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Securities Lending by Mutual Funds, ETFs, and Closed-End Funds: Regulators' Concerns

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Third in a series of Viewpoints on securities lending

This post is the third in a series that focuses on securities lending by U.S. regulated funds—mutual funds, exchange traded funds (ETFs), and closed-end funds that are registered under the Investment Company Act of 1940. The first post answered the questions of "what" and "how"; the second post answered "how much." This post builds on that foundation to explore some of the concerns identified by the Financial Stability Oversight Council (FSOC), the U.S. Department of the Treasury's Office of Financial Research (OFR), and the Financial Stability Board (FSB).

In their consultations and reports, the FSOC, OFR, and FSB have expressed concerns primarily about three aspects of securities lending: the investment of cash collateral; indemnifications by asset managers; and transparency and the availability of data.

Let's take a closer look at each.

Concern over Investment of Cash Collateral

Regulators have expressed concerns that the investment of cash collateral involved in securities lending can involve "maturity and liquidity transformation, which if left unchecked can present risks…in a stress event" (quoting the FSB). The regulators' basic concern stems from the fact that, when a loan is terminated, the lender is obligated to return the cash it took as collateral and will need to liquidate the investments it made with that cash collateral.

Appropriately, regulators appear most concerned that lenders might take excessive risks with respect to cash collateral investment. The OFR cited "inadequate risk management relating to reinvestment of cash collateral" as contributing to the potential for systemic risk. But as we have explained, U.S. regulated funds don't engage in risky practices when investing cash collateral. Consistent with SEC guidance, U.S. regulated funds invest cash collateral only in highly conservative and liquid investments, such as money market funds. During the financial crisis, this practice held U.S. regulated funds and other institutional investors with conservative collateral-management practices in better stead than, for example, AIG, whose risky collateral investment practices are described in the OFR's 2013 report and have been analyzed in depth by academics.

The bottom line is this: we agree that cash collateral investment practices may raise legitimate concerns. But those concerns can be mitigated when cash collateral is invested conservatively, as U.S. regulated funds are required to do.

Concern over Asset Managers Providing Indemnification

The FSOC's 2014 annual report highlighted a concern that "indemnification that asset managers provide may be a source of stress on their own balance sheets." This was not a concern discussed by the FSB or OFR in their reports, and for two reasons, it seems like a red herring.

First, while an asset manager may provide indemnification for securities loans, it is more commonly offered by the *securities lending agents* that many institutional investors employ to administer their securities lending programs. Almost all securities lending agents are (or are affiliated with) custodian banks or broker-dealers. Very few solely are affiliated with an asset manager.

Second, this type of indemnification is very limited in scope. It does not cover any losses on the investment of the cash collateral, which is a risk borne solely by the lending funds. It also typically does not cover the full amount of the securities on loan; it covers only a “collateral shortfall” when the value of the collateral is insufficient to replace lent securities. In other words, the indemnification is triggered only if the borrower fails to return the lent securities *and* the value of the collateral is insufficient to replace those securities, neither of which is likely to occur because defaults requiring indemnification are rare and, as we’ve explained, securities loans are typically over-collateralized and required to be marked-to-market daily. If a default does occur, the amount of the indemnified loss (the shortfall) likely will be a small fraction of the value of the securities the borrower failed to return.

As a result, the potential that a lending agent will suffer significant losses on indemnifications is remote, whether that agent is a bank, broker-dealer, or asset manager.

Concern over a Lack of Transparency

The FSOC, OFR, and FSB are concerned that they lack data on the securities lending market. This is a fair point—we agree that improved transparency is necessary for regulators to better monitor the securities lending market for financial stability risks and to make informed policy decisions.

That is not to say that there is a complete lack of information available on securities lending activities. As we pointed out in our first post, U.S. regulated funds file periodic reports with the Securities and Exchange Commission (SEC) that disclose a great deal of information about the funds’ securities lending activity. The data that are reported, however, generally are designed to provide transparency to the investing public, rather than to meet regulatory needs. Similarly, the existing marketwide data generally are based on surveys of large lending agents and are tailored to the needs of market participants. Though useful as a business tool, this data might not be comprehensive or precise enough to serve all regulatory purposes.

It also is important to note that, while insufficient transparency may be a legitimate regulatory concern, it is not *in and of itself* a systemic risk. Rather, it is a concern that should be addressed so that regulators can better determine *whether* there are systemic risks.

Toward that end, the FSB has established a “data experts group” to look at this topic. The SEC, meanwhile, is working on rules that would increase transparency in the securities lending market and considering whether to seek additional data on certain types of U.S. regulated funds. ICI looks forward to working with both the FSB and SEC to find an efficient and effective way to ensure that regulators have the information they need to effectively monitor the securities lending markets.

Next Up—Putting These Pieces Together

So far, we’ve examined securities lending by U.S. regulated funds in an attempt to answer the basic questions of what securities lending is, how it is conducted and regulated, how much lending these funds do, and why regulators are concerned about securities lending in general. In the next post, we’ll wrap up by taking a look at what all of this means to the systemic risk debate.

Read the other entries in this ICI Viewpoints *series:*

- Securities Lending by Mutual Funds, ETFs, and Closed-End Funds: The Basics
- Securities Lending by Mutual Funds, ETFs, and Closed-End Funds: The Market
- Securities Lending by Mutual Funds, ETFs, and Closed-End Funds: Regulators' Concerns
- Securities Lending by Mutual Funds, ETFs, and Closed-End Funds: Are the Risks Systemic?

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