



Changing motivations

Moving forward do you think more lenders will look to unbundle securities lending from custody? Cash collateral management from lending? What are the advantages/disadvantages/considerations?

The future of the lending industry may be characterized by a change in motivations. Motivations in how Agent lenders and clients pursue custody and securities lending investment services.

Lending industry veterans expect that there will be a significant reduction for general collateral (GC) loans from the demand side of related trades. A reduced number of actual borrowers coupled with interest rates poised to stay at historically low levels, provides a poor

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environment to motivate previous levels of GC trading. This lending environment would seem to take us back to lending's old roots: lending specials for their high intrinsic spread and reinvesting the collateral in high quality, very liquid securities, producing a low risk alpha boost to portfolios.

What was lending's old school roots has, over the years, become a poorly understood and sophisticated long-short investment program i.e. receive short-term GC lending cash collateral and reinvest in longer term, 1-5 year, fixed income securities to pocket a handsome duration based spread. The resulting spread and revenue from this strategy has had a major impact on securities lending, custody negotiations and contract structure over the last decade.

In my opinion, given current financial market conditions, both beneficial owners and custody agent lenders may look to separate the close relationship between the real costs of custody services and the revenue sharing of securities lending. Currently, custody services operate at low margins with high fixed costs while lending activities have enjoyed a healthy positive margin. If, as expected, lending income is reduced from lack of demand from

fewer hedge funds and low interest rates, many custody contracts will suffer a negative spread. Result? The cost of overall custody and lending services will exceed the fee and revenue clients are required to pay. This is not good news for clients. Industry experts will agree it is an untenable service relationship.

At the present time, cash collateral management is most often bundled with agent lending services. 2008 has been an unprecedented year for collateral reinvestment programs. Clients and agents are having to contend with possible SIV exposures, Lehman issues and a liquidity crisis. It is clear that many in the lending industry are reconsidering their options on how to better manage their cash collateral. Similarly, clients will be driven to reduce risk and exposures highlighted by their 2008 collateral investment experiences. These experiences represent an opportunity for short-term money manager specialist to pursue outsourced cash collateral investment mandates.

Both provider and client must have similar motivations that allow each service to stand alone on cost and merit.

Thoughtful consideration of current vendor roles and service expectations will provide management with the needed market based intelligence to make prudent decision.

For many clients who are reviewing their options, it would be natural for them to also consider unbundling all or portions of custody services, securities lending and collateral management with the use of a third party provider. Clients need to undertake a clear and honest review of their financial service needs and the associated costs. Thoughtful consideration of current vendor roles and service expectations will provide management with the needed market based intelligence to make prudent decisions.

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