Investment opportunity

A market perspective on the changing securities lending landscape

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The recent financial crisis has been, without doubt, one of the most challenging periods for the global economy in the history of modern finance. Even so, investors are still seeking to enhance returns on their investment portfolios, given the specific risks inherent in these investments. One of the opportunities in enhancing the portfolio return is to utilise securities lending.

Financial markets went through major changes over the past decade: investments considered relatively safe defaulted, large international investment banks filed for bankruptcy and European governments failed to meet capital requirements. Still, investors seek to maximise returns on their investment portfolios.

Securities lending

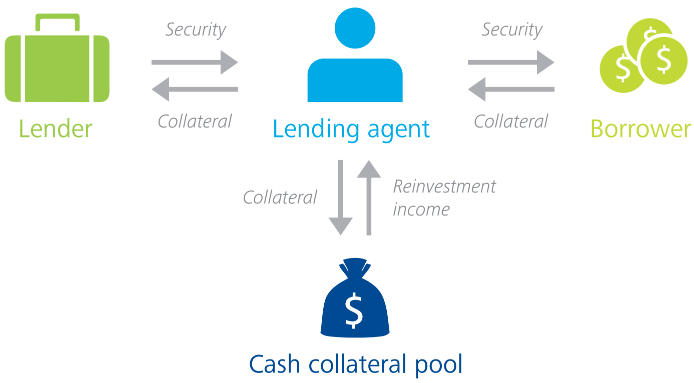
Securities lending is the market practice by which, for a fee, securities are transferred temporarily from one party (the lender or beneficial owner) to another (the borrower). Borrowers want to own securities for a certain period for a variety of reasons, including covering a short position and enhancing settlement efficiency. The vast majority of securities lending is executed by a securities lending agent (figure 1). Pension funds and insurance companies are typical lenders of securities since they hold large, relatively stable asset portfolios. The reason lenders make their securities available is to generate additional returns on their portfolios. Returns can be generated from both the loan fee from the borrower and any return from cash collateral reinvestment.

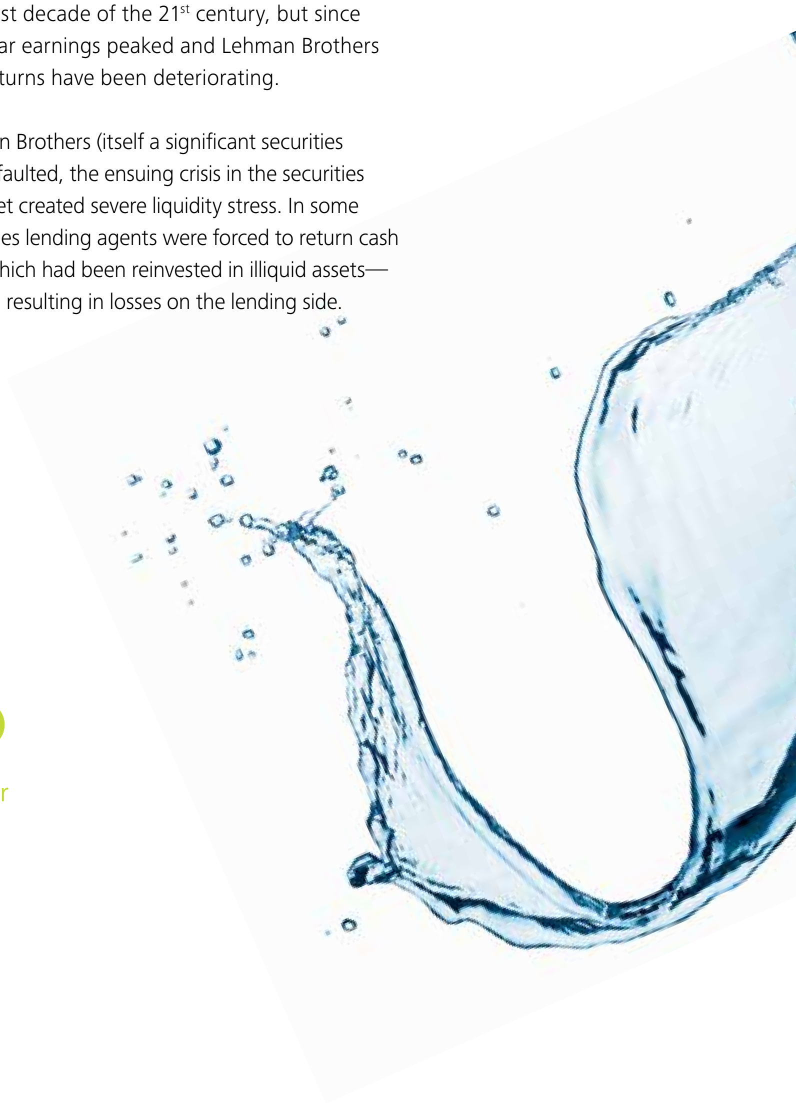
Market developments

Securities lending arose in the 1960s in the UK as an informal practice among brokers who had insufficient share certificates to settle their sold securities. During the 1970s and 1980s, it evolved into the market practice it is today. The market continued to develop during the first decade of the 21st century, but since 2008, the year earnings peaked and Lehman Brothers defaulted, returns have been deteriorating.

When Lehman Brothers (itself a significant securities borrower) defaulted, the ensuing crisis in the securities lending market created severe liquidity stress. In some cases, securities lending agents were forced to return cash collateral—which had been reinvested in illiquid assets—to borrowers, resulting in losses on the lending side.

Figure 1: Agency securities lending transaction





The losses and liquidity stress were typically commensurate with the degrees of credit risk and liquidity transformation associated with the investment of cash collateral. Asset-liability mismatches were created by excessive speculation in cash reinvestment in what could have otherwise been a relatively safe activity. The collapse of Lehman Brothers forced many financial institutions to review their lending programmes, resulting in a range of measures, from introducing more conservative guidelines to drastically scaling back or suspending lending activities. Another reason has been the host of short-selling regulations appearing and disappearing, which have resulted in investors temporarily suspending their participation in the lending market, fearing they may contravene short-selling bans.

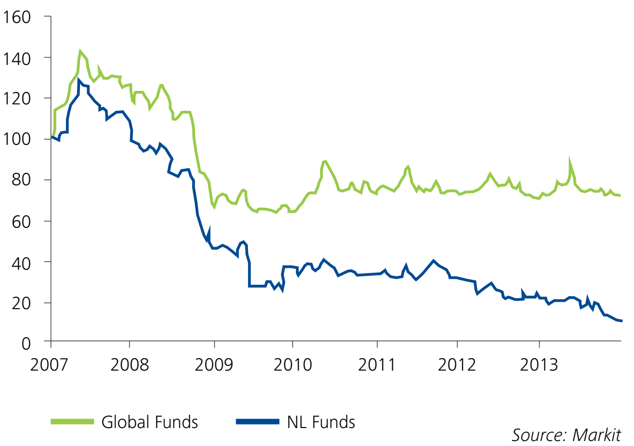
The crisis struck at the heart of financial markets and slowed securities lending activities significantly, on a global scale, where it decreased 56% (figure 2) in 2014 as compared to the pre-Lehman period. Another major consequence of the global financial crisis is the shift from cash collateral to non-cash collateral (figure 3) as institutions now require non-cash collateral to avoid reinvestment risk, as some participants have suffered significant and unexpected losses due to cash reinvestments in instruments riskier than the loaned securities. Securities lending improves overall market efficiency and liquidity, supports a variety of trading strategies and general financing techniques and can help facilitate the timely settlement of securities.

The Dutch pension sector is considered one of the largest and most developed pension fund industries in the world and has traditionally been very active in securities lending. The activity decreased significantly more in the Netherlands as compared to the global decline after Lehman.

Tax considerations

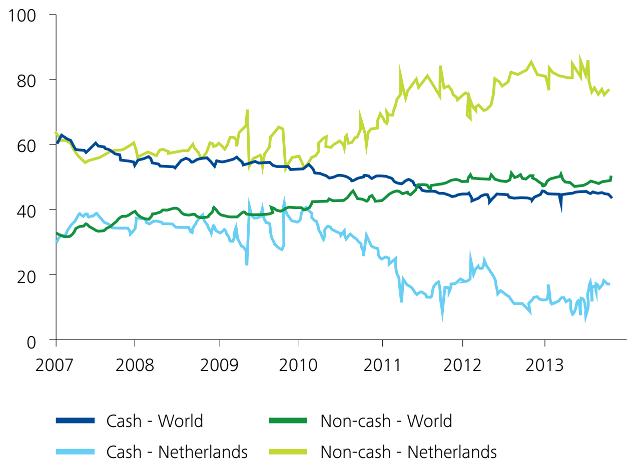
Transfer tax consequences depend largely on the country in which the security is issued. There is nothing standard about the way in which a particular tax is levied and the amount a party to the transaction must pay. For instance, a country may levy a tax on each individual security transferred, while another country may exempt the transaction from tax if parties can demonstrate that it is part of a group of transactions that constitute a securities lending transaction.

Figure 2: Increase/decrease securities lending



Source: Markit

Figure 3: Cash vs non-cash



Source: Markit

Another type of tax that indirectly affects a securities lending transaction is the withholding tax on interest and dividends. In a securities lending transaction, the legal title transfers from the lender to the borrower. As a result, the holder of the legal title of an equity security has the right to receive the dividend. This means the lender will not receive the dividend income he would have received if he had not entered into the securities lending transaction. To resolve this, it is common for the borrower to reimburse the lender with a manufactured/ substitute dividend, so that the lender is effectively remunerated in the same way he would have been had there been no securities lending transaction. This is where withholding tax comes in. Dividend withholding tax is usually levied on the account of the security's legal owner. In other words, the borrower receives the dividend, but also incurs dividend withholding tax. When both parties to a securities lending transaction determine the substitute dividend, both the borrower and the lender consider the fact that dividend withholding tax may be levied. Therefore, parties need to establish how best to deal with this tax issue when arranging the securities loan.

Market data typically show an increase in securities lending volumes during periods when companies pay dividends. This implies that tax plays an important role in securities lending. Securities lending is a way of optimising withholding tax payments. Becoming involved in dividend trading may deter investors from entering into securities lending programmes, but is this theory correct? Let us assume that a lender would normally receive a dividend on a certain type of security at a withholding tax rate of 15%. Accordingly, the lender may choose to lend securities at the market rate (i.e. the amount that borrowers are willing to pay to hold the securities beyond the dividend date, expressed as a percentage of the gross dividend). If the prevailing market rate is, say, 90%, the lender would receive 85% in substitute dividends and 5% in fee income.

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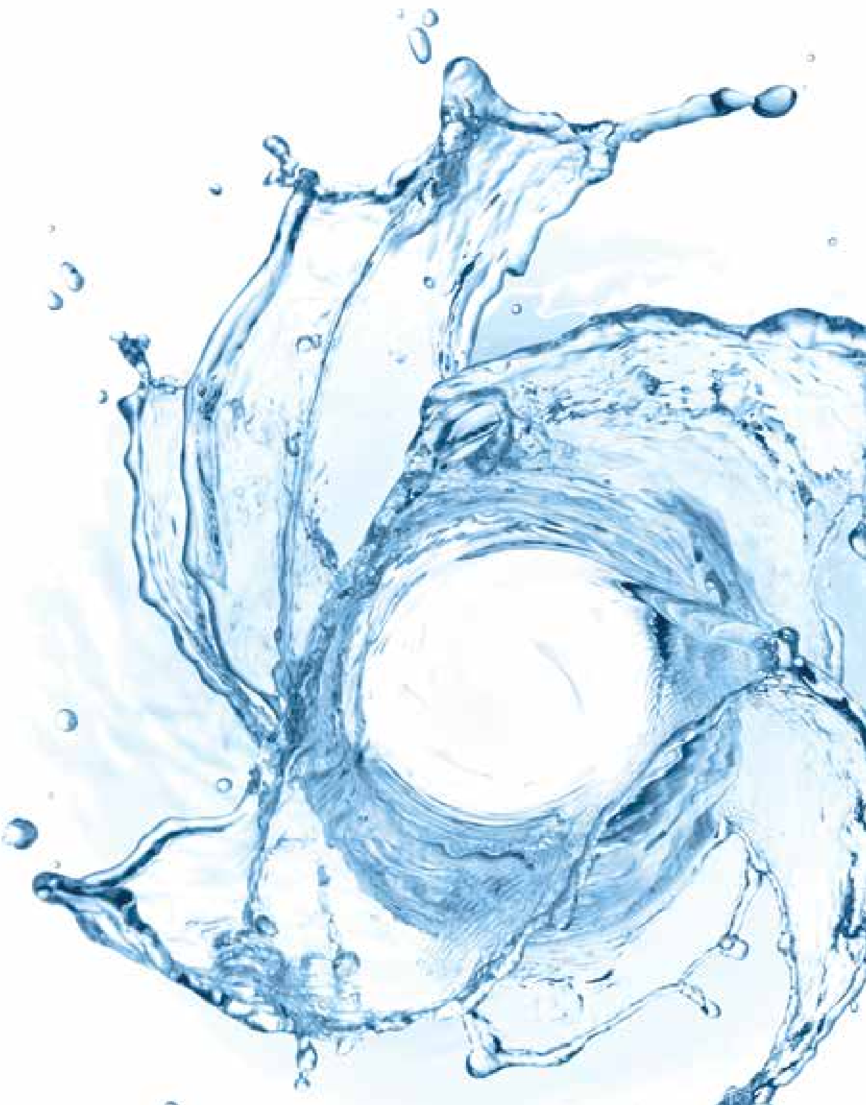
This scenario demonstrates that the lender is potentially better off entering into a securities lending agreement than keeping the securities beyond the dividend date. A lender typically has a schedule of the net dividends that the lender would receive if the securities were not on loan and only lend when market levels are greater than this level.



Another driver may be the timing of the local withholding tax refund. A dividend recipient prefers receiving tax relief at source as opposed to filing a claim for a refund. However, tax authorities and paying agents require certainty of the recipient's tax position. It is far less difficult for tax authorities to deny a claim for a tax refund than it is to levy additional withholding tax, especially in the case of a foreign recipient. Investors are focusing increasingly on obtaining relief at source or, failing that, a quick reclaim procedure (in some countries it may take as long as seven years for local withholding tax to be refunded). Long-winded reclaim procedures, which do not bear any interest, encourage lenders to enter into a securities lending transaction as it is an effective way to effectuate immediately the tax rate to which the lender is entitled. It seems the changing landscape is offering opportunities for securities lending transactions.

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Risks and opportunities

Although securities lending is designed to be a relatively low-risk activity, it has not been wholly immune to the economic crisis. Recent market events have reminded lenders of securities that securities lending has a specific risk and return profile and should be evaluated on the basis of the risks inherent in the specific structural characteristics of each lending programme, just like any other investment decision. However, lenders may mitigate securities lending programme risk by carefully planning, executing and managing their participation in a lending programme.

Risks, such as counterparty credit risk, reinvestment risk, liquidity risk and tax risk, have to be taken into account when deciding on programme parameters. For example, cash reinvestment risk is the risk that, in case of cash collateral, the value of the assets in which the cash is reinvested fluctuates and may drop below the value of the cash that needs to be returned to the borrower of the securities at the time such repayment is due, incurring a loss for the lender. By combining a clear strategy of securities lending with continuous monitoring, securities lending can match the risk appetite and investment attitude of lenders seeking to increase the returns on their portfolios.

Supervision and monitoring

Internationally, securities lending is a crucial issue for policy makers. Nevertheless, most regulations have yet to be finalised. Regulators are focusing increasingly on transitioning from firm-specific supervision to global rules, affecting all market participants.

The UK's Financial Stability Board performs an important coordinating role in the regulation of securities lending. In August 2013, the FSB published a final document on 'Strengthening oversight and regulations of shadow banking'. This report sets out recommendations categorised into three groups, in accordance with the nature of the recommendations: improvements in regulatory reporting and market transparency, the regulation of securities financing and improvements in the structural aspects of the securities lending market.

The recommendations could result in an increase in disclosure and minimum margin requirements. In the Netherlands, the supervisory authority (The Dutch Central Bank) is currently working on regulations to improve the control of securities lending risks. Currently, very few regulatory changes are specifically directed at lenders such as pension funds. However, many of the new proposed liquidity rules for banks and other securities lending agents under Basel III indirectly affect them.

"A carefully thought-out approach to running a securities lending programme helps to enable the beneficial owner of the security to extract the intrinsic value and liquidity inherent in a portfolio. By combining a clear strategy with continuous monitoring, securities lending can match the risk appetite and investment attitude of lenders seeking to increase the returns on their portfolios."

James Day, Managing Director Global Collateral Services, BNY

As with other types of investments, lenders should continually monitor their securities lending programmes to ensure they achieve their objectives and stay within the expected risk profile. The monitoring of a securities lending programme should encompass three main areas:

1. The monitoring of lending activities should include counterparty creditworthiness, counterparty concentration, the market value of securities on loan, the lending agent's financial condition and company-wide exposure to various counterparties
2. Collateral monitoring should consist of the cash collateral investment strategy, the securities purchased with cash collateral, the investment guidelines and the securities collateral
3. Performance measurement should cover investment return, the core drivers and the risks taken. Various metrics should be reviewed within each area through reporting, due diligence reviews and ongoing communication with the lending agent

Conclusion

After the 2007-2008 financial crisis, the dynamics of the securities lending market changed dramatically. The global market activity decreased significantly and observed a shift from cash to non-cash collateral. Lenders have become more conservative, more discriminating in the choice of collateral in the case of non-cash collateral, and they have improved their understanding of the risks involved. By taking into account the risks and changing market environment, following a clear securities lending strategy and continually monitoring the programme, security lending can be managed according to the lenders' risk appetite and investment beliefs, increasing the return on their portfolios.

To the **point**:

- Securities lending activities have decreased on a global scale by more than half, as compared to before the collapse of Lehman Brothers
- The characteristics of securities lending have changed significantly. Collateral has shifted from cash to non-cash and risk aversion has increased. Still, securities lending is generating market liquidity and improving market efficiency
- Securities lending has evolved into a collateral management technique, and a risk monitoring programme should be set up to remain in control of the different risks
- By combining a clear strategy of securities lending with continuous monitoring, securities lending can match the risk appetite and investment attitude of lenders seeking to increase the returns on their portfolios