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Securities Lending: What a Difference Five Years Makes

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CAMBRIDGE ASSOCIATES LLC

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Executive Summary

In 2008, lending programs, thought of as a way to earn a small, low-risk incremental return on portfolio holdings, became a painful and unexpected source of illiquidity for many investors. Even investors without direct lending programs felt the effects through investments in lending-eligible commingled funds. Nearly five years later and under pressure to investigate any source of incremental return in what remains a highly uncertain investment environment, institutions may find themselves attracted to "unlocking the value" of holdings through a lending program.

This brief paper provides an update on the securities lending market. We would not discourage investors from participating in a lending program, whether directly or via a commingled fund. However, investors must understand the risks involved and have a clear view of the costs and benefits of engaging in a lending program.

Securities lending is simply a collateralized loan transaction. Asset owners lend out securities and receive collateral from the borrower. Many aspects of a lending relationship are customizable, including the term of a loan, the type of collateral, and the level of collateral supporting the loan. Most investors use a securities lending agent to manage their lending program. In the United States, the dominant fee model in the lending business has been for the lender and its agent to split the earnings on the lending business, including fees from loans and the income generated by the lender's reinvestment of cash collateral.

While supply of lendable securities now exceeds pre-crisis levels, demand has not made similar gains. The outlook for securities demand is mixed. Structural shifts in demand, regulatory changes, and the ever expanding pie of lending-eligible markets contribute to the murky picture on the demand side of the lending equation.

Today, lenders are more actively engaged in managing their lending programs than ever. Lending has moved out of the back office and institutions now integrate investment personnel into program management. Agents have seen a decided shift toward "value lending" approaches that emphasize lending fewer but more expensive-to-borrow securities. Lenders are also customizing their programs and using many available opportunities to fine tune program details to achieve their risk and return objectives.

For investors of scale, establishing a securities lending program is still an option. Investors considering a program should review the types of securities that are eligible to be put out on loan and decide whether they are appropriate to include in the program. This review should take into account the expected role of the holdings in the portfolio and associated liquidity needs for those holdings. Lenders have many levers to adjust programs to reflect specific objectives, risk factors, and institutional preferences.

Securities lending should be unbundled from custody or other services and lenders should scrutinize the return-sharing fee structure of the typical lending arrangement and consider how it affects incentives. Under this asymmetric structure, agents are compensated for the upside associated with a collateral reinvestment program and do not participate if returns go negative.

We prefer "value lending" approaches to approaches that emphasize general collateral or "volume" lending. Especially in the current environment, the risk-reward proposition for approaches that rely on stretching for yield is unattractive. From a risk and liquidity manage-

ment perspective, value lending approaches reduce the portion of a lendable portfolio exposed to lending risks at any given time.

For index fund investors, reviewing a fund's policy on securities lending should be part of the fund selection process, especially when an investor will rely on the index product as a ready and certain source of liquidity. While it would make selection simpler if index funds were all alike, these "commodity" products are, in fact, not all the same. More broadly, as part of an investor's due diligence for funds employing securities lending, consideration should be given to factors that are indicative of misaligned incentives, heightened liquidity risk at the fund level, or heightened risk through the collateral reinvestment vehicle. ■

When we last wrote about securities lending, the great liquidity crunch of late 2008 was in full swing. Lending programs, thought of as a way to earn a small, low-risk incremental return on portfolio holdings, became a painful and unexpected source of illiquidity for many investors. The collateral reinvestment portion of lending transactions, not defaulting lending program borrowers, was the primary driver of problems in lending programs. Even investors without direct lending programs suffered through investments made in lending-eligible commingled funds, often index funds.

As a result, many institutions withdrew from the lending market. Investors found themselves slowly and painfully managing their way out of their exposure to the illiquid collateral pools that lurked beneath the placid surface of low-cost, "liquid" index funds. Managers, responding to client demand, began offering "non-lending" investment vehicles, albeit with higher (explicit or implicit) cost structures.

Nearly five years later, what has changed? Under pressure to investigate any source of incremental return in what remains a highly uncertain investment environment, institutions may find themselves attracted to "unlocking the value" of holdings through a lending program. Yet U.S. regulations that severely restrict banks' use of proprietary trading and a more generalized reduction in assets pursuing highly leveraged strategies have put a damper on lending demand. Furthermore, the low interest rate environment makes the economics of short selling less attractive for managers unaccustomed to paying out of pocket to borrow securities (see "The Changing Economics of Short Selling" on the next page).

What is the supply/demand environment for lending today? What risks do investors take when entering a direct lending program or investing in a commingled fund that employs lending? Should institutions re-enter the securities lending market? This paper explores our views on these and other questions about securities lending.

How Lending Works[1]

At the most basic level, securities lending is a collateralized loan transaction. Asset owners lend out securities and receive collateral from the borrower. Many aspects of a lending relationship are customizable, including the term of a loan (can the security be recalled by the lender when it is needed or is the loan for a set term?), the type of collateral (cash collateral, common in the United States, or other types of securities), and the level of collateral (lenders typically receive cash collateral worth 102% of the asset out on loan, and a higher percentage for other types of collateral[2]).

In the United States, lenders profit in two ways. First, there is the "cost of borrow" or the "intrinsic lending value" of a security, which varies based on supply and demand for the particular issue. Borrowing costs are typically quoted as a percentage of the value of the security. Second, the lender may reinvest cash collateral and earn a return ("spread") on that investment above what is owed to the borrower. The borrower receives a portion of the interest earned on its collateral—typically the overnight rate, less the borrowing cost of the security—referred to as a "rebate." The lender in turn receives from the borrower all cash flows (divi-

[1] For a more detailed discussion of securities lending, please see our primer *Securities Lending: An Introduction*.
[2] Higher collateral amounts are required for non-U.S. securities.

The Changing Economics of Short Selling

While this paper focuses on the environment for securities lending from a lender's perspective, short sellers' demand for securities is an important part of the picture. Since 2007, the economics of short selling have changed significantly, with implications for hedge funds and lenders alike.

The dramatic decline in short-term rates since 2007 has impacted the ongoing cost of maintaining significant short exposure. Short sellers receive a "rebate" on the collateral posted to support a loan. The rebate reflects the cost of borrowing the security and short-term interest rates. In a higher-rate environment, the rebate is a profit center for most managers. However, with the federal funds rate at 25 basis points (bps), managers now pay out of pocket to keep short positions open—a negative carry for a fund.

Structural changes within the securities lending market have also significantly impacted the economics of short selling. Market participants see more transparency in the lending markets today than in the past. Lenders are much more active in monitoring the price at which their securities are out on loan and any positive trends in pricing for that security. Many lenders rely on data services that provide pricing information across the lending markets. Agents frequently field queries from lenders about the prospects for re-pricing securities that have moved up the data provider's pricing "heat map." As a result, prime brokers and hedge funds are much more likely to be subject to re-pricing requests from lenders. Clearly, re-pricing impacts a short seller's return on a position and adds an element of risk to the successful execution of a short investment thesis.

Another structural shift in the lending market is a move toward "value lending" approaches to lending program construction. Under this approach, lenders may only be willing to lend securities that will earn more than a specific fee rate. As a result of this market shift, some supply is likely to become available only as prices rise, hitting lenders' target rates of return. This change, combined with the trend toward re-pricing, seems to be responsible for what some market participants characterize as a notable increase in the velocity of lending (fee) rate changes.

How have managers reacted to these changes? There is little a manager can do to reduce the headwinds created by low interest rates and this continues to be a drag on performance. Managers have taken several approaches to mitigating the impact of other lending market changes on their funds. In some cases, managers have increased the number of prime brokers they employ in the hope of improving sourcing and diversifying re-pricing risk. Firms have also sought term loans where possible to reduce re-pricing risk. Some managers are increasingly looking to the options markets to create synthetic short positions. The increased transparency within the lending markets has become another tool for managers as they monitor lending cost and other data to understand changing perceptions of individual companies.

dends and interest) associated with the security on loan over the term of the loan (Figure 1).

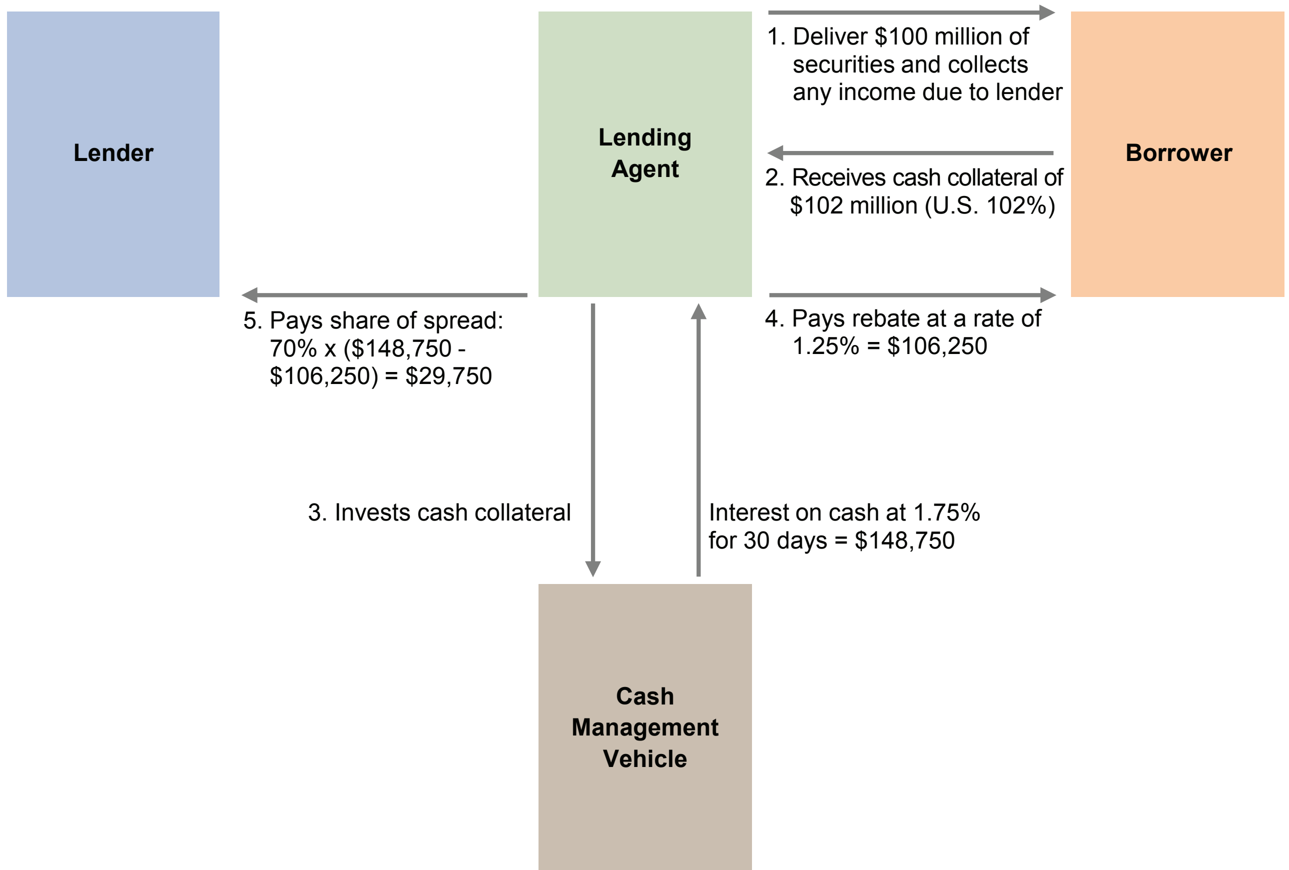
In Europe, lenders more typically receive non-cash collateral (including equities) in support of a loan, so the cash collateral reinvestment piece of the typical U.S. lending transaction is not part of the economics of the lending arrangements. U.S. broker-dealer regulations, which limit the types of collateral that can be used to support lending, are one reason for this difference in approach.

Most investors use a securities lending agent to manage their lending program. The largest lending agents are custodian banks that have historically offered this service as an add-on to a custody relationship.[3] While hedge funds

[3] Lending agents that are custody bank affiliates also offer their services independent of a custody relationship.

Figure 1. Hypothetical Transaction Diagram

Example: Loan of $100 million of securities for 30 days collateralized with cash, where the prevailing interest rate is 1.75% and the lender/agent split on income is 70/30.



Securities Lending Process

Investor
- Select Lending Agent
  - Execution skill
  - Credit quality
  - Access to borrowers
- Negotiate share of spread

Lending Agent
- Identify Borrower
  - Credit review
- Negotiate price with borrower, called "rebate"
- Execute
- Provide indemnity to lender

Broker/Dealer (as Borrower)
- Execute

are the most often cited stock borrowers, they generally source borrowings through their prime broker. As a result, lenders typically look at the prime broker's creditworthiness rather than that of a hedge fund in a lending arrangement. Most lending agents offer their clients indemnification against *borrower*[4] defaults, but agents bear no risk for losses in *collateral* reinvestment accounts. There are also non-custodial lending agents—some are independent specialist firms and others are affiliated with larger financial organizations.

In the United States, the dominant fee model in the lending business has been for the lender and its agent to split the earnings on the lending business, which includes not just the fees garnered on loans but also the income generated by the lender's reinvestment of cash collateral. Outside the United States and among non-custodial lenders, agents normally charge a fee for their services that is not linked to earnings on cash collateral managed by affiliates.[5] We believe this is a better model. Today, given heightened scrutiny of lending relationships, custodial lenders are more willing to unbundle terms, enabling institutions to untangle the costs associated with their lending programs from their other relationships.

[4] Notably, lending agents do not indemnify their clients against defaults by affiliated entities.

[5] In fact, as noted earlier, most lending transactions in Europe are supported with non-cash collateral.

Current State of the Securities Lending Market

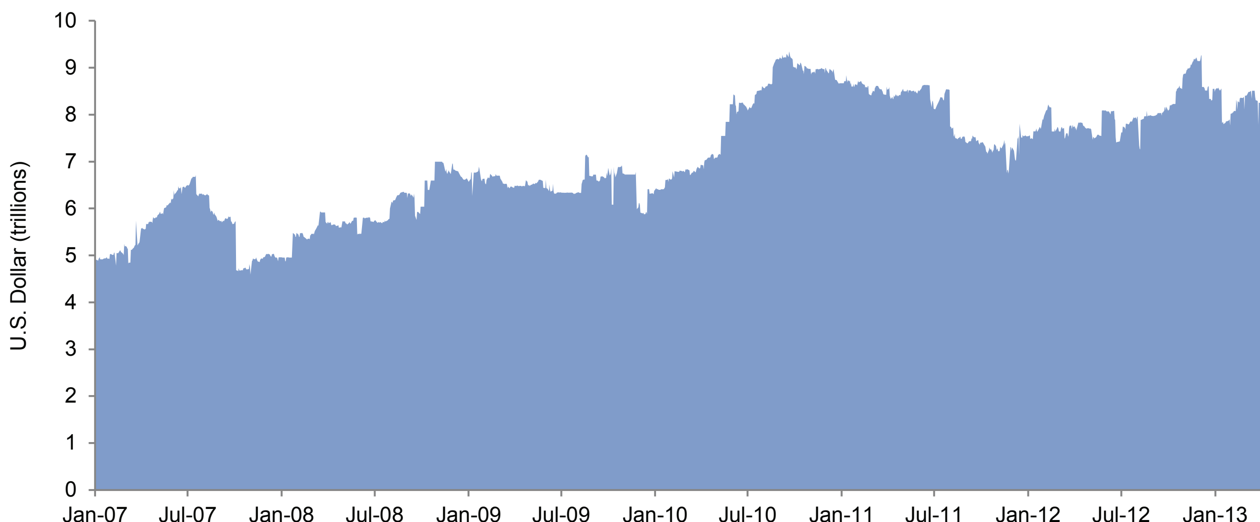
We have repeatedly heard from lending agents and other market participants that lenders are more actively engaged in managing their lending programs since the crisis. Some lenders have integrated investment personnel into lending program structure and management, recognizing that lending is not solely a back office function. Agents report that clients are focused on customizing lending programs and are looking beyond maximizing earnings in structuring their programs. To the consternation of borrowers, lenders are more frequently asking agents whether securities out on loan should be re-priced (upward) as market conditions change.

Supply has improved, but demand remains below peak levels. *We do not believe there is a supply/demand imbalance that makes a compelling case for re-entering the lending market.*

Supply Back Up to Pre-Crisis Levels. Coming out of the financial crisis, many institutional lenders suspended or limited lending programs and still others discontinued programs. Big lenders have now returned to the market, albeit with different program rules in place, and the supply of lendable securities now exceeds pre-crisis levels (Figure 2). While the shifting regulatory sands may impact the supply side of the securities lending business, many regulatory initiatives, discussed in more detail later in this paper, have not yet been finalized.

Demand Across All Lending Remains Below Peak Levels. Hedge funds are an important source of demand for borrowing. With a number of large hedge funds winding down during the 2008–09 period, some firms exiting highly levered strategies, and an overall

Figure 2. Securities Available for Lending
January 1, 2007 – April 25, 2013



Source: Sungard's Astec Analytics.
Note: Data are for global universe.

reduction in the amount of capital dedicated to hedge fund–like strategies,[6] demand for securities remains below 2008 pre-crisis levels. While leverage levels at hedge funds remained below historical averages immediately following 2008, they have drifted back toward the pre-crisis average in recent years.

The mix of securities in demand varies with market conditions. For example, during periods when market correlations are high, exchange-traded funds (ETFs) have been in greater demand by borrowers. When correlations decline and markets appear poised to distinguish between individual securities based on fundamental factors, managers tend to move away from ETF-based short exposures. The risk-on/risk-off environment of the past several years has thus introduced some volatility to the demand for security types.

The other facet of demand is the dynamics around the demand for specific securities. Easy-to-borrow securities that generate little return on the loan are referred to as "general collateral" securities. For these loans, the name of the game is to lend many securities at a small spread and make money on collateral reinvestment. As of this writing, the environment for general collateral lending (also known as "spread lending") is unattractive: demand is down and cash yields are essentially zero. At the other end of the spectrum are "specials," securities with a higher cost to borrow, where the "intrinsic value" of the securities rather than the return on the reinvestment of collateral

[6] For example, proprietary trading strategies were believed to represent a significant and highly levered part of the market for hedge fund–like strategies pre-2008. By some estimates, proprietary trading strategies (including leverage) made up 40% or more of the total assets pursuing hedge fund–like strategies pre-crisis.

drives the economics of the lending transaction. As a percentage of total securities in the market, specials today are a smaller proportion of total market than in the past (Figure 3). However, pricing for high-demand securities, even those that do not rise to the "specials"[7] category, is reasonably attractive.

Outlook

Like many other areas of the financial markets, the securities lending market is in the midst of change. Demand for securities remains subdued relative to pre-crisis levels. As market dynamics shift, investors should consider how these changes will affect their lending programs. Investors should also evaluate the changing landscape in their due diligence process for external managers that employ securities lending. Current factors are mixed in their impact on securities lending programs.

Structurally Lower Demand. Some sources of demand for lending, such as now shuttered hedge funds and unfettered bank proprietary trading desks,[8] have been permanently taken out of the market. Other significant sources of demand outside of the United States, such as dividend arbitrage,[9] have been curtailed in

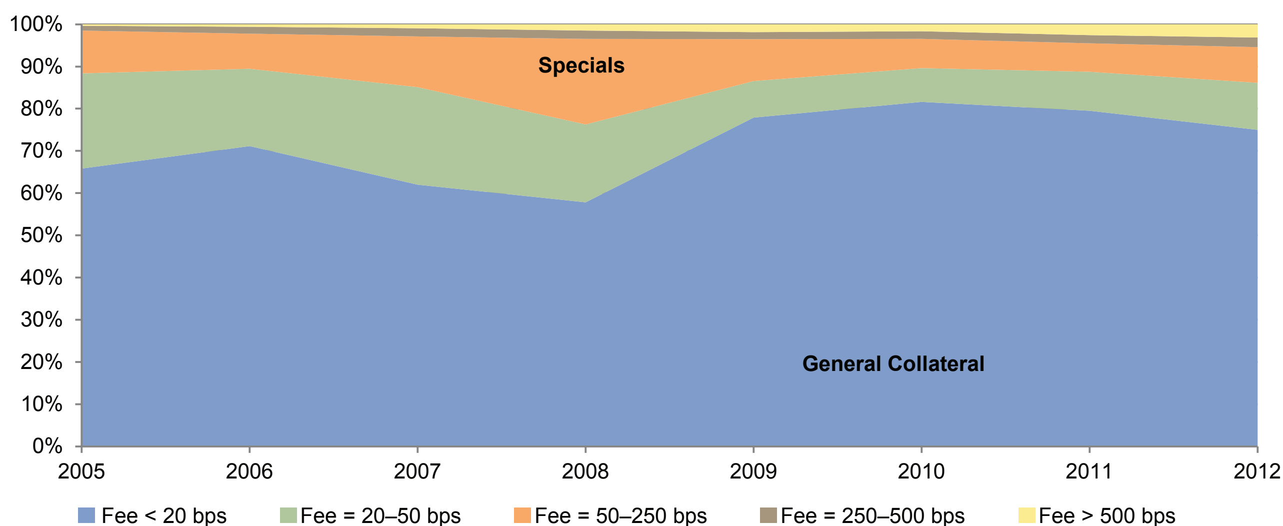
[7] "Specials" may earn 100 bps or more on an annualized basis.

[8] Many former proprietary traders have spun out of banks and into independent firms, and thus may still be a source of borrowing demand. However, our sense is that these teams, once independent, generally operate with lower levels of leverage than they had as part of a larger organization. As a result, we would not expect these new firms to fully fill the demand hole left by the looming implementation of the Volcker Rule.

[9] Historically, dividend arbitrage was a significant source of lending revenues for holders of European securities. In a number of European countries, certain classes of shareholders receive more favorable tax treatment on dividends than others, creating demand to borrow

Figure 3. Relative Loan Volume of General Collateral vs. Specials Over Time

January 1, 2005 – December 31, 2012



Source: Sungard's Astec Analytics.
Note: Data are for global universe.

some markets.[10] While assets allocated to hedge funds now exceed pre-crisis levels, we believe there remain fewer dollars pursuing hedge fund–like strategies today as the Volcker Rule ban on most proprietary trading by banks in the United States has reduced the amount of highly leveraged capital pursuing these strategies. These shifts imply lower borrower demand for securities.

Other developments may also dampen the demand side for securities lending, including on-again, off-again short-selling bans in Europe and the continued threat of regulation in the United States. In late 2012, the European Union implemented short-selling disclosure regulations.[11] At the same time, new EU bans on short sales of sovereign debt and short positions in credit default swaps on sovereign debt went into effect.[12] The U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act required studies related to short selling,[13] but like many other Dodd-Frank implementation items, the study has been delayed. Dodd-Frank also mandated increased regulation of the lending business with a focus on improving transparency. To date, the SEC has not taken action on this requirement.

Shift in the Types of Securities in Demand. The year 2011 saw a trend of shorting indexes or ETFs. In fact, one estimate suggests ETFs represented 20% of the total volume of securities lent during that year. However, as the risk-on/risk-off condition in the markets moderated at points in 2012, demand for individual securities improved. Changes in market sentiment, corporate activity (a pick-up in merger activity), and further regulatory developments will impact the specific types of securities sought by borrowers and their associated economics.

Increased Lending Program Costs. The potential implementation of a financial transactions (or "Tobin") tax in Europe[14] could have a significant impact on the economics of securities lending. As proposed, a tax of 10 bps would be applied to each leg of a securities lending transaction. Given the current low-rate environment, this seemingly modest tax could have a significant percentage impact on lending economics. According to an analysis by Sungard Financial Systems, lenders may see a 50% decline in lending income due to the imposition of the tax.[15]

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securities ahead of the record date for dividends. The borrower and lender share in the resulting tax arbitrage. In recent years, several countries in Europe have eliminated differential dividend tax treatment for foreign and domestic shareholders, which has the potential to shrink the current opportunity set for this "yield enhancement" strategy.

[10] Sweden, Spain, and, most recently, France have been subject to court rulings striking down discriminatory tax treatment on dividends.

[11] On November 1, 2012, new short-selling disclosure regulations came into effect in the European Union. Under the regulations, firms are required to make private disclosures to authorities when they sell short 0.2% or more of the shares of a company and make public disclosures of net short positions of more than 0.5% of a company's shares.

[12] Under the new rules, naked short positions are permitted for hedging purposes, including for hedging positions correlated with sovereign bonds. However, the new rules do not ban short positions in futures, ETFs, or other economic equivalents to short positions on sovereign debt positions.

[13] Under the Dodd-Frank Act, the SEC was required to conduct a study on, in effect, increasing disclosure of short positions in publicly traded securities.

[14] Currently, 11 of 27 EU countries are pursuing the tax: Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia, and Spain.

[15] "Sungard Securities Lending Focus," April 2013.

Other regulatory wildcards would generally increase lending program costs. Basel III proposals would increase the capital cost to banks of providing indemnification to lenders. Proposals under Dodd-Frank limit the amount of counterparty credit exposure between large, systemically important banks and, thus far, include securities lending and other securities financing transactions in the mix.

New Sources of Demand. While all of the regulatory impacts discussed so far have negative implications for securities lending, there are some potential bright spots on the horizon. For example, the global regulatory shift moving swaps trading to centralized counterparties could have demand implications in the lending markets as participants source high-quality collateral to support swaps trades. Similarly, financial institutions may be a source of regulation-driven demand for high-quality securities, thus driving demand for so-called collateral upgrade trades. Further, the size of the pie is expanding. New markets, especially in Asia, are opening up, increasing the potential opportunity set for lenders.

Thinking About Lending Risks and Mitigating Them

Direct Programs

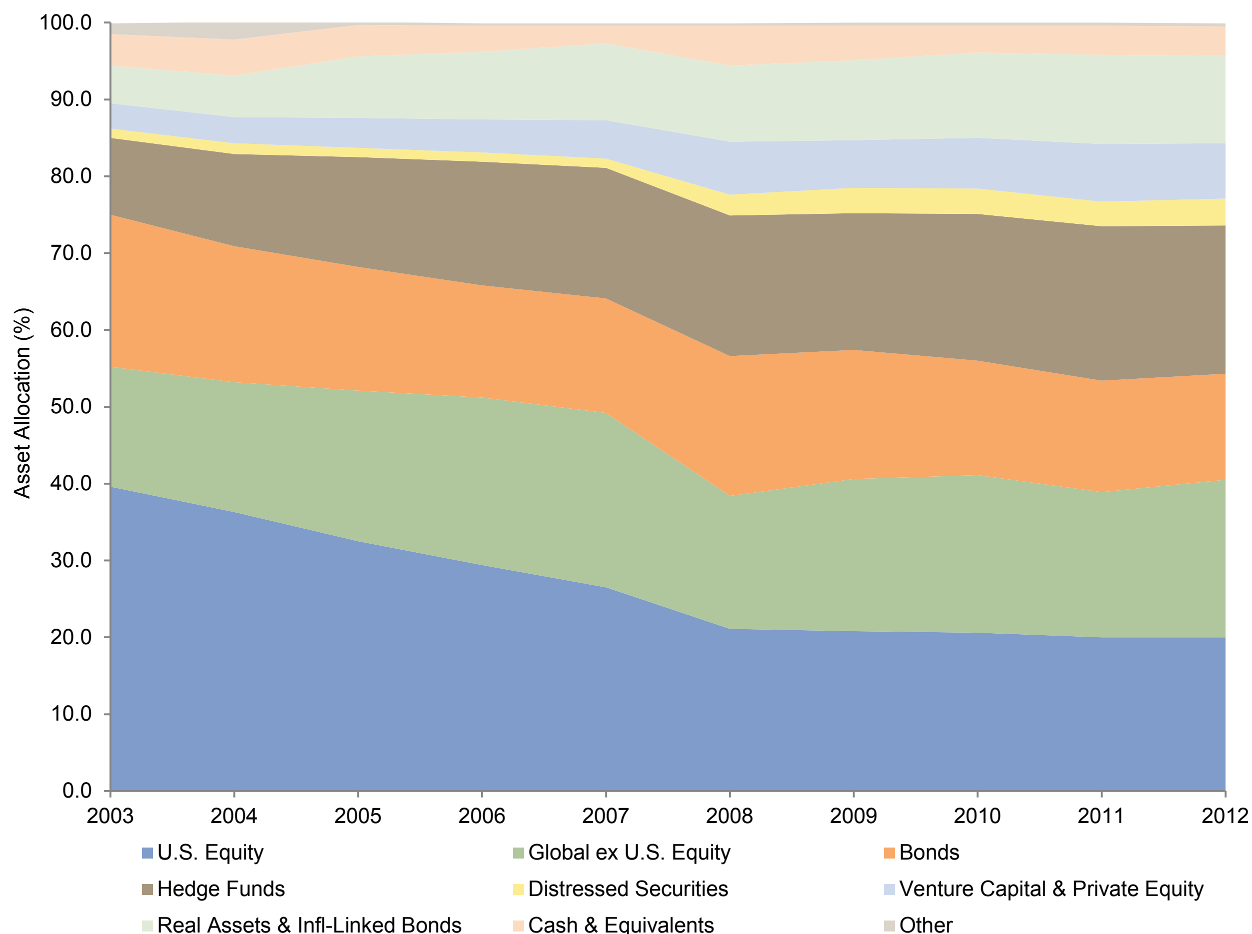
Today, only larger investors are likely to have sufficient scale to warrant implementing a securities lending program. Over the last decade or more, institutional portfolios have dramatically shifted away from a focus on long-only domestic securities and toward a broader range of investments (Figure 4). As a result of this evolution, investors hold assets with a larger number of managers in smaller average investment sizes, a shift frequently accomplished through commingled vehicles rather than separately managed accounts. At the same time, many managers have steadily increased their minimum separate account sizes, further reducing the possibility for investors to use these lending-eligible separate accounts.

For investors of scale, establishing a securities lending program is still an option. What are some of the considerations in developing a program? Historically, securities lending was an add-on product wrapped into a master custody relationship as a way to defray cost. Viewed in this light, lending programs were seen as more of an operational decision than an investment decision. The problem with this approach became clear in 2008 as some investors experienced losses and illiquidity in their investment portfolios driven by collateral positions for lending programs. Entering into a securities lending program is an investment decision with operational implications that also has an impact on total portfolio liquidity and risk posture. Lending programs should be structured with these issues in mind.

Types of Securities Included in a Program. As a starting point, investors should review the types of securities that are eligible to be put out on loan and decide whether they are appropriate to include in the program. This review should take into account the expected role of the holdings in the portfolio and associated liquidity needs for those holdings.

On one end of the spectrum, an investor might hold a portfolio of U.S. Treasuries as a form of deflation hedge insurance to provide liquidity during a period of market stress. Including Treasuries in a lending program adds a layer of risk to the holding and could decrease their usefulness as a hedge. This is because the same events (significant equity market decline and flight to quality) that would cause an investor

Figure 4. Historical Asset Allocation Trends
2003–12 • Percent (%)



Mean Asset Allocation as of December 31

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
U.S. Equity	39.6	36.3	32.5	29.4	26.5	21.1	20.8	20.6	20.0	20.0
Global ex U.S. Equity	15.6	16.9	19.6	21.8	22.7	17.3	19.8	20.5	18.9	20.5
Bonds	19.8	17.7	16.1	14.6	14.9	18.2	16.8	14.9	14.5	13.8
Hedge Funds	10.0	12.0	14.3	16.1	17.0	18.3	17.8	19.1	20.1	19.3
Distressed Securities	1.2	1.4	1.2	1.2	1.2	2.7	3.3	3.3	3.2	3.5
Venture Capital & Private Equity	3.3	3.4	3.9	4.3	5.0	6.9	6.2	6.6	7.5	7.2
Real Assets & Infl-Linked Bonds	4.9	5.4	8.0	8.8	10.0	9.9	10.4	11.1	11.6	11.4
Cash & Equivalents	4.1	4.7	4.1	3.4	2.3	5.2	4.5	3.5	3.8	3.8
Other	1.4	2.3	0.4	0.3	0.3	0.3	0.4	0.4	0.4	0.4
n	*243*	*255*	*255*	*272*	*311*	*344*	*380*	*412*	*426*	*434*

Source: Cambridge Associates LLC Investment Pool Returns Database.
Notes: This exhibit shows the “All Endowments” universe, which includes colleges and universities, foundations, museums and libraries, independent schools, medical long-term investment funds, and other miscellaneous endowments. "Other" includes faculty mortgages and assets that cannot be classified as one or more of the other asset classes.

to liquidate Treasuries for spending might also be correlated with stress at borrowing institutions or a shift in the liquidity and risk profile of spread-driven collateral investments. In this example, including Treasuries in the lending program could limit their effectiveness within the broader portfolio construction.

At the other end of the spectrum is an investor that holds a portfolio of small- and mid-cap stocks as part of a growth allocation. In this case, lending the securities may not add significant risk to the total portfolio. Why? While small- and mid-cap stocks would be expected to perform poorly in an equity market decline and that same environment might also stress borrowers and be poor for spread-based collateral, an investor is not looking to this part of the portfolio for liquidity in a market decline. Viewed from this perspective, lending the portfolio of small- and mid-cap stocks may not inhibit the effectiveness of the allocation within the total portfolio. With or without securities lending, this allocation would be expected to perform well in a "risk-on" environment and poorly in a "risk-off" environment—it is not expected to act as an "insurance policy" or source of funds in a down market. As a result, taking on the risks associated with a lending program would not necessarily be detrimental to the role of the investment in the portfolio

Also important are the expected returns associated with lending particular types of securities. An investor should seek information about the value of the prospective lending portfolio in the current market environment (Figure 5). Some portfolios may naturally tend to have a higher proportion of highly valued lending securities, while others may be focused in lower-priced, volume-lending securities. Industry participants often speak of the trade-offs between the value of individual securities loaned and the volume of securities out on loan (the "utilization rate") at any given time. Investors should consider how these characteristics of a lending program marry with the role of the securities loaned from their portfolio. Returning to the Treasuries portfolio example, does having a high percentage of the Treasuries portfolio out on loan hinder its expected role in the portfolio?[16] Would having a lower percentage of a stock portfolio out on loan have less impact on the portfolio while generating similar fees?

Structure of a Program. Investors structuring a lending program today have the ability to customize many aspects of the program, including:

- amounts and types of securities available for loan;
- minimum price at which securities may be loaned out to borrowers;
- establishment of "buffers" (e.g., never lending out all of a security in a portfolio to allow for rebalancing without having to recall a security on loan);
- type of borrowers;
- concentration limits/creditworthiness of borrowers;
- maximum percentage of portfolio out on loan;
- type of collateral to be accepted (cash only or other types of securities); and
- risk posture of collateral reinvestment vehicle.

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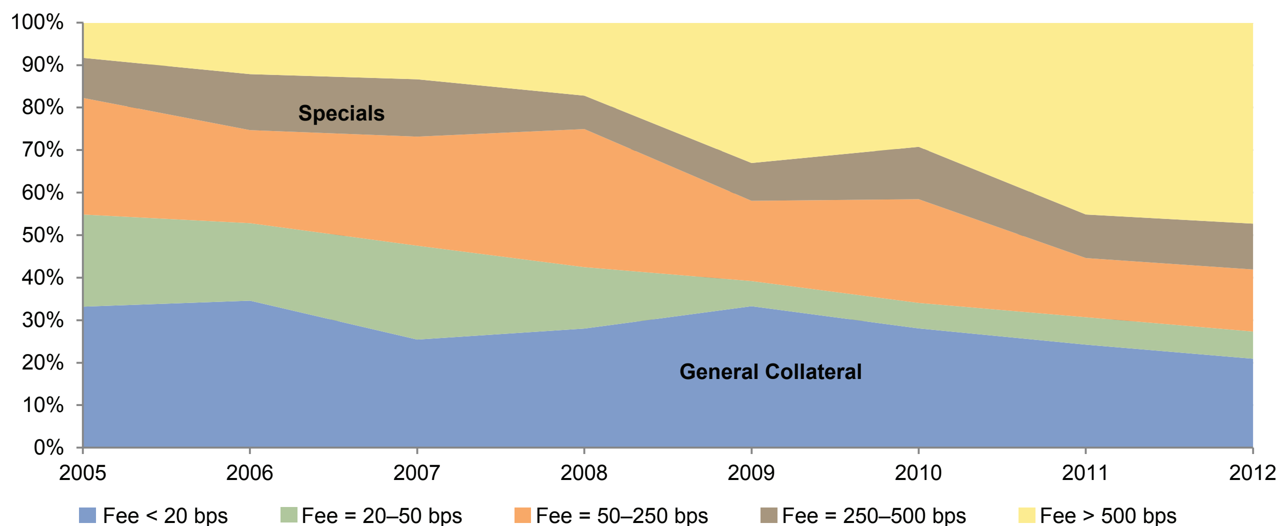
[16] High-quality bonds are often in the low-fee, "general collateral" part of the lending spectrum. However, as noted earlier, regulation-driven demand could have an impact on pricing in this market in the future.

Figure 5. Relative Loan Revenue of General Collateral vs. Specials Over Time
January 1, 2005 – December 31, 2012



Source: Sungard's Astec Analytics.
Note: Data are for global universe.

Each of these program construction elements gives investors a lever to adjust their program to reflect specific objectives, risk factors, and institutional preferences. Lending agents have seen increased focus on program customization in recent years for this reason.

Consistent with what many commentators about the lending space would say today, we prefer "value lending" approaches to approaches that emphasize general collateral or "volume" lending. The value lending approach has an inherent economic driver of return—scarcity of the high-demand security. The economics of the loan (excluding collateral reinvestment) should stand on its own. In contrast, the returns to general collateral lending depend on generating positive spread on collateral reinvestment. Especially in the current environment, the risk-reward proposition for approaches that rely on stretching for yield is unattractive. Further, from a program risk-management perspective, value lending programs allow fewer assets to be out on loan compared to volume approaches. In lending agent speak, the programs have "lower utilization, but higher intrinsic value." From a risk and liquidity management perspective, value lending approaches reduce the portion of a lendable portfolio exposed to lending risks at any given time.

Incentives. Historically, custodians offered lending programs bundled with custody services. Securities lending should be unbundled from these or other services. Bundled pricing has the potential to obscure the real costs associated with a lending program. Even if one decides to use a custodian as lending agent, we believe best practice is to evaluate both functions and cost structures independently. While there may be economies of scale

in employing a custodial lending agent, looking at each relationship separately enables an investor to evaluate each on its own merits.

Investors should also scrutinize the return-sharing fee structure of the typical lending arrangement and consider how it affects incentives. Historically, lending agents participated in a portion of all returns earned on lending programs, including both fees earned on loans and returns on collateral reinvestment. Most agents continue to offer indemnification[17] against borrower defaults and they still do not offer similar support against collateral pool losses. Often, a lending agent or affiliate manages the collateral reinvestment pool, and the returns on these pools can have a significant impact on the risk-reward proposition of a program. Under this fee-sharing structure, a lending agent is compensated for the upside associated with a collateral reinvestment program and does not participate if returns go negative. Investors structuring a securities lending program should be wary of these asymmetric incentives.

Lending Programs Used by Commingled Funds

In 2008, index funds were disproportionately affected by problems in securities lending collateral pools. Many managers in this highly competitive "commoditized" space aggressively pursued lending as a way to reduce the all-important expense ratio (or, perhaps, maintain margins). In our discussions with managers of large index funds, we have found that the approach to lending programs can still vary significantly. For example, managers have different approaches[18] to fee splits, collateral reinvestment, and limits on the amount of securities out on loan. In a well-publicized study of securities lending practices by European ETFs, Morningstar reached a similar conclusion.[19]

For index fund investors, reviewing a fund's securities lending policy should be part of the fund selection process, especially when an investor will rely on the index product as a ready and certain source of liquidity. While it would make selection simpler if index funds were all alike, these "commodity" products are, in fact, not all the same. The fact that investors tend to treat them as such and not scrutinize them much beyond asset size and expense ratio encourages managers to find other avenues to improve profitability. Regulators have begun to push the industry for more transparency around their lending policies. In mid-2012, the European Securities and Markets Authority proposed changes that pushed ETF and UCIT managers in the direction of disclosing more details about the funds' lending programs.

More broadly, investors in commingled funds that employ securities lending in effect have to take what they get. They cannot have an impact on the risk profile of either the fund's lending program or its associated collateral pool. As a result, investors should consider the manager's approach to lending and incentives when evaluating such funds.

As part of an investor's due diligence for funds employing securities lending, consideration should be given to factors that are indicative of

[17] Pending regulatory changes raise the possibility that banks may limit or charge an explicit fee to clients for providing indemnification.

[18] Perhaps surprisingly, some investment management firms have different approaches to securities lending depending upon the type (registered mutual fund, ETF, or commingled fund) and domicile of the product.

[19] Hortense Bioy and Gordon Rose, "Securities Lending in Physical Replication ETFs: A Review of Providers' Practices," Morningstar, August 2012.

misaligned incentives, heightened liquidity risk at the fund level, or heightened risk through the collateral reinvestment vehicle. These include the following:

- whether the fund employs an affiliated securities lending agent;
- the fee split (or other fee arrangements) between the fund and lending agent and/or manager;
- the maximum percentage of the fund permitted to be out on loan at any one time;
- the historical maximum percentage of the fund out on loan at any one time; and
- the collateral reinvestment policy for the lending program.

As in the case of a direct program, investors in commingled funds should also consider the expected role of the investment in their portfolio, and whether participating in lending would have negative implications for the investment's ability to fulfill that role.

Conclusion

The securities lending market has significantly changed post-2008. While securities available to loan now exceed pre-crisis levels, demand has yet to come back to peak levels. Lenders have begun to integrate consideration of their lending programs into their investment function and are also more focused on customizing their lending programs to reflect portfolio structure and institutional risk preferences. A number of looming regulatory and tax changes could have an impact on the economics for securities lending—some seem poised to increase lending program costs while other changes could have a positive impact on demand.

Investors considering a direct program or investing in a fund that employs securities lending should evaluate the lending program in light of the investment's role in their portfolio. Investors in "commoditized" index products need to understand the role of lending in the funds and to evaluate whether the use of a lending-eligible product could diminish the fund's effectiveness in their portfolio. Those evaluating or structuring a program should also be cognizant of the conflicts inherent in lending agent relationships where the agent is paid a portion of the positive return on a collateral reinvestment account (often managed by an affiliate) but does not participate in the downside. Relationships with this type of asymmetric risk-reward proposition should be structured cautiously.

We would not discourage investors from employing funds that have securities lending programs or developing a direct program. However, we believe it is prudent to understand the nature and type of risks in the programs in the same way that other investment risks are evaluated. ■