Physical ETFs: A Call for Transparency

Ironically, we believe that today as it pertains to counterparty risk there is greater transparency on swap-based ETFs than on physical ETFs

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A flurry of warnings from global financial regulators in the spring of 2011 highlighting potential risks within and posed by exchange traded products (ETPs) caused quite a stir in the industry. Many responded by saying that regulators' concerns were overblown either because ETPs represent a very small part of the market or because a lot of the risks that were identified are non-specific to ETPs. Nonetheless, the great majority of market participants welcomed the call for greater transparency surrounding certain practices. Leading providers acknowledged the importance of disclosing more information on both synthetic and physical ETPs so investors can make better informed decisions.

Among the potential risks that were highlighted by the regulators, counterparty risk is one that we, at Morningstar, have never failed to remind investors of through our reports, articles and webinars. Following the publication of a comprehensive report on the mechanics of swap-based ETFs and the risks associated with them, we thought it was only fair that we re-address the risks embedded in physically-replicated ETFs that engage in securities lending.

Securities lending, also known as sec lending or stock lending, is the process of loaning securities to a third party in exchange for a fee. The borrower, typically a hedge fund or other short seller, hopes to profit from a decline in the price of the securities.

It should be noted that securities lending is by no means exclusive to exchange-traded funds (ETFs). In fact, it's common practice across the investment management industry carried out by mutual funds, pension funds and others to enhance returns. In the context of physically-replicated ETFs, lending out the securities held by the fund can help to partially, or in some cases completely, offset management fees and other sources of tracking error.

No Free Lunch

Investors should be aware that securities lending carries risks. There is no free lunch. There is a chance that the borrower will default on its commitment to return the lent securities. To mitigate this risk, ETF providers require the borrower to post collateral for the duration of the loan. Should the borrower default, there is also a risk that the collateral transferred will not be sufficient to repurchase the securities. This is why the lender usually takes margins (or haircuts) on the collateral received and marks the securities on loan and corresponding collateral to market on a daily basis to ensure that the value of the collateral always exceeds that of the loan. This risk management policy is central to minimising the risk associated with securities lending.

The amount of revenue earned from securities lending depends on several factors. These include the level of demand for the ETF's underlying securities, the type of collateral offered and the credit quality of the counterparties. Securities in high demand amongst borrowers tend to be hard-to-locate, small, and illiquid and these will typically merit higher fees than large and heavily-traded securities. An ETF provider could also increase revenue by accepting more risky collateral or lending to counterparties that have a poorer credit rating.

A Wide Range of Securities Lending Practices

To find out more about securities lending practices in physically-replicated ETFs, we conducted a survey among eleven European issuers that have engaged in sec lending programmes. The firms that participated in the survey include not only those that use physical replication for all or the large part of their product ranges (like iShares and HSBC), but also those that employ physical replication for only a few of their ETFs (like Amundi and ComStage whose product line-ups consist mainly of synthetic ETFs). The results* show that there is a wide range of practices across providers.

Firstly, the level of counterparty exposure linked to sec-lending can vary significantly from provider to provider and from fund to fund. Many investors in physical replication ETFs would be surprised to know that up to 100% of their funds' assets are effectively lent out and for some on a near-constant basis as the average on-loan level of some funds reveals.

For instance, German provider ComStage lends nearly 100% of the assets held by its physically-replicated DAX and EURO STOXX 50 ETFs. For the year ending this past June, the iShares FTSE 250 had an average lending utilisation rate of 92%. However, the iShares FTSE 100 loaned only 1% of its underlying securities on average with a maximum level of 9% in the same period.

While it is understood that all providers are permitted to engage 100% of their funds' assets in sec lending, in reality, effective lending rates observed tend to be much lower. As far as we learnt in conducting this survey, only one issuer in Europe, Dutch firm Think Capital, doesn't participate in any securities lending "in order to limit risks".

Also, ETF issuers offer different levels of investor protection against the counterparty risk associated with sec lending. The type and quality of collateral requested from borrowers can vary. In Europe, equities and government bonds seem to be the most commonly accepted form of collateral to which margins ranging from 2% to 15% are applied. Cash and certificates of deposit can also be accepted, although these seem to be less widely-used in Europe than in the US. Investors need to be aware that in some cases, cash collateral might be reinvested to generate extra income, which introduces additional risks. Some US lending agents faced major liquidity issues during the financial crisis because they had reinvested cash collateral in what they thought were highly liquid cash instruments, like auction rate securities, which ultimately froze in the face of the credit crunch.

Further risk mitigation measures taken by ETF providers and lending agents include careful selection of borrowers (their creditworthiness is important) and revaluation of loans and collateral on a daily basis.

In addition, some firms will provide borrower default indemnification in the event that a borrower is unable to return the securities. This is the case for UBS Luxemburg-domiciled ETFs which have State Street acting as lending agent. Equally at HSBC, stocks lent to third parties are also covered by a full indemnity from the bank such that the stock will be replaced in the fund should there be any issue with the loan.

Thirdly, there are a wide range of practices as it pertains to revenue sharing. While some ETF issuers will pass on 100% of the income derived from sec lending (net of costs) to the fund, others will retain up to 50% of the proceeds, with the ETF issuer and lending agent covering all operational costs. These differences, which clearly show that some firms are much more generous than others, begs the question: shouldn't all the providers funnel 100% of the revenues earned to the fund given that fund shareholders are ultimately assuming 100% of the risk associated with this practice? Undoubtedly, this would serve to provide a superior risk-reward trade-off and be in the best interest of investors.

Providers	Net Fees Returned to Fund	Acceptable Collateral Types (margins)	Additional Risk
Amundi [1]	60%	Undisclosed (110%)	Non
ComStage [2]	100%	Equities, Gov Bonds, CDs, Cash (100%-105%)	Non
Credit Suisse [3]	100%	Undisclosed (102%-115%)	Non
EasyETF [4]	50%	Equities, Gov Bonds, Cash (102%-115%)	Non
ETFLab	100%	Equities, Gov Bonds, Cash (103%-110%)	Non
HSBC	60%	Gov Bonds (105%)	Borrower Default In
iShares	60%	Equities, Gov Bonds, CDs (102.5%-112%)	Non
PowerShares [6]	70%	Gov Bonds (102%)	Borrower Default
SPDR	50%	Equities, Gov Bonds (102%-105%)	Borrower Default
UBS [7]	Undisclosed	Equities, Gov Bonds (102%-115%)	Borrower Default In
XACT	100%	Equities, Gov Bonds, CDs, Cash (105%-110%)	Non

[1] *Amundi offers only three physically-replicated ETFs*

[2] *ComStage offers only two physically-replicated ETFs*

[3] *Credit Suisse participates in securities lending only for Luxembourg and Swiss-domiciled ETFs. At the time of writing, all securities lending programmes at Credit Suiss*

[4] *EasyETF's sec lending activities for 11 physically-replicated ETFs are currently under restructuration*

[5] *HSBC Bank offers to indemnify investors for any loaned securities that cannot be returned by third party borr*

[6] *PowerShares participates in securities lending only for its EQQQ fund. Average on-loan level over the last 12*

[7] *UBS engages in sec lending only for Luxembourg and Swiss-domiciled ETFs*

[8] *Indemnisation offered by State Street for UBS Luxembourg-domiciled ETFs and by UBS for UBS Swiss-domicil*

Source: ETF providers

Insufficient Disclosure

Ultimately, the key question for investors is whether the incremental return earned from securities lending is sufficient to justify the counterparty risk associated with this practice. To know if they are being adequately compensated for assuming this additional risk, investors need to do proper due-diligence. However at the moment, very little information is made publicly available by issuers of physical ETFs, with the exception of iShares.

A few months ago, iShares began to publish a detailed quarterly report outlining all its ETFs' securities lending activities. The report, due to become daily, includes the average and maximum amount of securities on loan (expressed as a percentage of fund NAV), net returns to the fund together with collateral levels and composition. The issuer also gives details of its most frequently-used counterparties in a separate brochure. iShares is currently the only issuer making such a wealth of information available on its website, while others generally provide only a few details about their programmes buried in annual and semiannual reports and/or upon request.

Ironically, we believe that today as it pertains to counterparty risk there is greater transparency on swap-based ETFs** than on physical ETFs. Most providers employing synthetic replication in Europe now disclose daily swap counterparty risk exposures and collateral composition on their websites. They started doing so in response to investor pressure. Following the warnings from financial regulators across the globe, it's about time that best disclosure practices are harmonised between synthetic and physical ETFs. After all, "securities lending may create similar counterparty and collateral risks to synthetic ETFs", as the Financial Stability Board (FSB) noted in its April report. Indeed, in a sense, securities lending can simply be seen as making physical replication an approximate mirror opposite of synthetic replication: you start with a perfect basket and you turn it into an imperfect basket by accepting collateral in exchange for the lent securities. Conversely, with synthetic replication, you start with an imperfect basket and use a swap to receive the performance of a perfect basket.

Recommended Best Practices

After international regulators have drawn attention to the risks associated with securities lending in ETFs, we expect increasing pressure from investors on issuers of physical ETFs to enhance transparency as it pertains to their lending practices. As far as we are concerned, we believe these issuers should disclose, via their websites, the following information for each fund on a daily basis:

- The amount of securities on loan expressed as a percentage of the fund's NAV
- The maximum amount of securities on loan over the last 12 months expressed as a percentage of the fund's NAV
- The amount and composition of actual collateral received by the fund

In addition, we suggest that issuers clearly disclose their risk management policies in their marketing literature, especially as it pertains to the management of counterparty risk. While it's understandable that revealing the name of the borrowers on a daily basis might not be possible because of the market-sensitive nature of such information, we think that providing a regularly updated list of the largest counterparties could be useful. It would allow investors to assess the quality of credit standards set by ETF issuers.

As suggested by the FSB, disclosing detailed information on collateral posted by borrowers in exchange for the fund's securities is crucial. While many investors might not be able to make sense of the make-up of the collateral, its regular disclosure will certainly help build the trust of the investor community and allow for greater scrutiny of the assets used in sec-lending programmes. This in turn will ensure that this collateral is consistently comprised of high-quality, liquid assets, which, in the event of a borrower's default, would be easy to liquidate in order to repurchase the lent securities.

Finally, we recommend that issuers regularly disclose net return to the fund generated by their sec lending activities (expressed in basis points) as this will help investors to know if they are being adequately compensated for the additional risk they are assuming. Also, we strongly believe that investors have the right to know the percentage split of gross sec lending revenue between the fund on the one hand and the ETF issuer and the lending agent on the other, together with the factors that determine this split. As previously mentioned, we believe that best practices dictate that ETF issuers should return 100% of the revenue (net of costs) generated by securities lending to fund shareholders.

All that said, because securities lending is not unique to the realm of ETFs, it's equally important that regulators create a level playing field throughout the asset management industry by requiring the same level of disclosure from all funds, including mutual funds, who participate in this practice.

** Please note that the information we have provided in this article was supplied to us directly by the relevant providers. As such, we cannot guarantee that it is complete, accurate, or timely.*

*** Providers of synthetic ETFs can also engage in sec lending but it's typically done at the level of their parent bank, not at the fund level (as is the case for physical ETFs). This means that the bank, not the ETF, directly assumes the counterparty risk. The ETF, typically being exposed to the creditworthiness of its parent bank in the case of most synthetic ETFs, is one step removed from this risk in this instance.*

ComStage Securities Lending

Fund name	Average on Loan	Maximum on Loan	Net return to the Fund
ComStage ETF DAX FR	99.3%	100%	10 bps
ComStage ETF EURO STOXX 50 FR	99.3%	100%	15 bps

Source: ComStage

EasyETF Securities Lending

Fund name	Average on loan	Maximum on loan	Net return to the Fund	T
EasyETF iBoxx Liquid Sovereigns Extra Short	85-95%	100%	4 bps	15
EasyETF iBoxx Liquid Sovereigns Global	85-95%	100%	3 bps	15
EasyETF iBoxx Liquid Sovereigns Long	85-95%	100%	3 bps	15

Source: EasyETF

ETFlab Securities Lending

Fund name	Average on Loan	Net Return to the Fund	TER
ETFlab Deutsche Börse EUROGOV Germany 3-5	98.6%	8.9 bps	15 bps
ETFlab MSCI USA MC	62.8%	16.9 bps	30 bps
ETFlab DAX	55.5%	14.3 bps	15 bps
ETFlab STOXX Europe Strong Style Composite 40	49.9%	22.5 bps	65 bps
ETFlab MSCI USA LC	48.5%	13.6 bps	30 bps
ETFlab EURO STOXX 50	41.3%	25.7 bps	15 bps
ETFlab MSCI Japan MC	33.1%	9.1 bps	50 bps
ETFlab MSCI China	23.9%	10.2 bps	65 bps
ETFlab STOXX Europe Strong Growth 20	20.7%	20.1 bps	65 bps
ETFlab EURO STOXX Select Dividend 30	14.2%	9.0 bps	30 bps

Source: ETFlab

HSBC Securities Lending

Fund name	Average on Loan	Maximum on Loan	Net Return to the Fund	TER
HSBC CAC 40 ETF	13.1%	51.9%	63 bps *	25 bps
HSBC EURO STOXX 50 ETF	7.8%	33.3%	43 bps	15 bps
HSBC MSCI Europe ETF	5.2%	16.1%	22 bps	30 bps
HSBC FTSE 100 ETF	4.7%	12.6%	1 bp	35 bps
HSBC FTSE 250 ETF	2.3%	2.3%	0 bp	35 bps
HSBC MSCI Turkey ETF	1.1%	10.3%	1 bp	60 bps
HSBC MSCI World ETF	1.1%	3.8%	6 bps	35 bps
HSBC MSCI Canada ETF	1.0%	2.1%	1 bp	35 bps
HSBC MSCI Pacific ex-Japan ETF	0.6%	2.6%	0 bp	40 pbs
HSBC MSCI Japan ETF	0.2%	0.4%	0 bp	40 pbs
HSBC MSCI China ETF	0.2%	0.4%	0 bp	60 bps

** 85% of the sec lending revenue on the CAC 40 ETF is returned to the fund. All other funds retain 60%.*

Average on loan *is calculated as average assets on loan from January to August 2011 divided by the average AUM of fund over the same time period*

Maximum on loan *is calculated as assets on loan at highest level from January to August 2011 divided by the AUM of the fund on that day*

Net return to the fund *is calculated as securities lending revenue to the fund from January to July 2011 divided by the average AUM of the fund over the same time period*

Source: HSBC

iShares Securities Lending

Fund name	Average on Loan	Maximum on Loan	Collateral Coverage
iShares FTSE 250	92%	95%	109.8%
iShares MSCI Japan SmallCap	73%	94%	108.0%
iShares Barclays Capital Euro Government Bond	68%	91%	103.3%
iShares MSCI Turkey	18%	42%	121.4%
iShares FTSE/EPRA European Property Idx Fund	13%	45%	121.0%
iShares EURO STOXX 50	6%	39%	110.0%
iShares MSCI Emerging Markets	4%	6%	113.6%
iShares S&P 500	1%	14%	109.0%
iShares FTSE 100	1%	9%	111.0%
iShares Markit iBoxx Euro Corporate Bond	1%	2%	107.5%

Average on loan *is calculated as average value of securities on loan over the last 12 months divided by the average NAV of the fund over the same time period.*

Maximum on loan *is calculated as maximum percentage of the total NAV lent in a single day over the last 12*

Net return to the fund *is calculated as net 12 months securities lending revenue to the fund divided by the average fund NAV over the same time periods.*

Source: iShares, trailing 12-month data as at 30 June 2011

SPDR ETFs Securities Lending

Fund name	Average on Loan	Maximum on Loan	Collateral Coverage	Net Re the
SPDR MSCI Europe Info Tech	35%	74%	105.3%	11.2
SPDR MSCI Europe Industrials	27%	42%	105.1%	14.8
SPDR MSCI Europe Healthcare	25%	57%	105.1%	5.6
SPDR MSCI Europe Energy	24%	64%	105.1%	5.3
SPDR MSCI Europe Cons Discretionary	23%	40%	105.0%	11.1
SPDR MSCI Europe	19%	34%	105.2%	10.9
SPDR MSCI Europe Utilities	18%	46%	105.4%	20.0
SPDR MSCI Europe Materials	15%	37%	105.0%	8.8
SPDR MSCI Europe Financials	14%	31%	105.3%	12
SPDR MSCI Europe Telecom Services	14%	39%	105.5%	11.9
SPDR MSCI Europe Small Cap	14%	19%	105.4%	6.8
SPDR MSCI Europe Consumer Staples	11%	38%	105.1%	2.6

Source: SPDR ETFs Europe, trailing 12-month data as at 31 Dec 2010

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