

STOCK LENDING AND REPO COMMITTEE

TUESDAY 11 JUNE 2002

MINUTES OF MEETING HELD

AT THE BANK OF ENGLAND

Present:	David Rule	Chairman
	Dagmar Banton	LSE
	Krystyna Beck	LIBA
	Andy Clayton	ISLA
	Toby Davies	CRESTCo
	Hugh Gibson	APACS
	Mark Hutchings	Intermediaries
	Jens Pöhland	The Bond Market Association
	Simon Hills	BBA
	Steve Russell	Intermediaries
	Alan Spargo	Intermediaries
	Steve Whiting	DMO
	John Serocold	LIBA
	Cameron Dunn	ERC
	Mark Wharton	FSA
	Graham Jones	ISLA
	John Rippon	Bank of England
	David Sheppard	Bank of England
	Jon Carr	Bank of England
	Will Parry	Bank of England
	Howard Jones	Bank of England
	Simon Ainsworth	Bank of England, Secretary

MINUTES OF MEETING HELD ON 12 MARCH

The minutes of the previous meeting were agreed. Previous meetings' minutes are available at: <http://www.bankofengland.co.uk/markets/slrc.htm>

CONTINGENCY PLANNING

1. Mr Parry explained that the public version of the financial continuity website had been launched by the Bank, FSA and HM Treasury on 29 April. It can be found at <http://www.financialsectorcontinuity.gov.uk/> Minutes of the SLRC, Money Market

Liaison Group (MMLG), FX Joint Standing Committee and Merlin group will be posted on the site.

2. Mr Parry informed the committee that the deadline for submission to the FSA of business continuity management matrices (designed to capture current best practice) was 31 July. The committee was also updated on the work of the Financial Sector Working Group.

3. Mr Rule stated that the MMLG had discussed market-wide contingency planning. It had decided that the MMLG itself could act as a contact group following a market-wide event and a separate operational sub-group was unnecessary. MMLG members had therefore exchanged contact details, including of contingency sites and these would be updated regularly. The MMLG meeting on 20 June would discuss whether more practical work could be done on market-wide contingency planning – one initiative already underway was a sub-group chaired by Richard Pattinson of Barclays (with Paul Mikhailoff from the Bank as secretary) considering the pros and cons of different rates to be paid/charged on unintended long/short balances following a market-wide event. Mr Rule asked the SLRC whether attendees thought that there was merit in exchanging contact details for contingency purposes. The consensus was that such an exchange was not necessary as members had the information through other channels.

4. Mr Hills noted that the BoE FX joint standing committee sub group was looking at establishing a disaster database that could be published on the BBA website in the event of a disaster. The BBA itself had gathered contact details of all its members that would be made available on its website in an emergency.

SHARHOLDER VOTING WORKING GROUP

5. A paper (attached at the end of the minutes) had been circulated to attendees ahead of the meeting. Mr Sheppard reported that the working group had been reconvened in February. Mr Rule asked attendees three questions.

- Does the SLRC remain of the view that stocks should be recalled to vote?

- If stock lending continued to grow and recalls of stocks to vote became more common, what would the market impact be ?
- Is there any need to introduce new procedures to smooth the recall process?

6. Ms Beck explained that most lending of equities was for delivery into the hands of purchasers, passing on instructions to vote therefore made no sense. The only way for lenders to retain voting rights was to recall stock. However, she did not think the market impact of higher recalls by UK institutional lenders would be damaging. If UK stock lenders recalled more frequently, overseas lenders would come into the market to take their place. Stocks might trade special, but this would attract other lenders into the market.

7. Mr Gibson agreed. He asked where the 7% figure (quoted in the paper) for lent stock came from, when most other sources put it at 1%. Mr Rule said that feedback from some custodians had suggested that particular stocks might have larger proportions on loan than average. Demand from hedge funds to finance short positions was said to be growing. Mr Davies agreed to look at CREST data to find out about the maximum proportions on loan for individual stocks as well as the average across all stocks.

8. Mr Rule said he would draft a letter prior to the SWVG, if possible backed up by Crest statistics, setting out the committee's thoughts on the subject, covering the following points:

- The committee was not opposed to initiatives to encourage more voting by institutional investors.
- If investors lend stock, they needed to recall it to vote. This was the only feasible mechanism consistent with a well functioning stock lending market.
- The committee did not expect any market disruption if recalls became more common.

9. On a related point Mr Davies informed the committee that from the end of the year, it would be possible to use the CREST system to submit electronic votes to registrars, eliminating the need for proxy forms.

STOCK BORROWING AND LENDING CODE: UK ANNEX

10. Mr Rippon said that the annex had been under preparation for some time. The key issue the annex had to deal with related to corporate actions, in particular dividend elections, with cash and scrip options. Some progress had been made by the London Stock Exchange amending its rules to reduce the deadlines for giving instructions on elections; and there had also been helpful developments in CREST functionality. The one key issue that still required resolution was that of unadvised returns of stock close to the election date. The SLRC Working Group thought the solution to this problem could be the introduction of a ‘callover period’, during which the borrower would have to notify the lender of the intention to return the stock and the lender would be entitled to decline the return. Reflecting in part changes in CREST functionality relating to corporate actions, it was envisaged that the callover period would be the day before the election/record date; and would begin at the start of the settlement in CREST and end at the end of the settlement day. This approach could be implemented if the legal agreements were modified; and it had been envisaged that this could also be underpinned by guidance in the annex and by the London Stock Exchange introducing a rule.

11. The London Stock Exchange has since considered the issues further and undertaken an informal consultation with some members. It was thought that it could well be problematic to introduce a rule that sought to override a term of the legal agreement. Some members thought that the lender should not have the option of declining a return of stock during the callover period, although Ms Beck asked why the lender should not be entitled to refuse the proposed return of stock. These points would need to be considered further in the SLRC Working Group; and the London Stock Exchange would consider further objections to introducing a rule.

12. Mr Clayton said that it would be possible to amend the legal agreements covering stock lending, however this would take considerable time to execute. Subsequently he felt that the most effective course of action would be for the London Stock Exchange to introduce a rule, given that the annex could only give guidance. On the practicalities, Mr Spargo replied that it was not currently possible to freeze a free-of-payment return. Mr Davies noted that it was not envisaged that functionality would be introduced to prevent a party returning stock. Mr Rule said that more thinking on these subjects was required.

MARKET ABUSE DIRECTIVE

13. Mr Wharton explained that while there was a lot of political pressure for the directive to be adopted, it looked like being delayed until the autumn. This was the first FSAP directive to be implemented since the Lamfalussy report. The directive is a so-called Level 1 'Framework' directive, and the Committee of European Securities Regulators (CESR) has been requested by the Commission to advise on Level 2 implementing measures which will flesh out the detail. The CESR paper provides the next effective way to influence the new legislation. In scope the directive will be similar to the current UK regime that it will cover exchange based markets and off-exchange transactions in exchange-traded instruments.

SLRC NETTING SUB-GROUP

14. Mr Jones informed the committee that the European legal opinions had had to be brought forward to take account of the EU insolvency directive. The exercise was now essentially complete and to timetable.

15. The new UK opinion had been received. It covered full enforceability and a separate schedule for additional counterparties.

16. Two recent overseas developments had taken place. First, the New Zealand (NZ) Personal Property Act had given statutory support to NZ legal opinions. Second, South African case law had put into doubt the outright transfer of title by appearing to re-characterise repo as a collateralised loan. The legal situation is now far from clear

and Mr Jones warned counterparties dealing in South Africa to exercise caution. Mr Pöhland asked about Greece. Mr Jones said that while repos were possible in Greece, there were differing opinions regarding the enforceability of netting provisions, similar to the previous problems in Italy.

UPDATE FROM CRESTCO

17. Mr Davies explained that in response to market requests, CREST had been seeking to improve its stock lending and DBV functionality. In doing so, CREST will provide stock loan valuations where requested and from July will be charging for doing so. Receivers of DBV will also be able to put bars on some individual stocks. CREST has offered to expand this service so that the receivers of stock can select stocks that they do not want to receive more actively. This will be both transparent and chargeable. The third enhancement allows counterparties to refuse suspended stocks automatically. Mr Jones asked whether it would be possible for the providers of stock to pledge initial collateral worth less than 100% of the loan. Mr Davies answered that it would.

CREST FAILURE: 18 APRIL 2002

18. On 18 April, the CREST DBV settlement cycle had to be abandoned, before all the day's trades had been settled, leading to a number of failed trades in the market. Attendees wanted clarification on the consensus rates to be charged on stranded long and short balances following the failure. Mr Rule explained the Bank of England's stance. On that occasion the Bank, following consultation with APACS, had decided that the high of the day (3 1/2%) would be charged on overdrafts with the Bank, with the low of the day paid on excess long balances (3 3/16%). The Bank had made this policy known to the settlement banks, and was happy for this approach to be promulgated more widely in the market. The actual rates that the banks charged or paid to their customers were of course for them to decide, however.

19. Mr Spargo said that this policy did not appear to be well known throughout the market, especially by some of the non-settlement banks. He believed that a number of repo participants had experienced significant losses. Mr Rule said that the minutes of

this meeting (and of the MMLG meeting on 20 June) would provide public statements of the approach that the Bank has taken.

20. CREST's communication was discussed. Some attendees felt that it had not been sufficiently proactive. Mr Davies emphasised that there had been a considerable amount of market communication on the day and reiterated that it had been the correct decision to suspend DBV.

ECB/CESR RECOMMENDATIONS ON SECURITIES SETTLEMENT SYSTEMS

21 Mr Sheppard reminded the committee that The International Organization of Securities Commissions (IOSCO) and the Committee on Payment and Settlement Systems (CPSS) of the central banks of the G10 countries had jointly issued 'Recommendations for Securities Settlement Systems' in 2001. One of the standards stated that securities lending and borrowing should be encouraged as a means of expediting settlement.

23. The European Central Bank and the Committee of European Securities Regulators are now seeking to apply the Recommendations in an EU context. Mr Sheppard reported that the Bank and FSA are participating in this work. The result may be a more detailed set of standards. As regards stock lending it seemed likely the standard will state only that a securities lending market should exist in each country rather than specifying how it is organised. The next meeting of the group was to be on 18 June and feedback would be provided at the next SLRC meeting.

UPDATE FROM THE BOND MARKET ASSOCIATION

24. Mr Pöhland updated the committee on various discussion topics from the Vienna repo conference. The annex to the Japanese opinion dealing with withholding tax was due to have been published by 14 June. In Spain revisions to the draft financial law have been made which strengthen the status of repo transactions. The Bond Market Association opinion exercise has been completed, though there remained outstanding issues with the Polish opinion.

VIENNA REPO CONFERENCE / BASLE 2

25. Mr Jones said that the general theme of the Vienna conference concerned the potential impact of Basle 2. Comments that the cost of capital could be increased by up to 6 or 7 times were mentioned in some of the sessions. Mr Jones wondered if there was more information available on the subject. Mr Pöhland stated that the TBMA had sent a letter to the Basle group, a copy of which is on the TBMA website: http://www.bondmarkets.com/regulatory/final_response.pdf.

26. Mr Rule asked whether a short note by the FSA or Bank summarising the current Basle 2 proposals regarding repo and stock lending would be helpful. Mr Clayton thought that it would.

27. Following the meeting, LIBA reported that a number of trade associations (including LIBA) had lobbied the relevant Basle committee subgroup (Credit risk mitigation Subgroup). The present position is that Basel is finalising its treatment of repo-style transactions, including conducting further data gathering exercises. The proposed framework will reflect the risk reduction benefits of global master netting agreements in the regulatory capital regime.

UPDATE FROM EUROPEAN REPO COUNCIL

28. Mr Dunn reported that the European Commission had published a consultation paper on clearing and settlement. It looked at ways to remove remaining barriers to cross border transactions. Responses were invited by 31 August. Mr Davies added that this followed on from the Giovanni report and mostly considers tax and regulatory issues.

29. Mr Dunn said that ISMA was conducting their third survey on the European repo market and encouraged all institutions to take part. Details could be found at <http://www.isma.org/surveys/repo.html>.

PRE-SETTLEMENT COLLATERAL

30. Mr Rippon reported that an institution had recently raised a concern about increased demands for pre-settlement collateral; this was seen as problematic in that it increased counterparty exposure and put pressures on limits. The institution had suggested that a possible solution was segregation of the collateral in a trust account; and it felt that a market-wide solution might be desirable with the segregation required to accord with FSA rules on client money or custody. Mr Rippon asked if others shared this concern or thought such a solution was desirable. Mr Russell said that there was nothing new in demands for pre-settlement collateral; and there was a ready-made market solution in triparty repo.

DIRECTORS FOR EUROPE AND MARKET OPERATIONS

31. Mr Carr reported to the committee that John Townend, the Bank's Director for Europe had retired. Bill Allen, who will be taking over from Paul Tucker, as the Bank's Deputy Director for Financial Stability, will also be the Director for Europe and will chair the City Euro Group. Mr Rule said that Paul Tucker had replaced Ian Plenderleith as the Bank's director responsible for Market Operations.

NEXT MEETING

32. The next meeting is scheduled for 10 September.

To: SLRC Members

VOTING ON LENT STOCK

Summary

1 The question of voting rights on lent stock remains an issue of concern to members of the Shareholder Voting Working Group (SVWG). It was raised at the SVWG meeting in February, and was discussed again its May meeting where the Bank suggested that the only practical solution to the problem was for the lender to recall the stock so that he can vote on it.

2 The Bank also said that it would raise the matter again with the Stock Lending and Repo Committee. In particular, the Bank would be interested to receive views on whether an increase in the amount of stock recalls could have an adverse effect on the operation of the stock lending market; and on whether there is any scope (or need) for changes in the existing procedures and documentation governing stock lending that could facilitate the recall process.

Detail

3 At the 15 February meeting of the SVWG, which the Bank attends, the potential loss of voting rights on lent stock was raised as a “major hurdle, particularly amongst custodians, as most master contracts governing lending effectively mean that lenders lose the right to vote”. The Group also felt that an issue to be addressed was “the expressed wish of lenders to retain voting rights on lent stock without the necessity of recall”. The Bank agreed to investigate the matter further.

What the existing stock lending documentation says

4 Paragraph 6.3 of the Global Markets Securities Lending Agreement (GMSLA) deals with the exercise of voting rights on lent stock:

'Where any voting rights fall to be exercised in relation to any Loaned Securities or Collateral, neither Borrower, in the case of Equivalent Securities, nor Lender, in the case of Equivalent Collateral, shall have any obligation to arrange for voting rights of that kind to be exercised in accordance with the instructions of the other party in relation to the Securities borrowed by it or transferred to it by way of Collateral, as the case may be, unless otherwise agreed between the Parties.'

So, unless otherwise agreed between the two parties, lenders cannot instruct borrowers on voting.

5 Paragraph 8.2 of the GMSLA covers the lender's right to terminate a loan/recall stock:

'Subject to paragraph 10 [set off] and the terms of the relevant Loan, Lender shall be entitled to terminate a Loan and to call for the redelivery of all or any Equivalent Securities at any time by giving notice on any Business Day of not less than the standard settlement time for such Equivalent Securities on the exchange or in the clearing organisation through which the Loaned Securities were originally delivered. Borrower shall redeliver such Equivalent Securities not later than the expiry of such notice in accordance with Lender's instructions.'

Paragraphs 9.1 to 9.4 go on deal with instances where there has been a failure to redeliver securities as instructed.

6 The Stock Borrowing and Lending Code (paragraphs 7.3 and 7.4) provides the clearest statement of the current practice:

'Stock lending involves the absolute transfer of title to both the securities lent and the collateral taken and any voting rights are transferred along with the title. Stock must therefore be recalled by the lender, or collateral substituted by the borrower, if they wish to exercise the voting rights attaching to particular securities. It is in the interests of both parties to a stock lending relationship to understand each other's attitudes to voting from the outset.'

and

‘Similarly, lenders need to be aware that, if they lend their entire holding of a particular stock, they may cease to receive information about corporate events in relation to it.’

7 The current approach to voting in the equity repo market is different to that for stock lending, in that the documentation (TBMA/ISMA GMRA 2000 Equities Annex and Equity Repo Code of Best Practice) specifically calls for the transferee to use best endeavours to ensure that it uses the voting rights on repo-ed stock in accordance with the wishes of the transferor. However, there have been discussions recently about the possibility of bringing the approach on voting in line with that in the GMSLA.

Views of stock lenders

8 There appears to be no support for changing the current arrangements and introducing measures whereby lenders retain the voting rights on lent stock. Settlement of UK equities within CREST now operates on a t+3 basis; and, generally speaking, sufficient notice is given of voting events for lenders to be able to recall stock in time. In addition, stock can be involved in complex transaction chains, involving further on-lending and possibly outright sale; it would be difficult to track and co-ordinate voting rights in circumstances where those rights remain with the original holder/lender.

9 While it is possible that stock recalls may pose problems when liquidity is tight and for instance the borrower has on-lent or sold outright the stock in question, such instances are reckoned to be the exception rather than the rule. In any stock recall, it is important to consider the lender/borrower relationship, and ideally, the reasons for a recall should be explained to the borrower.

10 Stock lending attracts fee income, and lenders need to weigh the cost to themselves or to their clients of losing this remuneration (by recalling the stock in question) against the perceived economic benefits of participating in a particular vote.

Scale of the problem

11 It had been thought that lent stock accounted for as little as 1% of the total market. More recent estimates put this figure at as much as 7%. However, the position varies very substantially as between different stocks. For some stocks, a lender may have lent out his total holdings, whereas some others may never be lent. Some borrowers seek specific stocks in particular circumstances; in others, borrowers will take a package of different stocks.

12 Some institutional investors complain that when voting on some corporate events/actions, they do not know whether they will be voting with their full stock holding or whether some or all of it has been lent out by the custodian/fund manager. This problem should be easily resolved: stock lenders should provide regularly updated information to those clients whose stock has been lent.

Issues for SLRC

13 On the assumption that SLRC remains firmly of the view that there should not be a change in practice (such that stock lenders retain the voting rights), the Bank would welcome views from members on:

- (a) whether there is more that could be done within the existing stock lending documentation to facilitate the process of stock recalls, and
- (b) what might be the effects of an increased rate of stock recalls on the stock lending market.