



## The Australia Securities Lending Seminar 18th and 19th November 2009

Data Explorers and eSecLending, in partnership with the Melbourne Centre for Financial Studies, hosted an Australian Securities Lending Seminar in Sydney and Melbourne. The purpose of the seminar was to discuss the increased focus of securities lending and its relationship to short selling both globally and particularly in Australia. The seminar brought together a group of industry experts to provide information and perspective which led to lively debate and education for those attending.

Topics and speakers featured during the seminars included:

### **Panel One: The Fundamentals of Securities Lending**

Reviewed the basics of securities lending, size of the market, demand drivers, participants, operations, risks and controls and recent industry events.

*Ed Oliver, Director, Data Explorers Consulting*

*Giselle Awad, Senior Vice President, eSecLending*

### **Securities Lending Defined**

Securities lending is defined as a market process whereby securities are temporarily transferred by one party to another for a fee. The borrower is obligated to return the securities to the lender, either on demand or at the end of agreed period.

Securities lending is increasingly recognised and managed as an investment product with a risk/return profile. It plays a central role in providing liquidity and hedging to the global equity and fixed income markets. While there can be a relationship to short selling, the two practices are not mutually inclusive. In order to legitimately sell a security short (covered short), the seller must borrow that security from a lender. However, borrowed securities does not necessarily equate to those securities being used to cover a short. There are many other motivations for borrowing securities such as arbitrage activity and fulfilment of other operational needs as reviewed in the market drivers discussion.

### **Facts and Figures**

Securities lending is a US\$11 trillion industry where Australian lenders make up US\$70 billion in lendable assets, with their portfolios generating an additional 2-3 basis points. As of November 2009, the market value of securities on loan reached close to \$2 trillion, with 54% of balances being fixed income securities and 46% being equities.

### **Market Drivers**

Beneficial owners (Superannuation Funds, Endowments and Foundations, Insurance Companies, Asset Managers and Central Banks) lend their securities to achieve an incremental return on their portfolios. They retain all economic ownership benefits with the exception of the right to vote shares. They may also lend to maximize opportunities for leveraging a portfolio or to finance fund specific projects.

Broker/Dealers and Prime Brokers borrow securities for varied reasons. These include hedging strategies, financing inventory, operational needs and various arbitrage strategies. The graphic that follows illustrates the borrowing motivation for hedge funds. Short bias strategies (short selling with the belief the share price of a stock will fall) have recently been portrayed in the media as the primary, and



often only, motivation to borrow securities however as illustrated in the graphic that follows, dedicated short bias accounts for less than 1% of securities borrowing activity.

## Credit Suisse/Tremont Hedge Fund Index

### Current Sector Weights



## Securities Lending Risks

There are risks inherent in any securities lending program and beneficial owners should be cognisant of what these are and what controls should be in place to mitigate these risks as indicated in the table below.

Risk	Controls
<p><b>Counterparty Risk:</b> <i>Borrower default; failing to mark-to-market or redeliver securities upon demand</i></p>	<p>Ongoing credit review of borrowers incorporating qualitative and quantitative (VaR and CDS) risk factors 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>
<p><b>Reinvestment Risk:</b> <i>(when applicable): Investment default, liquidity, or duration mismatch</i></p>	<p>Cash management decision unbundled from lending decision Utilize premier asset management preferred providers Establish conservative reinvestment guidelines Monitor weighted average maturity, credit quality, sector allocation, and liquidity Quality analysis and oversight of investment vehicles, counterparties, collateral, and diversification</p>
<p><b>Operational Risk:</b> <i>Processing mistakes and errors</i></p>	<p>Daily reconciliation and marks-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>
<p><b>Legal/Contractual Risk:</b> <i>Compliance with program guidelines</i></p>	<p>Standardized documentation Audit/compliance reporting and oversight Industry experts as external legal counsel Regulatory and cross border tax reviews of all lending transactions</p>





## Recent Industry Events

In 2008, two major industry events are primarily responsible for the evolution of the securities lending industry.

Lehman Brothers is the most significant counterparty default in the history of the securities lending market to date. It is important to note, however, that the mechanisms designed to protect lenders against counterparty risk worked well across the industry. The greatest issues occurred on cash collateral reinvestment for those agents and lenders who had reinvested in instruments that became impaired or impacted by mark to market exposure during the turmoil.

The collapse of Opes Prime highlighted potential areas of operational risks. While Opes Prime was involved in margin lending the lessons learned with respect to ensuring that loans are margined and marked to market can be applied to securities lending.

These two events resulted in an increased focus on transparency and regulation. Globally, the impact of these events resulted in beneficial owners taking a closer look at their programs, seeking more information from their providers and evaluating alternative routes to market. Above all, lenders now view lending as an investment discipline with a risk/return profile instead of an operational function. In Australia, there have been significant changes to rules and regulations involving ASIC, RBA, ASX and ASLA which was further discussed during the Regulator's Perspective panel.

### Panel Two: Regulator's Perspective

*Explored regulatory motivation, Australian regulation compared to global regulation and what regulatory changes can be expected*

*Ed Oliver, Director, Data Explorers Consulting*

*Peter Martin, Chairman, Australian Securities Lending Association*

*Mark Manning, Senior Manager, Reserve Bank of Australia*


*John King, Partner, Mallesons Stephen Jaques*

*Doug Clark, Policy Executive, Stockbrokers Association of Australia*

Australian regulators are not looking to discourage securities lending. They view it as an effective mechanism for bringing liquidity and efficiency to the market. In a recent report, the Reserve Bank of Australia (RBA) stated that "Securities lending and short selling add to market liquidity and to the efficiency of pricing, contributing to lower bid-offer spreads and helping to ensure that prices reflect the views of both bullish and bearish investors". Regulators are however, introducing new regulations for securities lending, including in relation to transparency and disclosure. In relation to disclosure, the Reserve Bank has identified six key objectives:

- (i) Assisting the system operator (ASTC) in managing the daily settlement batch, and in particular supporting back-out and batch-recalculation procedures should these need to be invoked
- (ii) Assisting in the analysis of settlement fails
- (iii) Providing sufficient information to market participants to enable them to assess potential future settlement risks, perhaps arising from the large-scale recall of securities loans
- (iv) Improving general understanding of the role of securities lending in the smooth functioning of equities markets
- (v) Addressing imbalances in the availability of market information to participants



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- (vi) Complementing disclosure of the gross flow of covered short sales, currently required under an ASIC Class Order

Additional details can be found in the Feb 2009 Disclosure of Equities Securities Lending document linked here:

[http://www.rba.gov.au/PaymentsSystem/StdClearingSettlement/DisEquSecLen0209/desl\\_022009.pdf](http://www.rba.gov.au/PaymentsSystem/StdClearingSettlement/DisEquSecLen0209/desl_022009.pdf)

The RBA is working in conjunction with industry bodies, including ASLA and Stockbrokers Association of Australia to ensure the new regime is neither burdensome nor discourages investment, especially from overseas, into the market.

Market participants will provide data on a daily basis to the ASX, which will allow movements to be tagged as securities lending transactions and provide some transparency in the form of statistics on the net loan position. This will be posted with comparative statistics such as turnover in the stock and availability in hopes of putting the data in context and making it more meaningful. This data will also be used to complement short selling data. It is important to note that there is not a one-to-one relationship as not all securities lending transactions result in a short sale.

It was acknowledged that there is further work to be done and there could be potential issues getting overseas participants to adhere to the disclosure rules but the RBA and market participants are willing to work together to implement a productive and viable solution.

### **Panel Three: What really Drives Demand to borrow**

***Addressed demand drivers and trading strategies, including a summary of short selling studies assessing the impact of borrowing and the role of short selling in the capital markets.***

*Giselle Awad, Senior Vice President, eSecLending*

*Dereke Seeto, Director Equities Prime Services Trading, Credit Suisse First Boston*

*Ólan Henry, Associate Professor, University of Melbourne and Associate of Melbourne Centre for Financial Studies*

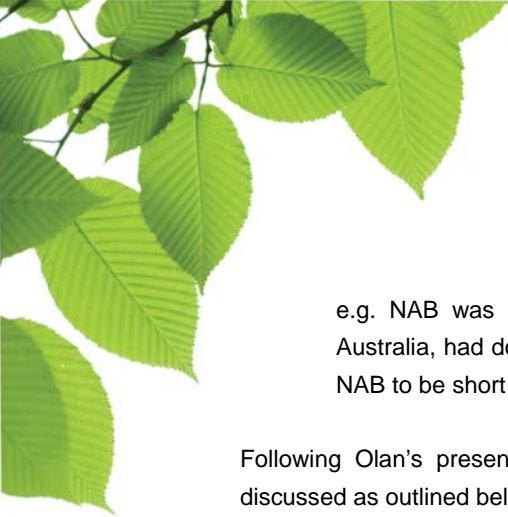
*Mark Heyburn, Director, Paloma Securities, Australia*

Short selling and securities lending play an essential role in capital markets servicing numerous participants including fund managers, superannuation funds and hedge funds. The events following the Lehman collapse drew increased scrutiny and hasty regulations such as short selling bans of financial stocks in multiple markets. As broadly stated in the press and reinforced by many regulators globally, the bans failed to prevent declines in share prices in some of the well known financial companies.

In this regard, Ólan Henry presented part of his research on short selling which had four main conclusions:

- (i) Short selling contains information which adds to the efficiency of markets
- (ii) Every short sale does not necessarily reflect a negative sentiment about a stock
- (iii) During the ban on short selling (compared to pre and post) there was more volatility in the market
- (iv) Examined some specific names that claimed to be 'victims' of short sellers





e.g. NAB was refusing to disclose exposure to sub prime debt when all other banks, in Australia, had done so. Therefore, there was good reason for its share price to drop and/or for NAB to be short sold.

Following Olan's presentation, a more detailed review on the primary reasons for borrowing was discussed as outlined below:

- (i) Financing inventory and managing balance sheets
- (ii) Hedging e.g. Options trader
- (iii) Facilitation of underwritings or share placements
- (iv) Operational needs to prevent fails
- (v) Risk, dividend, merger, index , cross border and other arbitrage strategies

While the details of these strategies were examined and vary from one to the other, the fundamental reasons as to why they are executed fall into three categories:

- (i) To hedge or make a strategy risk neutral
- (ii) Provide liquidity or avoid fails and
- (iii) To take advantage of an arbitrage opportunity

These strategies service not only hedge funds but an extremely broad range of market participants, including superannuation funds, fund managers and investment banks.

#### **Panel Four: The Beneficial Owner's Perspective**

*Discussed lessons learned from the events of 2008 and 2009, how the risk/reward profile of participants has changed and what "best practice" in securities lending really means.*

*Mark Faulkner, Founder, Data Explorers*


*Ross Clare, Director, Association of Superannuation Funds of Australia*

*Chris Jaynes, Co-Chief Executive Officer, eSecLending*

*Peter Curtis, Senior Investment Manager, AustralianSuper*

*Jonathan Green, Senior Manager, New South Wales Treasury Corporation*

During this panel, lenders and agents shared their recent experiences with securities lending programs. It seemed those who have viewed lending as an investment function fared better during the turbulent time. Specifically, two large and respected Australian superannuation funds shared their experiences with the audience. Both their Boards sought more information and, in some cases, wanted deeper education about securities lending over the last 18 months. What became apparent to their Boards (and was reinforced to the managers as they embarked on this review) is that securities lending should be treated with the same level of due diligence and understanding as any other investment mandate. Boards need to fully understand the risk and rewards inherent in their programs and feel confident about proper oversight and controls. With this shift in perception came both understanding and comfort in what funds were undertaking. ASFA, as both a representative and educator of superannuation funds, shares the view that securities lending should be managed with proper risk oversight and controls and viewed as an investment decision. ASFA will soon be introducing a best practices paper on securities lending to help with the process.





### **Seminar Recap and Conclusion**

The purpose of the Australian Securities Lending Seminar was to educate, inform, interact and understand securities lending. The hosts focused on bringing together various independent participants who presented unbiased data with the goals of educating and demystifying the topic. These goals were met as a result of the candid discussions provided by industry participants both on the panels and in the audience. To summarise the days' events, the key themes about securities lending reiterated throughout the day were:

- Trillion dollar global business
- Generates billions of dollars for funds
- Brings liquidity & efficiency to capital markets
- Supported by global regulators
- Increasingly transparent
- Viewed as an investment strategy

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