



Making the switch

Many clients are anxious about any potential risk surrounding moving providers but, says Joshua Lavender, executive director at J.P. Morgan, a considered approach can reap the benefits

EXCLUSIVE

For beneficial owners contemplating changing securities lending agents the potential fear, concern and in some cases the potential for realising losses, can often influence the decision as to whether to change lending agents or not. Such decisions to make a change of lending agent may be driven by service issues, poor revenue performance (and risk management), a desire for a different approach driven by change in parameters and risk appetite or historical issues relating back to the market crisis period.

Whilst there are challenges relating to changing providers, the greater concern comes from beneficial owners who may have issues relating to their cash collateral investment portfolio, and whether it's in a separate account or commingled fund. Those in this position fear that switching securities lending agents may cause them to realise investment losses and may require a great deal of staff effort and time.

When reviewing the possibility of changing securities lending agents, beneficial owners should primarily focus on four areas:

- Level of liquidity in their cash collateral investment portfolio;
- Ability to execute loan novations where necessary;
- Type of cash collateral investment account (eg, separate account vs. commingled funds); and
- Condition of their cash collateral investment portfolio and any in-kind distributions.

However with some careful thought, detailed planning and a partner with experience in undertaking large and complex transitions, these concerns can be overcome and should not prevent beneficial owners from working with a new securities lending agent.

Liquidity

Market participants were reminded during the 2008/09 financial crisis that liquidity plays a key

role in the ability to sell securities at appropriate prices. Poor liquidity can lead to forced selling of collateral investments, which increases the likelihood for realised losses. Therefore, the collateral investment portfolio's duration and liquidity ladder (or essentially when the securities will mature) play a key role in determining the appropriate timing or feasibility of transitioning to a new securities lending agent.

Loan novations

Liquidity concerns can be overcome if the beneficial owners' current and future lending agents, with co-operation from the borrowers, are receptive to loan novations.

Loan novations allow existing loans to remain outstanding with the same borrowers by transferring the loan from the books of the legacy agent to the new agent, without the need to recall loans and return the borrowers' collateral.

For beneficial owners that have cash collateral, the ability to novate outstanding loans is critical because if they are unable to do so, loans will be terminated and borrowers will expect to receive back the cash collateral.

Therefore, more loan novations will lead to fewer programme interruptions, have a smaller impact on revenue, and reduce the potential for forced selling of the cash collateral portfolio.

It's important for beneficial owners to work closely with their new lending agent to determine borrowing demand for their securities

Sometimes beneficial owners may need to remind their existing agent, that loans belong to the beneficial owner and not the agent!!

When and if loan novations are not possible and cash collateral is involved, the current lending agent may need to sell these re-investment securities and if done so below cost, a realised loss will occur. This loss will have to be funded by the beneficial owner. However, this can be avoided if the amount of cash collateral associated with the loan novations is at least equal to the illiquid portion of the invested cash collateral. Ideally, the new lending agent will look to execute new loans on the transition day sufficient to cover the liquidity needs of the collateral portfolio. It's important for beneficial owners to work closely with their new lending agent to determine borrowing demand for their securities around the transition date as this will be the source for liquidity.

Types of cash collateral investment account

Additional concerns may be warranted depending on the type of investment account (eg, commingled fund or separate account) a beneficial owner has with their current lending agent. Separate accounts generally pose fewer issues since the beneficial owner has the choice of how the existing collateral investments will be distributed (eg, cash, securities, or both), and the timing of the withdrawal. This type of fund structure reduces the chance for partial par amounts or "odd" distributions. The receipt of such non-marketable lots is more likely the case with distributions from commingled funds, where the beneficial owner owns a proportional share of the fund's investments. Moreover, commingled funds could have withdrawal restrictions in place that dictate when and how a distribution can occur. With either fund structure, a cash only distribution allows a beneficial owner to commence

the new securities lending programme at their discretion and eliminates any liquidity or funding concerns since all loans are terminated and cash collateral is returned to the borrowers prior to the transition date. Conversely, an in-kind distribution could lead to the need to fund a shortfall in the amount of cash collateral due back to the borrowers. In this instance and absent any loan novations, either the in-kind securities would need to be sold or the beneficial owner would be required to use their own cash (not collateral from loans) or reach an arrangement with the new lending agent, in order to return the cash collateral to the borrowers.

J.P. Morgan's Approach

The concerns associated with switching securities lending agents are not insurmountable. Using a comprehensive and risk-controlled approach, J.P. Morgan has successfully completed multiple complex transitions including mutual fund firms with significant numbers of separate accounts, and large public pension funds.

J.P. Morgan's conversion process entails specific actions that are designed to minimise the realisation of losses on beneficial owners' legacy cash collateral investments that are illiquid or have unrealised losses.

The process begins with J.P. Morgan conducting an asset/liability analysis to determine the optimal composition of existing loans and cash collateral investments for a staged transition. During this process, J.P. Morgan works closely with the beneficial owner to assess:

- the existing loan and collateral portfolio;
- current rebate levels;
- the market environment;
- borrowing demand;
- loan duration;
- the borrowers' willingness to novate loans; and
- target securities for loans to generate minimum funding on the transition date.

Based on its findings, J.P. Morgan works with the beneficial owner and current lending agent to formulate a specific strategy to govern the conversion and asset transition.

Throughout this process, J.P. Morgan leverages relationships in the borrower community to provide ample liquidity in order to determine the minimum number of transition date loans and/or novations that would have to be made in order to ensure that an appropriate level of liquidity is maintained in the existing securities lending account.

Additionally, J.P. Morgan coordinates a recall/return process with the terminated lending agent to ensure a smooth loan balance reduction process leading up to transition date, while making certain that minimum funding requirements are maintained.

J.P. Morgan establishes a separate account

structure to receive the transitioned investments from the current cash collateral investment portfolio. This type of structure is ideal for a beneficial owner who will be transitioning assets resulting from a pro-rata share distribution from a commingled fund. The beneficial owner's pro-rata share of assets will be transferred to J.P. Morgan and these assets will be isolated and established in a "hold to maturity pool." As these investments mature, the cash will be transferred to a newly formed separate account which will also hold any cash received in connection with the beneficial owner's new securities lending programme. Moreover, the investment guidelines for this separate account will be based on the beneficial owner's specific requirements and will therefore be consistent with their risk/return profile.

The aftermath of the 2008/09 financial crisis created fears in beneficial owners' minds

Throughout this transition process, J.P. Morgan provides each beneficial owner with a detailed project plan, frequent status tracking calls, and fully transparent and customised reporting.

The aftermath of the 2008/09 financial crisis created fears in beneficial owners' minds that switching securities lending agents could be too costly and time consuming for them to change. However, beneficial owners are becoming more aware that these fears or concerns can be overcome and that their desire to change securities lending agents can be supported. Today, options abound for beneficial owners that work with an experienced securities lending agent that has a proven track record of migrating beneficial owners from their current provider into a new programme that is designed to meet their specific requirements. **SLT**



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