Securities Lending: A Tool to Generate Supplemental Income

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Introduction

In an era of lower return expectations, investors are increasingly exploring additional ways to boost returns and limit expenses. One tool that can help is securities lending, which can generate incremental income that can offset custody, administrative and management fees. In this paper, we review the mechanics of securities lending, the current market environment, and key issues to consider in implementing a securities lending program.

Securities Lending 101

Securities lending allows an investor to generate income by temporarily loaning securities to other parties, such as broker/dealers or hedge funds, which may be looking to borrow the securities to speculate or hedge risks, vote proxies, or settle failed trades. As illustrated in Figure 1, the lender (the owner of the securities) agrees to loan certain securities to a borrower in exchange for collateral that provides protection if the borrower defaults. At the conclusion of the term of the loan, the securities and collateral are returned to the original owners.

The amount of collateral required by lenders depends on the value of the borrowed securities, which are marked-to-market on a daily basis. The collateral can consist of either cash or securities: in the U.S., cash is the preferred type of collateral, while outside the U.S., posting securities as collateral is more common. For cash collateral, lenders require the borrower to post either 102 percent or 105 percent of the value of the borrowed securities, depending on whether the securities are domestic or international. If a borrower posts securities as collateral, the amount of margin (collateral in excess of the value of the securities borrowed) required is adjusted to reflect the characteristics of the borrowed securities, type of collateral, creditworthiness of the borrower, and term of the loan.

The lender generates income from this arrangement in two ways:

1. In exchange for a borrowed security, the lender receives a fee from the borrower commensurate with the supply/demand dynamics of that particular security. When cash collateral is posted, the fee received by the lender approximates the yield of a short-term cash vehicle less an amount referred to as the “rebate rate,” which represents compensation the lender provides the borrower to borrow the security. The rebate rate will be lower for securities in high demand — thus more profitable for lenders — and higher for securities in low demand. (For securities in extremely high demand, referred to as specials, the rebate rate can be negative.)
2. In addition to the revenue generated directly from loaning a security, a lender that receives cash collateral also has the potential to generate income by reinvesting that cash. When doing so, the lender’s primary goal is to generate yield in excess of the rebate rate owed to the borrower. (Accommodative monetary policies and corresponding low interest rates have been a headwind to generating returns from the reinvestment of cash collateral in recent years.) This process is illustrated in Figure 2.

Most lenders engage their custodian as the agent for a securities lending program, although third-party agency models have become more common. Under the custodian agency model, the custodian determines the borrower’s creditworthiness, loans the securities, and reinvests the cash collateral (usually through an investment affiliate). In exchange for these services, the lender and custodian contractually agree to split profits from the program. Fee splits can range from 50/50 to one where the lender receives 90 percent of the profits. According to the International Securities Lending Association, the average fee paid to lending agents is roughly 30 percent.

It is important to note that a securities lending program should not materially affect the underlying investment program. Most arrangements allow the lender to recall a security at any time, and although the borrower is entitled to dividend and interest payments while the security is on loan, borrowers often compensate lenders for these payments. While the securities are on loan, however, the borrower retains any proxy voting rights associated with the security.

**Current Securities Lending Market Environment**

As of December 2016, $15 trillion in securities were available for loan, $2 trillion of which were out on loan in securities lending arrangements. The current level of securities out on loan is lower than the peak of $2.5 trillion seen during the financial crisis in 2008. This decline in market size has been fueled by a September 2008 Securities and Exchange Commission (SEC) ban on short sales of nearly 800 financial stocks, losses experienced by lenders in cash collateral investment portfolios and the aforementioned extremely low interest rate environment in recent years that has limited the returns available from reinvesting cash collateral.
Of the securities available for loan, nearly three-quarters are either U.S. or non-U.S. equity securities while the remaining are bonds, including U.S. corporate and mortgage-backed securities, U.S. Treasuries and agencies, and non-U.S. bonds. Interestingly, while equities represent the largest pool of securities on loan, U.S. Treasuries are in the greatest demand relative to the amount of securities available for loan, as shown in Figure 3.

**Figure 3: Lendable Asset vs. Securities on Loan**
(as of Q1 2015, in trillions of dollars)

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**Issues and Solutions**

Two key issues facing lenders are counterparty risk and reinvestment risk. Counterparty risk refers to potential losses that could result from borrowers failing to return securities on loan. In reality, losses attributed to counterparty risk have been minimal historically, likely due to efforts by lending agents (custodians) to approve borrowers, set exposure and position limits, and ensure collateral is marked-to-market on a daily basis. In fact, counterparty risk is so low that most securities lending agents indemnify their clients from losses associated with it.

In terms of reinvestment risk, lenders face the risk of losses on the investment of cash collateral and are also exposed to the risk posed by a potential conflict of interest faced by their agents. Since agents share in the profits from securities lending (recall that agents typically oversee the reinvestment of cash collateral) but do not participate in losses, they may be tempted to maximize profits without regard to risk. In fact, many agents faced allegations of taking imprudent risks with such funds during the financial crisis of 2007–2008 and subsequently settled many class-action lawsuits. Regulations imposed by the SEC and the Office of Comptroller of the Currency since that time, however, have placed limits on the level of risk investment managers can take in managing money market funds and short-term investment funds, reducing the potential conflict of interest for agents of lenders that invested their cash collateral through these types of
vehicles. However, for lenders that do not invest cash collateral through either of these vehicles, it is important to establish clearly defined investment guidelines for the investment manager of the cash collateral portfolio, detailing allowed and prohibited investments, thresholds for overall portfolio quality, and the return and risk objectives. It is also important to establish a process to carefully monitor the investment manager. Generally, lenders should place as much emphasis as possible on due diligence surrounding the reinvestment process of cash collateral.

Conclusion

Securities lending programs offer investors a tool to generate income that can offset or reduce other fees associated with managing a portfolio, such as custodial, administrative and management fees, thereby enhancing the amount of portfolio assets. While memories of headline losses experienced in some securities lending programs during the financial crisis may raise questions about the effectiveness of such programs, Gallagher believes that clients may benefit from an effective program that incorporates prudent investment guidelines governing the investments of cash collateral and an effective method of monitoring the entire program.

About the Author

Joseph N. Stevens is an Area Vice President and Area Assistant Director with the Institutional Investment & Fiduciary Services practice of Arthur J. Gallagher & Co., Gallagher Fiduciary Advisors, LLC (“Gallagher”). He is responsible for working directly with clients on asset allocation, manager due diligence, investment performance analysis and attribution, stock research and various other investment related projects. He serves as a member of the U.S. Equity research team.

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