

Testimony to the United States Senate
Special Committee on Aging
Chairman Herb Kohl (D-WI) and Ranking Member Bob Corker (R-TN)
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“Risks and Responsibilities in Securities Lending”

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Chairman Kohl, Ranking Member Corker, and Members of the Committee, thank you for the opportunity to share a few thoughts with you today. I commend you highly for holding this hearing and hope that we will continue to share ideas well into the future. My oral and written remarks are my responsibility alone. They do not necessarily reflect the views of my employer, the Center, any of its staff or members.

I approach this issue with the perspective gained from 35 years of varied roles in the securities lending community and the experience gained from having built, and then sold a profitable business that pioneered the analysis of performance measurement for securities lending programs. Prior to that, I was an executive on Wall Street at Citibank and Bank of New York with responsibility for managing securities lending service lines, among other securities services. Before my Wall Street experience, I was a Captain in the United States Marine Corps, with graduate degrees from New York University and Pepperdine University, and an undergraduate degree from Fordham University.

Introductory Comments

On the surface, the problem cited by the GAO Report appears to be a lender-side issue, i.e., the cash collateral lockups that froze the assets of 401(k) Defined Contribution account holders and others during, and for up to a year after the crisis. However, this is really a problem for the entire investment community. The effect of restrictions on the supply of lendable securities could quickly degrade the liquidity and efficiency of the U.S. capital markets by raising the risks of settlement failures and increasing the capital charges for brokers with customer segregation deficits. All this would erode the global competitiveness of U.S. domestic capital markets and, ultimately, American business.

This is not an overstatement of the risks of punitive legislation and regulation. Restrictive actions of regulators affecting lendable securities could well impair the ability of pension plan sponsors to offer passive index funds and to hedge actively managed portfolios. (Index fund managers use securities lending income to offset trade commissions and custody fees, thereby reducing the tracking error against the fund's benchmark index. Active managers hedge with derivatives such as options and futures, which are created by dealers who then hedge their own exposures using short positions in the securities markets, that are, in turn, settled with

borrowed securities.) The reduced availability of index funds and hedges would increase portfolio risks and threaten the investment returns that pension beneficiaries need and expect.

At a very fundamental level, securities lenders help to make the markets more efficient. A 1999 report by the international bank and brokerage regulators (CPSS and IOSCO) concluded that, "Securities lending markets are a vital component of domestic and international financial markets, providing liquidity and greater flexibility to securities, cash and derivatives markets."

The supply of lendable securities is highly sensitive to the actions of federal regulators. The Department of Labor's 1981 amendment of its Prohibited Transactions Exemption to ease its rules for securities lending greatly increased the level of securities available to borrowers, as well as the income to pensioners. Indeed, it has been estimated that the earnings from securities lending programs *alone* can enhance the portfolio's yield to a level that can take as much as a year off the viable retirement age of new workers entering the labor market.

Let me pause here for a moment. If I say that securities lending is important, I do not mean to say that problems do not exist in the lending community. Nor do I intend my comments to be taken as a defense of the status quo, such that pensioners might once again be deprived of access to their own funds in the uncertain days of financial crisis. We should not, as a people, subject our elders to added fears of loss of their retirement funds. Life is uncertain enough in our advancing years without adding risk to our 401(k) accounts. Yet it will serve as no benefit if the unintended consequences of new regulations are to undermine the ability of the capital markets to contribute to the welfare of today's workers, senior citizens and other beneficiaries of Defined Contribution plans.

The cause of the lockups was the illiquidity of certain asset-backed securities, which were included in the cash collateral pools of those funds that lent out their securities. In that regard, the problems of securities lenders and their investor/beneficiaries are the same as those of many other commingled funds in the United States during the recent market crisis. This is not the first time that securities lending has been incorrectly linked with nefarious activities.

- For many years, institutional investors refused to lend securities in the belief that by so doing they would be feeding the short sellers, who would then act to reduce the value of their portfolios. A major study that I led, for which I presented the findings at a World Bank / IMF conference in Moscow, demonstrated that the short sellers actually preserved portfolio values, especially during times of greatest market stress.
- More recently, hedge funds were seen by academics as manipulators voting proxies to subvert the corporate governance process through with borrowed shares, to the disadvantage of the long-term investors who had lent them the shares. In fact, a study that I led and presented to the Securities and

Exchange Commission, demonstrated that sound alternatives existed to explain the vast majority of suspicious loans. The activity spikes seen as evidence of manipulation were actually caused by lenders recalling shares to vote, thereby triggering substitutions among the borrowing firms.

Securities lending, by its nature, creates a complex network of interrelationships whose intentions and processes may be misunderstood and wrongfully accused. It may be said that the workings of the US Congress attract similarly-misinformed disbelievers. In both cases, the true cause of the problem often lies outside the boundaries of the accused institution.

During the crisis, the suddenly-illiquid, individual beneficiaries of Defined Contribution accounts absorbed the effects of investment choices made by others, i.e., their plan sponsors and cash managers. By contrast, the sponsors of Defined Benefit plans have to absorb the losses from their own decisions, since they are the employers whose contributions are increased by the investment shortcomings of their retirement plans.

In that context, DC plan sponsors, unlike Defined Benefit plan sponsors, have no financial incentive to increase investment revenue, such as securities lending income, for their beneficiaries. To the extent that DC plan sponsors have fiduciary responsibility for investment decisions, they bear risks which create contra-incentives to engage in securities lending and make other risk/reward decisions that could ultimately increase their exposure to the trial bar. All in all, DC beneficiaries gain the income from securities lending while their administrators merely gain more work and more risk. As a result, it is easier for DC plan sponsors to simply reject as investment options those mutual funds which lend, rather than learn how to evaluate the ways in which risks in securities lending evolve as market conditions change, so as to help beneficiaries fine-tune their exposures.

Such a decision appears to have been made by many plan sponsors, whose management mandates now routinely reject the possibility of income from securities lending services. Not surprisingly, perhaps, the investment performance of DB plans is exceeding that of DC plans, even when offered by the same corporate plan sponsor. In effect, we're creating a yield deviation between DC and DB plans where there isn't a good reason for it.

Recommendations

Going forward, it will be necessary to construct a framework with more closely aligns the interests and responsibilities of all those in the DC plan securities lending community, without unnecessarily impairing the ability of the market system to contribute to the welfare of both DC and DB plan beneficiaries.

- Among the changes that I believe are necessary are an improvement and extension of the disclosure regime for securities lending cash managers.

However, I believe that such disclosures must be incentives-based and tempered by competitive sensitivities, not imposed by regulatory fiat.

- Furthermore, I believe that an expert council should be established to define the limits of prudence for collateral cash managers, one that is based on close monitoring of changing market conditions. That council might either be modeled on, or incorporated within the existing ERISA Advisory Council.
- Moreover, I believe that educational programs should be funded by the securities lending community, not the government, through incentives such as capital charge credits, and then provided to DC plan sponsors and beneficiaries as a way of improving their awareness of their own responsibilities and those of their service providers.
- Finally, I do not believe that the Prohibited Transaction Exemption should be modified, nor do I believe that the definition of a plan fiduciary should be expanded to include lending service providers. Any assumption of either real or potential liability (via fiduciary broadening) will have real yield erosion since provider service pricing, naturally, will be reflective of these risks. Again, every regulatory action influences the decision to either engage in securities lending or not, thus denying workers higher yields and fewer work-months until retirement.

In summary, if all members of the service provider community fulfill their responsibilities, no new legislation or regulatory enforcement will be necessary. The cash lockups of the financial crisis were not attributable to a failure of securities lending.

The importance of these lending programs to pension beneficiaries and their financial intermediaries makes the interrelated set of responsibilities for managing lending risks very important. I will discuss those responsibilities further in my written testimony.