Securities lending

Securities lending is an area of activity which has grown substantially in London in recent years as the London securities markets, and particularly trading in London in international securities, have expanded. The article below describes the development of gilt-edged stock lending and the role of the Stock Exchange money brokers since Big Bang, and presents some statistics (not previously published) on the scale of gilt-edged lending. It is followed by an extract from a recent speech by Ian Plenderleith, Associate Director of the Bank responsible for markets, reviewing some current issues in securities lending generally, including the work of the Stock Borrowing and Lending Committee which he chairs.

Gilt-edged stock lending since Big Bang

Previous articles on the gilt-edged market[1] have briefly described the role of the Stock Exchange money brokers (SEMBs). This article describes more fully the development of gilt-edged stock lending and the role of the SEMBs in the gilt-edged market structure which has been in place since Big Bang, and presents some statistics on the scale of gilt-edged stock lending.

The key feature of the market structure is that gilt-edged market makers (GEMMs) stand ready to make continuous two-way prices, at which they are prepared to trade in all conditions, whether or not they hold sufficient stock to cover a sale. If GEMMs are to meet this commitment, they need to be able both to borrow stock to be sure that they can complete their sales and to have access to an assured source of funding to finance their bull positions. Both of these services are provided by specialist intermediaries—the SEMBs. They borrow stock to meet the GEMMs' needs from approved lenders, which are mostly large investment institutions, while they service the GEMMs' needs for money from funds which they have taken on deposit or as collateral from other market makers or which they have borrowed from the discount market or from banks.

The stock loans are subject to a standard legal agreement which commits the SEMB to return equivalent securities, together with any interest payment which would otherwise have been due to the lender, and to pay the gilt lender a fee for lending its securities. Under the agreement the lender will be secured during the loan by collateral[2] which typically has a value slightly in excess of the stock loan, so that in the unlikely event of a failure to return the stock the lender could purchase equivalent stock by selling the security held as collateral. In addition the lender has the assurance that its anonymity as regards the GEMM is protected throughout the loan because it deals with the SEMB as principal; the GEMM has no knowledge of the identity of the ultimate lender. Gilt lending therefore allows a holder of gilt-edged securities to lend securities to a SEMB on a temporary and secured basis while still receiving the interest on the stock lent, thus improving the lending institution's return.

These arrangements for gilt lending are long established; they evolved in the market structure operating before Big Bang when there was a separation of functions in the market between jobbers and brokers. Borrowing was restricted to the jobbers, who had the same need as the current GEMMs to borrow stock to cover sales and to borrow money to finance their bull positions. Their borrowing was restricted to the SEMBs, which matched the stock borrowing needs of the jobbers to the stock made available for lending by approved lenders, and which serviced the money needs of the jobbers against the security of their bull positions. Both the SEMBs and the jobbers were Stock Exchange Members subject to Stock Exchange Rules and Regulations for the conduct of this business, and over time the system was found to provide an efficient and well-regulated means of servicing the jobbers' requirements.

At the time of Big Bang, when a new market-making structure was set in place for the gilt market, it was clear that there would be a continuing and increased requirement for

(1) 'The gilt-edged market since Big Bang' in the February 1989 *Bulletin*, pages 49–58, 'The gilt-edged market: developments in market making in 1989', in the February 1990 *Bulletin*, pages 68–70 and 'The gilt-edged market: developments in 1990', in the February 1991 *Bulletin*, pages 49–52.

(2) The word 'collateral' throughout this article reflects market terminology; legally, security is provided by a transfer of ownership which mirrors that involved in the stock loan.

stock borrowing facilities for an increased number of market makers. The Bank attached importance to the development of an efficient and competitive market in stock lending to meet the needs of the GEMMs. But it was also concerned that the market should operate within an appropriate regulatory framework in order to avoid problems such as had emerged outside the United Kingdom at that time. It therefore saw considerable benefit in building on the existing borrowing and lending system since this offered the prospect of providing an efficient service and could effectively be regulated through the oversight of the SEMBs. Moreover, the introduction of the Central Gilts Office (CGO) book-entry settlement system provided an opportunity to improve the efficiency and security of the existing arrangements for gilt lending for all parties. Stock lent in CGO moves against an assured payment, thereby providing immediate collateral to the lender and eliminating its daylight exposure to the borrower.

The Bank therefore sought applications from firms which wished to take advantage of the opportunities provided by the change in the structure of the market to become SEMBs servicing the GEMMs' stock and money needs. The Bank took on the role of supervising the SEMBs (as it did for the GEMMs).[1] Although the key obligation of the SEMBs was, and is, to provide a service to GEMMs in gilt-edged stock, SEMBs were permitted to provide a similar service in domestic equities to the equity market makers and to approved borrowers wishing to borrow international securities. In 1986 the existing six SEMBs applied to continue to operate as Stock Exchange money brokers under Bank of England supervision and three new firms joined the market. A further SEMB joined the market in 1988 and one firm has since left the market, leaving 9 SEMBs currently operating under the supervision of the Bank of England and the Securities and Futures Authority.[2]

The mechanics of gilt lending through CGO are relatively straightforward. The GEMM will apply to the SEMB to borrow whatever securities it needs to cover outstanding sales, either on a renewable overnight basis, until it can cover its sale, or for a fixed term. The SEMB will then negotiate a price with a lender which has the stock and agree on the type of collateral that the lender requires to secure its overnight exposure. The lender will then release the stock to the SEMB through CGO against an assured payment equal to the value of the security, as collateral, and the SEMB will release the security to the GEMM on the same day against the receipt of an equivalent assured payment. Later in the day the lender's assured payment will be replaced by equivalent security, normally either gilt collateral delivered through the mechanism of DBV (Delivery by Value)[3] in the CGO, or 'physical' collateral such as certificates of deposit delivered physically or through the CMO book-entry settlement system for sterling money-market instruments. The SEMB will obtain this equivalent security either from a GEMM, which borrows money from the SEMB on a secured basis, or alternatively, if the GEMM leaves money with the SEMB, by placing funds in the discount market against collateral acceptable to the lender. On the following day the DBV will be reversed automatically by the CGO system and, unless the loan is repaid, the lender will again be secured by an assured payment until the end of the day. (The attached diagrams show the flows in the simplest type of loans; the flows can be considerably more complex if the lender takes a mixture of collateral and its stock is lent to several GEMMs.)

The move to use of the CGO system, in which nearly all major institutions now hold their gilts, has encouraged the growth in the number of investment institutions wishing to take advantage of gilt lending to improve the return on their gilt portfolio. Since Big Bang there has been a substantial and continuing increase in the number of approved lenders and consequently the amount of stock available for lending has grown. An institution wishing to make available part or all of its gilts portfolio for lending need only establish a relationship with a SEMB. The SEMB then seeks authority from the Bank of England for the lender to be approved by the Bank and the Inland Revenue to lend stock to that SEMB.

In practice both institutions and GEMMs have found that the system of gilt lending has worked well, serving the GEMMs' needs for a reliable and efficient stock borrowing system for most stocks, with the only shortages occurring in some of the smaller, less liquid, issues which will always be difficult to borrow under any system. Technically the use of the CGO has meant that the system has worked smoothly and there have been no significant difficulties in its day-to-day operation. This has provided the GEMMs with the confidence to increase borrowing significantly since Big Bang, as is demonstrated in the table which shows that gilt lending increased from around £2 billion at the time of Big Bang to a level of £5-6 billion in 1990. The gradual increase in the amount of lending reflects not only the level of turnover in the market but also the increase in the GEMMs' arbitrage positions and in the level of positions taken to hedge their risks. As such there is significant variation from month to month as is demonstrated by the statistics.

There is no shortage of stock available for lending, and this increase in supply since Big Bang and the increase in the number of SEMBs has resulted in increased competition among SEMBs and lenders for the available business and consequently a reduction in the level of fees charged. It has also led to development of flexibility in charging for the loan according to its nature so that charges may vary with the size, the term of the loan and, occasionally, the particular stock being borrowed. Despite the reduction of charges, SEMBs have over the period been able to earn a positive return on this business, although this reflects the complete

(1) The basic requirements to be met by SEMBs are laid down in The 'Blue Paper' published by the Bank of England in 1985—'The future structure of the gilt-edged market' (reproduced in the June 1985 *Bulletin*, pages 250–82).
(2) The full list of SEMBs is shown in the Appendix.
(3) DBV is a feature of the CGO system whereby the system automatically selects stock from a member's account to a value equivalent to the collateral required and delivers it to the appropriate account.

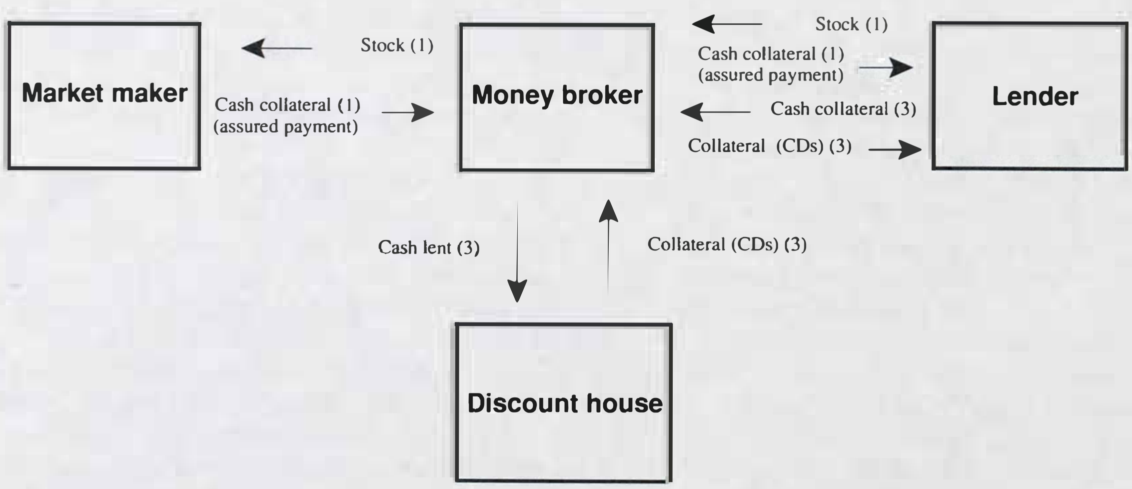
Flows in CGO associated with initial stock loan

(1) The lender lends stock to the SEMB, who on-lends to the GEMM; both transactions pass through CGO against an assured payment.

Initial stock loan and replacement of collateral by DBV

(2) The GEMM borrows back the cash collateral left with the SEMB during the day against a delivery of DBV collateral; the lender requests DBV collateral from the SEMB to be held overnight.

Initial stock loan and replacement of collateral by CDs



(3) The GEMM does not borrow back the cash collateral and the SEMB places it in the discount market to obtain the CDs which the lender requires as collateral.

Gilt-edged stock lending since Big Bang

£ millions

1986/87		1988		1989		1990	
31 Oct. 86	2,182	4 Jan. 88	3,400	9 Jan. 89	3,612	8 Jan. 90	5,260
28 Nov. 86	2,590	18 Jan. 88	3,460	23 Jan. 89	3,542	22 Jan. 90	5,753
24 Dec. 86	2,784	1 Feb. 88	2,973	6 Feb. 89	3,790	5 Feb. 90	6,102
30 Jan. 87	2,718	15 Feb. 88	3,718	20 Feb. 89	4,125	19 Feb. 90	6,064
27 Feb. 87	2,771	29 Feb. 88	4,085	6 Mar. 89	4,303	5 Mar. 90	5,981
27 Mar. 87	3,870	14 Mar. 88	4,470	20 Mar. 89	4,192	19 Mar. 90	5,645
24 Apr. 87	3,030	28 Mar. 88	4,063	10 Apr. 89	4,335	2 Apr. 90	5,645
29 May 87	3,306	18 Apr. 88	4,255	24 Apr. 89	4,438	17 Apr. 90	5,451
26 June 87	3,339	6 May 88	4,946	15 May 89	3,956	8 May 90	5,280
24 July 87	3,208	16 May 88	4,544	2 June 89	4,770	21 May 90	5,148
3 Aug. 87	2,975	31 May 88	5,010	12 June 89	4,132	4 June 90	4,952
17 Aug. 87	3,155	13 June 88	4,906	26 June 89	4,267	18 June 90	4,847
1 Sept. 87	2,824	27 June 88	4,943	10 July 89	4,469	2 July 90	5,068
21 Sept. 87	3,454	11 July 88	5,282	24 July 89	4,343	16 July 90	5,189
5 Oct. 87	3,452	25 July 88	5,628	7 Aug. 89	4,238	30 July 90	5,366
19 Oct. 87	3,731	8 Aug. 88	5,197	21 Aug. 89	4,423	13 Aug. 90	5,268
2 Nov. 87	3,891	22 Aug. 88	5,247	11 Sept. 89	4,345	28 Aug. 90	5,485
16 Nov. 87	4,067	12 Sept. 88	5,473	25 Sept. 89	4,170	17 Sept. 90	5,505
30 Nov. 87	3,580	26 Sept. 88	5,300	9 Oct. 89	4,594	1 Oct. 90	5,434
14 Dec. 87	3,862	10 Oct. 88	5,322	23 Oct. 89	4,406	15 Oct. 90	5,938
		24 Oct. 88	5,136	6 Nov. 89	4,544	29 Oct. 90	5,297
		7 Nov. 88	5,113	20 Nov. 89	4,638	12 Nov. 90	5,599
		21 Nov. 88	4,921	4 Dec. 89	4,860	26 Nov. 90	5,992
		5 Dec. 88	4,722	18 Dec. 89	4,975	17 Dec. 90	5,554
		19 Dec. 88	4,074				

Note: Prior to July 87 figures represent the value of gilt-edged lending outstanding on the last Friday of the month. After July 87 they represent the value of lending outstanding on each Stock Exchange account day.

service provided to the market makers and not simply the lending of gilts. More significantly for London, the successful operation of stock lending in the gilt market has provided a sound basis from which lenders and SEMBs could diversify into equity lending and into international lending, which operate somewhat differently, and hence has provided the basis for London's continuing growth as the pre-eminent centre for international stock lending.

Appendix

Stock Exchange money brokers

As at 31 March 1991

Cazenove Money Brokers

James Capel Moneybroking Limited

King & Shaxson Money Brokers Limited

Lazard Money Broking Limited

Lehman Brothers Gilts Money Brokers Limited[a]

LM (Moneybrokers) Limited

Prudential-Bache Capital Funding (Money Brokers) Ltd

Rowe & Pitman Money Broking Ltd

Sheppards Moneybrokers Limited

Withdrawn since Big Bang

Hoare Govett (Moneybroking) Limited

(a) Joined since Big Bang.