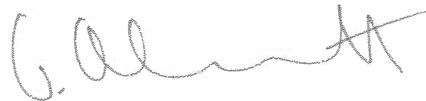
Haringey Council

Agenda item:

Pensions Committee	On 28 January 2010

Report Title. **Securities Lending**	
Report of **Chief Financial Officer** Signed : 	
Contact Officer : **Colin Duck - Corporate Finance** **Telephone 020 8489 3731**	
Wards(s) affected: **All**	Report for: **Non key decision**

1. Purpose of the report

1.1. To consider the introduction of securities lending programme in order to mitigate the overall costs associated with the provision of custodial services.

2. Introduction by Cabinet Member

2.1 Not applicable.

3. State link(s) with Council Plan Priorities and actions and /or other Strategies:

3.1 Not applicable

4. Recommendations

4.1. That Members give full consideration to the introduction of a securities lending programme in order to mitigate the overall costs of custody provision.

5. Reason for recommendation(s)

5.1. To reduce the costs of custody provision.

6. Other options considered

6.1. None

7. Summary

7.1. Hewitt's recommend that consideration be given to the introduction of a securities lending programme which could result in annual income accruing to the Pension Fund in the region of £64,000 to £108,000 thereby eliminating the current costs of custody.

8. Head of Legal Services Comments

8.1. The Head of Legal Services has been consulted on the content of this report and comments that, in considering the recommendations set out in this report, the Committee should give full consideration to the financial advice received concerning the introduction of a securities lending programme. In giving consideration to this matter the Committee must bear in mind its duty to take into account the interests of stakeholders and beneficiaries of the Pension Fund. Members may also wish to consider the implications of the communication from Cllr Ian Greenwood at Appendix 2 in the light of the Committee's policies on investment.

9. Equalities &Community Cohesion Comments

9.1. Not applicable

10. Consultation

10.1 Not applicable

11. Use of appendices

11.1. Appendix 1 –Report of Hewitts dated 16 November 2009

11.2. Appendix 2 – Communication from Cllr Ian Greenwood, Chair of the Local Authority Pensions Fund Forum

12. Background

12.1. At the last meeting, consideration was given to Hewitts recommendation that the Council adopt a securities lending programme. Hewitts estimate that the Pension Fund could earn between £64,000 and £108,000 p.a. from this activity thereby eliminating the current costs of custody which are estimated by Hewitts to be approximately £86,000 p.a. Hewitts proposals are re-circulated as Appendix 1 to this report.

12.2. Members expressed some concerns at the proposals and it was resolved that: "a report on securities lending, including the extent of local authority participation and the risks involved, be presented at the next meeting of the Committee".

13. Local Authority Participation in Securities Lending

13.1. Of the 33 London Pensions Authorities (32 London Boroughs and the London Pension Fund Authority), 7 authorities currently operate a securities lending programme. Anecdotal evidence suggests that the majority of non participants are either concerned at the perceived risks associated with the process or dislike the connotation to 'short selling' and other forms of market manipulation. In this latter connection, I attach a communication from Councillor Ian Greenwood, Chair of Local Authority Pensions Fund Forum as Appendix 2 in which he expresses some concern in respect of the role of stock lending in the ongoing Kraft bid for Cadbury.

14. The Risks and Safeguards Involved in Securities Lending

14.1. In the UK stock lending is supervised by the Financial Services Authority whilst HMRC monitors it for tax purposes. In the view of CIPFA (Guide to Stock Lending by Local Authority Pension Funds), this degree of regulation makes it a relatively low-risk market in which to lend. However, as securities lending is a commercial activity within financial markets, there is an inevitable degree of risk. In the attached report, Hewitts have highlighted three main risks, which are:

- Collateral risk – that the collateral received against the lent asset is insufficient to cover the repurchase of the asset in the event of a borrower default;
- Counterparty risk – that there is a problem with the party that borrows the assets (e.g. the collapse of Lehman Brothers, who were active as a counterparty in the securities lending marketplace); and
- Cash re-investment risk – any cash accredited as collateral has to be re-invested to provide the lender with a rebate when the cash is returned.

Hewitts proposals to obviate these risks are to ensure that the securities lending agreement stipulate that:

- The collateral remains at 105% of the value of the lent asset and will be maintained at that level and;
- Collateral be held in non-cash form i.e. Government Bonds, Certificates of Deposit, Equities and Commercial paper. In addition, as an additonal safeguard, an indemnity could be obtained from the custodian whereby Northern Trust would make up any shortfall between the collateral and lent asset in the event of borrower default. However Hewitts point out that 'this insurance comes at a price'.

15. Conclusion

15.1 The management of the above risks identified by Hewitts, namely maintaining collateral at 105% of the value of assets lent and holding collateral in non-cash form is consistent with the safeguards proposed by CIPFA. Whilst there are a number of ways to manage and mitigate risks of loss in terms of securities lending it is a permitted activity for local authority pension funds. Nevertheless, I recommend that given the concerns around the implications concerning 'short selling' and other forms of market manipulation and the relatively small savings associated therewith, that the Pension Fund does not lend stock at the present time.

Appendix A – Securities Lending

Proposal from NT on securities lending

We stated that we had asked NT to look at the assets held on behalf of the Fund, and to provide an estimate on what kind of revenue might be generated if the Fund chose to participate in their Securities Lending programme. We set out below what securities lending it, why we believe it is an important activity, what the LGPS Investment Regulations have to say on lending, the risks involved and our views on its suitability for pension fund clients.

What is securities lending?

At its simplest level, securities lending is an activity where the beneficial owner of an asset lends it to a borrower. In return, the lender receives a fee for lending the asset. Collateral is received from the borrower, which is held as security against the lent asset. If the borrower were to 'default' i.e. to not return the lent asset – then the collateral would be sold off, and the proceeds from the sale used to buy an equivalent holding of the asset that was originally loaned.

The most popular way of participating in securities lending as an activity is for pension funds' custodian to manage the process on their behalf on an agency basis. They include the funds' assets in their lending programmes, matching lenders and borrowers, and managing the collateral. They can also offer indemnities against problems relating to collateral held in certain circumstances. In return, the custodian takes a share of the revenue generated by the lending activity

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Securities lending & liquid markets

Securities lending plays an important part in helping to maintain liquid markets. Maintaining a liquid securities market is in the interest of pension funds – particularly in periods of intense market turmoil – as we now explain.

Market liquidity requires market makers to quote buying and selling prices in considerable size and on a narrow spread; their willingness to do so would diminish rapidly without access to borrowed securities in order to cover the short position that results automatically whenever their selling price is accepted. Without an ability to borrow, they would be forced to cover positions immediately at another trader's offered price, and therefore, - to protect themselves against the risk of loss - would widen the bid/offer spread and reduce the size of order for which their quote is good.

Therefore, it would become progressively more difficult to trade large positions without moving the price and pension fund investment performance would inevitably suffer as a result. Goldman Sachs recently published a research note on the short selling ban in the US, and the effect it had on the spreads of the stocks concerned. The report concluded that '...during the short-sell ban, quoted spreads on the short-sell ban stocks widened relative to other stocks'.

Securities lending and voting

One of the main concerns which we regularly come across when discussing securities lending with clients relates to voting. Most of our LGPS clients are actively involved in voting on the asset that they own, and worry that this kind of shareholder engagement might be impacted by lending.

Our advice is to simply instruct the custodian that they have to recall any stock that is out on loan to allow for all votes to be cast in a timely manner. This is something that any good custodian can simply build into the lending arrangements of their clients.

This may have a small impact on potential revenue earned, but clearly is worth the effort to ensure that votes continue to be cast on behalf of the Fund.

LGPS Investment Regulations

Securities lending is a permitted activity under the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998. The Regulations relating to lending were last amended in 2001, when securities lending

was defined as an investment conforming to the rules 5.14.4R and 5.14.6R of the Financial Services Authority Collective Investment Schemes (CIS) Sourcebook. The CIS rules ceased to apply after February 2007, when the CIS sourcebook was replaced with the New Collective Investment Scheme Sourcebook (COLL).

At the moment, we are awaiting revised LGPS Investment Regulations, following the recent consultation exercise undertaken by the Department for Communities and Local Government. From the draft Regulations that were issued as part of the consultation, there has been no change to the original position of securities lending being a permitted activity.

The LGPS Investment Regulations also state that the maximum amount of securities transferred by the authority under securities lending arrangements is 35%, although in practice we have found clients tend to have – at most – somewhere between 10-15% of lendable assets on loan at any given time.

Securities lending in the press

Financial markets endured unprecedented volatility during the initial stages of the credit crunch in 2008. Amongst many high profile events that occurred – in addition to the failure of Lehman Brothers - one of the more obvious was the collapse of the share prices of the large British banks, most noticeably HBoS.

During the initial stages of the collapse, much noise was made in the press on 'short selling' – and therefore through implication, securities lending. The public perception was that speculators had driven down the price of HBoS through borrowing securities and selling them – hoping to buy them back at a lower price and to therefore bank a profit.

Analysis on activity in the securities lending market undertaken by DataExplorers at the time did not indicate that there was any unusual lending activity generated around HBoS shares. They did not fall because they were being short sold – but instead fell because sentiment turned increasingly negative against Financials, and arguably 'long only' institutional investors began selling down their own holdings. This analysis is supported by the fact that the share prices of the large British banks continued to fall after the FSA brought in specific restrictions prohibiting the short selling of shares of certain Financial companies, including these banks.

Therefore, we would argue that 'spivs and speculators' targeted in the media were not the main cause of the collapse in the HBoS share price. They may well have played some part, but were not primarily responsible.

The risks involved in lending

No investment activity is without risk of some sort, and securities lending is no different. There are essentially three main risks:

- collateral risk – that the collateral received against the lent asset is insufficient to cover the repurchase of the asset in the event of a borrower default;
- counterparty risk – that there is a problem with the party that borrowed the assets (e.g. the collapse of Lehman brothers, who were active as a counterparty in the securities lending marketplace); and
- cash reinvestment risk – any cash accepted as collateral has to be reinvested to provide the lender with a rebate when the cash is returned to them

These risk are deal with in a number of ways:

1) Collateral held is 'marked to market' on a daily basis – that is, the value of the collateral held is compared to the value of the asset lent every day, and an adjustment is made where necessary, asking for more collateral from the borrower, or indeed returning excess collateral. The custodian will tend to operate a policy where the collateral has a 'haircut' – in effect, non cash collateral received will be 105% of the value of the lent asset, and will be maintained at that level.
2) Counterpart risk is effectively dealt with by means of the collateral. As was the case with Lehmans, when they went into liquidation and ceased trading, they

were declared in default by the custodians to whom they had lent assets. In this case, the collateral held was liquidated and the proceeds used to buy back the asset that had been borrowed, and which now could not be returned.

3) Our view of the best way to avoid the cash collateral reinvestment risk is to simply not take cash collateral. In our experience, this has little impact on the revenue to be earned from lending. Alternatively, for clients who are comfortable accepting cash collateral, it can be stipulated that it can only be reinvested in Government Bonds, thereby reducing the reinvestment risk.

4) As mentioned earlier, custodians also offer indemnities to clients in their lending programmes. What this means is that they will effectively make up any shortfall in the difference between the collateral and the lent asset in the event of a borrower default. This 'insurance' comes at a price, but may well be worth considering for clients who have a very cautious approach to lending.

NT's approach to collateral

As stated above, one of the key risks relating to lending is the deciding what kind of collateral is acceptable. There are essentially two kinds of collateral:

- cash – such as US Dollars, Sterling, Euros
- non-cash – such as Government Bonds, Certificates of Deposit, Equities, Commercial Paper

Problems arose in the lending industry last year relating to cash collateral. When a lender accepts cash collateral from a borrower, there is an expectation that when the cash is returned to the borrower it will have been invested in the intervening period to generate a return – the 'rebate'.

The problems encountered in the last year stemmed from the fact that several of the large custodians reinvested cash collateral in assets such as Asset Backed and Mortgage Backed Securities. As the credit crunch unfolded, these assets became extremely illiquid and fell in value. This presented a problem when cash collateral had to be returned to borrowers.

NT currently operates a pooled approach to collateral, whereby clients decide which of the available pools they wish to use as part of their lending programme. They currently run two collateral pools – one for cash, and one for non cash. Should the Fund decide to participate in securities lending with NT, we would recommend that only non-cash collateral is acceptable.

We are also aware that NT are exploring the possibility of creating additional collateral pools, which will be limited to more stable forms of collateral, such as only Government Bonds.

Should the Committee decide to explore securities lending further, we would be happy to discuss this issue of acceptable collateral further in due course.

Hewitt's View on Securities Lending

We believe that securities lending is a valuable, revenue generating activity for clients – albeit with some risks. Aside from the additional revenue it generates for lenders, it also helps to ensure a liquid securities market by providing market makers with the opportunity to borrow assets to settle transactions.

Conclusion

In our view, securities lending is an entirely suitable practice for pension schemes as long as the risks are understood and controlled. Recent events have not altered our advice.

APPENDIX 2

Dear Colleagues

As you will no doubt have been reading in the financial press the market for corporate control – otherwise known as M&A (mergers and acquisitions) - is beginning to hot up.

There are several potential deals under consideration in the UK market, both hostile and friendly, as well as various shareholder challenges to incumbent management taking place.

I have asked PIRC to prepare a note on these matters for consideration at a future Forum Executive meeting but I would like to draw your immediate attention to a particular and very important aspect of this market trend and that is the implication of such activity for your stock lending programmes.

Perhaps the most important hostile takeover proposal currently being considered is the Kraft bid for Cadbury. The press have reported on the build up of hedge fund positions in Cadbury. These positions are typically derived from so called "borrowed stock".

I would like to advise all LAPF Forum member funds to ask their lending agent if any Cadbury stock is included amongst their lent stock and to confirm the mechanism for recalling Cadbury stock in order to vote the shares at any forthcoming shareholder meeting associated with the Kraft bid. In addition you will no doubt be aware that your fund's shares could be held by a manager in their custody account or in a pooled vehicle. Such arrangements are not of course through a traditional lending agent and funds may wish to consider requesting where possible the withdrawal from lending their shares or challenge how the manager proposes to act if this is not possible.

Also where external managers are used funds may wish to question how their managers' propose to balance potential conflicts between short term performance gains against long term shareholder interests. In addition, those funds where governance arrangements, in particular proxy voting, are outsourced may also wish to question how their 3rd party proxy research advisers intend to deal with any potential bid affecting their shareholder rights, in both Kraft and Cadbury.

The Forum Executive has to date not considered the current bid from Kraft for Cadbury although I know of several Forum funds that are doing so.

If in subsequent weeks the Executive decides to issue a LAPFF Alert on the matter I shall write to you again on the matter.

With best regards for the New Year

Cllr Ian Greenwood