



Credit Crunch

Case Study

**How have lenders actually
responded to the credit crunch?**

Introduction

In January, Data Explorers Consulting, formerly known as Spitalfields Advisors published the paper “The Impact of the Credit Crunch upon the Securities Lending Market”. The paper commented on important developments in the credit and money markets, the relevance of the developments on the securities lending market and identified some questions and issues worthy of further consideration.

One of the questions we asked related to beneficial owners’ understanding of risk in their securities lending programmes. There is increased demand for risk reporting at a board level so the ability to articulate the risk exposure in a securities lending programme is now a necessity. Have discussions between lending agents and beneficial owners been sufficiently in depth to allow detailed risk assessments to be made? Well now we are pleased to bring you an example of the types of discussions that have been occurring.

How have lenders actually responded to the credit crunch?

Since the credit crunch there has been a lot of talk and many more meetings on the subject of risk management and cash re-investment. Far too often these conversations have been linguistic and qualitative in nature, not numeric and quantitative. We believe in the old adages that “if you cannot measure it, you cannot manage it” and that “numbers do not lie”. Securities lending risk and return can be measured and needs managing. Talking about guidelines is not risk management; it is just a part of a risk management framework.

Following on from these meetings there have broadly been three outcomes: -

1. Many lenders have done nothing – either because they were satisfactorily reassured by their providers or are just unclear about what to do.
2. A small minority have reacted in a “knee-jerk” manner and either stopped lending or adjusted their re-investment and collateral guidelines dramatically - with potentially costly consequences.
3. The responsible lenders have reviewed the performance of their programmes in detail and made decisions in consultation with their providers that have optimised their risk-adjusted-returns.

There are significant opportunities, however the opportunity cost of taking either no action or the wrong action can be material.

So much for the theory – what are lenders actually doing? Below we share with you a real-life case study, produced by Data Explorers Limited, showing how a responsible lender and their

provider have made responded to the issues with dramatic and positive results. The lender has given their permission to distribute this anonymous case study.

Executive Summary

These have been testing times for lenders of securities and their agents – presenting both unprecedented challenges and unprecedented opportunities. At times like this, those with fiduciary responsibilities need to ensure they have access to information that enables them to make decisions in the best interests of their beneficial owners. This information needs to have a number of qualities: be independent, quantitative and accessible. Independent - to ensure comparisons across providers are possible; Quantitative - because this is not a subjective issue; and accessible to an audience whose core responsibility and experience may not be securities lending. The client found that the outputs represented in this paper were invaluable in the communication at the level of detail necessary to enable their board to take the appropriate action.

By taking a calm pragmatic position, leveraging detailed and relevant intelligence, lenders can work with their agents to ensure that they factor risk management appropriately into their thinking and still remain capable of taking suitable opportunities as they present themselves.

If you would like to have informed, numeric and quantitative conversations about risk-adjusted-returns with your clients, or your provider, it is possible today. As the results in this paper demonstrate – it can also be extremely worthwhile.

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Programme Overview

- The Lender is an Asset Manager
- They lend via a Third Party agent
- They receive a comprehensive indemnity on their securities lending activity. Consequently, residual exposure to the client is minimal in the context of overall programme risk.
- Their outright re-investment activity falls outside of the terms of their indemnity, whilst collateralised reverse repo is covered by indemnification.
- The Lendable Portfolio is approximately USD30 bn
 - 60% Government Bonds
 - 40% Corporate Bonds
- Balances on loan are approximately USD15 bn
 - 82% Government Bonds
 - 18% Corporate Bonds
- Cash is taken as collateral

We will now summarise the steps that the Asset Manager took: -

Objectives

- To ensure the lending programme is not a source of inappropriately high levels of risk
- To continue to take suitable opportunities to generate securities lending revenue
- To avoid the realisation of mark to market capital losses

Actions

- Measure and understand the levels of risk and return being generated on a regular basis
- Meet with the provider to share objectives and explore possible alterations to policy
- Implement changes in a measured and considered manner
- Continue to monitor the programme to ensure compliance with stated objectives.



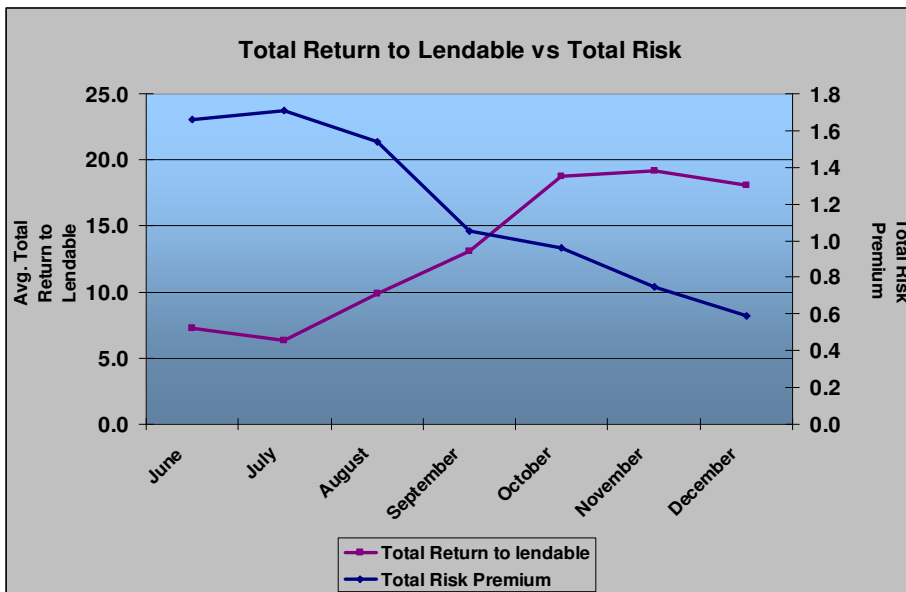
Outcome

The client has seen the following impact upon their lending results: -

- Rising Total Return to Lendable¹
- Falling Weighted Total Risk Premium²
- Rising Risk-Adjusted-Return Ratios³

Their results over recent months speak for themselves: -

	Average Total Return to Lendable (bp)	Weighted Total Risk Premium (bp)	Risk-Adjusted-Return Ratio
June	7.23	1.66	4.36
July	6.32	1.71	3.70
August	9.84	1.54	6.39
September	13.1	1.05	12.48
October	18.75	0.96	19.53
November	19.18	0.75	25.57
December	18.07	0.59	30.63



Source: www.performanceexplorer.com and www.riskexplorer.com

¹ The revenue from securities lending and reinvestment activity, scaled by the lendable assets, in Basis Points.

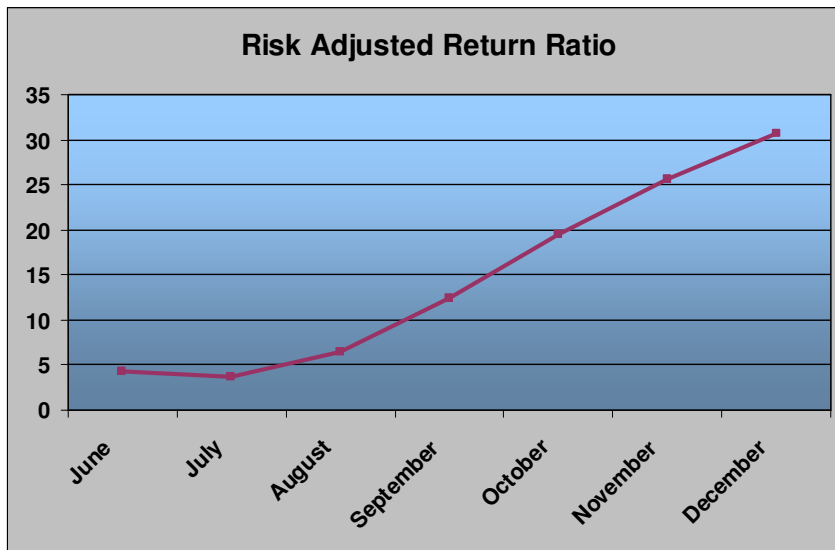
² Product of Expected Loss on Default and Probability of Default.

³ Risk-adjusted-return ratio – average total return to lendable/weighted total risk premium



Looking at the graph above, returns have risen and, at the same time, risk premium has fallen significantly.

The graph below shows how this affected the Risk/Return Ratio. For example, in June 2007 for every one unit of risk taken, the return was 4.36 but by December 2007, for every one unit of risk the return was 30.63.



Source: www.performanceexplorer.com and www.riskexplorer.com

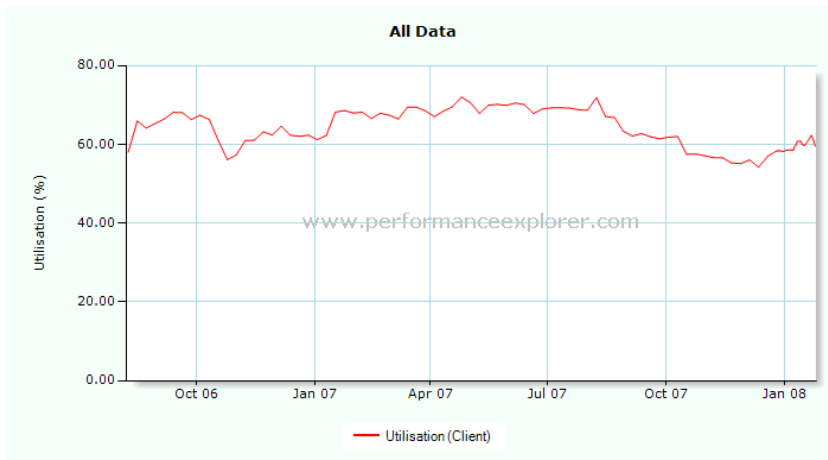
When things go this well inevitably lots of questions get asked – sometimes as many, if not more, than when things are going badly! These questions are often asked by individuals with oversight responsibility who have limited experience of the vagaries of the securities lending market. They are typically used to receiving detailed quantitative analysis relating to the performance and risk profile of the funds for which they have fiduciary responsibility. These were the circumstances that the client faced in this case study.

We will now consider some of the returns related questions before we look at the risk related issues.



Did demand for the portfolio increase?

No. As the graph below shows, the utilisation⁴ of the portfolio moved within a 10% range during the period (60% - 70%) and the increase in returns cannot therefore be attributed to an increase in demand for the portfolio. If anything, the demand decreased.



So where did the increase in revenue come from?

The revenue engine was the increased re-investment return.

Securities lending revenue comes from one of two sources – namely: -

1. Securities lending fees – the “rental” or “intrinsic” value of the securities being loaned
2. Re-investment returns – the gain (or loss) made from managing the cash collateral

⁴ The value of securities on loan expressed as a percentage of the value of securities available for loan



