



Passing the baton

How can you control the risks and maintain transparency in short selling?
GISELLE AWAD reports.

Over the last several months there has been increased media attention regarding securities lending and/or short selling.

While a heightened focus is warranted, it is essential to also understand the vital role securities lending plays in today's capital markets as it contributes to overall market efficiency and liquidity.

Both securities lending and short selling are critical elements of hedging and risk management for trading and investment strategies and also help facilitate timely settlement of securities. Like all investment decisions, there are risks involved which should be clearly understood by participants.

It is important to note that the risks can be controlled.

This article presents a high level view into the essential role of securities lending, the risks associated with participating and the increased focus on transparency and regulation in the industry.

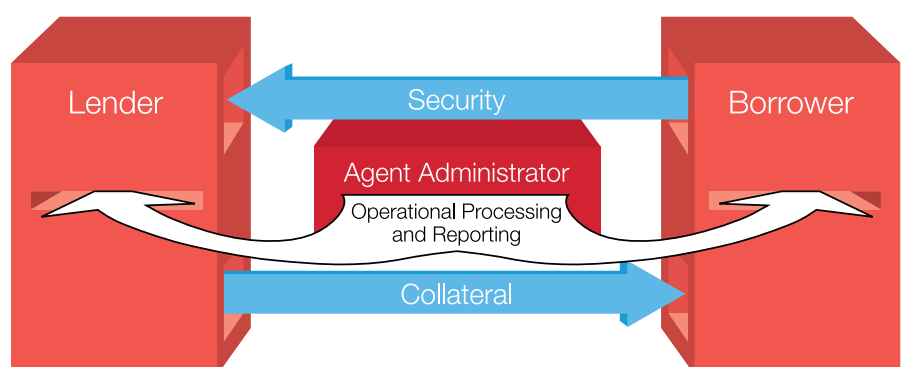
WHAT IS SECURITIES LENDING?

Securities lending is an investment strategy in which investors make short-term loans of their securities to generate incremental revenues from their portfolios.

Securities loan



Securities return



Risk	Controls
<p>Counterparty Risk: <i>Borrower default: failing to mark-to-market or deliver securities upon demand</i></p>	<ul style="list-style-type: none"> Capital requirements and extensive ongoing credit reviews, credit limits, credit monitoring Daily collateral mark-to-market and exposure review Diversification, including asset and liability exposure Independent indemnification insurance provided in the event of Borrower default Nominal and VaR-based review and control Stress testing and counterparty default simulations
<p>Reinvestment Risk: <i>(when applicable): Investment default, liquidity, or duration mismatch</i></p>	<ul style="list-style-type: none"> Consider unbundling “core” cash management Establish conservative reinvestment Monitor weighted average maturity, credit quality, sector allocation, and liquidity Quality analysis and oversight of investment vehicles, counterparties, collateral, and diversifications Consider non-cash collateral
<p>Operational Risk: <i>Processing mistakes and errors</i></p>	<ul style="list-style-type: none"> Daily reconciliation mark-to-market between program participants Best practice procedures and guidelines with all counterparties Sophisticated systems and technology Corporate action monitoring Business Continuity Planning/backup systems Routine reporting, verification and management oversight
<p>Legal/Contractual Risk: <i>Compliance with program guidelines</i></p>	<ul style="list-style-type: none"> Standardised documentation Audit/compliance reporting and oversight Industry experts as external legal counsel Regulatory and cross border tax reviews of all lending transactions

The loan results in a transfer of title/ownership to the borrower who is obligated to return the same type and amount of securities. Loaned securities are collateralised (typically 102 or 105 per cent), reducing the lender’s credit exposure to the borrower.

Revenue is generated based on the demand for the security loaned, known as intrinsic earnings, and also from the reinvestment of cash collateral, if applicable.

Some lenders choose to accept non-cash collateral such as Government Debt and Supranational Bonds rated Aaa/AAA or in other forms they stipulate.

Participants in the market include:

Lenders

- Public sector, industry, corporate or retail superannuation funds
- Mutual Funds and investment companies
- Corporate and government pension and sovereign wealth funds
- Endowments and foundations
- Insurance companies

- Off-shore investment funds (Ireland and Luxembourg)

Borrowers

- Broker-dealers – prime brokerage units
- Bank and/or broker-dealer proprietary trading desks
- Hedge funds

Facilitators

- Custodial agent or principal lenders
- Third-party agent lenders
- Broker-dealers acting as principal borrowers (exclusive principal deal)

Securities lending is a long established practice and, according to statistics provided by Data Explorers, an industry data specialist, the balance of securities on loan exceeds \$1.3 trillion globally.

The market for securities lending is driven by the demand of investment managers, large banks and broker/dealers and their hedge fund clients around the world. This demand is fuelled by the many different investment, trading and arbitrage activities they engage in plus the underlying need to borrow securities to

alleviate falls and shortages in the market.

Lenders participate to achieve incremental returns on their portfolios and increase overall performance (increase alpha) for portfolio managers.

The view of securities lending has changed significantly over the last several years. Once seen as an ancillary service to custody, the emergence of third party agents and advancements in technology have encouraged participants to treat securities lending as an investment function.

RISKS AND CONTROLS

When properly planned and executed, securities lending is a low-risk investment strategy.

However, since all investment activities involve some risks, lenders should consider certain potential risks with respect to their securities lending activities. These are outlined in the table above.

These risks are not unique to one provider and should be properly addressed and managed no matter the program structure or provider.

MARKET IMPACTS TO SECURITIES LENDING Short Selling Restrictions

Many countries have responded to the credit crisis by placing temporary short selling restrictions, of various levels, to combat stock manipulation and restore market stability.

The ban in the US was one of the shortest, lasting just three weeks.

While many of the countries that issued bans have since ended them, a number of governments have maintained that their markets are still considered too unstable to allow covered short selling.

Despite the ban, data shows that the share prices continued to decline. Academic research recently completed by Cass Business School showed no strong evidence that the emergency short selling restrictions imposed in various markets around the world have changed the behaviour of stock returns.

The researchers examined daily returns on UK, US, Italian, French and German shares before and after the introduction of restrictions on short selling, including shares which are subject to the restrictions, and those which are not.

There was no evidence of a reduced probability of large price falls or no sign of any detrimental impact.

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Regulation and Transparency

As a result of the Lehman and Opes Prime defaults, counterparty risk management has become a primary concern leaving many participants demanding more transparency and regulation.

ASIC is currently working with industry organisations to achieve improvements in this regard and the two primary changes are as follows:

	Lendable Assets (\$M)	Balance vs Cash (\$M)	Balance vs Non Cash (\$M)	Total Balance (\$M)	Util (%)
Mar-08	13,996,235.80	1,760,276.80	1,133,655.30	2,893,932.10	20.68
Mar-09	8,559,476.30	836,133.80	502,643.40	1,338,777.30	15.64

Source: Data Explorers

1 Short Sales will be tagged when executed on the ASX

While increased regulation is welcomed by most participants, one negative aspect of this regulation is that it does not require notification when the shares are bought back. Therefore, it is likely that short positions will be artificially inflated.

2 ASX is requesting securities lending activity be reported

The ASX is requiring that securities lending activity be reported on a daily basis by market participants. This requirement is mandatory.

Market Demand and Volumes

While the improvement in market conditions over the past month has brought some hope for a potential broader recovery, there are still many challenges ahead and the securities lending industry is certainly not immune.

Overall, borrower demand has decreased as a result of the de-leveraging across the global market and declines in certain hedge fund and proprietary trading strategies.

Although liquidity in the market has been improving, borrowers continue to face increased funding costs and balance sheet pressures.

As a result, many borrowers have decreased their balances of General Collateral (GC) securities or securities with little intrinsic value, and are using shorter durations for trades.

In addition, dividend payments have decreased across many sectors and IPO volumes are expected to remain lower than in previous years.

However, despite these market challenges there is still strong demand across many markets and asset classes including European and emerging market equity, US and European government fixed income and global small cap equities. For Australian equities, while fees remain stable, utilisation has decreased.

The above chart is a comparison

of securities lending volumes in March 2008 vs. March 2009, which illustrates a significant decrease in lendable assets that can be attributed to declining market values of assets and fluctuations in exchange rates.

TRENDS AND OUTLOOK

The securities lending industry is showing a renewed focus on optimising intrinsic lending returns and developing customised solutions for clients.

While all industry participants witnessed unprecedented market volatility in the last few quarters, the increased focus lenders have placed on risk management, transparency and performance will benefit the securities lending market in the long run.

The growing view of securities lending as an investment function rather than an operational task has also encouraged beneficial owners to more closely evaluate their programs and explore alternative routes to market.

As a result, it is expected that the market will see increased unbundling of securities lending and custody.

In a study released in January 2008 by Finadium, data showed that while a portion of institutions value bundled services, more than ever, they are seeking best of breed solutions for custody, lending and cash management in an effort to maximise returns and increase service levels.

In addition, lenders are encouraged to fully comprehend all the risks and rewards associated with securities lending but to also understand that these risks are controllable and that proper controls and procedures can mitigate issues that may arise. These trends have already been underway for several years but will likely accelerate as a result of recent market events and the increased focus on securities lending that has resulted. **SF**

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