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Securities lending

Current market environment

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Recent market events have had a substantial impact on securities lending practitioners and their clients. Notably, the demise of Lehman Brothers, some government restrictions on short-selling activity and under-performing money market funds, have all played their part in putting pressure on the lending industry.

Some clients have suspended their lending activity until such time as markets are more settled and their lending guidelines have been reviewed. We are supportive of this approach and believe all clients should review their lending arrangements to ensure they fully understand the risks involved and confirm the lending guidelines are appropriate.

We set out summary details on the issues below. Our focus in this paper is on lending via an agent (typically a client's custodian). In the conclusion we set out our views on appropriate options currently available to clients that wish to amend their lending arrangements.

The key areas:

Counterparty risk

As part of the lending process, agents will lend client assets to a number of counterparties (borrowers). The agents have processes in place for monitoring the credit-worthiness of the counterparties, and their overall exposure to them.

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Lehman Brothers was a sizeable borrower in the global securities marketplace, hence its demise impacted greatly on lending activity. A number of large agents had reduced their exposure to Lehman or increased the collateral requirements in the preceding weeks, but all had loans outstanding at the time of its default. The default of such a key borrower led to an unprecedented large-scale use of the collateralisation process to purchase (buy-in) clients' securities that were on loan. On the whole, the industry coped well with this process and the majority of client assets were re-purchased within two days of events unfolding.

Collateral

When agents lend securities to counterparties, they receive collateral to at least cover the value of the lent securities. This collateral is in the form of either cash or securities (non-cash). Clients that allow for cash collateral in their lending guidelines may find that the collateral was invested in securities that have declined in value or that the collateral holdings have experienced mark to market losses related to illiquidity. A requirement specific to cash collateral is that lenders are required to achieve a return at least equal to the rebate rate paid to the borrower on the cash received. All principal losses and failure to meet the re-investment rates are the responsibility of the client, who will be expected to fund any deficit. Clients holding non-cash collateral do not have such re-investment requirements.

To provide enhanced security over the loaned assets, the collateral posted by the counterparty includes a margin to account for changes in value of both the lent assets and the collateral in the event that non-cash collateral has been received. For example, it may be that for each £100 of securities lent, the collateral to cover that must be equal to £105. The quality of non-cash collateral accepted can vary, with a conservative and appropriate approach being to only accept high quality collateral, for example government securities.

It is important to ensure that the collateral arrangements agreed for a lending programme are in-line with a client's risk tolerances.

Indemnification

Agent lenders can provide clients with an indemnified lending programme. The indemnification typically covers clients for the loss of loaned assets, and any shortfall in any non-cash collateral in place to cover those assets. It is industry standard for the indemnification to not cover cash collateral.

While indemnification policies provide comfort for clients, there are still risks inherent, due to the policies being backed-up by either the agent's balance sheet or an insurance policy. The chain of events resulting in the indemnification to be required and to fail would be extreme (but not impossible).

Conclusion: What to do next?

It is our recommendation that clients suspend securities lending activity unless loan arrangements are well understood and each is comfortable with the risks associated with its programme. We recommend that clients research collateral types and amounts, re-investment guidelines (in the event that cash collateral is taken), counterparty restrictions and any collateral indemnification provisions provided by the lending agent. If risks are examined and deemed unacceptable, clients can:

- **Suspend securities lending, where possible**
  Clients with non-cash collateralised lending should be able to suspend lending immediately. If cash collateral was accepted and principal losses have been experienced in the collateral holdings, or the unimpaired collateral holdings have experienced mark to market losses related to illiquidity, clients will incur a cost to exit the programme unless the lending agent has made a compensatory concession. Further, some lending agents may restrict a wholesale withdrawal from the programme.

- **Initiate a gradual withdrawal from the programme**
  Several lending agents have initiated programmes where a client's exposure is gradually reduced over time. Again, if collateral is not sufficient to repay borrowers as securities are returned, at some point clients will incur a cost to exit the programme unless the lending agent has agreed, for whatever reason, to pay that cost.
- **Change the lending guidelines**
  All lending agreements, between client and the agent, set the guidelines for participation in the lending programme. It may be prudent to increase the collateral requirements (both quality and/or value), review the list of borrowers, review the indemnification structure and change the cash collateral reinvestment guidelines (where cash collateral and its associated risks are deemed to be acceptable). We strongly recommend conservative non-cash collateral guidelines or very conservative reinvestment of cash collateral as risk minimisation strategies.

Pooled funds – securities lending

Many investment manager pooled funds participate in securities lending. Just as with direct lending programmes, it is important to understand and attain a satisfactory level of comfort regarding the risks taken on behalf of clients as participants in these funds.

As with all investment decisions, clients need to be confident that the risks taken in securities lending are well compensated in terms of expected return.

Further information

No action should be taken on the basis of this paper without seeking specific advice. If you would like to discuss any of these areas covered in more detail, please contact your usual Watson Wyatt consultant.