MEMORANDUM

STATE OF ALASKA
DEPARTMENT OF REVENUE
Treasury Division

To: Wilson Condon
Commissioner

Date: January 5, 2001

Thru: Neil Slotnick
Deputy Commissioner

From: John Jenks, CFA
Chief Investment Officer

Telephone: (907) 465-4399

Subject: Securities lending

Recommendation: The State should resume a securities lending program that parallels the program established for the Alaska State Pension Investment Board. The program should cover all assets not precluded from lending by statute or other constraints except for the Domestic Equity Investment Pool.

Starting in early 1991 and continuing until mid 1995 the State as well and the retirement systems had in place a securities lending program that covered all public securities. That program was terminated in mid 1995. There were several features of the program and the securities lending market in general that led to its termination. The most important of these features were:

1. Neither the staff or the fiduciaries at the time of termination had been involved in the development or implementation of the program;
2. The state was using the proceeds from the lending program to pay for custody services. When market conditions resulted in losses or insufficient income to pay custody fees, budget complications resulted;
3. Securities lending programs have potential risk in several areas but much of the risk mitigation and education effort had been placed on the counterparty default issue. Not enough focus had been placed on the reinvestment of cash collateral risks; and
4. State Street Bank's, the securities lending agent, systems were not sufficiently developed to be useful monitoring tools for the Department of Revenue and the Department had no useful substitute.

Before reviewing the State's previous experience with securities lending and evaluating the current proposal a brief overview of the risks is necessary. The three primary sources of risk in any securities lending program are:

1. Operational Risk. This is the risk that normal or expected transactions will be delayed as a result of the mechanical process involved in securities lending. Examples of this risk are failure to receive dividends on loaned securities on the day they were due or failure to settle a security sale because the lending agent had not coordinated with the custodian regarding the return of the loaned security.
2. Counterparty or Default risk. This is the risk that a borrower of the State's securities fails for any reason to fulfill its responsibilities under the securities lending agreement. The worst case scenario is when a counterparty goes bankrupt and does not return securities. Other examples are failure to remit to the State a dividend payment made for a stock on loan or failure to pass on or act on a corporate action like a rights offering.
3. Reinvestment risk. Most Securities lending programs rely heavily on accepting cash collateral to insure the return of the loaned security. This cash is invested by the securities lending agent while it is held. To the extent that the investments purchased with that cash do not earn the anticipated rate of return the lending program could fail to make or could lose money.

The original securities lending program was reasonably successful during the first three years of its existence. Both the State and the retirement systems received significant earnings in excess of the cost of custodial services, which were also paid for out of proceeds from the program. Earnings in FY 93 were almost $6 million. Over the four years of the program the State and the Retirement system collected approximately $18 million.

During 1994 the Federal Reserve raised short-term interest rates by 3.00 percent. By late 1994 and early 1995 this sharp increase in short-term interest rates had caused investment losses in a number of securities lending programs. Mellon Bank and Bank of America had high profile losses as they infused hundreds of millions of dollars into their programs to make customers whole. The problems with State Street were not as great but they were still significant. Their investment problems resulted in one month of losses and months of concern that earnings would not be high enough to cover the custodial service fees. The lack of budget authority to pay for custodial services complicated the entire situation. Additionally, based on how the money market funds used to invest the cash collateral work, there was an unrealized loss that would be realized if the lending program were suddenly terminated.

Department of Revenue personnel, myself included, attempted to analyze the investments that were made with the program's cash collateral. That process was very difficult. Industry practices had not focused on client review of the investments being made or of the asset/ liability mismatch within the lending programs. After significant effort the securities lending portfolio was analyzed. Staff was not comfortable with some of the holdings or with its ability to regularly review the holdings going forward. Based on that the Chief Investment Officer at the time, Robert Storer, recommended to the Commissioner of Revenue and the Alaska State Pension Investment Board that they withdraw from the program. Both Fiduciaries accepted the recommendation and staff worked with State Street to terminate the program in a manner that resulted in no additional losses being realized.

Since that time there have been a number of changes in the securities lending industry. These changes focused on the investment of cash collateral, the asset/liability match between the loan term and the investment term, and reporting systems. New entrants to the securities lending business drove much of this change. These new entrants while largely ineffective in getting much business, did force the custodian banks to materially improve their programs. The program State Street is offering to the State and ASPIB is significantly improved over the original program.

The program that I am recommending to you addresses the three sources of risk in a securities lending program. Below is a brief discussion of how each risk source is addressed.

Operational Risk. Using the custodian bank as the lending agent and having State Street agree that nothing in the lending agreement affects or reduces their responsibilities under the custody contract virtually eliminates this risk. Using one organization will significantly reduce the possibility of an operational problem, leave one party responsible if there is a problem and leave undisturbed the contractual protections available in the custody contract. During the original lending program there were no operation problems.

Counterparty Risk. The responsibility for selecting and monitoring the counterparties used in the program is solely State Street's. The collateral held by the program at 102% of the value of the loaned securities is the first measure to control this risk. Should this prove to be inadequate State Street will indemnify the State for any losses resulting from counterparty failure or default subject to limitation relating to war, civil unrest or revolution, or beyond the reasonable control of State Street. Because this risk was long perceived as the major risk in securities lending this type of indemnification has long been the standard.

Reinvestment Risk. This is a major source of risk and was the source of problems in the original program. The new program has significant improvements in a number of areas relating to this risk. First, State Street is taking responsibility for any loans that have a loss. Any shortfall in cash collateral necessary to make payment back to the borrower will be made up for by State Street. This is to be measured on a loan by loan basis so that good loans will not be offset against bad loans. This is a very significant provision of the agreement and is very unusual in the industry. State Street has developed a performance analysis system, which will allow staff to easily and efficiently monitor the investment risk in the program. This was a serious shortfall of the previous program. Finally, the new program has incentives for State Street to liquidate the program in an efficient and short time frame if you chose to withdraw from the program.

While no investment transaction is zero risk this program is very low risk. State Street is among the largest lenders in the business. The indemnifications they are offering are very attractive. In the event that the State were to need the indemnification State Street's credit rating would be important. Their credit rating is Aa3/AA-.

The reason to have a securities lending program is to gain some additional revenue with very little increase in risk. Revenue estimates are somewhat difficult to make but a reasonable estimate based on the non-retirement assets as of June 30 was approximately $2.3 million dollars per year.

There are several funds that need special review or action prior to their participation in the program. Some research was required to make certain that the airport funds, both revenue and construction can participate. Deven Mitchell has provided me with written assurance that the airport fund can participate. Additionally, the Department manages funds for several other fiduciaries, the University System and the Exxon Valdez Oil Spill Trust that need to make their own determination about participation. Pending their decision to participate in the lending program their proportional share of total assets in any pool will be withheld from the lending program. The University System has indicated they would like to participate in the program. Once the Department receives written confirmation their assets would be included.

The Exxon Valdez Oil Spill Trustees will be meeting over the next several months to consider their participation.

Finally, the domestic equity investments of the State are made through a collective trust vehicle. The Russell 3000 assets can not at this time participate in the program developed for the balance of the State's assets. They could be leant but under a program that does not provide as much protection. These assets are not attractive assets to lend so the revenue loss for not lending them is minor. Therefore, I am recommending that the domestic equity pool not engage in securities lending at this time.

cc: Betty Martin, State Comptroller