



BACKGROUND:

Securities lending is the practice by which an owner of securities temporarily transfers their securities to a borrower for a fee. To secure the transaction, the borrower must transfer collateral to the owner, which can be cash or other agreed-upon financial instruments. Owners participate in securities lending to earn incremental income on idle assets, most often by contracting with lending agents, who facilitate loans of securities and invest cash collateral received on behalf of the owners. The owner and lending agent agree to investment guidelines that define who can borrow, the type of collateral the owner will accept, and what the cash collateral can be invested in. If a borrower were to default, the owner may liquidate the collateral and use the proceeds to repurchase the loaned securities from the market. If this were to occur, the owner bears the risk that the proceeds from collateral liquidation may be insufficient to purchase and replace the securities lent. To ensure sufficient collateral, the borrower must provide collateral that is worth 102% of United States (U.S.)-based borrowed securities and 105% for non-U.S. borrowed securities. The securities on loan and the collateral are marked-to-market daily with margin calls made daily when necessary. Borrower defaults are extremely rare.

Fiscal Year	Fair Value of Collateral Held	Fair Value of Securities Out on Loan	Securities Lending Income
2018	\$682,977,347	\$661,713,384	\$4,240,955
2019	\$806,626,871	\$782,847,870	\$2,586,030
2020	\$655,258,205	\$638,766,997	\$2,053,636
2021	\$972,978,845	\$944,831,697	\$2,122,354
2022	\$1,116,378,706	\$1,075,154,975	\$2,423,299

Source: UTIMCO Funds' audited financial statements

The University of Texas/Texas A&M Investment Management Company (UTIMCO) has outsourced operations of its securities lending program to a lending agent, which also serves as UTIMCO's custodian bank. This third-party entity has served as both custodian and securities lending agent since UTIMCO's inception. The lending agent administers the securities lending program on UTIMCO's behalf and provides indemnification to UTIMCO if a borrower were to default. No such defaults have occurred in program history. UTIMCO receives 80% of securities lending net income, while its lending agent

retains 20%. As of the end of Fiscal Year 2022, UTIMCO had \$1.075 billion in securities out on loan and earned over \$2.4 million in securities lending income. Over the last five completed fiscal years, UTIMCO has reported over \$13 million in securities lending income.

OBJECTIVE:

To determine whether UTIMCO's securities lending activities include sufficient controls to ensure investment management goals are met and are in compliance with relevant policies and investment agreements.

CONCLUSION

Overall, UTIMCO's securities lending activities include adequate controls to ensure investment goals are achieved and are in compliance with applicable requirements.

The engagement methodology can be found at the end of this report.

OBSERVATIONS

 **None**

The University of Texas (UT) System Audit Office has completed an audit of UTMCO's securities lending program and found that adequate controls are in place to ensure that program objectives are met and in compliance with UTIMCO's securities lending policy and the investment guidelines in the securities lending authorization agreement between UTIMCO and its lending agent. This audit resulted in no reportable observations. We separately communicated to UTIMCO some minor suggestions with respect to administration of the securities lending program.



The System Audit Office conducted this engagement in accordance with the *International Standards for the Professional Practice of Internal Auditing* and generally accepted government auditing standards (GAGAS). Those standards require that we plan and perform the engagement to obtain sufficient, appropriate evidence to provide a reasonable basis for our observations and conclusions based on our objectives. We believe that the evidence obtained provides a reasonable basis for our observations and conclusions based on our objectives. The System Audit Office is independent per GAGAS requirements for internal auditors.

SCOPE AND PROCEDURES

The audit scope included the period from September 2021 through August 2022. To ensure most recent practices were covered, we also included compliance monitoring activities UTIMCO conducted for January 2023. Audit procedures included, but were not limited to, interviewing members UTIMCO staff and a representative of the lending agent; confirming and validating monthly compliance testing performed by UTIMCO; reviewing securities lending best practices; and reviewing the “System and Organization Controls (SOC 1) Report – Custody and Securities Lending Services” for the period July 1, 2021, through June 30, 2022, issued by the lending agent’s third-party auditor.

OBSERVATION RATINGS

Priority	An issue that, if not addressed timely, has a high probability to directly impact achievement of a strategic or important operational objective of System Administration or the UT System as a whole.
High	An issue considered to have a medium to high probability of adverse effects to a significant office or business process or to System Administration as a whole.
Medium	An issue considered to have a low to medium probability of adverse effects to an office or business process or to System Administration as a whole.
Low	An issue considered to have minimal probability of adverse effects to an office or business process or to System Administration as a whole.

CRITERIA

- UTIMCO’s Securities Lending Policy, revised June 2022
- Second Amended and Restated Securities Lending Authorization Agreement, dated May 30, 2007, and related Amendment, dated November 1, 2011
- *Securities Lending Best Practices* guidance paper from eSecLending

REPORT DATE

May 18, 2023

REPORT DISTRIBUTION

To: Britt Harris, President and Chief Executive Officer, UTIMCO
Cc: Rich Hall, Chief Investment Officer, UTIMCO
Joan Moeller, Senior Managing Director and Chief Operating Officer, UTIMCO
Gary Hill, Managing Director - Operations, Accounting and Reporting, UTIMCO
Carolina de Onís, Managing Director, Chief Compliance Officer, and General Counsel, UTIMCO
Jonathan Pruitt, Executive Vice Chancellor for Business Affairs, UT System
Terry Hull, Associate Vice Chancellor for Finance, UT System
UT System Administration Internal Audit Committee
External Agencies (State Auditor, Legislative Budget Board, Governor’s Office)