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Securities Lending Today

What Retirement Program Fiduciaries Need to Know

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Executive Summary

Securities lending is alive and well in today's asset management and retirement industry. It involves the process by which an agent (e.g. custodian) acting on behalf of an asset owner (e.g. mutual fund) lends its securities to a borrower (e.g. broker-dealer acting on behalf of an investor). ***The main purpose of lending is to generate additional income for the fund, which in turn is used to reduce management fees and expenses paid by participants. While there is a clear benefit to securities lending, it also introduces risks such as counter-party and collateral re-investment and liquidity risks.***

There is a resurgent interest in securities lending presently, especially with an increase in money market and short-term yields having taken place and expected to continue. The great recession of 2008-2009 led to regulatory and industry re-examination of securities lending programs. This has had significant impact on the current state of lending, resulting in a more diligent risk management effort in lending programs utilized in most funds participating in lending today.

PlanPILOT's goal is to provide an assessment to help you understand the impact of securities lending, its benefits and risks, on your retirement investment program now and going forward.

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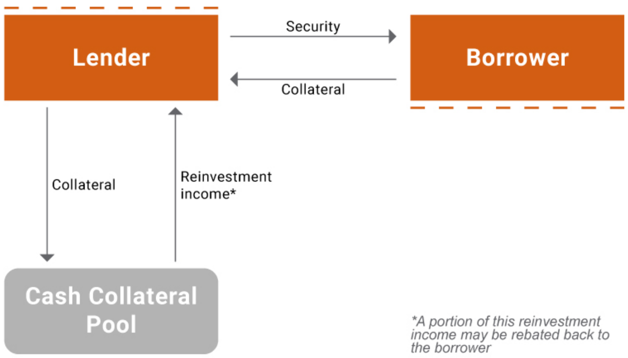
Refresher on Securities Lending Process

Securities lending has been present in funds for over 40 years. Simply described, lending is a process that involves a few parties:

- an asset owner (the fund owning the securities),
- the fund's board and investment manager with discretion over the fund,
- a lending agent, often a custodial bank, hired by the fund fiduciaries to administer the program,
- counter-parties, usually broker-dealers acting directly as market makers or
- on behalf of borrowers (typically investors needing a security, often to cover a short position, like a hedge fund).



In the typical transaction, the underlying investor, through the counter-party, agrees to borrow a security temporarily from the fund in exchange for posting collateral, typically cash (but can also be other securities, like U.S. Treasuries or money market securities). U.S. securities on loan are typically collateralized at 102%, while foreign securities are at 105%. The value of the collateral is mark-to-market daily and adjustments are made in order to maintain the collateral-to-loan value.

Cash collateral is invested in money market instruments generating additional income. This income is split between the borrower and the fund, and the fund's portion is shared in part with the lending agent as its fee.

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The benefit to the borrowers is the ability to efficiently cover their short position in the security via this short-term loan, rather than purchasing the security outright. This process provides liquidity and effective functioning to the markets.

The benefit to the fund is generating income on the spread negotiated with the borrower on the income earned on the cash collateral (or a direct fee paid by the borrower on non-cash collateral). This additional income is used to offset management fees and fund expenses, which in turn benefits your participants invested in the fund.

Intermediate-Term History

While securities lending has been around for multiple decades, it gained greater attention during the great recession of 2008-2009. A number of financial firms entered bankruptcy and/or were acquired by other institutions, and many received government funding to avoid liquidity issues. Perhaps most notably, the collapse of Lehman Brothers in 2008 demonstrated the potential downside of counter-party risk.

During the credit crisis, market liquidity was significantly impacted by credit concerns affecting many financial institutions. Particularly impacted were short-to-intermediate term fixed income instruments. To avoid having to liquidate these positions during the crisis period, many funds instituted redemption limits. Some fund sponsors made cash contributions to their funds to avoid any potential losses. This brought to light the collateral re-investment and liquidity risks present in lending.

As a result, some funds stopped participating in securities lending, and some plan sponsors switched from funds in lending to those non-lending. In response, the financial industry made some important changes to lending programs, which has produced a better return / risk trade-off in existence today.

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How Securities Lending Has Evolved Since

Securities lending has evolved in the last several years. Particularly, the following key changes have taken place:

- **Counter-parties.** Lending agents are engaging in greater due diligence of the credit worthiness of the counter-parties and borrowers, similar to the credit analysis that would go into the decision to making them a loan. Many lending agents limit the counter-parties they will work with.
- **Negotiated terms.** Lending is more focused on the "intrinsic value" of the loan, meaning negotiating the spread shared by the borrower and the fund. Programs are focusing increased attention on lending "specials" or harder to find securities that allow the lender to keep more of the spread on the income earned on cash collateral (or charging a higher fee when receiving securities as collateral).
- **Collateral re-investment.** The investment of cash collateral has moved toward money market instruments. In fact, funds typically now use a money market vehicle or securities following the SEC's requirements. Rule 2(a)(7) of the Investment Company Act of 1940 limits the maturity of any security, weighted average maturity and weighted average life of the portfolio, credit exposure to higher quality instruments, and liquidity requirements.

Current Benefits of Securities Lending

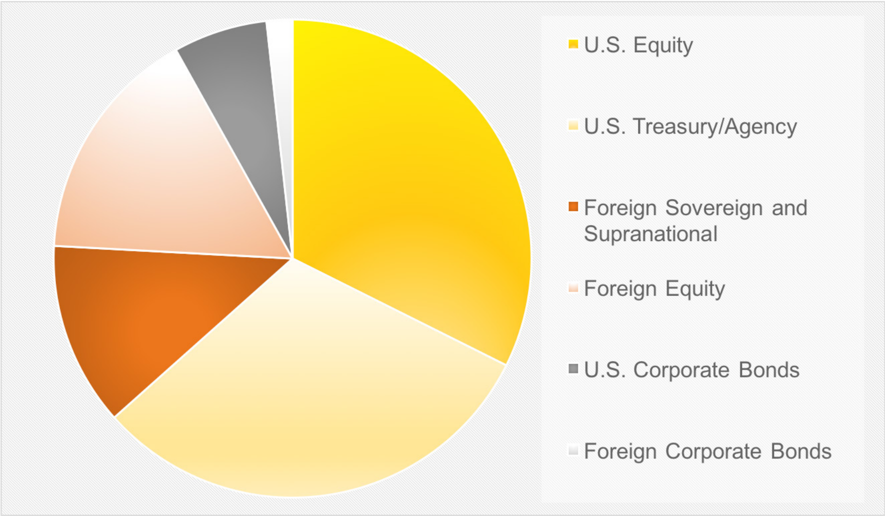
It is estimated that the aggregate securities available for lending globally now exceeds $16 trillion, and that $2 trillion on average is on loan.[1] Investment funds and retirement plans account for more than half of the approximately $10 trillion of lendable assets in the U.S.[2] Funds are limited by the SEC to having no more than one-third of their assets on loan at any time in order to maintain a 300% coverage ratio of fund asset value to securities on loan, so while having significant lendable assets, funds are limited in their actual participation (usually much less than the allowable limit is actually on loan)[3].

1 Paul Walsh, "Global securities lending hits $2 trillion mark," Global Custodian, https://www.globalcustodian.com/Securities-Finance/Global-securities-lending-hits-$2-trillion-mark, March 13, 2017

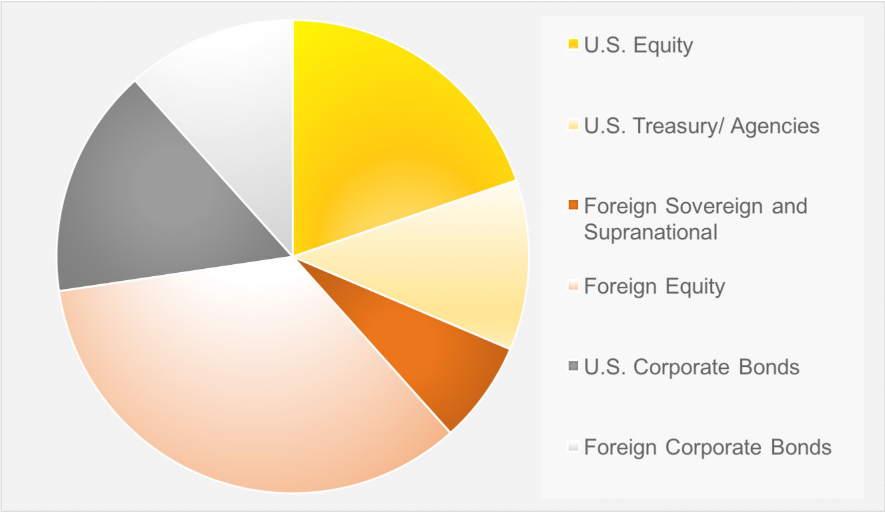
2 Viktoria Baklanova, Cecelia Caglio, Frank Keane, Burt Porter, "A Pilot Survey of Agent Securities Lending Activity," https://www.sec.gov/files/Porter_PilotSurveyAgentSecuritiesLendingActivity, August, 2016

3 U.S. Securities and Exchange Commission, "Securities Lending by U.S. Open-End and Closed-End Investment Companies," https://www.sec.gov/divisions/investment/securities-lending-open-closed-end-investment-companies, February 27, 2017

Most of the securities on loan in today's environment are as follows (in asset size order)[4]:



In contrast however, with the added focus on negotiating the spread of harder to lend securities, the highest level of income is generated from the harder to find securities (in income generated order)[5]:



4 Baklanova, Caglio, Keane and Porter, "A Pilot Survey of Agent Securities Lending Activity" Page 8
5 Baklanova, Caglio, Keane and Porter, "A Pilot Survey of Agent Securities Lending Activity" Page 11

The income earned by a fund is a function of the income earned on the re-invested collateral and the negotiated rebate rate between the borrower and lender. In North America specifically, it is estimated that $4 billion of lending revenue was earned in aggregate in 2016[6]. Net of the lender's fees for administering the program (which can run as high as 50-70% of the income earned), **a fund typically receives a net return of single basis points** depending on the type of securities the fund owns. This added income typically allows funds utilizing lending to **charge a lower management fee on the fund, thus producing cost savings to the participants** choosing to invest in the fund.

Current State of Risk Management

A well-run lending program for a fund follows the guidelines established by the SEC:

- No more than one-third of a fund's value on loan.
- Collateralization at 102% of U.S. instruments and 105% on foreign securities.
- Daily mark-to-market valuation of the collateral to maintain those levels.
- Loans are terminable by the lender at any time and securities able to be re-called in ordinary trade settlement periods.
- Cash collateral invested conservatively in money market funds or instruments to earn a reasonable return.
- Lending agent being independent of the fund to avoid potential conflicts of interest.
- Program approved and periodically approved by the fund's board.
- Disclosure in fund's prospectus and statement of additional information. [7]

It is important to review any securities lending program to ensure it is managed with an appropriate return / risk balance by an experienced lending agent under the independent supervision of a fund's fiduciaries.

6 Walsh, "Global securities lending hits $2 trillion mark"

7 Bob Grohowski, "Securities Lending by Mutual Funds, ETFs and Closed-End Funds: The Basics," Investment Company Institute, https://www.ici.org/viewpoints/view_14_sec_lending, September 15, 2014

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Conclusion

Securities lending has evolved in meaningful ways to become better risk managed in today's environment. As with any investment program, it is important to understand the risks involved. The anticipation of higher short-term yields increases the potential income that could be earned. That income is an important off-set to a fund's fees and expenses, thus benefitting the retirement plan's participants.

Fiduciaries with responsibility for a retirement program need to be aware of the presence of securities lending in its funds, and the return and risk characteristics of the lending program that impact the plan participants. To discuss further, please feel free to contact your consultant team at PlanPILOT.

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