

Loan spreads indicative of unique risks in cash-based lending programs

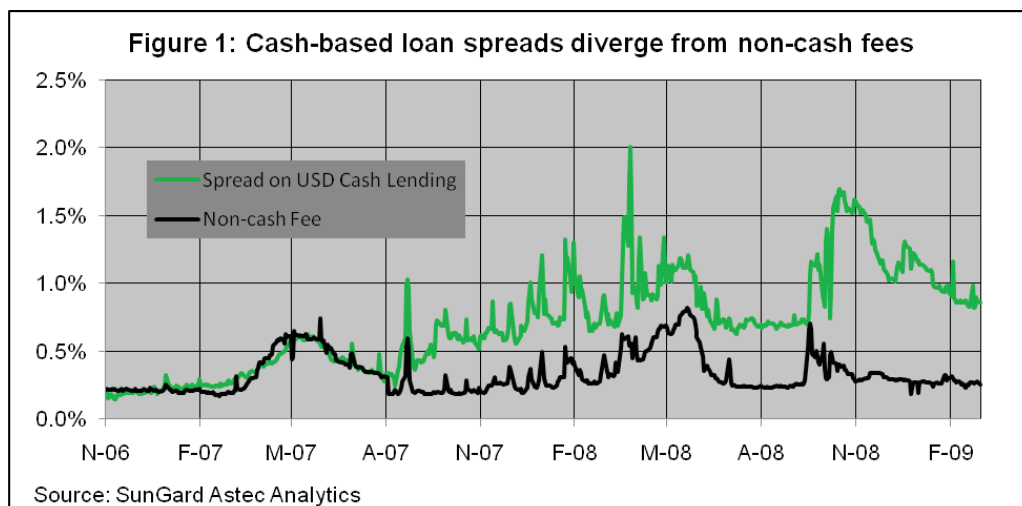
By Andrew Shinn, CFA

Lenders in the U.S. have traditionally insisted on receiving cash collateral while European and Asian lenders have preferred to receive non-cash. The difference in lending styles was mainly a matter of academic debate before the credit crisis. New data from SunGard Astec Analytics demonstrate the real differences in the risk-return profiles of each lending method.

As seen in Figure 1, before the credit crisis, cash-based loan spreads closely tracked fees from non-cash lending. Cash-based lenders have traditionally invested their collateral into short-term assets with strong credit ratings so they could quickly adjust to changes in interest rates. Arbitrage between cash/non-cash lending programs ensured that fees were similar.



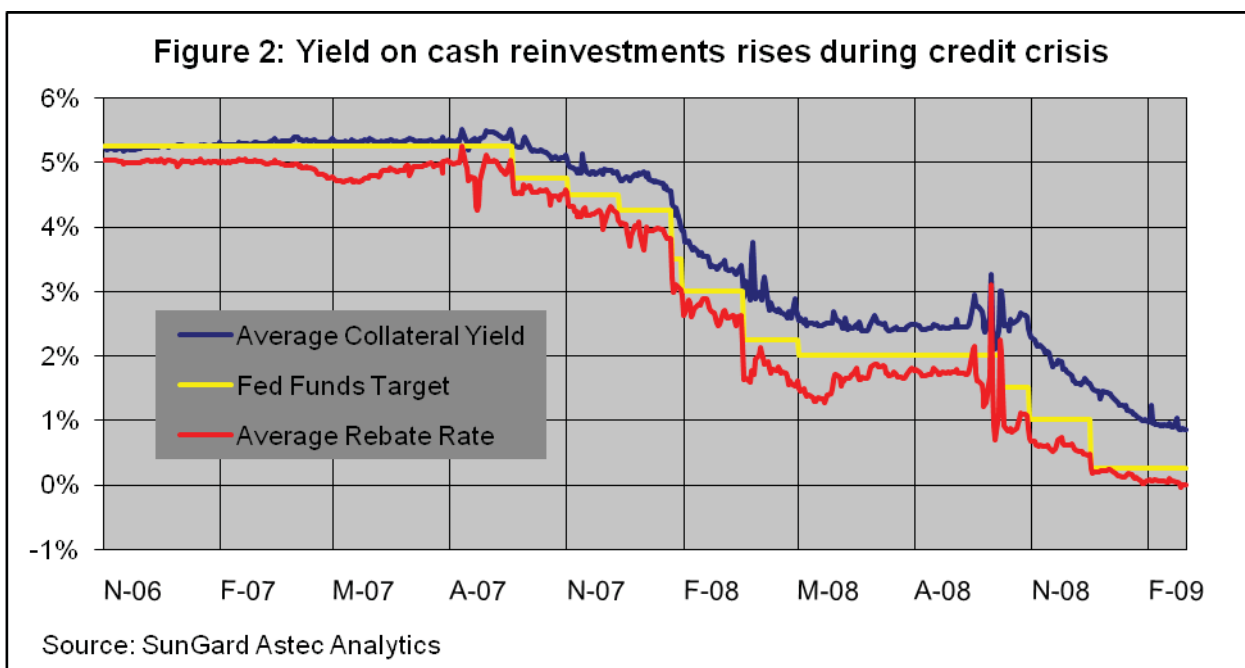
Something changed several years ago, however, as cash-based lenders began to take on more risk in return for additional yield on the reinvestment side. In order to earn higher yields, lenders went further out on the yield curve and purchased lower-quality debt instruments, a move that some lenders now regret.



As we now know all too well, the credit crisis drove down the prices of collateral reinvestments, boosting yields as seen in Figure 2. With higher yields, cash-based loan spreads increased. Fees, however, didn't increase along with spreads when the credit crisis accelerated in August '07. The non-cash fee displayed the "true" borrowing cost, while cash loan spreads were inflated due to markdowns in collateral reinvestments.

Despite the newspaper headlines about the few securities lending programs that invested in mortgage-backed securities, most lenders did not invest in those now-depressed assets. Most reinvestment assets were marked down because of reduced liquidity. Since the assets in question continue to have relatively strong credit, if lenders are able to hold them to maturity, they should be made whole.

We will undoubtedly see the average cash-based loan spread converge with non-cash fees again over the next couple of years. Once the liquidity-constrained reinvest assets are off the lenders' books, it remains to be seen what changes will be made to the cash-based model.



About SunGard Astec Analytics

SunGard Astec Analytics is a research company specializing in market information services for the global securities lending industry. Astec Analytics services also integrate with SunGard's leading solutions for US and international securities finance, including the Loanet, and Global One real-time multi-currency solutions for international securities lending and Martini, a real time trading platform for bond and equity securities financing.

To contact an Astec Analytics solution specialist: +1 212 514 8340

©2009 SunGard

SunGard, SunGard Astec Analytics and the SunGard logo are trademarks or registered trademarks of SunGard Data Systems Inc. or its subsidiaries in the U.S. and other countries. All other trade names are trademarks or registered trademarks of their respective holders.

www.sungard.com