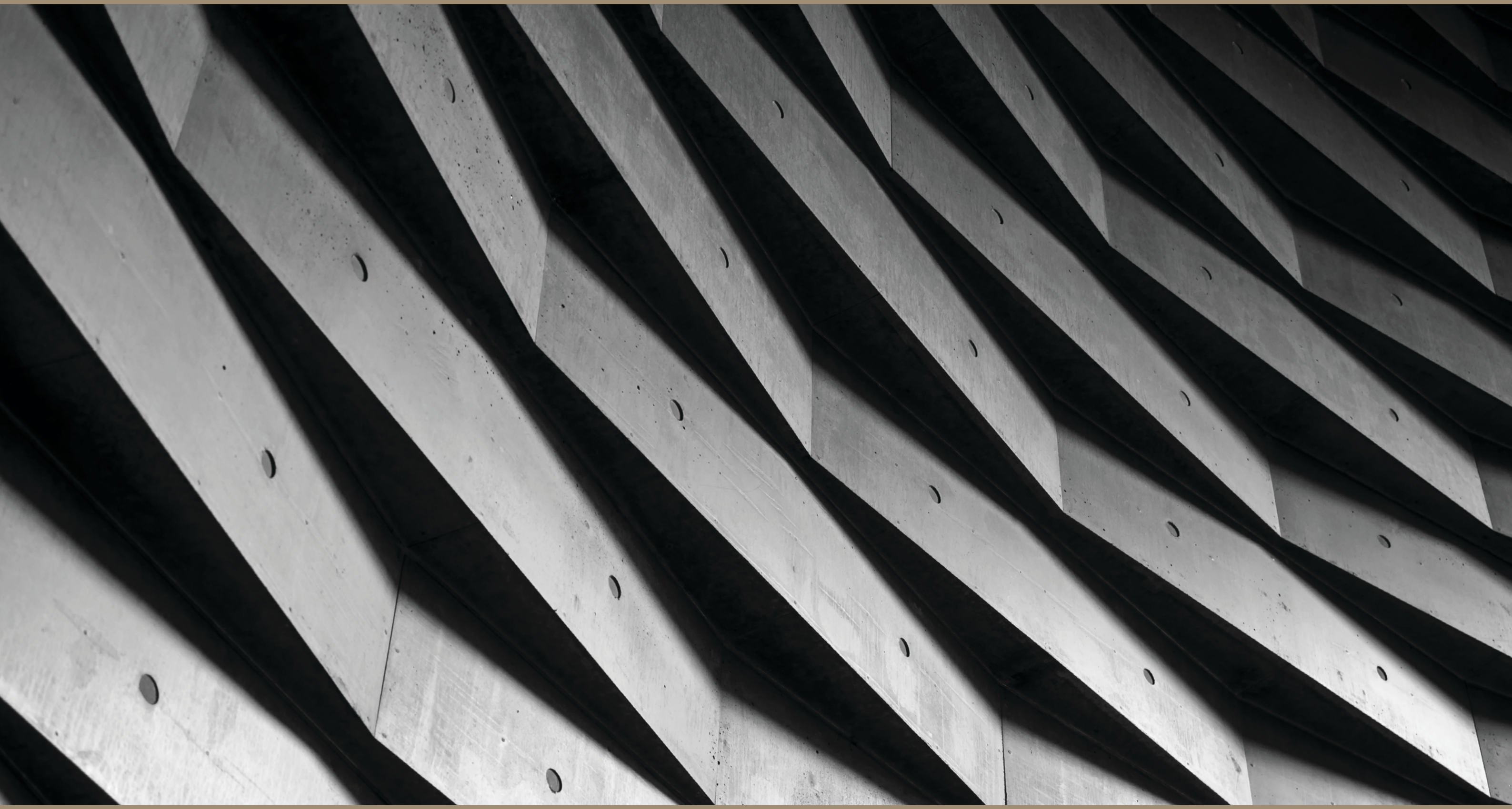
A Beneficial Owner's guide

Independent oversight management of a securities lending program



S&P Global
Market Intelligence

Introduction

Effective oversight management is a critical component of any well-run securities lending program. Whether the activity is fully outsourced to an agent lender, managed in tandem with another service provider or managed completely in house, good governance and oversight are essential to ensuring that an asset owner's fiduciary responsibilities are being fulfilled.

As the impact of regulations (e.g., SFDR, SFTR, CSDR) start to embed themselves into the securities lending landscape, the necessity for beneficial owners to perform independent program oversight has grown significantly.

Over the past 18 months, numerous "market events" have encouraged beneficial owners to introduce independent oversight management of their securities lending activity. Many of these events have shown how beneficial owners can benefit from designing their oversight structures to align with their specific program parameters rather than relying upon a "one size fits all" approach.

- The collapse of the hedge fund Archegos in March 2021 and its impact upon market liquidity sent markets into a tailspin. Beneficial owners were required to manage their exposures in a dynamic and real time manner to control their risk
- Managing recalls, restrictions, as well as understanding liquidity constraints and exposures in a timely manner was essential during the COVID -19 market sell off during the Spring 2020
- The Short squeezes linked to the "meme stocks" during the summer of 2021 led to risk departments questioning their real time exposures and their ability to recall and restrict assets. It also led to some competitive and volatile pricing of hard-to-borrow stocks. It was essential for beneficial owners to benchmark the revenues being generated to ensure that their assets were being lent at the correct fees in relation to their risk appetite on an ongoing basis
- As the impact of RWA constraints is being felt across the securities lending market, effective and independent benchmarking of on loan fees is gaining importance as the proportion of market "specials" activity grows and GC balances decline. Having the ability to create and belong to the correct "peer group" is an essential component of this
- The focus on ESG and sustainable investments has added another layer of complexity and oversight requirements for beneficial owners. Following preliminary moves by the Financial Conduct Authority to improve trust and integrity in services sold as sustainable, unique collateral schedules, increased numbers of restrictions and heightened reputational risk linked to "greenwashing" and "empty voting" have amplified the number of checks and controls required

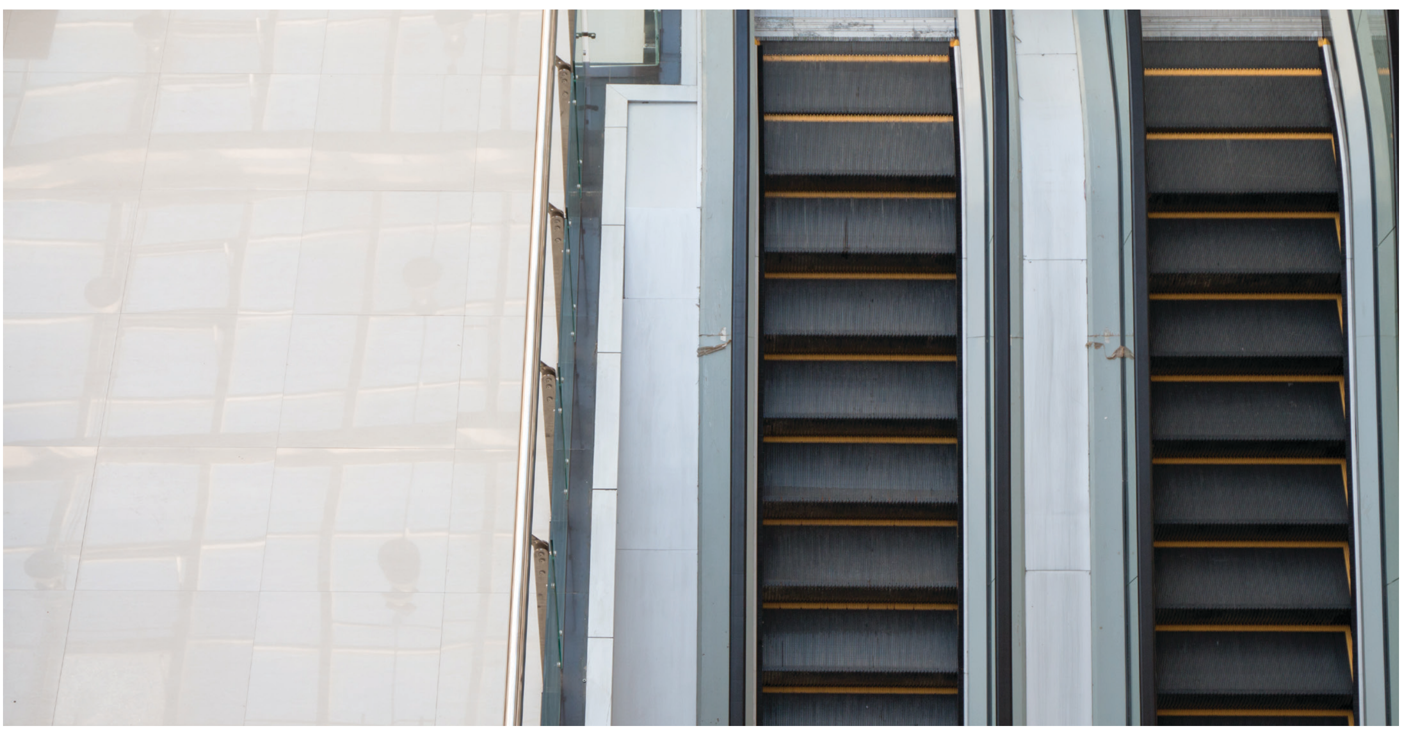
Oversight management for beneficial owners can be organized into three separate pillars; Control, Monitor and Understand.

Control

When lending through an agent lender, any direct control a beneficial owner has over lending their assets is transferred to the agent lender. It is very important to agree on a robust framework that dictates the terms and conditions in which an agent lender can engage in a loan on the asset owner's behalf. The Securities Lending Agreement usually guides these conditions that the agent lender has agreed with the lender. Regular reporting is required to ensure that these conditions are being adhered to.

The following reports and policy documents are recommended to ensure that a satisfactory level of oversight of the lending activity is taking place:

- Daily reporting from the agent lender showing on loan positions per fund, on loan positions per borrower, collateral held per fund, collateral held per borrower
- Daily recall reports identifying any outstanding and upcoming recalls
- A securities lending policy should be created and agreed to by all stakeholders. It is suggested that the policy should include details such as risk management, routes to market, indemnification, borrower, collateral and lending agent criteria, lending limits, regulatory requirements, monitoring and reporting and lists of lendable assets
- Quarterly activity reports should be compiled, focusing on exception management, performance, exposures, and any relevant market commentary
- Utilization reports should be issued daily on a per fund basis
- Active buffer management should be aligned with average traded volumes
- Regular reviews of the control process and frequent audits to ensure that they remain fit for purpose
- A regular assessment should be conducted of the securities lending and reinvestment risk at the asset class level based on loan and collateral positions
- Net exposure should be calculated at the counterpart level within a single report to create a single viewpoint in the event of default (if using more than one agent lender)
- Collateral exposures should be assessed regularly in relation to asset classes, credit ratings, counterparts, maturity buckets and top securities to identify any potential losses in the event of default
- Stress test scenario analysis should be employed to manage and simulate the impact of loan and collateral exposure in the event of a given stress scenario

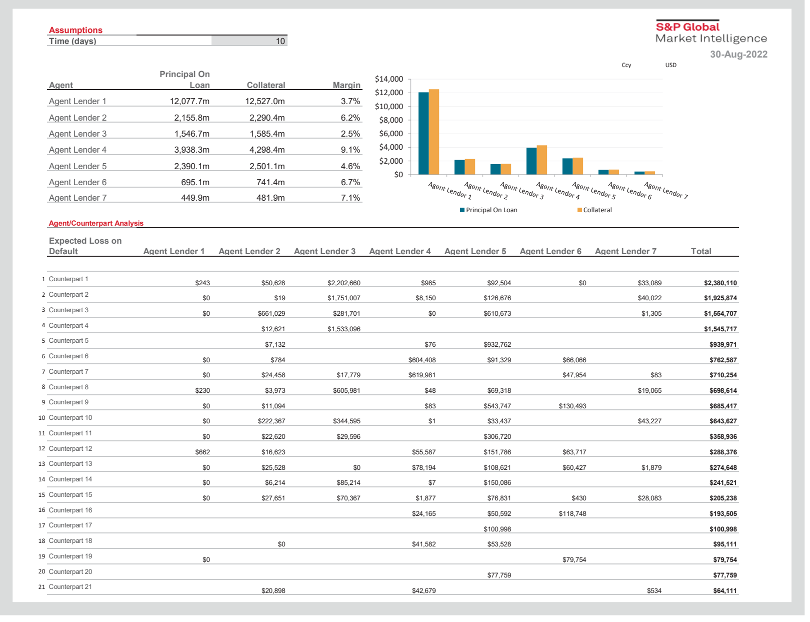


Monitor

Active monitoring of the securities lending activity is essential to ensure that risks are managed and that revenues and optimized. The monitoring function for a beneficial owner can be split into three different areas: Exposure, Exception Management, and Liquidity Management.

Exposure

Managing exposure to both counterparties at a legal entity level and through collateral holdings is essential in managing credit risk associated with securities lending. It is important to be able to provide consolidated risk reports which focus on the loans made, the collateral received and any reinvestment risk at the asset class level at any specific point in time.



Assumptions

Time (days)	10

Agent	Principal On Loan	Collateral	Margin
Agent Lender 1	12,077.7m	12,527.0m	3.7%
Agent Lender 2	2,155.8m	2,290.4m	6.2%
Agent Lender 3	1,546.7m	1,585.4m	2.5%
Agent Lender 4	3,938.3m	4,298.4m	9.1%
Agent Lender 5	2,390.1m	2,501.1m	4.6%
Agent Lender 6	695.1m	741.4m	6.7%
Agent Lender 7	449.9m	481.9m	7.1%

Agent/Counterpart Analysis

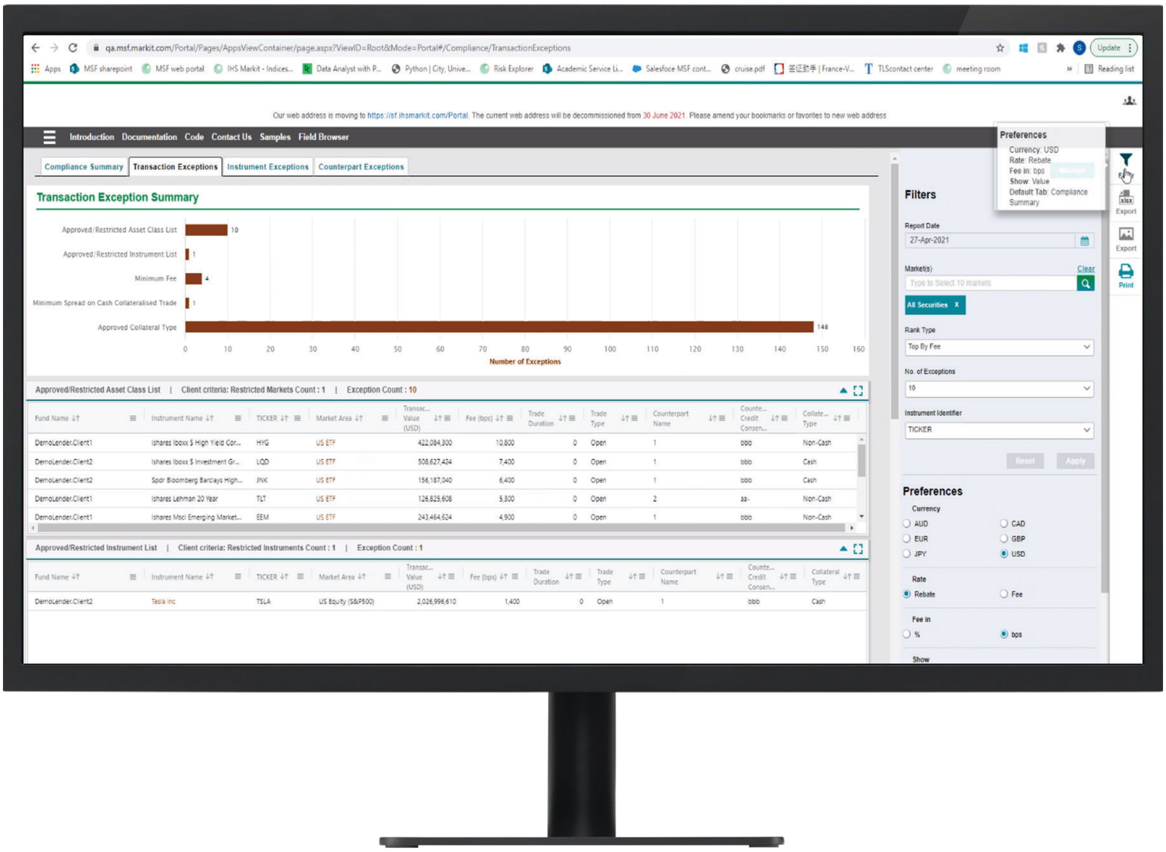
	Expected Loss on Default	Agent Lender 1	Agent Lender 2	Agent Lender 3	Agent Lender 4	Agent Lender 5	Agent Lender 6	Agent Lender 7	Total
1	Counterpart 1	$243	$50,628	$2,202,660	$985	$92,504	$0	$33,089	**$2,380,110**
2	Counterpart 2	$0	$19	$1,751,007	$8,150	$126,676		$40,022	**$1,925,874**
3	Counterpart 3	$0	$661,029	$281,701	$0	$610,673		$1,305	**$1,554,707**
4	Counterpart 4		$12,621	$1,533,096					**$1,545,717**
5	Counterpart 5		$7,132		$76	$932,762			**$939,971**
6	Counterpart 6	$0	$784		$604,408	$91,329	$66,066		**$762,587**
7	Counterpart 7	$0	$24,458	$17,779	$619,981		$47,954	$83	**$710,254**
8	Counterpart 8	$230	$3,973	$605,981	$48	$69,318		$19,065	**$698,614**
9	Counterpart 9	$0	$11,094		$83	$543,747	$130,493		**$685,417**
10	Counterpart 10	$0	$222,367	$344,595	$1	$33,437		$43,227	**$643,627**
11	Counterpart 11	$0	$22,620	$29,596		$306,720			**$358,936**
12	Counterpart 12	$662	$16,623		$55,587	$151,786	$63,717		**$288,376**
13	Counterpart 13	$0	$25,528	$0	$78,194	$108,621	$60,427	$1,879	**$274,648**
14	Counterpart 14	$0	$6,214	$85,214	$7	$150,086			**$241,521**
15	Counterpart 15	$0	$27,651	$70,367	$1,877	$76,831	$430	$28,083	**$205,238**
16	Counterpart 16				$24,165	$50,592	$118,748		**$193,505**
17	Counterpart 17					$100,998			**$100,998**
18	Counterpart 18		$0		$41,582	$53,528			**$95,111**
19	Counterpart 19	$0					$79,754		**$79,754**
20	Counterpart 20					$77,759			**$77,759**
21	Counterpart 21		$20,898		$42,679			$534	**$64,111**

Risk managers are likely to want to see net exposure by Agents at the counterparty level, assess collateral exposure in terms of asset classes, credit ratings, maturity buckets and top securities to identify any potential losses in the event of default. Having a customizable risk report will allow beneficial owners to document the risk profile during times of market fluctuations. The ability to provide this data when required in an easily digestible format allows for better decision making and potentially fewer restrictions or defensive changes to program parameters. The following should be considered when designing an effective exposure report:

- Assessment of the securities lending and reinvestment risk at asset class level based on loan and collateral positions
- Net exposure by Agents at counterpart level in the event of default (if using more than one agent lender)
- Assessment of collateral exposure to asset classes, credit ratings, counterparts, maturity buckets and top securities to identify any potential losses in the event of default
- Employment of stress tests scenario analysis on the impact of loan and collateral exposure in the event of a given stress scenario

Exception Management

Exception management lies at the heart of any oversight function that a beneficial owner carries out. Ensuring that the lending agent works within the agreed parameters of a securities lending mandate is essential.



A clear and timely process to identify any exceptions is critical for effective risk management and program governance. These checks should be made daily to ensure that no exceptions to the agreed program parameters are taking place and that the program is assuming no additional, unauthorized risk.

Suggested themes to consider include:

- Market/Asset Class and up to Instrument level
- Counterparts
- Limits on Loans and Lendable
- Spread/Fee
- Liquidity levels against market data
- Tenure of loans
- Restricted asset check

As Environmental, Social and Governance issues become more prominent, their inclusion and management within a securities lending program are essential to ensuring that a fund's strategy is being adhered to. Collateral management and voting are considered two critical themes relating to securities lending and ESG investing.

The ability to restrict and recall securities from the lending program using timely information is key to fulfilling these key fiduciary and stewardship responsibilities.

Suggested areas of consideration in relation to the oversight of ESG requirements include the following:

- A dedicated report showing loan details, including loan value, utilization, average fee and current daily revenue being generated
- Upcoming meeting/record date & number of days to record date
- Availability of days to cover metrics (in the event of recall) – client value on loan/average daily trading volume
- Evaluation of recall risk (based on the number of days it would take a security to be returned vs. number of days to the upcoming record date)
- Assessment of the liquidity profile of the loan in the market (utilization, lendable as % of market outstanding)
- ESG metrics (scores and risk) based on an agreed set of ESG data

Liquidity Management

Equally important to any lending program is the ability to understand the liquidity profile of any on loan position and/or piece of collateral received. Having this information allows the efficient management of lending limits and may help to highlight any potential market liquidity squeezes. Asset owners using this information can manage their lending portfolios in line with an investment manager's expectation, to be able to recall and restrict assets more effectively based upon market intelligence.

The following areas to consider include:

- Market liquidity of individual loan positions
- Availability of supply within lending pools
- Use of liquidity indicators and trigger points to highlight potential issues
- The use of liquidity metrics to manage lending limits with Lending Agents

Understand

All beneficial owners should have an in-depth understanding of their securities lending program parameters and their risk profile. In addition, having a true understanding of a program's earnings potential in relation to a specific risk profile is an important consideration. Independent benchmarking is considered best practice. A clear understanding of the program's peer group and the ability to benchmark to an appropriate and well-suited data set is of the utmost importance.

Benchmarking

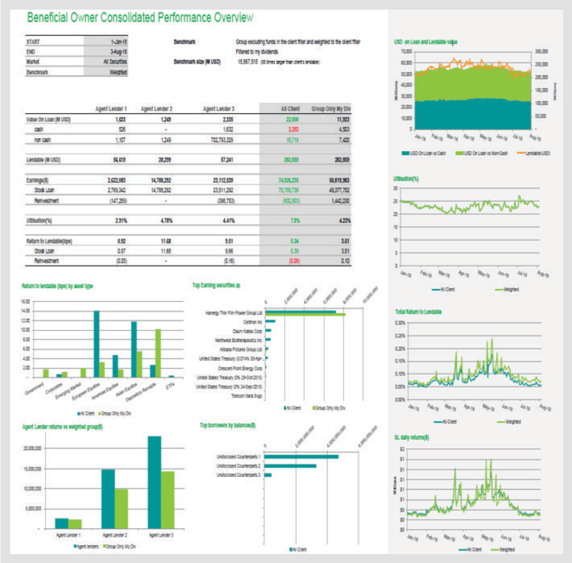
The introduction of Risk Weighted Asset requirements has led to a marked change in borrower behavior. Instead of sourcing borrows directly from agent lenders, most borrowers now look towards internal pools of assets, followed by opportunities in the swaps market before sourcing positions from beneficial owners. As a result, the lending market is becoming more price sensitive as those positions being lent are becoming the harder to borrow stocks. Benchmarking high value positions daily is essential to capturing the true value of any loan. Having an independent oversight process based upon benchmarking can therefore increase returns significantly.

The ability to create a unique benchmark independently that reflects a beneficial owner's exclusive lending parameters is essential to effective program oversight. Using a lender's unique collateral parameters, securities available are weighted to a lendable position. The only way that the true value of a lending portfolio can be evaluated is by only including those funds that actively lend in the benchmark.

Through the effective oversight of a securities lending mandate, beneficial owners can start to understand their program's activity and how it may react under certain situations. This improves a beneficial owner's ability to manage risk and gives them the ability to take a more proactive approach to managing their securities lending activity. By engaging in performance measurement and benchmarking, areas of over or under performance can be identified and discussed with agent lenders. Unrealized revenue opportunities can be identified, and revenue can be optimized within a defined risk appetite. Overlent securities or those loans which have heightened recall risk can be identified and recall risk can be more effectively managed, lowering costs and helping to avoid any market penalties.

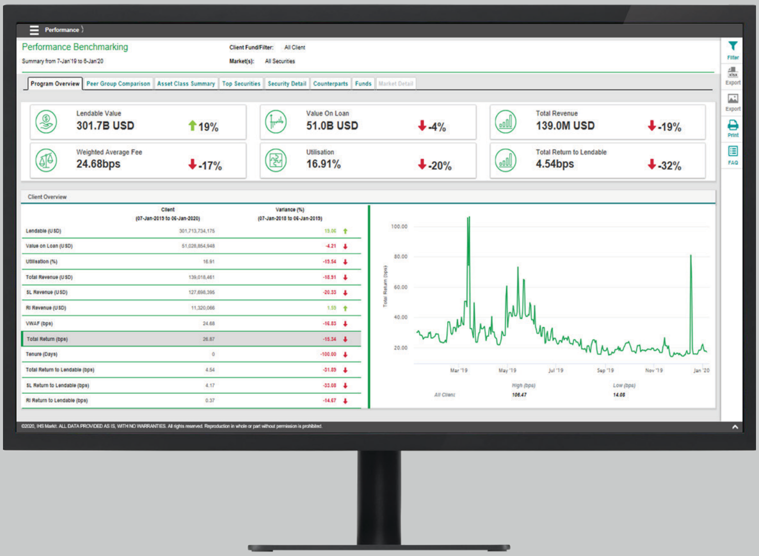
Having the ability to stress test lending scenarios and lending portfolios has the potential to add risk-adjusted returns to any lending program. Suggested themes for consideration include:

- Assessing the lending program using in-depth comparative performance of a beneficial owner's program against its appropriate peer group
- Identifying top market and instrument performers
- Identifying top overperforming/underperforming instruments
- Identifying unrealized revenue
- Recognizing top counterparts by revenue and exposure
- Employing a minimum fee filter



How can S&P Global Market intelligence help?

We continue to see an increasing demand from many beneficial owners, ranging from small Pension Funds to large Asset Managers and Sovereign Wealth Funds, for independent oversight management tools to manage and monitor their securities lending programs. S&P Global Market Intelligence offers a broad range of securities lending services that stretch beyond the typical benchmarking analysis. Our service provides the most in-depth data set available in the market to oversee risk and compliance, optimize trading performance, and enhance investment decisions. We work closely with our clients to determine the best and most appropriate peer group, program parameters and benchmarking criteria to provide an independent performance analysis, as well as to help identify potential opportunities/risks and compliance issues.



About S&P Global Market Intelligence

S&P Global Market Intelligence integrates financial and industry data, research, and news into tools that help track performance, generate alpha, identify investment ideas, understand competitive and industry dynamics, perform valuation, and assess risk.

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