



Securing the future

Securities lending is well on the road to recovery but challenges remain. A *Global Investor/isf* expert panel discusses reputational issues, regulation and how best to secure returns for clients

Simon Murray, chair: What are the most important issues facing the industry today?

Stuart Thompson, J.P. Morgan: The issues we are seeing from clients include cash re-investment, impaired assets and vertical slicing. Clients are generally concerned about lending, whether they have suffered losses or not, and those looking to lend for the first time are concerned about how best to construct their programme and collateralise.

Peter Askins, Independent Trustee Services: Shorting has a terrible reputation in my world. As a professional trustee, and a

former professional regulator, my interest is in the regulatory side given the impact on pension schemes, sponsors and trustees if things go wrong.

John Arnesen, BNP Paribas Securities Services: I'm concerned about regulation coming down the line, and how the industry can lobby some sort of sanity into that regulation. Secondly, the expectations of underlying beneficial owners. We're in an environment that's producing less revenue, and clients need to understand why that's happening.

Simon Lee, eSecLending: How will the subdued revenue environment we've been in

for a year or two affect agent lenders, and their future growth prospects? When you consider the ongoing investment required in people and technology I don't see every provider winning sufficient business to support this.

Julian Pittam, Data Explorers: The major issue is: how severe will the new regulations be? It's important the industry maintains a degree of participation to ensure that regulations don't make the situation any worse in this relatively low return environment.

Gareth Mitchell, Citi: An important issue for us is finding the right model for the

right client. Agent lenders used to offer a programme, and clients fitted into that programme. Now we offer many different types of programme for many different types of client. Put simply we give clients the ability to have what they want, but the investment in technology, administration and operations to actually deliver this is huge.

Stuart Catt, Mercer Consulting: From my conversations with beneficial owners, the biggest issue is trust. What concerns me more widely about the industry is that for a long time it's been the cash cow driving securities services businesses. That's been taken away and it will be interesting to see how it impacts beneficial owners' costs.

Chair: What are the trends in volumes this year?

Julian Pittam: In Q1 2010, fees paid to lenders totalled \$11.7m a day, or over \$1bn for the quarter. In Q1 2011 it's up 24%, to nearly \$1.3bn. If we go back over three years, European equities revenues in 2008 were \$5bn, compared to \$3.2bn in 2010. In the US, revenues were down 36%, 2009 to 2010, from \$2.5bn to \$1.6bn. However, the Citi trade alone generated \$700m worth of fees in 2009. Taking out this trade, the market was down 11%. Asia is a good story, up 12% from \$565m in 2009 to \$634m in 2010. Overall the market looks a little bit healthier.

Chair: Will volumes ever return to pre-Lehman levels?

Pittam: My opinion is yes. The question is when and how long is it going to take? The impact of technology and CCPs will increase volumes over time and will have an effect on fees as more people gain trust and build transparency.

Thompson: The question is really whether the business will ever return to the levels of margin and profitability of some three years ago. We have undertaken a great deal of hard work with clients, grown our teams, invested in platforms and worked steadily to improve the business through a very difficult time. Without predicting great uptakes in 2011, we are at least seeing a steady increase and are slightly optimistic.

Arnesen: Back in 2007/2008 the industry was over-reliant on revenue from cash collateral. If we're growing now without that element it's actually a much healthier market. It's also positive for us that the derivatives markets are likely to be collateralised not only by cash but in the future by securities.

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JOHN ARNESON

Pittam: The good news for beneficial owners is that there's still a good reason to be in the market. Fees have remained relatively flat so there's not been a huge pressure on margin. In some cases owners of ETFs are getting paid handsomely to lend right now, so there are lots of reasons for beneficial owners to be involved, assuming you like the risk.

Chair: Are beneficial owners switching providers? What is the demand for third-party solutions?

Mitchell: We're seeing a four- or five-to-one ratio of third-party to custody RFPs for proposals coming in. I would say it's very healthy in the third party solution space.

Lee: I agree. We're involved in more RFPs now than we have for some time. If you look at the industry broadly I don't think anyone would dispute there are more beneficial owners lending through a third-party agent today than there were a year ago, and this trend is likely to continue.

Chair: What are the compelling reasons to use a third-party provider? Are there cut-off points in terms of size of lender?

Lee: It depends on the lender, but some like the idea of segregating services from their custodian to take a best of breed approach, increase diversification and avoid conflicts of interest. Other lenders may be more focussed on the additional revenue opportunities that certain agents are able to provide. A lot of it boils down to the process that the agent employs and whether that meets the individual requirements of the lender. I don't think anyone would say there are cut-off points. The custodial pooled programme will always have a place and for certain lenders that's absolutely the right route to market. But size of assets is not necessarily the differentiator.

Arnesen: The minute you enter into a third-party arrangement both the provider and the client have to consider the operating structure from the incumbent custodian. Some custodians will do this very well, some will do it less well. That's the added operational burden or risk to be



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“How do you build trust? It’s an emotional word. Surely it’s the trustee’s job to understand the risks and returns associated with securities lending” JULIAN PITTAM



considered. You may also be facing shorter timeframes because you need to get information to the custodian.

Mitchell: There is a size issue. Third-party lending mandates are just not sensible propositions for all clients. But we’ve had clients come to us and say: ‘We are stuck in a pool, we don’t want to be forced to liquidate these assets and take the loss, what can you do for us in a third party arrangement?’ That’s where people are starting to look around. Obviously it’s easier to look at third-party

than doing a complete custody review.

Arnesen: Some of the switching has to be motivated by dissatisfaction with what’s gone on in the last three years. Some clients are so entrenched with their custodian that they find it very hard to unplug themselves, but in this particular discipline, namely securities lending, they are absolutely not going to stay with their incumbent custodian.

Thompson: The problem with ‘bundling’

as a concept is that it implies that you are compromising on custodian or agent – using the best provider in one area who is not the best provider in another. Third-party lending used to be the last resort pitch for custodians of a failed request for proposal (RFP). We are now seeing a change in this approach. Clients are sometimes too busy to conduct a full custody RFP, and because securities lending is well established, operationally easier than before, and has a proper economic value to attract attention, clients are prepared to be more tactical in this specific area. It’s an interesting shift for us.

Chair: What about the question of trust?

Pittam: How do you build trust? It’s an emotional word. Surely it’s the trustee’s job to understand the risks and returns associated with securities lending. The industry has not done this particularly well, I think, up until now and it needs to do it better. We’ve spent three years talking to pension funds about the risk of securities lending. They don’t want to write a cheque to understand what the risk is. They expect their agent to provide it, and I’m not sure that’s the right way.

Askins: Securities lending has been opaque. I see my actuarial advisors and my investment managers and consultants regularly. But I’ve never met any of the people here today. The regulatory pressure is on trustees to take a greater interest in everything, because ultimately if it goes wrong they are liable. Many trustees are lay people, even if they run businesses, and a proportion of trustee boards will be made up by member nominated trustees, shop floor people. The UK Pensions Regulator issued a document in January 2010 to help trustees understand and manage the risks of securities lending. At the moment, its only advice on the questions trustees should be asking and the internal controls they should be establishing. But trustees are being driven towards being surrogate regulators in terms of investment. That’s the major risk the securities lending industry should be alert to. I have a number of clients where all their investments are done on a pooled basis, and there is no way that the trustees know what’s going on.

Lee: We’re talking here about asset managers running pooled vehicles, participating in securities lending and not disclosing necessarily as much as they should to the investor. That’s an issue with the individual asset manager and how they conduct their business, not a securities lending issue per se.

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Catt: It is an issue the industry has to address. There is concern that trust is being undermined by the failure of some asset managers to adhere to governance best practice. There are some names in the asset management industry who have what we would regard as less than optimal arrangements for lending from a governance perspective. The only way it will change is when consultants talk to the beneficial owners and say 'we think this is sub-optimal' and the trustees start moving assets away.

Thompson: Peter raised an important point about clients knowing their contacts well on a personal basis and meeting them regularly. It's so easy for a transactional business like this to become impersonal. Clients tell us the importance of this particularly when things are not going well, and that some of their other suppliers did stop talking to them at critical points of the recent crises. We prefer keeping in close contact with our clients at all times. During the Lehman Brothers crisis, we had intraday calls with clients to keep them properly updated and ensure they understood their critical go-to contacts.

Askins: If you want the industry to prosper, and want people to trust you, you've got to make it 'normal'. At the moment most lay trustees and non-financially literate people would regard this as speculation, perhaps, abnormal, 'they're up to something'. The more you can make it normal in the way Stuart described, that's a sensible way forward. When trustees sit down in their investment committee and securities lending is treated as an investment decision, that's another definition of normal. The bigger schemes discuss and understand securities lending, because they can afford the best advice. But in small- to medium-sized schemes, trustees probably don't see this as an investment decision at all.

Lee: The idea that securities lending is an investment product is now widely recognised in the market. Remember though, you're going up against twenty years of securities lending being viewed as a back office administrative function. It takes time for everyone to get to the same point, but we're far more advanced now compared to where we were two or three years ago.

Chair: How can the industry change short selling's bad name?

Askins: You've got to find a strategy to stop it scaring people. Some trustees see it as

speculation and want nothing to do with it. 'How can the small returns be worth the potential damage going forward to our overall holdings because of the activities of hedge funds?' On the other hand larger pension schemes will happily pay a premium to hedge funds to derive a greater benefit, so they want their cake and eat it. You can see both sides of the argument.

Thompson: It really is a very practical issue still for us. To the person on the street, shorting is like betting against your own

football team. But even in the professional industry, getting the message out is a real challenge. In Scandinavia, for example, there is a real question mark over securities lending specifically because of shorting. This is something the industry needs to address collectively.

Lee: Concerns over short selling are cyclical to an extent. We're going through a period now where fewer concerns or objections are raised by lenders generally. Not to say it won't come up again in five years' time.



"To the person on the street, shorting is like betting against your own football team" STUART THOMPSON



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“In drafting the pensions regulations on ‘ethical’ investment for pension schemes the first thing I did was re-name it to ‘socially responsible investment’” PETER ASKINS

Pittam: At least we know the impact of short selling during a crisis. The SEC chairman said it was one of the worst mistakes of his career to ban short selling. I think the whole industry agrees that naked short selling should be banned. But there’s academic evidence world-wide that short selling is a very worthwhile exercise. The problem the industry has is telling people it’s a good thing and proving it over time so they can understand this. We’ve just scratched the surface really.

Catt: As an investment approach, short selling is a perfectly valid way to make a judgement on value. The difficulty is that negative comment in the mainstream press can unduly influence discussions. It can be difficult to make an argument in front of the investment committee that short selling is fine. A lot of it is how you phrase it. If you say to them, ‘here’s a fund that’s going to give you some extra return to close your liability gap,’ that’s a very different conversation to ‘we’re going to go short.’

Askins: Yes, a lot of it is in the terminology. In drafting the pensions regulations on

‘ethical’ investment for pension schemes the first thing I did was re-name it to ‘socially responsible investment’. That was because ‘ethical’ investing was seen as a negative thing, and social responsibility a positive thing. It’s similar in securities lending with naked short selling, where the consensus seems to be that it should be banned, versus short selling. The term short selling seems irredeemably disreputable in the ordinary person’s eyes. You need a new term for what you do.

Chair: Panel, any suggestions for such a term? ‘Value added selling’, ‘Hedging’, ‘Insurance’?

Arnesen: Can we ever change the wording? I doubt it. But one thing I can tell you is that short selling absolutely supports the pension funds that you’re a trustee in terms of their return, because otherwise spreads in markets would be much wider than they are and everything would cost more. Your asset management fees are lower because of it.

Askins: That’s the message you need to get out to trustees, to people who will increas-

ingly be forced to take an interest. That was one of my secondary questions: what’s in it for us, if it’s not a purely speculative tool, what is the positive side? You appear to have just described it.

Chair: What are the panel’s views on regulatory changes?

Mitchell: Hopefully we’ll get the short selling regulations slightly diluted, and in most jurisdictions they’ve moved from absolute bans to reporting limits. Now the debate is on what the limits should be and where they should be reported. Better than bans, but we are going to have something, the politicians are not going to just let this go.

Thompson: There are obviously many uncertainties of impact and timing from a multiplicity of issues and recommendations relating to Dodd-Frank, AIFMD etc, but – from an economic perspective at least – we are hoping that the demand for good collateral types will be enhanced through enhanced liquidity and reserve requirements.

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Pittam: The regulators are very concerned that they get it right this time, and avoid unintended consequences. If they introduce regulations that are too prohibitive, there'll be unintended consequences for retail in that the whole market would drive down prices. They're also very concerned about repo, because they don't want an environment where banks cannot finance themselves on a day-to-day basis. Despite the political rhetoric, that's why it's taking so long.

Askins: Speaking as an ex-regulator, we mustn't imbue regulators with superhuman attributes. It's important to have your say and help the regulators wherever you can to formulate a sensible regime. The only thing we can be sure of is there will be regulatory change in this area, and I see it as your opportunity to influence that.

Chair: Is the market for exclusives returning?

Lee: There are fewer direct principal exclusive deals out there post-Lehman, as lenders move away from the single counterparty concentration risk inherent in those trades. If those institutions are now lending again, and are utilising an agent exclusive programme, then they've diversified their counterparty risk, they've increased price transparency, they've likely increased their earnings, they're getting a better service, and they're getting indemnification – so they are clearly in a better position. Borrowers still source supply from a number of places; internally, from discretionary pooled arrangements, and from exclusives – and that demand dynamic hasn't changed. Good quality

portfolios will always command a premium when lent exclusively, compared to lending through a pooled discretionary programme, and again, that hasn't changed. Looking specifically at some of the auctions we've run in the last two or three months, the majority of those assets are commanding a premium in the fees being bid from last year.

Arnesen: From a fixed income point of view we're finding a resurgence of exclusive demand, particularly for AAA-rated government debt, which has a short term funding advantage to those banks who want it. The regulations are going to force them to have a lot of access to longer-term secured funding, so for the first time in many years government debt is popular. Of course the collateral on the other side has to be discussed because it's not government for government.

Mitchell: We had clients with exclusives who said 'we want out' after Lehman. Recently, we've also had it the other way round, with borrowers saying 'we don't like the lender anymore, because they've been downgraded, we want to get out', especially in countries that are more distressed than others.

Thompson: The exclusives market is important and has always been there, but risk and exit strategies are more important now. We are actually seeing a lower number of exclusives and the relative differential between the agency revenue profile and exclusives is much narrower. The experienced and sophisticated cli-

ent organisations still create demand for these programmes, they know what they're doing but want a more flexible and considered arrangement than was previously the case. They want to know what the arrangement is comprised of, especially around the intrinsic elements and nature/duration of the specials. We are working the auctions harder, and specials are a bigger component.

Chair: What about cash versus non-cash collateral?

Mitchell: Non-cash collateral has always been used in Europe. It's not like the US where cash was effectively the only option. We've got a lot better at how we move between cash and non-cash, knowing what the value of collateral is to clients. In some of the long-term funding deals being put together, non-cash is a better alternative because it's going off balance sheet. But there's nothing wrong with cash collateral; the problem was what people did with that collateral.

Lee: John described the increasing demand for high quality collateral. Implicit in that is a rising cost of collateral. What's the impact on lenders who don't accept cash, if borrowers have an increased cost to deliver the collateral lenders want? How will that affect the performance of their programmes? Will more lenders need to take cash if they're to maintain revenue levels?

Arnesen: Agency lending now is very much at the dictates of the borrower because there is a lot of supply chasing subdued



"If the benefits of CCPs are not material and not easily articulated then you're not going to get the will from beneficial owners to participate" SIMON LEE

demand. Like others here, we tailor-make our programme and try to fit a model around the client. It's quite bespoke to the underlying borrower you're talking to. If borrowers want to give you cash, you may be disadvantaged if you don't take it.

Thompson: If clients have their own in-house programmes with treasury portfolios or deposit desks, they think about re-investment programmes in the same way; the guidelines, risk parameters, counterparties and limits.

Mitchell: But still, not every pension fund understands the risk of re-investment.

Pittam: On the non-cash side we have a lot more questions from beneficial owners about the correlation of the asset class that is on loan to the asset class they are taking as collateral. Borrowers, the sell side, are pushing equities as collateral, and beneficial owners are asking 'if I'm lending equities and taking equities, what does the correlation look like and how much margin do I need to take?'. It's a good question and one we should have perhaps answered a while ago.

Arnesen: Conventional wisdom told you to lend equities and take in government debt as collateral, which everyone did. But if you look at the price action in the first four or five days after Lehman, government debt dropped in value and equities rose, and

that wasn't expected. It did smooth itself out later, but if you were liquidating during that period you may have found yourself in a position you didn't want to be in.

Chair: How effective are clients at monitoring loans and collateral?

Catt: The agent community is pushing more information out to beneficial owners. The agents will never give advice, but as long as they are pushing the information to allow beneficial owners to make a judgement then they've fulfilled their responsibility. Then it falls to the trustee to say, 'the information is provided to us, either our adviser or ourselves need to look at this and understand it.'

Mitchell: We've spent a lot of money on reporting, so that anything the clients want they can have. The challenge is how many clients take more than a basic look at loan collateral?

Askins: We need interpreters, we need translators. That's part of my job as an independent trustee. The UK Pensions Regulator is emphasising the need to improve the standard of trustees' knowledge and understanding, but only 11,500 out of 155,000 trustees have passed the regulator's Trustee Toolkit.

Thompson: As agent lenders, we don't just rely on simply sending-out reports. For us,

it is about constant communication with clients, and our dedicated relationship managers talk to them about how we can help them within the boundaries of their reporting, collateral, and data requirements, and particularly when something urgent needs bringing to their attention.

Arnesen: Peter, do you want to hear the conversation that Jules mentioned about the correlation of loans and collateral, and risks, from your agent lender?

Askins: I want to hear it from my trusted adviser. He has the knowledge, the understanding. It's incumbent on him to help me to up my skills and my knowledge and understanding, and to interpret or translate any of the stuff that I don't understand or the board doesn't understand.

Chair: What are the panel's views on central counterparties in Europe?

Mitchell: If CCPs exist across Europe, there may be several, covering each market. I can see the benefits, but what I can't see is how you make it work. Beneficial owners generally lend securities via an agent to a borrower or principal, so there's a principal relationship between that lender and that borrower with the agent putting the trade together. With a CCP, beneficial owners generally are unlikely to get direct access to that CCP. You'll need a general clearing member and your principal

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relationship with the borrower has gone. From having many counterparties you've effectively got one. The CCP will want to take margin off those clearing members as well, so the clearing member will take collateral off the beneficial owner. Instead of being up on the haircut the beneficial owner could end up being down. The only way it will definitely happen is if regulators say, 'you've got two years, it has to be that way'. My worry is a lot of the clients will say, 'I don't need to do this business any more' under that structure.

Arnesen: Exactly, the point is that securities lending is by choice, it's something you do because you've found value in it. It can be turned off just like that. If the regulators force CCPs they better provide the right platform on which to do it.

Pittam: We survey the industry regularly and well over 60% believe it will take a regulator imperative before it gains critical mass, and something like 17% think that won't happen within the next one to three years, more likely three to five years. Unless there's another major industry event that forces the regulator to do it.

Arnesen: The netting that a broker dealer would get from using a CCP is quite compelling. I asked a broker recently 'why aren't you beating down my door to enter into one of the CCP models that exist now?' Their answer was they find the benefits of netting are outweighed by the ability to know they have supply

from the agent via underlying clients. The anonymity they would achieve is not of as much value to them and they don't know the liquidity the CCP gives them when they suddenly need to raise €5bn (\$7bn) worth of government debt for example. The model may end up being something of a hybrid where there'll be a bilateral agreement and the clearing will be through a CCP which achieves their netting. That's a more compelling solution.

Lee: What are the benefits for a beneficial owner? If they are not material and not easily articulated then you're not going to get the will from beneficial owners to participate, and that's one more part of the chain that's disinterested. From our perspective we view CCPs as a potential additional distribution channel.

Thompson: Our clients are not talking about CCPs, unless we raise the subject. CCP's may become part of the securities lending landscape when they show how they are to be organised, and how they will reduce cost, risk and operational effort. J.P. Morgan supports such initiatives when they can prove-out these points.

Arnesen: But what if it increases risk? What if people lose valuable indemnities? An equity transaction in securities lending is an open-ended transaction with moving parts throughout its life.

Chair: What will the next 12 months be like for your own firm?

Catt: We're going to continue pulling out a lot of vertical slices from impaired asset pools. We're going to be a lot more active in advising clients on an ongoing basis and at the quarterly meetings, and we're going to be involved in more third-party RFPs.

Mitchell: I'm optimistic. I think we're back into a growth phase now. Clients are back and we're winning new business. We've done a lot of work over the last few years and it's starting to pay dividends. There might still be some industry consolidation among providers. I'm not convinced that all of the agent lenders out there will survive.

Pittam: A lot of the questions coming from clients asking us to react to the regulatory environment. There'll be a continued quest for more information.

Lee: We're optimistic. Lenders have spent two to three years analysing the risks in their programme, and they're more comfortable with those risks. Now they're looking at their programmes more from a performance perspective, restructuring, looking to improve returns, improve efficiencies and so forth, which will provide firms like eSecLending with numerous opportunities.

Arnesen: The interest rate environment will probably be more volatile and that will produce opportunities. We have a number of very large clients we're bedding into various structures which are not necessarily mainstream. We are placing a lot of store in Asia, it's a growth area. We're looking at Singapore, South Korea and Taiwan.

Thompson: While there is a lot that we are not able to control in terms of regulation, demand, dividends, M&A, interest rates and the like, we are focusing on what is within our control, such as closely working with our clients, re-building trust into the industry, communicating, and focusing on risk management. We are also driving through product enhancements, with particular focus upon emerging markets.

Askins: The suspicion, rational and irrational, about the industry is still there. You've got to address the transparency and communications problems. I think you would rather do it voluntarily in terms of codes of practice, industry best practice, so that you can put it in front of the regulator and say: 'You don't have to regulate us, look, we're doing it. Everything you want we've done voluntarily.' ■

By Simon Murray, freelance journalist

"We've done a lot of work over the last few years and it's starting to pay dividends" GARETH MITCHELL

