Current issues in securities lending

Mr Ian Plenderleith, Associate Director of the Bank responsible for markets, reviews[1] some current issues in securities lending generally, including the work of the Stock Borrowing and Lending Committee, which he chairs.

This talk first outlines why securities lending is an important component in the functioning of markets. It then describes briefly some of the work the Stock Borrowing and Lending Committee (SBLC)—a consultative body of practitioners which brings together representatives of borrowers, lenders, intermediaries, the regulatory authorities and the Inland Revenue as participating observers to discuss questions of general interest to the securities lending industry—has been undertaking in order to improve the contribution that securities lending can make to the functioning of markets. Finally, the talk seeks to draw out some of the major issues facing the securities lending industry, as an agenda of the kind of challenges that may need to be faced in the next few years.

Importance of securities lending

First, at the most fundamental level, securities lending clearly has a critical part to play in ensuring timely settlement of deals. That delays in settlement will occur from time to time is an inevitable part of the logistics of any market. The ability to borrow securities ensures that delays in one leg of the settlement process are not willy-nilly passed on to every subsequent stage. This was the original function of securities lending and has long been recognised as an essential part of the settlement process. By facilitating timely settlement, securities lending helps to improve the safety of the markets, saves costs and ultimately enhances investor protection.

Secondly, securities lending has, in modern markets, come to have a critical role to play in enhancing liquidity. Particularly in the structure of markets we have here in London—quote-driven markets in which liquidity derives from committed market makers, ready to make continuous firm two-way prices—the liquidity of the market is dependent upon the ability of market makers to run positions in both directions—bull and bear; and bear positions can only be run if the securities in question can be borrowed. Realistically, moreover, the market-making structure only delivers genuinely liquid markets if the market maker can be confident of borrowing the securities he needs at short notice, in size, on reasonable terms and through a mechanism that he can rely upon to work. Liquidity is dependent not just upon the sporadic ability to borrow securities, but upon a fully-fledged smoothly operating and reliable system for borrowing securities.

Thirdly, securities lending not only helps market makers to provide liquidity, but also materially helps borrowers and investors to improve their performance. The essential purpose of securities markets is to channel savings into investment by bringing together lenders who have funds to invest and borrowers who need to raise finance. Securities lending, by enhancing the liquidity of the market, can offer borrowers the opportunity to raise funds on finer terms. Equally, the heightened liquidity which stock lending fosters can materially assist investors, by reducing the price risks they face in placing funds in the market and by increasing their return through the fees they can earn for lending securities on top of the underlying return they earn on the investment itself. So securities lending is important not only to the market makers who make the market, but also to borrowers and investors who use it.

Fourthly, because securities lending has such a significant part to play in enhancing the liquidity of the market, it is important to London's role as an international financial centre. London has pre-eminent strengths in a whole variety of areas which taken together underlie its role as a major world financial centre. But one of its distinctive strengths has always been skill and versatility in intermediation. Securities lending is, par excellence, a fertile field for intermediation through the activities of the money brokers and other intermediaries in servicing lenders and borrowers, through the dealers who are frequently themselves both borrowers and lenders, and through the services provided by banks as custodians and paying and collecting agents. The distinctive skills which these players have demonstrated in securities lending in the London markets has made London the indisputable international centre for securities lending and borrowing, and this is a not insignificant contribution to the City's international role and its overseas earnings.

To recap, then, securities lending is important, first for the contribution it makes to timely settlement; secondly, for the enhancement it brings to the liquidity of markets; thirdly, for the assistance it provides to borrowers, in raising funds

(1) In an extract from a speech to a conference on securities lending, 15 February 1991.

on fine terms, and to lenders, in maximising the return on their investments; and fourthly, for the contribution it makes to London's position as an international financial centre.

These are not inconsiderable benefits. But—and this is an important caveat—these benefits are not costless. If securities lending is to deliver these benefits, it has to be conducted with proper regard to certain disciplines and safeguards.

What sort of standards are necessary? Essentially, there are three. First, securities lending takes place in order to improve the functioning of markets. Markets evolve, or are designed, with certain well-established structures. Securities lending must respect and enhance those structures, not undermine them. Thus, in London, for domestic equities and gilt-edged stock, securities can only be lent to market-makers, because the structure of the markets in London is one in which liquidity is provided by committed market-makers, and to enable them to take on that obligation, which benefits all users of the market, they need facilities like securities borrowing; and it would undermine their ability to maintain their market-making commitment if competitors undertaking no such commitment had equal access to the facility of securities borrowing. What is sometimes superficially criticised as a restriction is in fact an important ingredient in making the market structure work. So securities lending has to be organised in a way that respects market structures.

That is one area where there are standards that securities lending has to observe. A second area is prudential standards, where it is critical that those engaged in securities lending have adequate capital to cover the risks they undertake, that the lending of securities is properly secured by adequate collateral, and that the conduct of the business observes prudent standards and safeguards, with the responsibilities of all parties clearly understood and agreed. Through capital adequacy requirements and through conduct of business rules the regulatory authorities have developed a prudential framework that works well and ensures that the inherent risks are identified, controlled and covered. What might to the idle spectator seem restrictive requirements are in fact essential if the business is to be conducted safely and reliably: the problems that can arise if best prudential standards are not observed has been illustrated in recent experience outside the United Kingdom. Thus a second requirement for securities lending is that it be conducted to proper prudential standards.

A third requirement relates to the tax field. Because securities pay interest or dividends, and because securities lending typically entails the so-called manufacture of dividends to compensate the lender—but also for other reasons—there is inevitably scope within the course of perfectly normal securities lending activity for tax flows *inadvertently* to be altered. The qualification 'inadvertently' is deliberate, because it is not generally the intention of participants in securities lending to alter the incidence of tax. But since it can—inadvertently—happen, it is understandable, and entirely proper, that the tax authorities wish to ensure that the Exchequer does not lose tax revenue as a result of securities lending. Nor should it: there is no obvious reason why securities lending should attract any form of tax subsidy nor do those involved in securities lending in fact seek any such subvention. So tax authorities necessarily have to set rules as a safeguard against loss of tax, and the third requirement for securities lending—besides respecting market structures, and observing proper prudential standards—is thus that it be conducted in a way that does not involve loss of tax revenue. This is a perfectly straightforward technical requirement and need not be a particularly complicated one to meet.

The work of the Stock Borrowing and Lending Committee

The Committee is a relatively new arrival on the scene. It has been in existence for less than a year. In this brief span, it has addressed a variety of issues. What follows outlines specifically its work in one important area—in relation to the tax arrangements governing securities lending.

In the tax field, the issues facing the Committee have been very much those touched on above in discussing safeguards. Essentially, the questions the Committee has been addressing are concerned with how to strike a balance between, on the one hand, the need for securities lending to be able to function freely and effectively without unnecessary restrictions and, on the other hand, the legitimate interest of the tax authorities in ensuring that the business does not open the way for unintended loss of tax revenue.

The Committee initially addressed a couple of areas where well-established market practice appeared not to be fully covered by the tax legislative framework—lending of gilt-edged stocks to redemption, and the replacement of borrowed securities, when recalled by the lender, by borrowing from alternative sources. Having established that neither practice appeared to be objectionable *per se*, advice was sought from the Inland Revenue as to how the situation could be regularised. The outcome was the granting of specific extra-statutory concessions, subject to certain administrative safeguards.

Having resolved these immediate priorities, the Committee then addressed the tax treatment of lending of overseas securities, and specifically the tax treatment of dividends manufactured in that process. The Committee felt that to be a particularly important area, because it is a key area of growth. Lending of both gilts and domestic equities has expanded over the past few years, but it is in the area of trading, and hence borrowing and lending, *overseas* securities that London has seen the biggest expansion since Big Bang: it is one more way in which London's international pre-eminence continues to grow apace.

The Committee quickly identified a number of objectives. It was considered important that UK custodians and paying agents be able to handle lending of overseas securities, because this is an area where London's strength in intermediation needs to be allowed full rein. Equally, to encourage the business to grow, there are strong arguments for extending the range of borrowers who can borrow overseas securities, essentially to allow anyone to engage in borrowing overseas securities provided they operate tax arrangements satisfactory to the Inland Revenue. And to enable lending to keep pace with the demand from borrowers, the Committee recognised the need to allow more extended chains of on-lending than are possible under the present three-party rule. But to facilitate an expansion of activity by these means, and to ensure that it can pass through UK hands in the form of UK custodians, the Committee needed to come up with workable safeguards which would ensure that tax on manufactured dividends was satisfactorily accounted for.

This has now been achieved in relation to overseas securities lent by *UK lenders*, through new accounting arrangements which provide for a pool of participants to be set up who are prepared to account to the Revenue for tax on their manufactured dividends. Pool participants may, subject to their meeting certain conditions, act as borrowers, lenders or intermediaries. Lenders of overseas securities on which the real dividend would have been received under deduction of UK tax are now able to lend their securities, provided that they are lent either to a pool participant or on the basis that the manufactured dividend is received by a pool participant or collecting agent who will account for tax to the Revenue. Lending is also permitted where the real dividend would have been received in gross form. Market firms have been invited to apply for listing as pool participants or collecting agents and a significant number have taken on that function. These new arrangements enabled the Inland Revenue to introduce an amendment to the stock lending regulations to allow overseas securities held with UK custodians or paying agents to be lent provided that the new accounting arrangements for pool participants were operated. These amending regulations came into effect on 7 January and are working satisfactorily.

The Committee has since then turned to the potentially more difficult area of overseas securities being lent by *overseas* lenders. These discussions are still in progress. The complexities are not inconsiderable, and it is too early to try to specify the likely outcome. But the discussions are making progress and the Committee appears to be close to identifying a way forward that should satisfactorily serve the needs of the industry.

The Committee has also, in its agenda of tax issues, addressed the question of the appropriate treatment, for lending purposes, of ADRs; and of how far market makers in derivatives and convertibles, etc should be able to borrow securities. These are questions with an important bearing on market structure and the Committee has accordingly opened up a dialogue with the Stock Exchange, which is represented at senior level on the Committee. In addition, the Committee has considered various other current topics, including the effect of TAURUS on stock lending, the VAT treatment of stock lending, the SIB's consultative paper on lending by unit trusts and a code of practice for stock lending. Work is also in hand to review the impact of daylight exposure on stock lending.

Future issues

To conclude this analysis, it seems appropriate to offer a few suggestions about issues that seem likely to face the industry in the future.

First, there appears every prospect that the industry will continue to exhibit the three prime characteristics of a healthy market—growth, innovation and competition. There is undoubtedly great potential for growth in securities lending, particularly in relation to overseas securities. Equally, there are grounds for confidence that participants will continue to demonstrate innovation in meeting the needs of the market. And it seems also very likely that intense competition among participants will continue to be a factor in the market, as it should be to stimulate efficiency and to minimise costs.

Secondly, the advent of TAURUS and of rolling settlement will have implications both for the type of lending required and, possibly, for the way that lending is organised. This is one question to which the SBLC will need to return. The possibility of delivery against payment offers particular benefits to the industry.

Thirdly, the role of intermediaries may evolve. In the domestic area there has already been debate about the merits or otherwise of direct lending, without the intermediation of the Stock Exchange money brokers. Interestingly, in the field of overseas securities, where direct lending is already possible, the role of intermediaries seems likely if anything to expand as the demand for stock to borrow increases, enhancing the contribution that brokers and finders can make.

But fourthly, whatever changes come to pass, it will remain important that if the industry is to thrive, it will need to maintain proper arrangements in three critical areas—consistency with the structure of the markets it is serving, proper arrangements for prudential standards, and due regard to tax safeguards. If these basic requirements are given adequate attention, there is considerable scope for the industry to expand further.