Securities Lending 101

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?

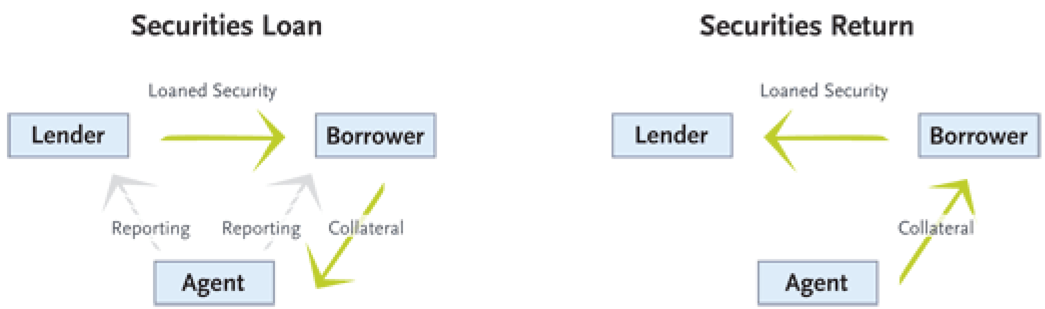
- Capital markets growing
- More institutions lending
- Express support from central banks
- Deregulation of international markets
- Growth of hedge fund activity

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

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

Source: eSeclending