The NAIC’s Capital Markets Bureau monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of U.S. insurance companies. Please see the Capital Markets Bureau website at INDEX.

Securities Lending Primer

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Executive Summary

- Securities lending is the act of loaning a bond, stock or other security to a borrower (i.e., other financial institution that is also referred to as a counterparty) on a short-term basis, often for less than one year.
- For U. S. insurers, securities lending can be a low-risk investment strategy and effective way to achieve short-term financing and obtain additional yield income.
- Lenders of securities not only earn a modest income from fees charged to the borrowers, but also they earn income on the reinvested collateral that is exchanged for the loaned securities.
- Reinvested collateral often consist of short-term, high-quality liquid assets.
- Traditionally, securities lending reinvested collateral has been less than 1% of U.S. insurers’ total cash and invested assets.

How Securities Lending Works

Securities lending is the act of loaning a bond, stock or other security to a counterparty (or borrower) in an over-the-counter transaction (i.e., just between the two parties), on a short-term basis, most often for a term of less than one year (which can be extended). It requires that the counterparty post collateral in the form of cash or another security(ies). The borrower may return the borrowed security(ies) and request its cash back on relatively short notice, and without penalty. The securities lender receives a fee for the transaction, as well as a return on investing the cash that is posted as collateral. And if the borrower fails to repay the loaned securities at the termination date of the securities lending agreement, the lender keeps the collateral. Upon termination of the securities lending agreement, the loaned securities are returned back to the lender by the borrower, in exchange for the cash that was originally posted as collateral, plus any investment income. Chart 1 illustrates the mechanics of a typical securities lending transaction.
The securities lender has the discretion to invest the cash posted by the borrower in “income productive” securities (i.e., reinvested collateral), which, on short notice, are liquid enough to be sold without losing significant market value. For U.S. insurers, as part of their reporting requirements, they must be able to identify additional liquidity when there is a maturity date mismatch between the reinvested collateral and the terms of the securities lending agreement. U.S. insurers also have written investment guidelines that they must adhere to as securities lenders, with regard to the types of securities that they are permitted to invest with the borrowers’ cash, such as in a documented statement of investment policy and guidelines manual.

**What Are the Risks?**

When lending securities, upon investing the posted cash into reinvested collateral, the lender must consider the credit and liquidity risks of the potential investments, as well as the asset-liability risks. With U.S. insurers, they are not only expected to follow appropriate statutory accounting rules, but also the individual companies’ investment policies, particularly with respect to duration of the investments. Prudent investment of cash posted as collateral calls for short-term, highly liquid assets that will be readily available to convert back to cash when the securities lending agreement terminates. In addition, daily marking-to-market of the reinvested collateral may address any liquidity or volatility concerns. Most reinvested collateral for U.S. insurers is typically in cash and cash equivalents; the majority of insurers’ reinvested collateral matures in five years or less.

As a lender of securities, insurers are subject to counterparty risk—that is, whether the counterparty, which could be a bank or another institutional investor, will be able to return the lent security(ies) on the securities lending agreement termination date. According to U.S. insurer financial statements data, the majority of securities lent by U.S. insurers to counterparties tend to be corporate bonds.

**What Went Wrong?**

Leading up to the 2008 financial crisis, what was believed to be firm-wide risk management inefficiencies that caused financial duress within one insurance company resulted in a review of the securities financing markets by authorities such as the Financial Stability Board (or FSB, an international body that monitors and makes recommendations about the global financial system) to promote transparency relative to these investments.
While this insurer is most known for significant losses that occurred within its credit default swap (CDS) program, the onset of an overwhelming demand for returned cash by its securities lending counterparties compounded the insurer’s liquidity constraints.

Between 2005 and 2007, the insurer changed direction of its investment strategy relative to securities lending reinvested collateral (without disclosing the change in its notes to the financial statement or to U.S. state regulators). This was discovered during a financial examination in 2007. Rather than invest in short-term, high-quality assets, the insurer mostly invested the posted cash collateral in long-term, subprime residential mortgage-backed securities (RMBS), and due to a liberal interpretation of accounting requirements, there was no transparency with regard to how the posted cash was invested. As a result, there was an asset/liability maturity mismatch. Meanwhile, the subprime RMBS also experienced significant market value declines as the financial crisis emerged. Due in part to financial distress brought about by the insurer’s CDS portfolio, borrowers of securities lent by this insurer began requesting the return of their cash (to reduce exposure to this insurer as a firm). The insurer, in turn, was unable to meet the growing demands for cash by its securities borrowers, and doing so meant that it would have to sell the subprime RMBS collateral that was now illiquid. Liquidity constraints within the insurer were now compounded.

With the assistance of regulators, the insurer was able to reduce its securities lending program exposure before a U.S. government bailout was implemented. The Federal Reserve Bank of New York created a limited liability company whose funds were used to purchase RMBS from the insurer’s securities lending portfolio to help raise cash to return to the securities lending borrowers.

While the insurer’s losses stemming from its securities lending program did not directly cause the changes in treatment of securities lending by the insurance industry, it did highlight a lack of transparency and varying interpretations of the accounting language related to these investments. After careful review and consideration by a dedicated subgroup, several revisions were made.

Given the size of the overall securities lending market, which was about $2.3 trillion globally, as of October 2017, according to the Financial Securities Oversight Council’s (FSOC) 2017 annual report, it draws attention from a financial stability perspective. So to promote transparency relative to these investments, regulatory bodies such as the FSOC and the FSB have made initiatives to establish guidelines related to data collecting and reporting in the securities financing markets.

**Statutory Accounting Treatment of Securities Lending**

*Statement of Statutory Accounting Principles (SSAP) No. 103R—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* states that the borrower of loaned securities must post adequate cash collateral, which is, in turn, invested by the insurance company, thus termed the “reinvested collateral.”

SSAP No. 103R also states that any cash as collateral received by the insurer that can be repledged should be reflected on balance sheet, while cash received by the insurer that cannot be repledged or sold (that is, it must be held) should be recorded off balance sheet, and it is not captured in the financial statements. For both on-and off-balance sheet reinvested collateral, summary information is required to allow for identifying potential liquidity constraints related to potential duration mismatches.

In addition, according to SSAP No. 103R, any cash or collateral received by the insurer in exchange for securities lent must have a fair value of at least 102% of the fair value of the loaned securities; if the collateral dips below 100% of the fair value of the loaned securities at any time during the securities lending agreement, the borrower is
then obligated to deliver additional collateral by the next business day so that the fair value of total collateral received equals 102% of the fair value of the loaned securities.

Note that the cash or collateral held on the balance sheet is treated like any other insurer asset in terms of reporting, valuation and risk-based capital (RBC). Accounting treatment for U.S. insurers’ securities lending exposure aims not only to promote consistency, but also to improve transparency with respect to reporting.
**Key Terminology**

**Securities Lending**

The act of loaning a bond, stock or other security to an investor in an over-the-counter market, requiring the borrower to post collateral in the form of cash or securities.

**Counterparty**

A financial institution that participates in a financial transaction.

**Over-the-Counter**

A trade of securities (without a physical location) directly between two counterparties without any supervision of exchange.

**Cash Collateral**

Cash proceeds that a counterparty, or borrower, gives to the lender in exchange for loaned securities.

**Reinvested Collateral**

Securities purchased with the cash collateral received for securities lent to borrowers.

**Reinvestment Income**

Income (i.e., interest earned) generated by the reinvested collateral.

**Liquidity Risk**

The degree to which an asset’s price is negatively affected as it is bought or sold in the financial markets.

**Asset/Liability Risk**

The risk that the value of the liabilities will exceed the value of assets.

**Counterparty Risk**

Risk that the counterparty/borrower will be unable to return the loaned securities back to the lender on the securities lending termination date.
Securities Lending Agreement

States the term of the loan (usually less than one year), the fee that the lender receives, and the amount and type of collateral to be posted by the counterparty, among other terms.

Income Productive Securities

Securities that generate income but on short-notice are liquid enough to be sold without affecting their market value.

Repos (Repurchase Agreements)

A form of secured financing, they represent commitments whereby one party sells securities to another party in exchange for cash, and agrees to repurchase the same (or substantially the same) securities back from the counterparty on an agreed-upon date and at an agreed-upon price. They are economically similar to securities lending, but there are some structural differences.

Fair Value

Estimated value of assets that is used in financial statements.

Financial Stability Board (FSB)

An international body that promotes financial stability by coordinating national financial authorities and international standard-setting bodies as they work toward developing strong regulatory, supervisory and other financial sector policies. It fosters a level playing field by encouraging coherent implementation of these policies across sectors and jurisdictions. The FSB, working through its members, seeks to strengthen financial systems and increase the stability of international financial markets. The policies developed in the pursuit of this agenda are implemented by jurisdictions and national authorities.

Financial Securities Oversight Council (FSOC)

The FSOC has a statutory mandate that creates for the first time collective accountability for identifying risks and responding to emerging threats to financial stability. It is a collaborative body chaired by the Secretary of the Treasury that brings together the expertise of the federal financial regulators, an independent insurance expert appointed by the president, and state regulators. The FSOC also has important authorities to constrain excessive risk in the financial system to help minimize the risk of any firm threatening the stability of the financial system.
Links to Published NAIC Capital Markets Special Reports on Securities Lending

U.S. Insurance Industry Year-End 2015 Exposure to Securities Lending and Repurchase Agreements and Regulatory Update, Sept. 9, 2016


Securities Lending in the Insurance Industry, July 7, 2011