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TREASURY Topics

Securities Lending

Executive Summary

In today's capital markets, investors with large portfolios always seek opportunities to maximize liquidity and return while preserving principal value. Securities lending offers just such an opportunity for many institutional investors including corporate investors. In securities lending transactions, securities held within investment portfolios are frequently lent to parties willing to pay to borrow them. These transactions, sometimes called repurchase agreements (repos), loans and sell-buyback arrangements, are generically described as securities lending.

A securities lending program for a corporate cash portfolio is similar in structure and risk to a program for a pension plan or insurance company, with accounting considerations being the notable exception.

Introduction

The basic transaction in securities lending is a collateralized loan, where the company borrows money from a brokerage firm at a very low rate (a rate that is much below market levels and may even approach 0%) collateralized by one or more securities held in the company's portfolio.

Participants

Brokerage firms that need specific securities in order to meet a delivery obligation or speculators that want to carry short positions in specific securities are willing to lend money to an investor that holds the desired securities in its investment portfolio at a below-market rate to gain access to that security. Firms seeking to prevent outright settlement failures, when a counterparty fails to deliver promised securities, will borrow securities overnight. Other reasons for borrowing securities include derivative or cash hedging and arbitrage transactions.

The primary lenders of securities (borrowers of below-market rate cash) are large, institutional investors such as corporations, pension funds, insurance companies

and mutual funds that are typically longer-term holders of securities.

Why a Securities Lending Program?

The underlying motivation for a company to start a securities lending program is the opportunity to earn incremental income with marginal additional risk. When a company borrows against securities that would otherwise be held idle in the portfolio, the company receives cash at a borrowing rate that is lower than overnight money market fund rates. This cash can be reinvested in overnight funds or in other investments, resulting in net positive interest income to the investor. This additional income can have a significant impact on a corporate cash portfolio, where even a small improvement in portfolio performance can have a noticeable impact on company earnings.

Securities lending can also be a liquidity tool. If a company needs to raise cash without realizing losses from selling securities, it can borrow against securities in the portfolio at below market rates to meet the short-term cash requirement. The company may then sell the securities in a more favorable market environment.

Fundamentals

Securities borrowers are generally required to provide collateral to assure the performance of their redelivery obligation. The two main types of collateral used are: (1) cash and (2) other securities.

In corporate cash security lending programs, cash is almost always provided as collateral. This cash is typically reinvested in a short-term fund specifically designed for securities lending collateral, at some premium over the borrowing rate on the cash collateral. No investor would lend securities if the borrowing rate were higher than uncollateralized alternatives, as the only motivation for lending securities is to earn a positive spread over the borrowing rate on cash collateral. In terms of net income, a securities lending program should always increase portfolio income.
Although there are also some increased risks, which will be addressed below, securities lending is generally seen as a low risk, positive value proposition.

Role of the Custody Bank

Securities lending has become widely viewed as an add-on to services provided by custody banks. Banks will lend securities on behalf of corporations whose portfolios they hold. Custodians use their infrastructure, including personnel and systems, to manage a large-scale securities lending program. Offering securities lending services enables custodians to increase revenue from their custody clients while providing the client an opportunity to earn incremental income with limited risk.

In an effort to keep things simple, most custodians run the entire securities lending program for their clients, including the reinvestment of cash collateral. Securities are only lent when a positive spread can be earned between the collateral rate and a market interest rate. This spread is known as “lending revenue” and the client generally sees the total lending revenue figure rather than a detailed breakdown of all borrowing and lending rates and individual transactions.

Negotiating a Securities Lending Program

Securities lending can be the most profitable part of a custody relationship for the bank. It can also be a valuable source of additional income for the custody client. A company can extract significant cost savings and potentially defray 100% of custody costs (or more) by entering into a securities lending program with its custodian or a more cost effective third-party lender.

The custody bank is compensated for managing a securities lending portfolio via a revenue split negotiated at program inception.

Not all portfolios are equally “lendable”.

Securities lending revenue depends on the demand for particular securities. Lending collateral of lesser quality can produces higher lending spreads. Similarly the interest rate spread earned by a securities lender is higher when there is greater demand for the security to be borrowed resulting in more value to the securities lending program.

Securities Lending Revenue Split

The fee split between client and lending agent can vary considerably although in almost all cases the client receives the majority of the fee. In general, portfolios of $300-$500 million in US Treasuries or Agencies can negotiate a revenue split of 70/30 with the client earning 70% of the total program revenue.

The revenue split is not the only pricing consideration. One bank may offer a 90/10 split, but if the total lending revenue earned by this bank is lower than the competition (due to less efficient lending of the portfolio or lower rates on the reinvested cash), the client may earn fewer dollars even after negotiating the higher percentage split.

The primary determinant for the revenue split is the level of competition between banks. Therefore, the company will benefit from requesting securities lending program bids from its custody bank and several other third-party securities lending banks.

A client is not limited to its custody bank for securities lending services. Third-party lending relationships can often be more profitable for the client.

Safekeeping and Securities Lending

If your company currently holds securities in safekeeping with a broker, you should review the contract. Even without a specific securities lending agreement, it is not uncommon for a brokerage firm to lend the company’s securities it holds and keep 100% of the lending revenue.

Program Risk and Indemnification

One of the most important benefits of working with a bank to manage the securities lending portfolio is the contractual indemnification of certain risks including counterparty default. This indemnification ensures that, if the borrower is unable to return the borrowed security, the bank will provide full economic restitution to the lending company. Liquidity risk, operational risk and settlement risk are also covered by the custody bank.

In summary, the bank managing the securities lending program will indemnify the company against charges resulting from settlement errors and, equally important, the program will have no impact on decisions or timing of trading for internal or external portfolio managers.

The Investment Policy

The risk from reinvestment of cash collateral is not covered by the bank's indemnification and should be addressed in the company's investment policy.

While most custodians run the entire securities lending program for their clients, including the reinvestment of cash collateral, the company, not the custody bank, bears the credit risk of reinvestment of cash collateral.

Most securities lending programs have an AAA-quality fund designed specifically for the collateral reinvestment.

Assuming the contract with the bank includes indemnification against counterparty, settlement and liquidity risk, the risk of a securities lending program borne by the client is simple: the risk of the collateral reinvestment. If the company's investment policy allows the cash collateral from a securities lending program to be invested in an AAA-quality fund, the company is taking AAA-quality fund risk.

The company may elect to reinvest cash collateral in a higher risk vehicle to earn a higher return on their program. Whatever the company's risk appetite, it is important to address the credit limits for cash reinvestment specifically in the investment policy.

A policy that adequately addresses the risk of a bank-managed securities lending portfolio includes:

1) A written contract with the securities lending provider that indemnifies the client against counterparty default, inappropriate margin, liquidity, operational and settlement risks.

2) A specific definition of minimum risk requirements for reinvestment of securities lending cash collateral (e.g., AAA-quality fund)

Accounting Considerations

Corporate accounting standards have an influence on a corporate securities lending program, particularly with respect to whether (and under what conditions) collateral must be reflected on the balance sheet.

It is commonly understood that securities lent over a fiscal quarter-end require the company to gross-up the balance sheet by the amount of the collateral. The result is an increase in liabilities by the amount of the securities lent. For example, if a company had $200 million in securities out on loan, there would be an additional $200 million in liabilities reflected on the balance sheet, and the off-setting cash collateral would be added to the asset side of the ledger.

To address this issue, many companies unwind the securities lending program at quarter-end to avoid the impact to the balance sheet (see sample disclosures below).

Banks would prefer not to unwind the program over quarter-end because it is more operationally intensive and decreases the total program revenue, of which they get to take a share. However, banks that provide securities lending services to corporations understand that this unique characteristic of corporate cash securities lending is part of the business and thus it will be reflected in the revenue and pricing estimates.

Sample Financial Disclosures for Securities Lending

Sun Microsystems, Inc. 2005 Annual Report

"From time to time, we enter into securities lending agreements with financial institutions to enhance investment income. Selected securities are loaned and are secured by collateral equal to at least 102% of the fair market value of the securities. Collateral is in the form of cash or securities issued or guaranteed by the U.S. government, and our securities lending agent has provided us with counterparty indemnification in the event of borrower default. Loaned securities continue to be classified as investment assets on the consolidated balance sheet. Cash collateral is recorded as an asset with a corresponding liability. For lending agreements collateralized by securities, no accompanying asset or liability is recorded, as we are not permitted to sell or re-pledge the associated collateral. The maximum amount loaned under Sun's securities lending program in fiscal 2005 was $923 million. As of June 30, 2005, there were no outstanding securities lending transactions."

EMC Corporation 2004 Annual Report

"We lend certain fixed income securities to generate investment income. We have entered into various agreements to loan fixed income securities generally on an overnight basis. Under these securities lending agreements, the value of the collateral is equal to 102% of the fair market value of the loaned securities. The collateral is generally cash, U.S. government-backed securities or letters of credit. At December 31, 2004, there were no outstanding securities lending transactions."

Intel Corporation 2004 Annual Report

"The company, from time to time, enters into secured lending agreements with financial institutions, generally to facilitate hedging transactions. Selected securities are loaned for short periods of time and are secured by collateral in the form of cash or securities. The loaned securities continue to be carried as investment assets on the balance sheet. Cash collateral is recorded as an asset with a corresponding liability. For lending agreements collateralized by securities, the collateral is not recorded as an asset or a liability, unless the collateral is re-pledged.
Intel's practice is to obtain and secure available collateral from counterparties against obligations, including securities lending transactions, whenever Intel deems appropriate."

Conclusion

Securities lending can be an attractive source of additional revenue to the institutional investor if the portfolio includes Treasuries, liquid, non-callable agencies and/or liquid corporate bonds. Depending on the size and quality of the investment portfolio, the additional revenue can be significant.
Let us know if you would like to learn more about companies with active securities lending programs, how to choose the right securities lending vendor (custody or third party) or more information on how to present to senior management, the audit committee or the board of directors.

Disclaimer

The information provided in this article is the result of experience with investment accounting issues and interaction with accountants and investment service providers. It is not intended to be relied upon substantively; rather, it is intended to inform and provide a discussion framework that treasury practitioners, internal management, and accounting and audit staff can use to discuss the impairment process.

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