



Joint Legislative Audit Committee

Office of the Auditor General



AUDIT OF THE RESULTS OF SECURITY LOAN AGREEMENTS ENTERED INTO BY STATE AGENCIES UNDER CHAPTER 1214, STATUTES OF 1975 FOR THE THREE YEARS ENDED SEPTEMBER 30, 1978

Chapter 1214, Statutes of 1975 authorized the State Treasurer and the Board of Administration of the Public Employees' Retirement System (PERS) to implement a security loan program. The State Treasurer plans to report net additional interest income of \$174,424 for the year ended June 30, 1978. This figure exceeds the amount we estimated in a 1975 report.

The Investment Committee of the PERS Board of Administration, on February 16, 1977 and again on January 16, 1979, decided not to embark on a securities lending program because "the returns appear small versus the risk incurred." Since it would be required that PERS would hold cash collateral equal to or greater than the market value of loaned securities, we cannot foresee any risks if the program is properly administered.

REPORT TO THE
CALIFORNIA LEGISLATURE

REPORT OF THE
OFFICE OF THE AUDITOR GENERAL
TO THE
JOINT LEGISLATIVE AUDIT COMMITTEE

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AUDIT OF
THE RESULTS OF SECURITY LOAN AGREEMENTS
ENTERED INTO BY STATE AGENCIES UNDER
CHAPTER 1214, STATUTES OF 1975 FOR THE
THREE YEARS ENDED SEPTEMBER 30, 1978

FEBRUARY 1979



California Legislature

Joint Legislative Audit Committee

GOVERNMENT CODE SECTION 10500 et al

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RICHARD ROBINSON
CHAIRMAN

March 2, 1979

The Honorable Speaker of the Assembly
The Honorable President pro Tempore of the Senate
The Honorable Members of the Senate and the
Assembly of the Legislature of California

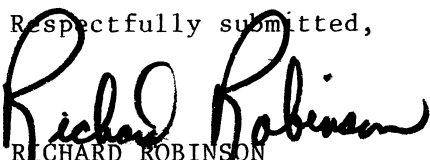
Members of the Legislature:

Your Joint Legislative Audit Committee respectfully submits the Auditor General's report entitled, Audit of the Results of Security Loan Agreements Entered Into by State Agencies Under Chapter 1214, Statutes of 1975 for the Three Years Ended September 30, 1978. Although both the State Treasurer and the Public Employees' Retirement System have legislative authorization, to date, only the State Treasurer has initiated a security loan program.

For the year ended June 30, 1978, the State Treasurer reported net additional interest income from security loans of \$174,424. This figure exceeds the amount the Auditor General estimated in a 1975 report. The State Treasurer has not incurred losses in the reacquisition of securities or unforeseen costs as a result of the security loan program.

The auditors are Richard I. LaRock, CPA, Supervising Auditor; Mildred M. Kiesel, CPA; Ross A. Luna and Peter A. Wolfe.

Respectfully submitted,



RICHARD ROBINSON
Assemblyman, 72nd District
Chairman, Joint Legislative
Audit Committee

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SUMMARY

Chapter 1214, Statutes of 1975 authorized the State Treasurer and the Board of Administration of the Public Employees Retirement System (PERS) to implement a security loan program. Although delays were encountered in implementing the program, the State Treasurer plans to report net additional interest income of \$174,424 for the year ended June 30, 1978. This figure exceeds the amount we estimated in a 1975 report.

We have obtained reasonable assurance to conclude that the State Treasurer:

- Has received from the borrowers all income which the Pooled Money Investment Account (PMIA) would otherwise have been entitled to, plus, all additional interest due the State as remuneration for lending PMIA securities
- Has fairly stated net additional interest income from PMIA security loans
- Has incurred no losses in reacquiring loaned PMIA securities

- Plans to publicize the net additional interest income from PMIA security loans beginning with results for the year ended June 30, 1978.

In the case of one security loan, however, for four consecutive days, the State Treasurer was approximately \$230,000 short of the amount of collateral necessary to enable the PMIA to reacquire securities in the open market had the borrower been unable to return the loaned securities. We have made recommendations to the State Treasurer to improve controls, records and reports used to monitor the program.

Contrary to the recommendation of PERS staff, the Investment Committee of the PERS Board of Administration, on February 16, 1977 and again on January 16, 1979, decided not to embark on a securities lending program. In response to detailed PERS staff proposals, the Investment Committee responded only that "the returns appear small versus the risk incurred." Since it would be required that PERS would hold cash collateral equal to or greater than the market value of loaned securities, we cannot foresee any risks provided the program is properly administered.

INTRODUCTION

In response to Chapter 1214, Statutes of 1975, we have audited the results of security loan transactions authorized by this legislation to the extent we considered reasonable.* This review was conducted under authority vested in the Auditor General by Section 10527 of the Government Code.

In a securities lending program, the borrower of securities (generally a broker-dealer or bank) generally provides the lender collateral either in the form of government securities or cash. The borrower generally needs specific securities to meet delivery requirements or to cover short sales. The value of the collateral is required to be maintained in an amount equal to or in excess of the market value of the securities being loaned. As consideration, the lender may receive additional interest income in excess of what would otherwise have been received had securities not been loaned, either in the form of negotiated interest payments or from short-term investments if cash is provided as collateral.

*Security loans are defined in Chapter 1214, Statutes of 1975, which is presented as Appendix A of this report, pages A-1 through A-3.

In March 1975 the Auditor General issued report No. 257 Evaluation of General Proposals to Allow State and Local Investment Authorities* in California to Increase Interest Income by Temporarily Lending Investment Securities through "Security Loans" and "Reverse Repurchase Agreements."** This report contained an evaluation of the risks and an estimate of net additional interest income which could be earned if legislation were enacted to authorize these transactions.

*Chapter 1214, Statutes of 1975 authorized only the State Treasurer and the Board of Administration of the Public Employees' Retirement System to loan securities.

**Chapter 378, Statutes of 1976 allows the State Treasurer to enter into "reverse repurchase agreements," defined in Chapter 378, Statutes of 1976 which is presented as Appendix B of this report. The Auditor General has not been directed to audit the results of reverse repurchase agreements.

Scope of Review

We audited results of the State Treasurer's security loan agreements for the three years ended September 30, 1978. The purpose of our examination was primarily to determine:

- Whether the State Treasurer received from the borrowers all income which the Pooled Money Investment Account (PMIA) would otherwise have been entitled to had securities not been loaned, plus all additional interest due the State as remuneration for lending securities*
- Whether the State Treasurer has accurately publicized the net additional interest income from PMIA security loans
- Whether the State Treasurer has received and maintained sufficient collateral to enable the State to reacquire PMIA securities in the open market had a borrower been unable to return the loaned securities
- Whether the State Treasurer has incurred losses in reacquiring loaned securities.

*Chapter 1214, Statutes of 1975 has been interpreted to restrict security loans of the State Treasurer to securities of the Pooled Money Investment Account.

We included such tests of the accounting records and other auditing procedures as we considered necessary in the circumstances. These procedures were designed to provide reasonable but not absolute assurance.

We also inquired about the decision of the Investment Committee of the PERS Board of Administration not to embark on a securities lending program.

\$178,125 to \$285,000. Government Code Section 760(a) requires the Treasurer to monitor the market value of the loaned securities daily and specifies that in no event shall the amount of the collateral be less than the market value of the loaned securities.

We also made recommendations to the State Treasurer's Office to improve its controls, records and reports used to monitor the program. Recommendations to the State Treasurer's Office are presented as Appendix C.

PERS BOARD OF ADMINISTRATION HAS DECIDED
AGAINST A SECURITIES LENDING PROGRAM


Contrary to the recommendation of PERS staff, the Investment Committee of the PERS Board of Administration on February 16, 1977 and again on January 16, 1979, decided not to embark on a securities lending program. The Committee stated that "the returns appear small versus the risk incurred." PERS staff recommendations to establish a securities lending program are presented in Appendix D.

The detailed PERS staff recommendation provided, among other things, that securities in a lending portfolio would be housed in a bank vault in New York. The bank selected to be the custodian (or security loan agent) would require the borrower to provide and maintain cash collateral equal to or greater than the market value of loaned securities. The State Treasurer would request interested banks to bid on the annual rate they would charge PERS based on the dollar volume of securities lending, for example, one, two or three percent per year, etc. PERS would invest the cash collateral in short term investments.

The Treasurer of the Regents of the University of California has, since 1967, maintained a security lending program which has produced a satisfactory level of earnings. In the annual report for the year ended June 30, 1976, the Treasurer of the Regents of the University of California described the securities lending program as "essentially riskless."

Since it would be required that PERS would hold cash collateral equal to or greater than the market value of loaned securities, we cannot foresee any risks, provided the program is properly administered.

Respectfully submitted,


THOMAS W. HAYES
Acting Auditor General

Date: February 28, 1979

Staff: Richard LaRock, Supervising Auditor
Mildred Kiesel
Ross Luna
Peter Wolfe

JESSE M. UNRUH
TREASURER

P. O. BOX 1919
SACRAMENTO 95809
(916) 445-5316



STATE OF CALIFORNIA
OFFICE OF THE

Treasurer

February 27, 1979

Members of the
Joint Legislative Audit Committee
925 L Street, Suite 750
Sacramento, California 95814

We appreciate your audit of Security Loan Agreements made by the Treasurer's Office.

It was through a recommendation of the Auditor General's Office that we were able to secure legislation to enter into these agreements and, as you know, we have earned over \$450,000 additional income as a result.

We are also appreciative of your recommendations and those that are not already a part of our procedures will be seriously considered. A new employee has been added to the investment staff and one of his duties will be to monitor the collateral so that market fluctuation will not find us short of collateral.

Cordially,

A handwritten signature in cursive script that reads "Jesse M. Unruh".

Jesse M. Unruh
State Treasurer

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Memorandum

To : Mr. Thomas W. Hayes, Acting Auditor General
Office of the Auditor General
925 L Street, Suite 750
Sacramento, CA

Date : February 27, 1979

File No.:

Attn: Richard LaRock

From : Mr. Carl J. Blechinger, Executive Officer
Public Employees' Retirement System 

Subject:

You have delivered to us, on February 23, 1979, a draft report on the audit of results of security loan programs. You ask for comments by February 27, 1979, as the report must be complete by March 1, 1979. This timing precludes review of the draft by the PERS Board of Administration and its Investment Committee. However, in order to be cooperative to the maximum extent possible under these circumstances, we offer the comments below.

We understand your charge was to "audit the results of all security loan agreements entered into by state agencies" under Chapter 1214, Statutes of 1975. We were unaware that the audit was to go beyond the charge to include agencies which did not enter the program. You comment further that PERS decided against a program and that you cannot foresee any risks provided the program is properly administered.

Some parties have described the program as "essentially riskless". We note that there have been losses suffered by organizations of some esteem, such as Harvard, Cornell, Yale and Carnegie-Mellon, in their programs. This should be noted in your report. The cash collateral is not always sufficient to cover a broken loan agreement when market prices are rising rapidly and a squeeze is placed on availability of a certain stock or stocks. There is also a potential legal problem in terms of perfectability and fungibility of collateral which must be guarded against. It can be seen there are some risks, although we agree the program might be described as of moderate risk or low risk.

The Board was also concerned about the financial stability of the only bank that we were aware was conducting an agency program at that time. While not wishing to demean that bank's financial integrity, it was rumored to be on the Comptroller of the Currency's list of troubled banks, which we were not able to either verify or reject.

Mr. Thomas W. Hayes, Acting Auditor General

February 27, 1979

We also note that there are added costs involved and considerable staff control necessary even in an agency program. For example, one must audit the agent's statement to see if they diligently mark-to-market and adjust collateral whenever appropriate. Also, a senior investment officer must determine the list of eligible borrowers, analyze financial statements of same and maintain an eligibility list. Finally, there is much telephonic communication with the agent on loans in process and cash to be transferred. Each return of cash will also cause an additional document for drawing of a warrant. Our staff situation at this time would require an expansion to assimilate even an agency oriented loan program. The audit recommendation should include a further recommendation for adequate staffing. We had hoped that information would evolve out of your report denoting how much staff time was necessary at the State Treasurer or University of California Regents to administer a well-controlled program.

In the past few days, a large, financially strong California bank has notified us they are now conducting a program. Securities are domiciled in California until the loan is made. Our staff is now investigating this prospect and will bring it to the attention of the PERS Investment Committee for consideration.


CARL J. BLECHINGER, EXECUTIVE OFFICER

CJB:MP:mw
cc: Members, Board of Administration
Mel Petersen

CHAPTER 1214, STATUTES OF 1975

Assembly Bill No. 2283

CHAPTER 1214

An act to add Sections 16481 and 20208.5 to, and to add Division 8 (commencing with Section 7600) to Title 1 of, the Government Code, relating to the investment of securities owned by state agencies, and declaring the urgency thereof, to take effect immediately.

[Approved by Governor September 30, 1975. Filed with Secretary of State September 30, 1975.]

LEGISLATIVE COUNSEL'S DIGEST

AB 2283, Beverly. State agencies: security loan agreements.

The existing law contains no express provision authorizing state agencies to enter into security loan agreements with respect to securities which they are authorized by law to invest in.

This bill would authorize specified state agencies to enter into security loan agreements with respect to securities invested in pursuant to provisions relating to the Public Employees' Retirement Fund, and the Surplus Money Investment Account.

This bill would require the Auditor General to audit the results of all security loan agreements entered into by state agencies under this chapter at the end of 3 years operation and would require the Auditor General to submit a report to the Legislature with recommendations on or before March 1, 1979.

This bill would take effect immediately as an urgency statute.

The people of the State of California do enact as follows:

SECTION 1. Division 8 (commencing with Section 7600) is added to Title 1 of the Government Code, to read:

DIVISION 8. SECURITIES OWNED BY STATE AGENCIES

CHAPTER 1. INVESTMENT OF SECURITIES OWNED BY STATE AGENCIES

Article 1. General

7600. It is the intent of the Legislature that:

- (a) Specified state agencies be authorized to invest marketable securities by entering into security loan agreements;
- (b) State agencies charged with such authority exercise prudence in making such agreements;
- (c) Sound fiscal management be established with respect to transactions involving security agreements.

7601. As used in this chapter:

(a) "Security loan agreement" means a written contract whereby a legal owner (the lender) agrees to lend specific marketable corporate or government securities for a period not to exceed one year. The lender retains the right to collect from the borrower all dividends, interest, premiums, rights, and any other distributions to which the lender would otherwise have been entitled. The lender waives the right to vote the securities during the term of the loan. The lender may terminate the contract upon not more than five business days' notice as agreed, and the borrower may terminate the contract upon not less than two business days' notice as agreed. The borrower shall provide collateral to the lender in the form of cash, or bonds, other interest-bearing notes and obligations of the United States or federal instrumentalities eligible for investment by a lending state agency.

Such collateral shall be in an amount equal to at least 102 percent of the market value of the loaned securities as agreed. The administrators of the funds involved shall monitor the market value of the loaned securities daily. The loan agreement shall provide for payment of additional collateral on a daily basis, or at such times as the value of the loaned securities increases, to agreed upon ratios. In no event shall the amount of the collateral be less than the market value of the loaned securities.

(b) "Marketable securities" means securities that are freely traded on recognized exchanges or marketplaces.

Article 2. Security Loans

7602. A state agency which is authorized pursuant to Sections 16481 and 20208.5 of the Government Code may enter into security loan agreements with broker-dealers and with California or national banks for the purpose of prudently supplementing the income normally received from investments.

7603. All loans of securities shall be made pursuant to one of the standardized security loan agreement forms, as developed jointly by the administrators of the State Pooled Investment Account (as authorized by Section 16481 of the Government Code) and the State Public Employees Retirement System (as authorized by Section 20209 of the Government Code) and as approved by the Commissioner of Corporations.

7604. In the event of a loss in the reacquisition of loaned securities, the responsible state agency shall make a written report of such loss to the Legislature and the Auditor General as soon as possible, but not later than 30 days after the incurrence of such loss.

7605. Each state agency which enters into security loan agreements shall (a) maintain detailed records of all security loans, (b) develop controls and reports to monitor the conduct of the transactions, and (c) publicize the net results of the security loan transaction separate from the results of other investment activities.

SEC. 2. Section 16481 is added to the Government Code, to read:
16481. Notwithstanding any other provision of the law, the State Treasurer may enter into security loan agreements pursuant to the provisions of Division 8 (commencing with Section 7600) of Title 1 of the Government Code with respect to securities which he is authorized by law to invest in.

SEC. 3. Section 20208.5 is added to the Government Code, to read:

20208.5. Notwithstanding any other provision of the law, the board may enter into security loan agreements pursuant to the provisions of Division 8 (commencing with Section 7600) of Title 1 of the Government Code with respect to securities which the board is authorized by law to invest in.

SEC. 4. The Auditor General shall audit the results of all security loan agreements entered into by state agencies under this chapter at the end of three years of operation and shall submit a report to the Legislature with recommendations on or before March 1, 1979.

SEC. 5. This act is an urgency statute necessary for the immediate preservation of the public peace, health, or safety within the meaning of Article IV of the Constitution and shall go into immediate effect. The facts constituting such necessity are:

The existence of a recessionary economy, a dynamic security market, high short-term interest rates, and the need for additional income through efficient investment of existing public assets make it essential that this act go into immediate effect.

CHAPTER 378, STATUTES OF 1976

Assembly Bill No. 3014

CHAPTER 378

An act to amend Section 16480.4 of the Government Code, relating to state funds.

[Approved by Governor July 8, 1976. Filed with Secretary of State July 9, 1976.]

LEGISLATIVE COUNSEL'S DIGEST

AB 3014, Beverly. State funds: investment.

Existing law specifies the types of securities which are eligible securities for the investment of surplus state funds.

This bill would permit the State Treasurer to enter into repurchase agreements or reverse repurchase agreements of any of these eligible securities. It would define these terms.

The people of the State of California do enact as follows:

SECTION 1. Section 16480.4 of the Government Code is amended to read:

16480.4. (a) Amounts available for investment under this article may be invested and reinvested by the State Treasurer in any securities described in Section 16430 of this code or in loans to the General Fund as provided in Section 16310 of this code. Such securities may be sold by the State Treasurer or exchanged by him for other securities of the kind authorized to be purchased hereunder, if, in his discretion, such sale or exchange appears to be in the best interests of the state. The State Treasurer may enter into repurchase agreements or reverse repurchase agreements of any securities described in Section 16430.

(b) The State Treasurer may hire or engage the services of an investment analyst to assist in such investment decisions.

(c) For purposes of this section, the term "repurchase agreement" means a purchase of securities by the State Treasurer pursuant to an agreement by which the seller will repurchase such securities on or before a specified date and for a specified amount.

(d) For purposes of this section, the term "reverse repurchase agreement" means a sale of securities by the State Treasurer pursuant to an agreement by which the State Treasurer will repurchase such securities on or before a specified date and for a specified amount.

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OFFICE OF THE AUDITOR GENERAL
RECOMMENDATIONS TO THE STATE TREASURER

- Formalize criteria to be met by approved borrowers and a policy on interest rates to be charged
- Maintain record of approved borrowers in the minutes of the Treasurer's Office Investment Committee
- Develop a system to assure receipt of current financial statements of approved borrowers and to monitor their financial condition
- Monitor the market value of loaned securities and collateral daily and maintain collateral in excess of the market value of loaned securities
- Develop a system of control to ensure the reliability of amounts shown on the computer printouts as earned by lending PMIA securities
- Maintain a log of security loans to readily identify the status of each loan.

PERS STAFF RECOMMENDATION TO
ESTABLISH SECURITIES LENDING PROGRAM

APPENDIX D

STATE OF CALIFORNIA—BOARD OF ADMINISTRATION

EDMUND G. BROWN JR., Governor

PUBLIC EMPLOYEES' RETIREMENT SYSTEM

INVESTMENTS DIVISION
515 L Street, Suite 550
P. O. Box 2749
Sacramento, CA 95812



February 9, 1977

AGENDA ITEM 11

TO: MEMBERS OF THE INVESTMENT COMMITTEE

SUBJECT: RECOMMENDATION TO ESTABLISH SECURITIES LENDING PROGRAM

Attached is last month's report which was set for further discussion. Below, we describe the chronology of an illustrative transaction:

- Day 1: Agent bank loans from our account 10,000 shares of XYZ Co. common stock and accepts \$750,000 in clearing house funds in exchange. These funds are credited to our account the same day. Agent bank notifies us of loan by telephone.
- Day 2: We invest clearing house funds. Agent bank sends us written confirmation of loan.
- Day 3: Dividend payment date for XYZ Co. Agent bank automatically credits to our account all XYZ dividends due.
- Day 4: We invest clearing house funds received for dividends due. Agent bank sends us written confirmation.
- Day 5: Closing market price of XYZ common stock is up enough to trigger a mark-to-market call for more cash collateral.
- Day 6: Agent bank debits broker and credits us with clearing house funds needed to bring cash collateral up to 102% of XYZ common stock's previous day closing price. Agent bank calls us with notification of cash balance.
- Day 7: We invest funds. Agent bank sends us written confirmation of transaction.
- Day 8: Closing price of XYZ common stock is down, bringing cash collateral to 110% of XYZ stock's market value. Broker asks agent bank for mark-to-market. Agent bank advises us.
- Day 9: Agent bank debits us and credits broker with clearing house funds needed to bring cash collateral down to 105% of stock's market value. Agent bank advises us.

Agenda Item 11 (Cont'd.)

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February 9, 1977

- Day 10: We wire Federal funds to settle clearing house balance. Agent sends written confirmation.
- Day 11: Broker returns borrowed stock to agent bank. Agent bank debits us and credits broker with amount of cash collateral in clearing house funds. Agent bank advises us.
- Day 12. We wire Federal funds to settle clearing house balance. Agent bank sends written confirmation.

For their services, agent bank charges us at a 3% annual rate of the average daily outstanding balance for the number of days we had use of the money; in this case, Days 2 through 11.

Melvin W. Petersen
Chief of Investments

PUBLIC EMPLOYEES' RETIREMENT SYSTEM

INVESTMENTS DIVISION
515 L Street, Suite 550
P. O. Box 2749
Sacramento, CA 95812

January 12, 1977



AGENDA ITEM 8

TO: MEMBERS OF THE INVESTMENT COMMITTEE

SUBJECT: RECOMMENDATION TO ESTABLISH SECURITIES LENDING PROGRAM

With Committee and Board approval, the Investment Office will begin a securities lending program as authorized by the provisions of Division 8 (commencing with Section 7600) of Title I of the Government Code. The Investment Office has been studying the feasibility of such a program for some time. Until now, we had not thought the potential earnings large enough, the logistic encumbrances resolvable enough, nor the possible administrative controls strong enough to justify our entering into such a program. Subsequent developments have caused us to reexamine the prospects and conclude that the circumstances are now favorable for a PERS securities lending program.

Recently, a major New York bank developed a securities lending program that would give us the strong but flexible managerial controls over security lending that we have always felt were needed to insure adequate safety. These would provide automatic collateral payments, automatic mark-to-market payments, automatic dividend payments on due date, and expeditious completed contract terminations.

Here is how these lending procedures would work. The securities in the lending portfolio would be housed in a bank vault in New York. The protection classification of the vault would be the highest available. The securities custodian would carry Bankers Blanket Bond Insurance in substantial amounts and in the broadest form available for commercial banks.

When lending securities, the custodian (or securities loan agent) would require the borrower to put up cash collateral in exchange for the securities. We would propose cash collateral equal to 105% of the securities current market value which is the highest ratio generally available. Then, once a day, the custodian would test the adequacy of the collateral against the securities market value. Anytime the collateral would not be equal to 100% or more of the market value, the borrower would be asked to put up enough extra collateral to bring the total up to at least 102% of market value. In order to insure that all cash due the lender is available for prompt use, the custodian would automatically bill all transactions through the Stock Clearing Corporation. The custodian would also automatically credit all dividend, interest, and other cash payments to our account on the payable date. If the custodian did not receive a dividend or interest payment on time, he would make any necessary claims against the broker or paying agent. Automatic billing for all transactions and this payable date credit would allow the lender to anticipate all income and properly plan its timely investment.

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January 12, 1977

Meanwhile, the custodian would monitor all actions affecting the lending portfolio such as mergers, splits, stock dividends, tenders, warrants, etc.

If needed, the custodian would also send the lender a "Custodian Open-Ticket Listing" by facsimile transmission. This computer report would summarize all transactions completed the previous day as well as all transactions in progress. In addition, the custodian would mail the lender a hard copy of each transaction daily and a complete account statement monthly or upon request.

The lender, of course, would have to have someone on duty each day the market is open. This person would receive the custodian's phone call about 4:30 p.m. (1:30 p.m. Pacific Time) notifying lender of cash being transferred to his account or due from lender to custodian. The lender could then adjust his next-day's short-term investments as needed. The custodian would handle all other phone calls--to brokers, finders, etc. This would relieve the lender of a mass of detail and the need to have someone on duty at 9:00 a.m. (6:00 a.m. Pacific Time) when the securities lending market opens on the East Coast.

At the end of each month the custodian would bill the lender's account for securities lending charges based on the average daily outstanding balance. The custodian would also notify the lender by letter of the total balance outstanding on the last day of the month, the daily average outstanding balance, and the custodian's monthly charge.

These procedures could be adapted for PERS use as follows: The State Treasurer would solicit bids either from major California banks or from all banks, using those criteria we propose. Interested banks would then bid on the annual rate they would charge us based on the dollar volume of our securities lending; for example, the winning bid might be 3% a year. We might also have to pay a small fee for securities added to or taken from our lending portfolio, but we would not pay any other fees. For instance, trade custom permits the bank to return part of the lending fee to the securities borrower, but, if the bank should find this necessary to meet trade competition, the bank would have to pay this from its own money. Note: Current securities lending practice provides for a 1% per annum rate fee paid by agent or lender to the borrower.

Meanwhile, the bank would enter into a signed securities lending agreement with us. This agreement would require the bank (or its agent) to accept custody of our securities lending portfolio. The selected stocks and bonds included in the portfolio would be stored in vaults conveniently located near authorized potential borrowers. At our option these storage vaults could be those of the bank trust department or of an approved agent such as the Depository Trust Corporation.

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January 12, 1977

All lending transactions and all dividend payments would be automatically billed to the securities clearing house on the due date. If any payments were not made to the clearing house on time, the custodian would be responsible for making payment claims against the broker or paying agent.

Then, when some authorized firm needed to borrow stock or bonds, the securities custodian (or securities loan agent) would exchange the needed securities for 105% of their market value in cash. This 105% would cover all fees due and also provide a cushion against a rise in the market price of the securities lent. Should a rise occur, the securities custodian would call for more cash collateral and would automatically bill the clearing house as soon as the value of the securities lent rose to 100% of the cash collateral posted. The borrower would then put up enough extra cash with the clearing house to bring the total collateral up to 102% of the securities market value. If the borrower could not put up the required extra collateral, he would have to return the securities at once, or the securities custodian would immediately buy a like amount of the same security to replace those on loan. On the other hand, if the market price fell beyond the point where the cash collateral equaled 107% or more of the market value, the securities custodian (if requested) would refund enough cash to the borrower so that his call collateral would be not more than 105% of current market value. Then, once a day the securities custodian would report his transactions and our clearing house balance to us. If our balance were negative, we would wire the needed money. If our balance were positive, we would invest the money in high-grade commercial paper as we already do with other cash not immediately expended.

If short-term interest rates reach 5%, our potential profit would be double what it would have been last January when rates were near 4% assuming a 3% custodian fee rate. This rate is close to that which non-bank agents charge. This "leverage" results from the fact that almost all of our costs arising from this program would be fixed in percentage terms. Of course, we would definitely not lend securities anytime short-term interest rates went down to near our breakeven point. Nor would we loan securities to any firm not meeting adequate financial requirements. We would develop a list of well-managed, well-financed firms in cooperation with the custodian for your review and approval. While this list would be short, I believe we should limit it to only a few firms and conduct a modest program until we got some experience with actual securities lending and develop a good feel for all the factors involved.

Eventually, however, we should be able to develop securities lending into a significant contributor to our net investment income. For example, if short-term interest rates were 5% and our lending grew to \$50,000,000 average outstanding, we would earn \$1,000,000 net income a year. Of course, if our

Agenda Item

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January 12, 1977

lending only grew to \$25,000,000 average, we would only earn \$500,000 a year at that same 5% rate. More important, however, than any net income produced at any such low rate, we would be developing the expertise needed to take full advantage of future high-interest-rate periods. Because securities lending is highly leveraged, each 1% increase in the interest rate (above the breakeven point) would produce an extra \$500,000 annually for a \$50,000,000 portfolio.

As the agent's fees would appear in our expense budget while the interest earnings would be lumped with other income, it will be necessary to publish the income and expense features of the program so interested parties would understand the gain.

There is attached a list of proposed lending controls and bidding criteria we would use in seeking competitive bids; at this time we know of only one bank which has an active program. However, the State Treasurer's staff has made recent inquiries of other banks which may stimulate some interest.

If the Committee concurs we will bring this matter to the Board. Additional steps entail budgetary submission and approval, the bidding process for an agent, approval of a securities lending form by the Commissioner of Corporations, and development of control lists over eligible stocks and brokers.

Malvin W. Petersen
Chief of Investments

Attach.

PUBLIC EMPLOYEES' RETIREMENT SYSTEM

Securities Lending Program

Lending Controls for Equity Securities

1. A securities custodian (or securities loan agent) shall handle all PERS securities lending. PERS shall choose this custodian from bids submitted to the State Treasurer's Office.
2. The PERS lending portfolio will consist solely of securities whose price would not be greatly affected by unpredictable events such as the discovery of a new drug or of a new fuel or other mineral deposit.
3. The agent shall lend PERS securities only to those borrowers and not to exceed those amounts approved in writing by PERS.
4. Borrowers must deposit with the clearing house (or custodian) cash (or certified check) equal to at least 105% of the borrowed security's market value based on New York Stock Exchange or composite tape prices.
5. If necessary, borrowers will deposit enough extra cash every day to bring collateral up to 102% of the security's market value.
6. Borrowers must deposit all dividends, interest, and other cash contributions with the clearing house (or custodian) on the payment date.
7. The agent will automatically bill the clearing house for all securities and cash due PERS unless the securities or a certified check have been already deposited.
8. When paying or depositing cash for PERS credit, the borrower will always use funds that are available next day for PERS investment.
9. PERS may recall securities from borrowers on not less than five business days notice.
10. Under California law borrowers may recall their collateral on not less than two business days notice at any time. In the normal course of business, however, PERS expects that the custodian will return collateral promptly as necessary to meet competition and conform with general trade practice.
11. At the end of the lending period, borrowers will reregister securities in PERS chosen nominee name before returning them.
12. The custodian will insure that all securities on deposit are registered in PERS chosen nominee name on the stockholder voting date of record.

PUBLIC EMPLOYEES' RETIREMENT SYSTEM

Securities Lending Program

Bidding Criteria for Financial Institution Custodianship of Equity Securities

1. Prospective bidders must be financial institutions which have at least \$100,000,000 in equity capital funds.
2. The securities custodian will hold PERS securities with the Depository Trust Corporation or in a New York City area bank vault whenever these securities are not on loan.
3. PERS will select those firms that qualify to borrow securities and will set limits on the amount that each firm may borrow. PERS may limit the amount of any issue or the total of all issues that any firm may borrow. PERS will send the custodian an up-to-date list of authorized borrowers and the amount each is authorized to borrow.
4. The custodian will handle all lending activity--calling PERS once a day with a summary of the day's transactions and the ending account balance. Monthly, the custodian will send PERS a securities lending activity report summarizing the month's transactions.
5. The custodian will automatically bill each transaction through a securities clearing house except when securities are exchanged over the counter for bank cashier or certified check.
6. The custodian will wire the cash balance in the PERS account to the State Treasurer each day.
7. On the original loan the borrower must post cash collateral of at least 105% of the borrower security's market value based on New York Stock Exchange or composite tape prices.
8. The custodian will automatically bill the clearing house for the amount necessary to increase cash collateral to 102% of the market value based on New York Stock Exchange or composite tape prices whenever cash collateral drops to 100% of market value.
9. The custodian may adjust cash collateral to 105% whenever cash collateral exceeds 107% of market value if requested by borrower.
10. The custodian may recall loaned securities on five business day's notice.
11. Under California law borrowers may recall collateral on not less than two business days notice at any time. In the normal course of business, however, PERS expects that the custodian will return collateral promptly as necessary to meet competition and conform with general trade practice.

12. On all payment dates the custodian will automatically credit PERS for dividends, interest, and other cash distributions paid on borrowed securities. If the custodian does not receive cash distributions on a timely basis, the custodian will make claim against borrower or paying agent.
13. The custodian will charge PERS net fees only. If the custodian has to remit funds to the borrower to meet competition, the custodian will pay this, not PERS. PERS will pay in-and-out fees for securities added to or subtracted from the PERS lending portfolio, but PERS will not pay in-and-out fees for individual securities lending transactions. Fee bids on securities loaned should be expressed in a per annum annual rate related to value loaned. Fee bids on custodianship charges for related securities should be expressed in a manner which allows aggregate cost to be readily evaluated.
14. Custodian will work with PERS in drafting a suitable securities lending agreement for necessary State of California approval.

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
Secretary of State
State Controller
State Treasurer
Legislative Analyst
Director of Finance
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Democratic/Republican Caucus
California State Department Heads
Capitol Press Corps