Securities Lending Performance Measurement

The Need for Modernization and an Industry Wide Standard

Background

Back in 2003, IHS Markit (under the guise of predecessor company Data Explorers) paved the way for greater transparency in the securities finance industry by developing the first benchmarking tools. Since then, the use of data within the securities finance industry has become commonplace, not just for performance benchmarking, but amongst other things: it is imbedded in trading desk algorithms and trading systems; aids price discovery; drives beneficial owner performance reporting; helps with income estimates and projections; helps with intra-day loan management and re-rating; highlights liquidity, illiquidity and depth of market; and estimates short interest.

To some degree, it could be argued that not too much has changed with regards to Securities Lending Performance Measurement (previously referred to as benchmarking). There have been developments and new functionality, but this has not necessarily kept pace with the substantial change across the industry and the structure of lending programmes. The level of divergence and customization in lending programmes has dramatically increased, focusing on adapting to regulatory change, regulatory compliance and maintaining income.

Beneficial owners have typically been less focused on benchmarking, not in the least because there is an almost unspoken sense that it seems to give rise to “everyone seems to win”. From a pure mathematical perspective, when using average returns as the benchmark, in dollar value terms, there should be an equal proportion of under and over performance. But feedback from beneficial owners does not indicate this.

Sixteen years on from those early beginnings, the time is right for an industry wide focus on the issues that drive these outcomes and to establish a global standard so that the industry as a whole - observers and participants - can be confident that there’s one global agreed upon methodology.

The Transition Management industry went through the same process in 2007 and developed “A Code of Best Practice for Transition Managers: The T-Charter”. A sample of the abstract reads:

In response to demands by Pension Funds in the UK and Europe, best practice standards have been adopted for Transition Managers through the T-Charter initiative since 2007. Throughout the Transition Management industry, regardless of their business model of investment bank/ broker, custodian, investment manager or consultant, all Transition Managers now work under a common code of operation and reporting.

Key Issues to be Addressed

Data Consistency

Different market participants have different views on inventory and lendable assets, which can lead to distorting performance measurement outcomes when calculated in a Return to Lendable form (return to lendable is the amount of income generated divided by the value of assets available to be lent). This could mean that two identical funds, both generating the exact same securities lending income, could have differing Return to Lendable outputs, simply driven by differing views of inventory/ lendable.

Common areas of difference are restricted markets, restricted assets, regulatory lending limits, program-imposed buffers, foreign ownership limits on a company, client hold backs and buffers.

Securities Lending Performance Measurement

The term benchmark, in respect of securities finance is somewhat misleading and given broader focus and reform across financial market benchmarks, the term is not relevant for securities finance and hence forward should be known as Securities Lending Performance Measurement.

There is an inherent challenge in the way that the reference rate for Securities Lending Performance Measurement is calculated. In no other part of financial markets is there a reference or benchmark rate calculated where the considerable majority of the input has a zero fee. According to IHS Markit, as of 31 December 2018, global utilization was 9.24% (lendable $19.1trn; on-loan $2.3trn), meaning that 90.76% of the input had zero fee (utilization is the proportion in percentage terms that a security, asset class or a portfolio is on-loan).

Securities Lending Performance Measurement generally weights the assets across the industry to the same size and form as those belonging to the fund being reviewed. This creates a slight distortion (due to different program

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structures, assets not actively lent, etc.) and leads to a higher proportion of funds outperforming (see key issue above). Whilst the implementation by IHS Markit of a new preferred benchmark is aimed at beginning to address this, nevertheless further work industry wide is required. Due consideration also needs to be given to moving towards multiple Securities Lending Performance Measurement metrics (for example - the current SLPM rate, a new active only SLPM rate, return to on-loan, etc.)

Timing

Securities Lending Performance Measurement outputs can be misleading on a short/medium term basis due to timing of trading strategies. This is especially acute around lending activity arising from the European dividend season.

Timing of trade negotiation and trade duration are key drivers in income generation, but outputs can be distorted on any given day, leading to inaccurate Securities Lending Performance Measurement. At some point, this converges (end of European dividend season) but a common approach and agreed set of principles needs to be taken so that apples to apples comparisons can be made on an interim basis.

The example below shows how such timing could create a distortion. For 15 days, (b) would show outperformance, whilst on day 24, (a) would show outperformance.

By day 30, both have the same performance.

7-day loan of $10m notional at 200bps would generate approx. $556 a day for a total income of $3,890. Trade date 16th of month.

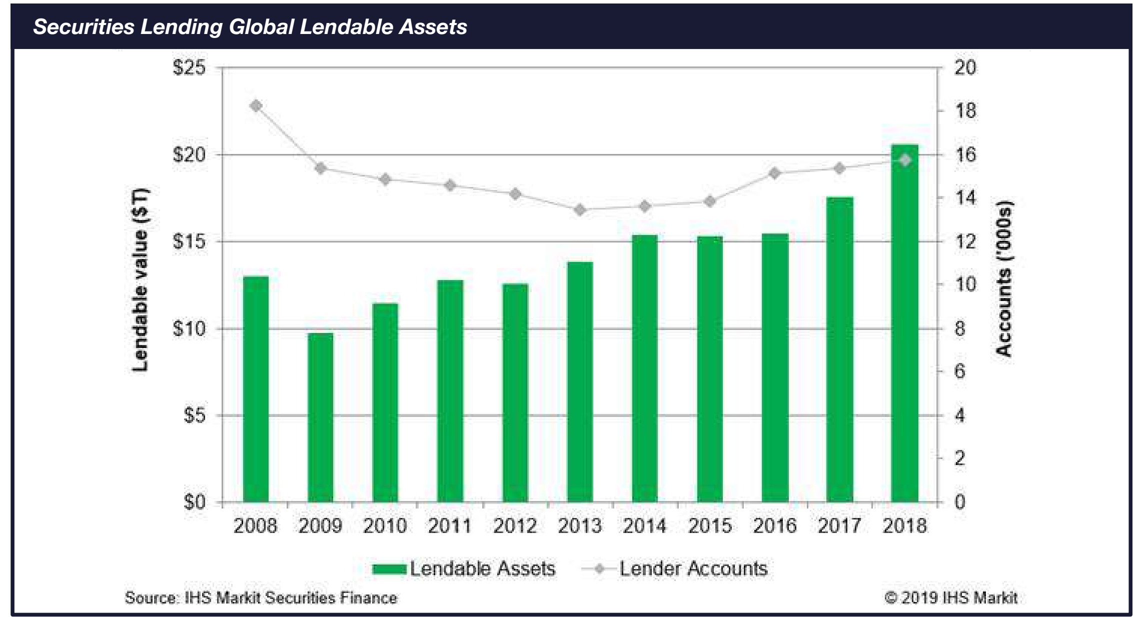
30-day loan of $10m notional at 46bps would generate approx. $130 a day for a total income of $3,890.

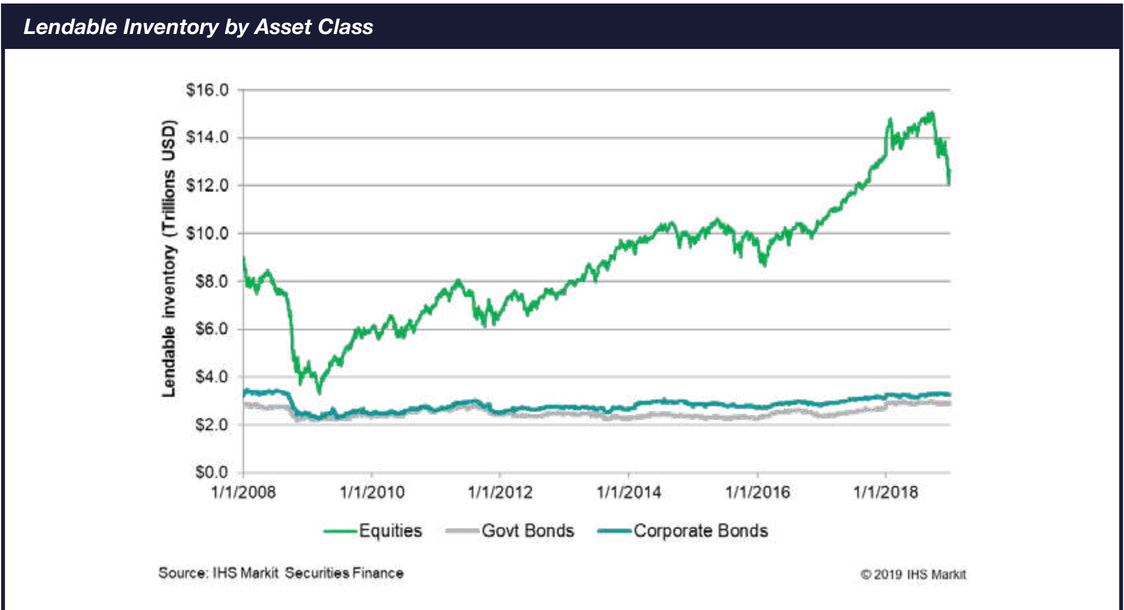
Trade date 1st of the month.

The example below of Total Sa, shows on a single stock differences in fees at different points in time

Optional Trades

A fund's investment objectives will greatly influence how optional trades such as scrips and cash/stock options are approached. For example, a fund that invests for income and an index tracking fund, will usually take the cash option whilst a longer-term investor may more often elect for the additional stock.





At the portfolio level, the latter will usually have the most value (as the stock is often provided at a discount rate), but those forced to take cash have the ability to effectively recover some of this discount via a securities lending trade. Such securities lending transactions usually have exponentially high income and that can disproportionately distort overall Securities Lending Performance Measurement.

This is especially true when a portion of the universe does not need to engage in such transactions as they are already better off from selecting the stock option.

For example: company share price is $10, additional shares offered at 2% discount or $9.80. Dividend of 25 cents. Investor owns 1,000,000 shares.

i. Take stock - gain to investor 255 shares. Value $2,550.

ii. Take cash - $2,500 but to buy more shares at $10 would result in only 250 shares. Value $2,500.

iii. Stock loan trade - lend stock with lender and borrower splitting the gain difference (5 shares at $10 or $25 each). Value $2,525.

In pure performance terms (i) is the best outcome, but from a Securities Lending Performance Measurement Perspective this could show the fund under-performing given that many other funds in the peer group may have opted for (iii) which at the portfolio level is better than (ii).

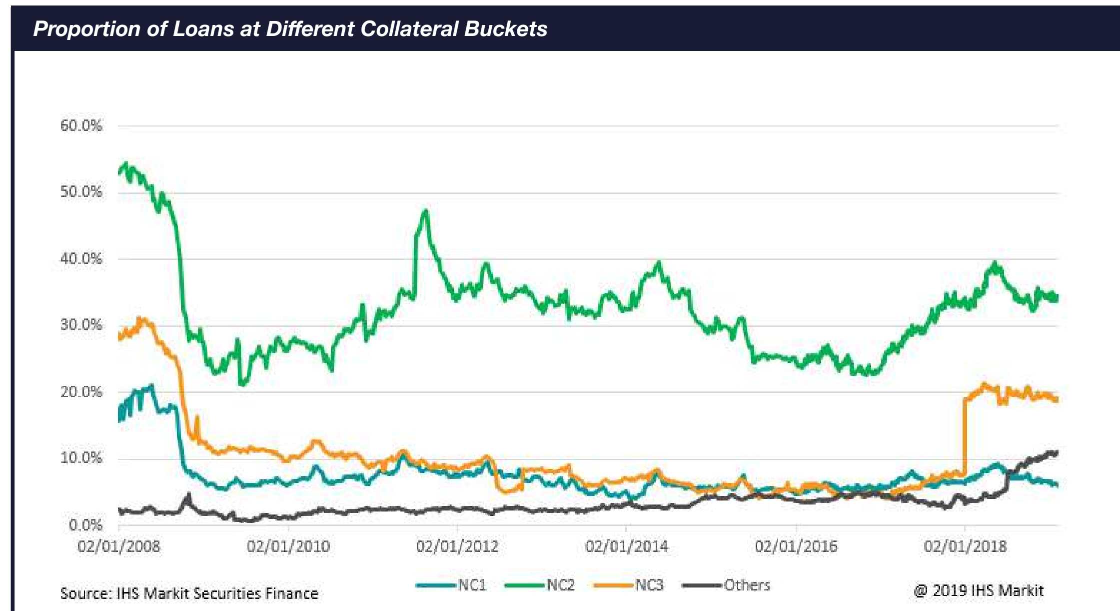
Collateral

In very general terms, pre-financial crisis collateral was either non-cash (AAA government bonds) or cash collateral (invested in 2a-7 like money market instruments). Collateral has considerably diversified now, with a broader range of government bonds, corporate bonds, equities (major and minor indices) and ETFs all being broadly accepted as collateral. New structures such as pledge have also been adopted more recently. In financing trade structures, it is in fact the collateral that drives the fee on the transaction. Many funds take a mixture of different types of collateral (bonds, equities, ETFs and cash, both pledge and non-pledge). For the same security being lent, the fee can vary based upon the collateral type being used (IHS Markit has just updated its collateral profiles to be aligned to the current market). However, when undertaking Securities Lending Performance Measurement, collateral can provide distortions to outcomes. A better process is required to align funds and peer groups to similar collateral profiles and more granular (transaction level) data is required to determine, even when an exact match in profile occurs, where differences arise from collateral choice.

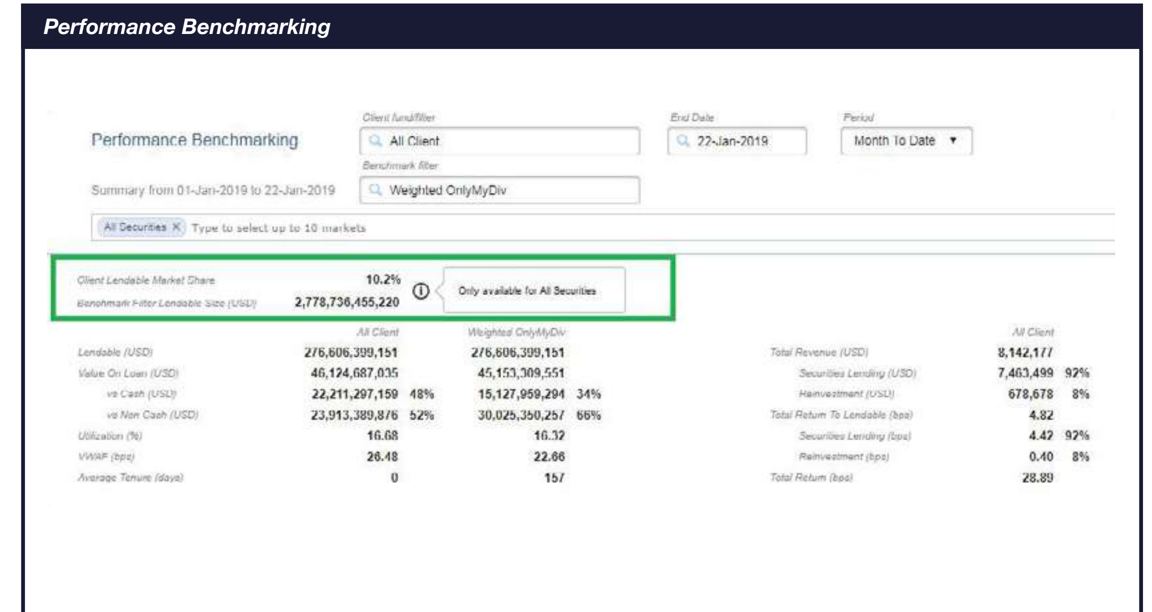
Disclosure

It is not always clear what criteria has been used and/or what the size of the peer group is. This insightful information is useful in developing confidence in Securities Lending Performance Measurement outputs and should always be reported together with the size of peer group.

Proportion of Loans at Different Collateral Buckets



Performance Benchmarking



Accuracy Versus Complexity

With so many variables that can materially impact Securities Lending Performance Measurement, one possibility is to have significant flexibility that allows greater customization in order that there is an exact match between a fund and the peer group. However, such customization is harder to manage, can become too time consuming and lead to comparisons to a peer group of one.

What is the right balance, then?

Conclusion

The securities lending industry has dramatically evolved and has managed to continue adjusting itself to a wide variety of challenges. Customization is now the cornerstone of the industry and beneficial owners can clearly express their risk and reward preferences with finely aligned programmes offered by a broad range of high-quality assets with varying attributes and specialties. At the same time, the use of data has increased and is essential to the well running and functioning of the market. However, as stated, not too much has changed with Securities Lending Performance Measurement in keeping pace or staying in line with the structural and customization developments. This has led to a common view from many beneficial owners that under the current approach "everyone seems to win". There are often many valid explanations as to why this can occur, but the lack of trust and use of Securities Lending Performance Measurement calls for overhaul and modernization. This is not about winners and losers - in fact, a fresh standardized approach will ensure all participants have a more accurate view of their respective program performance.

So, what is required?

There are no right or wrong answers to the issues noted, but having an industry-wide global standard, which all participants adhere to, will eliminate inconsistencies and lead to a far more trusted and utilized methodology. The way to achieve this is industry collaboration. This is why IHS Markit, in conjunction with ISLA (International Securities Lending Association) are launching an industry wide working group to address the challenges with the aim of issuing a global Securities Lending Performance Measurement charter. Chaired by ISLA with representatives from agents, direct lenders, beneficial owners and data providers. The aim is to complete the work by Q3 2019 but allow some flexibility around adoption given the impending SFTR implementation and potential development work.