

Few players fully ceasing securities lending to hedge funds, panel says

Margin requirements for securities lending likely to increase

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by Megan Harman

The credit crisis is fuelling a wave of concerns and a flight of securities lenders from the hedge fund industry, but much of the alarm is based on misinformation, a panel of industry members said on Tuesday.

Speaking at an Alternative Investment Management Association event in Toronto about securities lending and prime brokerage, the industry players said the public at large has a false impression of short selling. Widespread attention on the role short selling has played in recent market deterioration has further underlined this impression, they said.

"Short sellers have been largely blamed for the problems out there," said James Slater, senior vice-president of capital markets at CIBC Mellon. "I don't think that in all cases the evidence supports that hypothesis." He said that although short selling creates some short-term volatility, academic research shows that its effect is ultimately neutral to stock prices.

Furthermore, during the recent ban on short selling of certain stocks in the United States and Canada, both the New York Stock Exchange and the IIROC witnessed a heightened level of stock market volatility. "There were unintended consequences," Slater said.

The Securities and Exchange Commission recognizes short selling as a strategy that can benefit the market by mitigating market bubbles, increasing market liquidity and limiting upward price manipulations, among other ways, pointed out **Chris Guthrie, president and CEO of Hillsdale Investment Management**.

The recent turmoil has driven down the level of lendable assets for short selling in both Canada and abroad, according to Slater. Between Sept. 1 and Oct. 31, the value of assets available for loan globally fell 20% from \$14.6 trillion to \$11.7 trillion. In the same period, the assets fell by a similar 18.5% in Canada, from \$1.1 trillion to \$897 billion.

This is largely thanks to new concerns among lenders, including counterparty default, the strength of the parties providing indemnities, cash collateral, and others. But despite trimming their lending, Slater said few players are fully ceasing their securities lending practices.

"There are some market participants that are withdrawing from lending, but it is certainly by no means a mass exodus. The majority of players are still staying in the market," he said.

In the same period as the decline in lending, the value of assets on loan fell 26% around the world, from \$2.8 trillion to \$2.06 trillion, and fell 28% in Canada, from \$164 billion to \$118 billion. This rapid drop is likely a result of firms de-leveraging, according to Slater.

The credit crisis will likely have long term implications for the hedge fund industry, the panelists said. For instance, many prime brokers have already implemented such changes as raising stock borrowing fees and demanding higher quality collateral, according to Colin Bugler, head of global prime brokerage at RBC Capital Markets.

Margin requirements for securities lending are also likely to increase as industry players begin to reassess the risks and rewards involved in lending for short selling, Bugler said. He also expects some significant changes in regulation of the industry, including more oversight and leverage provision. A boost in regulation could also result in greater transparency in the realm of hedge funds and short selling, which could ultimately benefit the industry, according to Guthrie.

"This is part of the movement towards opening up what is quite a legitimate activity to begin with," he said.

In the meantime, most hedge fund managers are likely to begin re-leveraging in the near future, assuming the markets settle down, Guthrie said.

"Most hedge funds, if they aren't caught having to sell securities and liquidate their clients' holdings, are really patiently waiting, ready to leverage up to twice where they are today, typically," he said.