



Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 19

MEETING DATE: October 21, 2020

SUBJECT: Education: Securities Lending

SUBMITTED FOR: ___ Consent ___ Deliberation and Action X Receive and File

RECOMMENDATION

Staff recommends the Board receive and file the education presentation on Securities Finance Agency Lending (securities lending).

PURPOSE

This item supports the 2020 Annual Investment Plan to provide education to Board members. This education session will provide an update on SCERS' securities lending program.

BACKGROUND

At the October 2020 Board meeting, John Powell, Vice President, Business Development and Relationship Management, State Street Global Markets, will review SCERS' securities lending program, provide an update on performance, and offer education as to how securities finance agency lending works.

SCERS has participated in a securities lending program administered through State Street Bank since 1993. The program is encapsulated within SCERS' custody relationship with State Street Bank and is contracted through its own Securities Lending Authorization Agreement. Under this program, SCERS' lendable stocks and bonds (that are held by SCERS' custodian, State Street) can be borrowed on a short-term basis by broker/dealers approved by State Street. While broker/dealers typically borrow the securities to deliver against a "short" position in a securityⁱ, there are many other reasons for a security to be borrowed, as shown on page 16 of the attached State Street presentation.

In borrowing the stock or bond, the borrower must post collateral with State Street equal to 102% for U.S. securities and 105% for non-U.S. securities, of the market value of the securities being borrowed. The borrower is contractually obligated to return the securities upon recall by the

ⁱ A short, or short position, is created when a trader sells a security first with the intention of repurchasing it or covering it later at a lower price. A trader may decide to short a security when he/she believes that the price of that security is likely to decrease in the near future. Short sellers borrow shares of stock from an investment bank or other financial institution, paying a fee to borrow the shares while the short position is in place. Often employed by a hedge fund strategy.

lender. The collateral can be other securities, but is most often provided in the form of cash. The cash is then invested in a collateral pool managed by State Street, in the Quality D Short-Term Investment Fund (Quality D Fund). The Quality D Fund is invested in short term securities with an objective of generating investment returns that exceed the rate of return that is promised to the borrower as part of the loan/collateral transaction (the 'rebate') plus the investment management fees paid to State Street for managing the Quality D Fund. State Street indemnifies SCERS against the risk that a borrower (counter-party) will not return a borrowed security by using the collateral, plus its own cash if necessary, to purchase a replacement for any non-returned security. SCERS has never had a borrower fail to return a borrowed security, and operationally, the securities lending program has not interfered with SCERS' investment managers' ability to trade their portfolios.

DISCUSSION

SCERS receives 80% of the net income from the lending of its securities (State Street receives the remaining 20%). This figure increased from 75% when SCERS updated its securities lending contract with State Street in 2019. SCERS' securities lending program generated \$1.2 million in income in the 2019-20 fiscal year. Page 6 of the State Street presentation shows the earnings and historical yield of SCERS' securities lending program over the past 20 years.

The level of earnings generated by securities lending has ebbed and flowed over the years, but peaked around the time of the global financial crisis (GFC). SCERS' securities lending program generated \$5.6 million in income in the 2008-09 fiscal year, compared to \$1.2 million in the fiscal year 2019-20. A reason for the reduction in income is related to the change in the makeup of the Quality D collateral pool. Prior to the GFC, the Quality D collateral pool was heavily comprised of higher yielding asset backed securities (ABS) with longer durations and with greater inherent risks, including counter-party risk (the risk that an institution will default on a transaction), credit risk (the risk that an investment will be worth less than its purchase price due to actual or perceived lower credit worthiness), and duration risk (a rise/fall in interest rates which cause a decline in value from the mismatch between assets and liabilities).

In 2010, State Street restructured the Quality D collateral pool, by separating assets between a liquidity pool and a duration pool. As the name implies, the liquidity pool consists of lower yielding money market assets with short durations and which can be liquidated for cash presumably at any time. The liquidity pool is managed as a low risk, highly liquid money market fund largely in accordance with SEC 2a-7 guidelines, which require risk limiting conditions for money market funds around duration, credit ratings, and diversification. Page 6 of the State Street presentation reflects the lower yields of the liquidity pool.

By contrast, the duration pool consisted of the legacy securities such as ABS, with maturities extending beyond 90 days. The duration pool did not have liquidity, and was formed as a "run-off" portfolio for legacy collateral assets held prior to the GFC. Since this time, the duration pool has mostly run off (\$971k currently remains in the duration pool versus \$309.9 million in the liquidity pool), and State Street has been reinvesting all cash from principal and interest paid from the duration pool into the liquidity pool. Therefore, the Quality D collateral pool currently consists almost entirely of low risk and highly liquid money market fund assets.

Over the past three years, SCERS has had between \$3.7 billion and \$4.3 billion in eligible securities available for lending. Over this time period, SCERS has generally had between \$337 million and \$430 million on average out on loan. This includes a mix of U.S. and non-U.S. equity and corporate bond positions, and U.S. government securities.

Staff believes that while income in the securities lending program has moderated over the past decade, the program does generate consistent income for SCERS, with less re-investment risk and greater liquidity within the cash collateral pool. In speaking with State Street, SCERS' securities lending program held up well during the market volatility associated with the COVID-19 pandemic in March and April of 2020. Staff does not recommend any changes to the securities lending program at this time.

ATTACHMENT

- State Street Securities Finance Agency Lending Performance Review

Prepared by:

/S/

Steve Davis
Chief Investment Officer

Reviewed by:

/S/

Eric Stern
Chief Executive Officer



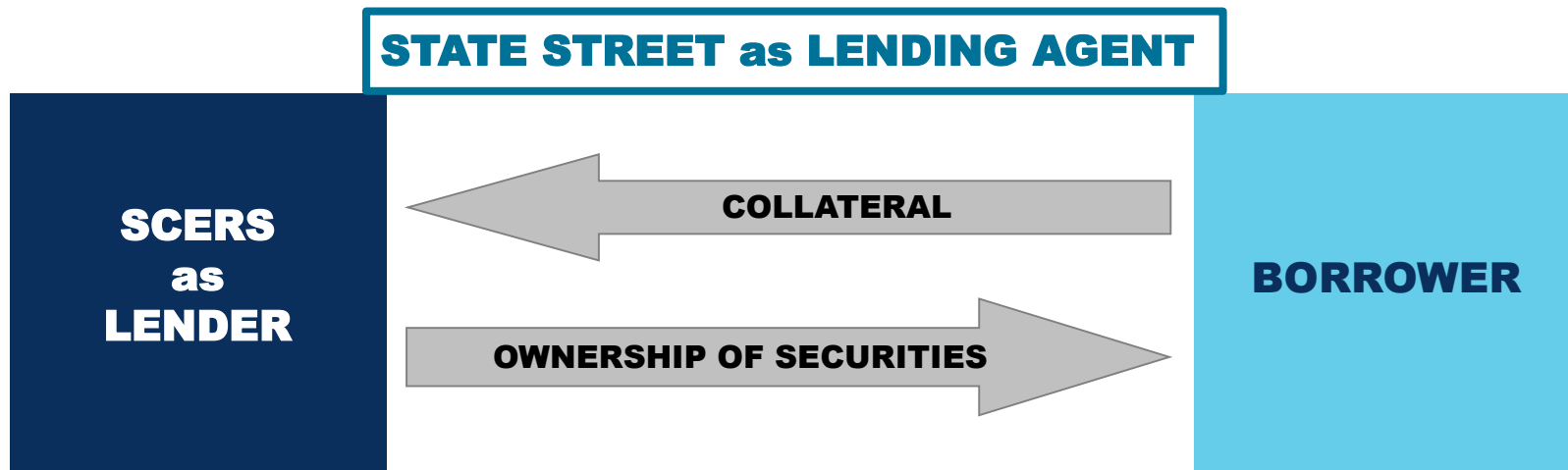
October 2020
Securities Finance
Agency Lending
Performance Review
SCERS

Securities Finance Relationship Summary

- **Securities Lending Relationship began in 1993**
- **Since 2000, Securities Lending has earned SCERS \$41.8m in revenue**
- **Securities Lending Revenue Fee Split = 80% Sacramento County, 20% State Street**
- **Standard Approved Borrower List**
- **Borrower Default Indemnification through State Street**
- **Acceptable Forms of Collateral**
 - **Cash**
 - **U.S. dollars only, reinvested in Quality D Short-Term Investment Fund**
 - **Non-Cash**
 - **Various asset categories such as US Treasuries, Agencies, Corporate Debt, Equities. All reviewed, priced & monitored daily**
- **Collateralized US Security Loans at 102% & Non US Securities Loans at 105%**

Securities Finance Defined

An investment management product where participants generate revenue by temporarily transferring idle securities, in a negotiated, collateralized transaction, to a borrower



- Lending Agent negotiates fee on borrowed securities and receives and settles associated collateral
- Borrower becomes legal owner of securities while SCERS retains rights of beneficial ownership entitling it to all distributions and corporate actions.
- SERS portfolios can be managed without limitation
- The Borrower is contractually obligated to return the securities upon recall by the Lending Agent/SERS

State Street Agency Lending

• Program Overview

State Street's securities finance program launched in **1974** and is one of the largest agency lending programs in the world today.

Leveraging our experienced global trading teams, State Street provides follow-the-sun **access to demand** within a **customized** framework that fits each client's requirements.

46 years of experience in securities lending

\$4.2 trillion of lendable assets

\$374.8 billion of active loans

38 security markets for equities and fixed income

246 active clients, **47** approved jurisdictions

163 borrowers, **16** approved jurisdictions

US (BTC) and **German** (GmbH) legal entities

Cash collateral is managed by **State Street Global Advisors** (SSGA), one of the world's largest cash managers

10 regional offices with **6** trading desks

433* dedicated employees

AA- rating from Standard & Poor's

"State Street provides us with regular updates on industry events and new opportunities. We've mandated State Street as our securities lending agent for many years. We are very satisfied with the service they offer. Their service is very reliable and high quality."

#1 in the 2020 Global Investor/ ISF Beneficial Owners Survey¹ **global isf**

#1 in the 2020 Asia Asset Management awards²

#1 in the 2019 ISF Borrower Survey³ **global isf**

#1 in the 2019 Global Investors Award dinner⁴

¹ #1 Agent Lender in 9 rankings, such as Custodial Lender, Collateral Management and Parameter Management

² #1 Securities Financing House, #1 Securities Lending

³ #1 Agent Lender in Americas in the unweighted division

⁴ #1 in the Americas unweighted category by the Equity Lending Survey Group 1

* Headcount data as of 30 June 2020. This headcount figure does not include contractors

Global Presence

10 Regional Locations with 6 Trading Desks and 3 Full Service Operations Centers

The Americas

- Boston, Massachusetts
(World Headquarters)
- Jersey City
- Toronto, Ontario

Europe/Middle-East/Africa

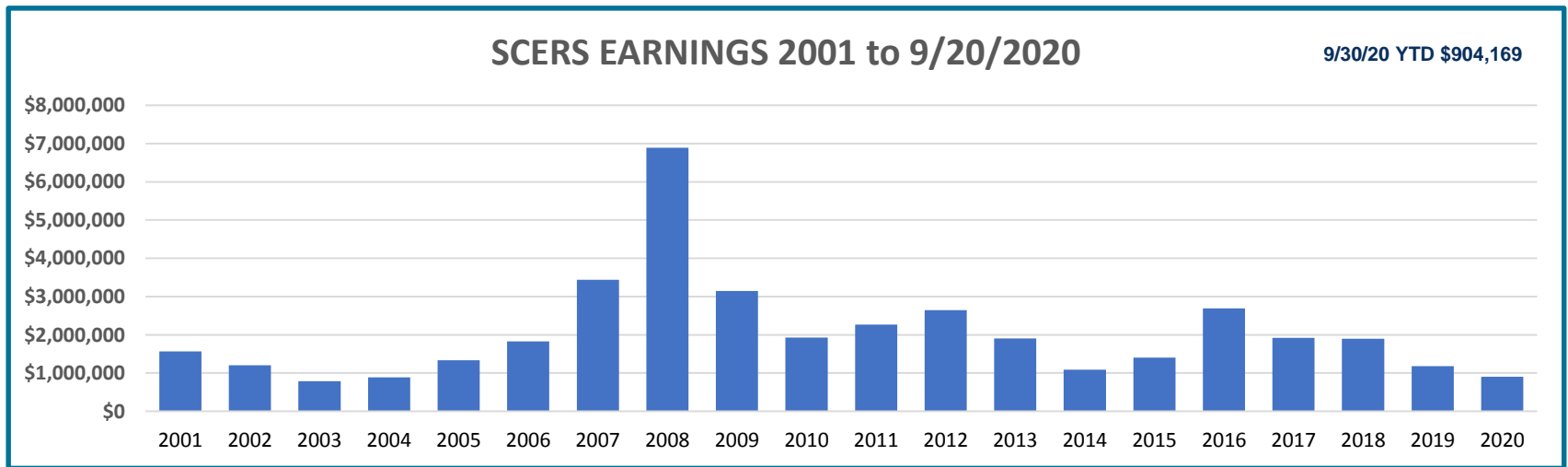
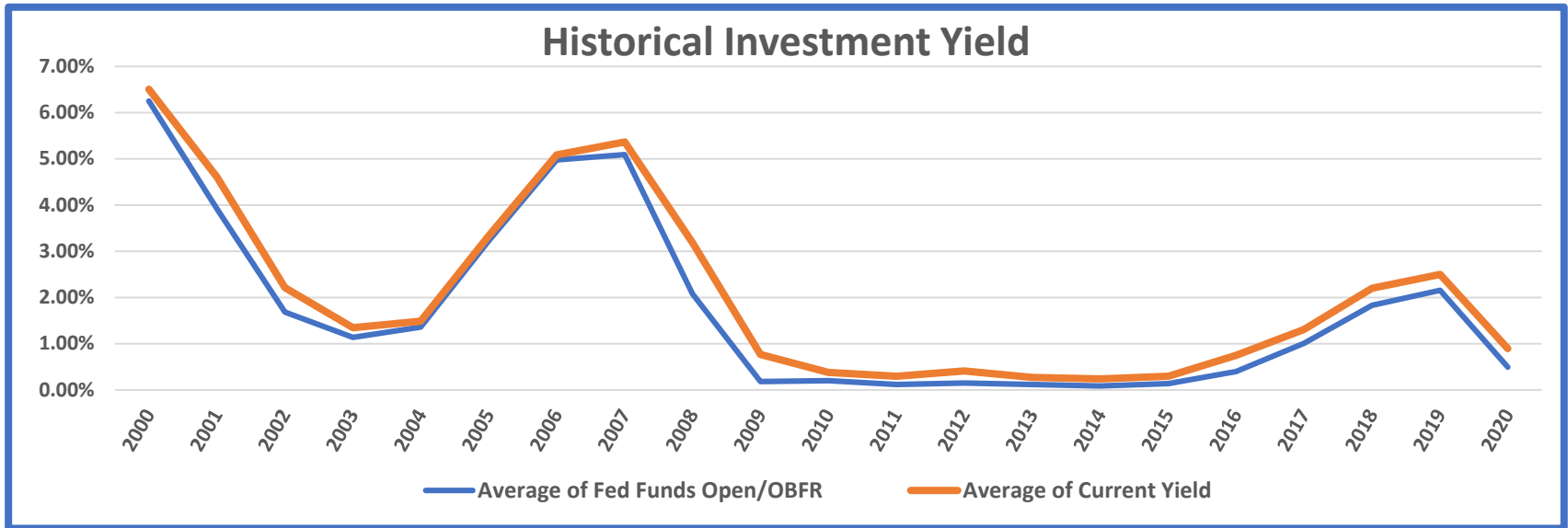
- Dublin, Ireland
- Frankfurt, Germany
- London, England

Asia/Pacific

- Hong Kong, China
- Sydney, Australia
- Tokyo, Japan
- Seoul, Korea

- Full Service Center
- Relationship Management Office
- Relationship Management and Trading Office

Historical Performance



6 Performance data shown represents past performance and is no guarantee of future results.

Performance Summary – FISCAL YEAR END

AVERAGE LENDABLE	FYE 6/30/20	FYE 6/30/19	FYE 6/30/18
NON-US CORP BOND & EQUITY	1,200,572,102	1,167,067,542	1,367,890,843
NON-US FIXED INCOME	21,219,396	21,962,121	22,242,699
US CORP BOND & EQUITY	2,228,613,839	1,896,632,916	2,410,414,675
US GOVERNMENT	649,689,490	629,482,191	454,539,626
TOTAL	4,100,094,827	3,715,144,770	4,255,087,843

AVERAGE ON LOAN	FYE 6/30/20	FYE 6/30/19	FYE 6/30/18
NON-US CORP BOND & EQUITY	17,634,644	22,962,360	28,716,072
NON-US FIXED INCOME	-	55,749	-
US CORP BOND & EQUITY	92,311,708	110,017,298	175,303,896
US GOVERNMENT	227,166,741	256,145,194	225,718,139
TOTAL	337,113,094	389,180,602	429,738,107

REVENUE	FYE 6/30/20	FYE 6/30/19	FYE 6/30/18
NON-US CORP BOND & EQUITY	\$ 199,859	\$ 342,098	\$ 426,337
NON-US FIXED INCOME	\$ -	\$ 566	\$ -
US CORP BOND & EQUITY	\$ 407,366	\$ 541,277	\$ 863,992
US GOVERNMENT	\$ 585,981	\$ 557,648	\$ 641,210
TOTAL	\$ 1,193,206	\$ 1,441,588	\$ 1,931,539

SPREAD	FYE 6/30/20	FYE 6/30/19	FYE 6/30/18
NON-US CORP BOND & EQUITY	120.5	157.5	145.1
NON-US FIXED INCOME	0.0	393.9	0.0
US CORP BOND & EQUITY	53.5	47.1	63.1
US GOVERNMENT	31.3	28.0	37.4
TOTAL	32.7	41.6	55.0

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STATE STREET.

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STATE STREET.

Performance Summary – Fiscal Year End 06/30/20 by Fund

FUND	FUND NAME	GROSS EARNINGS	REBATES	NET EARNINGS	SCERS EARNINGS	STATE ST. EARNINGS	NET SPREAD 360 (bps)
PK15	NEUBERGER BERMAN FIXED INCOME	1,713,642	1,285,044	428,598	342,880	85,718	27.4
PK35	MET WEST	1,033,736	787,722	246,014	196,813	49,202	41.9
PK36	M.A. WETHERBY	568,902	350,920	217,981	174,393	43,589	57.4
PK05	ALLIANCE CAPITAL RUSSELL 3000	409,859	262,954	146,904	117,533	29,371	48.3
PK44	LSV ASSET MANAGEMENT INTL LARGE CAP	166,172	41,071	125,101	100,081	25,021	102.0
PKBQ	PRUDENTIAL FIXED INCOME	351,313	247,338	103,975	83,181	20,794	41.3
PKAD	LAZARD INTL STRATEGIC EQUITY PLUS	90,577	29,302	61,275	49,019	12,255	123.7
PK78	WILLIAM BLAIR AND COMPANY SMALL CAP	58,672	4,930	53,742	42,994	10,748	193.5
PKRE	BROOKFIELD LIQUID REAL RETURN	73,768	31,105	42,663	34,125	8,538	62.6
PKZ4	SCERS BARCLAYS1-10YR TIPSINDX	173,396	152,630	20,766	16,613	4,153	22.8
PK34	DALTON, GREINER, HARTMAN, MAHER	34,817	18,633	16,184	12,947	3,237	56.9
PKYO	WALTER SCOTT INTL EAFE INCOME	18,311	5,589	12,722	10,178	2,544	97.6
PKPR	AQR US ENHANCED EQUITY	25,655	15,909	9,746	7,797	1,949	55.7
PK96	EAGLE CAP	33,496	27,679	5,817	4,654	1,163	35.2
		4,752,317	3,260,828	1,491,489	1,193,206	298,283	41.9

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STATE STREET.

Performance Summary – Fiscal Year End 06/30/20

Top Earning Loaned Securities by Category

Product : NON-US CORP BOND & EQUITY		
CUSIP ID	Security Name	Mthly Client Earn Base
528748908	DEUTSCHE LUFTHANSA REGCOMMON STOCK	28,023.98
713360907	EQUINOR ASACOMMON STOCK NOK2.5	16,103.08
712957901	SAS ABCOMMON STOCK	12,220.67
610817900	HARMONIC DRIVE SYSTEMS INCCOMMON STOCK	11,872.16
ACI1MYFC2	TOTAL SARIGHT	9,375.57

Product: US CORP BOND & EQUITY		
CUSIP ID	Security Name	Mthly Client Earn Base
74340E103	PROGYNY INCCOMMON STOCK USD.0001	55,558.74
92826C839	VISA INC CLASS A SHARESCOMMON STOCK USD.0001	9,424.62
143658300	CARNIVAL CORPCOMMON STOCK USD.01	9,040.49
29978A104	EVERBRIDGE INCCOMMON STOCK USD.001	7,194.00
135086106	CANADA GOOSE HOLDINGS INCCOMMON STOCK	6,878.36

Product: US GOVERNMENT		
CUSIP ID	Security Name	Mthly Client Earn Base
9128282Y5	US TREASURY N/BINTR: 2.125 MATD: 09/30/24	28,628.52
912810EJ3	8 1/8 BOND 21INTR: 8.125 MATD: 05/15/21	26,709.94
912810FE3	US TREASURY N/BINTR: 5.5 MATD: 08/15/28	25,180.95
912810SL3	US TREASURY N/BINTR: 2.0 MATD: 02/15/50	23,067.60
912828ZF0	US TREASURY N/BINTR: .5 MATD: 03/31/25	18,586.19

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STATE STREET.



APPENDIX

Securities Finance

How it works

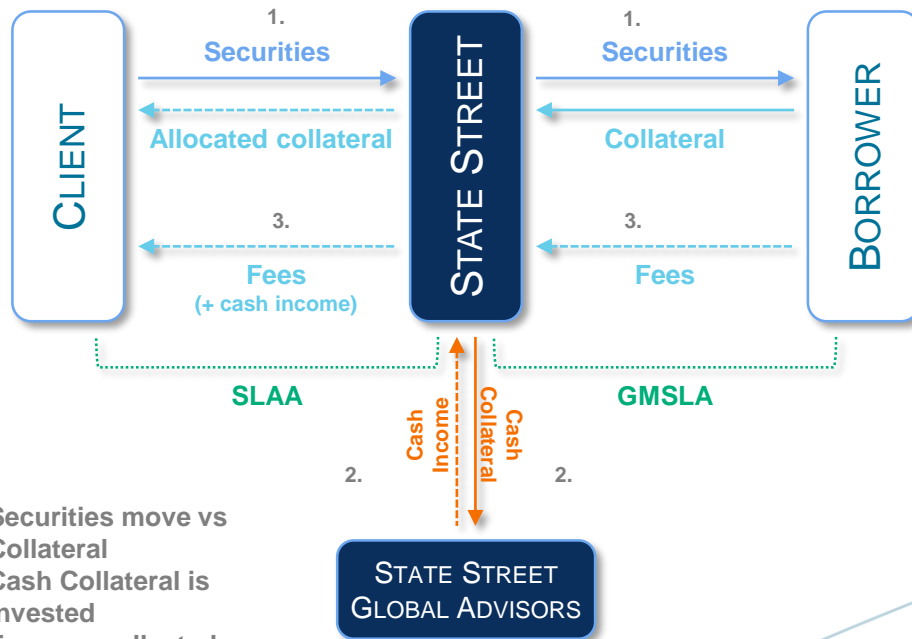
Agency Lending

What is agency lending?

Agency Lending is a **\$4.49 trillion*** global business that generates liquidity for global financial markets and additional yield for clients.

Clients lend **unutilized long securities** to a borrower in return for other securities or cash as collateral, and the borrower pays a basis point fee for the duration of the loan. The cash collateral is reinvested in a reinvestment vehicle usually managed by SSGA.

Agency Lending generates low risk **enhanced yield** to our clients' funds



1. Securities move vs Collateral
2. Cash Collateral is invested
3. Fees are collected

STATE STREET

Drivers of Demand

- Securities are borrowed by a counterparty that has a commitment to deliver those which it has sold, but does not possess
 - All asset classes
 - Failing purchase on the other side of the trade
- Securities are borrowed to deliver against a “short” position in a security.
 - All asset classes, but typically seen in corporate securities
 - Broker sells a position that they don’t own and borrow securities to make good on their delivery
 - Assume that the price of the security will fall before they have to return shares to the beneficial owner
 - Broker profits on the difference in price minus their cost to borrow the stock
 - This includes “hedged strategies”
- Tax treaties between governments allow for dividend arbitrage trades.
 - For US plan sponsors, these are non-U.S. equities
 - US Mutual Fund client entitled to 85% of a foreign dividend, borrower in the local market entitled to 100%
- Securities are borrowed as part of a financing strategy
 - Typically U.S. and non-U.S. government securities
 - “Repo” transaction
 - Collateral upgrade trade

Transaction Basics

- Revenue
 - Cash collateral backed loans generate revenue by the difference between the investment yield on the cash collateral and the rebate paid to the borrower for use of the cash
 - Non-cash collateral revenue generated by a payment made by the borrower representing a percentage of the market value of the loan (fee based, equivalent to net spread on cash loan)
 - Clients typically earn the overwhelming majority of the revenue generated by our securities lending program (Fee Split)
- Distributions
 - Client (beneficial owner) is entitled to all distributions of the loaned security
 - Financial distributions can be passed back by the short holder (Dividends, Corporate Actions, etc.)
 - Proxy voting is foregone by entering into a securities lending transaction if loaned out over record date
- Client Viewpoint
 - Securities lending is an incremental addition to the underlying investment activity / additional return
 - The main goal is to avoid sale disruptions, and to mitigate risk of principal loss on collateral assets (essentially align lending program with current risk parameters)

Securities Finance

Why borrow securities?



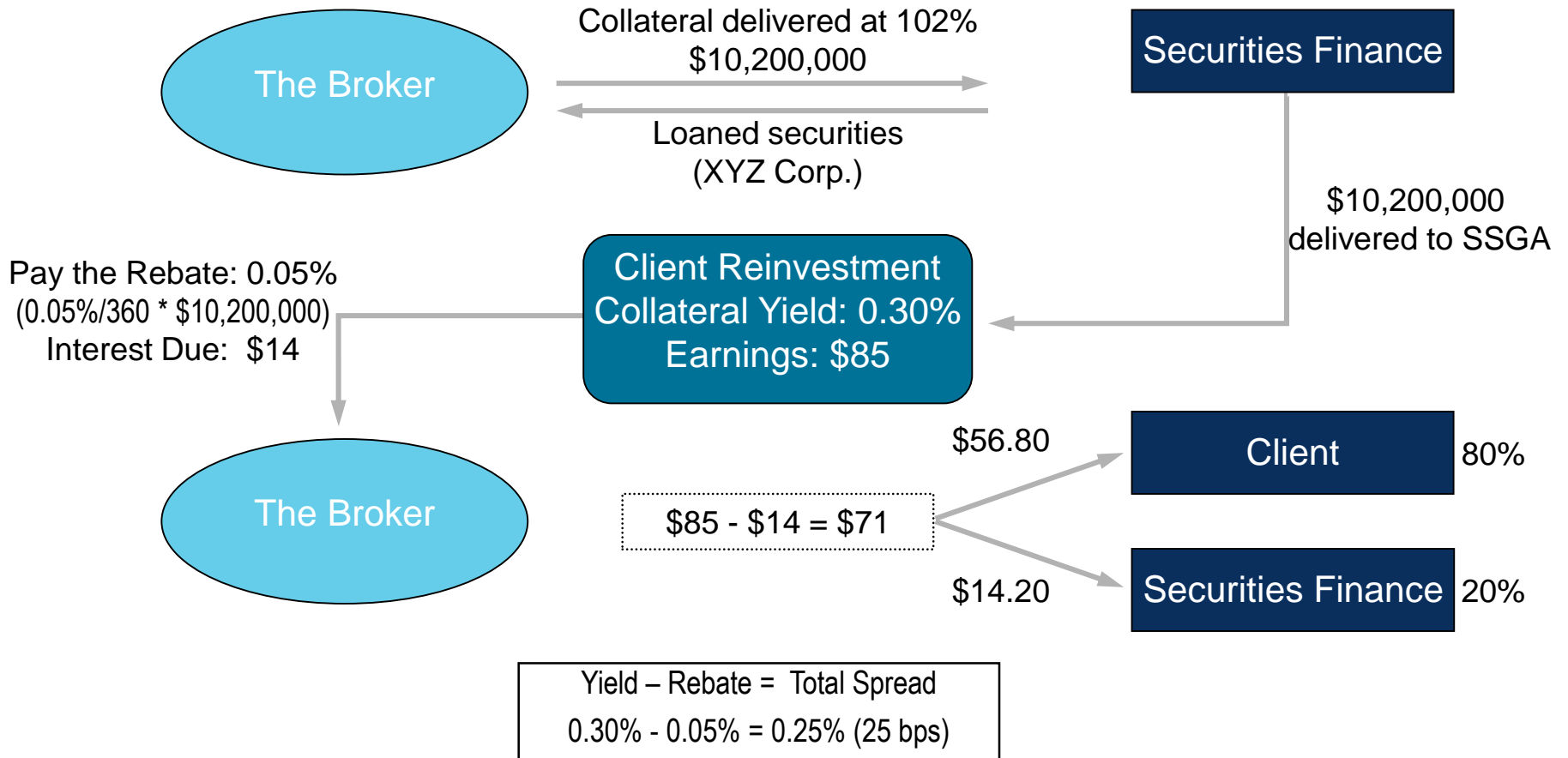
Fundamentals of Securities Finance

One Day Sample Transaction – Cash Collateral

- A Broker is looking to borrow 50,000 shares of XYZ Corp.
 - 50,000 shares of XYZ Corp. has a market value of \$10 million
- The Broker contacts the Securities Finance US Equity Trading Desk in Boston.
 - State Street has the supply/inventory
- Terms are agreed:
 - Rebate rate of 0.05%
 - Cash collateral
 - Open loan (no fixed period of time)
- Trade is executed on DML (Securities Finance's Trading and Accounting Platform).
 - The automated queuing system identifies fund ABCD as next in line for loan
 - ABCD has 50,000 shares of XYZ Corp available
- Collateral is delivered by the Broker
 - Cash collateral valued at 102% of the market value (\$10,200,000)
 - Cash is invested by SSGA in a specific, client designated re-investment portfolio, earning 0.30%
- Shares are delivered through DTC to the Broker

Fundamentals of Securities Finance

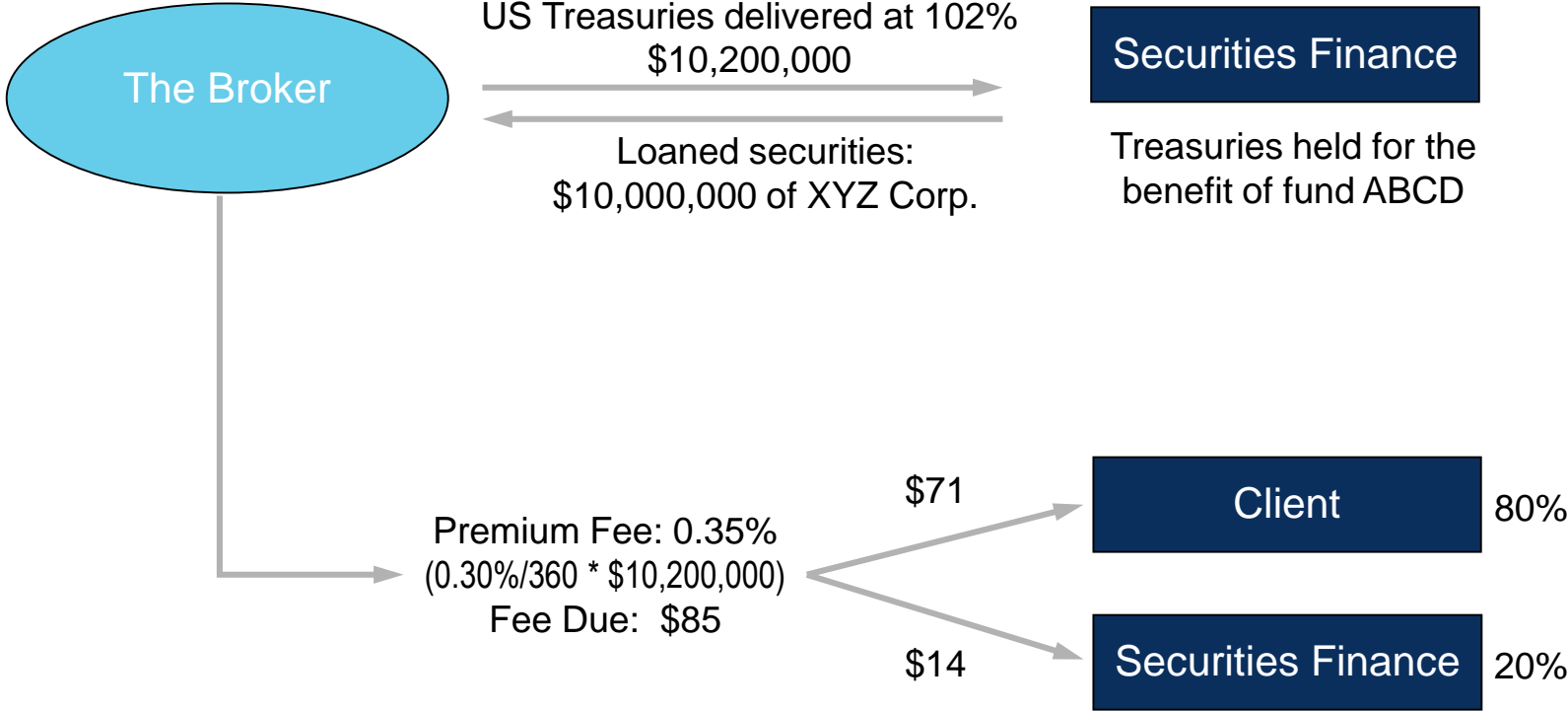
One Day Sample Transaction Diagram – Cash Collateral



Collateral Yield and Rebate Rate are annualized

Fundamentals of Securities Finance

One Day Sample Transaction Diagram – Non-Cash Collateral (US Treasuries)



Premium rate annualized using a 360-day basis.

Securities Finance

Major risks and mitigating factors

Credit Risk

State Street controls the quality of its **approved borrower list** and monitors all borrowers daily against credit limits approved by Enterprise Risk Management.

The optional borrower default **indemnity** transfers credit risk to State Street Bank & Trust Co which is rated AA- by S&P, the joint highest of any major agent lender.*

Market Risk

State Street **marks to market** all loans and collateral daily, takes a positive margin on collateral, and actively monitors value-at-risk in addition to stress scenario exposures.

The optional borrower default **indemnity** transfers market risk to State Street, who will cover the shortfall in collateral value in the event of a borrower default.

Ops Risk

State Street has **dedicated operations teams** to monitor daily processes and industry standard systems such as Pirum to reconcile positions with borrowers.

Security-level **buffers** are imposed to ensure that most sales can be facilitated through swaps with other clients, removing the need for a loan recall.

Legal Risk

Clients sign a single **Securities Lending Agency Agreement** (SLAA) defining all terms and parameters for their program.

The SLAA should be regularly reviewed and updated to ensure that it properly reflects the client's **risk/reward appetite**.

Reinvest Risk

Cash collateral is managed by **State Street Global Advisors**, one of the world's largest cash managers with over \$387.59 billion under management.**

State Street's optional borrower default indemnity typically **does not cover cash collateral** and clients should ensure that their reinvestment policy is appropriate.

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