# Introduction to Securities Lending

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## What is Securities Lending?

At a superficial level securities lending, also known as stock lending, is a process whereby the owner of a security (the lender) lends it to another party (the borrower) for a period of time in exchange for a fee. The security can be either a bond or an equity.

In practice however the situation is a little more complex. The term lending is actually a misnomer. Under a securities lending arrangement, the lender actually sells the stock to the borrower, who agrees to return (i.e. sell back to the lender) equivalent securities at the end of the loan period. This sale is often conducted on a no payment basis. To offer security to the lender the borrower transfers collateral to the lender for the duration of the loan. The value of this collateral exceeds the value of the loaned securities by a margin (usually between 2% and 5%). The value of the loaned securities and the collateral should be calculated every day and additional collateral paid across if necessary to maintain the required margin. This process is known as "marking to market". At the end of the loan period, the securities are sold back (returned) to the lender at no cost and the collateral is returned to the borrower. Thus the lender has the same shareholding as before the loan, and will have earned a fee thereby increasing his overall portfolio value.

There are a number of considerations to be taken into account in assessing the merits of securities lending. The fact that stocks are actually sold could technically mean that stamp duties are payable (although securities lending transactions are exempt from such taxes in many markets).

In addition the lender is not entitled to receive any dividends from the shareholding while it is on loan. However, it is usual for the agreement between the lender and the borrower to provide that the borrower must pay a manufactured dividend to the lender to compensate for this loss of income.

Another consideration which may be important in some cases is that the lender does not have the right to vote in respect of the loaned stocks. This right cannot be manufactured back to the lender, although it is possible that the lender might ask the borrower to vote on his behalf. Finally the lender cannot sell the stock while it is on loan. If the lender wishes to vote or sell the stock he would need to recall the stock from the borrower, which may create administrative issues with the fund manager.

## Why would anyone want to borrow securities?

There are a number of reasons why stocks are borrowed. The main reason is to cover "short" positions, i.e. if the borrower has sold stock which he does not already hold and needs to cover that position. Traders may have a need to borrow stocks to allow them to quote tight two-way prices and meet demand from buyers. Borrowers may also have short positions due to failed settlements.

Because of this, securities lending is actively encouraged by the authorities in many developed markets. The practice provides market liquidity, prevents chains of settlement failures, allows tighter dealing prices and efficient settlement, and facilitates modern trading strategies.

There may also be arbitrage opportunities created by the securities lending arrangement itself. For example, varying tax treatments of different classes of investors may offer the possibility of a higher tax paying lender loaning a stock to a lower tax paying borrower over the dividend period. The borrower then receives a greater net divided than the lender would have received and this gain is shared between the two parties. There can also be opportunities for arbitrage if a company is offering a choice between taking a dividend as cash or shares at a discounted price. If the lender requires a cash dividend (this is often the case with index funds) the borrower can take the option of discounted shares and then sell these at a profit on the open market. Again the gain is shared between the two parties.

**Why should anyone lend securities?**

The main reason why the owner of securities would consider lending stock is to earn additional income. There are two main ways in which fees are earned on lending, which depend on the type of collateral offered.

Firstly collateral can be in the form of securities. In this case the borrower pays a fee to the lender, which is usually calculated on a daily basis and paid monthly in arrears. The second type of collateral is cash. If the lender accepts cash as collateral, he may keep a proportion of the interest earned on the collateral. For example, the lender might invest the cash at a rate of 1% and pay 0.95% back to the borrower, thereby earning a fee of 0.05%. There is potential for additional yield pick up from investing the cash in higher yielding assets, typically less secure assets or longer term assets. These strategies can increase the risk associated with securities lending.

The level of the fee earned will depend on several factors. Some stocks are in great demand and these will attract a higher fee. If the lender can guarantee that the stocks will not be recalled early he can charge a higher fee. For this reason, passively managed funds (or index funds) are more likely to lend as the turnover in these funds is much lower than in actively managed funds, and the stock is less likely to be recalled in order to be sold. Fees may also be higher if a lender offers exclusive borrowing rights to a borrower rather than offering the stocks on the open market, or if the lender is flexible regarding the type of collateral he is willing to accept.

As mentioned earlier, fees can also be generated where stocks are lent for the purpose of tax or dividend arbitrage.

**Who participates in securities lending?**

The main borrowers are hedge funds and stock traders. The main lenders are long term investors such as pension funds, insurance companies and unit trusts. Most securities lending is not arranged directly between the lender and the borrower but through a third party agent.

Agents typically include asset managers, custodians, specialist securities lending agents and brokers. These agents allow the assets of smaller clients to be pooled together for the purpose of lending, while reducing risk by dealing with a large number of borrowers. Due to the size of most agents, they can benefit from economies of scale, they can offer borrowers stocks for a guaranteed term while still allowing lenders to recall stocks on demand and, perhaps most importantly, they can offer indemnities to lenders in the event of borrower default.

Where a lender participates in securities lending through an agent, the fee is split between the two parties. The proportion of the fee retained by the agent will depend on a number of factors, including the extent of any indemnity offered to the lender.

## What are the risks involved?

As with any type of investment activity there are risks involved. However these risks can be controlled by the use of an experienced stock lending agent utilising advanced technology and robust legal documentation. In addition to the ever-present risks of error, systems failure and fraud, lenders need to consider credit risk and market risk.

Credit risk arises in the event of a borrower defaulting on the loan (i.e. not returning the securities when asked). Therefore the credit quality of the borrower is a significant factor. However, an equally significant factor relates to the quality of the collateral. In the event that the borrower defaults there is a risk that the collateral being held is insufficient to repurchase the loaned stocks on the open market. This risk can be mitigated by taking adequate margin, daily (or more frequent) marking to market and ensuring that both the collateral and the loaned securities are correctly valued. If a loss does arise in this situation, the lender has recourse to the borrower or their liquidator along with other creditors. Many agents will offer lenders protection from this risk by agreeing to return the lent securities to the lender immediately the borrower defaults, thereby retaining the risk that the collateral is inadequate.

Where cash is accepted as collateral there may be additional risks arising from the investment strategy adopted in relation to this collateral. If extra return is sought through investing in assets with a higher credit risk there is a risk of default. If the collateral is invested in assets with a longer maturity than the loan the lender may be exposed to rising short term interest rates.

Market risk is associated with the market in which the lender is operating. To mitigate this risk it is important that market due diligence is conducted and that market standard documentation is executed.

Securities lending is governed by the terms of legally enforceable standard market agreements. These outline the rights, duties and obligations of both parties. It is very important that these are executed between the lender and the borrower. If a lender is using the services of an agent, a separate legal agreement will need to be drawn up governing the relationship between the lender and the agent.

## Summary

Securities lending offers pension funds the prospect of a small additional return for some small additional risk and administrative inconvenience. Most custodians have experience in this area and many would be prepared to act as lending agent on behalf of trustees.

The key question for trustees is whether the additional return available is sufficient to justify the additional risks and inconvenience. If it is likely that only a relatively small proportion of the scheme's assets would be lent at any one time the impact of stock lending on the overall fund return would more than likely be minimal, particularly if the credit risk is retained by the lending agent. However, for large funds or those with large, stable equity portfolios the potential gains may be more significant.