PARTICIPANTS

- **Alastair O'Dell,** Global Investor Group (Chair)
- **Ashore Badou,** securities lending analyst, BMO GAM
- **John Arnesen,** global head of agency lending, BNP Paribas Securities Services
- **Mick Chadwick,** head of securities finance, Aviva Investors
- **Stephen Kiely,** head of sales and relationship management, securities finance Emea, BNY Mellon
- **Donia Rouigueb,** securities lending & collateral management solutions, Caceis Investor Services
- **Mark Hutchings,** chief operating officer, Isla

PROSPECTS PROGRAMM

Beneficial owners and securities lending experts met in London to discuss future of securities lending including new routes to market, indemnification arrangements and trends in collateral usage

O'Dell: Ashore, how is your programme progressing? Which routes to market do you use?

Ashore Badou: We have quite a small, boutique agency lending programme, whereas in our previous F&C guise it was in-house. I look after our programme, which has been running for seven years. We initially had two lending agents and at the moment we are with State Street. We currently lend on three separate ranges.

We're not currently signed up to a CCP. We were all hit by 2008/09 and even now the investment managers are wary. Whenever we want to introduce anything they think about it a lot and we need to get over a few hurdles. We try to explain things such as transparency and reduced processing costs and defaults, but it is a slow burner as all associated risks need to be articulated in full.

Chadwick: You're not unique – we are not yet signed up to a securities lending CCP. Most buy-side firms have an innate antipathy towards central clearing. They were dragged kicking and screaming into clearing OTC derivatives – but this should make the education and approval process slicker for securities lending. However, unless we come under serious commercial sell-side pressure it will not move up the priority list.

O'Dell: Why hasn't that pressure materialised?

Chadwick: I think it's a question of when, not if, as the ship has sailed for Basel III RWA rules. There's a world of difference between 2%, 20% and 100% so the squeeze will come. These metrics are being measured on the sell side, but often only at the top of the house so it may take

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a while for pressure to trickle down to trading desks.

Rouigueb: Sell-side participants usually push the buy side to adapt the business in order to comply with the regulations that they face. Beneficial owners will only think about it if they see their revenues decrease. But as of today we don't see that many sell-side participants in CCPs, or pushing to enter because even they say it is too expensive regarding haircuts and costs.

Kiely: It has to manifest itself in price, which is demand-driven. If it costs five bucks there's going to be ten bucks of revenue, otherwise beneficial owners will say it's not worth it. Some may start to feel lower utilisation and not be part of bigger trades – the geopolitics of certain jurisdictions mean borrowers are less willing to over-collateralise. When the borrower initiates two-tier pricing there will be movement, but not before.

Chadwick: There could be potential advantages to CCPs for agent lenders, not just the sell side, if you've got clients domiciled in jurisdictions with enforceability issues or capital implications for indemnification provision.

Arnesen: It's a good point. Certain trades are net-able on a CCPs so we may gain an advantage using this route. Esma chair Steven Maijoor said he wants lending in a cleared structure. He'll get it, but we're still debating nine years on and may not have it in another three. We deal with banks that calculate their own live RWA at the desk level and still I don't feel pressure. I'm amazed.

Hutchings: It's very low on the to-do list. Agent lenders talk about it being possible but where's the driver to make CCPs happen? There are still a number of hurdles to overcome, but once they are the agent lenders need to sell it to their underlying clients. If you're not putting it high up on your to-do list, it's not going to happen anytime soon.

Arnesen: If I'm not convinced by the concept of CCPs I'm going to have a hard time selling it.

Badou: CCPs need to give us the minutiae. I haven't heard anything tangible about transparency, particularly reporting, and I need to report every comma and full stop to the investment management team. I need to know about every piece of collateral – what it's doing, how it's priced – and I can't get that from the CCP. This has echoes of the old Euroclear automatic lending programme – the reason we pulled out was its lack of transparency and reporting.

Kiely: CCPs have come to understand margin haircut and transparency issues. My concern is that this is yet another thing that beneficial owners, especially smaller ones, have got to contend with. There is a legal cost to making amendments or re-papering to include a CCP. On top of this, SFTR is coming up.

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O’Dell: **Is the pledge structure of CCPs a problem or can it be overcome?**

Arnesen: For CCPs I would have to alter the agreement from title transfer to pledge and convince clients that that’s okay. Then, I need to explain to my risk managers how indemnification is either rendered obsolete, still has to exist or applies to the CCP. They’ll want to know the entire risk management structure, which CCPs won’t share.

Rouigueb: With CCPs, the collateral is technically not in your house, only pledged. Ucits funds cannot technically take pledges. Regarding the other types *of clients, they might be able to accept the pledge but may not be able to post it elsewhere.*

Arnesen: This came up at an FSB meeting in April 2015. The industry said: ‘Don’t worry, rehypothification doesn’t happen at the agency level’. But someone argued that if the title has passed to the client they could re-use it – they wouldn’t prevent them doing so. It was a long conversation.

Chadwick: The whole SFTR disclosure obligation is based on creating awareness of the agreements under which collateral is re-used. But the issue for beneficial owners is that neither pledge nor CCPs is going to be a comprehensive solution, it will co-exist alongside the current model. It just adds complexity.

Rouigueb: Our clients might want to re-use non-cash collateral to cover exposures with their clearing brokers. They know what kind of collateral they have in-house and they would like to be able to move it. Clients have asked us for this – I have had the question on RFPs.

Arnesen: It’s interesting that you get clients saying they will use the cash collateral for the lending programme and non-cash for other purposes. And, they’re going to slightly change the model so that it won’t appear that they are collateralised. Most of our institutional clients would say the lending programme is blocked off. But, in theory, it’s doable because they’re their assets.

Kiely: The only time we see that is with cash collateral, particularly when clients have a cash transformation programme with us, lending their assets in order to raise cash.

Chadwick: Even if it’s legally permissible to re-hypothicate non-cash collateral, the operational mechanics mean it’s very difficult to move that out of the tri-party ecosystem and put it to work elsewhere. It’s problematic for Ucits – the depository needs to see that collateral and record it.

Hutchings: Imagine the risk processes you’re going to have to go through! And, leaving all this aside, the regulators are going to be very concerned about this whole activity. The collateral is meant to be there for a purpose. SFTR reporting will come into effect in late 2018 and regulators will be looking hard to see if there are any issues, especially around the re-use of collateral. Also, regulations around securities lending for Ucits funds are subject to interpretation and as such this restricts their potential. In this instance we are talking about doing the opposite something the current interpretation of the regulations does not allow.

O’Dell: **What is the current thinking of local regulators on the issue?**

Hutchings: There is some movement. It’s all about the interpretation of the Ucits Directive and Esma’s guidelines and local regulators apply the law differently. The largest ones, Ireland and Luxembourg, take different views. Luxembourg has taken the directive’s wording literally, which doesn’t actually make clear anything about pledge and only references title transfer. Ireland has followed the Esma guidelines, which leaves the possibility of providing collateral under a pledge open. The point is that interpretation of the regulations could suggest pledge is possible.

Rouigueb: Clients want to follow the philosophy of the Esma guidelines which say you need ‘real’ collateral, whatever jurisdiction you are under. Clients are very cautious when it comes to regulators, even if they are technically right.

Hutchings: Isla has a working group looking at Ucits. According to our latest Securities Lending Report, globally, approximately 45% of lendable securities come from mutual funds, which includes Ucits, with on-loan balances of 15%. This is out of line other lender types that see far higher on-loan balances compared to lendable and we highlighted this point in our Capital Markets Union response to the European Commission, showing major untapped potential for improving liquidity in the market. Asset segregation would also be an issue. Also a lot of people are interested in pledge structures and so we are working with legal counsel to come up with standard market pledge documentation.

Kiely: The development that could have significant effect on tri-party collateral is SFTR. If every single collateral movement must be reported, it could mean reporting 1,000 movements rather than a handful. What about the cost, who is getting indirectly charged?

Hutchings: This is something of particular concern for the small beneficial owners, the small Ucits funds. An Isla member recently said a big concern of SFTR is transaction reporting costs, as they are going to hit each individual account. The Emir rules state there's a charge of €2,000 per account, so every single Ucits sub-fund is going to get charged that amount, and that's before the movement costs on top of that, which still has to be fixed. This could have the impact of making the cost of lending unviable for those smaller funds.

O'Dell: Is peer-to-peer lending even more problematic for beneficial owners?

Chadwick: Peer-to-peer is tricky, if I look at the complexity of our fund structure and the sometimes bureaucratic guidelines for counterparty eligibility criteria. They were drafted pre-crisis assuming that counterparties are rated banks subject to prudential regulation. Even if you are prepared in principle to contemplate peer-to-peer, you're trading in an OTC environment with a non-bank entity. It opens a whole new front with reputational risk and other issues.

Badou: You think you know who you're trading with, but if your agent lender is trading through an affiliated borrower you would use up your risk concentration and perhaps on occasion breach your parameters.

Kiely: This may be a hurdle for the buy side. Do they want to go through this rather than trade with, say, 50 borrowers of a certain rating? They can hang their hat on an agent's approved list as it's already done all the credit intermediation. With peer-to peer they have to do an element of this themselves.

Rouigueb: Peer-to-peer in an interesting idea but we need to be practical. Think about all the ratios, systems, risk control, reporting, settlements etc. Would this model cover these costs?

Arnesen: Peer-to-peer may not disintermediate the agent lender – it might just reinvent them.

Kiely: Peer-to-peer platforms are a child of their times. BNY Mellon owns DBVX so we're already gearing up. They are all web-based, so there is very little IT to build, and they are repo-focussed as broker-dealers have reduced capacity in short term repos.

Peer-to-peer is a supplementary product, I see it as an outlet for excess cash. If the cash reinvestment desk cannot place it I can see them putting some through a peer-to-peer platform.

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Chadwick: The sell-side used to be worried that peer-to-peer would cannibalise their OTC franchise. Now they've got limited repo capacity with their own balance sheets so they appear increasingly prepared to facilitate trading on a peer-to-peer platform. Historically, most buy-side firms are price takers so if two buy-side firms trade, who sets the price?

Rouigueb: Price discovery is less of an issue nowadays as we now have all these data providers and benchmark reports.

Arnesen: If, for example, a cash-rich institutional client wants cash and an insurance company is long of it, they may want to use our facilities. I wouldn't indemnify them, of course, but might charge a fee. There's no way they would put in the infrastructure, given the hoops they'd have to jump through internally. The rise of platforms such as Elixium will be interesting to watch, and we'll take our cue from that.

O'Dell: Would you use a peer-to-peer platform?

Badou: We've had discussions. They produced some quite big numbers on the uptick, what we could add incrementally to securities lending. Maybe I'm being naïve, but I don't think it's that convoluted if you have a good link with your agent and good technology, which is all on the cloud. It's good for incremental income and liquidity, but selling it to buy-side boards, given the risk parameters and transparency, is hard.

We managed to on-board a few of our funds to lend securities a few years ago and they have since made significant gains in their sector because of the added value. They were pleasantly surprised at the impact securities lending had on their fund performance.

Kiely: A couple of years ago, a beneficial owner would have said it was too complex to set up, even if they had excess cash sloshing around. Since then it has become a drag on performance so they are interested. At the moment, every basis point (bp) matters.

Chadwick: Yes, especially given the current interest rate environment and the relative performance culture of long-only asset management. A couple of bps can really move the needle for low-fee passive products. Over the last 18 months I've had clients beat me up about not being quick enough to mobilise – I've never had that before. My clients aren't prepared to dial up the risk but, within their agreed risk appetite, they're keen to maximise every opportunity. If you trade via a bank you leave some performance on the table but if you disintermediate and trade directly there is potential reputational risk.

O'Dell: Indemnification has become much more costly to provide and there is increasing pressure on beneficial owners to go without it. Could you continue without indemnification?

Badou: I could not go to our board or fund ranges and announce that we are not getting indemnified. They see it as a vital cog. They see it as another layer of insurance, along with the collateral and the risk parameters on that collateral. We have a very good indemnification at the moment and they're comfortable. I know for a fact they would not entertain any change in our indemnity.

O'Dell: If it's that important, would they pay more for it through the fee split?

Badou: They have suggested that they would be prepared to pay a little bit more, maybe 5bps. But we've been with State Street for six years and I cannot imagine they will start to change the programme's structure, given its boutique nature,

but anything is possible. We have some very good securities in our programme and have had very good incremental income. State Street is not going to bite their nose off to spite their face by upping the cost. A couple of years ago there were suggestions indemnification costs could rise but these never materialised.

Kiely: I get more questions about indemnification than I get about collateral liquidity. It's odd because when I get into a car I ask if the brakes work before I ask if the insurance is up-to-date. Don't you want to know that the processes are right before you worry about the worst-case scenario?

You could just indemnify some trades. Is there a need to indemnify GC loans? And most insurance has an excess, and/or an insured amount and a cap – I can see that coming. Agent lenders have resisted changing an existing fee split, but certainly new clients could be offered two-tier pricing. We will pass on the business if it doesn't meet our return on capital calculation – Basel III changed everything.

Rouigueb: Indemnification can come in many forms but if clients go into an agency programme with a request for full indemnification it is going to cost them. The reality is that today's margins and balance sheet constraints do not allow agent lenders to be as flexible as they used to be.

Hutchings: Do we not think that haircuts do the same job as indemnification? If your haircut policy and collateral is well constructed, theoretically indemnification is not going to be required. You don't necessarily need indemnification, the collateral and haircut should be doing the job. Indemnification came about to give comfort to less engaged beneficial owners – the problem is that everybody had to

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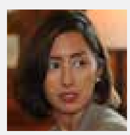

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jump on board and offer indemnification to be competitive.

Arnesen: There's a cost, and it may increase, so it should be priced correctly. Somebody will always offer a very high fee split with indemnification – we need to compete and I'll never be able to have this conversation with a sovereign wealth fund. But, if we absorb something, what are we trying to achieve? In theory we should never have another Lehman event but there could be a need to invoke it and it could be very expensive. My concern is that we're still pricing it as if the risk doesn't exist.

Agreements are not all-capturing – you could end up with cash at the last mark-to-market price. If they defaulted five, six or seven days ago you could still be out of pocket.

Chadwick: Consider what you're indemnifying against – in all probability the default of a systemically important bank. How prudent is it to hang your hat on indemnification provided by another systemically important bank? All bets would potentially be off in a major bank default scenario. Sophisticated clients say it's nice to have but not a deal breaker. Nobody should rely on it as their principal risk mitigant.

Smaller clients may not have the resources, bandwidth or engagement to do the due diligence on the other risk mitigants in a programme. They look at the risk involved and think: 'If my provider is a household name and they're indemnifying it, job done.'

O'Dell: The agents want to change the terms but many beneficial owners say they cannot or will not accept the changes, at least for now. Where will we end up?

Rouigueb: Clients understand the issue very well but it will come down to agent lenders to put in conditions as we are the ones with the constraints coming from above. For example, by not indemnifying 100% of the transactions. We have seen these kinds of metrics in RFPs, such as the type of collateral accepted or the geographic zone of the securities to which indemnification applies. It is always about equilibrium, and the client should be able to understand that.

Arnesen: Sometimes I hear people say that if we're indemnifying the client we should be able to pick the collateral. While this is a misnomer – because the client is always the principal right up until default – maybe there should be more conversations. If they insist on a certain fee split and indemnification the only way for us to generate revenue would be to insist on certain forms of collateral – but I've never done it that way before.

Rouigueb: That is what we are doing. When we run portfolio analysis for our new clients, we explain that if they want indemnification for a potential default we will not allow them to take very illiquid assets as collateral.

Arnesen: I've been reluctant to do that – we always talk about it being customised and it being their risk. I'm getting into a lot of discussions internally about pricing business. It's all leading to more transparency, even discussing with clients why they are priced differently. But how do you go to a fund and tell them they really need to take secondary index equity?

Chadwick: To be blunt, in most cases they would say 'No way'. They're generally not going to dial up the risk in pursuit of an arbitrary revenue target. We get occasional requests to take unusual collateral but given the bureaucracy and inertia associated with buy-side decision-making we'd need a fairly lumpy potential revenue number to justify it.

These conversations seldom take place in a vacuum – normally there is a broader relationship. If an agent lender pushed back the senior relationship manager would be running around fretting about losing the relationship.

O'Dell: How important is the collateral matrix for overall programme revenue?

Rouigueb: It is an important factor for programme performance. Af-

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ter Esma came up with a collateral framework in 2012 people felt more comfortable enlarging their collateral matrix, up to a certain point. The other thing was the emergence of the liquidity management, which is now a part of clients' revenues and is based on clients' collateral matrix optimisation.

> **Kiely:** I inform Ucits clients, which are regulated by Esma, that their collateral constraints make their assets appear less attractive. I am honest – there's no point telling them they could make X but find at the end of the year 1 they've only made Y because of restricted collateral. Outside of Ucits, collateral guidelines have widened. Over the last few years we have seen an increased use of equities and ETFs are now coming into the mix.

> **Chadwick:** The critical thing is the experience of 2008/09. People lending fixed income securities in some cases accepted structured credit products as collateral, thinking it would be well-correlated with the underlying loaned assets. However, during the crisis the secondary market for even supposedly liquid investment grade credit products fell off a cliff. Equities may not be so well correlated but they trade on an exchange and data can help set prudent haircuts and collateral concentration limits.

> **Badou:** Over six years our collateral matrix has changed, but ever so slightly. We've gone into FTSE250 equity DBVs and we're now potentially looking at taking equity indices as collateral.

O'Dell: Is anyone still concerned about a collateral shortage?

> **Arnesen:** Let's hope a squeeze happens as most of what we do is GC. I need to find homes for large swathes of GC equity. There isn't a single equity market that reaches double-digit utilisation. I don't know if collateralisation will make it move. Low utilisation is a function of risk profiles and €16trn of supply in the market, the highest ever level in a market where demand has halved since 2009.

> **Kiely:** There's a cumulative effect as more products are requiring collateralisation with cash or high-quality liquid assets (HQLA), so there is going to be a bit of a squeeze. Will there be a collateral cliff? No. Will there be a squeeze? Probably yes, but not severe.

A shortage would affect supply. For years we've been used to broker-dealers optimising through tri-party, but this is moving to the buy side. I don't want my buy-side clients using assets that have intrinsic value, to collateralise for example FX forward positions.

> **Chadwick:** That's certainly part of our expanding role within Aviva Investors. Effectively, we're a centralised collateral inventory warehouse. A lot of derivatives collateral still takes the form of cash but there will be greater pressure to mobilise alternative eligible assets such as government bonds. We make sure that we don't deliver securities that've got intrinsic value.

> **Hutchings:** In our latest Securities Lending Market Report the one thing that's quite clear is the changeover in demand over the last few years, particularly towards HQLA and, more importantly, the amount out on loan for over three months.

> **Arnesen:** Our weighted average maturity (WAM) is certainly beyond 35 days. The WAM is within the annex of the agreement. Clients take comfort from the fact that we have a portfolio large enough to maintain their liquidity. I've always found the real selling point is in accepting primary index equity as collateral, which we indemnify.

O'Dell: Is the liquidity of collateral important?

> **Kiely:** All the time – it can be more important than credit. In 2008/09, even if you were collateralised at 200% with AAA-rated MBS or ABS you could still have been underwater.

> **Chadwick:** It goes back to the historical perception of good collateral. In a default there's only two things you can do, sell it or keep it. One business within our firm looks at bespoke transactions involving illiquid collateral such as structured credit and social housing loans. There's no liquid secondary market for this stuff at the best of times. You have to scientifically analyse whether it's a good replacement asset. If you take a big enough haircut and know it's going to mature at par in five years, will the cash flow meet the client's liability profile? It's a very different set of risk assumptions and risk models.

> **Kiely:** Do clients have the ability, capability and desire to look at that? Most perform limited credit analytics. Credit agencies put signs on bits of collateral – but clients must trust the agency and hang their hat on that. I'm surprised people still do.