Knowledge based solutions

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Unit Linked Thematic Review: Securities Lending

Unit-Linked Funds

George McCutcheon MSc FIA discusses securities lending issues for life companies.

Background

Speaking at an ABI conference in July, the Financial Conduct Authority chief executive Martin Wheatley set out the key issues the FCA is addressing as part of its thematic review into the £900bn unit-linked fund sector including the allocation of securities lending proceeds. In this article, George McCutcheon discusses this issue in more detail.

Background

Mr Wheatley said the FCA review into the governance and management of unit-linked funds, first announced in January, represented one of the most important thematic reviews for life insurers. He said the unit-linked sector was "hugely significant", with around £902bn worth of funds under management, of which 87 per cent relates to pension business.

The key issues that Mr. Wheatley highlighted were:

a. Are firms allocating a fair proportion of revenue received from stock-lending to the fund or are they recycling too much to the shareholder?
b. Are providers of unit-linked funds managing them in line with the stated investment objectives?
c. Are they transferring counterparty credit risk from reinsured funds to policyholders without asking them and without obtaining their express consent?

In this research piece Financial Risk Solutions discusses the securities lending issue.

Executive Summary

- Securities lending is not a risk-free activity;
- Firms are required to have adequate systems and controls in place for securities lending;
- The EIPOA Consultation Paper on the System of Governance includes Guideline 23 which states that the risk management policy must cover the conditions under which undertakings can lend assets;
- Life companies intending to engage in securities lending must be careful to ensure that there is sufficient consideration of the risks involved and the impact of these on policyholders;
- Life companies should ensure that the published investment mandates for funds disclose whether securities lending is permitted and the possible effects on policyholders;
- Life companies need to consider whether or not they are underwriting an implicit indemnity to policyholders for losses on securities lending;
- Appropriate systems are required for determining the amount of stock lending expenses to be charged to the funds and how the net proceeds of securities lending are allocated between funds.

Securities Lending

Securities lending is used by insurance companies as a means of generating incremental returns on their securities portfolios. The loans are collateralised and conducted within a well-established legal framework. Investment banks and asset managers borrow their securities for a variety of reasons, including facilitating market making, covering settlement failures and supporting risk management (hedging) strategies. In the year to May 2013, long term investors in the European markets generated incremental revenues of EUR3bn through securities lending[1]. For the long term investors who participate in this market, securities lending is regarded as a valuable source of low risk incremental returns. In the past year, securities lending transactions generated 18 basis points of return on average per loan[2].

[1] source: the International Securities Lending Association
[2] based on data from Markit Securities Finance

In a securities lending transaction, the lender gives legal title to a security to the borrower for a limited period of time, in exchange for legal ownership of collateral. It is commonplace for a lender to require collateral that is worth more than the value of the loaned securities. This excess amount is known as the 'margin'. There is a change in legal title even though the transaction is called a loan. Legally a securities loan is the transfer of title against an irrevocable undertaking to return equivalent securities. This means that registered securities such as shares will be transferred out of the lender's name into that of the borrower and registered back when they are returned. The borrower will also pass over to the lender any dividends/interest payments and corporate actions that may arise. In the UK, special rules govern the tax treatment of such payments (to ensure they are treated similarly to normal dividends).

The collateral in securities lending can either be other securities or cash. The borrower pays a fee to the lender for the use of the loaned security. However, if cash is given as collateral, the lender is obliged to reinvest the cash for the borrower and to 'rebate' an agreed proportion of the reinvestment return back to the borrower. In this case, the lender usually deducts the borrowing fee from the rebate interest that he pays to the borrower, rather than paying it separately, so the fee is implicit in the rebate rate. Because securities lending transfers not only the legal ownership of equities, but also the attached voting rights and corporate actions, it has become convention in the securities lending market for loaned securities to be subject to a right of recall by the lender, so that he can recover securities if he wishes to exercise his voting rights or respond to corporate events.

The securities lending market in Europe is represented by the International Securities Lending Association (ISLA), which publishes the most widely-used model legal contract for international securities lending, the Global Master Securities Lending Agreement (GMSLA).

Investors who lend securities usually do so through their custodian, who acts as an agent. It is also possible to use a third party agent who will arrange loans (within agreed parameters) and instruct the custodian about securities deliveries, receipts and collateral movements. Generally only the very largest funds conduct their own lending. All securities lending arrangements are underpinned by market standard legal agreements (such as the Global Master Securities Lending Agreement or GMSLA).

Lenders may elect to use a Lending Agent based on a securities lending authorisation agreement between Lending Agent and Lender ("SLAA"). The securities lending is then based on the master securities lending agreement between the Lending Agent (acting as Agent) and the borrower ("MSLA"). Lenders need to understand the relationship between the SLAA and the MSLA and how this might impact the Lender.

The issue of securities lending might become less significant as the International Securities Lending Association say that Europe's proposed financial transaction tax will wipe out 65 per cent of lending activity in Europe and that securities lending fee levels would need to increase by over 400% just to maintain current revenue streams for long term institutional investors.

Risks

Securities lending involves risks. The main risk is that the borrower becomes insolvent and the value of the collateral falls below the cost of replacing the securities that have been lent. There are various risks:

- Borrower risk: The risk that the borrower defaults on the loan (e.g. the borrower becomes insolvent and is unable to return the securities).
- Collateral risk: The risk that the value of the collateral falls below the replacement cost of the securities that are lent.
- Cash collateral risk: The risk that the lender suffers a loss on the re-investment of the cash collateral.
- Intraday settlement risk: The risk that the securities being lent are delivered to the borrower before the collateral is received. At the end of the loan, lenders should ensure that their shares are returned before or at the same time as collateral is released back to the borrower.
- Operational risk: This covers day-to-day operational risk matters, e.g. what happens if the lender or its agent fails to claim for a dividend or other entitlement?
- Legal risk: The risk that the lender's legal agreement does not provide full protection in the event that the

borrower defaults.
- Other risks: Other non-financial risks, such as ethical or reputational risks which can sometimes arise as a result of investing activity.

ABI Guidance
The 2012 ABI "Guide of Good Practice for Unit Linked Funds" provides specific guidance to firms on what TCF means in the context of unit linked fund governance. The only reference to securities lending is in Section2.1.6 which says that firms should establish investment mandates for funds that cover all relevant guidance for the fund managers including whether securities lending is permitted and relevant collateral requirements should be specified.
In a similar way to Section 4.1.1 of the ABI Guide, which states that the unit pricing mechanism should not be used as a deliberate means of extracting value from the fund or from policyholders, the expectation is that firms should not have operational processes (such as securities lending) within their unit linked funds which could be interpreted as a means of extracting value from the fund or from policyholders.

Regulation
Per the FCA Handbook, for the purposes of GENPRU 2 Annex 7 R (Admissible assets in insurance), an approved stock lending transaction is one that meets the conditions in INSPRU 3.2.36 R. including that the assets lent are admissible assets, criteria on counterparty and criteria on collateral.

The Securities Lending and Repo Committee (SLRC) (chaired and administered by the Bank of England) is a UK-based committee of international repo and securities lending practitioners and representatives of trade organisations, together with bodies such as Euroclear UK and Ireland, the UK Debt Management Office, the London Stock Exchange, and the Financial Services Authority. Its terms of reference include the co-ordination of the development of the Securities Borrowing and Lending Code of Guidance. This is a summary of the basic procedures that UK-based participants in securities borrowing/lending of both UK domestic and overseas securities observe as a matter of good practice. The Code of Guidance is currently under review.

The Specialist Sourcebook for Collective Investment Schemes in the FCA Handbook is known as COLL. Whilst this doesn't apply to life company internal funds, the COLL provisions can be considered as best practice.
COLL 5.4 sets out detailed provisions on stock lending.

The regulatory guidelines for assurance companies on asset management generally refer to the "Insurance Core Principles, Standards, Guidance and Assessment Methodology" document published by the International Association of Insurance Supervisors. The relevant reference to securities lending is shown below.

ICP 15 Investment
Regulatory investment requirements regarding asset portfolio
15.3.13 When an insurer lends securities, it must consider both the risk inherent in the counterparty to which the securities are lent and the risk of the securities themselves. The insurer should seek to ensure that securities lending transactions are appropriately collateralised (with suitably frequent updating) and should recognise that lending a security does not mitigate the risk it poses to the insurer, even if doing so removes the security from the balance sheet. Care should be taken by the insurer when investing the collateral it holds that it will continue to cover the lending under adverse market conditions and that it will be returnable in the required form when due.

A useful reference source for Irish companies is UCITS Note 12[3] of March 2013 issued by the Central Bank of Ireland. This deals with issues such as criteria for collateral, credit rating of counterparty, disclosure of operational costs/fees deducted from the proceeds, identity of the entities to which the direct and indirect costs and fees are paid and the requirement that all the proceeds, net of direct and indirect operational costs, should be returned to the UCITS.

[3] "Techniques and instruments, including Repurchase/Reverse Repurchase Agreements and Securities Lending, for the purposes of efficient portfolio management"

Insurance regulations require that firms have sound administrative procedures and internal control mechanisms.
A life company engaged in securities lending will need to:

- Adopt an adequate investment policy or adequate investment objectives for securities lending;
- Set risk limits in respect of stock lending, and receive regular information from its risk management function on asset exposures and the associated risks;
- Specify parameters for securities lending to its investment managers;
- Have adequate reporting and internal control systems designed to monitor that securities lending is being managed in accordance with an adequate investment policy and investment mandate(s);
- Monitor the performance of the investment managers in relation to stock lending adequately against Board approved policies and procedures;
- Have adequate systems of internal control present to ensure that its securities lending investment activities are properly supervised;
- Regularly review its investment policies;

This places a significant expense burden on the life company and in equity the unit-linked funds should bear the costs because the funds receive the securities lending proceeds. The pertinent issue is how best to quantify the securities lending costs.

Taxation
Securities lending is an arrangement of the kind described in section 263B of the Taxation of Chargeable Gains Act 1992, under which the lender transfers securities to the borrower otherwise than by way of sale and the borrower is to transfer those securities, or securities of the same type and amount, back to the lender at a later date. Under section 263B, transfers and re-transfers of securities under stock lending arrangements are disregarded for capital gains purposes. The securities to which this rule applies are, for corporates, shares, and for non-corporates, shares and debt instruments such as gilts and bonds.

Fund Valuation
The securities lending transaction (other than the net fee) is not reflected in the fund valuation.

COLL 5.4.5
Where a stock lending arrangement is entered into, the scheme property remains unchanged in terms of value. The securities transferred cease to be part of the scheme property, but there is obtained in return an obligation on the part of the counterparty to transfer back equivalent securities. The depositary will also receive collateral to set against the risk of default in transfer, and that collateral is equally irrelevant to the valuation of the scheme property (because it is transferred against an obligation of equivalent value by way of re-transfer). COLL 5.4.6 R accordingly makes provision for the treatment of the collateral in that context.

COLL 5.4.6 R
(5) Any agreement for transfer at a future date of securities or of collateral (or of the equivalent of either) under this section may be regarded, for the purposes of valuation under COLL 6.3 (Valuation and pricing) or this chapter, as an unconditional agreement for the sale or transfer of property, whether or not the property is part of the property of the authorised fund.
(6) Collateral transferred to the depositary is part of the scheme property for the purposes of the rules in this sourcebook, except in the following respects:

(a) it does not fall to be included in any valuation for the purposes of COLL 6.3 or this chapter, because it is offset under (5) by an obligation to transfer; and
(b) it does not count as scheme property for any purpose of this chapter other than this section.

Key Questions for Life Companies on Securities Lending

- Does the life company understand the various risks associated with securities lending?

- Has the life company the necessary skills/knowledge in-house to assess the impact of a securities lending programme on its assets?
- What level of risks is the firm prepared to accept?
- What counterparties will be lent to?
- Is an indemnity being offered by the Lending Agent within the proposed lending activity? What is the scope of the indemnity i.e. what type of assets and collateral are covered and what's not covered? Under what circumstances would the indemnity trigger?
- What level of disclosure to customers should be given in relation to securities lending?
  Life companies should ensure that the published investment mandates for funds disclose whether securities lending is permitted and if so the risks and potential rewards to the fund associated with securities lending.
- Who is bearing the risk if securities lending goes wrong?
  The life company might intend that securities lending in respect of policyholders' assets is carried out for the benefit of policyholders and at the policyholders' risk. In practice whilst the policyholders would be taking the upside benefits the downside risks might still lie with the life company. This is because the circumstances in which losses arise might be circumstances where the life company could be considered to be at fault e.g. deficiencies in its systems and controls. Alternatively it might be that the life company decides to compensate policyholder for losses to avoid reputational damage. This raises the question of whether the life company needs to reserve against this possibility.
- How are the returns from securities lending split between shareholders/policyholders?
  The expectation is that the returns from securities lending in respect of policyholders assets should go to the policyholders. However there are significant costs for the life company associated with securities lending and unless there is some mechanism for recovery of these costs (or they are already built into the fund's annual management charge) the life company would be incurring additional expenses in order to carry out investment activity for the sole benefit of policyholders.

There are also computational issues:
- Where securities are held by multiple funds, securities lending presents practical problems in apportioning securities lending proceeds to the individual funds;
- Where the costs incurred by the life company in managing the securities lending activity are to be charged to the funds, there are practical difficulties in quantifying the amount of those costs and also in apportioning to individual funds.

There are a number of ways that life companies could address the issue of quantifying the proceeds from securities lending to be applied to the unit linked funds as follows:
- Consider securities lending as an integral routine part of the investment activity of the fund and make an allowance in the annual management charge for the associated costs, i.e. the full securities lending proceeds go to the funds but there is a quantified extra annual management charge;
- Exclude any allowance for the costs of securities lending in the annual management charge and have the funds receive the full fee less the associated securities lending costs computed on an objective and transparent basis;
- Outsource securities lending to a specialist Lending Agent on a market competitive basis and have the funds receive the full proceeds less the Lending Agent costs.

Implications for Life Companies
- Life companies are required to have adequate systems and controls in place for securities lending.
- Securities lending is not a risk-free activity. This is because collateral is not perfect. The value of even the best assets fluctuates and the liquidation of even the best collateral in response to an event of default, particularly insolvency, can be delayed by unexpected operational and legal problems. Consequently, collateral should be treated only as insurance against the default of the counterparty and not as a substitute for his credit risk.
- Notwithstanding the firm's controls, securities lending could in some circumstances lead to losses and notwithstanding that the intention was that securities lending was an activity for which policyholders take the

rewards and underwrite the associated risk, the life company may end up having to compensate the funds for losses either because there was some fault on the part of the firm or to avoid reputational damage

Biography; George McCutcheon MSc FIA:
Mr. McCutcheon is a graduate of University College Dublin in Mathematical Science and is a Fellow of the Institute of Actuaries. He is a director and co-founder of Financial Risk Solutions (FRS), a software company specialising in the licensing of fund administration software to life assurance companies.
He has presented a number of papers at the Life Convention of the Institute of Actuaries and has co-authored a number of papers for the Society of Actuaries in Ireland, including a 2011 paper on placing value on tax losses in unit linked funds.

About Financial Risk Solutions (FRS)
Financial Risk Solutions Ltd (FRS) is a leading provider of unit pricing and fund accounting software to the Life Assurance and Pensions industries. It was founded in 1999 by actuaries and IT specialists and is one of the leading software providers in its sector. Its Invest|Pro™ product family is a recognised leading benchmark in the investment fund accounting area and customers are some of the biggest brands in Life Assurance and Third Party Administration including MetLife, SEB, IFDS Percana, and Accenture Insurance Services.

Invest Pro™ was specifically designed to securely automate the complexities in companies that perform critical fund administration functions.

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