Pension Benefit Guaranty Corporation
Office of Inspector General
1200 K Street, N.W., Washington, D.C. 20005-4026

July 17, 2009

MEMORANDUM

TO: Representatives of the Board of Directors

FROM: Rebecca Anne Batts
Inspector General

SUBJECT: PBGC Office of Inspector General Report: Evaluation of PBGC's Activities with Respect to its Securities Lending Program (EVAL-09-06/FA-08-51)

This memorandum transmits both our evaluation report issued to the Pension Benefit Guaranty Corporation (PBGC) Chief Financial Officer and your July 16, 2009 response. The report, prepared by Independent Fiduciary Services under contract to the Office of Inspector General, included sixteen recommendations that primarily addressed the absence of written policy and guidance for PBGC's securities lending program. PBGC's response was incorporated in its entirety into the report as Appendix I. PBGC agreed with fourteen of the recommendations and proposed alternative actions for the remaining two recommendations. Our report reflects our initial concurrence with PBGC's planned corrective actions.

After the issuance of our report, I met with you and your representatives to discuss the report recommendations. As noted in your letter of July 16, 2009, attached, you agreed that the recommendations contained in the report generally appear sound and you were pleased that the PBGC would be working to implement them. However, you also noted that the Board has direct authority for overseeing the investment policy and its implementation, therefore, the securities lending guidelines proposed in our report's Recommendation No. 2 should be submitted to the Board and Board Representatives for review. We accept your management decision. Accordingly, we have agreement for proposed corrective action for all the report recommendations.

We look forward to working with you in the future and are committed to keeping you regularly updated. Please feel free to contact me if you have any questions or concerns.

Attachments

Pension Benefit Guaranty Corporation

Office of Inspector General

Evaluation Report

Evaluation of the PBGC'S Activities With Respect to its Securities Lending Program

July 9, 2009

EVAL-09-06/FA-08-51

Attachment 1

Pension Benefit Guaranty Corporation
Office of Inspector General
1200 K Street, N.W., Washington, D.C. 20005-4026

July 9, 2009

MEMORANDUM

TO: Patricia Kelly
Chief Financial Officer

FROM: Joseph A. Marchowsky Joseph A Marchowsky
Assistant Inspector General for Audit

SUBJECT: Final Report: Evaluation of PBGC's Activities With Respect To Its Securities Lending Program (EVAL-09-06/FA-08-51)

This memorandum transmits an evaluation report concerning the Pension Benefit Guaranty Corporation's (PBGC) securities lending program prepared by Independent Fiduciary Services (IFS) under contract to the Office of Inspector General. IFS evaluated PBGC's policies governing the securities lending program and its monitoring of its contract with State Street Bank which acts as PBGC's agent for the program.

Specifically, IFS (1) evaluated the adequacy of PBGC's monitoring State Street Bank activities; (2) how the PBGC contract compared to similar agreements in the industry; and (3) whether the arrangement was advantageous to PBGC. IFS identified several findings and recommended a number of corrective actions. In general, the findings dealt with the absence of PBGC written polices and guidance for the program.

PBGC's June 16, 2009 response has been incorporated into the report in it entirety as Appendix I. PBGC agreed with all the recommendations with the exception of recommendations 1 and 2, for which PBGC proposed alternative actions to address the findings. In both cases we accept PBGC's proposed alternative action since it meets the intent of the recommendation. Accordingly, we have agreement for the proposed corrective action for all the report's recommendations.

If you have any questions, please contact me at (202) 326-4000 extension 3928.

Attachment

cc: John Greenberg
Chief Investment Officer

Independent Fiduciary Services®

EVALUATION OF THE PBGC'S ACTIVITIES
WITH RESPECT TO ITS
SECURITIES LENDING PROGRAM

July 6, 2009

Table of Contents

Section I. - Executive Summary

Independent Fiduciary Services, Inc. ("IFS") was hired by the Office of Inspector General ("OIG") to evaluate the securities lending program activities of the Pension Benefit Guaranty Corporation ("PBGC") as they relate to PBGC's monitoring of the securities lending contract with State Street Bank ("State Street"). More specifically, IFS was asked to evaluate whether the internal controls surrounding PBGC's monitoring of these activities and the related contract are adequate, how the contract and agreement compare to similar agreements in the industry, and whether the arrangement is advantageous to PBGC.

PBGC lends its securities through a lending agent, which is a common vehicle to enable institutional investors to lend their portfolio. Even though most of the lending activities and some of the accounting for these transactions are conducted at State Street, the specified review objectives did not include a review of State Street's systems, processes, or transactions. Our key findings and recommendations are summarized below.

- Written policies regarding the Securities Lending Program are virtually non-existent.

- There is a general absence of written policy guidance from the highest level down regarding the establishment, investment objectives, risk tolerance, and measurement standards and operations of the securities lending program, including the absence of a policy to require periodic review and modification or reaffirmation of the policy.

- There is an absence of documentation of procedures used to implement, oversee and monitor the program against policy standards and benchmarks.

- PBGC is unable to independently calculate that its gross and net revenues earned in the commingled collateral trust pool are correctly calculated by State Street. State Street does provide timely annual audited financial statements of the securities lending collateral trust pool.

- Staffing levels are insufficient to allow for adequate backup of functions and ongoing education.

- State Street processes securities lending transactions in accordance with industry standards and the securities lending contract. However, further review is recommended in some areas, particularly involving differences between contract provisions and current practice.

- The agreements between PBGC and State Street cover the requirements of a securities lending program in all material respects and are generally favorable to PBGC within the constraints of standard practice.

- The SAS 70 report on controls is primarily designed for the independent auditors to obtain comfort on controls at external service organizations. It provides only a small piece of the necessary tools to adequately monitor the securities lending program.

Section II – Detailed Discussion and Analysis

A. PBGC's Securities Lending Policies and Procedures

Overview of Securities Lending

Historically securities lending was considered a low risk means to obtain incremental investment return. Recent significant collateral and borrower default events have altered this perception. Even prior to this, however, the process of lending securities has been a complex arrangement with several areas in which one or more of the involved parties has borne risk.

At its simplest, securities lending is the process through which an investor in possession of a security allows another investor to borrow that security and use it as if owned by the borrower in exchange for possession of collateral and payment of a fee.

There are three separate entities involved in any securities lending activity: the investor functioning as lender, the borrowers (as a set of institutions needing securities they do not own), and an agent acting as an arranger of loans and a coordinator of the several transactional, custody, investing, and recordkeeping procedures involved in the process. As it applies to this report, PBGC is the lender and State Street is the agent.

In a securities loan, in exchange for delivery of the borrowed security the borrower delivers collateral to the agent bank, usually in the form of cash or qualifying government securities. The collateral is initially worth a multiple of the value of the borrowed securities, and must be maintained at a multiple of the borrowed security's fluctuating value through a mark-to-market process. Daily marks to market result in the posting of additional collateral or recovery of excess collateral, as applicable. When the loan is repaid the borrower delivers the borrowed security and receives back the collateral.

During the term of a securities loan the borrower is the owner of record, but is responsible for delivering to the lender the equivalent of all the entitlements except the right to vote the shares. Thus, the borrower must pay the lender the equivalent of any cash dividend and must adjust the number of shares to reflect stock dividends and splits.

When collateral is government securities or any other asset other than cash (e.g. letters of credit), the borrower is entitled to the earnings on the collateral and pays a fee to the agent bank as consideration for the loan. When the collateral is cash the agent bank invests the collateral and pays the borrower a rebate expected to be less than the rate earned on investing the collateral. The fee and the spread between the collateral yield and the rebate associated with these two loan forms are the earnings on the securities loan. This is split between the lender and the agent bank.

Each loan is negotiated between the borrower and the agent bank. Agent banks typically establish master borrowing agreements with each borrower that form the basis for many individual loans. These agreements are usually based on industry standard agreements covering all the mechanics of the arrangement and setting out duties and responsibilities. The specific terms of each loan are all that needs to be negotiated: borrowed security, collateral, fee or rebate rate, and term or demand maturity. On many loans the supply and demand for the loaned security is in equilibrium and the loan terms are standard. Securities in particularly high demand (known as "specials"[1]) command premium pricing.

Investment risks in securities lending fall into two categories: Loan Default Risk in which the borrower fails to return borrowed securities or fails to post additional collateral when required and Collateral Investment Risk in which the return on cash collateral is insufficient to return the collateral and the rebate to the borrower.

In many securities loan programs the agent bank is contractually responsible for covering the risk of borrower default, although some banks seek to avoid this. Since the agent bank is the entity that qualifies the borrower, negotiates the loan, enforces collateral procedures, and controls repayment, this is reasonable. This indemnity is in practice limited by the standard terms it follows. This is discussed in greater detail in Section M regarding the lending contract.

The lender's most significant risk is its contractual and practical risk of collateral shortfall, which is borne entirely or almost entirely by the lender, who in this case is PBGC. This placement of risk prevails regardless of whether the collateral is invested by the agent bank or another investment manager, and regardless of whether the investment is in a pooled account under the manager's guidelines or in a separate account with guidelines imposed by the lender. Historically such shortfalls, if they did occur, were due to the investment rate being insufficient to cover the rebate. While that can occur on occasional days in almost any program, seldom were individual loans, much less entire programs, generating a negative spread on average for their entire term. The current financial crisis has resulted in some collateral investments defaulting and others becoming temporarily untradeable at a price reasonably related to maturity value.

Given the risks inherent in a securities lending program and the goals usually set for it by a lender, controls are usually set and managed to monitor the following aspects:

[1] Circumstances in the market from time to time may increase the demand to borrow a particular security. Among the situations that lead to this is the record date for a particularly important proxy vote or a concern over a management announcement leading to an increase in short selling. Such high demand securities lending situations are called "specials" because it is possible for willing lenders to obtain more favorable terms and because the process for bidding the loans is not the regular and ordinary one. Banks will use various mechanisms to lead potential borrowers for a scarce security to compete or bid against one another, thus driving down the rebate rate and increasing the profitability of the loan.

- Accounting for the program to assure all loans are properly recorded and all earnings properly credited.

- Investment of cash collateral to assure that it is invested in accordance with the approved investment guidelines.

- Sufficiency of cash collateral as maintained and marked-to-market in accordance with contractual requirements to assure the loan can be properly closed.

- Competitiveness of the program to assure its investment objectives are being achieved and that the benefit is sufficient relative to the risk.

At the time we conducted our interviews, the securities lending program at PBGC was primarily overseen by the Deputy Treasurer in the Treasury Division of the Financial Operations Department.[2] This organizational structure and staffing is described in Section B.

PBGC Securities Lending Policy

Under the Employee Retirement Income Security Act of 1974 (ERISA), as amended, the PBGC Director is granted authority to administer the Corporation in accordance with the policies established by the Board of Directors (U.S. Secretaries of Labor, Treasury and Commerce). The Board of Directors is granted the power to adopt, amend, and repeal by-laws, rules, and regulations relating to the conduct of its business. (29 U.S.C. §§ 4002(a) and (b)(3)).

PBGC's By-laws state that, among other things, the Board is to establish and oversee the policies of the Corporation. The Board may delegate most powers to the Director except that approval of the Corporation's Investment Policy Statement may not be delegated to the Director of the Corporation. (5 C.F.R § 4002.3(a)(3)(iv))

PBGC's investment staff, which is responsible for overseeing the securities lending program, has stated that the goal of the program is achieving a reasonable return within strict conservative risk tolerances. It is not to maximize return at the cost of possible investment and liquidity risk.

Observed Conditions

The PBGC Investment Policy Statement states simply: "Securities lending is allowed." Thus, we conclude that the authority for a securities lending program comes directly from the Board.

[2] All department names and titles were provided by PBGC and were as of the time we conducted interviews. We are aware that PBGC is implementing a restructuring of its financial operations and activities into two departments, and the investment activities are being reassigned to a new department, the Corporate Investment Department.

Through an agency agreement, PBGC has delegated authority to State Street to conduct all securities lending transactions and activities. Other than the hiring of State Street, no securities lending transactions and activities involving separately custodied securities are performed by PBGC.[3]

Conclusion

The absence of more detailed written policy level criteria for securities lending to guide staff and State Street increases the risk of participation in a sub-optimal securities lending program or not adequately structuring or monitoring the program. Inadequate structure or monitoring in turn may produce undue risk or sacrifice available returns.

There are no formal written policies subject to management review and approval through which the management and monitoring of the program is effected and appropriate management reporting created and delivered. The Investment Policy allowing securities lending needs enhancement.

We recommend that:

Recommendation 1
*The PBGC Board of Directors state in the Investment Policy Statement that securities lending will be conducted in accordance with separate guidelines for the program, including guidelines covering the investment of securities lending collateral and program implementation and monitoring policies and procedures. (**OIG Control No.CID-1**)*

PBGC Response:

PBGC did not concur with the finding as stated because the recommendation was addressed to the Board of Directors (Board), but proposed an alternative. PBGC will brief the Board regarding securities lending guidelines for its consideration of changes to the Investment Policy Statement.

OIG Evaluation:

We agree that PBGC cannot speak for the Board members as to whether they would include a particular statement in the Investment Policy. The intent of the finding was to ensure that the Board

[3] Certain commingled funds in which PBGC invests conduct securities lending activities within the funds. Since PBGC's investment in these arrangements is in the form of shares, units, or an undivided interest in the fund, and not in the underlying securities and investing activities, PBGC has no direct control over or monitoring ability except as may be reported by the funds' management. This indirect securities lending activity is outside the scope of this report.

was aware of PBGC's securities lending investment policies and guidelines by referencing them in the overarching Investment Policy. PBGC has proposed an alternative approach to address this recommendation: to brief the Board regarding the securities lending guidelines for their consideration of changes to the Investment Policy. As we are providing a copy of this final report to the Board and request to participate in that Board briefing, this alternative approach meets the intent of the finding.

Recommendation 2
*PBGC develop and submit to the Board of Directors for review a separate set of written guidelines containing the broad parameters and objectives of the program, e.g., collateral should have a market value of 102% for U.S. securities (105% for international securities), be marked to market daily in accordance with PBGC's stated requirements, etc. (**OIG Control No. CID-2)***

PBGC Response:

PBGC did not concur with the recommendation as stated because it believes this would be a level of detail not appropriate for Board review, but proposed an alternative. No later than December 31, 2009, PBGC would brief the Advisory Committee on the securities lending guidelines. PBGC noted that the Advisory Committee includes several members who are investment professionals with significant experience and knowledge in this area, and Board representatives regularly attend these meetings and can raise any concerns to Board members. (See Appendix A, for full PBGC response.)

OIG Evaluation:

The intent of this finding and recommendation is to have a third party review of PBGC's broad parameters and objectives of the securities lending program. It was not intended that the Board would review the operational guidelines and procedures. We believe it is important to have this external review of and input on the program's objectives. PBGC has proposed an alternative approach to address this recommendation: to provide a briefing to the Advisory Committee no later than December 31, 2009 on the securities lending guidelines. PBGC noted that the Advisory Committee includes some members who are investment professionals with significant experience and knowledge and the Board representatives regularly attend the Advisory committee meetings and can raise any concerns with the Board members. While we believe it is important for the Board, as PBGC's policy-maker, to have knowledge of PBGC's broad parameters and objectives, this alternative means satisfies the intent of the recommendation as long as the briefing includes documentation for the Advisory Committee and Board Representatives to review.

PBGC Collateral Investment Guidelines

Background

Collateral for securities loans may be in the form of cash, certain government securities, and letters of credit from acceptable banks. Government securities and letters of credit are collectively referred to as non-cash collateral. The choice of collateral is a subject of negotiation between the agent bank and the borrower. It is also a matter of custom and practicality in various markets. For example, posting government securities as collateral for a loan of other government securities is not typically practical.

When non-cash collateral is posted in the form of securities, acceptable collateral must be government paper and must meet strict industry requirements. Securities collateral must be held in trust by the agent bank or a third party depository. It should never be held in trust by the borrower.

Letter of credit collateral must meet the agent bank's criteria defining which issuing banks are acceptable, using generally accepted banking industry credit standards. Letters of credit are not negotiable. Documentation evidencing the letter of credit is normally held by the agent bank.

Non-cash collateral generally carries no collateral risk, but it also bears no opportunity to increase returns. Non-cash collateral securities are subject to being marked-to-market daily, in addition to the borrowed securities mark. Within normal settlement processes, this keeps the collateral and borrowed securities values aligned.

Cash collateral, in contrast, is invested in accordance with lender guidelines. The return on the investment of cash collateral affects securities lending directly, as revenue (before lender/agent split) is equal to the collateral investment return less the rebate paid to the borrower. PBGC has elected to invest its cash collateral from loaned securities in State Street's Quality A Fund. In that regard, State Street acts as an investment fiduciary to the PBGC. There is an expectation that State Street will only invest the funds in accordance with its stated investment policy and investment guidelines for the Quality A Fund.

Observed Conditions

Eligible investment instruments of the Quality A Fund and actual amount invested at December 31, 2007 are as follows:

Investment	December 31, 2007
US Treasury bills, notes and bonds	$ 637,090,000
Other US Government Securities	-
Corporate Debt including Commercial Paper	$4,120,757,921
Instruments of US and Foreign banks	$5,165,120,064
Supranational and sovereign debt	-
Repurchase and reverse repo	$ 552,537,000
Money market Mutual Fund shares or other	$ 58,517,443

PBGC staff stated that they periodically review the Quality A Fund investment policy although the exact nature of their review is undocumented.

State Street reported that there are several facilities that may hold non-cash collateral: Bi-Party Agreements, Letters of Credit and Tri-Party Agreements.

- For the Bi-Party Agreements, the collateral is held at State Street in a custody account. The accounts are separated by Treasuries only ("UST") and Treasuries and Agencies ("USTA").

- Tri-Party Agreements have a US Treasuries account ("TP1") and a US Treasuries and Agencies account ("TP2"). The collateral for these loans are held in accounts at JPMorgan Chase or Bank of New York. There is also another account, TP15. Again the securities can be held at JPMorgan Chase or Bank of New York. In this scenario, the minimum rating is AA- / Aa3, and the borrower limits are specifically defined by a collateral matrix generated by the State Street Securities Finance Credit Department.

- Letter of Credit collateral is only available for US and international equities, and is subject to a minimum rating for an issuer of AA-.

Conclusion

The Quality A Short-term Investment Fund has generally conservative investment guidelines and objectives. The stated objective is to maintain a short-term diversified portfolio of investment-grade short-term securities.

Since PBGC accepted the Quality A Fund as its investment vehicle of choice for securities lending cash collateral, there are no separate investment guidelines to compare.

We recommend that:

Recommendation 3

PBGC develop a Securities Lending Procedures Manual to provide guidance to staff on conducting and documenting the analysis and supervisory review required to implement the securities lending policies. ***(OIG Control No.CID-3)***

PBGC Response: PBGC concurred.

Recommendation 4

In the PBGC Securities Lending Procedures Manual, document the procedures followed and the extent, nature and timing of any reviews performed of the Quality A Fund, and of the Trust's management, policy and investment guidelines. The results of the review should be formally reported to the Chief Investment Officer and other senior management as appropriate. ***(OIG Control No. CID-4)***

PBGC Response: PBGC concurred.

Accounting Procedures and Controls

Observed Conditions

Simple summary accounting for the securities on loan and securities lending revenue is handled by the Trust Accounting Branch within the PBGC Financial Operations Department which receives month-end summaries from State Street.

A Lead Financial Analyst (LFA) in the Treasury Division is responsible for monitoring the securities lending program. That person is supervised by the Supervisory Financial Analyst (SFA). The LFA obtains information on the program from the agent bank and analyzes it. Periodic reports are created and the results are reported to the SFA, the Deputy Treasurer, and the Chief Financial Officer.

Investment Management Group (IMG) considers securities lending to be an investment management function. Treasury Division staff stated that the same requirements for reporting and periodic due diligence and performance review meetings as the Treasury Division requires of traditional and alternative investment managers are imposed on State Street as the securities lending agent. However, other than the designation of the commingled Quality A Fund as the cash collateral investment vehicle, there are no performance requirements or benchmarks specified.

The PBGC Contracts and Controls Review Department (CCRD) has identified 'key' internal controls over investment managers. These very high-level controls are reviewed periodically by CCRD. However, while the Treasury Division considers State Street to be an investment manager for purposes of the Securities Lending program, CCRD has not performed a review of the key investment manager controls at State Street. Further, there are no detailed internal reviews performed by PBGC at State Street.

Conclusion

PBGC applies an investment manager standard on State Street's securities lending and cash collateral investing activities in regards to the due diligence requirements for manager meetings and visits. However, more specific operational guidelines and controls are not specified and reviewed in the same manner as other investment managers.

PBGC has no formal procedure manual to prescribe the analyses and reviews to be undertaken in overseeing the securities lending program, defining the form, content, and timing of reporting, and establishing procedures for reporting and acting on exceptions. PBGC does not specify in writing the performance expectations and means of measuring them against appropriate benchmarks.

PBGC conducts no direct, detailed, on-site review of the securities lending activities performed at State Street.

We recommend that:

Recommendations 5 through 7
In the PBGC Securities Lending Procedures Manual, develop a formal policy and procedure which will set out the analyses and reviews to be undertaken in overseeing the securities lending program, defining the form, content, and timing of reporting, establishing procedures for reporting and acting on exceptions, and specifying the performance expectations and means of measuring them against appropriate benchmarks. ***(OIG Control No. CID-5)***
Formally identify State Street as an investment manager that is subject to the key controls review that is performed by CCRD. ***(OIG Control No.CID-6)***
Perform periodic detailed internal reviews of the securities lending activities performed at State Street. ***(OIG Control No. CID-7)***

PBGC Response: PBGC concurred.

Evaluation of the Competitiveness of the Program

Background

The lender's direct purpose in lending securities is to generate additional income. More universally, the system of lending and borrowing securities increases the liquidity and efficiency of markets and expands investment opportunities by creating a short market to complement the long one. Thus indirectly, securities lending may have tangential benefits. Nevertheless, the only direct and measurable benefit is income.

The value of securities lending income is a function of the volume of loans made and the rates or spreads paid in return for those loans. Several factors affect the success of a program whether measured at the level of the lending agent bank or the individual lender. Ultimately securities lending is demand driven at the individual security level, so success is a function of market share and pricing power relative to the pool of lendable assets. Thus, reasonable benchmarking of a program can be accomplished only over time and a large number of loans.

Securities lending benchmarks are constructed to compare loan volumes and spreads. Loan volumes are primarily a function of the types of securities in the lendable portfolio, since all lending programs use a queuing system to assure fair distribution among lenders. Spreads differences derive primarily from the yield on the cash collateral investment.

There are a small number of organizations that collect and publish information on the securities lending industry. Of these, we are aware of and familiar with two, though there may be others.

- The Risk Management Association (RMA), formerly known as Robert Morris Associates, collects data on an aggregate basis through an arrangement with Dataexplorer, a United Kingdom (UK) based company specializing in various support and research services related to short selling. Their data is published primarily as quarterly volumes and spreads for an aggregate of approximately 16 major lending agent organizations.

- Astec Analytics is a specialty consulting unit of Sungard providing support to securities lending participants. Astec offers several services to both lending agents and lenders. This firm can provide benchmarking for individual lending programs, in which a lender's activity is measured against its agent bank's data and industry data as a whole.

While the purpose of lending is to generate incremental income, it is not necessarily to maximize that income. Securities lending bears risks, as has been amply demonstrated in the recent market. That risk lies largely in the investing of cash collateral, an aspect in which lenders have a certain amount of discretion in the amount of risk they take and thus the amount of return they seek. Thus any benchmarking exercise requires a certain degree of art and interpretation.

Observed Conditions

Under the PBGC securities lending contract State Street provides certain Performance Reporter reports through RMA Dataexplorer. These reports are available through the on-line reporting system. The reports evaluate the PBGC program and measure the attribution of its income, and provide certain limited benchmarking evaluation.

Consistent with its objective that the level of income generated by the program is subordinate to reducing risk, PBGC does not actively use the available performance reports or participate in any Astec cooperative in order to evaluate the relative results of the program in terms of loan volume or spreads.

As a result, the only effective measurement and control over the securities lending program is the determination whether the program generates a profit.

Conclusion

PBGC has reached an investment conclusion that securities lending's purpose is to generate incremental income, subject to a primary goal of taking limited risk. The conclusion, however, is not documented as an official investment policy.

As a result of this investment focus, PBGC has concluded that intensively monitoring the income returns of the program against market benchmarks and competitive programs does not add value. Because such benchmarks cover a range of lending programs with varying risk tolerances, the PBGC program that incorporates a low risk cash collateral investment approach will fall into the lower ranges of the distribution of results during normal market periods. Only in severely disrupted markets will the avoidance of default risk result in favorable benchmarking data.

Generally, measuring and evaluating an activity is essential to controlling it. Consequently, establishing a process to measure and track the results of the securities lending activity is worthwhile.

Given that PBGC's investment staff asserts that safety is the primary objective and return only secondary, the measurement and benchmarking process needs to be carefully constructed against an appropriate set of standards. In a program structured in this manner, the income spreads and other profitability measures are likely to appear poor relative to industry benchmarks. There is a temptation to reach for yield to make up for what is perceived to be underperformance against a benchmark, even though that underperformance is consistent with the risk choice.

Nevertheless, having chosen a low risk program is not sufficient justification for PBGC not to maintain a thorough process of benchmarking and trend tracking. By setting the target of the conservative program appropriately against the benchmark, rather than setting a more commonly determined high performance target, valuable information on the program's consistency with its goals can be determined.

We recommend that:

Recommendation 8
In the PBGC Securities Lending Operating Manual, develop a formal process to monitor securities lending activity against appropriate standards and benchmarks including undertaking a thorough evaluation of the various sources and tools for securities lending performance evaluation that are available. ***(OIG Control No. CID-8)***

PBGC Response: PBGC concurred.

Income Calculation, Reconciliation and Distribution

Background

Securities lending agent banks make available to lenders various commingled funds to invest collateral received in cash. While a lender can establish its own set of cash collateral investment guidelines and invest its collateral in a separately managed account, this approach tends to be both more expensive and bear more liquidity risk than commingled funds for all except the largest and most active lenders.

For bank lending agents the more conservative of these funds are often structured as group trusts and managed in a manner similar to 2a-7 money market accounts.[4] The major lending agent banks usually offer several cash collateral investment choices structured to have a hierarchy of expected returns relative to Fed Funds in exchange for commensurately higher levels of credit and/or liquidity risk. In many cases the bank acts as investment manager of these funds.

Such group trusts incur certain operating fees, although these tend to be less than those on similarly structured and managed money market mutual funds. Typically, the bank as investment

[4] Rule 2a-7 of the Investment Company Act of 1940 describes the requirements for an investment fund to operate in the manner generally known as a money market mutual fund, characterized by a high degree of liquidity, relatively low risk, and carrying a constant net asset value per share of one dollar under ordinary circumstances. This very complex regulation defines a number of characteristics a fund must incorporate into its portfolio to qualify as a "Money Market Fund." Among these are liquidity, credit quality, average portfolio and individual security maturity, duration, diversification, interest rate sensitivity, and accounting and pricing standards.

manager receives an investment management fee. Both these classes of fees are charged against the fund's daily yield using similar accounting and pricing rules as do money market mutual funds.

These funds operate and are managed in a very similar manner to custody bank Short Term Investment Funds (STIF) that are used to invest residual and manager cash in the portfolio.

The pricing of custody and security lending services often also includes an asset-based fee applied to balances in short term investment funds charged outside the funds themselves. Whether a STIF or a cash collateral investment fund, these two layers of pricing are common. The fee inside the fund is not negotiable, since it is charged against the fund itself without regard to the set of investors. The fee outside the fund is negotiable as part of the overall custody pricing process. This fee is sometimes netted against the daily income and sometimes charged separately on the custody invoice.

The data on the calculation of the revenue on a loan-by-loan basis is not typically provided in standard client reports of a securities lending program. This calculation is quite complex.

Loan revenue on loans collateralized with securities is a fee paid by the borrower. The fee is typically a fixed rate which is applied to the value of the borrowed securities at it fluctuates from day to day.

Loan revenue on loans collateralized with cash is more complex. One component is the fee rebate and the other is the earned income on the investment of the collateral. The fee rebate is typically a rate tied to the daily Fed Funds rate applied to the daily fluctuating value of the borrowed securities. When collateral is invested in a commingled fund, the collateral investment yield is the daily yield on that fund, typically calculated net of fees on a daily basis under similar conditions as are used to calculate daily yields and values in a money market mutual fund.

In addition to the daily fluctuations on the borrowed security's value and the rates applied to that value, the face amount of borrowed securities on a particular loan may vary, particularly when a loan is on demand but remains outstanding for several days or months.

<u>Observed Conditions</u>

Under a Declaration of Trust dated January 25, 1995 State Street established the State Street Bank and Trust Company Quality Funds for Short Term Investment Trust.[5] This is a Massachusetts Business Trust qualified as a "group trust" under Revenue Ruling 81-100 and a Pooled Trust exempt from taxation under section 501(a) of the Internal Revenue Code. The Declaration of Trust provides for the creation of one or more separate investment funds within

[5] State Street Bank maintains other commingled vehicles for securities lending cash collateral, including the similarly named Securities Lending Quality Trust for non-qualified investors.

the Trust, each itself a separate trust. State Street has created two such funds, Quality A Short-Term Investment Fund and Quality D Short-Term Investment Fund.

PBGC has elected to invest its cash collateral in the Quality A Fund. This is the more conservative of the two funds in that trust.

Over the past several years State Street's lenders have tended to choose or migrate to the Quality D Fund seeking higher yields. As a result the Quality A Fund has declined in size and number of participating lenders. PBGC represents around 40 percent of the assets and is the largest participant in the fund.

Fees imbedded in the fund as disclosed in their December 31, 2007 audited financial statements were 1.78 basis points, of which 1.75 basis points is a management fee paid to State Street. The only other fee reported was an audit fee.

The pricing schedule for PBGC's custody relationship with State Street does not explicitly disclose any additional fee for the investment of cash collateral. However, the securities lending portion of the pricing schedule lacks clarity, as is discloses only the split ratio and the expected net revenue "after fees" to PBGC with no explanation of how that amount was determined.

Currently, PBGC relies on the audited financial statements of the Quality A Fund and an absence of findings of erroneous calculation in the SAS 70 audit for assurance that the Fund's income was properly calculated on a daily basis. This procedure is consistent with that followed generally by securities lenders utilizing commingled cash collateral accounts.

We attempted to re-calculate the expected fees on a sample of loans provided by State Street and found that we were unable to do so. In instances where the loan was outstanding for longer than a day, we could not calculate the fee because some of the variables had changed during the course of the loan and State Street was unable to provide the data for the variables that changed. Additionally, State Street could not easily access data for loans that were older than thirty days because the data had been archived and stored on a separate server.

<u>Conclusion</u>

A combined custody fee arrangement can be evaluated only as a package. It is very difficult to determine individually. Taken in isolation the fee charged against the Quality A Fund is reasonable. As discussed above, however, this is one aspect of a combined custody fee arrangement that can be evaluated only as a package.

PBGC is not able to re-calculate earnings on the collateral in order to verify that its share of the securities lending fees is correct. However, the controls over the various processes that determine income are evaluated independently. The Quality A Fund is independently audited. Controls over the loan amounts and fees and the calculation and posting of cash collateral earnings are part of the SAS 70 scope of work. This is one of the trade-offs of using a commingled vehicle for managing securities lending collateral.

While being able to replicate the calculation of pre-split income on individual loans would be a useful quality control, this calculation is complex and requires access to data that is not typically provided in securities lending reporting packages. Consequently, lenders rely on the agent bank's internal controls for assurance the loan revenue is calculated correctly. Such a test is especially difficult to accomplish after the fact, although it is possible to do so contemporaneously.

In order to perform such a verification, PBGC would require the terms of each tested loan, the daily data on the quantity and value of the loaned security, the base rate for the rebate fee calculation, and the daily yield on the Quality A Fund. Some of this information is available to PBGC via my.statestreet.com on a daily basis (although not necessarily available historically). Other information would need to be provided via other mechanisms.

We recommend that:

Recommendation 9
PBGC explore with State Street how State Street can provide additional assurance on correctness of earnings by providing monthly revenue reports that can be tied into the activity and returns of the Quality A Fund. To the extent such information can be provided, establish procedures for random, contemporaneous verification of loan fees. ***(OIG Control No. CID-9)***

PBGC Response: PBGC concurred.

Use of Reports

Background

Those charged with the responsibility for oversight of sophisticated investment programs require clear, concise, consistent reports on the performance and risk of the programs. The reports should be prepared on a regular periodic schedule (e.g., quarterly), and key statistics should be verified, if possible. These reports serve as one of the most important management tools available to those with oversight of the investment program.

Lack of current and accurate data limits the ability of those in charge of securities lending to reliably monitor the program. Reports perform several critical functions:

- They provide a basis for identifying changes over time, anomalies, and out of limit situations so that they can be investigated further;

- They provide a permanent and continuing record of due diligence steps taken; and
- They provide a basis of control over compliance with the Investment Policy Statement and other investment guidelines and constraints.

Observed Conditions

State Street provides numerous reports on the PBGC's securities lending program, to which PBGC staff has unrestricted access. Examples of reports found on my.statestreet.com include total on loan, earnings by security, exposure by borrower, and collateral by asset class. The majority of these reports can be downloaded on a monthly or daily time period. State Street also provides oral reports through regular periodic client meetings to present the status of the program at the request of PBGC.

In addition to raw data which can be downloaded into Excel and manipulated, there are bar charts, line graphs, and pie charts which help provide a visual representation of the program as a whole, as well as other aspects of the program. The Lead Financial Analyst (LFA) and the Supervisory Financial Analyst (SFA) stated they periodically review these reports from my.statestreet.com and discuss any issues with management on an as needed basis. They stated that they believe the reports are adequate in summarizing the securities lending activity.

There are three key personnel at PBGC that can avail themselves of the State Street reports. These persons include the Deputy Treasurer, the Supervisory Financial Analyst and the Lead Financial Analyst in the Treasury Division.

The Deputy Treasurer meets with the SFA and the LFA periodically and also whenever State Street is on-site for a presentation or on a conference call. The Deputy Treasurer receives quarterly reports on the levels of lending activity.

In the absence of written guidelines, the oversight of the program has been developed and maintained through more informal communication. The SFA has assigned to the LFA responsibility to review quarterly and monthly monitoring reports from State Street. Each year an annual review of securities lending is performed to compare year to year and also to support preparation of the Corporation's financial statements. Part of the annual review includes the audited statements of the Quality A Fund. The LFA prepares monthly summaries of performance using the reports from State Street. The LFA also reviews a monthly holdings report of investments in the Quality A Fund. One focus of the review is the ratio of the Market Value to Cost, to confirm the criteria allowing the Quality A Fund to be carried at a fixed value of $1.00 per share are met. The LFA also reviews the semi-annual SAS 70 report from State Street. (See our discussion below.)

The SFA's primary focus on the securities lending program is on the cash collateral investment pool using the Quality A Fund Holdings Reports and the Quality A Fund investment guidelines; counter party risk using borrower exposure reports and the approved borrower list; and utilization rates, using utilization reports developed by a benchmarking service.

The SFA reports that State Street's due diligence and credit processes for borrowers have been reviewed by PBGC staff. The establishment of credit limits at a bank is a confidential process, often involving access to information that is not fully publicly available. The supporting documentation and deliberation process by the bank's credit committees is thus not available to PBGC or any other bank client.

Quarterly and annual summary reports of securities lending revenue are provided to the Corporation's Chief Financial Officer. Periodically, State Street also makes a presentation to the Advisory committee to the Corporation. The last time this occurred was approximately two years ago.

Conclusion

Reports provided by State Street through mystatestreet.com are sufficient for analysis of the program and each of the three people involved in the securities lending program has access to the reporting functionality. Additionally, should PBGC staff need a report that is currently unavailable via my.statestreet.com, it can be requested from State Street. Reports are generally adequate for monitoring the program, assuming the correctness of calculation of pre-split revenue. Staff provides senior management with reports that support their analysis when necessary. However, the timing, frequency and process of reporting is undocumented.

The use of these reports as described by PBGC staff to monitor the program is reasonable, although it should be clearly documented in formal procedures.

We recommend that:

Recommendation 10
Within the PBGC Securities Lending Procedures Manual, document the collection, review, and dissemination of investment results received from the lending agent. ***(OIG Control No. CID-10)***

PBGC Response: PBGC concurred.

B. PBGC Personnel Capacity and Qualifications

Background

Any investment process needs to be monitored, measured, and evaluated in order to ensure that its goals are achieved and its risks are controlled.

These investing functions need to be documented, disseminated, and most importantly, implemented effectively. To do this the organization needs to attract and retain an adequate number of employees that possess the skill sets that, in the aggregate, enable an organization to carry out its mission and objectives effectively and efficiently.

PBGC needs people who are properly trained, organized, and supervised. While some of those people can be employees in the organization, advisors from outside the organization might be used in various ways, from simple advice to significant delegation of authority.

Inadequate staffing exposes an organization to a variety of otherwise controllable risks, including governance risk as well as implementation risks (both tactical and operational).

Observed Conditions

PBGC oversees its investment monitoring – including securities lending – in the Treasury Division. Accounting – including accounting for securities lending activity – is within the Controller Operations Division of the Finanical Operations Department. All financial and investments activities report to the Chief Financial Officer.

At the time of our work, the Treasury Division consisted of nine employees as follows: two Lead Financial Analysts (Team Leaders), two Senior Analysts, and four Analysts all reporting to a Supervisory Financial Analyst. Within this organization, one Lead Financial Analyst (LFA) is assigned to monitor the securities lending investment activity. This individual is responsible for all first-level monitoring of the investment activity of the program and maintaining contact with State Street in regard to all aspects of the program other than accounting for loans and income.

The LFA’s background as disclosed in his resume and discussed with him during our interview is consistent with his duties. While relatively new at PBGC (hired in August 2006, and in his current position since October 2007), he has approximately eleven years previous experience with investment management and financial valuation firms. He holds both a bachelor’s and a master’s degree in pertinent disciplines, a Chartered Financial Analyst designation, and several other currently inactive financial certifications.

He spoke clearly and comprehensively about his activities at PBGC involving oversight of the securities lending activity and its fit within the organization. Based on our observations, the LFA is qualified both on paper and in action to manage this investment function.

Within the operation of the Treasury Division there is a stated intent to bring all analysts into discussions of a wide range of investment activities. Staff stated that this is intended to expand each employee's span of knowledge and to better enable both backup capability and succession and replacement capabilities. In practice, workload often prevents staff from obtaining a sufficient amount of formal and on-the-job training in various disciplines to achieve this goal.

Evaluating the overall capacity of the Treasury Division is outside the scope of this review. The Treasury Division team is responsible for managing a large number of investment managers and functions across all asset classes. Staff advised us that the efforts to maintain an adequate level of current expertise and backup capability often fall victim to workload. Throughout the chain of command the desire for more time to train and cross train staff was expressed.

The Treasury Division maintains a close and active relationship with a large and well regarded investment consulting firm, Wilshire Associates. Due to the size and complexity of the PBGC portfolio and its activities, one Wilshire consultant is resident and works on site. Other Wilshire resources are provided from its office in California. Wilshire's responsibilities include assistance in understanding and evaluating the securities lending investment activity.

Conclusion

PBGC has qualified personnel in place to monitor and manage the securities lending program. However, with the current staffing and workload, there is insufficient capacity to provide adequate back up and to allow for continuing training. There is no designated and trained analyst able to quickly fill in in the event of turnover or other staffing disruption.

We recommend that:

Recommendations 11 and 12
*PBGC arrange staff assignments to incorporate backup responsibility over the securities lending monitoring process and permit each analyst time to spend in education and cross training. **(OIG Control No. CID-11)***
*For staff performing investment oversight duties, establish a minimum number of hours of continuing training and education in applicable areas as part of the analyst's duties. **(OIG Control No. CID-12)***

PBGC Response: PBGC concurred.

C. The PBGC and State Street Contractual Agreements

Background

There are two primary legal documents through which securities lending programs are effected. The Securities Lending Authorization Agreement (sometimes referred to by slightly different names) is between the lender and the agent bank, and forms the basis for the operation and pricing of the lending arrangement. The Master Securities Lending Agreement is essentially an industry standard document that forms the basis of each loan of securities. The agent bank enters into this agreement with the borrower. Other than detailed terms regarding individual loans, the terms of this agreement are universal within a market. Different forms exist for certain markets outside the United States.

Many aspects of the securities lending business are essentially standardized across all lenders and agents. A number of other aspects may vary. These variable aspects are potentially the subject of distinctions among lending agents that define, in part, their relative attractiveness in provider searches and in contract negotiations.

The aspects that are not standard are, for the most part, the ones that tend to determine the potential value and the potential risk of the program. These include:

- Whether and how the agent bank provides any indemnification to the lender for losses incurred by the lender in the program.
- How fee income is split between the lender and agent bank, including any reciprocal effect on the fee for other custody-related services.
- How cash collateral is invested and who is responsible for the investment results.
- Who is permitted to borrow a lender's securities and who is not.
- How an individual lender is treated relative to other lenders in allocating business opportunities.

Observed Conditions

The Securities Lending Authorization Agreement between State Street and PBGC was effective November 23, 1999. The basic agreement remains in force. Changes in the pricing split have been specified in modifications of the basic custody agreement to which the securities lending agreement is tied. Operational modifications regarding authorized borrowers have been effected through notice procedures.

The generic indemnified securities lending authorization agreement State Street is proposing to its securities lending clients today is in form fairly different from the PBGC contract. From a substantive operating perspective there are no differences between the two forms that we believe would lead to the necessity of updating the document. We did not determine whether from a legal viewpoint a modification is appropriate.

Indemnification over Collateral Losses

The indemnification standard across the industry is for the lender to take full risk over cash collateral investments. Regardless of whether cash collateral is invested in a commingled account or a separately managed account, and whether the commingled account is managed and controlled by the agent bank, the agent bank accepts no responsibility for collateral shortfalls. PBGC's contract follows this model.

Cash collateral shortfalls can occur in stepped amounts as the shortfall increases. The borrower is entitled to receive, upon return of the borrowed securities, the full value of cash collateral posted as adjusted by marks to market plus the agreed upon rebate. This rebate is frequently the result of applying a formula against the value of the borrowed securities. For example, a common formula used in many loans is the daily opening Fed Funds rate less ten basis points times the market value of the loaned securities. The source of the funds to be returned to the borrower is the principal value of the cash collateral investments and the earnings on those investments.

The first step of possible shortfall is the situation in which the investment earns just enough to cover the rebate; no net revenues are available to the lender. This "cost" is effectively shared by the lender and the agent at their earnings split ratio of 85%/15%, since neither receives any income.

The second step of possible shortfall is the situation in which the investment not only fails to earn a profit, but fails to earn enough to cover some or the entire rebate, i.e. the amount to be rebated is greater than the earnings received. Amounts needed to fund the balance of the rebate are paid entirely by the lender, and the agent bank may deduct the amount needed from the lender's account.

The third step of possible shortfall is a situation in which the collateral investment incurs a loss in the principal value of the investment such that funds are not available to repay any the borrower's collateral. This also is paid entirely by the lender, and the agent bank may deduct the amount needed from the lender's account.

Indemnification over Borrower Default

General practice is for the agent bank to indemnify the lender for the return of the loaned securities or their equivalent value. However, certain agent banks offer programs without indemnification, often in exchange for a more attractive split. PBGC's contract provides for State Street to indemnify the Corporation against borrower failure to return borrowed securities.

If a borrower fails to return a security the agent bank will use the collateral to acquire and return to the lender the equivalent securities, subject to sufficiency of collateral to do so. A shortfall of collateral would revert back to the collateral risk rules and the lender would have to provide the balance of the money to replace the securities.

If replacement securities cannot be obtained, the agent bank pays to the lender out of the available collateral the higher of the market value of the unreturned securities on the last day the loan was successfully marked to market or the next day. If this payment is delayed the lender absorbs any opportunity cost or enjoys any opportunity gain.

The Fee Split

Securities lending income is shared between the lender and the agent bank. The relative split is the major competitive factor in a securities lending program and has a significant effect on custody pricing overall.

The size of this split is often interrelated with other custody contract fees. The split cannot be fully evaluated in isolation. When securities lending is part of a broad custody relationship, as is the case with PBGC, it is impossible to separate entirely the pricing of the various components. Higher or lower hard dollar fees for custody and related services can be exchanged for lower or higher securities lending splits. We are not aware of any pricing discussions during contract negotiations in this regard.

A split of 85%/15% is toward the higher end of the range of splits for large lenders. This supports a conclusion that the PBGC securities lending program was competitively and appropriately priced and independent of the pricing of other services. Wilshire Associates advised PBGC that the overall compensation package for custody and securities lending at State Street is reasonable. However, we saw no evidence this view was expressed in writing.
Fee splits are almost always established in five percent increments. From the PBGC's current split of 85%/15%, the next higher increment would customarily be 90%/10% and the next lower would be 80%/20%. It is also customary to apply the fee to all classes of assets and to the totality of the lending program. However, we have occasionally seen lending programs in which the fee

split is not a factor of five, is higher on some asset classes than others, or increases after annual volume exceeds a threshold level.

Fee economics are a function of potential loan volume and actual loan volume. In normal markets the demand for fixed income securities, particularly government securities, is considerably higher than the demand for equity securities. As PBGC continues refocusing its portfolio toward equities and non-lendable securities and away from government and investment grade bonds, loan volume and revenue is likely to shrink.

Collateral Requirements

Security lending industry practices require the borrower to provide collateral (usually cash or qualifying government securities) for the securities borrowed. Collateral requirements across securities lending programs tend to be fairly standard with initial collateral set at 102% or 105% of the value of the securities borrowed and with additional collateral required when the ratio falls below a designated level (e.g. 100%). Collateral requirements vary depending on the denomination or domicile of the loaned securities. Agreements, including PBGC's, provide that the agent bank can make exceptions for particular loans.

PBGC's agreement with State Street specifies a mechanism for valuing the loaned securities and non-cash collateral at market on a daily basis and for obtaining additional collateral or returning excess collateral as necessary to maintain a specified collateral ratio. This process follows industry standard procedures.

However, the PBGC agreement differs from industry standards in two ways:

- The agreement requires State Street to consult with PBGC and obtain PBGC's approval for any loan that contains other than standard terms for initial collateral or mark to market requirements. PBGC has advised us that State Street has never made such a request.

- PBGC requires that collateral be maintained and increased at higher points than are typical in the industry. For example, common industry collateral terms require additional collateral to be posted when the 102% ratio drops below 100%, and then replenish to 102%. The PBGC agreement requires a collateral replenishment when the ratio drops to 101.5%. The requirement on 105% loans is to trigger at 104.5%.

PBGC has not discussed with State Street whether these tighter collateral requirements have adversely affected its loan volume, i.e. whether borrowers have required loans to be placed with lenders imposing lower collateral requirements.

Allowable Borrowers

As is typical in the industry, State Street is responsible for qualifying borrowers and setting credit limits. This list is provided to PBGC contractually on a monthly basis. In practice it is always available through my.statestreet.com.

The agreement also contains the common, but not universal, provision allowing PBGC to disqualify any borrower for any reason.[6] PBGC has never invoked this right, and has expressed its view that it should not interfere with the bank's credit decisions. Consistent with this approach PBGC has apparently not invoked its contractual (and untypical) right to obtain an explanation why a borrower was taken off State Street's list.

Under its agreement PBGC may request from State Street certain information regarding situations in which State Street failed to deliver sold securities resulting from a borrower's holding a loan.

Allocation of Loans among Lenders

ERISA requirements, as set forth in a number of class prohibited transaction exemptions, have in part defined the operations of the industry.[7] Many lenders are either subject to ERISA or to State laws and regulations following the same model. It is required under ERISA that a lending agent allocates loan opportunities among its lenders in a fair and equitable manner. This is customary industry practice. The PBGC agreement provides that State Street do so, and specifies that State Street has provided PBGC with a description of the rules and method under which an equitable distribution of lending opportunities is effected.

PBGC has reviewed these rules and a numerical example of their application and discussed them with State Street. IFS have reviewed these materials as well.

Such a process needs to include consideration of each lender's current and prior lending activity, within the constraints of the lender's available securities and other limitations. Basically the agent bank queues lenders based on their being "due" for a lending opportunity and allocates new loan opportunities to the lenders at the head of the queue provided they have the applicable security available for loan and otherwise are able to enter into the agreement.

[6] Under ERISA Title I, certain borrowers must be disqualified from borrowing a particular lender's securities. PBGC asserts that it is not subject to these requirements. ERISA section 406, 29 U.S.C. § 1106. DOL Prohibited Transaction Exemption 81-6, and DOL Prohibited Transaction Exemption 2006-16.

[7] See DOL Prohibited Transaction Exemptions 81-6, 82-63 and 2006-16.

Conclusion

The agreements between PBGC and State Street, while somewhat out of date, cover the requirements of a securities lending program in all material respects. Modifications in the agreement from standard form documents are generally favorable to PBGC within the constraints of standard practice. We did not identify any situations in which State Street's process did not comply with all the contractual requirements.

There have been changes in securities lending practice and regulation since this agreement was written. Inasmuch as securities lending in general has been significantly affected by current market events, further changes may be instituted within the near future. Reviewing the program both legally and operationally in light of these changes will be a worthwhile exercise in assuring the program has appropriate goals and is meeting them.

Certain aspects of the program, including the effect of tighter collateral replenishment requirements should be reviewed to determine whether they continue to meet PBGC's obligations and desired return-risk objectives.

We recommend that:

Recommendations 13 and 14
PBGC discuss with State Street whether and to what extent the tighter collateral replenishment requirements in this agreement have affected loan volume and, if so, evaluate the resulting trade-off between risk and return in order to conclude whether to keep or modify the requirement. ***(OIG Control No.CID-13)***
In the PBGC Securities Lending Procedures Manual, establish and implement a policy to monitor developments in the securities lending market, changes in regulatory requirements, and the volumes and economics of the program on an annual basis and as appropriate seek to amend PBGC's contract, lending policies, and participation in the program accordingly. ***(OIG Control No.CID-14)***

PBGC Response: PBGC concurred.

State Street's Borrower Credit Review Process

Background

The lending agent bank is primarily responsible for developing and maintaining the list of all borrowers having access to the entire pool of lendable securities made available by all lenders. Except when a loan between a lender and a borrower is prohibited by law or a lender or borrower chooses not to effect loans with one another, the agent bank allocates loans across all participants in a non-discriminatory fashion.

Agent bank systems provide in their loan queuing mechanism a means to prevent designated borrowers from entering into loans with particular lenders. This control is built into the loan allocation systems used by the agent bank to effect a fair allocation of lending opportunities. Absent such exclusion, lenders are subject to making loans to any and all approved borrowers. They are thus dependent on the agent bank's credit approval process and indemnity against borrower default.

Agent banks have relatively wide discretion in selecting borrowers and setting borrower limits. Tempering this discretion is the agent bank's overall responsibility as a fiduciary as well as its specific indemnification for borrower default in typical securities lending agency agreements.

Observed Conditions

State Street has informed us through conversations and through disclosure in their SAS-70 audit report that they have developed a process for qualifying borrowers and establishing credit limits for securities lending. This process is based on and integrated within its bank-wide credit processes for establishing general credit qualifications. The approval process for securities lending credit limits is conducted by a credit committee separate from the securities lending department. Thus, a firm is eligible to borrow securities under State Street's securities lending program only if, and to the extent that, the firm qualifies for money lending credit. This is generally a high standard within banks, as it is equivalent to the bank making a direct loan to the borrower, risking its own capital. Bank credit approval processes and specific credit information on a borrower are confidential.

As described in their SAS-70 audit report, outstanding loan balances and borrower credit limits are monitored daily by the designated unit within State Street. Changes in credit limits may be granted after proceeding through a designated review and approval process.

State Street's list of borrowers is available on the on-line reporting system and on request. PBGC's contract provides that State Street shall provide PBGC with a list of potential borrowers each month, identifying changes to the list. This agreement was written prior to the availability of the list on-line.

PBGC's Lead Financial Analyst reviews the on-line list of borrowers periodically. While PBGC may request information regarding the reasons a borrower has been removed from the list, it has not done so. This is consistent with PBGC's general approach to approved borrowers.

PBGC's procedure with respect to borrowers is not to question the agent bank's credit decisions, nor to exclude borrowers for other reasons. As a result no borrower has been stricken from their borrower list because of PBGC actions.

PBGC asserts that since it is not a pension plan it is not restricted as to allowable borrowers under ERISA and not subject to the regulations and exemptions affecting securities lending. As a result there is no monitoring in this respect and no borrowers have been disqualified as a result.

Conclusion

Given that State Street's process for qualifying borrowers is procedurally and financially equivalent to and integrated with its policy for establishing and monitoring their borrowers' general creditworthiness, the process is appropriately and conservatively structured.

PBGC's unwritten policy not to interfere with the agent bank's designation of borrowers and credit limits based on a PBGC credit process is reasonable. This policy is only understood, however, and is not in writing.

We recommend that:

Recommendation 15
In the PBGC Securities Lending Procedures Manual, document in writing policies in regard to qualifying allowable borrowers and establishing credit limits for its security lending program. ***(OIG Control No. CID-15)***

PBGC Response: PBGC concurred.

D. Use and Applicability of State Street's Statement on Auditing Standards No. 70 Report (SAS 70)

Background

Banks and other financial institutions regularly obtain and make available to their institutional customers independent audit reports describing and testing their internal controls and processes related to, among other functions, their custody and related operations, including securities lending. These reports, often issued twice yearly, are developed in accordance with auditing standards known as SAS 70.

A basic premise supporting the need for such a review is that a key component of the bank customer's control system for financial accounting and reporting exists outside of the customer's premises and is not accessible to the customer's financial statement auditor. The SAS 70 report was developed to help financial statement auditors address the requirements of other auditing standards to understand the financial accounting control system, and this remains its primary use.

- Statement on Auditing Standards (SAS) No. 70, *Service Organizations*, is a widely recognized auditing standard developed by the American Institute of Certified Public Accountants (AICPA). A service auditor's examination performed in accordance with SAS No. 70 is widely recognized, because it represents that a service organization has been through an in-depth audit of their control objectives and control activities, which often include controls over information technology and related processes.

- SAS No. 70 is the authoritative guidance that allows service organizations to disclose their control activities and processes to their customers and their customers' auditors in a uniform reporting format. The issuance of a service auditor's report prepared in accordance with SAS No. 70 signifies that a service organization has had its control objectives and control activities examined by an independent accounting and auditing firm. The service auditor's report, which includes the service auditor's opinion, is issued to the service organization at the conclusion of a SAS 70 examination.

- SAS No. 70 provides guidance to enable an independent auditor ("service auditor") to issue an opinion on a service organization's description of controls through a Service Auditor's Report (see below). SAS 70 does not specify a pre-determined set of control objectives or control activities that service organizations must achieve. Service auditors are required to follow the AICPA's standards for fieldwork, quality control, and reporting. A SAS 70 Audit is not a "checklist" audit.

- One of the most effective ways a service organization can communicate information about its controls is through a Service Auditor's Report. There are two types of Service Auditor's Reports: Type I and Type II.

- A Type I report describes the service organization's description of controls at a specific point in time (e.g. June 30, 2003). A Type II report not only includes the service organization's description of controls, but also includes detailed testing of the service organization's controls over a minimum six month period (e.g. January 1, 2003 to June 30, 2003). The contents of each type of report is described in the following table:

Report Contents	Type I Report	Type II Report
1. Independent service auditor's report (i.e. opinion).	Included	Included
2. Service organization's description of controls.	Included	Included
3. Information provided by the independent service auditor; includes a description of the service auditor's tests of operating effectiveness and the results of those tests.	Optional	Included
4. Other information provided by the service organization (e.g. glossary of terms).	Optional	Optional

- In a Type I report, the service auditor will express an opinion on (1) whether the service organization's description of its controls presents fairly, in all material respects, the relevant aspects of the service organization's controls that had been placed in operation as of a specific date, and (2) whether the controls were suitably designed to achieve specified control objectives.

- In a Type II report, the service auditor will express an opinion on the same items noted above in a Type I report, and (3) whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objectives were achieved during the period specified. [8]

Given the independence of the SAS 70 report, its comprehensive description of the processes underlying the set of services the bank is providing, and the set of compliance and quality testing in the Type II Report, this is a useful tool for users of custody services to evaluate their service providers.

A SAS 70 report on bank custody activities typically covers a wide range of direct custody operations, supporting processes, including securities lending (referred to as Securities Finance in the State Street report), and information technology (IT) operations used to support the full range of services.

Users of custody and other services from financial organizations should regularly obtain SAS 70 reports and review them as an indicator of areas of control problems. This review can be applied in several of useful ways.

[8] SAS 70 Overview quoted on www.sas70.com, based on the applicable AICPA audit guide.

- Reviewing the descriptive processes for general, non-technical understanding and questioning or discussing with the service provider areas that appear inadequate.

- Tracking improvement or deterioration over time in the number and type of adverse findings in the testing section.

- Evaluating management's responses to adverse findings, including their statement of cause and plan to correct.

Review of recent SAS 70 reports from competitive bidders for renewing or replacing service providers can be a valuable piece of insight into the bank's systems and particularly its degree of effective controls. While this is not the definitive differentiator, evidence of a material lack of control or of deteriorating controls is cause to further question a proposed provider.

A favorable opinion in an SAS 70 is important. Not only does it certify that the description of the controls is correct in all material respects, but it opines on *whether the controls were suitably designed to achieve specified control objectives*. The testing focuses primarily on the degree those controls are implemented in practice. Within the confidence limits of any sampling procedure, this portion provides insight into the types of control failures, their severity, and most importantly when tracked over time, whether they have been effectively addressed.

The findings of an SAS 70 report do not in themselves provide a definitive conclusion on the quality of a service provider's operations. There is no guarantee that any of the bank customer's transactions were included in the samples. However, taken together with other information, including day-to-day experience, a picture of the extent of operational and control risk in an organization takes shape.

<u>Observed Conditions</u>

State Street provides PBGC its SAS 70 report shortly after it is issued. PBGC's custody agreement with State Street requires a Type II report to be prepared annually or semi-annually and supplied to PBGC's Chief Financial Officer for further internal distribution. State Street issues this report twice each year.

We discussed with the LFA how PBGC uses SAS 70 reports provided by State Street in evaluating the securities lending process.[9]

There are no detailed procedures at PBGC regarding the receipt and analysis of this report within the Investment Management Group. (Whether the Chief Financial Officer maintains procedures and controls on receipt of the SAS 70 and its dissemination is outside the scope of this review.)

[9] General custody operations are managed through a different unit within PBGC; our scope and inquiry did not include any determination whether and how PBGC uses the SAS 70 to review other State Street custody operations.

We understand that the LFA follows his own informal processes regarding the review of the SAS 70.

Within State Street's SAS 70, all activities associated with the securities lending processes are identified as "Securities Finance." The remaining sections cover other aspects of trust and custody operations and supporting services.

The LFA indicated he receives the report twice per year. His review is focused on the Securities Finance test findings section. He states that he tracks findings from report to report to see whether they have been resolved and whether additional problems have been discovered.

During the period the LFA has been performing the function he has not found any material issues that required further action. We understand that any material finding would be reported and, if deemed necessary, pursued with the bank.

IFS has reviewed the Securities Finance sections of the SAS 70 reports for the past three half-years and agrees with the conclusion that no material concerns are evident.

Specifically, we reviewed the Securities Finance description of processes and controls in Section III and the test results in Section V for Control Objective 14 (Controls provide reasonable assurance that the lender and borrower participation in the lending program is authorized), Control Objective 15 (Controls provide reasonable assurance that loan processing, maintenance and returns are recorded completely and accurately), and Control Objective 16 (Controls provide reasonable assurance that securities lending collateral is invested in the investment vehicle selected by the client and income is calculated and distributed).

Notably, the SAS 70 addresses controls over the calculation of earnings in the cash collateral investment accounts. The process as described by the auditor includes calculation and tolerance checks. Income is identified as being accrued daily. There were no exceptions noted in the calculation of daily yields and the application of income to loans.

The processes and controls as described are thorough and adequate. They cover the range of topics we expect to see as part of a securities lending control structure.

The service audit was conducted by PricewaterhouseCoopers for all three periods. To IFS' knowledge this is a well regarded public accounting firm and one of the top tier firms in the country.

In the September 2007 report five exceptions were noted. All were for absence of evidence of review or secondary review of various transactions.

In the March 2008 report there were two exceptions for absence of evidence of secondary review, one exception in which a temporary change in a borrower credit limit was not reversed (however the correct limit was not exceeded), and one exception in which reconciliations of collateral could not be found. It is notable, however, that the two absence of evidence of review exceptions are for the same items as had exceptions in the prior report. This would seem to indicate that State Street management had not corrected the issue.

In the September 2008 report two exceptions were noted, all reflecting absence of evidence of review. One of these was in an area that was an exception in September 2007 but not March 2007. The third exception, however, appeared in all three reports. The item concerns reconciliation of collateral held in tri-party arrangements, i.e., where a bank other than State Street holds the collateral. Management's response partly asserts that there are redundant reconciliations that would have caught errors. It is possible some of PBGC's non-cash collateral is held in a tri-party arrangement.

Conclusion

Treasury Division staff is receiving and analyzing the SAS 70 reports on State Street's securities lending processes and controls appropriately. However, the review procedure is not documented, and there is no documentation that recurring issues were identified and referred to PBGC management.

We recommend that:

Recommendation 16
In the PBGC Securities Lending Procedures Manual, document the process to receive and analyze the lending agent's SAS 70 report sections on securities lending, and for supervisory review of the results. ***(OIG Control No. CID-16)***

PBGC Response: PBGC concurred.

Section III. - Background, Review Methodology, and Limitations on the Report

IFS specializes in evaluating the organization, administration, and investment programs of pension systems using combined expertise in investment practices, fund operations and fiduciary responsibility. In operation for almost 20 years, we have performed similar evaluations for numerous other public and private pension funds.

The analysis leading up to this Report progressed through several stages:

The first stage in our process was collection – with PBGC staff's cooperation – of information regarding the Board's securities lending operations, and practices. This included amassing data and documents, written operating policies and procedures, written investment policies and guidelines, service provider contracts, and other materials. This phase was conducted from October through December, 2008.

The next stage of our process, which continued throughout the project, was analysis. In undertaking this review, IFS employed a team approach, assigning certain of its personnel to concentrate on particular subject areas. Throughout the process, we coordinated and integrated our efforts and maintained communication with representatives of the OIG. The main interview phase was conducted in December 2008. Subsequent interviews were conducted January 27, 2009. Some interviews were conducted by telephone.

We also held discussions with people directly associated with PBGC. These included telephone interviews with State Street personnel.

This Report should be read and evaluated with several caveats in mind. First, many of the subjects addressed in this report are inherently judgmental and not susceptible to absolute or definitive conclusions. When we express a judgment or make a recommendation, we also set forth the observed conditions and rationale that led us to that viewpoint.

Second, in conducting this review, we necessarily relied on oral and written representations of the people we interviewed and on the contents of the documentary information we obtained. We sought to cross-verify certain information among different interviewees and documents, but the process of cross-verification was limited. We were not hired to detect or investigate fraud, concealment or misrepresentations; however, nothing came to our attention that should be reported. We were not hired to, and did not attempt to conduct a formal or legal investigation or otherwise to use judicial processes or evidentiary safeguards in conducting our review. Our findings and conclusions are based upon our review and tests of documents, the interviews we conducted with staff, and others associated with PBGC, independent analysis, and our experience and expertise.

Third, this Report does not and is not intended to provide legal advice or serve as a forensic audit.

Fourth, our observations are necessarily based only on the information we considered as of and during the period we performed our review. Our report cannot and does not attempt either to assess the manner in which any of our recommendations may be implemented or observed in the future, or predict whether PBGC practices, as represented to us, will be observed in the future. Nor does our report supplant or reduce the ongoing independent fiduciary duty of the Board and staff to structure and evaluate their investment program or policies and procedures.

Fifth, although this report sets forth observed conditions and recommendations regarding limited aspects of PBGC's internal controls, we did not conduct – or attempt to conduct – a full or formal examination of the PBGC or State Street internal control system. This Report is not intended as a substitute for such an examination, if one is deemed to be appropriate. The scope of our work was established through our contract with the OIG which did not include performing work at the lending agent.

Finally, although we discussed our findings with, and submitted a draft version of our report to the OIG, its final form and content reflect the independent judgment of IFS.

Section IV. - Exhibits

Exhibit A – Summary of Recommendations

Page	Rec	Recommendation
8	1	*The PBGC Board of Directors state in the Investment Policy Statement that securities lending will be conducted in accordance with separate guidelines for the program, including guidelines covering the investment of securities lending collateral and program implementation and monitoring policies and procedures.**(OIG Control No.CID-1)***
9	2	*PBGC develop and submit to the Board of Directors for review a separate set of written guidelines containing the broad parameters and objectives of the program, e.g., collateral should have a market value of 102% for U.S. securities (105% for international securities), be marked to market daily in accordance with PBGC's stated requirements, etc. **(OIG Control No. CID-2**)*
12	3	*PBGC develop a Securities Lending Procedures Manual to provide guidance to staff on conducting and documenting the analysis and supervisory review required to implement the securities lending policies. **(OIG Control No.CID-3**)*
12	4	*In the PBGC Securities Lending Procedures Manual, document the procedures followed and the extent, nature and timing of any reviews performed of the Quality A Fund, and of the Trust's management, policy and investment guidelines. The results of the review should be formally reported to the Chief Investment Officer and other senior management as appropriate. (**OIG Control No.CID-4)***
13	5	*In the PBGC Securities Lending Procedures Manual, develop a formal policy and procedure which will set out the analyses and reviews to be undertaken in overseeing the securities lending program, defining the form, content, and timing of reporting, establishing procedures for reporting and acting on exceptions, and specifying the performance expectations and means of measuring them against appropriate benchmarks. **(OIG Control No.CID-5)***
13	6	*Formally identify State Street as an investment manager that is subject to the key controls review that is performed by CCRD. **(OIG Control No.CID-6**)*
13	7	*Perform periodic detailed internal reviews of the securities lending activities performed at State Street. **(OIG Control No.CID-7)***
16	8	*In the PBGC Securities Lending Operating Manual, develop a formal process to monitor securities lending activity against appropriate standards and benchmarks including undertaking a thorough evaluation of the various sources and tools for securities lending performance evaluation that are available. **(OIG Control No. CID-8)***
19	9	*PBGC explore with State Street how State Street can provide additional assurance on correctness of earnings by providing monthly revenue reports that*

Page	Rec	Recommendation
		can be tied into the activity and returns of the Quality A Fund. To the extent such information can be provided, establish procedures for random, contemporaneous verification of loan fees. ***(OIG Control No. CID-9)***
21	10	*Within the PBGC Securities Lending Procedures Manual, document the collection, review, and dissemination of investment results received from the lending agent.* ***(OIG Control No. CID-10)***
23	11	*PBGC arrange staff assignments to incorporate backup responsibility over the securities lending monitoring process and permit each analyst time to spend in education and cross training**. (OIG Control No.CID-11)***
23	12	*For staff performing investment oversight duties, establish a minimum number of hours of continuing training and education in applicable areas as part of the analyst's duties.* ***(OIG Control No.CID-12)***
29	13	*PBGC discuss with State Street whether and to what extent the tighter collateral replenishment requirements in this agreement have affected loan volume and, if so, evaluate the resulting trade-off between risk and return in order to conclude whether to keep or modify the requirement**. (OIG Control No.CID-13)***
29	14	*In the PBGC Securities Lending Procedures Manual, establish and implement a policy to monitor developments in the securities lending market, changes in regulatory requirements, and the volumes and economics of the program on an annual basis and as appropriate seek to amend PBGC's contract, lending policies, and participation in the program accordingly**. (OIG Control No.CID-14)***
31	15	*In the PBGC Securities Lending Procedures Manual, document in writing policies in regard to qualifying allowable borrowers and establishing credit limits for its security lending program.* ***(OIG Control No.CID-15)***
36	16	*In the PBGC Securities Lending Procedures Manual, document the process to receive and analyze the lending agent's SAS 70 report sections on securities lending, and for supervisory review of the results.* ***(OIG Control No.CID-16)***

Appendix I – PBGC Response

PBGC Protecting America's Pensions
Pension Benefit Guaranty Corporation
1200 K Street, N.W., Washington, D.C. 20005-4026

To:	Rebecca Anne Batts Inspector General
From:	Patricia Kelly P Kelly Chief Financial Officer
Subject:	Response to the OIG Draft Report Entitled "Evaluation of the PBGC's Activities with Respect to Its Securities Lending Program"
Date:	June 17, 2009

Thank you for providing the opportunity to discuss the draft report with you and your staff, and for the additional time to respond to the draft report's recommendations.

The securities lending program is a small, but important component of the PBGC's overall investment program. PBGC management is pleased that the draft report concluded that the that information PBGC receives from State Street Bank is sufficient to analyze securities lending program activities, that PBGC has qualified staff overseeing its securities lending program, and that your review did not identify any instances of noncompliance with the securities lending contracts PBGC maintains with State Street Bank. However, the report does highlight a number of ways PBGC can improve its securities lending program, and we are in agreement with most of the report's recommendations. Our responses to each of the recommendations included in the draft report are provided below:

Recommendation:

The PBGC Board of Directors state in the Investment Policy Statement that securities lending will be conducted in accordance with separate guidelines for the program, including guidelines covering the investment of securities lending collateral and program implementation and monitoring policies and procedures.

Response:

We do not concur. The ability to concur with a recommendation addressed to the Board of Directors (Board) rests with the Board itself. Alternatively, PBGC would be willing to prepare a briefing to the Board regarding securities lending guidelines, so that they may consider whether changes to the Investment Policy Statement are necessary in this regard.

Recommendation:

PBGC develop and submit to the Board of Directors for review a separate set of written guidelines containing the broad parameters and objectives of the program, e.g., collateral should have a market value of 102% for U.S. securities (105% for international securities), be marked to market daily in accordance with PBGC's stated requirements, etc.

Response:

We do not concur. First, there is no reason to single out the securities lending program, which, while important, is a small component of the investment policy, for detailed treatment not provided to any other component. Second, to involve the Board at such a level of operational detail would be unprecedented in PBGC's history. Historically, the Board's role has been to set policy for the PBGC and then have the operational details developed and implemented by PBGC staff. This has been for both practical reasons of time and expertise as well as to insulate the Board from the consequences of being involved in PBGC operations, as reflected by the historical memoranda that have been provided to your office in the course of this audit. Alternatively, we propose presenting the Advisory Committee with a briefing on the security lending guidelines. The Advisory Committee includes several members who are investment professionals and have significant experience and knowledge in this area. Further, Board representatives regularly attend these meetings and can raise any concerns to Board members. PBGC management will include a presentation by the Corporate Investment Department (CID) on the security lending program of a future Advisory Committee meeting. This is expected to be scheduled no later than December 31, 2009.

Recommendation:

PBGC develop a Securities Lending Procedures Manual to provide guidance to staff on conducting and documenting the analysis and supervisory review required to implement the securities lending policies.

Response:

We concur. CID management is the process of drafting a securities lending component to the CID Policies and Procedures Manual. The process is expected to be completed by December 31, 2009.

Recommendation:

In the PBGC Securities Lending Procedures Manual, document the procedures followed and the extent, nature and timing of any reviews performed of the Quality A Fund, and of the Trust's management, policy and investment guidelines. The results of the review should be formally reported to the Chief Investment Officer (CIO) and other senior management as appropriate.

Response:

We concur. Monthly monitoring is in place, a formal monthly report is prepared and provided to the CIO, and the CID staff has regular meetings with the securities lending group at State Street. We will incorporate this process into the securities lending component of the CID Policies and Procedures Manual by December 31, 2009.

Recommendation:

In the PBGC Securities Lending Procedures Manual, develop a formal policy and procedure which will set out the analyses and reviews to be undertaken in overseeing the securities lending program, defining the form, content, and timing of reporting, establishing procedures for reporting and acting on exceptions, and specifying the performance expectations and means of measuring them against appropriate benchmarks.

Response:

We concur. Monthly monitoring is in place, a formal monthly report is prepared and provided to the CIO, and the CID staff has regular meetings with the securities lending group at State Street. We will incorporate this process into the securities lending component of the CID Policies and Procedures Manual by December 31, 2009.

Recommendation:

Formally identify State Street as an investment manager that is subject to the key controls review that is performed by CCRD.

Response:

We concur. Historically, CID has always reviewed the collateral fund (currently Quality A) within the State Street securities lending program as an investment manager in a similar fashion as the investment program's other fixed income managers. Going forward, the State Street securities lending program will be scrutinized at the same professional and prudent level. CCRD will review CID activities in this regard as part of investment cycle testing.

Recommendation:

Perform periodic detailed internal reviews of the securities lending activities performed at State Street.

Response:

We concur. Each year, CID staff will conduct an onsite site review and perform a follow-up review. The follow-up review will be conducted approximately six months later and will normally not require an onsite visit. The last review conducted was April 30, 2009, at State Street's offices. CID management will establish a schedule for reviews for FY 2010 by September 30, 2009.

Recommendation:

In the PBGC Securities Lending Operating Manual, develop a formal process to monitor securities lending activity against appropriate standards and benchmarks including undertaking a thorough evaluation of the various sources and tools for securities lending performance evaluation that are available.

Response:

We concur. We expect to have a formal process to monitor securities lending activity against appropriate standards and benchmarks in place within the next six months. We will incorporate this process into the securities lending component of the CID Policies and Procedures Manual by December 31, 2009.

Recommendation:

PBGC explore with State Street how State Street can provide additional assurance on correctness of earnings by providing monthly revenue reports that can be tied into the activity and returns of the Quality A Fund. To the extent such information can be provided, establish procedures for random, contemporaneous verification of loan fees.

Response:

We concur. We will explore with State Street ways to obtain greater assurance regarding the accuracy of reported earnings. Further, CID staff will perform calculations to make certain that the month revenue generate is within an expected range. If this calculation, when compared to the actual revenue earned, is outside this range, additional due diligence will be performed. We expect to complete these efforts by December 31, 2009.

Recommendation:

Within the PBGC Securities Lending Procedures Manual, document the collection, review, and dissemination of investment results received from the lending agent.

Response:

We concur. Monthly monitoring is in place, a formal monthly report is prepared and provided to the CIO, and the CID staff has regular meetings with the securities lending group at State Street. We will incorporate this process into the securities lending component of the CID Policies and Procedures Manual by December 31, 2009.

Recommendation:

PBGC arrange staff assignments to incorporate backup responsibility over the securities lending monitoring process and permit each analyst time to spend in education and cross training.

Response:

We concur and consider this recommendation to have been completed. We have already established such a system to provide backup responsibility to ensure adequate coverage during absences or training. Cross training goes on throughout the CID on a continual basis. Since several individuals within CID have been trained to serve as Contracting Officer's Technical Representatives, shifting one individual from one oversight assignment to another is not difficult. Primary oversight of the securities lending program is the responsibility of the team leader of CID's Equity Team. This person ensures that multiple individuals are trained to oversee the securities lending program. Beyond that, there are individuals outside the Equity Team that could easily oversee securities lending, if needed until a permanent replacement is identified. This would include the Private Equity team leader, the Deputy CIO, and the CIO. We note that the current CIO has significant experience in this area and successfully managed and oversaw a similar securities lending program in a prior position.

Recommendation:

For staff performing investment oversight duties, establish a minimum number of hours of continuing training and education in applicable areas as part of the analyst's duties.

Response:

We concur and consider this recommendation to have been completed. While we are not aware of a specific amount of training required for those working under the GS-1160 series (Financial Analyst), CID fully recognizes the importance of training in the investment area. CID management and staff are able to take advantage of a full range of training opportunities, including seminars on security lending concepts and practices. Employee development and training considerations are regularly discussed as part of interim and final performance discussions. We would expect that each CID staff member would be able to attend at least 8 hours of investment training each year. As noted later in our response, we are currently exploring attendance at conferences focused on securities lending topics.

Recommendation:

PBGC discuss with State Street whether and to what extent the tighter collateral replenishment requirements in this agreement have affected loan volume and, if so, evaluate the resulting trade-off between risk and return in order to conclude whether to keep or modify the requirement.

Response:

We concur and consider this recommendation to have been completed. In December 2008, State Street noted that due to the recent demand in U.S. Government securities, we would not have experienced any adverse impact; however, under more normal market environments, the PBGC would likely be impacted in terms of lending activity. Nothwithstanding the potentially adverse impact under normal environments and given the current environment, the PBGC is willing to accept the lower lending activity and revenues that are likely to occur with the more conservative collateral replenishment requirements. Within the PBGC securities lending program, risk mitigation is more important than incremental returns and therefore, CID management will continue to maintain stringent guidelines to avoid material losses.

Recommendation:

In the PBGC Securities Lending Procedures Manual, establish and implement a policy to monitor developments in the securities lending market, changes in regulatory requirements, and the volumes and economics of the program on an annual basis and as appropriate seek to amend PBGC's contract, lending policies, and participation in the program accordingly.

Response:

We concur. CID is working with the Office of the General Counsel (OGC) and the Procurement Department (PD) to modify the securities lending contract with State Street to include more details regarding the securities lending policy, including monitoring guidelines. We include additional provisions, including the need to monitor market changes and regulatory considerations, in the securities lending component of the CID Policies and Procedures Manual by December 31, 2009. Further, in order to keep abreast of the latest changes in the securities lending market, CID staff has already identified two conferences focused on securities lending.

Recommendation:

In the PBGC Securities Lending Procedures Manual, document in writing policies in regard to qualifying allowable borrowers and establishing credit limits for its securities lending program.

Response:

We concur. While CID staff is not responsible for determining the list of qualifying borrowers or establishing credit limits, CID will develop a list of policies in this regard and work with OGC and PD to incorporate the policies into an updated securities lending contract with State Street. This would include requiring State Street to report, on a monthly basis, whether any of these guidelines have been violated. We expect to complete this process by December 31, 2009.

Recommendation:

In the PBGC Securities Lending Procedures Manual, document the process to receive and analyze the lending agent's SAS 70 report sections on securities lending, and for supervisory review of the results.

Response:

We concur. We will continue to review State Street SAS 70 reports, including aspects of the report relating to securities lending, as has been our practice. We will incorporate into the CID Policies and Procedures Manual, a requirement that such reviews be documented by staff with any significant matters reported to CID management. This should be completed by December 31, 2009.

We appreciate the review of this important program, and the independent perspective that your office provides in making recommendations for improvement of our operations. We look forward to updating your office on our progress on the corrective actions taken in response to the agreed-upon recommendations.

cc: Vince Snowbarger
Stephen Barber
Terrence Deneen
Richard Macy
Judith Starr
Marty Boehm
John Greenberg

Attachment 2
July 16, 2009 letter from
Phyllis C. Borzi on behalf of the
PBGC Board Representatives

PBGC
Protecting America's Pensions
Pension Benefit Guaranty Corporation
1200 K Street, N.W., Washington, D.C. 20005-4026

July 16, 2009

Rebecca Anne Batts
Inspector General
Pension Benefit Guaranty Corporation
Office of Inspector General
1200 K Street, N.W.
Washington, D.C. 20005-4026

Dear Ms. Batts:

I am writing on behalf of myself and the other recently-designated PBGC Board Representatives Rebecca M. Blank, Under Secretary for Economic Affairs, Department of Commerce, and Michael S. Barr, Assistant Secretary for Financial Institutions, Department of the Treasury, regarding your draft final report (Report) entitled, "Evaluation of the PBGC's Activities with Respect to its Securities Lending Program." We appreciated the opportunity to meet with you to discuss the report and the role of the PBGC Board and Board Representatives. As you know, the Board has the authority and responsibility for establishing and overseeing the investment policy and its implementation. Accordingly, the PBGC and the PBGC Inspector General should directly brief the Board or Board Representatives on investment policy implementation recommendations such as are discussed in your report on the securities lending program.

The recommendations contained in the Report generally appear sound and we are pleased that the PBGC will be working to implement them. We, however, disagree with the PBGC response to Recommendation 2 in which PBGC proposes to brief the Advisory Committee rather than the Board or Board Representatives on proposed guidelines for the program. The PBGC may well wish to discuss the recommendations with its Advisory Committee and that is appropriate. However, insofar as the Board has direct authority for overseeing the investment policy and its implementation, such proposed guidelines should be submitted to the Board and Board Representatives for review and we have directed that this be done.

When the new director is appointed, we anticipate that the PBGC Board will undertake a review of the PBGC's investment policy. In the course of that review, we expect the Board to consider whether the Investment Policy Statement should provide more specific direction to PBGC management regarding the implementation of the policy. In addition, the Board will review its own role and the role of the Board representatives in overseeing the implementation of the investment policy.

We are currently working on scheduling a PBGC Board meeting and planning the agenda for that meeting. As is customary, you will be invited to meet with the Board at that time.

We look forward to working with you on PBGC matters and would appreciate your keeping us regularly updated on your activities and any matters of which the Board and Board Representatives should be aware. Please feel free to contact us or our staffs any time.

Sincerely,

Phyllis C. Borzi

Phyllis C. Borzi
Assistant Secretary of Labor, Employee Benefits Security Administration
Department of Labor