

The changing face of securities finance



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The securities lending industry is on the cusp of major change - and business models will have to adapt to the new environment. Now more than ever, the industry is facing a constant barrage of new challenges. In the same way that telecommunications providers are currently expanding their offerings and customer base to cope with a changing environment, agent lenders must also be prepared to innovate and diversify. The winners will be those that continue to invest in their business, enhance

the quality of client service and adapt to their clients' needs.

So what is causing these changes? Surrounding the way in which the securities industry operates (see diagram) are a number of external factors - including tax harmonisation, consolidation and hedge fund growth. These factors represent not only challenges, but also a wealth of opportunity and will have a huge impact on how we operate both today and how we re-engineer our businesses to seize opportunities for tomorrow.

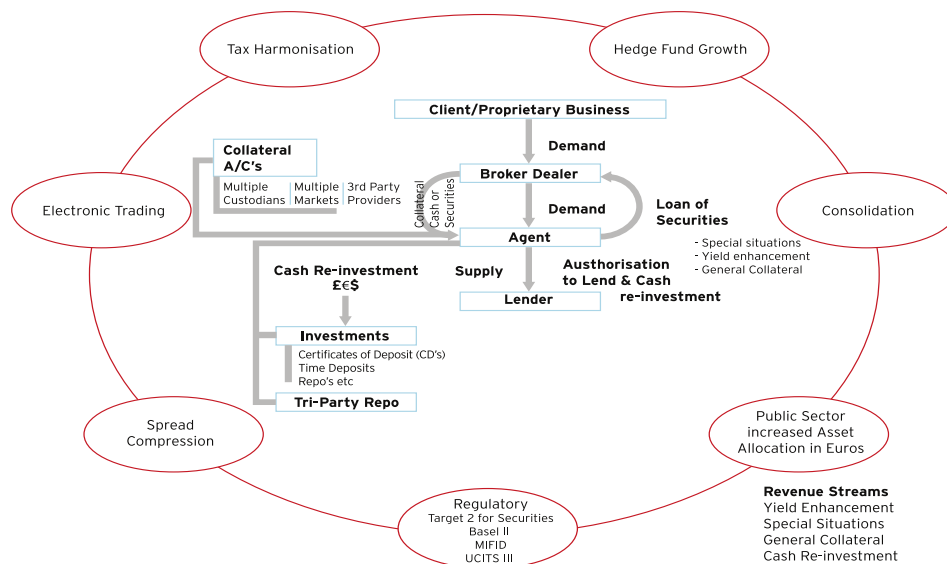
lenders to generate a return and the securities collateral is managed until the expiry of the loan. This model results in four key revenue streams: yield enhancement, special situations, general collateral (GC) and cash re-investment. However, as we will see in the examples below, if this model is integrated with certain external factors it becomes apparent that some of these revenue streams are threatened.

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In today's market, broker dealers borrow securities and cash from lenders to meet either their own needs or to service the needs of their clients - typically hedge funds. Collateral is taken either in the form of securities or cash. Cash collateral is re-invested by

Tax harmonisation

The issue of tax harmonisation is already under scrutiny and is gaining momentum. If this continues, it will have the potential to significantly reduce or eliminate revenues derived from yield enhancement trades. For some, the fact that a large percentage of revenue is generated through yield enhancement will be a cause



for concern. A number of market participants - both lenders and borrowers - will struggle to sufficiently diversify their revenue streams to adjust and compensate for this loss of income. The ramifications of this are numerous: businesses that are not earning sufficient revenue, by default will not be able to afford to continue to invest in the business; at the same time, companies that are not investing in their businesses will not be able to keep up with the latest industry initiatives such as Equilend and benchmarking services. Eventually, this inability to change, innovate and diversify could result in loss of business as clients will find a provider that can, or the other possibility is that the business is acquired by larger, more successful dynamic entities.

Consolidation

Across all industries, large banks and companies are driving consolidation forward. Additionally, with spreads continuing to narrow, volume is becoming a more important consideration. Scalability, through investment in technology, is paramount to support the unexpected increase in volumes that are necessary to grow revenues. This clearly benefits the bigger players. As a result, some smaller direct lenders may have to consider re-writing their business case unless they become a one stop shopping network and are fitted for scalability.

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Hedge fund growth

Of all recent developments, it is the phenomenal growth of hedge funds that has taken the securities industry to new heights. The prime brokers that support the hedge funds are funnelling business through the broker dealer model and into the hands of the lenders and agents. However, with discussion increasingly focused around hedge funds sourcing their supply directly, what does the future hold for this business model? Will the lenders and agents happily create direct relationships with hedge funds or will the brokers continue to differentiate their service by taking on the role of risk-taker for these institutions?

An opportunity arising in this area is the fact that pension funds and insurance companies are now adopting investment strategies that give them the look and feel of hedge funds. These institutions have long embedded relationships with their custodian banks and can readily respond should the custodian banks design and offer services that help them serve their 'hedge' funds while recognising that their needs are slightly different to an outright hedge fund.

This area of investment is ready for huge growth and represents uncharted territory for most of the incumbents. Banks that can team up with a prime broker and offer an integrated solution specifically for institutional clients will have a huge advantage in this space.

Rising to the challenge

Change is a challenge in any context and success is dependent on strong management skills and the flexibility to seize opportunities as they arise. In addition to the changes already

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discussed, other developments are at the forefront. These include regulatory changes, electronic trading and an increase in public sector asset allocation in euros, which are all placing pressure on businesses to be more flexible, innovative and bringing a commitment to service quality offered to both lenders and of course borrowers. Custodian agent lenders can learn from the experiences of other industries by minimising their exposure to revenue streams that are under threat and opening up to new opportunities that arise. Those that accomplish these goals through innovation, differentiation and a commitment to service quality will be at the vanguard of the new world.

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