

Securities Lending Current Market Environment

November 2008

Recent market events have had a substantial impact on securities lending practitioners and their clients. The demise of Lehman Brothers, some governments placing restrictions on short-selling activity and the under-performance of money market funds have all played a part in placing pressure on the lending industry.

In reaction to these events some clients have suspended their lending activity until the dust has settled and their lending guidelines have been reviewed. Watson Wyatt supports this approach and believes all clients should review their lending arrangements to ensure they fully understand the risks involved, and to confirm the lending guidelines are appropriate.

This paper provides summary details of the current issues in securities lending caused by the market turmoil, and sets out Watson Wyatt's views on options currently available to clients that would like to amend their lending arrangements. It is important to note that the focus is on lending through an agent – typically a client's custodian.

The key areas

Counterparty risk

As part of the lending process, agents will lend clients' assets to a number of counterparties (borrowers). The agents have processes in place for monitoring the credit-worthiness of the counterparties, and their overall exposure to them.

Lehman Brothers was a sizeable borrower in the global securities marketplace; hence its demise significantly impacted lending activity. A number of large agents had reduced their exposure to Lehman or increased their collateral requirements in the preceding weeks, but all had outstanding loans to Lehman at the time of its default. The default of such a key borrower led to an unprecedented large-scale use of the collateralization process to purchase (buy-in) clients' securities that were on

loan. On the whole, the industry coped well with this process, and the majority of client assets were repurchased within two days of events unfolding.

Collateral

When agents lend securities to counterparties, they receive collateral to at least cover the value of the lent securities. This collateral is in the form of either cash or securities (noncash). Clients that allow for cash collateral in their lending guidelines might find that the collateral was invested in securities that have declined in value or that the collateral holdings have experienced mark-to-market losses related to illiquidity. A requirement specific to cash collateral is that lenders are required to achieve a return at least equal to the rebate rate paid to the borrower on the cash received. All principal losses and failure to meet the reinvestment rates are the responsibility of the client, who will be expected to fund any deficit. Clients holding noncash collateral do not have such reinvestment requirements.

To provide enhanced security over the loaned assets, the collateral posted by the counterparty includes a margin to account for changes in value of both the lent assets and the collateral in the event that noncash collateral has been received. For example, it might be that for each \$100 of securities lent, the collateral to cover that must be equal to \$105. The quality of noncash collateral accepted can vary, with the conservative and appropriate approach being to only accept high-quality collateral, (e.g., government securities). It is important to ensure that the collateral arrangements agreed for a lending program are in-line with a client's risk tolerances.

Indemnification

Agent lenders can provide clients with an indemnified lending program.

The indemnification typically covers clients for the loss of loaned assets, and any shortfall in noncash collateral that is in place to cover those assets. It is industry standard for the indemnification not to cover cash collateral.

While indemnification policies provide comfort for clients, there are still inherent risks due to the policies being covered by either the agent's balance sheet or an insurance policy. The chain of events resulting in an indemnification being required and then to failing would be extreme (but not impossible).

Conclusion: What to do next?

It is our recommendation that clients suspend securities lending activity unless loan arrangements are well understood and are comfortable with the risks associated with their program. We recommend that clients research collateral types and amounts, reinvestment guidelines (in the event that cash collateral is taken), counterparty restrictions and any collateral indemnification provisions provided by the lending agent. If risks are examined and deemed unacceptable, clients can:

- Suspend securities lending, where possible. Clients with noncash collateralized lending should be able to suspend lending immediately. If cash collateral was accepted and principal losses have been experienced in the collateral holdings, or the unimpaired collateral holdings have experienced mark-to-market losses related to illiquidity, clients will incur a cost to exit the program unless the lending agent has made a compensatory concession. Further, some lending agents might restrict a wholesale withdrawal from the program.

- Initiate a gradual withdrawal from the program. Several lending agents have initiated programs where a client's exposure is gradually reduced over time. Again, if collateral is not sufficient to repay borrowers as securities are returned, at some point clients will incur a cost to exit the program unless the lending agent has agreed, for whatever reason, to pay that cost.
- Change the lending guidelines. All lending agreements, between client and the agent, set the guidelines for participation in the lending program. It might be prudent to increase the collateral requirements (both quality and/or value), review the list of borrowers, review the indemnification structure and change the cash collateral reinvestment guidelines (where cash collateral and its associated risks are deemed to be acceptable). We strongly recommend conservative noncash collateral guidelines or very conservative reinvestment of cash collateral as risk minimization strategies.

Pooled funds – securities lending

Many investment manager pooled funds participate in securities lending. Just as with direct lending programs, it is important to understand and attain a satisfactory level of comfort regarding the risks taken on behalf of clients as participants in these funds.

As with all investment decisions, clients need to be confident that the risks taken in securities lending are well compensated in terms of expected return.

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2008-US-0280