J.P.Morgan

J.P. Morgan Agency Securities Lending

Securities Lending During Periods of Volatility

March 2020

As financial markets continue to face unprecedented levels of volatility due primarily to the COVID-19 pandemic, J.P. Morgan, as your Securities Lending Agent, is committed to closely partnering with each of our valued clients to help them navigate through these challenging times.

It is widely recognised that securities lending is an important part of an established capital markets system contributing to more efficient and orderly markets, facilitating price discovery and assisting with the provision of market liquidity - critical in these turbulent market conditions.

At the same time, however, J.P. Morgan acknowledges that during these uncertain times clients may be seeking reassurance that both risk and performance across their programme continues to be monitored closely, within the safety of J.P. Morgan's robust and diligent control environment. Further, we recognise that some of our clients may want to temporarily adjust their programme parameters to reflect changing risk preferences.

We have created this briefing note with which to address many of the important questions and considerations our clients may have at this time.

Is short-selling a major contributor to the current volatile market conditions?

- The topic of shortselling is currently causing considerable debate amongst market participants, specifically, about the current levels of short selling activity and the impact it may be having on the current market volatility. As part of this debate it is important to consider that there are a number of other factors which are contributing to the current market conditions, including the COVID-19 pandemic, tensions between global oil producers and the de-risking of portfolios by long holders, which can happen when markets are close to all-time high levels.
- The current market turbulence raises the question of whether securities lending may be acting as a supply for short selling. Firstly, we would like to highlight there can be multiple reasons to borrow a security, including allowing the facilitation of an efficient settlement process by preventing failed deliveries, hedging strategies or mobilising securities that can then be delivered as eligible collateral. Furthermore, in recent times we have seen the role of securities lending evolve to become a primary part of a firm wide liquidity management process as clients increasingly search for secured financing solutions that will enable them to run their business as efficiently as possible. It is therefore clear that securities lending plays a vital role in the well-functioning of the secondary markets in more than one way, and its purpose is not limited to only acting as a supply for short selling.
- Secondly, it should also be noted that short-selling is a regulated market practice which helps stock markets function effectively and is considered vital to improve the depth and liquidity of capital markets. Further, studies conducted by various industry and academic organisations[1], including one conducted by the U.S. Federal Reserve[2], have concluded that short selling does not systematically cause a lowering of asset prices, and, in fact, short selling bans can often have unintended consequences on market liquidity. Specifically, studies following the 2008 bans showed that the loss of liquidity led to wider spreads which ultimately means higher costs of trading for investors.
- We are aware that a number of measures are currently being taken by different countries to limit the levels of short selling during this period, and J.P. Morgan is monitoring these changes closely to assess any implications these may have for clients in the lending programme.

What controls or safeguards are in place to manage counterparty credit during this period of volatility?

- J.P. Morgan has various safeguards in place to manage counterparty credit risk effectively for clients during this period of heightened volatility, including leveraging the expertise and credit risk management resources of the J.P. Morgan Corporate and Investment Bank.
- All loans within the programme are fully collateralised, with only high quality collateral types accepted, with haircuts ranging from 2% to 10%. Loans and collateral positions are marked to market daily using market standard pricing sources and margin levels designed to adequately cover market volatility for cross currency loans and collateral markets.
- During the current market turbulence, additional monitoring of marks has been introduced, together with increased intra-day check points with tri-party collateral managers, to allow for the identification of any early issues with collateral coverage.
- We will swiftly respond to the situation should there be any concerns identified. We have various risk management options available, recently enhanced through our ongoing investment in new pre and post trade technology across our business, including but not limited to, the ability to amend collateral haircuts as well as adjustments to concentration limits.

Can clients amend lending parameters to manage the risk profile of their programme during this period?

- The J.P. Morgan programme provides clients, at all times, with the flexibility to adjust their approved programme parameters to align with their current risk preferences, whether that is restricting lending to selected markets, and asset classes or the implementation of lending limits to prevent exposure above certain risk tolerances. Furthermore, clients are able to tailor the collateral accepted on their loans by restricting single securities, as well as amend their approved counterparties and transaction types (e.g. restrict term lending).
- For clients participating in our cash reinvestment programme, we would like to reassure such clients that the activity continues to be managed within the investment guidelines as set by them and, similar to non-cash collateral eligibility, clients are able to amend these guidelines to align with their current preferences.

1 - Short-selling bans in the crisis: A misguided policy Marco Pagano (University of Naples), Alessandro Beber (Cass Business School) - February 2010

2 - Market Declines: Is Banning Short Selling the Solution - Federal Reserve Bank of New York; Robert Battalio, Hamid Mehran, Paul Schultz - September 2011

- This flexibility enables clients to achieve a reduction in exposure without having to apply a full programme suspension, which would not only disrupt clients' revenue stream, but also adversely impact the provision of market liquidity at a time when the financial markets require it the most. Dedicated relationship managers will work closely with clients during this period to set out the various options available in order to assist clients in evaluating the performance impact of proposed changes using our latest revenue predictive analytical tools.

Is the increase in the volume of sales transactions across the market, giving rise to an increased client sale fail risk?

- One of the greatest advantages we have is our global scale and international operations, giving us the ability to shift work and resources as needed. Our follow-the-sun model for many of our core functions and worldwide locations means that we can serve clients around the clock. During periods of the day, we are often operating in multiple sites simultaneously allowing timely processing and settlement of loan recall instructions to ensure minimum disruption to client activity.
- J.P. Morgan continues to monitor global markets for updates in settlement practices to ensure that we are managing risk effectively for our clients. Leveraging the strength of our extensive agent bank network, clients should be assured that we are able to respond swiftly to market updates, implement necessary changes, and we will continue to share relevant information with our clients.
- Lastly, we would like to highlight to our clients that where market volume driven settlement delays occur creating financial penalties or buy-ins, J.P. Morgan will continue to work with counterparties to recover costs or penalties that may be owed to the client.

There are a number of significant regulatory implementations scheduled for 2020 – will these still go ahead?

- The regulatory agenda for 2020 is dominated by a number of key implementations impacting our clients, notably Central Securities Depository Regulation (CSDR) and Securities Financing Transactions Regulation (SFTR). J.P. Morgan continues to plan implementation against original dates until formal changes are announced. In parallel we are monitoring for updates and working in conjunction with industry bodies to engage with Regulators where necessary.
- We understand this information is important for our clients, and your Relationship Manager will share more details with you as soon as they are available.

You Can Rely on J.P. Morgan

- Despite the challenging financial markets and the various resiliency measures in place across the globe, the global securities lending team remains on-hand to provide you with the highest possible risk management and service levels you have come to expect. We are fortunate to be able to leverage the significant expertise and resources of the wider J.P. Morgan franchise as the situation evolves.
- We will continue to share information as it becomes available. Please do not hesitate to contact us if you have any further questions or concerns.

For more information please contact your J.P. Morgan Agency Securities Lending Relationship Manager.