State Street Sec-Lending Revenue Drops, Lawsuits Percolate

By Beagan Wilcox Volz March 1, 2011

State Street’s securities-lending revenue decreased by 44% from 2009 to 2010, from $570 million to $318 million.

The firm’s 2010 securities-lending revenue stands in stark contrast to the $1.2 billion it had in such revenue in 2008, or roughly a 75% drop in two years.

The decline in 2010 securities-lending revenue was primarily the result of the low-interest-rate environment and lower volumes of assets on loan, due to “continued low levels of client demand,” according to State Street’s annual report filed Monday.

Average lending volumes were basically flat year-to-year, the firm says, with $396 billion for 2010, compared to $406 billion for 2009.

Other custodians that act as securities-lending agents have seen major decreases in related revenue as well. BNY Mellon, for example, had $113 million in securities-lending revenue through third quarter 2010, a 51% decrease from its $230 million in revenue through the same period in 2009 (figures for all of 2010 are not yet available).

In addition to dwindling revenues, State Street and BNY Mellon — along with others such as Northern Trust and JPMorgan — face ongoing litigation stemming from the management and performance of their securities-lending programs during the financial crisis.

State Street disclosed last year that the Securities and Exchange Commission was investigating the management of its securities-lending program. Its recently released annual report states that the SEC is looking at the adequacy of the firm’s disclosure regarding collateral pools and its redemption policy for agency lending participants.

Before the crisis, securities lending was viewed as a relatively low-risk way for mutual funds, pension funds and others to incrementally increase returns. But during the crisis, some collateral reinvestments sank in value or became illiquid. This was the case at State Street, which imposed restrictions on redemptions from its collateral pools in 2008.

State Street took a pretax charge of $414 million in second quarter 2010 as part of shoring up its securities-lending collateral pools.
“[W]e cannot determine whether the staff of the SEC will conclude that our disclosures or conduct of the program form the basis of a potential formal proceeding seeking damages or other remedies,” State Street reiterates in its 2010 annual report.

Part of the $414 million charge is a $75 million reserve “to address potential inconsistencies in connection with our implementation of those redemption restrictions prior to May 31, 2010,” according to State Street’s annual report.

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The amount of the reserve reflects the firm’s assessment of the amount required to compensate clients for the “dilutive effect” of redemptions. Yet State Street notes “there can be no assurance that participants in the agency lending program will not assert additional damages as a result of the implementation or existence of the redemption restrictions.”

State Street also outlines the SEC’s request for information regarding mutual funds managed by State Street Global Advisors that invested in subprime securities.

“During the course of our responding to such inquiry, certain potential compliance issues have been identified and are in the process of being resolved with the SEC staff,” according to State Street. The firm notes that these funds are different than the unregistered ones at the heart of a February 2010 settlement with regulators that was just north of $300 million.

Among other securities-lending-related lawsuits State Street is defending, it faces a putative class action filed by an Essex, Mass.-based glass designer alleging the firm breached its fiduciary duties under the Employee Retirement Income Security Act. The plaintiffs say Glass Dimensions’ profit-sharing plan suffered losses of “hundreds of millions of dollars” due to the percentage of securities-lending income State Street allegedly took: 50%.

The plaintiffs say this is among the highest splits in the industry and that State Street took a lower percentage of profits with other clients; for example, the firm received 30% of securities-lending income through its arrangements with the retirement plans of the states of Missouri and Florida, according to the amended complaint.

“I think we’ll be able to show profit margins in this are ridiculous,” says Gregory Porter, partner at Bailey & Glasser and attorney for the plaintiffs. “Is the fee in proportion to the work they did?” Porter asks.

Porter represented plaintiffs at law firm Fishman Haygood in a lawsuit brought against State Street that alleged mismanagement of securities lending. The judge dismissed those claims, and the case was voluntarily dismissed after plaintiffs appealed. With State Street shoring up the collateral pools, there were no longer any resulting damages, and Porter says his firm’s focus has shifted away from mismanagement of the securities-lending program toward excessive fees.
The Glass Dimensions lawsuit survived a motion to dismiss in December and is now in discovery.

State Street declined to comment on the lawsuit beyond what’s in its annual report.

The whole area of securities lending has been an “opaque, blind spot for fiduciaries” until relatively recently, according to Marcia Wagner, managing director of The Wagner Law Group. “A legal claim that fees were excessive in light of the services provided is one that can easily be made under Erisa when the service in question is not sufficiently transparent,” Wagner adds.