



# **Lessons in lending**

**Insights into the state of the securities lending market**

J.P. Morgan and AsianInvestor Securities Lending Roundtable Report

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**AsianInvestor**

# Lessons in lending

Five securities lending specialists discuss the state of the market, covering issues such as collateral quality, reinvestment of cash collateral and lending program flexibility.



**AsianInvestor:** Let's start by talking general trends and the state of the securities-lending market. Paul, can you give us a global overview?

**Paul Wilson:** Globally, and in Asia, one of the biggest shifts we have seen in sentiment around securities lending is in the way our beneficial-owner clients manage their lending activities.

One trend has been for the oversight of securities lending to move from the back office to the front office, the CIO or CRO office. Securities lending has evolved over the past five years or so and is now really viewed as a front-office, alpha-generating overlay business.

Another big change for many of our clients post-crisis has been the need for flexibility and transparency. So the winning formula from a service provider's point of view is the ability to customize all aspects of the lending program.

There has also been a big focus on cash reinvestment, where use of commingled funds has fallen significantly and separate accounts have become far more prevalent.

**Andrew,** could you talk about the situation in Asia?

**Andrew Cheng:** Asian institutional lenders are at the

forefront of the lending programs in terms of setting parameters and so forth. I would attribute that to two things: one is that Asia is coming into the forum later than other lenders in other parts of the world – we get to learn first what others have been doing. Secondly, we have very sophisticated investors in this region.

Asia had a crisis in 1997-98, and we and the regulators learnt a lot from that. Hong Kong, for example, put in some measures for short selling, having to keep records and so forth. Those things were still valid when it came to the global crisis two years ago and are still being used.

**Paul mentioned lending-program flexibility. How important is this for borrowers and lenders, and what do they look for from a lending agent?**

**Kirtes Bharti:** Collateral flexibility is one of the most important factors for a borrower like us. We need to provide collateral to the lender in multiple facets – it could be convertible bonds, fixed-income instruments, cash, equities etcetera. We need a good mix, because at any time you want to be agile enough to switch collateral, depending on internal requirements and market conditions.



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## **PARTICIPANTS (CLOCKWISE FROM LEFT)**

### **Paul Wilson**

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### **Ng Yin-Yin**

Head of securities borrowing and lending,  
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### **Kirtes Bharti**

Regional head of securities lending,  
Credit Suisse

### **Andrew Cheng**

Head of securities lending client sales management,  
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### **Daniel Loo**

Senior vice president, fixed income,  
Government of Singapore Investment Corporation

### **MODERATOR (bottom of picture)**

**Joe Marsh**, managing editor, *AsianInvestor*

## **Perhaps we can get a lender's perspective on lending-program flexibility from Daniel?**

**Daniel Loo:** We think it's important to actively manage a securities-lending program instead of viewing it as a passive, risk-free program. That's because in crises lenders may find themselves without the option of such flexibility, or such options might be available but the liquidity cost might be prohibitive.

In terms of your question about how we value flexibility, for a program to allow cash collateral and the ability to amend cash guidelines is important. There are several aspects of this: one is that it gives the asset owner the ability to tighten the credit quality of the reinvestment portfolio, such as by excluding certain asset types, like asset-backed commercial paper or corporate notes.

Another is the flexibility to dial up or down the asset-liability gap to react to fast-changing market conditions. For example, in the case of short-term interest rate volatility, asset owners that stick strictly to their guidelines around duration gaps might find themselves in a situation where spreads narrow, collapse or even turn negative.

**Wilson:** One of the challenges for us is to reconcile and manage the mismatch between what Kirtes [the borrower] wants and what Daniel [the lender] wants. What is absolutely critical here is liquidity as well as flexibility – whether it's for cash collateral, the loans being made, the counterparty or the non-cash collateral being accepted.

## **And that's something borrower are generally happy to pay a certain amount for?**

**Bharti:** Well, sometimes I'd rather not pay. [*Everyone laughs*]

**Ng Yin-Yin:** Phillip Securities stands in a very unique position as borrower and lender to both institutions and the retail individuals. I'll address the issue of flexibility in securities lending programs from the retail perspective.

We classify the borrowers and lenders from the retail side as man-on-the-street investors, high-net-worth individuals, boutique funds, hedge funds and prop shops. To ensure liquidity, we only allow retail borrowers to give us liquid assets, ie cash or equities.

On the other hand, retail lenders always want the maximum flexibility in liquidation. Therefore, we have



Paul Wilson, J.P. Morgan Worldwide Securities Services

to ensure that these lenders can recall anytime. As for collateral, it's operationally impossible for us to give them letters of credit or fixed-income assets due to the small size and large number of lenders, so we pool the cash and equities to protect them.

**It must be a challenge to manage retail-owned securities for lending, especially in Asia, where investors tend to be more short-term-oriented?**

**Ng:** It's definitely a huge challenge because we are trying to provide a long-term loan to short sellers and institutions by borrowing short-term assets. We have to manage the recalls and the liquidations to protect the borrowers. Managing the collateral is also a challenge, because sometimes we have to swap cash and equities with others to get fixed-income assets to pledge to our lenders.

**What are retail investors' main concerns when it comes to lending securities?**

**Ng:** When it comes to individual retail lending, it's a long road to educating investors. Securities lending and covered short selling are relatively new to Singapore.

But, interestingly, although it takes a longer time to educate the retail man-on-the-street on the idea of securities lending, it is easier to get them to participate. This is probably because their stakes in the names are not high, so they are less worried that lending the names could cause downward pressure on the stock price.

On the other hand, the high-net-worth individuals [HNWIs] are more resistant to securities lending. Some of the objections we face are: 'the rate of return (especially for general collateral names) is insignificant' or 'I do not wish to have other people short-selling my stocks'.

These HNWIs could be right in their own way, because some of the names they hold could be tightly held names and by lending them out could possibly cause a downward pressure on the names. But it could work the other way too – against the short-seller.

**Let's talk about reinvestment of cash collateral. Perhaps we can look at the pros and cons of different approaches?**

**Wilson:** J.P. Morgan predominantly runs separate accounts [as opposed to commingled accounts]. That means we have somewhere over 500 individual investment accounts that we need to manage to specific and individual client guidelines. There is an incremental cost of doing that.

Some providers who have one very large pool of cash collateral may gain some efficiencies of doing that for the provider, and small lenders may benefit from being commingled into something much larger. That's the upside. On the downside, lenders who want cash managed to their specific criteria, have to settle for something generic that each lender cannot change or control when market conditions or their risk perspective changes.

We feel – and the market seems to agree – that the best approach is to have individual client separate accounts.

**What's the important thing from a borrower's perspective in terms of cash collateral and reinvestment? What assurances do you seek?**

**Bharti:** As a borrower, we want to know that when we're providing cash as collateral, it can be returned at the drop of a hat. We do not have any control over how the lender/beneficial owner is going to reinvest that cash. But lenders do have track records we can judge them on, and you wouldn't want to deal with a lender/beneficial owner you know is very high risk in terms of reinvestment.

**How about the asset owners? Daniel, has your approach to reinvestment changed? How much risk do you take when reinvesting cash collateral?**

**Loo:** Our approach to reinvestment has not changed materially post-crisis, and we continue to operate reinvestments in segregated accounts. Clearly that offers us full flexibility in terms of customizing the reinvestment profile to suit our risk appetite, which can vary across time.

However, for participation in segregated accounts, lenders will need to be of a certain size for it to make sense, for both lender and agent.

One trend we've observed is that increasingly asset owners are taking the reinvestment function in house. This gives full control of reinvestments to the asset owners, in terms of controlling the credit quality, issuer selection, duration of the program etcetera.

However, the challenge is the need to work very closely with the agent lender to manage the liquidity aspects and to avoid settlement failures.

**Wilson:** Interestingly enough, pre-market crisis, particularly in the US, we saw a trend for some large US mutual funds to take cash reinvestment in house. The aim was to boost their AUM and to control the risk and investments more in line with their view of the market.

That being said, post-market crisis, we are starting to see a reversal of this. We are now in a marketplace where, because of the benign interest rate environment, it is difficult to generate the levels of returns achieved in 2007, yet the manufacturing costs of supporting the management of this cash has remained fairly constant.

Ultimately, however cash collateral is managed, lenders need to go through a comprehensive review process to ensure cash is going to be managed consistently with a lender's investment and risk objectives.

**Cheng:** Referring to the challenges Daniel mentioned about the timing of the loan return and the cash reinvestment, there needs to be much tighter management of these issues, so that when the borrower returns the loan, he can get the cash collateral back.

This is one area that an institution venturing into self-investment needs to look at very carefully, because a failure to return cash collateral or having to prematurely withdraw a cash reinvestment could be quite costly.

**Paul earlier mentioned the transparency of the cost of lending programs. Is transparency generally sufficient, or should it be better?**

**Loo:** Beneficial owners would generally require their agent lenders to provide reporting to a level of detail, so that the various risks of the program can be better understood and managed. I would say the transparency we get from our agents is sufficient.



Daniel Loo, Government of Singapore Investment Corporation



Ng Yin-Yin, Phillip Securities

**Bharti:** Transparency is always important, but I do not think there is a need for it as it's a lender/beneficial owner trading decision. Of course it would be great to know that if I pledged \$50 million as cash collateral, \$25 million is being managed this way and \$25 million that way. Maybe that would give me an idea of what return they've made, compared to the return I've been paid on the cash collateral.

**Which is probably why it won't happen.**

**Bharti:** Exactly. It would be nice, but it probably won't happen.

**Wilson:** But to be fair, with regard to the way you structure your loans, you know exactly what you're being paid in terms of the cash you've handed over as collateral. So in terms of the things that drive your business, you have that transparency.

**Let's look at collateral types. Have things changed for borrowers in terms of quality and types of collateral as to what you're being asked for and what you're prepared to offer?**

**Bharti:** As a borrower, you want to pledge the lowest grade collateral you can.

**Even if you have to pay more to do so?**

**Bharti:** Not necessarily pay more! It comes down to the individual borrower's cost of collateral and internal requirements. As a result, some are happier to pledge cash and some non-cash collateral.

**Wilson:** That's fair. The trend over the last year is that the borrowing community is generally moving in very different directions in respect of their preferred choice of collateral. So when we talk to our beneficial owner clients,





Kirtes Bharti, Credit Suisse

it's about making sure they have flexibility to accept a wide variety of different collateral within their risk tolerance.

**Loo:** From a lender's perspective, it's perhaps the opposite [of what borrowers' want]. *[Everyone laughs]* We would typically prefer more liquid and high-quality collateral, which helps mitigate risks of delays in liquidating collateral and deterioration in value of collateral in a stressed environment. For our fixed-income lending program, we take in cash, selected government and agency bonds and supranationals.

**Cheng:** Different lenders will have different profiling on the collateral types they would demand. So sovereign wealth funds and central banks would, rightly, have very high-quality requirements, while some insurance companies might be willing to trade down a little bit. But it also depends on the type of securities they're lending out.

**Wilson:** You're right – the underlying nature of the assets being lent is critical. If you're a central bank, your foreign exchange reserves are there for liquidity, and you might want to use them at a moment's notice. But an insurance company with, say, 20-year liabilities may have a very different viewpoint on the loans they are willing to make, the types of collateral and how they want to reinvest, based on their asset-liability profile.

**Bharti:** Since 2008, there has generally been much tighter risk management by the beneficial owners on how much they're willing to lend to the borrower. I think that's tightened up more than the changes in collateral.

**Have there been changes in how ready lenders are to accept different asset classes of collateral?**

**Wilson:** Borrowers have a greater appetite now to provide equity collateral, and beneficial owners lending equities

are far more willing to take equities as collateral or use equity repo as a way of managing collateral. That's been driven by a number of things: there can be greater transparency and liquidity in equities, higher haircuts and far greater correlation between assets and liabilities.

Corporate bonds have also become a lot more popular as collateral. And some have thought about using gold as collateral.

**Loo:** In terms of the trends around collateral types, one challenge we face is the shrinking number of issuers that we would accept as collateral. That's because some previously thought of as high-quality issuers have, through the crisis, experienced downgrades, deteriorating fiscal conditions and high levels of indebtedness. So that has seen the number of acceptable issuers in our program fall.

As for other collateral types, we don't take in equities for our fixed-income lending program. But gold is an interesting idea.

**Daniel, do you accept high-grade corporate bonds?**

**Loo:** Not at the moment. We are still quite conservative in terms of collateral selection. The priority for collateral would be to protect the value of loaned assets [rather than to make more money from the lending program].

**What are the most significant regulatory changes since the crisis?**

**Wilson:** There's still a lot of regulatory uncertainty whether it be about Ucits IV, Dodd-Frank, AIFM [Europe's Alternative Investment Fund Manager Directive], Basel III, liquidity rules or short-selling rules. I could go on forever, and the outcome of many of these regulations is unknown. Markets don't deal well with uncertainty, so lending activity has been subdued on a global basis.

Our challenge now is to monitor all these things and lobby for sensible regulation. If there's one thing I want to see in 2011, it's more regulatory certainty.

**Loo:** I echo Paul's point that asset owners are struggling to catch up and understand the impact of regulatory changes. A trend we have observed from the tighter liquidity rules is that there is greater demand for dealers to borrow and secure longer-term funding, while asset owners tend to be more conservative. There also seems to be a trend for borrowers to pledge lower-quality collateral for liquid government bonds.

Post-crisis, tighter banking regulations and higher capital requirements have caused some lending activity to fall off, as bank prop desks have been wound up and hedge-fund activity has dropped. That has affected overall turnover and securities lending revenues.

**What markets in Asia are things moving particularly fast or slow on securities lending?**

**Cheng:** I would classify Taiwan as a quick mover, because in the past couple of years the market has opened up a lot.

By contrast, the Philippines has been talking about

securities lending since I started in this industry 14 years ago and hasn't made much progress. One issue is the lack of reconciliation between the government tax department and the stock exchange.

**Bharti:** I agree. Taiwan and also Korea were both markets that were very restrictive to enter 10 years ago, but they've made positive changes in terms of improving the ability to borrow and facilitate short selling. In fact, a lot of markets that had been a bit more restrictive on short selling have started to open up in Asia.

**How about China? Not a lot is possible there yet, but has there been any movement towards the market opening up?**

**Bharti:** It's clearly a question of patience – we have to wait for the authorities to decide on a framework they want to use, and to do so on their terms.

We're all aware of announcements in the past year about pilot testing of securities lending and short selling in China. There hasn't been a huge amount of data on how it's progressing, but that doesn't mean it's stopped.

**Cheng:** I agree. China has tested short selling and margin trading – and I think it was a success, even though it was very limited internal testing. China will open at a time that is most suited for their market. Will it be six, 12, 18 months? I don't know, but it could be quicker than we think.

**Given that Asia is still developing on the securities lending side, there are obviously a lot of potential lenders in the region – could this further raise the issue of oversupply?**

**Wilson:** A supply-demand imbalance certainly exists today – supply-side sentiment is positive, new lenders are coming to the market. Because of all the regulatory things we've talked about and because we've still got a very high amount of government liquidity in the market, there is oversupply, which is holding down spreads and demand.

So what we actually want is for spreads and demand to increase. 2011 has thus far been slightly better than 2010 and we expect that to continue.

**Loo:** Paul, when you talk about new lenders coming into the market – are they lenders that exited due to the crisis who have returned, or are they brand new lenders?

**“ One trend we've observed is that increasingly asset owners are taking the reinvestment function in house. This gives full control of reinvestments to the asset owners ”**

Daniel Loo, GIC



Andrew Cheng, J.P. Morgan Worldwide Securities Services

**Wilson:** Probably 70% are new lenders, and 30% are those that lent before and are coming back in.

**Looking forward, what would be top of each of your wish lists for securities lending?**

**Wilson:** To end 2011 with more regulatory certainty.

**Bharti:** I strongly agree with that. And I'm very positive on Asia, so I want to see Asia to continue to represent itself admirably on a global stage, helping global markets to continue to flourish.

**Loo:** Post crisis, I'm looking forward to greater alignment of interest between asset owners and agent lenders. This potentially could come in the area of indemnification for issuer defaults on the reinvestment side of the program.

**Cheng:** I agree with Paul on regulatory certainty. That will let the people in the business carry on with what they're doing best and not worry about what the regulatory outcome might be. Like Kirtes, I am also very positive in terms of my Asia outlook.

**Ng:** I have two things on my wish list: regulatory certainty is definitely one. For example, post-crisis, regulators in Singapore are trying to put more controls on short selling, but the enforcement framework needs to be made clearer.

As for the second thing on my wish list, we are coming out of the worst of the crisis, so I really hope lenders will loosen their requirements and accept other assets as well as US dollars [as collateral]. ■



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