

INVESTMENT PERSPECTIVES

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Securities Lending Programs May Be Creating Unintended Risks for Retirement Plan Sponsors

As seasoned retirement plan sponsors well know, securities lending programs are intended to enhance portfolio returns with only minimal increases in risk. But over the past several months, declines in the market value of collateral pools that back these programs have led to unanticipated losses for some plan sponsors. Understanding these losses and developing forward-looking action steps to mitigate them will help plan sponsors align their retirement plans with their specific risk appetite and address their fiduciary obligations.

OVERVIEW

HOW SECURITIES LENDING PROGRAMS WORK

Securities lending programs provide an opportunity for plan sponsors to generate incremental income from an existing portfolio's assets. These programs serve as a short-term collateralized loan by an investor to a borrower in need of a specific security. Securities lending transactions typically include a borrower (e.g., a hedge fund), a lender (e.g., pension fund) and a lending agent (e.g., custodial bank) (see exhibit).

The mechanics of initializing a loan involve the temporary exchange of a security for cash or some other liquid, relatively low-risk asset. The lending agent plays an important role in executing the loan and overseeing its performance until termination. Securities lending, which helps meet the demand for securities created by short sales, is an essential mechanism for maintaining liquid, orderly markets. These programs are intended to enhance the portfolio return with minimal risk by translating the demand for securities lending into income.

EXHIBIT

How Securities Lending Programs Work

A: Loan Initiation

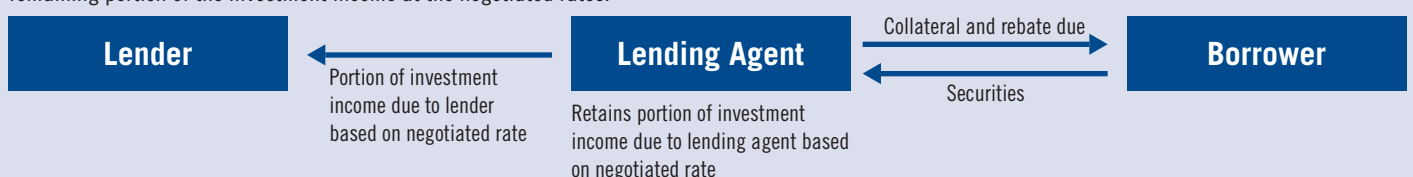


B: During the Course of the Loan

The lending agent invests the collateral and manages the process.

C: Termination of the Loan

The borrower returns the security and receives a negotiated rebate from the lending agent (i.e., return on collateral). The lender and lending agent split the remaining portion of the investment income at the negotiated rates.



¹Bank that has custody of the lender's assets

²Lend securities of a pooled vehicle whose assets they manage

³Have need for a specific security (e.g., cover a short position)

Credit Crisis Creates Collateral-Pool Losses

Despite their potential to enhance portfolio returns with minimal risk, securities lending programs used by investment managers and plan custodians are under increased pressure. The reason? The broadly defined credit crisis is creating problems with funds invested in collateral pools for the lent security.

In the best of times, how do lending programs enhance portfolio returns? Typically, a fee is charged by the custodial bank to the other borrowing party and the prime broker for borrowing securities. This fee accrues to the benefit of the fund. In addition, the custodial bank will often invest on behalf of the fund the collateral received as security from the borrower.

To increase securities lending returns (which also increases the revenue of the securities lending agent), some securities lending programs have taken on higher levels of risk in the reinvestment of the cash collateral. But over the past several months, rather than increased returns, the domino effect of losses in the market value of numerous collateral pools due to frozen credit markets and defaults has resulted in securities lender losses. This was exacerbated by Lehman Brothers' bankruptcy protection filing last year. To help stem these losses and the illiquidity of impaired securities in collateral pools, lending agents are taking actions, including the suspension of payments back to the fund.

In many cases, custodians have moved to make proactive changes to securities lending programs more transparent, liquid and less volatile. How? By changing future provisions (e.g., eligible investments, duration of the investments held) associated with the program that do not necessarily impact its prior approach. To understand the potential risk of a pension fund, it's necessary to assess the fund's specific investment manager, as well as its custodial agreements and exposures. In doing so, plan sponsors will be able to better align their securities lending programs with their specific risk-tolerance appetite.

Three Pension Fund Risks

Securities lending programs pose three primary risks to pension funds: counterparty risk, operational risk and collateral risk.

- **Counterparty risk** arises when there is a possibility of the borrower (i.e., loan counterparty) defaulting. This risk is typically managed through enhanced collateral adequacy and liquidity provisions. These provisions are marked to market daily (and set at a premium above the value of the securities (e.g., 102% of domestic securities) to minimize the risk.
- **Operational risk** arises when there is a disruption in the lender's investment portfolio due to activity in the securities lending program. These disruptions can be associated with the mark-to-market risk for the collateral received from the borrower or income collection risk by the lending agent from the borrower. These risks are typically managed by establishing automated procedures to handle marking collateral to market and developing lending agent guarantees and backup systems.
- **Collateral risk** arises from credit and interest-rate risk. Credit risk stems from a default in the portfolio in which the collateral is invested. Interest-rate risk occurs when there is a duration mismatch between the outstanding loan and the collateral investment, which leads to losses in changing interest-rate environments. Collateral risk has been at the heart of today's issues with securities lending programs. This risk is managed by establishing minimum credit quality requirements, limiting concentrations in issues/issuers, managing the asset/liability duration mismatch actively and stress-testing the portfolio for its exposure to interest-rate risk. In addition, aggressive negotiations regarding the rebate rate paid to borrowers may help lessen the investment risk, since the hurdle rate required to generate income would be lowered.

How to Mitigate Securities Lending Program Risks

1. Identify the impact of securities lending programs on portfolio returns.
2. Review custodian and investment manager agreements and indemnifications as they relate to the securities lending program.
3. Identify what steps are being proposed by the custodian and investment manager to address specific risks.
4. Determine if the proposed program's investment guidelines for investing received collateral are in line with plan objectives.
5. Assess the pros and cons of adopting an alternative strategy.

LOOKING AHEAD

Today's market environment has led to some unwelcome surprises in securities lending program performance. Defined benefit and defined contribution plan sponsors would benefit from a review of their securities lending programs to ensure they are appropriate for the plan.

Addressing this issue and developing a game plan for any necessary adjustments will help plan sponsors both align their programs with their appetite for risk and fulfill their fiduciary obligations. If you would like help assessing the impact of securities lending programs on your portfolio returns, reviewing custodian and investment manager agreements, and developing a plan of action tailored to your needs, please contact Chris McGoldrick at christopher.mcgoldrick@towersperrin.com or (215) 246-7492.

ABOUT TOWERS PERRIN

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Our Investment Consulting practice helps organizations develop and implement investment strategies. Whether the asset pool is a retirement plan, endowment, foundation, operating reserves or other, we focus on designing the appropriate strategy based on risk tolerances, business objectives, and internal and external governance standards.

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