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Automation Has Greater Impact As Securities Lending Increases

By John Hintze

Technology is taking hold in securities lending, one of the few remaining relationship-dominated bastions among Wall Street's many niche trading communities, and industry participants are anticipating more profound changes in the next few years. That was the message emerging from the industry's annual conference in Rome at the end of April, sponsored by the London-based International Securities Lending Association and Philadelphia's Risk Management Association, and it was underscored by executives who have been promoting automated solutions to securities lending's complexities.

"Securities lending has been a fairly opaque business historically and very operationally intensive, but it lacked to a tremendous degree any sort of standardization," said Brian Lamb, CEO of EquiLend Holdings, a New York company that, along with SunGard Data Systems, has taken the lead to standardize and automate the asset class with centralized electronic platforms where buyers and sellers can interact by means other than phones and faxes. SunGard launched its Loanet Centralized Order Routing four years ago in the U.S.; it automates borrowers' queries about the availability of securities from preestablished lenders, and SunGard extended the service globally a little more than a year ago.

EquiLend, a joint venture of top Wall Street banks, has pursued a global strategy since it began operations in 2002, automating securities-lending transactions in 26 markets. Its AutoBorrow function, for example, allows users to set transaction parameters: A securities borrower may give a counterparty five minutes to lend up to 40 percent of the order before moving on to other potential counterparties.

Lamb said that EquiLend today facilitates mostly high-volume, low-margin transactions, though he expects more customized, higher-margin deals to eventually go through as well. "Why avoid high-margin business if you can reduce costs?" Lamb said.

In fact, EquiLend's Negotiation function, available since day one, provides the ability to negotiate less-standard transactions on screen, outside the established parameters in AutoBorrow. Lamb said clients aren't using Negotiation much now, but, "as CEO of EquiLend, I'm going to promote the use of that more and more as time goes on."

Brian Lamb

Even if EquiLend is mainly used for customers' plain vanilla business for now, the growth of the firm—a broker-dealer in the U.S. and alternative trading system in Europe—has been rapid. Its fixed-income transaction volume jumped more than threefold, to $241 billion (107,108 transactions), in the year ending March 31, from $76 billion (68,319 transactions) in the previous 12 months. Meanwhile, equity volumes rose 65 percent, to $1.7 trillion (2,352,509 transactions) from $1.1 trillion (1,472,956 transactions).

Lamb explained that the leap in fixed-income transactions resulted in part from a concerted push last year on the part of EquiLend and its clients to transact Treasury and sovereign debt lending transactions over the platform. "The notionals tend to be very high—$15 million or more [per transaction]," Lamb said.

EquiLend's volume has also been pushed higher by major financial institutions that have started using its platform—Lamb said the client base increased 70 percent over the last year—including ABN Amro, Mellon Bank and Société Générale. Another factor has been the securities-lending industry's overall growth.

"There are a number of reasons why a firm would want to use EquiLend," said Eugene Picone, the venture's chairman and SVP of JP Morgan Chase & Co.'s securities-lending division. "From JP Morgan's perspective, we see the value in the overall economies of scale that we have been able to extract from the system. In the last year we have increased balances by over 100 percent and enjoyed a 20 percent improvement in our cost-efficiency ratio. For other participants, the cost story is also true, but also more compelling is the centralized access to counterparties. The technology allows them to compete in a way that they never could."

Tim D'Arcy, managing director of operations and technology at New York-based Astec Consulting Group, said his firm's estimates, derived from Federal Reserve data, put the volume of outstanding stock loans in the U.S. at $1.5 trillion at mid-year 2005, compared with $1.3 trillion at the same time in 2004. The loan volume is probably up another 20 percent so far this year, which D'Arcy attributes to hedge fund activity as well as proprietary desks designing derivatives for asset-manager clients that include stock loan components. D'Arcy added that the principal-to-principal nature of non-U.S. securities lending and the blurred distinction between securities loans and repurchase agreements makes it difficult to estimate volumes outside the U.S.

Along with EquiLend's announcement of recent growth data at the Rome conference, Sharon Walker, the London-based managing director of EquiLend Europe, said, "European growth has been explosive. Firms are truly excited about EquiLend's value proposition, and many of the recent joiners in Europe are opting for EquiLend's Express Solutions offering, an expedient route to market, with plans to migrate over to the full-featured EquiLend platform."

Joint Industry Effort

Lamb took the helm of EquiLend last September after 17 years with Barclays Global Investors (BGI). He said he "grew up" in BGI's securities-lending business, first as a generalist, then specializing in fixed income as a product manager, and eventually moving over to the collateral reinvestment side of the business where he ran the cash strategy division. He worked with representatives from the nine other companies that initially funded and launched EquiLend. (The current investment group consists of BGI, Bear Stearns & Co., Credit Suisse, Goldman Sachs Group, JP Morgan, Lehman Brothers, Merrill Lynch & Co., Morgan Stanley, Northern Trust Corp., State Street Corp. and UBS.)

An EquiLend board member since its inception, Lamb worked with former CEO Dirk Pruis, who left in April 2005 to join Michigan's Calvin College as VP of advancement. BGI adopted EquiLend early on, Lamb said, and found it was "able to grow our business by multiples and really not have to add headcount." EquiLend thus plays into the cost-cutting and scalability themes that attract Wall Street technology dollars. In addition to market forces, Lamb said, new industry and regulatory initiatives will further increase securities-lending participants' need for transparency and automation.

In the first category is the Agency Lending Disclosure (ALD) initiative, an effort led by several securities-lending players and organized by consultancy Capco. The objective is transparency: to have agent lenders disclose the names of the principals lending the securities so their creditworthiness can be evaluated by borrowers. The second step of ALD is scheduled to go into effect in August, when counterparties will be asked to transmit data to update capital requirements on a daily basis. Lamb said EquiLend began supporting the first phase early this year and will have functionality to deal with the second by the deadline. "In my opinion, once ALD is live in the U.S., we'll likely see that model adopted elsewhere," Lamb said.

One reason for the likely "globalization" of practices is the Basel II capital adequacy requirements, which take effect in Europe next year and in the U.S.—where the largest banks will be most affected—in 2008. Although ALD focuses on identifying and monitoring a securities principal and the risk identified with that principal, and Basel II centers on allocating the proper regulatory capital in lending transactions, their risk-control goals are intertwined.

"One is about greater transparency of principals, the other is about the more efficient use of capital to make sure risk is mitigated," said Lamb. "ALD could help on the Basel front because it could facilitate allocating the appropriate amount of collateral to the ultimate principal."

EquiLend has either launched or soon will launch additional applications aimed at alleviating back-office burdens. Because securities may be lent for anywhere from a day to several years, there is a robust daily process to make sure counterparty information is accurate and up to date. The EquiLend applications automate data comparison in areas such as mark-to-market valuations, billing and dividends. An application allowing for contract comparison will be released June 1. ■