The performance of a fund’s securities lending program is linked to the composition and structure of its board. That’s one of the major findings of the recently published study “Affiliated Agents, Boards of Directors, and Mutual Fund Securities Lending Returns.”

Written by three university professors, the study found that the more directors on a fund board and the higher their compensation, the lower their funds’ securities lending program returns are likely to be. But if a fund board has practices associated with strong governance, such as many independent members and a mix of men and women, securities lending programs are more likely to net higher returns.

The study also found that securities lending returns are lower when funds use a lending agent affiliated with the adviser.

Experts say the findings point out the continuing need for directors to be vigilant in their oversight of securities lending programs. One director, however, argues the board-related findings should be taken with a grain of salt, because there’s such a scarcity of information about funds’ securities lending programs that it’s hard to know if the scant data available from SEC filings give the fullest picture of what’s really going on. The writers of the study conceded that point: “Mutual fund disclosure, as far as their securities lending programs, is not very good. We have to use the data that mutual funds give us,” says John Adams, assistant professor of finance at the University of Texas at Arlington and one of the authors of the study, with Virginia Tech professor of finance Sattar Mansi and Takeshi Nishikawa, of the University of Colorado at Denver.

“All we see are the net proceeds. One of the first criticisms is that there may be some unobserved factors, events, procedures, risk management effects that we cannot see,” Adams says. “Mutual funds could rectify that by giving better disclosure on their securities lending programs.”

The professors examined SEC filings of 266 index mutual funds from 78 advisers, looking specifically at securities lending data and information about the funds’ boards of directors between 2003 and 2009.

They found that board independence, gender diversity and director fund ownership were associated with higher securities lending returns, while large boards with excess compensation were associated with lower securities lending program returns.

The professors found that funds using adviser-affiliated lending agents had lower returns than funds that used unaffiliated lending agents – even though the funds that used affiliated agents lent more than the funds with
unaffiliated lending agents. Securities lending returns for those with affiliated agents were 70% lower, and the amount of securities on loan was 50% higher, than for funds that used third-party agents.

The professors also found that overall portfolio returns for funds with a securities lending program did better than those without. A desire to boost returns is the main reason directors approve securities lending programs for their funds. Funds with a securities lending program had higher alpha and lower overall expense ratios, sales loads, marketing fees, management fees and custodian fees than those that didn’t lend. About 72% of funds lend securities, and those funds typically lend about 10% of their portfolios, the study found.

The study comes as fund complexes have taken a more nuanced approach to securities lending programs in the wake of the financial crisis.

In securities lending programs, a mutual fund lends its portfolio securities to borrowers through lending agents, and the borrowers give the funds collateral in return, typically in cash. Then the fund invests the collateral to generate revenue. If the loaned securities are in high demand, like certain foreign stocks, then the borrower may pay a rebate to the fund or to the custodian – which may give some of it back to the fund. If the loaned securities aren’t in high demand, such as U.S. large-cap stocks, then the lending fund pays a rebate to the borrower.

Before the financial crisis, funds typically counted on the revenue generated from the investment of cash collateral as the main way securities lending programs contributed to the bottom line. But after problems arose in collateral investment programs during the crisis, funds put more emphasis on earning returns from the rebates paid by borrowers for the most in-demand securities. Funds are also making lending decisions on a case-by-case basis, assessing each counterparty, and in some cases each security, to make sure the deal is worth it, and they are adding lending agents to the roster if they offer appealing expertise in certain kinds of investment products.

At the same time, boards have been strengthening their oversight of securities lending programs, asking more specific questions and in some instances interviewing lending agents.

Adams says the findings of the study point out that boards should continue their hard look at securities lending and that they may be able to do more, especially when the lending agent is affiliated with the adviser. Boards can focus on whether the affiliated lending agent is doing an adequate job, asking about the fee split between the agent and the fund and inquiring whether the expenses in the fee split are based on growth proceeds or the fee split after expenses.

“The reason programs that use affiliated agents have quite a bit lower returns than ones that use non-affiliated agents is that the boards may not be doing as good a job of vetting or negotiating the fees with affiliated agents as they might be with third-party agents,” Adams says.

But that is not the only consideration for directors, he says.

“There’s wide disparity in securities lending returns, and we see that some of the factors associated with high returns are also associated with good governance,” he says. “Maybe we need to align the directors’ interest with shareholders, perhaps through fund share ownership and diversity. It helps. And how boards are compensated is important, as well – highly compensated boards are associated with lower returns. Directors that are highly paid may be acting as rubber stamps because they don’t want to lose their position.”

He added that “for whatever reason, when there are more women on the board, the funds’ securities lending returns are higher. It seems like those boards may be doing a better job of oversight.”

For Kathleen Dennis, independent director of Morgan Stanley Funds and the founder and president of consulting firm Cedarwood Associates, the study is useful in that it raises questions about securities lending programs that are worth examining periodically, including the fund group’s relationship to the lender, how the fees are structured, the program’s overall risk, whether there is counterparty indemnification in the contract and how competitive the pricing is with the agent.

“The other thing that does not come out in the study, which is really important, is that when you have an affiliated agent, there are stricter criteria within which the program needs to be run. Same thing with an affiliated
custodian. Things get more complicated with the oversight. And I think that what this study does, is it says, ‘OK, turn up your radar, ask the important questions, try as much as you can to make sure you’re getting a competitive fee,’” Dennis says.

But she is skeptical about some of the specific results of the study because it’s so difficult to dig out the data concerning each fund’s program. Such details are not required to be disclosed, and there are many underlying elements that can impact a program’s performance, such as how the portfolio manager approaches securities lending. One portfolio manager may avoid it because she finds it constrains the way she runs the funds; another may not.

“The other thing that’s often difficult to figure out is the return structure to the funds. In some cases, and this is irrespective of whether it’s using an affiliated or unaffiliated lender, securities lending and custodian services can be bundled. So 'transparency' is not the first word that comes to mind when you think about securities lending. It tends to be murky. It’s gotten a little better, but not very much,” Dennis says.

And, she says, it’s unclear whether the number of women on a board can really be connected to better portfolio returns.

“That finding made me laugh, and I’ll tell you why. I think there are a lot of things you can tell by running numbers. And it was not entirely clear to me how, exactly, other than by coincidence, they decided that the board had any impact on the returns,” Dennis says. “The connection from boards meeting, through lending agent negotiations through a portfolio manager, is pretty tenuous.”

Dennis says that if a board wanted to examine its lending program it could first look at whether its securities lending program is part of a bundled arrangement. If it is, the board could seek data from the adviser showing the cost and benefit of each service separately. She says it’s reasonable for the board to ask for competitive data so they can see their funds’ activities in the context of the rest of the industry.

In the case of a new securities lending agent, Dennis says the board could ask for multiple bids from multiple agents, though this can become complicated because agents take volume into consideration when compiling their bids. And, she says, fund boards can assess what fees are reasonable for a fund group of their size.

“The board needs to understand where it is in terms of its relative size as a player in the market in order to understand the fee split,” Dennis says.

It would also be useful for directors to discuss the study’s findings about funds acting as their own lending agents.

“What would bother me in that situation is that in most securities lending arrangements, the agent indemnifies against counterparty risk. The only risk the fund would have is what it did with its cash collateral. But when the fund acts as its own agent, who makes the credit decisions? And is there indemnification of borrower default? Who’s providing the indemnification? Not the fund – they can’t do it – it’s got to be someone within the organization, if anyone at all,” Dennis says.

As for how to approach the matter of affiliated lending agents, Peter Bassler, managing director at eSecLending, says directors should look to make sure there’s a clear process for comparing affiliated and non-affiliated lending agents and measuring performance.

“Once directors have decided upon whether to hire an affiliated or non-affiliated agent, the board should receive regular updates on how the program is performing. Oftentimes, performance is compared against the original revenue estimate, which is a prediction on how much the agent expects to generate and provides directors with data to hold agents accountable for addressing any shortfalls if necessary,” Bassler says. “I also think it’s important to use market research offered by industry data providers as a means to benchmark performance. One thing to note with these platforms, however, is that you can’t necessarily compare similar funds’ performance against each other as one fund may have different risk parameters, which can dramatically impact returns.”
In addition, he says boards should consider not only fee splits, but also how much revenue is generated before the fee split and what kind of risk management is provided.

“One of the most important components of risk management,” he says, “is whether all potential conflicts of interest have been disclosed and addressed on a transparent basis.”