

A turbulent year brings securities finance into the mainstream

21



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Traditionally securities finance has had a low profile within the broader financial community. Other than market participants, few people really understand the lending and repo markets. And yet, as Table 1 on page 22 shows, this is an enormous market generating billions of pounds in gross fees – the vast majority of which flows back to beneficial owners. However, the storm that engulfed markets in 2007 and 2008 brought securities finance directly into the spotlight. It underlined the need for trustees to view securities finance as an integral component of their overarching investment strategy, and not to dismiss it as a back office decision, automatically bundled in with the broader custodial package.

Securities finance and its role in the crisis

The background to the credit crisis is now well known. In 2007, the share prices of institutions believed to be most exposed to sub-prime risk began to sink. Markets became increasingly febrile and by the middle of 2008 several UK institutions were having difficulties successfully launching rights issues. In response to growing rhetoric about short selling, in June 2008 the UK's Financial Services Authority (FSA) introduced measures requiring institutions that held net short positions greater than 0.25% of a listed UK company undertaking a rights issue to report them and any subsequent changes¹.

With markets suffering the extreme dislocation seen into 2008, it became a popularly held belief that short selling was to blame. This sentiment was typified by comments from Dr John Sentamu, Archbishop of York, who likened short sellers of HBOS shares to "bank robbers and asset strippers"². Normally sanguine regulators appeared obliged to respond, and implemented a variety of measures. In the UK and US this amounted to a ban on

any further short selling of shares in most financial institutions, and in other countries authorities all but barred any lending of equities. These measures reinforced the view that securities lending was at the heart of the crisis.

Unsurprisingly, beneficial owners became concerned about their association with an activity that attracted almost universal opprobrium and that, following the collapse of Lehman Brothers, was no longer seen as low risk. These concerns were compounded by stories of beneficial owners suffering unanticipated losses in their cash reinvestment programmes, even though this was primarily a US market occurrence³. Many responded by suspending their participation in lending programmes, with some yet to re-enter the market.

The case for securities lending

In light of these concerns it is worth revisiting the case for securities finance.

In contrast to the popular perception that equates securities financing with short selling, approximately 50% of all lending relates

1. "Financial Services Authority introduces disclosure regime for significant short positions in companies undertaking rights issues" FSA/PN/057/2008. 13 June 2008.
2. Speech to The Worshipful Company of International Bankers Dinner, 24 September 2008. See archbishopofcanterbury.org/1980.
3. Northern Trust reports tracking errors on some index funds", Financial Week, May 1, 2008 - referencing unrealised losses of 1.3% on USD1.35bn cash reinvestment portfolio.

TABLE 1: SECURITIES FINANCE, MARKET SIZE

	Security Type	Lendable Assets (USD m)	On Loan Balances (USD m)	Total Return to Lendable Assets (Bp)	Implied Annualised Fees (USD m)
29 June 2007	All Securities	13,936,818	3,461,996	8.19	11,414
29 June 2007	All Bonds	5,904,150	1,975,285	10.34	6,105
29 June 2007	All Equities	8,032,411	1,486,711	6.61	5,309
30 June 2008	All Securities	14,089,346	3,336,283	10.11	14,244
30 June 2008	All Bonds	6,287,932	1,910,491	10.49	6,596
30 June 2008	All Equities	7,788,794	1,425,726	9.82	7,649
30 June 2009	All Securities	9,382,363	1,630,414	8.31	7,797
30 June 2009	All Bonds	4,676,928	955,875	5.15	2,409
30 June 2009	All Equities	4,695,798	674,526	11.47	5,386

Source: Performance Explorer, Data Explorers.

to financing of fixed income. Primarily, this takes the form of government or credit repo, the purpose of which is to enable institutions to manage their liquidity requirements. Of equity loans, the vast majority of activity is used to support some form of arbitrage. Without the ability to short sell, many widely practiced activities that support efficient markets, such as convertible, index, or merger arbitrage, would be impossible. It is estimated that only 4% of equity lending activity is used to support pure directional shorting⁴.

Furthermore, studies have established that lending equities delivers a range of benefits to markets, including improved liquidity, tighter spreads, improved price discovery, mitigation of market bubbles and support for derivative trading and hedging⁵. Despite this, some professionals believe that securities lending, and associated short selling, damages their interests as “long” investors. Fears tend to focus on the idea that short selling is predatory, linked with abusive behaviour, and misaligned with the goal of long term capital appreciation. Certainly, regulators acknowledge such concerns – the FSA recognising that short selling could

“contribute to disorderly trading, increased short term price volatility and be used in manipulative trading”⁶. And indeed, some academic evidence suggests that short selling can make price discovery less efficient in certain circumstances⁷. However, the FSA also states that the risks outlined above are already addressed by existing regulation – relating to market abuse, for example. And while many studies demonstrate that short selling can impact prices negatively, this is generally interpreted as contributing to efficient pricing by allowing negative information about stocks to be expressed in the market. It is in this context that regulators in all sophisticated markets have long endorsed securities lending as an integral element of the efficient functioning of markets. Indeed, as recently as in January 2010, Paul Tucker, Deputy Governor of the Bank of England, described it as “absolutely vital to effective market making, and thus to efficient capital markets”⁸.

Data captured during the crisis has also served to dispel the notion that short selling drove down prices. Chart 1 shows the performance of the FTSE 350 financial sector in 2008. Despite bouncing on 19 September,

4. Ed Oliver, Data Explorers Consulting quoted in Financial Director “Tough Economic Times Demand Greater Return on Investment” 23 November 2009.
5. See:
 - i) “Short Selling” FSA DP 09/1, February 2009.
 - ii) “Regulation of Short Selling” Consultation Paper by IOSCO Technical Committee, March 2009.
6. FSA DP17 “Short Selling” October 2002.
7. See Tyler Henry & Jennifer Koski “Short Selling Around Seasoned Equity Offerings” September 15, 2008 for discussion of the impact on seasoned offerings and rights issues in US market.
8. “Shadow Banking, Financing markets & Financial Stability”, Paul Tucker addressing BGC Partners 21st January 2010.

CHART 1 FTSE 350 BANKS INDEX 2008



SOURCE
Bloomberg.

the day after the FSA introduced the ban on shorting financial stocks, the sector proceeded to lose a further 49% of its value by the time it bottomed on 22 December. These falls could only be attributed to sales by long holders.

Similarly, despite the rhetoric that held short selling responsible for the collapse of HBOS, it is interesting to note the data in Chart 2 on page 24, for the three month period spanning 18 September – the date on which its takeover by Lloyds was orchestrated. These show that the quantity of shares on loan (a reasonable proxy for shares sold short) was virtually unchanged in the weeks leading up to the announcement, and then dropped significantly – yet HBOS's share price fell from 294p to 99p.

Evaluating the regulatory response

Notwithstanding regulatory support, the events of 2008 inevitably meant that the industry would come under review once markets normalised – and so it has proved.

At a macro level, regulators charged with market supervision have been looking at what needs to be done to facilitate orderly,

efficient markets. This has been coordinated by the International Organisation of Securities Commissions (IOSCO), whose Technical Committee produced high-level recommendations in relation to short selling⁹ with a view to introducing greater transparency and control.

More pertinently for beneficial owners, at a micro level, regulators have been examining how to protect the interests of lenders more effectively. In the UK, this has taken the form of guidance notes issued by the Pensions Regulator¹⁰. These are meant to provide a framework enabling trustees and their advisors to better understand the nature of their lending programme. Building on this, new guidelines on securities lending are being drafted under the auspices of the Bank of England's Securities Lending and Repo Committee¹¹. These are expected to be issued in Q3 2010. This consultation process is in its early stages, but it is clear that the regulator is encouraging greater levels of understanding and involvement on the part of trustees.

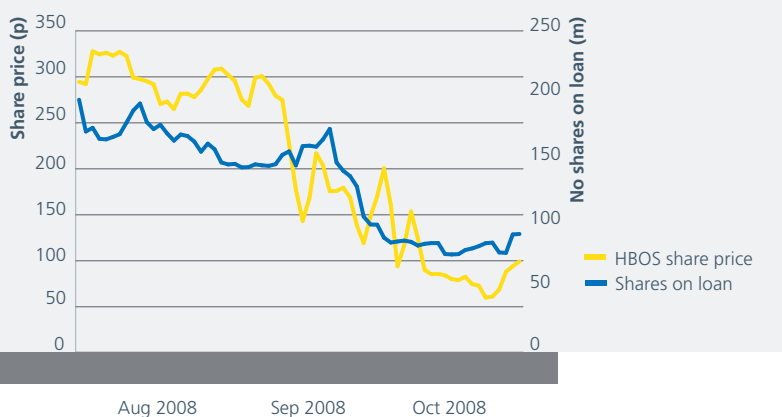
9. FSA Discussion Paper 17, October 2002.

10. The Pensions Regulator paper "Understanding and managing the risks of securities lending" January 2010.

11. "Stock Lending Rules on Target for Update", Pensions Week, 25th January 2010.

24

CHART 2 HBOS PLC, AUGUST-OCTOBER 2008



SOURCE

Bloomberg &
DataExplorers.

A new focus for beneficial owners

In light of this new found focus, beneficial owners should recognise securities finance for the overlay investment strategy that it is - one that can potentially unlock the full intrinsic value of the assets they own. But while it can generate significant additional revenue, as an investment activity it should be aligned with the client's broader risk-adjusted return objectives. Given this, the key elements that need to be considered are programme return, risk appetite, and compatibility with the lender's broader investment objectives.

Forecast returns are inherently unpredictable. However, to the extent possible, beneficial owners should examine the features of an agent's programme that underpin revenue forecasts. These include:

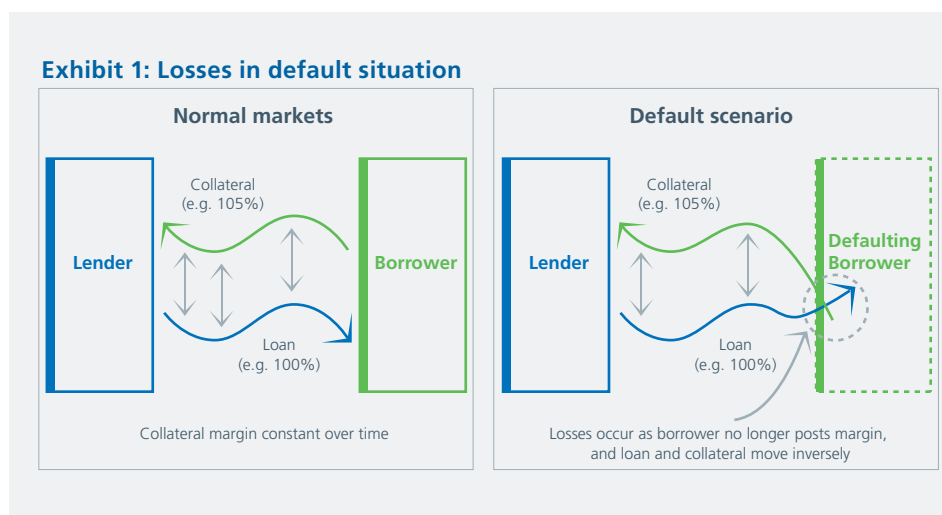
- Distribution capability for different asset classes: some agents may have particular strengths when distributing Asian equities, for example, others UK gilts.
- Distribution capability for assets sourced from different fund structures: opportunities for assets belonging to UK

pension funds are very different to those from offshore SICAVs.

- For sophisticated beneficial owners, the ability to tailor more structured solutions. This will, however, be subject to having a close dialogue with the beneficial owner, through which they can offer carefully screened opportunities.

With respect to risk, beneficial owners should articulate their risk appetite clearly and understand how their agent's lending model will incorporate this. In non-cash collateralised programmes, losses only arise when a borrower defaults (as shown in Exhibit 1 on page 25) and the value of collateral is insufficient to repurchase securities equivalent to those lent. The key risk considerations, therefore, relate to counterparty and collateral risk. So owners should understand how these will be monitored, mitigated and reported back, and whether an agent's risk model has been realistically stress tested and how dynamic it is in deteriorating markets.

Cash collateral introduces an additional layer of risk, albeit one that historically has served to enhance returns. Anecdotal



Source: Aviva Investors.

feedback suggests that losses incurred by beneficial owners during the credit crisis were caused largely by the illiquidity of holdings in reinvestment vehicles¹². So while cash collateral remains a legitimate means of enhancing return, it is important that beneficial owners monitor the securities to which the reinvestment vehicle gives them exposure, ensure these are compatible with their investment guidelines, and incorporate the figures into their overall risk calculation.

current revenue for an indemnification that, when required, proves inadequate.

Finally, beneficial owners should ensure their lending programme is compatible with their broader investment management activities. This not only relates to corporate governance, but to other areas where seamless cooperation between fund manager and lending agent can enhance overall portfolio returns.

Of course, many owners with indemnities from their agent lenders have deemed their involvement to be risk-free¹³. However, as events showed, the insurance these provided has varied widely – notably in respect to losses on cash reinvestment, which is precisely where owners appear to have been hit. It is, therefore, important that indemnities are scrutinised carefully to clarify what protection is on offer. Equally important is the creditworthiness of the indemnity provider; an indemnity from an agent lender who defaults is of little value. In the final instance, it may well be preferable for the beneficial owner to take a higher fee split and no indemnity rather than surrender

Good corporate governance is perfectly compatible with participation in a lending programme. By way of illustration, in a National Association of Pension Funds (NAPF) survey of its members, 75% of respondents lent their stock, 45% recalled it for contentious resolutions, and some 5% did so for all resolutions¹⁴. Together the International Securities Lending Association (ISLA) and the International Corporate Governance Network (ICGN) have produced codes, reconciling corporate governance interests with lending. Governance-focused owners should select an agent whose programme offers the flexibility to determine on a vote-by-vote basis whether the owner's

12. See:

i) CALPERS Investment Office "Securities Lending Annual Review" dated August 17, 2009 – detailing unrealised losses of USD854m on internal collateral reinvestment. Available at www.calpers.ca.gov.

ii) "Sec lending losses hit Dutch funds" Giovanni Legorano, in *Global Pensions* dated 15 Oct 2008 – reporting "a generalised problem" with losses on collateral invested in money market funds.

13. It is a common practice for agent lenders to offer clients an indemnity against losses arising from their involvement in lending – giving rise to the idea of "risk free" lending. In return the agent typically retains a higher percentage of the fee split. Perhaps unsurprisingly, the quality of indemnities varied widely when tested post-Lehmans, most notably in respect to what reinvestment losses were covered.

14. NAPF report "Pension Funds' Engagement with Companies" September 2008.

26

interests are best served by voting or by leaving the securities on loan.

Similarly, beneficial owners should investigate whether their lender can work with their investment manager on a case-by-case basis in respect of corporate actions. Such flexibility is also likely to help deliver enhanced returns.

Conclusion

It is worth reiterating that securities financing remains an important source of revenue for pension funds and other institutional investors. Far from reinforcing the view that the lending industry compromises the wider markets, the credit crisis served to highlight the robustness of the processes that underpin the industry. This has vindicated past and continued regulatory support. However, as with most investment activity, there is an element of risk. Beneficial owners should be actively involved, understand the risks and rewards and work closely with their agents to monitor the process appropriately.

KEY POINTS:

- Securities finance is fundamental to efficient markets and the credit crisis established that the model works.
- Lending generates much needed incremental risk-adjusted return for pension funds and beneficial owners.
- Securities finance is an investment overlay and it should be aligned with the owner's broader investment objectives.
- Beneficial owners need to be engaged and properly understand the process and risks involved.
- Agent lender selection should be a focus for the investment committee, not a subsidiary service automatically bundled into an integrated custodial offering.

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