



## MEMORANDUM

To: PCA Clients

Date: May 17, 2010

From: John J. Burns, CFA  
Managing Director

Re: Securities Lending Collateral Pool Investments

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Recent economic turmoil has exposed the fragility of the global banking system. One possibly overlooked area is pension funds which may have exposure in their securities lending cash collateral pool. We believe the recent events are possibly the beginning of a series of tests of confidence in the global financial/banking system. **Therefore, we believe it is warranted that clients have a discussion with their securities lending agent(s) on the risks in the cash collateral pool and their actions to mitigate such risks.** At the very least clients should be aware of the risks and be comfortable with the exposure.

The Greek sovereign debt crisis and subsequent rescue package has highlighted the fundamental weakness of several European nations' finances. Heavy debt loads and structural fiscal deficits have exposed fundamental contradictions inherent in the European Monetary Union (EMU). Investors are questioning the survival of the EMU and the Euro as a viable reserve currency.

European banks have substantial exposure to Greek, Spanish, and Portuguese sovereign bonds. A default or restructuring of these debts would have a severe impact upon the European banking system that could force yet another government-led bailout and force the banks to recapitalize. In addition, there could be a contagion to the global banking system if inter-bank lending was to cease up and liquidity disappear.

Therefore, we recommend clients ask their securities lending agents the following:

- Provide a detailed accounting of European Sovereign Debt exposure and European Bank Debt exposure, including:
  - Market Value, maturity date schedule, recent and pending rating change (external and internal ratings).
  - Is there exposure to European banks' local subsidiaries in Greece, Spain or Portugal?
  - Are any positions impaired?
- How are they managing the exposures above?
  - Are there plans to lower the exposure?

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- If there are impaired holdings or they expect them to become impaired, are there plans to sell positions and limit potential losses from this exposure?
  - Are there any instruments invested in foreign countries where local borrowers are making interest payments in U.S. dollars?
    - A sharp rise in the dollar could make repayments more difficult for the borrower. (i.e. Iceland's inability to pay off non-krona denominated debts to foreigners when their krona was devalued).
    - How is this exposure being managed?
  - Given the prospect of increased inter-bank illiquidity, how is the collateral pool's liquidity being managed relative to account guidelines?

Clients should remember they bear the investment risk of cash collateral pool investments. Lending agents may have incentives to ride out the crisis which could conflict with the client's desire to limit losses in the program. Finally, the current market environment is marked by uncertainty. It would seem prudent that this is not the time to be taking risks in a leveraged product.