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SECURITIES LENDING INDEMNIFICATION AT A CROSSROADS

In securities lending transactions, lending agents typically provide an indemnity guaranteeing lenders the return of their securities. Today, many agents have suggested that they are no longer willing to do so without additional compensation. The author discusses the risks this presents for lenders, and the corporate and the fiduciary implications in giving up the indemnity.

By Geoffrey Davis *

Agent securities lending is a dynamic, adaptable business which operates like a symbiotic biosphere advancing the interests of the various constituent parties to the lending transactions. The beneficial owner/lender receives incremental returns on loans of securities to borrowers from its portfolio, which therefore does not lie idle. The agent leverages its custody arrangement and/or expertise in the lending market to generate meaningful fees and facilitate other aspects of its business. The borrower gains necessary access to securities to be able to cover and complete short trades thereby sustaining a healthy stock market where bets can be placed on securities either increasing or decreasing in value.

The securities lending market is changing rapidly due to regulatory pressures on lending agent banks and changing dynamics among market participants. Typically, in agent-sponsored securities lending transactions, beneficial owner/lenders and agents work together as partners sharing the risk and splitting the return (e.g., 80/20). As part of the traditional risk sharing arrangement, agents have provided an indemnity guaranteeing lenders the return of the securities on loan. While indemnification is unlikely to go away entirely, the dynamics are changing, and the costs and borrower protections related to indemnification are likely to be a sensitive issue in the near term.

It should be noted that the commercial value of the lending agent's indemnity can vary across the board, depending on the agent's proffered documentation and the willingness of the lender to push back for better terms. For example, what is being guaranteed (return of securities and/or entitlements, conditions precedent to trigger recovery, return of replacement securities or cash, timing of replacement or payment, liability for failed trades, etc.) can be quite different and produce significantly different economic results for the lender in the event of a borrower default.[1] Depending on the size of the assets of the lender and its overall relationship with the agent/custodian, it is possible to vary these terms. Although agents often resist such negotiation of their forms for policy and cost reasons, sophisticated institutions have been able to negotiate superior protections over what is generally made available under an agent's "standard" form of securities lending agreement and obtain terms above "market" standards.

[1] http://www.bankofengland.co.uk/markets/Documents/gilts sl_intro_green_9_10.pdf.

* *GEOFFREY DAVIS is a partner at Squire Patton Boggs in Washington, D.C. His e-mail address is geoffrey.davis@squirepb.com.*

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Today many agents have suggested that they are no longer willing or able to continue to offer their standard indemnification without additional compensation, because the capital reserve implications on the agent's balance sheet have become too onerous.[2] The leverage coverage ratios and final Basil III capital standards are being put into place with some requirements already effective and others to be phased in by 2017. In particular, industry representatives believe that the calculation of the net credit exposure as a result of the guarantee of the return of the securities is being overstated.[3] Their view is that the amount of capital reserves being required does not accurately reflect, among other things, the value of the borrower's promise to return the securities and the collateral being provided by the borrower to which the agent is subrogated. The calculation of the capital reserve requirements is complicated and varies depending on the specifics of the transaction. For example, agent's programs are being pressured to move towards structuring the loans so that the currency of the loans and underlying collateral are the same, thereby significantly reducing the cost of capital for the agent. The problem with too tightly restricting the terms for loans is that it may shrink the scope and volume of lending transactions available to borrowers which would undercut the agents' revenue base.

Agents are therefore placed in a difficult position. They do not want to jeopardize their relationships with beneficial owner/lenders by insisting on taking away customary indemnification or increasing the costs in a very competitive market. However, they do not want to unilaterally absorb all additional capital costs, thereby diminishing their economic benefits.

The questions this article will explore are: (1) how important is the loss of the agent indemnity to lenders and are they really at significantly greater risk? and (2) what are the corporate governance and fiduciary implications for lenders considering giving up the existing indemnity?

Risks for Securities Lenders

The financial risks of securities lending may be overestimated or misunderstood. In the financial meltdown in 2008, almost all of the losses endured by beneficial owner/lenders came from the reinvestment of cash collateral, not from the failure to recover securities on loan.[4] Therefore, based on historical experience, one could argue that the diminution in protection may not be that significant. In a customary agent-sponsored securities lending program, beneficial owner/lenders are relying on a tripartite protection scheme comprised of: (1) the promise of the borrower to return the securities; (2) recourse to the collateral (which is typically marked to 102-3 percent of market on a daily basis); and (3) the agent indemnity. A borrower's credit is subject to continuous monitoring and the number of instances in which a borrower fails to return the securities and becomes insolvent is historically quite small. The circumstances when this occurs and the collateral is also insufficient to make the beneficial owner/lender whole are even rarer. At a recent beneficial owners conference I spoke at in Phoenix, Arizona, not a single person in the crammed auditorium was able to identify an instance when the guarantee was called upon and the agent actually had to go out of pocket.[5]

However, perhaps this historical analysis is too simplistic. Mortgage-backed securities (MBS) were also deemed safe because default rates were historically quite low and they were pooled together and credit-enhanced. However, we learned later that many MBS that were originated and sold included several undisclosed risks that were ultimately passed on to the purchasers of MBS. Many attribute the meltdown in the MBS market to there being little or no residual responsibility for the

[2] https://www.bnymellon.com/us/en/our-thinking/three-key-securities-lending-trends-for-2016.jsp; http://www.statestreet.com/content/dam/statestreet/documents/SecFinance/SL_Capital%20Cost_Implications.pdf.

[3] http://csfme.org/News/TabId/120/ArtMID/983/ArticleID/279/Will-Securities-Lending-Indemnification-Be-Regulated-Into-Oblivion.aspx.

[4] http://www2.deloitte.com/content/dam/Deloitte/lu/Documents/financial-services/performancemagazine/articles/lu-investment-opportunity-changing-securities-lending-landscape-092014.pdf.

[5] https://www.imn.org/investment-management/conference/Beneficial-Owners-International-Securities-Lending-Collateral-Management/Agenda.html.

originators/creators of the products and the financial risks being passed on to others.[6]

Now imagine a securities lending market in which agents no longer have financial responsibility for borrower defaults. Or a market where agents have responsibility for borrower defaults for some beneficial owner/lenders, but not for others that are not prepared to pay an additional premium for these customary protections. The crucial alignment of interests between agents and beneficial owner/lenders would no longer exist. The securities lending markets would inevitably develop differently. As the "invisible hand" reaches out to maximize an agent's profits, borrower qualifications and collateral requirements would deteriorate because there would be decreased incentives to maintain existing stringent standards (or impose new standards) that ultimately protect the beneficial owner/lenders.

The risks of diminished protections from borrower defaults may be ameliorated by the increased regulatory oversight of agents and their lending programs, but history has shown that regulators can often become complacent, can succumb to commercial pressures, or can be too slow to react to changing market dynamics. Lenders can also seek to monitor programs closely and limit exposures to borrowers and types of collateral, but it may be difficult to be continuously vigilant and it can create inefficiencies that may cause lenders to rethink the practicality of their securities lending programs altogether. Also, by practical necessity, the credit decisions need to be made by the agents. It is hard to predict the ultimate consequences of reduced borrower standards, but beneficial owner/lenders should consider how to manage and insulate themselves from the increased risks.

Corporate Governance and Fiduciary Implications

In this environment, the risks of not receiving indemnification, in a constantly evolving industry where some are receiving it, may be high. Therefore, first movers will be hard to find as there is no perceived benefit over the status quo, only greater risk. In the event of a loss, hindsight will almost certainly find the decision to give up the extra protection wanting. In all instances, governing boards and investment committees will need to be fully briefed on the risks in order to make an informed decision. In certain instances, changing the policy to lend without indemnification may also require a change in law.[7]

For fiduciaries the risks are high. Securities lending is viewed as providing a small, helpful, incremental return, but cannot be justified financially if there is any substantial risk of loss. It is intuitively hard to explain to decision makers why agents will no longer provide indemnification if there is not a substantial risk involved. Fiduciaries need to have a rational justification that will withstand subsequent scrutiny in the event that a loss occurs.

Among these changing market dynamics, it is prudent for beneficial owner/lenders to seek professional advice to explain and rationalize the decisions affecting their protections against market risks. Obtaining independent advice is critical as agent banks, while well-versed in the market and the changing environment, have an obvious conflict of interest that may affect the advice they provide. Consultants and lawyers are available to provide context on the risks, conduct due diligence on the agent's program, and negotiate protections for the beneficial owner/lenders.

So what is a beneficial owner to do? One position is to try to hold their ground and see how the industry changes shake out. It is also possible to test the market of agents and perhaps receive more favorable terms, or at least validate the terms that you are being offered. Beneficial owners collectively resisting higher fees or the loss of the indemnity will over time prompt the agents to seek regulatory relief, pass additional costs on to borrowers, and/or accept smaller margins. Perhaps the industry will shrink if lender participants are forced to withdraw because the risks no longer justify the returns. However, the securities lending industry has proven its ability to adapt to obstacles and changing circumstances over time. This time is unlikely to be any different. ■

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[6] http://www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article.

[7] http://csfme.org/News/TabId/120/ArtMID/983/ArticleID/279/Will-Securities-Lending-Indemnification-Be-Regulated-Into-Oblivion.aspx; Risk Management Association – Committee on Securities Lending Letter to Secretariat of the Basel Committee on Banking Supervision, Bank for International Settlements, dated March 27, 2015, regarding Revisions to the Standardized Approach for Credit Risk – page 4.