**AGENDA ITEM 7.**

## *COLLEGE ILLINOIS!* PARTICIPATION IN SECURITIES LENDING

**Submitted for:** Action

**Summary:** Entering its eighth year of operation, the *College Illinois!* prepaid tuition program has over $650 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, had recommended in mid-2004 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. U.S. Bank, as the current custodian for the program, would be the securities lending partner for *College Illinois!*.

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, if participation in the U.S. Bank securities lending program is approved, *College Illinois!* would receive an estimated $115,000 per year from lending securities, based upon the market value of program assets as of June 30, 2005. Additional revenue could be generated by future participation in the equity and stock index funds that participate in securities lending at State Street, the program's other custodial bank. It is expected that *College Illinois!* would use revenues from securities lending to pay for the majority of the custody fees incurred annually by the program.

During the past year, the securities lending concept has been studied and evaluated by *College Illinois!* staff in conjunction with Marquette Associates. The *College Illinois!* Investment Advisory Panel members also have been consulted both individually and formally as a group about the securities lending concept. Most recently, the Panel was convened for a meeting held at the ISAC-Deerfield Office on August 30, 2005. At that time, Panel members asked questions of Emil Busse, Managing Director of U.S. Bank's securities lending program, regarding possible participation by *College Illinois!* in the US Bank securities lending program.

Investment Advisory Panel members, with one exception, recommend that *College Illinois!* initiate participation in the U.S. Bank securities lending program.

**Action requested:** That the Commission authorize participation of *College Illinois!* in indemnified securities lending programs and that the Commission specifically authorizes *College Illinois!* to execute a participation contract with the indemnified securities lending program administered by U.S. Bank.

**Item 7.**
**9/19/05**

# *COLLEGE ILLINOIS!* PARTICIPATION IN SECURITIES LENDING

## Overview

Entering its eighth year of operation, the *College Illinois!* prepaid tuition program has over $650 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, had recommended in mid-2004 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. U.S. Bank, as the current custodian for the program, would be the securities lending partner for *College Illinois!*.

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. The United States securities lending industry in total has more than $7.7 trillion in lendable assets with roughly $1.2 trillion of that amount on loan during any given 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, if participation in the U.S. Bank securities lending program is approved, *College Illinois!* would receive an estimated $115,000 per year from lending securities, based upon the market value of program assets in the custody of U.S. Bank as of June 30, 2005. *College Illinois!* would use these revenues to pay the majority of the custody fees incurred annually by the program. Additional revenue could be generated by future participation in the equity and stock index funds that participate in securities lending at State Street, the program's other custodial bank.

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 services for the program are provided by U.S. Bank. The fact that U.S. Bank is already the custodian for the actively managed separate accounts for the Illinois Prepaid Tuition Trust Fund means that the U.S. Bank securities lending program should have no adverse impact upon the capacity of *College Illinois!* investment managers to (re)gain access to securities that had been on loan, when necessary.

**Controlling Risk**

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 the borrowers of the securities.

**Investment Advisory Panel Review**

During the past year, 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 and collectively consulted about securities lending. U.S. Bank made an initial presentation to Panel members and *College Illinois!* staff in October 2004. More recently, on August 30, 2005, the Panel reconvened at the ISAC-Deerfield Office to evaluate potential *College Illinois!* participation in the securities lending program.

After hearing a presentation by Emil Busse, Managing Director of the U.S. Bank securities lending program and taking the opportunity to question Mr. Busse regarding the program that he administers, all Investment Advisory Panel members, with one exception, have recommended that *College Illinois!* participate in the securities lending program. The majority of Panel members agreed that participation in securities lending is justified by both the expected revenue to be gained at the low level of risk offered via the indemnified securities lending program administered by U.S. Bank. The dissenting member of the Panel indicated that the revenue gained from securities lending was not significant relative

to the size of program assets and, if ever necessary, the complexity of the securities lending program makes the program's participation difficult to explain.

**Precedent**

There 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 custody fees and some of the investment management fees for those public retirement systems' portfolios.

**Conclusion**

Commission approval is requested to initiate program participation in the indemnified securities lending program with U.S. Bank. The program's Statement of Investment Policy, which the Commission reviews each year, is scheduled for revision in November 2005 and will at that time incorporate securities lending as part of the program's investment strategy.

It is expected that a representative of U.S. Bank will be in attendance at the Commission's September 19, 2005, meeting to answer any specific questions or concerns that Commissioners may have about securities lending participation.