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Other People's Money

The Unrealized Conflicts of Securities Lending

By Timothy DeLange and Ian Berg

Lending agents are not responsible for any investment losses, and thus are incentivized to seek maximum gains, regardless of increased risk, placing their interests in direct conflict with their clients' interests.

The primary goal of most institutional investors, such as public pension funds, is to prudently invest their assets and develop a portfolio that will accommodate long-term financial needs. Accordingly, these investors typically hold large blocks of individual securities in their portfolio, hoping that the value of those securities will appreciate over time. Over the past twenty years, institutional investors and other large stock holders have increasingly used these long-term holdings to reap short-term profits through "securities lending" programs.

Securities lending utilizes long-term stock holdings that would otherwise sit idle by temporarily lending them out on a cash-collateralized basis and investing the cash in safe, short-term investments for a modest return. Borrowers typically use the securities to cover short positions, to hedge positions or to take advantage of arbitrage opportunities. Although the concept of securities lending dates back more than a century, the practice became widespread in the 1970s when custodial banks initiated formal programs to broker loans involving their custodial clients.

In its most basic form, securities lending is where a loan results in a transfer of title or ownership of certain securities to a borrower, who is obligated to return the same type and amount of securities in the future. Modern securities lending programs typically work as follows (see charts on opposite page):

Step 1: A securities lender, typically an institutional investor or other large securities holder, deposits its securities with a lending agent, which is often that institution's custodial bank.

Step 2: The lending agent offers a block of securities to a borrower, typically a hedge fund or other short-seller, in exchange for cash, usually 102 to105 percent of the market value of the securities.

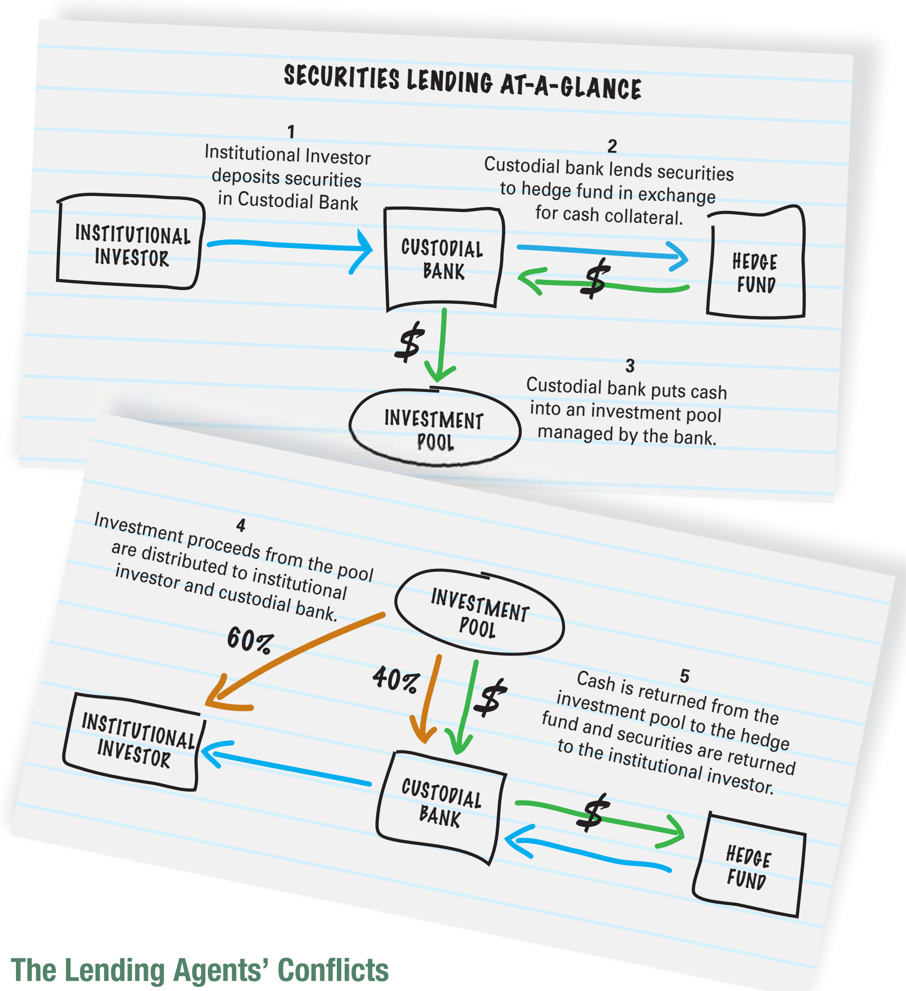
Step 3: The lending agent then deposits the cash into an investment pool managed by the lending agent or an affiliate.

Step 4: The investment pool is used to acquire safe, short-term assets, with proceeds distributed to the securities lender, minus a percentage fee paid to the lending agent.

Step 5: Upon request, or at a negotiated time, cash is returned to the borrower in exchange for the securities being returned to the lending agent.

In the 1990s and 2000s, the demand for securities lending grew with the expansion of global securities markets and the exponential increase in short-selling and hedge funds with related trading strategies. In 2007, there was an estimated $5.5 trillion worth of securities on loan through various lending programs. These securities lending programs attracted institutional investors because they were marketed as a relatively low-risk venture that was consistent with the conservative investment philosophy and guidelines of most participants. Indeed, most securities lending program contracts require the custodial bank or investment pool manager to invest the collateral funds conservatively and prudently to safeguard principal and to maintain adequate liquidity. Moreover, most collateral pools are restricted to short-term investments because shorter investment periods usually have less volatility.

With an emphasis on short-term assets, collateral investments should, in theory, be well insulated from a market downturn. Such theory, however, overlooks the substantial conflicts of interest among the custodial banks and brokers that facilitate the largest and most widely-used securities lending programs. Indeed, recent experience shows that these conflicts likely ensured that reinvested collateral would suffer losses that otherwise could have been avoided, or at least mitigated.



The Lending Agents' Conflicts of Interest

In exchange for brokering loans and investing collateral, lending agents receive a percentage of the investment returns, typically 30 to 40 percent. Lending agents are not, however, responsible for any investment losses. In other words, institutional lenders shoulder 100 percent of collateral reinvestment losses, yet receive only 60 to 70 percent of the gains. Thus, lending agents are incentivized to seek maximum gains, regardless of risk, placing their interests in direct conflict with their clients' interests. The result is that lenders might not invest collateral consistent with appropriate risk controls and investment guidelines, causing the institutional investor to unknowingly bear a disproportionate risk to the collateral received.

This is exactly what happened on an industry-wide basis in the period leading up to the credit crisis of 2008. Several custodial banks that run securities lending programs and manage collateral investment pools were caught holding riskier, long-duration asset-backed and mortgage-backed securities when they were supposed to be holding safer and less volatile short-duration assets. While such securities had boosted the returns to lending agents and institutional investors alike during the boom years of the economy, by early 2008, the value of these long-term securities had steeply declined, leaving the institutional investors (but not the lending agents) at risk of significant losses.

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As the unrealized losses for investors mounted, the conflicts of interest between institutional investors and lending agents became more severe. Not only did the lending agents have no exposure themselves to past or future losses of the investments, but many were also self-dealing, profiting from investments in entities in which they held a direct or indirect financial interest. In addition, governing accounting principles would require the lending agents to consolidate any realized losses from the related-entity collateral investment pools on their own balance sheets — making them more reluctant to sell the assets at impaired values. Consequently, despite the declining values of these long-term securities, collateral pool managers largely failed to adjust their investment strategies in favor of safer, short-term securities. In other words, though the lending agent banks had the opportunity to sell the assets at a slightly impaired value (thereby realizing some losses but mitigating exposure and preventing greater future losses), lending agents almost uniformly declined to do so, maintaining that the long-duration asset-backed securities in the cash collateral pools were not impaired and that valuations would soon return to normal levels.

As a result, by the Fall of 2008, the major securities lending programs were no longer producing gains and were, in fact, showing significant losses. Indeed, *Pensions & Investments* magazine estimates that valuation problems in the enhanced cash collateral pools that back securities lending programs were negatively impacting as many as 90 percent of U.S. pension funds and many defined contribution plans. A majority of these losses were the direct result of an illiquid market for long-duration asset-backed securities in the wake of the collapse of Lehman Brothers and CIT, as well as the government bail-out of AIG. Notably, these events occurred after the lending agents were already aware of the declining values of long-duration assets held in their respective investment pools. In stark contrast, the market for short-term investments — the types that collateral pools were intended to invest in, and that lending agents purported to invest in — was less affected by these events and the general economic downturn.

Market volatility in the pricing of long-duration securities caused the net asset value of the cash collateral pools to decrease across the industry, including at the three leading global custodians and largest securities lending agents: Northern Trust, State Street and The Bank of New York Mellon. The lending agents — who were incentivized to sit tight while asset values continued to decline and collateral deficiencies grew — prohibited several institutional investors from exiting their respective securities lending programs.

A "collateral deficiency" occurs when the lending agent determines that a substantial portion of the invested collateral is so impaired that it will be insufficient to repay borrowers upon redemption. Contractually, when there is a collateral deficiency, the institutional investor has to make up the difference between the collateral pool and what is owed to the borrowers. For example, in September 2008, Northern

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Trust, one of the largest securities lending agents, declared a collateral deficiency of $885 million on a pool that held upwards of $70 billion in assets and is now demanding payment from its institutional investor clients.

Several other lending agents, including Wells Fargo, JPMorgan, U.S. Bank, State Street and The Bank of New York Mellon, have also declared collateral deficiencies. Investors are now being asked to contribute additional funds to make up for the significant realized and unrealized losses in the collateral pools. If an institutional investor wanted to accept its realized losses and exit its respective securities lending program, the institutional investor would still have to make up its share of the collateral deficiency caused by unrealized losses on impaired assets.

Institutional Investors Fire Back

Stuck between the proverbial rock and a hard place, several investors have filed claims against these lending agents and others, alleging that the lending agents improperly invested collateral pool assets and acted in their own undisclosed interests at the expense of their clients—in clear violation of their fiduciary duty and in breach of their contractual arrangements. The need for greater transparency and investor protections, particularly in regards to lending agents' conflicts of interest, is also increasingly becoming a topic of discussion among institutional investors and regulators. On September 29, 2009, the SEC hosted a "Securities Lending and Short Sale Roundtable" discussing these issues. While the SEC commissioners and panelists generally agreed that securities lending is critical to a properly functioning market, in part because such lending creates greater liquidity and enhances short-selling ability, the SEC has decided to explore possible regulation of what SEC Chairman Mary Schapiro called an "opaque" multi-trillion-dollar securities lending market.

The promise of future regulatory safeguards may offer some comfort to institutional investors that severe losses from securities lending can be avoided in the future; however, it offers little consolation to institutional investors who are struggling to make up for the losses already incurred. The lessons for any institutional investor are to actively monitor your securities lending program and collateral investments, to be mindful of collateral deficiencies of any amount, and to potentially take action to protect your assets, as several institutional investors have already done.

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