What are the risks associated with Securities Lending?

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Securities lending is a pure alpha solution that can enhance returns, increases revenue and offsets costs. But, like all investment activities, it can involve risk.

Matt Barnett, Head of Operations at Sharegain, looks at the principal risks associated with securities lending and breaks-down how Securities Lending as a Service (SLaaS) mitigates them.

Counterparty risk

The risk that a borrower defaults and fails to return lent securities, triggering the process of liquidating collateral and repurchasing lent securities

Mitigation

Counterparty management

We work exclusively with highly credit worthy, well capitalized, top-tier borrowers. They are subject to in-depth and extensive reviews, which continue throughout the life cycle of the relationship.

Our clients have the flexibility to remove borrowers at any time, in just one click, using their dashboard – enabling them to choose who they lend to, based on their own internal credit assessments.

Collateral management

All loans are over collateralized to at least 105% and, just like the underlying loan value, collateral is marked to market daily. This means that in the unlikely event a borrower defaults and cannot return securities, there's enough collateral to liquidate and repurchase any loaned shares. Since the collateral account is in a designated underlying lenders name, they can dictate their collateral eligibility schedule based on their own risk appetite and asset concentration requirements.

Collateral is held and managed by one of the two world's largest custodians through our tri-party arrangements.

Cash collateral reinvestment risk

The risk that cash placed as collateral is reinvested in other financial-products that incur losses or underperform

Mitigation

Cash-collateral reinvestment is an optional secondary activity which introduces additional risk to securities lending. The obvious way to eliminate this risk is to use non-cash collateral.

Non-cash

We offer our clients complete non-cash collateral flexibility. Although we promote ESMA defined HQLA (High Quality Liquid Assets) collateral schedule eligibility, clients have the ability to control and define the eligibility in accordance with their wishes and risk profile.

Cash

For clients that prefer to use cash collateral, we adopt a conservative approach – refraining from reinvestment. Given the current environment this provides the opportunity to earn interest without exposure to further market reinvestment risks.

Operational risk

The risk of error around the lifecycle of the loan and corporate actions.

Mitigation

Our clients have full control over their securities lending program all the way down to single security level. Active ownership doesn't end once a security is out on loan – and all loans can be recalled at any time.

Voting

Lending securities involves transfer of title of the underlying asset, removing an owner's ability to participate in voting. Through Sharegain's intuitive, real-time dashboard, clients are able to block or recall securities on loan ahead of key dates and fulfil their voting rights.

Dividends & coupons

When securities are on loan under the contractual arrangement the borrower is liable for the manufactured cash* payments of income which replaces any ordinary dividend or coupon entitlement due to the underlying lender. Clients also have the ability to block or recall securities on loan in advance of associated record dates.

Corporate event entitlements

The lender still retains all ownership rights and optionality on any announced corporate events and Sharegain will instruct the borrower on the lender's behalf on voluntary events and any entitlement due will be booked and paid to the lender accordingly.

*Cash payments in lieu of dividends may not qualify for the same tax treatment as "qualified dividends". You should speak to an independent tax expert to understand the tax implication to you as a result of participating in a securities lending program.

Regulatory risk

The risk that new regulation will introduce complications to securities lending programs and incur significant additional costs to adhere to new rules.

Mitigation

Navigating the ever-evolving regulatory landscape poses a significant challenge for firms launching or managing an in-house program. At Sharegain, we proactively address this by offering a comprehensive 'business as a service' solution that caters to all aspects of securities lending. This includes all applicable regulatory reporting obligations, a full suite of reports that support all lending activities, and a real-time dashboard view of the program.

We provide loan transparency right down to the individual client, aligning our solution with regulatory requirements for retail lending programs, and championing industry-recognized best practices.

Our dedicated in-house compliance and legal teams stay abreast of regulatory trends, ensuring that our clients are informed of the latest industry developments. We are also proud members of the International Securities Lending Association (ISLA) and actively engage in relevant industry working groups to further strengthen our commitment to regulatory compliance and market best-practice.

Recall & settlement risk

The risk that recalls and settlements are delayed (buy-ins)

Mitigation

Our automated collateral allocation and loan release solution operates on a ‘pre-pay’ basis. This means loans are only executed when the excess collateral is confirmed and settled in the client’s custody account. In the same way, we only release collateral when the returned shares are confirmed settled back in the client’s custody account.

We use real-time reconciliation tools to ensure the integrity of our books and records. While our operations team oversees the loan process, the majority of the post-trade management is fully automated. This removes human error and ensures everything runs smoothly and efficiently.

Unlike programs that process files in batches, SLaaS accommodates intraday file consumption, operating in near real time across geographic regions and time zones. This way, we have a timely view on activity across our client portfolios meaning we have more time to act on any issues should they become apparent, and similarly have the ability to distribute recall notifications on confirmation of a sale on trade date meaning we seek to avoid associated settlement fines and liabilities for our clients.

All investment opportunities present risk. The Sharegain SLaaS program has considered where these are present and developed a full e2e solution that appreciates the controls to manage them.

Our expertise, your advantage

Effectively mitigate securities lending risks with Sharegain

Learn more

With securities lending, as with other investment activities, your capital may be at risk.

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