Securities Lending: Runs and Opacity*

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***Note: The views expressed here do not necessarily reflect the views of the Federal Reserve Bank of New York or the Federal Reserve System.**

Opening Remarks

- How do securities loans fit under a discussion of runs and opacity?
- Not all securities loans are subject to run risk, yet the most popular form, the securities loan against cash, can be subject to runs.
- The opaqueness of cash reinvestment combined with the open maturity of most securities loans underlie this exposure.

Discussion Outline

- Terminology
- Transactional Forms & Participants
- Common Indemnification Scope
- Implications Absent Indemnification
- Incentive and Transparency Issues
- Closing Remarks

Distinguish Markets from Transactions

- Examples of Markets
  - Money
  - Collateral
- Examples of Transactional Forms
  - Repo
  - Securities Loans
- Why delineation is useful
  - Various transaction types can access either market

Securities Loan Transactional Forms

- Borrow vs. Pledge
- Securities Loan vs. Cash
- Securities Loan vs. LOC
- Borrow Program

Most Used Forms of SL Transaction

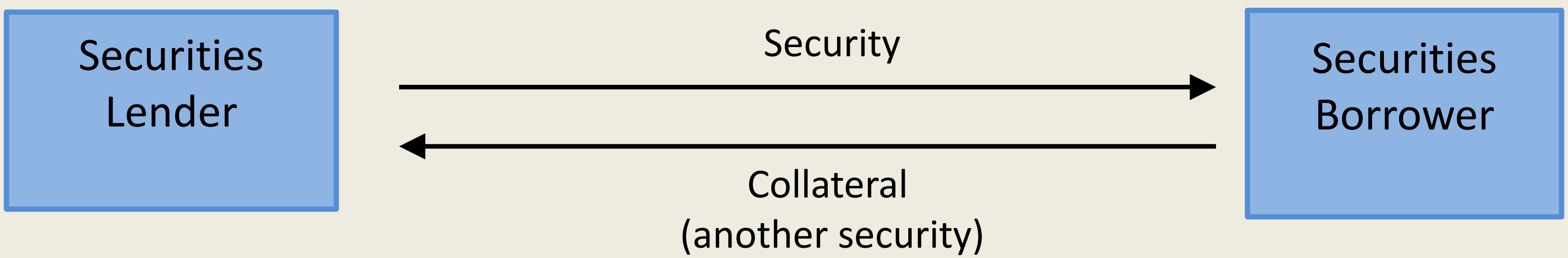
Bonds vs. Pledge

- Simple 2-party structure
- Purely a collateral market transaction
- Used to make deliveries, facilitate hedging and market making
- Little exposure to run risk

Securities vs. Cash

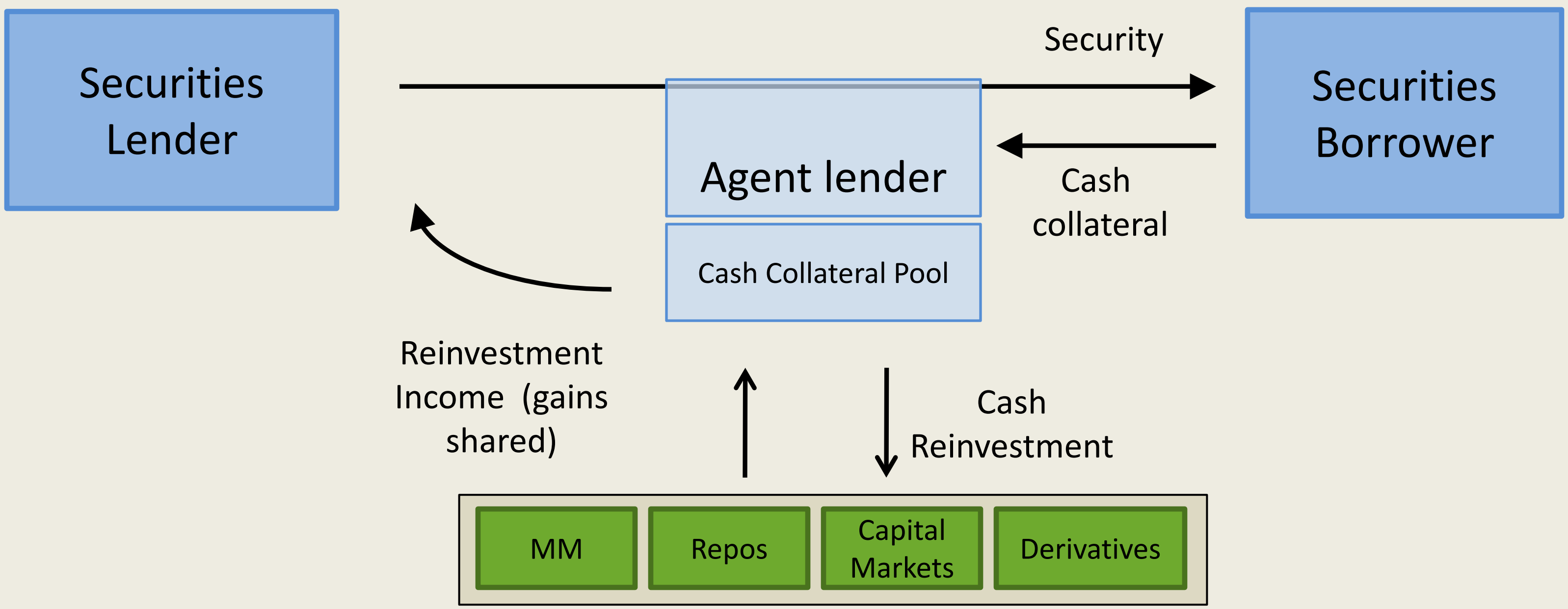
- More complex 3-party structure
- Used to access either collateral market or money market
- Can intersect with both collateral and money markets simultaneously
- Exposure to run risk

“Borrow vs. Pledge” Securities Loan



- Transaction used to access the collateral market (securities are temporarily swapped for a fee)
- Securities lending fee equivalent to differential between collateral market repo rates for exchanged securities.
  - Examples: SOMA lending program and Collateral Transformation (transform for margin, transform to fund less liquid collateral)

Securities Loan Vs. Cash



- Agent lender engages in dual activity; facilitates a loan of security into the collateral market and manages cash reinvestment on behalf of beneficial owner.
- Cash reinvestment expands reach of transaction to money markets, and sometimes to capital or derivatives markets as well.

Run Risk in Cash Reinvestment

- Open maturity standard for securities loans means funding has effective 1-day maturity
- Lacks backstop such as deposit insurance
- Less regulated than money market funds
- Open maturity of SL virtually ensures liquidity or maturity transformation in reinvestment
- Reliance on beneficial owners and internal risk managers to limit scope of reinvestment risk

Introduction to Indemnification

- Useful to review indemnification practices in SL vs. Cash
  - Lending Agents do not indemnify beneficial owners against loss in cash reinvestment
  - Lending agents commonly, but not always, indemnify beneficial owners from loss associated with non-return of the loaned security.

Common Indemnification Practice

- Agents commonly indemnify lenders against non-return of loaned security.
- Agents do not indemnify against loss from cash reinvestment.
- Indemnification protection analogous to securities loan vs. LOC, both collateralized by contingent claims.
- Indemnification supplements or frees cash entirely from collateralization function.

Issues Absent Indemnification

- Cash “collateral” becomes conflicted.
- Conflict arises from simultaneously protecting against borrower default on security loan and funding cash reinvestment.
- If cash needed to repurchase loaned security, funding of cash reinvestment is lost suddenly, simulating a run.
- Sudden funding withdrawal may precipitate reinvestment loss, which is never indemnified.

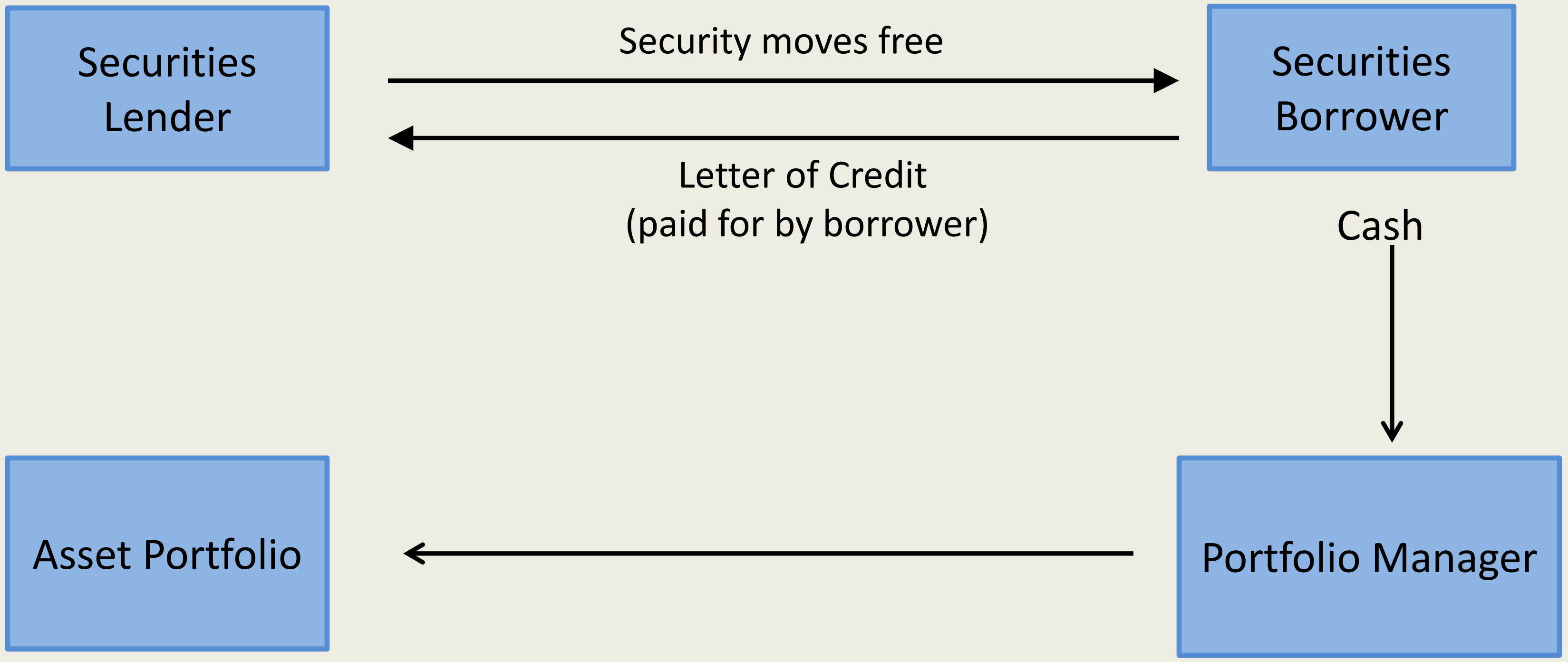
Flexiblity of Securities Loan vs. Cash Supports its Usage

- Supply scarce collateral to the collateral market
- Substitute for repo transaction, can be alternate way to borrow money from collateralized money market
- Transform risk exposure of beneficial owner of loaned securities through levered maturity and liquidity transformation
- Some or all of the above

Securities Loan vs. Cash as Two Activities

- Transaction may operate solely as a collateral or money transaction
- Transaction often intersects with collateral market and other markets at the same time
- Useful to unbundle
- Viewing as two distinct activities helps illustrate potential for run risk

"Unbundled" View of SL vs. Cash with Indemnification



Incentive Issues

- Agents share in reinvestment gains but not losses
- Agent compensation profile similar to a long call option position
- Agent have risk seeking incentive, as high volatility strategies have higher expected payout
- Burden on lenders, cash providers, and internal risk managers to monitor risk transformation in cash reinvestment

Benefits of Increased Transparency

- Increased transparency around cash reinvestment to cash providers useful pursuit
  - Allows cash providers better opportunity to manage credit risk
  - Such visibility to cash providers provides incentive to limit risk transformation in the first instance
  - Decreases run risk

Closing Remarks

- Securities lending is vital for function of capital markets
- Welfare benefits of companion activity of cash reinvestment not as well established
  - Further research needed on social benefits of cash reinvestment
- Agent compensation may unintentionally provide risk seeking incentives for agents
  - Consider adding loss sharing to agent compensation arrangements
- Increased transparency to cash providers may lessen run risk
  - Strong due diligence by cash providers recommended