BBS investment update

Securities Lending

The Pensions Regulator has released guidance for trustees on the issues raised by the practice of 'securities lending' by investment managers.

Background

What is 'Securities Lending'?

Investment managers may lend stocks they manage to third parties for a specified period of time. In return, the manager receives a fee from the borrower. The borrower of the stock will need to return an identical stock to the lender at the end of the agreed period. The lending manager may require the borrower to provide collateral for the loan, which can be sold if the borrower does not return the stock as agreed. Such collateral may, for instance, be in the form of high quality bonds.

By lending stocks to third parties, the investment manager is attempting to provide an additional source of income to the portfolio.

What is the Borrowed Stock Used for?

There are a number of reasons why a third party may wish to borrow stock:

- To allow settlement of a transaction on a particular day, if, for administrative reasons, the seller is not able to deliver the stock on the settlement day.
- To take advantages of tax opportunities if, for instance, the borrower has a tax advantage over the owner of the stock during the dividend season.
- Short selling, where the borrower will sell the stock in the hope that it will fall in value so that they can buy it back at a lower price before returning it to the lender. In doing so, the borrower will take the profit made by selling the stock high and buying it low.

What are the Advantages and Disadvantages of Securities Lending for the Owner?

The main advantage of securities lending to the owner of the stock is the additional income it generates. This can be particularly beneficial when market performance is flat or falling.

On the downside, certain rights of ownership may be lost during the period a stock is on loan. For instance, in the UK, voting rights are lost during the loan period, so that the manager has reduced power to influence the behaviour of the companies in which it is invested.

Trustees may also have concerns that the practice of lending stock for the purpose of short selling is contrary to their own investment objectives.

More specifically, Trustees are typically long-term investors seeking growth in the value of their holdings, yet their managers may be facilitating sales of their stock, which could drive prices down in the short term.

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The consensus in the investment industry is that short selling does not, in fact, have a significant impact on prices. Instead, past data suggests that large price fluctuations tend to be driven by the original owners of the stock deciding to sell at the same time.

Proponents of short selling suggest that it leads to more honest valuations of stocks, as it provides an efficient vehicle for traders to make profits by expressing negative views on companies.

The above said, the Financial Services Authority (FSA) implemented a temporary ban on short selling of particular financial stocks during the recent market crisis to avoid prices being driven downwards by speculators and prevent market abuse. The FSA therefore had concerns that short selling could exacerbate market volatility in stressed conditions. The ban has now been lifted, although the FSA is currently undertaking a review of governance and risk management of stock lending in the market.

The Regulator's Guidance

The Regulator's guidance is summarised below:

- The FSA accepts the view that securities lending allows markets to operate more smoothly and efficiently.
- However, securities lending will not be appropriate for all schemes and the decision to carry out securities lending is for the trustees of each scheme to consider.
- Trustees should ensure they are aware of the stock lending policies of their managers.
- Where securities lending does occur, trustees should clarify the proportion of income arising from such transactions that is passed on for the benefit of the scheme.
- Trustees should ensure that appropriate arrangements and financial terms are in place between the scheme, investment manager and borrower.
- Trustees should be aware of the risks of securities lending and check the nature of the collateral provided by borrowers against the risk of default.
- Trustees should further ensure that they have a process to monitor the appropriateness of securities lending arrangements in the context of their overall strategy.

Questions to Ask Your Investment Managers

The Regulator goes on to set out questions that trustees should consider to help them clarify the position on securities lending for their own schemes:

- Do the scheme's arrangements provide sufficient clarity about whether (and which) scheme assets may be lent, and on what terms, including the benefits for the scheme in terms of enhanced returns or reduced management fees?

- Do the trustees understand the proportion of scheme assets that may be lent out under any stock lending arrangements?
- Do the trustees have up-to-date knowledge of the extent of securities lending that has taken place in respect of their scheme's assets?
- Does the trustees' investment manager have appropriate legal agreements in place which make clear the obligations of the borrower and lender?
- Do trustees have appropriate controls and expertise in place to monitor the risks involved in lending scheme assets and to ensure that collateral for loaned assets is appropriate to mitigate these risks and is properly secured?

BBS View

The Regulator's guidance provides helpful direction for trustees and will lead to useful discussions with investment managers about their attitude to securities lending and the extent to which any benefits are passed on to schemes.

Please contact your usual BBS consultant if you have any queries on this briefing paper.

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