Securities Lending in 401(k) Plan Investments

GAO Presentation for the 2011 North American Securities Lending Summit

Tamara Cross, May 12, 2011

GAO's Role

- Independent, nonpartisan agency that works for Congress
- Mission:
  - Help improve the performance and ensure the accountability of the federal government for the benefit of the American people
- This work was requested by Senator Herb Kohl, Chairman of the Senate Special Committee on Aging
    - GAO-11-291

      401(k) PLANS: Certain Investment Options and Practices That May Restrict Withdrawals Not Widely Understood
    - GAO-11-359T

      401(k) PLANS: Issues Involving Securities Lending in Plan Investments

Overview of Our Work

- This work was requested because it was unclear why certain investment options restricted 401(k) participant and/or sponsor withdrawals
  - Real estate accounts
  - Money market funds
  - Stable value funds
  - Investment options that lent securities and accepted cash as collateral
- Testimony focused on securities lending within 401(k) plan investment options

Researchable Questions

1. How does securities lending with cash collateral reinvestment work within 401(k) plan investments?
2. Who bears the risk of loss?
3. What are some of the challenges plan participants and plan sponsors face and actions that can be taken?

How Does Securities Lending Work Within 401(k) Plans?

- Securities lending with cash collateral reinvestment is a complex arrangement
- It can be done through separate or commingled funds
  - With separate accounts, the 401(k) plan sponsor chooses whether or not to participate directly in a securities lending program by lending out the plan assets held in the separate account
    - Plan sponsor engages directly with the securities lending agent, selects investment guidelines for cash collateral reinvestment, and monitors the securities lending agent and gains and losses from cash collateral reinvestment.
    - Plan participants own the assets held in the separate account and experience realized gains and losses directly

How Does Securities Lending Work Within 401(k) Plans?

- With commingled funds, the manager of the commingled fund makes the decision to engage in securities lending, so the plan participates in the lending activities indirectly
  - Plan sponsor offers prudent investment options to participants
  - Commingled fund owns the assets. Commingled fund manager makes the decision about whether to engage in securities lending
  - Plan participants own a share of the assets held in the commingled fund. Realized gains and losses from cash collateral reinvestment are passed through to the participant by increases and decreases in the value of the participant’s shares in the commingled account

Who Bears the Risk of Loss?

- Participants ultimately bear the risk of loss from the market risks of the cash collateral portfolio, yet only receive a small portion of the return generated by reinvesting the cash collateral
- Securities lending with cash collateral is profitable to plan participants only after there is a positive return on the cash collateral pool investments and other parties engaged in the transaction are paid
    - Securities lending agents receive a portion of the return
    - Cash collateral pool managers receive a fee to manage the pool
    - Broker-dealers receive a rebate of a portion of the return
- In the past few years, risky assets in the cash collateral pool, which lost value and were difficult to trade, caused realized and unrealized losses for 401(k) plan participants

What Are Some of the Challenges Plan Participants and Sponsors Face?

- Securities lending with cash collateral reinvestment seems even more complex because of a lack of transparency
- Plan sponsors and participants may be unaware that their 401(k) plan’s investments are utilizing securities lending with cash collateral reinvestment
- Plan sponsors and participants are also unaware of, or may not fully understand, the risks involved with cash collateral reinvestment portion of securities lending programs

Agencies and Key Stakeholders Are Already Taking Some Action

- Financial regulators and industry participants are beginning to make changes that can help plan sponsors fulfill their obligations
  - SEC and private sector entities are seeking to make securities lending more transparent
  - Some securities lending agents have already begun to implement various changes to their securities lending programs and the way they manage cash collateral
- Labor can also take steps to assist plan sponsors

Actions Can Be Taken to Improve Transparency and Disclosure

We recommended that the Department of Labor

1. Amend its regulations on plan sponsor disclosure to participants to include provisions specific to the practice of cash collateral reinvestment utilized by fund providers' securities lending programs
2. Provide guidance to plan sponsors about the following when 401(k) plan assets are utilized in this practice:
    1. risks of engaging in the practice
    2. types of information they should seek from their service providers
    3. reasonable levels of fees
    4. reasonable distributions of returns
3. Revise PTE 2006-16 to include the practice of cash collateral reinvestment by requiring that plan sponsors who enter into securities lending arrangements with cash collateral reinvestment not do so unless the ensure the reasonableness of the distributions of expected returns

Questions?

Thank you!

GAO on the Web

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