INTRODUCTION TO SECURITIES LENDING

HERTFORDSHIRE COUNTY COUNCIL

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WHAT IS SECURITIES LENDING?

- Securities lending is the act of loaning an equity, bond or other security to another investor via a brokerage firm.
  - The borrower provides collateral - in the form of highly liquid securities - against what they have borrowed (in case they don’t return the loaned security).
  - The terms of the loan are set out in a securities lending agreement which details the term of the loan, the lenders fee and the nature of the collateral.
- Securities Lending is a permitted and regulated activity in most of the world's major securities markets but can only be conducted for specific purposes.
- When a security is loaned, the **title of the security** transfers to the borrower. This means that the borrower has the advantages of becoming the full legal *and* beneficial owner of the security, without purchasing it.
- The borrower **receives all coupon and/or dividend payments, and all voting rights.** The dividends or coupons must be passed back to the lender in the form of a "manufactured dividend".

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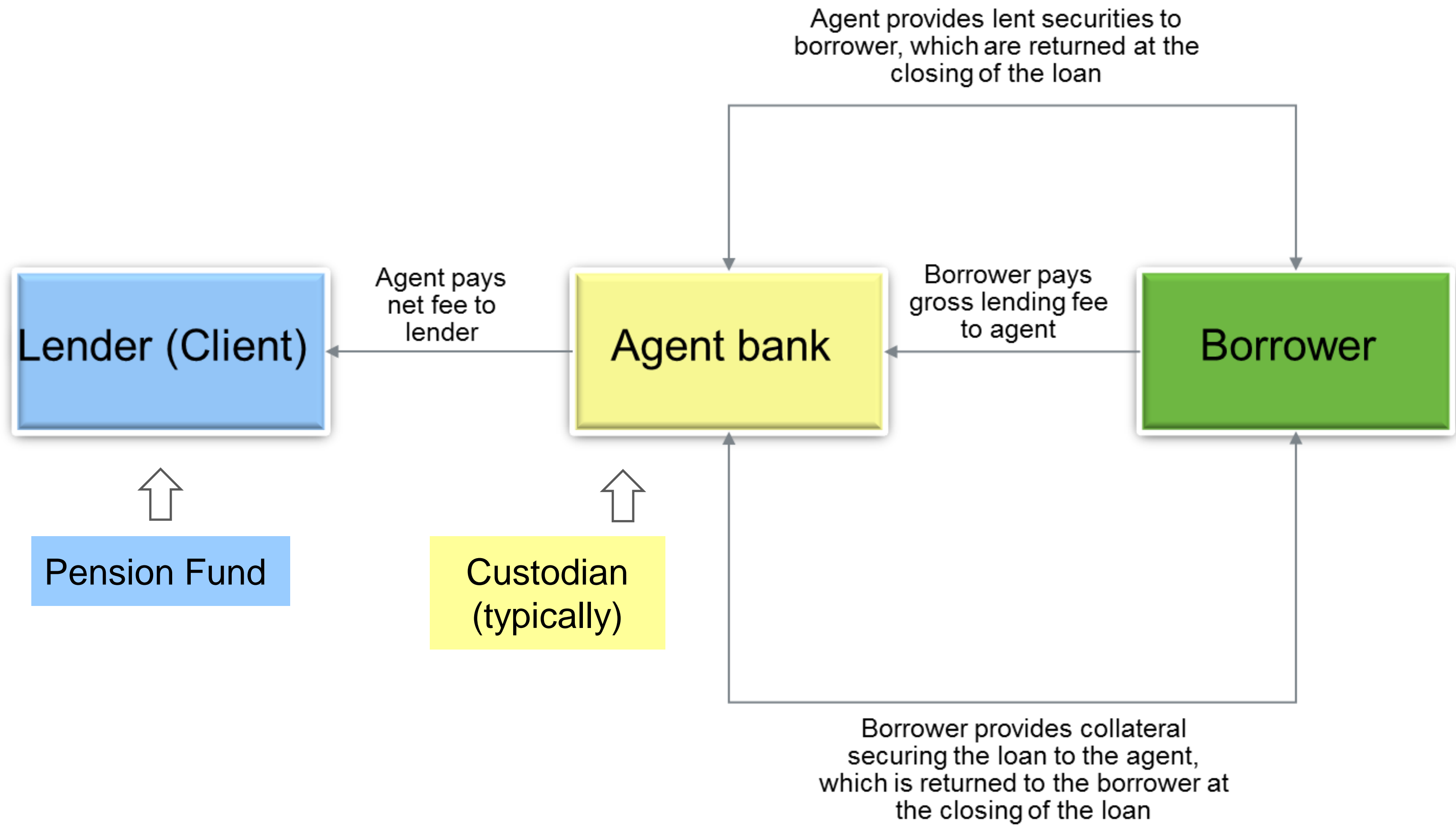
THE MECHANICS OF SECURITIES LENDING



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WHO ARE THE BORROWERS?

Who borrows equities?

- Asset managers needing to cover unexpected trade failures
- Hedge funds who wish to “short the market” will borrow equities and sell them immediately.
  - When/if the value of the security declines, then the borrower of the “short” position then will decide to buy the security back at a lower price and close the loan, whilst realising the gain.
- If the price goes up, the hedge fund may close its position by buying back the asset at the higher price and realising the loss, and returning the loan.

Who borrows fixed income?

- Banks and other financial institutions looking for high-quality liquid assets (HQLA) for balance sheet support, to lower their Risk Weighted Asset (RWA) ratios for regulatory and capital charges
- Collateral transformation trades to support OTC (over the counter) clearing collateral requirements for central counterparties
- Pension funds looking to hedge the interest rate and inflation sensitivity of their liabilities as part of “liability driven investment” strategies

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FIXED INCOME LENDING EXPLAINED

- Pension funds often hold large, stable positions of High Quality Liquid Assets (HQLA) such as UK Gilts or US Treasuries. Prior to the financial crisis, there was no demand to borrow this asset class. However, with new Basel III regulations on collateralisation and capital quality, HQLA is very attractive for lending. There are two main drivers:

  1. **Collateral upgrade:** OTC derivatives must now be collateralised in a Central Counterparty (CCP) clearing house; only HQLA is accepted. Investors who do not hold HQLA then must trade lower quality assets, such as corporate bonds or equities, against HQLA so that they can support their LDI strategies that require OTC swaps.
  2. **Term Lending**: Banks are required to maintain a high quality of risk weighted assets (RWA) to achieve regulatory risk ratio targets under Basel III regulations. The assets must be held for over 90 days in order to be considered long-term holdings for this purpose. Therefore they will borrow HQLA on a 95 day "evergreen" rolling term in order to improve their RWA rating and lower their capital charges. This attracts a much higher fee but locks up the position for 90 days or more.

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HOW DOES SECURITIES LENDING MAKE MONEY?

The asset owner (pension fund) earns **fees on the value of its loans**, based on the type of asset and its desirability, for example up to:

- 5 basis points (bps) on general collateral trades
- 20 bps on term lending of fixed income
- 50 bps on certain emerging markets equities
- 100+ bps on “specials” that are in demand and hard to find

The agent bank generally takes a gross fee from the borrower, then **splits the fee** with the lender by an agreed percentage:

- 50-50: only seen in internal bank pooled funds, quite rare
- 60-40: typically seen in pooled funds
- 70-30: more usual for segregated lenders and some pooled funds
- 80-20: for larger segregated accounts of $1+ billion of lendable assets
- 90-10: for the very largest accounts with $25+ billion

As a larger pool of assets, ACCESS should be able to negotiate strong securities lending terms

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RISK MANAGEMENT

What are the Risks of Lending?	How Lending Risks are Mitigated
Borrower credit risk	**Counterparty Management**
Securities "lending" involves a transfer of legal title to the borrower's name. The lender therefore has a credit exposure to the borrower.	The agent will have rigorous counterparty credit management. Lenders can select approved counterparties, set credit and concentration limits to spread risk.
Collateral Quality	**Collateral Management**
All loans are collateralised. Collateral selection is a critical part of the lending programme. Whether to accept cash, fixed income or equities, and the quality of the collateral, will determine the attractiveness of the lender to the borrower. There will be pressure to accept lower quality collateral in order to increase revenues.	The lender (pension fund) has the right to determine the quality of the collateral that is acceptable. The lender must seek a balance between collateral quality demanded and the attractiveness of the portfolio to potential borrowers. For example, high-quality Gilts will not be attractive to borrowers if high-quality fixed income is demanded as collateral.
Borrower default	**Over-Collateralisation**
A borrower becomes insolvent and/or is unable to return a loan on demand. This is relatively common.	Borrowers pledge collateral which has a "hair-cut" that exceeds the value of the securities on loan, typically by 102 to 105%. Lenders can raise this hair-cut for lower quality collateral, such as equities, to 108% or more. Upon default, the agent will sell the collateral and re-purchase the loaned securities in the market to make the lender whole.
Collateral Shortfall	**Indemnification**
If the borrower defaults, AND the collateral is insufficient to re-purchase the securities on loan in the market, then there will be a shortfall. This is relatively uncommon, and usually happens with lower-quality illiquid collateral that cannot be sold quickly.	Many agents, and all custodian banks as agent lenders, offer an indemnification against collateral insufficiency, and will pay the difference between the loan and collateral value in order to make the lender whole. They will mark-to-market the collateral on a daily basis in order to ensure positions are over-collateralised by the agreed haircut to mitigate this occurring.
Agent default	**Creditor**
Worst Case: The borrower defaults, AND the collateral is insufficient to repurchase the loan, AND the agent (custodian bank) becomes insolvent, all on the same day. This has never happened: even with Lehman Brothers' default, all the positions were closed within 72 hours.	When engaged in an agency agreement there is no credit exposure to the securities lending agent per se. The only exposure would be in the marginal difference between the value of the loan and the shortfall that is not covered. The lender would then become a creditor to the agent.

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WHAT WENT WRONG IN THE FINANCIAL CRISIS?

- Mis-management of cash collateral was the source of securities lending losses in the financial crisis of 2008/2009.
  - As a result cash collateral is not commonly used in Europe (although it remains common in USA).
  - European lenders primarily use a basket of equities or gilts as collateral due to the liquid nature of these assets.
- Where cash collateral is used, it is invested into a Liquidity Fund where the manager invests the cash collateral in a wide variety of fixed income securities e.g. overnight, 30 to 90 day time deposits and commercial paper.
- Longer duration Asset Backed Securities (ABS) with higher returns may be used to improve returns. In the crash of 2009, very long dated (multi-year) ABS were held and when lenders went to terminate their programs, the borrowers returned the securities and demanded their cash collateral back.
  - The collateral was then found to be held in illiquid ABS and in that case could not be liquidated. The lenders were left with large un-indemnified losses as they were obligated to return cash they did not have.

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