

# A Best Practice Oversight Approach for Securities Lending

At its core, securities lending is an investment overlay strategy. It's an investment product that complements existing investment strategies allowing investors the ability to take a portfolio of idle securities and monetize their intrinsic lending value.

The process of lending out these securities affords an investor the opportunity to produce alpha by generating income that can be used to increase portfolio returns or reduce portfolio expenses all while accepting a manageable level of risk. For the global markets, securities lending provides critically needed liquidity in the financial markets, supports a variety of trading strategies, facilitates trade settlements and supports general financing techniques.

## Mechanics of a transaction

In a traditional securities lending transaction, securities are lent short-term after provisions such as loan length, collateral type (cash or securities) and rebate rate or fee are agreed to by a lending agent and borrower. When transactions are collateralized with cash, a rebate rate will be negotiated between the lending agent and the borrower. This rebate rate, stated as an interest rate, represents the interest on the borrower's cash collateral that the lending agent agrees to pay back to them at the termination of the loan. In order to generate a yield, the lending agent will invest the cash via a commingled fund or a separate account in short-term fixed income instruments in order to generate a spread above the rebate rate. The difference between the yield on the cash collateral and the rebate rate is the revenue that will be shared between the lender and their lending agent. Consequently, lenders should be aware of the market risk they assume with the investment of the cash collateral.

If securities (e.g., fixed income or equities) are accepted as collateral, or there is no cash to invest, a borrowing fee is charged. The fee will be applied against the market value of the securities on-loan and is shared between the lender and their lending agent.

## Oversight and monitoring - overview

Lenders should monitor their securities lending programs to ensure that they are achieving their objectives while staying within the expected risk profile. This monitoring should encompass three areas: lending, collateral and performance. Within each area, various metrics should be reviewed on a periodic basis by individuals whose training is in line with the appropriate oversight task. Oversight can be conducted through reporting, due diligence reviews, and on-going communication with the lending agent.

## Oversight - lending

The first area of oversight, lending, focuses on the loan side of the transaction. Specific metrics should be reviewed daily, while others can be done monthly. Lenders should be aware of the counterparties (i.e., borrowers) involved in their program, review the market value of securities on-loan to each, and the proportionate share that each borrower has to their overall program. Lenders may want to avoid concentration risk by requiring their lending agent to use a diverse universe of borrowers. Since lenders are typically indemnified by their lending agent against borrower default, they need to be comfortable that their lending agent has the capital resources available to stand behind the indemnification, and therefore, it's important for lenders to be aware of their lending agent's financial condition. Finally, lenders may find it prudent to aggregate their securities lending borrower exposures with that of other transactional activity (e.g., swaps) to determine their overall firm-wide exposure to various counterparties.



The vast majority of loans are for an overnight (i.e., open) period, meaning they can be terminated on any day and the rebate rate can be negotiated daily, when the transaction is secured by cash collateral. When loan transactions are collateralized by cash, lenders should compare the yield earned on the cash collateral against their loans' overall rebate rate in order to gauge the profitability of their program.

Generally speaking, loans are overcollateralized at either 102% for same currency transactions or 105% for cross currency transactions. As such, lending agents mark-to-market the collateral daily after the financial markets close to determine if additional collateral is required from the borrowers or if collateral needs to be returned.

To further gain an understanding of the supply/demand dynamics of their lendable assets, lenders should periodically evaluate their utilization rates (e.g., program-wide and security type) to determine how much of their portfolio is out on-loan. With this information, lenders can assess the overall risk/reward profile of their lending program. For example, fewer loans with higher fees or wider spreads imply a high degree of "specials" (i.e., high borrowing demand) allowing for a lower risk/higher return program or a very efficient loan distribution.

Lending securities should be largely transparent to the lender's portfolio management process and it should not impede an investment manager's trading ability. On occasion however, a security that was out on loan and subsequently sold by the lender may fail to be delivered on settlement date. Failure to return securities on time may be caused by a combination of lower liquidity and high borrowing demand or a sale instruction received past an agreed upon deadline. Under most circumstances, large securities lending agents may be

able to execute a loan swap thereby substituting the loan with another lender to avoid the fail. If this option is not possible when sale instructions were received on-time and the lending agent provides contractual settlement, lenders will be advanced the sale proceeds on settlement date. The borrower will be penalized by not being entitled to share in the earnings from the investment of the cash collateral from the fail date forward. In those cases where a security sale fails as a result of lending, the lending agent should provide a detailed analysis of the underlying cause and propose a resolution strategy. Actively reviewing the metrics of securities on-loan provides a lender with the necessary tools to adequately assess exposures to various counterparties, borrower demand, and the overall intrinsic value of their portfolio.

## Oversight - collateral

The second area of oversight involves the review of the collateral. As previously mentioned, securities lending transactions are either collateralized with cash or securities. In either case, it's incumbent upon lenders to know whether their lending agent indemnifies them in the event of a borrower default to protect against the risk that the value of the securities or cash collateral delivered to the lending agent is not sufficient to cover the return of the collateral to the borrowers at the end of the loan, or in the unlikely event of a borrower default.

Market events that can affect your securities lending program when cash collateral is accepted:

- Federal Reserve eases or tightens rates
- Credit spreads widen or contract
- The yield curve inverts, flattens or steepens
- Short term interest rates such as LIBOR rise or fall

Cash which is typically used to collateralize a loan transaction in the United States is invested in short-term fixed income securities, adding a layer of investment risk to the lender. Therefore, it's prudent to have an individual with fixed income investment experience involved in the monitoring process. In addition, it's imperative that lenders have documented, well defined and transparent cash collateral investment guidelines. Overseeing the cash collateral in a securities lending program should encompass a similar process to that of any short duration fixed income mandate. Essentially, when cash collateral is involved, a lender takes on the risks from the investments such as interest rate, credit, duration and liquidity risk, and therefore having input from individuals familiar with such risks is recommended.

As financial market conditions change, lenders should work closely with their lending agent to be aware of the effect of these changes on their program and anticipate the impact

of market events. An understanding of how these events or actions can affect or influence a program's profitability and performance is critical in order to assess whether a mandate is positioned appropriately to be in-line with its expected risk and return.

At the very least, lenders and their lending agent should discuss on a periodic basis the cash collateral investment strategy, investments held and overall program philosophy. As a starting point, a lending agent should provide an indication or estimate of the expected return from the investment of the cash collateral versus the demand to borrow securities while lenders should assess whether this estimate is in line with their risk/return profile. Lenders need to have a clear understanding of their program's cash collateral investment guidelines with respect to such attributes as security types, duration, sectors, issuer concentration, liquidity levels, proportionate share of fixed versus floating rate securities, and credit ratings.

When securities (i.e., not cash) are used to collateralize a loan transaction, if the lending agent does indemnify against borrower default, then a lender's exposure to their lending agent is increased. Knowing the types of securities utilized to collateralize their loans and whether or not indemnification is provided against a short fall in the value of the collateral, will help lenders discern how much if any of their lendable portfolio's risk profile has been altered and therefore, how their portfolio might be impacted by market movements or events. Effectively, if one security type is loaned out to a borrower and collateralized with another security type, a mismatch scenario would ensue and the risk profile of the lender's portfolio could be altered. Consequently, it's important to be aware of any correlations between security types.

## Oversight – program performance

The last area of oversight involves the assessment of the overall program's performance with respect to investment return, core drivers, and the associated risks taken. It's not enough to focus solely on earnings; a lender should seek a clear understanding of how those earnings were achieved.

Program performance focuses on reviewing:

- Investment return
- Core drivers
- Risk taken

Earnings can be derived from two places – the demand to borrow securities and the investment of the cash collateral. Assessing the performance of a program that accepts cash collateral encompasses a variety of metrics. First, lenders need to be aware of three types of spreads – gross, demand and investment. The investment spread is the yield the lender earns on the invested cash collateral less a risk free rate (generally viewed as the overnight Fed Funds rate) and the demand spread is the difference between the risk free rate and the rebate paid back to the borrower. The combination of the two spreads equates to the gross spread. Wider investment spreads may indicate a greater assumption of investment risk, and similar to any other investment strategy, this risk is borne by the lender. Therefore investment guidelines should reflect the lender's risk/return profile.

An important metric that lenders should understand is the maturity gap. The maturity gap measures the difference in duration between a lender's assets (i.e., cash collateral investment portfolio) and liabilities (i.e., loan portfolio).

### Tips for Better Oversight

To facilitate oversight, lenders should obtain information on a variety of metrics including:

- Borrower exposures
- On-loan amounts
- Collateralization levels
- Rebate rates
- Spreads
- Investment portfolio or securities collateral holdings
- Earnings

### Lending Oversight Tips

In managing your lending, monitor the following:

- Counterparty exposure
- Lending agent's financial strength
- Yield on cash collateral versus rebate rate
- Open versus term loans
- Factors that affect rebate rates
- Market value of collateral versus market value of the securities on loan
- Securities that are trading "special"
- Utilization rates
- Security sale fails as a result of lending

Generally speaking, a wider maturity gap increases a lender's interest and duration risks but can lead to greater earnings as one moves further out on an upward sloping yield curve allowing a lender to take advantage of higher interest rates. Familiarity with the projected direction of interest rates, expected changes to the slope of the yield curve and an understanding of the proportionate share of fixed versus floating rate investments will help a lender ascertain the level of risk their securities lending agent is taking in managing the maturity gap risk.

Looking at trends and discovering the core drivers behind a program's results is an important oversight tool for lenders. Reviewing results and trends of various metrics such as earnings, utilization rates, spreads, and the maturity gap will allow lenders to ask questions about their program's performance. Lenders will gain a better understanding of how changes in borrower demand and interest rates along with market activity affect their results and will help set future expectations.

Depending on a lender's resources and the overall sophistication of their program, more extensive due diligence reviews should be conducted with their lending agent on a quarterly or semi-annual basis to discuss in greater detail the market environment, performance results and attribution and the agent's overall program as well.

## Summary

Proper oversight is about education, monitoring and goals. Having a thorough understanding of securities lending, performing on-going monitoring of the key metrics behind your program and having a defined set of goals with respect

## Performance Metrics

In assessing the performance of a program that accepts cash collateral the lender must understand the following metrics:

- Gross spread
- Demand spread
- Investment spread
- Maturity gap

## Core Drivers of Program Results

As lenders assess their program's various metrics, they should be aware of the core drivers behind these results. Examples include:

- Changes in the Fed Funds rate
- Fluctuations in borrowing demand
- Increased/decreased market volatility
- High number of "specials" securities
- Increased/decreased lending of less liquid securities such as small cap equities and high yield bonds
- Lending international dividend paying equities during a specific time of year

to lending motives and risk/return parameters will provide the framework for proper oversight.

Today, securities lending continues to present an attractive opportunity for investors to generate additional alpha or income within a risk controlled environment. Utilizing a disciplined oversight approach, this investment strategy allows lenders to benefit from enhanced portfolio returns and lower operational expenses while remaining transparent to the portfolio management process. On-going oversight by an appropriate set of professionals enables lenders to gain a better understanding and appreciation of the risk/return dynamics in their program. ■

## Tips for Monitoring Your Program

As a lender you should work with your lending agent to understand the factors that affect rebate rates and be aware of the proportionate share of open versus term loans to determine how interest rate changes will impact your program's return.

Monitor the market value of the collateral versus the market value of the securities on-loan on a daily basis to make certain that the collateralization of the loaned securities remains at a sufficiently protective level.

On a daily basis, inform your investment managers of securities that are trading "special" since it may provide them with additional market color.

## Collateral Tips

Review the following in managing your collateral:

- Cash collateral investment strategy
- Securities purchased with cash collateral
- Program philosophy
- Investment guidelines
- Securities collateral



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