Securities Lending Defined

Securities lending is an overlay strategy that enhances the intrinsic value of a portfolio of securities by producing alpha or income which can be used to increase a portfolio's return and offset expenses. In a basic transaction securities are lent short-term and collateralized by either cash or securities. When cash is taken as collateral, it is typically invested in short-term money market securities, thus making securities lending an investment overlay strategy for the lender. Securities lending is also an important source of liquidity to the financial markets.

Mechanics of a Transaction

Securities as Collateral

Earnings derived from fee paid by borrower

Collateral Value
$50,000,000*102% = $51,000,000

Fee[1]
0.10%

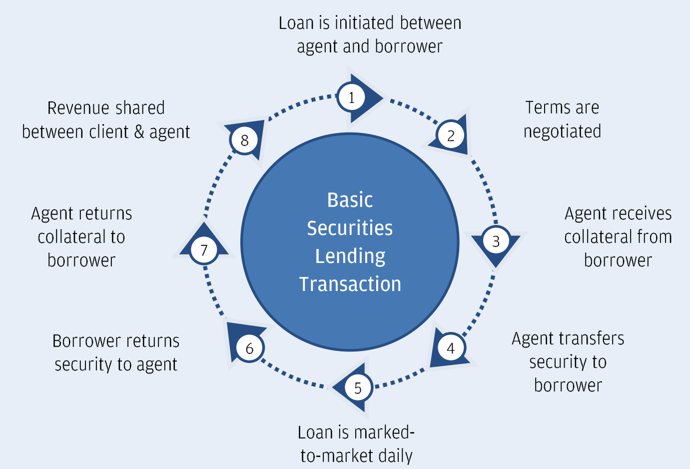
Daily Earnings
($50,000,000*0.10%) / 360

= $138.89[2]

[1] Annualized

[2] Split between account and agent lender

Example - $50,000,000 Loan of U.S. Equities – Collateral is in U.S. Securities or U.S. Cash



Cash as Collateral

Earnings derived from difference between yield earned on invested cash collateral and rebate paid to borrower

Collateral Value
$50,000,000*102% = $51,000,000

Yield on cash collateral[1]
0.40%

Rebate to borrower[1]
0.05%

Total spread[1]
0.40% - 0.05% = 0.35%

Daily Earnings
($51,000,000*0.35%) / 360

= $495.83[2]

[1] Annualized

[2] Split between account and agent lender

Reasons Securities are Borrowed

- Facilitate trade settlements
- Finance inventory and manage balance sheets
- Facilitate trading activities
  - Arbitrage trading (e.g., mergers and acquisitions, yield enhancement, active extension strategies, dividend reinvestment plan, convertibles and pair trading or relative value)
  - Directional plays / short selling
- Pledged collateral for derivative products
- Index rebalancing / index changes
- Transition management

Routes to Market

- **Discretionary** – Clients utilize an agent lender who is responsible for facilitating and negotiating loan transactions, evaluating borrower credit risk, providing collateral monitoring and/or reinvestment, on-going loan maintenance, and recordkeeping.
- **Directed** – Clients operate their own program using a custodian to facilitate loans and/or cash collateral reinvestment transactions.
- **Auctions, Exclusives and Principal** – An arrangement whereby, for a pre-determined fee or price, a client agrees to make its portfolio or a portion of its portfolio available for borrowing on an exclusive basis to a particular borrower
- **Third Party** – Discretionary and exclusive programs where lending agent is not the custodian of the loan balances.

Major Factors Affecting Return

- **Program Parameters** – Flexibility around borrower selection, collateral types, negotiated spreads, maximum on-loan and reinvestment guidelines.
- **Loan Length** – Structures such as term or overnight.
- **Demand Spread** – The spread generated from the intrinsic value of the securities as determined by supply and demand. Higher borrowing demand leads to greater demand spreads
- **Investment Spread** – The spread generated by the reinvestment of the cash collateral. Wide flexibility around investment product and maturity allows for the opportunity to achieve wider investment spreads.

Lendable Assets

- U.S. treasuries
- U.S. Agencies
- U.S. & International Corporate Bonds
- U.S. & International Equities
- American Depository Receipts
- Real Estate Investment Trusts
- Mortgages
- Fixed Asset-Backed Securities
- Sovereign Bonds
- Eurobonds

Benefits to Financial Markets

- Provides critically needed liquidity
- Reduces bid/ask spreads or transaction costs
- Offsets operational expenses
- Enables investors to hedge risks
- Reduces failed trades
- Provides financing to facilitate transactions
- Enhances portfolio returns
- Supports short term fixed income instruments

Industry Associations, Regulators and Supporters

- Federal Reserve
- Global Securities Exchange Regulators
- Financial Services Authority
- Most major Central Banks
- International Securities Lending Association
- Risk Management Association
- G-30
- Pan Asia Securities Lending Association
- Securities Industry and Financial Markets Association
- Australian Securities Lending Association
- Canadian Securities Lending Association

Securities Lending Participants

Lenders	Borrowers
Pension funds	Broker/dealers
Mutual funds	Prime brokers
Insurance companies	Banks
Endowments & foundations	Hedge funds
Central banks	Tax arbitrageurs
Sovereign wealth funds	Mutual funds
Other asset managers	Proprietary traders

Risks

- Counterparty / Borrower
- Cash collateral reinvestment
- Legal / Contractual
- Operational / Trade settlement

Risk Mitigation Techniques

- Robust counterparty and issuer credit analysis
- Indemnification against borrower default
- Overcollateralization of loans to borrowers and robust daily process for collateral management
- Operational flexibility to restrict securities or borrowers when necessary
- Diverse universe of borrowers that are vetted as counterparties, subject to client restrictions
- Cash collateral reinvestment portfolio liquidity level based upon agreement between client and agent lender
- Reporting transparency and ongoing program reviews by both agent lender and client
- Separate account management structure with customized guidelines or commingled funds for cash collateral reinvestment