



JAMES SLATER *Senior vice-president, capital markets, CIBC Mellon, Global Securities Service Company*

RISK AND PERFORMANCE

A look at risk-adjusted returns and securities lending.

Pension plan and mutual fund sponsors quantify the risk and performance of their investment portfolios and analyze how they compare to their peers in a meaningful way, exploring alternatives to improve their risk-adjusted returns for their underlying beneficiaries and investors. Securities lending should not be any different.

HOW IS SECURITIES LENDING GOVERNED?

Historically, sponsors have relied heavily on the qualitative attributes of the industry to understand the risks of securities lending. The global securities lending market is substantial, with over US\$5 trillion on loan, and Canada is one of the oldest securities lending markets in the world, ranking third (not including the U.S.). In addition, securities lending plays an important role in capital markets by providing liquidity for hedging. It is also dominated by large, sophisticated institutions that are supported by central banks. Securities lending activities and participants are also highly regulated and the process is governed by standard market practices, codes of conduct and industry standard agreements. In addition, the industry has several distinguished trade associations (e.g., The Risk Management Association).

In the event of a default, indemnification mitigates the shortfall and, at the same time, independent credit adjudication typically leverages the sophisticated credit function of banks. Finally, securities lending expertise is rounded out by technology, people, daily mark-to-market and sound margin practices.

However, even with these positive attributes, securities lending still needs to quantify a sponsor's exposure to a potential dollar loss. In response to the ever-increasing complexities of growing world capital markets as well as new products, technological advancements and regulatory initiatives like Basel II, securities lending participants are embracing the high level of dynamic risk measurement techniques that were once reserved for the most sophisticated investment banking firms.

With the advancement in technological refinements, most agent lenders now use Value-at-Risk (VaR) methodologies to supplement their current risk management framework.¹ A key benefit of VaR is its ability to measure the correlation between constituents of loans and collateral portfolios to assess how the risk is mitigated. It is important to understand that VaR has limitations—how liquidity risk is factored in as well as simplification and mathematical shortcuts. Participants typically look at the overall risk profile of the program and any risk measurement methodology should consider risk from all levels: for the entire program as well as at the levels of borrower, sponsor, sponsor account and transaction.

THE IMPORTANCE OF RISK METHODOLOGIES

Risk methodologies provide a better understanding of the risks sponsors and agents are assuming on a day-to-day basis. However, a risk information system does not provide a performance measure. In fact, securities lending benchmarks and performance comparisons are difficult to produce. Furthermore, each lender faces different collateral requirements that affect the performance of the transaction. The securities lending industry also does not have a central database that collects measurable data.

Some of the need for information has been met with the emergence of comprehensive tools that enable sponsors to see their absolute performance and compare their performance to that of their peers. With the quantification of risk and performance, sponsors and their agents can understand their performance on a risk-adjusted basis, facilitating a better appreciation of the correlation of risk and returns. The measurement of risk and reward will continue to fuel the growth, transparency, and acceptance of securities lending as a viable option that adds to the overall capital markets along with plan sponsors and their participants. Sponsors will also benefit from the ability to be flexible with the mix of collateral they are willing to accept, and the level of collateral margin permissible. ■

1. The three main methods for calculating portfolio VaR are Monte Carlo simulation, historical simulation and parametric.