Introduction

Securities lending is now an established element of South Africa's capital markets. A recent survey of South African lenders estimates that between R17 billion and R20 billion worth of South African equities are on loan at any given time.

Securities lending gives lenders an additional return on long-term holdings. Lending also makes a country's financial markets stronger and more useful to investment funds, with very little downside.

The crux, though, is this: for retirement funds and other institutional investors these benefits are only worth having if they can be had at virtually zero risk. As with ordinary loans, the main risk in securities lending is that the loan is not repaid. Unlike ordinary loans, however, there are measures in place that, if taken effectively, reduce the risk of default to negligible levels.

For retirement funds the proper management of risk is therefore the central issue, and *fund trustees* need to be *satisfied that the risks are appropriately managed*. Hence this guide, which is written from the perspective of the lender, particularly retirement funds. The guide answers frequently asked questions on a host of securities lending issues, but it focuses relentlessly on *reducing the risk faced by lenders*. Readers should note that, by taking this perspective, the guide omits discussion of issues that, while they may be germane to borrowers, are irrelevant to the interests of lenders.

The economic consulting firm Genesis Analytics, which is the author of this document, also conducted the major 1999 study on securities lending in South Africa for the Financial Services Board.

1. The Basics

What is securities lending?

One of the best descriptions of securities lending states that:

Securities lending is the practice of lending equity and debt securities from an investor's portfolio to meet the temporary needs of another party. The borrower agrees to return identical securities to the lender in the future, to deliver collateral of value in excess of the loan and to pay the lender a fee.

Why are securities loaned and borrowed?

The *lenders* - currently mainly retirement and life funds - earn a fee that adds to the overall return of their long-term portfolio. The *intermediaries* - who facilitate the transaction, administer the loan and may provide certain guarantees - also earn a fee for their services.

The *borrowers* have two distinct motivations: they borrow either for settlement purposes or for strategic purposes.

When a broker is required to settle a transaction on behalf of a client and the client's shares are not available, the broker may borrow the securities in order to complete the settlement. When the client's shares are finally available, they are used to repay the loan.

When securities are borrowed for strategic purposes, the borrowed securities are sold into the market as part of an arbitrage strategy, or to effect a hedge. When the loan needs to be repaid, the borrower purchases equivalent securities in the market and transfers them to the lender. In a recent survey of the market, it was found that 73 percent of loans were for strategic purposes.

What is the fee structure in securities lending?

The borrower is charged a lending fee, usually around 90-150 basis points annualised. No matter how short the loan or cheap the securities, the lending fee is never less than a stipulated minimum fee intended to cover the estimated transaction costs incurred by the loan.

In South Africa most securities loans are facilitated by an intermediary. A portion of the fee paid by the borrower accrues to the intermediary. The size of the fee paid to the intermediary differs according to the services it provides, ranging from 10 basis points for purely acting as an intermediary to 50 percent of the overall fee for intermediaries that provide a comprehensive service. Fees charged, as well as the split between lender and intermediary, can change depending on market conditions. For example, fees can reach far higher levels - a total fee of up to 5 percent - when a security goes 'special', i.e. when there is a huge demand for stock in the market and very limited supply. This imbalance typically arises when a lucrative short-term arbitrage gap opens up due to a corporate action such as an unbundling.

Some large institutions lend their securities without the help of an intermediary. Loan facilitation and administration are then done in-house, and the lender assumes all risks. In such an instance the lender retains the entire lending fee.

What are the benefits of securities lending?

A 1999 study for the Financial Services Board found that securities lending has benefits not only for the lenders and borrowers involved, but also for South Africa's capital markets, and hence the economy as a whole. The main benefits are:

- For lenders, it generates an *additional revenue stream* on long-term assets
- The ability to sell loaned securities has a strong positive impact on *liquidity* in tightly held securities listed on the JSE, increasing trade by twenty percent or more. Additional liquidity enables large holders such as retirement funds to increase or decrease their holdings in a share at a lower cost than would otherwise be the case
- Securities lending facilitates the *settlement of transactions*, traditionally the Achilles' heel of South Africa's equities market. During the second phase of South Africa's new equities clearing and settlement system, STRATE, the loan of securities will be critical in facilitating contractual settlement
- Securities lending is a prerequisite for the availability of *cheap and effective techniques to hedge South African equities risk*. These techniques depend on equity index futures that move in tandem with prices on the JSE. Prices would not move in tandem without being pushed to do so by arbitrage activities that require the use of loaned securities.

Is securities lending good or bad for South Africa's capital markets?

The benefits of securities lending for liquidity and hedging techniques are widely accepted. But securities lending has also attracted criticism. Two years ago, some market observers pointed to the volatility on the JSE during 1997-1998, and asked whether the then recently introduced practice of securities lending might not be to blame.

If securities lending and market instability are linked, the critics continued, regulators should prohibit lending. In 1999, the Financial Services Board commissioned a study to investigate whether securities lending is associated with market turbulence. After exhaustive statistical analysis, the study concluded that there was no link between higher levels of lending and market turbulence on the JSE.

The study also investigated a related issue - whether securities lending, and the arbitrage it enables, might set off a spiral of falling prices during crisis periods. The study, after analysing three crisis periods - October 1997, May-June 1998 and August 1998 - refuted this view. It found that securities lending, and the attendant arbitrage, tended to stabilise markets and in certain cases reduced volatility.

The study concluded that securities lending is beneficial to South Africa's financial system and has a stabilising influence on the market. On the basis of this conclusion, the Financial Services Board decided not to place regulatory obstacles in the way of securities lending. Instead, in tax legislation and elsewhere, the government is taking steps intended to promote and encourage securities lending.

The three principles of securities lending

When the securities lending industry first developed, demand for scrip outstripped supply. Lenders' early negotiating advantage is reflected in the adoption of many industry practices aimed at satisfying their demands. Today, securities lending is based on three principles that work to the benefit of lenders:

1. The *'same economic position'* principle states that the lender must (other than having earned the lending fee) be in the same economic position at the completion of the loan that it would have been in had it simply continued to hold the securities in its portfolio.

   In principle, of course, because the lender ends up with equivalent securities after the return of the loan, the value of its portfolio is ultimately unaffected by the loan.

   The 'same economic position' principle is also applied to so-called corporate actions: events such as dividend and interest payments, capitalisation awards, rights issues, share splits and conversions. In each of these cases the borrower is obliged to provide the lender with the same benefits and opportunities it would have had, had it continued to hold the securities. The details are discussed in section 5 of this guide.

   An important *exception* to the 'same economic position' principle is that upon loaning the securities, the lender loses the right to vote those securities at company proceedings. However, should the lender urgently need to exercise its vote, one option is to recall the loan. This can be done in terms of the second principle, to which we now turn.

2. *The right to recall the securities at any time*. The international norm is that the lender has the right to recall the loaned securities at any time for return within the standard settlement time for such securities on the exchange through which they were originally delivered.[1] South African securities lending contracts also provide for a right to recall at any time. Lenders may recall securities for any reason, including wishing to sell the securities, concern about market turbulence, concern about borrower credit quality, or because the lender needs to vote the shares. In the latter case, the quick return of the shares is well within the notice periods specified for annual and special general meetings.

3. *The 'no costs' principle*. Securities lending agreements specify that borrowers are responsible for all costs incurred in transferring the securities, such as stamp duty, transfer fees and marketable securities tax.

What is the fiduciary duty of retirement fund trustees with respect to securities lending?

The 1999 study for the Financial Services Board found that the primary fiduciary duty of retirement fund trustees in the securities lending context is to see to it that the risks are properly managed.

Most retirement funds do not have extensive internal resources to deal with the risk of counter-party default, and trustees will commonly rely on outside firms, whether as service providers or fully-fledged intermediaries guaranteeing return of loaned securities. Some of the larger retirement funds, which were pioneers in securities lending, are exceptions to this rule. *In either case, trustees and their advisors are obliged to manage this process effectively.*

[1] In the ISLA standard agreement, 8.2 subject to 10. The right to recall the securities is either specified, or, more commonly, can be exercised at any time, for return 'within the standard settlement time for such equivalent securities on the exchange or in the clearing-house through which the loaned securities were originally delivered.

2. The steps of making a loan, and ensuring it is repaid

This section sets out the key steps in the securities lending process. The steps can either be performed in-house, in the direct lending scenario, or one of the outsourcing options can be followed.

1. Borrower credit assessment and credit line / limit

Assessing the borrower and setting a credit limit for it is critical to managing risks. An intermediary which is a bank would, after a credit evaluation process, extend a credit line to a counterparty, of which the securities lending operation takes up a part. It is as important for direct lenders to assess the creditworthiness, and to set up credit limits per borrower.

When the lender works through an intermediary, they enter into a master agreement ahead of any actual loan. This agreement may contain a blanket authorisation to the intermediary to lend the shares. Alternatively, the lender may choose to authorise each loan separately. When the lender's main exposure is to the intermediary, the lender is often not informed of the identity of actual borrowers.

2. Negotiating a master lending agreement with the borrower

The person administering the loan, whether the lender or an intermediary, has master agreements in place with regular borrowers. These agreements are usually based on industry standards, with conditions specific to that borrower added. Such conditions may specify what asset classes are acceptable collateral, and how much collateral is required in excess of the value of the loaned securities. The specifics of actual loans are recorded on loan notes, which are sub-agreements to the master agreement.

3. A request from a borrower for specific securities

Once the preliminaries are in place, an actual loan is usually initiated by a request from a borrower with a credit line. The borrower typically asks whether certain securities are available, and what the lending fee will be. Once the securities have been located, the borrower may ask for a right of first refusal or for the securities to be 'put on hold'.

If a second borrower requests the reserved securities, the first counter-party can be asked to 'fill or kill', in other words, to borrow the securities ('fill') or to allow the securities to be loaned to some-one else ('kill' his reservation). How this process is handled by the lender or intermediary may affect whether the lender ultimately gets the best fee.

4. A loan note is drawn up and agreed upon

Once the loan has been informally agreed to, the lender or intermediary draws up a loan note, which is the actual legal loan agreement signed by both parties on the day before settlement. The loan note, which may override the master agreement, fills in all the specifics, including the capacity of parties and nature of contract: description, price and amount of securities; settlement date; type of collateral; amount; additional margin; and the fee.

5. The securities are transferred and the collateral is provided

On settlement day, the securities are transferred on a free-of-value basis from the lender to the borrower for sale into the market. The securities are delivered to the exchange in settlement of the sale. At the same time, the collateral assets should be pledged with or transferred to the lender. When this is delayed, so-called 'daylight exposure' occurs, during which the securities have been transferred, but the collateral has not yet been isolated and pledged. During this period, the risk, whether of the lender or intermediary, is for the full value of the securities loaned. This issue is discussed in the next section.

6. The collateral and loaned securities are marked-to-market daily

The value of the loaned securities and of the collateral will of course fluctuate, and shortfalls are assessed at the end of each trading day. The intermediary or, with a direct loan, lender runs software that recalculates the loan value and, using the additional margin agreed to, the collateral level required. When the collateral falls below the required level, the borrower is required to provide additional collateral. When the collateral exceeds the level required, some of it may be returned to the borrower. This administratively intensive process is critical for the success of the risk management of the loan.

7. Implementing the 'same economic position' principle

When a dividend or interest payment is due on the loaned securities, the borrower pays to the lender the amount that is required to put the lender in the same after tax position that it would have been in had the securities not been lent. This is only one of a number of activities that needs to take place to ensure that 'the same economic position' principle is applied. See Section 5 for others relating to capitalisation awards, conversions, pre-emptions, rights issues, consolidations and share-splits. All of these matters require appropriate systems and continuous monitoring.

8. Termination

The borrower purchases the same type and number of the securities originally loaned, and these are transferred to the lender. The parties ensure that all the 'same economic position' measures have been taken, outstanding fees are settled, and collateral assets are returned to the borrower.

3. Risks faced by lenders of securities

All the risks faced by the lender of securities come down to a *risk of default* either on the return of the loaned securities or on the other obligations undertaken by the borrower to put the lender 'in the same economic position'.

The securities lending process is designed to minimise the risk of default to negligible levels. The main instrument is the system of posting collateral in excess of the value of the loaned stock, and marking the collateral to market on a daily basis. If the *collateral system* works as intended, the risk of loss on default is virtually zero, but the 'if' is an important one. The collateral system is complex, both legally and operationally - hence the prominence of *operational and legal risks* in this discussion, among which *settlement risk* (or so-called daylight exposure) requires special attention. Because of these risks, one cannot entirely ignore the creditworthiness of the borrower, so *residual credit risk* needs to be managed. We look at each of these risk elements in turn.

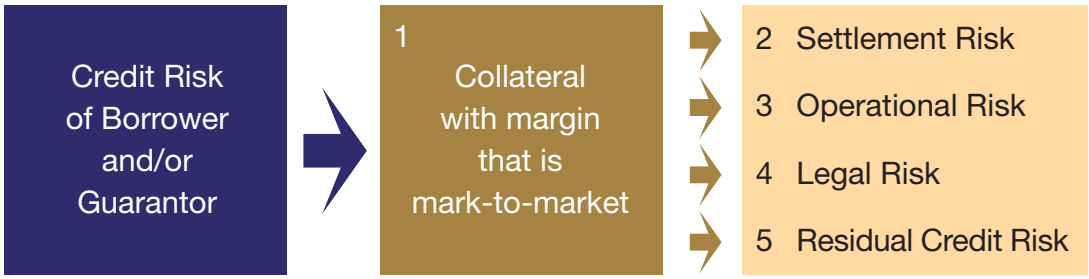

Figure 1: How to think about the risk of default of a securities loan

1. Collateral

The purpose of collateral in securities lending is to reduce the amount at risk for the lender from the full loan amount to virtually zero. The objective is to ensure that the amount provided as collateral is large enough to cover sudden adverse movements in market prices and for the collateral levels to be kept up to date with market movements. This is achieved by a system of 'margins' and 'mark-to-market'.

The collateral most often consists of South African or - in the case of foreign borrowers - G-7 foreign currency. Other acceptable forms of collateral include South African money market instruments such as negotiable certificates of deposits and bankers' acceptances, and South African equities and bonds.

Margins

When the value of loaned securities rises, or the value of collateral falls, or both, the lender might, in the event of default by the borrower, find that the collateral is insufficient to purchase securities equivalent to those loaned. To cover this contingency, the level of collateral required is usually in excess of the value of the loan.

The extent of the excess collateral required is called a 'margin', and it is market practice to set margins according to the type of collateral provided as in Table 1, which reflects current South African market practice:

Type of collateral	Collateral required as % of value of loaned securities
Equities	115%
SA money market instruments	110%
Currency	105%

Table 1: Standard minimum collateral levels in the SA market

Mark-to-market

To ensure that the collateral remains at the required level (including the 'margin'), it is adjusted daily to reflect changes in the value of the loaned securities or of the collateral assets. When collateral falls short of the requirement, a 'margin call' is made on the borrower to top up the collateral. If the collateral exceeds the required value, the borrower may call for a return of a part thereof. This *mark-to-market* process is intended to ensure that, upon default, the collateral is sufficient to fund the repurchase by the lender of the loaned securities in the market.

The effect on the lender's position

Together, the margins and the mark-to-market system sharply reduce the actual exposure of the lender. Without these techniques the exposure of the lender would have been the full amount of the loan. Now, the lender is exposed only if there has, since the last mark-to-market, been an adverse price movement in excess of the margin - and the amount of the exposure is the difference between adverse price movement and the margin portion of the collateral.

Example of actual value at risk. In the case where cash collateral was provided, the margin is 5%. Were the borrower to default, the lender would only be at risk if the value of the loaned shares had increased by more than 5% since the last mark-to-market, and then only to the extent that the price rose by more than five percent.

Two notes. Firstly, even a well-functioning mark-to-market process creates 48 hours of exposure. The required payment is calculated on the previous day's close relative to that of the day before - 24 hour price change - and the borrower has until close-of-business to pay - another 24 hours before default is detected. Therefore the value truly at risk is the extent to which prices can change adversely, in excess of the margin provided, during those two trading days.

Secondly, it is clear from the explanation that it may make sense to require higher margins in certain situations. Three examples are periods of market volatility, borrowing by a less creditworthy entity, and when the values of the loaned securities and the collateral assets are poorly correlated. These refinements are now starting to appear in South African markets.

Dependence on settlement, operational and legal aspects

Lenders should note that while the collateral system dramatically reduces the lender's exposure, its effectiveness depends on how well it is implemented and administered. Therefore, the lender - or its intermediary - needs to have effective arrangements and administrative processes in place to ensure secure settlement of the collateral, adequate collateral margins and timely mark-to-market, and watertight legal arrangements. It should also be noted that with all these elements in place, and the collateral functioning well, there is still a measure of counterparty credit risk, even if vastly reduced, that needs to be managed.

2. Settlement risk

In South Africa, the securities loaned are often transferred to the borrower the day BEFORE transfer of the collateral can be confirmed. During that overnight period, the lender's exposure - or under some arrangements the intermediary's exposure - is for the *full value* of the loaned securities. The risk of the collateral leg of the transaction not being completed is a form of settlement risk, and is also sometimes called 'daylight exposure'.

Settlement delays in cash collateral

In South Africa, settlement risk mainly occurs when the cash collateral is paid by cheque or normal electronic funds transfer (EFT). Both these methods of payment result in an overnight delay in the settlement. During this delay the transfer of the funds is not irrevocable.

Example of cash settlement risk. The lender will usually transfer the securities for settlement on the settlement day. While the borrower may arrange for electronic transfer of the collateral funds on the same day, due to the settlement period of South Africa's electronic funds transfer process, receipt, or clearance, of the collateral funds will only be confirmed on the following day. During the overnight period, the default exposure of the lender (or its guarantor) is for the full value of the loaned securities, as no collateral is yet in place. A similar problem occurs when payment is by cheque.

The effect of the cash settlement problem on the lender's position

Unless performance has been guaranteed by an intermediary, during the overnight period the lender's exposure to the borrower is for the full value of the loaned securities. This exposure needs to be minimised, and residual credit risk vis-à-vis the borrower that remains needs to be managed.

Minimising the cash settlement exposure

Various options are available for minimising the overnight exposure. The borrower may be required to settle the cash the previous day, or to furnish a bank guarantee. A third option, currently only available where the borrower is a bank, is settlement through the National Payments System (NPS). Cash transfers through the NPS are immediate and irrevocable.

Managing residual credit risk

To the extent the settlement delay cannot be eliminated, the exposure that remains needs to be managed as a credit risk. This is discussed below under the fifth risk element, 'residual credit risk'. It is worth noting that, as settlement risk becomes better understood, the method of funds clearance available to borrowers may depend on their financial strength, with only those borrowers with sufficient credit lines allowed methods that create 'daylight exposure'.

Equities and bonds

At this point the lender bears some intra-day exposure when bonds or equities are provided as collateral. The exposure arises from the market practice of delivering loaned securities in the morning but only transferring collateral in the afternoon. With equities as collateral, the possibility that the scrip received may be tainted is a risk factor discussed under operational risk.

3. Operational risk

By now it is clear that securities lending calls for diligent administration of fairly complex processes. Operational risk deals with these issues, and entails risks inherent in day-to-day operations. Important elements of operational risk are:

- Taking in tainted scrip either as collateral or as returned securities
- Proper segregation and pledging of collateral assets
- Appropriate and prompt action in event of default
- Accurate, timely and effective marking-to-market and margin calls
- Proper administration of 'same economic position' procedures
- Accuracy and enforceability of contracts.

Each of these points can sustain a long analysis, and requires much care in implementation. Here we discuss a number of them, as well as the general importance of sound computer systems.

(a) Taking in tainted scrip either as collateral or as returned securities

Until such time that the securities listed on the JSE are all de-materialised, there will be a risk of tainted scrip either being pledged as collateral or returned as repayment of the loan. When that occurs, the credit exposure of the lender to the borrower is effectively increased by the amount of scrip that is tainted. This risk needs to be managed.

The risk of scrip being tainted can be reduced or eliminated in various ways, including scrip settlement facilities, guarantees against tainted scrip, tainted scrip insurance and the validating of returned scrip prior to pledged security being released.

The 'dispossessed shareholders fund' has been set-up as part of the implementation of the STRATE system, to compensate the holders of tainted scrip. Readers should note that this fund does not protect securities lending operations from the effects of tainted scrip.

Ideally, the validity of all scrip needs to be checked with the relevant share registrar upon settlement, but this poses practical problems. To the extent that scrip is not vouched for, a credit exposure vis-à-vis the borrower occurs that has to be managed.

Tainted scrip presents a transitional problem in that it will disappear once all scrip presented as collateral or repayment is on the new STRATE clearing and settlement system.

Bonds

The risk of tainted scrip in the bond trading environment has been eliminated by the immobilisation of the vast majority of scrip in the Central Depository.

(b) Proper segregation and pledging of collateral assets

Unlike international practice, in South Africa collateral is generally not provided by way of an outright transfer. Instead, the collateral assets of the borrower are pledged to the intermediary or lender.

Practically a pledge is created in the following ways:

Cash is deposited in a separate account, flagged as a pledged account, and outflows other than those authorised by the beneficiary of the pledge are barred.

Section E.5(E)(ii) of Exchange Control Rulings stipulates clear guidelines with regards to securities lending transactions entered into with a non-resident counterparty. Based on this ruling only authorised dealers may enter into such transactions provided these transactions are fully secured by cash cover in rands or foreign currency. *Foreign currency* collateral is held in a segregated nostro account of the intermediary with its foreign banker.

Where *equities, bonds* and *money market instruments* are in paper form, delivery thereof must take place to establish the pledge. Where they are in electronic form, they are held in a separate account with the custodian and flagged as pledged.

(c) Appropriate and prompt action in event of default

There has been no reported default on a securities loan in South Africa. Were a default to occur, the procedures of the lender or the intermediary need to work swiftly and effectively. The longer it takes before the collateral is sold and equivalent securities to those loaned purchased with the proceeds, the larger the chance of adverse movements in market prices resulting in a shortfall. Other than the procedural aspect, a comprehensive list of default events is also required.

(d) Accurate, timely and effective marking-to-market and margin calls

Mark-to-market involves an accounting stage, communication of the required flow to the borrower, and settlement of the flow. These actions are well honed in financial markets. Market participants report that daily margin calls are skipped when the day's shortfall or excess is negligible relative to the size of loan and the borrower is a good credit. In most instances this does not materially increase risk. Skipping a substantial margin call, on the other hand, increases the exposure to the borrower and undermines the foundation of the risk management process.

(e) Proper administration of 'same economic position' procedures

The failure of systems can expose the lender in the critical areas of mark-to-market calculation, activation of margin calls, the loading of new deals and the closing out of deals that are settling. Systems capability becomes even more crucial when dealing with counterparties which have a lower credit standing or counterparties against which no credit risk is desirable. Systems must be able to produce up to date, accurate information as and when required in order for active risk management to occur. Therefore computer failure or inability to handle the required business load can increase risk.

In addition, the system must be able to perform the corporate action processes required to place the lender in 'the same economic position', as described in Section 5.

(f) Accuracy and enforceability of contracts

Legal agreements that are incorrectly drafted or signed can be challenged and potentially reduce the claim of the lender or intermediary on collateral upon default. Incorrectly drafted legal agreements may also effect the margin that can be charged on lending positions and reduce the ability to decline certain types of security that a counterpart wishes to provide.

4. Legal risk

The securities lending industry in South Africa is less than a decade old and relies heavily on novel contractual arrangements. Therefore uncertainty about the legal consequences of certain arrangements - or legal risk - need to be minimised.

The legal status of the pledged assets in the case of borrower default or insolvency.

No case of recourse to collateral after borrower default in a South African securities loan has been reported to us. This means that the collateral set-off mechanism contained in standardised securities lending agreements has not been tested by either practice or the courts.

5. Residual credit risk

From the discussion, it is apparent that, under certain circumstances, the financial strength or creditworthiness of a borrower is still relevant to the lender even though the usual credit management arrangements have been put in place. Among these circumstances are:

- Upon default, if movements in market prices lead to an adverse movement of collateral value relative to the value of the loan in excess of the margin of safety built into the collateral.
- If a borrower defaults and the transfer of the collateral funds was not made prior to default.
- Where shares are held as collateral or shares used to repay the loan are tainted.
- Where the administration of the mark-to-market and margin call processes with respect to collateral has been faulty.
- Where the administration of corporate action repayments has been faulty.

Intermediary guarantee

One way for lenders to eliminate the residual credit risk vis-à-vis the borrower is to require a guarantee of performance from the intermediary. This possibility is discussed in Section 4. Lenders that follow this option need to satisfy themselves of the financial strength of the intermediary.

Credit assessment procedures

The alternative, for lenders that do not want to share a fee, is to take on the residual credit risk. That means that the lender will have to assess the creditworthiness of borrowers, set credit limits for each borrower, and monitor changes in their financial health.

4. Managing lender risks in securities lending

Lenders can choose how much administrative responsibility and exposure to the risk of borrower default they wish to shoulder - with commensurate differences in the proportion of the fee that goes to them. The range of options is likely to increase as the market grows more sophisticated. In this section, we do not attempt to cover all the permutations in lending arrangements. Instead, we discuss the trade-offs and considerations that come into play. The optimal choice for a lender will depend on its situation, particularly its administrative resources and appetite for risk.

Key decisions for the lender

There are two key decisions the lender needs to make. These involve risk and process.

1. **To what extent does the lender want to pass on the risk of borrower default?**

   As Section 3 shows, the default risk is essentially made up of:

   - settlement risk
   - operational risk
   - legal risk and
   - residual borrower credit risk (including that arising from tainted scrip or mismanagement of corporate action repayments).

   The issue for the lender is whether it feels comfortable in assuming these risks. The alternative is to pass on some or all of these risks to an intermediary. To the extent this is done, the lender's exposure is to the intermediary. *The decision of which risks to keep and which to pass on is a critical one for the lender.*

2. **Which of the tasks that make up the securities lending process does the lender wish to perform in-house, and which does it wish to pass on?**

   As Section 2 shows, the most important of these tasks are:

   - marketing (finding and setting up relations with borrowers)
   - credit assessment
   - legal contracts and negotiations
   - loan administration including dealing effectively with default
   - collateral management including mark-to-market and margin calls
   - implementing the 'same economic position' procedures.

   Some or all of these processes can be performed by outsiders. Options range from simply having agents find borrowers to outsourcing all five elements. With the most comprehensive form of outsourcing, the institution gives a general authorisation to the intermediary to lend its stock, thereby no longer authorising on a loan-by-loan basis.

Example : Lending arrangements

Potential lenders will note that the two key decisions - risk and process - each present the lender not just with polar opposites, but a range of options in between. Each combination of extent of process outsourcing and risk transfer yields a particular lending arrangement. Many arrangements are feasible, and each lender has to determine its preference. By way of illustration, we focus on three possibilities: direct lending, the intermediate case of agency, and the fullest outsourcing of both process and risk possible.

1. Direct lending

By lending directly to borrowers, the lender elects to assume the four risks (settlement, operational, legal and credit) as well as to administer the lending process. This is an appropriate route only for lenders with the resources - knowledge, systems and credit analysis capacity - to manage the whole process as well as the risks. The advantage is that the direct lender does not have to share the lending fee.

2. Intermediate forms of agency

This is an intermediate position between the two poles of direct lending and outsourcing. In fact it represents a myriad of options in terms of which more or fewer process elements, and more or fewer risks, are passed on to the intermediary. In the plainest form of this arrangement, the lender outsources only administration - but continues to assume settlement, operational, legal and residual credit risk with respect to the borrower. Lenders that choose this arrangement need to be confident in their abilities to analyse and manage (a) the credit risk of particular borrowers and (b) the capacity and ability of the agent to perform whatever functions are entrusted to it.

3. Comprehensive outsourcing

At the opposite side of the spectrum from direct lending is the option of comprehensive outsourcing. The lender shifts all risks of borrower default onto the intermediary, who guarantees the borrower's performance. Effectively, therefore, the lender relies on the financial strength of the intermediary. At the same time the intermediary performs all the functions and operations, which are appropriate given that it has assumed operational, legal and settlement risk in addition to the credit risk of the borrower. In the most complete form of outsourcing - the lender gives the intermediary blanket authorisation to conduct its lending operations, and no longer requires loan-by-loan authorisation.

Figure 2. shows how the three arrangements relate to the preference of lenders concerning risk and administrative outsourcing. The shadows surrounding the agency option shows that various levels of risk transfer are possible depending on the details of the contract with the intermediary.

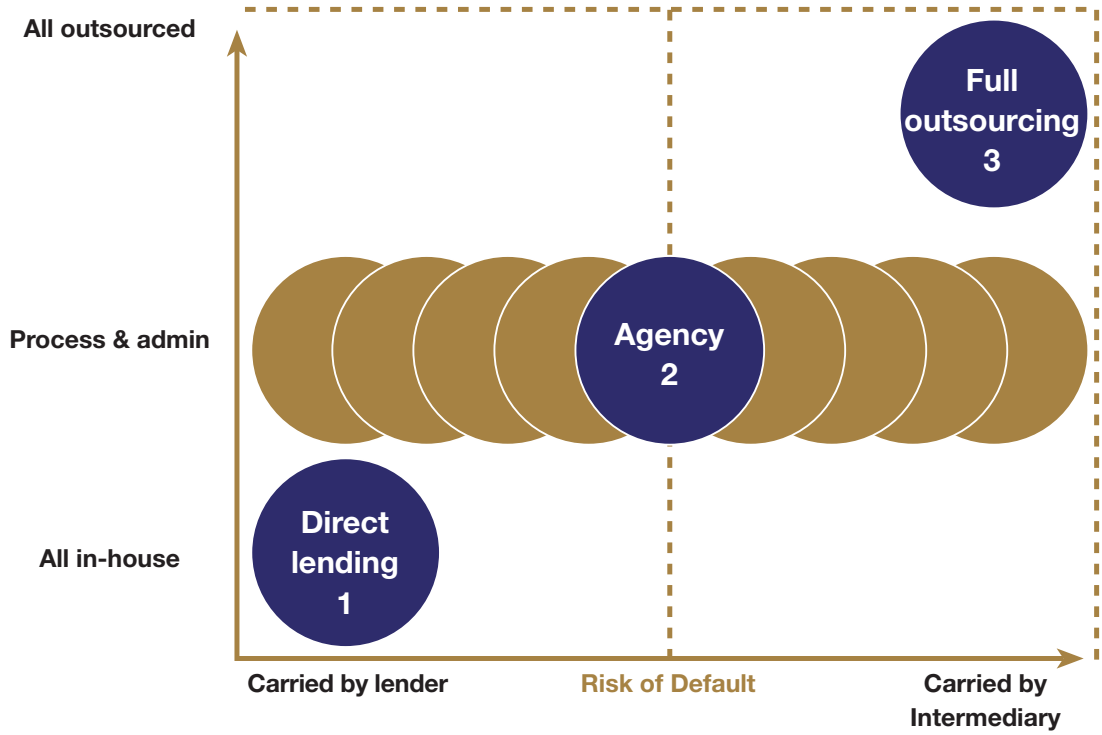

Figure 2. SA lenders' options for arranging securities loans

Access to off-shore borrowers

Foreign borrowers remain a mainstay of securities lending in South Africa. The 1999 Financial Services Board study into securities lending concluded that more than half of all loans by value are made to off-shore borrowers. These borrowers insist on providing lenders with one type of collateral only: foreign currency deposits. In terms of South African exchange control regulations, only banks that are authorised foreign exchange dealers are permitted to hold these cash balances on behalf of lenders. Therefore direct lenders - and those lending through intermediaries that are not authorised dealers - need to ensure that an arrangement is in place with an authorised dealer, or they will be cut off from a large part of the borrowing market.

Another arrangement waiting in the wings?

The arrangements outlined above are not exhaustive. Any number of intermediate arrangements are possible. Also, another arrangement, which is a variation on the 'agency with principal risk' option, may come to the fore. Here, the intermediary does not act as an agent, but borrows from the lender to on-lend to the eventual borrower. While this arrangement is common abroad, it has not been implemented in South Africa due to unfavourable tax implications. As is pointed out in Section 5, a loan which is to be on lent does not qualify for tax relief on stamp duty. This issue is being addressed, the time frame is uncertain.

5. How lenders are placed in the same economic position

The ‘same economic position’ principle seeks to ensure that the lender is placed in the same economic position as if it, instead of making the loan, had retained the securities. The principle therefore requires the lending arrangement to address all the things that can happen in the ordinary course of holding a security, such as: dividend or interest payments, capitalisation awards, conversion, subdivision, consolidation and rights offers.

In short, the arrangement must ensure that the lender has the opportunity to benefit from these events to the same extent as if it had retained the securities. How is this achieved? We look at each of the events in turn.

What happens to capital gains, and how these are taxed?

Actual capital gains
As securities equivalent to those that were loaned have to be returned to the lender at the end of the loan, the lender registers the same gain or loss in the value of the securities as if it had held them for the period of the loan.

Taxation of capital gains
Section 9B of the Income Tax Act allows a taxpayer to elect to treat the proceeds of the disposal of an “affected share” as being of a capital nature. An “affected share” is one that has been held for an uninterrupted period of at least five years.

Section 9B makes specific provision for share loans and provides that if a loan is in terms of a “lending arrangement” (referred to more fully below) then the lender will be deemed not to have disposed of the share in question.

As far as capital gains tax is concerned, the 2001 Taxation Laws Amendment Bill provides a similar exemption for purposes of securities loans. In terms of the Bill, there is no disposal of an asset by a lender to a borrower or by a borrower to a lender where a marketable security has been lent by a lender to a borrower in terms of a “lending arrangement” as defined in the Stamp Duties Act.

Warning

The exemptions provided for in section 9B and the proposed section dealing with capital gains tax relate only to securities loans which comply with the definition of “lending arrangement” in Section 23 of the Stamp Duties Act, which defines a lending arrangement as:

Any arrangement of agreement in terms of which:

(a) a person (hereinafter referred to as the lender) lends a marketable security to another person (hereinafter referred to as the borrower) in order to enable the borrower to effect delivery of the marketable security under a transaction entered into by the borrower to sell the marketable security; and

(b) the borrower in return undertakes to transfer a marketable security of the same kind and of the same or equivalent quantity and quality to the lender within a period of 12 months from the date of such loan.

Note the underlined parts of the definition. The Practice Note points out that the effect of these is to limit favourable tax dispensation to securities loans to which the following apply:

(a) If the purpose of the borrower of the securities is to enable the borrower to deliver such securities under a transaction entered into by the borrower to sell such securities. If the borrower has any other purpose e.g. to deliver the borrowed securities in terms of another lending arrangement, the stamp duty exemption does not apply.

(b) The borrower must undertake to return marketable securities of the same kind and of the same or equivalent quantity and quality to the lender within a period of 12 months from the date of the loan (prior to 29 June 1998 this period was 6 months).

Virtually all current securities loans are structured to fall within the SARS definition, and to enjoy the favourable tax treatment. Market practice is therefore for intermediaries to act as agents.

Proposed changes

It is worth noting that the industry has been in discussion with SARS to broaden the dispensation to loans with a term longer than twelve months and to loans where the security is on-lent by the borrower. The current wording of the practice note has had an unfortunate effect. It has prevented intermediaries from offering lenders the internationally preferred lending arrangement, in which 'intermediary acts as principal'. This arrangement may become more feasible in South Africa once the tax dispensation is widened.

How is the lender compensated for interest and dividend payments missed?

If, during the loan period, dividends or interest become payable, the borrower pays a similar amount to the lender who, no longer the registered owner of the securities would otherwise receive them. This payment is referred to as 'manufactured' interest or dividend.

What is the tax status of 'manufactured' dividends?

Dividends in South Africa are tax-free, but manufactured dividends are taxable in the hands of recipients other than retirement funds. Practice note 5 of 1999 states the position succinctly:

Securities lending arrangements also normally provide that the borrower shall pay to the lender a "manufactured dividend" in lieu of any dividends declared in respect of the security borrowed from the lender. The "manufactured dividend" may include adjustments for the effects of Income Tax or Secondary Tax on Companies (STC). Any payment made by the borrower to the lender as a "manufactured dividend" is not a dividend for Income Tax purposes and must not be treated as a dividend by either the lender or the borrower. The "manufactured dividend" will constitute gross income in the hands of the lender and will not qualify for the exemption in terms of section 10(1)(k).

When the manufactured dividend is taxable, the manufactured dividend payment is 'grossed up' so that the lender receives the same income after taxation as it would have had it received the actual dividend. The extent of the 'grossing up' depends on the tax rate applicable to the lender.

The taxability of manufactured dividends is why retirement funds are a preferred category of lenders. Retirement, Provident and Retirement Annuity funds are taxed at a rate of 25 percent on net rental and gross interest received by or accrued to them. Manufactured dividend is not taxable in the hands of these funds as they do not fall into either of the above-mentioned tax categories. Therefore borrowers borrowing from these funds do not have to gross up manufactured dividends.

How is the lender compensated for income in the form of securities?

The lender does not forfeit scrip dividends or capitalisation awards that are made to holders of the loaned securities during the course of the loan. In terms of South African market practice, either the borrower is obliged to transfer the appropriate number of the new securities to the lender after these have been issued or the newly issued securities owed to the lender constitute a new loan to the borrower, at an agreed lending fee.[2]

How is the lender affected by corporate actions such as conversion, sub-division, consolidation, pre-emption and rights issues?

The 'same economic position' principle is applied strictly in the event of any corporate action. Where the lender would have been offered an election between two alternatives, or would have received a particular treatment, it can require from the borrower that the effects of its preference or treatment be reflected in the securities returned. For example, the lender can require to be repaid in securities into which those originally loaned out could have been converted in the meanwhile. Sub-divisions and consolidations are similarly taken into account when the amount of securities to be repaid is calculated. If the shareholder has the option to exercise *rights to purchase further securities*, the borrower is obliged to make similar rights available to the lender at no charge.

What about voting rights?

With securities loans the voting power is transferred along with the shares, only to be restored once the securities are registered in the name of the lender upon the repayment of the loan. As mentioned above, the lender has the option to recall the loan in order to exercise a vote at annual or special general meetings. Although unusual, one does sometimes encounter an undertaking by the borrower to procure the exercise of votes on behalf of the lender. This will often not be feasible as the borrower may sell the securities right away or otherwise not be the registered holder.

How can a lender ensure that corporate action administration is properly implemented?

Effective administrative machinery is required to give practical effect to the 'same economic position' principle. Multiple corporate actions such as dividends, interest payments, capitalisation awards and rights issues need to be monitored, and appropriate payments or transfers need to be calculated and effected.

[2] See ISLA Standard Agreement paragraph 6.2

6. International trends in securities lending

Trend 1: A new global master securities lending agreement

The International Securities Lending Association has finalised a revised master agreement to act as a template for securities lending agreements around the world.

This agreement, called the Global Master Securities Lending Agreement (GMSLA), replaces the six-year old Overseas Lending Agreement, or OSLA. It incorporates two other template agreements, the Gilt Edged Securities Lending Agreement (GESLA) and the Master Equity and Fixed Income Securities Lending Agreement (MEFISLA).

The new master agreement has the following aims:

- To incorporate transactions relating to securities (including gilts) and equities under one agreement
- Consequently, to reduce the number of agreements in circulation that have to be amended or replaced in the event of legislative or market change
- To make it less UK specific
- To take account of changes in law, market practices and rules of other organisations, including clearing and settlement systems
- To make it more user-friendly.

The most important changes relate to remedies upon default, and certain aspects of securities given as collateral.

A new remedy upon default

A new remedy will be introduced with regard to a party's failure to deliver securities, whether it is a borrower's default, or failure by the lender to return securities equivalent to those given as collateral, at the point that the loan is repaid. Were a borrower to default, the lender will have the ability either to:

- Terminate the relevant loan and liquidate collateral held to the extent of the value of the securities that the lender failed to deliver; or
- To serve written notice on the other party declaring an Event of Default.

A borrower has similar remedies in respect of a lender's failure to deliver equivalent collateral, except that it has no right to elect to continue the related loan of securities.

Other improvements

The new agreement will improve upon OSLA by dealing with income on both loaned securities and securities forming collateral. Further, the new agreement will deal explicitly with market disruption events, such as the suspension of a security that is loaned or forms part of collateral. The new agreement will make it clear that there is no obligation to exercise voting rights arising in respect of any securities lent or provided as collateral, unless otherwise agreed by the parties. There are also several other changes.

Impact in South Africa

A new global master agreement will not have an impact on existing securities lending arrangements and contracts in South Africa. It will also not lead to an immediate change in the form of agreements in the country. However, over time the force of its example will probably lead to changes in market practices in South Africa, as around the world.

Trend 2: The rise of hedge funds as major borrowers

As markets have become more volatile, and mutual funds face reduced inflows because of falling equity prices, hedge funds are becoming an important - and even mainstream - recipient of investment flows. Within this broad category, it is the classic hedge fund types - those that balance long and short positions and therefore have low net exposure to the movement of the market as a whole - that are attracting the most support. Examples are arbitrage with convertible instruments, and equity arbitrage. These 'hedged' styles can generate returns with little or no correlation with the market. Funds that bet on markets taking a certain direction - distressed securities funds and the directional global macro funds - have, in the volatile market situation, attracted less support.

Because of the increased popularity of hedge funds and their need to complement long positions with short positions, hedge funds are now counted among the most important borrower categories in the securities lending market. In most of the world, including Europe, hedge funds have become a key driver of growth.

Trend 3: Experimentation with the internet

Intermediaries and large lenders in the UK, US, Japan, France and Germany now offer web based lending services to borrowers. Pre-trade, these web capabilities are aimed at enhancing the reporting of availability of lending stock, along with collateral requirements and flexibility. Post-trade, borrowers are provided with automatic contract compare, marks to market, recall of securities and pending settlement reporting. Direct communication with borrowers and lenders should reduce both operational risk and the cost of trades.

Mutant Technology is in the process of establishing Internet-based securities lending exchange, in which institutions will be able to offer or seek loans in a wide range of securities at any time.

Companies are also investigating Internet *auction* systems for the securities lending community. One such system, eSeclending, had planned to auction $120 billion of CalPERS assets for loan during the first quarter of 2001. It is not clear yet whether the auctions have gone ahead.

One challenge for these new forms of matching borrowers and lenders is that both parties must be satisfied that the new systems serve their purposes, or the services will not take hold. Bidders, in particular, have concerns about confidentiality.

7. Glossary

The securities lending industry is as jargon-filled as any other area in financial services. The jargon may intimidate, obscure or confuse: then it serves no purpose. On the other hand, it can be a convenient shorthand, aiding communication between intermediaries, lenders and borrowers. The only thing required to achieve the second, is a decent glossary. This one is provided by the Australian Securities Lending Association, ASLA.

Basis point

One hundred basis points is equal to one percent. This is the standard division of a percentage used in the securities lending market.

Buy-in

A lender buying securities in the open market where the lender has recalled securities and the borrower is not able to return them in line with the securities lending agreement. All costs are normally borne by the borrower.

Collateral

Deposits of currency, financial instruments, or securities, that are delivered by the borrower to the lender to support a loan transaction.

Daylight exposure

Where the movement of securities and collateral does not take place simultaneously, the first giver of assets has an exposure, called Daylight exposure.

Distributions

Entitlements arising on securities, e.g. dividends, interest and non-cash distributions such as bonus shares.

Fee (1)

The fee is the interest rate as charged by the lender and paid to the lender by the borrower on the value of the loan transaction.

Fee (2)

Can also be payment from one party, either Borrower or Lender, to the other party and may not necessarily relate to an interest rate or value of the loan transaction. Can also be called a levy.

Fill or kill

See Holding Stock below.

Haircut

See margin below.

Holding stock

Also known as Icing, is the practice of reserving securities with a lender. The securities are still shown as available for loan by the lender. To other potential borrowers the lender must then show these securities as ‘held away’, and the ‘holder’ of stock retains rights of first refusal. Any other borrower can ask that the holder of stock either take or release the stock (this request is called a ‘fill or kill’). If the holder declines to borrow the stock, the borrower requesting the fill or kill must then borrow the stock. Holds generally apply for 24 hours but this will differ for each lender.

Hot/hard stock

A security for which demand to borrow is high relative to its availability in the market and hence becomes expensive to borrow.

Manufactured dividends

When securities that have been lent out pay a dividend, the borrower of the securities is required to pass on the distribution to the lender of the securities. This payment is known as the manufactured dividend or substitute payment.

Margin

Margin (also referred to as initial margin) refers to the excess of cash (or other collateral) over securities or securities over cash in a securities lending transaction. One party may require an initial margin (haircut) due to the perceived credit risk of the counterparty or non-cash collateral taken.

Margin call

Margin Call extra collateral repaid or paid due to changes in the value of stock borrowed.

Mark-to-market

The act of re-valuing the securities and collateral to current market values.

Rebate

The rebate is an interest rate paid by the holder of cash to the counterparty of the transaction. Usually negotiated between the lender and borrower at the beginning of the loan.

Recall

A request by a lender for the return of securities by a borrower where they are lent on an open term basis.

Repay

Occurs when the borrower of securities returns them to the lender. Also known as a ‘Return’.