Securities Lending with Cash Collateral Reinvestment in Retirement Plans: Withdrawal Restrictions and Risk Raise Concerns

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SUMMARY OF COMMITTEE RESEARCH

PREPARED BY THE

MAJORITY STAFF

OF THE

SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE

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Special Committee on Aging

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SPECIAL COMMITTEE ON AGING HEARINGS ON RETIREMENT SAVINGS

On October 24, 2007, the Senate Special Committee on Aging held a hearing on "Hidden 401(k) Fees: How Disclosure Can Increase Retirement Security," which examined the effect hidden 401(k) fees can have on retirement savings and the need for simple and clear disclosure. The Committee heard testimony from: Barbara Bovbjerg, Director of Education, Workforce and Income Security Issues, GAO; Bradford Campbell, Assistant Secretary of Labor, the Employee Benefits Security Administration; Jeff Love, Director of Research, AARP; Mercer Bullard, assistant professor, University of Mississippi School of Law; Michael Kiley, President, Plan Administrators, Inc.; and Robert Chambers, Esq., Partner, Helms, Mulliss & Wicker LLC and Chairman of the American Benefits Council.

LEGISLATIVE ACTION:

Increasing the Transparency of Pension Fees. In the 111th Congress, Rep. George Miller (D-CA, 7th Congressional District) introduced H.R. 1984, the *401(k) Fair Disclosure for Retirement Security Act*, and Senators Tom Harkin (D-IA) and Herb Kohl (D-WI) introduced S. 401, *the Defined Contribution Fee Disclosure Act*, to amend ERISA to require the disclosure of fees to both plan sponsors and participants. In 2010, the Department of Labor issued regulations that will bring greater transparency and disclosure of 401(k) fees. These regulations will make it easier for employers to ensure that their plans' fees are reasonable – and 401(k) participants will now know how much they are being charged to invest in their 401(k) plan.

On April 30, 2008, the Senate Special Committee on Aging held a hearing entitled, "Leading by Example: Making Government a Role Model for Hiring and Retaining Older Workers" evaluating the federal government's efforts to hire and retain older workers. The Committee heard testimony from: Barbara Bovbjerg, Director, Education, Workforce and Income Security Issues, US Government Accountability Office, Robert Goldenkoff, Director, Strategic Issues, US Government Accountability Office, Nancy Kichak, Associate Director, Strategic Human Resources Policy, Office of Personnel Management, Thomas Dowd, Administrator, Office of Policy Development and Research, Employment and Training Administration, US Department of Labor, Max Stier, President and CEO, Partnership for Public Service, Chai Feldblum, Co-Director, Workplace Flexibility 2010.

LEGISLATIVE ACTION:

Remove the pension penalty for seniors to continue working in a phased retirement:
In the 111th Congress, Senator Herb Kohl (D-WI) joined Senator George Voinovich (R-OH), the ranking member of the Senate Homeland Security and Governmental Affairs Committee's Subcommittee on the Oversight of Government Management, the Federal Workforce and the District of Columbia, in introducing S. 469, which would remove the penalty for federal workers in the CSRS who would have otherwise had their pension reduced for working part time at the end of their career. This legislation was signed into law by President Barack Obama on October 28, 2009.

On July 16, 2008, the Senate Special Committee on Aging held a hearing entitled "Saving Smartly for Retirement: Are Americans Being Encouraged to Break Open the Piggy Bank?" to examine the reported increase in leakage and to explore ways to protect American's retirement savings. The Committee heard testimony from: Christian Weller, Senior Fellow, Center for American Progress; Mark Iwry, Principal, Retirement Security Project; David John, Principal, Retirement Security Project; Gregory Long, Executive Director, Federal Retirement Thrift Investment Board; John Gannon, Senior Vice President, Financial Industry Regulatory Authority; Bruce Bent, Chairman, The Reserve.

LEGISLATIVE ACTION:

Reducing the "Leakage" of Pension Savings. In conjunction with the July 2008 hearing, the Aging Committee requested that the U.S. Government Accountability Office (GAO) study the extent to which Americans tap into their accrued retirement savings prior to retirement. In August 2009, GAO issued *401(k) Plans: Policy Changes Could Reduce Long-term Effects of Leakage on Workers' Retirement Savings*, which suggested that Congress consider changing the requirement for the six-month contribution suspension following a hardship withdrawal, as well as recommended that the Secretary of Labor promote greater participant education on the importance of preserving retirement savings, and that the Secretary of the Treasury clarify and enhance loan exhaustion provisions to ensure that participants do not initiate unnecessary leakage through hardship withdrawals. In conjunction with the 2008 hearing, Senators Charles Schumer (D-NY) and Herb Kohl (D-WI) introduced S. 3278 in the 110th Congress, to limit the number of 401(k) loans to three and prohibit the widespread use of 401(k) debit cards.

On February 25, 2009, the Senate Special Committee on Aging held a hearing entitled "Boomer Bust? Securing Retirement in Volatile Economy," which examined the economic downturn's effect on retirement security, particularly for those on the brink of retirement. The Committee heard testimony from: Jeanine Cook, a Baby Boomer from Myrtle Beach, South Carolina; Dallas L. Salisbury, President & CEO, Employee Benefits Research Institute; Dean Baker, Co-Director, Center for Economic and Policy Research; Ignacio Salazar, President & CEO, SER - Jobs for Progress; Barbara B. Kennelly, President & CEO, National Committee to Preserve Social Security and Medicare; Deena Katz, CFP, Associate Professor, Texas Tech University, and Chairman, Evensky & Katz.

On May 20, 2009, the Special Committee on Aging held a hearing entitled "*No Guarantees: As Pension Plans Crumble, Can PBGC Deliver*," to consider whether the federal government's Pension Benefit Guaranty Corporation (PBGC) has the capability to fulfill its mission to insure the pensions of nearly 44 million Americans, at a time when several of the country's largest automobile companies are teetering on the edge of bankruptcy. The question of PBGC's governance came amidst allegations of mismanagement by the agency's former director, Charles E.F. Millard, who deviated from PBGC's conservative investment strategy just before the market downturn. In addition, the PBGC Inspector General alleged that Millard improperly influenced the procurement process surrounding the restructuring of the Corporation's investments. The Committee heard testimony from: Dallas L. Salisbury, President and CEO, Employee Benefits Research Institute; Barbara Bovbjerg, Director, Education, Workforce and Income Security, U.S. Government Accountability Office; Rebecca Anne Batts, Inspector General, Pension Benefit Guaranty Corporation; and Vincent Snowbarger, Acting Director, Pension Benefit Guaranty Corporation. Charles E.F. Millard, Former Director, Pension

Benefit Guaranty Corporation, was invited to testify but availed himself of the privilege afforded to him under the Fifth Amendment of the Constitution not to give testimony that might tend to incriminate him.

LEGISLATIVE ACTION:

> ***Strengthening the Pension Benefit Guaranty Corporation's Governance Structure.*** On the basis of the Committee's findings, Senators Herb Kohl (D-WI), Russ Feingold (D-WI), Claire McCaskill (D-MO), and Michael Bennet (D-CO) introduced S.1544 in the 111th Congress, which expands and strengthens PBGC governance and oversight, in part, by expanding the PBGC's board of directors, redefining the Inspector General's reporting structure, and adding additional procurement safeguards. We expect this bill to be reintroduced in the near future.

On October 28, 2009, the Special Committee on Aging held a hearing entitled "*Default Nation: Are 401(k) Target Date Funds Missing the Mark?*" to explore issues detrimental to target date fund's effectiveness. The Committee heard testimony from: Barbara Bovbjerg, Director of the Education, Workforce and Income Security, U.S. Government Accountability Office; Andrew Donohue, Director of Investment Management, U.S. Securities and Exchange Commission; Phyllis Borzi, Assistant Secretary of Labor, Employee Benefits Security Administration, U.S. Department of Labor; John Rekenthaler, Vice President of Research, Morningstar; Ralph Derbyshire, Senior Vice President and Deputy General Counsel, FMR LLC; and Michael Case Smith, Senior Vice President of Institutional Strategies, Avatar Associates.

On June 16, 2010, the Special Committee on Aging held a hearing entitled "*The Retirement Challenge: Making Savings Last a Lifetime*," which examined how to help seniors manage their savings throughout their retirement. The Committee heard testimony from: Phyllis Borzi, Assistant Secretary of Labor, Employee Benefits Security Administration, U.S. Department of Labor; J. Mark Iwry, Senior Advisor to the Secretary of the Treasury and Deputy Assistant Secretary for Retirement and Health Policy, U.S. Department of Treasury; Ted Beck, President and CEO, National Endowment for Financial Education; Kelli Hueler, Founder and CEO, Hueler Companies; William Mullaney, President of U.S. Business, MetLife (representing the American Council of Life Insurers); and Lisa Mensah, Executive Director, Aspen Institute's Initiative on Financial Security.

AGING COMMITTEE MAJORITY STAFF INFORMATION PAPER

Executive Summary

In response to reports between 2007 and 2010 of employers that sponsor 401(k) plans being restricted from withdrawing their plan assets from investment options that lent securities (the practice of lending plan assets to third parties in exchange for cash as collateral that a fund reinvests), the Majority Staff of the Aging Committee (the Committee) conducted an investigation of securities lending within retirement plans. The Committee requested information on securities lending from employers that sponsor 401(k) plans and banks in the securities lending market.

The Committee surveyed employers that sponsored the 30 largest 401(k) plans with assets that totaled over $330 billion. All 30 employers stated that at least one of the investment options they offered to participants within their plans engaged in securities lending at some time between 2006 and 2010. However, five of these employers no longer offered an investment option that engaged in securities lending within their 401(k) plans in 2010. The five employers that transitioned out of securities lending cited the changing market environment and credit crisis in 2008 and 2009, low and negative returns on the cash collateral reinvestment and liquidity restrictions as their reasons for no longer participating in securities lending within their plans.

The Committee also surveyed the seven largest banks in the securities lending market. In total, these banks had over $1 trillion of securities on loan in 2010. Six of the seven banks we surveyed currently provide direct securities lending services to defined contribution, defined benefit and other retirement plans. In 2010, the total number of retirement plans that these banks provided services to was 570 and these plans had a total asset size of about $1.3 trillion.

Our investigation uncovered withdrawal restrictions in defined contribution retirement plans. Over 1/3rd of the employers we surveyed indicated that they had been restricted at the plan-level from withdrawing from at least one investment option that participated in securities lending between 2006 and 2010. In addition, three of the seven banks we surveyed restricted defined contribution and defined benefit plans from exiting funds that engaged in securities lending. The types of restrictions included only permitting employers to take in-kind (rather than cash) distributions or only permitting employers to withdraw a maximum percentage of between two and four percent per month of the value of its interest in the fund. These results are troubling as employers must be able to change investment options offered in their 401(k) plans to meet their duties under ERISA in prudently selecting such options.

In the case of securities lending with cash collateral within 401(k) plans, participants bear the ultimate risk of loss from the cash collateral pool investments. Securities lending agents generally do not reimburse plan participants for losses that the cash collateral reinvestment pool may suffer. However, in the event that there are gains from the investments of the cash collateral pool, participants generally share the gain with securities lending service providers, including broker-dealers and securities lending agents. The data we received from the surveyed employers

and banks is generally consistent with these conclusions. For example, most of the employers we surveyed stated that any losses within the cash collateral pools were ultimately borne by the participant. In terms of revenue sharing arrangements between the plans/participants and the securities lending service provider, it ranged from 50-50 percent split to a division of 92 percent to the plan/participants and eight percent to the service provider.

Finally, for the investment options that lent securities in 2010 within the surveyed employers' plans, the average percent of the investment option's assets that was lent out was 9.93 percent. The range of the percentages of investment option's assets that was lent out in 2010 was 0.04 to 97 percent. That is, one of the investment options offered by an employer lent out 97 percent of its underlying assets.

Recommendations

Based on our research on securities lending practices, the Committee makes the following recommendations:

- Employers should increase their knowledge of securities lending within their defined contribution retirement plans.

- Participants should be given information about securities lending within their defined contribution retirement plan investment options.

- The Department of Labor should issue guidance to employers on securities lending practices within qualified retirement plans.

- Companies in the business of securities lending should report information about their businesses practices.

Introduction

With the shift from traditional defined benefit pension plans to defined contribution retirement plans, today much of the burden for preparing for a financially secure retirement falls on American workers. The dominant and fastest growing defined contribution plan is the 401(k) plan, which allows workers to choose to contribute a portion of their pre-tax compensation to the plan. According to estimates by industry experts, 49 million Americans were active 401(k) plan participants in 2009 and, by year end, 401(k) plan assets amounted to $2.8 trillion.[1] Unlike those covered by traditional defined benefit pension plans, participants in 401(k) plans personally contribute to their individual accounts and are responsible for selecting from an array of investment options, such as mutual funds, money market accounts and stable value funds. Furthermore, the investment risk generally falls solely on participants in 401(k) plans.

[1] Employee Benefit Research Institute. *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2009,* Issue Brief No. 350 (Washington D.C., November 2010).

Securities lending is the practice of lending plan assets to third parties in exchange for collateral that a fund reinvests. The collateral for the loan can be either cash or other securities, such as bonds or stocks. However, in the U.S., cash is the primary form of collateral taken in securities lending. Many defined contribution and defined benefit plans participate in securities lending programs within their plans to generate additional revenue to cover fees or increase earnings.

During the financial crisis, some of the cash collateral pools of retirement plan assets participating in securities lending programs experienced significant losses. This was as a result of the cash collateral being invested in risky assets that subsequently lost value and became difficult to trade. The losses and illiquid assets in the cash collateral pools led to many employers being restricted from withdrawing or transferring their retirement plan assets from investment options that lent securities. Some plans and participants also experienced realized losses when terminating their securities lending arrangements.

These losses in cash collateral pools and withdrawal restrictions highlight the risks associated with securities lending with cash collateral reinvestment within retirement plans. This is especially true of 401(k) plans where the investment risk falls on participants. However, many employers and participants are not even aware that securities lending is going on within their plans – and if they are aware, they may not recognize the risks.

Government Accountability Office Report

In response to participant and employer concerns over withdrawal restrictions, in June 2009, Chairman Kohl asked the Government Accountability Office (GAO) to determine what happened during the financial crisis to participant accounts and to employers' control over the investment options offered to 401(k) plan participants. GAO was asked to answer the following questions:

- What are some of the specific investments and practices that prevented employers and participants from accessing 401(k) plan assets?

- What changes, if any, could the Department of Labor make to assist employers in understanding the challenges posed by certain investments and practices?

Some of the descriptions in this report are derived from GAO's March 2011 report entitled, "401(k) Plans: Certain Investment Options and Practices That May Restrict Withdrawals Not Widely Understood."

Aging Committee Report

To supplement GAO's research, the Aging Committee conducted its own investigation of securities lending within retirement plans, the findings of which are summarized in this report. Currently, there is no comprehensive, public data source available with respect to securities lending, including securities lending within the retirement plan market. Therefore, the

Committee requested information on securities lending from employers that sponsor 401(k) plans and banks within the securities lending market.

In November and December 2010, the Committee sent out two sets of letters related to securities lending within retirement plans to better understand the potential problems. The first set of letters was sent to the employers that sponsor the thirty largest 401(k) plans in the U.S. (by asset size). These employers were asked a series of questions about securities lending practices within their plans, including requests for information on:

- The size of their plans;
- Whether their plans participates in securities lending;
- The investment options within their plans that participate in securities lending, including the total revenue (loss) from securities lending and the average percent of the funds' assets that were lent out;
- The types of disclosures (employer and participant) on securities lending; and
- Whether plan sponsors and/or participants experienced withdrawal restrictions.

The second set of letters was sent to the seven largest banks within the securities lending market. These banks were asked a series of questions about their securities lending business within the retirement plan market, including requests for information on:

- The size of their defined contribution and defined benefit retirement plan business;
- The range of revenue sharing arrangements for splitting securities lending revenue;
- The total amount of gains and losses from their securities lending programs involving defined contribution and defined benefit plan assets; and
- Whether they have restricted any defined benefit and defined contribution plans from exiting funds that engage in securities lending.

Background

Retirement Plans – In General

Private sector employers generally offer their employees two broad types of retirement plans, defined benefit and defined contribution. Employers that offer defined benefit plans typically invest their own money in the plan and, regardless of how the plans' investments perform, promise to provide eligible employees retirement benefits. These benefits are generally fixed levels of monthly retirement income based on years of service, age at retirement, and, frequently, earnings.

In contrast, employers that offer defined contribution plans do not promise employees a specific benefit amount at retirement – instead, the employee and/or their employer contribute money to an individual account held in trust for the employee. The employee's retirement income from the defined contribution plan is based on the value of their individual account at retirement, which reflects the contributions to, performance of the investments in, and any fees charged against their account. Over the past three decades, there has been a general shift by

employers away from defined benefit plans to defined contribution plans. The dominant and fastest growing defined contribution plan is the 401(k) plan, which allows workers to choose to contribute a portion of their pre-tax compensation to the plan under section 401(k) of the Internal Revenue Code.[2]

Employers that offer 401(k) plans have responsibilities under ERISA. The law establishes that a plan fiduciary includes a person who has discretionary control or authority over the management or administration of the plan, including the plan's assets. Typically, the employer is a fiduciary under this definition. ERISA requires that plan fiduciaries carry out their responsibilities prudently and do so solely in the interest of the plan's participants and beneficiaries. In accordance with ERISA and related Labor regulations and guidance, employers and other fiduciaries must exercise an appropriate level of care and diligence given the scope of the plan and act for the exclusive benefit of plan participants and beneficiaries, rather than for their own or another party's gain. Responsibilities of a fiduciary include, but are not limited to, selecting and monitoring investment options the plan will offer and ensuring that the plan has a broad range of investment options.

401(k) Investment Practice: Securities Lending With Cash Collateral Reinvestment

Many of the investment options offered by employers within their 401(k) plans, including mutual funds, money market accounts and stable value funds, engage in a practice called securities lending, where some of the assets held in these investment options on behalf of plan participants are lent out for a period of time by a securities lending agent to a third party, usually a broker-dealer. In return the broker-dealer provides collateral to the securities lending agent to hold until it returns the borrowed securities. The collateral for the loan can be either cash or other securities, such as bonds or stocks. However, in the U.S., cash is the primary form of collateral taken in securities lending. Many plans participate in securities lending to generate additional revenue to cover fees or increase earnings.

Some of the $2.8 trillion in assets held in 401(k) plans at the end of 2009 were utilized in securities lending programs, but the specific amount is unknown. The percentage of assets lent out at any given time varies by type of 401(k) investment option. The SEC limits the amount of assets that can be lent from a mutual fund at one time to one-third of the fund's total asset value. Other 401(k) investment options that are not registered with SEC, such as some equity, bond, and stable value funds, are generally not limited in the percentage of assets that can be utilized by securities lending programs.

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[2] Other defined contribution plans include 403(b) plans, profit-sharing plans and employee stock ownership plans.

Findings

Employer Findings

In response to the Aging Committee's request, the employer sponsors of the thirty largest 401(k) plans in the U.S. provided the following information.

Plan Information

Of the 30 employers we surveyed, 25 provided information about their plans for the time period of 2006 through 2010 (the 25 Employers). The total amount of 401(k) assets in 2010 for the 25 Employers was $332.6 billion. Table 1 shows the total 401(k) assets from 2006 through 2010 for the 25 Employers. As expected, asset levels dropped significantly in 2008 but increased in 2009 and 2010 – and almost recovered to 2006 levels by the end of 2010. The average amount of 401(k) assets per plan in 2010 for the 25 Employers was $13.3 billion. Table 2 shows the range of 401(k) assets per plan in 2010. Asset size ranged for the 25 Employers from $2.4 billion to $33 billion.

Table 1. Total 401(k) assets from 2006 to 2010 for the 25 Employers

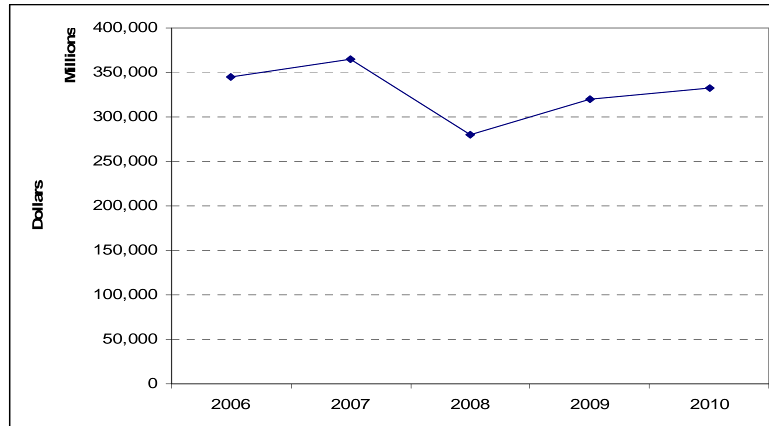
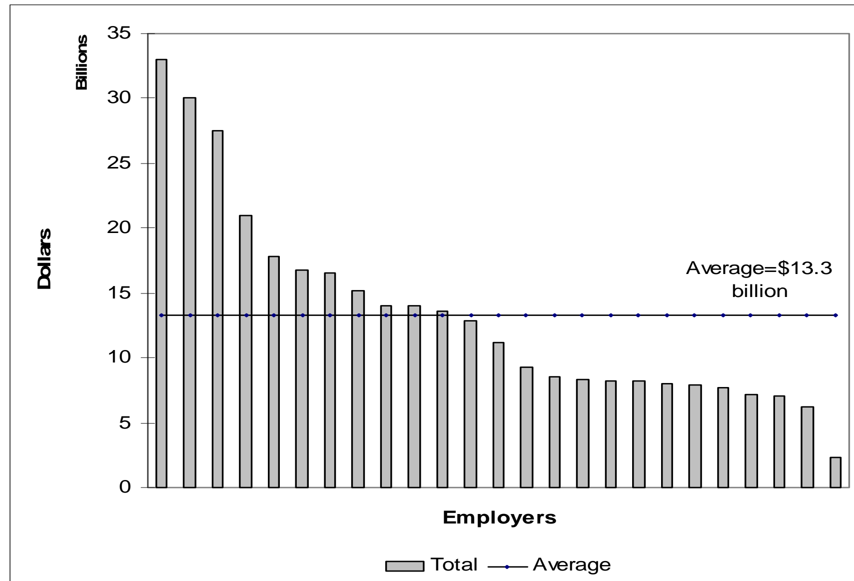


Table 2. Range of amount of 401(k) assets per plan in 2010 for the 25 Employers



The total number of participants in the plans offered by the 25 Employers in 2010 was 4.2 million. From 2006 to 2010, the total number of participants increased from about 4.0 million to 4.2 million (Table 3). The number of participants per plan in 2010 ranged from 32,500 to 1.3 million (Table 4). The average number of participants per plan in 2010 for the 25 Employers was 168,300.

Table 3. Total number of 401(k) plan participants from 2006 to 2010 for the 25 Employers

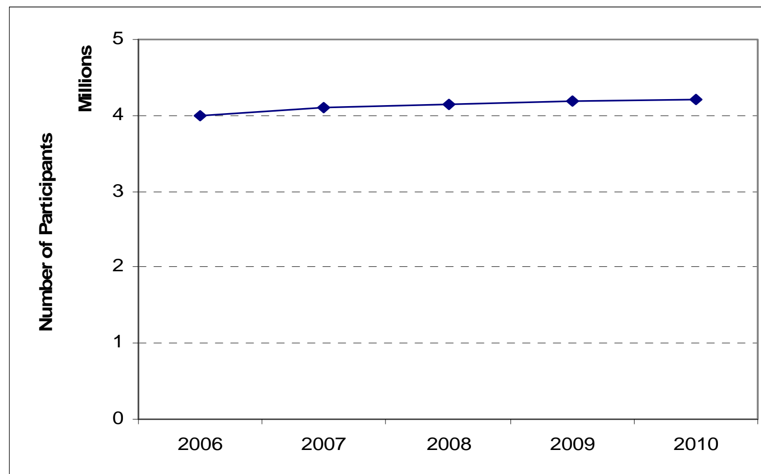
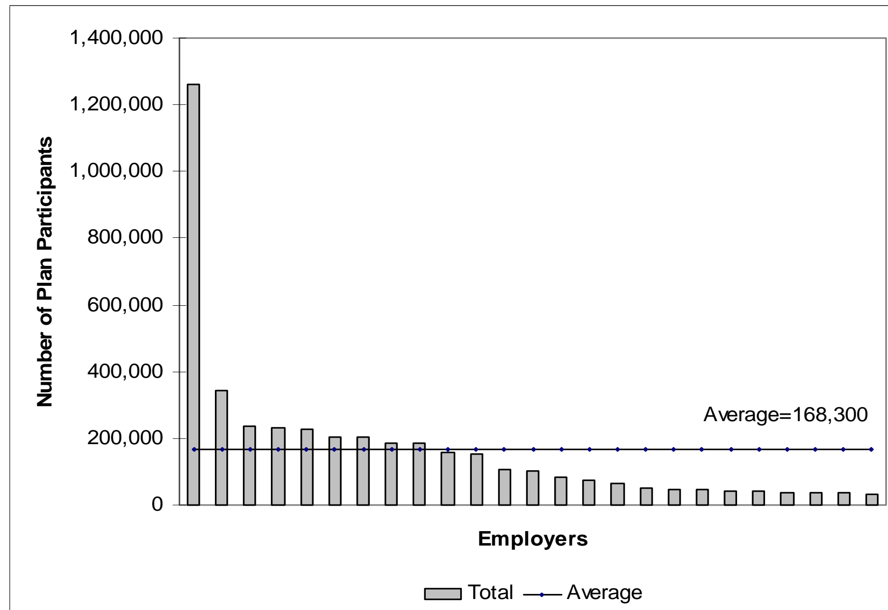


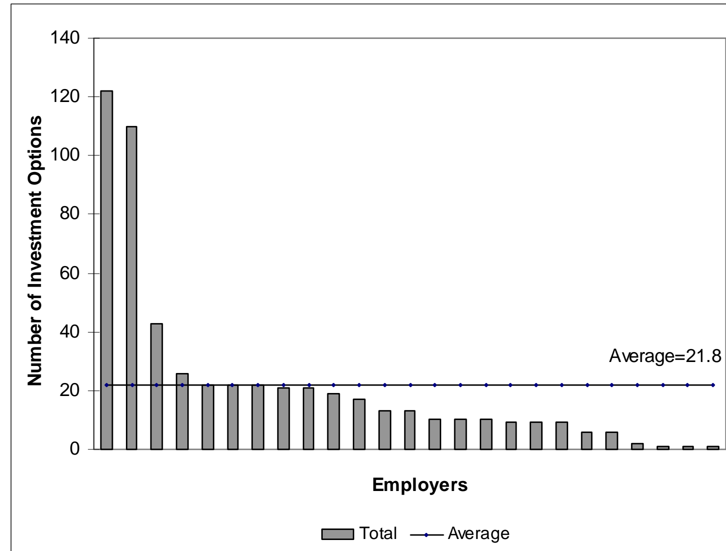
Table 4. The range of number of 401(k) plan participants per plan in 2010 for the 25 Employers



Participation in Securities Lending Programs

Of the 30 employers we surveyed, all of them stated that at least one of the investment options they offered to participants within their 401(k) plans engaged in securities lending at some time between 2006 and 2010. However, five of these employers no longer offered an investment option that engages in securities lending within their 401(k) plans in 2010. Of the 25 employers that do have securities lending options, all offer indirect lending options (e.g., a mutual fund or collective investment trust that participates in securities lending) and three of those 25 employers offer direct lending options (e.g., a separate account that participates in securities lending). For those 25 employers that engaged in securities lending in 2010, the number of investment options that engaged in securities lending per plans ranged from one to 122 with an average of 21.8 (Table 5).

Table 5. Range of number of investment options that engaged in securities lending per employer in 2010.



Transitioning Out of Securities Lending

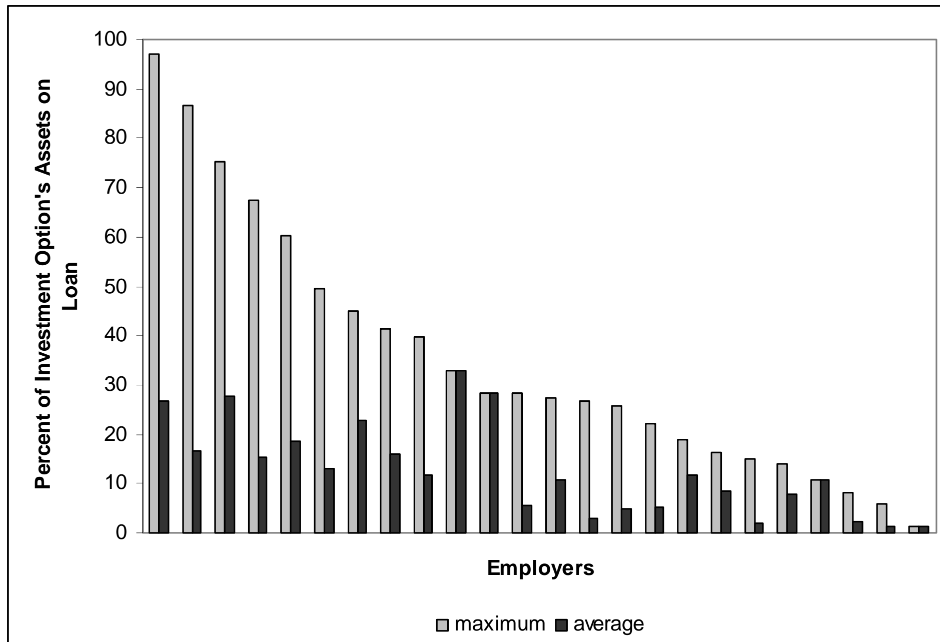
Five of the employers we surveyed did not offer any investment options that engaged in securities lending within their 401(k) plans in 2010 (although all of these employers had participated in securities lending within their plans in the past). In addition, 16 employers indicated that they stopped securities lending for at least one of the investment options they offered within their plans between 2006 and 2010. This includes five employers that stopped indirect lending completely and six employers that stopped direct lending completely.

The reasons the five employers transitioned out of securities lending completely within their 401(k) plans were similar. A few stated that they initially saw securities lending as a low-risk way to offset fees and gain additional earnings for participants. However, due to the changing market environment and credit crisis in 2008 and 2009, the benefits of securities lending programs became less certain and therefore, they decided to cease securities lending within their plans. One employer also cited low and negative returns on the cash collateral reinvestment and liquidity restrictions as one of the reasons they decided to no longer participate in securities lending within their plans.

Percentage of Assets Lent Out

For the investment options that lent securities in 2010 within the surveyed employers' plans, the average percent of the investment option's assets that was lent out was 9.93 percent. The range of the percentages of investment option's assets that was lent out in 2010 was 0.04 to 97 percent. That is, one of the investment options offered by an employer lent out 97 percent of its underlying assets.

Table 6. Maximum and average percent of an investment option's assets on loan by employer in 2010



The range of securities lending varied by type of investment.

- Mutual funds. For the mutual funds that lent securities indirectly in 2010 through the surveyed employers' 401(k) plans, the average percent of the investment option's assets that was lent out was 3.35 percent. The range for these mutual funds was 0.04 to 28.3 percent. Therefore, the highest percentage of assets lent out for a mutual fund was 28.3 percent.
- Collective investment trusts. For collective investment trusts that lent securities indirectly in 2010, the average percent of the investment option's assets that was lent out was 17.33 percent. The range of percentages for these collective investment trusts was 0.10 to 97 percent. Therefore, the highest percentage of assets lent out for a collective investment trust was 97 percent.

While these are significant differences, they are not entirely surprising. The SEC limits the amount of assets that can be lent from a mutual fund at one time to one third of the fund's total asset value. And collective trusts, which are generally overseen by the bank regulators, are not subject to such limitations.

Withdrawal Restrictions

Employer Level

We have found that over the last five years, some service providers that offered the investment options that lent securities did not allow employers to withdraw or transfer all of the 401(k) plan's assets that were invested in those investment options. These service providers placed restrictions on employer withdrawals because the cash collateral pools had been invested in assets that subsequently lost value and became difficult to trade, causing cash collateral pool losses. As a result of the losses, the pools were not worth the amount that the investment option needed to return the cash collateral and pay rebates to borrowers.

Of the 30 employers we surveyed, over 1/3rd (11 employers) indicated that they had been restricted at the plan-level from withdrawing from at least one investment option that participated in securities lending between 2006 and 2010. All employers that faced withdrawal restrictions used one of two providers.

From those surveyed, the withdrawal restrictions were placed on employers beginning in the fourth quarter of 2008 and the restrictions were removed between the summer of 2010 and the first quarter of 2011. The restrictions varied amongst the employers we surveyed. For some, employer withdrawal requests from lending funds were limited to a per month maximum of between two and four percent of the total account's net asset value in the fund at the time of the redemption request. Another employer, for about nine months beginning in October 2008, was not permitted to transfer any funds out of several investment options that participated in securities lending. After nine months, the service provider permitted the employer to request redemptions of up to 15 percent of each investment option's assets two times per month (however, the service provider reserved the right to authorize a lesser percentage).

Participant Level

Of the 30 employers surveyed, none reported participant withdrawal restrictions from investments within their plans that participated in securities lending. However, one employer reported that their securities lending service provider notified them that if participant withdrawals and/or transfers out of the funds with securities lending programs rose to a certain unspecified level, then the service provider would deem the participant activity to be at the plan-level and thus, subject to restrictions on plan-level redemptions. The employer did note though that this never occurred and therefore, participant-directed withdrawals and transfers out of the investment funds with securities lending arrangements continued without restriction.

Average Gains and Losses from Securities Lending

Table 7 summarizes the average revenue gain and loss from securities lending per investment option for each employer that provided plan-level data (25 employers). In 2006, employers on average experienced only gains and no losses from securities lending. And in 2007, 2009 and 2010, only one employer each year experienced average losses per investment

option from securities lending. In 2008, four employers experienced average losses per investment option from securities lending. These average losses ranged from $171,753 to $1,666,667.

Table 7. Average revenue gain (loss) from securities lending per investment option for the 25 employers surveyed that provided plan-level data

	Average revenue gain (loss) from securities lending per investment option, when the data provided was at the plan level				
	2006	**2007**	**2008**	**2009**	**2010**
1	261,194	329,339	527,969	527,489	253,829
2	337,588	558,707	1,151,730	758,836	236,207
3	333,333	333,333	(1,666,667)	1,666,667	Not lending securities
4	66,372	90,333	215,269	101,188	42,518
5	136,929	364,433	731,943	640,064	307,595
6	1,045,251	(345,498)	2,382,103	Not lending securities	Not lending securities
7	427,222	1,135,708	3,722,016	1,709,610	504,500
8	86,217	109,838	142,730	175,376	39,742
9	N/A	59,501	305,315	312,690	65,570
10	81,868	101,988	162,283	80,856	37,897
11	135,276	89,149	(265,906)	(1,607)	46,081
12	145,640	212,968	(171,753)	114,919	98,932
13	90,965	272,883	424,093	184,516	223,401
14	26,360	26,237	45,076	124,732	58,000
15	42,402	122,840	336,732	106,262	59,444
16	837,454	608,827	(404,342)	218,966	(15,924)

17	120,557	55,974	247,616	137,692	57,289
18	39,788	98,067	229,073	136,689	45,780
19	297,464	631,468	1,138,619	933,050	469,044
20	8,580	22,713	74,324	52,882	24,080
21	191,627	201,017	492,950	337,796	207,464
22	59,080	107,875	452,767	272,363	73,877
23	282,978	114,321	26,470	219,198	33,537
24	102,103	133,911	42,550	313,433	73,991
25	N/A	N/A	111,500	65,045	56,381

Revenue Sharing and Liability for Losses

In the case of securities lending with cash collateral within 401(k) plans, participants bear the ultimate risk of loss from the cash collateral pool investments. Securities lending agents generally do not reimburse plan participants for losses that the cash collateral reinvestment pool may suffer, which is the risk that remains with plan participants. However, in the event that there are gains from the investments of the cash collateral pool, participants generally share the gain with securities lending service providers, including broker-dealers and securities lending agents.

Our survey results are generally consistent with these conclusions. Most of the employers we surveyed stated that any losses within the cash collateral pools were ultimately borne by the participant. In terms of revenue sharing arrangements between the plans/participants and the securities lending service provider, it ranged from 50-50 percent split to a split of 92 percent to the plan/participants and eight percent to the service provider. It should be noted that a few employers invested in mutual funds where the revenue sharing arrangements provided that 100 percent of the cash collateral revenue in excess of costs was allocated back to the mutual funds as revenue (and ultimately to participants).

Disclosures Provided to Employers and Participants on Securities Lending

Our survey found that employers are provided with some disclosures about securities lending. The most common form of disclosure is fund documentation (e.g., a Prospectus or Statement of Additional Information). Some securities lending service providers also provide periodic reports to their clients. And nine of the employers we surveyed had signed securities lending agreements with their service providers. Table 8 summarizes the examples of

disclosures about securities lending provided to the 30 respondents to our survey – and the number of surveyed employers that indicated receiving such disclosure.

Table 8. Examples of disclosures provided to employers about securities lending.

Type of disclosure	Number of employers that indicate they receive that type of disclosure
Fund documentation (e.g., a Prospectus or Statement of Additional Information)	20
Meetings (in person and conference call)	6
Signed securities lending agreements	9
Periodic reports	13
Investment guidelines	3
Fee and other disclosures	5
Letters	4

In general, the 30 employers we surveyed also provide some documentation about securities lending to their participants. Like the employer disclosures, the most common disclosure is fund documentation. Six employers provide a description of securities lending in their summary plan descriptions or plan participant investment guides. Five employers stated that they provide no information to participants on securities lending.

Table 9. Examples of disclosures provided to participants about securities lending

Type of disclosure	Number of employers that indicate they provide that type of disclosure
Fund documentation (e.g., a Prospectus or Statement of Additional Information)	20
Provide no securities lending disclosures	5
Financial statements	4
Form 5500	1
Summary plan descriptions and plan participant investment guides	6

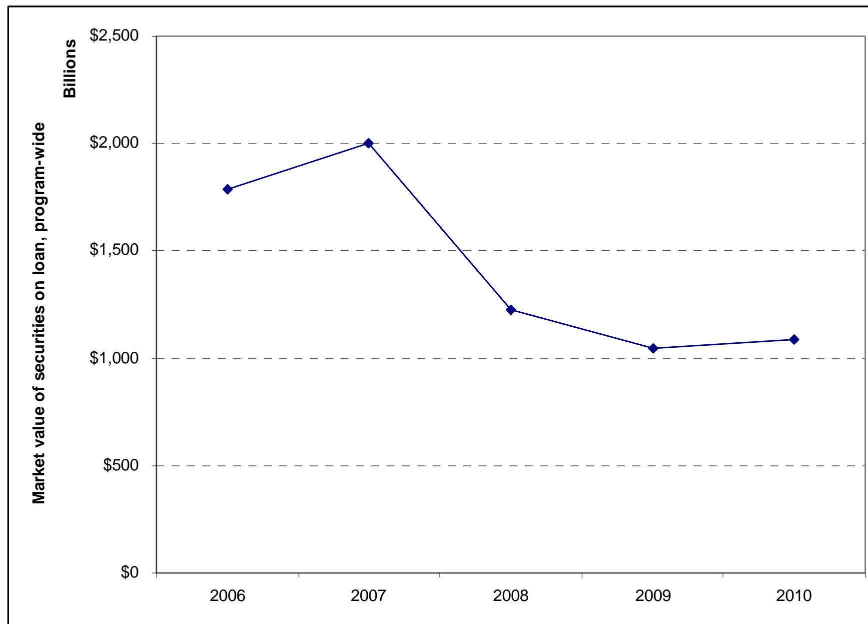
Bank Findings

In response to the Aging Committee's request, the seven largest banks within the securities lending market provided the following information.

Size of Securities Lending Business – In General

Six of the seven banks that we surveyed had a total of about $1.1 trillion of securities on loan in 2010 (six of seven banks provided information, direct and indirect securities lending). This is down from the high point in 2007 when nearly $2 trillion of securities were out on loan (Table 10). In 2010, the average value of securities on loan per bank was about $181 billion.

Table 10. Market value of securities on loan, program wide (six of seven banks provided information, direct and indirect securities lending)



Types and Sizes of Plans Serviced by Banks

Six of the seven banks we surveyed provided direct securities lending services to defined contribution, defined benefit and other retirement plans in 2010. The one bank that did not provide these services did provide such services to retirement plans during the period of 2006 through 2008.

In 2010, these six banks provided securities lending services to a total of 570 retirement plans (defined benefit, defined contribution and other retirement plans) (Table 11) and these plans had a total asset size of about $1.3 trillion (Table 12). The average number of retirement plans per bank that were provided securities lending services was 95 plans in 2010. The range in

2010 included one bank that provided securities lending services to 259 plans – and one bank that provided services to just four plans.

Table 11. Number of defined benefit, defined contribution and other retirement plans for which each bank provided direct securities lending services

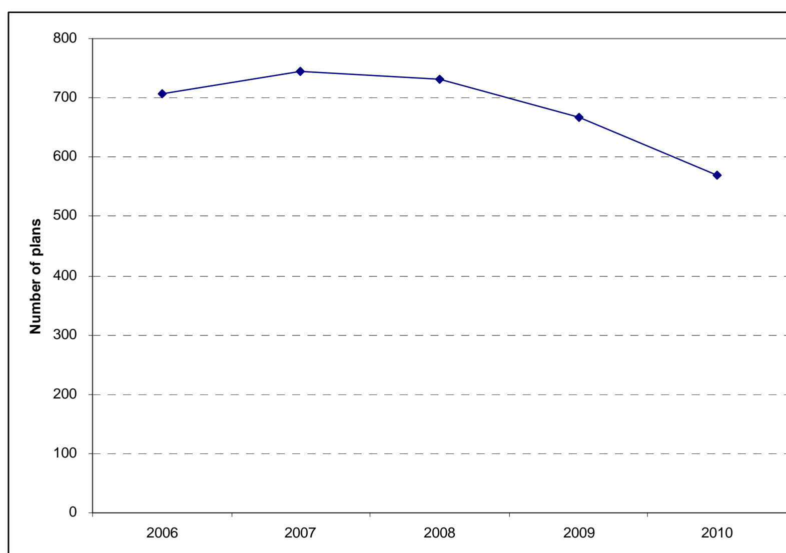


Table 12. Asset size of defined benefit, defined contribution and other retirement plans for which each bank provides direct securities lending services

(billions)	2006	2007	2008	2009	2010
sum	$1,585.3	$1,671.4	$1,133.9	$1,213.5	$1,260.1
average	$396.3	$417.8	$283.5	$303.4	$252.0
maximum	$723.1	$742.9	$554.1	$604.3	$594.8
minimum	$17.2	$17.3	$14.4	$21.7	$10.4

Five of the seven banks surveyed provide direct securities lending services to defined contribution plans. The total number of defined contribution plans that these banks provided securities lending services to was 48 in 2010, with the average number of plans per bank being 9.6 (Table 13). The total asset size of all of the defined contribution plans directly serviced by these banks in 2010 was nearly $38 billion (Table 14).

Table 13. Number of defined contribution plans for which each bank provides direct securities lending services

	2006	2007	2008	2009	2010
sum	56	57	55	50	48
average	11.2	11.4	11	10	9.6
maximum	19	19	18	19	17
minimum	1	2	2	3	3

Table 14. Asset size of the defined contribution plans for which each bank provided direct securities lending services

(billions)	2006	2007	2008	2009	2010
sum	$47.9	$52.0	$41.1	$51.4	$37.7
average	$12.0	$13.0	$10.3	$12.9	$9.4
maximum	$16.6	$17.4	$11.5	$17.2	$16.0
minimum	$5.5	$8.5	$9.1	$10.8	$0.5

In terms of defined benefit plans, six of the seven banks surveyed currently provide direct securities lending services to these plans. The total number of defined benefit plans that these banks provided services to was 518 in 2010, with the average number of plans per bank being about 86.3 (Table 15). The total asset size of all of the defined benefit plans directly serviced by these banks in 2010 was about $1.2 trillion (Table 16).

Table 15. Number of defined benefit plans for which each bank provides direct securities lending services

	2006	2007	2008	2009	2010
sum	646	684	671	612	518
average	129.2	136.8	134.2	122.4	86.3
maximum	243	258	268	255	247
minimum	73	77	73	64	4

Table 16. Asset size of the defined benefit plans for which each bank provides direct securities lending services

(billions)	2006	2007	2008	2009	2010
sum	$1,503.6	$1,585.3	$1,073.8	$1,143.7	$1,208.1
average	$375.9	$396.3	$268.5	$285.9	$241.6
maximum	$683.8	$705.5	$526.0	$568.6	$564.4
minimum	$5.1	$5.2	$3.9	$9.3	$9.9

It should be noted that most of the banks we surveyed only provided data on the retirement plans to which they provide ***direct*** securities lending services. Most banks did not provide information on their ***indirect*** securities lending business in the retirement plan market. For example, many banks provide securities lending services to some of its pooled funds in which defined contribution plans and defined benefit plans may invest. Therefore, the above data is only one segment of the securities lending business in the retirement plan market.

Withdrawal Restrictions

Three of the seven banks we surveyed restricted defined contribution and defined benefit plans from exiting funds that engaged in securities lending. These restrictions began in the fall of 2008. One bank reported that all restrictions have now ended. Another bank reported that most of the restrictions have been removed; however, withdrawals continue to be subject to a determination as to whether there is sufficient liquidity to allow the withdrawals to be processed entirely in cash. The third bank removed some of the restrictions at different times but it appears that the final restrictions were removed in January 2011.

The rationale behind the withdrawal restrictions was similar between the three banks. One bank stated that it instituted the restrictions to protect its securities lending clients in the face of unprecedented market conditions. This bank stated that it had instituted its “safeguards” to forestall the possibility of a run on the collateral pools in which exiting clients would use up all of the available liquidity, leaving the remaining clients with assets that could only be sold (if at all) at “firesale” prices. Another bank similarly stated that it implemented restrictions in response to illiquidity in the market for fixed income securities, sharply declining equity markets, and borrower deleveraging.

In terms of the types of restrictions, one bank stated that withdrawal restrictions were only triggered if employers chose to exit securities lending within their plans. Under the restrictions, employers were only permitted to take in-kind (rather than cash) distributions, which included employer’s shares of both liquid and illiquid assets in the applicable cash collateral pool. In addition to in-kind distributions, this bank also provided employers with the option of participating in a staged withdrawal program (e.g., gradually reducing their loan balance over a

period of time). Another bank only permitted employers to withdraw a maximum percentage of between two percent and four percent per month of the value of its interest in the fund.

In terms of participant withdrawal restrictions, one of the three banks stated that all transactions requested by participants in 401(k) plans were processed in the normal course. Another of the three banks notified their employer clients that to the extent that the bank observed a volume of participant-directed withdrawal activity from any plan or plans that it believed to be out of the ordinary course and detrimental to the liquidity of the bank's cash collateral pools, the bank could apply the plan-level withdrawal restrictions to participants. This bank did not state what level of participant-directed withdrawal activity would trigger these restrictions. However, it appears from the bank's response that they never triggered these restrictions.

Cash Contributions to Cash Collateral Pools

In response to cash collateral losses during the financial crisis, three of the seven banks surveyed made cash contributions to cash collateral pools that contained defined contribution and defined benefit plan assets. One of the banks made a one-time $330 million cash contribution and another bank made a one-time payment of $150 million. These banks made clear in their responses that they were not required to make these cash contributions but did so voluntarily. In addition to cash contributions, two of the three banks stated that they also purchased securities from certain cash collateral pools. For example, one of the banks purchased four securities from one of their collateral vehicles for a total purchase price of approximately $113 million. And one of the banks stated that it reduced its fee split for a period of time to increase the securities lending revenue that its retirement plan clients received.

Range of Revenue Sharing Arrangements and Other Costs

In the case of securities lending with cash collateral within retirement plans, participants and plans bear the ultimate risk of loss from the cash collateral pool investments. Securities lending agents generally do not reimburse the plan or plan participants for losses that the cash collateral reinvestment pool may suffer. However, in the event that there are gains from the investments of the cash collateral pool, plans and participants generally share the gain with securities lending service providers, including broker-dealers and securities lending agents. The information we received from the surveyed banks is generally consistent with these conclusions.

For the seven banks we surveyed, the amount that the lender (e.g., a retirement plan) receives from the fee split or revenue split for securities lending ranges from 60 percent to 100 percent. That means the bank share ranges from zero to 40 percent. Furthermore, one bank pointed out that it is industry practice for compensating securities lending agents that the lending agent receives no compensation for its services when there are no positive net revenues from the cash collateral reinvestment activities.

Other types of costs paid to third parties in a typical securities lending transaction include cash collateral pool manager fees. These fees may include investment management,

administration and custody fees for the collateral pool. These fees range from one to six basis points of assets under management. Five of the seven banks indicated that they do not always charge clients an investment management fee for the cash collateral pool. However, one bank indicated that it recovered certain out-of-pocket costs it incurred, including transaction accounting and reporting expenses, auditing fees, brokerage fees and other commissions.

Rebates

The surveyed banks also indentified rebates as an additional cost to lenders, including retirement plans, within securities lending transactions. A rebate is the portion of the return earned on the cash collateral reinvestment that is paid to the broker-dealer. This payment is made because the broker-dealer would have earned a short-term rate of return on the cash had they held on to it themselves. The greater the demand for the security being lent, the lower the rebate paid to the borrower. Securities that have an extremely high borrowing demand can obtain "negative" rebates, requiring the borrower to not only pledge cash, but also pay a fee to the lender.

In 2009, the total amount of rebates paid by surveyed banks for all of their retirement plan business was about $70.4 million. Note that the minimum in total rebates paid by one of the banks in 2009 was negative $29.6 million. That means that this bank must have received a significant number of negative rebates (Table 17).

Table 17. Total amount paid/received in rebates for all retirement plans

(millions)	2006	2007	2008	2009
sum	$15,497.9	$18,236.1	$6,456.8	$70.4
average	$3,099.6	$3,647.2	$1,291.4	$11.7
maximum	$5,854.4	$7,021.3	$2,496.5	$54.7
minimum	$1,916.2	$2,232.5	$705.0	($29.6)

In 2009, the total amount of rebates paid for defined contribution plans that participated in securities lending by the banks was about $11.3 million – and for defined benefit plans it was $61.2 million. The average amount paid in rebates for defined contribution plans by each bank for 2009 was $2.3 million – for defined benefit plans, it was $10.2 million (Tables 18 and 19).

Table 18. Total amount paid/received in rebates for defined contribution plans by surveyed banks

(millions)	2006	2007	2008	2009
sum	$796.9	$936.4	$349.5	$11.3
average	$159.4	$187.3	$69.9	$2.3
maximum	$441.6	$522.1	$157.7	$9.1
minimum	$44.1	$43.7	$15.2	($0.5)

Table 19. Total amount paid/received in rebates for defined benefit plans by surveyed banks

(millions)	2006	2007	2008	2009
sum	$14,506.4	$17,014.2	$6,003.0	$61.2
average	$2,901.3	$3,402.8	$1,200.6	$10.2
maximum	$5,610.4	$6,680.9	$2,323.6	$54.1
minimum	$1,474.6	$1,710.4	$564.0	($30.0)

Recommendations

As a result of our investigation into securities lending practices, the Committee makes the following recommendations.

Employers Should Increase their Knowledge of Securities Lending within their Defined Contribution Retirement Plans

The Committee found through its investigation and discussions with industry experts and stakeholders that many employers that sponsor defined contribution retirement plans do not know whether the investment options in their plans engage in securities lending. For those that did, they understood the benefits of these transactions, but many were not aware of the risks involved with securities lending and in particular, the risks associated with the cash collateral reinvestment portion of their service providers' securities lending programs.

This is alarming, as employers are required understand whether their plans engage in securities lending and the consequences of such engagement to meet their fiduciary responsibilities under ERISA. The Committee thinks it is important for all employers (small and large) to, at a minimum, know the answers to the following questions:

- Are the investment options in my defined contribution retirement plan(s) engaged in securities lending?

- If the answer is yes, for each investment option engaged in securities lending:

    - What is the percentage of underlying assets that are being lent out?

    - In exchange for the loan, does the plan's service provider receive cash collateral (or collateral in another form)?

    - If cash collateral, what is the cash reinvested in and what are the returns (gains and losses) on such investments? How are the gains and losses divided between the plan/participants and the service providers? What fees do the plan service provider, the broker dealer, the cash collateral pool manager and the securities lending agent receive?

Participants Should be Given Information about Securities Lending within their Defined Contribution Retirement Plan Investment Options

To satisfy their responsibilities under ERISA, plan sponsors should provide participants with sufficient information for them to make informed decisions about the investment options within their defined contribution plans. Although securities lending is a complicated topic, participants should be provided with easy to understand information and tools about securities lending and cash collateral reinvestment and the benefits and risks associated with the practice, including the potential for withdrawal restrictions.

The Department of Labor Should Issue Guidance to Employers on Securities Lending Practices within Qualified Retirement Plans

To help employers comply with their fiduciary responsibilities, the Committee recommends that the Labor Department develop basic information and tools for employers on securities lending within qualified retirement plans. Such information should alert employers to the benefits and risks involved with securities lending, including those related to securities lending with cash collateral reinvestment. The Labor Department also should provide plans sponsors with guidance on the types of information they should seek from their service providers about securities lending and cash collateral reinvestment within retirement plans.

Companies in the Business of Securities Lending Should Report Information about their Businesses Practices

Currently, there is no comprehensive, public data available about securities lending, including securities lending within the qualified retirement plan market. Although this is a common practice in retirement plans, this Committee had to directly survey plans sponsors and banks. Companies in the business of securities lending should be required to report information on such practices to the Securities and Exchange Commission and bank regulators. Such

disclosures should include information on the cash collateral reinvestment portion of such companies' securities lending programs. Sponsors of qualified retirement plans that engage in securities lending also should be required to report basic information on securities lending within their plans to the Department of Labor.