Report: affiliated agent lender return lower
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A new academic report into mutual funds returns from securities lending shows potential conflicts of interest when using agent lenders affiliated with fund sponsors. Stephanie Baxter reports

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Securities lending returns are “dramatically lower” when funds use lending agents affiliated with their sponsors, according to a new academic report.

The report, which looks at whether affiliated lending agents and mutual fund boards affect securities lending returns, was carried out by academics at three universities in the US.

An affiliated agent is where the investment company that manages the fund is under the same umbrella as that fund’s lending agent.

Here, returns tend to be smaller and there are conflicts of interests, said John Adams of the University of Texas, who co-wrote the report.

Using securities lending data from 2003 to 2009, the research found that returns are 70% lower and the amount of securities on loan is 50% higher than the sample means when funds use sponsor-affiliated lending agents.

However, returns are “significantly higher” when funds administer their own lending programmes.

The report said this is a strong indicator that agency problems are potentially severe in securities lending arrangements.

“This finding strongly suggests that some affiliated lending agents act to expropriate mutual fund shareholder wealth,” said the report.

According to Adams, the new research builds on an investigation in 2004 by the Securities and Exchange Commission (SEC) into the management of securities lending programmes for mutual funds administered by several investment banks.

Although the investigation uncovered “potential conflicts of interest” when funds used securities lending agents that were affiliated with their sponsor, the SEC never disclosed the findings of the report.

Adams said State Street and JPMorgan were some of the names mentioned by SEC officials, but with no inclination of who came out good or bad in the investigation.

The report also said that mutual funds tend to make higher returns when they act as their own securities lending agent. Funds who use custodian banks as lending agents only earn about 30 basis points per year on the securities they lend while funds that act as their own agent make 110 basis points.
The report said the reasons behind this could be that funds acting as their own agent – referred to as ‘self-lending agents’ in the paper - can have better terms from borrowers and do not incur securities lending fees. It was also suggested that they might choose to only lend profitable securities while custodians lending on behalf of funds may choose to lend both high and low profit securities.

The research also looked at whether mutual fund boards affect securities lending returns. Returns tend to be lower when boards are larger and when director pay is high, but are higher when funds have boards with greater independence and gender diversity.

Transparency issues

Adams said it was difficult to find information when carrying out the study, pointing out that mutual funds are generally not very transparent in their securities lending practices.

“When we asked them how much the fee was split, mostly they had no idea what we were talking about or refused to divulge that information.”

Adams said a lot of mutual fund sponsors seem to quit lending and liquidate positions immediately before filing date so it doesn’t look like they have securities on loan.

“Transparency and disclosure can be improved,” said Adams, who added that mutual fund sponsors and boards need to be asking questions such as: ‘should we be more active and investing more resources into lending?’, and ‘should we be using an affiliated lending agent or an independent consultant?’

The report was produced by Adams, Sattar Mansi from the Virginia Tech, and Takeshi Nishikawa at the University of Colorado in Denver.