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Securities Lending by Mutual Funds, ETFs, and Closed-End Funds: The Basics

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First in a series of Viewpoints *on securities lending*

The Financial Stability Oversight Council (FSOC) recently announced that it has directed its staff to "undertake a more focused analysis of industry-wide products and activities to assess potential risks associated with the asset management industry."

Securities lending is likely to be one of the activities that the FSOC considers. For several years now, as part of their analysis of potential systemic risks, the Financial Stability Board (FSB), the U.S. Treasury's Office of Financial Research (OFR), and the FSOC have focused on securities lending. The FSB has done the deepest dive, through multiple consultations. The OFR addressed securities lending in its 2013 report on the asset management industry, as did the FSOC in its 2014 annual report.

As the FSOC, FSB, and OFR drill down in their analysis of securities lending, they will have to carefully consider the different ways that institutional investors lend securities. Securities lending is an investment technique employed by many different types of institutional investors, including various collective investment vehicles, insurance companies, pension funds, corporations, endowments, foundations, central banks, and others. For many of these institutional investors, securities lending may be conducted in ways that do not raise systemic risk concerns.

For example, U.S. regulated funds—mutual funds, exchange-traded funds (ETFs), and closed-end funds registered under the Investment Company Act of 1940—are among the most conservative of securities lenders, operating under strict regulatory limits. Not all funds engage in securities lending, and those that do often lend a relatively small percentage of their portfolio.

This *Viewpoints* is the first of several posts that will focus on securities lending by U.S. regulated funds and the factors that should mitigate concerns about risks—particularly systemic risks—that might arise from this activity. We'll offer new data that puts into perspective the level of these funds' securities lending; examine the specific concerns about securities lending raised by the FSOC, FSB, and OFR; and explain why securities lending by U.S. regulated funds does not pose a threat to financial stability.

Let's start with the basics, answering a few of the questions that we frequently are asked about securities lending, with a focus on lending by U.S. regulated funds.

What is securities lending? Who lends securities and why?

Securities lending is exactly what the term implies. It refers to the lending of a security by one party (the lender) to another (the borrower) in exchange for collateral.

Government bonds and equities account for the vast majority of securities lent, both globally and in the United States. Corporate bonds, depositary receipts (such as ADRs), and shares of ETFs are also commonly lent, although in smaller volumes. Institutional investors that own these types of securities may employ securities lending in an attempt to improve the return on their portfolios. In this sense, it is just one of myriad investment techniques that they might use.

As discussed more below, the additional return is derived from the investment of the collateral. That additional income (net of expenses) adds to the portfolio's return and, for regulated funds, directly benefits fund shareholders.

What types of institutional investors lend securities?

U.S. regulated funds are one type of lender. Other common lenders in the United States include insurance companies, public and private defined benefit pension funds, central banks, foundations, endowments, and other institutional investors. Similar institutional investors outside the United States also lend securities.

Who borrows securities and why?

Global banks and broker-dealers are the most common types of borrowers. They act on behalf of clients, such as hedge funds, that need to borrow securities to implement certain types of investment strategies, such as short-selling or various types of arbitrage. Broker-dealers also borrow securities to facilitate the process of settling securities trades and to prevent failures to deliver securities that might occur as part of that process (known as “trade fails”).

Does securities lending benefit the markets?

Yes. Securities lending benefits the wider capital markets by making markets more liquid and helping broker-dealers settle trades, including large trades, more efficiently. As one group of commentators explained to the FSB in 2012, “without securities lending it would be prohibitively more expensive and risky for investment firms to make markets in a wide range of securities, and more difficult for investors to hedge investment positions or engage in trading strategies such as arbitrage. Securities lending is therefore a very important contributor to the functioning of the secondary markets.” The FSB took note of this in its 2013 consultation, saying that “securities lending and repo markets play crucial roles in supporting price discovery and secondary market liquidity for a variety of securities issued by both public and private agents. They are central to financial intermediaries’ abilities to make markets, and facilitate the implementation of various investment, risk management, and collateral management strategies.”

What types of U.S. regulated funds lend securities?

Mutual funds, closed-end funds, and ETFs may engage in securities lending. Unit investment trusts (UITs)—another type of U.S. regulated fund—may not.

A U.S. regulated fund may lend securities only if lending is permitted by its organizing documents and disclosed to investors in the fund’s prospectus or statement of additional information (SAI). The fund’s lending program also is subject to approval and oversight by its board of directors, including its independent directors.

As we’ll explain more in our next post, large funds with relatively passive portfolios, such as ETFs and index mutual funds, are more likely than other funds to lend securities. The nature of their portfolios enables these funds to lend more securities for longer periods, making them favored counterparties for their loans.

How is securities lending regulated?

Securities lending is not a practice governed by any single set of laws or regulations. Rather, each type of lender operates under the laws and rules that apply to it. For example, in the United States, defined benefit pension plans are subject to the Employee Retirement Income Security Act (ERISA), as administered by the U.S. Department of Labor. Insurance companies in the United States are governed by state law and overseen by state insurance commissions.

With respect to U.S. regulated funds, the staff of the Securities and Exchange Commission (SEC) has established the following guidelines:

- **Express limit on lending.** A U.S. regulated fund may not have on loan at any time securities representing more than one-third of the fund’s total value. In practice—as discussed in our next post—very few U.S. regulated funds ever come close to this legal limit, and the overwhelming majority lend far less.

- **Termination and recall rights.** A U.S. regulated fund must be able to terminate the loan at any time and recall the loaned securities within the ordinary settlement time. The fund must recall a loaned security in time to vote proxies if the asset manager has knowledge that shareholders will be asked to vote on a material event (a merger, for example).

- **Collateralization.** A U.S. regulated fund must receive collateral equal to at least 100 percent of the value of the securities on loan. In practice, funds require 102 percent collateral for domestic securities and 105 percent for international securities. Because loaned securities must be available for recall on short notice, the collateral that funds can accept from borrowers must be highly liquid, such as cash, government securities, or bank letters of credit. U.S. regulated funds typically demand cash collateral.

- **Daily mark-to-market valuation.** The value of the securities on loan must be marked to market every day. Collateral levels are adjusted every day and cash flows between the fund and the borrower to ensure that the 102 percent or 105 percent levels are maintained. Thus, if the value of the securities on loan increases, the borrower must provide additional collateral.

- **Conservative investment of cash collateral.** SEC guidance states that cash collateral should be invested conservatively, in instruments that produce reasonable interest for the loan but also give maximum liquidity to pay back the borrower if and when the loan is terminated. In practice, U.S. regulated funds most often invest cash collateral in money market funds.
- **Reasonable return.** A U.S. regulated fund must receive a reasonable return on the loan, including any income from the loaned securities, such as dividends.
- **Board oversight.** A U.S. regulated fund's board, including its independent directors, must approve the fund's securities lending policies. Board-approved procedures will establish the parameters for the lending program, such as approved borrowers and the terms of lending agent compensation. The board also oversees the securities lending program, periodically reviewing the appropriateness of those policies and the program's performance and costs.
- **Restrictions on the use of affiliated lending agents.** A U.S. regulated fund may not use an affiliate as its lending agent without SEC approval, either under a no-action letter or an exemption. This approval, when granted, includes additional conditions to protect fund shareholders.

For more specific details about the regulations governing securities lending by U.S. regulated funds and the related SEC and staff positions, visit the SEC's securities lending resource page.

What are the economics of securities lending?

In a securities loan against cash collateral (the model favored by U.S. regulated funds), the return to the lender is a function of the types and volume of securities being loaned, the income generated by the investment of the cash collateral, and the expenses of the lending program.

The type of securities lent often drives the volume of lending. "General collateral" loans are higher-volume, lower-spread loans of securities that are easier to obtain and thus less in demand. "Specials," on the other hand, are securities with high borrowing demand. Lending "specials" offers significantly higher spreads.

The investment of cash collateral generates the income that produces the return on the loaned securities. Practices with respect to cash collateral investment vary among institutional investors. For U.S. regulated funds, cash collateral typically is invested in very high-quality, highly liquid investments—often U.S. money market funds managed according to Rule 2a-7 under the Investment Company Act of 1940, or other funds managed with very conservative short-term investment strategies.

In any securities lending arrangement, the return to the lender is net of expenses. The most common expense is the use of a lending agent to administer the lending program. Lending agents serving U.S. regulated funds typically are custodian banks or third-party lending agents, independent from the funds. Funds may use an affiliated lending agent, subject to additional regulatory restrictions.

Lenders also incur expenses in managing securities lending collateral. For example, if the collateral is invested in a money market fund, the lender pays a share of the money market fund's expenses—just like other investors in the fund.

How much do U.S. regulated funds earn from securities lending?

For most U.S. regulated funds, securities lending is a marginal portfolio-management technique that generates incremental income to the portfolio. For example, as we'll discuss at length in our next post, we looked at the 500 largest U.S. long-term funds. Only 37.6 percent of these funds lent securities, and of those that did, fewer than one in five lent more than 5 percent of their assets.

How are U.S. regulated funds' securities lending activities disclosed?

As noted above, a U.S. regulated fund must disclose that it may lend securities. This disclosure appears in the fund's prospectus and SAI, both of which are filed with the SEC and available to investors and the public.

U.S. regulated funds also must prepare financial statements twice per year that are included in annual and semiannual shareholder reports that are filed with the SEC. A fund's financial statements identify securities out on loan; an asset reflecting the investment of the cash collateral (e.g., shares in a money market fund); a liability reflecting the obligation to return the cash collateral at the conclusion of the loan; and income earned from securities loans. After the fund's first and third fiscal quarters, the fund also must file Form N-Q, which includes a detailed listing of its portfolio. The filings on Form N-Q, which are available to the public, identify securities out on loan.

Other institutional investors may be subject to similar disclosure standards, based upon the accounting standards applicable to their particular industries. Some, such as the insurance industry, have taken steps to improve disclosure in recent years.

Next Up—How Much Do U.S. Regulated Funds Lend?

Given all of the SEC's guidelines and restrictions, securities lending is a marginal portfolio-management technique for most U.S.

regulated funds that engage in it. Yet the policy debate over systemic risk often leaves the impression that mutual funds account for a large part of the securities lending market. In the next post in this series, we'll explore this disconnect—and explain why it appears that U.S. regulated funds have a much smaller share of the securities lending market than the discourse might suggest.

Read the other entries in this Viewpoints *series:*

- Securities Lending by Mutual Funds, ETFs, and Closed-End Funds: The Basics
- Securities Lending by Mutual Funds, ETFs, and Closed-End Funds: The Market
- Securities Lending by Mutual Funds, ETFs, and Closed-End Funds: Regulators' Concerns
- Securities Lending by Mutual Funds, ETFs, and Closed-End Funds: Are the Risks Systemic?

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