Securities lending

In finance, **securities lending** or **stock lending** refers to the lending of securities by one party to another. The terms of the loan will be governed by a "Securities Lending Agreement", which requires that the borrower provides the lender with collateral, in the form of cash, government securities, or a Letter of Credit of value equal to or greater than the loaned securities. The agreement is a contract enforceable under relevant law, which is often specified in the agreement.

As payment for the loan, the parties negotiate a fee, quoted as an annualized percentage of the value of the loaned securities. If the agreed form of collateral is cash, then the fee may be quoted as a "short rebate", meaning that the lender will earn all of the interest which accrues on the cash collateral, and will "rebate" an agreed rate of interest to the borrower.

Market size

Until the start of 2009 Securities Lending was only an over-the-counter market, so the size of this industry was difficult to estimate accurately. According to the industry group ISLA, in the year 2007 the balance of securities on loan globally exceeded £1 trillion.[1]

An example

In an example transaction, a large institutional money manager with a position in a particular stock would allow those securities to be borrowed by a securities lender. The securities lender (investment bank) would then allow a short seller to borrow the stock and sell it. The short seller would like to buy the stock back at a lower price (which would create a profit). Once the shares are borrowed and sold, it generates cash from selling the stock. That cash would become collateral for the borrow. The cash value of the collateral would be marked-to-market on a daily basis so that it exceeds the value of the loan by at least 2%. The institutional manager would have access to the cash for overnight investment and maintains a long position in the stock.

Legalities

Securities Lending is legal and clearly regulated in most of the world's major securities markets. Most markets mandate that the borrowing of securities be conducted only for specifically permitted purposes, which generally include;

1. to facilitate settlement of a trade,
2. to facilitate delivery of a short sale,
3. to finance the security, or
4. to facilitate a loan to another borrower who is motivated by one of these permitted purposes.

When a security is loaned, the title of the security transfers to the borrower. This means that the borrower has the advantages of holding the security, as they become the full legal and beneficial owner of it. Specifically, the borrower will receive all coupon and/or dividend payments, and any other rights such as voting rights. In most cases, these dividends or coupons must be passed back to the lender in the form of what is referred to as a "manufactured dividend".

The initial driver for the securities lending business was to cover settlement failure. If one party fails to deliver stock to you it can mean that you are unable to deliver stock that you have already sold to another party. In order to avoid the costs and penalties that can arise from settlement failure, stock could be borrowed at a fee, and delivered to the second party. When your initial stock finally arrived (or was obtained from another source) lender would receive back the same number of shares in the security they lent.

The principal reason for borrowing a security is to cover a short position. As you are obliged to deliver the security, you will have to borrow it. At the end of the agreement you will have to return an *equivalent* security to the lender. Equivalent in this context means *fungible*, i.e. the securities have to be completely interchangeable. Compare this with lending a ten euro note. You do not expect exactly the same note back, as any ten euro note will do.

Securities lending & borrowing is often required, by matter of law, to engage in short selling. In fact, recent regulation in the United States required that, before short sales were executed for 19 specific financial stocks, the sellers first pre-borrow shares in those issues.[2] This caused securities lending volumes in these 19 issues to double.[3] The SEC is currently evaluating whether to extend such a rule to the wider market.[4]

Securities lenders

Securities lenders, often simply called **sec lenders**, are institutions which have access to 'lendable' securities. This can be asset managers, who have many securities under management, custodian banks holding securities for third parties or third party lenders who access securities automatically via the asset holder's custodian. The international trade organization for the securities lending industry is the International Securities Lending Association. According to a June 2004 survey, their members had euro 5.99 billion worth of securities available for lending. In the US, the Risk Management Association publishes quarterly surveys among its (US based) members. In June 2005, these had USD 5,770 million worth of securities available.

Typical borrowers include hedge funds and the proprietary trading desks of investment banks.

Term in investment banking

In investment banking, the term "securities lending" is also used to describe a service offered to large investors who can allow the investment bank to lend out their shares to other people. This is often done to investors of all sizes who have pledged their shares to borrow money to buy more shares, but large investors like pension funds often choose to do this to their unpledged shares because they will receive interest income. In these types of agreements, the investor still receives any dividends as normal, the only thing they cannot generally do is to vote their shares.

Term in private securities-collateralized lending

The term "securities lending" is sometimes used erroneously in the same context as a "stock loan" or individual "securities-collateralized loan". The former refers to the actual lending typically of banks or brokerages to other institutions to cover short sales or for other temporary purposes. The latter is used in private or institutional securities-backed loan arrangements across a wide spectrum of securities. In recent years, FINRA has cautioned all consumer to avoid nonrecourse transfer-of-title stock loans, but they enjoyed a brief popularity before the SEC and IRS came to shut almost all such providers down between 2007-2010, reclassifying nonrecourse transfer-of-title title stock loans as full taxable sales at inception. Today, it is widely accepted that the only legally valid consumer lending programs involving stocks or other securities are those in which the stocks remain in the client's title and account without sale through a fully licensed and regulated institution with membership in the SIPC, FIDC and other mainline regulatory organizations.

References

[1] "An Introduction to Securities Lending. 1 August 2005, "Executive Summary", Page 8." (http://www.asla.com.au/info/LongSecLendingPaper.pdf) (PDF). . Retrieved 2012-05-18.

[2] "SEC Emergency Short Sale Rule 15 July 2008" (http://sec.gov/divisions/marketreg/emordershortsalesfaq.htm). Sec.gov. . Retrieved 2012-05-18.

[3] Analysis of the effect of the SEC's special order on the securities lending market (http://217.151.192.253/SecuritiesFinance/Mailers/AstecAnalytics15Aug/AstecMarketAnalysis.pdf)

[4] Wutkowski, Karey. "SEC to propose short sale rule in weeks" (http://www.reuters.com/article/businessNews/idUSN1929265720080819). Reuters.com. . Retrieved 2012-05-18.

External links

- International Securities Lending Association website (http://www.isla.co.uk)

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