



# Europe

## How are the various financial crises in Europe affecting the securities lending market?

### ANNA REITMAN REPORTS

After Greece's bailout, a domino effect across Europe toppled Ireland and Portugal with Spain widely believed to be next in line. As it turned out, it would be Italy that would grip markets this summer as bond rates crossed the crucial seven per cent threshold.

As European leaders struggle to fix the eurozone crisis, securities lending desks are trying to find the opportunities presented by the challenges from the continuing fallout of the GIIPS countries (Greece, Ireland, Italy, Portugal, Spain).

For Citi, which transacts globally, it was the scale of involvement in any of those countries which determined the impact on the securities lending programme, says Gareth Mitchell,

EMEA head of trading, Securities Finance at Citi Global Transaction Services (GTS).

Italy and Spain are Citi's only significant GIIPS markets for equities, while outstanding loans in Greece, Portugal and Ireland accounted for less than one-quarter per cent of the desk's entire book. Still, Mitchell did see many more 'specials' with, for instance, some Greek securities hitting between 5000 and 6000 basis points.

In Italy and Spain, quite a few securities gained in lending value when the crisis hit a feverish pitch during the summer, but short selling restrictions on financial stocks contained the market somewhat, but failed to achieve the object of reducing the decline in the cash price. Overall, on-loan balances in these two markets contin-

ued to remain constant but trading at a slightly higher spread, Mitchell notes.

On the collateral side, though Citi clients have never taken Greek, Portuguese or Irish bonds as collateral, with Italy and Spain, some clients have reviewed their collateral profiles and stopped accepting those sovereign bonds as collateral.

However, Citi's clients, a range of banks, central banks, sovereign wealth, pension, mutual and insurance funds, have not abandoned securities lending programmes during the eurozone crisis in the same way they did after the Lehman collapse, explains Mitchell.

"All through the credit crisis, and especially

following the Lehman default, we have been working closely with all of our clients, looking at their risk appetite and how they could comfortably return or remain in the securities lending market. What has happened is that every client has ended up being comfortable with their own individual position on the risk curve and the risk mitigants available. Publically some clients, especially non European clients, have expressed concerns with their overall exposure to the eurozone and have made changes to their lending programmes. This is very different to where we were post-Lehman when there were some publicised losses on the cash collateral reinvestment side of the market which in turn caused many clients to suspend lending," Mitchell says. "Post-Lehman clients that revised collateral risk parameters have been quite happy to stay where they are, there has been some pull back from the GIIPS countries but clients are still happy lending into those markets."

Clients are however being affected by European short selling regulation and the potential issues associated with a short sale classification. There is concern of the treatment of a sale of a security which is already on loan, which Mitchell hopes the industry will receive clarification on. For the borrowers, such as prime brokers and banks, the concern is that they will be creating a short position by lending to a hedge fund if they have not already borrowed or located the security. If this is classed as a short sale, then there will be a whole raft of extra legislation on the transaction to contend with.

The wave of short selling regulations across Europe also spread to Asian markets, and though some countries such as Korea continue to be one of Citi's strongest markets, at the same time activity has slowed as a result.

But one of the biggest concerns on the regulation front is the Financial Transaction Tax (FTT), which formed part of the UK's recent political decision not to sign on to any far-reaching pact to bind Europe's economies more closely.

In an article published by Data Explorers, Adam Blakemore, partner at Cadwalader, Wickersham & Taft, outlines the potential impacts on the securities lending market of the broadly defined tax intended for financial transactions and the UK government's decision to effectively veto participation in a "new fiscal compact" with the other 26 member states of the European Union.

"The next step appears uncertain. It is possible that the 17 Euro area member states may create the FTT but without participation from the UK, although such a move would be bound to raise questions about the possibility for the migration of financial transactions towards the City of London. It is also possible that the proposals for the FTT might be radically overhauled, perhaps with a view to re-casting them along the lines of a more familiar imposition such as the UK's stamp duty reserve tax. And it is also possible that the FTT might be replaced altogether with an alternative method of imposing repara-



tive liabilities on the European financial sector, such as some form of European bank levy or financial activities tax," writes Blakemore.

"Until greater clarity is obtained, the FTT is likely to remain in the background of both European and British economic policy and domestic politics. An example of this is the increase in the rate of the UK bank levy in the 29 November 2011 Autumn Statement announced by the Chancellor of the Exchequer. This might be construed as a careful move by the UK Government to show that the raising of specific bank levies and taxes is a credible, non-FTT alternative to other methods of seeking contributions from the banking sector towards the costs of the financial crisis," Blakemore adds.

Repo and stock lending, as well as collateral transfers as part of financing transactions and hedging would be caught within the scope of the FTT and, depending on how the tax was structured, may make conducting trades uneconomical.

"The feeling is that [the FTT] would have a significant impact on securities lending," Gareth Mitchell at Citi GTS says.

Looking into next year, he expresses concern that levels of lending have reduced in the last few months as a result of uncertainty, hedge funds and banks are de-risking on the back of market volatility but the question out there is: When do they put risk back on?

"Currently there are many funds that are cash rich and are probably not being paid by their investors to just hold cash. In the New Year there will be significant pressure on these funds to seek investment opportunities, which in turn benefits the securities lending market as a whole. he says.

## View from Luxembourg

Commenting on the recent decision by the UK to reject European treaty overtures, Guy Knepper, head of securities lending at Caceis notes, "The last word has not been said. I think everybody stood behind the [European treaty], except for the UK because it has its own views, which I understand because [UK politicians] feel that... they could lose control of instruments to steer [financial] policy."

He adds that the City of London's lobbying over the FTT still has a long way to go and that UK prime minister David Cameron is likely to continue to protect the financial industry while the UK's political structure is likely to remain open to discussion at later stages. For the moment, however, the island appears as isolated as media reports have stated. "It really is going to be interesting times to see how this unfolds but it is still very early to tell," he says.

CACEIS is the asset servicing banking group of Crédit Agricole with institutional and corporate clients and offices across Europe, North America and Asia. The bank provides depository and

custodial services, fund administration, middle office services, fund distribution support and issuer services.

As a custodian lender, it is a multi-market player focusing on clients in Luxembourg, France and Germany across asset classes such as government or corporate bonds, convertible bonds, equities and exchange-traded funds (ETFs).

Knepper explains that his Luxembourg-based desk operates for any clients throughout the network, a large portion of which are UCITS funds, and that CACEIS' operational set-up concentrates flow as much as possible through the central location. From his point of view, the challenges facing the securities lending industry from the ongoing fallout of the GIIPS are very much linked to the opportunities.

"The big challenges for some players are that collateral metrics are getting much tighter, much narrower, because all these countries have fallen out of the more traditional collateral schedule, which means that the universe of paper instruments that you can take as collateral has really narrowed," Knepper says. "On the other hand, for players who are willing to still have some risk appetite, they will be able, with softer metrics, to get business from those leaving the more aggressive sphere."

This leads to an evolving situation of historically higher margins than have ever been seen. Where some of the GIIPS sovereign bonds were trading from double-digit basis points to double-digit percentages for countries such as Greece. Those bullish players willing to take risk on board are in "paradise", Knepper notes.

Moreover, cash is becoming king as German, French and Dutch bonds become more expensive on the securities lending and repo markets, a trend that he thinks is here to stay. That means clients are paying more attention to the duration of trades, particularly for dividend enhancements as preferences tend to lean towards shorter time frames on the collateral costs side.

Luxembourg's regulation which focuses on securities lending practices was updated in 2008, ending a 30-day prescribed limitation for securities lending transactions which put technical burdens on the back office. It also became more specific on identifying collateral requirements, which Knepper says benefits Luxembourg investment funds. Many of CACEIS' deals are conducted on an essentially open-ended basis, he adds.

Though it is fixed income most directly impacted when it comes to the economic woes of the GIIPS, indirectly, ETFs are gaining in popularity on the theme of cost efficiency.

"[Physically-backed ETFs] is our fastest growing business, it is much more attractive than going through the cash/equity market from my perspective and it is a growing part of the securities lending market, especially those doing

directional trades. It is very easy to play and also we are seeing an increase of liquidity because investor demand is growing," Knepper says, adding that Europe still has some steps to take on education to make the instruments seem less esoteric.

At the same time, though the resulting impact of the GIIPS fallout has set these trends in motion to some degree, Knepper plays down the negative effects on his securities lending desk. Even during the Lehman crisis, CACEIS was adding new clients because of the firm's "plain vanilla" business model while during the sovereign downgrades and bailouts, its flexibility in accepting cash as collateral has helped it steer turbulent markets.

"[The GIIPS fallout] doesn't hinder development of the business. Yes, the GIIPS countries are no longer eligible as collateral but counterparties can pledge cash and in fact that is working out quite nicely. On the other hand, as some of our clients are still investing in these instruments, we still manage to lend them," Knepper explains.

He adds, "We are not limited to lending them, but we are limited in accepting them as collateral, so for us it is more of a balance of opinion, but in the end, for the bottom line, it will be positive. Still, if Standard & Poor's continues to downgrade those [European countries] that are AAA, then of course we will enter into very dangerous territory."

But even with the shock of Italian debt no longer being accepted as collateral, CACEIS was already receiving French, German, Dutch and Austrian bonds, so even on this front, the impact was minimal because the group was conservative with regards to interpretations of minimal thresholds, asking for substitution as soon as downgrades were announced. The impact, he notes, was felt more on the operational side than in the front office.

## Over-regulation risk?

Like many market participants, Knepper sees a risk of over-regulation in securities lending. Still, with events such as the Lehman bankruptcy, the high risks of sovereign default in Europe, rogue trading at UBS and the most recent market event, the default of MF Global, the need to address public trust in markets has not left the headlines.

Knepper says that traders will need to face a new era of risk mitigation as a result.

"People sitting in trading rooms will not likely be in command in the coming months or years. I think the environment will not be shaped by those in trading rooms, we cannot be the drivers of decisions. Decisions will be taken by politicians, lobbying groups, risk managers and compliance, from now on a specialist from the operations side will be in meetings with clients. That is something that you just have to face and is not going away, and we must be ready to deal with this new situation," Knepper says. **SLT**

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