Securities Lending

Bridging the Funding Gap in the Public Sector

Securities and Fund Services

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Securities Lending: Bridging the Funding Gap in the Public Sector

It is no secret that some Public Sector institutions have come under economic strain following the financial crisis. With falling revenues, rising costs and limited resources, a number of Public Sector institutions have a reduced set of options at their disposal. Despite a significant recovery in the global markets and the U.S. economy as a whole, these entities are faced with overcoming past underperformance and low government bond yields. New challenges are combining that force institutions to protect their fiscal stability, including historic underfunding, an increase in retirees from the 'Baby Boomer' generation, and a general increase in pension costs.

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Public Sector Institutions Face Challenging Environment

By any measure, the recent recession has been felt far and wide across America. Public Sector institutions seemed to get hit on all sides. As economic activity slowed, revenues from business and income taxes fell; investment portfolios declined in value; and expenses rose, as pension costs spiked. National unemployment briefly topped 10%, with considerably higher joblessness in some local communities.

As recently as fiscal year 2010, 39 states made $18.3 billion in mid-year budget cuts.[1] Although the picture has since improved, revenues remain 7.9% below FY 2008 levels in real terms,[2] and retirement obligations to public employees remain a key concern. According to Milliman, Inc., a global actuarial firm, adjusting for aggressive return assumptions, the 100 largest public retirement systems in the U.S. have unfunded liabilities of $1.2 trillion, or $300 billion more than the pension funds have actually reported.[3] Furthermore, the cost of providing Other Post Employment Benefits (OPEB), especially healthcare, has skyrocketed, creating an additional drain on resources. The average premium paid for employer-sponsored healthcare plans rose 13.4% for the two years ended December 2012, while the consumer price index rose just 4.8%.[4]

Government pension fund managers are under increasing pressure to source new contributions to meet the funding gap. Given these challenges, in FY 2013, 20 states looked to raise revenues by tapping rainy day funds, privatizing state assets, expanding gambling or the lottery system, or other creative means.[5]

Solutions for Public Sector Institutions Enter the Spotlight

Against this backdrop, many Public Sector institutions are eager to find solutions that can provide additional income without taking undue risk. A well-crafted securities lending program can provide valuable incremental income for states and municipalities.

[1]"The Fiscal Survey of States, Fall 2010," National Association of State Budget Officers
[2]Ibid.
[3]"Study: Public Pensions Underfunded by $1.2B," Reuters, October 15, 2012
[4]Kaiser Family Foundation, Health Research and Education Trust, Bureau of Labor Statistics
[5]"The Fiscal Survey of States, Fall 2012," National Association of State Budget Officers

A lending agent delivers the lent securities to approved borrowers. In return for lending these securities, the lender receives collateral of least 100%, which can take the form of cash or securities.

While some Public Sector institutions have earned significant amounts lending their securities, others may be less familiar with this solution. Securities lending is typically defined as a transaction in which the owner of securities (e.g., state treasury or pension fund) agrees to lend its securities to a borrower in exchange for collateral consisting of cash or securities. The framework for this transaction is governed by a formal contractual document.

A lending agent delivers the lent securities to approved borrowers. In return for lending these securities, the lender receives collateral of least 100%, which can take the form of cash or securities. The lender may receive a premium that is dependent upon the demand for the securities being lent. If the collateral posted by the borrower takes the form of cash, the lender also has the potential to earn additional revenue by reinvesting that cash.

Importantly, the lender retains the economic benefits of the security (including price appreciation and dividends, if any), and can sell the security, which, subject to timely notice, will be returned within normal settlement periods. The term of a securities lending contract can be customized at the discretion of the lender with duration as short as overnight. At the end of the loan, the broker returns the securities and the agent returns the collateral. The lender and the agent share in the revenue from the transaction. The objective is to generate incremental income while maintaining safety of principal.

It is worth stressing that while lenders of securities generally relinquish control over proxy voting, the lender can put restrictions in place to retain the right to vote proxies as they see fit. This is a major comfort for treasurers and investment officers of public funds, many of whom wish to adhere to their governance guidelines.

The range of lendable assets is quite broad, with many of these securities likely to be found in institutional portfolios. Examples of lendable assets include:

United States

- U.S. Government & Agency Securities
- U.S. Corporate Bonds (Investment Grade & High Yield)
- U.S. Equities

International (Developed & Emerging Markets)

- Sovereign Debt
- Corporate Bonds
- Global Equities

At any given time, market events or changing investor preferences can increase the demand for certain bonds or equities, thus possibly increasing the return realized from lending these securities. Since the financial crisis, some Public Sector institutions have expressed concerns about the risks of lending securities and management of cash collateral. However, agent lenders offer flexibility and customization in this regard. "Lenders have the ability to specify how their collateral is managed," says David Martocci, Global Head of Securities Finance, Citi. "The lender can select collateral investment criteria that are consistent with their fund's underlying investment guidelines and risk profile," he says.

Securities lending continues to rebound post-crisis. Institutions who have never lent before are lending for the first time and institutions that exited lending have come back with robust programs. To further illustrate this point, the Options Clearing Corporation (OCC) reported that its securities lending central counterparty activities in April 2013 saw a 53% increase in new loans versus one year ago.[6]

[6]OCC's Lending CCP Rises by 53 Percent, Securities Lending Times, May 2, 2013

Securities lending offers incremental investment income, typically anywhere from 20 to 300 basis points of return for assets on loan, but possibly more for securities in high demand.

In addition, according to Finadium, in 2012, 75% of U.S. pension plans engaged in securities lending, with four large plans restarting their programs. This is up from approximately 55% in 2008.

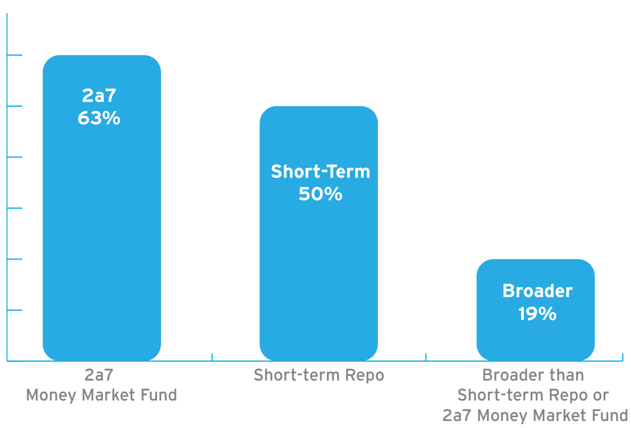
Faced with difficult budgetary decisions, many Public Sector institutions are returning to securities lending. Public Sector institutions realize that securities lending can be treated as an investment decision, and are taking greater ownership and control of their programs. They also see the opportunity cost of not participating in lending and this is for good reason. Securities lending offers incremental investment income, typically anywhere from 20 to 300 basis points of return for assets on loan, but possibly more for securities in high demand. According to Josh Galper, Managing Principal of Finadium LLC, "Securities lending has stabilized to offer a steady stream of modest basis point returns to conservative asset holders."[7] He adds that, "The most important decision today is that asset holders understand the risk/reward trade-offs of their cash collateral investment options."

Flexible Solutions

Today, agent lenders have taken a flexible approach to securities lending by offering a variety of lending arrangements:

- Custodial Lending: Agent bundles custody and securities lending.
- Third-Party Lending: Agent lends assets held with a third-party custodian.
- Flexible Collateral Alternatives: A number of customized options for cash and non-cash collateral should be provided to the beneficial owner.
  - For cash, beneficial owners typically place their collateral in short-term reverse repurchase agreements (repos), 2a7-like investment vehicles, or they customize their reinvestment guidelines.
  - Optionally, for collateral management in the industry includes:
    - Agent manages the cash;
    - Lender can take the cash in-house;
    - Lender can have a third-party advisor manage their cash.
  - For non-cash collateral, the beneficial owner should have the option to select which types of collateral (e.g., fixed income and/or equities) to accept in the transaction.

Exhibit 1:
Beneficial Owner Investment Types for Securities Lending Cash Collateral



Source: Finadium
Note: Institutions may invest in multiple cash collateral types

[7]Securities Lending is Back, Plan Sponsor, April 2013

The agent should offer a robust monitoring program designed to demonstrate compliance with these guidelines as well as complete transparency for all collateral portfolios.

So exactly what are the financial benefits of securities lending once the program is in place? Assuming that 20% of a $4 billion portfolio is on-loan, a net securities lending return of 62 basis points would yield $4,960,000 in gross revenue (to be split between the beneficial owner and agent lender). In today's economic environment, this is a considerable contribution to reducing fund expenses and increasing performance.

It is not only the largest states and municipalities that can benefit from securities lending. Although 89% of large institutions participate in lending, according to Finadium, the experience of institutions with moderate securities lending programs is illustrative. For instance, one public plan investment officer recently told Finadium, "$25 million over ten years adds up to real money."[8]

When constructing a securities lending portfolio, several aspects should be considered. Three of the key factors for lending are risk management, customization and transparency.

Risk Management

Though painful, the experience of the financial crisis taught many market participants the importance of a good risk management program. In securities lending, there are four main risks, namely, counterparty risk, collateral risk, operational risk, and legal or contractual risk. Fortunately, a strong securities lending program should have specific controls and processes in place to mitigate these risks.

Counterparty Risk

The agent should have a careful credit review process for all borrowers, and lenders should select their borrowers from a list pre-approved by the agent. All loans should be fully collateralized, and loan values should be marked to market each day to ensure the proper amount of collateral for each loan. Additionally, the agent should have a robust process in place in the event of a default scenario, and should provide indemnification against borrower defaults.

Collateral Risk

The lender should have full control over the collateral requirements and reinvestment program. Clients should have the ability to define cash collateral investment guidelines that are consistent with their risk profile and regulatory requirements. The agent should offer a robust monitoring program designed to demonstrate compliance with these guidelines as well as complete transparency for all collateral portfolios.

Operational Risk

The agent should offer full transparency on all loan activity, including daily reconciliation and marks to market, corporate action monitoring, and business continuity planning. The agent should recall securities as per the lender's requirements and systematically restrict positions from being available for loan as directed.

Legal/Contractual Risk

A securities lending agreement (SLA) should govern all aspects of your securities lending program. The agent should track and keep abreast of all laws and regulations impacting the industry allowing the business to operate in compliance with all requisite rules and regulations.

[8] "Institutional Investors on Securities Lending and Collateral Management in 2013," Finadium, January 2013.

Clients should also note that a securities lending program can be tailored to their specific needs, either to mitigate risk or to suit client tastes.

Customization

Clients should also note that a securities lending program can be tailored to their specific needs, either to mitigate risk or to suit client tastes. Participants should have the ability to tailor both the lending and reinvestment aspects of their programs. For lending, having the ability to restrict the amount on loan for an individual security, fund or program is necessary. As for collateral, whereas a pooled investment structure is common in the industry, segregated accounts can offer clients additional protection. The parameters a client chooses to take into account normally include a number of factors, such as investment vehicles, credit rating, weighted average maturity and interest rate.

Transparency

Consistent with a movement across the entire financial sector, the financial crisis led institutions to seek further transparency into practices in securities lending. Agent lenders should provide clients a full view into their lending program, including loan collateralization and counterparty exposure. There should be tools available from providers in order to offer these checks and balances. Reporting tools can provide comprehensive analysis to monitor performance and benchmark results versus the client's objectives. Furthermore, clients should be afforded the ability to determine the true cost and scope of the services they are receiving. Some beneficial owners have separated their securities lending program from a traditional custodial lending model to one where lending is provided by a third-party lending agent. This helps to best ensure diversification, lending expertise, transparency and management focus.

Conclusion

Like many other market participants, Public Sector institutions will continue to look for ways to cut costs and increase revenues. While a securities lending program alone is unlikely to bridge the gap, it does offer a way for Public Sector institutions to move the needle in the right direction. Today's stronger risk controls, better reporting solutions, and re-focus on collateral quality make it a good time for Public Sector institutions to consider securities lending as an innovative and low-risk way to use existing portfolio balances to generate additional income.

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About Finadium LLC

Finadium is a research and consulting firm focused on financial markets.

In its research practice, the firm assists asset holders, banks and technology firms with understanding the market for securities finance and asset services, and in maximizing the effectiveness of their resources.

Finadium research is available on a subscription basis. Finadium also conducts consulting assignments on custody, securities lending and cash investments for the financial markets industry.

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