

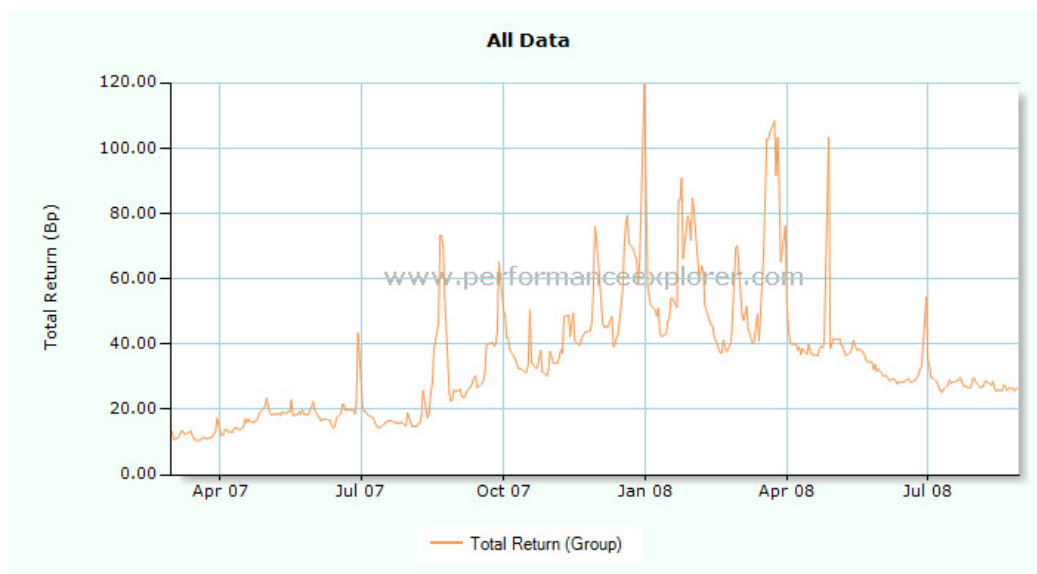
Central Banks – Is Securities Lending a Solution, a Tool or a Risk Problem?

In 2008, Central Banks and securities lending have become inextricably linked. In seeking solutions to promote liquidity during the credit crunch, Central Banks have used securities lending as the tool of choice. In allowing their regulated banks to switch unwanted mortgage backed assets for prime Government Bonds owned by the Central Bank, the Federal Reserve Bank, the European Central Bank and the Bank of England have engaged in the ultimate collateral upgrade transaction.

The importance of the Central Banks in securities lending programmes is clear and the additional liquidity that can be provided by adding their assets is much needed. Therefore the issues need to be addressed and the opportunity to listen to experts and voice their issues should lead to a discussion that focuses on a subject not covered in an event previously.

Securities lending is in the frontline of the market's reaction to the lack of liquidity, a reason often cited as the biggest benefit for new markets who are considering allowing securities lending.

But Central Banks have participated in securities lending for many years – lending the fixed income securities that they hold in reserves in order to earn some additional revenues. The following charts show that the revenues from securities lending have been particularly strong in the last year. Total return has increased from 12 or 13 bps in early 2007 to 30 bps in June 2008. In Q4 2007 and Q1 2008, average total return was 50 bps driven by the increased spreads earned from reinvesting cash collateral.

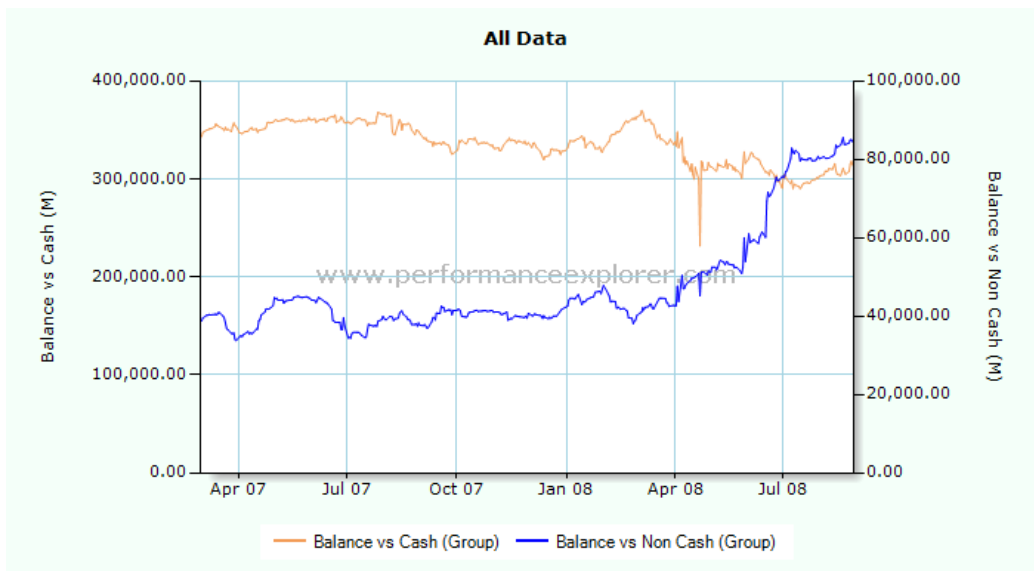


Source: Dataexplorers.com

Central Banks are risk averse at the best of times, and one would hope that they have focused on this element of their securities lending participation in recent months – the increased return would be welcome but not at the expense of a potential upturn in risk

from the cash activities. Volatility has been high - as demonstrated by the peaks and troughs in this chart, so close monitoring of the activity is critical.

Cash has been at a premium for borrowers; and it is interesting to note that Central Banks appear to have shown some flexibility in reacting to the new market dynamics. The following chart shows that in Q2 this year, there has been a substantial increase in loans being transacted versus non-cash collateral – non-cash balances have increased by 100% during the quarter. This demonstrates that Central Banks are moving away from the repo type transaction (loan of security versus cash) that they are most familiar with and would suggest that there is a new world of opportunity opening to them. Their fixed income assets are some of the most in-demand securities worldwide consisting of predominantly high quality government bonds, market participants will welcome the chance to unlock further supply by virtue of tweaks to securities lending programmes.



Source: Dataexplorers.com

Some of the larger Central Banks will diversify their lending programme by appointing a number of different lending agents, sometimes selected by asset class in a manner similar to the appointment of a Fund Manager for a specific index or strategy. As a key client sector for service providers, Central Banks attract the attention of all financial players – the bees surround the honey pot looking for investment management mandates, custodian selection - and securities lending is increasingly important. The numbers shown in the earlier chart indicate the importance of what is now considered to be a front office activity.

Data Explorers Consulting have seen increased interest from Central Banks considering participation in a securities lending programme. However, some struggle with the process – uncertainty of the accounting for lent securities and the collateral

taken does exist and clarity would be welcomed – certainly any steps that can assist in removing barriers to entry should be encouraged.

Should Central Banks appoint a lending agent or a principal lender? Some prefer to lend via an agent and not disclose their name as a party to the loan, however in the current environment where US borrowers are required to know the lender as part of the SEC mandated Agent Lender Disclosure initiative, and in Europe where disclosure to borrowers is increasingly necessary in order to mitigate the borrowers capital constraints under Basel II, disclosure and transparency of their name is increasingly a requirement. Principal programmes could be a useful alternative where the lending agent acts as the principal in the transaction to both the lender and the borrower. This way, the loan is seen to be from the lending agent acting as principal, not the Central Bank as lender.

However, the principal programme has its downsides. In an agency programme, the lending agent will typically indemnify the Central Bank against counterparty default – the situation where the borrower is unable to return a lent security. The agent will increasingly indemnify the Central Bank against losses that may occur as a result of certain types of investments made with cash collateral. In a principal programme, the Central Bank has one counter party – the principal lending agent. Therefore there is a substantial concentration of risk, a risk that has been enhanced as financial institutions have stumbled in recent months.

Central Banks are making more money from securities lending than ever before. But, understanding how their securities lending risk profile has changed and connecting this with a variety of other issues means this is the time to focus on the securities lending business.