VIEWPOINT

SECURITIES LENDING: THE FACTS

BLACKROCK®

MAY 2015

Introduction

Though often poorly understood, securities lending is a well-established practice in the global financial system that provides liquidity to markets while also generating additional returns to investors who lend securities. In the wake of the 2008 Financial Crisis (the "Crisis"), securities lending has come under scrutiny by policy makers globally. In part, this reflects the excessive risk-taking in certain cash collateral reinvestment pools associated with securities lending businesses[1] as well as other risks associated with securities lending that were exposed in the Crisis. Since the Crisis, significant regulatory reforms have been implemented to specifically address cash reinvestment vehicles. The Financial Stability Board (FSB),[2] European Commission,[3] European Securities and Markets Authority (ESMA),[4] International Organization of Securities Commissions (IOSCO),[5] the Financial Stability Oversight Council (FSOC),[6] and Securities and Exchange Commission (SEC)[7] have each reached out to market participants to develop a better understanding of securities lending to identify the risks in the activity and whether enhanced regulation of securities lending practices is appropriate.

In this *ViewPoint*, we explain the respective roles of lenders, lending agents, and borrowers. In addition, we address some of the common misunderstandings that have arisen regarding securities lending and potential conflicts of interest, leverage, counterparties, collateralization of loans, use of cash collateral and cash reinvestment vehicles, the use of non-cash collateral and rehypothecation, and borrower default indemnification. We explain the mechanics of each practice, the risks involved, and how these risks are managed.

Who are the participants in a securities lending transaction?

The securities lending market is driven by demand to borrow securities. This demand is driven primarily by large banks and broker-dealers on behalf of their clients, including other banking institutions or hedge funds. The end-clients typically use the loaned securities to take active positions or hedge against market risk vis-à-vis a short sale or to facilitate settling of trades that could otherwise fail. Collectively, the large banks and broker-dealers as well as their end-clients are referred to as "borrowers".

An asset owner that chooses to lend its securities to enhance the returns on its portfolio is referred to as the "lender". For the most part, lenders consist of large institutional investors such as pension plans, sovereign wealth funds, charities, and endowments as well as a variety of collective investment vehicles (i.e. mutual funds, UCITS, and bank collective funds).

Lenders can either lend securities directly to a borrower or they can do so through a securities lending agent acting on their behalf.[8] The lending agent may be the lender's custodian, the lender's asset manager, or a third party vendor that specializes in securities lending.[9] BlackRock acts as a lending agent for some of its asset management clients.

Mechanics of a Securities Loan

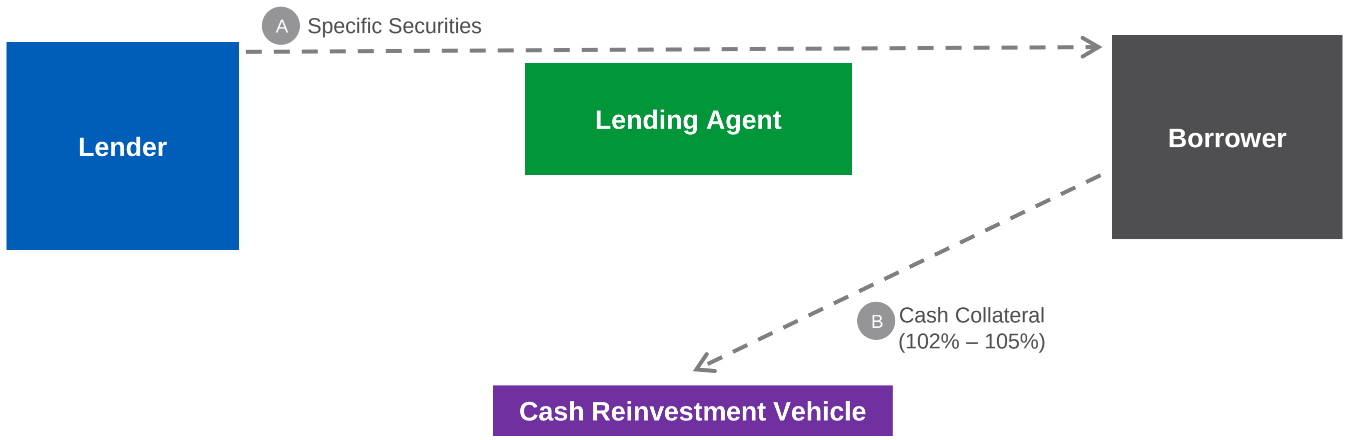
Before a securities loan can occur, several decisions need to be made:

- A lender must choose to participate in a securities lending arrangement and make its securities available to be lent
- A lender must choose whether to lend directly or to appoint a lending agent
- A lender must specify its collateral guidelines, including indicating cash reinvestment guidelines if cash collateral will be received, and
- A lender and a lending agent must enter into a fee arrangement, generally a fixed percentage split of the income generated by the lending activity and the reinvestment of collateral (where applicable).

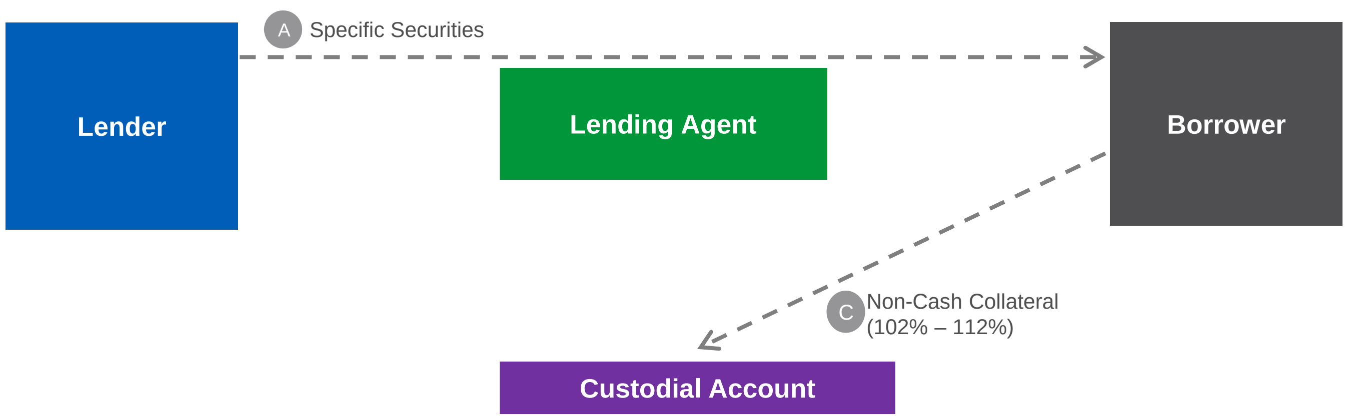
After these decisions are made, the lending agent can enter into securities loans on behalf of a lender. The process begins when a borrower requests to borrow a stock or bond from a lender. In order to borrow the security, the borrower must pay a fee and provide collateral for the benefit of the lender. The collateral is held to secure repayment in case the borrower fails to return the loaned stock or bond. In order for the lender to have a safety cushion to protect them from potential loss, the lending agent requires that the value of the collateral exceeds the value of the loaned security. When acting as a lending agent, BlackRock typically requires borrowers to post collateral between 102% and 112% of the value of the securities lent. The over-collateralization percentage varies depending on the type of collateral posted. In some cases, prevailing market practices effectively determine the level of over-collateralization.

Exhibit 1: ILLUSTRATION OF CASH AND NON-CASH COLLATERAL TRANSACTIONS

Cash Collateral Transaction



Non-Cash Collateral Transaction



Here's an example of how it works:

To start the process:

1. A hedge fund indicates to a bank or broker-dealer that they seek to borrow a security to hedge or cover a short position.
2. The bank or broker-dealer then asks to borrow a stock from a lender.
3. The lending agent requests the borrower (the bank or broker-dealer) to deliver collateral to secure the loan. The collateral can come in the form of cash or securities (referred to as "non-cash collateral").
4. Once the collateral is received, the lending agent delivers the security to the borrower (the bank or broker-dealer) on behalf of the lender. The length of the loan is negotiated at the time of trade, with overnight being the most common term.

While the security is out on loan... *(See A in diagram).*

5. If the borrower provides cash collateral, the lending agent directs the cash into a cash reinvestment vehicle designated on behalf of the lender. This cash collateral is marked-to-market daily and the borrower may be required to deliver additional collateral to maintain the required over-collateralization cushion. The cash collateral must be invested in accordance with the lender's investment guidelines. Where BlackRock is the lending agent for U.S. based lenders, lenders can choose cash vehicles which are managed in accordance with SEC Rule 2a-7 or by Office of the Comptroller of the Currency (OCC) short-term investment fund (STIF) rules. *See B in diagram.*
6. If the borrower provides non-cash collateral, the collateral is delivered directly to a custodial account for safekeeping. The non-cash collateral is marked-to-market and the borrower may be required to deliver additional collateral to maintain the required over-collateralization cushion. Where BlackRock is the lending agent, and non-cash collateral is delivered, the collateral is not used by either the lender or BlackRock, except in the event that the borrower defaults, at which time the collateral would be used to cover the replacement cost of the securities that were on loan. *See C in diagram.* BlackRock does *not* rehypothecate collateral.
7. If the stock or bond pays dividends or interest while out on loan, the borrower must send to the lender what the lender would have received if the security had not been out on loan. (Note we have not included this in the diagram for simplicity).
8. The total income from the transaction is continuously divided between the lender and the lending agent according to the previously negotiated fee split. The lending agent's portion represents its compensation for arranging the loan.

To end the process...

9. At the end of the loan (or when the lending agent requests), the borrower must return the security to the lending agent.
10. The lending agent will instruct the release of the collateral back to the borrower.

Securities Lending: Facts Versus Concerns Raised

As policy makers have begun to review securities lending, several common misunderstandings have arisen regarding securities lending practices and associated risks, including potential conflicts of interest, leverage, collateralization of loans, use of cash collateral and cash reinvestment vehicles, the use of non-cash collateral and rehypothecation, and borrower default indemnification. In addition, there are many misunderstandings specific to BlackRock's involvement with securities lending. Unfortunately, these concerns have formed the foundation of recent policy discussions. We believe it is imperative for policy makers to have all the facts. A recent staff report issued by the Federal Reserve Bank of New York raises a number of concerns about securities lending.[10] In Exhibit 2, we identify the concerns raised and explain how these issues are addressed.

Exhibit 2: SUMMARY OF HOW CONCERNS RAISED ARE ADDRESSED

Concerns Raised	Industry & BlackRock Practices
Potential Conflicts of Interest	
An asset manager can lend directly from a mutual fund for which it acts as securities lending agent to a hedge fund for which it acts as investment manager, potentially suggesting that self-dealing is occurring.	• Consistent with a combination of regional regulatory requirements, market practices, and BlackRock's policies and procedures, BlackRock does *not* arrange transactions between the lenders for which it acts as securities lending agent and entities for which it acts as investment manager. • BlackRock has two broker-dealers for the distribution of mutual funds and other retail sales activity and for agency execution services, as required by SEC rules. Neither of these entities have any involvement in the securities lending markets.
Leverage	
Securities lending introduces a material amount of leverage into a lender's investment portfolio.	• Securities lending does not introduce a material amount of leverage into a lender's portfolio because the effective lending utilization rates are typically quite low and, more importantly, post-Crisis regulations highly constrain the economic risks allowable in cash collateral reinvestment pools. • The intent of requiring collateral for securities loan transactions is to protect against a borrower default and it is designated for that purpose. The cash is not intended as a source of funding to purchase additional assets in a portfolio. • At BlackRock, collateral is held either in a custodial account in the case of non-cash collateral or in a cash reinvestment vehicle for cash collateral.
Use of Cash Collateral and Reinvestment Vehicles	
The use of cash reinvestment pools for cash collateral represents both maturity and liquidity transformation and cash collateral reinvestment pools are subject to "run risk".	• In response to issues associated with cash pools that arose during the Crisis, significant reforms have been implemented to address cash reinvestment vehicles: SEC Rule 2a-7 Reforms in 2010[11] and OCC STIF reforms in 2012.[12] The resulting cash portfolios are comprised of short maturity and high credit quality securities, and have a high degree of liquidity (Exhibit 3). • In BlackRock's securities lending program, securities lending transactions involving cash collateral use cash reinvestment vehicles that are managed consistent with Rule 2a-7, OCC STIF rules, or funds with similar investment guidelines (e.g. those which only allow short term instruments).[13] Therefore, BlackRock's reinvestment of cash for securities lending clients does *not* entail meaningful maturity, credit, or liquidity transformation. • However, we note that the rules pertaining to STIFs managed by state-chartered trust banks in the U.S. have not yet been modified.
Use of Non-Cash Collateral and Rehypothecation	
Non-cash collateral is re-hypothecated (e.g., used as collateral in other transactions), reflecting multiple intermediation chains.	• BlackRock does *not* rehypothecate non-cash collateral. • In BlackRock's securities lending program, the borrower posts all non-cash collateral directly to a custodial account for the benefit of the lender. The collateral is not used by either the lender or lending agent, except in the event that the borrower defaults, at which time the collateral would be sold to cover the replacement cost of the securities that were on loan.

Exhibit 2: SUMMARY OF HOW CONCERNS RAISED ARE ADDRESSED (CONTINUED)

Concerns Raised	Industry & BlackRock Practices
Borrower Default Indemnification	
Borrower default indemnification represents a material balance sheet risk to lending agents that provide borrower default indemnification. While banks hold capital against borrower default indemnification liabilities, asset managers do not.	• Where “borrower default indemnification” is provided, the lender is *not* indemnified for investment results, such as cash reinvestment. • Borrower default indemnification is triggered only when *both* of the following conditions are met: (i) the counterparty defaults on the loan and (ii) the collateral is insufficient to cover the cost of replacing the securities (Exhibit 4). Each loan is over-collateralized, and the collateral is marked-to-market daily. • In the unlikely circumstance where a borrower defaults and collateral received is insufficient to cover the repurchase price of the lent securities, this shortfall would be borne by the indemnification provider. If the indemnification provider was unable to cover a shortfall, the loss would be borne by the client. • BlackRock typically requires borrowers to post collateral between 102% and 112% of the value of the securities lent. Additionally, loans and collateral are marked-to market daily. • BlackRock provides borrower default indemnification to some clients for which it acts as lending agent. The fair value of these indemnifications was not material at Dec. 31, 2014 as disclosed in BlackRock’s 10-K.[14] BlackRock (and its predecessors) has never had its indemnification agreements triggered or had to use its own monies to repurchase a security on a lending client’s behalf. • BlackRock holds $2 billion in unencumbered liquidity against potential indemnification exposure to which it is subject and has access to an additional $6 billion of liquidity, both in the form of unencumbered cash and a $4 billion, 5-year bank credit facility as of December 2014. BlackRock does not rely on wholesale funding nor government-insured deposits to support its liquidity. • BlackRock is currently rated A1 and AA- by Moody’s and S&P, respectively, which is among the highest in the asset management industry, and equal to or higher than other major securities lending agents.
The amount of securities loans that BlackRock indemnifies grew significantly between 2012 and 2014.	• The increase observed by various commentators reflects a major organizational change during this time period. As part of the terms governing the acquisition of BGI by BlackRock, Barclays was contractually obligated to continue providing counterparty default indemnification to certain BlackRock securities lending clients through Dec. 1, 2012. BlackRock assumed these indemnification obligations prior to or upon the expiration of Barclays’ indemnification obligation. • As disclosed in our 10-K, the amount of securities on loan in BlackRock’s securities lending program subject to indemnification as of Dec. 31, 2014 was $145.7 billion. Borrowers posted $155.8 billion as collateral for indemnified securities on loan at Dec. 2014. The fair value of these indemnifications was not material at Dec. 31, 2014.[15]

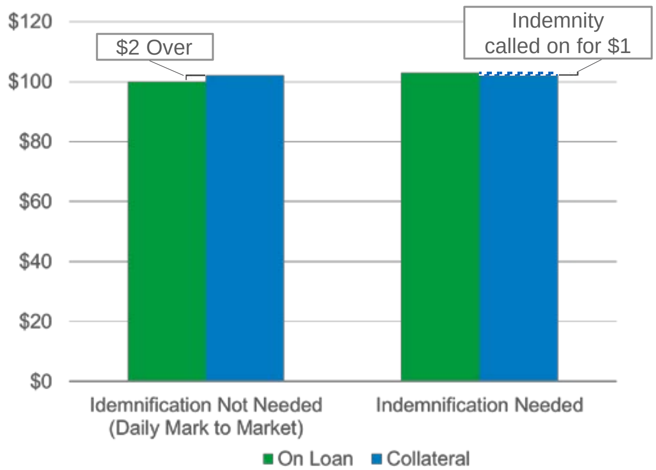
Exhibit 3: POST-REFORM RULES FOR CASH MANAGEMENT VEHICLES

	SEC Rule 2a-7	OCC STIF Rules
Quality / Concentration / Diversification	• Max. issuer concentration: 5% • Max. 2nd tier issuer concentration: 3%	• Portfolio and issuer quality standards and concentration restrictions must be identified, monitored and managed
Maturity / Duration	• Max. WAM: 60 days • Max. WAL: 120 days	• Max. WAM: 60 days • Max. WAL: 120 days
Liquidity	• ≥10% in daily liquid assets • ≥30% in weekly liquid assets	• Liquidity standards, contingency plans for market stress must be developed and regularly tested
Stress Testing	• Required to periodically stress test MMF to examine MMF’s ability to maintain a CNAV	• Required to periodically stress test STIF to examine STIF’s ability to maintain a CNAV
Transparency / Disclosure	• Monthly public disclosure of portfolio holdings and additional data (i.e. shadow NAV) • Daily NAV	• Monthly disclosure to client and OCC of portfolio holdings and additional data (i.e. shadow NAV)

WAM = Weighted Average Maturity WAL = Weighted Average Life CNAV = Constant Net Asset Value

Exhibit 4: ILLUSTRATION OF INDEMNIFICATION

Borrower default indemnification is limited to the shortfall that could occur in the event the borrower has defaulted and the collateral is insufficient. For example, in the event of a borrower default, if a borrower had delivered $102 of collateral to borrow securities currently valued at $100, and the cost of repurchasing the loaned securities was $103, the indemnification provider would make the lender whole only for the difference between the collateral delivered and the cost to repurchase the loaned securities (in this example, $1).



Example for illustrative purposes only.

BlackRock's Approach to Securities Lending

Since 1981, BlackRock and its predecessor firms have served as securities lending agents as a fiduciary for our clients. In order to provide this service, we have built a proprietary securities lending infrastructure which brings together best investment practices and prudent risk management. Lenders conduct due diligence on the lending agent which includes an assessment of risk management and operational controls as well as the financial strength of the lending agent.

- **Independent risk management.** BlackRock's Risk & Quantitative Analysis group (RQA), an independent function within BlackRock, works closely with our securities lending business to manage the risks associated with securities lending. In addition to monitoring counterparty risk, RQA monitors all aspects of the risk process including loan to collateral correlation, fair allocation controls, and macro market trends affecting securities lending risk.
- **Robust assessment of borrowers.** We select borrowers based on conservative credit standards defined by our Counterparty and Concentration Risk Team, which is a part of the larger RQA group. BlackRock continuously monitors the financial performance of borrowers and sets individual lending limits for every borrower to help minimize default risk and monitor all trading activity against these limits to prevent new transactions if the limits are reached.
- **Collateral standards.** BlackRock typically requires borrowers to post collateral between 102% and 112% of the value of the securities lent; the over-collateralization percentage varies depending on the type of collateral posted. Additionally, loans and collateral are marked-to market daily, and BlackRock reserves the right to recall a security or require a borrower to provide additional collateral at any time.
- **Prudent collateral management.** Cash collateral is conservatively invested in funds with guidelines that are consistent with Rule 2a-7 or OCC STIF rules.
- **Proprietary technology.** Our dedicated team works on custom-built reporting, operations and trading systems to help ensure transparency and operational efficiency. Our core trading system enables our traders to extract value for our lending clients in rapidly changing markets by incorporating proprietary trading research and securities lending supply and demand data in a rapid, consistent and scalable manner. Capturing re-pricing opportunities is a key component in outperforming competitors. Our trading system helps to ensure that traders focus on the most significant opportunities.

  Our proprietary collateral and loan processing technology delivers a seamless exception-based process for loan management. While borrower default is rare, our collateral and loan processing technology is designed to manage the default process systematically, and mitigate risks to the lender.
- **Integrated investment process.** Using one vendor for asset management, securities lending, and cash reinvestment can be advantageous to clients by ensuring consistent policies and procedures and facilitating the management of settlement cycles and other time-sensitive interactions. The synergies amongst securities lending professionals and portfolio and risk management teams enables us to reduce the operational risks of securities lending.
- **Financial Strength.** Securities lending agents may hold liquidity on their balance sheet to cover a potential loss associated with the provision of borrower default indemnification. For example, BlackRock holds $2 billion in unencumbered liquidity against potential indemnification exposure to which it is subject and has access to an additional $6 billion of liquidity, both in the form of unencumbered cash and a $4 billion, 5-year bank credit facility as of December 2014. BlackRock does not rely on wholesale funding nor government-insured deposits to support its liquidity. BlackRock is currently rated A1 and AA- by Moody's and S&P, respectively, which is among the highest in the asset management industry, and equal to or higher than other securities lending agents.

RELATED CONTENT

- Asset Management Products and Activities, Letter to FSOC, March 2015
- Borrower Default Indemnification in the Securities Lending Marketplace, May 2014
- *ViewPoint* - Securities Lending: Balancing Risks and Rewards, May 2012
- Green Paper on "Shadow Banking", Letter to European Commission, June 2012

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Notes

1. See for e.g., Nicola Cetorelli, Federal Reserve Bank of New York, Staff Report No. 705, Hybrid Intermediaries (Dec. 2014), available at http://www.newyorkfed.org/research/staff_reports/sr705.pdf ("NYFRB Staff Report") which cited the example of American International Group, Inc. ("AIG") and securities lending activities undertaken by its subsidiaries leading up to the Crisis. The securities purchased by AIG using cash collateral in 2008 would not be eligible investments for securities lending activities subject to SEC or OCC regulation today. Short-Term Investment Funds, 77 Fed. Reg. 61229 (Oct. 9, 2012); Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47735 (Aug. 14, 2014). Similarly, UCITS funds would not be permitted to reinvest cash collateral in such securities under ESMA's rules today.
2. See FSB and IOSCO, Second Consultation on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (Mar. 2015), available at http://www.financialstabilityboard.org/2015/03/fsb-and-iosco-propose-assessment-methodologies-for-identifying-non-bank-non-insurer-global-systemically-important-financial-institutions/ ("Second Consultation").
3. European Commission, Green Paper on Shadow Banking (Mar. 2012), available at http://ec.europa.eu/internal_market/bank/docs/shadow/green-paper_en.pdf. See also European Commission, Reporting and Transparency of Securities Financing Transactions (Jan. 2014), available at http://europa.eu/rapid/press-release_MEMO-14-64_en.htm. See also European Commission, Consultation Document on Undertakings for Collective Investment in Transferable Securities (UCITS): Product Rules, Liquidity Management, Depositary, Money Market Funds, Long-term Investments (Jul. 26, 2012), available at http://ec.europa.eu/internal_market/consultations/docs/2012/ucits/ucits_consultation_en.pdf
4. ESMA, Consultation Paper: ESMA's Guidelines on ETFs and Other UCITS Issues (Jan. 2012), available at http://www.esma.europa.eu/system/files/2012-44_0.pdf. This resulted in the publication of ESMA's Guidelines (Dec. 2012), as subsequently revised (Aug. 2014).
5. See Second Consultation.
6. See FSOC, Notice Seeking Comment on Asset Management Products and Activities (Dec. 18, 2014), available at http://www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Notice%20Seeking%20Comment%20on%20Asset%20Management%20Products%20and%20Activities.pdf.
7. SEC, Examination Priorities for 2014 (Jan. 2014), available at http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf.
8. Some lenders are not permitted to lend directly and some may be permitted to lend directly but lack the capacity to do so themselves. In either case, the lender would engage a lending agent in order to participate in securities lending.
9. There are numerous global entities providing securities lending agency services, including BMO, BNP Paribas, BNY Mellon, Brown Brothers Harriman, Citibank, Comerica Bank, Credit Suisse, Deutsche Bank, eSecLending, Frost Bank, Goldman Sachs, JP Morgan, Northern Trust, Schwab, Scotia, State Street Bank, Sumitomo, US Bank, Vanguard, and Wells Fargo.
10. NYFRB Staff Report.
11. SEC, Press Release, SEC Approves Money Market Fund Reforms to Better Protect Investors (Jan. 27, 2010), available at https://www.sec.gov/news/press/2010/2010-14.htm.
12. Short-Term Investment Funds, 77 Fed. Reg. 61229 (Oct. 9, 2012).
13. Certain separate account clients may not be obligated by regulation to use cash vehicles governed by Rule 2a-7, OCC STIF rules or similar, but currently all clients using BlackRock's lending program have chosen cash vehicles governed by Rule 2a-7, OCC STIF rules, or similar requirements.
14. BlackRock 10-K Filing as of December 2014, available at http://www.blackrock.com/corporate/en-us/investor-relations.
15. Ibid.

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