June 10, 1996

Mr. Charles G. Saums
Investment Manager
Endowment Fund Investment Board
P. O. Box 83720
Boise, ID 83720-0046

THIS CORRESPONDENCE IS A LEGAL GUIDELINE OF THE ATTORNEY GENERAL SUBMITTED FOR YOUR GUIDANCE

Re: Request for Attorney General Opinion
Regarding Proposed Security Lending Agreement

Dear Mr. Saums:

QUESTION PRESENTED

In 1988, the Endowment Fund Investment Board (the "Board") sought the advice of the Attorney General on the question of whether the Board could enter into securities lending agreements under article 9, section 11 of the Idaho Constitution. In Attorney General Opinion No. 88-1, the Attorney General stated that the use of security lending agreements would not violate the constitution, provided legislation was enacted permitting such transactions. Legislation was enacted, and the Board is authorized by Idaho Code § 57-722 to enter into security lending agreements.

The issue presented by your request for an Attorney General's opinion is whether the Board complies with the Idaho Constitution and Idaho Code if it does not require the custodian bank to indemnify the Endowment Fund for losses that may occur while investing the collateral received as part of the securities lending transaction.

Your question arises from the holding of the leading case construing the constitutional limitations upon investments. The Idaho Supreme Court, in Engelking v. Investment Board, 93 Idaho 217, 458 P.2d 213 (1969), held that the term "loan" must not be loosely construed to include all types of investments. The court held there must be an unconditional promise to repay the principal lent as well as interest. 93 Idaho at 223, 458 P.2d at 219.

CONCLUSION

A securities lending agreement is an approved investment that, in the final analysis, is nothing more than a purchase, sale and repurchase of certain securities. The risk of investment loss to the state is virtually the same as if the state were buying the underlying securities. It makes good business sense to require an indemnification from the custodian bank. However, the customary practice in securities lending transactions may not provide for a broad indemnification for investment losses. Securities lending transactions are not speculative investments, provided the custodian bank unconditionally promises to transfer the full value of the "loaned" securities to the Endowment Fund.

ANALYSIS

1. Authority of Board

The Board has the authority to acquire certain investments described in Idaho Code § 57-722. Idaho Code § 57-722(10) authorizes the Board to loan securities owned by the Endowment Fund to any state or federally regulated institution. The Board's inherent authority to invest in authorized securities includes the authority to sell or exchange those securities. *See* 1979 Idaho Att'y Gen. Ann. Rpt. 48.

The Board has, for several years, participated in securities lending agreements similar to that described in Attorney General Opinion No. 88-1. These agreements have provided that the custodian banks indemnify the Endowment Fund against loss in such securities lending transactions. The Board is negotiating the renewal of its current securities lending agreement. The custodian bank raised the issue concerning the extent of the bank's indemnification. A closer look at securities lending transactions is important to understand the potential risk of exposure to the Endowment Fund.

2. Overview of Securities Lending

Attorney General Opinion No. 88-1 provided a brief overview of securities lending transactions. Today's business setting is more complicated than that described in the 1988 opinion.

Securities lending provides a method of matching the supply of available securities with a specific demand for such securities. This demand usually stems from a need to settle investment transactions, and the most frequent borrowers are brokers-dealers and commercial banks. Most of the securities loaned are held in institutional investment portfolios. Most loans of securities are short-term, and participation in the securities lending program depends upon a variety of factors such as the borrower and the types of security and collateral.

The securities lending agreement is similar to what is commonly known as a "repurchase agreement" or "reverse repurchase agreement."[1] It involves two parties, one of whom is deemed the "Borrower" (here, the broker-dealer or commercial bank) and the other is the "Lender" (here, the Endowment Fund Investment Board). From the borrower's perspective, the Borrower is obtaining a secured loan from the Lender of the securities. The Lender, in turn, requires collateral during the period the securities loan is outstanding. The most common form of collateral provided in a securities lending transaction is cash, but other forms of collateral, including other securities, are also accepted.

Each securities lending agreement may also be viewed as comprising two distinguishable transactions which, although agreed upon simultaneously, are performed at different times:

1. The Lender agrees to "sell," and the Borrower agrees to buy, upon immediate payment and delivery, specified securities at a specified price; and

2. The Lender agrees to "buy back" and the Borrower agrees to sell, with payment and delivery at a specified future date, or, if the agreement is "open," on demand the same securities for the same price plus an interest charge. The Borrower transfers cash or other securities as collateral to secure the return of the loaned securities to Lender.

The parties customarily provide that any interest accruing on the securities between the dates of the initial purchase and the subsequent "repurchase" remains the Lender's property. The Lender is authorized to invest the cash collateral in certain approved investments. From a purely economic perspective, therefore, a repurchase is essentially a short-term collateralized loan, and the parties to these transactions tend to perceive them as such. The element of the transaction over which the most bargaining occurs is the interest rate.

The Board has historically used a bank as the middleman to match a Borrower with the Board as the Lender. The bank's responsibility includes the safeguarding and investing of the collateral, establishing collateral requirements and monitoring collateral levels on a regular basis. A Borrower provides the Lender with collateral at least equal to the market values of the securities. Collateral adequacy is maintained by means of a daily adjustment process referred to as "marked-to-market." If the market value of the loaned securities increases and the collateral does not increase equally, a Borrower is required to furnish additional collateral. On the other hand, if the market value of the loaned securities decreases and the collateral value exceeds that of the loaned securities, the Borrower can request the return of the excess collateral.

The role of the bank in monitoring levels of collateral is one of its primary responsibilities under the proposed securities lending agreement. An additional role is that the bank acts as an agent in investing the collateral. Typically, the collateral is held by the bank and is lent to the Lender of the securities as a short-term loan. The bank and the Lender of the securities obtain their profit or "interest" from the difference of the interest rates from lending the collateral versus the investment of the collateral. In the security lending document, the bank has security interest in the collateral which is perfected for the benefit of the Lender.

Generally speaking, in analyzing the potential risk to the Lender in a securities lending transaction, two broad categories of risk exist. The first is the risk of the failure of a Borrower to return the loaned securities or to adequately maintain collateral. The second risk, which is somewhat beyond the control of the Board, is the market risk that the value of the collateral may decline below the replacement cost of the loaned securities. Coupled with this second risk is the risk that the collateral earnings are less than the interest charged for the collateral.

The first risk is minimized by the adequacy of the collateral. Generally, the bank is not hesitant in guaranteeing the return of the borrowed securities. Typically, required collateral is at least 100%, and in some instances 102%, of the value of the loaned securities and is "marked-to-market" on a daily basis. Thus, the risk of a fail is minimal since collateral should be adequate to cover the value of the loaned securities. Additionally, the quality of the financial soundness of both the Borrower and the bank is closely monitored.

The second risk, the decrease in the value of the collateral, is where the indemnification issue arises. The bank is reluctant to agree to an indemnification of the collateral because of the federal banking requirements. Apparently, if the bank were to agree to indemnify the Board for the investment losses to the collateral, the bank would then have to adjust its capital reserves. The practical effect would be that the amount the bank could loan to its customers would be decreased and the securities lending program would become unprofitable for the bank.

3. Speculative Investments are Prohibited

The Board is limited by Idaho Code § 57-722 to certain types of investments. Moreover, the Board, pursuant to Idaho Code § 57-723, is subject to the Idaho Prudent Man Investment Act found at Idaho Code §§ 68-501 *et seq*. The Prudent Man Investment Act requires the exercise of prudence, discretion and intelligence in the management of financial affairs, without regard to "speculation." Idaho Code § 68-502.

While otherwise prudent investors may purchase speculative investments in hopes of "striking it rich," that is not the way they should permanently dispose of their assets. Rather, the primary focus is one of caution with an eye to preservation of the trust property. Withers v. Teachers Retirement System of the City of New York, 447 F. Supp. 1248 (S.D.N.Y. 1978).[2] The fund is a trust of the most sacred and highest order. Moon v. Bd. of Examiners, 104 Idaho 640, 642, 622 P.2d 221, 223 (1983). The Board has a statutory and fiduciary duty to preserve the trust property. Idaho Code §§ 68-501, *et seq.*, and Restatement (Second) of Trusts § 176 (1979). The Board, as trustee, has the duty to invest the fund to derive income in accordance with the objectives of the Endowment Fund. Idaho Code §§ 57-720, *et seq.*, and Restatement (Second) of Trusts § 181 (1979).

4. Investment Losses are Allowable

The Prudent Man Investment Act does not name prohibited investments. The act describes certain general principles of conservatism. However, it has long been recognized that "a loss is always possible, since in any investment there is some risk." Restatement (Second) of Trusts § 227, Comment e (1979). The Idaho Legislature recognized the possibility of a capital loss when enacting Idaho Code § 57-724, which authorizes the netting of capital gains and capital losses. The Idaho Supreme Court has construed that Idaho Code § 57-724 is constitutional in Moon v. Investment Board, 96 Idaho 140, 525 P.2d 335 (1974); and State ex rel. Moon v. State Bd. of Examiners, 104 Idaho 640, 662 P.2d 221 (1983). This means that merely having a loss is not a breach of duty, something else is required to constitute a breach.

Although there may be investment losses, the payment of the losses must be made in accordance with Idaho Code § 57-724. The principal and interest earnings of the endowment funds, particularly the public school fund, must remain intact. In other words, if the net earnings are inadequate then a special appropriation is required by the Idaho Legislature. The securities lending agreement must be carefully drafted to prevent creating a deficiency in violation of the Idaho Constitution and the provisions of Idaho Code § 59-1015.

CONCLUSION

The substance of the transaction cannot be overwhelmed by its form. The Board is selling securities and acquiring new securities and repurchasing the old securities, at an established price. The Board could enter into this type of transaction without calling it a securities lending transaction. What securities lending provides is the opportunity to increase a gain.

Other jurisdictions have reviewed whether securities lending and repurchase agreements are lawful investments. The Texas Court of Appeals found that repurchase agreements were lawful investments. Bache, Halsey, Stuart v. University of Houston, 638 S.W.2d 920 (Tex. Ct. App. 1982). The Washington Attorney General concluded that securities lending agreements are investments of funds and may be constitutionally entered on behalf of the permanent common school fund, public pension funds, and industrial insurance funds. Wash. Att'y Gen. Op. 1986 No. 5; *see* 44 Cal. Att'y Gen. Op. 140.

The securities lending agreement must overcome two prohibited obstacles. First, the Idaho Constitution, article 9, section 11, requires an unconditional promise to repay the principal lent as well as interest. Second, the Idaho Code, through the Prudent Man Investment Act, prohibits speculative investments.

The first obstacle is overcome by holding the loaned securities and collateral in securities or instruments that guarantee the repayment of principal and interest. The investments must be within the category of investments authorized by Idaho Code § 57-722. The securities lending agreement must require the posting of collateral at least in the amount of 100% of the market value of the loaned securities, subject to a "marked-to-market" requirement. Additionally, the bank has agreed to indemnify the Board for any failure to return the loaned securities. The only apparent risk to the principal and interest payment is the risk of a market decline, which is a normal risk.

The second obstacle is more difficult to fully overcome. There is a risk that the yield on the collateral will be less than the interest due under the terms of the securities lending agreement. Whether a court would view this as an acceptable risk is unknown. The answer will depend upon an analysis of the facts. It is our opinion that the risk is not "speculative" because the principal and interest on the underlying security is guaranteed and is secure (other than the market risk). The remaining risk can be minimized by carefully drafting the securities lending agreement and collateral investment guidelines. These documents should require the bank to match the collateral investment to that of the loaned securities, or even net the gains and any losses to assure a minimum return to the Endowment Fund. The Board should obtain the greatest indemnification possible from the bank.

The requirements of both the Idaho Constitution and Idaho Code are met even if there is no indemnification clause in the securities lending agreement, provided the principal and interest payment is guaranteed by the issuer. Care must be taken to negotiate and draft a favorable securities lending agreement.

Very truly yours,

MICHAEL R. JONES
Deputy Attorney General
Contracts & Administrative Law Division

[1] A detailed discussion of the nature of repurchase agreements is contained in the case of Securities & Exchange Commission v. Miller, 495 F. Supp. 465 (S.D.N.Y. 1980).

[2] *See* Attorney General Opinion No. 82-7 for a complete analysis of what is the permissible scope of state funds. 1982 Idaho Att'y Gen. Ann. Rpt. 82.