Brown Brothers Harriman

An Asset Manager's Guide to Evaluating Securities Lending

Securities lending can be a valuable source of additional revenue for asset managers. In the current environment, the practice has become more relevant than ever as a way of reducing the impact of fees on performance, protecting their profit margins, and improving their fund investors' returns.

Although securities lending is becoming increasingly common among asset managers, it is not universally embraced and typically invokes a philosophical discussion about its place within a fund product. This guide is designed to help address the typical questions and concerns which arise from stakeholders involved in a decision on securities lending using a data driven approach to shine a light on the benefits and possible risks.

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Introduction

In today's climate, investors are increasingly aware of the relationship between fees and performance. Every asset manager faces greater fiduciary pressure to evaluate techniques that can add revenue to their funds and mitigate the impact of fees on performance, including a well-run securities lending program. It's therefore imperative to determine whether securities lending is in fund investors' best interests. However, it's just as important to establish that a decision not to lend — and forgo potential revenue — is also in the fund investors' interests.

Historically, the decision to lend or not has been a philosophical one. But with the introduction of new tools and more data available than ever before, the decision whether to lend is made easier through rigorous analysis that's paired with data specific to a fund company's circumstances. Brown Brothers Harriman (BBH) has worked with some of the world's most sophisticated asset managers to assess the value of securities lending using these new methods.

First, it's instructive to understand the key internal stakeholders involved in a lending decision and some of their most common concerns. Consider the table below:

Key Securities Lending Stakeholders and Concerns

The Basics

Who lends and why?

Securities lending is on the rise. Nineteen of the top 20 global asset managers by AUM are engaged in securities lending.[1] Additionally, all of the top ten cross-border asset managers by net new sales engage in securities lending.[2] The majority of passive and exchange traded funds (ETFs) also engage in lending. In each case, securities lending has been a powerful revenue source that compounds each year to offset fees and transaction costs, protect an asset manager's profit margins, and improve fund investor returns.

Leading Asset Managers (by AUM) Who Engage in Securities Lending

LENDING	ASSET MANAGER	COUNTRY	2019 AUM ($M)
Y	**BlackRock**	US/UK	$4,475,428
Y	**Vanguard**	US/UK	$3,960,967
Y	**SSGA**	US/UK	$2,130,315
Y	**Legal & General Investment**	US	$1,531,028
Y	**BNY Mellon Investment Management**	US/UK	$1,510,703
Y	**Fidelity**	US	$1,496,326
Y	**J.P. Morgan Asset Management**	US/UK	$1,192,999
Y	**Prudential Financial**	US	$1,156,289
N	**Wellington Management**	US	$1,153,278
Y	**Amundi**	FRANCE	$1,104,417
Y	**Goldman Sachs Group**	US/UK	$1,095,697
Y	**PIMCO**	US/GER/UK	$873,568
Y	**Northern Trust Asset Management**	US	$792,751
Y	**AXA Investment**	FRANCE	$761,528
Y	**Capital Group**	US	$738,400
Y	**Nuveen**	US/UK	$714,461
Y	**T. Rowe Price**	US/UK	$660,461
Y	**Dimensional Fund Advisors**	US	$609,337
Y	**Legg Mason**	US	$594,906
Y	**Morgan Stanley**	US/UK	$584,324

Source: IPE Top 400 Asset Managers 2020.

19 OF THE WORLDS 20 LARGEST ASSET MANAGERS ENGAGE IN SECURITIES LENDING

One of the most powerful examples of how securities lending can mitigate costs comes from the fastest growing area of investment management: ETFs. It has been common for some passive ETFs to not only track the index more closely, but to even outperform the index because the securities lending revenue exceeds the annual management fee and all other costs. Consider the Vanguard Small Cap ETF and the iShares Russell 2000 ETF, which in 2017 both generated more income from lending (27 bps) than they charge investors (20 bps).[3,4] These ETFs are purely passive and have no "alpha" component, so their outperformance is solely a factor of low costs and securities lending revenue compounding over time.

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1. *Morningstar Fund Family Report, Q2 2018*
2. *Broadridge Data Digest, 2017 Edition*
3. *Ignites, "Cutting Fees? 10 bp Reduction Could Require 38% Asset Boost," May 2017*
4. *Bloomberg, "Hedge Funds Will Pay for You to Own Small-Cap ETFs," February 2016*

While most ETFs and passively managed funds lend, the case is arguably even stronger for active asset managers because their costs are considerably higher. BBH research indicates that for every 10% increase in portfolio turnover, a manager can expect an added 15 bps of cost to a fund once stamp duty, taxes, commission, and market spreads are all factored in.[5] It is not uncommon for active funds to have portfolio turnover rates well above 50%. Therefore, an active fund can easily generate 150-200 bps of performance-sapping cost differential each year versus a low-cost passive fund.

Outside of the core investment strategy, securities lending is one of the few revenue sources available to offset these costs and preserve hard-won investment alpha.

Securities lending by asset managers

While securities lending is common among asset managers, they're not the most common lenders of securities. In fact, they're a minority, accounting for only 8% of securities on loan.[6] This would not be significant in itself were it not for the fact that the other types of lenders have a vastly different approach to securities lending. And this difference has important consequences for investor protection.

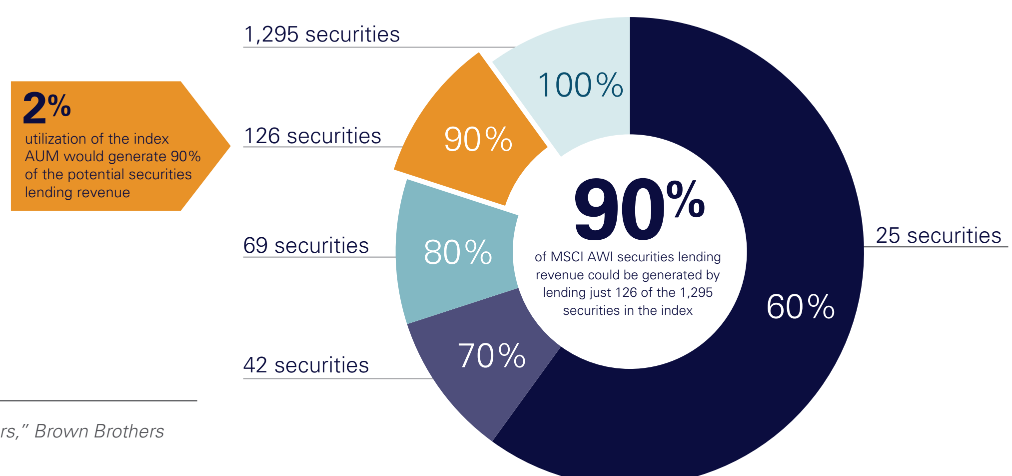
92% of securities on loan are lent by sovereign wealth funds, pensions, central banks, and insurance companies.[7] Largely because of their need for annuity revenue streams, these institutions prefer a type of securities lending often referred to as "volume lending," which has different risk characteristics and levels of investor protection compared to the style of lending most asset managers prefer, known as "value lending.

However, absent a rare borrower default, the most common losses are typically operational, arising from either the difficulty in protecting corporate action entitlements for lent securities or the settlement of securities that are sold while on loan. Thoughtful securities lending trading and limiting the volume of securities on loan helps reduce these risks.

Intrinsic Value Lending – A good place to start

Because of its lower risk profile and reduced potential for interference with the investment process, asset managers typically choose to enter the lending market with an intrinsic-value approach. Below is an example of the concentration of securities lending revenue in the MSCI All World Index using an intrinsic-value approach (assuming collateral restricted to a subset of G10 sovereign debt). 90% of total revenue is generated by just 2% of the AUM. In fact, 13% of total revenue is concentrated in just one stock, so the starting point for our data-driven analysis is to use an intrinsic-value approach to limit the scope of securities lending to only the 126 highest fee-earning securities, and then to examine their characteristics in detail.

After all stakeholders have become more familiar with securities lending and its intersection with other parts of the investment process, the asset manager can consult with its agent lender to determine the benefits and considerations of shifting towards a more volume-oriented program. An agent lender will be able to provide the approximate increase in expected revenues and portfolio utilization with the changes needed for the risk profile of the program.



5. *"Passive Lessons for Active Investors," Brown Brothers Harriman, April 2016.*
6. *ISLA Securities Lending Market Report, September 2020.*
7. *ISLA Securities Lending Market Report, September 2020.*

Two approaches to lending

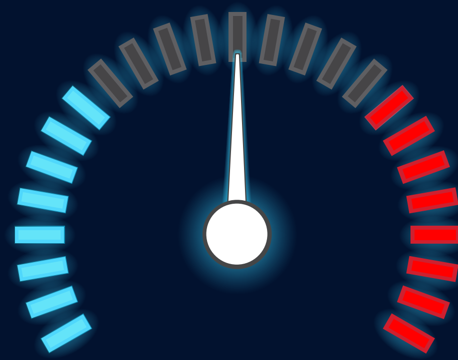
Understanding the two approaches to securities lending is key for asset managers who are deciding whether or not securities lending is in their investors' best interest.

- **Volume lending (also known as general collateral or GC) prioritizes revenue maximization.** Large volumes of liquid, easy-to-borrow securities command a minimal fee from the borrower (less than 25 bps) are lent, and returns are enhanced by taking varying levels of risk with the collateral. Increased collateral risk is usually expressed either by accepting less creditworthy collateral, like equities, lower grade and less liquid bonds, or by taking cash collateral and reinvesting it in higher-yielding reinvestment vehicles. Volume lending also requires a much larger percentage of the portfolio to be on loan, often 30% or higher, in order to generate meaningful income. This approach increases the risks of lending, including risk of disruption to the core investment process.
- **Value lending (also known as intrinsic-value lending) prioritizes higher risk-adjusted rates of return by selectively lending securities with a scarcity premium (specials), combined with a more conservative approach to collateral.** This typically means that the highest-quality non-cash collateral can be demanded (usually a subset of G10 sovereign debt), or where cash is taken, it's reinvested into a conservative money market fund. Since this strategy results in a lower overall percentage of assets on loan, usually less than 5%, the risk of lending then interfering with rebalancing, sale, and corporate action activity is commensurately reduced.

Historically, the losses from securities lending and associated headlines have been primarily due to the reinvestment of cash collateral into vehicles containing instruments that have defaulted or fallen below par. When this intersects with needing to liquidate the collateral (e.g., to buy-in replacement securities upon a borrower default), it results in the lender crystallizing a loss. In terms of non-cash collateral, in the event of a borrower default, there is also the risk of a shortfall between the value of the collateral held and the replacement securities that need to be "bought in," which increases depending upon the credit quality, liquidity, and price volatility of the collateral. Effective mitigation of these risks is essential.

Securities Lending

Credit Risk, Operational Risk, Market Risk

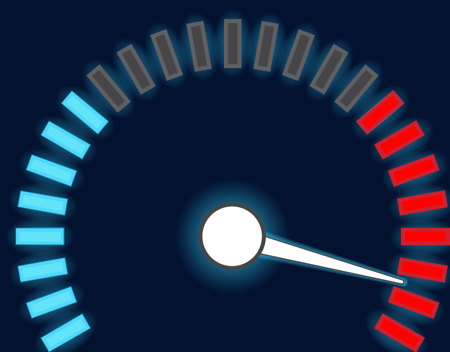


VALUE LENDING

Less Securities on Loan

Selective Borrower List

Higher Quality Collateral



VOLUME LENDING

More Securities on Loan

More Expansive Borrower List

Lower Quality Collateral

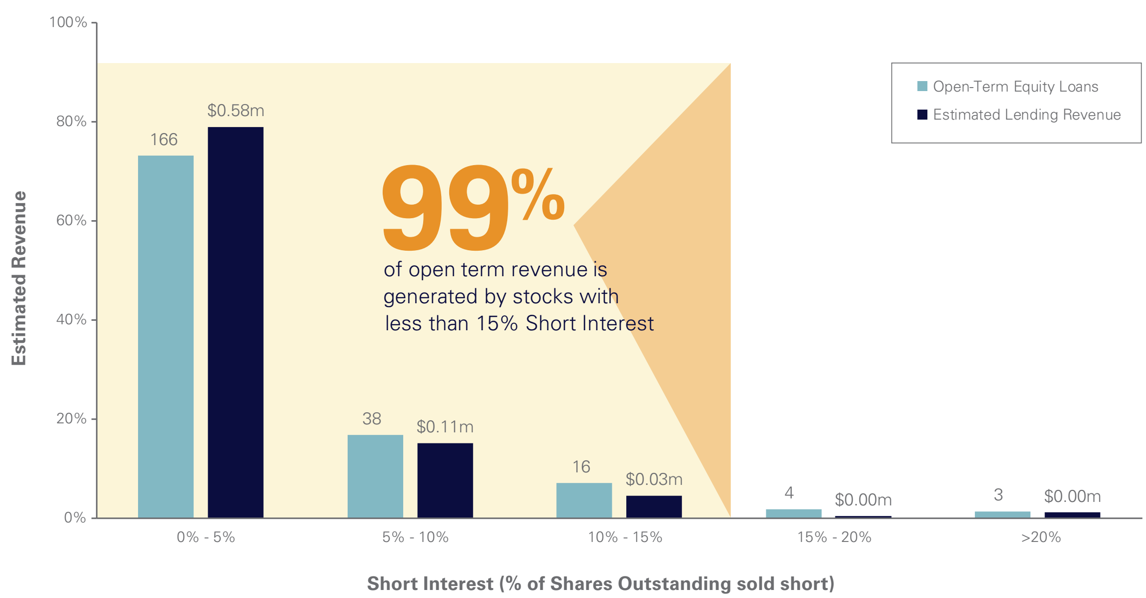
Common Objections

"Lending drives prices down by facilitating shorting"

The most common objection from portfolio managers and chief investment officers is the belief that securities lending will facilitate short selling, which will undermine their investment objectives. Using a sample loan portfolio, we can address this point using a few helpful data points, like short interest.

Below is an example of how we might approach the question: does securities lending facilitate harmful shorting? The chart below shows the distribution of revenue versus "short interest" (the percentage of a stock's outstanding shares that are sold short) in the stocks generating that revenue. It shows that this asset manager can earn 99% from stocks where short interest is 15% or less. In other words, shorting is relatively low in these stocks and the holding in these stocks would not be lent into an environment of high speculative interest or aggressive shorting. At this level of short interest, portfolio managers typically take the view that a program may "lend at will."

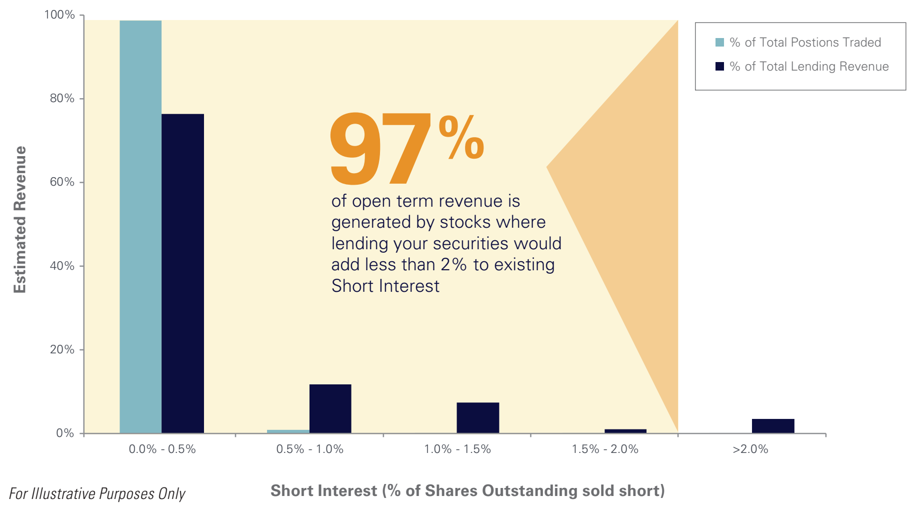
Relationship Between Estimated Lending Income and Short Interest



For Illustrative Purposes Only

The following chart helps to answer the next question a portfolio manager might have, namely how much short interest could change when their holding is lent. The chart follows the same logic as the above and illustrates that over 75% of lending revenue is from loans which would add only 0.5% or less to short interest, with 97% lending revenue capture still only adding less than 2% to short interest.

Potential Impact on Short Interest of Lending Additional Stock



For Illustrative Purposes Only

Of course the relationship between short interest and securities lending revenue will vary from portfolio to portfolio, as will the sensitivity to it. However, analyzing a portfolio in this way enables an objective discussion about the potential guardrails that could be put in place to ensure that loans are only executed in stocks the portfolio manager is comfortable with. This results in a more objective and precise approach than what can typically be binary decisions to lend or not lend at the portfolio or complex level based upon philosophical view towards short selling.

There are also a number of empirical research studies by independent academic institutions that are relevant to any discussion on the effects of securities lending. The most notable example involved a team of academics partnering with an asset manager to assess the effects of sudden supply shocks to the lending market on underlying stock prices. Significant excess supply was made available (i.e., large volumes of in-demand securities were lent), then withdrawn, and share prices were monitored to observe the effects. This study concluded

- "We find that exogenous changes in loan supply have significant effects on loan fees and quantities, but no adverse effects on security prices."
- "Our findings suggest that fund managers can learn meaningful lending fees to enhance their returns without generating adverse effects on the value of their holdings."[8]

While securities lending and short selling are not the same thing, the two topics are inevitably related in the minds of some commentators. The next two research examples use a number of short selling bans around the world as control group experiments to examine the effects of short selling bans.

The first report uses the short selling bans in 30 countries during the financial crisis as a control group to assess how the absence of shorting affected the 16,491 stocks observed.[9] The report noted that imposing the bans "was at best neutral in its effects on stock prices," "slowed down price discovery," and was "detrimental for market liquidity, especially for stocks with small market capitalization, high volatility and no listed options." This conclusion is summarized by former SEC Chairman Christopher Cox in a 2008 interview with Reuters: "Knowing what we know now, I believe on balance the commission would not do it again. The costs (of the short-selling ban on financials) appear to outweigh the benefits."

The second study was conducted by the Federal Reserve of New York and provides an in-depth review of the short-selling ban imposed in the US during 2008.[10] "The preponderance of evidence suggests that the bans did little to slow the decline in the prices of financial stocks. In addition, the bans produced adverse side effects: Trading costs in equity and options markets increased, and stock and options prices uncoupled." The report also notes that: "together, the inflated costs of liquidity attributable to the short sale ban in US equity and options markets are estimated to exceed $1 billion."

8. *The Effects of Stock Lending on Security Prices: An Experiment, Kaplan, Moskowitz & Sensory, August 2012*
9. *Short-Selling Bans around the World: Evidence from the 2007-09 Crisis, Alessandro Beber, Cass Business School and CEPR, MarcoPagano, Università di Napoli Federico II, CSEF, EIEF and CEPR*
10. *Current Issues in Economics and Finance, Federal Reverse Bank of New York. Volume 18, Number 5F 2012*

"It's not worth it"

Another common objection is that the revenue does not justify the investment of time necessary to secure board approval, implement a program, and ensure appropriate ongoing oversight. Today's world of performance and cost scrutiny is reversing the balance of this judgement from "Why would we lend?" to "Why wouldn't we lend?" Although securities lending revenues can fluctuate, they are nonetheless one of the few reliable sources of income outside core investment process and importantly like dividend reinvestment or income accrual, they compound.

There are two ways to consider expressing the value of securities lending income to stakeholders.

The first is the impact to the fund's relative performance to peers, where Morningstar's "QuickRank" can help determine how much a given fund's performance ranking would improve if it were engaged in lending. Here, we typically find that funds are tightly grouped together so the incremental returns from securities lending can be meaningful and that most funds in the peer group are already lending, creating a strong commercial argument to engage in the practice.

The second way is to calculate how the fund's expenses could be offset by the additional income from securities lending. While directly offsetting fund expenses with securities lending income is complicated to achieve from a legal and regulatory perspective, the argument can be made that the additional income could mitigate the impact of fees on performance, a topic that is currently at the forefront of investors' minds.

"Securities lending is risky"

When Lehman Brothers (a significant borrower of securities) declared bankruptcy on September 15, 2008, it was the single largest test of the risk management framework of securities lending in its history. It's worth examining a case study of what worked, what didn't, and the lessons learned.

For value lenders, the Lehman event was a vindication of their approach to securities lending. Their controlled loan balances and high-quality collateral ensured these lenders were well-protected and did not suffer loss or significant disruption to their investment process. The contractual framework of the securities lending industry, the process of seizing and liquidating collateral, and the replacement of the securities that were on loan all took place smoothly. Lenders who required high-quality, non-cash collateral (usually G10 sovereign debt) or who reinvested cash collateral in conservative money market funds, found that their collateral was more than sufficient to cover the replacement of their securities. The process took a matter of a few days in most cases and once complete, many lenders had significant collateral surpluses that were later returned to Lehman's administrators. Value lending passed the Lehman bankruptcy test with flying colors.

The performance of volume lending programs during the Lehman event is a more varied story due to the widespread practice of reinvesting cash collateral in higher yielding collateral reinvestment vehicles. These funds had been a significant source of revenue prior to Lehman's bankruptcy. Loan balances were increased to maximize the collateral available for reinvestment. Although many of the higher yielding vehicles purchased instruments with high credit ratings, they were subsequently found to be holding mortgage backed securities, SIVs, CDOs, and even Lehman Brothers commercial paper — some of which either defaulted or became highly illiquid. The cash collateral that was reinvested was then needed to purchase replacement securities which were on loan to Lehman, which meant losses in the reinvestment vehicles were crystallized and the collateral was insufficient to cover the repurchase of the loaned securities. Consequently, some lenders lost significant sums of money or were forced to continue lending to avoid redeeming out of funds which had "broken the buck." In some instances, lenders brought legal action against the lending agent, claiming that the investment guidelines were breached or not adequately explained.

Note that collateral reinvestment in itself was not the issue. Lenders who reinvested their cash collateral in short-term money market funds focused on capital preservation and liquidity — rather than seeking higher yields — found that they didn't suffer collateral shortfalls. It was the practice of reaching for additional revenue through taking credit and duration risk — via higher-yielding money market funds that resulted in collateral shortfalls and lender losses.

Contrasting these very different experiences highlights two important lessons:

- First, the contractual mechanics of securities lending worked. Collateral was seized, liquidated and, where sufficient, securities were repurchased and returned to the lender without loss or serious disruption.
- Lenders that suffered losses did so due to additional investment risk they took in their collateral reinvestment programs to generate additional revenue. Therefore, collateral-reinvestment risk can be eliminated by restricting collateral to high-quality non-cash only, such as sovereign debt or, if cash is taken, mitigated by reinvesting it in conservative short-term money market funds.

"It's problematic to sell stocks that are on loan"

One of the most common questions regarding securities lending is its potential to interfere with the investment process, specifically when a stock on loan is sold and a late returning recall causes the security sale to fail.

Borrowers are contractually bound to return shares that are on loan in the event of the lender selling their securities. Typically, most agreements will require that the lender inform the agent of a security sale on T+0. Security sale notification does not require a special process, simply a copy of the security settlement instruction that would usually be sent to the custodian.

If a lender has provided a T+0 sale notification, then they should expect their shares to be returned within the settlement cycle of their security sale. If a borrower fails to return shares in time, then either the stock exchange or their agent lender will "buy-in" the shares necessary to ensure the lender's sale settles, with any associated costs borne by the borrower. Agents may offer slightly differing terms and consequential damages coverage.

Beyond contractual remedy, it is important to consider the number of securities on loan. A volume lender may have 30% or more of a portfolio's assets on loan at any time, while a value lender may have just a few high value stocks. Data analysis will highlight how many stocks are likely to be on loan at any given time, the markets in which they trade, and hence, their settlement window.

A well-managed intrinsic-value program with a limited number of stocks on loan should not generate settlement issues for the investment process. An agent lender should be able to share their settlement statistics and articulate the liquidity parameters they monitor as part of their trading process to ensure no single position is over exposed.

"It will interfere with our need to vote"

While the lender retains the economic rights to securities that are on loan, they do relinquish the right to vote, so reconciling the revenue benefits of lending to shareholders with the benefits of voting is an important consideration, especially given the increased focus on governance.

A thorough data analysis can help assess the potential for disruption by highlighting the stocks that may be lent. Cross-referencing this list to historic voting patterns often reveals that the number of incidences with the choice of "to vote or to lend" will be small. A lender will need to have a policy in place to resolve this question that gives priority to the investor interest. Consideration must also be given to whether the manager wishes to vote on the full holding — which would necessitate a recall of the lent security — or if voting on the "buffer" position retained in custody will suffice.

A blanket recall policy has the capacity to reduce the attractiveness of a lender's funds in the eyes of borrowers who require a stable supply. Therefore, thought must be given to the policy to provide discretion where a vote will have material impact versus the revenue that will be foregone.

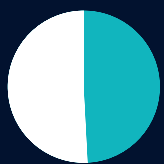
Where the decision is made to recall, it's advisable to give an agent lender two or three weeks of advance notice because recalling for voting purposes is usually covered by different legal obligations than recalling for a security sale. Brokers will need time to source additional supply for their clients, but with sufficient notice, the agent lender and borrower can usually work together to facilitate a recall.

In summary, a well-constructed data analysis builds a picture of what a securities lending program would look like in practice, allows asset managers to accurately test the validity of internally held opinions (like the sentiment that lending facilitates harmful shorting), and assesses the risk profile of the potential loan book. Below, we have built upon the earlier graphic by summarizing the key elements necessary to manage the concerns of the relevant stakeholders.

Securities Lending: Key Stakeholders and Concerns

Executive Committee

	Risk	Operations	Investment & Trading	Distribution/Product
KEY CONCERNS	• Borrower default • Collateral shortfall • Contractual protections • Operational disruption	• Portfolio utilization • Security sale settlement • Proxy voting • Oversight effort	• Facilitating shorting • Security sale settlement • Proxy voting	• Investor sentiment
MITIGATING FACTORS	• Value-lending approach • Low utilization/high risk-adjusted return • Counterparty default indemnification	• Value-lending approach • Low utilization/high risk-adjusted retur • Policy to recall only for material votes • Reporting from agent lender to streamline oversightn	• Value-lending approach • Low utilization/high risk-adjusted return • Parameters to control lending into aggressive short interest • Policy to recall only for material votes	• Value-lending approach • Low utilization/high risk-adjusted return



Mutual funds and ETFs account for

48%

of the global supply of securities, but only

16%

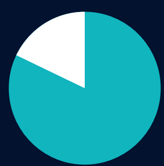
of the global on-loan balance.

Choosing an Agent Lender

Asset managers and their unique requirements

Once asset managers establish the type of securities lending approach and program they want, the next step is to select an agent lender that is best aligned in terms of their own approach and area of specialization. Asset managers have unique securities lending requirements. No other type of lender has the same standards of regulatory oversight and fiduciary responsibility placed upon them, particularly if they manage retail funds. No other sector is as sensitive to the potential impact on their investment teams, portfolios, operational processes, or market reputation. Furthermore, asset managers have unique needs in terms of daily fund liquidity and voting. These distinct requirements are often at odds with how the rest of the securities lending industry operates.

1	The agent lender's **product development** will be focused on areas relevant to volume lending such as collateral flexibility, fixed term trading and other volume lending program-enhancing strategies that are unattractive, irrelevant or prohibited for registered funds. Product enhancements that are attractive for asset managers may be less of a priority for such an agent lender.
2	Programs that service volume lenders tend to be industrial in scale and can have difficulty accommodating the customized needs of asset managers such as mitigating the fueling of shorts and recalling for **proxy voting**.
3	The agent lender's ability to extract the highest fees for high value stocks can be compromized by the distraction and **conflicting interests** of managing large volume balances.
4	Asset managers are subject to very specific **regulations** that are often unique to the sector and do not affect other types of lender. Often these regulations can make the asset manager's funds more challenging to lend. If asset managers are a small part of an agent lenders program, such regulations might receive less attention and strategies to maintain the competitiveness of their funds may not be as actively pursued.
5	Volume lenders tend to require less support so the agent lender may have a far higher **ratio of clients to relationship managers**.



84%

of industry activity is from lender types other than asset managers, driving solutions that are not specifically relevant to asset managers.

Why an asset management specialist is important

Most agent lenders serve all types of underlying lenders, but because asset managers account for just 16% of assets on loan across the securities lending industry their specific requirements can be overlooked in favor of other types of lenders with contrasting objectives and characteristics.[11] A program predominantly focused on meeting the volume lending needs of a broad range of institutional clients will present an asset manager with five main challenges.

Trading performance – Conflicting dynamics

An agent that combines volume and intrinsic-value lending must balance two conflicting dynamics when trading clients' assets. When trading "specials" (the stocks in highest demand that command the highest fees) they must negotiate the highest initial rate possible, and "re-rate" the loan when the market fee rises. Because specials are in high demand by borrowers, the agent lender often has the upper hand in negotiating the best fees. However, their ability to do this can be compromised by having to manage a large volume lending book for two reasons:

- The distraction of managing a large, low-margin volume-lending book that requires constant attention and fine tuning
- Having to negotiate volume loans with the same borrowers to whom they're also lending their specials

When lending general collateral securities, relationship dynamics are reversed; i.e., because general collateral securities are 10 times over supplied, the agent is now asking the borrower to take their general collateral loans instead of another agent lender's. As a result, the borrower now has leverage to push back on the agent lender when it demands the highest fees for their specials.

Inevitably, a compromise must be reached, and this can affect the fee the agent lender receives for their specials. An asset manager who's part of a program heavily weighted toward volume general collateral lending may generate lower revenues from their specials as a result. Because general collateral lending accounts for 70% of securities on loan, it's critically important for an asset manager to understand how much their agent's program is made up of these general collateral loans. It's likely the majority of an agent lenders lending program, with potentially negative consequences.

11. *Predictive Power of Fees, Why Mutual Fund Fees Are So Important, Morningstar Manager Research May 2016, Russel Kinnel*

Custodians vs. Third Party Lenders

In an era of electronic messaging and straight through processing (STP), it has become common to decouple the provision of securities lending and custody. Most securities lending agents' procedures and systems are designed to be agnostic to whether position, sale, and corporate actions data is fed from their in-house custody systems or an external party. This allows an asset manager to select a securities lending agent based on how they align with their selection criteria, and not because they happen to be their custodian.

While many asset managers will seek detailed information from potential providers via RFPs, some key questions to ensure alignment of philosophy and focus are:

- What percent of your business by number of clients, lendable assets, and balances on loan are from mutual fund managers?
- What percent of your on-loan balances generate less than 25 bps (general collateral) versus more than 25 bps?
- What percent of your client base by number is third party versus custodial?

As fee pressures challenge asset managers, bundling securities lending with the custodian has the potential to achieve reduced custody fees. However, given historic issues caused by bundled pricing in areas such as FX and transition management, a decision to select a custodial lender on this basis should be subject to appropriate rigor to ensure that it is in the best interests of the fund's shareholders. Specifically, managers should consider the potential compromises to the securities lending program in terms of revenue performance, risk management, ability to customize, and overall service level. Some key questions to consider are:

- What is your track record in managing your clients' risks? Have any of your clients suffered realized or unrealized losses from collateral reinvestment or faced redemption restrictions from their collateral reinvestment vehicle?
- What is your client service and relationship manager model, including the ratio of clients to relationship manager?

Evaluating Trading Performance

The main driver to engage in securities lending is additional revenue. Although there is more data and electronic trading activity than ever before, there is no central exchange for securities lending, making it difficult to compare trading performance among agent lenders. Traditionally, the most common way for an asset manager to compare trading performance is to ask each agent lender to provide a forward looking 12-month estimate. We think this process is inherently flawed given the main drivers of revenue (such as borrower demand and the value and composition of the clients' holdings) cannot be predicted. Instead, we suggest becoming familiar with agent lenders' respective trading philosophy, techniques, and technology, and speaking with their clients to get performance feedback. Those who use multiple agents are in a good position to compare. If a comparative analysis of performance is required, we recommend that 1) it focus on actual historic performance and 2) the following specific parameters are given to each agent to ensure a quality comparison:

- Exact period of evaluation
- Trading performance only from loans of clients of the same type as those contemplated for lending (e.g. 40 Act Funds, Irish UCITS, etc.)
- Withholding tax rates by market
- Specific collateral/collateral reinvestment guidelines
- Any minimum spread per loan beneath which you would not wish to lend
- Buffers by market (% of position to be held back from lending)
- Market values of holdings and FX rates used by the agents

Conclusion

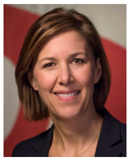
For asset managers who don't engage in securities lending, pressures on fees means there's now more reason than ever to review that decision.
In the past, this question might have been resolved at a philosophical level. Today, however, there are far more rigorous and precise methods available to establish the case for or against. More importantly, once a review has been conducted, the asset manager will have fulfilled their responsibility to thoroughly assess the benefit to their fund investors.

The distinction between volume lending and intrinsic-value lending is the starting point for a careful examination of securities lending. Using an intrinsic-value approach as the foundation of a comprehensive data analysis of the proposed loan book is a direct and effective way of addressing internal stakeholders' concerns. Focusing the discussion on the potential loan book — rather than on abstract concepts — is the key to understanding what securities lending means to each fund company, the benefits it will bring, and the risks that must be managed. In our experience, starting with an intrinsic-value program is the most successful way of getting the buy-in of internal and external stakeholders. Then, after a period of the program being operational, an assessment can be made to determine whether the approach can be refined based on an analysis of the potential revenue increase and corresponding risks.

We've also noted a selection of empirical academic studies, research papers, and news articles that are recommended as supportive material and context for the data analysis, rather than the primary basis for discussion. We will leave the final word to one of the world's largest asset managers who has run an intrinsic value program for many years:

"We've delivered excellent risk-adjusted value to our fund shareholders through securities lending. We've substantially increased our fund shareholders' wealth and improved their fund returns within a framework of highly conservative risk policies, procedures, and controls. We have no incentive to take on imprudent risks to generate a return and every incentive to put our clients first at all times."

For more information please contact:



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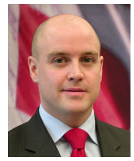

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