January 2010

The Pensions Regulator

Help for trustees

Understanding and managing the risks of securities lending

As part of our current campaign to promote good governance and administration of pension schemes, we are consulting on revised guidance for trustees on the requirement to have adequate internal controls.

In this context, we have noted concerns expressed in the pensions community of the risks to scheme assets from the practice of 'securities lending'. Situations have been brought to our attention of scheme assets being lent by fund managers on schemes' behalf without full awareness on the part of the trustees, with fund managers retaining the majority of the investment return despite the scheme retaining all the risk, and with inadequate collateral in place to cover this risk.

We are therefore seeking to provide help for trustees to understand the specific investment practice of 'securities lending' and to manage the risks involved for schemes. In particular we suggest some specific questions you should consider and address with fund managers.

The practice of securities lending, often termed 'stock lending' – although it can involve a variety of asset classes – involves investors lending securities for a fixed period, in exchange for a fee, together with collateral to cover the loan. Securities lending can offer pension schemes an opportunity to generate an income to enhance returns on ownership of particular assets or offset the costs of fund management. Typically, the lender effectively retains all the benefits of owning the assets, including the payment of dividends, except for voting rights.

Securities lending is widely practised. The Financial Services Authority (FSA) noted in its recent discussion paper on short selling (**www.fsa.gov.uk/pubs/discussion/dp09_01.pdf**) that securities lending allows market makers to increase liquidity, which in turn helps the markets operate more smoothly and efficiently. Borrowing of securities also occurs as part of financing strategies.

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Securities lending will not be appropriate for all schemes however, and the decision to carry out securities lending is for the trustees of each scheme to consider. Trustees and others involved in managing both DB and DC pension schemes need to identify and control the risks involved. In particular they should:

* ensure they are aware of whether their fund managers are lending assets on their behalf, and where this is the case, that the scheme is receiving due benefit from this approach. In particular trustees should ensure they are aware of the proportion of income derived from the securities lent that is not passed on to the scheme. This includes where scheme assets are invested in pooled funds.
* ensure they understand the arrangements and financial terms in place between the scheme, fund manager and borrower.
* be fully aware of the risks of securities lending and of the nature of the collateral covering these risks to satisfy themselves that it is sufficient and appropriate.
* ensure that the controls they have in place allow them to monitor the appropriateness of these arrangements in the context of their overall investment strategy.

Key questions for trustees to consider

We suggest that trustees and others involved in managing pension schemes consider the following questions and review their arrangements for the management of schemes assets accordingly:

* Do the scheme's arrangements with fund managers provide clarity about whether (and which) scheme assets may be lent, and on what terms, including the benefits for the scheme in terms of enhanced return or reduced management fees?
* Do you have a good understanding of what proportion of scheme assets may be lent out under this arrangement?
* Do you have an up-to-date knowledge of how much securities lending has taken place and is currently taking place in respect of your scheme's assets?
* Does your fund manager have appropriate legal agreements in place which make clear the obligations of the borrower and the lender?
* Do you have appropriate controls and expertise in place to understand and monitor the risks involved in lending scheme assets and to ensure that collateral for loaned assets is appropriate to mitigate these risks and is properly secured?

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We believe that consideration of these questions will help trustees to ensure that arrangements they have in place with those managing funds on behalf of their schemes provide sufficient clarity on the extent of securities lending being undertaken. This will enable them to ensure that these arrangements are aligned with the scheme's overall investment strategy and members' choice of investment approach and risk preferences.

The FSA has been reviewing the governance and risk management of stock lending in the market. We welcome this work and will continue to work with the FSA and market participants as necessary to help develop thinking in this area.

Useful links

* For more information on our governance and administration campaign, including our current consultation on revised guidance on internal controls, and 'bite-sized' learning on managing risks, visit: **www.thepensionsregulator.gov.uk/safe/index.aspx**

* The Bank of England published its *Securities Borrowing and Lending Code of Guidance* in July 2009, available at: **www.bankofengland.co.uk/markets gilts/stockborrowing.pdf**

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