Boards Need To Understand, Monitor Securities Lending

Mutual fund boards should make sure they understand their funds' securities lending programs and be vigilant in reviewing both the returns generated by the program and the risks associated with it. A recent study published by a group of university professors found that funds that use lending agents affiliated with the advisor have lower annual returns on lent securities, a trend directors should consider when overseeing their funds' programs.

The study also examined the role of the board in securities lending programs and found that both board size and excess director compensation are "negatively associated" with securities lending returns, while board independence, gender diversity and director fund ownership are "positively associated" with lending returns.

"I think boards need to understand what securities lending is, how the process works [and] what the risks involved are," John Adams, a finance professor at the University of Texas at Arlington and one of the study’s three authors, told FDI. "They need to understand the risks because I think a lot of boards view this as easy money. It can be risky. There needs to be a risk management program in place."

In addition to understanding the securities lending strategy used by the fund and how the program is used by the fund, trustees need to get prices from a number of different lending agents and compare the external firms to those affiliated with—or under the same corporate umbrella as—the fund advisor, Adams said.

Adams and co-authors Sattar Mansi from Virginia Tech and Takeshi Nishikawa from the University of Colorado at Denver found that when compared to sample means, securities lending returns were 70% lower and the amount of securities on loan was 50% higher when an affiliated lending agent is used. "That points to pretty strong evidence of conflict of interest; it appears funds may be favoring internal or affiliated agents," Adams said. The authors looked at securities lending data from nearly 1,300 funds covering the period from 2003 to 2009. About 28% of the time, funds used affiliated agents.

"Larger boards may be more myopic and have more people, therefore it’s hard to get anything accomplished," Adams said, noting there was “some mixed evidence” with regard to the relationship between the size of the board and securities lending returns. A more controversial finding is the one about director compensation. "When director compensation is high relative to the amount of [assets] they have to oversee, when relative pay is compared to monitoring responsibilities...returns tend to be lower,” he said. “One interpretation when director compensation is too high is that it’s possible that the directors fear losing a lucrative position and tend to rubber stamp.”

On the other hand, directors with skin in the game are more vigilant in their monitoring of securities lending programs and those boards with a higher percentage of female directors tend to oversee programs with better returns, Adams said. "When boards are more diverse—specifically more gender diverse—we found that monitor effectiveness increased," he said.

The paper, which Adams said is the first to look closely at the relationship between boards and securities lending programs, can be accessed by clicking this link: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1947503.