

## AGENDA ITEM 13.

### **COLLEGE ILLINOIS! SECURITIES LENDING**

**Submitted for:** Information

**Summary:** Now entering its eighth year of operation, the *College Illinois!* prepaid tuition program has over \$600 million in assets. Now that the program has reached this asset level, certain revenue-generating opportunities exist that had not previously been possible. Foremost among such revenue-generating options is participation in a securities lending program.

Marquette Associates, investment consultant for the program, has recommended that the securities lending concept be evaluated by *College Illinois!*. Securities lending is the temporary transfer of a security by its owner (in this case, *College Illinois!*) to another investor or financial intermediary. In exchange for loaning out its securities, *College Illinois!* would receive back cash collateral worth 102 percent of the value on loan. This collateral would be invested in short-term low-risk money market investments, with the interest income (profit) split between *College Illinois!* and the custodial bank that administers the securities lending program.

The purpose of participation in securities lending is to generate revenue, at very low risk, that can help defray administrative expenses for the *College Illinois!* program. It is expected that the program would receive between \$100,000 and \$150,000 per year from lending securities, based upon a portfolio size of at least \$600 million.

During the past nine months, the securities lending concept has been studied and evaluated by the *College Illinois!* staff in conjunction with Marquette Associates. The *College Illinois!* Investment Advisory Panel members also have been individually consulted about securities lending, and they are individually and collectively supportive of the program participating in a securities lending program in the near future.

The information in this report is a prelude to a proposal that will be submitted for the Commission's consideration. It is expected that such a proposal will be prepared for the Commission's next meeting scheduled for July 2005.

**Action requested:** None

**ILLINOIS STUDENT ASSISTANCE COMMISSION  
SECURITIES LENDING:  
A REVENUE OPTION FOR *COLLEGE ILLINOIS!***

Now entering its eighth year of operation, the *College Illinois!* prepaid tuition program has over \$600 million in assets. This is a portfolio size wherein the program has certain revenue-generating opportunities that had not previously been possible. Foremost among such revenue-generating options is participation in a securities lending program.

Marquette Associates, investment consultant for the program, has recommended that the securities lending concept be evaluated by *College Illinois!*. Securities lending is the temporary transfer of a security by its owner (in this case, *College Illinois!*) to another investor or financial intermediary (i.e., the borrower). In exchange for loaning out its securities, *College Illinois!* would receive back cash collateral worth 102 percent of the value on loan. This collateral would be invested in short-term low-risk money market investments, with the interest income (profit) split between *College Illinois!* and the custodial bank that administers the securities lending program.

Securities are borrowed primarily by brokers. Brokers choose to borrow securities for a variety of purposes, including: to cover short sales; to complete deliveries on sales where the securities sold are not in good deliverable form; to complete sales when the broker has not yet received securities; to accommodate customers who invest in repurchase agreements; or in cases where the broker wishes to establish a market in a particular issue.

It is envisioned that if the *College Illinois!* program were to participate in securities lending, it should be done through a contractual arrangement with U.S. Bank, the custodial bank for the program's Illinois Prepaid Tuition Trust Fund. *College Illinois!* would become a participant in the U.S. Bank Securities Lending program already in place. U.S. Bank's Securities Lending program was established in 1990, is managed in-house by a team of industry professionals, and currently has more than \$34 billion of assets available for loan, of which roughly \$12 billion is typically on loan each day.

Estimated Revenue from Securities Lending

The purpose of participation in securities lending is to generate revenue, at very low risk, that can help defray administrative expenses for the *College Illinois!* program. It is expected that the program would receive between \$100,000 and \$150,000 per year from lending securities, based upon a portfolio size of at least \$600 million. This additional revenue would more than cover the program's annual investment consulting fee and could pay for a portion of investment management fees, as well. Over time, the amount generated from securities lending potentially could pay a more significant portion of the program's investment management fees.

## U.S. Bank's Role

The role of U.S. Bank is central to the securities lending program. U.S. Bank already is the custodian for the *College Illinois!* Illinois Prepaid Tuition Trust Fund within the State Treasury. U.S. Bank would oversee the entire securities lending process, including: rigorous screening of borrowers; checking availability of requested securities; delivering securities; receiving and investing collateral; and negotiating all other aspects of each transaction within the parameters of the securities lending program. *College Illinois!* would not incur additional administrative costs due to participation in securities lending.

U.S. Bank's Securities Lending program has its own investment policy which is more restrictive than that approved for *College Illinois!*. Collateral received on behalf of *College Illinois!* would take the form of cash and would be invested in money market instruments only. The *College Illinois!* program would be subject to investment risk (albeit very minimal, in this instance) on the collateral, just as it is on all other program investments. U.S. Bank controls this investment risk in several ways, first and foremost through its Securities Lending investment policy that establishes strict policy guidelines for collateral investment. Furthermore, all credit sensitive investments made in the securities lending program are pre-approved by the U.S. Bank Asset Management Fixed Income Credit Committee; the maximum maturity on floating rate corporate debt tops out at 430 days; and the maximum maturity on fixed rate corporate debt is 190 days.

U.S. Bank would fully (100%) indemnify *College Illinois!* from the potential for borrower insolvency, so the program would carry no risk associated with borrowers of the securities.

## Why Securities Lending?

Securities lending provides the *College Illinois!* program with an exceedingly low-risk method for generating incremental revenue to defray administrative expenses. Much of the risk associated with the program is eliminated by choosing the indemnification option, which protects *College Illinois!* from any financial loss due to the borrower's failure to pay principal and interest at maturity. There are no fees associated with securities lending and no long-term commitment is required. *College Illinois!* can withdraw from the program at any time. There is no additional administrative burden upon *College Illinois!* since all administrative functions of the program are provided by U.S. Bank. The fact that U.S. Bank already is the custodian for the *College Illinois!* Illinois Prepaid Tuition Trust Fund means that the U.S. Bank Securities Lending program should have no adverse impact upon capacity of *College Illinois!* investment managers to (re)gain access to securities that had been on loan, when necessary.

## Next Steps

During the past nine months, the securities lending concept has been studied and evaluated by the *College Illinois!* staff in conjunction with Marquette Associates. The *College Illinois!* Investment Advisory Panel members also have been individually consulted about securities lending, and they are individually and collectively supportive of the program becoming a participant in the U.S. Bank Securities Lending program in the near future.

There also is ample precedent within Illinois state government for participation in securities lending. Securities lending is permissible in accordance with the “prudent person” standard referenced within the program’s investment policy (i.e., “The Commission will conduct their responsibilities with the care, skill, and caution under the circumstances then prevailing which a prudent person acting in a like capacity and familiar with those matters would use in the conduct of an activity of like character and purpose.”) Both the State Universities Retirement System (SURS) and the State Board of Investment (the entity that invests funds for the Illinois Judges Retirement System, the Illinois General Assembly Retirement System and Illinois State Employees Retirement System/SERS) have been participants in a securities lending program for more than two decades. In fact, their most recent financial reports show that SURS generated \$3.5 million from securities lending in FY2004, whereas the State Board of Investment generated \$2.4 million from securities lending during the same time period. In both instances, the monies generated were sufficient to pay most, if not all, investment management fees for those public retirement systems’ portfolios.

The Commission would need to amend the *College Illinois!* investment policy to explicitly allow for participation in a securities lending program before such participation would be initiated. The information in this report is a prelude to a proposal that will be submitted for the Commission’s consideration. It is expected that such a proposal will be prepared for the Commission’s next meeting, scheduled for July 2005, and at that time representatives of U.S. Bank will be in attendance to answer any specific questions or concerns that Commissioners may have.