Securities lending plays a major role in the efficient functioning of the securities markets worldwide and fund participation in securities lending programs can be a valuable part of efficient portfolio management, offering benefits to both lenders and borrowers.

Securities lending is a common practice for institutional investors as well as commingled funds, mutual funds and exchange traded funds (ETFs), and are strictly regulated in most financial markets.

In a securities lending transaction, securities are temporarily transferred by one party (the lender) to another (the borrower). The borrowers are brokers, dealers, and other financial institutions, which provide collateral in return for the loan. The lender retains the economic benefits associated with ownership of the loaned securities such as the dividends and corporate action entitlements. The borrower is contractually obligated to return the securities upon recall by the lender. The borrower pays a fee to the lender for the use of the borrowed securities.

Typically, a fund uses a lending agent to lend a portion of the underlying securities in the portfolio to brokers, dealers and other financial institutions. The lending agent works with the lending client to establish a program that best meets the client’s risk/return parameters.

The diagram below represents a typical example of the lending process. For clarity, certain portions of the process have been simplified.

**Step 1  Loan is Initiated**
A loan is typically initiated when a borrower contacts the lending agent’s trading desk inquiring about the availability of a particular security. The lending agent should also work to proactively price securities available for loan.

**Step 2  Terms are Negotiated**
The lending agent and the borrower negotiate the terms of the loan, including:

- Collateral (non-cash or cash)
- Rebate rate for cash transactions or premium for non-cash transactions
- Loan duration
- Dividend/reclaim rate
Understanding the Securities Lending Process

Step 3 Borrower Delivers Collateral to Lending Agent
Minimum collateral requirements may vary according to the type of security loaned, ranging from 102% to 105% of the value of the securities on loan.

Step 4 Lending Agent Contacts Sub-Custodian
In some transactions, a sub-custodian may be involved. The lending agent sends delivery instructions to the sub-custodian, and then the borrower sends the receipt instructions to the sub-custodian.

Step 5 Securities are Moved to the Borrower’s Sub-Custodian Bank

Step 6 Cash Collateral Is Invested
Cash collateral is invested in a short-term reinvestment fund. When non-cash collateral is accepted, there is no reinvestment. Instead, the borrower pays the lending agent a fee (premium) for the collateral.

Step 7 Daily Mark-to-Markets are Executed
The lending agent should perform daily mark-to-markets to ensure the collateral is adjusted based on the daily market value of the borrowed securities.

Step 8 Securities are Returned
At the end of the loan period, the securities are returned to the lending agent via the sub-custodian bank.

Step 9 Loan is Closed
The cash collateral plus interest (rebate) is returned to the borrower when the loan is closed.

Step 10 Loan Earnings are Paid
The investment earnings, less the borrower’s rebate, are divided between the lending client and the lending agent. This fee split is determined at the beginning of the loan.

Understanding the securities lending process allows investors to more efficiently buy and sell investments that may engage in securities lending. Securities lending may directly benefit shareholders, as it generates revenue for the fund which can potentially offset fund expenses and improve index tracking. In addition, the funds can continue to collect dividends on loaned securities. The borrowers gain an opportunity to turn a profit in a transaction such as shorting a security. Securities lending allows borrowers to obtain securities with which to express their investment opinions at a lower cost than if they bought the securities outright. This improves the efficiency of market pricing and lowers costs for investors overall.