

SECURITIES LENDING: THE BAROMETER OF CHANGE



PARTICIPANTS:

Attendees: from left to right

BRIAN LAMB, chief executive officer, Equilend

FRANCESCA CARNEVALE, editor, FTSE Global Markets

ROGER FISHWICK, director, Ratings, Thomas Murray

DAVID RULE, chief executive, ISLA

RICHARD STEELE, executive director, Financial & Market Products, JPMorgan

SIMON LEE, senior vice president, Business Development, EMEA, eSecLending

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THE IMPACT OF THE CREDIT CRUNCH

BRIAN LAMB, EQUILEND: I have been in this market for 21 years and I have never seen anything like this before; and I am not quite sure what to make of it. Having said that, with regard to EquiLend and its business; we are very much at the centre of the business from a trading and operational perspective a utility in the marketplace. In that regard we take a back seat to any of these issues. If anything, we have been trying to leave market participants alone while everyone deals with some of these very challenging issues. Having said that, we know our place and we, as ever, are striving to innovate and to give the market what it needs in order to evolve. As a consequence, I believe our services are stronger than ever. That is perhaps due to the fact that the people we serve are themselves striving to do the business more efficiently, in a cost-effective manner; and trying to scale their business globally.

RICHARD STEELE, JPMORGAN: I would agree with Brian. Clearly, we are seeing unprecedented conditions in the global financial markets. You would almost have to go back to 1929 to find an event of similar magnitude. A number of us lived through the Barings crisis and the sterling exchange rate crisis and, you know, those were pretty minor skirmishes compared to what we are seeing today. Having said that, it is difficult to predict how deep and how long the downturn might be for the wider economy. At a time like this, our absolute focus must be on risk management, and staying very close to our clients and explaining to them what is happening every step of the way; so that they can make appropriate choices about the assets they lend in this market. Right now, people are managing risk on a day to day basis, and obviously looking at how they may change their lending practices in future to take on board any lessons learned from current events. However, with events moving so quickly at present, it is difficult to speculate on what markets might look like even months down the line.

ROGER FISHWICK, THOMAS MURRAY: Have you seen any clients starting to withdraw their securities from lending because they perceive the risks to have gone up?

RICHARD STEELE: We are not really seeing a notable move in that direction. Clients are dealing directly with the immediate issues and (quite rightly) looking at their risk management approach over the medium to longer term. We are having conversations with clients about making changes in lending parameters, however, and that is normal under current conditions.

FRANCESCA CARNEVALE: Simon, how is eSecLending's auction model bearing up in a market that is, frankly, confusing a lot of people?

SIMON LEE, ESECLENDING: Very well actually. Obviously there is a degree of uncertainty in the market at present and at times like this there's an increased level of focus on risk management. Particularly, lenders are being assiduous in assuring themselves that their lending agent has robust risk management procedures, as it pertains to collateral management, counterparty selection and so forth. When



BRIAN LAMB, chief executive officer, EquiLend

you look at the bigger picture and look at eSecLending's model, which primarily facilitates exclusive contracts through an auction, one advantage that emerges is the increased level of transparency it presents in regards to counterparty selection. This has always been a part of our business that our clients value. So in today's market, where transparency is critical when considering a securities lending programme, eSecLending is well positioned and proving its worth.

FRANCESCA CARNEVALE: David, there's a lot of talk about risk management. Is it too little too late? Have the horses already bolted as we try to lock the stable door?

DAVID RULE, ISLA: Securities lending is designed to be a low risk business. This has been the biggest test that that the market has ever had, both in terms of how lenders manage counterparty risks and the failure of a major dealer, which frankly, a lot of people probably thought was unthinkable. So, will people actually have adequate collateral? Will the close out mechanics work? Everyone is working through that at this very moment, and we will not know the outcome for a little while yet. The other side of it is the cash reinvestment business where we've had a huge movement in money market spreads. Investing at 12 months and borrowing overnight was not the greatest strategy to be in a year ago, albeit with hindsight; although it may be a good strategy to be in right now, if you are clever. So risks (even low risks) taken within this business have crystallised for the first time. Hopefully, we can come out of it stronger with the model tested and proven to be largely resilient. Hopefully, people will be more aware of the risks involved. For example, people will no longer look at cash reinvestment as something they can ignore. They will regard it as an integral part of their investment management business, if they

choose to do it. The concern is that beneficial owners decide that securities lending is no longer core to their overall business and actually a bit more risky than they thought, and bale out. I hope that that will not happen to any great extent. I believe there are ways that most beneficial owners can run a securities lending business consistent within their overall risk appetite. Finally, one other concern I have is that some kind of regulatory backlash might emerge on the back of a popular outcry against short selling. We must avoid a misguided blame game.

RICHARD STEELE: It is an important test for the industry and it is also about how well the industry performs as a whole in terms of making sure that its clients are looked after; that they don't come away from this with a bad impression, or a bad experience. When you listen to commentators and read the news reports, people often overlook the fact that liquidity provided by securities lending is also important to the functioning of the money markets and the capital markets. Regulators and policymakers therefore should guard against throwing the baby out with the bath water. From JPMorgan's perspective, the good news is that the legal contracts are working the way they were intended to and the collateralisation process has worked the way it was intended to. So those are some of the good things we can take away from our experience so far.

MANAGING THE IMAGE OF SECURITIES LENDING

FRANCESCA CARNEVALE: Roger, rightly or wrongly, securities lending is an industry that suddenly has come into very sharp focus, for reasons not necessarily of its own making. How does it manage its PR now?

ROGER FISHWICK: From where I sit, the biggest immediate danger is a kind of Maxwell effect. In the 1990s we saw a lot of UK pension funds withdraw from securities lending following the Maxwell scandal. The danger is that kind of reflex action again, where everybody says: "What on earth are we doing in this business?" Now, the onus is on the lending community to manage that process more carefully, manage the communication, both with individuals, individual lenders and borrowers, but also to manage the macro PR (as is being done at the moment) to try and make the case that, really, securities lending is part of efficient market operations. It is not there to provide a load of madcap speculators with easy pickings, which is, kind of, how the populace press seems to come over when it discusses all of these issues. So it is really time for the big players in the market to make the case very positively for what they're doing and why they're doing it.

SIMON LEE: This increased focus on risk management within securities lending started when the credit crunch began last year and obviously it remains to be seen how far this current downturn will last. One benefit that does come out of this is that lenders have become far more educated through their efforts to understand where returns are being generated from and what risk are taken to achieve them. When the dust finally settles, lenders and agents will be much better for it.

BRIAN LAMB: This situation is different. It was true with Drexel Burnham Lambert which went out of business; it was true with the derivatives problems that we had in the early 1990s; it was true with the Russian debt crisis and the Latin American debt crisis, with the Malaysian crisis, and so on. However, this particular event – if you can even call it one event – is absolutely different. It will go to the core of what securities lending is all about. This roundtable will support talk about the things that we all know, that securities lending is good for liquidity and price stability in the market place, and that there are logical and good reasons for securities finance. However, there must be some fundamental changes in this business. For example, this whole general collateral or hot stock relationship that's existed for years, may alter. The marketplace has benefited from the liquidity offered by lenders of general collateral. Perhaps, the margins on that collateral will widen. Perhaps general collateral shouldn't trade at two basis points. Perhaps it should be much wider. I never thought that I would see the day when repo would trade at the spreads it has been trading at lately. Perhaps what is happening is a return to a more appropriate price point for those sorts of things. This is unprecedented.

RICHARD STEELE: We can make some educated guesses but probably we will not know the end game players for some time. Some of the demand drivers will be different in future. You can also see it in the proposed merger of Lloyds Bank and HBOS, people are starting to say that those who stayed with the more traditional commercial banking model seem to be the smart guys, all of a sudden. I am not saying everybody will go back to that, but invariably we have got to look at what is going to happen with dealers who create a lot of the demand for this product. What will their management decide to do? What will their shareholders and regulators want them to do? It is a hard one to call: as there are many possible scenarios.

SIMON LEE: It is commonly suggested that the market will continue to grow as more supply is made available by more investors making their assets available to lend, as more emerging markets remove lending restrictions, as sovereign wealth funds increase their lending activities, and on the demand side, an ever increasing number of hedge funds, hedge fund strategies, and 130/30 funds. That said, will that suggestion be realised? It's clearly no longer easy to predict what this business will look like in the future or the timeframe for continued growth.

DAVID RULE: I was just going to say that balance sheet is going to get more expensive. Regulators are going to have higher capital requirements on banks for a while. Investment banks, running on very high leverage, are, I suspect, history. Moreover, lenders may require higher returns for risk. So marginal trades are not going to happen. In that sense, activity in the market may fall. On the other side, particularly in bond lending, we are in a world where everything is going to be required to be collateralised and demand for collateral is going to go up, and dealers just don't have large values of high quality bonds on their balance sheets. So they are going to have to borrow them. I predict bond borrowing demand will remain high, but equity borrowing demand may fall.



SIMON LEE, senior vice president, Business Development,
EMEA, eSecLending

IS THERE A NEED FOR INCREASED REGULATION?

FRANCESCA CARNEVALE: Is this the kind of perfect storm where the markets now have become so complex that it is going to be quite difficult to unravel a lot of situations because of a lot of contradictory movements and exposure? Are investors going to be more reliant on professionals, such as yourselves, to create more transparent and rigorous investment and lending structures? Or, will existing structures and regulations, such as Basel II, come to the forefront?

RICHARD STEELE: I can't see the regulator giving the market more freedom at the moment. However, you are right; they have to decide where they want to focus. Taking your point about Basel II, it is part of the framework of managing risk, but it typically requires banks to set up their own value of risk model or use the regulator approved model. Obviously the regulator would have to approve the internal model, but any model is only as good as the assumptions that you plug into it. Given that the assumptions have changed along the line it is clear that the capital adequacy framework will have to be revisited.

ROGER FISHWICK: Brian made a very important point at the beginning, which is all about the de-leveraging that is going on. There has been a push for the last year or so to de-leverage the balance sheets of the investment banks because, basically, they have operated like macro hedge funds for a long time. My concern, for the medium term, is that securities financing has really grown very rapidly on the back of that increasing leverage we've seen over the last few years. In future, the market may well be smaller than at current in the medium term for the securities financing industry.

BRIAN LAMB: Securities finance demand essentially touches every part of the market place. Perhaps it is the broad ubiquitous nature of the business that makes it an easy target. While there are complexities at the very essence of securities finance in fact, they are actually not that complex. Rather, they are not fully understood either by the public or by regulators. It is also not very sexy or interesting. Instead, it is often rather mundane. Paradoxically, that is why it is a target right now.

FRANCESCA CARNEVALE: Brian has highlighted the fact that maybe some areas need clarification and certainly some regulators may require help with understanding how, going forward, the business can work in what is looking to be the new world order. What role can you play in providing that education, in lobbying for the right kind of support rather than extra regulation? Moreover, how might you mobilise the industry to best leverage what's happening now as opposed to being placed in a reactionary role because of this fear that people have?

DAVID RULE: Well, that's the role of ISLA. With our limited resources, we have done a reasonable job over the past couple of years of doing just that. The concern I have is that the regulators will not be able to take a dispassionate, consultative approach and they will be under pressure from politicians to act. Frankly, we have already seen that in the United States. Moreover, regarding your earlier point about Basel II and changing capital requirements, my interpretation is that a well-organised dealer that has all the information, would actually come out with lower capital requirements for this business from Basel II. Although that's probably history now because, although Basel II may not be rewritten, there will be a kind of over-ride which says banks have to have higher overall capital requirements.

ROGER FISHWICK: That's one of the important things that the industry can influence. Securities lending and repo are very important providers of liquidity, and liquidity is a big issue for banks at the moment. It is a message for the politicians as well, but constricting securities lending drastically will constrict liquidity in the banks themselves, which impacts overall, delaying money flows to corporates, which oils the wheels of the economy.

DAVID RULE: The best we can hope for is that the storm will pass in terms of banks failing and etc. The news story will be gone, and then the regulators will, maybe, be given enough space to come up with a measured response.

THAT'S THE BAD NEWS: NOW WHAT ABOUT THE GOOD?

SIMON LEE: Taking an optimistic view of things, where do we see the industry going in the short to medium term?

BRIAN LAMB: Historically, people have had lots of time to respond to change, but today, we have to manage change. Change happens at such an increasing rate every day. Moreover, it seems to me that is exactly what is happening here and it is not going to slow down. Additionally, we have got access to information unlike any other point in history. Is all that a good thing? Perhaps not. You know,

transparency in the market sounds like a really good idea. However, everything has its limits, and I do not think that it is necessarily a good thing that people have access to such critical information on a minute by minute basis. Moreover, you don't have time to really absorb it and understand what the larger implications are, and so things are more knee-jerk. I do not think that is a good thing.

SIMON LEE: To pick up on that point made on transparency; that is the environment we are in and we have been going down that path for some time. However, it was not too long ago when transparency was not a primary concern and when there wasn't clear information available to lenders to easily review the risk /return profile of their programme. This is means that there is still room for improvement in certain areas which could be a good thing for participants.

DAVID RULE: We may come out of this crisis with a completely new order of big players in the industry, especially on the borrowing side. Moreover, that may mean that change in market structure is more feasible than maybe it was with the people who were dominating the market six months ago. Priorities may also change. For example, managing balance sheet and counterparty risk have become much more important.

RICHARD STEELE: Obviously, the future for the securities lending industry will look a bit different, but then the market today looks different to how it was ten years ago, and part of that is down to technological change. I agree with Brian, perhaps there is too much information, but fortunately or not depending on your point of view, we are paying a lot of very clever people to keep churning out more and more products all the time and it seems to be the way that the market works nowadays. Looking to the future, securities lending will remain a value added product to most fund managers, and the industry needs to convince its customer base that the returns and the risks are still in alignment. We do have to make a case for this, but we can do that by reaffirming our core principles which are around risk management and being close to our clients, so that we can present them with options that fit best with their overall investment framework. However, collateral guidelines will likely change, and also the level of reporting which is required. I for one remained convinced however, that the securities lending industry will continue to add considerable value to its customer base, even in the new market conditions.

FRANCESCA CARNEVALE: Do you think that clients will review how they get to market, how they achieve their securities lend out, provide, securities lending provider? Does it bring into focus the stability of their securities lending outlet?

RICHARD STEELE: It does, but they already go through a rigorous review process. Roger's firm contributes to that. Consultants go through a very detailed RFP process at the moment. Moreover, any securities lending provider at the moment has to be able to offer a full service to clients like JPMorgan can, whatever their route to market is. But it's not just saying you can do it; it's also about demonstrating that you've risk management expertise, as well as the capital base to support the indemnity.



RICHARD STEELE, executive director, Financial & Market Products, JPMorgan

ROGER FISHWICK: Clearly, consultants try to do as thorough a job as possible to look at the lending component of the overall portfolio, what the custodian is offering, and to see how well risks are managed. Consultants do that because people find it very difficult to judge themselves. Independent advice does help people to understand the risks, understand the differences between different lending programmes and different lending agents.

BRIAN LAMB: I am sure the five of us would be very good at describing why this market is efficient and a good idea, and how the risks are mitigated, but when we turn on the TV tonight, what people are talking about is short selling and why that is contributing to this calamity. So we get drawn into that because of our relationship with short selling, obviously. Therefore what we need to do is more than we have done in the past to describe and educate people about benefits of this business. This is hard because, for instance, I do interviews all the time with various publications and I will look at the results after the interview and sometimes, there's been nothing that I've said that appears on the page. That is because what I've had to say might be uninteresting, or it is not going to sell a magazine. Good news, quite often, doesn't really sell. I'm sorry, but that's life.

FRANCESCA CARNEVALE: Again, do you need to temporarily educate the retail market, or are you having to educate, what seems to an outsider, to be a sophisticated market that should understand the difference between speculative short selling, to drive down the value of a respective bank, and short selling in order to make a profit for your portfolio?

BRIAN LAMB: I heard Greenspan on the weekend when he was being pressed quite aggressively about short selling. What I took away from the interview was that without short selling, you will have everybody on one side of the equation; you'll have everybody whose self-interest is of supporting one another and you'll have people who are weighting the value of what they own. Moreover, when the truth of the position is realised, the price collapse will be so dramatic because it has been too irrational on the upside. So obviously, there is absolutely some great rationale for short sellers to add value.

SIMON LEE: We are getting to a point where regulators are becoming better educated on the industry and beneficial owners are even more educated as well. Unfortunately, it seems as though the politicians and the mainstream press continue to misrepresent what is happening.

THE QUESTION OF COLLATERAL

RICHARD STEELE: The challenge is one of providing appropriate returns, but also managing risk versus that return. I guess if the tide goes out, we will probably see who's been managing that risk to the utmost. Managing the correlation between risk and return on your portfolio should always be part of the focus; not just in the last year during the credit crisis. Therefore, you need to be looking at your agent's ability to manage cash on your behalf and looking at what sort of credit analysis they perform on those investments, and whether you are indemnified or not. On the non-cash, securities collateral side (and a lot of clients, frankly are still in government bonds when it comes to collateral), as long as those are seen to be diversified, it all comes back to best practice. I don't think ideas about best practice will necessarily change, because diversification, looking at your liabilities, to your maturity date; all of these are still core principles. What people may do is just move their calibration of some of these things into an area where they feel they're going to probably get maybe less return, but also less risk at the same time.

SIMON LEE: The nature of collateral, if not its form, has changed over the years. Collateral is taken first and foremost to mitigate the risk of counterparty default. Over time, for some lenders collateral became a key component of securities lending revenue as additional returns can be generated through cash reinvestment. Since the Lehman collapse, the focus has reverted back to the ability of collateral to protect lenders in the event of counterparty default. Secondly, the management of cash collateral is now seen as an asset management function, with the attendant risks and rewards. Concerns over liquidity are at the forefront and understanding the relationship between lending activity and cash collateral management is paramount. For Lenders, collateral flexibility is key. When lenders review their cash collateral reinvestment program, they should undertake the same level of due diligence as they would when employing an equity or bond fund manager.

ROGER FISHWICK: One of the things that has given me a bit of anxiety over the last couple of years has been the development of more aggressive cash management. We expected to see more aggressive cash funds being put out to certain sophisticated lenders, and you wonder what all of that means. Well, the consequence are losses in those that are publicly known about.

BRIAN LAMB: Fundamental and simple point is that collateral is meant to be collateral. It is not meant to be a means to leverage. With regard to where we are today, absolutely, there's only going to be less cash collateral in

this market going forward; there's not going to be more. We can all agree on that point. How quickly we get there, I don't know. The US market is probably, at least, 90% cash collateral and is challenged by these issues more so than probably the non-US market. How quickly that evolves to a non-cash model, I don't know; but it's headed in one direction, and one direction only.

FRANCESCA CARNEVALE: Once collateral comes into the picture, then the securities lender uses that as a fund, as an asset manager. Cash collateral, has often been used as a selling point as to why you should use one securities lender over somebody else.

DAVID RULE: That's right. The industry however has been wrong to sell securities lending and cash reinvestment as a bundle product. They are actually two separate products that are related. You should be saying to your client, "By the way, off the back securities lending, you can get involved in the leveraged money market investment business with us, if you want to". In Europe, you can unravel it in that way as well, because the client can say: "I don't want to, thank you very much. I prefer to take non-cash collateral and not take the risk in the money markets." In the US, ERISA guidelines mean that pension funds are drawn into cash reinvestment if they want to lend securities. The irony is that the regulators probably think the safest bet here is to just have cash collateral – that sounds really safe. It's cash. The fact of course, is that it is potentially – potentially, but not necessarily – more risky than any form of non-cash collateral.

ROGER FISHWICK: We get our clients to look very closely at the guidelines that they are prepared to put in place, and to compare them with their corporate treasury guidelines. The question we ask is: "Would you allow your corporate treasury to do some of the things that the money managers do with the cash?" We then find that they then start to cross certain instruments off because they know that their corporate side would not use them.

RICHARD STEELE: The regulations come into this as well. If you look at UCITs regulations, it broadly states that any collateral should be held in accordance with the investment profile of the UCITs fund. On a very strict interpretation, that could lead to anomalies. An emerging markets fund, for example, might feel obliged to take emerging markets securities as collateral which could appear to be inherently more risky.

BRIAN LAMB: I want to be clear: we should not throw the baby out with the bath water. Cash collateral in and of itself, is not a bad thing. What is wrong with cash? To the extent that it's consistent with the investment objectives of the clients, then it is quite often, a very positive thing. To the extent that it is not, as Richard's example illustrates, clients need to understand that even non-cash collateral needs to be well understood and managed. Back to the point, collateral is meant to be collateral.

SIMON LEE: This goes back to the need for transparency. Lenders should be able to clearly understand program earnings and identify intrinsic versus reinvestment returns.

FRANCESCA CARNEVALE: When clients give you instruction on the use of collateral for reinvestment, are they equally concerned with overall risk and the compatibility of cash collateral reinvestment programmes with their overall investment approach; or are they simply looking to make an extra tip on return?

SIMON LEE: Within our programme, we encourage lenders to first evaluate the intrinsic value of their portfolio. Reinvestment returns, then, are incremental. This results in increased transparency for the lender as they have a better understanding of the sources that revenue is derived from; whether it's the intrinsic value of the loan or from the cash reinvestment. To underscore Richard's point about agents managing cash, some lenders manage the cash themselves or use a third party investment manager. The cash collateral reinvestment is truly an investment management decision, and lenders should make their decisions based on the factors I have just described.

ROGER FISHWICK: Is it the case, then, that in the last year or so, the cash crisis dog has been wagging the tail? It's always been about cash and the returns on that, and very much less emphasis on the intrinsic value of the securities lending.

SIMON LEE: I can only speak for our programme and the answer is no. Route to market for our clients is determined via an auction. The bids that are placed for exclusive arrangements are driven off the intrinsic value of the underlying portfolios. So, from our perspective, no. The decision that our lenders make is based on the revenues generated from the lending activity, and not the cash reinvestment process. However, it should be noted that over the last 12 months, within the industry as a whole, there's been a shift away from the use of cash collateral with more focus on collateral flexibility and the use of non-cash collateral.

THE VIEW FROM A BRIDGE

FRANCESCA CARNEVALE: When it comes to cash collateral, reinvestment, gain returns from your portfolio, you all seem to have very well-informed customers. When it comes to securities finance, the issue of short selling and problems in the market, these very same customers aren't as well informed. I don't see the consistency in that.

RICHARD STEELE: It's an interesting point. I wouldn't probably put it as black and white as that, but I see where you're coming from. You know, managing cash is more often than not an integral part of the client's business. Whatever cash guidelines they agree with the securities lending agent, will be a subset of their own treasury guidelines. That's clear. So depending on where the securities lending activity touches the client, it may well be very close to their treasury function; it may be in their operations function, and they understand the business of managing cash on a day to day basis. Some of the other issues, Francesca, that you brought up are more overarching and I think this emphasises the importance of having regular dialogue with your clients.



DAVID RULE, chief executive, ISLA

THE TRADING EQUATION

BRIAN LAMB: Electronic trading is here to stay and just about every market in the world, and it's here to stay in securities finance. And the definition of that... and the acceptance of that are things that will be debated. But in my view, a trade's a trade, whether I pick up the phone to execute a trade with another person, or I set up an automated means to execute a hundred trades with that same person, regardless, those are trades. They were trades yesterday and they're trades tomorrow. This industry will absolutely need more of that sort of a solution in order to prosper, especially in light of recent events and in order to manage programmes in the best interest of clients.

RICHARD STEELE: There's still a lot more to be done in all areas of the industry in order to leverage the capabilities of technology from electronic trading all the way through to back office efficiencies. It is kind of interesting because we have been going through this year by year and developing more products; Equilend, for example, has developed lots of products to help people manage their risk, their back

office, and their front office, and there's a lot being invested by firms in connectivity, but there's still more to be done, frankly. When you are managing risk, you want to be able to get all the information you need to make a decision fast, and then be able to press the button to execute. Because when you're trying to allocate collateral or close down a loan position, speed and accuracy are key.

ROGER FISHWICK: It's where the electronic transactions will come into their own. If you have a proper exchange and proper risk mitigation through the use of a central counterparty and efficient clearing, settlement and collateral management in the same way that the equity markets and so on work, where you've got intermediation of the post-trade risk by central counterparties.

BRIAN LAMB: In some respects, yes, absolutely, there is a portion of the business that it would make sense for it to be that way, but this business is different; it's different than the cash equity business. It's different than the futures business. There's a duration to a loan. It may be overnight or it may not be; it may be for a year or more, and because of that it creates subtleties that aren't easily managed in a central counterparty model.

SAFEGUARDING LENDERS RIGHTS IN A VOLATILE OR UNCERTAIN MARKET:

FRANCESCA CARNEVALE: In an insecure world – and we do seem to be in an incredibly insecure world right now – is the message, the one message that has to go out is that lenders' rights are safeguarded, or is there another more important message to go out in order to build on what's been achieved in the securities lending market?

RICHARD STEELE: Securities lending is a voluntary activity. It's not the core activity of the investment manager of the fund, so it needs to be conducted in an environment that provides an incentive for them to do so. If that balance is tipped, then they will withdraw from that activity, voluntarily if you like. So it's absolutely paramount that the industry is organised in such a way that clients' rights, as beneficial owners, are protected. Nobody should lend shares without the assurance that they're going to get back all the rights and entitlements, be it with dividends, corporate actions and obviously, ultimately, the return of the securities that they lent in the first place. Moreover, it is an ongoing process and it needs to be calibrated according to market conditions. The future of the industry and providers will be built around the fact that hopefully we have all demonstrated that we are up to those challenges and that we have managed the clients' risks successfully, and that clients have actually been looked after during this period of market turbulence.

FRANCESCA CARNEVALE: Simon, given the general gist of the conversation, do you think that, going forward, the securities lending industry will have to redefine what beneficial owners should expect from lending their assets? Will the expectations of beneficial owners of securities lending now change?

SIMON LEE: As an industry, we continue to improve our communication about how the industry operates, ensuring that Lenders understand how their programme is managed, where their risks are and how those risks are mitigated. Securities lending is a risk/reward product and that doesn't change, thus beneficial owners' general expectations of the industry should not change. I don't see the message changing much from where it is now. That said though, I expect beneficial owners to become more demanding of their providers around these points, requiring more detail around counterparty selection, collateral management and pricing. Also, it will become clearer to beneficial owners that they have a choice when it comes to accessing alternative routes to market. We were talking about technology earlier which has dramatically changed the landscape in recent years. From an operational perspective, technology has enabled third party programs to run efficiently which was less the case in years gone by. This results in more choices for lenders.

COMMODITISATION OR CUSTOMISATION?

ROGER FISHWICK: One of the difficulties the industry has is that everything is bespoke. It's all based on bi-laterals, every borrower or lender relationship is different. The mechanics are, very often, different, the operation mechanics, cash reinvestment, guidelines are bespoke for everybody. It does need some standardisation.

SIMON LEE: Is that not, though, indicative of a risk/reward product in much the same as asset management is? Wouldn't every asset manager argue that they are providing a bespoke service based on their client's ultimate investment guidelines and parameters? Securities lending is not dissimilar in that every beneficial owner will have different guidelines on risks, revenue, counterparty exposure, market exposure and so forth.

ROGER FISHWICK: There are similarities, but coming back to Richard's point, it's not the same at all. Investment management is fundamental to the clients; that's what they have to do to generate a better return, that they're going to pay the members with. The securities lending is a kind of voluntary, they don't have to do it and they would be marginally worse off if they didn't, perhaps. The revenues that they're earning are not the 18% annual returns that they're seeking from investment managers and so on. They are very small returns. And to expect a huge amount of effort on behalf of each of these individual funds, to understand the risks at the levels that we're describing them, to understand the different variants, is asking too much for too little return. That is why the future for the business is more standardisation, more standard components, and just certain negotiations around the edges of that, rather than everything is negotiable when you start the relationship.

SIMON LEE: However, it very much depends on the lender and how they want to participate in the business.

And whilst I agree with you that some beneficial owners would rather be in a standardised pool, which I would liken to an index fund, there will always be lenders that require more from their lending programme that wish to achieve optimal returns and want to be more actively involved. They will be the ones seeking customisation and going down the specialist route. They will view lending as an investment management decision and using the asset management analogy, will be active managers of their securities lending programme. So the question is, will the industry evolve to serve lenders in both camps?

ROGER FISHWICK: So, people, who just want the standard return, could go into your index version, and people who are perhaps more sophisticated in their requirements ...

SIMON LEE: ...would use a specialist agent. For lenders that want to go down a standardised route, it requires full standardisation of technology and infrastructure.

BRIAN LAMB: Standardisation is the very premise on which EquiLend was founded. Our tagline is the global standard in securities lending. Applying standards, in my experience, to markets that are over the counter, is quite challenging. It's not impossible, but it is very challenging. You need to get people to agree, to have the same standard, agree the same terminology. Even the terminology, especially in the global market, is a difficult thing to achieve. This is a market that is only going to need more standardisation in order for people to optimise their approaches to manage the business. In order for the ultimate consumer, the beneficial owner, to understand what they are getting themselves involved in; we are going to have to be able to describe it in standard terms that they can understand, and to accept or not accept, because it is a voluntary piece of business, as Richard said. In addition, it is my view that, the beneficial owner, is going to want to get paid more for it than they have been paid so far; regardless of what it is that he or she is agreeing to lend.

RICHARD STEELE: Yes, lack of standardisation will just increase costs for the industry so whilst there will always be a requirement by some clients for a customised service you also need a baseline that you can work from. Sometimes, this will involve putting the information in the client's hands, for instance, client reporting tools will deliver a standard set of data that they can then manipulate it themselves and feed it into their own applications. And that's much better than the old days when you would actually create umpteen different permutations on a standard report because the client wanted it in green ink rather than black ink.

ROGER FISHWICK: It sounds like there's risks around standardisation as well. When we are going through these considerations for funds, we are looking at the securities lending parameters, we're looking at the cash management guidelines and trying to knock out some of the instruments that perhaps are not required. If something gets standardised, this is the basic agreement. This is the basic, what you should do with the cash. Just get that in place,



ROGER FISHWICK, director, Ratings, Thomas Murray

and then everybody would agree it, it would just mean that you were only then looking after the more, like the very sophisticated, very interested parties.

SIMON LEE: I would argue, to an extent, that that scenario is already in place in the industry. Custodial discretionary programmes are that standard, vanilla programme that you are looking for.

ROGER FISHWICK: But for each custodian separately, and they're not the same for every custodian; each has his own bespoke client lending agreements, cash management guidelines etc.

SIMON LEE: Again, to an extent, though I would argue that the custodial programmes aren't overly dissimilar. You then have specialist providers, like eSecLending, and others who are delivering a more customised product that certain sophisticated investors will always require because they want to optimize their risk/return profile. They don't necessarily want to accept the traditional custodial route. So, I agree with your point and believe that to an extent, the scenario you describe does exist already. Similarly, you could argue the same about the global custody business in that every custodian provides a different flavour of a standardised product. You already have an element of standardisation there, but you also have a number of specialist providers serving a specific client base.