Agent Lending Newsletter

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J.P.Morgan

Welcome

Welcome to the third quarter edition of J.P. Morgan's *Agent Lending Newsletter*. After the hectic second quarter, the summer months and third quarter were no less busy. As you will read in our market updates, there was a noticeable divergence between fixed income and equity lending markets. For fixed income we saw a modest increase in demand across the U.S. and Europe, particularly for lenders who own corporate bonds. It was a tough quarter for equity lending, with equity markets continuing to rise. The rise in stock prices led borrowers to refinance down fees on specials, as hedge fund appetite to short stocks continued.

We were pleased to see many of our clients at the IMN Beneficial Owner Conference in London in September. If Beneficial Owner attendance is any sort of barometer then it was a record year. J.P. Morgan was represented on a number of panels and workshops by Samantha Brown, Dan Rudd, John Shellard, Mark Tidy and Paul Wilson. Regulation is the current hot topic across the industry, specifically Basel III capital requirements and revised leverage ratio framework and disclosure requirements, and how these will impact borrowers, agents and lenders. In this newsletter, Judy Polzer, our Head of Quantitative Research and Analytics, provides a summary of some of the anticipated impacts of Basel III on the industry.

At the end of August, ahead of the G20 meeting in St. Petersburg, the Financial Stability Board ("FSB") published its "Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos". A summary is included in this newsletter, but key focus areas are Transparency, Collateral Policy and Structural Elements. The deadline for feedback to the FSB is November 28.

Lastly, please make a note of February 27, as this is the date for J.P. Morgan's joint securities lending and collateral management conference in London. We encourage you to attend this event as it will cover many topical subjects across the lending, financing and collateral management industries, and will include discussions and debates from leading J.P. Morgan and industry experts.

We hope you enjoy this newsletter.

Paul Wilson
Managing Director
Global Head of Agent Lending Product and Portfolio Analysis

Judith Polzer
Managing Director
Global Head of Analytics and Research

Shirley McCoy
Managing Director
Global Head of Fixed Income Trading, Agent Lending

John Shellard
Managing Director
Global Head of Equity Lending Trading, Agent Lending

Matthew Sarson
Managing Director
Global Head of Asset Management, Agent Lending

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Insights from Our Equities Desk

Equity markets ended the quarter higher but saw volatility within the time period, coupled with low volumes during the Northern Hemisphere vacation season. Good economic data out of China, Europe and the U.S., plus decent company earnings, were all positive for equity markets, reflected in the fact that the S&P 500 hit a record milestone in August, closing above 1,700 for the first time. There was concern that the Federal Reserve would begin to taper its extraordinary monetary stimulus and put equity markets under pressure. However, when the Federal Reserve did not announce that it would begin tapering, it created further uncertainty about the future direction of U.S. monetary policy. The threat of military action in Syria also negatively affected markets, which responded positively to a deal between the U.S. and Russia. The end of the quarter was dominated by the threat of a budget and debt ceiling show-down in the U.S., plus a potential Italian government collapse. Risk assets, however, held up reasonably well, with investors of the opinion that these political issues would ultimately get resolved.

Borrowers continued to refinance down fees on specials, with hedge fund appetite to short stocks coming under pressure as share prices continued to rise. This trend was particularly noticeable in Asia, Australia, the U.S. and Brazil. Amongst the most affected stocks were GCL-Poly Energy Holdings, ZTE, PICC and China Minsheng Banking in Hong Kong; Celltrion in Korea; Olam International in Singapore; JB Hi-Fi and Mesoblast in Australia; Sharp in Japan; HTC in Taiwan; and InterOil, Herbalife, Arena Pharmaceutical, VirnetX and Solazyme in the U.S. Although fees were in decline, balances remained strong due to rising share prices and increased General Collateral loans from borrowers, with the U.S. equity balance hitting a high for the year, to date. In Taiwan, additional downward fee pressure was placed on specials due to increased market supply (as more lenders enter the market) and daily short-sell quotas, which make it difficult to execute shorts. Demand remained strong for emerging market ETFs such as iShares Trust MSCI Emerging Market ETF, iShares Trust Emerging Market Bond ETF and Vanguard FTSE Emerging Markets ETF. Directional demand eased for Brazilian equities as the market rallied and the August Bovespa futures contracts expired, with a large portion of the reverse cash and carry positions (long futures/short stocks) not being rolled and shorts getting covered. Specials that saw a reduction in demand and fees included Multiplus and Lojas Americas.

Companies were active in raising capital in the third quarter, taking advantage of strong equity prices to strengthen balance sheets or to fund takeovers. In Europe, J.P. Morgan lent shares off the back of capital raisings by Soitec, Maire Tecnimont and Royal Imtech. In Japan, we had demand to borrow shares in Ezaki Glico, Kintetsu, IBJ Leasing, Kenedix, Maeda, Mitsubishi Motors and Sharp. M&A was also active, with the following deals generating borrowing demand: Kazakhmys/Eurasian Natural Resources, Loblaw/Shoppers Drug Mart, and Deutsche Wohnen/GSW Immobilien. The big M&A news of the quarter was Microsoft's offer to buy the mobile phone business of Nokia. Nokia has been a long-term directional short, but borrower demand eased and shorts were closed as the stock price rallied after the takeover announcement. The other big deal was Verizon Communications Inc's ("Verizon") agreement to buyout Vodafone's share of their joint wireless venture for $130 billion, making it the third-largest deal in history. Unfortunately, there was not a noticeable pick-up in borrowing demand in what are two very liquid stocks. Also in the news was Blackberry, another long-term directional short, which announced a big loss and a possible takeover by a consortium led by Fairfax Financial. Finally, in the U.S. tender offers by Halliburton and WebMD Health generated borrowing demand for shares that clients had elected not to tender.

European dividend activity slowed down after the peak second quarter period. The last remaining German Dax names were traded, including ProsiebenSat.1 and Suedzucker. Spain was also active, with BBVA, Red Electrica de España and Indra Sistemas, plus the scrip option trades in Iberdrola and Banco Santander. In September, we had Italian dividend paying stocks including ENI and Snam, and Dutch scrip dividends in Aegon, Royal Dutch Shell and DSM, with clients taking the cash election earning premium lending fees. This dividend season, borrowers in Australia and Japan swapped out of high-dividend domestic stocks and into low-dividend foreign held shares, seeking to lower their borrowing costs over the dividend record dates. Balances in Japan peaked over the end of September, having more than doubled from their pre-dividend level. In Australia, J.P. Morgan also lent shares for the drip dividend arbitrage including Tatts, AGL Energy, Qube and Mermaid. In addition, there was scrip dividend trading in Asia and the U.K., including Bank of East Asia, Standard Chartered and HSBC in Asia; and BP, Standard Chartered, HSBC, Royal Dutch Shell and Barclays Bank in the U.K.

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Insights from Our Fixed Income Desk

U.S Fixed Income

The trend of low rates, which started at the beginning of the year, continued in the third quarter. The end of Operation Twist in 2012, a sharp reduction in Treasury bill issuance and the Federal Reserve's continuing asset purchase program ("QE3") of $85 billion in Treasuries and Mortgage Backed Securities ("MBS"), have created persistent downward pressure on repo rates. We expect this trend to continue for the remainder of 2013.

Recently, the Treasury began reducing the auction size of its two- and three-year benchmark Treasury coupon issues due to an improving fiscal outlook as a result of higher tax receipts. The two-year note has been reduced by $1 billion both in August and September and had previously been a $35 billion monthly issue since the third quarter of 2010. The three-year note was reduced by $1 billion in September from its $32 billion monthly auction size. Moreover, Treasury bill issuance is forecasted to decrease on a weekly basis into the fourth quarter, with the total reduction in supply leaving the market exceeding $100 billion. This reduction in supply supports our forecast of low repo rates continuing for the remainder of the year.

As we have seen in the past, the actions of the Federal Reserve have a direct impact on lending programs, with near-zero rates and continued large scale asset purchases removing supply from the market. With lower rebate rates we have been able to lend Treasury General Collateral ("GC") for accounts that have investment guidelines able to support these trades. Additionally, we continue to see demand for non-cash trades and have expanded the eligible list of pledge collateral to include high-rated Eurozone sovereign debt as well as Japanese Government Bonds. Lenders who approve expanded pledge collateral schedules have the flexibility to participate in these trades when we have the opportunity to structure a trade. Agency collateral continued to trade in a narrow range of two to three basis points above Treasury GC while mortgage-backed collateral traded in a three to four basis points range. The spread between one- and three-month term tenors remained narrow for the reporting period. Balance sheet considerations remain a large concern for dealers, which continues to challenge utilization for these assets classes.

U.S. Corporates

Corporate bond balances fell during the third quarter, as markets were very quiet through the summer. Trades covered positions and borrowing activity fell off through the middle of August. As Labor Day approached, borrowers became very active with locate lists. However, very few trades were executed off those lists.

Balances in September did recover, with very high daily volumes, but the turnover rate also remained high. On September 18, Verizon settled the largest corporate bond deal in history. Across multiple tranches, Verizon issued $49 billion of new debt, more than double Apple Inc.'s issuance in April. We did see increased activity in telecommunications bonds issued by companies such as AT&T Inc. leading up to the deal. However, any uptick in borrowing was short lived. Borrowers were able to settle the new issue very quickly, and with the bonds rallying in the cash markets, traders were very quick to cover their shorts.

With a normal increase of activity ahead of quarter end, we anticipate demand for corporate bonds to remain robust through early November. As the holidays approach, most market participants will be focused on closing out trades and cleaning up fails prior to year-end.

U.S. – Looking Forward

- We believe that lending rates will continue to trade with a downward bias, likely averaging in the high single digits through year-end
- The Federal Reserve has maintained a decidedly dovish stance and has maintained its monthly asset purchases of $85 billion Treasuries and MBS. The Federal Open Market Committee has stated that these *"asset purchases are not on a preset course, and the Committee's decisions about their pace will remain contingent on the Committee's economic outlook as well as its assessment"*

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- As J.P. Morgan expected, the government shutdown and debate over the U.S. debt limit affected markets globally. On October 16, the debt limit was temporarily increased through February 7, and the U.S. government reopened through January 15, pending further resolution
- We anticipate further impacts to the repo market with regulations from the Volcker Rule ban on proprietary trading as part of the Dodd-Frank Act, to risk-weighted asset requirements and new supplementary leverage ratios under Basel III rules

International

Balances in the international fixed income lending book remained within a fairly narrow range during the third quarter, ending September flat to where we started in July. Core European GC repo markets were also very stable, trading at just above zero for the entire quarter. We saw a gradual tightening of core to peripheral repo spreads, with Spain and Italy trading just three basis points and five basis points respectively, to AAA issuers in short dates towards the end of the period. A high number of specials remained, especially in the German four- to seven- year maturities. Specific issues were volatile day-to-day but remained special for the entire quarter.

Balance in the corporate bond book increased strongly in the first part of the quarter, reaching an all time high towards the end of August, before dropping off towards quarter end as borrowers managed balance sheets. Activity levels continue to be helped by further automation of shorts coverage through BondLend, though the turnover rate is high, meaning that the average tenor of loans is shorter than in previous periods. Liquidity generally remains good and we are still seeing very few long-term fails. Specials remain concentrated on the less liquid, higher yield issues.

The European Central Bank, as expected, kept its benchmark interest rate unchanged at a record low after economic data signaled that the Euro-area may be recovering from its longest-ever recession. The Bank of England ("BOE") left its benchmark rate and Quantitative Easing target unchanged (0.5% and £375 billion, respectively), while Governor Carney's first policy decision on July 4 marked the central bank's first steps into forward guidance, with the Monetary Policy Committee issuing a statement indicating that investors' expectations of when the BOE would begin rate increases were premature.

International - Looking Forward

Demand remains for high quality European sovereign GC, but with spreads so tight in cross currency trades, only those lenders with three-month euro cash reinvestment guidelines will be able to take advantage of this opportunity. Term levels indicate that specials will remain concentrated in shorter maturity German sovereigns. There is increasing demand for local currency Eastern European bonds, such as Poland, Hungary and Romania.

Outside of Europe, demand will remain strong for Australian sovereigns, but spreads remain under pressure, as there are so few issues trading with any intrinsic value.

Euro OverNight Index Average ("Eonia") and Sterling OverNight Index Average ("Sonia") remain low and stable so the bulk of our activity will remain on open, with very little term lending opportunity.

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Insights from Our Re-Investment Desk

Highlights

- The September Federal Open Market Committee ("FOMC") meeting held a surprise as the Federal Reserve refrained from a widely expected taper
- Issuers in expanded regions experienced increased demand as supply from many issuers remained limited

3Q Review

During the third quarter, expectations were for the FOMC to begin tapering at the September meeting. However, the Federal Reserve decided to postpone, citing fiscal policy as well as the potential impact a government shut down or a failure to raise the debt limit would have on growth. In Europe, the European Central Bank ("ECB") and the Bank of England also left policy unchanged, with the ECB making continued efforts to guide market expectations with comments that they remain attentive to liquidity conditions and market rates. The Reserve Bank of Australia ("RBA") cut to 2.50% in August, also as expected. The minutes of the board meeting noted that they "should neither close off the possibility of reducing rates, nor signal an imminent intention to reduce rates further." The markets took this as a signal that the RBA could have reached the end of the rate cut cycle. USD and EUR repo remained at depressed levels, maintaining a consistent positive spread between term unsecured investment yields and lending fixed income general collateral in an environment which has remained challenging for this asset class. In USD, demand for alternative products remained robust as investors continued to seek higher yields for their cash away from the repo market. Strong demand has remained for floating rate products, with maturities of one-year and longer.

Outlook

In the U.S., heading into the final quarter, we anticipate downward pressure to remain on most repo, bank and corporate products. However, while uncertainty remains surrounding the debt ceiling, we expect heightened volatility in levels, particularly for repo, to continue. This will compress the spread between investment yields and the lending of fixed income general collateral. In Europe, while the ECB remains on hold, with declining excess liquidity levels and an increasing focus on the expiring Long-Term Refinancing Operation ("LTRO") programs in 2015, a new LTRO operation remains a possibility. In the meantime, current liquidity levels and the declining EUR/USD FX basis has put upward pressure on the yield curve, including at the front end, assisting investment yields. In AUD, given the desk view that the market may be under-pricing the probability of a rate cut in the near term, we continue to buy duration by adding high credit quality exposures in the three- and six- month part of the curve. Overall, our global strategy continues to focus on maintaining liquidity overnight and through our maturity structure, by layering bank and corporate investments in the one- to three-month maturity range. We anticipate the availability of repo collateral supply for overnight investments to remain limited, driven by counterparty requirements, to efficiently manage liquidity and balance sheet usage. We will continue to optimize account liquidity structures by utilizing term repo along with other alternative investments, where eligible. We will selectively target negotiable investments in the four- to six-month tenors where we expect to receive a premium over available three-month yields of up to 10 basis points. We will continue seeking attractive opportunities to diversify and add incremental yield in core longer-dated, high quality investments for eligible accounts, with a majority of our interest out to one-year. This often includes issuers that are no longer active in the shorter dates due to their funding profile requirements.

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Regulatory Update

Despite the summer vacation period, the pace of regulatory review and changes has continued, with the publication of the Financial Stability Board's ("FSB") Policy Framework for Securities Lending and Repo.

FSB – Policy Framework for Securities Lending and Repo

On August 29, 2013, the FSB published a document entitled "Strengthening Oversight and Regulation of Shadow Banking – Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos" (the "Policy"). A copy of the Policy can be found on the FSB's website

The Policy covers the main themes for which the FSB had requested feedback in its prior consultation in November 2012 – transparency, collateral policy (specifically cash collateral), and structural elements of the securities financing market.

Transparency – the Policy makes five recommendations in this area, suggesting, amongst others, the need for more granular data on securities lending and repo exposures to be submitted by financial institutions to regulators, and the development of improved public disclosure standards for financial institutions participating in securities lending, repo and collateral management activities. The report stops short of specifying the data fields that are required, but the FSB has established a 'technical data experts group' which will develop proposed reporting standards and processes. The FSB will publish its conclusions by the end of 2014. In addition, the FSB has recommended to the Enhanced Disclosure Task Force (a sub group of experts formed by the FSB in May 2012 to consider risk reporting standards) certain disclosure standards for consideration.

Collateral Policy – the Policy makes four recommendations in the area of collateral policy. In relation to cash collateral reinvestment, the FSB sets out a number of high-level principles which should be considered by both the lender and its agent. In addition, there are recommendations to regulatory authorities to ensure that regulations governing re-hypothecation of client assets address certain disclosure requirements and limitations to re-hypothecation and re-use of collateral assets, and a recommendation to regulators for non-bank entities that engage in securities lending to adopt 'minimum regulatory standards' for collateral valuation and management. The FSB also issued a public consultation on its proposed regulatory framework for haircuts on non-centrally cleared securities financing transactions (Annex 2 of the Policy).

Structural Elements – the FSB made two final recommendations relating to the structural elements of the securities financing market. In relation to the use of central counterparties ("CCPs") for securities financing transactions, the FSB believes that there is a case for the wider use of such arrangements, but the final outcome has been left to the national regulators to evaluate.

The consultation on the proposed regulatory framework for haircuts and numerical floors is open until November 28, 2013, and J.P. Morgan is working with various industry associations/bodies in order to reply to the consultation.

Other Regulatory Headlines

European Commission – Publication on Shadow Banking – The European Commission ("EC") published its Communication on Shadow Banking in early September. The document signaled the intent of the EC to present a Securities Law Legislation that would cover asset re-use, collateral and re-hypothecation in the securities financing market. In addition, the document contains a proposed regulation on Money Market Funds, which would be in addition to any requirements under the current UCITS directives.

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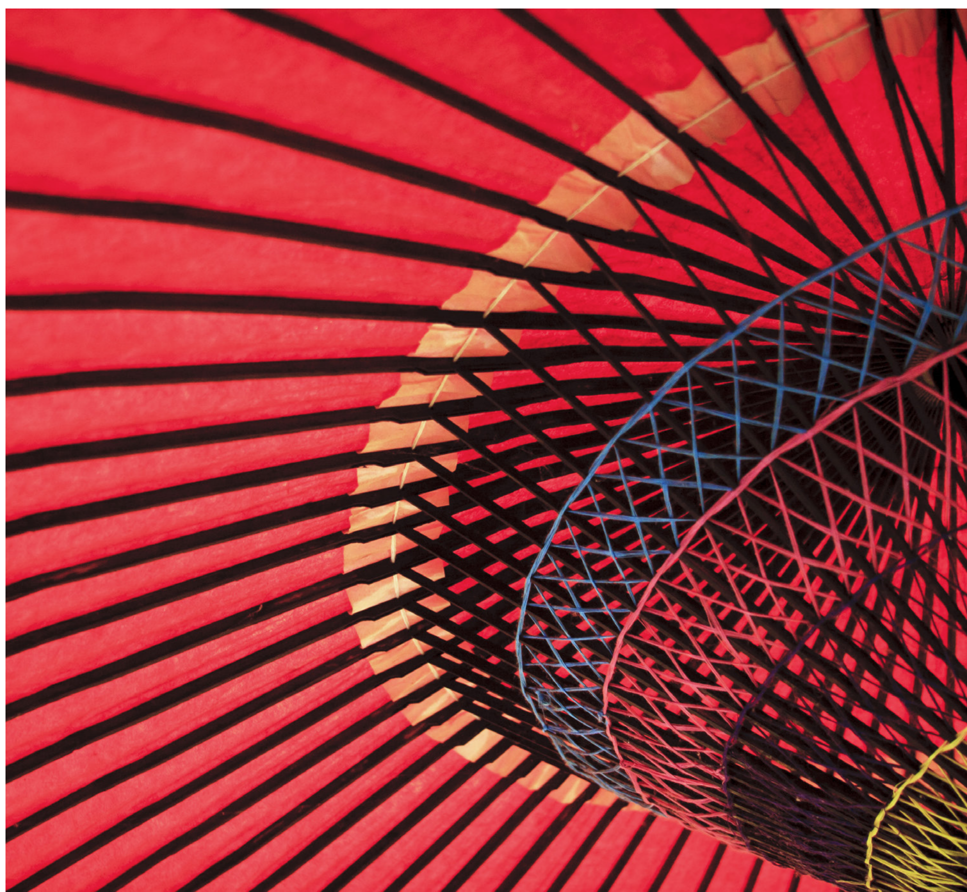
Securities Lending in Asia-Pacific

Asia-Pacific ("APAC") is a diverse region with a combination of mature and emerging markets. We conduct our business in many different languages and with respect to the many diverse cultures over this expansive geographical area. J.P. Morgan is the region's leading Securities Lending Agent with a team including six dedicated loan traders covering nine markets, two portfolio managers managing AUD and USD cash collateral, six portfolio advisors focused on client coverage spanning ten countries, plus middle- and back-office staff who provide local time zone operational support for Asian assets and clients.

Barry Griffin is the regional Head of Trading and Stewart Cowan has responsibility for Product and Portfolio Advisory. Barry and Stewart provide their insights into some of the region's opportunities and challenges



How would you describe the current lending environment in APAC?

BG: From a trading perspective, the market continues to be challenging. Most markets across APAC have rallied over the year, forcing the return of a number of directional positions. Whilst at a macro level there is minimal M&A activity, Asia remains stronger in relative terms, accounting for 49% of all IPOs globally in the third quarter of 2013.

SC: APAC lenders have been focused on the mix of global regulations, as well as domestic reforms, leaving some lenders seeking additional sources of alpha from investment activities such as lending. There is also a general sense that the worst of the market volatility has passed, so many clients are open to one-off loans, term trades and relaxing collateral guidelines. Low demand and spreads on the trading side, as Barry mentioned, have been offset by increasing assets values and this appetite for enhanced broader trade opportunities.

What has been happening in 2013?

BG: Year-on-year, balances remain positive across Asia, with the exception of Australia, where there have been significantly fewer Dividend Reinvestment Plan trade opportunities, a key revenue generator historically.

Our highest regional balances are in Hong Kong and Japan. September 2013 was a particularly good dividend season for Japanese equities because, depending on the domicile of the client, withholding tax could increase to 15% in 2014, provided the holder has owned the stock for the two prior record dates. Some brokers have preemptively borrowed stock in order to fulfill this requirement.

SC: For the first time since the financial crisis, beneficial owners have been actively looking to lend, or reassessing their current risk profiles to take advantage of both global and local opportunities. The driver for lending varies, from clients wishing to supplement low-yielding Fixed Income securities, to covering the ever increasing regulatory costs and reducing fund expense.

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What aspects are unique about APAC?

BG: In May 2012, J.P. Morgan became the first oversees lender in Malaysia, and as such, is the lender of choice for borrowers, resulting in a steady increase in volumes. Thailand has been an active market for longer but only recently have we seen a material increase in demand. In Taiwan, hedge funds have primarily shorted the tech sector this year, which has resulted in solid lending returns. However, the market is very heavily regulated, with restrictions that severely impact lending. No on-lending is allowed and no more than 20% of a security may be borrowed. The Taiwan restrictions are a popular topic amongst industry participants who share the same frustrations.

SC: We experience challenges within a multi-jurisdictional region like APAC but there are opportunities too, and this is where our established infrastructure really comes into its own.

In June, in association with our colleagues in tri-party collateral management, we became the first international lender to be able to support same-day loans via tri-party in most markets. This has gone down extremely well with the borrowers and our securities collateral balances are rising accordingly.

Our Australia-based portfolio managers have consistently generated excellent returns over the last few years – albeit within quite conservative parameters. The Australian cash market maintains higher interest rates compared to other major currencies, with our cash fund yielding 2.72%.

What is the J.P. Morgan footprint in APAC, and how is it growing?

BG: J.P. Morgan is the largest lender within APAC; the recent statistics from Markit and EquiLend confirm this position. We continue to expand our local capabilities, having recently added an additional Hong Kong based trader and substantially increasing our regional Corporate Bond trading via Euroclear. There has been more short interest in certain corporate bonds, but as supply is plentiful in the bond market, it is essential to capture any demand efficiently. Previously, these trades had to wait until London opened but we are now uniquely placed to book these trades throughout the Asian day to maximize revenue opportunities.

SC: APAC is a growing region and China's economic rise creates significant opportunities for future growth. Lendable assets have increased by 35% year-over-year, driven by new lenders and the increasing asset values of existing lenders. We recognize the value of being on the ground, in person, to which end we have added additional staff to cover new countries in South East Asia, and we have plans for further expansion in 2014.

Can you expound upon the developments you've been working on?

BG: In 2013, the team has been focused on leveraging the EquiLend and BondLend automated loan systems. We have also begun accepting Japanese Government Bonds as collateral, which has proved to be highly successful in the region, helping grow balances as borrowers have been keen to optimize their existing collateral pools.

SC: We have recently appointed Darren Measures as regional Agent Lending Product Management Head. Darren is undertaking extensive analysis of the region in order to effectively expand our product capability for both local and global lenders. A key priority is to develop new market opportunities in Indonesia, India, the Philippines, and in the future, China. We will also continue to expand our collateral capability with the addition of new form of collateral (e.g., KTBs [Korean Treasury Bonds]). On the cash reinvestment side, we have recently been approved lines to purchase Chinese banks' issuances.

What is the outlook for the coming months and next year?

BG: We are expecting 2014 to look broadly similar to 2013. Demand will likely continue to fall as borrowers try to minimize their expense and more supply enters key markets such as Taiwan. However, on a more positive note, we do expect trading to become increasingly automated, using Equilend and T20, which will allow the traders to focus their energy on more special and complex opportunities. We believe that stagnant growth in China will inevitably lead to more directional shorts in sectors such as resources and manufacturing and we also expect a rise in yield enhancement trading in Japan.

SC: 2014 is shaping up to be a busy year. J.P. Morgan has a strong pipeline of new business and a significant product agenda to execute which will enhance returns. We are keen to support our lenders in Asia who have traditionally held purely domestic portfolios and are gradually diversifying into international, lendable assets. We are actively dealing with local tax authorities to introduce equity repo in the region, which will enhance returns on reinvestment income.

Whilst we are under no illusion that 2014 will continue to present challenges, we feel well placed for solid growth in the region and to retain our market-leading position.

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How Basel III is Impacting the Industry

Regulatory control over the financial industry can come in several forms. In some cases, the efforts will be in the form of prudential rules which, more or less, dictate business standards. In other cases, the regulators will impose capital rules which impact behavior through cost. Unlike a number of the various regulatory rules around the world, capital rules have been unified on the Basel Accord.

Beginning in 1988, the Basel Committee set out to establish minimum capital standards which were adopted by the G10. Over the years, the Basel I rules were seen as inadequate and the Committee began drafting and implementing a more sophisticated and comprehensive set of rules known as Basel II. The financial crisis halted the efforts of full global implementation of Basel II and in the aftermath, Basel III was devised to continue the efforts and to address some of the concerns raised by the crisis.

The key area that Basel III seeks to address, in addition to the rules set out in Basel II, is the ability of institutions to withstand financial shocks. This translates into, among other things, higher required levels of capital. These increased requirements will likely impact all aspects of financial services, including Securities Lending

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Even though Securities Lending is an off-balance sheet activity, any indemnification provided by Agent Lenders requires that capital be held against lending activity. Capital is calculated by determining the amount of risk weighted assets ("RWA") that a business generates. The RWA takes into account the credit quality of the counterparty as well as an estimate of the net unsecured position on a trade, known as the Exposure at Default ("EAD"). Depending on the size and sophistication of a firm, internal models can be used to determine both the credit assessment and EAD of a trade as long as the models are approved by the regulators. If a firm is not able to provide its own internal assessments, a supervisory haircut is applied to each trade.

As mentioned above, the changes that Basel III made to Basel II mostly involved increasing the amount of capital that a firm needs to hold to support its business. This is achieved by increasing the minimum Tier 1 Capital from 4% under Basel II to 7% and giving regulators the ability to assess an additional 2.5%, bringing the total Tier 1 Capital ratio hurdle for some banks to 9.5%.

These higher hurdles increase the cost of indemnification for Agent Lenders, which, combined with other constricting rules, will require that they rethink pricing strategies for their clients' activities. Agent Lenders will need to calculate whether or not fee splits cover the cost of the capital needed to support the level of indemnification. In some cases, in order to sustain adequate capital ratios, the Agent Lender may have to become selective about to whom and on what types of loans they offer the indemnity.

In addition to the pricing aspects of lending programs, Basel III will also impact demand. As all firms would be operating under these higher capital costs, borrowers will become more selective about what trades they can afford to enter into from a return on capital perspective. They will have minimum returns that their trades will need to meet in order to justify the capital usage. Low spread trades, such as General Collateral loans, may not meet these hurdles. In addition to capital constraints, other pending regulations, such as liquidity coverage and leverage ratios and large exposure rules, will change the level and type of demand in the market. Borrowers may become constrained on the overall size of their portfolios and will be more selective about the types of assets they are willing to borrow and the tenor of these loans. While the final capital rules for Basel III and other regulatory initiatives are not yet finalized, the timeline more or less is. Regulatory reporting under Basel III requirements will begin in 2015, with implementation occurring in 2019. Despite these extended dates, most firms are already beginning to adjust their business models to adapt to the new environment. The next several years could herald changes to the Securities Lending market as firms adapt to both capital and prudential regulatory changes.

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Client Profile: Petercam

An interview with Luc Van den Brande, Board member, Petercam B Fund & Petercam Horizon B

Can you provide a brief summary of Petercam and describe your main business?

LVB: Petercam was founded in 1968 with the merger of two Brussels-based investment firms, Peterbroeck and Van Campenhout, with a history dating back to 1919. Petercam is a leading independent investment firm specializing in private banking, institutional asset management and investment banking (corporate finance and brokerage activities) with clients across Europe and the United States. Based in Belgium, Petercam operates from offices in Brussels (headquarters), Antwerp, Ghent, Hasselt, Knokke, Leuven, Liège, Roeselare and Wavre. A global company, it also has offices in Germany, Italy, Luxembourg, the Netherlands, Spain and Switzerland. Petercam has 421 staff and managed assets totaling approximately EUR 14 billion for private and institutional clients, corporates and public institutions.

Petercam B Fund and Petercam Horizon B are managed by Petercam Institutional Asset Management, a UCITS management company and an affiliate of Petercam.

How was 2013 for your business and are you optimistic or pessimistic about 2014?

LVB: From an economic viewpoint, the market was looking positive in early 2013. The U.S. economy continued to recover, while there were increasingly positive signals from Japan and Europe. On the other hand, there were disappointments throughout the emerging markets from an overall performance perspective. Meanwhile, the possibility of a change in U.S monetary policy captivated markets. Against this backdrop, equity markets have performed quite well, while conditions in bond markets have been more difficult.

There were also changes in the legislative and fiscal environment that our firm and clients operate in, as authorities continued to drive for regulatory change to improve the operation of financial markets. This has been visible in Luxembourg and Switzerland, where historical principles have been reevaluated within the EU as a whole, as demonstrated by regulatory authorities strengthening their supervision through a number of new directives that have had an impact on the asset management industry.

Looking ahead, we are optimistic about the outlook for 2014. Developed markets are in a clear recovery phase that looks set to strengthen as fiscal tightening eases next year. Increasing activity in developed markets will have a positive impact on emerging markets. Strengthening recovery implies that the end of extremely loose monetary policy is coming closer, and in our view, this will be a source of volatility for financial markets.

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With global equity values close to near all time highs, do you feel the issues and challenges in Europe are behind you?

LVB: There are still issues and challenges to overcome, particularly in relation to regulation, such as ESMA, AIFMD, UCITS V, and now VI, under consideration. It is our role to navigate and implement for the benefit of the fund holders, so there is still work to be completed. On the positive side, standardization across Europe, particularly from a documentation perspective, can only be a good thing.

How long have you been engaged in Securities Lending?

LVB: Since the first quarter of 2007, so for over six years.

How important is Securities Lending to you and do you feel the returns outweigh the risk and overhead? Why?

LVB: The main business of Petercam Institutional Asset Management is fund management and the creation of return for investors by actively managing our funds. Securities Lending creates additional revenue for the fund holders.

We operate our program within a strict risk framework and the indemnification J.P. Morgan provides to us is important in providing the level of comfort we require. The management company monitors the program on a daily basis.

Petercam Institutional Asset Management adopts a conservative, risk avoidant approach. We appreciate that our Agent Lending Portfolio Advisor at J.P. Morgan is well aware of our Securities Lending program strategy and is able to highlight what potential expansions mean from a risk and reward perspective. Our current levels of return make our participation worthwhile, however, we do continually validate participation and consider opportunities for expansion and flexibility accordingly.

You were a recent participant at the IMN's 18th Annual European Beneficial Owners' Securities Lending conference. What was your main takeaway?

LVB: This is our second year at the conference and attendance is absolutely beneficial. The conference allows us to understand the issues, drivers and demands from a wider industry perspective and helps us understand the business more. The closed door session with other beneficial owners was particularly valuable to obtain honest feedback and provided insight into what other beneficial owners seem to be doing.

Understanding the impact of current world and changing legislation is key. Regulation and tax has an impact on the Securities Lending business, but whilst not always a direct impact, it changes the way in which Securities Lending operates. Another key takeaway is that Securities Lending revenue drivers are subject to constant change, therefore flexibility is required and Petercam needs to constantly remain engaged.

Who will win the 2014 FIFA World Cup?

LVB: Although Belgians are modest by nature, we are hoping that our national team will play an excellent tournament. The current Belgian selection is a true "grand cru" and most footballers are playing at the highest level and are key players in the best foreign football leagues in the world. We took the first hurdle with flying colors, eight victories in nine games; we only had three goals against us and scored 14 times! The statistics are already working in our favor!

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Upcoming Events

07 Nov

IFIA UK Annual Symposium 2013

Millennium Gloucester Hotel, London SW7 4LH

J.P. Morgan is sponsoring the inaugural U.K. Annual Symposium 2013 hosted by the Irish Funds Industry Association. The event will provide delegates with a general overview and update on the funds industry in Ireland.

15 Nov

The Channel Islands: A Flexible Domicile for Alternative Fund Managers

J.P. Morgan offices, 25 Bank Street, London E14 5JP

This seminar will provide an opportunity for alternative fund managers to discuss how the Channel Islands offer an attractive flexible option for distributing funds into both the EU and non-EU markets.

27 Nov

Investor Services Client Reception

Spencer House, 27 St James's Place, London, SW1A 1NR

Our annual client winter reception invites clients across Investor Services for the opportunity to network with J.P. Morgan.

28 Nov

Annual Dutch Forum

Hotel InterContinental Amstel, Amsterdam

The Dutch Forum will provide a timely and topical discussion on the theme of *'Perspectives on a Changing Reality'*, where topics will include changes in the global political landscape, an overview of merging and alternatives markets and a practical view on cyber security. The Forum will be followed by a proprietary cocktail reception.

27 29 Jan

IMN's Beneficial Owners' International Securities Lending Conference

Sheraton at the Capital, Austin, TX

J.P. Morgan is sponsoring this annual event. Our sponsorship includes a booth and panel speakers. We will also be the exclusive sponsor of a breakfast or cocktail reception.

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