, Vanguard; **Arianne Collette,** executive director, Morgan Stanley; **Jill Rathgeber,** director, BNY Mellon

Diversity and inclusion are hot topics these days because 'striving to increase workplace diversity is not only a slogan – it is a good business decision'.[1] A 2016 Harvard Business School article on "Why Diverse Teams Are Smarter" provides compelling data to support this business decision, including statistics on companies with 'ethnic and racial diversity in management that were 35% more likely to have financial returns above their industry mean, and those in the top quartile for gender diversity were 15% more likely to have returns above the industry mean.' The article also notes that organizations with at least one female board member yielded higher return on equity and higher net income growth than those that did not have any women on the board.

Firms should consider diversity and inclusion as a part of its overall mission to help create meaningful (qualitative) and measurable (quantitative) improvements

**Monique Boucher,**
senior legal counsel, Fidelity Investments

Redefine how and who you hire. Consider making changes at every layer of your recruitment process to accomplish this, including connecting earlier and in new places with female prospects, driving awareness among women of the broad career paths in financial services, and optimizing job descriptions to attract women and people who will bring diversity to the company.

Tap into the power of differences to create an empowering and inclusive environment for women. Every employee contributes to a company's success and must play a role in creating an inclusive and empowering environment for all. For example, sending both women and men to conferences that are specific to women can provide perspective and enable open conversations that have never been had before. Plus, empowering women in the workplace is the responsibility of both genders.

Strive to build a culture where women are empowered, but are also helping to advance women everywhere. Allow women to feel empowered at every stage of their lives – from their career to varying life events, from starting a family, to taking on care of aging loved ones, to experiencing divorce or loss of a spouse. More diversity and a culture where differences are valued will benefit investors and firms alike and the customers we do business with every day. ■

> **“Empowering women in the workplace is the responsibility of both genders”**

for individuals and the industry overall. Some of the challenges facing women in the securities finance industry and the financial services sector generally, include low numbers of female applicants (at all levels), a lack of community (both informal and formal networks), and most importantly – a lack of sponsorship critical for advancement. We launched Women in Securities Finance, an independent industry women's group, at the beginning of 2018 to foster connections in the securities finance industry to help address some of these challenges. Our guiding principles are to encourage and empower women in securities finance to connect professionally, collaborate and share insights. The group has made progress on achieving these goals through hosting multiple events where discussion topics have included diversity in the work place, career development, cultivating mentor relationships, as well as offered networking opportunities. We are thrilled with the support we've received to date, and as connections are made and insights shared, we hope to expand our community to ultimately enable women to grow and develop in the securities finance industry globally. ■

(1) https://hbr.org/2016/11/why-diverse-teams-are-smarter [hbr.org], by David Rock and Heidi Grant

WOMEN IN SECURITIES FINANCE

**Lynn Blake,** chief investment officer of global equity beta solutions, State Street Global Advisors

I have been in the investment management industry for 30 years and have been so fortunate to have experienced a rewarding and successful career at State Street Global Advisors all while raising two daughters. Key programs and initiatives encouraged at State Street provided support throughout my career progression. While my children were young, I worked remotely, often with flexible hours, and even a reduced work schedule so that I could feel actively engaged in my daughters' lives while still pursuing a demanding career. Having work/life balance is critical to a long-term, sustainable career and State Street gave me the flexibility that I needed to stay in the work force and in this demanding industry.

Additionally, a mentoring and sponsorship program is also critical to advance a career in asset management. At State Street, we have a formal mentoring program as well as a large and active professional women's network whose mission is to create advancement opportunities for women. Throughout my career, I have had several mentoring and sponsorship relationships that were vital to my success.

Despite powerful initiatives like these at State Street and many other financial organizations, women's participation and advancement in financial services have moved at a glacial pace. Recruitment efforts and promotion pipelines are often dominated by men; women continue to average less than 20% on corporate boards. For this reason, we decided to push with a purpose beyond our internal programs by placing Fearless Girl on Wall Street to call attention to gender inequality in corporate America – with a very specific call to action for boards to increase women on their boards and to enhance gender diversity across their organizations. Our Fearless Girl campaign is about empowering women today and in the future to strive for leadership positions – and she has definitely gotten well-deserved attention! ■

**Marney McCabe,** senior vice president - global securities lending, investor services, Brown Brothers Harriman

Mentorship and sponsorship are keys to increasing gender diversity in our industry. It doesn't matter whether they are done formally through established programs, or informally through relationship building and networking. But to be successful, connections need to be made with an awareness of unconscious bias and an intention to set it aside. Studies have proven that we all carry biases based on past experiences, presumptions, and stereotypes, and some are so ingrained in our culture and society that they go unnoticed. But they mean we are attracted to and make decisions that favour people who remind us of ourselves, often at the detriment of creating a more diverse and inclusive environment.

**Nancy Allen,**
global product owner, DataLend

I strongly believe forward thinking, innovative and profitable organizations are taking the right steps to advance and support women; I'm fortunate enough to be part of the EquiLend team, one which recognizes that diversity, a core tenet of our culture, drives success.

However, many individuals and organizations continue to battle unconscious gender bias, which is a challenge to overcome. Leaders in the securities finance industry can help to mitigate unconscious bias by making a concerted effort to identify and recognize female talent. We need to promote talented women to key management positions and shine a spotlight on successful women leaders. Strong female role models will attract and inspire younger women to the industry by illustrating a path to success. Meanwhile, young men will become accustomed to seeing women in senior positions, thereby changing the existing bias.

For our part, women need to put in the work to manage our careers and ensure we are well positioned to assume senior management roles. Simply working hard and being a strong performer will only take you so far. Maintaining a strong network of peers and finding a senior sponsor is equally critical to success. A network helps you better solve problems, identify new opportunities and better understand the future direction of the industry. A senior sponsor is positioned to advocate for you and guide you through your time in an organization and the broader industry.

I also encourage all women to be open to new opportunities – new roles, new departments, even new countries. Never stop growing, learning and diversifying your skill set. Soon after graduating from university, I jumped at the opportunity to move to London for a six-month rotation (which ended up turning into 16 years!). That experience helped to shape my career and afforded me the opportunity to work with many different cultures and to build a global network. While I spent almost all of my career in securities finance, I continuously challenged myself by moving from a product role, to sales and relationship management, to trading and finally to technology. Be a leader, and step into leadership roles when you can. ■

These filters or preferences will strongly influence the adoption of a mentor/mentee connection, causing us to choose and support someone who looks and thinks like us. Firms and the industry can reduce unconscious bias by creating awareness – adding formal training to educate on the types of bias that occur, their impact, and how combating them can strengthen workplace culture. However, individuals also have a responsibility to deliberately look for where it's happening and help reduce it. We need to create a more favourable environment where men are mentoring more women and women are mentoring more men. These sorts of cross-gender relationships will create a more informed workplace and increase awareness of the assumptions and generalizations we make. Mentorship and sponsorship are key to employee engagement, succession planning, leadership development, and are proven to benefit both employees and their organizations. With an appreciation for unconscious bias they can also help the industry achieve gender, and other types of, diversity. ■

**Lori Paris,** head of client management for securities lending in North America, Northern Trust

*Lori Paris was recently promoted to head of client management for securities lending in North America, leading a team responsible for regional client servicing and sales.*

*As part of her personal development journey, Lori took advantage of programming offered by Northern Trust's Women in Leadership Business Resource Council (BRC), one of eleven groups sponsored by Northern Trust's Global Diversity and Inclusion group. The Women in Leadership BRC's mission is to engage and empower women in the workplace by building leadership competencies through educational programs, mentoring opportunities and opportunities for impactful connections.*

My work on Northern Trust's Women in Leadership Business Resource Council (BRC) provided an opportunity to be engaged, grow my network, gain senior management visibility and hone leadership skills.

My goal was to demonstrate that I can do the work, add value and show how my interests are aligned with the corporation. I've led BRC committees that host 40+ events per year, serving 1,500+ employees – this additional commitment has built a solid network across the organization and industry, taught leadership, delegation, efficient and effective communication and the value of having a broad network that can assist with making any event a success.

I have seen first-hand the value of networking with and mentoring successful professionals. This has broadened my perspective on our clients' businesses and Northern Trust's solutions while learning about different leadership, sales and client servicing approaches. It's about truly understanding where my client or prospective client is coming from. By understanding their needs in the context of their place in the market, I can consult with them to design a customized solution. When I talk with colleagues and peers in the industry about career development, I encourage them to look at each interaction as an opportunity to grow in a way that will help them excel in their current role and help position them well to identify and achieve future career goals.

Over the past year, I have taken the opportunity to be involved in Women in Securities Finance, a fairly new industry group focused on collaborating, sharing insights, and connecting current and emerging leaders across securities finance. I was fortunate to be recommended by my manager, Sandra Linn, head of securities lending, NA, to become involved. As a result, I have met a group of professionals who understand that the whole is greater than the sum of the individuals, and to advance the industry, everyone's voice needs to be heard. ■

**“I have seen first-hand the value of networking with and mentoring successful professionals”**

# EquiLend Spire: Untangling the sec finance spider web



EquiLend's **Paul Lynch** and **Dan Dougherty** and Stonewain's **Armeet Sandhu** speak to *Global Investor* about the launch of EquiLend Spire, and the importance of integrated solutions in achieving efficiencies in the face of industry pressures and regulatory change.

**EquiLend and Stonewain have big ambitions for their new joint offering, EquiLend Spire, the most recent high-profile technology integration in the securities finance market. Both firms announced an agreement in February 2019 designed to give lenders and borrowers of all shapes, sizes and cities the ability to manage their securities finance business on a single platform.**

The deal comes at a time of significant industry change as firms across the globe rethink their current technology setup in a bid to cut costs, meet reporting requirements, improve risk profiles and gain a more holistic, real-time view into securities lending and associated securities finance activities (repo and collateral management).

Vendors are looking to team up and integrate their best-of-breed applications within large financial institutions that are poised to update their tech. EquiLend and Stonewain look to have secured an early mover advantage.

Founded in 2009 in Berkeley Heights, New Jersey, Stonewain first launched Spire in 2015. The system, described in a 2017 vender report by Aite Group as 'intuitive, customizable, and problem-solving', supports agency lending, stock borrowing/lending, regulatory locates, trade and position management, risk analysis, compliance, accounting and reporting. The system is tailored to the distinct needs of the different players in the securities finance market, namely agent lenders, broker dealers, retail brokers and even collateral managers and beneficial owners.

Put simply, it is a fully integrated front, middle and back-office platform rivalling the likes of Loanet, Global One, 4sight and others.

A link with New York-headquartered EquiLend means the EquiLend Spire system will be fully integrated into EquiLend's own well-known suite of trading, post-trade, market data, clearing and regulatory services, including NGT, the company's flagship trading platform which has been known to handle as many as 100,000 or more executed trades in a single trading day.

"The whole objective of this partnership is to provide clients with a comprehensive, state-of-the-art books and records system which completes our product set overall," explains Dan Dougherty, global head of sales and client relationship management at EquiLend.

Paul Lynch, global head of products at EquiLend, adds: "Over time we've noticed

**“The whole objective of this partnership is to provide clients with a comprehensive, state-of-the-art books and records system which completes our product set overall.”**

**Dan Dougherty, EquiLend**

the legacy books and records systems in this market have become old, antiquated and mostly inflexible. As firms have held onto ageing systems, spider networks of proprietary systems have been created around various technology platforms. Efficiency has been sacrificed as a result of not moving forward in search of better solutions.

“It’s a struggle to interface with a lot of these legacy systems, so we knew there was a gap in the marketplace. We had a lot of conversations with borrowers and lending agents, and everyone pointed us to the same product – Spire.”

For Armeet Sandhu, chief executive at Stonewain, it is clear that the securities finance industry is going through a transformation driven by regulatory changes and pressure on the business as a whole to generate more revenues and control costs.

“What we have seen previously is a lot of time, effort and money being wasted in supporting what are, quite frankly, very inefficient processes,” Sandhu explains. “Collectively, both Stonewain and EquiLend have been able to create an efficient platform that every player in the industry can utilise to their benefit.

“EquiLend has been helping firms become more efficient since its inception in 2001. Stonewain has always followed the same guiding principle.”

### Problem solving

Both parties believe one of the big selling points of the new combined platform is the fact that EquiLend Spire doesn’t dictate what clients should be doing, but instead places a priority on solving the business problems customers themselves want to tackle first.

The modular nature of the platform allows users to address specific challenges along a path towards, potentially, a wider and more holistic technology replacement.

“We see this as a journey,” Stonewain’s Sandhu adds. “We want clients to come on board and use our technology in areas which make sense to them. EquiLend Spire offers modules that address pain points first and then enable clients to pick up a wider value proposition down the line as they get comfortable with the system. It’s not an all-or-nothing solution.”

At the same time, EquiLend and Stonewain aren’t expecting somebody to switch over to the service entirely on day one and are open to supporting integration, even with competitors, where needed.

EquiLend’s Lynch says the benefits from EquiLend Spire are multiple. “From a front-end perspective, the inventory management software helps traders. If you look at the core books and records technology, the efficiencies are exceptional, particularly in post-trade.

“There is great value to be found. Certain firms who can handle an all-in implementation process will see efficiencies immediately. Others who prefer a modular approach to implementation can implement parts that are best for them.”

**“We had a lot of conversations with borrowers and lending agents, and everyone pointed us to the same product – Spire.”**

**Paul Lynch, EquiLend**

Sandhu says EquiLend Spire has also been designed to benefit different levels of sophistication. "For banks and brokers with large IT budgets and programming stacks in house, APIs and sophisticated trading algorithms can be used, allowing them to do things that are propriety in nature, creating a competitive advantage.

"Those that are investing less or have a different strategic interest can still use the solution's inbuilt tools to have highly efficient processing. The goal is to provide a service that isn't one size fits all but instead offers multiple levels of technology and processing capabilities so that a firm can use the solution to best suit its requirements."

**Pre-compliance**

In 2020, Securities Financing Transactions Regulation (SFTR) reporting will raise the reporting bar for firms engaged in the European securities lending market.

EquiLend's London and Dublin teams are continuing to work with Trax, part of MarketAxess, collaborating on a full front-to-back SFTR toolkit.

Globally, in Europe, U.S. and Asia post-SFTR, Stonewain's Sandhu says EquiLend Spire is designed as a pre-compliant solution which is able to reduce the burden on the industry.

"Our solution takes away some of the anxiety SFTR creates. Using a mix of legacy systems creates complexity and makes it challenging to get the transaction data needed for legislation such as SFTR.

"Users of EquiLend Spire would only have to focus on the business impact of SFTR versus the technical impact of changes."

As well as SFTR, the growing appetite for central counterparties (CCPs) in the securities lending space has also created a need for connectivity and standardized communications. "In general, EquiLend Spire is open to furthering products and creating new links. We want our products to be as efficient, end-to-end and functional as possible," Sandhu says.

> **"EquiLend has been helping firms become more efficient since its inception in 2001. Stonewain has always followed the same guiding principle."**
>
> **Armeet Sandhu, Stonewain**

"We're open to working with multiple parties," Dougherty adds. "EquiLend Clearing Services already directs trades through Eurex, for example, and we do a robust business in our Loan Market, which flows through to OCC for central clearing. Extending these and other cleared offerings would be a natural next step for integration with EquiLend Spire."

**Positive feedback**

According to Sandhu, existing Stonewain clients have been very positive of the relationship. "The general feedback is that this is a good solution for both firms involved, as well as current and potential new clients. People see the efficiencies and advantages of having a solution like this available along with the future innovation potential that comes with it.

"Legacy systems increase spend and risk. The fear of migrating away from old platforms is starting to be outweighed by the benefits that a solution like EquiLend Spire brings to the table, especially in the current market environment."

"People are holding onto platforms, but constantly re-evaluating," EquiLend's Lynch concludes. "For a long time clients didn't have fully functioning, integrated choices, and now they do. EquiLend Spire is a global, multi-asset class solution for securities finance market participants of all types, and we're excited about offering it to the marketplace." ■

# Sec lending: The view from Canada

In this Q&A, **Donato D'Eramo,** president at the Canadian Securities Lending Association (CASLA) and managing director and global head, securities finance at RBC Investor & Treasury Services, Royal Bank of Canada, provides an update on the association's activities and the latest trends in the Canadian securities lending market.

**What notable highlights and hurdles did the Canadian securities lending industry experience in 2018?**

Although 2018 was the most outstanding year for the global securities lending industry post financial crisis, this did not necessarily translate in North America, and especially here in Canada where specials were somewhat subdued. Canadian cannabis stocks carried much of Canadian equities throughout the year and Canadian government bonds remain highly sought after. With the increasing focus to fulfil liquidity requirements, financial institutions continue to seek out sizeable balances for high-quality liquid assets (HQLA) and especially on longer duration trades.

The Canadian securities lending industry continues to face several challenges from a regulatory readiness perspective, in line with global peers. Not necessarily hurdles per se, but with the onset of Securities Financing Transactions Regulation (SFTR), Central Securities Depositories Regulation (CSDR), and pledge structures, all imminent in the next 12 to 28 months, much work has been done across all players to ensure solutions are in place.

> **"Asset managers specifically are increasingly looking to securities lending as an alpha generating tool and a mechanism to help offset lower fixed income yields."**

**As we approach a year since Canada voted to legalise recreational cannabis, can you outline how you have seen demand for cannabis stocks evolve and impact the securities lending market?**

Despite the challenges surrounding specials in the Canadian market, we saw a great deal of activity within the Cannabis sector in 2018. The market followed the evolution of the legalization scheme here in Canada quite closely over the past 12 to 18 months, and it remained a hot topic and an area of interest amongst beneficial owners throughout the year. In addition to the general directional demand names across this sector, M&A activity also presented additional revenue opportunities to beneficial owners open to

> **Overall, Canadian firms have been working diligently on enhancing efficiencies in the market and lately there has been a particular focus towards borrow/return automation with the goal of the desk focusing more on value added opportunities.**

lending. As certain US states continue to move towards similar legalization, further consolidation within the sector is to be expected, which should ultimately drive demand for securities lending.

Cannabis names continue to dominate the warm and hot space, albeit at lower levels than last year, and more volatile in demand and levels. Additionally, as companies in the sector continue to evolve and become mature, we begin to see an emergence into the large capitalization indices, which may or may not impact demand.

**January 2019 saw Canada implement new rules allowing retail investors to access alternative investment strategies through alternative mutual funds. What does the new regime mean for securities lending and borrowing?**

Liquid alternatives was quite the buzzword in 2018 as the industry geared up for its January 2019 implementation. Its introduction is significant as it now allows a broader investor base access to this investment structure. However, it may still be early in the life cycle as the adoption by retail investors may take some time. As more asset managers develop and launch various alternative strategies, it is expected that the impact to both borrowers and underlying beneficial owners will continue to grow through increased flows and activity for Canadian securities lending.

**Have you seen beneficial owners' approaches and attitudes towards securities lending change over the last few years? If so, what do you believe is driving this?**

Generally, since the financial crisis of 2008, we have continued to see an increasing number of beneficial owners re-enter into securities lending arrangements. In the current environment, beneficial owners are more attuned with the intricacies of securities lending than ever before as they are increasingly open to new revenue generating strategies and are moving towards a more flexible collateral profile. Asset managers specifically are increasingly looking to securities lending as an alpha generating tool and a mechanism to help offset lower fixed income yields. In the public fund space, some managers now see securities lending revenue as a necessity in an effort to reduce fees in an increasing competitive market.

**What steps are being taken to enhance efficiencies in Canada's securities lending industry?**

Overall, Canadian firms have been working diligently on enhancing efficiencies in the market and lately there has been a particular focus towards borrow/return automation with the goal of the desk focusing more on value added opportunities. Additionally, the efforts to streamline collateral through tri-party agents and enable contract compare functionality has enhanced efficiencies, not only within the front office, but also with middle and back offices.

We continue to see the industry apply emerging technologies towards providing beneficial owners with an enhanced view of how programs are being optimized, which capture incremental returns on assets as well as present client information in different mediums to be ingested. Future opportunities revolve around deploying machine learning in some elements of day-to-day decision making to further optimize returns, but also resolve post-trade activities to reduce operational risk. Distributed technology is another space that has the potential to be a significant game-changer. This is because it could radically alter the industry operating environment where the interaction between agents and counterparts is a single view that is real time and always matched.

**What are the key regulatory issues facing market participants in 2019?**

SFTR remains the key regulatory focus facing market participants today. Although not expected to take effect until April 2020, firms are investing efforts to ensure the optimal solution is deployed. This in itself warrants a strategic view, however simple details are critical for firms to grasp as it would likely result in how firms want to approach their SFTR solutions. There is no one-size-fits-all solution and market participants should remain conscious of not making assumptions on their European Market Infrastructure Regulation (EMIR) experience. SFTR aside, various tax administration changes continue to create uncertainty around permissible securities financing transactions. This has presented market participants with its own set of challenges as such changes remain short on guidance.

Additionally, recent Canadian federal government tax changes announced on March 19 2019 impact the treatment of compensation payments for non-Canadian beneficial owners lending Canadian equities and non-Canadian equities to Canadian borrowers versus equity.

**CASLA's objectives include increasing public understanding of securities lending and advocating on behalf of the industry. Can you share examples of how the association works to achieve these aims and your main priorities in these areas for the year ahead?**

One of CASLA's fundamental aims is to enhance the public's understanding of securities lending and the role it plays in Canada. As such, CASLA will be focussed on developing and promoting the importance, subtleties and breadth of the securities lending industry, particularly geared towards beneficial owners and stakeholders, while remaining engaged with other global industry associations where international regulations may impact Canadian beneficial owners.

Also, an ongoing focus of CASLA in 2019 will be the advocacy work being done to permit National Instrument 81-102 mutual funds to accept equity securities as eligible collateral in securities lending transactions. CASLA continues to engage with regulators, and although these discussions are still in their early days, it is a key priority here in the Canadian market – similar to that in the US for equivalent 40 Act funds. ■

**"One of CASLA's fundamental aims is to enhance the public's understanding of securities lending and the role it plays in Canada. As such, CASLA will be focussed on developing and promoting the importance, subtleties and breadth of the securities lending industry, particularly geared towards beneficial owners and stakeholders, while remaining engaged with other global industry associations where international regulations may impact Canadian beneficial owners."**

# Beyond automation: How sec finance is adapting to tech advances

Securities finance markets across the Americas are imposing greater demands on technology as they seek to move beyond automation into process improvement. **Paul Golden** reports.

In a recent article on the bank's website, Michael Saunders, head of securities lending, Americas, and Kevin Stahl, head of business development for market and financing services, securities services North America at BNP Paribas, described technology as the critical competitive element in the business. However, they also acknowledged that technology innovation is a difficult task to master and that a bank can rarely be sure that a technology at first look will be reliable, secure and fit for purpose.

When asked to what extent advances in technology tools and platforms are driving efficiencies and growth in securities finance markets across North America, Central America, South America and the Caribbean, Philip Morgan, COO and head of sales at Pirum Systems, observes that more than ever, market participants are looking to utilise technology solutions for all aspects of trade lifecycle automation.

"Along with meeting regulatory and capital requirements, this is driven by the need to create efficiencies and manage risk," he explains. "In the past, technology was viewed as purely a way to do things faster and with more efficiency as volumes increased. Whilst in some cases this remains the case, participants are now looking for technology to change more fundamental elements of their operating model."

In this scenario, improvements in human efficiency are mirrored by improvements in financial resource management, allowing firms to do more with less capital and balance sheet whilst increasing control.

Technology also assists in bringing real time data to decision makers and improving - and in some cases executing – decisions, whether that is suggesting the best execution venue, more efficient use of collateral, or identifying a failing trade that is creating a significant P&L impact.

**Connectivity and interoperability**

According to Martin Seagroatt, marketing director for securities finance and collateral management at Broadridge, technology solutions are driving efficiencies in a number of ways.

"Firstly, connectivity between electronic trading platforms, market infrastructure and firm level systems increases the potential for straight through processing across the trade lifecycle," he says. "Increasing electronification of trading also opens up opportunities for automation of parts of the trading process, particularly for high-volume, low-touch transactions. Greater automation and operational efficiency allow firms to scale their business and process higher transaction volumes, while minimising the costs of adapting to regulatory change."

As critical market infrastructure, exchanges must ensure that any new technologies can cope with the high volume and velocity of trading activities. There is also a need for a clear regulatory framework and common regulatory standards, along with system interoperability.

In an ever-changing ecosystem that is becoming more complex and fragmented, connectivity is more important than ever and the industry is looking for low-touch, easy-to-integrate solutions. However, changing behaviour continues to be an issue that industry needs to be cognisant of and future-proofing solutions should be a focus.

That is the view of Morgan, who says software as a service or SaaS-based platforms are becoming increasingly popular with clients as they are easier to integrate without the need to install, upgrade and maintain a software asset.

"Service providers that are agile and evolving will be able to support the constantly changing industry landscape," he suggests. "There is widespread appreciation of the benefits of adopting new technologies, so education is not necessary - what is challenging for firms is understanding how best to utilise and

**"There is widespread appreciation of the benefits of adopting new technologies, so education is not necessary - what is challenging for firms is understanding how best to utilise and implement solutions to ensure the intended benefits are achieved."**

**– Philip Morgan, COO and head of sales at Pirum Systems.**

**“Blockchain has a role to play in enabling the rapid dissemination of information, which would be a major benefit to the end of day post-trade services cycle.”**

**– Armeet Sandhu, chief executive officer at Stonewain.**

implement solutions to ensure the intended benefits are achieved.”

### Exploring emerging technologies

Some exchanges in the Americas have committed to using blockchain in their securities lending systems, while others are looking to deliver digital asset capabilities.

In April 2019, for example, the Jamaica Stock Exchange announced the execution of a master agreement with Canadian fintech Blockstation that will see it become one of the first stock exchanges in the world to enable live trading of digital assets and security tokens in a regulated and secured environment.

The master agreement was completed following a successful live trading pilot, which included participation from Jamaica Stock Exchange's broker-dealer members and the Jamaica Central Securities Depository (JCSD).

The agreement will provide international SMEs with a streamlined and simple process for raising capital in a compliant and transparent manner through security token offerings. The exchange also hopes it will demonstrate market leadership by showing the financial community that digital assets and cryptocurrencies can be traded safely through trusted broker members like any other security, in full compliance with regulations.

Other objectives include creating an inclusive, regulated market that is more accessible to institutions - as well as non-accredited investors who would otherwise be excluded from opportunities in the digital asset space – and streamlining the public disclosure process for SMEs, making it easier and more cost effective to list shares and other assets.

Elsewhere in the Americas, securities lending was the first service provided by Chile's Santiago Exchange to use blockchain technology, as part of a strategic partnership established by the exchange and IBM in May 2017 that will over time incorporate the technology into other operational processes. The blockchain application for securities lending launched in June 2018.

Morgan accepts that blockchain and other emerging technologies are grabbing the headlines at present and that for certain use cases there is a strong argument for exploring the use of these technologies.

“However, adoption and how these technologies are rolled out requires careful consideration, as does the common domain model that is to be used to define them,” he adds. “Despite the promise of these technologies, their use within the financial industry needs to be viewed on a case-by-case basis and for the market to ask itself whether a revolution is necessary or would evolution suffice.”

Blockchain has the potential to benefit the industry in the long run by speeding-up transaction times, improving transparency, streamlining business processes and reducing costs, says Seagroatt.

“There are possibilities to reduce trade fails and operational risk while increasing speed and accuracy, particularly around areas such as collateral mobilisation and substitution,” he continues. “However, there are still many challenges and concerns that need to be ironed out before we will see widespread adoption and commercialisation of the technology.”

**"I understand companies have achieved very high levels of automation, especially in the equities space where the large primes and tech-savvy companies are moving to a model where their desks are focused on finding those hard-to-borrow securities."**

**– Armeet Sandhu, chief executive officer at Stonewain.**

Artificial intelligence is another emerging trend, one that is referenced by Saunders and Stahl who suggested that it has the potential to be impactful in areas from improving the scalability of resources to providing greater visibility and auditability of transactions.

Seagroatt agrees that artificial intelligence has a huge number of potential use cases, from applying intelligent automation to parts of the trade lifecycle through to predictive analytics and machine learning around areas such as trade pricing and collateral optimisation.

"However, financial services is a heavily regulated industry and regulators are paying increasing attention to the technology," he adds. "Auditability and 'explainability' around how a machine learning solution arrived at a particular conclusion are thus becoming more critical and this could hold back some potential use cases in future."

## Enhancing efficiency

Over the last few years in particular, technology has enabled higher efficiencies at a time when existing service providers have not made any radical changes to their business models. There has also been a focus on making better use of tools that are already available, whether that is in the pre-trade space – such as auto-borrowing of securities – or in the general collateral space.

That is the view of Armeet Sandhu, chief executive officer at Stonewain, who refers to a similar trend post-trade where the focus is on increasing efficiency in the back office.

"The overall objective is to reduce the cost of the desks," he explains. "I understand companies have achieved very high levels of automation, especially in the equities space where the large primes and tech-savvy companies are moving to a model where their desks are focused on finding those hard-to-borrow securities."

Sandhu says there has been a realisation that investment is required in order to make the most of services such as NGT (EquiLend's trading platform) and this increased level of investment has enabled the end user to achieve more effective outcomes. There has also been increased focus on developing algorithms or processes that can enable users to create automation.

Earlier this year, Stonewain announced that it was partnering with EquiLend to offer securities finance market participants the ability to manage their book of business on a single, comprehensive and integrated platform.

"Blockchain has a role to play in enabling the rapid dissemination of information, which would be a major benefit to the end of day post-trade services cycle," says Sandhu. "There are some with more ambitious objectives for the technology which I am not completely convinced of as yet, but a ledger that has the same version of truth for all parties has obvious appeal."

The difficulty with implementing this type of technology lies in the standard network effect. Having two parties on the blockchain is of limited value - it requires wider participation, which is a challenge in terms of creating consensus across the industry.

"If we look at the experience of ALD (Agent Lender Disclosure), despite having a regulatory mandate it still took the industry a while to come together to build a solution," concludes Sandhu. ■

BNP PARIBAS

# Why central banks need securities lending more than ever

By **Michael Saunders** | Head of Securities Lending, Americas at BNP Paribas.

Regulatory initiatives have created an enduring demand among market participants for high-quality liquid assets (HQLAs). At the same time, central banks' HQLA portfolios (i.e. debt issued by G7 countries) have increased significantly in certain cases, owing to the trillions of dollars' worth of securities bought under their quantitative easing programmes.

By initiating or expanding their securities lending activities, central banks can become important suppliers of much-needed HQLAs to meet borrower demand. Financing facilities offered by central banks highlight the importance of securities financing in the capital markets.

### Benefits of securities lending

Revenue opportunities from securities lending participation can be substantial, depending on the portfolio of available assets. Non-cash collateral transactions can easily generate stable and predictable returns of upwards of 10 basis points on a portfolio of G7 government debt, with a highly risk-averse approach that takes other government debt as collateral and allows for transactions to be closed on a daily basis.

Beneficial owners willing to expand the tenor and permissible collateral set to include cross-currency assets or lower-rated securities can boost returns to 25 basis points or more, while likely increasing utilisation rates. Employing trade structures that minimise the capital impact for borrowers, such as a pledge structure, can provide an additional return. Augmenting revenue streams through securities lending can then provide a significant contribution to meeting central banks' administration expenses and custody fees.

### Well-managed risks

Many central banks have traditionally been wary of participating in securities lending. This hesitancy stems in large part from the risks brought about by the use of cash collateral and the losses that could result when that cash was reinvested in other, higher-yielding instruments. However, the way programmes are structured has changed, bringing extra layers of protection for market participants.

Non-cash collateral transactions – which remove the interest rate mismatch, credit and liquidity risk associated with cash collateral, while providing equivalent returns – are increasingly the norm.

### All gain and no pain

Central banks have long recognised the value of securities lending as a mechanism for managing market liquidity. Fewer have taken advantage of the significant and stable revenue streams an active lending programme can deliver for participating asset owners. But that is changing. And with the robust risk mitigation measures that the best agency lenders now provide, the risk-reward calculations have never looked so compelling. ■

# Repos: A fresh look at a key driver of short-term returns



It is time to pay attention to repos, the building blocks of return for many short-term strategies, say **Jerome M. Schneider,** head of short-term portfolio management, and **Tina Adatia** and **Kenneth Chambers,** fixed income strategists at PIMCO.

Repurchase agreements, or repos, in many ways serve as the underlying plumbing for financial markets by providing a key source of liquidity. A deeper understanding of these building blocks of short-term strategies may also help improve returns.

Repos are a form of short-term funding in which dealers sell securities to investors, usually on an overnight basis or predetermined term, and agree to buy them back the next day with additional interest or premium due to the lender of cash. While repos were in the spotlight during the financial crisis for accounting irregularities, their importance to the daily functioning of global financial markets remains steadfast and evident. We see the need for a renewed focus on repos today for the opportunity they present to invest cash while typically receiving high quality collateral in return, often US Treasuries. Frequently overlooked, the repo market offers investors a real-time barometer of the health of liquidity in global markets and highlights the true cost of capital and funding for institutions and investors alike.

### Short-dated assets like repos look compelling

In an aging expansion marked by inverted yield curves in the US, the return of market volatility, and anaemic average yields for many equity dividends, investors are looking for options that provide acceptable risk-adjusted return potential amid an uncertain global economic outlook. We think short-dated assets look compelling in this economic environment, and specifically favour repos as a foundation of our diversified portfolios given their attractive yield (as we discuss in more detail below), minimal price volatility relative to other securities, and the investment opportunity that a flat yield curve is providing by minimizing interest rate exposure. Moreover, such overnight and short-dated maturities can provide dry powder to take advantage of dislocations that may arise in other sectors of the financial markets late in this economic cycle.

While we believe short-dated rates in general look attractive, rates in the repo market continue to exceed those of many asset classes on a risk-adjusted basis: Overnight repurchase yields, currently around 2.50%, are outyielding US Treasuries with maturities out to 10 years (see chart on following page).

Why would repo yields be higher than those of nominal Treasuries? It's because many market participants are expecting the Federal Reserve to cut rates over the next one to two years, and US Treasury yields have recalibrated lower recently as a result. If you believe a recession may be right around the corner, longer-duration assets are likely your allocation of choice.

However, if the Fed manifests its stated cautious approach by keeping rates on hold for the foreseeable future, as we expect, then exposure to front-end strategies with a foundation in repos is an attractive proposition versus other alternatives which open investors to greater market volatility. Recent incremental market needs for financing assets, predominantly Treasuries, have also supported higher yields in the repo market, now currently trading above the Fed's benchmark rate for interest on excess reserves (IOER) of 2.40%.

### Not all repo approaches are created equal

Not all repo approaches yield the same results, and we see two key ways for investors to seek value in the repo markets:

1. **Seek competitive execution.** Investment managers often act as both lenders and borrowers of cash at times, which encourages dealers to make competitive markets for them on both sides. This can potentially provide a competitive advantage over traditional money market funds that act as lenders only and may not benefit from the dealer's incentive to step up yield offers to win the business. Competitive execution by the investment manager helps capture these higher yields, which can be passed on to investors.
2. **Look for high quality collateral and operations.** The method for receiving collateral on repurchase agreements may also provide potential benefits (or drawbacks). We think a framework in which the investment manager places collateral into a custody account on behalf of clients, rather than having it held at a third-party custodian (as with most 2a-7 money market funds), not only offers better protection of collateral; it also may potentially earn a higher rate.

Although repos benefit from overcollateralization relative to the proceeds lent, like all investments, repos have risks – most notably counterparty risk. And just as clogged or leaky pipes can wreak havoc on a home, disruptions in the repo market can quickly turn into an expensive problem if not addressed, as markets learned during the "run on repos" leading up to the financial crisis. While the media and market participants quickly moved on to more exciting topics once repo markets had calmed, we think they warrant ongoing attention.

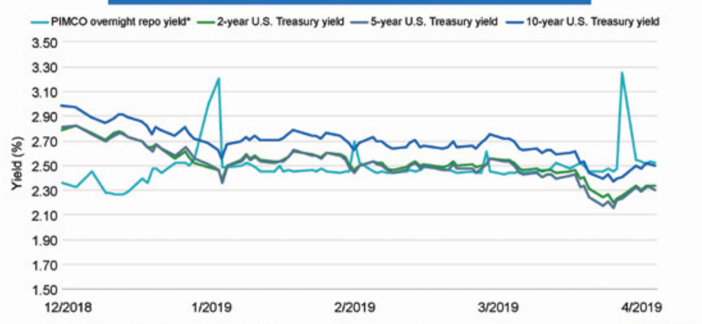
### Investor takeaways

For investors, the race is on to find income with minimal volatility. With yields that continue to exceed those of US Treasuries with maturities out to 10 years, overnight repos deserve attention.

An active approach founded on a thorough understanding of what drives movements in the repo markets may help investors optimize the attractive and changing dynamics of de-risking higher-risk portfolios into short-term investments. ■

*Editor's note: This article was first published on PIMCO's website in May 2019 (see bit.ly/2W4Kvrx).*

REPOS ARE OUTYIELDING FRONT-END U.S. TREASURIES

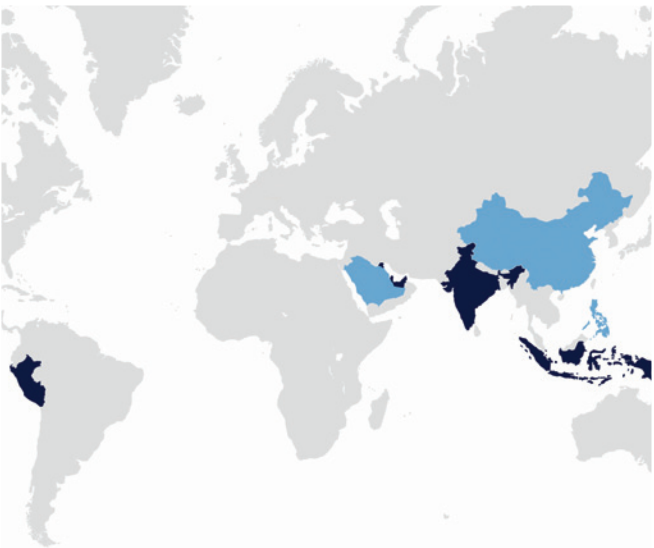



Source: PIMCO and Bloomberg as of 25 April 2019. *Yields reflect PIMCO's cash lending rates on the dates specified.

# Emerging markets securities lending update

By **Ed Oliver** | Managing director, product development
eSecLending (Europe) Ltd.

**The early part of 2019 has seen a pick-up in activity in markets that are looking to add the possibility for foreign investors to participate in lending local shares. Some of this has been driven by new additions to the Emerging Market Indices, some by a reaction to other markets taking a leadership role, and others by continuing to work through long-term projects to add new liquidity sources.**



**Saudi Arabia**

Saudi Arabian securities will be included in the MSCI Emerging Markets Index and the MSCI ACWI Index in a two-step process starting in June 2019. In addition, Saudi Arabian securities were included in the FTSE Emerging Index as of March 2019, as part of a phased implementation through to December 2019. Saudi Arabia is expected to represent approximately 2.6% of the MSCI Emerging Markets Index and 2.7% of the FTSE Emerging Index. The Saudi Stock Exchange (Tadawul) has published Securities Borrowing and Lending Regulations. It is highly likely that there will be a pre-sale notification requirement as securities are required to be in custody before sales can be executed. Thus, in order to recall securities on loan, a pre-sale notification will be required similar to the situation we have lending securities in Taiwan.

**China**

Like Saudi Arabia, the Chinese A share market has benefited from being added to the MSCI Emerging Markets Index. This process started in May 2018 with the addition of

China large-cap A shares to represent 0.7% of the Index. This will increase to 3.3% during the remainder of 2019. China A shares will also be included in the FTSE Emerging Markets Index from June 2019, eventually representing approximately 5.5% of the Index.

There was a flurry of excitement in 2015 with the introduction of the Stock Connect product. Unfortunately, this was a false dawn as it became apparent that foreign investors could not participate in securities lending. This is expected to change with the recent announcement of the Hong Kong Exchange Strategic Plan for 2019-2021 which includes the initiative to enhance Stock Connect.

This involves working with onshore regulators to expand securities lending and borrowing. The Pan-Asia Securities Lending Association (PASLA) is leading discussions with onshore regulators to assist in the development of securities lending.

**Philippines**

eSecLending, as part of a PASLA delegation, met with representatives from the Philippines twice in 2018 to discuss how to implement a securities lending structure that will allow foreign investor participation. PASLA continues to be involved in discussions with the Philippines Stock Exchange (PSE) to enable change in legal documentation and acceptance of overseas collateral when lending Philippine equities. The PSE CEO recently confirmed that short selling would commence within the year.

**Indonesia and India**

We expect more engagement with regulators and representatives in both these markets during 2019. This is primarily the "China effect" with the increased "muscle" of China in the emerging markets indices leading to other markets becoming more interested in adding liquidity solutions to the marketplace.

**It looks like the remainder of 2019 could be interesting for most lending agents with passive investors investing in the likes of Saudi Arabia and China for the first time.**

**Peru**

In March 2019, the Bolsa de Valores de Lima (BVL) announced an enhanced securities lending platform featuring Cavali, the Peruvian Central Securities Depository, as well as other local players. It is intended that this platform will enable non-Peruvian investors to borrow and lend securities in Peru and requires a Peruvian Appendix to the Global Master Securities Lending Agreement (GMSLA).

It looks like the remainder of 2019 could be interesting for most lending agents with passive investors investing in the likes of Saudi Arabia and China for the first time. There will be assets in custody that will make the research and due diligence to add these markets a worthwhile exercise. ■

# Securities finance regulatory rundown

**Chen Xu,** associate at Debevoise & Plimpton, offers an overview of the regulatory agenda impacting the securities finance industry in the US.

Last year, the highlight of President Trump's financial regulatory agenda was passage of the Economic Growth, Regulatory Relief and Consumer Protection Act (EGRRCPA), which mandated that the US federal bank regulators scale back certain elements of their post-crisis regulatory regime. In the second half of 2018 and the first half of 2019, these regulators have been working to execute their Congressional mandate, culminating in a set of proposals to tailor their prudential framework for large US and foreign banking organizations.

Although these proposals provide significant, targeted relief for some firms, these proposals represent a tailoring of requirements rather than a wholesale reduction. In particular, US federal bank regulators remain focused on ensuring that the largest and most complex firms remain subject to a robust prudential framework, particularly with respect to their securities financing transaction (SFT) activities. This tension between regulatory tailoring and a special focus on certain core areas of prudential regulation will be a key theme of this coming year.

### Impact of EGRRCPA and tailoring proposals on SFTs

Prior to adoption of the EGRRCPA in 2018, the original 2010 version of the Dodd-Frank Act required federal regulators to adopt enhanced prudential standards for all banking organizations with $50 billion or more in total consolidated assets. The EGRRCPA raised this threshold to $250 billion, but gave the federal bank regulators the ability to further tailor standards for firms with at least $100 billion, but less than $250 billion in assets based on their capital structure, riskiness, complexity, financial activities, size and other risk-related factors.

The tailoring proposals published by the federal bank regulators implement this new framework by creating four categories of prudential standards for firms with $100 billion or more in the assets. Category I firms include the US global systemically important banks (GSIBs). Category II firms include firms with $700 billion or more in assets or $75 billion or more in cross-jurisdictional activity, and includes the foreign GSIBs most active in the US. Category III firms include firms with $250 billion or more assets or at least $75 billion in one of: nonbank assets, short-term wholesale funding or off-balance sheet exposure. Category IV firms include all other firms with $100 billion or more in assets. For foreign firms, the relevant thresholds would be measured with respect to their US operations or US intermediate holding company, as applicable.

The proposals would significantly reduce prudential requirements for firms in Categories III and IV, but would largely retain the requirements for firms in Categories I and II. For many foreign firms operating in the US, the proposals would even impose new quantitative liquidity requirements on their US intermediate holding companies, including liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) requirements. The LCR requires firms to hold a buffer of high quality liquid assets to cover potential net cash outflows over a 30 day stress scenario. The NSFR requires firms to fund their longer term and less liquid assets with stable funding in the form of "sticky" deposits, medium/long-term debt and regulatory capital. Each of the LCR and NSFR are designed to penalize short-term wholesale funding, including overnight cash obtained from, and provided in connection with, SFTs.

Previously, US intermediate holding companies of foreign banking organizations that did not own a US depository institution were not subject to the LCR or NSFR. This provided the US broker-dealer arms of certain foreign banks with a comparative funding advantage to US firms. If adopted as formulated, the proposals could place increased pressure on these foreign firms to reduce their reliance on short-term wholesale funding and impair their access to US dollar funding generally, which could be at odds with their business strategies in the US.

Even the framing of the categories themselves could have a significant influence on US SFT activity. For example, a key inflection point in the four category system is the level of a firm's weighted short-term wholesale funding, which includes to varying degrees funding obtained from SFTs with maturity of one year or less. Another key inflection point is nonbank assets, which would include SFT assets (receivables) held by US broker dealers. Yet another inflection point is off-balance sheet exposure, which would include borrower default indemnification provided by securities lending agents. Firms seeking to avoid a particular category or specific requirements could be incentivized to scale back their SFT activities in order to fall below one of the relevant thresholds.

On the other hand, one of the most significant positive changes contemplated by EGRRCPA has resulted in a proposal to amend the supplementary leverage ratio (SLR) denominator to exclude the fiduciary, custody and safekeeping funds of certain firms deposited with central banks if the firm is predominately engaged in custody, safekeeping and asset servicing activities. This change is particularly relevant for SFT activities, as many types of principal-based SFT activity (e.g. repo bond financing repo) relies heavily on balance sheet usage, which is constrained by the SLR. Currently, this relief would apply to The Bank of New York Mellon Corporation, State Street Corporation and Northern Trust Corporation. Allowing these firms to exclude this type of cash from their SLR denominator would significantly free up their balance sheets to engage in additional SFT activities.

**Pending implementation of Basel Committee frameworks**

At the international level, the Basel Committee on Banking Supervision (Basel Committee) announced in December 2017 that it finalized all outstanding reforms under its Basel III framework. Although the US has yet to even propose regulations implementing the Basel III finalization, the breadth and potential impact of the changes has caused a significant amount of regulatory uncertainty as firms engage in business planning.

The specific changes that directly impact SFTs include the introduction of a more risk-sensitive standardized methodology for measuring the potential future exposure for SFTs. The pre-revision Basel III framework (and the current US regulatory capital rules) requires firms to measure their potential future exposure to SFTs using the "comprehensive approach" (or "collateral haircut approach"). The primary criticism of this approach is that it does not recognize the risk mitigating benefit of correlations between long and short positions or of the effect of portfolio diversification. Consequently, the capital charges associated with the comprehensive approach can be up to 30-50 times higher than those required by a firm's regulator-approved internal models. The Basel Committee's revised comprehensive approach attempts to address the perceived defects of the current approach by modifying the calculation to address these two criticisms. Although pro forma analysis suggests that the revised approach would still be more stringent than any internal model, the revised approach would represent an improvement over the current comprehensive approach, resulting in significantly lower exposure amounts (and therefore lower capital requirements).

This change is of particular significance in the US, where even firms that are permitted to use internal models to calculate their exposures to SFTs must also calculate their exposures under the standardized collateral haircut approach. In addition, many aspects of the US regulatory framework outside of the capital rules measure credit exposure to SFTs by reference to the collateral haircut approach (e.g. the single-counterparty credit limits). Consequently, implementation of the revised comprehensive approach would not only provide significant capital benefits to firms in the US, but would also have positive ripple effects on other, related requirements. On the other hand, failure to implement the revised comprehensive approach in the US could place US firms at a significant disadvantage to firms in jurisdictions that did adopt the revisions.

Another significant change to the Basel III framework is the introduction of a capital charge that would impose minimum haircuts for non-centrally cleared SFTs. In particular, the minimum haircuts would apply to non-centrally cleared securities financing transactions in which financing (lending of cash) against collateral (other than government securities) is provided to counterparties who are not supervised by a regulator that imposes Basel-style prudential requirements. The framework would also apply to so-called collateral upgrade transactions with such counterparties where a bank lends a security to its counterparty and the counterparty pledges a lower quality security as collateral. Transactions that did not meet the minimum collateral haircuts would be required to be treated as uncollateralized, significantly increasing the capital requirements associated with those transactions.

Although the rule includes significant exclusions, including for more "traditional" types of cash collateralized securities lending transactions, and although the minimum haircuts are largely consistent with current market standards, the possibility of significantly higher capital requirements could increase SFT transaction costs as market standard collateral practices evolve and could incentivize firms to centrally clear their securities financing activities.

### Outstanding US reforms

Other proposals that have remained outstanding since last year that could have a significant impact on securities financing activity in the US include a proposal to implement the NSFR, a Federal Reserve and OCC proposal to revise the enhanced supplementary leverage ratio (eSLR) applicable to GSIBs and their insured depository institution subsidiaries, a "stress capital buffer" proposal to incorporate the results from the Federal Reserve's CCAR program into the capital rules (via the capital conservation buffer) and proposed changes to the regulations implementing the Volcker Rule. ■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# Emerging technology for emerging markets: Into the uncharted electronification of credit and EM financing markets

By **Andy Wiblin** | Chief Product Officer at GLMX.

**The pace of electronification of the securities financing market has accelerated in recent years, driven in part by regulations such as MIFID II and SFTR, but also by cost pressure to do more with fewer resources. This has undoubtedly delivered benefits to the market, but in terms of true value of automation and efficiency, is this just the beginning? There is real potential to add immediate and significant value to the credit and emerging markets segments in terms of operational efficiency.**

To date, streamlining the daily securities financing workflow in government bond repo has been the primary focus. However, the credit and emerging markets segments have been somewhat neglected, with limited access to technology solutions that cater to their specific needs. The industry has been reluctant to change behavior and resistant to discover the efficiencies that electronification will provide. The market for cash bond trading has seen a proliferation of platforms catering to electronic execution. Dealers have looked to increase automation and reduce operational friction to boost returns, but without considering the credit repo markets, which grease the wheels of the corresponding cash trading, there is still a weak link in the chain. Arguably, this weakness is even more important to address given the specific complexities of this segment of the market including the multi-step and multi-variable nature of initial trade negotiation and the administrative drag of ongoing trade maintenance.

The challenge lies in transforming the complex liquidity ecosystem that exists between clients, their dealers, and their own counterparts, and streamlining communications to eliminate friction and operational risk wherever possible. This will then allow the key parts of the ecosystem – sales and trading – to focus on where they add most value: ensuring best execution and management of relationships, risk and scarce resources.

Buy-side participants in securities financing span a wide variety of organizations. Each one, though, requires a consistent, easy-to-use interface for their liquidity pool that accurately reflects the different stages of negotiation, from pre-trade locates, price discovery and comparison, through to execution. For credit and emerging markets in particular, once the trade is on, managing the day to day maintenance is complex, labour intensive and fraught with operational risk. This maintenance ranges from handling re-rate requests from dealers to managing changes in the underlying position through resizes to substitutions and close-outs. The ability to manage both the initial trade negotiation and subsequent lifecycle management within a single platform, such as GLMX, is a key enabler for complexity, cost and operational risk reduction.

Moving from a world which is highly manual in terms of its communication flow (as email and instant message exchange still reign as the dominant channels) to a platform presents the additional benefit of providing better analytics. Firms can gain a deeper understanding of their access to liquidity and how that evolves over time by tracking clean and consistent data covering pre-trade, negotiation and post-trade. These concrete metrics can allow players to have meaningful, data-driven discussions with their counterparts to help improve key relationships. Not only are these data necessary to better analyze trade metrics, but they may also be required by future regulations and benchmark rates like the imminent Secured Overnight Financing Rate. As of now, these data are difficult to obtain, especially from less-regulated buy-side institutions; however, to accurately read this mammoth marketplace it will be necessary to track these trades more thoroughly. The data generated, and captured digitally, as part of this can allow broker-dealers to better understand their clients' current and historical flows and needs, benchmark their own performance against internal targets, and feed directly into their own trading decision support.

In a world of increasing cost pressure, reduction of operational friction is vital. Receiving client flow digitally with contextual decision support (including inventory, pricing and credit) allows negotiation back and forth quickly and easily. Specifically, for credit and emerging markets securities financing flow, having the ability to provide rapid pre-trade locates, initiate flow to source inventory and then manage the open trading book through lifecycle management is critical. Beyond that, full straight-through processing (STP) provides for virtually zero operational risk on the back-end. When talking to current and potential clients, we've discovered that some of the biggest pain lies within the credit and emerging market repo segment. That is why we've invested in extending an already flexible platform to cater to the nuances and complexity of these flows. We've seen tangible excitement from our users as they realize how some of their daily flows are now simplified.

No discussion on securities finance would be complete without reference to SFTR. In our experience the level of preparedness for SFTR is low. The regulation is large and complex, and platforms such as GLMX are a key building block in the compliance journey, both from a matching perspective and in terms of accessing the data required by SFTR. Negotiating trades and managing their subsequent lifecycle on a platform means they are matched at the source and thus, ahead of actual reporting. This offers the benefit of reducing the operational friction caused by breaks and subsequent curing within the mandated timescales.

Perhaps most importantly, utilising a platform allows maximum time for the human capital intensive activity of managing relationships with clients. The business will still be driven by relationships, only now, technology allows people to focus on the relationship rather than the related administration. Looking forward, automation across all sectors of the securities financing markets allows for deeper relationships, richer conversations, and overall more efficient markets. ■

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# Maintaining best practice while preparing for change

**Fran Garritt,** director of global markets and securities lending at the Risk Management Association (RMA), explains how the association is working to promote best practices in securities lending as the industry adapts to the evolving regulatory, legal, and tax landscape.

## Securities Lending Council

RMA's Securities Lending Council is made up of representatives from a number of agent lender firms. The Council works closely with the subcommittees to determine key areas of industry concern and the most appropriate means of addressing them. The Council also works closely with other industry groups such as the International Securities Lending Association (ISLA) and the Pan Asia Securities Lending Association (PASLA) to coordinate industry responses to global issues.

The Council, with support from the Legal, Tax, and Regulatory Subcommittee, has worked closely with regulators on the implementation of Single Counterparty Credit Limits (SCCL) in the US. Through these efforts, the finalized version of the SCCL will be significantly less disruptive to the securities lending industry than earlier proposals. Under earlier proposals, a significant amount of loans would have had to be recalled from the largest borrowers.

The Council has also worked on the implementation of Basel III and advocated for a more risk-sensitive standardized approach to calculating credit exposures for securities finance transactions. Through these efforts, the Basel Committee released a new finalized calculation methodology that takes into account the correlation and diversification of lending and collateral portfolios. Once adopted at the jurisdictional level this should result in a reduction in the cost of indemnification for agent lenders.

## US and international developments

Over the past year, RMA's Legal, Tax, and Regulatory Subcommittee (LTR) has focused on determining the impact on the US securities lending industry from recent non-US market developments and regulations. One such development was ISLA's implementation of the new form GMSLA pledge agreement. This agreement allows borrowers to pledge collateral in support of loans, rather than transferring title to such collateral as was traditionally done under English law. The LTR tracked developments in this space for several years and brought the latest developments to the attention of its participants as they occurred, including when ISLA formally launched the form of agreement in 2018.

Members of the LTR also worked closely with the International Swaps and Derivatives Association (ISDA) and ISLA on the development and implementation of the US Resolution Stay Protocol. Specifically, LTR was instrumental in

**As the applicable US rules come into play for most of the effected market in July 2019, LTR will continue to monitor developments and consider whether industry action is needed to address any unforeseen consequences stemming from the US Resolution Stay Protocol or the adherence process.**

ensuring that a viable mechanism exists for allowing agents to adhere on behalf of their clients. This change allows agent lenders to efficiently modify their client and borrower agreements using the protocol. The LTR also worked to develop an industry standard form of client consent, expanding an agent lender's authority to take appropriate resolution-related actions on behalf of its clients. As the applicable US rules come into play for most of the effected market in July 2019, LTR will continue to monitor developments and consider whether industry action is needed to address any unforeseen consequences stemming from the US Resolution Stay Protocol or the adherence process.

Domestically, the US experienced the impact of the first National Day of Mourning to be held in many years. This took place on December 5 2018, in remembrance of former US President George H.W. Bush. Members of the LTR have been working closely with the Securities Industry and Financial Markets Association (SIFMA) and the relevant exchanges and depositories to debrief on the impact of the associated partial market closures. The objective of these discussions is to have an industry consensus as to the best practices for making market closure decisions, taking into consideration all relevant areas of the markets, including securities lending.

**In Latin America, RMA has continued to play a significant role in helping to educate our various constituents as well as offer assistance to those local market participants who have requested inputs.**

### Latin America

In Latin America, RMA has continued to play a significant role in helping to educate our various constituents as well as offer assistance to those local market participants who have requested inputs. In late 2018 we partnered with EquiLend to publish a Latin America Users Guide, which has been met with positive feedback from the industry as a whole. With the help of various RMA members we saw the launch of Peruvian securities lending in April of this year; the Bolsa de Valores de Colombia has reached out to discuss its plans to launch an OTC product; B3 in Brazil continues to be a great partner in the overall efforts; and we continue to liaise with local providers in Mexico as they too contemplate wholesale changes to local securities lending. Lastly, we have been approached by numerous members regarding the formation of a regional securities lending association, an effort we are seriously considering and discussing with relevant parties.

### Technology and operations

Much like the rest of the industry, securities lending operations teams are dealing with transformation and change across multiple areas. Most notably, these changes are coming in the form of new technologies, regulatory/market implementations, and industry drives to reduce risk and improve efficiency. Operations has been the front line for many of our

> **The industry has seen limited advancement on a strategic solution that would provide enhancements to effectively manage the inherent risk — which makes this an opportunistic time to mobilize and take action.**

firms' robotics initiatives and is ample ground for machine learning and artificial intelligence (AI). While the regulations continue to settle themselves out, the impact on operations is coming into focus. The Securities Financing Transaction Regulation (SFTR), Central Securities Depositories Regulation (CSDR), and implementation of central counterparties (CCPs) are the most impactful events in the near term, with SFTR potentially having a significant impact on what an operations team is responsible for completing on a daily basis. While there is much occurring in these areas, RMA is focused on moving forward with industry-wide efficiencies across non-cash collateral in the US and in addressing the risk that global corporate actions pose to our firms.

## Corporate actions

Corporate actions continue to present significant risk to the stock borrow/loan industry, with recent challenges pertaining to exponential increases in event volume and complexity. The industry has seen limited advancement on a strategic solution that would provide enhancements to effectively manage the inherent risk — which makes this an opportunistic time to mobilize and take action. A working group consisting of representatives from the global stock borrow/loan as well as asset servicing communities has been established to identify existing and forthcoming challenges globally; to collaborate among industry leaders to prioritize the greatest areas of risk; to propose strategic enhancements; and to coordinate with industry vendors to build viable solutions. There is a great opportunity to harmonize the demand of the industry for enhancements that effectively manage risk and position the industry for future success.

## SFTR

Over the past year, RMA's SFTR working group has been coordinating industry updates with ISLA to share information with RMA members, and to help establish global best practices for SFTR trade reporting. The primary issues raised by RMA include identifying trade reporting information dependencies, by both the lenders and borrowers, on the agent lenders, as well as the extraterritorial impact of SFTR trade reporting requirements for out-of-scope lenders (e.g. US-domiciled lenders).

The RMA SFTR working group continues to promote the importance of close coordination across all global trade associations, trade repositories, and vendors to create awareness of potential issues and to agree on SFTR trade reporting interpretations with the goal of minimizing trade reporting failures.

This coordination has resulted in ISLA's development of various securities lending trade reporting intricacies (e.g. timing and life cycle events) for the European Securities and Markets Authority's (ESMA) consideration, as well as the promotion of ISLA's efforts to establish best practices for the global securities lending industry. Specifically, issues relating to certain mandatory reporting fields, including the lack of legal entity identifiers (LEIs) for both trading counterparties and securities issuers, have been raised and are in the process of being resolved.

Finally, RMA's SFTR working group has recommended that ISLA consider drafting a standard form of delegated reporting agreement for SFTR market participants to promote consistency and efficiencies to comply with SFTR trade reporting requirements.

**Tax**

The Tax Subcommittee is currently monitoring several recent tax developments affecting the securities lending market. In France, a new withholding tax of 30% on manufactured payments from French borrowers referencing underlying French dividend income is scheduled to take effect on July 1 2019. Although the tax is recoverable if the lender can establish that the transaction's principal purpose was not tax avoidance, it is still expected to have a negative effect on the supply of French equities to French borrowers over record date.

The Subcommittee is also tracking proposed legislation in Canada that, if enacted, is projected to have an overall positive effect on non-Canadian lenders. Among other provisions, the proposal would exempt manufactured payments paid by Canadian borrowers that reference dividends from non-Canadian securities from Canadian withholding tax. Such payments are currently subject to Canadian withholding tax at a rate of up to 25%, which generally limits the flow of non-Canadian supply to Canadian borrowers.

Aside from recent market developments, the Tax Subcommittee is also finalizing a comment letter to the IRS and Treasury Department to request regulatory guidance on the tax implications of securities lending transactions with a fixed term. These transactions present significant risk to certain securities lenders (e.g. sovereign wealth funds) because of the lack of certainty with respect to their treatment under current US tax law, which diminishes supply and liquidity in a growing segment of the securities lending market. ■

# Pirum in the Americas: An evolving company in complex times...

Q&A with **Nancy Steiker** | Head of business development – Americas at Pirum.

Pirum has been servicing North American-based clients for many years. As the need for automation becomes more important in the securities finance market, Pirum's expansion into the North American market is well positioned and timed to help clients improve their daily processes. As a market practitioner for over 15 years, I experienced firsthand some of the process inefficiencies, and the ability to work closely with clients to improve their processes is what attracted me to the role at Pirum.

**How has Pirum expanded its North American presence?**

When I joined, I was pleasantly surprised as to the extent of Pirum's usage in the Americas where they are already supporting US domestic and international business. Due to regulatory changes (e.g. Dodd-Frank and Basel) and subdued market trading conditions, there is currently a laser focus on the cost of doing business which in turn leads to the need for more efficient trading and collateral management. As a result, US domestic clients who have historically used Pirum's overnight comparison services are now actively engaged in using Pirum's real-time services such as trade compare, marks, returns and exposure management. The appetite of US domestic clients to ensure post trade STP between counterparts and collateral venues has grown and we are seeing US domestic entities wanting to match the level of automation already achieved by the international businesses.

The securities financing industry is increasingly global, not only from a markets perspective, but within each respective institution. Firms are demanding increased transparency of deployed and available assets and collateral in a global and enterprise-wide manner. Having this view enables traders to make the best decisions from both a revenue as well as a regulatory standpoint. This has led to the breaking down of regional and product silos (and in this regard we have seen a strong uptick in repo and other fixed income-related business).

Institutions are increasingly seeing FinTech services as the most optimal way to solve these increasingly broad and complex challenges. Automation of post-trade processes not only reduces cost, operational risk and balance sheet usage, it also enables more time to focus on alpha generation be it through different trading strategies or market access solutions. When firms weigh up the buy vs. build options, they increasingly determine that a FinTech solution can be viewed as the most efficient especially for non-differentiating elements of their business and process flows.

**What about Canada?**

Canada is clearly a significant market in the securities lending market tapestry. Canada has over $1.2tn in assets lendable available with approximately $160bn on loan, with demand for Canadian government bonds strong as well as general liquidity provisions. The increase of automation and transparency on a global scale has brought more Canadian firms to the market looking to generate revenue through securities lending programs. We have absolutely seen this increase in activity and importance translate in the volume and activity of our clients. In many ways Canada has more similarities with the international markets than US domestic, so has been an ideal area for us to assist clients given our market share in post trade in the international space.

**How has Pirum expanded into the Americas product wise?**

The US domestic market has some functions that are specific to the US cash settlement market, Pirum has assisted this with the launch of its SPOConnect. This provides an automated, scalable, and centralized solution for managing all Security Payment Order (SPO) activity. The service is available to any area within an organization that process Security Payment Orders.

We have also built US tri-party connectivity for our clients. Pirum is able to assist clients in calculating and instructing requirements (RQV) for US domestic tri-party. Our tri-party RQV product at Pirum has seen an explosion in growth, with usage nearly doubling in two years to $1.4tn calculated daily, across 6,466 accounts and four tri-party agents (BNY, Clearstream, Euroclear and JPM). Full STP RQV calculation and submission to all agents has been a well-established product for our international clients, however, this is now also required for US clients due to changing market processes and regulatory change. The anticipated 15c3-3 amendment is likely to result in further growth in tri-party business for this region.

**"The increase of automation and transparency on a global scale has brought more Canadian firms to the market looking to generate revenue through securities lending programs."**

**So collateral management is an increased focus for your clients?**

Absolutely right, collateral management is front and center for pretty much every client we engage with. As a result, Pirum has introduced CollateralConnect which is a front-office solution providing enterprise-wide collateral management capabilities including projection, exposure management and improved efficiency. Subscribers can view a global record of all collateralized exposure, across all bi-lateral and tri-party relationships covered by Pirum.

Both borrowers and lenders are benefiting from real-time connectivity and STP capabilities to efficiently manage collateral - utilizing digitized schedules, eligibility checks and collateral requirement forecasting. There are pre and post-trade analytic tools available to identify efficiency opportunities.

CollateralConnect is well positioned to respond to the increased regulatory demands and drive for enhanced returns that the market is facing.

**"Although I believe the North American market is aware of CSDR and the associated implications, perhaps CSDR has not received as much attention or press as other regulations to date."**

### What about CCPs?

Pirum is built out and fully functional with Eurex CCP in EMEA. It has been well documented that a CCP allows clients to reduce their capital requirements while increasing their efficiency in the market place and we have enabled clients to make the transition from OTC trading, by building an effective gateway and lifecycle management process. OCC has been operational in the US for some time now, with clients putting billions of security lending transactions through the platform. With the addition of the newly announced DTCC CCP clients will have more options going forward on trades that can reduce the RWA on their balance sheet and these are absolutely on Pirum's product development roadmap for the coming period.

### What impact will SFTR have on the North American market?

I think this is where Pirum's global footprint is really resonating with clients. Obviously, we have seen a lot of interest and made strong progress with the international participants, however, what has been surprising to me is the extent to which traditional US domestic only participants are asking for information and services. I have no doubt that SFTR will have a global impact, and that is why in our partnership with IHS Markit we have built a global solution. It is interesting to note that just because an institution may be out of scope, if they are trading with an in-scope entity there is a requirement to exchange data. Firms that have adopted our core SFTR product have done so as they do not want to negatively differentiate themselves by not having a robust data exchange solution.

### What impact will CSDR have on the North American market?

Although I believe the North American market is aware of CSDR and the associated implications, perhaps CSDR has not received as much attention or press as other regulations to date. Since joining Pirum, I have begun to realize the scope of CSDR and have no doubt that it will inevitably pose numerous challenges for securities finance participants, not only those domiciled in the EU, but globally.

In September 2020 all transactions which are intended to settle on an EU/EEA CSDs (regardless of where the trading entity is domiciled) will be in scope of CSDR, which could result in penalty fines and mandatory buy-ins. As with SFTR I think Pirum's global footprint is resonating with clients who realize that it is vital that firms utilize tools that are currently available to mitigate economic and reputational impact. Pirum has several existing modules that will assist clients in mitigating the aforementioned impact and are currently working closely with clients to enhance current modules and discuss potential additional solutions to assist the workflow even further.

### What are your concluding thoughts?

What has surprised me most since joining Pirum is the level of activity and output the team put into meeting clients and the market's evolving demands. So, whilst we have a lot going on, with the high calibre team assembled, in my opinion Pirum are ready and able to meet our clients' needs. I look forward to adding to this as we continue the deep dialogue with clients to assist their complex needs in North America. ■


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Trading Venues
Market Depositories
Counterparts
Central Counterparts
Data Provider
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# Repo in review

Repo market veteran **Jeffrey Kidwell,** who has over 36 years' experience in securities finance, takes a journey back through 2018 and looks ahead to the issues on the industry's plate in 2019.

We can't even say the year 2018 without mentioning that it was a record year for securities lending revenues globally. That $10.7 billion of global revenue was the highest recorded since 2008! It was earned through a volatile and exciting year, with EM lending leading the charge, with over $1 billion in revenues, the global credit markets uncertainty leading to many short issues, ETF Lending hitting a record of nearly $400 million in revenues, Treasury lending doing its best since the crisis but slowing, and US equities diverging halfway through the year to crush short sellers and plummet revenues down 27%. The volatility erupted from sudden Central Bank tightening (including our Federal Reserve), trade wars between the US and others, the US political drama, the Brexit saga, and oil price and currencies volatility. However, despite a record year of revenue, we saw even more puzzling large-scale layoffs and consolidation among banks, particularly at the middle- and upper-management layers.

If we turn away from revenues and jobs, there were many developments in our industry in 2018. We had a bizarre year-end funding in 2018 that made old folks like me reminisce about year-ends decades ago. There was a dislocation of funding that caused a divergence for buyside cash providers and buyside collateral providers that was exacerbated by some broker/dealers only providing balance sheet to their "platinum" accounts (who pay for other services at those banks or trade in many other products) and turning away other collateral providers, and some broker/dealers keeping balance sheets very low for new regulatory purposes (what we used to call "window dressing" on quarter-ends), which turned out not to be the same across different jurisdictions or size of organizations. This all forced some collateral providers to hit bids over 6% and some cash providers to jump back into the Fed's RRP program and put up with sub-market interest rates, creating this huge gap in rates on the offer side and the bid side. This calls into question all of those articles about how market liquidity has 'improved' dramatically. It all depends who you are and what you define as 'liquidity'.

The two positives that came from that are that more peer-to-peer or sponsored repo was traded, recognizing the benefit of closing that bid/offer gap somewhat, and a couple of opportunistic large broker/dealers swooped in, reallocating their enormous balance sheets out of less profitable bid/offer spreads and into repo, helping out some of the buyside customers and reaping the rewards for themselves. I should also note that these disruptions that occurred at year-end did not seem to be as prevalent at the first quarter-end of 2019, so that still leaves some puzzles to solve.

### Inclusivity rises up the agenda

So, I was at most of our industry conferences in 2018 and some in 2019, even chairing one for a change. One huge change in 2018 that has carried over to 2019, and it is well overdue, is a focus on women and inclusivity (non-discrimination) in our securities financing industry. I was very honored to participate in those efforts to outline issues and to create action plans. I see on other conference agendas that it is now becoming a main staple discussion and I am very pleased with that. I know that other industries, like entertainment and sports, are just now broaching these subjects but an industry like ours, which is all about best service, best execution and revenues, should never have had these issues. Our industry was founded on performance-based pay and who can solve problems the best in teams.

### Industry buzzwords maintain their hold

2018 was a year of innovative thinking for our industry. We saw beneficial owners start focusing on collateral flexibility, use of alternative collateral, trading term rather than overnight, and even delving deeply into non-cash collateral for their reinvestments. There was a new development of using ETFs for not only reinvestment cash but also as collateral to be lent. The buzzwords for 2018 (and carrying through to 2019) were collateral optimization, collateral transformation, varying pledge structures, indemnification, benchmarking, oversight, data usage, fintech, peer-to-peer, P4P, agented repo, blockchain, DLT, machine mearning, data mining, CCPs, and electronic trading platforms.

### What lies ahead?

Let's look at 2019. We've already had some significant events and issues. Since, the number one topic of 2018 was "revenues are back to 2008 levels", we have to start by saying: "those revenues disappeared again in Q1 2019". That has led, unfortunately, to even more layoffs. Ironically, some consolidation, like Commerzbank and Deutsche Bank, was actually waved off recently and didn't happen. On the regulatory side, although we have the whole Banking Union, Capital Markets Union, and Digital Single Market to slog through, as well as the Libor/Euribor/Eonia replacement rates, the major focus will likely be on the impacts of SFTR and this Brexit delay (re-vote?). Also, we have some dark horses coming up on the outside, in China perhaps opening up its markets, CFTC proposing new rule changes on futures and swaps for money funds and insurance companies, and the surprisingly absent regulations on fintech. And, are we all done now with Mifid II and its impact on our market? Believe me, from my informal polls of my myriad clients, when I asked what the major disruptor of 2019 would be, from these topics: technology, regulations, macro-economic forces, geopolitics, China, and another financial crisis (?), they all said "regulations".

On the technology front for 2019, as much as I, personally, would like to say electronic trading platforms, CCPs, and blockchain, the likely big topics will be data mining and collateral optimization.

On the trading side, we still have to watch out for US government shutdowns, issuance of government securities, regulatory discrepancies across jurisdictions, and this elusive "liquidity" due to regulatory balance sheet restrictions, LCR, and other capital and liquidity ratios. I am also a little concerned by patterns breaking down, including the recent high funding and dislocations.

We are not only "not in Kansas anymore", but we are "very far from Kansas". New issues, new regulations, new transparencies, new technology, and more communication will create new opportunities. At least, for those who can adapt. ■

# Argentina

The Argentine exchange, Bolsas y Mercados Argentinos (BYMA), has been making a number of enhancements over the last two years to improve ease of access for foreign investors, increase liquidity, and promote local capital markets activity. This includes the launch of a securities lending and short selling programme in 2018, as well as extensive upgrades to its technology infrastructure.

In May 2019, the exchange unveiled BYMA Listed, a web-based platform that uses blockchain technology to enable issuers to submit filings electronically. Upon its launch, Alejandro Berney, chief executive at BYMA, said: "This new platform represents a new milestone in our commitment to incorporating state-of-the-art technology, with the aim of enhancing efficiency and offering market participants safer and more flexible products and services. Digitalization is a key element to development and to position ourselves at the level of international markets."

Future plans include the implementation of a new market surveillance system, in addition to the selection of a new central securities depository system which is due to be rolled out by 2021. BYMA is also continuing to focus on steps to reduce operating and counterparty risks, enhance counterparty risk controls, and encourage Argentine companies that are listed abroad to dual list on the domestic exchange in a bid to bolster local liquidity.

BYMA is awaiting approval for a banking licence to complement its capital markets activity. According to its roadmap, this will enable it to provide fully-collateralised overdrafts to market participants to improve efficiencies in settlement.

## Economy and politics

Argentina's economy contracted by 2.5% in 2018, while the Argentine peso depreciated by 50.6%, according to the World Bank. April 2019 data from Argentina's Central Bank (BCRA) puts month-on-month inflation at 3.4% and year-on-year inflation at 55.8%. On April 29 2019, the Monetary Policy Council and BCRA announced changes to the existing monetary and foreign exchange regime in response to increased foreign exchange volatility.

In June 2018, the International Monetary Fund (IMF) approved a three-year Stand-By Arrangement amounting to $50 billion. This was extended to $56.3 billion in October 2018. This April, the IMF completed its third review of the country's economic performance under the arrangement, which saw it approve a $10.8 billion disbursement, bringing the total since June 2018 to approximately US$38.9 billion.

According to *OECD Economic Surveys: Argentina 2019,* published in March 2019, the economy is forecast to contract by 1.5% this year before returning to growth in 2020. In the survey, the OECD notes that structural reforms remain key to future growth. The survey states: "Since 2015, the current administration has made considerable efforts to create conditions for sustainable and inclusive growth. Recent reforms include a tax reform, changes in the fiscal relations between the provinces and the central government, a new competition law, improvements in the sustainability of the pension system, new legal frameworks for capital markets and for public-private partnerships, the creation of an independent fiscal council and a commitment to bolster the independence of the Central Bank. But much more remains to be done."

In October 2019, the country will go to the polls to elect their next president. At the time of writing, current president Mauricio Macri and the pairing of former president Cristina Fernández de Kirchner with Alberto Fernández, who plan to run for vice president and president, respectively, were touted as the frontrunners. ■

# Netting regulations boost Argentine OTC derivatives and repo markets

By **Pablo J. Gayol,** partner at Marval, O'Farrell & Mairal

The Argentine capital market has been in turmoil since Argentina requested the assistance of the IMF last year, following a run against the Argentine Peso and the impossibility for the government to obtain financing from the capital markets. However, even in the midst of this financial crisis, the cross-border derivatives and repurchase markets have been active. This activity is the result of new laws and regulations1 which allow the enforcement of close-out netting provisions in OTC repo and derivatives transactions, even in insolvency scenarios. These regulations are part of a policy by the Macri administration aimed at integrating Argentina with the global capital markets, and was initiated by the decision, in 2016, to allow Argentine residents to enter into derivatives transactions with foreign dealers without the need for Central Bank approval.

These regulations require that the derivatives are registered with a Register of Derivatives Transactions kept by an authorized market. Also, international banks need regulatory legal opinions on the new regulations in order to operate on a net basis in Argentina. Therefore, over the last few months, most international derivatives and repo traders have been putting in place their legal and operative structures to be able to trade with Argentine counterparties: opening an account with the Register of Derivatives Transactions, obtaining legal opinions, and executing and negotiating the ISDA and ICMA Master Agreements with local counterparties. As these structures are being finalized, the derivatives and repo market will start to pick up, especially with interest rate and FX swaps and cross-border repos to financial institutions.

Another sector in which activity is growing is the distribution of foreign securities and funds to individuals through local broker dealers. The new regulations on broker dealer services have allowed them to provide investment advisory services to clients and to place orders outside Argentina. This has facilitated access to global markets to local individuals. The market would receive an additional boost if mutual funds regulations are changed to allow them to invest a larger share of their assets in foreign securities. This is expected to happen sooner rather than later, since the regulator has already called for comments on proposed regulations for mutual funds aimed at qualified investors, which will not be subject to mandatory minimum local investment requirements. ■

*1) Law 27,440 and Regulation 775 of the Comisión Nacional de Valores, the Argentine equivalent to the Securities and Exchange Commission.*

# Brazil

After a period of system consolidation following the 2017 merger of Cetip and BM&FBovespa, the Brazilian market infrastructure provider – now known as B3 (Brasil, Bolsa, Balcão) – turned its attention to the delivery of new products and services in 2018. This includes a particular focus on data analytics and tech enhancements aimed at realising increased efficiencies for market participants.

"We are developing new services that better explore our potential around market data and analytics. We have a lot of data and we consider ourselves able to bring more value to everyone in the market in this area," says Claudio Jacob, managing director, international business development – client relations at B3.

The exchange is also developing new functionalities to support securities lending activities, which are due to launch this year. This comprises the introduction of securities lending services for government bonds, the automation of broker-dealer accounts, and the creation of an electronic securities lending system. Direct access to the buy side, counterparty selection, and automatic renewal of lending assets are among the capabilities offered by the new system.

Brazil is also moving from a T+3 to T+2 settlement cycle for equities. The Central Bank of Brazil and the Securities and Exchange Commission of Brazil granted B3 the necessary approvals for the transition on May 14 2019. The implementation date for the new settlement cycle is May 27 2019.

While continuing to work on the rollout of new offerings under its comprehensive 2019-2020 Roadmap, B3 has also been celebrating new milestones within the Brazilian stock market. In March 2019, the Ibovespa index, which accounts for 85% of the country's stock market, hit a new record by surpassing 100,000 points. "Some 3-4 years ago the Ibovespa was running at 50,000 points so it has almost doubled. That's very impressive, particularly if you consider the fact that inflation in Brazil is higher than in many other countries," says Jacob. "It also helps to support new IPOs and follow-on offerings."

As of March 29 2019, there were 336 companies listed on the exchange, with a total market capitalization of more than BRL3,829 billion ($944 billion). The market has also seen growth in average daily traded values for equities, such as a 48.5% year-on-year increase in cash equities to more than BRL16 billion ($3.9 billion) in 1Q19.

## Economy and politics

Over the last 12 months Brazil has experienced a rather turbulent election, which resulted in a win for far-right presidential candidate Jair Bolsonaro in October 2018. Bolsonaro was sworn into office in January, bringing with him the newly appointed economy minister Paulo Guedes, a former banker. The Bolsonaro administration has promised fiscal reforms and changes to the pension system in a bid to reduce the fiscal deficit and strengthen the Brazilian economy, which emerged from a severe recession in 2017.

In a note published in November 2018, shortly after the election results were announced, Cassiana Fernandez, J.P. Morgan's chief economist for Brazil, wrote: "While Guedes' proposed agenda was welcomed by market participants, we remain cautious on the government's ability and willingness to move forward with the reforms. We believe that at this point there is a 50% chance of approval of a meaningful reform agenda that will be enough to timely address the country's medium-term fiscal challenges, including the social security reform, which requires a tough-to-get 60% of support in two votes in each house."

Brazil's GDP grew by 1.1% in 2018 and April 2019 estimates from the IMF project growth of 2.1% in 2019. However, the country's economy minister has since revised its growth forecast to below 2% for the year, while minutes from a May 2019 meeting of the Central Bank's Monetary Policy Committee note that 'available indicators suggest a relevant probability that the seasonally adjusted Gross Domestic Product (GDP) declined slightly in 2019Q1, when compared to the previous quarter'.

At the time of writing, the Central Bank's benchmark interest rate (Selic) remains at a record low of 6.5%, a rate that has been held since March 2018. "The low interest rate is bringing about a very interesting change in the behaviour of Brazilian savers, but also institutional investors who are looking at new alternatives in terms of financial instruments in order to maintain the performance of their portfolios," says B3's Jacob, who indicates a move towards "more sophisticated" investment vehicles.

Brazil's investment fund industry – which is estimated to have $1 trillion of assets under management – closed 1Q19 with a net inflow of R$47.8 billion ($11.9 billion), up 3.3% on balances at the end of 2018, according to the Brazilian Association of Financial and Capital Market Entities (Anbima).

"The perception that we have is that Brazilian investors are more optimistic about Brazil, so they are buying more equities and other 'riskier' products. Despite the noise around reforms, we feel there is a belief that things are going in the right direction and that foreign investors are due to come to the market," concludes Jacob. ■

**Brazil equities**

| Securities lending | 1Q19 | 1Q18 | 1Q19 year-on-year change | 4Q18 | 1Q19 quarter-on-quarter change |
|---|---|---|---|---|---|
| Average open positions (BRL billion) | 55.8 | 43.7 | 27.6% | 52.9 | 5.5% |

*Source: B3*

# Canada

Last year was a somewhat challenging one for the Toronto Stock Exchange (TSX), with the TSX Composite Index down 11.64% at the end of 2018, says Phil Zywot, managing director and Canada regional securities finance trading head at BNY Mellon Markets. However, 1Q19 experienced a rebound. "It's been the best start to any year in the last 19 years, with the TSX Composite Index coming up 12.42% in the first quarter," Zywot adds.

Cannabis stocks continue to drive momentum in the Canadian securities finance market. According to data from IHS Markit, Canadian equity securities lending revenue reached over $144.8 million in 1Q19, up 11.5% on 1Q18. Canadian cannabis stocks accounted for $63 million of 1Q19's equity lending revenue, an increase of 32% year on year. In North America, four of the top 10 revenue-generating stocks in the first quarter of the year were in the Cannabis sector.

Mark Skowron, senior vice president, global securities lending trading at Northern Trust, says: "In Canada, one of the main themes of 2018, and likely into 2019, was borrower interest in shares of cannabis-related companies, as the country legalized the use of recreational marijuana. Ongoing borrower demand and elevated lending fees should drive good opportunities for holders of these companies' shares as the sector is broadly viewed as overpriced."

While mining and energy stocks have historically been a key driver of demand for specials in Canada from a short-selling perspective, recent demand has been more subdued in these areas and cannabis stocks currently represent the lion's share of growth in the Canadian market, explains Sam Pierson, director, securities finance at IHS Markit. "There are hedge funds that seem to have a long-term view that it is going to be hard for Canadian cannabis players to grow into their market caps," he says. "As the market caps have grown so have the short balances, as share price volatility continues to attract a lot of trading on both sides."

Meanwhile, on the fixed income side, there has been continued strength on the back of Canada's AAA rating and the need for high quality liquid assets (HQLA), notes BNY Mellon's Zywot. This trend is expected to continue over 2019.

## Collateral diversification

The country's securities finance market has also seen a move towards greater collateral diversification. Zywot says: "Canada has generally been a non-cash collateral, sovereign debt market. Now we are seeing more equities as collateral, other sovereign debt options as collateral, and an expansion into corporate bonds as collateral. We have even seen an expansion into different forms of cash collateral and different currencies."

The industry continues to push for broader collateral options for Canadian mutual funds.

The Canadian Securities Lending Association (CASLA) is advocating for changes to National Instrument 81-102 in order to allow mutual funds to accept equities as collateral for securities lending transactions.

### Regulatory change

The Canadian Federal Budget, announced on March 19 2019, laid out proposed reforms with a bearing on the securities lending industry. This includes changes to the tax treatment surrounding securities lending transactions where a non-resident lends Canadian stocks to a Canadian resident, which aim to 'prevent non-resident taxpayers from avoiding Canadian dividend withholding tax on compensation payments made under cross-border share lending arrangements with respect to Canadian shares'.

"These regulatory changes have been proposed but not yet implemented," says Zywot. "If they do pass, they will be retroactive back to March 19. Participants both globally and here in Canada are monitoring the situation closely."

2019 has already seen the introduction of new rules that provide retail investors with access to liquid alternatives, which came into effect on January 3. Zywot says: "This is potentially a new market opportunity for the Canadian industry. It may be off to a slow start as the retail sector gains a better understanding of what the product offer is, but it should be an avenue of growth over the upcoming years for the Canadian marketplace."

### Beneficial owner engagement

While Canadian beneficial owners are typically au fait with, and accepting of, securities lending practices, Zywot believes there has been a trend towards increased utilisation of securities lending as a tool to help generate incremental revenue for their underlying funds.

He says: "We have seen more engagement from securities lending beneficial owners on all fronts, whether that's getting into a securities lending programme if there isn't one, or looking at an existing programme to see how they can expand it or consider new trading strategies, ideas or collateral to further increase the incremental revenue that it can generate." ■

**Canada equities**

| | 2017 | 2018 | 1Q18 | 1Q19 |
|---|---|---|---|---|
| **Securities lending revenues (US$)** | 445,511,125 | 484,674,284 | 131,351,378 | 144,861,548 |
| **Average loan balances (US$)** | 43,008,817,580 | 41,156,738,051 | 40,874,907,716 | 43,483,598,620 |
| **Average fees (%)** | 1.03 | 1.17 | 1.28 | 1.34 |

*Source: IHS Markit* IHS Markit

# Chile

The Santiago Stock Exchange (Bolsa de Comercio de Santiago) turned 125 last year and the central securities depository, Depósito Central de Valores (DCV), celebrated its 25th anniversary. Both organisations continue to look ahead to new innovations to support the country's capital markets, including partnerships to bolster their technological capabilities.

DCV is working with Nasdaq to improve its technological infrastructure. Under an agreement signed in May 2017, Nasdaq is providing the CSD with a new system that will include seamless trade and instruction management, settlement, custody, corporate event management and registry capabilities; offer full coverage for all types of securities and multiple currencies; enable full STP and based on global standards and market practices; support smooth settlement with optimization algos, as well as potentially providing facilities for securities lending and borrowing accounting.

Meanwhile, the exchange has launched a securities lending platform using blockchain technology, which is based on the Linux Foundation's Hyperledger Fabric open source solution. Securities lending is the first area in which the exchange has applied this technology as part of a strategic partnership with IBM.

At the time of the launch in June 2018, Martin Hagelstrom, blockchain leader for IBM Latin America, said: "Blockchain has the potential to transform the financial industry in Chile and in Latin America. The Santiago Exchange's solution is designed to help reduce errors, possible fraud and the processing time of each transaction, while providing transparency and security to the entire business chain."

## Economy and politics

Chile's economy grew 4% in 2018, up from 1.3% in 2017. The country's Central Bank has predicted growth of between 3% and 4% in 2019 and 2020, and forecasts growth in the range of 2.75%-3.75% in 2021.

In a 2Q19 note published on BNP Paribas' economic research portal, economist Hélène Drouot, said: "GDP growth rebounded in 2018, buoyed by higher copper prices and the renewed confidence of investors following the election of Sebastian Piñera.

"Over the course of his mandate, President Piñera's ambition is to implement fiscal policies that will boost growth and stimulate investment while consolidating public finances, but this could prove to be harder to achieve than expected.

"The president's party lacks a congressional majority, and is struggling to push through the fiscal and pension system reforms that have been presented so far. Even so, economic growth prospects will remain rather favourable over the next two years and fiscal consolidation should continue."

In October 2018, the National Congress approved a new banking law that will revamp regulations on capital requirements and risk management, update the Chilean banking system to align with Basel III standards, and transfer regulatory and supervisory powers to the recently-created Financial Market Commission (Comisión para el Mercado Financiero or CMF). President Sebastián Piñera passed the law in January 2019, when he stated: "This law seeks to establish the highest quality standards for solvency and transparency in the banking system and financial system so that they can play the important role that they are supposed to play." ■

# Colombia

The Bogota-based Colombian Securities Exchange, Bolsa de Valores de Colombia (bvc), has been investing heavily in technology to promote market development and support the adoption of digital tools for investment.

"We are upgrading all of our core trading systems, as well as the clearing and settlement system, to be able to expand our product offering, to enhance liquidity, and to facilitate automatic and high frequency trading," explains Juan Pablo Córdoba, president at bvc. "We are upgrading our technology to align with the needs of our clients, the intermediaries in the marketplace, and also to enable digital banking throughout the value chain."

The exchange is also adapting its processes to bring it into sync with international markets. In September 2019, bvc will begin clearing equities through its central counterparty (CCP) and will also transition to a T+2 settlement cycle. "This is a very positive step forward for the Colombian marketplace – enhanced security, adopting international standards, and new standards for the clearing cycle – all of this will help to enhance liquidity in the marketplace," says Córdoba.

## Developing Colombia's capital markets

One of the key challenges facing the bvc and the country's capital markets is encouraging smaller companies to list. Córdoba notes that while there is continued appetite among institutional investors, Colombia's capital markets typically tend to be the reserve of much larger corporations.

Both the government and the exchange have been taking steps to address this challenge. "The

**"The government has been very proactive in reducing the costs of listing, simplifying the procedure, and automating prospectuses, which all facilitates the process of coming to market."**

**Juan Pablo Córdoba, president at bvc.**

government has been very proactive in reducing the costs of listing, simplifying the procedure, and automating prospectuses, which all facilitates the process of coming to market," says Córdoba. "We are also working directly with investment banks, brokers, and companies to provide more information, explain that coming to market is not as difficult as corporations may think, and raise awareness of the benefits."

In October 2018, the government launched the Capital Markets Mission. This initiative brings together market experts to analyse barriers to market growth and offer recommendations as to how these hurdles can be overcome. At the Mission's launch, Luis Alberto Rodríguez Ospino, deputy minister of finance and public credit, stated: "There has been a consensus for quite some time that the capital market in Colombia is not as deep as it should be for the size of our economy. [...] There are still challenges to accelerate the depth, liquidity and efficiency of the market, which is why the national government is committed to generating an environment conducive to its development."

Córdoba says: "The government is very keen to help develop the capital markets in Colombia, and this panel of experts will consider how we can take the markets to the next level. We are expecting their diagnostic by the middle of this year and proposals around August. So, in the second half of the year there will be a very rich debate about the type of policies that need to be implemented in order to enhance the markets."

## Economy and politics

2018 was a presidential election year in Colombia, bringing with it the usual political uncertainty that accompanies election cycles. This came to a head in August 2018 when newly-elected Iván Duque, considered to be pro-business and market-friendly, took office.

In December 2018, the Colombian Congress passed tax reform legislation that will see the corporate income tax rate reduced from 33% in 2018 to 32% for 2020, to 31% for 2021, and to 30% for 2022 and onwards.

"This is creating a very positive mood in terms of economic activity and investment, and that is of course reflected in the markets which started off on a positive trend this year," says Córdoba.

The Organization for Economic Cooperation and Development (OECD) anticipates real GDP growth of 3.4% in 2019 and 3.6% in 2020. This compares to growth of 2.7% last year.

According to the OECD's *Economic Outlook* for May 2019, growth is expected to remain strong on the back of higher domestic demand. The report states: "Investment will be a key driver of growth, aided by a lower tax burden and infrastructure projects. Low and stable inflation and improving financing conditions will support consumption. Upside risks include higher oil prices, which could boost investment further. The tourism sector holds potential for upside surprises, thanks to the end of the armed conflict. Downside risks include regional instability, particularly in Venezuela, additional delays in infrastructure projects, and a spill over of financial volatility in emerging-market economies." ■

**"So, in the second half of the year there will be a very rich debate about the type of policies that need to be implemented in order to enhance the markets."**

**Juan Pablo Córdoba, president at bvc.**

# Mexico

The Mexican government kicked off 2019 with proposed changes to the pension system that would enable more pension funds to participate in securities finance activities.

The proposals would see Pension Investment Companies (Siefores) replaced by Pension Investment Funds (Fiefores), which would be granted greater investment flexibility. Under the changes, Fiefores would be able to take part in securities lending and repo agreements.

Amendments to the Retirement Savings Bill proposed by the Mexican Federal Executive branch were published in January 2019. The Mexican House of Representatives approved a revised version of the Bill on April 29 2019, and further revisions may be made when the Bill passes through the Senate.

## Economy and politics

Banco de México revised down its forecast for economic growth in 2019 to 1.1%-2.1% from 1.7%-2.7%, citing a more marked deceleration than expected towards the end of 2018 as a contributing factor in the downward revision.

The final quarter of 2018 featured the inauguration of leftist president Andrés Manuel López Obrador. The former mayor of Mexico City was sworn in at the start of December after winning the presidency in July.

"It is worth noting that at the beginning of a new administration there is usually a lag in public spending, which could affect economic growth," stated Banco de México's quarterly report for October-December 2018. "Additionally, there are different elements of public policy that have uncertain effects on the economy. This could contribute to a lower dynamism of economic activity in the early part of this year. Thus, significant uncertainty prevails regarding this outlook and it is deemed that the Mexican economy will continue facing a complex environment in which different external and domestic risk factors prevail in the forecast horizon."

Following GDP growth of 2% in 2018, the OECD also anticipates a slight slowdown to 1.6% this year, before rising to around 2% in 2020.

Speaking in May 2019 upon the launch of the latest *OECD Economic Survey of Mexico*, OECD secretary-general Angel Gurría, said: "The Mexican economy has performed well in recent years, but is now facing serious headwinds from the external environment and important structural challenges at home. The only response is to continue designing and implementing new reforms to instil confidence, improve the quality of public administration, increase opportunities, reduce inequalities and bring about a stronger and more inclusive society for all Mexicans."

According to the country's national institute of statistics INEGI, GDP growth shrank by 0.2% in 1Q19 compared to 4Q18, although it was up 0.1% on 1Q18. ■

**Mexico equities**

| | 2017 | 2018 | 1Q18 | 1Q19 |
|---|---|---|---|---|
| **Securities lending revenues (US$)** | 4,799,899 | 5,500,376 | 1,345,185 | 1,087,574 |
| **Average loan balances (US$)** | 869,126,110 | 990,700,145 | 1,167,903,271 | 929,600,537 |
| **Average fees (%)** | 0.56 | 0.56 | 0.46 | 0.48 |

*Source: IHS Markit*

# Peru

The IMF describes Peru as one of the top performers in Latin America since the turn of the century. Robust growth has helped close the income gap with the largest regional economies and reduce poverty significantly, while inflation has remained low.

In 2019 and 2020 the recovery of private domestic demand is expected to push growth above 4%, even as gradual fiscal consolidation takes place. In the medium term, growth is projected to converge to its potential of 4%, while headline inflation is expected to gradually increase to the middle of the central bank target range of 1-3%.

EquiLend and the RMA's most recent *Latin America Securities Finance Guide* notes that in order to address the paucity of securities based lending activity, the Lima Stock Exchange (Bolsa de Valores de Lima or BVL) and Cavali - the Peruvian central securities and settlement depository - have instigated improvements aimed at providing better information to international custodians as well as making the securities-based lending model more accessible to foreign short sellers.

Additionally, efforts were made to promote a Peruvian appendix within the Global Master Securities Lending Agreement or GMSLA framework. As Peruvian inventory from pension funds is now widely available, the key objective going forward is to attract new participants to the market on the short-selling side.

The report also notes that BVL and Cavali are working to create a CCP model that is expected to launch during 2020 and would take into consideration the potential benefits and

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**Miguel Zapatero, chief business development officer at BVL.**

limitations regarding foreign participation.

The last two years have seen significant developments in Peru in an effort to increase liquidity and overall trading volumes. For example, in March of this year, Lima Stock Exchange – in conjunction with Cavali, Citi Peru, Scotia Bolsa, Scotia Capital USA, and AFP Integra – launched an enhanced platform aimed specifically at attracting foreign investors. The enhancement included the drafting of the Peruvian appendix to the GMLSA as well as the acceptance of USD denominated collateral.

According to Diego Castro, head of securities services at Citibank del Peru, the platform enhancement is instrumental to the securities lending model as its operating environment will enable foreign investors to borrow and short sell equities in the market.

“The participation and collaboration of BVL and market players that are part of the value chain were a key component of this achievement,” he says. “Their collaboration helped to identify gaps and improve the model. Now we have a standard GMSLA appendix for Peru and an enhanced infrastructure that is more attractive to non-domiciled investors.”

Miguel Zapatero, chief business development officer at BVL, explains that in Peru, there is a securities finance market involving local banks, over-the-counter, which involves mainly central bank notes utilised for monetary policy by the central bank.

There is also a securities finance market at Lima Stock Exchange involving stocks and other listed securities. In 2018, the exchange recorded $700 million in repo transactions, mainly between local investors, both institutional and retail.

“Volumes are very sensitive to market performance,” he observes. “Regarding stock lending, we are at the first stages of adoption as the exchange is beginning to register regular intra-day short selling as well as stock lending transactions for longer periods.”

## Targeting increased securities lending participation

Stock lending requires participation from large pension funds, which own about 50% of the free float of the blue chips in the local market. Since April 2016, there have been several test transactions with pension fund assets.

The enhanced securities lending platform should help execution greatly as it makes available liquidity that was previously held at pension funds, says Zapatero. “It is expected that stock lending will represent between 1% and 3% of total turnover of the exchange within a few years, in line with markets such as Chile and Colombia. It may seem small, but it could be significant for specific names, as we expect this activity to be focused on a handful of liquid stocks at the exchange.”

The enhancement is the result of a two-year process working with all relevant parties, including local regulatory bodies. The lending transaction in Peru will still require a local broker dealer to act as stock lending/borrowing agent, but the exchange has brought full visibility to the

**"Price discovery in Peru could be greatly improved by using the right tools, harvesting significant rewards in the process if it is properly conducted. However, it is a long-term effort."**

**Miguel Zapatero, chief business development officer at BVL.**

asset and money flows involved in the transaction by leveraging the custody and clearing capabilities of Citi Peru. Supply is provided by Integra, one of the largest pension funds in Peru and part of Sura Group.

"Also, we have introduced more standard governance between the local agent and the final participant in the shape of the Peruvian appendix within the GMSLA framework," says Zapatero. "Investors don't take Cavali risk, as their collaterals are separated and Cavali is a bankruptcy remote entity. Local regulation provides additional layers of risk controls within the actual trade at the exchange."

Cavali will soon accept international stocks and ETFs as collateral in addition to cash and Peruvian securities, which is seen as another way of promoting participation of foreign investors.

When asked to outline the main obstacles to increasing foreign/cross-border and domestic participation in securities lending and borrowing in Peru, the chief business development officer at BVL suggests that it is a chicken-and-egg situation in that Peru represents only 0.3% of global emerging market benchmarks, represented mainly by American Depositary Receipts (ADRs) and little representation of locally-traded names.

"Peru doesn't have local hedge funds due its low liquidity and because nobody could functionally borrow from the pension funds in the past," explains Zapatero. "In addition, local know-how is limited, particularly in the short selling/stock lending area. As local volumes are small, many traditional players have little incentive to develop or invest in new securities trading technologies or put additional resources to work in this area."

Nevertheless, there are players willing to invest and use their global reach to develop new solutions, such as Scotia Capital USA and Citi Peru, he adds. "By building an enhanced model for stock lending, we are hoping to break the inertia and put the massive inventory from the pension funds back into the market. Price discovery in Peru could be greatly improved by using the right tools, harvesting significant rewards in the process if it is properly conducted. However, it is a long-term effort."

Developments in Peru have also been held up as an example of what can be achieved across the wider South American securities finance market as the RMA - in conjunction with local participants such as Scotiabank, Citibank and the local exchanges - looks to drive education and development.

So what further steps need to be taken to ensure the future growth of securities finance activity in Peru? According to Zapatero, communication is a big part of the effort and Lima Stock Exchange has been working with the two international custodians present in Peru - Citi Peru and BNP Paribas - to bring true DVP to the market.

"This development - added to the possibility to have international stocks and ETFs as collateral - expands the possibilities of foreign investor participation in the Peruvian market," he concludes. "Also, Cavali is working with the government and other players to develop a government bond lending and repo market to expand the liquidity in the fixed income market." ■

# United States

US equities securities lending revenues came in at $593 million in the first quarter of this year, according to data from IHS Markit. This represents a double-digit decline on the $726 million recorded in 1Q18.

Mark Skowron, senior vice president, global securities lending trading at Northern Trust, says: "During the first nine months of 2018, US equity markets rallied, with the Nasdaq posting a 12.5% gain. At the same time volatility, as measured by the CBOE Volatility Index (VIX), remained relatively subdued. This environment contributed to hedge funds maintaining a net long bias, with softer demand on the short side of the market negatively impacting lending activity.

"Equity markets globally experienced a significant reversal in sentiment as a seemingly more hawkish Federal Reserve raised interest rates for a fourth time in December and signalled yet more rate increases for 2019. The market, fearing that ever higher interest rates would derail the growing US economy, reacted negatively, with a massive de-risking and de-leveraging taking place and Nasdaq share prices falling 17% for the month." The impact on equities – including negative marks to market, covering of profitable directional short transactions, and a reduction of short hedges as long exposure was reduced – had a negative knock-on effect on loan volume.

Skowron continues: "As 2019 began, the Fed pivoted to a more dovish stance, signalling a more flexible posture towards future rate movements. The market embraced this new stance and by the end of Q1, rallied 25% from the December lows. This rally resulted in additional short covering and further weakened already soft borrower demand."

**“We saw utilisation declining as we went into year end and that, combined with the more dovish stance of the Fed in addition to the market rebound, placed challenges on securities lending fees.”**

**Richard Marquis, managing director and Americas (ex-Canada) regional equities finance trading head at BNY Mellon Markets.**

The correction seen in late 2018 put downward pressure on the securities finance market and disrupted year-end positioning, explains Richard Marquis, managing director and Americas (ex-Canada) regional equities finance trading head at BNY Mellon Markets. “We saw utilisation declining as we went into year end and that, combined with the more dovish stance of the Fed in addition to the market rebound, placed challenges on securities lending fees.”

Subdued borrower demand is anticipated to persist in 2019. “A lack of investor conviction, largely driven by uncertainty around the outcome of US/China trade negotiations and a general softening in global growth, along with resilient risk asset prices, have many hedge funds on the side-lines and/or continuing to maintain net long exposures to take advantage of rising equity prices,” states Skowron.

## Specials

One of the notable trends thus far in 2019 is lack of growth in demand for and conviction to hard-to-borrow securities. “A large portion of the trading that we are currently seeing is in the GC universe and the commitment to the fundamental hard-to-borrow space is limited, though there has been solid focus on deal based strategies,” says Marquis.

IHS Markit found the dearth of hard-to-borrow stocks with significant balances to be a revenue growth pinch point for US equities in 1Q19; specials balances declined by 32% year on year, with just over $7 billion in balances with fees of more than 500bps.

However, there have been some bright spots in specials demand. Sam Pierson, director, securities finance at IHS Markit, points to pockets of demand such as US-listed cannabis stocks, Chinese ADRs, and IPOs, for example, Lyft’s

**United States equities**

| | 2017 | 2018 | 1Q18 | 1Q19 |
|---|---|---|---|---|
| **Securities lending revenues (US$)** | 2,775,146,267 | 2,642,240,156 | 726,412,806 | 593,895,843 |
| **Average loan balances (US$)** | 413,986,928,167 | 461,131,414,475 | 422,475,421,854 | 468,624,874,246 |
| **Average fees (%)** | 0.67 | 0.58 | 0.69 | 0.51 |

*Source: IHS Markit* IHS Markit

March 2019 listing on Nasdaq was briefly the most expensive to borrow US equity with more than $10 million in loan balances. Some of the smaller float IPOs such as Beyond Meat have seen special fees for longer following public listing.

Corporate actions, in particular Eli Lilly's exchange offer for its holdings of Elanco Animal Health, also remain key drivers of securities lending revenue, adds Pierson. Eli Lilly was the second highest revenue-generating security in 1Q19.

### US Treasuries

The US budget deficit reached $779 billion in the 2018 fiscal year, ending on September 30. The rising deficit – $113 billion more than in fiscal year 2017 – left its mark on the US Treasury repo market.

Skowron says: "The start of 2018 was punctuated by large auctions of Treasury Bills, driven by a widening government deficit, adding a significant amount of inventory to the market. This increase in inventory pushed the yield on repo higher, as dealers were forced to pay higher levels to fund this new supply. Cash reinvestment yield, as measured by three-month LIBOR levels, rose in lockstep with higher repo and rebates. This tailwind, attributed to higher LIBOR and reinvestment yields, subsided as the year wore on, resulting in lower overall spreads on cash based loans in the latter part of the year."

Meanwhile, demand for high quality liquid assets (HQLA) to meet regulatory obligations remained strong. "Borrowers sought US Treasuries versus a pledge of non-cash collateral, with particular interest in pledging equities for the added benefit of the balance sheet efficiency that it achieves," explains Skowron.

### Collateral flexibility

From a regulatory perspective, momentum appears to be picking up around changes to the SEC customer protection rule 15c3-3, which would enable US broker-dealers to pledge equities as collateral when borrowing equity securities.

> **"The start of 2018 was punctuated by large auctions of Treasury Bills, driven by a widening government deficit, adding a significant amount of inventory to the market."**
>
> **Mark Skowron, senior vice president, global securities lending trading at Northern Trust.**

BNY Mellon's Marquis believes this would help level the playing field for the on-shore US securities finance market, where participants face greater restrictions around the use of equities as collateral. At the same time, such changes may require increased awareness around their impact across the value chain. "Outside of a significant market correction, there will be a move to more non-cash collateral in the US equities space, we have been discussing the potential developments with our beneficial owners and, following any regulatory change, it will be up to us to educate them how to best optimise the new landscape and the impact of these changes," he says.

The impetus on increased and more diverse non-cash collateral utilisation continues in the US. "Borrowers have been challenged in recent years by regulatory constraints such as regulatory capital rules, Basel III liquidity coverage ratio and net stable funding ratio and the need to manage balance sheets more efficiently. As a result, lender type and jurisdiction has become a key determining factor in lending activity," notes Skowron. "Looking forward, client type will become part of the upfront trade criteria requested by borrowers for certain transactions. Lenders with a flexible collateral schedule, along with a low risk weighting, are viewed as desirable counterparties to transact with given the benefits borrowers can achieve through this activity."

## Laying the foundations

Both in North America and globally, securities finance market participants are adapting to a range of regulatory and technical developments. "There has been a fundamental shift, driven by both necessity and design, where intellectual and technological changes that have taken place over the last few years are now coming to the fore," says Marquis, who explains that the current muted trading environment is enabling firms to "set the table" for a future correction in the market. This includes a focus on areas such as cost maintenance, personnel and system development.

When it comes to technology, concepts such as artificial intelligence, machine learning and robotics to support trading are also gaining traction, says Skowron. "The shift of investor cash out of fundamental long/short strategies into quantitative strategies will require ongoing investments in trading technology as these more 'algorithmic' type strategies rely heavily on automation and straight through processing capabilities," he concludes. ■

**Top 10 revenue-generating stocks in North America: 1Q19**

| Instrument name | Sector | Country |
|---|---|---|
| **Nio Ads Rep 1 Cl A Ord** | Automobiles and components | CN ADR |
| **Eli Lilly And Co** | Pharmaceuticals, biotechnology and life sciences | US Equity |
| **Elanco Animal Health Inc** | Pharmaceuticals, biotechnology and life sciences | US Equity |
| **Canopy Growth Corp** | Pharmaceuticals, biotechnology and life sciences | CA Equity |
| **Tilray Inc** | Pharmaceuticals, biotechnology and life sciences | US Equity |
| **Sociedad Quimica Adr Rep 1 Srs B Ord** | Materials | CL ADR |
| **Gtt Communications Inc** | Software and services | US Equity |
| **Aurora Cannabis Inc** | Pharmaceuticals, biotechnology and life sciences | CA Equity |
| **Accelerate Diagnostics Inc** | Pharmaceuticals, biotechnology and life sciences | US Equity |
| **New Age Beverages Corp** | Food, beverage and tobacco | US Equity |

*Source: IHS Markit* IHS Markit

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### For more information, please contact the HSBC Prime Finance Team in Americas:

Christopher Rosen
Head of Institutional Equity Derivate & Delta-One Sales, Americas
E: Christopher. rosen@us.hsbc.com
T: 212 525 3200

Matt Kiraly
Global Head of Origination
E: matthewjkiraly@us.hsbc.com
T: 212 525 4202

Warren McCormick
Head of Equity Finance & Delta-One Americas
E: Warren.mccormick@us.hsbc.com
T: 212 525 0180

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