



RECOMMENDED PRACTICE

Securities Lending Programs for Non-Pension Fund Portfolios (1995, 2002 and 2008) (CASH)

Background. Where permitted by state statutes, governmental entities participate in securities lending programs as a way of earning incremental investment income on non-pension fund assets. In securities lending programs a governmental entity lends securities such as U.S. Treasury, agency, or government sponsored enterprise (GSE) securities, from its investment portfolio, in return for collateral. The collateral is often cash, which is then reinvested.

A securities lending transaction has many of the same characteristics as a reverse repurchase transaction. In both, securities are lent to a counter party with the governmental entity receiving collateral to be reinvested. A major difference is that securities lending programs are ongoing whereas reverse repurchase transactions are typically one-time or non-recurring.

Broker-dealers typically are the borrowers in securities lending programs. They use the borrowed securities primarily to cover fails (the non-delivery of securities expected to be delivered on a date certain) and short sales (the sale of securities not presently owned by the seller in order to take advantage of an expected lower market price), and to execute arbitrage transactions. Accordingly, securities lending programs play an important role in maintaining orderly markets.

The securities loaned are collateralized for the term of the loan and marked-to-market daily. Collateral may be cash or other securities, and is usually 102% or more. This overcollateralization reduces the lender's exposure to the borrower. The lender retains the economic benefit of owning the securities including the coupons paid during the period the securities are loaned.

Cash collateral usually has a borrowing rate less than the overnight money market funds rate. The difference between the borrowing rate and the reinvestment rate produces a net gain in interest income. The resulting income is subsequently split between the participants in the securities lending program.

Because securities lending programs are not primary activities for most participants, governmental entities may depend on the expertise of a lending agent. Typically, the master trust, custodial and safekeeping banks or asset managers act as lending agents or intermediaries, facilitating securities lending programs for their customers.

Typical Steps

Typical steps are illustrated in the graphic that follow this recommended practice.

- 1) Governmental entity works through lending agent to lend securities
- 2) Broker-dealer borrows securities
- 3) Collateral (for securities loan) is delivered at predetermined level
- 4) Simultaneous to receipt of the collateral, securities are delivered to the borrower
- 5) Cash collateral is reinvested
- 6) A negotiated portion of the cash collateral reinvestment interest is paid to the borrowing broker-dealer as a rebate, typically a market rate. In the case of cash collateral, the lending agent negotiates the interest

rate on the collateral paid to the borrower of the securities, which is called the rebate rate. In the case of non cash or securities collateral, the lending agent negotiates a fee paid by the borrower.

- 7) The difference between what is earned on the cash collateral investment and the rebate rate is the gross spread. The lending agent retains a portion of the gross spread as its fee and credits the remainder to the owner of the securities as negotiated between the governmental entity as the lender and the lending agent
- 8) The governmental entity keeps the remaining reinvestment income
- 9) The value of the collateral is marked to market daily to ensure full collateralization
- 10) At the end, borrower returns securities to governmental entity via lending agent and simultaneously the lending agent returns collateral to borrower.

Risks

While securities lending programs are considered relatively low risk, there are risks.

Lending Risks

- Counterparty or Borrower (Broker-Dealer) Risk. This is the risk the borrower will not return the securities borrowed at the end of the loan term. Borrowers must have high credit ratings from the rating agencies, and, more importantly, must meet certain other financial criteria as specified by the lending agent or the governmental entity in the securities lending agreement. A part of the counterparty risk is that the broker-dealer as borrower fails to provide additional collateral on a daily basis or as required
- Concentration Risk. This risk is related to and amplifies borrower risk.
- Collateral Risk. The lender (governmental entity) does not have enough collateral to cover the market value of borrowed securities.

Reinvestment Risk

- Interest Rate Risk is the risk that the yield on the invested collateral is less than the rebate paid to the borrower.
- Maturity Risk The risk that the maturity of the collateral investment differs from the maturity of the loaned securities (more than by a specified range).

Operational Risks

These risks generally involve problems with administrative or logistic issues of the program. These may include problems with settlement, corporate actions, dividends or interest, marking to market, monitoring, billings reporting.

Typically, a lending agreement provides that counterparty (broker-dealer) credit risk, broker-dealer default risk, and collateral maintenance are risks undertaken by the lending agent. However, indemnification provisions vary. The government as the lender of the securities often determines what counter-party is acceptable, the size of the investment program, and the type of securities used, generally reflected in the split of the investment proceeds. Risks typically borne by the lender or governmental entity include: lending agent credit risk, lending agent default risk, and collateral investment risk.

Liquidity requirements are often accepted and guaranteed by the lending agent upon one day's notice, as substitution of the lending client in large lending programs is easily accomplished and essentially risk-less. Programs that require the client to undertake responsibility for managing the liquidity present greater risks and require that the client place limits on the amount of the portfolio which may be put on loan. The term of the securities on loan and the reinvestment of the proceeds must be carefully established by the client and strictly managed.

Recommendation. While investment strategies that include securities lending programs are not inherently risky when employed judiciously with appropriate precautions and controls, the Government Finance Officers Association (GFOA) urges state and local government officials to exercise caution in their use of securities lending programs.

Only governmental entities that have expertise and resources should engage in securities lending programs. Prior to participating in a securities lending program, government finance officers should:

- Determine whether securities lending is permissible under state statute and the governmental entity's written investment policy;
- Exercise special caution in selecting and evaluating the creditworthiness of lending agents and counterparties to the securities lending program
- Consider the lending agent's experience
- Implement a written lending agreement subject to appropriate legal and technical review
- Pay special attention to
 - indemnification provisions
 - the investment guidelines and terms of the lending, including the maturity of loans and the types of securities purchased
 - the liquidity provisions and risks
 - the frequency of marking the collateral to market
 - the agreement for the split of investment proceeds
- Ensure independence of audit process. Avoid possible risk from number of parties involved (government, dealer, and custodian) by having signed contract and requiring proper reporting procedures.
- Consider the resources required to monitor compliance with the agreement.

References

- *Investing Public Funds*, Second Edition, Girard Miller with M. Corinne Larson and W. Paul Zorn, GFOA, 1998
- GFOA Recommended Practice, *Repurchase Agreements & Reverse Repurchase Agreements* (2003 and 2006)
- GFOA Recommended Practice, *Presenting Securities Lending Transactions in Financial Statements* (1998)

Approved by the GFOA's Executive Board, October 17, 2008.

Overview of a Securities Lending Transaction

