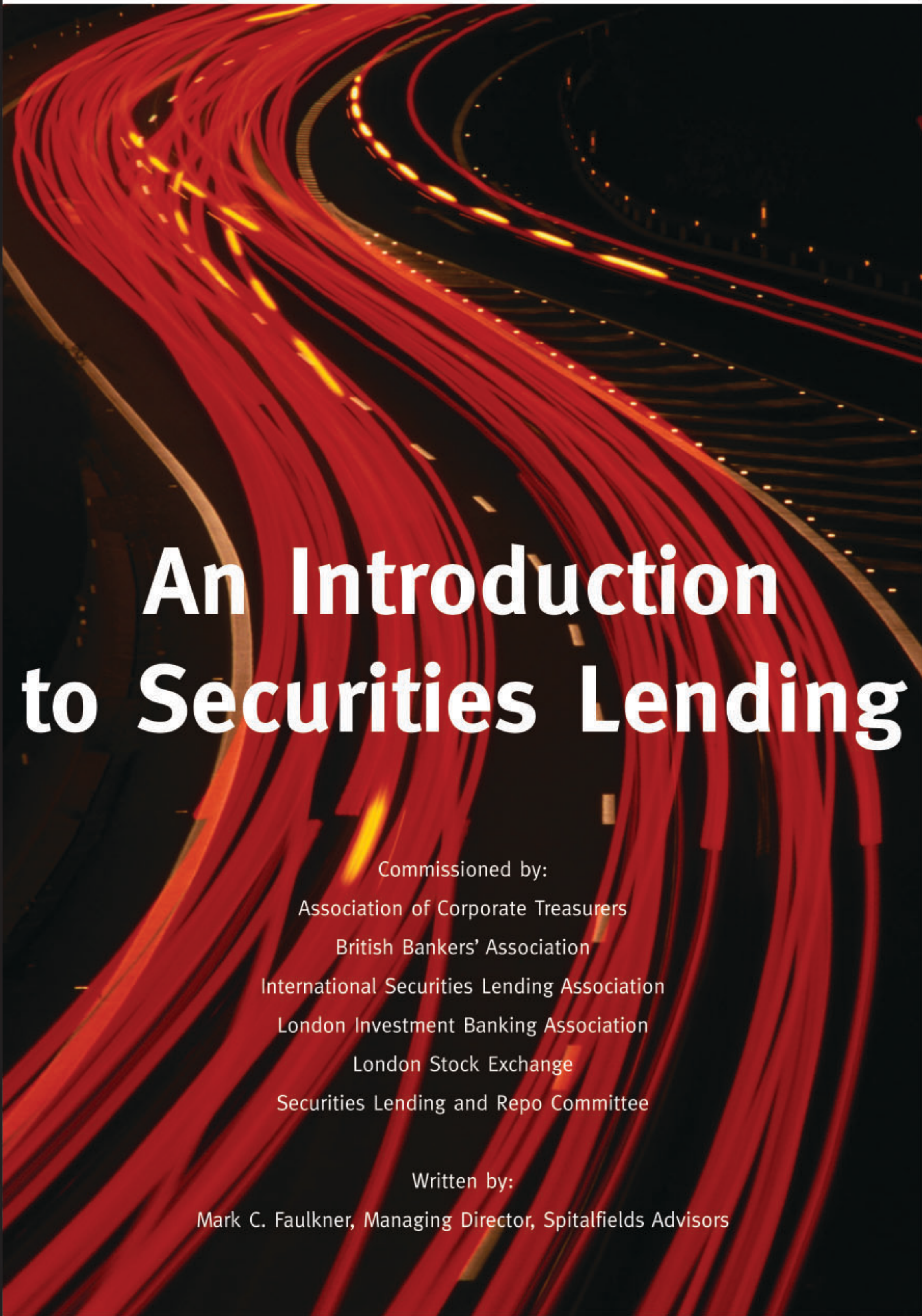

An Introduction to Securities Lending

Commissioned by:

Association of Corporate Treasurers

British Bankers' Association

International Securities Lending Association

London Investment Banking Association

London Stock Exchange

Securities Lending and Repo Committee

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ACT

BBA British Bankers' Association

LIBA London Investment Banking Association

ISLA International Securities Lending Association

London Stock Exchange

Executive Summary

Securities lending – the temporary transfer of securities on a collateralised basis – is a major and 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 estimate, as it is an 'over the counter' rather than an exchange-traded market. However, it is safe to say that the balance of securities on loan globally exceeds £1 trillion.

What is securities lending?

Securities lending describes the market practice by which, for a fee, securities are transferred temporarily from one party, the lender, to another, the borrower; the borrower is 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 counterpart 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 and 'on lent'. Both practices are commonplace and an intrinsic part of the functioning of the market.
- Once securities have been acquired, the new owner of them has certain rights. For example, it has the right to sell or lend them on to another buyer and, vote in AGMs.
- The borrower is entitled to the economic benefits of owning the lent securities (e.g. 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 movements on them since the borrower can return them at a pre-agreed price. Lenders typically reserve the right to recall equivalent securities from the borrower and will exercise this option if they wish to vote. However, borrowing securities for the specific purpose of influencing a shareholder vote is not regarded as acceptable market practice.

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 they 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 FTSE 100 equities against securities collateral ranged from 6-200 basis points per annum and fees for borrowing conventional UK government bonds from 6-40 basis points per annum towards the end of 2003.

As well as securities lending, sale and repurchase (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 this boundary is fuzzy. For example, reinvestment of cash collateral has been an integral part of the securities lending business for many years, particularly in the United States, with reinvestment opportunities often driving the underlying securities lending transactions.

Lenders and intermediaries

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. The importance of intermediaries in the market partly reflects the fact that securities lending is a secondary activity for many of the beneficial owners and underlying borrowers. 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, but they also use the market to finance their own wider securities trading activities. They may seek returns by taking collateral, counterpart 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 and the borrowing of securities to finance their positions has grown rapidly.

For beneficial owners, there are a number of different possible routes into the market. These include using an agent (custodian bank, asset manager or 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.

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 this is rarely a simple speculative bet that the value of a security will fall so that 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.
- 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 (e.g. FTSE 100) against a long position in the index future (e.g. 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. Financing drives many transactions – the lender is seeking to borrow cash against the lent securities, whether using repo, buy/sell backs or cash-collateralised securities lending.

Another large class of transactions not involving a short comprises those motivated by lending in order to transfer ownership temporarily, an arrangement which can work 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 (e.g. 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 larger manufactured dividend.

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 in which the lent securities have been delivered but the collateral securities have not yet been received. To avoid this exposure some lenders insist on pre-collateralisation, so transferring the exposure to the borrower.

In the United Kingdom, 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 'on 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 or lending in the United Kingdom will need to comply, where appropriate, with the notification requirements applying to notifiable interest in shares as set out in Part VI of the Companies Act 1985.

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 taking cash as collateral 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 reinvestment of cash collateral.

Transaction collateralised with other securities. Added to the risk of errors, systems failures and fraud that are always present in any market, problems can arise from the default of a borrower. Following a default the lender must 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 or 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 United Kingdom would generally be carrying on a regulated activity according to the terms of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, and would therefore 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, in particular the Inter-Professional Conduct chapter; and 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 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, which UK-based market participants observe as a matter of good practice. The Code does not in any way replace the FSA's or other authorities' regulatory requirements, nor is it intended to override the internal rules of settlement systems as regards borrowing or lending transactions.

Securities Lending and Repo Committee

The Securities Lending and Repo Committee (SLRC) produced the Code. 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. Its terms of reference are shown in Appendix 2.

Many questions are asked about the securities lending industry and Chapter 6 (Frequently asked questions) responds to many of these. They have been grouped into legal, dividends and coupons, collateral and risk management, operational and logistical, corporate governance and lending options for beneficial owners.

Finally, every market has its own jargon, and securities lending is no exception. Appendix 3 is a glossary of terms.

Securities lending is too significant to ignore. It touches 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. This book is intended to provide an authoritative introduction to the modern industry.