Stock Lending

Addressee

This paper is addressed to the Officers and Pensions Committee ("the Committee") of the East Sussex Pension Fund ("the Fund"). It provides a brief overview of stock lending. The paper should not be released or otherwise disclosed to any third party except as required by law or regulatory obligation or without our prior written consent. We cannot be held liable for any loss incurred by a third party relying on this paper without such permission.

Background

Stock lending has been carried out previously within the pooled passive fund investments which the Fund has held with State Street and Legal and General. However, it has not been carried out by the custodian in respect of the Fund's segregated equity mandate with Longview.

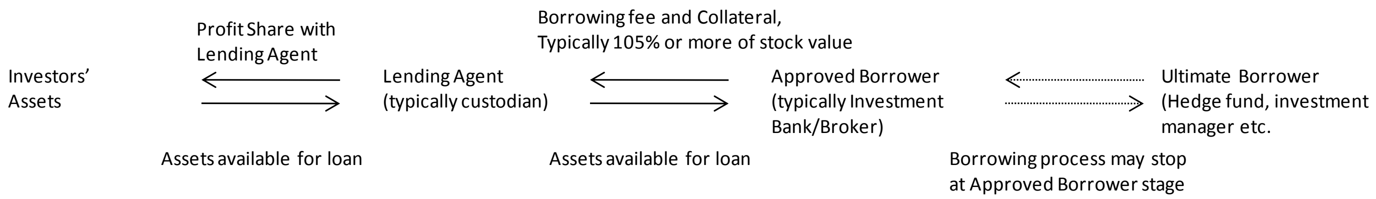
Going forward, it is intended that the sub funds being launched by the ACCESS pool will allow stock lending. It will also be carried out within the passive pooled investments with UBS. As a result, there is specific wording regarding stock lending included in the Fund's Investment Strategy Statement ("ISS").

This short paper is designed to provide a brief reminder on the nature and mechanics of stock lending, the potential risks to the Fund and how these are mitigated by the operator of the programme. In practice, the lending programme is managed by the relevant custodian.

What is stock lending?

Stock lending is an opportunity for pension funds, who are traditionally long-term investors, to extract a premium from their assets by providing liquidity to the market. Securities (mainly equities, though occasionally bonds) are lent to approved borrowers (typically investment banks/brokers) who pay a borrowing fee and who also transfer some form of collateral (typically cash or gilts) to mitigate the lender's credit exposure to the borrower.

Funds typically sub-contract the lending process to an agent, usually the investors' custodian, who has responsibility for recording details of stocks that have been lent and ensuring that risks are managed through the posting of collateral. An overview of the lending process is shown below:



Over time, stock lending programmes can generate an additional return of a few basis points on an investor's assets. However, the amount of income generated from stock lending varies over time depending upon the level of borrower demand, which is driven by a number of factors, including market activity and seasonality around dividend payments. Stock lending is carried out widely by local authority pension funds.

Why do people borrow stock?

Stock lending initially came about as a method to cover settlement failures, i.e. brokers would borrow stock to avoid incurring the costs and penalties associated with failed settlements. However, stock borrowing has become more widely used in the investment industry, with investors borrowing stocks to meet an array of short-term needs, including:

- Avoiding settlement failures;

- Facilitating tax arbitrage opportunities (i.e. where investors domiciled in different countries make mutually beneficial arrangements to take advantage of differences in tax laws). Such opportunities typically occur at the time of dividend payments; and
- Supporting short-selling and hedge fund strategies.

What are the risks involved?

The risks below are managed by the custodian operating the stock lending facility.

Risks	Mitigating the risk
Borrower risk - the risk of the borrower defaulting on a loan	The lender should only enter into stock lending agreements with borrowers they are comfortable lending to.
Intraday settlement risk – the risk of the securities which are lent being delivered to the borrower before collateral is received.	The lender can specify that collateral is received a day before the loan settles. On maturity of the loan, the lender should ensure that their shares are returned prior to or in conjunction with the collateral being released back to the borrower.
Legal risk – the risk that the contract in place does not provide sufficient protection to the lender in the event of the borrower defaulting.	In most cases, it is recommended that lenders seek professional advice when reviewing contracts. Any agreements signed with the borrower should adhere to commonly used market standard documentation.
Collateral risk – the risk that the value of the collateral the loan requires is below the replacement cost of the stocks on loan.	Collateral positions can be reviewed daily. The lender should ensure their collateral policy specifies the types of assets which can be used as collateral.
Cash collateral risk – the risk that on re-investment of the cash collateral, the lender suffers a loss.	The lender should be aware of the level of liquidity risk involved in the investment of cash collateral in the event of investments being sold at short notice. The lender's investment guidelines should provide an appropriate level of risk and return.
Operational risk – the risk of operational matters involved in the day-to-day running of the lending.	Agreements between the lender and borrower should clearly state which party takes responsibility for which operational risk and in what circumstances. All parties should ensure that robust procedures are developed in order to protect against such risks.
Other risks – any non-financial risks, such as ethical or reputational risks which can arise as a result of stock lending.	The lender should ensure stock lending conforms to their policies and investment objectives.

In addition:-

- The custodian operates a pooled facility for assets which are available for lending. This means that if a Fund's individual manager wishes to sell shares, then they can be supplied from the pool without impeding the manager's ability to trade.
- The lender receives payments from the borrower equivalent to any dividend payments made during the lending period.
- Voting rights are lost when stock is lent. Therefore, there may be instances when stock is recalled from the borrower in order to exercise voting.

The collapse of Lehman brothers in 2008 (a large counterparty at the time in the stock lending market) gave some comfort that risk management policies in the market are effective as there was very little disruption for participants and collateral arrangements worked well.

Summary

Stock lending programmes operated on a low risk basis for institutional pension funds have been a consistent if modest source of revenue for pension funds. The practice is intended as a permitted activity within ACCESS and we are comfortable that the Fund agrees to its use within the proposed sub funds.

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February 2018
For and on behalf of Hymans Robertson LLP