

Loan stars

THE SECURITIES LENDING INDUSTRY CONTINUES TO GROW IN STRENGTH AND SCALE. KRIS DEVASABAI REPORTS ON THE SEEMINGLY INEXORABLE RISE AND RISE OF THE BUSINESS



Once an arcane back office activity, securities lending has seen spectacular growth over the past decade as the emergence of new structures and entrants, the rise of the custodian lender, hedge funds and prime brokers have all contributed towards an enormous boost in volumes. Today, securities finance is a multi-trillion dollar business for the largest and most sophisticated investment banks, brokers and funds.

But in one area, the business has lagged behind the rest of the investment community. “Historically, securities lending has been a very labour intensive, manual process. Lenders’ availabilities of lendable assets were posted to borrowers, rates and collateral agreed by phone, and dividend claims and payments processed manually,” explains Allen Postlethwaite, CEO of SecFinex.

The relationship-led model preferred by traders and the complexity of lending contracts have acted as a bar to automation in the

past. But as the industry matures, moves are afoot to bring electronic trading and post trade STP to the market, particularly with regard to plain vanilla general collateral trades. “Automation is catching up with the securities lending market,” says Richard Steel, chairman of the International Securities Lending Association. “A few years ago it was a completely voice and fax brokered market, but recently we have seen the rise of electronic trading platforms and order matching systems.”

Perhaps the best known and most successful of the technology initiatives in the securities lending space to date is Equilend. Owned by 11 of the world’s largest investment banks and custodians, Equilend offers a range of trading and operations services for the industry. According to CEO Brian Lamb, the company was able to succeed where others had failed due in part to its unique ownership structure. “The fact that these large institutions came together behind Equilend gave us the opportunity to

create industry standards where none had existed previously,” he says. “We pioneered our own XML standard for the securities lending market, and all our users have agreed to follow that protocol.”

Equilend has leveraged its messaging protocol to build a central hub for the industry, and pioneered a range of post trade services that have helped to reduce risk and improve efficiency among users. The company’s suite of trading and order routing services also account for the majority of electronic transaction volumes in the securities lending space today.

“Prior to Equilend there were elements of automation sprinkled throughout the industry. However, there was no central hub that allowed industry participants to come together on the same basis, and no one had embraced the real time paradigm,” adds Equilend’s chief technology officer, Ben Glicher.

Commenting on Equilend’s contribution to automation, Chris

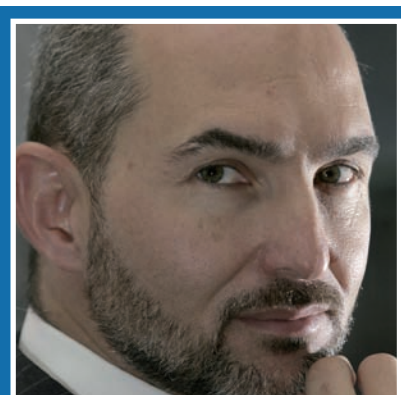
Taylor, senior managing director of securities finance at State Street, says: “Equilend has created tremendous efficiencies, and we continue to encourage industry initiatives that would increase automation and STP in the securities lending space.”

On the automation front, 2007 is set to be a breakthrough year for true electronic trading in the securities lending market. The concept has been alive since SecFinex launched its ‘Order Market’ – an electronic screen based trading system – in 2003. “Speak to anyone in the market and they will tell you it’s a relationship business. To a large extent, it is based on, in no particular order, friendships, favours and balances. We wanted to test this concept and believe the business should move on – it should be based on price, regardless of balances or any other influence,” says Postlewaithe. “The Order Market allows a trader to post a bid/offer and size in a security on a firm to trade basis and is anonymous pre-trade. It does away with all of the old conventions of a relationship business.”

While SecFinex’s innovative approach to the business has won plaudits, transforming embedded practices has been a tough challenge. However, Euronext’s recent move to acquire a 51 per cent stake in the company should open up greater opportunities and lead to more widespread adoption of electronic trading in the year ahead, says Postlewaithe: “We are working on using Euronext’s existing networks to deliver SecFinex straight into the banks and brokers and using their infrastructure to provide straight through processing to our clients.”

April 2007 will also see the launch of ICAP’s new screen based electronic trading platform for the securities lending market. The company enters the market from a position of strength. As the world’s largest interdealer broker, ICAP can rely on pre-existing relationships and operational links with many of the lead players in the industry and boasts an in-depth experience with electronic trading across other product areas – most notably the repo business.

According to Roy Zimmerhansl, head of electronic securities lending at ICAP, there are compelling reasons for market participants to take the plunge. “While transaction volumes are going up dramatically, the vast majority of securities lending activity is very liquid, low margin activity. The



ZIMMERHANSL
There are compelling reasons to adopt electronic trading.

firms need to protect their margins, and to do that they need to be more efficient,” he says. By implementing an electronic trading platform firms can improve distribution and utilization and get more out of existing relationships by bringing together multiple strands of supply and demand, in addition to reducing costs, adds Zimmerhansl.

Commenting on the launch of ICAP Securities Lending, Zimmerhansl says the industry may be approaching a watershed in terms of the adoption of electronic trading. “Up until our launch, market participants interested in electronic trading have been faced with limited options. Now it’s no longer a question of if they should move to electronic trading, but rather which platform they should choose,” he says.

Commenting on the potential for electronic trading in securities lending, Postlewaithe adds: “Three years ago, there was perhaps less than two per cent of the business done this way, now it’s more like 10 per cent. I would expect to see this double in the next couple of years.”

For now, it’s hard to judge the impact that the anticipated upturn in electronic trading will

have on institutional investors’ lending programmes. But the rise of technology has already helped to spark a revolution in the way beneficial owners view their lending portfolios, and there is no telling where the latest innovations may eventually lead.

Anyone who still thinks of securities lending as a back office activity to be entrusted to their custodian by default should spend a few minutes in the company of the likes of ABP Investments head of global securities lending, Mark Linklater. The engaging Canadian has more than doubled the Dutch pension scheme’s securities lending earnings in little over three years by challenging that very notion.

Armed with a custom built securities lending platform that monitors risks and performance, Linklater’s two strong securities lending desk has sought to maximise utilization rates and returns within ABP’s lending portfolio. “We view securities lending as a front office operation – an alpha generation strategy,” says Linklater. As part of this approach, the fund investigated alternative routes to market and opted to try the securities lending auctions pioneered by the third party specialist eSecLending – a move which has transformed ABP’s securities lending programme.

“It has proven to be a really good strategy for us,” says Linklater. “With the auction process ABP’s portfolio’s receive special attention – we’re not mixed in with thousands of other custodial clients. This has led to much better utilization and collateral re-investment rates.” Auctions have also had a major impact on earnings, which have shot up from €42m to €90m over the past three years. “I would say that up to 80 per cent of our gains have come from the auctions process,” says Linklater, adding that ABP now lends close to 70 per cent of its assets through eSecLending.

ABP’s success has not gone unnoticed. An increasing number of pension funds now view securities lending as a trading and asset management function and have moved to separate it from custody.

Of course eSecLending has been

one of the major beneficiaries of this trend. The company has built its success on eschewing the securities lending pools or queues favoured by custodians, seeking instead to maximize returns by awarding exclusive borrowing rights to client portfolios through a blind online auction. "There are a number of reasons why our approach can capture a premium price," says eSecLending president Chris Jaynes. "Since we don't pool our clients' assets, they are able to realise the maximum value for their portfolios and their most attractive assets because they are not disadvantaged by subsidizing general collateral trades. Borrowers will often pay a premium for exclusive access to a portfolio due to a variety of supply and demand factors, and the blind auction process exploits these pricing factors in the market." In addition to potentially higher returns, the auction process also grants beneficial owners greater control and price transparency as they are able to identify and select their counterparties, adds Jaynes.

Amid the increased competition from third party providers and the

soaring expectations of beneficial owners, custodian banks have had to up their game. Most custodial agents now offer the securities auctions pioneered by eSecLending as an additional route to market. For example, State Street leverages EquiLend's browser based AuctionPort service to host and conduct blind and open auctions on behalf of customers. The company completed its latest auction – involving \$15bn in international assets for funds managed by State Street Global Advisors France – last January. Commenting, Taylor says: "The last auction State Street completed for Euro-zone clients was in late 2006 for the term of 2007 and we have been active with auctions for North American and Asian clients in the first quarter of 2007."

In addition to offering alternative routes to market, the most astute custodial agents also recognised the emergence of third party lending as a key business opportunity. "We have invested considerable capital in developing the technology and connectivity required to act in a third

party capacity," says Taylor, adding that while the majority of State Street's securities finance business continues to be sourced from custody clients, the organization does count a number of third party clients within its book of business. Another leading custodian lender, JPMorgan, was recently selected by the New York State Teachers' Retirement System to act as non-custody lending agent for fixed income securities totaling \$12bn.

Indeed, there can be no doubt that custodians still rule the roost in sheer volume and revenue terms. State Street boasts a €1.9trn global lending pool, which generated \$90m in securities lending revenue for the bank in the fourth quarter of 2006. Other custodians to post impressive growth in securities lending in 2006 included JPMorgan, where the average balance on loan increased 21 per cent last year. And while third party lending agents and electronic trading platforms pose significant challenges, the strong relationships that custodians have built with beneficial owners and broker dealers still count for a lot in this business. **ICFA**

BALANCE OF POWER: THE CORPORATE GOVERNANCE DEBATE

With the European voting and dividend season fast approaching, the securities lending industry is bracing itself for the customary round of questions on whether borrowed stock could be used to swing key corporate decisions. While proven cases of borrowed stock being misused are rare, the spikes in lending around company AGM dates have raised suspicions.

"Some commentators draw the obvious conclusion, but the increased demand around the AGM date is largely attributable to the popularity of dividend related trading activity," says Steele, who is "convinced" that the vast majority of shares are not borrowed for voting rights. "However, there is a recognition across the industry that there are issues here that need to be addressed," adds Steele.

As things stand, the onus is squarely on the beneficial owner to monitor loaned securities and recall them if necessary in order to vote, though not everyone has taken the necessary steps, says Taylor. "While there is undoubtedly an increased focus on corporate governance these days, not everyone actually has a corporate governance

policy in place that covers securities lending activity. We would encourage all beneficial owners to take that step," he says. ISLA has worked hard to raise awareness of lenders' duties and responsibilities, notably releasing a well received code of practice and research paper on corporate governance in late 2005, and Steele believes progress is being made. "More and more firms these days have codes or policies in place to guide them through this area," he says.

At ABP, Linklater stresses that the fund's active approach to securities lending is coupled with an equally active and robust corporate governance policy. The scheme recently took on two new hires to work on a new and improved protocol to be unveiled in April, though Linklater believes a regulatory tweak could bring added clarity to the corporate governance picture. "We recently hosted a small conference for some of our European peers where the idea of splitting the record date and the dividend date received a lot of support. If that were to happen we would have more insight into whether people were borrowing shares for the dividend trade or the vote," he says.