

the need to outsource to keep up with trends

Swelling volumes of securities lending business has led to a great deal of optimism in the market, but with new popularity comes tighter regulation and the need to invest in sophisticated technology, which means outsourcing is increasingly the preferred route. Elizabeth Cripps reports

With the introduction of new markets, a shift by traditionally long-only managers into alternatives, and increasing economic disincentives for fund managers to handle securities lending in-house, the industry's major providers are unsurprisingly upbeat.

It is, as Rob Coxon, head of international securities lending at ABN Amro Mellon, puts it, "very difficult to get your hands around exactly how big the market is". But he cites estimates from Data Explorers which put lendable assets at \$14,400bn (€10,675bn) globally, with around \$3500bn out on loan.

Research house Celent puts the value of outstanding stock, as of last November, at approximately \$2500bn for the US, \$500bn for Europe. The US market is, it predicts, set to grow at 5 per cent annually, and the European one at 10 per cent.

Allen Postlethwaite, chief operating officer of lending platform SecFinex, explains: "The difference in growth rates is simply due to the fact that the US is a mature market. Europe will benefit from the European-side regulatory changes and harmonisation, plus the continued increasing activity of hedge funds."

Mark Fieldhouse, director, technical sales, Americas, at RBC Dexia Investor Services, expects the market to grow in two primary ways over the next few years. "First, we are likely to witness growth through the introduction of several new markets, with the opening up of Eastern European and Far East emerging markets. And, second, we will probably see added growth on the demand side, as traditionally 'long-only' managers move into alternative structures such as 130/30."

Mr Coxon agrees, adding: "The trend has been that the size of the market is growing and will continue to do so." The drivers, he suggests, have been hedge funds, "which are increasingly doing long-short plays", as well as 130/30 and 120/20 institutional funds, "which are also fuelling demand for short coverage".

Securities lending promises the holy grail of additional revenue at a low risk. The attraction to institutions is obvious – and growing.



"the trend has been that the size of the market is growing and will continue to do so"

MARK FIELDHOUSE, RBC DEXIA INVESTOR SERVICES

"Securities lending has always been sold as a value added product from a custody perspective," explains Mr Coxon. "Historically, say 10 years ago, people would have taken the view that your securities lending revenues covered your custody fees, but today, depending on the type of client you are, your securities lending revenue can be seen as an alpha generator."

Mr Postlethwaite suggests, more cautiously, that securities lending revenue "can help to offset custody charges". An investor using "a prop-

erly managed securities lending programme" can, he explains, expect increased returns through the incremental income generated from lending, as well as diversification for the portfolio income.

He adds: "Whatever structures are used and no matter what the driver for the initial trade – whether it's a traditional market maker short sale, a failed settlement, convertible bond arbitrage, index arbitrage or pairs trading – a stock loan is invariably involved somewhere in the process. The product provides liquidity to the cash and derivatives markets."

need to outsource?

According to Mr Fieldhouse, thanks to "a market with so many high quality providers", investors can reap the benefits of securities lending without "a significant demand on resources". The trend, he says, is for fund managers to outsource securities lending. Mssrs. Coxon and Postlethwaite agree.

Mr Coxon says: "The economics of the business mean it increasingly does not make a lot of sense for fund managers to retain in-house lending desks." He adds that the last year or so has seen programmes traditionally run in-house being closed. "Hermes is a good example of a very large manager which has opted to pull the plug."

A primary reason for outsourcing, says Mr Fieldhouse, is to achieve ease of execution. Moreover, future revenue opportunities and risk management requirements do not "necessarily lend themselves to a handmade individual shop product, but do lend themselves to providers who are continually reinvesting in their infrastructure".

Mr Coxon agrees that, given the scale of the infrastructure and risk management required, there is little point in retaining securities lending in-house. "Factor in Basel II and the additional operational risk burden you have to shoulder, and you come to the conclusion that outsourcing is the way to go," he adds.

In securities lending, it seems, you have to be ahead of the game in order to be in it at all. In-

house platforms will struggle to keep up. Mr Fieldhouse says: "From the point of view of opening up new markets, providers are continually investing to ensure they will be where they want to be in 18 months or three years. If you operate your securities lending programme on a reactionary basis, you will almost certainly be behind the curve when it comes to revenue."

However, some managers do continue to run securities lending in-house. Mr Coxon cites Morley as one example. According to Mr Postlethwaite, the decision will rest at least in part on size and diversity of funds. "Direct lenders tend to be the large institutional investors such as pension funds or insurance companies. Those funds that wish to participate in lending but are not very large or are concerned at the cost of setting up the necessary infrastructure can still take part by electing to use one of the agent lenders, either a global customer or asset manager."

Mr Fieldhouse agrees that "there are a few who run an internal securities lending programme as part of their alternative strategies". He notes that the approach benefits from not having to share revenue with a third party provider. But, he adds: "It tends to be a 'right place, right time' approach."

risk and transparency

As the securities lending market has grown, so too have the requirements constraining it. "From a risk management perspective, the adoption of Basel II is changing how risk is viewed, as well as the perception of the resources needed to manage risk on a global level," say Mr Fieldhouse. He adds: "The industry will continue to push for increased adoption of alternative forms of collateral, which is excellent, but you need the resources and infrastructure to manage those appropriately."

According to Mr Coxon, recent key developments have been in terms of agency loan disclosure and transparency, particularly in the US. "As an agent you need to disclose a lot more information," he says. "A lot of time, effort and expense has been devoted to that. And we are starting to disclose more and more in Europe. It's required for regulatory reasons but also for their capital treatment under Basel II."

Another key driver has been the establishment of benchmarking providers such as Astec and Data Explorers. These have, says Mr Coxon, "brought a lot more transparency to the market as far as pricing information is concerned". He adds: "The market has traditionally been fairly opaque, with people ringing each other up and doing business. Now, there is more transparency and that has been good for our side of the business."

It is not all good, however. The industry faces some major challenges, not least, according to Mr Fieldhouse, in terms of meeting the demands of specific clients. He explains: "The industry



"because there is so much volume, there has been this drive for better execution, better efficiencies"

**ROB COXON,
ABN AMRO MELLON**

needs to take a realistic view of the overall objectives at the fund manager level. The adoption of alternative strategies represents a worthwhile opportunity, but securities lending on behalf of those funds needs to be done in line with the overall objectives of the fund, including factors such as corporate governance."

Providers need, he stresses, to "design tailored programmes on a client-by-client basis, with sufficient flexibility to tailor lending activity to ensure the programme will generate as much alpha as possible in the context of their individual objectives".

Challenges are also faced in terms of execution efficiency. Mr Coxon says: "Because there is so much volume, there has been this drive for

better execution, better efficiencies." The BNY Mellon programme, he adds, will have approximately \$700bn on loan daily. "That is a lot of assets that need to be marked and reconciled, and to carry out income collection for."

To achieve this kind of efficiency, the industry has to focus on automation. It is "a big factor", according to Mr Postlethwaite. The "challenge", says Mr Coxon, "is to provide better automation, better risk operational efficiency".

Things are already moving in that direction – and fast. "There is probably somewhere around 15 per cent of the business traded electronically now," says Mr Postlethwaite. "This could easily double over the next couple of years, and maybe double again by 2011."

AUTOMATED PLATFORM ALLOWS FOR VOLUME TRANSACTIONS

As soon as it became apparent that securities lending was a fast-growing, global industry, the introduction of a global trading platform was the natural next step. Accordingly, a group of leading players took matters into their own hands as far back as 2000.

Equilend, which was set up by 10 global financial institutions and went live in 2001, claims to have doubled its client base since launch. It reported an all time high in daily trade values in April this year, and announced an expansion earlier in the summer to provide post trade services in Australia and Canada.

The platform's list of investors reads like a financial Who's Who: Barclays Global Investors, Credit Suisse, Goldman Sachs, JPMorgan Chase, Lehman Brothers, Merrill Lynch, Morgan Stanley, Northern Trust, State Street Corporation and UBS.

ABN Amro Mellon joined in 2006 – a move which allowed it to maximise revenue oppor-

tunities and increase sophistication, according to head of international securities lending Rob Coxon.

"It has enabled us to cope with extra additional volumes on the international side," he says. "It frees up our traders to extract better value out of the specials market. Instead of being tied up with bread and butter business, it allows us to concentrate our expertise on bigger value tickets where we can extract better value."

With Equilend and its own I-bid platform, ABN Amro Mellon has, Mr Coxon says, seen a dramatic change in how it distributes over the past five years. "We have multiple routes of distribution. We have Equilend for the international market, I-bid as a competitive auction platform, and our traders who can deal with brokers and extract extra values. On the international side, we distribute 70 per cent of equity business via I-Bid and Equilend."