

ON Loans

An overview of the securities lending market.

BY DAVID RULE

SECURITIES LENDING

markets have grown tremendously in recent years and they have become more important than ever to the efficient functioning of wider capital markets. The data tell the story: Spitalfields Advisers estimates that around US\$6 trillion of securities are on loan globally, with about US\$22 trillion available for loan and around US\$100 trillion in issue. Securities on loan are split equally between government bonds and equities/corporate bonds—around 45% of these are North American, 35% are European and 20% are from the rest of the world. While securities lending is central to the liquidity of modern securities markets, it often gets bad press and is not widely understood by regulators and commentators. Too often, for example, securities lending and short selling are made the scapegoats for falling share prices. In this article, I aim to outline and clarify the key issues facing borrowers and lenders of securities and the trends and challenges currently facing the industry.

The ability to borrow securities underpins the services that securities dealers can offer their customers as well as the trading strategies of dealers, hedge funds and, increasingly, asset managers. Since the start of the credit crunch in August 2007, securities lending volumes have remained high, providing vital liquidity to the money, bond and equity markets. As an example of how important securities lending has become, problems in the unsecured bank financing markets led banks and securities dealers to increase their collateralized financing, primarily through the government bond repo markets. Especially in Europe, the ability to borrow government bonds against the collateral of other securities such as corporate bonds and increasingly equities has been critical to the success of such financing strategies. Indeed, the Federal Reserve and Bank of England

introduced facilities to lend government bonds against wider collateral as part of their response to the financial crisis.

SHORT-SELLING CONUNDRUM

Securities lending is not without its challenges, however. For instance, critics of the practice often ask why securities are loaned in order to facilitate short selling when, so the argument goes, this could drive prices lower? While genuine market manipulation is clearly unacceptable, three responses can be made to such arguments. First, short selling should have no net long-term effect on share prices. If short sellers caused a share price to fall below its fair value, other investors would take the opportunity to buy. Academic research has shown that placing restrictions on short selling reduces market efficiency, and in particular that share prices may overshoot. Second, far from all lent securities are used to cover directional short sales. Securities are also borrowed for many other reasons; for example, to avoid settlement failures; by market makers in order to provide liquidity to buyers and to enable arbitrage-related activity: for example, to go short individual shares versus an index-based basket. Third, institutional investors lend securities in order to earn additional returns at low risk. If they decide not to lend they not only miss out on that return, to the detriment of their investors, but one certain consequence of reduced securities lending would be to lower market liquidity. Particularly in current markets, that is the last thing that any investor or the authorities should want.

Some recent papers by certain U.S. academics have given the impression that securities are often borrowed for the purpose of voting in corporate elections—in effect, ‘renting’ the voting rights without taking a corresponding economic interest in the company. ISLA has made clear that ‘borrowing to vote’ is an unacceptable market practice,

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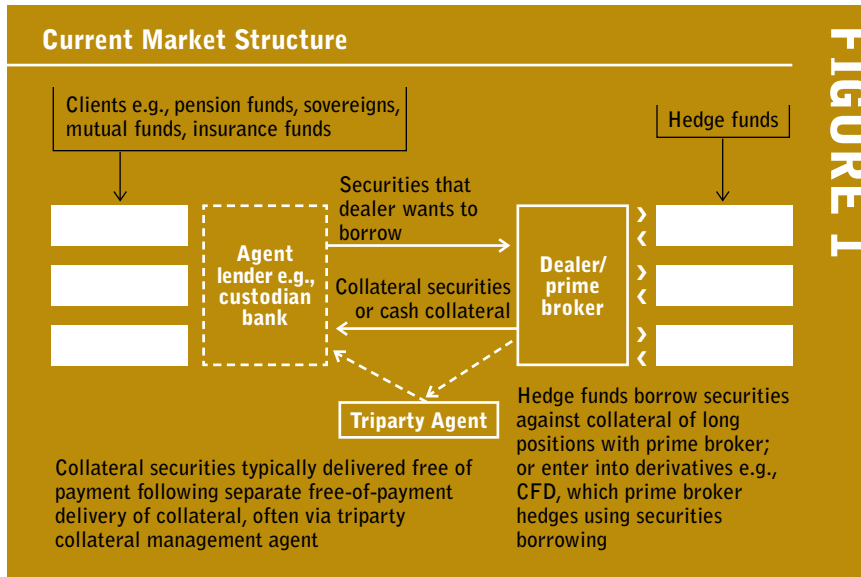


FIGURE 1

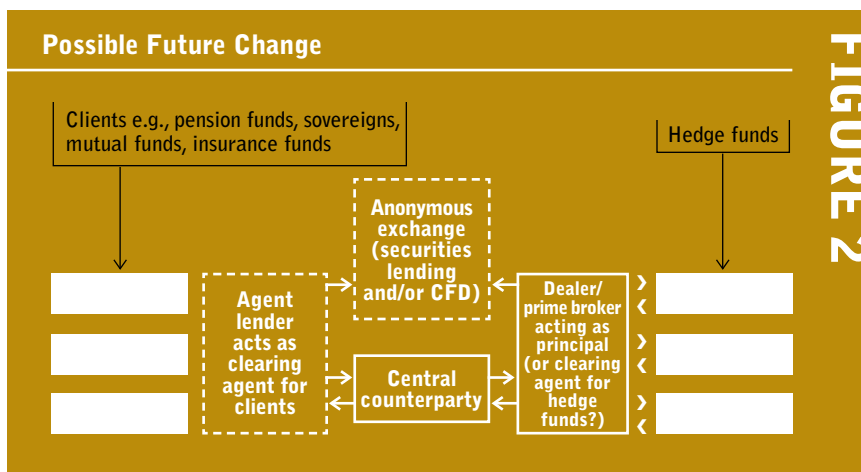


FIGURE 2

manage this activity in the same way as they would any other investment business. An important difference between the U.S. and the European markets is that around 95% of U.S. loans are collateralized with U.S. dollar cash, which is reinvested by lenders and their agents in the money markets, whereas around 70% of European loans are collateralized with other securities and only 30% with cash. Most cash collateral is reinvested in money market instruments at maturities between one and twelve months, with lenders earning any spread between term money market interest rates and the overnight rate typically paid to borrowers on the cash. Lenders are exposed to interest rate, liquidity and potentially credit risk. Recent falls in the market values of some money market instruments, notably asset-backed commercial paper, have highlighted these risks. But equally the steepening of the money market yield curve and widening of credit spreads since August 2007 have created some attractive opportunities.

which its members do not knowingly facilitate. Under standard securities lending agreements, lenders have the right to recall securities from borrowers on demand. Most lenders, working closely with their agents, have procedures in place to block new lending and recall existing loans if a vote is important to them. ISLA has been engaging with regulators and academic researchers to bring balance to the debate about the prevalence of borrowing to vote. To our knowledge, only a couple of cases have been substantiated globally and even in those cases, borrowing was not a decisive influence on the outcome of the vote.

RISKY BUSINESS

Securities lending has been designed to minimize risk to lenders, with over-collateralization, the right to recall on demand and use of robust legal agreements. Lenders can choose to undertake risk on the associated reinvestment of cash collateral in order to boost returns. They need to

MARKET IS EVOLVING

Changes in the structure of the securities lending market are on the horizon. Recent developments include beneficial owners auctioning exclusive rights to borrow from portfolios directly to borrowers, electronic trading in the inter-dealer market and lending institutions running 130/30 funds and becoming borrowers as well. In the future, a securities lending ‘exchange’ with a central counterparty could very well emerge. Such an exchange would bring benefits, including standardization of credit risk, greater price transparency, operational efficiencies and the ability to cope with rising volumes. At the same time, the industry would need to overcome difficulties, including whether lenders would be prepared to pay margin to a clearing house and the challenges involved in recalls of securities. Another question—Would the prominence of intermediaries in the market—both agent lenders acting on behalf of beneficial owners of securities and prime brokers servicing hedge

funds—decline if the market developed in this direction? That is certainly a possibility, but the fact remains that securities lending is a secondary activity for most beneficial owners and hedge funds, and the economies of scale from processing large volumes of transactions will continue to give intermediaries an edge. At the same time, intermediaries add value in the market, maintaining liquidity between borrowers wanting stable borrowing over a period of time and lenders who need to be able to recall securities when necessary.

THE CREDIT CRUNCH

Securities lending markets have been deeply affected by the credit crunch; however, lending has continued, providing vital liquidity to the securities markets. Importantly, most market participants are responding to the crisis in a calm and measured way. Many lenders have tightened collateral and cash reinvestment guidelines (e.g., augmenting ratings-based guidelines with restrictions by asset class). Some have increased margin requirements or sought

greater diversification across borrowers in order to reduce counterparty credit risk. Given the illiquidity in some markets, particularly in asset-backed securities, lenders have rightly looked closely at how securities are valued, including by triparty collateral management agents, in order to be confident that they are adequately collateralized.

Agent lenders have been faced with reduced liquidity and, in some cases, mark-to-market losses on their cash reinvestment pools. Initially, they have been reacting by shortening the maturity and reducing the risk of new investments. In most cases, forced liquidations of cash reinvestment portfolios into illiquid markets have been avoided as clients have maintained lending balances and borrowers have continued to provide cash collateral. Nonetheless, giving U.S. dollar cash as collateral has become expensive, especially for non-U.S. borrowers. Some have re-priced cash collateral at higher rates than the overnight Fed Funds rate or have encouraged lenders to reinvest cash in term reverse repo lending to the borrower. Others have sought increasingly to give non-cash collateral, with lenders who are able to accommodate this preference picking up market share. Indeed, for borrowers, collateral has increasingly been driving the trade and has become a way of financing inventory: for example, equities, convertible bonds and emerging markets securities. Data from Performance Explorer illustrates some of these trends, with lending volumes holding steady since August 2007, and with more use of non-cash compared to cash collateral. ■