SEC Roundtable - Securities Lending and Short Selling

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Opening Statement of William F. Pridmore, President - William F. Pridmore, Ltd.
Panel Topic - Overview of Securities Lending

I am pleased to participate in today's introductory panel session. I hope I can shed some light on securities lending. It is one of the hidden but vital areas of modern securities markets. Securities lending is part of the plumbing of the market. It runs smoothly in the background, so people don't usually spend too much time worrying about it. But like the plumbing in your house, when it doesn't work correctly it can quickly turn into a messy problem for everyone.

For the past 15 years I have been providing advice to large institutional investors on their participation in the securities lending markets. I work exclusively for the beneficial owners. These are the lenders who provide the supply of securities to the lending market. They range from large public and private pension funds, to multinational insurance companies and mutual fund complexes. Prior to becoming an independent consultant, I held various senior management positions in the institutional trust and securities finance businesses.

For the potential lender of securities, there is no shortage of highly knowledgeable and experienced people willing to provide advice about securities lending. But this advice is usually from the perspective of a vendor selling their product. Often the lender has a difficult time determining when their interests may not be aligned with the lending service vendor. As an independent consultant, I help the institutional investor bridge that knowledge gap. Together we design a lending program where the investor's interests are put before those of a vendor. My goal is to provide the lender with an unbiased perspective.

Securities lending, on the surface at least, looks like a fairly simple process. The owner of securities lends their stock to a broker, receives collateral in return and earns a small fee. But in practice it is far from simple. The owner of securities commonly hires multiple investment managers to decide how their investments are deployed. To keep track of the multiple managers they usually employ a custody bank to provide centralized information management, hold the securities in safekeeping, consolidate the investment of short-term funds and provide many other ancillary services. Beginning in the mid 1970's, these custody banks added the service of acting as agent in the lending of securities to brokers. Typically, the custody bank would charge a fee for acting in this role, taking somewhere between 10 and 50% of the lending income earned. For this fee, the custody bank would often indemnify their lending client against the risk of loss if the borrower defaulted on the loan and the collateral was insufficient to replace the security lent.

Further complicating the process, the most prevalent form of collateral provided by the broker was cash. The lender could invest that cash and earn some amount of interest. Depending on the level of demand for a particular security, the lender might have to compensate the borrower for use of this cash by paying the borrower interest. Although not directly tied to the underlying investment of the cash collateral, this was called a "rebate". The lender's profit on the transaction was the interest income earned on the cash collateral less the rebate to the borrower minus a fee to the custody bank.

The custody bank presented this service as one that would take care of all of the back office tasks necessary for the institutional investor to participate in the lending market. Between moving the securities among its clients and the many borrowers, tracking the collateral and investing the cash, the custody bank might process thousands of transactions each day. This transaction volume had the effect of binding the institutional lender closely to the custody bank. It was difficult to think of extracting securities lending from the other custodial tasks. There appeared to be little risk in lending and the biggest perceived risk, borrower default, was often assumed by the custody bank. As a rule the institutional lender didn't think too deeply about lending. Everything was handled by their custody bank and the risks to the lender were thought to be low.

But beneath the low risk perception we can now see there are significant potential risks and perverse incentives. First and foremost was the extent of investment risk inherent in the cash collateral lending model. I won't dwell on the investment default risks of short-term investments. These credit risks were pretty well understood by the participants. Lenders were encouraged to believe that the cash collateral investment risk was minimal. It could be dealt with by using investment guidelines that limited investment to only the highest quality instruments. But the liquidity risk was not addressed..

Although each day the custody bank stood ready to return the cash collateral if the borrower returned the loaned security, experience suggested that the actual pattern of returns was more stable. With the resulting stable level of cash collateral, custody banks invested with a longer time horizon. This produced a higher rate of return, and, ultimately generated higher income to their clients (not to mention higher fee income to the custody banks). Further, some custody banks would pool the cash collateral from a number of their lending clients and invest the proceeds wholesale. Some charged a fee to the lender for managing these cash collateral pools. (In some cases, a custody bank could earn more fee income from investing the cash collateral than from their share of their client's income from lending.)

For the most part this system worked well. Lenders got a small return with little perceived risk. The custody banks got a stream of high margin income from a product that tied the custody client ever more closely to the bank. The system survived the default of a few broker-dealers in the 1980's with no major losses suffered by the institutional lenders. But in 1994 there was a "crisis" suffered by a few custody bank lenders that looks eerie in light of the developments of the recent past. In 94, the Fed unexpectedly tightened short-term rates. Some custody bank lenders had invested in highly-rated notes that suddenly became less attractive. Dealers stopped making a market in these securities leaving holders with illiquid positions. This caused some custody banks to step forward and make substantial support payments to keep their lending clients from suffering a loss.

But that is ancient history. Since 1994 the market has grown, fueled by healthy demand to borrow from hedge funds. Participation in the lending market has also broadened. The initial growth in lending supply was fueled by ERISA and public pension plans, but recently the growth has come from '40 Act funds and overseas investors.

In the past few years technology has also played a role in changing the dynamics of the securities lending business. In the past, one could not think of participating in securities lending without relying on the custody bank. Technology has allowed the decoupling of this relationship with the development of what are called "third-party" lending platforms. These platforms provide the back office processing necessary for an investor to lend independent of the custody bank. These third-party lenders attempted to distinguished themselves by providing clients with better returns and/or lower fees than the custody banks.

With the entry of third-party lenders came a growing focus on lending returns. Lending was evolving into what I call an asset-liability play. Traditionally securities lending was stock specific. The fee to borrow a particular stock was driven by the intrinsic value derived from a specific investment strategy. But the market evolved so that a significant volume of lending was unrelated to the underlying stocks. This is termed "general collateral" or GC lending. At some rebate level it becomes economical for a broker-dealer to borrow a basket of shares to finance their operations. The custody banks and third-party lenders were willing participants. Although margins were small, the higher volume resulted in higher income. But the unseen risk was that this ballooning of the lending book put increasing pressure on the lender to find profitable ways to invest the cash collateral. This huge appetite resulted in the design of short-term investment securities to fit the special needs of securities lending cash collateral investors. These securities had longer maturities but monthly or daily floating interest rates. This structure appealed to cash collateral investors, but not the normal short-term investor.

The custody banks and third-party lenders assumed that as long as they could earn a competitive short-term interest rate, the cash collateral would be available to "fund" these investments. No one thought about having to sell these designer investments. Today there is little or no appetite to invest in these securities. The market to sell them, never robust, has seized up. Lending clients are faced with the unappealing prospect of taking large losses on what they were encouraged to believe was a minimal risk activity.

What can we learned from this? We need to remember that for the most part this is a problem experienced by sophisticated institutional investors. They should have known better. I want to focus on some practical steps those investors can take to make sure this sort of problem does not arise again. It starts with making sure you have a clear understanding of the motivations of your lending service providers. You may have delegated day-to-day management of the lending process to a custody bank or third-party lender, but you still own the risk. You need to make sure you have a clear idea of the specific risks of your lending program. Don't rely exclusively on your service provider to define the risks. You need an independent risk assessment.

Finally, the news is not all bad. Many investors had done their homework and designed their lending programs to eliminate this liquidity risk. I worked closely with one mutual fund complex whose trustees and management spent years researching lending. They paid particular attention to minimizing cash collateral investment risk (both credit and liquidity) while focusing on intrinsic value lending. This client was able to enter the lending market in late 2008, arguably the worst time possible, build a lending book close to $ 1 billion. When concerns of a systemic financial collapse became too great, they were able to completely exit the lending market in a matter of days with no losses. Once concerns about the financial system had passed, they were ready and able to re-enter the lending market. This illustrates that the basic framework of the lending market is sound. By paying close attention to the design of the lending program, lenders can earn a safe and steady return.