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"Having a thorough understanding of securities lending is the first step in any program design."

A Best Practice Approach for Designing a Securities Lending Program

A best practice approach for entering a securities lending program requires lenders to be able to clearly define the product, how it works, and the associated risks in order to design a customized program that explicitly meets the lender's risk and return objectives.

Program overview

Securities lending is an investment overlay strategy that involves the temporary transfer of a security by its owner (the lender) to another investor or financial intermediary (the borrower) in a transaction that is collateralized with cash or securities. Securities lending is intended to compliment investment strategies and allow investors the ability to monetize the intrinsic lending value of idle securities. The process of lending out these securities affords an investor the opportunity to produce alpha by generating income which can be used to increase portfolio returns or offset portfolio expenses with a manageable level of risk. Globally, securities lending provides critically needed liquidity in the financial markets, supports a variety of trading strategies, facilitates trade settlements and supports general financing techniques.

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 upon by the lender (or their lending agent) and the 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 lender agrees to pay back at the termination of the loan. To generate a yield, the lender will invest the cash in short-term fixed income instruments via a commingled fund or a separate account in order to achieve an interest rate above the rebate rate. The difference between the interest rate earned on the cash collateral and the rebate rate is the revenue (or spread) that is retained as earnings by the lender. In the case where the lender employs a lending agent, these earnings will be shared between the lender and the lending agent. 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. This fee (quoted as an interest rate) will be applied against the market value of the securities on-loan. If a lending agent is used, this fee is shared between the lender and the lending agent.

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Managing program risks

Securities lending, like all investment strategies, has a risk/reward trade-off. Historically, four types of risk have been associated with securities lending. Typically each of these can be managed through implementing a variety of controls with the lending agent's assistance. Counterparty/borrower risk can be mitigated by the lending agent through conducting extensive and continuous credit reviews, ensuring overcollateralization with daily mark-to-market, providing lenders with indemnification against borrower default, and a strong balance sheet to support the indemnification. Operational risk can be reduced by the lending agent through a robust operating framework, global scale and comprehensive understanding of transactional flows. Legal/contractual risk can be mitigated by using an industry standard securities lending agreement, compliance reporting and making certain the lending agent is utilizing a front-end compliance system. Cash collateral reinvestment risk rests solely with lenders and can be managed through appropriate program design and oversight from front-office or investment professionals. The cash collateral should be invested in securities that match a lender's risk/return profile and be treated like any other short duration fixed income mandate.

Defining your approach

Traditionally, the income earned from securities lending is added to the investment return associated with the lending portfolio(s). The lender's portion of this income is utilized to lower the cost of various bank services (e.g., custody) provided to the lender. There are lenders who choose not to use this type of "bundled" approach and look for each bank service to be priced independently (i.e., "unbundled") of the income earned from securities lending. Either approach, bundled or unbundled, should become part of the process for designing a securities lending program, requiring a lender to define their goals for participating in this type of investment strategy. A lender will need to decide if they are looking only to earn enough income to fully or partially offset bank-related fees, or if the main focus is to enhance portfolio returns. Each approach or goal will lead a lender to a different type of lending strategy risk profile. For example, if a lender is simply looking to offset some of their bank-related expenses, they might consider having strict lending and cash collateral reinvestment parameters, such as using only overnight government repo or accepting just securities collateral, thus limiting their lending opportunities. On the other hand, a lender seeking to produce additional alpha or income to reduce significant unfunded liabilities, considerably lower portfolio expenses and/or outperform competitors' funds (e.g., index funds) may be willing to invest the cash collateral in a 2a-7 or money market type structure and take advantage of additional lending opportunities.

Selecting a program structure

Working in tandem with the lending agent, lenders should design a program that achieves their goal and meets their risk/return objectives. A lender will need to consider four areas: program structure, loan type, parameters and collateral. Program structure refers to five types of lending distribution methods: agent discretionary, client-directed, auctions, exclusives and principal. In an agent discretionary program, a lender will utilize the lending agent to facilitate and negotiate loan transactions, evaluate borrower credit risk, provide collateral monitoring and/or cash collateral reinvestment and ongoing loan maintenance, and recordkeeping. A client-directed program allows lenders to operate their own lending platform using their custodian to facilitate loans and/or cash collateral reinvestment transactions. Generally speaking, auctions, exclusives or principal, are arrangements whereby a lender agrees to make their portfolio(s) or a portion thereof available for borrowing on an exclusive basis to a particular borrower for a pre-determined fee or price and period of time. Each program structure may be appropriate depending on a lender's goals, portfolio composition and market conditions.

Securities lending benefits the global economy by:

- Providing liquidity in the financial markets
- Supporting a variety of trading strategies
- Facilitating trade settlements
- Supporting general financing techniques

There are four types of risks associated with securities lending:

- Counterparty/borrower risk
- Operational risk
- Legal/contractual risk
- Cash collateral reinvestment risk

Main goals for participating in a securities lending program:

- Higher portfolio returns
- Offset bank-related fees

Lenders need to consider four areas in designing a customized securities lending program:

- Program structure
- Loan type
- Parameters
- Collateral

Loan types

The second program design consideration is the types of loans (e.g., open, term, general collateral and specials) a lender is willing to engage in and the lending philosophy (e.g., value or volume) utilized. Most loans are specified for an open period, which implies that the loan can be terminated at any time and the rebate rate or fee can be renegotiated. A term loan is for a specific period of time, generally at a fixed rebate rate or fee. General collateral loans are for securities that are not experiencing high borrowing demand and therefore produce lower earnings per loan due to higher rebate rates or lower borrowing fees. This approach, often described as volume lending, could necessitate a more aggressive cash collateral reinvestment strategy (e.g., money market) to allow for a greater level of reinvestment spread (i.e., yield earned above the federal funds rate) through the investment of cash collateral in higher yielding and longer duration securities. Volume lending will typically produce larger cash collateral balances which may lead to higher program earnings. A value approach would involve lending mostly "specials," which are defined as securities with high borrowing demand as noted by very low and sometimes negative rebate rates or high fees paid by the borrower(s). This type of strategy produces a higher return per loan and would allow for more conservative cash collateral reinvestment guidelines (e.g., overnight repo).

Parameter specifications

During the design and implementation phase, a lender will need to determine if any specific parameters should be enacted. One parameter, minimum spread, is defined as a specific level that sets a spread between the collateral investment rate and rebate, which needs to be achieved before a loan can take place. Another parameter, maximum on-loan, is used to specify the highest amount of a portfolio and/or a security that can be on-loan at any point in time. This parameter can be noted as an outright percentage of a portfolio or specific market value. Borrower limits parameter denotes the maximum amount (e.g., by market value or percentage) that a lender's program can be on-loan to a particular borrower. Finally, a lender can establish specific account and security level restrictions. For example, a lender may choose to make a certain cusip ineligible for lending. Each of these parameters allows a lender flexibility to design and implement a securities lending program that explicitly meets their objectives.

Working in tandem with the lending agent, lenders should design a program that achieves their goal and meets their risk/return objectives.

Options for collateral

The final step a lender takes in designing their securities lending program deals with collateral options (e.g., cash and/or securities). Lenders who choose to accept only securities as collateral should be aware that lending opportunities may be reduced, and they will need to decide which types of securities are acceptable from a risk standpoint. When cash collateral is accepted by the lender, they may have the option of selecting from a variety of cash investment vehicles. Such options include a dedicated separate account, a commingled fund, an external (i.e., to the lending agent) investment vehicle and a "self-invest" model, whereby the lender invests the cash. A separately managed account allows a lender to customize their cash collateral reinvestment program to meet their unique risk and return requirements, allowing for increased transparency and control. A commingled fund pools lenders together according to a common investment strategy. With an external investment vehicle, a lender may already have positive experience with a specific fund or investment manager and therefore select this option. A lender who feels that managing short-term cash is a core competency of their firm may choose

There are several types of loans that can be considered when designing a securities lending program. They include:

- Open period loan
- Term loan
- General collateral loan
- Specials

There are several types of parameters that lenders can enact in implementing their securities lending program. They include:

- Minimum spread
- Maximum on-loan
- Specific account and security level restrictions

Options for investing cash collateral include:

- Dedicated separate account
- Commingled fund
- External investment vehicle
- Self-invested account

Choosing the appropriate cash collateral reinvestment vehicle depends on:

- Lending program size
- Liquidity requirements
- Control/ownership level
- Desire to influence investment decisions
- Transparency level
- Ability to match risk/return tolerance

to utilize the self-invest model. This part of the securities lending design process requires that the lender fully understands and is comfortable with the cash collateral reinvestment vehicle's investment philosophy (e.g., capital preservation, income) and guidelines (e.g., liquidity level, duration, credit quality, security types and sector). Choosing the appropriate cash collateral reinvestment vehicle can depend on a variety of factors such as lending program size, liquidity requirements, control/ownership level, desire to influence investment decisions, transparency level and ability to match risk/return tolerance.

Summary

Securities lending has been an integral part of the financial markets for over 75 years and continues to provide valuable opportunities for investors to earn additional income or alpha within a risk-controlled environment. This investment strategy enables lenders to enhance portfolio returns and offset portfolio expenses. The best practice approach to designing a securities lending program should encompass a thorough understanding of the product, lending and collateral options and the lender's individual goals and risk/return objectives.

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