What is Securities Lending?

- An investment strategy in which investors make short-term loans of their securities to generate incremental revenues from their portfolios
- Loan results in a transfer of title/ownership to the borrower who is obligated to return the same type and amount of securities
- Loaned securities are collateralized, typically 102% or 105%, reducing the lender's credit exposure to the borrower

Who Are The Players?

Lenders

- Mutual funds and investment companies
- Corporate and government pensions and sovereign wealth funds
- Endowments and foundations
- Insurance companies
- Off-shore investment funds (Ireland and Luxembourg)

Borrowers

- Broker/dealers – prime brokerage units
- Bank and/or broker/dealer proprietary trading desks
- Hedge funds

Facilitators

- Custodial agent lenders
- Third party agent lenders
- Broker/dealers acting as principal borrowers (exclusive principal deal)

Routes to Market

- Discretionary: stock by stock "agency" lending, best-efforts basis
- Exclusive: guaranteed fee payment for a portfolio or segment of a portfolio (can be executed directly with a broker/dealer or through an agent who also manages all ongoing program administration and indemnification)

Source: eSeclending
Why Lend Securities?

- Lenders are interested in achieving an incremental return on portfolios
- Increase overall performance for portfolio managers, increase alpha
- Offset expenses associated with maintaining a portfolio
- Maximize opportunities to leverage a portfolio
- Finance fund-specific projects
- Retain all economic ownership benefits, except right to vote shares

Why Borrow Securities?

Borrowers are typically global banks and broker/dealers with proprietary trading desks and prime brokerage units supporting hedge fund activities. Reasons to borrow:

- Operational needs - covering shorts and preventing fails
- Risk, tax, dividend, merger, index and convertible bond arbitrage
- Pairs trading and market making
- Various cross-border strategies
- Financing inventory and managing balance sheets

What type of collateral can be used?

Typically, collateral consists of:

- Cash (USD, GBP and Euro primarily)
- US government or agency securities or G1O debt and Supernationals
- Other U.S. and/or foreign securities as allowed by the lending institution
- Letters of credit

What drives the securities lending market?

- Capital markets growing
- More institutions lending
- Express support from central banks
- Deregulation of international markets
- Growth of hedge fund activity

Source: eSeclending
What does the transaction look like?

In a typical securities lending transaction, the beneficial owner of the assets lends securities to a borrower. The borrower must provide collateral in an amount equal to the market value of the security plus a margin, typically 102% to 105%. At termination of the loan, the borrower must return a like quantity of the same security.

The diagram below describes a basic securities lending transaction where cash is accepted as collateral and the collateral is reinvested into a short-term money market investment vehicle.

What Determines the Potential Revenue?

In a discretionary program, fees are negotiated on a trade-by-trade basis. At eSecLending, price is effectively established for portfolios, or segments thereof, through a competitive blind auction process. Revenue can be affected by many factors. These include:

- Availability of security in open market
- Value of portfolio
- Asset class
- Duration of loan
- Size of individual holdings
- Type of investment strategy
- Market/geographic diversification
- Dividend yield of security
- Tax status of underlying lender

What are the Risks?

When properly planned and executed, securities lending is a low-risk investment strategy. Since all investment activities involve some risks, lenders should consider the following with respect to their securities lending activities:

Source: eSecLending
<table>
<thead>
<tr>
<th>Risk</th>
<th>Controls</th>
<th>Tools</th>
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<tbody>
<tr>
<td>Counterparty:</td>
<td>Ongoing credit review of counterparts incorporating qualitative and quantitative risk factors</td>
<td>Semi-annual counterparty credit review</td>
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<td></td>
<td>Analyze daily price volatility of securities on loan and collateral received</td>
<td>CDS analysis with dynamic mark requirements</td>
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<td>No loans to affiliates</td>
<td>Daily VaR analysis and regular stress testing</td>
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<td>Independent indemnification provided in the event of counterparty default</td>
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<td>Collateral:</td>
<td><strong>Cash Collateral</strong></td>
<td>Strict collateral schedule</td>
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<td>Flexibility on cash management decision</td>
<td>Daily compliance monitoring</td>
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<td></td>
<td>Intrinsic lending strategy that supports reinvestment in assets that are collateralized with high quality, liquid securities</td>
<td>CDS analysis</td>
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<td></td>
<td>Monitor credit quality, sector allocation and liquidity of collateral</td>
<td>Asset/Liability monitor</td>
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<tr>
<td></td>
<td><strong>Non Cash Collateral</strong></td>
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<td></td>
<td>Loans structured against high quality liquid securities</td>
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<td></td>
<td>Collateral held by tri-party agent in a segregated account in client’s name</td>
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<tr>
<td>Commingled:</td>
<td>Separately managed programs: segregated lending and collateral accounts</td>
<td>Program structure</td>
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<td></td>
<td>Visibility into risk decisions and trade execution</td>
<td>System architecture</td>
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<td></td>
<td>No allocation of specials based upon GC borrows; no ratio lending</td>
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<tr>
<td>Earnings/</td>
<td>Create known, contractually obligated revenue stream for a given period of time</td>
<td>Auction platform / capabilities</td>
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<tr>
<td>Estimate Volatility:</td>
<td>Utilize exclusive bids to rationalize traditional queue based lending</td>
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<tr>
<td>Operational:</td>
<td>Daily reconciliation and marks-to-market between program participants</td>
<td>SWIFT messaging</td>
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<td>Best practice procedures and guidelines with all counterparties</td>
<td>EquiLend reconciliation</td>
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<td>Corporate action monitoring</td>
<td>4sight auto recalls</td>
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<td></td>
<td>Business Continuity Planning / backup systems</td>
<td>SunGard Loannot reconciliation</td>
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<td></td>
<td>Routine reporting, verification, and management oversight</td>
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