SURREY COUNTY COUNCIL

PENSION FUND BOARD

DATE: **31 MAY 2013**

LEAD OFFICER: **SHEILA LITTLE, CHIEF FINANCE OFFICER**

SUBJECT: **PENSION FUND STOCK LENDING**

SUMMARY OF ISSUE:

Stock lending is a long established way to generate substantial additional income for the pension fund within accepted risk parameters. Given the extensive variety of stocks within the Surrey Fund, consideration should be given to taking advantage of this additional income stream.

RECOMMENDATIONS:

It is recommended that:

1. The Pension Fund Board approve Northern Trust be appointed to operate the Pension Fund's lending programme with immediate effect, subject to the necessary due diligence carried out with regard to contract amendment.

REASON FOR RECOMMENDATIONS:

To generate an additional income stream for the Pension Fund within approved risk parameters.

DETAILS:

The Current Regulatory Position

1 The general prudential provisions of the Local Government Pension Scheme (LGPS) Investment Regulations apply when the activity is undertaken by LGPS funds, and it should be conducted in accordance with the relevant Rules under the Financial Services and Markets Act 2000. Bank of England guidance has also been issued.

2 Under the LGPS Management and Investment of Funds Regulations 2009 (SI No.3093), a "stock lending arrangement" means an arrangement such as is mentioned in section 263B of the Taxation of Chargeable Gains Act 1992 (Regulation 2).

3 The current limit is a maximum of 25% of the market value of an authority's pension fund on "all securities transferred (or agreed to be transferred) by the authority under stock lending arrangements" (regulation 11 and Schedule 1, Part I, paragraph 11).

The Mechanics of Stock Lending

4 Stock lending (also known as securities lending) is the commonplace market practice whereby securities are temporarily transferred by one party (the lender) to another (the borrower). The borrower is obliged to return the securities to the lender on demand or at the end of the agreed term. For the period of the loan, the lender is secured by acceptable assets delivered by the borrower to the lender as collateral, known also as security, plus a margin (minimum 5%) to take account of upward movements in stock prices.

5 Borrowers of stock include market makers who need to be able to borrow to support their ability to quote a two-way price throughout the dealing day and investment banks to enable them to offer securities lending as part of their prime brokerage service to hedge funds.

6 Under English law, absolute title to the securities lent passes to the borrower, who is obliged to deliver back equivalent securities. Similarly, the lender receives absolute title to the assets received as collateral from the borrower, and is obliged to deliver back equivalent collateral. This means that a stock loan and return, and the delivery of collateral and its return, each consists of two simultaneous transactions, which transfer complete title to the securities and collateral to the respective parties. This legal form is intended to protect the lender's title to the collateral in the event of the default of the counterparty.

7 When the loan of a stock is set up, a rate of commission is agreed between the lender and the borrower. This rate can vary according to the length of the loan and the scarcity of the stock and may be adjusted during the course of the loan according to market changes. The average commission rate received is between 0.10% and 0.15% per annum for UK Equities and 0.25% for overseas securities but can significantly increase where demand exceeds supply.

8 Although stock lending involves the absolute transfer of title of those securities to the borrower, the lender is protected regarding the normal benefits (dividends) and corporate actions that would have been received if the asset had not been lent. The borrower of the stock is obliged to pay the lender all cash benefits arising in respect of the stock borrowed.

9 The right of voting is the only right that the lender does not retain when lending a stock. In a particular instance where the pension fund wants to vote their shares, then those shares should be recalled in good time. Securities lending plays a critical role in enhancing market liquidity by assisting the ability of market makers to quote two way prices at all times throughout the day.

10 Permitted stock lending must be under an agreement whose terms are acceptable to the Pension Fund and are in accordance with good market practice. Deals must be with counterparties who are authorised persons who provide security in the form of collateral that is acceptable to the depositary, adequate and sufficiently immediate.

Practical Implementation

11 In order to implement such a programme, a pension fund needs to own a sought after portfolio with the right markets and stocks. It is considered that the Surrey County Council Pension Fund owns such a portfolio.

12 With regard to implementing a programme of stock lending, there are advantages to using the Fund's existing global custodian (Northern Trust) and these include the ease of getting started and a certain level of indemnification that may be provided by the custodian. The Global Custodian has an existing stock lending programme and a large demand from its current list of borrowers. A significant 22% of Northern Trust's international securities lending clients are LGPS funds so Northern Trust is experienced in this sector.

Northern Trust's Stock Lending Programme

13 The Northern Trust lending programme has been in operation since 1981 under the auspices of The Northern Trust Company and currently services 354 custody clients in North America, Europe, the Middle East, Africa and Asia Pacific

14 In brief, Northern Trust proposes to use a small percentage of the Pension Fund's assets (typically 8-15% at any one time) to generate lending returns. All lending is done on a fully collateralised basis to pre-approved, high quality counterparties with great attention paid to the management of risk. For the fund to experience a loss direct from a stock loan, a counterparty would have to become insolvent AND the collateral proceeds would have to be insufficient to cover any marginal shortfall between the value of the loan securities and the value of the collateral. As all loans are valued each day, loan margins are checked and additional collateral collected from a borrower if required, it is extremely unlikely that collateral values would fall before the purchase of replacement securities within three days.

15 While the above risks are very limited, they are further mitigated by Northern Trust by diversifying loans to many different, financially sound counterparties and managing collateral each day to ensure loan margins in excess of 100%. The lending activities of Northern Trust are in line with the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (the "Local Government Regulations"). UK Local Authorities are restricted to lending only to European Economic Area State borrowers. The initial list of potential borrowers will be provided to Board for approval. Subsequent amendments to the list will be delegated for final acceptance to the Chief Finance Officer.

16 The annual gross estimated income achievable from engaging in such a programme is considered to be around £530,000 per annum, generating £371,000 in net revenue to Surrey. This assumes all revenues are split 70/30, with Surrey receiving 70% of the total revenue and Northern Trust receiving 30% (from which all their lending and transactions costs are taken). The revenue estimate assumes non-cash collateral (highly rated government debt and equities from major indices) is only accepted under the conservative guidelines in place for other LGPS clients.

17 The Fund’s consultant will advise on the specific lending agreement prior to implementation.

CONSULTATION:

14 The Chairmen elect of the Pension Fund Board has been consulted on the proposal and has offered full support for the proposals.

RISK MANAGEMENT AND IMPLICATIONS:

15 There is a counterparty risk within the lending programme. However, the value of stocks lent is fully collateralised and the net risk after this safeguard is taken into consideration is regarded to be minimal.

FINANCIAL AND VALUE FOR MONEY IMPLICATIONS

16 Aside from the net additional income to be generated, there are no financial or value for money considerations.

CHIEF FINANCE OFFICER COMMENTARY

17 The Chief Finance Officer is satisfied that all material, financial and business issues and possibility of risks have been considered and addressed and that the proposed initiative will generate a worthwhile income, taking into account the associated risks and the inbuilt safeguards to counter these risks.

LEGAL IMPLICATIONS – MONITORING OFFICER

18 The statutory context to the proposed arrangements and the legal implications of entering into them are dealt with in the report.

EQUALITIES AND DIVERSITY

19 The creation of a stock lending programme will not require an equality analysis, as the initiative is not a major policy, project or function being created or changed.

OTHER IMPLICATIONS

20 There are no potential implications for council priorities and policy areas.

WHAT HAPPENS NEXT

21 The following next steps are planned:

- Approval of the stock lending programme.
- Request that Northern Trust forward to necessary contract amendments to enable commencement of the programme.
- Liaison with Legal and return of contract documentation and lending agreement.
- Commencement of programme.

Contact Officer:
Phil Triggs, Strategic Finance Manager (Pension Fund and Treasury)

Consulted:
Pension Fund Board Chairman

Annexes:
None

Sources/background papers:
None

This page is intentionally left blank