THE EVOLVING TREASURY AND SECURITIES FINANCE ECOSYSTEM

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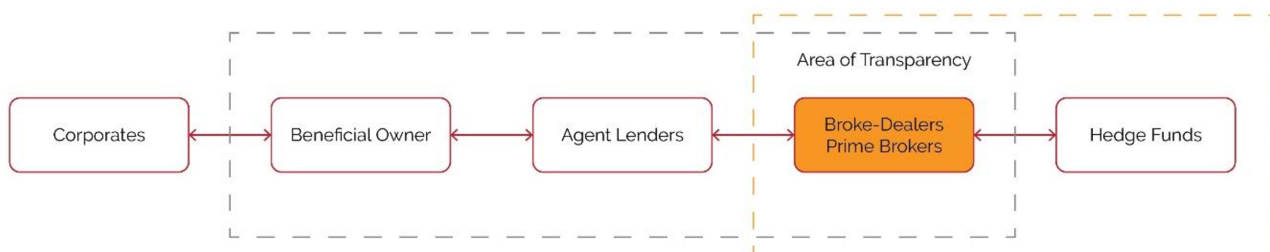
A combination of market forces and regulatory mandates have driven an evolution of the treasury and securities finance ecosystem. Processes that were once opaque have been brought to light by far wider access to data. For asset managers, hedge funds and other investors, embracing transparency, gaining an edge, and actively managing the treasury function are essential ingredients for success in an increasingly competitive environment.

Looking back, securities finance transactions were facilitated through several intermediaries, the market was oligopolistic, and any participants with access to information were unwilling to share it. Beneficial owners, such as insurance companies and pension funds, maintained their securities holdings with custodian banks. In order to generate incremental income, the asset owners often entered into securities lending programs. The custodian banks, acting as agent lenders, lent the securities, mainly to broker-dealers, who in partnership with their prime brokerage affiliates used the borrowed securities to facilitate short positions for their clients. Institutions within the value chain had little visibility and transparency other than the limited information they might glean from the broker-dealers and prime brokers.

The Traditional Securities Finance Value Chain

While hedge funds and other investment managers were always aware of the rates they were being charged, due to the historically one-sided nature of the brokerage business, they did not feel that they were in a position to negotiate with their prime brokers. In the early 1990s, however, portfolio managers began to realize that short rates and financing rates were an integral part of portfolio management, and returns could be increased significantly by actively managing them. They also came to realize that they had underestimated their negotiating power. To illustrate, hedge funds that were paying 90 bps “through the middle” for financing could potentially reduce the rate down to 50 bps. For a $1 billion-dollar hedge fund that is levered 3 times, saving 40 bps on financing added 120 bps to their bottom line. This contractual negotiating power gave hedge funds the push they needed to begin challenging rates on their short positions. Still, most investment managers only had one or two prime broker relationships, and they lacked access to rate data. The entire process was manual, and paper based with limited data points.



As investment managers’ assets grew, firms decided that they needed to diversify their counterparty risk and required more sources for financing and short availability. Larger firms with around $10 billion in assets under management, for example, may have established up to 10 prime broker relationships, so their access to data and financing increased tremendously. Finally, they could get a good picture of what the street looked like, but not without substantial operational processes and oversight.

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Eventually, new technology solutions emerged to offer transparency and data analytics around securities lending rates. The first pioneers received rate and volume files from banks and institutions and investment managers thus obtaining access to more data than ever before.

By 2008, transparency had increased significantly. Investment managers, on average, maintained several prime broker relationships, and they also began to subscribe to securities finance data. Recognizing that increased transparency resulted in opportunities to save money, some began to establish processes to aggregate and analyze their own data, usually with spreadsheets. The largest, most progressive investment managers moved portfolio finance out of the middle and back office into the front office, and it became an alpha generating group.

Even so, most investment managers were still taking FTP files from their prime brokers, manually converting them to spreadsheets, running macros to sort the data, and then manually reviewing them. If daily rates between prime brokers were discrepant, someone would usually call the bank with the inferior rate and ask for a rate improvement. However, any potential savings had to cross a certain threshold before the fund would assume the operational burden of transferring a security. Ultimately, a big portion of the savings went unrealized because of the manual workflow around the rate improvement.

Regulatory Mandates

In the aftermath of the crisis, a host of regulatory mandates have improved transparency and accountability. Many regulations that affect securities finance have come out of Financial Stability Board initiatives and are being implemented by the European Securities and Markets Authority (ESMA), the U.S. Securities and Exchange Commission (SEC) and other regulators globally. Under the Markets in Financial Instruments Regulation (MiFIR), for example, the regulators can stop activity based upon the level of transparency in the market. The Securities Financing Transactions Regulation (SFTR), now approved for rolling out in early 2020, requires 155 fields of information to be provided to the regulators daily.

The regulators are still working today to align securities finance regulations, including transaction reporting, with the rest of the capital markets. This is a challenge because securities lending is not a trading function. It is a loan arrangement, not a commitment, done on a “best endeavors” basis, and it often changes throughout its life cycle. Due to these nuances, securities finance deals are being treated as derivative transactions for regulatory capital usage purposes. Further, while MiFID II bolstered the best execution requirements which are now applicable to securities lending transaction with the focus mostly on price rather than counterparty credit, fiscal location or solidity of supply or demand.

Convergence on transparency: a catalyst for change

Many people tend to think of the 2008 financial crisis as a watershed event, but the market dynamics and forces had been changing before then.

- From a business perspective, the events of 2008 convinced investment managers that had not already diversified their counterparty risk that they needed to do so. Firms very quickly put counterparty exposure monitoring processes in place by looking at credit default swap rates, ratings and other factors, thereby limiting exposure to their counterparties. Essentially, the crisis was one more reason investment managers were compelled to have multiple prime broker relationships.

- From a regulatory perspective, these events showed that if there was more transparency in the market, steps could have been taken earlier to prevent the crisis. It also demonstrated the need for institutions to prepare for the worst-case scenarios by ensuring capital adequacy and limiting the forms of acceptable collateral along with other measures.

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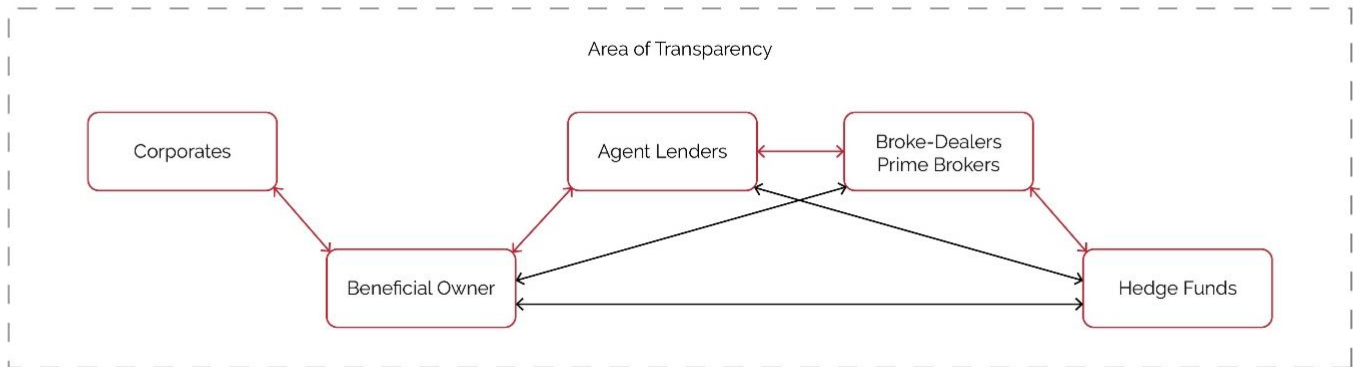
A transformed ecosystem

The traditional, linear securities finance chain has broken down and a new dynamic has emerged, forcing entities to reconsider their value proposition. The convergence of the business and regulatory worlds in the area of transparency have borne down on the traditional value chain, causing it to buckle under the weight. The new ecosystem is far more competitive, and there are multiple ways of doing business. While there has been some disintermediation, there are also opportunities to add value, especially by taking advantage of data and transparency.



With wider access to information and automation, asset owners have more control over their entire business. Previously, beneficial owners lent through their agents, which gave them a counterparty default indemnification. Today, beneficial owners can, with appropriate credit/risk oversight, lend securities without going through an agent lender, and investment managers and beneficial owners can borrow and lend directly from each other. Moreover, a large pension fund's long positions can be lent through an agent lender to a hedge fund that manages that same pension fund's long-short funds. Essentially, the pension fund is lending to itself through about two intermediaries. Theoretically, the pension fund could lend directly to itself, if it has the systems and the capabilities in place to settle, monitor, control and collateralize properly.

Currently, the best execution requirements do not apply to most hedge funds, but many firms are complying voluntarily. Investment managers are increasingly benchmarking their prime brokers to ensure that, when they borrow from a prime broker, they are paying the lowest fee – or at least a standard market fee. In addition, beneficial owners are benchmarking their agent lenders' performance to ensure they get the most money for the securities that they lend.

Finally, agent lenders have an opportunity to add value by offering better reporting and data access to their clients. They can introduce new methods of risk and counterparty analysis that enable beneficial owners to go around the broker-dealers and lend directly to investment managers. They can also provide different forms of collateral and collateral substitution.

Active treasury management: a new paradigm

To thrive in this competitive and complex environment, firms need a full front-to-back process that is efficient and agile so they can actively manage and execute on their treasury operations. When a new convertible security is issued, for example, traders need short rate data and short availability indications immediately. They also need to track and keep up with rate fluctuations over time. Technology makes it easier to manage the daily portfolio finance function, to find the best rate and pro-actively execute on the opportunity.

Investment managers that take an active treasury management approach can leverage the efficient workflow and automation to in one view to quickly identify the book's holdings and counterparties. Automating the workflow eliminates the operational burden associated with transferring securities and cash, allowing finance professionals to maximize their time to focus on value-added initiatives and treasury alpha. According to a recent Hazeltree analysis*, active treasury management can potentially result in a 40-155 bps cost savings, which could be passed on to investors.

**Based on Hazeltree survey of more than 80 world's leading hedge fund managers with AUM ranging from $2B to over $50B.*

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An automated platform allows traders to access data that can help them make decisions to minimize financing cost, maximize borrowing capacity at their prime brokers and optimize the allocation of borrowing across counterparties. Internal research groups focused on securities finance can develop new strategies and determine the optimal time to get into or out of positions across different regions and sectors. For example, they can monitor when a certain stock reaches a specified level of liquidity or illiquidity and assess the potential for short squeezes. They can identify illiquid stocks and construct portfolios that are based upon their ability to obtain lending revenue. In addition, the securities finance group can alert the portfolio manager when data show that a particular security is heating up and a potential trading opportunity emerges. Further, investment managers that have a global presence are better equipped to manage transactions across multiple time zones and comply with specific settlement rules.

Conclusion

Market forces and regulatory mandates have driven an evolution in the securities finance market. Specifically, wider access to data and greater transparency have been a catalyst for change. Today, there are many more ways of doing business, and while this has contributed to a more complex environment, it has also presented new opportunities. Those that fail to embrace change run the risk of being left behind and losing clients.

To stay competitive and improve performance, asset managers and hedge funds need a centralized view of their entire business operations. They need technology and automation to analyze and monitor financing options and risk – and optimize cost savings – efficiently, effectively, systematically and holistically. Having a centralized view and automating processes can help them transform treasury and portfolio finance into a front office function that has an impact on the firm's bottom line.

About Hazeltree

Hazeltree is the leading Treasury Management solution provider, serving hedge funds, asset managers, fund administrators, insurance companies and pension funds with powerful, proactive performance enhancement and risk mitigation capabilities that generate alpha from treasury, reduce a range of risks and streamline operations. Hazeltree's integrated treasury management solution includes comprehensive cash management, securities financing, collateral management, counterparty management and margin management capabilities. Hazeltree is headquartered in New York with offices in London and Hong Kong.

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