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Stock-lending: overview

Introduction

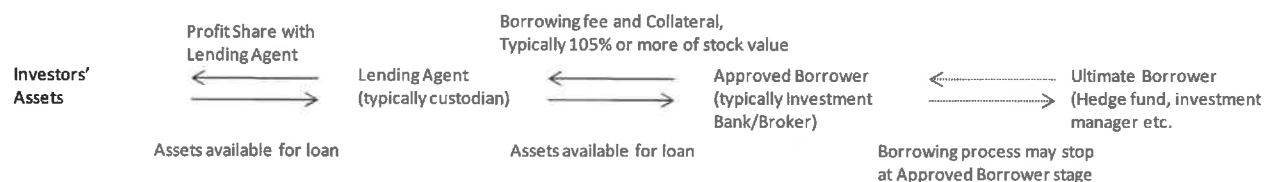
This paper has been prepared for the Officer Working Group ("OWG") of the Wales Pension Partnership ("WPP"). It provides an overview of stock-lending. Attached to this paper is a presentation that the OWG received from Mercer Sentinel on this subject. The aim of the paper, and the attached presentation, is to help WPP funds come to a view as to whether stock-lending should be permitted in one of more of the WPP's underlying sub funds. This paper should not be released or otherwise disclosed to any third party except with our prior written consent, in which case it should be released in its entirety. We accept no liability to any other party unless we have accepted such liability in writing.

What is stock lending?

Stock lending is an opportunity for investors, such as pension funds - as traditionally long-term investors, to extract a premium from their assets by providing liquidity to the market. Securities are lent to approved borrowers (typically investment banks/brokers) who pay a borrowing fee and who also transfer some form of collateral (typically cash or gilts) to mitigate the lender's credit exposure to the borrower.

An overview of the lending process is shown below (chart1).

Chart 1: Overview of lending process



The lending process is typically sub-contracted to an agent who has responsibility for recording details of stocks that have been lent and ensuring that risks are managed through the posting of collateral. Whilst the lending agent is commonly the investors' custodian, there are a small number of specialist lending agents who can provide stock lending services.

Why do people borrow stock?

Stock lending initially came about as a method to cover settlement failures, i.e. brokers would borrow stock to avoid incurring the costs and penalties associated with failed settlements. However, stock borrowing has become more widely used in the investment industry, with investors borrowing stocks to meet an array of short-term needs, including (but not limited to):

- Avoiding settlement failures;
- Facilitating tax arbitrage opportunities (i.e. where investors domiciled in different countries make mutually beneficial arrangements to take advantage of differences in tax laws). Such opportunities typically occur at the time of dividend payments;
- Supporting short-selling and hedge fund strategies;
- Upgrading asset quality to help collateralise over the counter derivatives; and
- To improve the credit quality of a borrower's balance sheet for regulatory purposes (e.g. banks)

Generally it serves a useful economic purpose in supporting liquidity in markets.

Why would pension funds lend stock?

Pension funds lend stock because:

- They receive a fee for doing so and this will help defray the additional costs of operating the pool (see comment below); and
- It supports market efficiency.

Fees are earned based on the value of the loans and the desirability of the assets (see table 1 below - the lender also receives payments from the borrower equivalent to any dividend payments made during the lending period.) Over time, stock lending programmes can be expected to generate an additional return of a few basis points on an investor's assets, with the amount of income generated from stock lending varying over time depending upon the level of borrower demand - driven by a number of factors, including portfolio composition, trading volume/patterns, lending restrictions, market activity and seasonality around dividend payments.

As well as the fees earned, another important consideration is the agreement with the lending agent on how the borrowing fees are split (also shown in table 1 below – shaded column). As well as scale of assets being lent, revenue splits can also often depend upon the level of protection the lending agent provides the lenders e.g. more protection offered the agent typically seeks a larger proportion of the revenue.

Table 1: Example fees and revenue split

Annualised Fee Rates	Revenue splits
• 5 basis points (bps) on general collateral trades • 20 bps on term lending of fixed income • 50 bps on certain emerging markets equities • 100+ bps on "specials" that are in demand and hard to find	• The agent bank generally takes a gross fee from the borrower, then splits the fee with the lender by an agreed percentage (larger % to the lender): • 60%-40%: historically typically seen in many pooled funds • 70%-30%: more usual for segregated lenders and some pooled funds • 80%-20%: for larger segregated accounts of $1+ billion of lendable assets • 90%-10%: for the very largest accounts with $25+ billion • 100%: very rarely, for the largest sovereign wealth funds, on a tiered basis

Source: Mercer Sentinel

On the face of it, for the WPP, a fee split of 80:20 or more would be a positive outcome (most sub-fund mandate sizes are sub-£1bn) - subject to the Funds being satisfied with the indemnity agreements that are being offered by the provider.

What are the risks involved?

The risks below are managed by the lending agent operating the stock lending facility.

Risks	Mitigating the risk
Borrower risk - the risk of the borrower defaulting on a loan	The lender should only enter into stock-lending agreements with borrowers they are comfortable lending to. Ultimately this is controlled by the lending agent's approach to assessing and managing counterparty credit risk.
Intraday settlement risk – the risk of the securities which are lent being delivered to the borrower before collateral is received.	The lender can specify that collateral is received a day before the loan settles. On maturity of the loan, the lender should ensure that their shares are returned prior to or in conjunction with the collateral being released back to the borrower.
Legal risk – the risk that the contract in place does not provide sufficient protection to the lender in the event of the borrower defaulting.	In most cases, it is recommended that lenders seek professional advice when reviewing contracts. Any agreements signed with the borrower should adhere to commonly used market standard documentation.
Collateral risk – the risk that the value of the collateral the loan requires is below the replacement cost of the stocks on loan.	We would expect and require collateral to be greater than the value of the stocks on loan (typically 105% or more in the current market). Collateral positions can be reviewed daily. The lender should ensure their collateral policy specifies the types of assets which can be used as collateral.
Cash collateral risk – the risk that on re-investment of the cash collateral, the lender suffers a loss.	The lender should be aware of the level of credit and liquidity risk involved in the investment of cash collateral in the event of these investments needing to be sold at short notice. The lending agent's s investment guidelines should provide an appropriate level of risk and return and be consistent with the investment guidelines agreed with the lender. t.
Operational risk – the risk of operational matters involved in the day-to-day running of the lending.	Agreements between the lender and borrower should clearly state which party takes responsibility for which operational risk and in what circumstances. All parties should ensure that robust procedures are developed in order to protect against such risks.
Loss of voting rights	Securities out on loan cannot be voted by lenders. However lenders can, if they wish, recall the securities by the record date in order to exercise their votes. The right to recall securities on loan is enshrined in the legal agreement underpinning securities lending activity, Beneficial owners can adopt one of several positions with regard to votes and recalls: • voting and recalling all or some securities at every opportunity • voting and recalling securities only on certain votes • not voting (i.e. not recalling positions) • maintain a "buffer" position in each holding to ensure an efficient flow of information from the issuer and vote every security.
Other risks – any non-financial risks, such as reputational risks.	The lender should ensure stock lending conforms to their policies and investment objectives.

Summary and next steps

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Stock lending is carried out widely by local authority pension funds e.g. stock lending occurs in a number of the leading passive managers' pooled funds (including BlackRock). However, within the WPP, only one of the eight partner funds currently stock lends in their actively managed funds.

We are seeing a number of LGPS funds revisit their policy on stock lending, as part of the move to pooling. This is in part due to the need for collective agreement and a common policy within their pools, but also due to the collective scale offering much more competitive terms, in terms of revenue split, than was typically available previously at an individual Fund level.

Whilst there are risks associated with stock lending, there is no such thing as a 'free lunch', overall we are broadly comfortable with funds stock-lending, subject to the agent having suitable risk management arrangements in place and offering appropriate indemnities.

Next steps

Each sub-fund in WPP's ACS must either allow or disallow stock-lending. If some investing authorities wish to stock-lend and others do not, then it would be necessary to have two sub-funds – one which stock-lends and one which does not. In order to avoid "doubling" the number of sub-funds and avoid any associated increase in costs, the WPP would prefer to have a single, common policy on stock-lending.

It follows that if the WPP wants to lend stock then all of the participating authorities must agree to that policy. If any authority decides it does not wish to stock-lend, then that policy will be built into the prospectus for the given sub-fund and no investing authorities will be able to access the additional revenues from stock-lending. It is therefore important that each partner fund considers their needs, alongside the points raised in this paper and the appendix, to reach a decision as to whether they are willing to permit stock-lending in the sub-funds that they will invest in.

In the event that the administering authorities agree in principle to have stock-lending on the ACS sub-funds for the WPP pool, we would recommend WPP takes advice from specialists in stock-lending (e.g. Mercer Sentinel) on the stock-lending agent (eg Northern Trust has been proposed as agent by Link) and reviews the competitiveness of the fee split proposed, the quality of the indemnities offered and the proposed Stock Lending Agreement.

We look forward to discussing this paper with you in the near future.

Prepared for, and on behalf of, Hymans Robertson LLP

William Marshall and John Wright

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General risk warning

Please note the value of investments, and income from them, may fall as well as rise. This includes but is not limited to equities, government or corporate bonds, derivatives, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of investments. As a result, an investor may not get back the full amount of the original investment. Past performance is not necessarily a guide to future performance