

A photograph of several large, intricate ice sculptures in a snowy outdoor setting. The sculptures are made of clear, blue-tinted ice and are arranged in a row. The background shows a clear sky and some buildings, suggesting an outdoor event or festival. The text is overlaid on the image in a large, bold, sans-serif font.

Securities lending: Testing the temperature of the market

Loan supply has pushed back to pre-crisis levels, but borrower demand remains depressed, restricting lending opportunities and impairing the recovery of lending income. **Bob Currie** explores the origins of these supply-demand imbalances in securities lending markets and their implications for lender, borrower and lending agent

The global financial crisis has prompted a fundamental review of the securities lending industry, pushing lenders to reassess potential risks that they face across their lending strategies and to weigh these up against the potential income that their lending programme is likely to generate. Against this backdrop, total annual returns generated through securities lending have contracted sharply over the past three years, down from almost US\$21bn in 2008 to less than US\$8bn in 2010 (fig 1).

James Slater, Global Head of Securities Lending at BNY

Mellon Asset Servicing, indicates that securities balances available for loan through BNY Mellon's global securities lending programme are approaching levels of 2007 and 2008 prior to the escalation of the global financial crisis. In contrast, demand to borrow securities is down significantly on pre-crisis levels. This is the case, even though assets under management in the hedge fund industry are now at record levels. "We view this imbalance in the supply-demand equation as principally a demand-driven issue, rather than the result of supply irregularities," comments Slater. "Many plan sponsors have remained in their lending



James Slater,
Global Head of Securities
Lending, BNY Mellon Asset
Servicing

programmes throughout the financial crisis, although in many cases they have adjusted their risk parameters on the basis of experience acquired during this period." Specifically, institutional lenders have reinforced their procedures for evaluating credit and liquidity risk, they have adjusted the range of eligible collateral that they will accept against loaned securities, and in some instances they have refined the types of securities that they are willing to lend. "But we have seen no significant withdrawal of plan sponsors, fund companies and other potential lenders from our programme," says Slater. "Rather, the reverse is true. We have seen a number of new entrants during 2009 and 2010, each holding a clear view on how they wish to manage their risk and how they aim to generate return via their lending relationships."

eSecLending, similarly, has seen loan supply return to pre-crisis levels. The challenge in the current lending environment is that demand remains well below levels of 2007 and early 2008, thereby restricting lending opportunities and creating a situation where the lending agent has strong loan balances but relatively weak utilisation. Chris Poikonen, Executive Vice President, Business Development and Strategy at eSecLending, identifies several factors that have been important in explaining this demand constraint. The hedge fund community, which embraces a broad family of investment strategies, has remained net long during the post-crisis period. A marked excess of institutional long value over short sale value reflects the slow return of borrower demand.

Alongside this, banks have become more cautious in extending credit to buy-side firms. As a result, hedge fund managers that have traditionally applied high levels of leverage have been forced to review their investment strategies as financing has become harder and more costly to obtain.

Third, event-driven activity has been limited during the post-crisis period. Securities lending markets typically receive a stimulus when the market is ripe with M&A activity and when these transactions have a significant equity component. Though sizeable

M&A deals have occurred during the past 18 months, these have been predominantly cash-based transactions with limited equity exchange included as part of the offer.

On the borrower side, the investment banking and prime brokerage community is adopting a cautious approach to securities financing activity until it has greater clarity regarding how steps to strengthen bank capital protection will impact their business. Under Basel III, banks are required to increase their ratio of Tier 1 capital to risk-weighted assets, implying that they boost common equity and disclosed reserves relative to the Risk Weighted Asset of the bank (RWA). Though this may lead to safer banks, with a more substantial cushion of equity and reserves in place to withstand a future crisis, it will force them to reconsider how they manage activities that draw on the bank's balance sheet, including securities finance.

In line with these observations, Jean-Robert Wilkin, Executive Director and Head of Product Management, Global Securities Financing at Clearstream, indicates that for fixed-income securities, Clearstream now has stronger supply through its securities lending programme than it had prior to the 2008 crisis. This reflects increased activity from its existing lenders, particularly the central bank and commercial bank clients that represent key contributors to Clearstream's lending pool. Also, this is testament to a strong pipeline of new lenders that have signed up to Clearstream's securities lending and borrowing programme.

Though lending supply now exceeds pre-crisis levels, borrower demand has remained well below the levels witnessed prior to the crisis. Clearstream has also observed a change in the composition of demand from its borrower customers. With the introduction of revised bank capital and liquidity requirements under Basel III, there has been increased appetite for term lending – typically of 2 weeks' to 12 months' duration – driven particularly by clients' need to comply with new bank liquidity requirements. "It is clear," notes Wilkin, "that some lenders are still reluctant to extend the term of their fixed income lending,

either via agency lending arrangements or via a principal lender structure such as that offered by Clearstream. However, for those comfortable with the associated risk, term lending within a stable and well-managed securities lending programme provides opportunities to generate higher yield, given that borrowers are prepared to pay a premium to access fixed-income securities on a term basis." In the equities lending space, loan supply is again moving back close to pre-2008 crisis levels. However, again there is a significant mis-match with loan demand, which remains well below levels of 3-4 years ago.

Reflecting on the dynamics of the market over the past 18 months, Will Duff Gordon, Research Director at securities financing data specialist Data Explorers, reminds us that securities lending continues to be most lucrative during bear markets. "2010 was typified by sometimes savage bouts of volatility against a rising market," he notes. "With most fund managers long, the conditions deterred hedge funds from directional short sellers." However, beneficial owners make substantially more money from their investments rising in value than from rental value of their securities – and with many equities indices up by 10 per cent or more, this was a year in which strong improvement in portfolio valuations will leave few asset owners bemoaning the decline in lending income.

Looking more closely at 2010 data, Data Explorers calculate that the total value of

equities and loans on loan was US\$1.8 trillion on 31 December 2010, up slightly on the US\$1.7 trillion total loan value 12 months previously (Fig 1). Gross income for lending shared between asset owners and custodians was US\$9.87bn, slightly down on the US\$7.61bn gross income generated during 2009 but well down on the equivalent figure of US\$20.10bn for 2008. "It would be nice, of course, if interest rates were such that custodians could make more income from the safe re-investment of cash collateral as opposed to virtually nothing," says Gordon. "This is a major reason why lending income is far lower than 2008. On the other hand, given the problems encountered with this aspect of the business during the credit crisis, one imagines that pension funds are content with the income being generated from intrinsic securities lending, without risk being taken and would not want it any other way."

Fredrik Carstens, co-Head EMEA and Asia Agency Securities Lending at Deutsche Bank, notes that the global financial crisis has impacted the lender community in varied ways. Some lenders elected to put their lending activities on hold at the height of the crisis and to wait for market conditions to stabilise; while others opted to continue lending throughout this period. In the US, where the effects of the financial crisis were most acute, a number of asset owners chose to curtail their lending activities – and to reassess how they wished to engage with the market and which components of their securities inventories they wished to

Fig 1: Total Loan Balances and Annual Return by Asset Class, 2008-10

	Total balance (US\$ bn) as 31 Dec 2010	Total annual return (US\$bn) 2010	Total balance (US\$bn) as 31 Dec 2009	Total annual return (US\$bn) 2009	Total balance (US\$bn) as 31 Dec 2008	Total annual return (US\$bn) 2008
All Securities	1,851.5	7.6	1,763.7	9.9	1,737.8	20.1
All Equities	760.3	5.9	711.5	7.2	684.8	12.2
All Bonds	1,090.9	1.7	1,052.2	2.6	1,052.6	7.9
Corporate Bonds	184.6	0.4	164.3	0.5	155.6	0.7
Government Bonds	900.1	1.3	880.7	2.2	891.3	7.1

Source: Data Explorers

lend. Some of these concerns did carry over into Europe. However, with relatively few exceptions, confidence is returning across the asset owner communities on both sides of the Atlantic. Many asset owners have now returned to the market or are planning to re-enter in the near future.

Collateral preferences

One implication of the global financial crisis for lending strategy is that it has prompted some asset owners to move back towards an intrinsic value approach, prioritising returns generated on the securities lending transaction ahead of the additional yield delivered through reinvesting collateral.

Deutsche Bank's Fredrik Carstens confirms that there is a current focus from asset owners on intrinsic value – though he emphasises that in focusing on intrinsic value one cannot ignore the collateral component. It is widely assumed that by accepting cash collateral against their securities lending activity, lenders will be exposed to greater risk than they will through taking non-cash collateral. In reality, the relative risks will be dependent on how this collateral is utilised. For example, a lender of securities may re-deploy cash collateral through reverse repo, diversifying counterparty risk by selecting a different counterparty for the securities loan and reverse repo trade and benefiting from an efficient DvP mechanism for settlement of the transaction.

In the US, cash collateral continues to dominate in securities lending and financing relationships, although there has been a gradual rise in activity conducted against non-cash collateral over the past two to three years. In Europe, there has been a rise in the number of institutional lenders willing to accept equities as collateral – typically liquid large cap equities such as FTSE 100, CAC40 or DAX30 stocks. These blue-chip equities offer the advantage of transparent pricing and high levels of trading liquidity, while enabling lenders to diversify their range of eligible collateral and to generate some additional spread relative to, say, G10 government bonds.

In today's low volume, low interest rate environment, asset owners are seeking

ways to increase their yield in line with their specified risk parameters. J.P.Morgan's International Head of Securities Lending Relationship Management and Sales Paul Wilson points out that a lender may be able to command higher yield without taking on an appreciably higher level of risk by extending the term of its lending arrangements and carefully selecting its counterparties. The credit quality of banks willing to borrow in the six-month space may be better than those borrowing through overnight in this current financing environment. As a result, extending the lending term may diversify and reduce risk for a cash provider, rather than the opposite.

Commenting on the relative balance of cash and non-cash collateral being used to support lending activity, and the type and quality of non-cash collateral employed, eSecLending's Chris Poikonen has observed limited movement in the types of collateral that lenders are willing to accept. "Some asset owners today and historically will only accept non-cash collateral," he says. "Other clients mainly take cash collateral and have continued to do so throughout the crisis, though they are becoming much more selective in what they do with that cash collateral. Many of these customers are operating in a 90-day or less environment. We note a lot of overnight activity via reverse repo for example. What we do not see today to any significant extent are lenders willing to stretch for yield."

eSecLending has noted a contrasting set of preferences from the borrower community. Regulatory obligations are pushing dealers to seek term loan commitments from their counterparts, with the sweet spot likely to be 90 days and greater. Thus an imbalance exists in the lending relationship, with the supply side pushing to operate on the short end and the demand side searching for more term-based activity.

Against this background, the equity repo product has become one of the most popular financing products since the financial crisis. Dealers have a sizeable amount of equity collateral to post and are eager to put this to active use in their securities lending and financing relationships. In instances



Chris Poikonen,
Executive Vice President,
Business Development and
Strategy, eSecLending

where they are offering highly liquid main index securities as collateral and this is supported by an acceptable haircut, there is a good chance that a beneficial owner counterpart will be willing to do that trade. In the US, Regulation 15c3-3 prohibits US broker dealers from posting equities as collateral to US holders of securities. Borrower and lender may overcome this limitation by employing two separate contracts, enabling them to achieve a comparable end result – an equity-for-equity transaction – but achieved through synthetic means via a repo transaction.

Clearstream's Jean-Robert Wilkin believes there is still caution on the part of many lenders regarding their willingness to accept cash collateral or to participate in a cash reinvestment programme. This has been reinforced as the yield benefits offered through receiving cash collateral relative to non-cash have narrowed since pre-crisis times. Previously, many lending programmes would offer relatively low return through lending fees, with much of the yield generated via

against the credit strength of Clearstream as its borrower counterpart, in order to improve return on their securities inventory. "Though until recently we were lending primarily on an open basis, with lenders having right to recall securities at two days' notice, we are now finding more customers willing to enter into term lending transactions," he says.

Although yield benefits offered through receiving cash collateral relative to non-cash have narrowed over the past three years, BNY Mellon's James Slater believes it important to situate this development in a longer historical context. Looking back to 2006-7, immediately prior to the financial crisis, the percentage of securities lending transactions collateralised by cash (relative to non-cash) was higher than is the case currently – and the return on cash reinvestment relative to the intrinsic component represented a higher percentage of overall earnings accruing to the lender. However, stepping back slightly further, to 2003-5 for example, there was a more equal balance between income generated from the

Borrower demand is destined to strengthen in times ahead. Interest rates are unlikely to remain at their current low levels and even a 25-50 bps rise in policy rates is likely to provide an important trigger for increased activity. Hedge funds' current bias towards net long strategies will change and, with more fund managers taking a short view on the market, this is likely to stimulate greater demand to borrow securities. Moreover, dividend yields are rising in many countries and this is having a positive effect on loan demand.

the cash reinvestment programme. Since the global financial crisis, the pick-up available through taking cash collateral has contracted and some lenders no longer feel this rewards them adequately for the additional risk they may bear through participation in a cash reinvestment scheme.

More generally, potential return available to asset owners through securities lending strategies has contracted as a result of the supply-demand imbalances outlined above. Though GC loan supply now exceeds pre-2008 levels, borrower demand is still well down. In this context, Wilkin indicates that some lenders have been willing to extend the term of their lending arrangements, within a conservative programme and

intrinsic component and that delivered by cash reinvestment. "At BNY Mellon, the primary focus is always on generating return via the intrinsic component," emphasises Slater. "Every loan on our books is fundamentally an intrinsic loan and we offer flexibility to the customer regarding how they wish to define their lending parameters." For instance, some lenders may indicate that they wish to participate only in lending contracts that generate returns above a specified threshold. Some lenders may be willing to accept only a specified quality of non-cash collateral. And lenders accepting cash collateral may have very different views on the cash reinvestment strategies they wish to employ: some may wish only to do overnight; some may wish to do one month

money market; and others may be willing to extend the term up to 12 or 13 months.

More generally, BNY Mellon has seen a strong rise in demand for cash collateral to be held in segregated accounts. Many plan sponsors have voiced concerns about holding collateral, particularly cash collateral, in pooled account structures and a large majority of collateral held on behalf of lender clients at BNY Mellon is held on a segregated basis. This provides surety regarding how their collateral is held in safekeeping and confidence that owners will retain prompt access to this collateral in instance of insolvency of a counterpart or lending agent. This also affords greater flexibility to customise reinvestment options according to the client's risk parameters and overall investment objectives.

Economic drivers and market dynamics

As we go to press with this July edition of *FSR*, US rating agency Moody's has taken the decision to cut its rating on Portugal sovereign debt by four notches to sub-investment grade, reflecting fears that the Portuguese government may fail to satisfy deficit-reduction targets established under the €78 billion financial rescue plan agreed with the EU and International Monetary Fund in May.

As debt concerns in Greece, Ireland and Portugal have become more acute, the European Union has taken collective steps designed to prevent contagion to other EU members. But during the past two weeks, yields on Spain's government debt reached their highest levels since euro adoption in 1999; and Italy's cost of borrowing hit its highest point since October 2002. "The extreme spread levels for Spain and Italy indicate the market meltdown that a Greek default would trigger," comments one senior industry analyst. "This would hit not just specific countries such as Spain or Italy, but affect all the eurozone."

Reflecting on the impact of these uncertainties on securities lending markets, Societe Generale Securities Services' Denis Tréboit notes reduced inventory for Greek, Irish and Portuguese government bonds

as funds sell down their holdings in order to redeploy resources elsewhere. This is likely to be a primary reason why the fee to borrow this asset class has risen quite significantly in the last year. The average lending fee for EU Government bonds in 2009 was 8.73 bps. In 2010 the average was 10 bps. The average for Q1 2011 was 11.43 bps (see Data Explorers' Q1 11 Securities Lending Review, p 24). "Admittedly, an average fee of 46 bps for Greece and 26 bps for Portugal is lifting this," he says. "However, those markets are pretty small compared to Germany, UK and France but even here the fees have risen a little, especially due to an increasing need for AAA rated collateral. The rise of the fees will likely convince new beneficial owners to bring assets to securities lending."

One major European asset management company told *FSR* that it had, during 2009 and 2010, withdrawn fixed income funds from lending owing to liquidity concerns and fears that it may be unable to reconstitute the portfolio quickly in instance of a borrower default. Having ceased lending its UK gilt funds in 2009, in 2010 it took the decision to withdraw all its corporate bond funds from lending owing to liquidity concerns in that market segment. It reportedly took several weeks to receive back the last of the corporate bonds that were out on loan.

Fixed income has been the asset class in which there has been sharpest reduction in lending activity since the global financial crisis, confirms BNY Mellon's James Slater. In the US market, for example, policy rates remain close to zero and there is limited juice in fixed income-based trading strategies for dealers and repo desks. As demand to borrow securities has fallen, so potential yields available to the lender have contracted. However, Slater has seen no clear trend of lenders withdrawing sovereign debt or corporate debt securities from their lending programmes.

eSecLending ceased lending Greek sovereign debt through its programme approximately two years ago. It is no longer lending Spanish or Portuguese government debt at the current time. Rather, the bulk



Fredrik Carstens,
co-Head EMEA and Asia
Agency Securities Lending,
Deutsche Bank

of its lending in the government debt space is in liquid G5 securities, namely German, UK, US, Canadian and French government bonds. In practice, few of eSecLending's asset owner customers are currently holding Greek government debt – or other problem bonds – in significant quantity in their securities inventories. "Most sold out of these some time ago as fears mounted regarding the ability of these governments to service their debt obligations," says Chris Poikonen.

Given the economic uncertainties confronting Greece, Ireland and Portugal, Deutsche Bank's Fredrik Carstens affirms that there has been contraction in lending activity for Greek, Irish and Portuguese sovereign debt, mainly due to liquidity concerns. However, lending volumes in these securities represent a relatively small percentage of aggregate daily lending in government securities even prior to the Greek and Irish debt crises – and long dwarfed by lending activity in G5 govern-

ments each taking a cautious approach to business expansion until they have greater clarity regarding the regulatory framework in which they will be operating and the capital and liquidity implications this will have. Thus, for Slater, it is unlikely that demand will promptly, if ever, return to levels witnessed during 2007 and early 2008. For prime brokerage firms, the capital cost of supporting clients' trading activities has become a key consideration in shaping their future business strategies. Those trades that consume a high level of balance sheet but that generate only moderate return are being avoided. This is very much in line with what financial regulators are setting out to achieve: to dial down the level of risk by demanding close alignment between risk exposure and associated capitalisation cost.

In the equities space, Deutsche Bank has witnessed expansion in loan demand for specific securities, driven in part by clients targeting yield enhancement trades – and

[Moves] towards CCP intermediation in securities lending markets will take time to become established. In repo markets, the transition from bilateral to CCP-intermediated transactions was slow at first, but now accounts for 30-40 per cent of transactions. Given that a sizeable percentage of securities lending transactions take place via a principal-agent relationship - rather than on a principal-principal basis - there is clear incentive for CCPs to develop a model that can fit the requirements of an agency lending structure.

ment securities for example. There is a deeper and more liquid market for Spanish and Italian government debt and Deutsche Bank has continued to lend actively in these markets, albeit with a close eye on liquidity. Carstens indicates that, as far as it is possible to generalise, the market for corporate debt has remained relatively steady both in Europe and the US.

At BNY Mellon, equities lending balances have continued to grow over the past 6-12 months. James Slater is confident that borrowing demand will receive a boost as investor money continues to flow into the hedge fund sector. On the downside, high levels of regulatory uncertainty are acting as a counterweight, with buy side firms, bank trading desks and prime brokerage opera-

this year the timing of the transactions has been particularly important to the performance of these strategies. "In responding to these market dynamics, we continue to monitor market liquidity closely across the range of securities that our clients employ for lending or collateral," says Carstens. "In cases where we identify liquidity concerns, we contact our customers at an early point to discuss whether they wish to review their existing lending parameters and collateral eligibility."

Two corners of the market in which loan demand continues to grow are in exchange-traded funds (ETFs) and sector swaps. Buy-side firms are interested to borrow these instruments in order to hedge their portfolios – and limited supply means that



Jean-Robert Wilkin,
Executive Director and Head
of Product Management,
Global Securities Financing,
Clearstream

attractive deals are available to potential lenders. "Europe has seen a 210 per cent increase in ETF supply, but it is sector swaps that keep prime brokers most busy since they are a bespoke basket of names to best hedge a fund's position in the absence of a suitable ETF," says Data Explorers' Will Duff Gordon. "In cases where the broker does not have the shares in house, then they will go externally to source them."

One implication of the current environment of low interest rates, few "specials" and a drive for greater transparency in lending arrangements is that this may encourage greater market efficiency since custodians will be required to ensure that they are charging the highest possible lending fee to meet clients' income objectives. "This," believes Gordon, "is good for beneficial owners, but less good for intermediaries or the buy side if this leads to fee inflation. An even more serious scenario will be one where the borrowing fee deters the short sale in the first place."

Lending strategy and service support

As asset owners and buy-side firms refine their approaches to securities lending, in many cases they are seeking to embrace their securities lending decisions more centrally into the investment process – with judgement calls being made on the investor's risk budget based on the risk-reward

parameters that it sets for its lending strategy. Sarah Nicolson, Head of Securities Finance at Aviva Investors, describes an evolution towards a client-based, solutions-based lending relationship. Rather than evaluating lending opportunities from borrower counterparts simply as an opportunity to maximise return over a specified loan term, the lender is typically seeking a solution that will address a specific problem within the investment process. First and foremost, the objective is to meet the investment objectives of the fund; and to manage specific risks embedded within that process. The level of return remains important, but this may come several positions down the priority list.

So too, this co-operative model is attractive on the borrower side, enabling banks to meet regulatory commitments through extending the term of loan agreements, diversifying counterparties and financing against a wider range of assets. Flexibility is key; no single model will meet lenders' need for bespoke solutions outlined above. Thus, more and more lending solutions are being developed out of the money manager, with the borrower counterpart tailoring a service to meet these specifications, rather than standardised lending products being developed on the bank side and being pushed across to potential lenders to see who will buy. Matthew Boyd, Director of Securities Lending Trading at Blackrock, observes that traditionally lenders have been very much price takers in the relationship. Now the balance is changing, with lenders being more proactive in defining the terms under which they will do a trade (factoring in counterparty risk, liquidity risk and concentration risk, along with additional variables such as interest rate risk if they are accepting cash collateral) and against what price.

eSecLending offers a customised lending programme to meet the dedicated needs of its beneficial owner customers. The strength of this approach, Chris Poikonen believes, is reflected in the fact that it has taken on a range of new institutional customers over the past 24 months, including US and UK-based corporate pension plans, US mutual funds and a Europe-based UCITS

fund manager. To build on this momentum, the firm is taking measures to reinforce its product set and to extend its geographical coverage. This includes recent steps to bolster its discretionary lending programme and to strengthen its Boston- and London-based trading desks. In April, it appointed Paul Lynch, a senior industry veteran with more than 20 years' securities lending experience, as Chief Operating Officer. In June Oberon Knapp joined as SVP, Business Development. Both previously held senior management positions at Premier Global Securities Lending and State Street prior to joining eSecLending.

"eSecLending has been one of the few securities lending specialists that has continued to hire right through the global financial crisis," says Poikonen. "We take the view that when the market is quiet, this is a good time to invest in our core business, strengthen our product offering, enhance our risk management and reporting capabilities, and reinforce our staff expertise and supporting technology. When the market revives, we believe that we will be well placed to extend new lending opportunities out to the beneficial owner community that we serve. Securities lending is the only business that we do – and this is our focus 365 days per year. As such, we provide a specialised service and are not involved in any parallel business activities that may conflict with the best interests of our asset owner customer base."

On balance, Fredrik Carstens indicates that Deutsche Bank is well equipped to support the securities borrowing and lending needs of a broad global client base, either through its third-party or custodial agency securities lending programme offered within the Trust and Securities Services division in Global Transaction Banking. When Deutsche Bank acquired Dresdner Bank's Global Agency Securities Lending business from Commerzbank AG in May 2009, this provided an opportunity to review systems and operational procedures. This has enabled the securities lending team to draw on the sophisticated credit risk analysis and other risk management systems available within Deutsche Bank, developing interfaces through to these risk systems via the bespoke securi-

ties lending platform that it had in place to support its Global Agency Securities Lending programme. "Through these arrangements, we have the ability to supply a broad range of reporting to our agency and custodial lending clients, providing analysis of performance and risk profiles across clients' lending activity and collateral holdings," says Carstens. Many clients are taking deeper interest in these performance and risk analytics, particularly in instances where they use more than one provider and are interested to compare performance and to draw up a consolidated picture of their risk across these respective programmes.

BNY Mellon has introduced a series of enhancements to the securities lending reporting and analytics extended to clients via its Workbench platform. Plan sponsors and fund houses are seeking a higher level of transparency around all areas of their asset servicing, including their securities lending activities. "Customers are not simply seeking data, they are looking for information and analysis of the risks that they face and the return opportunities available to them," comments James Slater. BNY Mellon has created a series of dashboard reports which enable senior decision makers and risk managers within these organisations to establish an overview of their lending programmes, supported by key summary statistics detailing which securities are out on loan, what the top earners are, how their credit profile looks across their cash reinvestment programmes, what the maturity and reset profiles will look like, and so on. These reports bring together detailed MIS, along with additional transparency that can be used to support internal decision making and external reporting and compliance obligations. To enhance the efficiency of its cash reinvestment programme, BNY Mellon has upgraded its order management system, providing greater flexibility for clients to customise their investment guidelines and to bring greater automation to compliance and control functions.

Paul Wilson believes that JPMorgan's financial stability throughout the financial crisis has provided a strong foundation for the continued growth of the bank's securities lending and financing businesses. "The



Paul Wilson,
International Head of
Securities Lending Relationship
Management and Sales,
J.P.Morgan

indemnification we offer in our securities lending programme is underpinned by our strong balance sheet," he says. "We have long offered clients the security of holding their cash in segregated accounts rather than commingled funds. We also offer the client a high level of customisation regarding how we manage their securities lending, collateral and cash reinvestment preferences." Reflecting on implications of the financial crisis, J.P.Morgan did not feel it necessary to make wholesale changes to its product or approach owing to the provisions it had in place. In October 2009, it introduced the third-generation of its securities lending dashboard that enables clients to monitor key dimensions of their lending activities in a customised view, accessible through ACCESSSM, J.P. Morgan's web portal for Treasury and Securities Services. This dashboard is supported by approximately 200 underlying reports sup-

plying portfolio data, risk and performance analysis, including loan activity dissected by asset class, top earners by security, collateral held, non-cash collateral by rating and top borrowers by loan balance.

as collateral, accepting only fixed-income securities that meet specified minimum eligibility criteria." Although cash reinvestment programmes did prove to be attractive to many lenders prior to the financial crisis, Clearstream has held firm in its decision not offer a cash reinvestment option. "With hindsight, we believe this has proven to be a sound decision and one that aligns with the conservative risk approach applied by Clearstream across our Global Securities Financing product area," says Wilkin.

As its client base has widened, Clearstream has been taking steps to build greater flexibility into its lending programme for both borrower and lender. Collateral management for the securities lending programme has been migrated onto its CmaX tri-party collateral management platform, thereby reinforcing optimisation, substitution and reporting benefits offered by this collat-

For prime brokerage firms, the capital cost of supporting clients' trading activities has become a key consideration in shaping their future business strategies. Those trades that consume a high level of balance sheet but that generate only moderate return are being avoided. This is very much in line with what financial regulators are setting out to achieve: to dial down the level of risk by demanding close alignment between risk exposure and associated capitalisation cost.

eralisation engine. Also, it has introduced enhancements to its reporting capability, providing to the customer a transparent, real-time view on the status of its collateral. Needless to say, this is important for borrowers, which are required to provide collateral to Clearstream and thus hold a counterparty risk against Clearstream as principal lender; and for lenders, which receive collateral from Clearstream as principal borrower over the duration of the lending agreement.

Jean-Robert Wilkin highlights a number of features of Clearstream's securities lending programme that he believes have proven attractive in the market environment witnessed over the past 36 months. "One is our specialisation in fixed-income securities," he says. "Another is that we adopt a conservative, risk-averse approach in our lending structures: as principal lender, we have a pure match book business such that everything that we borrow from our lenders we match exactly to demand on the borrower side. We do not take cash

Additionally, Clearstream has responded to client demand by extending its equity lending coverage. "We remain predominantly a fixed income lender on the ICSD side," notes Wilkin. "However, we offer equity lending services out of Clearstream Banking Frankfurt and one of our major

projects is to extend our equity lending from the ICSD platform, enabling us to deliver greater efficiency on the equities that our customers hold with us as custodian. In 2010, Clearstream introduced a series of enhancements to its collateral management programme for equities – and in 2011 it expects to extend its equity lending programme, both through ASL+ and its actively-managed programme, thereby replicating the efficiencies that Clearstream has long delivered on clients' fixed income portfolios.

J.P. Morgan's global securities lending product reach is expanding by targeting new opportunities in emerging markets. Paul Wilson highlights that J.P. Morgan was the first international lending agent to establish activities in South Korea and the first non-domestic firm to establish securities lending in Brazil. It is also the largest securities lending agent in Taiwan. Each of these markets presents a different set of challenges. Taiwan requires the market to provide pre-trade date notification of sales; and any firm deemed responsible for the failure of a securities transaction to settle risks a suspension period from the market. In Brazil, securities lending transactions are intermediated by CBLC, the CCP owned by BM&F Bovespa, which accepts collateral from the borrower and holds it centrally, managing margin calls around the transaction as necessary. It has been important to seek legal clarification regarding clients' access to collateral in instance of default of a lending counterpart or the CCP. J.P.Morgan has also needed to adjust to procedures specific to the Brazilian market – for example lending fees are calculated on the basis of working business days over the loan period, rather than on a 365 day basis.

The Brazilian securities lending market has also been of interest to eSecLending. "We have conducted our diligence and we are now able to support those clients interested in lending in this market," says Chris Poikonen. "Our fundamental approach is that, when there is demand from beneficial owners to access a new securities lending market and the market meets our required standards from a legal, tax, regulatory and operational perspective, we will take the necessary steps to establish such a service.

In applying this approach, we do not seek to be first into a new market. Rather, our goal is to establish a robust and efficient lending solution that is aligned with our customers' specialised service requirements and meets our own high standards from a risk management perspective."

During the past 18 months, Deutsche Bank has been building on its existing securities lending coverage in the EU and the US by expanding in Asia, the Middle East and other emergent securities lending markets worldwide. "In India, for example, we have been working closely with our Domestic Custody Services team to identify new lending opportunities and to adapt our product to the requirements of the local market," says Carstens. SBL transactions in the Indian market are currently exchanged-traded and cleared via a CCP – and Deutsche Bank has maintained a close dialogue with the regulatory authorities and market infrastructure providers to discuss how best to generate liquidity in the local securities lending market and to allow this to mature in a way that best meets the needs of domestic and international users.

Concluding thoughts

We have focused in some detail in this article on the origins of supply-demand imbalances currently prevailing in global securities lending markets. However, eSecLending is positive about the outlook and confident that borrower demand is destined to strengthen in times ahead. Interest rates are unlikely to remain at their current low levels and even a 25-50 bps rise in policy rates is likely to provide an important trigger for increased activity. New hedge funds are being created and are being invigorated by strong institutional flows into the hedge fund sector. "We predict that hedge funds' current bias towards net long strategies will change and, with more fund managers taking a short view on the market, this is likely to stimulate greater demand to borrow securities," says Chris Poikonen. "Moreover, dividend yields are rising in many countries and this is having a positive effect on loan demand, raising the potential yields that may be secured on yield enhancement trades. On balance, although each of these factors represents a small part

of a bigger picture, taken collectively we believe that these will contribute to a tangible rise in borrowing demand and new lending opportunities over the next 18-24 months."

Clearstream's Jean-Robert Wilkin appears to be more guarded in his forecast. Speaking from a personal viewpoint, he questions whether yields generated through lending arrangements will rise dramatically in months or years to come. Any tangible improvement in performance may be eaten

towards CCP intermediation in securities lending markets will take time to become established. In repo markets, the transition from bilateral to CCP-intermediated transactions was slow at first, but now accounts for 30-40 per cent of transactions. Given that a sizeable percentage of securities lending transactions take place via a principal-agent relationship – rather than on a principal-principal basis – there is clear incentive for CCPs to develop a model that can fit the requirements of an agency lending struc-

A lender may be able to command higher yield without taking on an appreciably higher level of risk by extending the term of their lending arrangements and carefully selecting their counterparties. The credit quality of banks willing to borrow in the six-month space may be better than those borrowing through overnight in this current financing environment. As a result, extending the lending term may diversify and reduce risk for a cash provider, rather than the opposite.

up by higher associated cost of collateralisation. With many lenders remaining highly risk averse, every additional basis point demanded as haircut on the collateral will represent additional cost for the borrower – a cost that each will need to evaluate very carefully. For prime brokerage firms with significant balance sheet constraints, for example, these capital cost considerations may be an important determinant of their future positioning in securities lending markets.

In times ahead, Wilkin anticipates that a rising percentage of securities lending activity will be filtered through central counterparty arrangements. A number of CCP initiatives for the securities lending market are in place or in development. For example, Eurex Clearing has recently announced its intention to go live in 2011 with CCP services for securities lending of European equities (see further in *FSR*, Q3 2011 forthcoming). Though CCP intermediation is likely to ease the balance sheet cost of a borrower's activities in securities lending markets, this will impose significant collateralisation costs on those engaging in centrally-cleared securities lending transactions.

Parallel experience from the European repo marketplace suggests that this move

is likely to be a prominent feature of the forthcoming Eurex Clearing service.

There has been detailed industry consultation regarding the potential merits of extending central counterparty clearing in OTC derivative markets. However, BNY Mellon's Slater believes that the jury is still out on the potential value of central clearing in securities lending markets. "If we reflect back on experience during the global financial crisis, lenders typically either had indemnity from their agent lender against the potential default of a counterparty, or they were holding adequate collateral to ensure that they could cover the costs of buying in any securities that were out on loan with a defaulting counterparty," he says. "In this context, we do not believe that counterparty risk proved to be a primary danger to plan sponsors or fund complexes that had securities out of loan at the time of the Lehman default. On the contrary, the existing risk management arrangements that they had in place via their lending agents provided effective protection against these risks. Lending contracts worked broadly as they should and the operational functioning of agency lending relationships generally held up well under stress conditions." ■