Change to the programme

Beneficial owners are still happy to lend their securities but regulation will increasingly determine the shape of their programmes

Sonja Spinner and Jeannine Lehman

Chairman: Hugo Cox

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Chair: What trends are you seeing in the value chain between beneficial owners, agent/custodial lenders, prime brokers and hedge funds?

Sonja Spinner: In some recent market tenders we have seen some lenders wanting to include cash collateral in the UK market, which historically has not been strongly demanded given the low yields on cash reinvestment. I think that is been delivered by demand for collateral upgrade trades.

Gavin Callan: Yes, I think this is coming partly from the shift in how lenders view the service. Traditionally they participated to generate some additional returns, or to offset some of their costs. Now collateral transformation is becoming more popular, as are liquidity swaps, total return trades and outperformance trades. All of these expand the rationale for clients to look at the value that securities lending can offer.

Spinner: I am interested whether firms want to use securities lending to finance their longer-dated financing requirements arising from derivative contracts, or whether they want to maintain the ability to have a day-to-day recall.

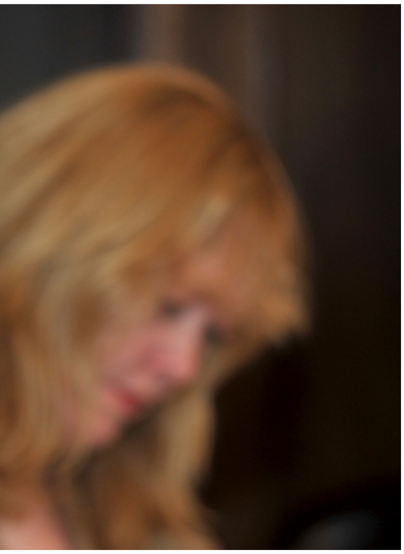
Callan: We are seeing a very specific demand around term financing. In particular, this relates to demand for high quality government bonds against a range of collateral and for many trades, the term aspect of the trade is as important as the collateral.

Jeannine Lehman: I agree that there is a general lengthening of the term of loans. And I do not think beneficial owners mind that. As long as they are happy with the parameters of their programme, then they are willing to look at longer-term structures.

Chair: How far do you feel different participants are aware of the implications of regulation? What effects do you think the changes will have?

Joyce Martindale: One concerning point I have noticed about regulations is that regulators appear to assume that beneficial owners have lots of high-quality assets, but neglect the fact that they will need these to comply with several different regulations. I fear there may be a crunch in availability. Looking at the Institutions for Occupational Retirement Provision (Iorp) directive being proposed by Eiopa for pension funds, for example, the numbers there are eye-wateringly large. For me, there are so many things that are not settled yet.

Lehman: Beneficial owners are starting to understand that they are sitting on what you would call "good collateral". So they need to understand how to apportion that, come the changes brought by regulation. They could lend it out for large upgrade trades, for example, if they can get their head around the kind of risk/reward ratio involved. We are entering a period when



Gavin Callan

beneficial owners are going to have to think about the sources of the assets that they are sitting on, and the uses they put them to.

Chair: To what extent do beneficial owners appreciate the impact securities lending has on portfolio performance? Can the industry do more to communicate the benefits to them?

Spinner: For multiple third-party asset managers, the problem is how you delegate responsibility down to them and how you reflect securities lending in performance calculations. You do not want managers to be penalised if they do not hit the benchmark.

Martindale: I agree. You are used to the risks being with the investment manager, and saying "they would have had great performance had they not bought the wrong equity" or "they got the timing wrong". You are not expecting a performance shortfall relative to the benchmark because they made some collateral decisions that were incorrect.

Spinner: We have dealt with some larger pension funds that deal with multiple investment managers. We have seen clients create central collateral pools. But here the question is how you apportion the performance of that collateral pool back onto all of those underlying investment managers. Nobody has really got to the point where they want to constrain their investment managers to the activities of their securities lending programme.

The real issue is that we do not have a way of managing performance and returns against a constrained portfolio. This is a problem because it means that asset managers have not started thinking carefully about how they can transform collateral as required by the new regulations. We are going to need expanded repo lines with financing terms that match the duration of derivative portfolios to protect investors from repo roll risk. It is not clear how the repo markets will supply the required liquidity. I do not think it is going to happen, to be quite honest, so I think will see an increase in term loans.

Bob Campion: On the question of education, it is worth noting that beneficial owners are generally one step removed from the process. Unless you are a very large, sophisticated beneficial owner you will not have some sort of external securities lending programme. Most pension funds' experience of securities lending is that it is something their asset manager will do with the funds that they invest in.

I agree that beneficial owners are in the driving seat. They are under no obligation, even in today's low-yield world, to do securities lending or to approve it to be done by any of their fund managers. If they do not feel comfortable with the risk management processes of the fund managers they delegate to, then they lose interest quite quickly in my experience.

Martindale: I think you are right in that securities lending returns are small compared to returns if the fund manager makes the right investment decisions. If you have a chief investment officer who feels that, because they have entered into term trade they cannot change an asset manager when they want, they would find that too restrictive. I think that is something that the rest of the lending community needs to be aware of.

Campion: On the other hand, we are seeing quite a big trend towards passive investment management and that comes with a much greater focus on securities lending, or certainly should do. So I think there is greater awareness now, but I think it is probably far less than you would all like it to be.

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GAVIN CALLAN, CITI

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SONJA SPINNER, MERCER

Chair: What other trends are people seeing on the passive side?

Campion: We are seeing a lot of growth in interest in passive funds generally, whether that is traditional index funds or ETFs. Here, from the beneficial owners' point of view, securities lending does have a much more material impact than in active management. This is because five or 10 basis points difference on a passive portfolio can make a big difference. Now the level of securities lending that goes on under the bonnet is relatively low, as we said before. But it is clearer in ETFs – most providers in their fact sheets on their websites are increasingly making it very clear not only that they are they doing securities lending, but the proportion of the revenue that they get is generated from securities lending.

Chair: What risks are salient for beneficial owners?

Spinner: We published a client paper noting that the biggest losses to clients were not in their segregated accounts but in their pooled funds, where clients had aggressive managers with very aggressive securities lending pooled fund programmes. But we have had barely a client who has actually wanted to do a review of their pooled fund managers, so awareness is poor. It is very unusual for a pension fund going into a pooled fund investment – after they have spent time considering asset allocation, manager selection and increasing undertaking an investment operational risk assessment – to then choose to additionally review securities lending.

Campion: Increasingly very large pension funds are investing large amounts of money in enormous pooled vehicles rather than taking segregated approaches, because it is cheaper.

Callan: My experience is slightly different in securities lending. Citi has never utilised commingled vehicles and within the separately managed structures that we use, we have seen our clients becoming far more specific around their parameters including investment types and counterparty limits. Indeed, I see clients moving more and more towards these increasingly customised lending programmes.

Spinner: Many pension funds with assets of less than £0.5bn are being pushed towards increasing use of pooled fund structures. This is partially a consequence of custodians increasing minimum custody fees and minimum accounting fees.

Chair: Joyce mentioned earlier that beneficial owners are more aware of the value of the collateral that they have. Has this affected the purposes for which they are willing to lend their collateral?

Lehman: Across our client base, it is the larger, more sophisticated clients that are considering the more sophisticated upgrade trade for the bunds that they are sitting on, and also what they will take in return. But the "nirvana" trade – bunds against whatever you want to give, whether on the equities side or major indices – is not priced right for clients yet.

Callan: The beneficial owners I see are very much open to collateral proposals. I would emphasise that the door is very much open. So the more conservative clients who once upon a time maybe only wanted to take AAA bonds are now willing to consider perhaps government guaranteed AAA bonds. And that is filtering all the way down into the equities sphere, where you are seeing clients considering expanding from primary indices to also include secondary indices.

Chair: What about other regulations like central clearing or the FTT?

Lehman: Regarding CCPs, I would suggest there is still a lot for beneficial owners to get come to terms with in respect of concentration risk. You are effectively taking a whole list of counterparties and you are collapsing that into one. So what kind of guarantee do you need for that? How does that sit alongside the indemnification that your agent lender provides? To my mind, there is work still to do before this becomes really palatable for the beneficial owner community.

Callan: We feel that there is a potential role there for CCPs, but not every securities lending trade will go through them. Rather, in certain markets, or in certain kind of trades where CCPs will work they will act as another distribution channel for lenders. The key beneficiaries of CCPs are going to be the broker-dealer side in terms of their reduced capital costs. As such, beneficial owners will need to see higher returns to incentivise them.

Lehman: Exactly. And those with lower ratings will be helped by having the CCP in front of them, so they can pick up volume in that way.

Martindale: When CCPs were first mentioned, people thought there might be three around the world, now there are hordes of them. So how does all the plumbing work? How quickly does your collateral move if you are switching from one country to the next?

Regarding the FTT, securities lending is technically still a sale and repurchase so is liable to the tax.

"Beneficial owners are starting to understand that they are sitting on what you would call 'good collateral'"

JEANNINE LEHMAN, BNY MELLON

Lehman: Yes, 10 basis points on the end of every trade is going to kill off everything except highly intrinsic lending. So you are likely to see much less volume.

Spinner: In the markets that have already put in a transaction tax we are already seeing volume reductions and lower spreads.

Callan: The current FTT in France does not apply to securities lending trades but because it applies to derivatives it does have a knock on effect in this sector. The FTT currently being discussed by 11 EU member states would have a very significant impact on the industry. That said, if you look at the history of regulatory changes, many of them can be very worrying at the initial draft stage but, over time, as knowledge, education and alternative views are considered by the regulators, the final outcome is considered and far more practical and reasonable.

Campion: I think when it gets better understood the political attitude may change. Currently it seems like quite a non-specific target – financial transactions. But once everybody comes to the understanding it is actually their pension funds that are losing money, then attitudes may shift. I think that things may change when that becomes headline news, but it is nowhere near headline news at the moment.

Chair: Is it fair to say that lenders are still proving slow to respond to regulation?

Lehman: The problem, especially for beneficial owners, is that regulation is generating so many new requirements that many funds end up doing nothing. I would say firms need to reach out – to their providers, to their banks, to their lending agent – to help them figure out what they need to do. Because the paralysis that has come from this surfeit of legislation is not a good thing.

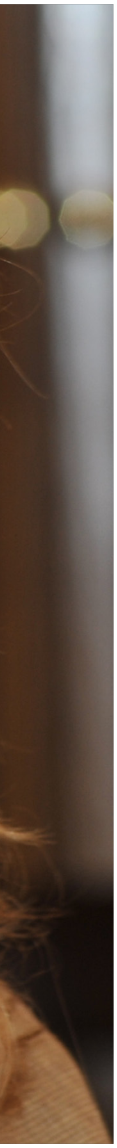
Martindale: I agree. And currently for UK beneficial owners the proposed Iorp directive is far and away the regulation that they are most concerned about. This would require huge amounts of additional money to be put into UK pension schemes alone – the estimates are hundreds of billions of pounds. If this if happens, it will be so much bigger than the collateral issue – you are talking about running pension funds like insurance businesses. How to make asset liability management consistent with this would entail a mammoth change in thinking.

Joyce Martindale

Campion: The UK pensions industry is mobilising to counter this threat as much as possible. The impact on liquidity and securities lending programmes would be, if pension funds are obliged to start operating like insurance companies, that they are simply going to have to reduce their risk assets substantially, which will take a whole load of equities out of the system.

Chair: What do people think will be the impact of the depository requirements under the AIFM directive on hedge funds and their prime brokers?

Spinner: A key question is whether or not custodians will have to take full depositary liability for assets within a pooled fund? And, what does that mean for fees for accounting for those assets? Because we are increasingly seeing custodians



Bob Campion

Gavin Callan

just holding units in a pooled fund, as opposed to an actual encumbered prime brokerage account. People are very much looking at these in terms of prime brokerage accounts, and the liability over those. In some cases they are not custodian of the fund they are just acting as the accountant.

Lehman: A lot of hedge funds use multiple primes. They will probably cut down on that, just to make it easier to watch over what is going on.

Campion: Beyond the AIFM directive, there is also the Esma discussion, around Ucits rules on securities lending – specifically, the guidelines suggest that 100% of securities lending revenues should be returned net of costs back to the investor. Now, most of the time – with a few exceptions, some ETFs and index providers pass them – the model is still to share revenue between the product provider – the index fund provider or the ETF provider – and the pension fund. But we have to be careful, because if ETFs cannot generate any revenue from securities lending I think the inevitable consequence would be fewer passive funds and perhaps higher costs, which you would have to pay upfront.

Spinner: When it gets very difficult is if you are a fund manager also acting as the principal for the securities lending trade, and you want to keep what looks like a generous element of the revenue for your own purposes. There is a real cost to the provision of a lending desk and the associated administration support. The key is to be able to demonstrate the reasonableness of the lending split and that it is not a proxy for offering lower asset management charges.

Chair: Dodd-Frank and Basel III both appear to usher in a model where beneficial owners are expected to pay for the indemnification they receive? How are they reacting to this? Will some be prepared to give it up?

Lehman: Our existing clients and prospects understand that indemnification comes with a cost. So as long as you are open and willing to discuss it, there can be discussions on that matter – whereas two or three years ago those conversations were hard.

Callan: I think beneficial owners, particularly in non-cash programmes, have grown up with indemnification and with significant risk protections. They get to pick their counterparties, they can set various limits, they get collateral, they get extra margin, they get daily mark to markets and, on top of this, they are indemnified. And, so I think clients are still very keen on indemnification, although they may be more open to discussing what it includes and what levels are required. I think the general principle is that they are still in favour of indemnification, where it is reasonably priced.

Spinner: I would say indemnification is very important. Some agent lenders have been seeking to remove indemnification for trades undertaken in the Euroclear lending programme. I am not aware of clients who have continued to trade with no indemnity. So that indemnity is valued, I would say, commercially. Now, the big issue with indemnities is quite what is covered. So you have got some providers where they will cover any mark to market losses, and then you have got other providers where it will only be from the point of default until the point at which the collateral is actually either returned. Clients are increasingly looking at that.

On the question of expectations, I do not see people wanting to pay for data. Everybody that I know just wants to just use Markit and get a report from their agent lender. I do not know anybody that has actually paid a cheque for independent data in the last 18 months.

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BOB CAMPION, EVERCORE PAN-ASSET

Martindale: The other question is whether in these cases the collateral will be replaced with cash or with cash-like securities. If you are running a European equities portfolio, you do not suddenly want to find it's full of US treasuries, which you then have to sell and reinvest. You need something similar so that you do not have to spend umpteen days reinvesting in the event of a default.

Chair: Do the accumulated costs from these pieces of regulation put the mid-term prospects of the industry at risk?

Campion: I think cost is a potential killer for securities lending because it is, for beneficial owners, relatively low margin, so those benefits can be eroded very quickly when you have layers of regulatory cost. And it is not necessarily the industry's problem, or something it can control, but where they are getting incremental layers of cost burdened on them from the regulators it is going to be a problem for the industry.

Martindale: Yes, I think what you have to remember is, for most beneficial owners who have segregated assets, securities lending is discretionary. Once it gets difficult – the revenues go down, the risks go up or the costs of oversight increase – they can stop doing it.

Lehman: That said, there is always going to be a market when it comes to the buy-side and the sell-side needing to transform assets. So it depends on how you are looking at it.

Callan: Also, I think if you are a hedge fund that has a strategy that involves shorting, you need to borrow securities in order to operate your business. Hence, for many high-value trades, you cannot stop doing it simply because of a few basis points here or there. In terms of the model, the beneficial owners have grown up receiving the vast majority of revenues, so with the exception of conversations related to indemnification, it is more likely that areas such as industry consolidation will be the focus of cost efficiencies. When you consider the costs associated with supporting a securities lending business – from the trading desks to the technological and infrastructural investments required as well as changes needed to keep pace with the regulatory environment – it is not surprising that we have not seen any new significant entrants to the agent lender market while others have taken the decision to exit the business.

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JOYCE MARTINDALE, EX-RAILPEN

Chair: What do people feel about the viability of third-party offerings?

Spinner: The reality is the low number of clients that actually want to take their securities lending to the market separate from their custodian appointment is tiny.

Lehman: It just adds operational risk.

Callan: I disagree. I am seeing that more clients are open to the third-party route. Clients are increasingly seeking out the provider that offers them the best lending package to achieve their risk, return, operational and transparency goals.

Martindale: I think the problem with third-party business is that it can begin to get complex and messy. If you have a segregated asset manager speaking to a custodian that then passes information on to the lender it starts to get complicated, especially since firms are limited by the number of staff they have and the amount they can spend on oversight. When it is passive it is easier because you know you have a fairly stable base.