Australian Securities lending: Key considerations

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Securities lending—the short-term loan of securities in exchange for collateral and fees—can modestly enhance an investment portfolio's return. The practice is widespread in the Australian and global markets. As of the end of December 2017, the global value of securities on loan was more than € 1.9 trillion.[1]

Securities-lending strategies exist along a spectrum. A value-lending strategy seeks to capture a "scarcity premium" by lending only hard-to-borrow securities. A volume-lending strategy puts many securities on loan, independent of scarcity value. Collateral reinvestment strategies also sit along a spectrum. Some lenders take minimal risk, reinvesting cash collateral in high-quality money market securities.

Others try to augment their lending fees by taking on greater credit or maturity risk. Regulatory guidelines and industry practice provide robust protection against counterparty risk. The greater source of risk has been collateral reinvestment strategies. We share Vanguard's views on best practices and highlight questions to consider as you evaluate a securities-lending program.

What is securities lending?

Securities lending, as the term suggests, is the short-term transfer of security ownership in exchange for fees and the borrower's collateral. The Reserve Bank of Australia has described securities lending as "an integral component of Australia's equity market, contributing to the efficiency of the market and supporting the equity settlement process" (Carroll and Clarke 2014). Australian securities lending first began in the 1970s and has since developed into common portfolio management activity. In the 2018 financial year, the ASX reported approximately 49,000 securities lending scheduled settlements per month.[2] At the end of December 2017, the value of securities on loan in the global investment management landscape totalled more than EUR 1.9 trillion.[3]

Securities lending can modestly enhance an investment portfolio's return. In 2017, for example, global equity securities of Australian-domiciled funds earned an asset-weighted average of about 3.35 basis points (0.0335%) from securities lending.[4] Because of their limited trading activity and extensive holdings, index funds are attractive sources of securities loans. In smaller-capitalisation and international stock funds, returns from lending can average 10 basis points or more. Profits also depend on the market environment. Some years are better than others.

In this piece we review the participants and mechanics in a securities-lending transaction. We explore the strategies used to generate return, the primary sources of risk, and the role of the agent lender in shaping both. We also provide an overview of Vanguard's securities-lending program.

Participants and mechanics

In a typical securities loan, a borrower approaches a lender (also known as the beneficial owner), or the agent lender, to request the loan of a security or securities. The lender's goal is to earn income from fees that enhance an investment portfolio's return. Illustratively, The Federal Reserve Bank of New York has described the practice as "the collection of rental fees on idle assets through fully collateralised loans" (Baklanova, 2015).

The borrower's goal may be to facilitate a strategy such as short-selling (borrowing a stock to sell it), to settle a trade, or to complete an arbitrage operation. Short-selling occasionally causes controversy, particularly in regions where the practice is less established. Such transactions nevertheless have benefits for all market participants, enhancing liquidity and facilitating efficient price discovery (Baklanova, 2015).

Lenders are typically institutional investors with large portfolios such as mutual funds, superannuation funds, insurance companies and endowments. The primary borrowers of securities are broker-dealers, hedge funds and the proprietary trading desks of broker-dealers. An owner can lend directly to borrowers, but most rely on an "agent lender" to administer the program or serve as a tri-party collateral management service on behalf of the lender and borrower. Agent lenders are generally custodian banks in the Australian securities lending landscape.

1 Source: ISLA Securities Lending Market Report, March 2018.
2 Source: ASX Settlement & Securities Lending - Comparison Report. August 2018.
3 Source: ISLA Securities Lending Market Report. March 2018.
4 Source: IHS Markit. Industry self-reported data. 2017.

Loan terms

When a lender (or agent lender) and borrower enter into a securities loan, they negotiate the following terms under the standards of the Australian Master Securities Lending Agreement for Australian-domiciled borrowers, otherwise the Global Master Securities Lending Agreement is used:

The collateral amount. Borrowers generally pledge cash or non-cash collateral between 102% and 105% of the value of stocks loaned. The lender can request that the borrower pledge more or less collateral, based on the kind of collateral posted. Lenders may demand that the value of non-cash collateral be greater than 105% of the security's value to account for any volatility in the collateral, but over-collateralisation of more than 15% can have regulatory capital consequences in Australia.

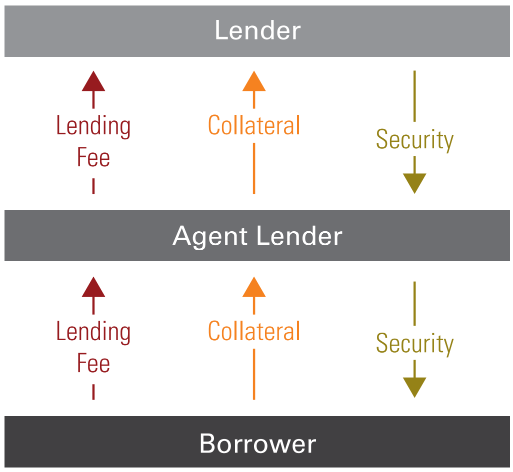
The fees. The borrowing fee on stocks can vary according to supply and demand of the given security. Types of fees include the lending fee, which can be a standalone fee, a function of the "rebate rate", or a combination of the two. The rebate rate, which is based on a benchmark overnight rate, specifies what percentage of the cash collateral's reinvestment return the lender must rebate to the borrower.

The duration of the loan. Loans are usually "open", with no specified term, giving lenders the flexibility to recall the securities from the borrower at any time. However, given tax implications for securities loaned longer than one year under section 26BC of the Income Tax Assessment Act of 1936, securities are generally returned before one year at which time they can be immediately reloaned to the same borrower.

The dividend/reclaim rate and other economic benefits. Because ownership passes to the borrower, the borrower must make cash-in-lieu-of-dividend payments to the lender and compensate the lender for other distributions such as stock dividends and warrants. These are often called manufactured payments.

Because most loans are open, they are subject to daily renegotiation of the lending fee/rebate. The two parties mark the values of both the loaned security and the collateral to market values to ensure that the collateral remains at 102% or 105% (higher, if required by the lender) of the borrowed security's value. The values are marked to market daily and if the value of the loaned securities rises, the borrower must provide additional collateral.

Figure 1. A typical scenario for securities lending



Source: Vanguard.

Figure 1 illustrates the flow of securities, collateral, collateral reinvestment income and fees in a loan facilitated by an agent lender. The key elements of this transaction include the terms of the loan and the lender's (or agent lender's) reinvestment of cash collateral. These elements determine the loan's potential profitability and the transaction's potential for risk.

Collateral reinvestment

Once the parties agree to terms, the borrower delivers the collateral to the lender (or agent lender), and the lender delivers the securities to the borrower's custodian bank or sub-custodian. The lender reinvests cash collateral to generate income. (The lender holds non-cash collateral with a tri-party custodian bank.) As with any investment decision, the lender can invest cash collateral in a lower-risk, lower-expected-return vehicle such as a money market fund or in a potentially higher-returning vehicle that includes lower-rated or longer-maturity securities.

Two lending strategies: Value and volume

Securities-lending strategies can be characterised as either value or volume lending.

Value lending, also known as intrinsic-value lending, seeks to capture a scarcity premium by lending hard-to-borrow securities, or "specials". The scarcity premiums provide the lender with a high return per dollar of securities loaned, though with fewer opportunities to lend. At the other end of the spectrum is volume lending, also known as general collateral lending. Here the owner seeks to lend many securities, independent of scarcity value. Per-loan fees are lower, but there are more opportunities to lend.

In 2017, general collateral loans—approximately 72% of global loans by on-loan balance—generated 22.4% of the securities lending revenue. The valuable specials, commanding over 250bps, represented just 2.44% of the total on-loan balance, but accounted for 46% of the total revenue of securities lending in 2017.[5]

Because per-loan fees are high, a value lender can generate high returns on the lending program while minimising risk in the reinvestment of cash collateral. The cash can be invested in a high-quality money market-like fund, as the lender profits more from "rental fees" than from investment activity. With general collateral loans, by contrast, lenders have typically tried to augment low lending fees by taking on more risk in collateral reinvestment (Bank of New York, 2009).

Figure 2. Risk-reward decisions for a securities lending program

There are two main phases to consider in a securities lending transaction: lending the security to a borrower and reinvesting the collateral. Within each phase, there are several risk-reward trade-offs to weigh. Value lending captures a higher return at the lending phase, so less risk needs to be taken with the cash collateral to generate a given return. Volume lending receives little return at the lending phase, so the agent lender may try to make it up with more aggressive reinvestment of the cash collateral.

		Value lending	Volume lending
Lending phase	Volume	Low – lend only hard-to-borrow/high-demand securities.	High – lend many securities from portfolio.
	Securities-lending return	Higher revenue per dollar loaned; captures scarcity premium.	Lower per dollar loaned.
	Rebate rates*	Low (to negative).	Higher.
Reinvestment phase	Cash-collateral investment	• Conservative. • Cash equivalents. • Money-market-like strategy. • Minimise investment risks, maximise liquidity.	• Aggressive. • Longer-dated, lower-quality securities. • Maximise reinvestment spread. • Expose collateral to credit, interest rate, and/or liquidity risks.
Additional considerations	Counterparty risk**	• Includes the risk that borrowers may not return securities. • Selective lists of approved borrowers and frequent reassessment of such lists for standards of creditworthiness can be used to mitigate potential problems. • Agent lenders can also be used as intermediaries and indemnification against counterparty default is common practice.	

*Rebate rates paid to borrower.

** Counterparty risk is heightened if paired with losses in the cash-collateral pool. This may result in collateral insufficient to repurchase securities loaned out.

5 Source: DataLend April 2018.

Although the definitions of the two lending strategies are well established, the characterisation of any one lender's strategy is in the eye of the beholder. Value and volume lending sit at ends of a spectrum. Some value-oriented owners may lend specials exclusively, while others may lend both specials and general collateral.

Securities-lending risks

Both value- and volume-lending programs are subject to counterparty risk, the risk that a borrower will fail to return the loaned securities. If the collateral is insufficient to purchase replacement securities, the lender can experience a loss. Lenders mitigate counterparty risk through daily marks to market of the collateral value and by scrutinising counterparties. "Over-collateralisation" in a typical lending agreement provides additional protection if a borrower fails to return a security that has since increased in price.

The reinvestment of cash collateral introduces different risks. The lowest-risk strategy is to invest in a conservative money market fund made up of short-term government securities, overnight repurchase agreements, or high-quality certificates of deposit. Such vehicles are not risk-free, of course, but their primary goal is the capital preservation and liquidity necessary to return the borrower's collateral at any time, in any market environment.

A higher-returning and higher-risk alternative is to invest cash collateral in lower-rated and/or longer-maturity securities. Even if such cash management vehicles are generally liquid and stable, they can be vulnerable during periods of extreme stress in the financial markets.

These risks materialised during the depths of the 2007–2009 global financial crisis. Yields on all but the shortest-term, highest-quality securities spiked (and their prices declined). Some cash management pools—and their investors—sustained losses as the value of the pool's securities tumbled below the value of the cash collateral owed to borrowers. These losses led to lawsuits and settlements between lenders and agent lenders (Karmin and Scism, 2008). The episode spotlighted an underappreciated reality: the most significant risk in securities lending lies not in the lending itself, but in the reinvestment of the cash collateral.

In evaluating securities-lending losses during the crisis, Frank M. Keane of the Federal Reserve Bank of New York concluded: "If investment activity [had been] limited to the money market instruments, the attendant risks would [have been] more manageable because these assets are typically liquid and have a short maturity . . . But the risk increases when the cash is reinvested in less liquid instruments" (Keane, 2013). Recommendations from the Financial Stability Board (FSB), Basel III reforms, changes in the over-the-counter derivatives market and domestically introduced reporting initiatives from the ASX and RBA have sought to establish regulatory safeguards and increase transparency. The reforms proposed and changes enacted since the financial crisis increase essential oversight of security lending.

Potential agent lender risk

A portfolio's securities-lending returns depend not only on the lending strategy, the markets' supply-and-demand dynamics and the collateral reinvestment strategy, but also on the fee split negotiated with the agent lender. A typical fee split is 70% for the lender, 30% for the agent (Baklanova, 2015), though agreements vary widely. The fee split depends on the services provided by the agent. These services can include administrative and trading support, management of the collateral reinvestment pool, or indemnification against losses from a borrower default.

A note on indemnification: If the counterparty fails to return a security, and the collateral is insufficient to repurchase the security, the agent will make up the difference between the value of the collateral and the security's price. Indemnification does not cover losses in the collateral reinvestment pool. At its discretion, the agent may decide to reimburse clients for losses in the pool, but such indemnification is not part of the typical agency agreement.

The fee split and the agent's role in managing or selecting the collateral pool can raise concerns about agency risk (Keane, 2013). The lender bears the investment risk in the cash collateral pool, while the agent shares in the income, perhaps giving the agent an incentive to stretch for yield. To minimise these risks, lenders should understand the terms of the agency agreement—including the reinvestment guidelines for the cash collateral, the approval process for potential borrowers and any indemnification provisions (Comptroller of the Currency, 2002).

Considerations for due diligence

Securities lending can enhance a portfolio's return. But like any source of return, the practice has risks. Different lending strategies, and the agreements with agent lenders (if any), help determine a lending program's returns and risks. In Vanguard's view, a value-lending strategy coupled with conservative reinvestment of cash collateral offers the best balance of risk and return. And whatever the strategy, a lending agreement between the beneficial owner and an agent lender should reflect the owner's risk preferences and maximise its share of program revenue.

Vanguard's approach to securities lending

In Australia, Vanguard works with an independent agent lender. Vanguard funds do not lend fixed income securities. All Vanguard portfolios follow the same policies and risk constraints.

Our program seeks to capture the scarcity premium found in hard-to-borrow securities. In Australia, Vanguard accepts only high quality sovereign debt as non-cash collateral. When the fund lends a security, its voting rights pass to the borrower. With investment stewardship in mind, Vanguard has developed a monitoring program and lending limits for individual securities to ensure that securities are only loaned to a select list of approved borrowers and any securities on loan can be recalled for important material proxy votes.

To reduce the risk of counterparty default, Vanguard lends to a limited number of preapproved financial institutions and maintains strict internal guidelines on the aggregate dollar amount of loans to any one borrower. In addition, Vanguard ensures proper collateral coverage by valuing the loaned securities on a daily basis—using current market prices—and by calling for additional collateral when necessary to bring the coverage to 105%. Vanguard's agency agreement requires the agent lender to indemnify our fund in the case of a counterparty default by replacing either the security or the security's current market value to the fund, including non-cash collateral.

A fund's Product Disclosure Statement (PDS) contains information about a fund's securities-lending practices. The financial statements in a fund's annual and semi-annual reports include information about the income earned from securities lending and the value of the collateral held for securities on loan.

Consistent with Vanguard's client-owned structure, Vanguard negotiates with the agent lender on the fee split and then returns all net lending revenues—after subtracting program costs, intermediary agent lender fees and any broker rebates—to the funds.

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