Securities lending (sec lending) is an established practice in global financial markets that provides liquidity to markets while also generating additional returns to investors who lend securities. In the wake of the 2008 financial crisis, sec lending as well as many other established practices has come under review by regulators in various jurisdictions. The Financial Stability Board (FSB), European Commission, European Securities and Markets Authority (ESMA), International Organization of Securities Commissions (IOSCO), and Securities and Exchange Commission (SEC) have each reached out to market participants to develop a better understanding of how to manage the risks associated with sec lending.

Sec lending provides benefits to the financial markets and to investors. First, the availability of securities through lending arrangements translates into liquidity for the settlement of transactions. A number of academic studies have cited this benefit, e.g. Saffi and Sigurdsson, Price Efficiency and Short Selling, December 10, 2007. During the recent financial crisis beginning in 2007, sec lending helped to mitigate market stresses. A second key benefit comes from the income generated for investors whose securities are lent. This extra return is generated both by the “intrinsic value” of the securities as well as (primarily in the US market) by reinvesting any cash collateral received, resulting in enhanced returns to investors.

Several sec lending risks have been identified and need to be managed. Key risks include counterparty credit risk, cash collateral reinvestment risk, non-cash collateral risk, and operational risk. During the financial crisis, issues surfaced related to cash collateral reinvestment strategies which have triggered increased scrutiny of sec lending. Each of these risks can and should be addressed and monitored in a well-managed sec lending program.

BlackRock manages approximately USD $1.425 trillion in a wide variety of investment strategies for which BlackRock also acts as the sec lending agent. Sec lending has added substantial value to these portfolios for our clients. BlackRock brings a portfolio management perspective to sec lending, integrating collateral management, and risk management into its sec lending practices.

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The opinions expressed are as of May 2012 and may change as subsequent conditions vary.
In this ViewPoint, we describe securities lending transactions and the risks involved. We have compiled questions we have been asked by various regulators and make suggestions to address these issues. We also provide suggestions for improving sec lending practices while preserving the benefits described above.

What is Securities Lending?
The market for sec lending is driven by demand from large banks and broker-dealers and their largest end-borrowers clients around the world. Investors are the lenders of securities and they lend securities to achieve enhanced returns on their portfolios.

Lenders are typically large institutional investors, including pension funds, foundations and endowments, sovereign wealth funds, mutual funds, bank maintained collective trust funds, UCITS funds and similar investment funds. They are sometimes referred to as “beneficial owners”. Lenders normally employ an agent to arrange, manage and report on the lending activity. Most custodian banks offer lending agent services. BlackRock generally acts as sec lending agent on behalf of clients for whom it acts as investment manager (often referred to as an “affiliated lending agent”).

Borrowers are typically large financial institutions, such as broker-dealers, investment banks, and market makers. While hedge funds are among the largest end-borrowers of securities, they generally borrow from investment banks or broker dealers rather than directly from the investors or their agents.

Sec lending involves a loan of securities (such as shares or bonds) to a third party (the borrower), who gives the lender collateral in the form of cash, shares, or bonds. The collateral value is adjusted daily for changes in the market value of the loaned securities, and a margin is maintained above the market value.

In addition to providing the collateral plus a margin, the borrower pays the lender to borrow the securities. If the collateral for the loan is cash, the cost of the loan is expressed as a “rebate” or interest rate paid to the borrower on the cash collateral. The lower the rebate paid to the borrower, the more the lender earns. If the collateral is non-cash, the lender pays the lender a fee. If the lender (i) sells the security, (ii) wishes to vote proxies, (iii) wants to reduce exposure to a certain borrower, or (iv) otherwise wants the security back for any reason, the borrower is contractually obligated to return equivalent securities within the standard market settlement period for the loaned securities. If the lender follows normal market deadlines the borrower is responsible for any penalties or “fail” charges for a late return.

The lender receives the same economic exposure to a security on loan, including any dividends or distributions, as if the loan had not occurred, although they must recall shares if they want to vote proxies. The processes described above are managed by the lending agent, who is generally compensated by the lender by receiving a percentage of the return generated from the transaction. Some lenders lend directly without the assistance of a lending agent, in which case they manage all aspects of the lending transaction directly.

Risks of Securities Lending
As noted above, sec lending risks need to be actively monitored and addressed by the lender and their lending agent. Not surprisingly, the recent financial crisis tested risk controls of lenders and lending agents. Following is a discussion of each of the risks associated with sec lending and the actual experience of lenders during the financial crisis.

Counterparty Risk
Lenders or their lending agents need to consider the possibility that a borrower may default on a loan and be unable to return the securities borrowed. For this reason, lenders or their lending agents review and monitor borrowers’ creditworthiness, and require borrowers to post collateral. Assuming the value of the collateral equals or exceeds the value of the securities on loan and any other amounts the borrower owes under the lending agreement, the lender is protected in the event of a borrower default, provided the lender or lending agent acts promptly to enforce their rights under the lending agreement.

During the financial crisis, several sec lending counterparties ran into difficulties, including Bear Stearns, RBS and Lehman Bros. Notwithstanding these difficulties, Bear Stearns and RBS did not default on their loans, therefore, they had little impact on sec lending markets. Lehman Bros. defaulted and tested the system, including the legal framework and collateral management practices. However, lending agents were able to liquidate collateral and repurchase replacement securities without disrupting markets. As a result, we believe that lenders generally did not experience losses from counterparty risk.

Cash Reinvestment Risk
When the lender receives cash as collateral, this cash is reinvested. The lender’s objective is to generate income, however, the lender is also exposed to investment risk including, the potential loss of principal. During the financial crisis, two problems emerged: (i) liquidity in cash collateral pools and (ii) losses in cash collateral pools. Pool liquidity problems stemmed from illiquidity of underlying investments and in several cases, lenders temporarily limited withdrawals from their pools. Some pools realized losses which were borne by lenders and/or lending agents.
Non-Cash Collateral Risk

For regulatory reasons, cash collateral is the predominant form of collateral in the U.S. market, while forms of non-cash collateral are predominantly employed outside of the U.S. While some U.S. regulators have questioned the use of non-cash collateral, perhaps due to a lack of familiarity, the primary concern is robustness and frequency of the mark-to-market process used. In addition to the initial valuation, changes in the value of the securities on loan and of the non-cash collateral held may cause a lender to be exposed. This risk is addressed by valuing the loans and the collateral daily and adjusting the collateral between the parties accordingly.

In general, the Lehman default showed that the daily mark-to-market process described above can protect lenders from exposures and may permit them to repurchase replacement securities with the proceeds of the liquidated collateral.

Operational Risk

Operational Risk is not unique to sec lending but is present in all investment activities. For sec lending, it can include market or exchange problems, miscommunication between lenders and borrowers regarding the terms of transactions between them, failed reconciliations, missed record dates, incorrect tax entitlements, etc. As with any investment activity, the lenders, borrowers, and lending agents, as well as other parties involved in the transaction including custodians, tri-party agents, data providers, etc., should all have robust operational risk teams and automated processes to quickly identify an operating event and to minimize exposures.

The financial crisis did not present unusual or an increased number of operating events; indeed, the number of securities loan transactions peaked at the beginning of the financial crisis and then declined sharply for several years, only recovering recently. This decline in volumes reduced pressures on the various systems and processes involved.

The risks associated with sec lending are important for borrowers and lenders to understand and to manage. While some problems emerged in cash collateral reinvestment pools during the financial crisis, these issues were addressed without government intervention, and did not trigger further systemic issues. Other than the issues with certain cash collateral reinvestment pools, the other areas described above functioned effectively and successfully through the financial crisis. This is consistent with the long history of sec lending.

Concerns expressed by various regulators

Over the past year, several regulators have raised questions about sec lending. As part of their review, regulators have sought information regarding sec lending. We support these fact finding efforts as we believe it is important for regulators to have full transparency into the sec lending market to ensure that any new rules avoid unintended consequences. Following is a compilation of the questions we have been asked by various regulators and our responses suggesting ways specific issues might be addressed.

Regulatory Interest in Securities Lending

- The Financial Stability Board, which includes regulators from all G20 nations, created a Task Force to study "Shadow Banking" including sec lending, which issued an interim report April 27, 2012 and will issue a final report by December 2012.
- The European Commission has proposed additional disclosure requirements and restrictions on collateral that would apply to all UCITS funds.
- The European Securities and Markets Authority has issued proposed rules to implement the above UCITS restrictions.
- International Organization of Securities Commissions has included sec lending in its study of "Shadow Banking".
- The Securities and Exchange Commission in the US was given authority by the Dodd-Frank Wall Street Reform Consumer Protection Act of 2010 to regulate sec lending transactions, but did not set out goals for the regulations nor direct what form they should take. A separate section of Dodd-Frank mandates that the SEC issue rules to increase "transparency" regarding sec lending to investors and broker-dealers.

How do we ensure sec lending does not create undue risk for any lending financial institutions?

Prior to the financial crisis, a few market participants used sec lending transactions as a mechanism to raise cash and to generate leverage. Unlike the more common collateral reinvestment activities conducted by most sec lending agents, this investment process was not designed with the primary purpose of capital preservation. One regulatory response would be to provide principles for cash collateral reinvestment in order to preclude this type of investment approach.

We recommend that all lenders, regardless of whether they appoint a lending agent or not, be required to put in place investment objectives whose primary focus is the "preservation of capital". These generally conform to the cash investment guidelines prescribed by the Federal Financial Institutions Examination Council Supervisory Policy on Sec Lending, which already governs all sec lending agents in the United States, but not all lenders. Cash reinvestment objectives should take into account the more stable and predictable nature of sec lending flows, which have different liquidity and maturity characteristics than money market funds. As a result, we believe that guidelines that match those of money market funds such as UCITS CNAV funds or SEC Rule 2a-7 funds would be unnecessarily restrictive and will create risk by concentrating even more assets into the money market space.
How do we ensure sec lending is sufficiently transparent and well understood by regulators, lenders, and underlying investors?

There is a significant amount of information regarding sec lending available today due to advances in technology, the development of robust third-party data firms and client demand. Lack of information is not the issue, but rather a lack of standardized information combined with a clear understanding of the context. We suggest that there are three levels of transparency to be considered: for regulators, for lenders, and for investors in funds which lend.

We support additional disclosure to regulators. For example, this could take the form of a transaction repository accessible only by regulators.

► We do not support the concept of a real time, public “ticker” of securities loan transactions because the information would be of little value compared with the data already provided to lenders, borrowers, and available through data vendors. Loans are priced based on various factors which include things that may be unique to a particular lender or a particular borrower, for example - the terms of a particular trade, the form of collateral used, the stability of the fund’s holdings, the tax status of the parties, etc. A ticker would not be able to incorporate these differences thus creating an “apples to oranges” comparison which could confuse rather than inform.

► We have concerns regarding a “central counterparty” or CCP model which some have suggested as a means of increasing market transparency (as well as a potential solution to perceived weaknesses in market infrastructure). The existing CCP models for sec lending arguably benefit borrowers but do not appear to benefit lenders in any way. Indeed, lenders receive no credit enhancement or better pricing, yet lenders are expected to post margin and pay higher costs. However, we remain open to considering a CCP model if and when a viable CCP for the sec lending market develops which provides benefits and not just increased costs for all participants.

We believe lenders already receive sufficient information either because they lend directly or from their lending agent. Lending agents routinely provide their lending clients with detailed transaction level data, their approved borrowers and their cash collateral reinvestment guidelines. In addition, several data vendors provide extensive and detailed data feeds on the sec lending market as a whole, including some same-day data. This data is used by many lenders to evaluate the performance of their lending agents by comparing their performance against the detailed market information provided.

For underlying investors of a fund that lends, we favor a set of best practices related to disclosure as described below. This would apply to all pooled funds that are sold to investors such as UCITS, mutual funds, ETFs, bank maintained collective trusts, etc. These funds are already provided with information regarding their lending program and they may choose to provide some or all of this to their underlying investors or shareholders.

► Disclosure to investors by the lender should be subject to the same materiality standards applicable to other activities of that fund, i.e., based on a percentage of the assets at risk, the possible losses from the activity, etc. This disclosure should be consistent with the disclosure standards that apply to all activities of that fund. If sec lending exposure is determined to be material under that standard for a particular fund, such disclosure at a minimum should include:

- A description of the transaction;
- The parties to the transaction, including whether any parties are an affiliate of the fund or its advisor;
- How returns are achieved and how those returns are allocated among the fund, the lending agent, the cash fund manager (if applicable) and any others; and
- A description of the major risks, how those risks are controlled, and the possible exposures to the fund from those risks.

Could sec lending, and a rapid unwinding of positions or increase in margins, accelerate a financial crisis, i.e., be ‘procyclical’?

If the underlying concern is the use of sec lending by banks and brokers as a source of short-term financing, regulators should address that issue directly by imposing liquidity requirements on those banks and brokers, rather than indirectly by regulating the sec lending markets and thereby risking harm to markets and investors.

Regulators should not attempt to artificially limit “pro cyclicality”. For example, limits on changing collateral margins will have the opposite effect. If lenders cannot adjust margins on loans to a counterparty with declining creditworthiness, they will simply use a more straightforward option – recalling loans to reduce overall counterparty exposures. This, in turn, may be more procyclical than allowing margin adjustments.

As acknowledged in the Interim Report of the FSB Working Group on Securities Lending and Repo issued April 27 2012, significant adjustments to margins did not occur in the sec lending markets but rather in the markets for repurchase agreements (“repo”). Regulators should keep in mind the significant differences between sec lending versus repo transactions such as the tax and legal treatment of the transaction, the mechanics of the transaction, and the uses of the transaction as they consider changes to avoid inadvertently harming the sec lending markets while trying to regulate the repo markets.
In a financial crisis, lenders will rationally seek to reduce their exposures to certain counterparties. Given the conservative nature of the underlying lenders: pensions, insurance companies, funds, etc., this is a prudent reaction, and should not be limited or restricted. A key lesson from the financial crisis is that regulators should have access to and value market signals such as this, and the response should not be to eliminate that signal when lenders are acting rationally to protect their interests.

Is one form of collateral ‘better’ than another?

At a high level, the choice of cash or non-cash collateral, is driven more by specific regulatory considerations than any commercial preference by lenders, borrowers, or lending agents.

For example, US bankruptcy law exempts cash collateral from the stay in bankruptcy for sec lending. By contrast, non-cash collateral for sec lending is subject to an open-ended stay under SIPC. As a result, most US lenders prefer cash collateral to minimize their potential market exposure by allowing for a rapid repurchase of securities.

US and Canadian mutual funds and US pensions cannot accept equity securities as collateral but can accept cash as well as highly-rated sovereign debt as collateral.

In Europe non-cash collateral is more prevalent, but cash collateral is used by some investors. For the majority of retail funds, the UCITS rules define the permissible parameters for collateral and cash collateral reinvestment.

Most lending agents such as BlackRock operate globally and thus have experience with all forms of collateral: cash, equity, and fixed income.

In our view, no form of collateral is “better” than another. Any form of liquid collateral (cash, equity, or fixed income) may be appropriate so long as the margins are set based on the liquidity and price volatility of that collateral as well as the correlation of the collateral to the securities on loan.

A variety of collateral can have a risk-reducing effect through the diversification it provides. Therefore, we urge regulators to permit a range of collateral, including equities, with limits only to ensure a high level of liquidity and to require a margin-setting process which takes into account volatility and correlation factors.

Should indemnification against losses due to borrower default be required?

Some lending agents offer their clients indemnification against certain losses due to borrower default. These arrangements vary in their structure, but are normally limited to a shortfall in collateral to cover the borrower’s obligations when a borrower defaults. We believe no such requirement should be imposed.

Given the structure of the sec lending transaction, and based on historic experience, the loss exposure currently being indemnified against is among the smallest risks in sec lending. Indemnification is not triggered unless the borrower’s obligations exceed the value of the collateral plus margin obtained from the borrower during the most recent mark to market – a margin which ranges from 102% up to 112% or more. That said, indemnification does cover a real risk and therefore comes at a cost to provide which must necessarily be reflected in lending agent fees. Changes in bank capital rules or increases in market volatility can increase the cost of providing this indemnity. We believe that the provision of indemnity should be part of the negotiated terms between lender and lending agent.

We also note that not all lenders use lending agents. Some beneficial owners such as pensions or mutual funds manage their own sec lending program directly. Since they are lending directly they cannot receive indemnification unless they purchase it from insurance companies or banks in the open market, and we are not aware that such insurance is available.

Would a ‘Resolution Authority’ for sec lending transactions reduce systemic risk?

We believe a specific regime designed to unwind sec lending transactions would duplicate existing structures, further complicate the existing resolution process and cause unnecessary confusion in the event of market stress.

Borrowers are generally broker-dealers or banks. All major markets that permit sec lending have a well-established bankruptcy regime, and many have additional procedures in the event of the bankruptcy of a broker-dealer or a bank. Using Lehman as an example, participants were able to act quickly to protect their interests on the basis of well-established precedent in the US and the UK. In both cases the insolvency was handled under bankruptcy rules, with the addition in the US of the SIPC regime for the transactions versus non-cash collateral.

A new, untested resolution authority would certainly create questions of interpretation and potential conflict the first time it was utilized. We do not see the value beyond current practices.

Recommendations

In considering new regulations for sec lending, regulators need to balance the benefits to the markets and to investors with the need to mitigate risks. We offer the following recommendations:

1. Investment objectives for cash collateral reinvestment should emphasize preservation of capital while providing more flexibility than money market funds given the relatively stable nature of sec lending collateral balances. Lenders may chose to be more conservative but these would serve as a “floor.” Importantly, all lenders should be subject to these minimum investment objectives, regardless of whether or not they use a lending agent.
2. Regulators could require disclosure in the form of non-public reporting by lenders and borrowers in order to monitor the markets. The exact information to be gathered, the frequency and the format of the information should be agreed between regulators and the industry globally to make the information most useful to regulators and the process workable for the industry.

3. Regulators should establish consistent principles for disclosure of securities lending risks and exposures. These would take three forms: by lenders to regulators, by lending agents to lenders and by lenders to their underlying shareholders. These principles should be consistent with the disclosure standards that apply to all activities of that fund.

4. Regulators should permit a range of permissible collateral that includes both cash and non-cash collateral. The latter should include both debt and equity securities. Guidelines for non-cash collateral should be based on the liquidity and volatility of the securities. In addition, the guidelines should take into account their correlation with the securities being lent.

5. Regulators should not address the perceived “procyclicality” of the participants’ behavior by limiting or restricting lenders’ and lending agents’ ability to protect their interests. Rather, they should welcome the robust market signal this behavior provides.

6. Indemnification by lending agents against possible losses due to borrower default should not be required but rather should be part of the normal commercial negotiation of pricing and services between lenders and their lending agent, if any.

7. There is no need for a resolution authority specifically for sec lending. The existing bankruptcy processes are robust mechanisms to resolve insolvent borrowers and they operated well during the unwind of Lehman Brothers.

8. Given the global nature of sec lending and the interest by regulators in multiple jurisdictions, we recommend an internationally coordinated approach to standards and regulations.

BlackRock welcomes the opportunity to explore these issues further to preserve the benefits of sec lending for our clients while also reducing the risks associated with sec lending.

Related BlackRock Comments and ViewPoint Papers

- Comments on: ESMA’s policy orientations on guidelines for UCITS Exchange- Traded Funds and Structured UCITS, submitted 22 September 2011
- ViewPoint: ETFs: A Call for Greater Transparency and Consistent Regulation
- ViewPoint: Money Market Funds: The Debate Continues

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