Insight
Securities Lending

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Well-Functioning Markets Boost Investor Interest in Securities Lending Programs, Despite Lower Returns

Axel Hester
Director of Securities Lending

This update will discuss the key market dynamics impacting returns and risk in securities lending over the past year, and highlight our clients' current perspectives on lending programs.

In general, the supply of securities available for lending outpaced demand in 2020, resulting in lower returns (offset slightly by a period of high reinvestment spreads in the wake of pandemic-related interest-rate cuts). Despite the turbulence tied to the pandemic and the high volatility of the GameStop Affair, securities lending markets continued to function effectively. We continue to see increased interest in securities lending programs, which are increasingly becoming a differentiator for index-based investment management.

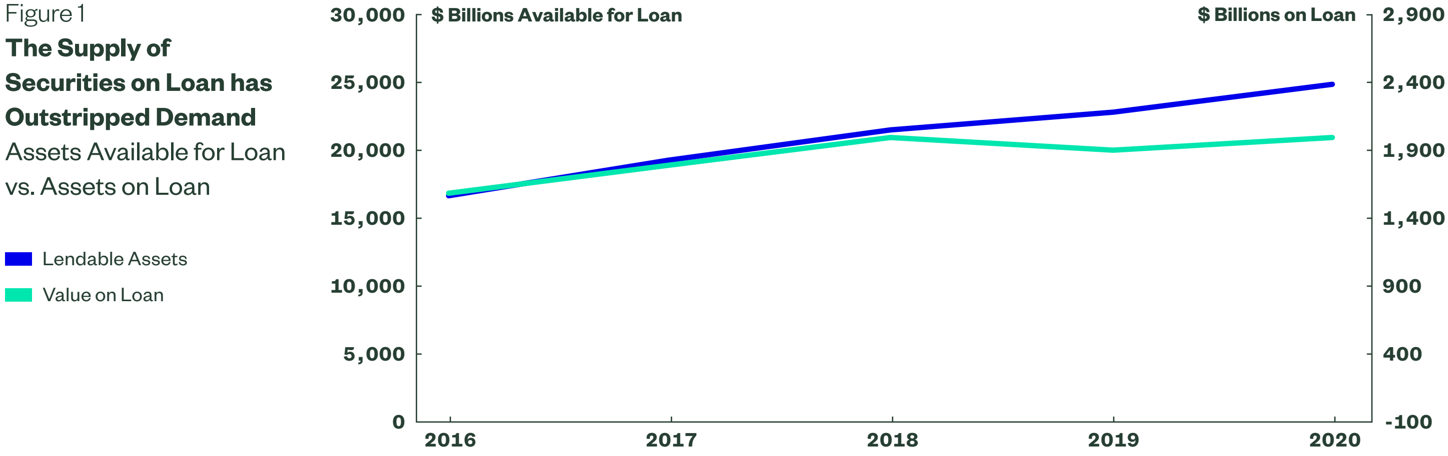
Lending Returns

The past 12 months continued a secular trend in the securities lending marketplace that has been in place since 2019. The value of securities available for loan (i.e., the supply) in the market has outpaced the amount of securities on loan (i.e., the demand) (see Figure 1). When supply outstrips demand, the outcome is predictable: price reductions. That is exactly what we have seen. Average spread per dollar on loan has declined from 45.9 bps to 43.7 bps since 2018. In addition, the compounding effect of lower utilization percentages has resulted in declining return to lendable assets from 4.3 bps to 3.5 bps (see Figure 2).

Figure 1

The Supply of Securities on Loan has Outstripped Demand

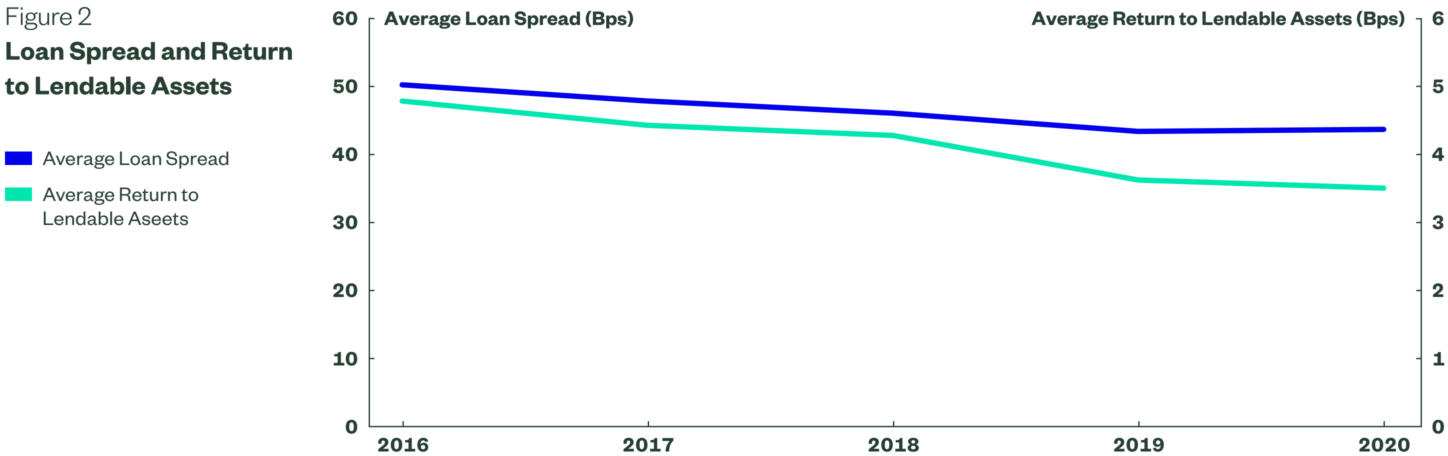
Assets Available for Loan vs. Assets on Loan



Source: IHS Markit, as of 12/31/2020.

Figure 2

Loan Spread and Return to Lendable Assets



Source: IHS Markit, as of 12/31/2020.

That said, this utilization trend was offset slightly in 2020 by high reinvestment spreads attributable to central banks' surprise interest rate eases in response to the pandemic. While international markets tend to have a higher proportion of loans versus non-cash collateral that don't directly benefit from the monetary easing, the US still uses a substantial portion of cash collateral with reinvestment pools that did benefit. This benefit had largely been played out by the end of the third quarter of 2020, however, and reinvestment spreads relative to the benchmark overnight bank financing rate (OBFR) contracted. Credit spreads have also tightened beyond historical norms due to continued monetary support, resulting in lower reinvestment spreads for pools with credit exposure.

In recent months green shoots have started to appear, specifically in the lending markets for government bonds. Revenues are up about 30% on a year-over-year basis mitigating the negative trend across all securities and despite the reinvestment spread contraction. We will have to see whether this trend continues. We expect a positive impact from increased dividends to the seasonal trades in equity markets, which are expected to have some recovery relative to the emergency dividend cuts of 2020 at the start of the pandemic.

Lending Risks

Lending markets have weathered the turbulence that took shape at the start of the pandemic in 2020, and more recently, the high volatility surrounding the short squeezes on GameStop and other retail sector equities. Despite the headlines regarding these two disruptions, the securities lending markets continue to function effectively.

Particular to GameStop, many questions have been raised regarding the impact on securities lending programs. The activity temporarily inflated earnings for targeted stocks as short demand increased, but the securities continued to be available to borrow and settlements continued in the ordinary course. And although some clearing brokers may have requested increased security for trades in the targeted securities, securities lending markets were not otherwise impacted. It should be noted that beneficial owners lending the securities are intermediated from a credit perspective from the end users shorting the securities through large banks and broker/dealers, and the particular securities targeted commonly represent a very small portion of those entities' businesses. As such, the creditworthiness of most borrowers has not been negatively impacted.

Variability in the performance of individual securities lending programs during these disruptions can be traced back to risk tolerances embedded in the program design. Aggressive reinvestment programs during the money market disruptions in early 2020, and programs accepting credit risk of second-tier counterparties, may have been subject to greater concern. Our more conservative approach at State Street Global Advisors focuses on intrinsic value and fared well as a whole. In particular, our focus on liquidity in collateral reinvestment funds, high-quality borrowers on our approved borrowers list, and dynamic management of operational risks has provided strong resilience compared with more aggressive programs.

Lending Programs at State Street Global Advisors

Across our lending programs in commingled vehicles, we remain focused on an intrinsic value approach that seeks to capture all demand value for securities in the lending markets while mitigating excessive risk in the reinvestment of cash collateral. This approach may take different forms for funds domiciled in different countries and subject to various regulatory regimes and market practices, but the objective remains consistent. Where viable, we seek to emphasize the utilization of non-cash collateral to avoid reinvestment risk. In markets where cash collateral still predominates, we use reinvestment guidelines similar to those of SEC's Rule 2a-7.[1]

At State Street Global Advisors, we employ an internal team to review counterparty credits; we do not outsource the function to our lending agents or third parties. This hands-on approach allows us to manage borrower default exposure by limiting lending to only the strongest participants in the market. In addition, our lending programs benefit from borrower default indemnification provided by the lending agents to further reduce exposure. Finally, we manage operational risks through the use of dynamic models that guide decisions regarding lending limits and sufficiency of collateral liquidity.

Client Perspectives

We continue to field increased interest in securities lending programs as investors recognize that the issues associated with the 2008 global financial crisis have been appropriately managed through stronger risk controls and tightened regulation. Strong risk management through the 2020 money market disruptions have also provided further confidence in lending program controls. This increased confidence is contributing to supply outpacing demand, as assets historically on the sidelines of the lending market continue to step in. In general, investors wading back into lending programs recognize that capturing the demand value for securities in lending markets is an attractive risk/return trade-off for incremental return on their assets. This conclusion has been amplified by increased recognition that tracking error and investment management fees continue to decline, leading securities lending returns to take up a more substantial portion of relative performance to an index (particularly for index mandates). Securities lending programs, in other words, are becoming a differentiator for index-based investment management.

Investors considering participation in lending programs are more astute regarding the dynamics of securities lending and associated risks than they have been in the past. They recognize that securities lending is not an on/off switch, but rather programs can have different designs that impact the risk and return a given program can provide. Beneficial owners are seeking programs that match their risk tolerances and are not just chasing the highest-returning lending programs.

In closing, we believe that an intrinsic value approach, focused on demand value and risk management, is most likely to provides the best outcomes for our clients. If you have any questions regarding the market dynamics discussed here, or if you would like more information on risk and lending program structures, please contact your State Street Global Advisors representative.

Endnote

1 The reinvestment funds generally are similar to the liquidity, quality, maturity, and diversification requirements set forth in Rule 2a-7 of the US Investment Company Act of 1940; however, the cash collateral pools are not all registered investment companies, and may not be required to comply with Rule 2a-7. Therefore the investment guidelines for the cash collateral pools may not incorporate all of the requirements of Rule 2a-7, providing the funds with greater flexibility in responding to market conditions.

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Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 31 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third-largest asset manager with US $3.47 trillion* under our care.

* This figure is presented as of December 31, 2020 and includes approximately $75.17 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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Securities lending programs and the subsequent reinvestment of the posted collateral are subject to a number of risks, including the risk that the value of the investments held in the collateral may decline in value and may at any point be worth less than the original cost of that investment.

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