THRIFT SAVINGS PLAN

FEDERAL RETIREMENT THRIFT INVESTMENT BOARD
1250 H Street, NW Washington, DC 20005

November 7, 2008

MEMORANDUM FOR BOARD MEMBERS SAUL, FINK, WHITING, SANCHEZ, & DUFFY

FROM: GREG LONG
Executive Director

SUBJECT: **Securities Lending Activities**

Securities lending is the process whereby asset owners (lenders) agree to lend securities that they own to broker/dealers (borrowers) in exchange for collateral and a small fee. Broker/dealers borrow securities for a variety of reasons including facilitating the orderly settlement of trades as well as the execution of short positions employed in various trading strategies. SEC rules do not permit investors to sell a security that they do not own (take a short position in the security) unless they first borrow the security from someone that owns it. This requirement to borrow a security in order to implement short positions creates the market for securities lending.

In a typical securities lending transaction, a lending agent, acting on behalf of the asset owner, lends securities in exchange for some collateral - generally cash or cash-like instruments. Collateralization levels are typically set at 102% of the value of the borrowed security for domestic assets and 105% for international assets. At the initiation of a loan transaction, the lending agent agrees to pay the borrower a fee, referred to as the rebate rate, on the collateral received against a securities loan. The rebate rate is expressed as an interest rate and is often quoted with reference to the Federal Funds Open Rate (Fed Funds). The rebate rate associated with securities that are in short supply or are hard to borrow is generally low or set at a steep discount to the Fed Funds rate. The difference between the Fed Funds rate and the established rebate rate is one of two components of lending income and is referred to as the intrinsic spread, which may be considered a risk-free spread.

The lending agent invests the collateral received against security loans in high quality, short-duration fixed income securities with a view to earning a premium over the Fed Funds rate. Income earned in excess of the Fed Funds rate is referred to as the reinvestment spread / income and represents the second component of securities lending income. Thus, the total revenue earned is the difference between the return earned on the cash collateral and the rebate rate paid to the borrower.

The F, C, S, and I Funds all invest in collective funds managed by Barclays Global Investors (BGI) that engage in securities lending. Those TSP Funds earned approximately $94 million in income from securities lending in 2007 and over $100 million through September 30, 2008. Securities lending is a common practice among large defined contribution plans and is typically considered to be a low-risk method of enhancing the economic benefit delivered to the plan participants. However, recent extraordinary market activity has heightened concerns about risk in securities lending transactions, which include borrower or counter-party risk, operational risk and collateral reinvestment risk. Each of these risks can be mitigated and/or managed through strong risk controls.

In 2006 the FRTIB selected BGI to manage the F, C, S, and I Funds through an open competitive bidding process. An analysis of BGI's capabilities in managing the risks associated with securities lending was a significant focus of the review and procurement process. During the recent market turmoil we have been in regular contact with Ennis Knupp, our independent investment consultant, to ascertain their opinion of BGI's ongoing capabilities to appropriately manage the securities lending program. The FRTIB management team has also been in regular contact with BGI senior officers to identify any potential concerns. We and Ennis Knupp are in agreement that BGI is a conservative organization with strong risk controls, thorough research and experienced professionals that focus on minimizing risk for their clients. The various risk committees and control processes that BGI has in place appropriately support the securities lending activity of the TSP.

Starting in Q4 2007, Barclays has taken a number of additional steps to protect clients' interests in the cash collateral portfolios, which the FRTIB has reviewed with Barclays and believes protects TSP participants. The overall credit profile of the portfolios is strong, and the BGI portfolio managers are managing through an extraordinary lack of market liquidity. The cash collateral reinvestment portfolio held no paper in Lehman Brothers, Bear Stearns, Washington Mutual, Fannie Mae or Freddie Mac at the time those institutions defaulted, were rescued or merged. TSP staff has been very closely monitoring the program and believes BGI's risk management policies are sound.

We feel it is in the best interest of plan participants to engage in securities lending. We will continue to closely monitor the situation and will recommend changes if deemed necessary.