Report to:	**Pension Committee**
Date:	**15 June 2018**
By:	**Chief Finance Officer**
Title of report:	**Pension Fund Securities Lending Programme**
Purpose of report:	**To provide the Pension Committee further Securities lending analysis and seek securities lending participation that will generate an additional income stream for the Fund within approved risk parameters**

RECOMMENDATIONS - The Pension Committee is recommended to:

1) approve the East Sussex Pension Fund's participation in the Securities lending programme; and

2) approve the Fund's participation in and compliance with the future ACCESS Pool Securities lending policy.

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1. Background

1.1 Security lending (also known as stock lending) is a long established way to generate additional income for the pension fund within accepted risk parameters. Given the extensive variety of securities within the East Sussex Pension Fund (ESPF), consideration should be given to taking advantage of this additional income stream.

2. Supporting Information

2.1 Securities lending is the act of loaning equity, bond or other securities to another investor via a brokerage firm.

- The borrower provides collateral - in the form of highly liquid securities - against what they have borrowed (in case they don't return the loaned securities).
- The terms of the loan are set out in a securities lending agreement which details the term of the loan, the lenders fee and the nature of the collateral.

2.2 Securities lending is a permitted and regulated activity in most of the world's major securities markets but can only be conducted for specific purposes. When a security is loaned, the title of the securities transfers to the borrower, this means that the borrower has the advantages of becoming the full legal and beneficial owner of the securities, without purchasing it. The borrower receives all coupon and/or dividend payments, and all voting rights. The dividends or coupons must be passed back to the lender in the form of a "manufactured dividend".

3. Practical Implementation

3.1 In order to implement such a programme, a pension fund needs to own a sought after portfolio with the right markets and securities. It is considered that the East Sussex Pension Fund owns such a portfolio.

3.2 With regard to implementing a programme of securities lending, there are advantages to using the Fund's existing global custodian (Northern Trust) and these include the ease of getting started and a certain level of indemnification that may be provided by the custodian. The Global Custodian has existing securities lending programme and a large demand from its current list of borrowers. A significant number of Northern Trust's international securities lending clients are Local Government Pension Scheme (LGPS) funds including the ACCESS Pool, so Northern Trust is experienced in this sector.

3.3 A formal security lending policy report and recommendation will be presented to the ACCESS Pool Joint Committee for consideration at its future meeting. A Securities Lending Update/FAQ produced by our custodian - Northern Trust is attached as Appendix 1.

4. Key Risks and Mitigations

What are the Risks of Lending?	How Lending Risks are Mitigated
Borrower credit risk - Securities 'lending' involves a transfer of legal title to the borrower's name. The lender therefore has a credit exposure to the borrower.	Counterparty Management - The agent will have rigorous counterparty credit management. Lenders can select approved counterparties, set credit and concentration limits to spread risk.
Collateral Quality - all loans are collateralised. Collateral selection is a critical part of the lending programme. Whether to accept cash, fixed income and equities, and the quality of the collateral will determine the attractiveness of the lender to the borrower. There will be pressure to accept lower quality collateral in order to increase revenues.	Collateral Management – the lender (pension fund) has the right to determine the quality of the collateral that is acceptable. The lender must seek a balance between collateral quality demanded and the attractiveness of the portfolio to potential borrowers. For example, high quality Gilts will not be attractive to borrowers if high-quality fixed income is demanded as collateral.
Borrower default - if a borrower becomes insolvent and/or is unable to return a loan on demand.	Over-Collateralisation – Borrowers pledge collateral that exceeds the value of the securities on loan, typically by 102 to 105%. Lenders can raise this for lower quality collateral, such as equities, to 108% or more. Upon default, the agent will sell the collateral and re-purchase the loaned Securities in the market to make the lender whole.
Collateral Shortfall – if the borrower defaults and the collateral is insufficient to re-purchase the securities on loan in the market, then there will be a shortfall. This is relatively uncommon, and usually happens with lower-quality illiquid collateral that cannot be sold quickly.	Indemnification – Many agents and all custodian banks as agent lenders offer an indemnification against collateral insufficiency, and will pay the difference between the loan and collateral value in order to make the lender whole. They will mark-to-market the collateral on a daily basis in order to ensure positions are over-collateralised by the agreed haircut to mitigate this occurring.
Agent default - worst case. The borrower defaults and the collateral is insufficient to repurchase the loan and the agent (custodian bank) becomes insolvent, all on the same day. This has never happened, even with Lehman Brother's default, all the positions were closed within 72 hours.	Creditors – when engaged in an agency agreement, there is no credit exposure to the Securities lending agent per se. The only exposure would be in the marginal difference between the value of the loan and the shortfall that is not covered. The lender would then become a creditor to the agent.

5. Conclusion and reasons for recommendations

5.1 There is counterparty risk within the lending programme. However, the value of Securities lent will be fully collateralised and the net risk after this safeguard is regarded to be minimal. The Fund's investment consultant will advise on the specific lending agreement prior to implementation.

5.2 The Pension Committee is recommended to:

1) approve the East Sussex Pension Fund's participation in the Securities lending programme; and

2) approve the Fund's participation in and compliance with the future ACCESS Pool Securities lending policy.

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Background Documents
None