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SECURITIES LENDING MARKET TRENDS

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Securities Lending Market Trends

The securities lending market grew along with asset prices during the 2003-2007 period of rising stock prices and easy credit. The daily value of securities lent by U.S. investment companies doubled from $80 billion to almost $160 billion, while annual lending revenue reported by mutual funds tripled from $300 million to over $1,000 million. Securities lending revenue at public pension funds increased from $250 million to almost $500 million. Additionally, many ERISA funds, state and local treasurers, insurance companies, central banks and other institutional investors participated in and profited from the securities lending market for years, both before and during the recent bull market.

Securities lending revenue has always been used to cover administrative expenses and to add to overall portfolio returns. A typical mutual fund that lends between 2% to 15% of its assets can gain about 5 basis points, on average, in up as well as down markets. Although October 2007 was the turning point for the stock market, the securities lending market had not yet peaked.

As 2007 turned into 2008 and the stock market steadily declined 20%, securities lending revenues and loan volumes reached new highs. Investment companies earned almost $1.5 billion from lending their securities during the year ending July 2008, one-third more than the previous year. Average loan spreads widened from 20-30 basis points in 2005-2006, to over 60 basis points in 2008. Institutional investors everywhere saw their net asset values decline during this initial market correction, but those engaged in securities lending made record profits filling demand to borrow their stocks for short selling.

Short interest on the New York Stock Exchange peaked in July 2008 at 18.6 million shares short, up 60% from October 2007 and up 150% from January 2003. In retrospect, it appears the stock market was priced at unsustainably high levels and short sellers were readily contributing their contrarian (and accurate) views to the marketplace. Without this selling pressure in 2007, and the subsequent buying pressure that came when short sellers covered their trades in 2008, financial theory suggests the market might have risen and fallen even more severely.

Through lending shares to short sellers, securities lenders were systemically important in providing this liquidity to the equity markets by enabling a fuller expression of viewpoints – negative as well as positive. Securities lenders benefitted their investment portfolios by not only contributing to an elusive, market-wide ‘shock absorbing’ mechanism, but also generating tangible lending revenue at record levels for their shareholders and pensioners. However, demand to borrow securities was about to decline dramatically in the third quarter of 2008, and the securities lending market would contract commensurately.

The SEC caused a short-lived boom in borrowing of large bank shares when it issued an emergency order on July 15, 2008 regarding tighter borrowing requirements for shares in 19 firms. Loan volume in these issues doubled and borrowing costs quadrupled because of this emergency order, although much of the new borrowing appears to have been an overreaction due, in part, to confusion around its application and scope. By the time the emergency order expired on August 12, 2008, loan volume in these 19 major financial firms had reverted to lower levels and the entire equity loan market had begun a contraction that would last until March 2009.

While securities lending volumes had already started to ease somewhat in August as short interest fell 5%, the steepest decline was precipitated by the SEC's ban on new short sales of financial stocks, the first national short sale prohibition in U.S. history. During this three-week period, loan volume (in shares) decreased 13% across all equities and 43% across U.S. financial stocks. Loan volume measured by market values declined even more sharply, as stock prices themselves fell over 20% during the ban.

While this was a remarkably abrupt contraction for the securities lending market – and the stock market – it was not the end of the story for securities lending. Even after the short sale ban was lifted, the securities lending market decreased further in size, at a slower pace, until bottoming out in early March 2009. At the end of the first quarter of 2009, the size of equity loan market (in terms of market value of loans) was less than half of what it was at the midpoint of 2008. Since then, however, the securities lending market has regained some of that volume, expanding more than 50% from March to September 2009, aided by rising asset values.

Such a tumultuous period would be stressful for any financial market, and the securities lending market has been no exception. An already highly competitive landscape has seen new entrants as well as mergers among big firms. Attention to risk analysis and benchmarking has never been higher in the industry. There has been a shift toward extracting higher 'intrinsic' value from securities that are highly sought after by short sellers, and away from generating large loan balances; that is, a shift to higher-return, lower-volume lending. This shift has been motivated by the most significant problems faced by some securities lenders during the market turmoil; namely, their difficulties in the area of cash management.

Securities lending, narrowly defined as the generation of rental fees on idle assets through fully-collateralized loans, was almost universally a profitable enterprise for institutional investors even during the great contraction in late 2008. But the related area of cash management caused some securities lenders to record unrealized or realized losses. It was the way in which cash collateral was invested that tripped up these securities lenders.

In the U.S. securities lending market, cash is the predominant form of collateral. In this cash-based securities lending market, it is the responsibility of lending institutions to determine what type of investment strategy to pursue in their cash collateral management fund. These are typically short-term investment funds, restricted to high-quality, short-term Treasuries, commercial paper, and investment-grade fixed income securities. Regulators such as the Department of Labor and the SEC have rules governing what kind of assets pension funds and mutual funds are allowed to purchase with their securities lending cash collateral.

Three general problems occurred with some securities lending cash collateral management programs. First, some programs chose to take on more risk than they should have. Second, some high-quality assets turned out to be low-quality. And third, some institutions had too high of a weighted-average maturity in their cash collateral investment program. This made them inadequately prepared to deal with a liquidity squeeze due to dramatically reduced loan volumes that coincided with lower book values for some assets purchased in the collateral re-investment program. A few institutions suffered sizable losses due to these problems in their cash collateral management programs and sent a clear message to the rest of the industry that cash collateral must be carefully and conservatively managed – if cash is to be used as the collateral of choice at all.

The lessons learned during the past year in the securities lending market have led to some shifts in market practices for the benefit of institutional investors, most notably a renewed focus on cash collateral risk management. As the market continues to expand this year, it is helpful that these best practices are shared at roundtables, discussed at conferences, and worked on in meetings between institutional investors and their securities lending agents.

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