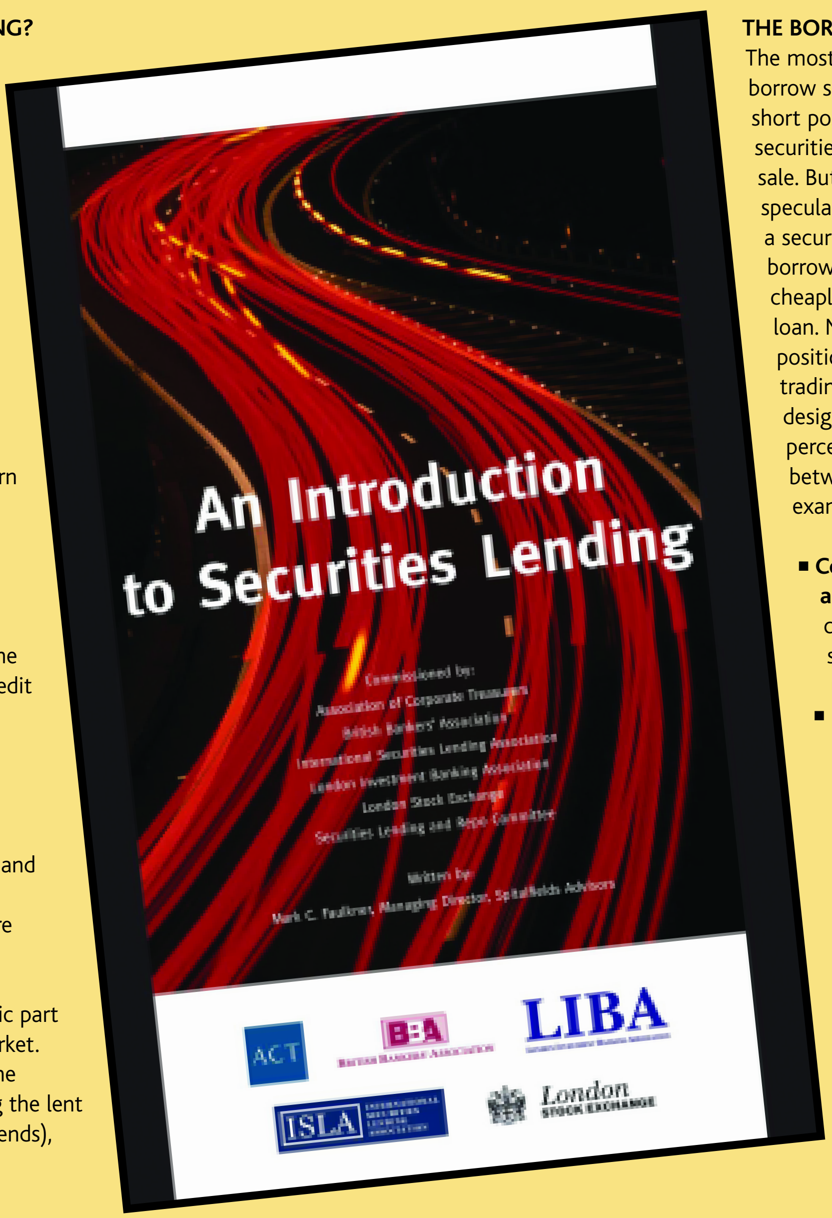
GAINING SUCCESS

A NEW JOINT PUBLICATION FROM THE ACT PROVIDES VALUABLE INSIGHT INTO THE WORLD OF

Securities lending, the temporary rental of securities on a collateralised basis, is a major and fast-growing activity, providing significant benefits for issuers, investors and traders alike. These are likely to include improved market liquidity, more efficient settlement, tighter dealer prices and perhaps a reduction in the cost of capital. The scale of securities lending globally is difficult to determine accurately, as it is an 'over-the-counter', rather than an exchange-traded market. But it is safe to say that the balance of securities on loan globally exceeds £1 trillion.

WHAT IS SECURITIES LENDING?
Securities lending describes the common market practice by which securities are transferred temporarily from one party (the lender) to another (the borrower), with the borrower obliged to return them either on demand or at the end of any agreed term. However, the word 'lending' is in some ways misleading. In law, the transaction is in fact an absolute transfer of title (sale) against an undertaking to return equivalent securities. Usually, the borrower will collateralise the transaction with cash or other securities of equal or greater value than the lent securities in order to protect the lender against counterparty credit risk. Some important consequences arise from the nature of securities lending transactions:

- Absolute title over both lent and collateral securities passes between the parties, therefore these securities can be sold outright or on-lent, which is commonplace and an intrinsic part of the functioning of the market.
- The borrower is entitled to the economic benefits of owning the lent securities (for example, dividends), but the agreement with the lender will oblige it to make ('manufacture') equivalent payments back to the lender.
- A lender of equities no longer owns them and has no entitlement to vote. But it is still exposed to price risk on them, since the lender can return them at a pre-agreed price. Lenders typically reserve the right to recall equivalent securities from the borrower and can exercise this option if they wish to vote. Borrowing securities for the specific purpose of influencing a shareholder vote is not regarded as acceptable market practice.



THE BORROWING MOTIVATION.
The most common reason to borrow securities is to cover a short position, using the borrowed securities to settle an outright sale. But it is rarely a simple speculative bet that the value of a security will fall so the borrower can buy it more cheaply at the maturity of the loan. More commonly, the short position is part of a larger trading strategy, typically designed to profit from perceived pricing discrepancies between related securities. For example:

- **Convertible bond arbitrage:** buying a convertible bond and simultaneously selling the underlying equity short.
- **'Pairs' trading:** seeking to identify two companies, with similar characteristics, whose equity securities are currently trading at a price relationship that is out of line with the historical trading range. The apparently undervalued security is bought, while the apparently overvalued security is sold short.

IN SECURITIES

SECURITIES LENDING – A GLOBAL MARKET THAT IS FAST EXCEEDING £1 TRILLION AND GROWING.

- **Merger arbitrage:** for example, selling short the equities of a company making a takeover bid against a long position in those of the potential acquisition company.
- **Index arbitrage:** selling short the constituent securities of an equity price index (for example, the FTSE 100) against a long position in the index future (such as a FTSE 100 contract on Liffe).

Short positions also arise as a result of failed settlement, with some securities settlement systems arranging for automatic lending of securities to prevent chains of failed trades, and where dealers need to borrow securities in order to fill customer buy orders in securities where they quote two-way prices. Not all securities lending is motivated by short selling. Many transactions are driven by financing; the lender is seeking to borrow cash against the lent securities, whether using sale and repurchase (repo), buy/sell backs or cash-collateralised securities lending.

Another large class of transactions is motivated by lending to transfer ownership temporarily to the advantage of both lender and borrower. For example:

- Where a lender would be subject to withholding tax on dividends or interest, but some potential borrowers are not. The borrower receives the dividend free of tax and shares some of the benefit with the lender in the form of a larger fee or larger manufactured dividend.
- Where an issuer offers shareholders the choice of receiving a dividend in cash or reinvesting it in additional securities (scrip) at a discount to the market price, but some funds (for example, index trackers) are unable to take the more attractive scrip alternative because their holdings would become larger than permitted under investment guidelines. The borrower chooses the scrip dividend alternative and sells the securities in the market. Again, the return is shared with the lender through a larger fee or a larger manufactured dividend.

DIFFERENT TYPES OF SECURITIES LENDING TRANSACTIONS. Most securities loans are collateralised, either with other securities or with cash deposits. Where lenders take securities as collateral, they are paid a fee by the borrower. By contrast, where they are given cash as collateral, they pay the borrower interest, but at a rate (the rebate rate) that is lower than market rates, so that the lender can reinvest the cash and make a return. Pricing is negotiated between the parties and would typically take into account factors such as supply and demand for the particular securities, collateral flexibility, the size of any manufactured dividend and the likelihood of the lender recalling the securities early. For example, fees for borrowing UK FTSE100 equities against securities collateral ranged from 6bp-200bp per year and fees for borrowing conventional UK government bonds from 6bp-40bp per year towards the end of 2003.

As well as securities lending, repo and buy-sell back transactions are used for the temporary transfer of securities against cash. In general, securities lending is more likely to be motivated by the desire to borrow specific securities and repo and buy-sell backs by the desire to borrow cash – but these boundaries are fuzzy.

For example, reinvestment of cash collateral has been an integral part of the securities lending business for many years, particularly in the US, with reinvestment opportunities often driving the underlying securities lending transactions.

MAIN MARKET PARTICIPANTS. The supply of securities into the lending market comes mainly from the portfolios of beneficial owners, such as pension and other funds and insurance companies. Underlying demand to borrow securities begins largely with the trading activities of dealers and hedge funds.

In the middle are a number of intermediaries. Their importance in the market partly reflects the fact that securities lending is a secondary activity for many of the beneficial owners and underlying borrowers. But intermediaries provide valuable services, such as credit enhancement and the provision of liquidity, by being willing to borrow securities at call while lending them for term. They also benefit from economies of scale, including the significant investment in technology required to run a modern operation.

Intermediaries include custodian banks and asset managers lending securities as agents on behalf of beneficial owners, alongside the other services provided to these clients. Some specialist securities lending agents have also emerged. Agents agree to split securities lending revenues with lenders and may offer indemnities against certain risks, such as borrower default.

Another category of intermediary is dealers trading as principals. Dealers intermediate between lenders and borrowers, as well as using the market to finance their own wider securities trading activities.

They may seek returns by taking collateral, counterparty credit or liquidity risk – for example, by lending securities to a client for a period while borrowing them on an open basis, with a risk of early recall by the lender. Through their prime brokerage operations, they also meet the needs of hedge funds. Borrowing of securities to finance their positions has grown rapidly.

For beneficial lenders, there are a number of different possible routes to the market. These include: using an agent (custodian bank, asset manager or a specialist) to manage a lending programme; auctioning a portfolio to borrowers directly; selecting one principal borrower; establishing an 'in-house' operation and lending directly; or some combination of these strategies.

'MARKET PARTICIPANTS HAVE DRAWN UP A STOCK BORROWING AND LENDING CODE THAT UK-BASED MARKET PARTICIPANTS OBSERVE AS A MATTER OF GOOD PRACTICE'

TRADING AND SETTLEMENT. The securities lending market is a hybrid between a relationship-based market and an open, traded market. Historically, transactions were negotiated by telephone, but increasingly securities are broadcast as available at particular rates using email or other electronic platforms.

Loans may be either for a specified term or, more commonly, open to recall, because lenders typically wish to preserve the flexibility for fund managers to be able to sell at any time. Settlement occurs on a shorter time frame than outright transactions, so that securities can be borrowed to cover a sale.

In most settlement systems, securities loans are settled as 'free of payment' deliveries and the collateral taken is settled quite separately, possibly in a different payment or settlement system and maybe a different country and time zone. This can give rise to 'daylight exposure', a period when the loan is not covered as it has been delivered and the collateral has not yet been received. To avoid this exposure some lenders insist on pre-collateralisation, so transferring the exposure to the borrower. In the UK, Crest has specific settlement arrangements for stock lending transactions.

UK STAMP DUTY. London Stock Exchange rules require lending arrangements in securities on which UK stamp duty/stamp duty reserve tax (SDRT) is chargeable to be reported to the exchange. This enables firms to bring their borrowing and lending activity to the exchange, making them exempt from stamp duty/SDRT under Inland Revenue regulations. Non-exchange member firms that conduct borrowing and lending activity through a member firm are also eligible for stock lending relief from stamp duty/SDRT.

COMPANIES ACT 1985. Firms that are engaged in equity stock borrowing and lending in the UK will need to comply, where appropriate, with the notification requirements applying to notifiable interest in shares, as set out in Part IV of the Companies Act 1985. These requirements apply to interests in a public company's shares and include shares acquired or disposed of in stock borrowing, lending transactions and repo transactions.

TRANSPARENCY IN THE UK MARKET. Crest provides some time-delayed information on the values of securities financing transactions in the top 350 UK equities. This information was first published in September 2003 and excludes intermediary activity where possible.

RISKS AND RISK MANAGEMENT. When taking cash as collateral, a lender pays rebate interest to the securities borrower, so the cash must be reinvested at a higher rate in order to make any net return on the collateral aspect of the transaction. Expected returns can be increased by reinvesting in assets with more credit risk or longer maturity in relation to the likely term of the loan, with a risk of loss if market interest rates rise. Many of the large securities lending losses over the years have been associated with re-investment of cash collateral, as, in effect, a securities lending business can hide a risky investment portfolio.

TRANSACTION COLLATERALISED WITH OTHER SECURITIES. Apart from the risk of errors, systems failures and fraud always present in any market, problems arise on the default of a borrower. The lender must then sell its collateral in the market in order to raise the funds to replace the lent securities. It will lose money if the value of the collateral securities falls relative to that of the lent securities. Generally, the risk of loss is greater if it takes longer to close out these positions, if the collateral or lent securities are wrongly valued, if the markets for these securities are illiquid and if the market prices of the lent and collateral securities do not tend to move together.

UK REGULATION. Any person conducting stock borrowing or lending business in the UK would generally be carrying on a regulated activity in terms of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 and therefore would have to be authorised and supervised under that Act. The stock borrower or lender would, as an authorised person, be subject to the provisions of the *Financial Services Authority (FSA) Handbook*, including the Inter-Professional Conduct chapter. They would also have to have regard to the market abuse provisions of the Financial Services and Markets Act 2000 and the related Code of Market Conduct issued by the FSA. *The FSA Handbook* contains rules, guidance, and evidential provisions relevant to the conduct of the firm concerned in relation to the FSA's High Level Standards.

STOCK BORROWING AND LENDING CODE. In addition to the prudential standards set by the FSA, market participants have drawn up a stock borrowing and lending code that UK-based market participants observe as a matter of good practice. The code does not in any way replace the FSA's or any other authorities' regulatory requirements, and it is not intended to override the internal rules of settlement systems as regards borrowing or lending transactions.

UK SECURITIES LENDING AND REPO COMMITTEE. The code was produced by the UK Securities Lending and Repo Committee (SLRC). The SLRC provides a forum in which structural developments in the stock lending and repo markets can be discussed and recommendations made by practitioners, infrastructure providers and authorities.

Securities lending is too significant to ignore, touching the interests of securities investors, companies that issue securities, market intermediaries and the authorities. It is also too central to the efficient running of the modern financial markets to be misunderstood.

The Association of Corporate Treasurers is pleased to have worked with the British Bankers' Association, International Securities Lending Association, London Investment Banking Association, London Stock Exchange and the Securities Lending and Reps Committee on this guide to securities lending markets.

The guide is available to download in full at **www.treasurers.org/technical/securities-ebook.cfm**

This article is taken from the executive summary to the publication An Introduction to Securities Lending; *© Mark C. Faulkner.*