

THE RISK FACTOR: NEW PARADIGMS IN SECURITIES LENDING



Attendees (from left to right)

DON D'ERAMO, senior managing director and securities finance regional business director for EMEA & Canada, State Street

KEVIN McNULTY, chief executive of the International Securities Lending Association

MATT BOYD, director securities lending trading, BlackRock

ROB COXON, international head of lending, BNY Mellon

GERARD MOORE, financial controller, Merseyside Pension Fund

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LIVING IN THE AFTERMATH

MATT BOYD: One of the most salient characteristics of the market today is the lack of demand to borrow securities. Looking at some statistics from Data Explorers comparing the present to mid-2007, global equity balances are down roughly 33% and European equities are down 40%. That is a drastic reduction in the amount of securities borrowed. Bonds on loan are also down roughly 25% globally. Invariably this has a dramatic impact on all of our businesses. The source of demand has also changed. In the current market, event-driven demand has primarily been the result of capital-raising activities. Directional shorts have not been specific to individual stocks but rather focused on instruments providing broad exposure such as ETFs or unit trusts. Both sell side and independent research is clearly pointing to a risk aversion from hedge fund managers as it relates to single, unstructured, stock exposure. Proprietary trading is on the wane as well, particularly post Dodd-Frank. Couple this with a distinct lack of leverage in both the hedge fund and proprietary trading space, and it becomes obvious why returns from securities lending programmes are down year over year.

SIMON LEE: We are now two years past the Lehman Brothers' default, and many lenders have experienced challenges with their securities lending programmes as a result. I would not say everyone is out of the woods, however in recent months there has been a noticeable increase in activity, and beneficial owners are looking at their securities lending programme in a more optimistic manner. They now allocate more time and have the determination to focus less on fire-fighting, and more on development opportunities. Many institutions are in the process of either making decisions, or considering decisions around their lending programmes, and how they want their programmes managed. Against the backdrop of some of the comments Matt made about falling demand and falling revenues, one of the first questions that lenders are asking is whether or not they want to be actively engaged in securities lending and whether the revenues that their programme generates are meaningful. Assuming that the answer is yes and they do want to continue to participate, many lenders recognise that there is a choice in providers and the traditional routes they chose historically are not necessarily the best routes for their programme today. Many beneficial owners are also looking at their collateral management profiles and are making decisions around the forms of collateral they wish to accept, and the impact those decisions have on revenue and on risk. Specifically, with respect to cash collateral, beneficial owners are evaluating whether this is best serviced by cash management specialists rather than by their securities lending provider.

DON D'ERAMO: Over the past 20 months we've heard such a lot about intrinsic value lending. In fact, intrinsic value lending has always been an important ingredient of our lending programme. More importantly, we see beneficial owners wanting to clearly understand the types of programmes that they are in and the different choices their provider can offer. It is not always an asset/liability construct. It could equally be in a very de-risked type of portfolio. The old adage of understanding what



Gerard Moore, financial controller, Merseyside Pension Fund.

your risk parameters are and operating within those parameters has been a key consideration both for us and for our beneficial owners. Intrinsic value lending is a phrase that a lot of people throw around nowadays. It is what beneficial owners really value.

KEVIN McNULTY: I'm wondering whether there is a change in the demand profile in terms of who's out there borrowing securities. My sense is that that's changed quite significantly over the last two or three years as well, and demand has become more evenly spread between prime brokers.

DON D'ERAMO: I would agree with that. I would also add to that the focus on capital and the balance sheet has forced people to look at the true costs of doing business. The old leverage-style business, in that context, might be a changing model. Distribution channels and borrowers are paying a lot of attention to where they're allocating capital. Carrying the general file balances of three years ago really isn't an option any more. Understanding that and understanding what a beneficial owner wants out of the programme are vital to the industry going forward.

GERARD MOORE: If we move onto the supply side, in the investment community I represent, most, but not all, pension funds have recommenced lending. Some, on a selective basis, are participating just for the European dividend season. However, concerning that, and given the possible extension across Europe of the principle of free movement of capital, meaning you can get more tax back; more funds will re-evaluate the equation; whether it's worth getting a fee for lending plus a manufactured overseas dividend, compared with the more generous tax allowances when directly receiving higher net dividends.

ROB COXON: The key thing on the broker borrower/demand side is very much how they're managing their balance sheets; and they're very sensitive to any factors that may impact it. We are seeing that they are very selective regarding how much they want to borrow, and the durational tenure they're prepared to accept. Also, there's certain asset types that are much easier to lend than others, which actually explains why there is this refocusing on intrinsic lending. For example, there is no intrinsic value in the US treasury market because clearly there has been a lot of government issuance, the US treasury market doesn't behave like it used to. Moreover, because of the sensitivity around balance sheets, brokers are using in-house supply or supply that they've accumulated through their natural prime brokerage activities. They're putting that to work much more keenly than ever before, and that's affecting the demand that the institutional supply side is seeing. In terms of clients, I

would say that if you see a 40% reduction in demand, then the supply side is probably down by 10% to 15%. Additionally, our clients remain sensitive to counterparty risk and they're scrutinising their programmes, and have been doing so even more keenly over the last year. Even so, many of our clients stayed in the programme, and those that left have since rejoined. That shows that they're confident with the way that the market is operating.

ADJUSTING TO LOWER VOLUMES: WHAT'S NEEDED TO REKINDLE THE MARKET?

KEVIN McNULTY: From all quarters it is apparent that demand is down quite considerably from where it was two or three years ago. What would re-ignite demand? It is going to be a combination of things, such as confidence in markets, trading opportunities, companies essentially becoming stronger again and embarking on corporate acquisition strategies. Hedge funds have been under pressure in Europe, particularly with the uncertainty of regulation and a lack of performance. If that gets resolved hopefully there will be a return to confidence, and we'll see new money flows into hedge funds and proprietary trading strategies.

SIMON LEE: I would echo Kevin's points, but to see a material increase in volumes you need those factors to happen in unison. It might be that all of them may come to pass over the next year or two, but unless those events occurred simultaneously, you won't necessarily see a material increase in volumes. Importantly, there may be other factors that are influencing volumes toward a downward trend, so it's difficult to try and predict how things will look next year.

DON D'ERAMO: While I acknowledge Kevin and Simon's points, perhaps we are looking at volumes with the wrong slant. Perhaps 2008 was an anomaly in terms of volume. If you take the years 2002 through 2005, and project them forward, it normalises to a compound annual growth that is probably a lot more applicable to today's securities lending volumes. Perhaps that is a better benchmark. Obviously when you look at events in retrospect, you have 20-20 vision. Black swan events, such as the financial crisis, force markets to change and most of the time they change for the better.

KEVIN McNULTY: That is certainly a valid viewpoint. I agree, what's been noticeably over the last few years, and not just the last two years, is that the industry has done a good job of making itself much more efficient. In that context, in terms of weathering a (hopefully) temporary downturn, the securities lending business is in as good a shape now as it could feasibly be. I would say that most firms are operating highly efficient systems, highly efficient platforms and have adopted market technology that really helps firms do business in a highly efficient manner.

ROB COXON: The normalisation of markets, and/or central bank's intervention through quantitative tightening and the rising of interest rates will also help the mix, particularly in terms of generating yield for cash reinvestment funds and so on. Moreover, not only has the industry been very strong in



Matt Boyd, director securities lending trading, BlackRock.

terms of efficiency, it's been very good at unearthing supply, and Gerard alluded to this: it could well be that supply needs to contract and that some clients may well decide that they don't want to be in the market, simply because the returns aren't there or they don't want the risk. That could certainly happen and it could be a positive thing for those lending clients that remain in the market.

GERARD MOORE: From the viewpoint of somewhat smaller beneficial owners, in hindsight they were probably too dependent on guidance and relied too much on their agent lender rather than fully understanding the risks themselves. Since the collapse of Lehman Brothers there has been significant investment over the last 18 months in educational documents and events (such as beneficial owners' breakfast discussions at conferences) that has greatly benefited smaller beneficial owners and trustees. As a result, there is far more awareness of risk and reward than previously. Will owners choose to take a step back thinking it's not worth the risk or, will they think they're more confident managing those risks? Some funds will go more confidently down the securities lending road: others might decide to step back.

RISK AND REWARD

FRANCESCA CARNEVALE: Is the risk/reward ratio clear right now? Everybody talks about it, but what does it actually mean? Is there a measurable ratio out there? How is it measured?

MATT BOYD: When you look at the transparency that has been introduced to the securities lending marketplace, it has focused on the return side of the equation. What I think you can say is that there is a good comparison point for returns amongst providers. This is a great benefit as beneficial owners finally have the ability to look beyond split, which has often been a red herring, and have visibility into the relative yield that is being generated for their accounts. Unfortunately, there is not a clear benchmark for the risk embedded in different programmes; I am not convinced that there will ever be one that is as clear cut as a return benchmark. There are tools in development that can help beneficial owners stress test their programmes, but at this point I don't believe there is a substitute for old fashioned due diligence. On the bright side, the credit crisis has ensured that no one can deny that there is market risk implicit in securities lending. In 2005/2006, there wasn't a lot of focus on market risk; it was almost dismissed as not relevant to this business. It is different now and this is something the industry has to address. As we continue to move forward, the business ►►



Kevin McNulty, chief executive of the International Securities Lending Association.

is going to be focused on exactly what risks are and are not acceptable to our clients and ensuring we have solutions that meet their needs.

KEVIN McNULTY: The challenge that this industry has is that revenue is very tangible. It's very easy to measure it. Risk is much more difficult to measure. So if you're looking for a simple quantitative answer to your question, it's not out there at the moment. Individual firms can and do model risk in quite sophisticated ways for their own risk management purposes. You would then have an additional challenge in that a lot of beneficial owners would not necessarily be in a position to think about this business on such technical lines. However, if you look at the core of the business in simple terms from a beneficial owners' perspective where you're perhaps lending through an agent, receiving good quality collateral, you may have indemnification from your agent, and you're perhaps not doing cash collateral reinvestment. Start at that point and you undoubtedly have to say this is a low-risk, but not risk-less, business. The question then becomes what do you lay on top of that to take additional risk? Moreover, are you getting rewarded for those additional risks that you're taking? That is the job of lending agents: to help their clients understand those types of things.

ROB COXON: Certainly in the instances where clients are looking to eliminate risk or take on very low risk—for instance taking in sovereign debt collateral and there is an indemnification—the rewards are very, very small because of the way the market is currently working. This harks back to the question: should those types of clients actually participate in securities lending? In reality, at the end of the day, there is no free lunch. There is always going to be some degree of risk, and what's key in that regard is to really understand the level of that risk you are taking and mitigate it as much as possible. That in turn involves properly understanding the lending contract that you have with your provider, and it also means taking time to understand the securities lending market and monitor the product.

DON D'ERAMO: The market continues to become much more transparent. We are able to have very good granular discussions with beneficial owners and to understand where they want to be. So, if it is a strictly non-cash programme with very, very conservative guidelines, you can provide the client with a model of the profiles or revenue streams that are possible. The discussion of whether the client will or will not be in a programme will obviously follow that. These days however, we are seeing that some of our clients really want to understand

the drivers behind the revenue streams and the risks associated with them. These clients know specifically which parts of the market they want to participate in. It is not a question of all in or all out. Actually, that is just part of being able to offer a bespoke product for customers, and we're going to see more and more of that going forward.

SIMON LEE: Just to add to that, many lenders have different views on the question of risk versus reward, and lenders vary in their perceptions and measures of risk. It differs from lender to lender. Also, when you look at revenue, lenders have different views of their revenue, whether they're measuring in absolute terms or whether they're measuring as a performance-based return, all of which can cause different opinions. You also need to factor in the level of involvement that the lender has in their programme. For instance, one lender's level of involvement may be active and voluntary because they are a lender who likes to be engaged in the management of their programme. Another lender's involvement may be involuntary and subject only to when problems arise. These factors will influence whether the lender participates or not, and whether they feel that the question of risk and reward is adequately addressed.

REINVESTING CASH COLLATERAL: HOW RISKY IS IT?

KEVIN McNULTY: I'll start by saying it is important to understand it's not necessarily very risky to invest cash. We've spent quite a bit of time in the past couple of years convincing people that had a view that cash was great, that it may not always be great and, conversely, convincing those that think cash is evil that actually it may not be evil either. It's all about what happens to that cash and how it's reinvested. In my view, speaking to firms, there's no doubt that most lenders that take cash collateral, and there are still a lot of them, have made adjustments to their reinvestment guidelines to make them as comfortable as they need to be. They'll continue to take cash collateral.

DON D'ERAMO: Naturally, clients are adopting more conservative guidelines. They are putting their focus on ensuring that their agent lender is assessed properly, from having the right infrastructure to being able to manage cash in all market environments. The trend has been to de-risk and build liquidity in the portfolios, which is not a bad thing. The emphasis has shifted to really understanding your guidelines and making sure that the agent lender truly has the commitment, the core, and the infrastructure to manage through the difficult times that we have seen.

ROB COXON: The lending of securities is essentially a trading and over the counter (OTC) market activity but when it comes to cash collateral reinvestment, the client is moving into investment management, and therefore into a new area with a different set of risks around it. We tend to talk about securities lending very generically, but cash reinvestment is an investment management activity and should be approached as such by any firm that undertakes it. Moreover, because its investment management, the clients that participate have to fully appreciate the risks in terms of market, interest, credit and liquidity risk.



Don D'Eramo, senior managing director and securities finance regional business director for EMEA & Canada, State Street.

Certainly, you'd hope that in this day and age clients aren't slipping into cash reinvestment through the backdoor, via a securities lending programme. Securities lending and cash reinvestment management are two very different disciplines. It is important they are properly educated on that point.

GERARD MOORE: I agree with that. Again, in my community, a lot of people see cash reinvestment as a further step up the ladder, requiring an extra set of skills, due diligence, expertise and competences. Some may be reluctant to take that extra step and may want to stick with a more simple approach. Usually your custodian is your agent lender. If you wish to keep it simple, I would say: get your solid indemnity, and avoid the extra complexities of taking cash collateral. There's far greater awareness now, certainly in the last two years, of the implications and options when taking cash collateral and beneficial owners have to ask themselves the question: do they have the competence and knowledge to take that further step up the ladder?

SIMON LEE: The cash collateral environment you're describing is somewhat dated now and the industry has evolved significantly since then. If you spoke to every agent lender in the market, they would have a very different approach to the reinvestment of cash collateral now than they would have two years ago. Also, to echo Gerard's point, most lenders that take cash collateral have better understanding of that aspect of their programme.

MATT BOYD: There's another component to this. This was a market-wide phenomenon and virtually everyone was fundamentally mispricing risk in the 2005-2008 period. One of the largest investment banks in the world went bankrupt because of that mispricing and two other major financial institutions were only spared due to government intervention. The over-emphasis on cash collateral programmes may be a bit of a distraction as this segment of the market should have learned its lesson through the credit crisis. As providers, we must be diligent in ensuring the lessons of the past are understood and that new controls and practices are adopted, but we cannot afford to myopically focus on the risk that hit us recently or we will lose perspective on new risks that will inevitably develop.

ROB COXON: Perhaps also to clarify: cash reinvestment guidelines as a "norm" is more based along the lines of the short duration US money market 2A7-type funds. They are more conservative, but some clients may want to take an additional risk and may want to go further up on the curve, and they're perfectly entitled to do that. That's their prerogative. We always maintain that we are acting as agent and we are facilitating that for them.

KEVIN McNULTY: That's a really important point. What we want to see in the industry is lenders making proper decisions about their security lending programmes based on real facts and understanding of the business. Once you have that it is reasonable that beneficial owners and lenders or investors would have different levels of risk aversion, and may decide to structure their programmes in very different ways. It's ultimately about them making informed decisions.

SHORTING AND THE EU: THE CONSEQUENCES OF REGULATION

ROB COXON: I don't know what the impact is going to be in the short term; my understanding is that the regulation will be introduced by July 2012, so as an industry we have time to gear up for the changes. My personal thoughts are that it's going to have a negative impact on demand. What concerns me most is not so much the fact that you will have to have your shorts covered, because that is already market practice, and whether you choose to formalise it or not is down to a regulatory preference. In the Hong Kong market we have to complete regulatory reporting on all potential securities located for shorts, so that's not insurmountable for the European markets. What worries me most, however, is the proposed public disclosure threshold limit of 0.5% for short sales, which I believe is too low. This will invariably impact upon the amount of business the hedge funds do or the amount or level of trading activity they take on in any particular arbitrage play. Additionally, most people would agree that you'd want equality between long positions and short positions in terms of reporting. You'd think that would make sense.

MATT BOYD: Short selling is an important component of an efficient marketplace; academic studies clearly demonstrate this. Impingement on, or discouragement of, short selling is a problem and will impact the efficiency of the marketplace. It will have a negative impact on long investors as bid-ask spreads widen. Short selling is also one of the practices that creates demand to borrow securities and many beneficial owners depend on the alpha their securities lending programmes generate to offset fees and improve investment performance. Considering the pressure many pension funds face due to liabilities outstripping assets, limiting an important source of revenue for these plans seems contrary to the spirit of the proposed regulations.

GERARD MOORE: From a beneficial owner's perspective, it might be a double whammy, in the sense that it would reduce the income from securities lending, but also, as most pension funds also invest in hedge funds, lower volume might be delivering lower returns from those as well.

DON D'ERAMO: Everyone agrees with more transparency, whether it's in short selling or market exposure, but to what point or to what degree? Will that have an effect on clients wanting to hold certain positions or lead to restrictions of certain assets? Also, will that have a knock-on effect on the availability of liquidity in the marketplace? I think we have to consider these issues. ▶▶

SIMON LEE: I'm going to take a slightly contrary view to what Don's just said. Looking at certain European domiciles where there is still an element of uncertainty about securities lending amongst beneficial owners. There may be more lenders sitting on the sidelines than in other jurisdictions. When regulatory comments on securities lending are issued, there is a secondary effect in that further clarity is provided to beneficial owners with respect to what the regulator's view is therefore there is an element of an implicit endorsement of lending. So in some jurisdictions it may actually help lenders who want to lend. It may give them that extra level of comfort to have the regulators comment on the industry.

KEVIN McNULTY: Speaking to our members, there are a number of concerns with what is being proposed. One of the biggest, particularly among prime brokers, is the public transparency provision. The problem that they already see in cases where there is a requirement for public transparency is that their investor clients won't short sell beyond the threshold. They just don't want to signal their trading or investment strategies, and in some cases there is concern about being associated with short selling. So that's likely not to help demand, and that's not good for the securities lending industry or the efficiency of the market. Other provisions in the proposed legislation, such as the requirement to reserve shares before placing a short sale order, a mandatory buy-in procedure on T+4, and the flagging of short sale orders are all costly to implement and have questionable benefits to anyone. The fundamental concern we have is that this is a very politically-driven piece of legislation. There seems to be a desire to knock short selling. We don't think there's a theoretical basis for wanting to hit short selling hard. We are sympathetic to regulators needing to see what goes on in the markets (and that's why we've been supportive of private transparency) but the biggest issues for the industry are the public disclosure and reserving elements. One of the stated aims of the commission is to create some information symmetries. As Rob notes, this proposal will require short sellers to disclose an awful lot more than long investors.

FRANCESCA CARNEVALE: I don't want to put anybody on the spot, but do you feel that the description of the legislation by the commission was done with a full understanding of the impact on the market?

KEVIN McNULTY: I went to see the commission, which does understand the benefits of short selling, and they do understand the arguments that the market has made. The challenge they have is they're under a lot of political pressure to do something about regulating short selling. I don't think the problem is necessarily short selling or the commission's understanding, and Rob alluded to the fact that this is draft regulation at the moment, and the industry, including ourselves, will be likely going to see some politicians through the next few months to see whether we can influence their thinking.

FRANCESCA CARNEVALE: Who is exerting this political pressure? I have to tell you, it's not the man on the street. He wouldn't know what short selling was if it hit him in the face.

SIMON LEE: Through the mainstream media, it is the man on the street. There is an awareness of short selling but some people may not understand the whole picture. The press have

certainly talked about it, and will likely continue doing so. Many conclusions can be drawn from where that political pressure's coming from.

KEVIN McNULTY: I don't honestly know what's driving it, but the sorts of things that could be that when things are not going well, for economies and for political parties, it's natural to look for things to fix. Presenting some fixes for things like short selling or for hedge funds in an environment where there is a general anti-banks sentiment may be a natural thing for them to want to do.

MATT BOYD: If you rewind the clock two years and you asked the managers of companies with plummeting share values who was causing problems for their firms, they would have said it was the short sellers. It is ironic that some of the individuals toeing this line had revenue streams dependent on hedge fund businesses heavily engaged in short selling. This sentiment was blown out of proportion as the asset bubble began to deflate in 2008 and 2009; all of a sudden you had growing public sentiment against the "malicious" or "evil" short sellers. Under pressure, people tend to find scapegoats and market participants engaged in short selling wore the scarlet letter through the credit crisis and its aftermath.

SIMON LEE: Also, if you go back 18 months and picked up any newspaper there would be something about short selling, whether in the financial press, broadsheets or tabloids. At that time I thought it was a given that there would be some form of regulation in the future as a result. If these regulations had been announced 18 months ago, when these stories were first published, would they have the same effect? Or are we having these conversations because of the time that has elapsed.

GERARD MOORE: My community are sometimes seen as politically-exposed investors, and this is why terms such as short selling can get translated as "a bad thing". A lot of trustees' education has taken place, and is continuing, to provide that better understanding. It's not just what they see in the headlines. Again, going back to the educational documentation just produced, a lot will hinge on how successfully that reaches out to trustees, on the time invested in training and learning, and getting a better understanding of the true impact of short selling. It behoves those of us who perhaps have a decent insight into the subject to spell out the pros and cons to the investing community who basically need the confidence that whichever route they choose, they know the risks and the rewards associated with their decisions.

CAPITAL REQUIREMENTS RULE, AND THEN THERE'S LIQUIDITY...

KEVIN McNULTY: The publications that Gerard is referring to emerged out of an FSA review of the securities lending market last year. Generally I don't think they found anything of particular concern, however, when they called on a sample of pension fund trustees, they found a varying degree of awareness about securities lending, and so we were challenged as an industry, to try to do something about that. We worked with a number of other trade associations, such as the NAPF, ABI and the IMA, and produced the documents that Gerard



Rob Coxon, international head of lending, BNY Mellon.

referred to, one of which is an introductory guide to securities lending, aimed specifically at pension fund trustees. We are in the process of pushing these documents out and working hard to get them to the right readership. Separately, we are in a perfect storm of regulation. Basel III and the developing regulations governing the management of bank liquidity are something we should be concerned about. My sense is that many firms have been examining the impact of these types of rules at the enterprise level for some time, but now the discussions are filtering down to business units. For the first time, firms are starting to figure out what it might mean for the securities finance businesses, and I expect that that's going to be a very interesting set of developments. We'll see how that impacts on the business because there's no doubt in my mind firms will have to set more capital aside for this business. It is after all a stated aim of the new regulatory measures that banks should set aside more capital for all of their activities. The question is how much and whether it impacts the types of businesses that they can continue to do.

MATT BOYD: I'd like to jump in quickly here because it's a really important event in the industry right now that I do not believe it is well understood. Basel III is getting attention at the moment due to the recent press releases, but people do not tend to correlate Basel III or the FSA liquidity regulations with securities lending. As banks continue to be under pressure to improve earnings while operating in an environment focused on balance sheet, we are starting to see their financing desks reach out to pension fund assets as liquidity backstops. This essentially means that banks are transferring that liquidity risk to someone else. I am not convinced that regulators are necessarily thinking about the potential impact of that liquidity problem being transferred to pensioners. Is that really the intention of these regulations? Even if the programme is indemnified, does the provider really have the balance sheet to backstop this type of agreement in a distressed market? How does this impact the liquidity of the underlying client's investments? These are core questions in which the industry needs to invest both the time and energy.

ROB COXON: Picking up on that point: what a pension fund will probably do is try and transfer that risk back to their provider, their custodian or agent lender, in a form of indemnification—and once again, I'm not sure that we particularly think that's a good trade off, to be honest, in terms of the use of our balance sheet. Obviously it needs to be looked at in detail, but I'm just thinking that, with Basel III, Solvency II, or the FSA liquidity ratios, whether that is going to be a catalyst for the CCPs. CCPs had their initial burst, if you like, of raising their profile and pushing

themselves up the agenda. It's gone reasonably quiet now. I guess we're all in consultation mode with CCPs, but I'm wondering whether this will be a catalyst for more business to be conducted through CCPs. If we all start to have balance sheet issues, whether it's because we're acting as principle or because we have indemnifications and so forth, then as I said that could be a catalyst.

DON D'ERAMO: I would just underscore on the indemnity front that the focus on capital costs will definitely change. It may cause changes to structure. It may change principal/agency relationships. However, indemnities are still going to be there whether it's an upgrade or downgrade. I guess the question becomes: has the industry priced indemnities correctly in the past and what will it look like going forward?

FRANCESCA CARNEVALE: Is this an opportunity to redraw the institutional framework? Is there room for a new breed of institution to rise up to service these requirements?

MATT BOYD: Yes. Inevitably new institutions are going to form and new solutions will be created. That is the beauty of a capitalist system. People are going to find ways to conduct business within the regulatory framework that create an opportunity to make money. Data Explorers and Equilend are great example of companies that did this over the last decade. If accessible capital becomes the focal issue, then, sure, someone is going to come up with a solution that makes money. Someone will take on the liquidity risk. I don't know who that person will be, but hopefully they will have better infrastructure and management than some of their failed predecessors that offered similar services in other industry segments.

TURNING UP THE HEAT: THE PROVIDER'S PERSPECTIVE

DON D'ERAMO: From an asset servicing perspective and maybe a custody perspective, for a number of years now we've had this cycle going on where we've continually been asked to reduce our fees. To a certain extent that's been possible because we've been able to find operational efficiencies. Today, we are asked to do more work on the back end to satisfy regulatory and client requirements, which can translate into added cost on the servicing side.

ROB COXON: When you look at the value chain, we asset servicing providers take far less out of it than probably anybody else, and we do an incredible amount of work. If you heap onto us more risk in order to fulfil regulatory requirements, then our answer to that is: "Yes, we want to provide a service to our clients, but we need to be paid for taking on that additional risk".

DON D'ERAMO: Increasing efficiencies is an ongoing effort. Whether it's creating centres of excellence to drive down the efficiencies on the cost side, or other initiatives, purely from a securities lending perspective, we're going to see more and more solution selling to our clients. Clients are becoming more sophisticated and selective. Inevitably, this emphasises how crucial it is to continue developing the right business model. As a firm, we must make sure that we are committed to investing in the business globally and delivering economies of scale. ►►

Demand will surface from new markets, and you need to ensure that you have the right product development initiatives and tax analysis to ensure that beneficial owners are not disadvantaged. I think it continues to develop as it is more of a solution-oriented type of product going forward.

MATT BOYD: I just want to ask a broad question here, following a comment made by Rob around how providers tend to take a smaller cut of the business these days. I took this to mean a smaller split relative to what you pay beneficial owners. I wonder, and I'd love to get your opinion on this; are prime brokers achieving an unfair premium for the services they offer to both hedge funds and principal lenders? They have, after all, been a huge profit centre for investment banks over the course of the last ten years due to the spread between the wholesale and retail market. How overpaid do we think they are? Why are their commissions so high on a somewhat commoditised service? Moreover, what portion of the economics do you think should come back to our clients based on the risks they are taking lending their securities, and how much should the hedge fund receive that is principal to the short position? Where do you think that shakes out when you consider indemnity? We are seeing more demand for risks to be moved from banks to our clients and ourselves; shouldn't that mean that the returns for prime brokers relative to beneficial owners will shrink as compensation for that risk?

ROB COXON: It goes back to that question of being able to price the risk. I don't think we as an industry have always done that very well, to be honest. We've always been hungry to win the business, to compete amongst ourselves in what is a very competitive space, and everyone does a good job at that—but not in terms of pricing the risk. But that will change as better risk/reward analytical tools are introduced.

DON D'ERAMO: Actually, I think that the market itself will change. You are already starting to see things such as prime custody and custody offerings that are dabbling in the active or leverage space. That will beget more price transparency and get you a better understanding of the total value and although there is a cost, it is principle business. In turn, it suggests we are moving towards a better understanding of how much more is there.

ROUTES TO MARKET: THE STRAIGHT AND THE NARROW

SIMON LEE: I don't think there's been a fundamental change in the routes available to the market. Whether it's a custody programme, a third party programme, an agency exclusive, or a direct exclusive, they've all been there for some time and will remain as such. It is arguable as to how much direct exclusive business will be undertaken in the future, given the rise in concerns around single counterparty concentration risks post-Lehman default, but in terms of custodial, third party, and agent exclusive programmes, they will continue to be the most widely accepted routes to market. There is a clear trend toward unbundling lending from custody, and similarly, there is an increased trend for providers actively marketing their third party capabilities who have not done so historically. I'm not



Simon Lee, senior vice-president EMEA, eSecLending.

just talking about eSecLending; I'm talking about other agent providers that will now talk about their third party lending services. As a result, beneficial owners are far more cognisant of the options available to them in terms of providers which have increased the recognition of third party models.

GERARD MOORE: I'd agree with that; we have to recognise the difference in scale between the large asset managers on one hand and some of the modest pension funds on the other. We can be talking chalk and cheese, but generally, when it comes to re-pricing custody mandates, more pension funds will be looking to get quotations both with and without securities lending, and that might offer more opportunities for the third party option. From the perspective of larger pension funds, the days of "let us lend out your securities and we charge you nothing for your custody" are behind us now. People are aware that these are two different activities. On the subject of different routes to market: pension funds tend to be quite conservative. I'd be quite shocked if relatively small pension funds suddenly jumped into bed with a little-known custodian, for example. There would be quite a huge risk on the table there, and we tend to be quite risk averse by nature. However, larger funds will be better positioned to explore other options; as it were, being able to grab the steering wheel rather than sitting in the passenger seat being driven by their custodian.

DON D'ERAMO: I agree with Gerard that there is a greater awareness of securities lending among clients, which is driving them to look carefully at the partners they choose for both custody and securities lending. That said, we have seen clients migrating towards larger providers with established global operations.

GERARD MOORE: From the pension fund side, there's still a great fear of concentrated counterparty risk.

SIMON LEE: There is that issue of perception but the reality is that there is more diversification when using a model like ours where the increased level of transparency is inherent in the process and provides our clients with that comfort. I would also add that certain portfolios or assets do not suit the exclusive model, and lenders always need to consider which programme is optimal given their individual goals and objectives.

DON D'ERAMO: From the custodian's perspective, we invest heavily in that business and have made distributions capabilities for clients. Gone are the days where you made x amount of dollars each month, and the cheque's in the mail. It's really about understanding the programme and understanding where the revenues are coming from, and that's a commitment to ensuring that transparency moves forward and to investing in the technologies that enable us to provide it.

MATT BOYD: I speak from a slightly different perspective working for an asset management company. In a lot of ways the

route to market question can be a distraction for what a client really needs to consider. I believe clients should focus on: what sort of returns am I receiving? What sort of optimised performance is my provider achieving based on specific risk parameters? Part of that is what Don was talking about earlier. It's the infrastructure and the in-house expertise that providers can offer. Part of it's what Rob was talking about earlier in relation to cash reinvestment and the need for it to be part of an investment management discipline. I'd actually take that one step further and say non-cash collateral management also has to be considered an investment management discipline. The risk you run in a non-cash program represents real exposures and has similar liquidity and credit constraints in a default situation. Securities lending is a front office activity. It's not a back office cover fails activity like it may have been 20 years ago. There is significant market risk in this business that requires the management expertise of investment professionals.

DON D'ERAMO: It is definitely a front office activity, that's why clients are looking closely at all of their options. While it may make sense for some clients to unbundle, there are other clients out there that want it to remain bundled because they get pricing leverage from their provider. It all depends on what the client wants, and at the end of the day, it's not as simplistic to say, it's a custody securities lending relationship. Asset servicing encompasses many aspects nowadays. There's back office processing, there's derivatives processing, fund accounting and so on. If a client wants bundled, then we're happy to accommodate that, and vice versa if they want unbundled.

KEVIN McNULTY: The advent of third party lending has generally been a good thing for the industry. It has required everybody involved in the business to sharpen their pencils a bit. Whether we see a significant shift towards more of that, I'm not sure, but certainly the unbundling of fees is happening and will continue to happen. The reality is probably third party lending options are currently really limited to the largest of beneficial owners and those that have particularly attractive funds to lend. Not everybody has the choice that the largest investors have.

NEW BUSINESS GROWTH: SHOULD WE BE OPTIMISTIC?

MATT BOYD: Optimism or pessimism? I guess it depends on your expectations, really. Generally speaking, I'm very optimistic about the future of securities lending and excited that it is getting both the attention and the investment it warrants. It is tremendous that there is recognition of the implicit market risk in this business and the requirement to have investment professionals manage risk and return in securities lending programs. Managing risk within a framework that meets client needs while optimising returns through continued investment in both people and technology is what will differentiate providers in the future. I am very optimistic that BlackRock is well positioned to further demonstrate our expertise in this segment of the market as transparency continues to increase.

SIMON LEE: If you're in this business and not optimistic then you should consider moving to a new industry. From an agent

lender's perspective, what's important now is what will be important in the future, which is providing a high-quality product to your customers, optimising returns, and minimising and managing risks. For an agency lending business, that will remain the case in the future. In terms of future opportunities, much will be driven by the growth in third party lending, and as more institutions look to change provider, opportunities will surface. That's where optimism comes from.

ROB COXON: You've got to be optimistic, otherwise you'd go mad! What I love about this business, and I've been doing it for a plenty of years now, is that it is an evolving business. Always has been, and—regardless of the challenges of new regulation, regardless of balance sheet constraints—it will evolve and move on, and it will grow. There are plenty of things at the moment that are working against us. As soon as the economic environment improves, and trading opportunities start to present themselves, this business will grow from a volume perspective, and also from a market participant perspective. So I'm optimistic.

GERARD MOORE: Optimist or pessimist? At the risk of sounding corny, I hope I am a realist. As markets change, as new providers emerge, as regulations change, we've have to continue to strike the right balance between risk and reward. If I describe the pension fund assets as a cake, it's nice to have a thin layer of icing on the cake. It's even nicer if the layer of icing is thicker, but not at the risk of losing even the smallest slice of the cake. It's vital to keep that balance right.

DON D'ERAMO: I'm optimistic about the ability to develop this market. This marketplace will likely become a lot more solution oriented, a lot more bespoke, and that will be the challenge. However, securities lending is an evolving and changing market. It is up to us to continue to listen to our client base, our beneficial owners, and help them to achieve their goals through an agent lending programme. Our industry faces a lot of uncertainty around regulation and I think that translates into an opportunity for us as providers to help shape solutions for our client base.

KEVIN McNULTY: It is important to remind ourselves that the securities lending business has in many ways fared quite well over the past two to three years. Of course, there have been some problem areas, such as where some lenders lost out in cash collateral reinvestment programmes. Aside from that, the core business of securities lending performed very well. If you think that Lehman Brothers was one of the most significant counterparties to participants in this business, that most people liquidated their collateral positions and didn't suffer any form of loss was a major, major positive. We've also talked a lot about demand being down and Don made some very good points that we have tended to use 2007/2008 as our benchmark, which is probably not the right thing for us to do. If we took a long-term view, the trending is still reasonably okay. I have to think that once we get through the next period, and I don't know whether that's one year, two years, or three years, of regulatory reform and hopefully through an economic cycle which is pretty challenging, that demand will pick up again. I like to think that the outlook is a good one, and we shouldn't be too pessimistic about this business. ■