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Q&A WITH JOHN STACCONI

By **Global Treasurer, Jefferies Group LLC**

You've been a corporate treasury executive at both major banks like J.P. Morgan and non-banks like Nomura and your current employer. What would you say are the major differences in how banks and non-banks approach the markets? How do your top 10 concerns differ in each platform?

The approaches that securities firms take to markets and clients are based on a successful system of regulation and risk that has evolved over an extended history. Jefferies focuses on providing market liquidity to clients across fixed income and equities as well as investment banking services. Securities firms manage risk, while banks seek to avoid and minimize risk. Broker/dealers got into trouble heading into the financial crisis when they moved into traditional banking products such as corporate lending and derivatives. SEC holding company regulations allowed the five large pre-crisis broker/dealers to take on too much risk. Banks can't fail, but broker/dealers fail orderly.

With a focus on market-making for clients and very tight leverage limits, efficient use of balance sheet and return on capital is in sharper focus at Jefferies than at my previous firms. Non-flow assets and aged inventory are tightly controlled so as not to restrict the firm's ability to provide liquidity to clients. Our size gives us the flexibility to measure returns at the trader level and to allocate balance sheet and capital accordingly. Banks have often been willing to accept certain loss leader businesses in support of a broader client relationship. We don't have that luxury at Jefferies given more limited financial resources.

For Jefferies Treasury, key items of focus are maintaining our liquidity stress models, allocating balance sheet and capital to businesses, managing lending relationships and working to preserve/improve our credit rating. Banks, with the luxury of more diversified funding sources and a central bank back-stop, are not as focused on managing counterparty lending relationships as a broker/dealer. Jefferies has always operated with the knowledge that government support was not an option. That discipline led to the firm's long-standing policy of low leverage and Level 3 assets.

Do you agree with the recent Federal Reserve study showing that the Volker Rule has led to a significant reduction in secondary market liquidity for fixed income products during periods of stress? If so, how has this change impacted Jefferies' businesses and outlook?

I would tend to agree that, on the margin, the Volcker Rule has reduced liquidity in the secondary market for fixed income products.

With respect to Jefferies, the Volcker Rule has helped Jefferies increase trading volumes at the margin with key clients as banks can no longer lead with balance sheets and now need to compete more on execution and research. But the reduction in market liquidity has also increased the risk of sudden price moves during a stress. This is one of the reasons why we've reduced our balance sheet, inventory and risk profile in fixed income.

Given that Jefferies is not regulated as a bank, but also does not have access to the Federal Reserve for liquidity, you naturally focus on building a robust liquidity fortress. We note that your level 3 assets represent only 3% of long inventory, that over 75% of repo

collateral is eligible for CCP clearing and that 75% of financial assets are readily financeable at haircuts of 10% or less. You also maintain very conservative leverage by bank standards with long term capital maturities capped at no more than 20% per year. Given this background and your experience, how do you think about corporate liquidity differently than a bank would? What impact does this have on the DNA of your firm's daily operations?

Liquidity management at a broker/dealer such as Jefferies is significantly different than a bank. Unlike banks, Jefferies is not in the business of carrying a significant amount of long dated assets. Banks take long dated liquidity risks in their lending and derivative books, both of which are minimal balance sheet users at Jefferies. Most of our balance sheet is used for market making activity in liquid securities (97% Level 1 and 2), reverse repo and stock borrowed. The liquidity risk DNA of the firm mandates that we know the fundability of every asset we own. The stress haircut for inventory and illiquid assets is covered with capital. Harder to fund assets are required to obtain longer dated funding. Though Jefferies isn't subject to Basel LCR and NSFR, we run liquidity and capital stress models that, in many assumptions, are more conservative than the bank models. We clearly understand that our business model is based on access to market-sensitive funding, which is why we focus our balance sheet on liquid products, with conservative term funding and an ample reserve of capital.

Knowing that the FRTB does not directly apply to Jefferies, but will likely impact global markets, what threats and opportunities does his present for your firm?

We don't anticipate a major change due to the introduction of FRTB. At the margin, it will likely continue the trend towards increasing the cost and reducing the return on regulatory capital for impacted firms, enhancing the potential for Jefferies to continue to increase market share.

Jefferies reports traditional bank metrics such as VaR even though it is not required to by regulation. Given that Jefferies is able to take a less prescriptive and more practical view of credit, market and liquidity risks than its large bank competitors, what traditional bank tolls do you utilize in daily risk management and why? Specifically, I am thinking of both traditional tools like VaR and cash capital as well as newer tools like Expected Shortfall, Liquidity Horizons, and non-modellable risk factors.

As we outline in our financial disclosure, we apply a comprehensive framework of limits on a variety of key metrics to constrain the risk profile of our business activities. The size of the limit reflects our risk tolerance for a certain activity under normal business conditions. Key metrics included in our framework include inventory position and exposure limits on a gross and net basis, scenario analysis and stress tests, Value-at-Risk, sensitivities (greeks), exposure concentrations, aged inventory, amount of Level 3 assets, counterparty exposure, leverage, cash capital, and performance analysis metrics.

While VaR measures potential losses due to adverse changes in historical market prices and rates, we use stress testing to analyze the potential impact of specific events or moderate or extreme market moves on our current portfolio, both firm-wide and within business segments. Stress scenarios comprise both historical market price and rate changes and hypothetical market environments. These generally involve simultaneous changes of many risk factors. Indicative market changes in our scenarios include, but are not limited to, a large widening of credit spreads, a substantial decline in equities markets, significant moves in selected emerging markets, large moves in interest rates, changes in the shape of the yield curve and large moves in European markets. In addition, we also perform ad hoc stress tests and add new scenarios as market conditions dictate. Because our stress scenarios are meant to reflect market moves that occur over a period of time, our estimates of potential loss assume some level of position reduction for liquid positions. Unlike our VaR, which measures potential losses within a given confidence interval, stress scenarios do not have an associated implied probability; rather, stress testing is used to estimate the potential loss from market moves that tend to be larger than those embedded in the VaR calculation.

Stress testing is performed and reported regularly as part of the risk management process. Stress testing is used to assess our aggregate risk position as well as for limit setting and risk/reward analysis.

How has the transition in many global fixed income markets from market-making to agency models created a level playing field for Jefferies to compete with its bank competitors?

On the margin, the reduction in bank balance sheets and the Volcker Rule has tended to help Jefferies level the playing field with larger banks. Banks no longer have the same ability to lead with balance sheet and offer the buy side cheap execution. Their ability to carry bonds for an extended period of time is restricted by Volcker and has become more expensive with new capital rules. Banks now need to compete on execution and research, where we feel our capabilities are on par with the largest banks. This new market dynamic is still playing out, but the early trends are positive for Jefferies.

Describe the value brought to Jefferies by your parent Leucadia and how this relationship changes how you think of risk management at Jefferies as compared with your prior non-bank employers.

The merger with Leucadia hasn't changed risk management at Jefferies. We continue to operate Jefferies under the same stringent guidelines and limits that were in existence prior to 2013. We have no liquidity or capital line in place between Jefferies and Leucadia and make no assumptions of parental support in our liquidity stress models. Jefferies and Leucadia agreed to balance sheet, liquidity and stress limits with the ratings agencies prior to the merger and both entities have operated well within those thresholds for four years. That said, counterparties and bond investors appear to take comfort in Jefferies being fully owned by Leucadia as opposed to being an independent investment banking firm. Jefferies operates in a volatile industry and having the support of a large, prudently capitalized parent is a net positive.

How is Jefferies considering implementation of the new SIMM rules for initial margining?

What impact do you foresee to either Jefferies or markets from these new rules?

Jefferies' swap RSDs are currently not subject to regulatory initial margin. At this time, SIMM rules will require us to be in compliance by May 2020. We are looking at third party vendors to calculate two-way initial margin under the SIMM model. The liquidity requirements and operational impacts for Jefferies in 2020 are still unknown. We will have to post IM on all swaps, but netting will apply and we can post collateral other than cash (i.e. corporate bonds and equities) which should mitigate a significant portion of the liquidity need.

What impact has technology played in the way you manage your business? Specifically, are you moving away from so-called enterprise solutions to more flexible or cloud-based solutions? If the latter, how do you think about maintaining cybersecurity walls? If the former, how do you ensure that your systems are robust and up to date?

We are actively moving away from enterprise solutions into more flexible cloud-based architectures. For example, we are:

a) migrating our exchange on premises to the cloud;
b) moving from our proprietary system developed CRM to a vendor-based product; and
c) utilizing features and services of third party clouds to perform complex analytics.

We see the move to the cloud as an opportunity to review the security posture and requirements of the systems that we are migrating. We believe that with the right design, the cloud migration will in many cases provide us with a superior security architecture compared to the on premise version.

However, it is important to note that not all cloud providers are created equal. We review every cloud opportunity and only move forward with the ones that meet our security requirements. In most cases, the cloud provider must meet a minimum set of key requirements before we allow our applications to migrate. Some examples of these requirements are:

a) Independently audited for security and operation by a reputable firm
b) Ability to encrypt Jefferies data using Jefferies encryption keys (managed and rotated by us)
c) Ability to monitor the cloud usage using logs
d) Ability to establish a secure connection between Jefferies network and the cloud provider
e) Ability to restrict access to the cloud application to certain IP addresses

Looking out over the next year, what are your top five priorities or concerns within Jefferies Group Treasury?

We focus on many things daily, but if I had to pick the top five, they would be:

1) We need to continue to diversify our counterparty lending group. Some banks, primarily European, are reducing balance sheet and lending in the secured funding market. On the flip side, we're seeing more balance sheet available from Asian and Australian banks.
2) As markets continue to rally, we need to stay focused on watching for asset bubbles in certain sectors. No immediate concerns, but that can change quickly.
3) Continue to monitor the allocation of capital and ensure that the Jefferies is generating proper returns.
4) Impact of Brexit on European business. We may need to move headcount and b/s out of London.
5) A never-ending focus on increasing our credit ratings.