



US securities lending panel debate

The biggest market in the world has seen its share of trials and tribulations over the past couple of years. Our panel examines the issues.

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“Hope to see you at the IMN conference in Arizona”
Justin Lawson, Publisher
Securities Lending Times

SLT: How was 2011 for you?

Doug Brown: The securities lending market continues to be challenging. However, from a revenue standpoint, 2011 was a better year for our clients as compared to 2010 - given wider intrinsic and reinvestment spreads. We saw more event-driven activity in the first half of the year, and in the second half of the year concerns about the economies globally increased demand for many securities. As concerns related to both sovereign and bank/broker-dealer balance sheets continued to rise in the second half of 2011, counterparty exposure (MF Global default) and liquidity management were key focuses once again. We have spent a higher percentage of our time than usual working with regulators to formulate new policy. As fiscal and regulatory reform around the world continue to

evolve, we continue to keep our clients abreast of these developments and their corresponding impact on market volatility, sovereign debt, as well as their impact on financial institutions. Given continued uncertainty around the world, risk management and communication with our clients have been critical areas of focus. Providing clients with solutions that allow them to participate in a low risk securities lending program, providing transparency, and extracting competitive returns continues to be key.

Anne Sylvester: Overall 2011 was a reasonable year for our business. We added a good number of clients to the program around the world, both on a custody and third party basis and saw additional growth in Asia and specifically in emerging markets, such as Brazil where J.P. Morgan was the first and still only agent lender to lend in this market. We saw clients

willing to review their lending parameters and many willing to add equities as a collateral type and consider one-off /high revenue opportunity trades. Generally speaking, client reaction to the market environment in the second half of the year was relatively benign compared to 2007 and 2008. Overall, supply remained healthy as noted, but the demand side remained subdued given the market environment and the impact of deleveraging and impending regulation.

George Trapp: 2011 was a good year for clients in securities lending. Client interest in securities lending certainly grew during the year with new participants joining securities lending programs and current clients increasing their securities available to lend. Beneficial owners are looking to extract incremental return from their portfolio so long as they have the ability to manage risk. This is an ideal time for beneficial owners

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to review securities lending opportunities and establish a program that fits their risk and return objectives. This will allow them to capitalise on dynamic market opportunities in the future.

Trapp: 2011 was a good year for clients in securities lending. Client interest in securities lending certainly grew during the year

Peter Bassler: 2011 was a busy year for eSecLending, particularly in the area of product development. We launched several initiatives including our Treasury and Financing Solutions product which now has over \$6 billion in assets under administration. It was designed to support large institutional investors in managing the operations around their treasury management functions by combining the strength of our securities lending and liquidity management services with our ability to capture, synthesise and provide recordkeeping for multiple sources and uses of cash flows. In addition, after extensive due diligence and the development of risk mitigation solutions, we approved lending in two emerging markets which we are in the process of discussing roll out to our clients. We also continued to expand the expertise and depth of our team by hiring two new senior staff members who have extensive securities lending knowledge and who broaden the breadth and depth of our executive team. In addition, in light of the increasing regulatory initiatives underway we have increased our legal resources to ensure we have dedicated staff focused on monitoring developments and impact to our clients. Finally, we are in the final phases of our new client reporting infrastructure which will go live in the first quarter of 2012. And we announced top rankings in three significant industry awards, we reached \$2.5 trillion in assets auctioned since inception and implemented new clients and expanded mandates with several existing clients.

Brian Lamb: 2011 was EquiLend's best year in terms of new clients, trading volumes and overall profitability. We added 17 new clients in 2011 and several new key services to the platform. For example, our Trade Optimisation services, Standing Settlement Instructions Repository, Borrower-bid and hundreds of new enhancements to existing functionality. These have been widely embraced by our clients.

James Slater: In 2011 client sentiment improved and our new business pipeline was strong. Regulatory change began to drive new types of demand and many hedge funds saw increases in assets under management. We continued to deal with regulatory uncertainty and market volatility. However, these market conditions and the impact of the financial crisis have created a business environment that favors BNY Mellon's lending franchise where we strive to extract the full intrinsic value for our clients from lending opportunities.

Rory Zirpolo: As it was for many, 2011 was a challenging year for KDC in the securities lending environment. Looming issues regarding Europe helped to dampen risk taking in broad markets, which was of course felt in the securities lending community. We saw increased focus on names with the highest intrinsic value and a general shrinking of our book's breadth. Near-zero interest rates and a lack of intriguing financing opportunities meant little-to-no general collateral business in 2011, further contributing to the focus on the hardest of hard-to-borrow assets. The ongoing Europe problem combined with the unfortunate bankruptcy of MF Global spurred a greater focus on risk management. In securities lending, that means counterparty default risk and operational risk, which we examined in much greater depth during 2011 than in the past.

SLT: Where can further growth come from?

Brown: Further growth can come from increased activity by hedge funds and other asset managers, regulatory changes, new markets, as well as by utilising other collateral types than traditional US cash and US government securities.

Sylvester: Our growth strategy is centred on building and diversifying the book, and bringing good high quality clients and securities to the lending market, especially in the third party space. Focus will continue on emerging markets and there are a number of new markets on our priority list that we would like to add in the first half of the year.

Trapp: On the supply side of the market, further growth will most likely come from expansion into new markets. Northern Trust continues to research and expand our lending program into emerging markets such as Poland, Russia and Malaysia, increasing the supply of securities available for lending. On the demand side, ongoing uncertainty in global markets is likely to continue to weigh on investors and affect the level of securities borrowed. That being said,

there are some indications that mergers and acquisitions (M&A) activity may be on the rise in the coming year, as cash rich corporations look to deploy capital and expand businesses. Increased M&A activity has historically been a driver of securities lending demand. Additionally, ongoing growth in the use of a broader set of non-cash collateral may contribute to increased demand. With the expected implementation of new regulations requiring the collateralisation of derivatives contracts, we may see an increase in demand for US treasuries.

Lamb: Several key areas. We opened an office in Hong Kong last year and we are adding to our head count in the region because we think Asia is an important area for our growth in 2012. Also, our BondLend service offering continues to gain significant traction amongst the European and North American fixed income markets.

Zirpolo: Looming issues regarding Europe helped to dampen risk taking in broad markets, which was of course felt in the Securities Lending community. We saw increased focus on names with the highest intrinsic value

Slater: Regulatory change is reshaping demand and in the process new lending opportunities are being created. Basel III liquidity requirements and new derivative legislation is driving increased volumes of collateral trading. Capital and balance sheet management is increasing the volume of non-cash transactions. In addition, hedge fund assets under management have been increasing and that trend is expected to continue in 2012. As those new investments are put to work, we would expect to see increased demand in the lending market.

Zirpolo: Further growth can come from diversification in credit exposure. While we've seen a trend of tightening credit exposure among our counterparties, it's our belief that growth comes from diversification. We see that larger lending agents are sitting on supply of lendable assets



waiting for a narrower range of counterparties to borrow from them.

SLT: Will the potential move to securities lending through CCPs encourage more beneficial owners to the market?

Brown: Since the crisis of 2008, there have been many changes to the securities lending market to reduce risk. Due to these changes, we have seen most clients who exited lending re-enter, along with some beneficial owners who have never participated in lending entering the market as well. The majority of clients who do not participate in securities lending don't participate because of concerns related to the risk of investing cash collateral. Looking at recent counterparty defaults, Lehman and MF Global, for example, we are not aware of any clients in agency programs who experienced losses related to loans to these counterparties. Thus, we do not believe that a CCP will increase the number of beneficial owners participating.

Sylvester: The CCP discussion has been in the public domain for some time. Each new iteration of a CCP structure that is launched is an improvement on the previous, however, the feedback from many of our clients is that a CCP adds another layer of complexity and cost which could limit activity over time if returns don't improve correspondingly. From our discussions, most lenders seem fairly comfortable and happy with the risk and parameters of their programs and are not looking for the seismic changes being debated.

Trapp: We will continue to evaluate the role of central counterparties in the securities lending market. We continually assess market developments and ultimately seek ways to best serve our clients' objectives.

Lamb: There are some examples where the mechanics of a CCP's operations don't work for beneficial owners

Bassler: There are clear benefits of CCPs in the lending market such as price discovery



and greater distribution to a wider universe of counterparties. There is also the opportunity for this model to evolve over time and possibly offer benefits to the short term cash markets. It is important to understand the pros and cons of any distribution channel, but there does not appear to be any downside to having more options. We expect the debate will continue with more beneficial owners expressing interest, particularly if regulatory changes force the industry in this direction.

Lamb: It doesn't appear to me that CCPs have done much to get more beneficial owners into the securities lending market to date. CCPs have existed for many years. On the contrary, there are some examples where the mechanics of a CCP's operations don't work for beneficial owners.

Slater: While regulators like CCPs and they have a place in our market, significant regulatory change would have to happen based on the current clearing models that exist today for agent lenders and their clients to get the full benefits of a CCP. Current CCP models don't really deal with agency lending in a high-volume, low-cost manner. Beneficial owners may benefit from a wider distribution via CCPs but without having the concept fully developed it is difficult to determine if they would embrace a CCP.

Zirpolo: That is highly doubtful. While counterparty risk is of great concern, counterparty failure has not caused any real losses in the securities lending space, meaning a push towards a CCP model does not add any value from that standpoint. The vast majority of losses associated with lending during counterparty default events has come in the cash reinvestment space, which a CCP model does not address.

SLT: Is the US market still focused on cash collateral, or are alternatives gaining any ground?

Brown: Beneficial owners in the US market continue to predominantly lend against cash as collateral. However, in general, we have seen clients in the US move towards more liquid investments with shorter maturities. Furthermore, we have seen more clients accepting equities and other liquid collateral in both non-cash trades and in the form of repurchase agreements, as the collateral has proven to be more liquid and more accurately priced than many other forms of collateral during a crisis and are correlated when used against other equities. Prime brokers have an increased desire to do more non-cash and non-traditional repo business, as they look to utilize their balance sheets

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more efficiently, as well as to meet new regulatory requirements.

Sylvester: Cash is still the preferred collateral option for both borrowers and lenders but we have seen strong growth in non-cash collateral for fixed income loans and an increased use of non-cash collateral including equities for equity loans.

Trapp: Although the US market is still predominantly focused on cash collateral, some beneficial owners are expressing an interest in the potential benefits of adding non-cash collateral as an alternative. Diversification of collateral options may enhance revenue while at the same time potentially mitigating some risk. Northern Trust consults with clients to help structure their ideal program, which includes acceptable parameters for investing cash collateral and the acceptance of non-cash collateral. Although some forms of collateral are still not permitted in the US (i.e., equities), borrowers have an increasing appetite to pledge other forms of non-cash collateral, such as convertible bonds and other fixed income instruments.

Bassler: Although more beneficial owners are evaluating non-cash collateral, the majority of the US market remains focused on cash but they are opting for more conservative guidelines.

Lamb: The US markets are focused on cash collateral because it's the superior form of collateral in a bankruptcy. Non-cash collateral will always be prevalent as well. The percentage of cash and non-cash will continue to ebb and flow over time.

Slater: Yes, cash is still the collateral of choice in the US, but collateral flexibility is a topic of discussion with our clients. Regulatory changes and market conditions are significantly changing borrower demand and opening the door to alternative collateral arrangements. Increased focus on capital, leverage and liquidity has increased demand for non-cash collateral.

Zirpolo: While not terribly complicated, there are additional logistical hurdles involved in settling non-cash collateral. Because of that, cash remains the collateral of choice in US markets.

SLT: 2012 is going to see a lot of regulatory changes. Are there any issues that are particularly concerning you?

Brown: As regulatory reform takes shape, our biggest concern is that the changes enacted provide the risk management results intended.

Many of the proposed regulations as written today could negatively impact the breadth and flexibility of structures offered by securities lending providers to clients, as well as returns generated for clients. As such, we are working with regulators to help devise these new regulations and hope that more clarity will ensue in 2012.

Sylvester: As with all market participants, we are very focused on Dodd Frank and EMIR, and the potential implications and opportunities they present. Both regulations include requirements around margin for cleared derivatives which will dramatically increase demand for high quality assets. This demand will likely translate into greater appetite to borrow certain security types which we feel could be a driver of positive growth in the lending industry over the next couple of years.

Trapp: The global regulatory environment will remain prominent in 2012 with the roll-out of new rules from regulation such as Dodd-Frank, Basel III, and global short selling rules. Northern Trust's securities lending experts are active in industry associations around the globe such as the Risk Management Association in the United States, ISLA in Europe, CASLA in Canada and PASLA in Asia. Our involvement with these industry groups allows us to provide valuable input to the various agencies responsible for drafting these new regulations. Our involvement also puts us at the forefront of regulatory and market changes, which ultimately benefits our clients.

Bassler: The various industry associations have made significant progress in educating regulators and policy makers around the globe regarding the impact and unintended consequences of certain regulatory changes. We are closely monitoring all proposed changes however there are several at the top of our radar.

Bassler: The securities lending industry has taken great strides in increasing transparency over the past decade

As part of our role on The Risk Management Association's Committee on Securities Lending (RMA), we are actively working to clarify the scope of the one business day stay imposed on the ability to close out securities lending and



repo transactions with a borrower that is subject to Dodd-Frank's "Orderly Liquidation Authority" (OLA). In addition, in the current environment, transparency is on every regulator's mind. The SEC has a mandate to promulgate rules designed to increase transparency of securities lending information available to brokers, dealers and investors. Additionally, the Financial Stability Board's securities lending and repo workstream is reviewing data collection in the industry, among other issues, as part of its review of the shadow banking system. While the securities lending industry has taken great strides in increasing transparency over the past decade, further transparency and reporting, particularly as it relates to regulators, is likely to be a future requirement for industry participants, as foreshadowed by the NY Fed staffers' report. Another key focus is short selling. After months of negotiations, the European Parliament adopted regulations to curtail short selling and certain credit default swap transactions. One of the specific goals of the regulations was to "lay down a regulatory framework with regard to the requirements and powers relating to short selling to ensure greater coordination and consistency between the Member States where measures have to be taken in exceptional situations." The effective date for the regulations is 1 November 2012. While the uncertainty of these regulations is currently hindering lending demand we believe their overall objective of greater transparency is good for the industry. From eSecLending's perspective, our model is strongly positioned to address the regulators goals in this regard.

Sylvester: On the whole, lenders have reviewed, amended and evolved their lending activities in the wake of the financial crisis so they are consistent with their risk and reward objectives

Lamb: We've already had too much regulatory change. More regulation for the sake of regulation without fully understanding ultimate consequences is a potentially dangerous thing. Many market participants are still struggling to keep up with the changes taking place. It would be more helpful if there were less regulatory changes to come.

Slater: One of the biggest challenges we face right now is regulation. The challenge is the speed and volume of the regulatory change that is occurring globally, not just here in the U.S. We have to be aware of what is going on and comment on as much of it as we can to make sure that there are no unintended consequences that could have a negative impact on securities lending. One of our main concerns is global regulation with respect to short selling, specifically, the treatment of the sale of a lent security. Any characterisation of the sale of a security on loan as a short sale would have significant negative impact on securities lending and overall market liquidity.

Zirpolo: The speed with which the Volker Rule is implemented by institutions could have an impact on the overall pool of demand for borrowed securities. Additionally, Basel III will raise capital requirements on derivative products that can be hedged with borrowed stock. Early implementation of Basel III could see overall demand shrink.

SLT: Is securities lending in the US now transparent enough?

Brown: Transparency in the securities lending industry continues to improve. Third-party performance benchmarking tools to compare a provider's performance have improved over the last few years and continue to evolve. Many aspects of securities lending programs have also become more transparent including client reporting, contracts, and Agency Lending Disclosure (ALD). Furthermore, future potential regulations may help in increasing transparency as well.

Sylvester: We have been very pleased with the trend for increased transparency for securities lending programs. On the whole, lenders have reviewed, amended and evolved their lending activities in the wake of the financial crisis so they are consistent with their risk and reward objectives. They have become very focused on program management, oversight and understanding the drivers of risk and return. Performance benchmarking is less prevalent than several years ago. We provide our clients with a vast array of reporting, MIS and information including our securities lending dashboard, daily, weekly, monthly reporting and regular in-depth review meetings.

Trapp: The securities lending market is largely transparent and has been for several years. Demand remains high for transparency through reporting and program benchmarking. Clients want to know what is happening in their lending program such as which borrowers are bor-

rowing their securities, which types of collateral they hold and how their cash collateral is invested. Northern Trust provides clients with comprehensive and timely information on all aspects of their securities lending program. In addition, the growth of industry data providers allows lending agents and beneficial owners to benchmark various aspects of their overall or individual lending program.

Brown: Third-party performance benchmarking tools to compare a provider's performance have improved over the last few years and continue to evolve. Many aspects of securities lending programs have also become more transparent including client reporting, contracts, and Agency Lending Disclosure

Bassler: Transparency in securities lending can take on different meanings. The SEC's focus is on price transparency which has certainly improved with the advent of data providers such as SunGard Astec and Data Explorers. The remaining challenge however is that each transaction is unique to each lender's individual lending profile making it challenging to accurately draw benchmarking comparisons. We also believe that the auction model has helped introduce price transparency in the market.

Lamb: For whom? It certainly seems transparent enough for many participants including beneficial owners but there will always be people who will want greater access to more information.

Slater: The securities lending industry has been very transparent for many years vis-a-vis the participants in the market. Agent lenders have for many years provided detailed information to beneficial owners about their securities loans, collateral and cash reinvestment portfolios. In

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addition, the same information on securities loans is provided on a daily basis to the counterparty or borrower of the securities. Much of the regulatory focus on transparency deals with providing more disclosure to investors in entities that engage in securities lending. In addition, regulators are also interested in information so that they can monitor the market in order to get a sense of the volume and the size of the industry and the interconnections between market participants.

Zirpolo: Yes. Between the environment of transparency that has been created industry-wide by the recent set of new regulation and the bevy of analytical tools that are industry standard in securities lending, there is an appropriate balance between transparency and the responsibilities firms have with their customers.

SLT: Has the US credit downgrade affected the market?

Brown: There has been little impact on the securities lending market given similar macroeconomic and fiscal concerns for other global economies. At the onset of the downgrade, many investors were surprised that the US debt was downgraded, which created a great deal of volatility. As a result, there was a brief period when borrowers demanded higher rebates to borrow US government debt, as concerns in other global economies had not arisen yet. Since that period, US government debt has trended back to normal rebate rates. As concerns about other economies continued to grow, the US debt continued to trade as if it were rated AAA, reflecting the markets confidence in the economy. Unless solutions to reduce the US deficit are enacted, we can expect to see continued volatility in both the general markets, as well as the securities lending market.

Sylvester: We saw surprisingly little impact to the market. Clients who accepted US treasuries as collateral before the downgrade continued to accept them today.

Trapp: In advance of the rating downgrade announcement, the market was clearly braced for potential disruption; however, the actual event did not have a significant impact. More than anything, our focus was on pro-active communication with our clients and their consultants during this time.

Bassler: The US credit downgrade did not have a material effect on the securities lending market aside from communicating relevant updates and potential impacts to client regarding any collateral exposures.

Lamb: Yes – it caused the treasury market to rally and ultimately called into question the significance, relevance, and viability of the credit rating agencies.

Slater: The short answer is no. As part of our due diligence leading up to the resolution of the US Federal debt ceiling increase we prepared for the prospect of a US credit downgrade. Institutionally, the impact was vetted with senior short-end traders and consensus was reached that it would be a non-event, some even calling for a flight to quality to treasuries. At the same time client contracts and investment guidelines were reviewed for outliers that might specify a credit rating for U.S. Treasury securities. These were addressed to accommodate the split ratings or the rating criteria were removed all together. In no instance did clients remove treasury debt from its approved investments.

Zirpolo: It hasn't. The glut of subsequent downgrades that followed the US downgrade resulted in a parallel shift in credit ratings and did not affect the relative credit riskiness of assets or entities.

SLT: What are your predictions for 2012?

Brown: We expect 2012 to be very similar to 2011, given an expected continuation of current Fed policy on interest rates, uncertainty around reform to regulations and global macroeconomic policy, which will contribute to continued global market volatility. Securities lending providers will need to be prepared to manoeuvre adeptly through the myriad of potential changes impacting our business, while proactively keeping clients informed.

Sylvester: Our expectation is for the market environment to remain challenging, at least for the first half of the year. This is in some ways the opposite of 2011 where the first half of the year was quite positive and then became difficult mid-year. Positive progress with the eurozone resolution and more clarity around the regulatory agenda will be reason for more optimism but there are good opportunities out there now, especially in Asia and the emerging markets which we hope to capitalise on. We're hopeful that through opportunities like these, new entrants to the market, and demand drivers like collateral transformation trades, 2012 will be a positive year.

Trapp: We anticipate that 2012 will be similar to 2011. Market volatility will likely persist with uncertainty around the European markets remaining in the near term. Interest rates should remain at historic lows. Again, there will be a

continued diligence around regulatory developments. Northern Trust will continue to focus on crafting solutions for our clients and remaining at the forefront of developing market opportunities to best extract value for our clients.

Slater: We need to set realistic expectations with our clients as we will continue to be in a low yield environment for the next 18-months to 2-years

Bassler: We expect the industry evolution to continue, with beneficial owners placing increased focus on multiple providers, benchmarking and performance attribution. In addition, certain sectors of the securities lending market such as Asia are expected to continue experiencing strong growth. Likewise, emerging markets will continue to be a focus for the industry as they have growing economies, a large base of assets to invest, multiple constituents, good liquidity, and passively held investments.

Lamb: Interest rates will remain low for quite some time. The crisis in Europe will continue to infect markets and EquiLend will have some significant developments to announce.

Slater: 2012 will be a busy and challenging year for the industry. We need to set realistic expectations with our clients as we will continue to be in a low yield environment for the next 18 months to two years. We need to continue to monitor ongoing regulatory action and comment when necessary but also engage with our clients as this regulatory change creates new opportunities.

Zirpolo: It is likely that we will see a further tightening of the credit landscape. However, it is our hope that we will see a return to the more traditional banking model, which relies on diversification of credit exposure as a key means of managing risk. **SLT**