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Reaping the benefit

Beneficial owners are expanding their lending programmes in a modest way. But looming regulation means that they enter 2013 with some trepidation

Chair: How are beneficial owners now approaching their lending programmes?

Lane: Fidelity's programme has been around since 1999. We run an agent-based programme for our equity funds and manage cash internally. It's primarily a specials-only programme. We are very conservative with our cash investment. Our programme and supply is relatively stable. Our risk tolerance was not changed by 2008-09.

The programme is structured so that the decision whether to lend is made at the top. For the most part portfolio managers are not involved in the decision making on what to lend and how much to lend. It is managed by the equity trading desk but includes input from other areas across the firm– from the treasurer's office to the back office.

We have support staff in New Hampshire and in Texas, and two folks in Boston on my desk that work on daily lending with the agents. We are in the process of taking a fresh look at our programme – we're looking to check our processes, roles and responsibilities and make sure we're staying up-to-date with technology and best practices.

Karier: Invesco runs a conservative, risk-managed programme, similarly targeted at the equity asset base. It is an agent programme, which we leverage. The portfolio managers are actively involved in whether or not to participate in lending. We made no major changes this year but we did do a complete due diligence review. We were interested in the industry best practices and measuring those against our current practices. It confirmed that our approach is somewhat conservative – but we are comfortable with that.

We are strictly cash collateral in our programme, and we invest our own cash. The last couple of years have been very different as far as revenue opportunities are concerned – they have been on both ends of the spectrum. 2013 will be interesting given the tax reclaim changes being rolled out in several countries and how this might impact demand on yield enhancement trades.

Avitabile: Clients are focused on both performance and risk. Firstly, how an agent can extract the maximum intrinsic value from their portfolio within the client's lending parameters. Secondly, over the past few years we've certainly seen clients become more risk averse. Regarding risk the focus extends beyond standard collateral investment – clients are looking at portfolio risk mitigants such as trading volume at the transactional level and accepting different types of collateral. Clients have become ever more sophisticated in evaluating as well as monitoring the lending activity for their portfolios. Although transparency continues to be critical to any lending programme another theme is customisation and flexibility, the ability to change a programme at a minute's notice in reaction to market events.

One of the more popular ways for clients to expand their programmes has been into new markets where they haven't lent before. Clients are truly engaged in understanding the dynamics of the markets and the revenue opportunities realised for their portfolios.

Swanson: We've definitely seen a trend towards more non-cash type of trades, particularly on the fixed income side and in trades with lower returns. On the borrower side, balance sheet constraints and collateral optimisation come into play, and the ability to accept different types of collateral maximises lending opportunities. We've seen a lot of clients, particularly in Europe, open to accepting different types of collateral.

Our US fixed income book has seen a significant shift from cash to non-cash, which intensifies near the quarter-end. Europe, which remains a market focused on non-cash collateral, tends to have more options whereas in the US, there are fewer collateral choices especially with regard to equities which face challenges from a regulatory perspective.

McDonald: Over the last few years clients have become more insightful about the product. They are more discerning with respect to identifying a specific profile for lending, taking into consideration many variables such as risk appetite, their specific portfolio make up and a clearly defined expectation for a lending programme. There may also be different dynamics to consider depending on the type of beneficial owner. For example, a pension fund with a long term investment horizon may approach the market in a different way than a mutual fund. The common thread is that both are looking to have a programme that fits their specific profile.

McIntire: Key themes that we have observed across our client base include enhanced transparency, greater client engagement and increased interest in flexibility. Enhanced transparency has taken the form of greater interaction with fund boards as well as improved management reporting. Some boards want the opportunity to ask providers face-to-face about the direction of future regulation or borrowing demand from hedge funds. We welcome this sort of dialog as it gives stakeholders a more direct understanding of securities lending.

Also, many clients have either broadened the distribution of existing reports or added new kinds of reporting so that they have complete transparency, understand exactly where the risks are and where they're making money. The flexibility theme also encompasses a more "hands-on" approach to the way clients' set guidelines and parameters such as minimum spread criteria, inventory available to lend, among others.

Avitabile: Beyond normal client reporting it's gone up a notch with performance benchmarking comparing where the client is *vis-à-vis* other clients, using information from Markit and Astec Analytics.

"We talk way too much about collateral shortfall – when what we should be talking about is collateral dislocation"

PAUL LYNCH, ESECLENDING

Chair: Has the acceptance of non-cash in the US taken the market by surprise?

McAuley: We've certainly seen a significant movement to more non-cash collateral in the US market especially in fixed income lending. Currently, driven by balance sheet considerations and Basel liquidity and capital requirements, this trend will continue as new initial and variation margin requirements become effective for centrally cleared derivatives. Clients are reviewing their collateral schedules with a view to expanding non-cash options in order to be able to take advantage of the lending opportunities being created by this new demand for high quality collateral.

Galper: There is definitely more interest in non-cash but we're in the early days.

"The data available does not always reflect the true liquidity in the security – what's needed is a more granular level of detail"

PAT AVITABILE, CITI

"Folks who are in the trade first are getting squeezed out by folks who come in later at higher rates, and duration is no longer accounted for" JUSTIN ALDRIDGE, FIDELITY PRIME SERVICES

Many large beneficial owners are evaluating what they are going to accept. There is no mass acceptance of the idea of lending a treasury and taking a corporate. There's most comfort in lending out a government bond and taking in a government bond or cash in exchange. Data from the last couple of years reveals that the securities lending collateral of US public plan sponsors has been about 9% of institutional investors' total assets. Non-cash has almost never reached 35% of that figure, and that's only in a few cases. I agree that a perfect storm is coming on the collateral side, and many beneficial owners still don't grasp their lending opportunities.

Chair: Are there still potential beneficial owners sitting on the sidelines?

Swanson: Definitely. Involvement depends on their risk/return mindset and what assets they hold, their collateral flexibility and any programme parameters they have enacted. Given the current level of interest rates and borrower demand, there are certainly fixed income clients who have determined that lending isn't viable from a risk/reward perspective at the current time– but more diversified clients who, believe the risk/reward is worthwhile. We have seen more clients who opt to select specials-only or minimum spread-type trades, slowly dipping their toes back in the water.

Lynch: It's really about the equilibrium of the market. If tomorrow demand for collateralisation meant a GC US Treasury was worth 25bps versus US dollars, a lot of those clients would come back. It's really about the need for GC collateral – there is still a lot more supply than demand for a lot of securities right now.

McIntire: Although equity supply has returned to near pre-crisis levels, there are still a few lenders on the sidelines. The reasons for not re-engaging vary from a bad experience with reinvesting cash collateral to reduced revenue opportunities, compared to 2007-2008. Recently, we have seen renewed interest from some holdouts looking to return to lending, albeit within a revised program structure.

Most lenders have substantially reduced the potential risk in their cash reinvestment pools, and this year's returns in the US have generated renewed interest in lending. We have also seen some new supply coming to market, particularly in Asia.

Avitabile: Clearly there is more supply in the market which includes a number of new entrants, clients who have never lent before. That said, I believe there are clients that are still sitting on the sidelines, for some of them it's a longer process in educating their boards on the securities lending product.

Chair: Beneficial owners, do you feel adequately compensated for risk?

Lane: We're very comfortable with the current structure of the programme. Given the current interest rate environment, we are not making anything on the cash side – but that doesn't change our philosophy. Our programme has been right down the middle the whole time.

Over the last five years the amount of assets we've had on loan has only fluctuated by a few percentage points. The revenue sees more volatility. One of my goals in 2013 is to focus on the risk/reward calculation. Are we optimising our portfolio the way we have it right now? I am

"Indemnification will continue to be an important part of securities lending" MIKE MCAULEY, BNY MELLON interested in performing sensitivity analysis to see if I change 'X', it means 'Y' for the programme. Today it's more art than science – and I would like to focus on the science piece.

Karier: We have run an accredited programme for quite some time. Our participation hasn't varied much over the years as far as the asset base is concerned. We did see differences in the revenues from our 2010-11 and 2011-12 programmes and see the revenue aspect of the programme swinging on an ongoing basis based on market demand. Our managers are actively involved in participation and electing in-and-out of a particular programme and I don't see that changing.

There are drivers in the market that impact our revenue stream. We will consider the supply/demand impact on revenue, but our participation is not an investment strategy so we continue our participation as we can manage the risks.

Swanson: To manage risk, we continue to see clients moving from commingled vehicles to separately managed account structures utilising their own customised guidelines or in some instances 2a7 (SEC/money market) like guidelines. It allows them to make dynamic changes to their portfolio as market events occur. They can work with a dedicated portfolio manager to manage detailed requirements around items such as specific names and duration. In this structure, clients are in control of their detailed guidelines, and have full transparency and dedicated portfolio management access at all times. Clients can choose to have separate accounts by fund or use one singular account for multiple funds.

Chair: Are returns living up to the levels that beneficial owners have been promised or were expecting?

Lynch: Clients receive returns according to how they define the rules. If six firms bid on a client's portfolio without any definition of that structure, you get six completely different estimates based on different assumptions. If there is a very well defined set of terms then our estimates are going to be very, very close and they will have very accurate expectations.

Avitabile: If the rules established during the RFP or revenue estimate process are the same as when the client goes live, expectations are typically met or exceeded, unless there was a major market change or a change in portfolio composition. There are cases where prospective clients don't tightly define their lending parameters during the estimate process. For these clients the estimate is based on the limited parameters provided. However, if you are selected as their provider and the lender imposes new restrictions the lending agent should re-run the numbers and make the client aware of the impact the restrictions may have on the original projections.

Swanson: Those previously in overnight repo, experienced diminishing returns and in many cases have now extended duration out from three to six months. While this is not where duration was pre crisis, it makes the programmes much more viable.

McAuley: Many of us view securities lending as an investment management overlay product. However, it is one of the only investment management products that projects returns. Earnings are difficult to predict especially for equity lending as they are often driven by unpredictable events. Over the past couple of years,

"There is a tremendous effort to avoid regulatory arbitrage, pulling in the regulators from all over the world" TRED MCINTIRE, GOLDMAN SACHS

"Any reduction in the capacity to provide indemnification will make it imperative that an agent lender manages its programme as efficiently as possible" JIM MCDONALD, STATE STREET

"We've seen a lot of clients, particularly in Europe, open to accepting different types of collateral"

SHEILA SWANSON, J.P. MORGAN

changes have been made by clients and the industry to reduce risk and improve the overall quality of earnings.

Karier: At this point the market is probably waiting to see the final requirements of the regulatory changes – for the beneficial owners as well as the agents. It is the one thing that will drive the market in 2013. How long will we have to wait for clarity, lack of clarity makes market participants nervous? Will they impact the beneficial owner? How quickly will they need to be implemented? Will we have a reasonable time in which to react? Will there be a knee-jerk reaction by the market?

Chair: Are regulators supportive of securities lending?

McIntire: There has been good dialog with the major US regulators, including the Fed, SEC, FDIC and OCC. Also, a number of us have been involved in discussions with the Fed in cooperation with our trade associations (either RMA or SIFMA). The Fed has taken a leadership role in the US and is participating in the FSB Shadow Banking effort. It is taking the time to solicit input from participants in all corners of the market and to consider the potential consequences of regulatory reform proposals.

In the UK, David Rule (of the FSA) provides a great example of somebody who has been very thoughtful about stock lending. We understand that he was an important contributor to the Financial Stability Board's overview paper issued in April; it set out the Shadow Banking group's overall view of securities lending and repo. There is a tremendous effort to avoid regulatory arbitrage, pulling in the regulators from all over the world.

McAuley: Yes, however, the real threat to securities lending is not any one single regulation but the combined effect of all new regulation. Each new regulation addresses its own legislative requirement without any consideration of its impact when combined with other regulatory initiatives. The recent FSB consultative document on securities lending and repo was one of the first proposals to acknowledge other regulations, suggesting that minimum haircuts might not apply to firms subject to liquidity requirements under other regulation. Maybe the delays are giving regulators more time to co-ordinate and asses the overall impact.

Chair: Could increased cost of indemnification resulting from Dodd-Frank become a deal-breaker for beneficial owners?

Lynch: It remains to be seen. One thing we know for sure is that the boards of directors value indemnification – it's something that comes up every time we meet them. It's probably not an option not to have it. The issues then become the cost, how to obtain it and the impact on the programme.

We run a slightly different business model where we pay our indemnification. It may get more expensive still if a lot of people went to the market, but that would probably bring some new providers in. It depends on how many hundreds of millions, or billions, of dollars people were looking for.

Karier: Indemnification is a very important aspect of the lending programme to many registered owners. Each beneficial owner will need to review their programme and the objectives of their programme regarding their tolerance for change in this attribute. It is analogous to running a conservative programme. It brings comfort to the board that we have managed our risk and we believe that we are covered in the case of a Lehman Brothers-type event. If there was a cost increase there would have to be an analysis to look at that increase versus the revenue stream. Many regulated products would be very restricted in a programme without indemnification.

Galper: Indemnification is an anomaly for the securities lending market – futures don't have indemnification – that is just a historical practice. We've been asking beneficial owners what they would do if their agent lenders said they can continue to indemnify but wanted to move fee split 5-10% in their favour. We're finding that a fair amount of beneficial owners are amenable to that idea. On the other hand, the reduction in GC balances helps agent lenders by eliminating balances that would require indemnification, and that may make indemnification still affordable for the remaining balances.

McDonald: Understanding how the rules are to be applied will be essential in managing a portfolio of assets that are under an indemnification. Any reduction in the capacity to provide indemnification will make it imperative that an agent lender manages its programme as efficiently as possible. The type of assets being lent, the collateral mix, cross currency exposures, the margin levels and specific counterparties will all have varying impacts to your credit exposure calculation. The product mix will need to be managed much more aggressively than it is today.

McAuley: If the regulations come into effect as currently proposed, indemnified transactions will need to be optimised within all the regulatory limits utilising some form of algorithm. The interesting issue is that it's the high value trades that have the largest impact on the limits. The lower spread trades – such as treasuries versus cash – hardly impact the limit at all. Agents and clients will need to determine how best to optimise lending portfolios to generate revenue within the regulatory limits.

Indemnification will continue to be an important part of securities lending. It may cost more or need to be rationed but it is unlikely to go away. In the US, many lenders have statutory or other requirements that make obtaining borrower default indemnification protection a condition to participating in a lending programme. Without indemnification there would be a significant reduction in supply.

Chair: Is there a level playing field under Dodd-Frank between systemically important financial institutions (Sifis) and non-Sifis? Is there an opportunity for non-Sifis?

Lynch: Either you have a very large balance sheet and self-indemnify or you buy a financial contract. If a regulator changes the rules it would not necessarily change the playing field – just the parameters. Would it force the biggest firms to be more like eSecLending? Possibly, if the regulator prevented self-indemnification we would all look exactly the same.

McAuley: It is not a level playing field. Bank holding companies with less than $50bn in assets and non-bank financial companies that are not deemed systemically important are not subject to the counterparty credit limits of Dodd-Frank 165(e). However, asset size may have an impact on the perceived value of the indemnification. In addition, different states have different lending limit statutes and some provide exclusions for securities lending and others don't. While there has been some consideration of creating global counterparty credit limits, at present, non-US financial institutions are also not subject to these limits.

McDonald: If there is a level playing field then it becomes more about each of the market participants making a determination on which businesses generate an appropriate amount of return to warrant continued support.

Even at the conservative end of the estimated demand for collateral, there should be some impact on the value of treasuries in the lending market. Lending a US treasury against cash is not overly punitive under the DFA language as initially proposed. In a scenario in which an agent needs to be more selective in the use of indemnification, and if spreads were to widen versus the lending of equities, lending fixed income may become more interesting.

Chair: To what extent will the combination of these limits create a collateral shortfall?

McAuley: It is more of a reality than people realise – not just because of regulation but also as a result of other market events. One of the main regulatory initiatives generating demand for high quality collateral is the central clearing of derivatives where buy-side participants, who haven't typically posted margin in the over-the- counter market will now have to post initial and variation margin. There is also the Basel III liquidity provisions that require certain institutions to lock up high quality assets for certain time periods. In addition, many new regulatory requirements such as Dodd-Frank Section 165(e) and proposed US capital rules encourage the holding of high quality collateral to lessen the impact of the limit or capital requirement.

As a result of Lehman, many investors now require that their collateral be segregated and not subject to rehypothecation. In addition, new regulation such as the recent FSB proposals may impose limits on the reuse and rehypothecation of assets. These changes reduce the velocity of collateral which adds to the potential shortfall.

In the US, the reduction in FDIC insurance and money market reform could cause a significant shift of assets into the government repo market creating further demand for high quality collateral.

Galper: Conservative numbers put additional collateral demand at $3.6trn and more excitable people have estimated $25trn. Finadium estimates it to be in the $3.6trn to $6.7trn range. If you need triple-A government bonds and only three countries have triple-A there will be a rush and the returns will become nil.

There's certainly substantial demand but there is also a substantial amount of OECD government bonds out there – the IMF estimates $33trn outstanding in OECD government debt and $41.3trn outstanding in all government debt. This doesn't mean that the debt is readily available though. A great example is that the Fed holds 41% of US treasuries, or $6.4trn, out of the $15.6trn pool. It lends treasuries but only takes treasuries as collateral. Another TARP that took everything would solve the problem – but the politics are terrible.

Lynch: We talk way too much about collateral shortfall – when what we should be talking about is collateral dislocation. This is what's going to drive supply and demand. It's going to be dramatic over the next two years. There will be lots of people with collateral but they may not necessarily want to pass it on.

Chair: Is there is any possibility the Fed would be able to change its policy? Or is this collateral locked away permanently?

Galper: There are always possibilities. It is generally acknowledged that regulators made the rules without thinking through all the consequences for collateral. How things get sorted out is anyone's guess. The big wildcard is non-cleared derivatives and how much collateral will be required for initial and variation margin for non-cleared derivatives – and how much of that market even remains in two to three years.

Swanson: The CCPs are also still planning what they will accept. That could change the dynamics. We are assuming that they're all going to require US treasuries or OECD bonds but in fact this will depend on the CCP and some may allow a mix of other types of collateral.

McDonald: The return available from lending US fixed income today against cash collateral that is invested in the short end of the yield curve is not great. It's relatively expensive to fund treasuries in the current market and there is limited return on the short end of the curve. This dynamic may change as demand shifts for high grade collateral in the coming year.

There has certainly been more interest over the last couple of years from both the borrower and the lender to utilise non-cash collateral more extensively. This could be strictly non-cash collateral or collateral pledged in a repurchase agreement as part of a cash reinvestment process. It is basically a continuation of the trend toward more securitised transactions.

Chair: Is there sufficient demand to borrow assets from hedge funds?

Aldridge: We have seen increased demand on our platform across the board this year. Fidelity holds a unique position in the marketplace. Fidelity is viewed as a strong

Anita Karier, Invesco US Funds

credit counterparty; with exclusive access to a large pool of internal assets. In addition, our structure as a private company provides a unique combination that has been attractive to our clients as they diversify their borrow needs. We do understand that demand street-wide may be down, but it is dependent upon your position in the marketplace. Some providers are doing really well and others are doing poorly as funds diversify their business.

We are finding that clients are becoming increasingly sensitive to the intrinsic lending model as their cost to short hard to borrow securities is more expensive and volatile than in previous years. It's really becoming a huge drag on their returns and it's forcing them to look for additional providers who have access to supply and limiting their opportunities on the short side as the economics become prohibitive. Lenders and beneficial owners are extremely focused on extracting maximum value on their special securities. The market has evolved into a 'mark to market' pricing model from an 'allocation model'. Historically, GC trades were subsidising hard to borrow securities and rate changes were less frequent. We have noticed that the duration of trades are decreasing and that can be partly attributed to the velocity of rate changes and the increased cost to borrow special securities.

On-loan balances won't increase one-for-one for the beneficial owners as demand increases when market activity picks up again. Prime brokers are extremely focused on internalising as much demand as possible for two reasons: cost and efficient optimisation of their balance sheet. I don't expect that to change. On the flip side, lenders are generating higher returns for clients with smaller on-loan balances. Borrow costs are significantly higher than they have been in years past; this can be attributed to the intrinsic lending model.

McIntire: Do you think that that's going to increase the borrowers' appetite to lock up supply to exclusives?

Aldridge: Absolutely. It's increasing demand for exclusive supply because prime brokers need stable supply to satisfy their client's demand for stable rates and supply. We're seeing hedge fund demand increasing for single stock term opportunities on hard to borrow securities in an effort to lock in their borrow costs. The volatility of rate changes has become so problematic that some clients are requesting that their borrows not be placed with certain lenders that are known to rerate aggressively. Securities lending capabilities and sources of supply have become a greater focal point for hedge funds. They're specifically trying to find counterparties that have internal supply with the expectation that they can provide better rate stability and a lower cost to borrow.

Lynch: People want to smooth out their cost to carry but it's difficult. That's where there is potential for an exclusive. Putting all the value in one portfolio allows the borrower to show stability to his client base.

Aldridge: The market has gone away from its fundamental premise, that all sources of supply are not equal. It's my understanding that the beneficial owners are looking to have their on-loan positions repriced at the highest rate printed by their data providers. Broadly, the market cannot function under this premise because the cost will become too prohibitive to the short seller and they will cover or stay on the sidelines. Folks who are in the trade first are getting squeezed out by folks who come in later at higher rates, and duration is no longer accounted for.

Their assumption is that they should be getting the top of market but it depends on their supply, their timing in the market and – something people have lost track of is duration. I don't think anyone cares about duration any more – they just say 'I saw the rate move yesterday, that's where I want my supply. Why isn't my supply at that price?'

Avitabile: It has evolved. There was a point where lenders just looked at utilisation or they looked at the fee independently. Today more lenders are increasingly looking at the return on their whole portfolio – the equilibrium point of maximising utilisation with a fee level that allows the loan to have the greatest duration. It creates stability of supply to the borrower and consistent income to the lender. For example when you perform an attribution and duration analysis, you may find a security with 80% utilisation and a 3% fee on loan for 33 days, compared to a loan with 90% utilisation and a 4% fee on loan for nine days – each having a different impact on revenue. Clearly all variables of a loan need to be considered when evaluating a loan's impact on revenue.

Aldridge: Then there is index supply. Passively managed supply should carry a premium over actively managed supply. I know the beneficial owner doesn't want to hear that, but not all supply is equal and there are multiple factors that make some supply more valuable than others. We need the client education process to improve and additional transparency around the types of supply in the market so that beneficial owners can properly evaluate if their agent lender is performing on their behalf.

Chair: How has the increased – but still incomplete – provision of data affected the relationship between the various parts of the lending chain?

Avitabile: It's about interpretation, there


Josh Galper, Finadium

needs to be more information. The data may say there are a million Facebook shares available but it doesn't indicate if there is a minimum fee required by the lender, collateral restrictions or other limitations which may impact its attractiveness for loan. In summary the data available does not always reflect the true liquidity in the security – what's needed is a more granular level of detail.

McIntire: For beneficial owners, improved transparency and access to performance information has been a positive as it provides them with the means for evaluating performance. However, it is important for users of this data to, firstly, understand that it is incomplete in some respects and, secondly, to consider how to use this data to best advantage. An important aspect of assessing performance is the need to review the data over a long enough period of time to avoid putting too much weight on short-term anomalies.

For agent lenders, improved access to market data facilitates performance analysis for clients and also enhances the agent's ability to generate improved returns. Data from Markit and Astec allow lenders to spot trends in utilization and rates.

Swanson: There needs to be more detailed information around performance attribution as the actual investment return is just one piece of the performance equation – and you may not be doing a true 'apples to apples' comparison. For example, you need to consider metrics such as loan size, loan duration, lending parameters and acceptable collateral type. Beneficial owners must have some way to compare – but each has its own unique characteristics such as holdings, parameters, lending structures, collateral, etc. Unless you can incorporate that into the data, comparison is difficult.