

Product Focus: Securities Lending

Securities Lending: Liquidity and Short Selling

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Worldwide Securities Services

Securities lending: A major source of market liquidity

Liquidity is the main component of any normally functioning market. When markets lack liquidity, as investors have experienced during the recent financial crisis, fear accelerates, bid/ask spreads widen, and price discovery proves challenging. Liquid markets allow investors to transact quickly and easily, contributing to efficiency in the market.

Securities lending, which has been part of the financial markets for over 70 years, is viewed by all major securities regulatory bodies as a vital component and major source of liquidity for domestic and international finance markets. In fact, the Federal Reserve's recent creation of the Term Securities Lending Facility was viewed by many in the industry to be a vote of confidence in the role securities lending plays in the marketplace.

In order to demonstrate how securities lending contributes to market liquidity, consider the effects that a basic US Treasury lending transaction has on the broader marketplace. An investor borrows US Treasuries and in return provides the lender with collateral. These borrowed securities, which were sitting idle in the lender's portfolio, are essentially recycled back into the market and the collateral (if cash) is then used to purchase additional investment products, generally short-term money market or other short duration fixed income instruments such as US Government Agencies. As a result, market liquidity is enhanced as both components of this transaction, the lent securities and the reinvested collateral, have essentially injected additional securities or cash into the financial markets. Multiply this one transaction by millions, add in all of the trading strategies and trade settlement transactions (as noted in table 1), and one can quickly see the role that securities lending plays in providing critically needed liquidity to the financial markets.

Table 1: Reasons Securities Are Borrowed

Facilitate Trade Settlement
Finance Inventory and Manage Balance Sheets
Arbitrage Trading
- yield enhancement, dividend reinvestment plan, convertibles, pair trading or relative value
Directional play / Short selling
Active Extension Strategies (e.g., 130/30 mandates)
Merger and Acquisition Activity
General Hedge Fund and Trading Activity
Derivative Products / Cheapest to Deliver (i.e., futures, options)
Index Rebalancing / Index Changes

Source: J.P. Morgan

Securities lending benefits the broader marketplace by increasing the supply of assets which in turn enhances overall liquidity. This leads to more efficient pricing through narrower bid/ask spreads, and supports the timely settlement of transactions. Without securities lending, more transactions would fail, leading to an erosion of investors' confidence.

As the number of trading strategies has expanded and global markets continue to grow, the demand to borrow securities will increase as well. Securities lending has evolved over time, from a back office function used primarily to settle trades into an integral part of the investment management business, supporting a variety of trading strategies, and serving as a necessary tool for delivering alpha and reducing portfolio expenses for asset managers.

Securities lending's link to short selling

In the June 2007 issue of *Reserve Management Quarterly*, David Bule and William Smith reviewed the basics behind securities lending, which included a discussion on risk management and the key aspects of a successful securities lending program.

Generally speaking, securities lending is a stable and low profile activity. However, with the commencement of various short selling restrictions world-wide that were imposed in September, securities lending is front and center in the news given its role in facilitating short selling transactions.

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Short selling or “shorting” is an investment strategy that involves the practice of selling a financial instrument that the seller borrows first (does not own), and then purchasing it later to “cover the short.” The investor’s goal is to profit by purchasing the security at a lower price than the original sale price. In many cases, investors utilize shorting to hedge a related long position. Short selling is, however, only one reason that securities are borrowed in a securities lending transaction. Securities lending is utilized to support various trading strategies and facilitate trade settlements (see table 1 on the previous page).

Investors often wonder if lending securities helps short sellers drive down equity values. A variety of independent studies have been published on this issue, and the overwhelming conclusion is that short sellers tend to be contrarian in nature. Generally, studies have demonstrated that as equity prices rise, short activity increases. In fact, during the recent short selling ban in the United States, equity markets performed poorly (table 2) from the ban’s inception (September 19) to its removal on October 8; a clear indication that poor fundamentals, and not short selling in and of itself, drove down equity values. Ironically, investors who are often concerned about the effect short sellers have on the financial markets, and therefore may choose not to lend securities, often allocate assets to hedge funds and long/short mandates.

Table 2: US Equity performance—start to end of US short selling ban

S&P 500	-22%	Financials	-31%	Tech.	-22%
DJIA	-19%	Banks	-33%	Retail	-24%
Nasdaq	-23%	Brokers	-32%	Materials	-29%
NYSE	-23%	Cons. Discre.	-23%	Industrials	-23%

Source: J.P. Morgan

Additionally, regulators continue to regard short selling as a legitimate investment technique that contributes to price efficiency and liquidity. Christopher Cox, Chairman of the Securities and Exchange Commission (SEC), said on September 18, 2008, “Under normal market conditions, short selling contributes to price efficiency and adds liquidity to the markets.” On the same day, Hector Sants, CEO of the U.K. Financial Services Authority (FSA), stated that “short selling is still regarded as a legitimate

investment technique in normal market conditions.”

Furthermore, the SEC’s former Chief Economist and Director of the Office of Economic Analysis, Chester S. Splatt, said in 2007, “In my view, securities lending itself is important in our marketplace, because securities loans facilitate the short selling of assets, which in turn help protect investors against purchasing overpriced assets. Short selling can enhance market competition by allowing the pricing process to fully benefit from the insights of investors with negative as well as positive opinions.”

Despite the continued support for short selling by influential industry experts, even during these unprecedented market conditions, more than 20 of the world’s major securities markets outside of the U.S. still have temporary short selling restrictions in place. Most are expected to be removed by year-end, while the UK ban remains in force until January 16, 2009.

As market conditions improve and these bans are lifted, securities lending will continue to play an integral role in facilitating short selling.