

# point of view

## Recent developments in securities lending: Are funds' lending programs at risk?\*

Fund management and boards are reevaluating the use of securities lending programs because of the increased risks associated with the current market environment.

### Highlights

- There is increased scrutiny of securities lending programs because the current market environment has highlighted counterparty, operational, valuation, and accounting-related risks.
- Active management oversight and effective controls are required to mitigate potential risks to a fund and its investors.
- While some funds manage securities lending themselves, others rely on global custodians or other third-party service providers. Controls are required at the fund and, if applicable, the service provider to ensure proper oversight of lending activity, transaction processing, and related accounting and tax considerations.

### What are the risks associated with securities lending?

#### Counterparty and concentration risk

Risk of potential financial loss arising from counterparty failure or excessive exposure to a single counterparty.

#### Operational risk

Risk that transaction processing related to securities lending is not performed in accordance with fund management instructions.

#### Valuation and accounting risk

Risk of valuation and accounting errors posed by mark-to-market accounting related to the investment of cash collateral.

#### Tax risk

Risk that dividends paid to a security on loan will lose their tax treatment status and in turn disadvantage the fund.

# Recent economic developments have exacerbated the risks of security lending programs

Securities lending has traditionally been a low-risk method for funds to generate additional income for their shareholders. However, given recent market events and increased scrutiny of securities lending programs, the risks associated with securities lending have moved to the forefront.

## Risks have become more acute

Counterparty risk and concentration risk have become more prevalent in recent months. It is critical that funds have policies and procedures for monitoring borrowers and their current exposure. For example, in the case of Lehman Brothers, funds that actively monitored their borrowers were able to react before Lehman failed.

Additionally, for those that had outstanding loans with Lehman, many were made whole through the return of collateral. However, where the return of collateral took place, attention was required to ensure that the related accounting was accurate.

Also, unrealized gains or losses may have been incurred related to the vehicles used for the investment of cash collateral received from borrowers. Funds often invested collateral in short-term obligations, which historically exhibited stable values close to the value of the liability for the collateral.

Current market conditions have caused the value of collateral investments to diverge, in some cases significantly, from the liability for the return of collateral. Funds that have not monitored this divergence may be valuing their collateral investments incorrectly.

## Less liquidity, more volatility

The recent lack of liquidity and volatility of the short-term instruments markets has highlighted the risks related to the valuation and accounting for collateral investments. In addition, in certain instances, collateral was invested in individual securities, rather than securities lending collateral funds, which may pose an increased risk to funds depending on the type of security and exposure concentration.

The lack of oversight of corporate actions related to securities on loan has also led to securities not being recalled and received into the fund's possession prior to ex-dividend date. Failure to recall these securities may lead to the loss of the preferential tax treatment of the dividends paid to the fund, which could eventually disadvantage the funds.

# Funds should minimize risks through active oversight and controls

Funds that participate in securities lending should ensure that controls are in place to mitigate risks. It is critical that funds value investments properly, and ensure that appropriate collateral is retained, valued and accounted for accurately and timely. Also, funds should understand the risks associated with their collateral investments, and ensure they are recorded at fair value.

The tax implications related to securities lending should also be reviewed. The lack of oversight of corporate actions related to securities on loan could lead to the loss of the tax status of the dividends paid to the fund, which in turn disadvantages the funds.

As many funds have outsourced their securities lending programs to global custodians or third-party service providers, funds should monitor their contracts with their service providers. Fund managers should understand how collateral is invested and the mark-to-market processes, including the frequency and source of valuation. Fund managers should also review their service providers' controls and ensure they are evaluated regularly.

For example, service providers may have a SAS 70 report, which provides an overview of the control environment and an independent auditor's opinion of the design and effectiveness of the controls. Fund managers should obtain and review any SAS 70 or controls reports to ensure that they understand the controls in place and whether they are operating effectively. They should also confirm that the controls identified in the user control considerations (i.e., internal controls that the service provider believes should be in place at the fund) are in fact in place and operating effectively at their organization.

## Minimizing the risks

The following list includes certain controls that funds can apply to help mitigate the risks related to securities lending. While not comprehensive, this list provides examples for your consideration.

## Program oversight

- Contracts are established that identify key provisions, such as borrowers with whom the fund will lend, and borrower limits. These contracts should be reviewed periodically and updated, as needed.
- The financial condition of new borrowers should be evaluated, reviewed, and approved prior to participation in the lending program and on a periodic basis thereafter.
- Lending should only take place against the list of approved borrowers and only to the extent of pre-established limits. Exceptions to credit limits should be reported to and reviewed by someone independent of securities lending operations (e.g., credit committee).
- Cash collateral received should be invested in accordance with established policies. Those investments (including underlying portfolios of collective vehicles) should be regularly monitored for changing market and credit conditions, and investment criteria updated accordingly.
- Failures to return securities loaned should be monitored and buy-ins or indemnifications for losses should be executed accurately and in a timely manner, as required.
- Timely review of reports of securities on loan with mark-to-market value and the associated collateral investment balances should be performed by the fund.
- When intermediaries are utilized for securities lending, the intermediaries should be subject to appropriate due diligence to ensure that the intermediaries meet established criteria concerning reputation and financial stability.

### Transaction processing controls

- Securities should be loaned in compliance with the terms and conditions of the borrower agreements or established policies. Loan restrictions should be reviewed and programmed in the securities lending system and monitored and reviewed on a daily basis.
- Executed trades should be input into the securities lending system by traders and reviewed by operations. Only authorized individuals should have the ability to execute and approve trades.
- Securities delivery confirmations should be received from lender's custodian banks and reviewed for completeness and accuracy.
- On-loan security positions should be reconciled to on-loan security records at the custodian and at borrowers on a periodic basis. Discrepancies should be identified, researched and resolved.
- Outstanding loan balances and borrower credit limits should be monitored daily using system-generated reports. Loans should be reallocated or recalled on a timely basis based on established policies or fund instructions.
- Rejected loans, returns, terminated loans, and collateral transactions should be identified and adjustments made to the appropriate loan positions to reflect correct settlement.

### Collateral management

- Initial collateral amounts (e.g., 102 percent on domestic equities, 105 percent on international equities) and daily mark-to-market requirements based upon FX rates, security price changes, and settlement activity for cash and non-cash loans should be calculated daily. Mark-to-market activity should be reconciled on a counterparty by counterparty basis.
- Loan market value should be compared to collateral market value for each broker. Collateral should be evaluated for adequacy based on the lender's instructions on a daily basis. If the borrower is undercollateralized, the borrower should be contacted and required to deliver additional collateral.

In addition to these controls, fund management must ensure that there are information technology controls in place to protect automated procedures and systems. These controls should include restricting access to update standing data in the securities lending and supporting systems (such as approved borrowers, limits and collateral investment vehicles) to authorized users. Also, controls related to system security, program change control, and business resumption planning should be considered and implemented.

The risks associated with securities lending should be frequently reassessed against the returns realized and funds should ensure that adequate controls are in place to monitor securities lending programs.

## Contact Information

To have a deeper discussion about securities lending programs in the current market environment, please contact:

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