

securities lending

As an Asset Management Technique

Securities lending was invented and used by traders and post-trade operations, where it was equally useful in averting trade failure as covering short positions. Today it is an asset management discipline, which is expected to make a full contribution to the search for alpha, within agreed risk parameters. Like any fund management business, it is also the province of the specialist expert.



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Securities lending may not be new, but it is a dynamic and evolving industry as beneficial owners find new uses and revenue sources for the assets they hold. Beneficial owners, who once paid little or no attention to market developments, have long since ceased to treat securities lending simply as a means of paying for custody services. Custodians no longer make the assumption to expect to secure the right to lend a portfolio as a matter of course.

In a sign of the growing importance of securities lending, beneficial owners have been shifting responsibility for the management of securities lending from operational (back office) to fund management (front office). Additionally, earnings from securities lending are not an administrative subsidy, or an operational activity, or even a source of incremental income. Modern securities lending is a specialized investment management activity in its own right, which is expected to make an important contribution to the generation of alpha and the overall performance of the fund.

Securities lending has not merely developed an existence separate from custody; a range of specialist skills are now available within securities lending. That is why beneficial owners now have begun to purchase custody and securities lending as separate services, and assess the value to their funds by different criteria. They now assess securities lending providers on the full gambit of services whether it be discretionary lending, establishing a principal program, supporting the beneficial owners' own lending activities (directed lending), holding auctions, managing an exclusive or managing collateral be it cash or securities.

In fact, beneficial owners now face a wide range of options when choosing how to lend their portfolios. Some lend their entire portfolio directly, or make use of third party lenders, and pay fees or share revenues with


a custodian bank for providing the necessary administrative support. Others sell some or all of a portfolio on an exclusive basis to a single borrower, either directly or via an auction.

In recent years, synthetic or swap transactions have become yet another option, especially in emerging markets where a local securities lending infrastructure has not been fully developed. In Taiwan, for example, where securities lending is complicated by the combined influence of a tax on earnings and different settlement timetables for purchases and sales, offshore synthetic transactions have provided a convenient alternative to the onshore market.

Specializations have developed in particular asset classes as well. There are experts in lending U.S. and global fixed income and U.S. and global equities, each requiring differing skills and a varying approach in order to maximize the assets' earnings potential. Some techniques are better adapted to high volume lending activity, while others are more adept at managing the risks of higher value markets subject to buy-in or recall risk. The management of both cash and securities collateral has become an area of specialist expertise. It is also not unknown for a lending agent to compete chiefly on the quality of reporting systems.

Granting exclusive access to a portfolio to a single borrower for a predetermined period and price, and holding auctions of portfolios or parts of portfolios to single or multiple buyers, are now commonplace. They enable lenders to exchange potentially lucrative but unknown opportunities in the future for the certainty of an up-front fee, though they also entail the risk of





exposure to a single borrower for a prolonged period. There are even multiple auction methodologies. Some offer a single bidding process, while others favor multiple rounds with bidders competing against each other until only the winner remains.

For the largest and most progressive of institutional lenders, only the most valuable and diversified portfolios would make full use of all of these options. But medium-sized and small lenders now explore all of the possibilities continuously in search of a combination of techniques that offer their portfolios the best achievable blend of risk and reward for their portfolios.

This search for best-of-breed in securities lending is less advanced in Europe than in the United States, where large pension funds have been at the forefront for using specialist securities lending providers. It is only now starting to penetrate to Europe, Asia and Latin America, where rising market capitalizations have attracted foreign brokers and fund managers in sufficient numbers to fuel the growth of a securities lending market for the first time. But the broadening of choice has nevertheless improved service quality, reduced risk and cut prices in all parts of the world. The clearest sign of that improvement is the increased transparency of market pricing and performance.

Even five years ago, it was unusual for any meaningful information to be available to lenders, and retrospective reports on positions and earnings were delivered perhaps once a month. Today, lenders can see information in most asset classes on a daily basis and some demanding this in real-time. They also have access to full details of assets on loan, the proportion of a portfolio on loan, and the risks to which they are exposed through counterparts and collateral, across all of the routes they take to market. The more sophisticated provider platforms even offer current and historical performance measurement analysis.

It is data of this quality that enables lenders to make informed choices about lending techniques, by allowing them to assess the performance of service providers more rigorously. For lending agents, it has created a more demanding environment in which talent and technology, not scale or longstanding relationships, are the principal sources of competitive advantage.

Retention of experienced personnel in operations as well as trading and sales is essential, especially in the face of increased competition for talent from prime brokers and hedge fund managers.

Paradoxically, the competition for talent increases the need for a higher level of automation, since technology enables a service provider to transact higher volumes of business with fewer people. A high proportion of business transacted is in general collateral, and is a high-volume, low-value business putting a premium on efficient processing that frees traders to focus on higher-margin business. Rising transaction volumes also mean efficient connectivity to industry platforms and are as important as the reliability and functionality of proprietary technology.

Many participants in the securities lending industry have yet to adapt to this changed environment. Overall levels of automation remain relatively low. Yet a variety of tax initiatives — including withholding tax relief at source, the renegotiation of double taxation treaties on more favorable terms, and the tax harmonization drive led by the European Commission — pose an existential threat to the yield enhancement transactions on which equity lending has traditionally thrived.

Never was access to a large number of clients with well-diversified portfolios more important. With their large numbers of institutional clients, the major custodians have that advantage of scale. Their role as custodians also means that they have asset-servicing capabilities such as income collection or corporate actions processing. Despite the high degree of collateralization, the financial strength of the major banks is increasingly important too, given the scale of the indemnifications offered by agent lenders to their clients.

These competitive advantages double as barriers to entry for newcomers. But today every provider of securities lending services has to be prepared to support whatever route to market a client chooses, and retain or develop multiple service capabilities, if they are to continue to compete successfully. The more successful custodians have long since ceased to rely on agent lending alone, and have themselves become third party lenders, and auction hosts. In the modern securities lending markets, there are many specializations, but there are no boundaries. ○○○