Securities Lending: Program Management

Proxy voting and exercising corporate governance responsibilities can work in tandem with securities lending

There are a range of options available to beneficial owners seeking to manage a securities lending program and maintain their corporate governance responsibilities. By setting out lending parameters within the legal agreement and with the appropriate monitoring and oversight structure in place, a securities lending program can be aligned to the core investment activity of the fund.

A topic of increasing prominence with beneficial owners is corporate governance with regards to proxy voting. Securities Lending involves the temporary transfer of ownership rights (title) to the borrower. Whilst the borrower can transfer (manufacture) all the economic entitlements due to the lender, the key entitlement which the borrower cannot manufacture is the voting rights.

There are a few ways that beneficial owners manage corporate governance and securities lending activities, and this will vary dependent on individual governance polices. However, no matter what size program you manage, an active and effective corporate governance plan is essential to balancing the reputational and financial risk/reward.

Information is essential to maintaining an effective balance between securities lending and corporate governance. Specifically, understanding and identifying corporate events combined with relevant market and lending data-sets. Leveraging these adjacent datasets allows beneficial owners to intelligently select which securities they may want to recall and to evaluate the profit tradeoff to doing so. Corporate actions and securities lending data support an effective alert and evaluation process for lending programs.

Historical data suggests the existence of an active approach to selecting securities to recall for voting purposes. Academic research published in 2014 showed a tendency for lenders to reduce lendable assets around proxy vote record dates, however that behavior is less pronounced in securities with higher fees suggesting that in many cases the value of lending revenues is deemed to exceed the value of the vote. The researchers used control variables to determine the impact of lending and the likelihood of the vote being contentious, which is summarized in their conclusion: "These results show that recall is higher for firms with a higher proportion of investors with stronger incentives to monitor and exert governance, for stocks where governance is more valuable and for proposals where the returns to governance are likely higher." (Aggarwal et al, 2014)

When considering the recall of securities, there are two primary liquidity concerns for lenders. The measurement of securities lending liquidity, i.e. answering the question of whether the decision to lend a given security is likely to impact the overall lendable supply for the security. That provides owners with the option of cutting off supply at certain thresholds to avoid a situation where the beneficial owner represents a large portion of total lending activity or volume where the need to recall would have a significant impact on the total supply. The second liquidity concern is in the cash market, where borrowers may need to purchase securities to return if the lender wishes to recall the security and the borrower is unable to find an alternative source of borrow. By combining securities lending data with cash market statistics for equities and fixed income, beneficial owners can evaluate risk and opportunity in real-time.

These controls form the basis of liquidity management for securities

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lending programs, however knowing when to apply them is vitally important. The use of corporate actions data to give a heads-up on potential liquidity issues is critical to maintaining appropriate levels of exposure and can also be helpful in generating returns. In recent years, some of the most profitable trades for lenders have involved lending "take no action" shares around tender offers. This may be entirely appropriate for some owners, while others may give up the return in favor of either tendering the shares or retaining the option to sell them. Similarly, for proxy votes there are often recalls from shareholders seeking to exercise their vote, which can drive up lending returns for lenders who elect to forgo their voting rights. In all cases, awareness of the action allows for comprehensive decision making.

Risk controls are used to limit exposure, and therefore put a limit on resulting gains and losses. The goal is to take on an appropriate level of risk in the pursuit of a targeted return profile. At the outset an assessment of the potential rewards to lending must be assessed. Knowledge of the risk exposure is critical, as is the potential for the scale of the exposure to impact the market. These considerations affect the provision of a portfolio as lendable assets on both a program and security specific level. Tracking the opportunity and then measuring the returns realized against the risk exposure form the core of securities lending program management.

The decision to not lend securities at all reflects a decision that it isn't possible for a security loan to deliver a return which justifies the exposure. While that may well be the appropriate posture for some owners based-on risk tolerance or return targets, we believe that having the proper program management tools put beneficial owners in the best position to make that decision and to report the results.

Conclusion:

The number of lending accounts reported in our performance measurement tool bottomed out in 2013, following the departure from lending programs after the financial crisis. Since then, the number of accounts has grown each year. While the increased participation has certainly boosted lendable assets, the primary driver of growth post-crisis has been the appreciation of assets. On that point the industry would hardly be said to be supply constrained, with global utilization of lendable assets on pace for being the lowest average on record in 2019, 8.4%; Utilization averaged 19.5% in 2008 and has declined steadily in each year since, with the exception of 2018. The point above regarding corporate actions is relevant here as well: in general, there is far more supply of lendable assets than there is borrow demand, and the limited cases where that condition doesn't hold are also those with the greatest return opportunity for lending. Situations where borrow demand exceeds lendable supply have significantly greater revenue potential, while also increasing the liquidity concern and potentially other tradeoffs. There is no "right" way to make these decisions, in our view the only incorrect approach would be to make decisions blindly.

Citation:

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