

# MONEY & INVESTING

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## Securities lending crimped by credit crisis

### Losses spark lawsuits as customers allege mismanagement

BY CRAIG KARMIN  
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**T**HE CREDIT crisis is causing a contraction of the little-noticed but huge business of securities lending, and financial players including pension funds, insurers and hedge funds are paying the price.

Losses are sparking lawsuits in the U.S. from customers who pursued securities lending as a way to squeeze additional gains with seemingly little risk. Northern Trust Corp. and Wells Fargo & Co., which run programs for institutional investors with securities to lend, were sued last week by clients who alleged that they mismanaged money and, in the case of Wells Fargo, deceived the clients about the nature of their investments and degree of

losses. Both companies are defending against the suits.

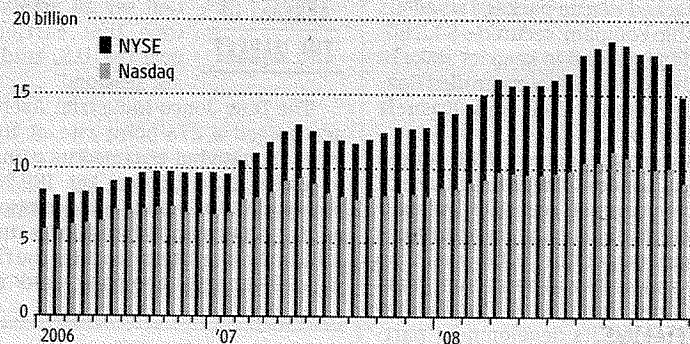
Securities lending programs, which combined have represented at least a trillion dollars, involve lending securities to short sellers or others and investing the collateral for gains. The strategy for many has lately backfired as once-reliable credit investments have seized up amid market woes.

In recent weeks, the city of Hartford, Conn., and other institutional investors have suspended their securities lending programs. State Street Corp. and other large custodian banks have restricted investors from exiting the programs. And insurers including MetLife Inc. and Chubb Corp. are trimming or winding down their programs; American International Group Inc. has suffered more than \$15 billion in unrealized and realized losses.

Kathleen Palm Devine, treasurer of the city of Hartford's \$1 billion Municipal Employees' Retirement Fund, froze her securities-lending plan in August, when it had securities worth \$52 million. She said the

### Getting shorter

Short-selling positions, in billions of shares



Note: Starting with Sept. 2007 figures are reported twice a month

Source: WSJ Market Data Group

fund earned about \$425,000 a year, "but we are willing to forgo that income until we know better what is going in the markets."

If markets improve, it is possible fear of losses will subside and participants will resume lending. Investors who hold large portfolios of securities such as pension funds, in-

dex funds, insurers and endowments often lend them out and profit by investing the collateral they receive in exchange for the securities. Often a custodian handles the program including the investing, which is generally done in low-risk investments. While the profit on any individual transaction is

small, with big portfolios the gains add up.

Securities lending is widespread, but it has had critics. David Swensen, chief investment officer of Yale University's endowment, has derided these programs as "make a little, make a little, make a little, lose a lot."

In Minnesota, the Robins, Kaplan, Miller & Ciresi Foundation for Children, two other foundations and a nonprofit insurance association filed a state-court lawsuit last week alleging Wells Fargo repeatedly assured securities-lending clients that their cash collateral would be invested in safe investments, such as "high-grade money market instruments." Instead, "Wells Fargo also invested in highly illiquid securities, including mortgage-backed assets with maturity dates that reach out nearly 40 years."

The suit says the combined losses, going back to last year, for the four clients are at least \$17 million on securities-lending programs valued at \$373 million. But the suit

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# Credit crisis crimps securities lending

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adds that "since Wells Fargo's valuations have been based on an artificially inflated [net asset value], it is believed that these numbers substantially understate actual losses."

Wells Fargo spokesman Gabriel Boehmer said: "We dispute the allegations. Like all investments, investors bear the risk of losses. We intend to vigorously defend against these charges." He added: "All the investments were highly rated and highly liquid at the time of purchase."

BP Corporation North America Inc., a unit of BP PLC, filed a suit last week in U.S. District Court against Northern Trust, seeking to get its pension fund out of Northern Trust's securities-lending program without incurring losses. BP alleges the bank violated U.S. employment law operating "the securities-lending program in an imprudent manner."

The suit said some of cash collateral investments had defaulted, while others "have been marked down in value and...have become so illiquid that such investments could only be sold" at substantial markdowns.

Northern Trust, which has acknowledged losses, says the BP suit "seeks to avoid safeguards that Northern Trust put in place to ensure that all the participants in those funds are treated equitably during extraordinarily difficult economic conditions."

The University of Washington sued Northern Trust last month to get

out of its securities-lending program when the university learned it was losing money. The school agreed to accept a \$6.6 million loss to exit from the program, according to an Oct. 3 settlement agreement. The school's program had been \$750 million.

Some insurers also have large securities-lending programs, though they generally lend debt securities to Wall Street firms seeking to hedge positions. Their programs play off their expertise running huge bond portfolios. Problems with the securities-lending program at AIG prompted it this month to secure as much as \$37.8 billion from the U.S. government, which had already made available \$85 billion to the insurer to help it avoid bankruptcy last month.

MetLife had about \$45 billion of securities on loan as of June 30, the company's chief financial officer, William J. Wheeler, told investors and analysts in an Oct. 8 conference call. The total was down to about \$40.4 billion as of Sept. 30, according to a regulatory filing. On its third-quarter conference call Thursday morning, executives were expected to discuss the latest cutback in the securities-lending program.

"I think it's safe to say we assume that the program, the overall outstandings, will probably shrink," Mr. Wheeler said on the Oct. 8 call. "We do make good money" from securities lending, so a cutback "will probably have an impact on earn-

ings power next year."

The three big custodian banks that run securities-lending programs with a combined value of about \$1 trillion could be among the bigger losers if institutions continue pulling out.

State Street had \$246 million in revenue from securities lending in the third quarter, or about 10% of its total revenue that quarter. Moody's Investors Service cited the possibility that "client interest in securities-lending activities could also decline going forward" as a reason for keeping State Street's credit outlook as negative. A spokeswoman said "about 10% of our customers and 10% of the assets have left the program—something that we believe to be temporary."

Bank of New York Mellon Corp. said it had revenue of \$155 million from securities lending in the third quarter, out of total revenue of \$3.9 billion. The bank said on a recent conference call that about 2% of its client base, and slightly more than that in terms of assets, has exited its securities-lending program.

Because of the losses in its cash collateral investments, Northern Trust said its securities-lending revenue in the third quarter was negative \$4.6 million. That figure was down from \$150 million in revenue from securities lending, or 15% of the bank's total revenue, in the second quarter.

—Jenny Strasburg  
contributed to this article.