Transcript

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Episode 58 – Securities Lending

Chris Kunkle - Securities lending is kind of like icing on the cake, but you want good cake, right? So, that first part is your review and getting the good cake. The icing on the cake, if you participate in securities lending, there is a benefit from a performance touch, even for a 500 fund. I think securities lending is a relatively safe activity that helps the funds and other types of clients perform better.

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Emily Larsen - And I'm Emily Larsen. In each episode, we'll explore topics relevant to today's trusted financial advisors, interviewing experts and investigating the world of wealth advising from every angle. We'll also provide you with actionable ideas designed to improve outcomes for advisors and their clients.

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Emily Larsen - Before we get started, one quick request. If you have enjoyed the show and found them a value, please take a moment to leave us a rating or review on iTunes. It would really mean a lot to us.

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Ben Jones - Today, we're exploring the often misunderstood world of securities lending. What are the benefits, what are some of the risks and challenges, and why you, as an advisor, should take some time to understand it. Our guest today is Chris Kunkle, Head of Securities Lending for BMO. And Emily was able to track him down for this discussion in Princeton, New Jersey.

Emily Larsen - As Chris said in the opening, securities lending shouldn't be your first priority when selecting a fund for a client's portfolio, but it should be considered. This episode will help you better understand the securities lending environment and simplify the mechanics so you can easily explain it to your end clients.

Ben Jones - First, let's start at a high level. What is securities lending?

Chris Kunkle - Securities lending, and let's talk about my business, agency lending or agency securities lending. There's two sides of this, this is the borrowers, which are broker/dealers, and there's agent lenders, which are the banks or asset managers that have securities to lend. And agency securities lending, basically, is lending the static assets that are held in clients' accounts

and you lend them to US broker/dealers, UK broker/dealers, Hong Kong or Japanese broker/dealers who need to borrow these securities to satisfy shorts or strategy needs. And so, if a client like -- our clients consist of mutual funds, pension plans, US pension plans, public funds, like state treasures and state teachers associations, global firms, central banks; the Central Bank of England, Central Bank of Korea. The Fed actually has its own lending program, which is a little different. It's called the SOMA Desk. In any event, anywhere there's assets, we can lend them, even insurance companies globally.

Emily Larsen - What types of securities are we talking about?

Chris Kunkle - Everything, except for municipal securities in the US and money market instruments. So, any types of equities, any types of corporate debt, and any types of government securities, like G7, maybe the G20, sovereign debt. So basically, everything can lend.

Emily Larsen - When did this practice begin? How did the need for this product evolve?

Chris Kunkle - When I was a kid, it started. No, basically, securities lending started as a cashiering function between broker/dealers in the 60s and 70s, but it really developed into the 80s, when more robust processes started. I mean, in Europe, Repo, which most people participated in in the 60s and 70s, was a stabilizing business for finance purposes. And it was created in the US for ERISA plans, originally, to be able to lend securities to broker/dealers because broker/dealers could not work between each other to have enough supply, they needed the borrowers in the United States, meaning the broker/dealers that had needs for these securities for regulatory purposes or short sale covering, those type of activities needed to go to where the supply was. And that supply was mostly with these big pension plans in the 70 and 80s. It became very formalized in the mid -- the early to mid-80s with full groups being set up. Interestingly enough, I graduated from college in '84, and was in the broker/dealer side for about nine years before I got into securities lending. So, it was in its earlier stages when I was starting out in brokerage. Now I was not in securities lending then, I was in sales, but interesting timing. But that's about how long it's been around, if that gives you an answer.

Emily Larsen - Absolutely. And then, you mentioned in the response, talking about the supply and locating that supply. In what way are the lenders compensated for loaning out these securities?

Chris Kunkle - Sure. Let me give you a quick idea of what occurs in the securities lending transaction, if you will.

Emily Larsen - Sure.

Chris Kunkle - When you are a lending client, or a lender, and we're your agent, or you have an agent lender that does your activities between yourself and your portfolio and the broker/dealer market. We basically lend your securities to the broker/dealer and take, for the most part, over-collateralized cash, US dollar cash. So if we lend $100M in IBM, we will take $102M in US dollar cash, and then invest that overnight in very safe methodologies; Repo, government money market, these are laddered in terms of how they're invested. So it's according to how the client investment guideline works, but it's very short-term. So, that's a quick and dirty of how a basic securities lending transaction works. So for instance, to put in something that our teams would understand, or asset management would understand or investment advisor who buys a specific mutual fund, if a mutual fund wants to participate in securities lending, such as a Legg Mason or

a BMO, or a MFS or State Street Global Advisors, they basically lend their securities to US broker/dealers or international broker/dealers through their agent lender and, for instance, if you lend a special, or what you call a hot stock, meaning highly in demand, like a Tesla, you would be paid not only a fee by the broker/dealer to borrow that, but you'd also be able to invest at about a -- to a seven-like guideline rate, which is about 1.8% presently. So you would make maybe 800 basis points, plus another 180 just for lending your securities. Now that's gross, so if, for instance, on a loan of Tesla, we would make 100,000, in most cases, you'd have a fee split with the client in the client's favor. That's how this business has evolved. But it might be 70/30. So the client would get 70,000 of that and the agent lender would get 30,000 because we're doing all the activity, we're introducing, we're finding the borrower for that and additionally, we're taking the risk and indemnifying the client from a borrower fail, meaning a default or a failure to return the security. And we're investing the cash collateral also, so we get the smaller portion, but what's fair to process this business.

Emily Larsen - This goes back to something you mentioned earlier. You also manage the demand cycle side of things for the client?

Chris Kunkle - The demand is created by the US borrower in our case, or the international borrower. For instance, if Tesla is a massive short right now by hedge funds, who are clients of Bank of America, Merrill Lynch, Goldman Sachs, Morgan Stanley, so there's never enough Tesla to go around, whereas IBM is what's called general collateral, or easy to borrow. It is not as highly in demand. So, the trading desk in securities lending primarily works to get both general collateral out, in addition to -- that's the harder job, and they actually have to expend calories to do that, while also getting the hard to borrow, or special stocks out, like Tesla. So, for the client, we basically have all their portfolios downloaded into our system on a blind basis. The borrower doesn't see the client, they basically see assets available to lend on behalf of BMO's agency program and this is pretty much how it works everywhere. And we can then negotiate the rate that I described before. If it's a special, you're going to pay us, and we're going to invest safely. If it's general collateral, we have to pay a rebate back to the borrower, and so in a 1.8% environment, we may have to rebate 1.4% of it back. And so, that comes out to a 40 basis point trade. And we're able to split that with the client. And the volume and size is so big, that's where the benefits occur.

Emily Larsen - After Chris provided some background on securities lending, he went on to explain that securities lending runs seamlessly in the background of a fund, and the primary benefit for shareholders is improved fund performance.

Ben Jones - As an advisor, you may want to find out if a particular fund participates in securities lending. Emily asked Chris how someone could go about locating that information, and what type of funds tend to utilize securities lending. They also dove deeper into the differences between hot stocks, also known as specials, and general collateral.

Chris Kunkle - Where you find, if an investment advisor is so inclined, is in the prospectus of the fund. And most prospectuses, even if the fund is not actively lending, will have a disclaimer that says this participates in securities lending. The trustee has deemed it beneficial, and then the way to see if it's actually participating in lending is to look at the financials and you'll see the outstanding shares on loan versus the outstanding collateral maintained in the prospectus. You know, securities lending helps mutual funds – or 40 Act Funds investment performance or offsetting fees, but it's not usually something that an IA would look -- or a financial consultant would look at to really check. It's just an added benefit.

Emily Larsen - I get a sense that it's -- right, since it's is in the prospectus, it's determined on a fund by fund basis if they'll participate in securities lending activities, correct?

Chris Kunkle - In many cases, you'll have a family of fund that signs onto it and then we'll just constantly peruse the portfolios to see if there's anything available. A few years ago, Sears went special. So, these things were formally large cap securities. Sears became temporarily, and I think it still is a hedge fund. I mean, it's just parked -- it's basically all these investments. So Sears really doesn't sell Craftsman Tools as much anymore as do a variety of investments and other sub-products and processes. So, that's, for the most part, a family of funds will sign up. So if it's Vanguard, the Vanguard Admiral -- the whole Vanguard group lends in all the three family of funds - I believe they have three still - across different asset classes. So, for instance, Emily, a municipal bond fund will not lend. Something in a -- it's just munis have never been of interest. There's no reason. No one shorts them, they're very -- and it's not that people short US treasuries, either, it's the people use them for other activities, like collateralization, financing. So, again, we constantly peruse our clients' assets. They buy new things. They might have owned IBM and no Tesla and all of a sudden, one of their portfolio managers buys Tesla in a mid cap or small cap fund, and they're off to the races, as they say. So, that's kind of how we operate.

Emily Larsen - Do you have a sense of if it's a majority or a minority of mutual funds that actually do utilize sec lending?

Chris Kunkle - It's a vast majority. Floats between about 75% and 80% of most mutual fund companies that can participate, and most large RIAs or 40 Act Funds in the US participate. And many of them overseas also do.

Emily Larsen - You talked about hot stocks and the comparison between easy to borrow hot stocks, and then general collateral. Can you talk about these hot lists and what drives those lists?

Chris Kunkle - Sure. So, hot lists, or hot stocks or specials, as they call them, are driven by borrower demand. For the most part, in the United States, stock borrowings are driven -- equity borrowings are driven by demand, whether high or low. And for the most part, there might be about 100 stocks out of the 4,800 that -- I think there's 9,000 and change of total equities on all exchanges in the US and NASDAQ, but -- that have a beneficial price that aren't on the pink sheets, let's say. And of those, there's about just under 5,000 that are in demand. And of those, there's probably 200 that are hot. And by hot, I mean that earn 50 basis points or more, and that's a definition that hot is driven by high demand. So like, for instance, Tesla. There's instance where something can be out there for 1,000% one day, and those stay out for a few months. We only do overnight loans, we don't do term loans. So every night, we re-price them, but they might be re-priced at the same amount and that gives our clients comfort that we're not locking up their position if they want to sell it or they always have the right to sell it. But they -- those in-demand stocks are driven by deals going on. Tesla, up and down like the cars and ships they make, rocket ships they make. I mean, if someone's concerned about a company or a hedge fund shorts it, and hedge funds account for about 35% of the hot -- maybe 35% to 50% of the hot stock borrowings in the United States. And their clients want to be able to short those stocks, which isn't necessarily a bad thing. If you think about it, shorting stocks creates liquidity in the market. So, if a stock can go up, it also should be able to go down. Not that you want that, and even if you short a stock, it just creates a certain stability of liquidity for that stock. Otherwise, it could come up massively or increase artificially and massively, and a short against it kind of keeps it growing a little slower, let's say. So, that, the creation of high demand is what drives hot stocks. We have a list of about -- we monitor probably 100 of them, but there's

probably like 50 to 60 that really are in the 90s, let's say.

Emily Larsen - Wow, okay.

Chris Kunkle - And above.

Emily Larsen - Let's talk about the non-specials. The general collateral and things that are most commonly lent, can you tell about those?

Chris Kunkle - Yeah. So, primarily, what drives the non-special or general collateral markets are the demand for equities by US borrowers that need to reverse those out versus equity repo for financing purposes. So think of it as a two-way trade for a borrower. I'm lending my IBM that isn't that highly in demand, but I can lend it and get, between the rebate and the investment, I can get a spread for the client. And the borrower takes that equity that it doesn't really need, but it always needs to be financing. So, it will then take that equity and put it out to another broker/dealer or another bank for what you call a reverse repo to get funding. So the bank wants to invest to make a yield, so they will -- the borrower will put that equity that it’s borrowed from our client back to another entity and use that as collateral. So they get another amount of cash for a different purpose and it actually has a different regulatory capital requirement, so it's more beneficial in their favor. And there's also -- yeah, people short IBM. I mean, people, when they see it going down or grandma has a physical stock she still has. She has her 200 shares of Disney. She decides to sell it because she's going into the -- she's getting present for grandpa and she forgets to bring it into the broker/dealer for three days. So they have to go out -- regulatorily, you have to have 140% of any short stock you have at a broker/dealer. So, if you -- she forgets to bring that stock in so you can sell it on T+2, trade date plus two, the broker she's at has to go out and find a stock to cover it from a regulatory standpoint. So that's another reason that it's not all just hedged funds.

Ben Jones - Since a majority of large funds participate in securities lending, you might be wondering if it's something that you and your clients should ever be concerned about. Emily asked Chris about the risk of securities lending, as well as what happened during the liquidity crisis in 2007 through 2009.

Chris Kunkle - During the liquidity crisis, a few entities had hiccups, and actually, some had some bad things happen, mostly around the reinvestment. If you think about the risk area of securities lending, it's borrower default or a borrower failure to return securities. Secondarily, it's operational expertise, which any agent lender should -- that's still in the game should have very good operational expertise. And for those first two areas, you're indemnified. You, the client. If you have a situation where a borrower takes two days to -- extra to return securities or it just goes into default, like Lehman, you have excess collateral with which to liquidate. And I can describe the Lehman fail in a little bit. But if -- the third area of risk is the reinvestment, and that's one of the areas that has been watched since '08, '09 is what is being reinvested. If you think about it, back in '07 or '08, a lot of even money market funds had structured investment vehicles, SIVs, that were -- they were a very small component, but they could have caused many of the money markets to drop below a dollar. They might've gone to 0.994 or point -- because you couldn't own more than 3% of that type of investment in your portfolio. And within that 3%, you had to be diversified even amongst the structured investment vehicles money markets were buying. But that affected securities lending too, and the clients. So you have to really be diligent in what you're purchasing and the clients had authorized that, as an investment, so it was very hard for them to countersue unless there was some negligence that there was deemed, so the regulators are looking for a few things. They're looking to make sure

excessive risk isn't added back over time. Everyone gets comfortable with risk and then maybe trying to get yield enhanced. They also want to make sure liquidity isn't affected too bad, so they're being careful to say okay, we need to make sure there's liquidity in the market and security funding is a part of that. We provide flow of assets into the market when there's a demand.

Emily Larsen - So I do think we could talk a little bit more about '08, '09.

Chris Kunkle - I think the biggest punishment was on separately managed pension plans and public funds and separately managed on their reinvestment side. So mutual funds did okay. There were a couple things:

One - Mutual funds during the liquidity -- there was a situation that was called a short restriction, so Christopher Cox before the former chair of the SEC, put a financial stock short restriction on 19 stocks and all of a sudden there were a lot of financials corporations, city and others that you were not allowed to short and then they expanded that, they did it about six to eight months later, they had another short and they took it off restriction after three months and about six months after that they put another short restriction on there. They called it a financial stock short restriction. Meanwhile, that got about 1,100 stocks on it including Google and some of these great names. How they became financial stocks I don't know and then that came off restriction again so again it was a free market and Mr. Cox after he retired basically stated that both the uptick rule for shorting a stock and the short restriction was probably one of the bigger mistakes that the SEC has made. It really didn't do anything. And just caused havoc for liquidity on like PNC and Citi and others so that's point one. And then Lehman US claims default, Lehman UK trying to decide what it's doing overnight so we're all in the office and I was at Wachovia at the time running the management team of an agency lending product, you basically have a borrower that's also a primary dealer, which is a massive borrower and repo counter party to the US treasury market going into default. Well the good news is for the most part any large programs got most all of their treasuries back from securities lending and repo transactions Monday afternoon and their equities came back for the most part Tuesday, Wednesday and Thursday which was within the standard settlements cycle of a recall process so anyone lending with the biggest agent lenders, or even the medium tiered agent lenders should not have lost money because we all got our securities back. And the reason was is that a trustee came in Monday morning. I think they were actually in New York at the request of the Fed on Sunday night and we all turned off our mark to market systems so Lehman could not mark against us, meaning stocks were dropping in price so Lehman could have asked for their money through DTC or the automated process. Lehman could have asked for their money back. Well each day now I think on Monday night instead of being 102% over collateral we were 111% collateralized. By Wednesday when I was at Wachovia we were at 119% collateralized and we were not providing any money until you returned our securities and the trustee just wanted to return the securities and get their extra money back because that was -- and billions and billions and billions of dollars that's most banks had 19% extra. That was a smart deal in a situation where if you allowed them to mark, they would just say ah just keep my money. I'll keep your securities. But there was a huge financial incentive and that's the safety built into this system, of how it works with a defaulting party, so that's kind of an example during the liquidity crisis of what occurred with the return of securities. Now the consequential period for the next few months if Merrill Lynch being at risk, I think Bear Stearns was purchased at a bargain basement price by JPMorgan, you had stocks dropping in price, you had some other things going on so you had some people getting nervous including mutual funds, pension plans, so they might request a recall securities and mutual funds for the most part it made boards nervous and so what they did is probably about 70%+ of mutual funds were participating. It might have dropped back to

about 60% at that time, maybe 62% in the US and now it's back well up over that amount.

Emily Larsen - And so how does the market affect returns?

Chris Kunkle - So securities lending either likes an up market or a down market, we just like some direction. The second thing it likes is a tightening environment from the Fed because that allows you to make a little more revenue on general collateral for the client so from '07 '08 to just last year Treasury lending got way low. Agency lending, US government agency lending was wiped out. A part of that was just driven by the SOMA Desk at the Fed. If you think about the Federal Reserve, they created a desk during the liquidity crisis after QE1, QE2, and QE3. They had all these assets sitting out there that were a little junkier so they created their own lending desk and they don't have a cost of capital, so they don't have to calculate -- they were making five basis points because they had inexperience on the trading side. Okay, we'll lend these out, make five basis points, but those were securities, they didn't have a demand hierarchy, so you had clients that were used to getting 65 basis points and now borrowers were going to the Fed first. It made sense. I can get cheap securities over there. Problem was it created a disinterest for about three to five years. It's just starting to come back with interest rates coming up so you know a down market or an up market helps us. A flat market you know you survive but I was just seeing today on CNBC that we're in -- we're working our way to set up a -- if we can get one more year out of an up market we'll have equaled via ‘81 to ‘91 periods. That'll be the longest expansion ever, that's if we get there.

Emily Larsen - Many lessons were learned from the liquidity crisis which resulted in new regulations being adopted to improve reporting as well as help people understand the risks associated with securities lending. As Chris mentioned, securities lending provides an incremental revenue opportunity with robust risk mitigation processes built into the system. Chris shares a final thought:

Chris Kunkle - I wouldn't go at it from a fearful standpoint. I think there was a period of time about eight years ago that some HR departments asked BlackRock to create non-lendable ETFs or non-lendable mutual funds so those mutual funds underperform sometimes by a percent, and BlackRock really didn't have a problem with their securities lending performance or the liquidity crisis but some fear struck into others in their DC plans. That's starting to wind its way out. Again it'll always be around to the investment advisor trying to understand more about how securities lending benefits the funds they're investing in it's helpful to really know how it benefits in addition to what some of the light risks are. Securities lending is one of the multiple activities that you can do, that you can increase performance as we said earlier with a low risk appetite as long as you have good reporting and a good provider and I think the people that are providing securities lending for the most part out there are pretty good providers. But you want to make sure that your fund is asking the right questions and that they go out for review, most providers every three years.

Ben Jones - Just to sum up some key takeaways here. Securities lending provides an opportunity to increase returns for investors. While there are risks involved in securities lending there are robust processes built into the system to help mitigate those risks. Advisors can look at the prospectus of funds or ETFs that they select to see how and if they are using securities lending. Funds should review their providers every three years or so to ensure that there's good reporting and solid providers in place. Now hopefully coming out of this episode you feel better equipped to discuss this aspect of fund due diligence with your clients. Additionally we hope that you walked away with some ideas for another aspect of investment due diligence that you can adopt when analyzing investment solutions for your clients' portfolios.

Emily Larsen - Thanks so much to Chris for making time and sharing his expertise on this topic.

Ben Jones - Thanks for listening to *Better conversations. Better outcomes*. This podcast is presented by BMO Global Asset Management. To learn more about what BMO can do for you, visit us at www.bmogam.com/betterconversations.

Emily Larsen - We value listener feedback and would love to hear what you have thought about today's episode. Or, if you're willing to share your own experiences or insights related to today's topic, please e-mail us at betterconversations@bmo.com. Of course, the greatest compliment of all is if you tell your friends and coworkers to subscribe to the show. You can subscribe to our show on iTunes, Google Play, the Stitcher app, or your favorite podcast platform. Until next time, I'm Emily Larsen.

Ben Jones - And I'm Ben Jones. From all of us at BMO Global Asset Management, hoping you have a productive and wonderful week.

Emily Larsen - This show and resources are supported by a talented team of dedicated professionals at BMO, including Pat Bordak, Gayle Gipson, Matt Perry, and Derek Devereaux. This show is edited and produced by Jonah Geil-Neufeld and Annie Fassler of Puddle Creative.

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