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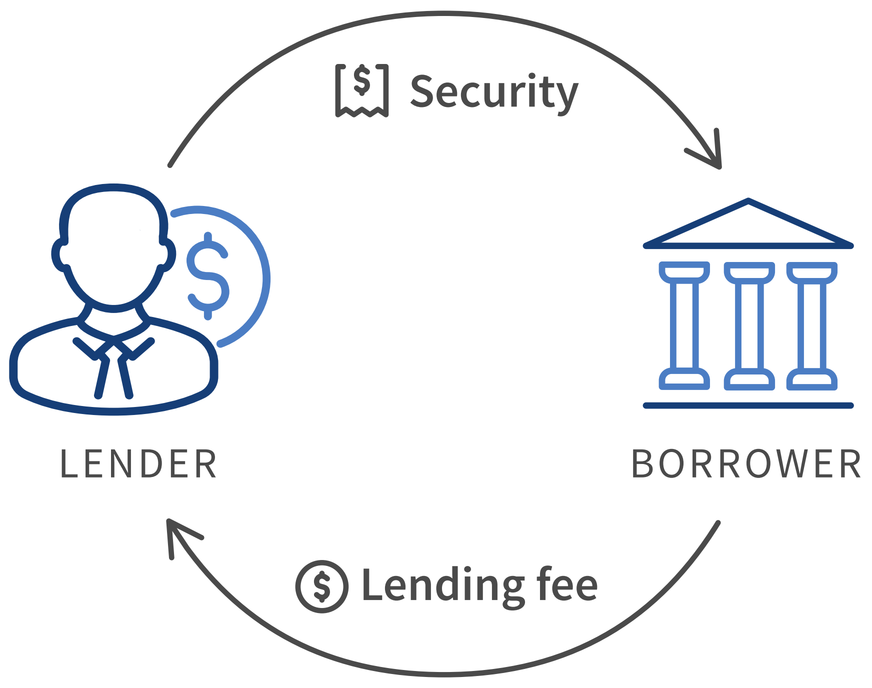
A simple guide to securities lending

What is securities lending?

Securities lending is the practice of lending out stocks, bonds and ETFs. Investors who lend their securities receive a fee from the borrower. Whilst your securities are out on loan, you are still exposed to price fluctuations and hence any share price appreciation. Equally, you are still exposed to losses which occur when the price of your security falls.



Securities lending has been utilised by investors since the 1960s to generate positive returns over and above the general performance of their portfolio. In theory, anyone who owns a security can lend it. In practice however, only a few investors have had the ability to lend their securities.

Why would you lend?

Securities lending is used to generate additional returns, over and above the returns generated by the general performance of your portfolio. What's more unlike renting out your car or your home, your security is over-insured (collateralised) against the risk of counterparty default.

Whilst your security is on loan, you still retain the right to elect on any relevant corporate events. Similarly, you still retain the right to receive all dividend entitlements on securities that are lent, however you forgo your right to vote at company meetings.

How does it work?

There are a few different routes to market for investors who are considering lending their securities.

DIRECT LENDING

This is how securities lending started, an investor lends their securities directly to a borrower. The benefit is you have complete control and transparency over your operation.

If you want to directly lend your securities, you need to establish your own securities lending operation. Consequently, this route is normally only viable for large financial institutions, due to economies of scale, high costs and required expertise.

LENDING VIA YOUR CUSTODIAN/BROKER

Some custodians and brokers offer their clients the ability to lend securities. If you lend through your custodian or broker, your programme will likely be structured in one of two ways. In a so called 'principal programme', the custodian or broker is the borrower and counterparty to your trade. In an 'agent lender' programme they help you to offer your securities to third party borrowers.

This route is normally only offered to large financial institutions, due to economies of scale associated with providing this service to large clients.

APPOINTING AN AGENT

When you lend through an agent you outsource your securities lending activities to a third party who specialises in securities lending. Since securities lending requires necessary infrastructure and expertise, many investors prefer to outsource to a specialist provider who will operate and manage your lending activity.

What are the risks?

Securities lending, involves a degree of risk. The risks set out below are nonexhaustive and are intended to be an illustration of the risks inherent in securities lending activities in general, and not necessarily for specific programmes:

BORROWER DEFAULT

As with any loan, the lender is exposed to the risk of default of the counterparty. Default events are, however, extremely rare in securities lending and should the borrower default, your loan should be covered by collateral.

Borrowers' capital strength and effective collateral management are essential to managing the risk of counterparty default.

OPERATIONAL RISK

Operational risks arise from failed and inadequate procedures, systems or policies. In the case of securities lending this may include, but is not limited to, errors in transactions between the Lending Agent and the borrower, errors and faults in transaction flows, faults in the IT platforms, etc.

Securities lending has benefitted greatly from the automation and standardisation of post-trade processes. Anyone considering securities lending should scrutinise the operational processes of any potential programme.

CASH COLLATERAL REINVESTMENT

Collateral is used in securities lending transactions as insurance for the lender, this collateral can be cash and non-cash. In some cases where cash is used as collateral, lenders and borrowers agree to re-invest the cash in other securities. Cash collateral reinvestment can increase risk, depending on the risk associated with the underlying cash reinvestments. Cash collateral reinvestment is an optional add on to securities lending, and participation in one does not imply participation in the other.

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