The Impact of the Credit Crunch upon the Securities Lending Market

Spitalfields Advisors, January 2008

Purpose

The purpose of this short note is to draw the reader's attention to some important developments in the credit and money markets. These developments have a direct relevance and bearing upon the securities lending market; they create questions and issues that might be worthy of further consideration.

Please note that our target audience is the beneficial owner community that is either lending or considering lending.

Background

During the last six months, the US sub-prime mortgage crisis has grown to become a global concern, with funding costs rising every month.

In the words of the US Federal Reserve, we have witnessed a dislocation of the money and credit markets. Rating agencies' structured products were quickly downgraded, sparking suspicion and fear as to who had the greatest exposures – exposures potentially exacerbated by leverage.

As these less liquid assets became, in many cases – nearly illiquid, so financing became more difficult and expensive. Banks became increasingly reluctant to lend money and ultimately, central banks were forced to pump billions into the market in an attempt to restore confidence.

In December, five central banks coordinated a response to the lack of liquidity. The Federal Reserve, European Central Bank and central banks in the UK, Canada and Switzerland announced they would work together to provide liquidity into the market.

Some senior credit strategists have observed that the markets remain "uniquely illiquid" and that 2008 will continue to see the spread of the credit crunch.

The impact upon Securities Lending

Cash is the dominant form of collateral for many lenders, particularly in the US, and as credit spreads have widened, an environment has been created for securities lenders to earn significantly greater returns. Their risk profile has also changed accordingly. The key challenge is keeping liquid, i.e. holding on to the cash you already have and wherever possible building cash balances to facilitate the pursuit of the opportunities presented. This is easier said than done as many of the borrowers in the securities lending market are under severe balance sheet pressure and keen to recall cash collateral and substitute non-cash alternatives. This has led to a build up of pressure between the borrowers and the lenders. Should cash have to be returned the lenders face the possibility of having to liquidate positions and potentially realising losses on positions that have been devalued as a result of the credit crunch.

For lenders with the right reinvestment strategy … the rewards have been exceptional

Now, more than ever, the scale, strength and nature of lender-borrower relationships have come into focus. The scale of the securities lending market and its impact upon the short term money markets of the world has never been more important or appreciated. For an industry that is so often the whipping boy for market instability it is most welcomed and unusual to be recognised as part of the solution rather than part of the problem.

For lenders who have the right reinvestment strategies in place to navigate successfully through these difficult market conditions without being forced to liquidate under-water positions, the rewards have been exceptional.

Data from the Performance Explorer Service[i] shows that Re-investment Returns to Lendable Assets[ii] in recent months, across all asset classes, have been multiples of average 2007 levels. Furthermore, it looks like these conditions may set the tone for 2008 and should be factored into any portfolio evaluations, exclusive proposals and auctions.

What is my Risk?

The recent turmoil has not only created profit opportunities for some, but also some interesting discussion points for the securities lending industry. With the high levels of income volatility being witnessed, do beneficial owners really understand the level of risk that they are now exposed to? There are two opinions on this.

The first opinion is that they do not understand the risks they are taking, or they do not want to understand them. The second thought is that they do recognise the risks, but they are comfortable with it and are changing their lending guidelines accordingly. The truth, as always, is somewhere in the middle, but one thing is certain; that in this situation, ignorance is certainly not bliss. It is important that all parties understand their relative risk and risk-adjusted returns numerically, not in words. It is well known in this business that if you cannot measure it, you cannot manage it.

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Have beneficial owners with more flexible non-cash collateral guidelines been suitably rewarded? On the face of things it would appear that the answer to this question is yes, at least for Bonds. The collateral upgrade trade whereby high quality bonds are lent out and substituted for lower grade collateral, has generated a higher level of income. However, the more important question is whether that style of transaction looks attractive on a risk-adjusted basis relative to other transactions. The numbers do not lie.

A more intriguing question to answer is whether the credit crunch has changed the historic borrower-lender relationship.

Although mass redemptions from hedge funds do not appear to have occurred, prime brokers, as well as other borrowers, have felt the liquidity and financing pressure as their balance sheets have absorbed assets.

Selling pressure from fund managers leading to recalls has been a constant fear, and data providers such as Lipper Feri observed that the fund management industry experienced significant outflows in the third quarter of 2007.

The pressures that have affected supply and conflicting collateral, liquidity, and capital demands have placed relationships under extreme strain at times. Were they strengthened in the heat of battle, or will we look back at this period in three years time and reflect that this was the moment the traditional dynamic altered?

Analysis

The shortage of cash liquidity in the capital markets has prompted two key reactions in the securities lending market. The first is an increase in the cost of, and demand for, borrowing Government Bonds as borrowers sought to secure quality assets for liquidity purposes. The second results from the extreme balance sheet pressure the borrowers are experiencing, and led to concerns that borrowers would either return loans secured versus cash collateral or have to substitute cash for non-cash collateral. If this were to happen it would force a liquidation of re-investment assets – some of which may be loss-making due to the re-pricing of risk in the market place.

How did the lenders, or more precisely their agents, react? Broadly speaking - rationally - they raised rebates to maintain cash balances (sometimes effectively lending some securities for nothing or even at a loss) – and it's a tactic that has worked to a large degree so far. Balances versus cash collateral have remained broadly unchanged, whilst the percentage of revenue share from reinvestment activity has soared. On occasions it has even exceeded 100%.

There are now a number of securities lending programmes that are effectively mis-named. Such is their orientation and revenue generation profile, they are more appropriately "re-investment" or "leveraged finance" programmes as opposed to their given names. Some might say the "tail is now wagging the dog"

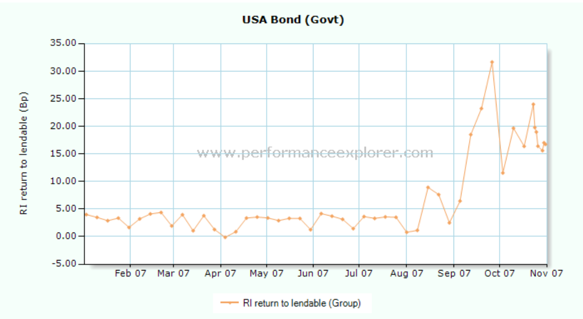
Whilst Utilisation[iii] levels and the percentage of balances versus cash and non-cash collateral remained more or less unchanged, significant volatility was witnessed with regards to fees, Securities Lending Return to Lendable Assets[iv], and Re-investment Return to Lendable Assets, as well as the percentage revenue share from Re-investment.

The volatility itself followed a broadly similar pattern. There was one consistency with what was happening in the money and credit markets. Due to tighter credit conditions, spreads had widened significantly through August and September to two-to-three-times pre-August levels. As in any part of the financial world, where volatility exists, so does the potential to make above average returns.

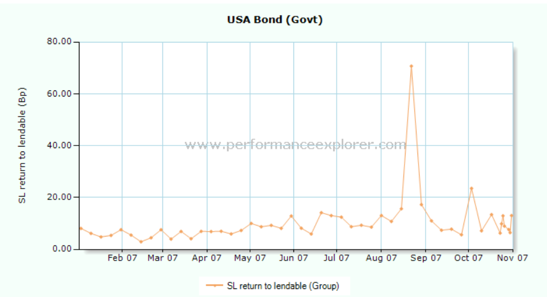
Securities lenders who re-invested cash collateral were presented with the opportunity to buy the same assets they were buying before, but this time with a reward that was two-to-three times higher for taking the same risk. However, as yields rose, prices fell - meaning those already holding these securities were suffering mark-to-market losses. The adoption of either mark-to-market accounting polices or an accrued methodology played an important role in the transparency and communication of this situation to the underlying beneficial owners who bear most - if not all - re-investment risk.

This was the challenge for lenders and their agents – to maintain cash collateral balances, avoid crystallising their losses on existing positions and, at the same time, take advantage of the re-investment return environment, which has been exceptional.

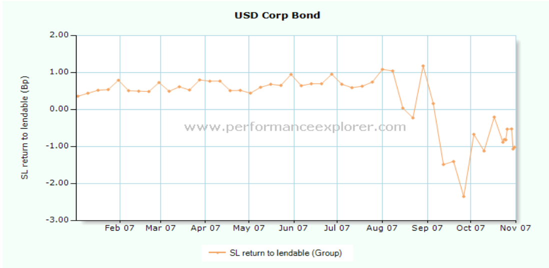
US Government Bonds Re-investment Return To Lendable Assets, which had averaged 2.91bp for 2007 up to the end of July, averaged 4.19bp in August, 19.95bp in September, and 17.60bp in October.



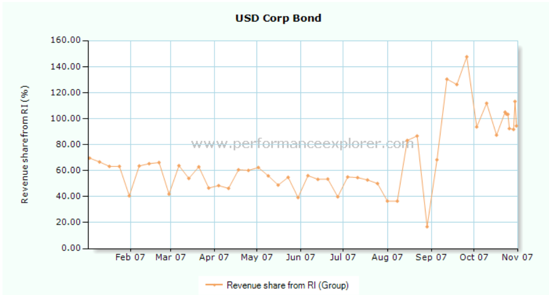
Supporting the observation of increased demand for Government Bonds, Securities Lending Return To Lendable Assets for US Governments also rose. For the same periods it averaged 7.67bp, 25.48bp, 7.93bp and 10.91bp respectively.



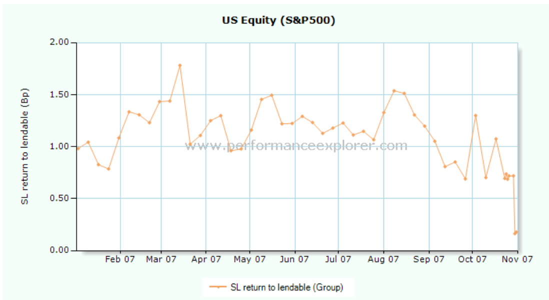
The most dramatic impact on Securities Lending Return To Lendable Assets and percentage of revenue share from reinvestment was noted in USD Corporate Bonds and the S&P 500.

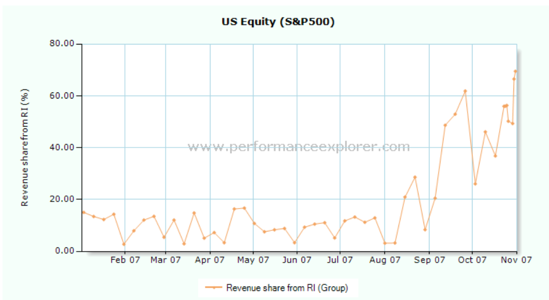


In the case of USD Corporate Bonds, Securities Lending Return To Lendable Assets in fact became negative, and revenue share from reinvestment exceeded 100%.

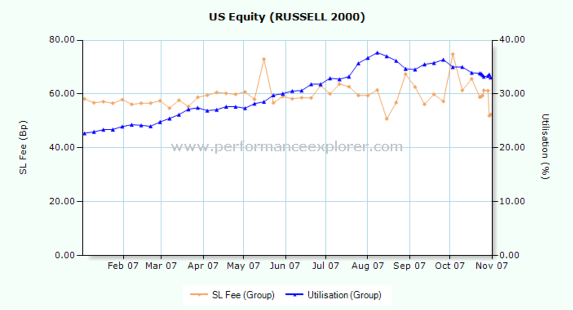


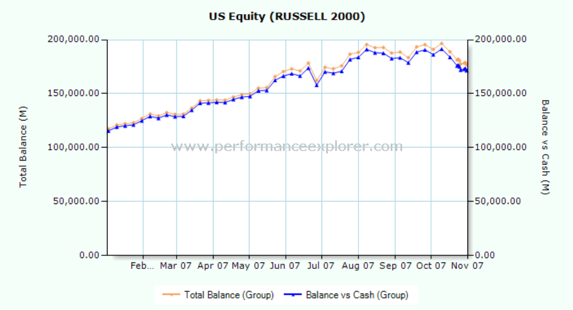
The S&P 500, meanwhile, has seen its Securities Lending Return to Lendable Assets drop to close to zero and revenue share from reinvestment rise from under 20% to over 65%.





Were there any warning signs in the securities lending market that the sub prime crisis was looming?





Certainly the activity in the Russell 2000 in 2007 bears close attention.

If the sub prime crisis was not enough of a warning, then it was definitely a flag that the US economy was due for some difficult times, especially given the increased short interest.

Total Balances rose from $116bn at the start of the year to a peak of $196bn in October; and Utilisation levels – which had started the year at 22% - by early August had reached 37% and at the end of October were still around 33%.

Conclusion

The credit crunch has had a very significant impact on the securities lending market. It has created a unique-in-recent-times environment for lenders to earn exceptional returns. It also shows no sign of ending soon as further central bank money is injected into the global banking system and concerns persist as to the amount of losses global financial institutions really are carrying.

Against this background, it remains to be seen if the volatility of earnings, shortage of available cash, borrower capital restraints and volatile share indices will lead to further specials and re-investment opportunities. Time will tell whether this is, in fact, a great buying opportunity for those with a risk appetite and patience to weather the storm. Alternatively those who exit certain investments now may have chosen the better option.

Risk, and the measurement of risk-adjusted-returns, is at the forefront of most beneficial owners' minds as they try and come to terms with lending programmes that have changed character significantly over recent months.

Agents have, generally speaking, done a good job responding to the demands of the beneficial owner community for additional information. The difficulty that the beneficial owners (particularly those with multiple agent lenders) have faced is in receiving a consistent response that enables them to compare one programme with another. There is a need for an independent risk management approach that will enable the risk takers to put their securities lending returns into a relative risk-adjusted context.

We have already seen a significant growth in the demand for independent risk-adjusted-return analysis. It is to be expected that beneficial owners will dedicate more resources to the management of their securities lending programmes and in particular collateral and re-investment guidelines going forward.

This desire for more tangible information is both understandable and welcomed. It is understandable, as the beneficial owners take most of the re-investment risk. It is welcomed, because informed customers make for better customers.

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i www.performanceexplorer.com for more information on this specialist securities lending global benchmarking service

ii Re-investment Returns to Lendable Assets is defined as Revenue received from Cash Reinvestment activity only (weighted by lendable assets and displayed in basis points)

iii Utilisation is defined as the balance of assets on loan as a % of lendable assets.

iv Securities Lending Return to Lendable Assets is defined as Revenue received from Securities Lending only (weighted by lendable assets and displayed in basis points).

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