



Securities Lending Newsletter

Q4 2012

J.P.Morgan

Welcome

Overall, 2012 was a positive year; while volumes continue to be well below historical highs, revenue generation continues its recovery, delivering attractive risk adjusted returns. The first half of the year was very encouraging, with strong equity markets, better corporate activity, including increased dividends and improved hedge fund activity. 2012 faced many headwinds including the Euro Zone debt crisis, the U.S. fiscal cliff, faltering economic growth and concern about company earnings. However as we enter 2013, equity markets have been rallying, European peripheral bond yields have been falling and investors appear to have acquired more appetite for risk. In the updates from our trading desks we talk a bit more about the impacts on 2012 and our view for 2013.

For 2013, the regulatory agenda and subsequent developments are sure to dominate. There are plenty of upcoming and impending regulations and as many, if not more, white papers in the pipeline. ESMA guidelines for ETFs and UCITS, various European financial transaction tax regimes, specific titles within the Dodd-Frank Act, most notably Sections 165 and 166, the FSB Shadow Banking paper for Securities Lending and Repo, and Basel III will keep us all occupied. Taken together, when we look at all of these regulations we see a number of themes encompassing Systemic Risk & Inter-connectivity, Transparency, Investor Protection, Collateral and Tax Developments. We have therefore devoted space in this newsletter to provide you with updates on these matters and we are committed to doing so going forward.

As you read through this Newsletter you will see there are many variables, each of which could have an impact both positively and negatively on the year, but in summary:

- USD Interest rates remain 0.0-0.25%
- Treasury general collateral rebates to decline to mid-teens
- Lower issuance of corporate bonds driving strong demand
- European sovereign repo markets to trade with narrow spreads between issuers
- Early borrower interest in 2013 dividends, but some companies cancelling their dividends
- Positive demand in Asia and emerging markets
- Continued low appetite from hedge funds to add to short positions
- Potential for increased corporate activity

With so much attention on capital and balance sheet usage, collateral diversification and flexibility are critical factors for the borrowing community. In 2013, we will continue to focus on this where appropriate, adding more collateral types as well as working with clients to help them optimize their collateral parameters. We will continue, when possible, to develop our emerging market lending capabilities (Russia, Indonesia, and India) and importantly, continue with our commitment to furthering our multimillion dollar investment in new securities lending technology.

We will be in attendance at the 19th Annual IMN Beneficial Owners Securities Lending Conference in New Orleans beginning Monday, January 28, where we hope to see many of our clients. We are also hosting our inaugural Securities Lending Forum in London on February 12, with an agenda of outstanding speakers discussing thought provoking subjects. We hope many of you will be able to attend and participate.

Throughout 2012 we added more clients across all regions, both custody and third party lenders. In close consultation with our clients we assisted them in reviewing their lending parameters to identify additional ways, within their overall risk framework, to add additional returns. We know from your feedback that this is something that is greatly appreciated, so we look forward very much to working with you in the year ahead.



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Desk Updates

From the Fixed Income Desk

Treasuries, Agencies and MBS

The last quarter of 2012 provided answers to many of the questions that will shape the market in 2013. As intended, the Fed's Operation Twist was completed by year's end; however the Fed will continue to maintain its ultra easy monetary policy stance. In September, the Fed announced an historic plan to purchase \$40 billion of mortgage-backed securities per month in an open-ended approach that would continue until the labor market improves. **Moreover, at its last meeting of the year, the Fed said it will keep its stated target rate at 0.0% to 0.25% and also buy \$45 billion of Treasuries per month as long as unemployment remains above 6.5% and inflation for 1-2 years ahead is expected to be no more than 2.5%.**

Finally, overall balance sheet considerations remain a large concern for dealers, which continues to challenge utilization for these asset classes. This trend is expected to continue into the next year. Funding needs from REITS continue to put pressure on mortgage backed securities term rates, which remain inflated across the curve.

Corporates

Borrowers of corporate bonds pared risk throughout the fourth quarter, continuing a trend that began after Labor Day. National elections, the fiscal cliff, Hurricane Sandy, and strong performance by corporate bonds kept market participants protecting profits for the duration of the quarter. The new issue calendar remained heavy throughout the fourth quarter as issuers took advantage of excellent technicals.

Investors had plenty of cash to put to work and the majority of new issues immediately began trading at a premium. As corporate bonds rallied, traders were quick to cover shorts and borrows were quickly closed.

International

Balances in the international fixed income lending book fell slightly throughout the fourth quarter of 2012, and were significantly off the highs seen at the end of 2011 – mainly as a result of improving market sentiment in the Eurozone – leading to less specials in Euro sovereign repo markets. Volumes picked up significantly, however, as dealers micro-managed balance sheets, resulting in shorter loan tenures.

ECB President Mario Draghi noted that he expects a recovery by the second part of next year as global demand strengthens and the ECB's low rates feed through to the economy. However, investor sentiment in the Eurozone remained strong, and spreads between European sovereigns in the repo market were very tight. Italy and Spain continue to trade in the overnight market only a few basis points away from the AAA "core" countries. We have also seen a reduction in the amount of specials, especially in Germany and France.

Balance in corporate bonds increased over the quarter, and continues to be helped by the automation of shorts coverage through Bondlend. European financials are still in high demand in the repo markets (nearly half of our corporate bond loans are in financials) but we are still not seeing any significant long term fails.

Looking Ahead

Looking ahead to 2013, we believe Treasury rebate rates will decline significantly from the recent highs reached in 2012 as market dynamics change. J.P. Morgan has forecast **Treasury General Collateral rates to decline from the mid-upper 20s potentially to the mid-teens by the end of the year.** Some of the main drivers pushing rates lower will be the aforementioned Fed purchases (removing supply from the market), increasing the Fed's balance sheet and increasing demand for high-quality collateral, such as Treasuries, with the expiration of the Transaction Account Guarantee Program (TAG) and with various financial regulations coming into effect.

We anticipate **strong demand for corporate bonds in 2013.** After several years of strong performance, issuance could be lighter this year, increasing demand for secondary corporate bonds.

In addition, if spreads start to widen, market participants and traders will likely be ready to establish new trades and short corporate bonds, creating demand from borrowers.

Turning to Europe, German Chancellor Angela Merkel said the economic environment will be more difficult in 2013 than 2012, and that the sovereign debt crisis is "far from over," though progress has been made. However, financial market tensions have abated after the ECB unveiled its Outright Monetary Transactions bond-buying plan in September. As a result, we **expect sovereign repo markets to trade with narrow spreads between issuers** going forward. In addition, with Greek Prime Minister Antonis Samaras delivering on austerity commitments, and euro region leaders showing determination to keep the bloc intact, economists have scaled back their predictions of Greece's euro exit.

From the Equities Desk

Equities

Equity markets ended the quarter higher, with the U.S. S&P 500 being a notable exception. Improving economic data, especially out of China and the U.S., the continued easing of the Euro debt crisis, and central bank stimulus measures were all positive factors for equity markets. The U.S. S&P faced headwinds on concern over company earnings, uncertainty about the U.S. presidential election and the Fiscal Cliff. At the other end of the spectrum, Japan was one of the best performing markets as the incoming Government pledged to press the Bank of Japan to provide additional stimulus to the economy and bring down the value of the yen.

Equity markets made decent gains in 2012 with the U.S. S&P 500 +13%, Japan +23%, Hong Kong +23%, U.K. +6%, France +15%, Germany +29%. Stimulus measures by central banks around the globe, improving economic data and ECB action to contain the EU debt crisis drove demand for shares (risk-on environment).

Rallying equity markets led to short covering by hedge funds, which in turn led to a decrease in loan balances, particularly in the U.S. and Hong Kong, which have been two of the best performing lending markets of 2012. Hedge funds have been closing short positions against the U.S. and Chinese economies, and instead adding to long positions (to capture the upside from rallying markets). Borrowers actively refinanced positions (negotiated fees lower) as demand decreased and supply increased (as loans were returned). Lending activity continued to be driven by directional trades, with investors expressing a negative view on a stock or a sector.

There was a continued decline in both the number and value of M&A deals, with the lowest number of deals since 2009.

European dividend activity was steady over the quarter with France, Italy and Spain producing the biggest revenue generating stocks (e.g., Ferrovial of Spain, SNAM of Italy and Total of France).

We also saw **strong borrower interest in 2013 dividends** and towards the end of the year committed to lend some of that inventory. Outside of Europe, balances increased in Japan and South Korea over the end of the year as borrowers swapped out of expensive dividend, locally held shares and into cheaper offshore stock. Additionally, the IOC trade of Vale in Brazil was a big revenue generator.

Across the lending book, sectors in demand included:

- **Asia-Pacific:** Consumer cyclical, industrial, financial; then a big drop to basic materials, consumer non-cyclical, communications, technology.
- **Europe, Middle East and Africa:** Consumer non-cyclical, industrial; then a drop to consumer cyclical, communications, basic materials, financial.
- **Americas:** Consumer non-cyclical; then a big drop to consumer cyclical, financial; then a drop to communications, technology, industrial.

At J.P. Morgan, we added to our collateral flexibility in the fourth quarter. U.K. sterling cash for our U.K. equity lending book and JGB Governments bonds for our APAC lending book. We expect these additions to help defend and grow business for our clients.

New European short selling regulations came into force in November, including new buy-in and fail penalty rules.

The new regulation includes rules on disclosure of short positions (including public disclosure), restrictions on uncovered short sales, buy-in procedures and additional regulatory restrictions in times of market stress. Implementation went smoothly, although we did see a pick up in borrowing activity as brokers made greater efforts to cover fails.

Looking Ahead

We expect more of same in the first quarter of 2013, with **low appetite amongst hedge funds to add to short positions**. Should the economic and market environment continue to improve, there's an **expectation that corporate activity will increase**, resulting in more lending opportunities. However, as we enter a new year, continued uncertainty about the U.S. debt ceiling is probably the biggest threat to financial markets and the global economy.

We expect a volatile European dividend season, with concerns about perceived tax risk and the ability of end users to fund their trades hitting demand. There's currently no significant changes expected in terms of tax treaties or rulings intended to drive tax harmonization, both of which negatively impact supply and lending revenue. We have however seen a few companies cancel 2013 dividends (e.g., ThyssenKrupp of Germany, Telefonica of Spain and KPN of the Netherlands).

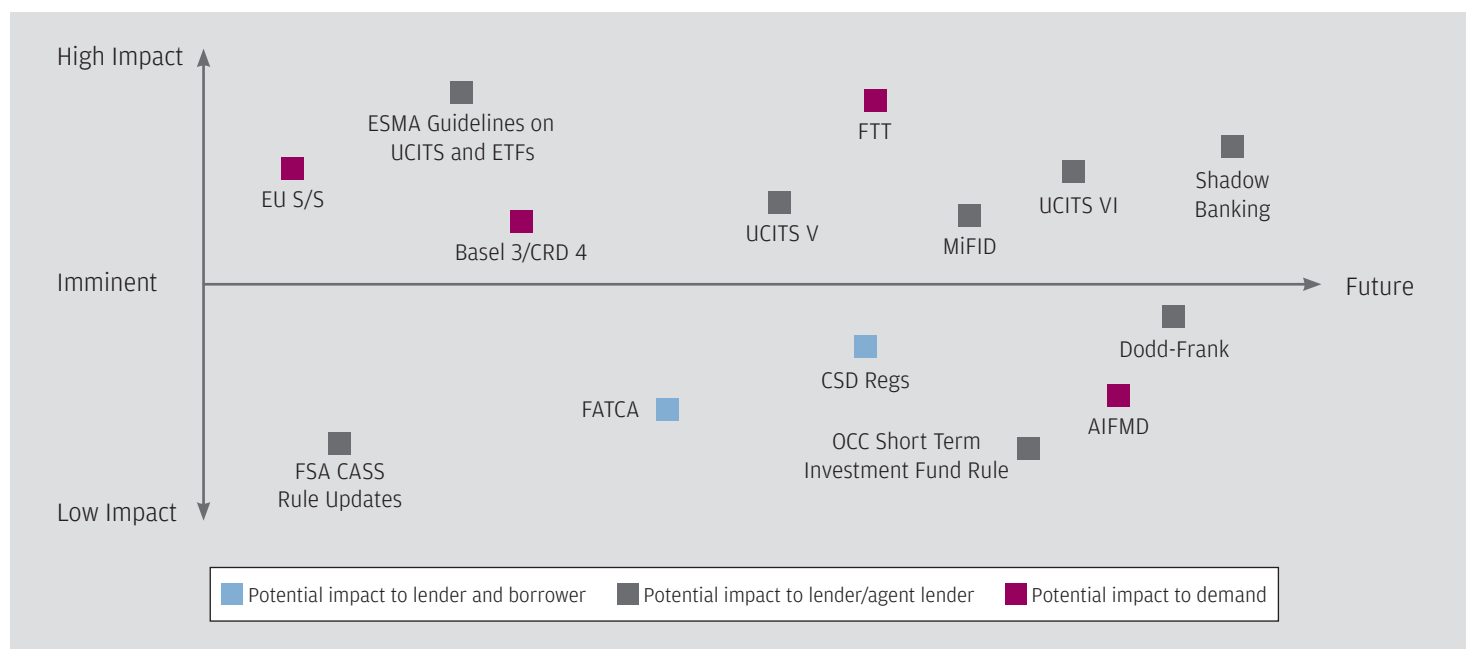
Regulatory Report

The securities lending regulatory environment continues to evolve, as multiple jurisdictions and regulators propose and implement new regulations. This report provides a summary of the key regulations that are under review and outlines potential implications of the regulations for lenders, their agents and the wider securities lending industry. J.P. Morgan plays an active role in the ongoing developments to consult and educate regulators about the securities lending process. Should you wish to discuss any of the items in the report, please contact your Securities Lending Relationship Manager.

Securities Lending Regulatory Update

Regulation Title	Effective Date	Securities Lending Implications	Potential Impact
EU Short Selling Regulations	Nov 1st, 2012	New short selling regulations expected to have limited impact on securities lending business directly. Sale of shares on loan not considered a short sale. Possible broader market implications due to proposed limits on market making exemption and requirement for public disclosure of short positions.	Low
ESMA ETFs and UCITS Guidelines	Q1, 2013	ESMA has published guidelines covering various aspects of securities lending for UCIT funds. Although not effective, they are final. The key points in the guidelines are: <ul style="list-style-type: none"> Aggregation of collateral thresholds and limits across both OTC derivative and securities lending transactions; Collateral provided under 'title transfer' to be held in the name of the depositary; Specific diversification and concentration limits to apply to all types of collateral - cash and non-cash - together with a prohibition on rehypothecation; Requirement for funds to disclose fee splits in prospectus and annual reports, together with undertaking 'stress testing' if more than 30% of NAV is on loan. 	High
Shadow Banking - SL/Repo Workstream	2014 (earliest)	Following the EC green paper on Shadow Banking, the Financial Stability Board ("FSB") created several work-streams to review the issue. One work-stream is specifically looking at securities lending and repo activity, and is looking at issues such as transparency/disclosure, minimum regulatory haircuts and rehypothecation of assets. The working group is expected to publish its interim report in November 2012 following the G20 Finance Ministers meeting.	High
Basel III / Capital Requirements Directive	2013 (Q1 earliest)	Basel III guidelines are still to be formalized, however the EU has issued the Capital Requirements Directive and Regulation (CRD4) which sets out how much of a bank's own capital must be set aside to cover their potential risks and to protect depositors. Other potential outcomes of the Basel III guidelines may include higher risk weighted assets for indemnified transactions, potentially increasing the cost of indemnification for agent lenders.	Medium
EU Financial Transaction Tax	Jan 1st, 2014 (earliest)	Eleven EU member states have now indicated support for a EU wide FTT - and the proposal is now subject to 'enhanced cooperation' and the European Commission is preparing its next draft proposal. It is expected to be published early in 2013. Notwithstanding this, individual markets are moving forward with their own FTT - France has implemented, with a securities lending exemption, Italy and Portugal are in the process of drafting legislation.	High
UCITS V / VI	Late 2013 / 2014	UCITS V is expected during 2013 and focuses mainly on the interaction between the depositary and the custodian. UCITS VI - which is still in consultation and expected early in 2014 - is part of the Commission's work on the Shadow Banking agenda and will address securities lending and repo.	TBD
Dodd-Frank Various sections	2013 / 2014	Consultations underway on a number of areas, including the setting of limits for counter-party exposure, rules around orderly liquidation of assets on default, increased transparency for both lender and borrower and restrictions on a bank's ability to undertake proprietary trading (Volker Rule).	Medium

Client Regulatory Update



Key Regulatory Timeline

2012	2013			2014 and Beyond
Q4	Q1	Q2	Q3-Q4	
<ul style="list-style-type: none"> EU Short Selling Regulations FSA CASS Rule Updates 	<ul style="list-style-type: none"> ESMA Guidelines on ETFs and UCITS CRD4/R 	<ul style="list-style-type: none"> EU CSD Legislation FATCA - payee tax tracking OCC Short Term Investment Fund Rule 	<ul style="list-style-type: none"> AIFMD UCITS V EMIR 	<ul style="list-style-type: none"> EU Wide FTT Shadow Banking UCITS VI FATCA - full regulations

Regulatory Themes

Systematic Risk	Transparency	Investor Protection	Collateral Management	Tax Developments
<ul style="list-style-type: none"> EU Short Selling Basel 3 / CRD 4 Shadow Banking Dodd-Frank 	<ul style="list-style-type: none"> ESMA Guidelines for UCIT Funds Shadow Banking Dodd-Frank 	<ul style="list-style-type: none"> MiFID UCITS V and VI OCC Short Term Investment Fund Rule Dodd-Frank 	<ul style="list-style-type: none"> ESMA Guidelines for UCIT Funds AIFMD UCITS VI 	<ul style="list-style-type: none"> EU Wide Financial Transaction Tax FATCA Widening scope of Tax Harmonization

Upcoming Events

European Securities Lending Forum

Tuesday February 12, 2013
London

J.P. Morgan will be holding its first Securities Lending Forum in London where industry experts will discuss current and forthcoming regulatory developments and the impact on Securities Lending. This topical and candid conversation will focus on how to succeed in the new environment following regulatory changes, the current state of the Securities Lending industry and the outlook for 2013.

IMN's 19th Annual Beneficial Owners' Securities Lending Conference

Monday, January 28 - Wednesday, January 30, 2013
New Orleans

J.P. Morgan will be a platinum sponsor at this conference focused on trends and issues affecting the Securities Lending industry. J.P. Morgan will have several panel speakers discussing topics including: issues beneficial owners need to focus on in the current regulatory and economic climate, best practices in agent lender - beneficial owner communications and relations, lending internationally, and what Securities Lending will look like in 2015.

We look forward to seeing you at our upcoming events. For additional information, please contact your J.P. Morgan representative.

Awards



Congratulations to J.P. Morgan's Securities Lending team for their recent first place rankings in the Global Investor, ISF Beneficial Owners Securities Lending Survey, 2012.

First Place Ranks in the following categories:

- **Overall Weighted:** Americas
- **Overall:** Asia Pacific (Unweighted, Weighted and Footprint)
- **Custodians:** Asia Pacific (Unweighted and Footprint)
- **Custodians:** Provision of Market and Regulatory Updates

Global Investor, ISF Beneficial Owners Securities Lending Survey, 2012

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Invitation 12.02.13

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European Securities Lending Forum

Tuesday February 12, 2013

14:00 - 17:00, followed by a drinks reception

**J.P. Morgan, Auditorium, 25 Bank Street,
Canary Wharf, London, E14 5JP**

J.P. Morgan is delighted to invite you to our first European Securities Lending Forum where industry experts will discuss current and forthcoming regulatory developments and the impact on Securities Lending. We will be looking at how our clients can succeed in the new environment following regulatory changes.

We hope you will be able to join us.

If you have any questions about attendance, please contact Kathryn Wright at kathryn.s.wright@jpmchase.com or on +44 (0)20 7742 0899

