

# Top five things investment managers need to know about securities lending

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Securities Lending has evolved from a back-office operational activity originating in the 1960s/70s – borrowing securities to cover settlement failures and supporting short-selling investment strategies – to a recognised investment management discipline that can be a source of additional alpha and revenue for beneficial owners and investment managers. Furthermore, it is widely accepted that securities lending can [improve market liquidity, aid price discovery](#), potentially reducing the cost of trading and increasing market efficiency. For further insights on the contribution of securities lending to well-functioning markets do read [this post](#), [how OTC market liquidity is affected by securities lending](#), and lessons from [AIG's collapse](#).

Given the cost pressures the investment management sector is facing, securities lending can be a significant source of alpha, and the incremental revenue<sup>1</sup> can reduce the operating costs when the lending programme is appropriately executed with robust risk management and good governance. If you are an investment manager and are considering (re-) entering the market, here is a framework to help you evaluate your decisions:

**1. Balancing your objectives as an investor** – board room/management's motivations (price discovery, generate returns for the funds, reduce direct and indirect operating costs) for lending should be balanced with the need to act as a responsible investor (contribute to well-functioning markets, exercise voting rights, maintain active dialogue/engagement with the companies invested in, etc.)

**2. Risk appetite** – securities lending isn't risk-free. The business is OTC, and to a large degree, is still governed by bilateral agreements and is relationship-based. Management and internal corporate functions need to

have a heightened awareness of the operational, counterparty and reinvestment risks associated with the business and the available solutions for mitigating those risks. Beneficial owners need to be informed of the additional risks, how the lending programme will monitor and mitigate such risks, and the compensation they are expected to receive for bearing those risks.

**3. Lending mandate, policy and programme monitoring** – these are necessary to align the investment manager's business objectives (Why do you want to lend? What and how much can you lend? Type of lending, route(s) to market, acceptable risk profile and controls, fees and costs) with the broader incentive structure between the beneficial owner and the investment manager. Transparency on fees, best execution, and ESG topics will continue to attract attention from policymakers, regulators, and the general public. The question remains whether securities lending can co-exist within a strong corporate governance<sup>2</sup> framework, and the investment managers need to be able to evidence what their programmes do when they are in the spotlight.

**4. Business processes** – given the regulatory burdens (SFTR, CSDR) associated with securities lending, the cost pressures and the technological developments, the timing now is as right as it can be to set up a lean, efficient operation from scratch using trading and post-trade platforms automated to a great extent. If you are already lending, this is an opportunity to reassess your business objectives and improve your business processes. From a firm-wide perspective, as securities lending is part of the securities financing toolkit, the

<sup>1</sup> Though 2019 was the second most profitable year (est. earnings: \$8 billion - \$10.5 billion) for the industry since 2008, the revenues from securities lending have declined by about 6% compared to 2018. As of 31 Dec 2019 the value of securities on loan globally was ~€2.3 trillion, with bonds representing 55%, equities 42% and ETFs 2%; Institutional lenders had made available ~€21 trillion of securities globally; Mutual/Retail Funds represented the supply of 48% of lendable assets, but only 17% of the total securities on loan; Across all asset classes, SWFs represented 6% of lendable assets but 15% of the total securities on loan. Source: IHS Markit / ISLA (Feb 2020)

<sup>2</sup> <https://www.bankofengland.co.uk/-/media/boe/files/markets/money-markets-committee/uk-money-markets-code.pdf?la=en&hash=C7854B22B681B65244EE35A8CC306288454B4506>

business process improvements need to be executed as part of a holistic collateral and liquidity management optimisation programme which are being undertaken at many firms in response to UMR.

**5. Education** – make informed decisions by accessing independent, unbiased insights and in-depth knowledge from market practitioners, including from us at Margin Reform (Mandy Rice-Davies Applies.) We can guide you through your decision-making process and address questions specific to your business needs.

In the next article, we will draw on experience from recent engagements with investment managers and provide practical information on designing a bespoke programme and the various routes to market.

If you would like further information on how we can help you, please drop me an email [sakti@marginreform.com](mailto:sakti@marginreform.com) or give me a call on +44 7887 637445.

#### Recommended reading

**Blocher, J, Reed V., A, and Van Wesep D., E (2013)**, Connecting Two Markets: An Equilibrium Framework for Shorts, Longs, and Stock Loans, Journal of Financial Economics

**Foley-Fisher, N, Gissler, S and Verani, S (2019)**, Over-the-Counter Market Liquidity and Securities Lending, Finance and Economics Discussion Series 2019-011. Washington: Board of Governors of the Federal Reserve System, <https://doi.org/10.17016/FEDS.2019.011> or <https://www.federalreserve.gov/econres/feds/files/2019011pap.pdf>

**International Securities Lending Association (Oct 2019)**, Securities Lending Explained – What you need to know in 5 minutes! [https://www.youtube.com/watch?v=E42XA0g\\_wrY](https://www.youtube.com/watch?v=E42XA0g_wrY)

**International Securities Lending Association (Feb 2020)**, Securities Lending Market Report <https://www.isla.co.uk/assets/smart-pdfs/isla-securities-lending-market-report-february-2020/>

**McDonald, R and Paulson, A (Aug 2015)**, What Went Wrong at AIG? <https://insight.kellogg.northwestern.edu/article/what-went-wrong-at-aig>

**Miller M., E (1977)**, Risk, Uncertainty and Divergence of Opinion, Journal of Finance, <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.667.5934&rep=rep1&type=pdf>

**Zimmerhansl, R (Feb 2020)**, Securities lending: Contributions to a well-functioning market <https://www.pierpoint.info/post/securities-lending-contributions-to-a-well-functioning-market>