ETF Know:How

Securities lending with ETFs

An exchange-traded fund (ETF) may lend its underlying securities to a financial institution (typically a broker-dealer or hedge fund) in exchange for fees and collateral received from the borrower to generate income for the ETF. Financial institutions typically borrow the securities to benefit from making short sales in the market or to facilitate settlement of trades that could otherwise fail. In this installment of the ETF Know:How series, we explore the concept of securities lending and examine the potential benefits and risks.

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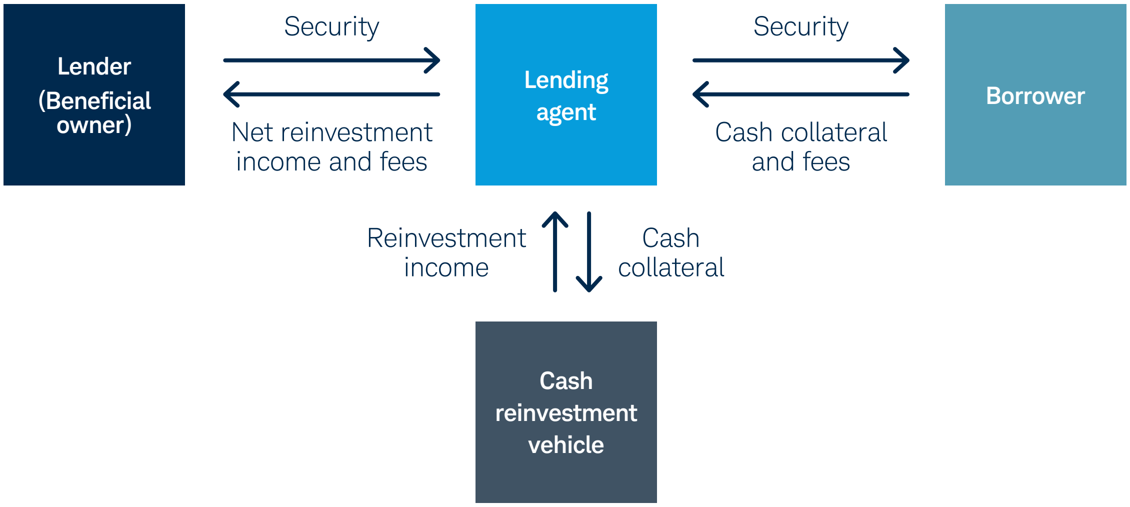
What is securities lending?

Securities lending is a common, well-established practice in which an ETF, as the beneficial owner of a security ("lender"), lends that security to a financial institution ("borrower") in exchange for a fee. The borrower provides collateral, usually in the form of cash, to the lender for the duration that the security is on loan. The collateral is held by the lender to protect against loss if the borrower should fail to return the security. Cash collateral is invested in a cash reinvestment vehicle, from which the lender typically earns income. The lender returns the collateral to the borrower when the borrower returns the security.

The lending agent facilitates transactions between the lender and the borrower. The lending agent provides services to the ETF, facilitating the lending of securities to approved borrowers, negotiating the loan terms, monitoring the value of loans and collateral on a daily basis, ensuring the investment of cash collateral, and managing recalls of borrowed securities and termination of loans.



How does securities lending work?

1 The borrower communicates a demand for a security to the lending agent. The lending agent and the borrower agree to the terms, price, loan duration, and collateral required to secure the loan.

2 The lending agent facilitates the transaction, including delivering the security to the borrower. In return, the borrower provides collateral, as either cash or securities, to cover the value of the loaned security. Borrowers may pay an incremental fee for securities that are in high demand.

- **a** Cash collateral received is invested in an approved cash reinvestment vehicle.
- **b** The lending agent performs daily marked-to-market calculations to ensure that the collateral is sufficient to cover the current market value of the security on loan.
- **c** All dividends or interest paid from the security while it is on loan are sent to the lender in the form of a substitute payment.

3 The borrower returns the security to the lender via the lending agent, and the lending agent returns the collateral to the borrower upon receipt of the security. The lender may recall a loan at any time.

4 The lending agent distributes the securities lending revenue to the lender. Securities lending revenue represents the income earned from the investment of the cash collateral plus any fees paid by borrowers, minus the fees paid to the lending agent and broker rebates.

Evaluating a securities lending program

An ETF may generate incremental returns and improved benchmark tracking by lending its underlying securities as it continues to receive the economic benefits of the security, such as dividends and interest. ETF shareholders should consider the following key points when evaluating an ETF that engages in securities lending:

Speak with the ETF manager to understand its lending practices	Do your due diligence on the ETF manager's risk mitigation practices
Understand the lending revenue fee split between the ETF and the lending agent	Review the ETF's annual reports and statement of additional information to understand the historical earnings generated by securities lending

What are the risks of securities lending?

Reinvestment risk

Risk of loss with respect to the investment of cash collateral and the decrease in value of the collateral that needs to be returned to the borrower.

- Cash collateral may be invested in a variety of securities, including repurchase agreements, Treasury securities, bank deposits, and pooled vehicles, including money market portfolios operating under Rule 2a-7 of the Investment Company Act of 1940.

Program risk

Risk associated with the parameters of a lending program and the lending agent's adherence to the lender's guidelines. Lenders mitigate this risk by:

- Overseeing the lending agent's adherence to the lender's guidelines
- Performing an annual due diligence review of the lending agent
- Approving borrowers and, for global funds, the countries where lending may occur

Borrower risk

Risk that a borrower will be unable to return the security and will default on the loan. This risk is typically mitigated in two ways:

- For ETFs that are registered under the Investment Company Act, the collateral received for the security on loan must be marked-to-market on a daily basis in an amount at least equal to the current value of the securities loaned. It is typically in the range of 102% to 105% for securities traded on U.S. and non-U.S. exchanges, respectively.
- The lending agent may indemnify the lender against borrower default, further reducing the risk of loss to the lender if the borrower defaults on a loan.

Summary

Securities lending is a common, well-established practice that allows borrowers, usually financial institutions, to borrow securities from a lender (ETF). Although the practice of lending securities carries some risk, an ETF may mitigate the risk by implementing specific lending guidelines with the lending agent and thoroughly validating all borrower counterparties on a regular basis. Ultimately, lending securities may generate additional revenue for the ETF, which could result in incremental returns for its shareholders and improved performance.

ETF Know:How

We're always here to help

ETF Know:How is a full-spectrum curriculum of ETF tools, resources, and insights created for all levels of ETF expertise. This educational program offers you a 360-degree view of ETF investing, with tactical steps to help support your business—from client engagement to portfolio implementation.

To learn more about ETF Know:How and how it can help advance your ETF expertise, call 877-824-5615 or visit schwabfunds.com.

Investment returns will fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost. Unlike mutual funds, shares of ETFs are not individually redeemable directly with the ETF. Shares of ETFs are bought and sold at market price, which may be higher or lower than the net asset value (NAV).

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