FINADIUM

Finding Best Execution in Securities Lending

Josh Galper, Managing Principal

October 18, 2011

Measuring best execution in securities lending for mutual funds, pension plans and other asset holders is achievable but can be difficult to manage. With the introduction of Dodd-Frank, Basel III and a multitude of European rules, there is a general desire to increase transparency for a wide variety of financial products. Any moderately opaque market like securities lending, particularly one that can fall under the heading of Shadow Banking, is a prime target. Regulators would like mutual funds, pension plans and similar institutional investors to show transparency to their investors and stakeholders; best execution seems like a practical way to achieve this goal. Many investors themselves are interested in whether they got the best securities lending rates and if their agents have done the best jobs. Best execution should serve to answer these questions as well.

Best execution for asset holders has many uses across the financial industry, including selecting brokers or agents, proving to regulators that fiduciaries are monitoring service providers and showing clients that their investments are in good hands. The natural users of best execution data are investment and operations officers, traders, Board member and sales and relationship management teams who use the data in client meetings. Product standardization in equities and other trading markets has encouraged the growth of the Transaction Cost Analysis industry, which uses sophisticated models to help investors see if their pricing was due to market timing, the skill of their traders or other factors. The rationale for best execution in securities lending is no different than for other products; it can be genuinely useful information to have.

The trouble is that securities loan cannot meet the definition of a standardized trading product. In fact, securities lending transactions are not trades at all; they are arrangements between two parties for the temporary loan of a security in exchange for collateral. At the end of the arrangement the collateral and securities are re-exchanged and the loan is concluded. The details of each loan depend on the identity of the lender, the size of the loan and the type or quality of collateral given in exchange. Some loans may be overnight or held for a few days while others may be for a specific term. Still others may be for fixed rates with an annual payment for access to a portfolio in an exclusive arrangement.

To make matters more confusing, the technology now exists to create a securities lending rate "ticker." This sort of ticker may make sense for brokers or hedge funds with similar credit ratings, as one borrowed share looks much the same as any other. A ticker alone does not work however when it comes to the pension plans and mutual funds that lend securities. A securities lending feed for lenders is more analogous to a ticker of real estate mortgage rates than equities, where some loans are jumbo, others conforming, some are for home loans while others are commercial. The feed could not tell which rates had what attributes, only that the loans were made.

For mutual funds, pension plans and other asset holders, evaluating best execution based on a securities lending ticker alone would require more standardization than currently exists in the market, and no one data source can reliably produce every needed variation among lender types. Put another way, securities lending rates are unable to conform to the widely used and well-understood models of best execution in equity, options or other trading markets. Rather, best execution in securities lending requires a substantially different format to be effective.

How Finadium Approaches Best Execution for Securities Lending

The Finadium methodology for identifying best execution in securities lending recognizes the unstandardized attributes of this market and provides a means for evaluating risk versus return. Rather than a single data point, our experience is that a series of metrics is the best method for evaluating the performance of a program, agent or asset class in the context of the lender. A mutual fund board, pension plan operator, insurance company, endowment or municipality can then conclude whether best execution has been achieved for their own market arrangements.

The Finadium methodology is based on the following ideas:

There is no one best execution for all market participants. As each set of securities lending arrangements differ by lender, jurisdiction, types of assets and internal policies, best execution becomes a series of decisions and metrics that allow professionals to assess their own positions relative to their objectives.

Quantitative metrics provides managers important tools for assessing best execution. Breaking down where and how returns are generated, including the impact of utilization and the contribution of collateral returns, is critical for a reasoned understanding of best execution. Reviewing these metrics in a time series provides additional support for decision-making.

The context of a securities lending program matters as much as returns. Quantitative metrics are important but only tell part of the story. Qualitative analysis, including applying standards for initiating loans, selecting and monitoring collateral quality and evaluating fee structures with agent lenders, forms the other part.

It is fair and reasonable to want best execution for securities lending, and it makes sense to evaluate the rates obtained by one program compared to "the market." At the same time, since securities loans made by asset holders are an unstandardized product, looking at rates alone will provide as many distortions as valuable information. Best execution methodologies must conform to the realities of the securities lending market without falling into the securities-loans-are-like-equities trap. This realistic application of a best execution standard will give regulators, investors and the market credence that methodologies are sound and that programs are effectively supervised.

About Finadium

Finadium's consulting services include risk management, oversight and best execution for securities lending and collateral management. In its research practice, the firm assists asset holders, banks and technology firms with understanding the market for asset services including custody, securities lending and cash management, and in maximizing the effectiveness of their resources. Finadium research is available on a subscription basis.

For more information, please visit our website at www.finadium.com or email us at info@finadium.com.