Safeguards for securities lending

In this extract from a recent speech,[1] Mr Ian Plenderleith, Associate Director of the Bank responsible for market operations, describes the framework of safeguards which apply to securities lending as conducted by professional market participants. Mr Plenderleith chairs the Stock Borrowing and Lending Committee, a consultative body of participants in the securities lending market.

Securities lending is important, first for the contribution it makes to timely settlement; second, for the enhancement it brings to the liquidity of markets; third, for the assistance it provides to borrowers, in raising funds 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 and particularly as the pre-eminent world centre for international equities trading.

Safeguards

These are considerable benefits. But they are not costless. If securities lending is to deliver these benefits, it has to be conducted with proper regard to certain disciplines and safeguards. If I can try an analogy, securities lending is a little like electricity: largely unseen, it can deliver great benefits, but only provided it is delivered in a way that observes certain safeguards and meets certain standards. Otherwise, if standards are not observed, it can deliver a shock—both to the users and to the innocent bystander. Hence electrical installations have to meet industry-wide safety standards and so must securities lending. Like any investment activity, it has to be operated within a proper framework of controls which clearly lay down who has authority to dispose of, or lend, securities and in what circumstances and within what limitations.

What sort of standards are necessary for securities lending? Essentially, I have in mind three: regulation and prudential standards; the support of market structures; and proper accounting for tax.

First—and perhaps most importantly, in view of recent developments which have provoked interest in securities lending, though these developments appear to have very little to do with the professional securities lending activity which is a long-established feature of the securities markets —securities lending has to observe high prudential standards and a clear framework of rules and legal responsibilities; the *regulatory framework* is critical to its success. This regulatory framework has a number of different elements. It rests on a foundation of bilateral legal agreements signed between each pair of counterparties—whether borrower, intermediary or lender—which set out on a binding contractual basis the terms on which the two parties deal with each other. These agreements incorporate a range of commercial and operational safeguards which are a normal and integral feature of the business, designed, for example, to ensure that the lending of securities is properly secured by adequate collateral, including agreed margins; that loans are regularly marked to market and that collateral and margin are adjusted accordingly; that agents or managers engaged in securities lending are properly authorised to do so by their principals and trustees; and that the responsibilities of all parties are clearly understood and agreed. But all participants, as a matter of prudent commercial practice, need to carry out credit assessment of their counterparties.

Besides these legal agreements, many aspects of securities lending are also governed by industry-wide rules, agreed practices and regulations—eg the rules and regulations of the London Stock Exchange, which govern activity undertaken by members of the Exchange, the conduct of business rules of the various UK regulatory authorities, and tax legislation in the United Kingdom and in overseas countries which sets down conditions that participants have to meet if they are to receive the tax treatment they need for the activity to be commercially viable. Moreover, although there is no single regulator for stock lending as a whole, many of the participants are supervised by one of the regulatory authorities in respect of the prudential standards they are required to maintain and the business standards they must observe. The regulators will require that participants maintain adequate capital to cover the risks they undertake.

The *second* requirement relates to the *structure of markets*. 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 the ability to borrow securities to cover bear positions so that they can quote continuous,

(1) To a conference on international stock lending on 30 January 1992.

two-way prices. 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.

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—but also for other reasons— tax authorities necessarily have to set rules as a safeguard against loss of tax and to ensure that securities lending is conducted within an appropriate tax framework. Securities lending needs to be conducted in conformity with these rules.

Through these various safeguards, the industry and the regulatory authorities have developed a framework for securities lending that works well and ensures that the inherent risks are identified, controlled and covered. No amount of safeguards— in securities lending or in any other area of activity— can, of course, protect against a breakdown of managerial control or failure to observe authorisation within an organisation. But it is evident throughout our discussions in the Stock Borrowing and Lending Committee that the regular participants in the securities lending market are totally committed to maintaining and observing these safeguards at the highest professional standard. That is an important reason why professionally-conducted securities lending has been able to contribute so beneficially to enhancing liquidity in the securities markets.