SECURITIES LENDING: AN INTRODUCTORY GUIDE

ABI Association of British Insurers

bba The voice of banking & financial services

ICMA EuropeanRepoCouncil

Investment Management Association ima

ISLA International Securities Lending Association

Local Authority Pension Fund Forum

NAPF Securing the future of pensions

SEPTEMBER 2010

This guide is a simple introduction to securities lending for anyone seeking a basic understanding of it (such as pension fund trustees). Other papers have been produced for those engaged in the day-to-day management of securities lending activities and a bibliography can be found at the end of this guide.

The guide was produced and endorsed by the Association of British Insurers, the British Bankers Association, the ICMA European Repo Council, the Investment Management Association, the International Securities Lending Association, Local Authority Pension Fund Forum, the National Association of Pension Funds and Thomas Murray. The FSA, Bank of England, HM Treasury and The Pensions Regulator also supported the development of the guide.

More information can also be found in the Lender Checklist and Agent Disclosure Code papers that accompany this guide.

WHAT IS SECURITIES LENDING?

Securities lending involves a transfer* of securities (such as shares or bonds) to a third party (the borrower), who will give the lender collateral in the form of shares, bonds or cash.

The borrower pays the lender a fee each month for the loan and is contractually obliged to return the securities on demand within the standard market settlement period (e.g. three days for UK equities). The borrower will also pass over to the lender any dividends/interest payments and corporate actions that may arise.

In essence, the lender will retain the key rights they would have had if they had not lent the securities, except they will need to make special arrangements if they want to vote on the shares. Securities lending does give rise to certain risks however, and these need to be considered.

WHY IS THERE DEMAND TO BORROW SECURITIES?

Investment banks, brokers and market makers borrow securities for a variety of reasons, including:

- to ensure settlement of trades can take place; and
- to facilitate market making and other trading activities, such as hedging and short selling.

Securities lending plays an important role in providing liquidity for the market by facilitating price formation and high settlement success helping to ensure that the financial markets operate efficiently.

Because demand to borrow exists, securities lending can be used by certain investors as a way of deriving additional income from their investment portfolios.

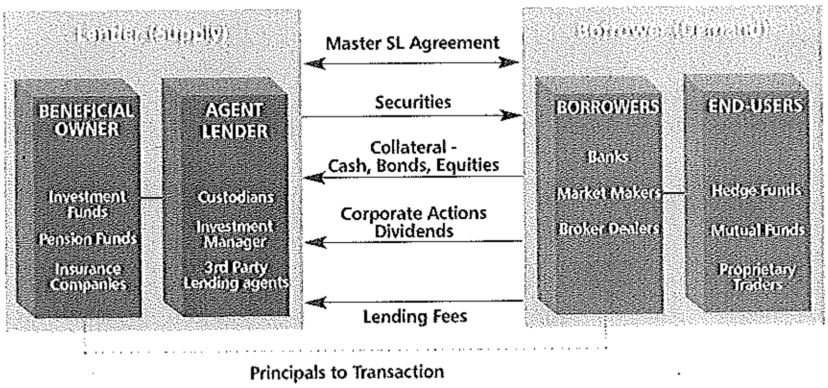
** Legally a securities loan is the transfer of title against an irrevocable undertaking to return equivalent securities. This means that registered securities such as shares, will be transferred out of the lender's name into that of the borrower and registered back when they are returned.*

WHO LENDS AND WHO BORROWS?

Lenders are typically large scale investors, such as pension funds, insurance companies, collective investment schemes and sovereign wealth funds. These investors would normally employ an agent (such as a custodian) to arrange, manage and report on the lending activity.

Borrowers are typically large financial institutions, such as investment banks, market makers and broker dealers. Hedge funds are among the largest borrowers of securities, but they will borrow through investment banks or broker dealers rather than directly from the investors.

Who Lends and Who Borrows



RISKS

As with all investment strategies, lending securities involves risks. The main risk is that the borrower becomes insolvent and the value of the collateral falls below the cost of replacing the securities that have been lent.

Table 1 describes the main risks involved when lending securities and how these risks can be managed. Where a lender uses an agent, it is the agent that manages these risks on behalf of the lender. The agent may offer some additional risk protections by providing the lender with a type of insurance (often called an indemnity). The terms of such insurance or indemnity can vary and it is important that the lender has a clear understanding of what risks are covered. Regardless of whether an indemnity is in place it is also important that the lender understands the risk issues listed below and discusses them with their agent. Lenders should be aware that whilst the lending agreement will usually strive to align the incentives of the lender and the agent, the activities of the agent should be closely monitored and agreements revisited at an appropriate frequency. Securities lending programs can usually be tailored to suit a lender's own risk tolerances.

Table 1

Risk	How to manage it
Borrower risk The risk that the borrower defaults on the loan (for example, the borrower becomes insolvent and is unable to return the securities).	The lender must consider who they are willing to lend to and how much they are willing to lend.
Collateral risk The risk that the value of the collateral falls below the replacement cost of the securities that are lent. If this happens AND the borrower defaults on the loan, then the lender will suffer a loss equal to the difference between the two.	Establishing rules governing collateral can be complex and lenders are advised to discuss this with their agent or adviser. A lender's collateral policy will affect the returns that are achievable (the riskier the policy, the higher the return). The main issues to be considered are: • **What is acceptable as collateral?** Lenders must consider what types of collateral they are willing to accept. • **How much of any one type of collateral should be accepted?** Lenders should place limits on the amount of any one bond or share that is received as collateral to avoid ending up with a concentration of one type of collateral that might prove more difficult to sell. • **What level of over-collateralisation is required?** It is commonplace for a lender to require collateral that is worth more than the value of the loaned securities. This excess amount is known as the 'margin' and the lender needs to decide what level of margin is required. In setting these policies, the lender and agent should take into account technical factors such as liquidity (ie the ease with which the collateral may be sold at a fair value), and price correlations between the loans and collateral (ie whether the price of the collateral is generally expected to move in line with the price of the lent securities).

Risk	How to manage it
Cash collateral risk The risk that the lender suffers a loss on the re-investment of the cash collateral.	Where a lender takes cash collateral, the cash must be reinvested to generate a return. The lender must ensure that the investment guidelines governing the investment of cash collateral are fully understood and provide an acceptable level of risk and return. Lenders should be aware of the liquidity risk inherent in the investment of cash collateral should investments need to be sold at short notice to return the collateral. This is likely to be a matter for consideration by someone with knowledge and responsibility for portfolio management decisions.
Intraday settlement risk The risk that the securities being lent are delivered to the borrower before the collateral is received.	Lenders should consider whether they wish to receive their collateral a day before the loan settles to avoid this risk. At the end of the loan, lenders should ensure that their shares are returned before or at the same time as collateral is released back to the borrower.
Operational risk This covers day-to-day operational risk matters, such as: • What happens if shares that are sold are recalled late? • What happens if the lender or its agent fails to claim for a dividend or other entitlement?	It is important that the lender understands if the agent takes responsibility for operational risks and in what circumstances, if any, they do not. If the lender is undertaking the lending activity directly then robust procedures need to be developed to protect against operational risks.
Legal risk The risk that the lender's legal agreement does not provide full protection in the event that the borrower defaults.	Lenders should review their legal agreements (typically a securities lending authorisation agreement signed with their agent, and the agreement that the agent signs with the borrower). The latter should conform to commonly used market standard documentation. In case of any doubt it is recommended that the lender seeks professional advice.
Other risks Consideration should also be given to other non-financial risks, such as ethical or reputational risks which can sometimes arise as a result of investing activity.	Lenders should consider whether lending securities is consistent with their policies and investment objectives.

VOTING OF SHARES

You cannot vote if your securities are out on loan. However, your securities lending does not need to interfere with your corporate governance activity as shares may be recalled from loan if you wish to vote.

You should consider under what circumstances you may wish to recall securities to vote (or prevent certain securities that you wish to vote on being lent in the first place) and ensure that all parties (such as your fund manager and agent) are aware of your policies. Normally securities can be recalled at any time but it is essential that timescales for recalls are understood and documented.

POOLED FUNDS

Many pooled funds vehicles, such as unit trusts, OIECS and UCITS, may engage in securities lending of the securities held within the funds. Investors in such funds cannot directly influence the securities lending arrangements, so they should make sure they are happy with them before investing. Information about the securities lending activity should be available from the relevant fund manager.

SECURITIES LENDING IN PRACTICE

Investors who lend securities usually do so through their custodian, who acts as an agent. It is also possible to use a third party agent who will arrange loans (within agreed parameters) and instruct the custodian about securities deliveries, receipts and collateral movements. Only the very largest funds conduct their own lending.

All securities lending arrangements are underpinned by market standard legal agreements (such as the Global Master Securities Lending Agreement or GMSLA). As well as this legal agreement, the lender will enter into an operating agreement with their agent, that may complement the custody agreement and set out all the terms of the lending programme. The agent will then enter into a market standard agreement on the lender's behalf with the borrowers. Once the agreements are in place, the agent will be responsible for all day-to-day activities and should provide the lender with information tailored to their requirements. Properly structured, the securities lending programme should not interfere with day-to-day fund management.

As with any investment activity, investors should be sure that they have made adequate provision for understanding and complying with legal, regulatory, tax, accounting and operational requirements.

Robust internal procedures should be established and regularly reviewed that ensure all relevant parts of the organisation understand their responsibilities.

A Checklist for Lenders exists for investors who are considering entering into securities lending arrangements and details of this are included in the useful references at the end of this guide.

FREQUENTLY ASKED QUESTIONS

As an investor, what will I be paid and when?
You will normally be paid monthly for the securities you have lent. The size and composition of your portfolio, together with the frequency of trading may all influence the ability of your securities to be lent out – demand may also depend on market factors. You should get an estimate of what the annual income is likely to be after any charges applied by your custodian/agent.

What happens if the value of the collateral goes down?
The value of your securities on loan and the value of the collateral is compared on a daily basis and an adjustment is made to ensure that you achieve your collateral management objectives. Your agent will do this for you.

What happens if I sell securities that are out on loan?
As long as you tell your agent within the agreed timescale, the securities should be returned in time to settle the sale.

How will I know what securities are on loan?
Your agent will provide you on request with full details at an agreed frequency (which can be daily), usually electronically. You will also receive a monthly statement of your earnings.

What do I do if I want to vote?
You cannot vote on shares that are out on loan. You must therefore recall them in time to be registered to vote. Ensure that your voting policies are understood by all parties and that you are aware of and comply with your agent's cut-off times for instructions.

What happens if the borrower goes bust?
The legal agreement allows you to instruct your agent to realise the collateral immediately to enable you to buy back the stock you have lent.

What is cash collateral?
Lenders may accept cash in an agreed currency as collateral for their loans. Cash collateral is however quite different from non-cash collateral (such as shares or government bonds) as the lender must pay the borrower interest on the cash collateral for the period it is held. If you take cash collateral you will need to invest the cash to generate enough interest to repay the borrower. In most cases your agent will manage this process (known as cash collateral reinvestment) for you. It is essential that you understand and agree the risks of these investments.

How do I get my dividends?
The borrower will pay you the same amount as you would have received, if the stock had not been lent. You should establish whether this will be on the due date or when received from borrower. In the UK, special rules govern the tax treatment of such payments (to ensure they are treated similarly to normal dividends). Lenders are advised to take tax advice on this before commencing lending.

USEFUL REFERENCES

Documents that accompany this paper:
Agent Lender Disclosure Code
Checklist for Lenders
www.bankofengland.co.uk/markets/gilts/slrc.htm

Further Reading:
Securities Borrowing and Lending Code of Guidance
www.bankofengland.co.uk/markets/gilts/stockborrowing.pdf
Introduction to Securities Lending
Securities Lending: Your Questions Answered
Securities Lending and Short Selling
Securities Lending and Corporate Governance
www.isla.co.uk/dynamic.aspx?id=62
Global Master Securities Lending Agreement (GMSLA 2010)
www.isla.co.uk/uploadedFiles/Member_Area/General_Library/GMSLA%202010%20Final(1).pdf
FSA Conduct of Business Sourcebook
http://fsahandbook.info/FSA/html/handbook/COBS

Relevant websites:
Securities Lending and Repo Committee
www.bankofengland.co.uk/markets/gilts/slrc.htm
Financial Services Authority
www.fsa.gov.uk
HM Treasury
www.hm-treasury.gov.uk
The Pensions Regulator
www.thepensionsregulator.gov.uk
Association of British Insurers
www.abi.org.uk
British Bankers Association
www.bba.org.uk
ICMA European Repo Council
www.icmagroup.org/about1/international1/european.aspx
International Securities Lending Association
www.isla.co.uk
Investment Management Association
www.investmentuk.org.uk
Local Authority Pension Fund Forum
www.lapfforum.org
National Association of Pension Funds
www.napf.co.uk
Thomas Murray
www.thomasmurray.com

Glossary of relevant terms:
A full glossary of terms used in securities lending can be found in the SLRC Code of Guidance.
www.bankofengland.co.uk/markets/gilts/stockborrowing.pdf