

# Equity Finance Explained

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## Securities Lending Explained

### Development of Securities lending

Securities lending initially developed as a way of reducing costs resulting from failed deliveries and was often arranged on an informal basis between broker/dealers.

Today, the practice bears little resemblance to its origins and, in recent years, has attained greater visibility emerging as an increasingly vital component of the domestic and international securities markets. The steady growth of securities lending is a result of its pivotal role; improving efficiency, enhancing the liquidity of securities markets and supporting sophisticated trading and arbitrage strategies.

### What is Securities lending? – A definition

Securities lending is the loan of a security from a lender, often an institutional investor such as a pension fund or fund manager, to a borrower, usually a broker/dealer who requires the securities to support various trading activities.

The security is exchanged for collateral of an agreed type, for an agreed value plus margin. Loans are typically arranged on an open basis, meaning that there is an implicit agreement to return the security at a future undetermined date.

The borrower pays a fee for the loan to the lender, and for the period of the loan the lender retains all the benefits of ownership of the loaned security except the right to vote.

### Increase in demand

The growth of securities lending is attributable to various factors relating to the development of the securities markets. These include:

- Drive for efficiency in global securities markets;
- Deregulation and the removal of barriers to short selling;
- Increasing use of derivatives and hedging techniques;
- Enhanced yield opportunities;
- Internationally accepted standard documentation; and
- Need for alternative financing techniques.

### Increase in supply

The volume of securities available to lend has increased with the rise in cross-border investment and deregulation. Additionally, institutional investors recognise the inherent value of their portfolios and incorporate lending into their strategies as a means to increase the yield on their investments through the generation of stock loan fees and cash reinvestment income.

One impetus for growth in the securities lending market is the acceptance on the part of legislators of the advantages of securities lending. Legal and tax barriers which previously impeded borrowing in certain markets are now being reformed as regulators recognise that securities lending plays a key role in improving market liquidity and efficiency.

The importance of securities lending has been recognised in the recommendations of The Group of Thirty. This industry body, comprising leading representatives from the banking, corporate and academic sectors, published a set of nine

recommendations in 1989 designed as a blueprint to improve the efficiency of settlement and clearing systems around the world. Specifically, Recommendation Eight of the Revised Recommendations in 1995, advocated that:

"Securities lending and borrowing should be encouraged as a method of expediting the settlement of securities transactions. Existing regulatory and taxation barriers that inhibit the practice of lending and borrowing securities should be removed."

More recently, the ISSA (International Securities Services Association) recommendations of May 2000 promoted "the minimization of funding and liquidity constraints by enabling stock lending and borrowing." Recommendation Five specifically addressed the risk of loss, which can be the result of a "failure of a counterpart to pay or deliver or a delay in settlement." They concluded that a solution to stemming this risk is "easier access to stock borrowing."

## Why lend securities

Natural lenders of securities are institutional investors with long term holdings typically pension funds, insurance companies, mutual funds, fund managers, large corporations, banks, custodians and brokers.

Securities lending enables institutional investors to:

- Increase the yield on their portfolios through generation of stock loan fees;
- Finance long positions, often more cheaply than they otherwise could;
- Offset administrative costs, such as custody fees; and
- Where permissible, maximise opportunities to leverage their portfolios

## Global Markets – who are the borrowers?

The major borrowers include broker-dealers, hedge funds and financial intermediaries. Nomura has always been well known as a proprietary trading house, but in the past two years we have been quickly building a very strong global customer filtration business to better compliment our global institutions and Japanese retail customer base.

### 1. **Borrowing to cover proprietary short positions**

Securities lending provides additional liquidity to the cash market and thus allows a borrower to sell short without taking a corresponding long position. Consequently, securities lending plays an important role in facilitating arbitrage strategies, derivative trading and convertible bond and warrant arbitrage.

Nomura's proprietary demand generates a consistent broad-based borrowing requirement in global markets as a result of trading the various strategies we have outlined.

### 2. **Financing inventory/Collateral Trading**

The need to fund positions and manage the balance sheet also generates securities lending and repo activity in world securities markets.

### 3. **Synthetic Prime Brokerage**

A specialized brokerage service for clients who need non-standard services. Such service consists of clearing, custody, Equity Finance and financing arrangements.

## Revenue

A well managed securities lending programme can generate incremental returns within pre-established risk parameters. It can provide additional yield and therefore enhance the performance of a portfolio of investments. Many fund managers now regard securities lending as an essential tool in portfolio management.

Securities lending revenue is largely a function of the liquidity it provides. If a sizeable supply of stock is available to securities houses, broker/dealers and hedge funds, they are consequently able to execute their trading and arbitrage strategies. Alternatively, if there is only minimal supply, it will not be cost-efficient to develop, execute and monitor a particular strategy. Adequate supply encourages proprietary traders to implement their strategies and thus provides returns for lenders.

The collateral flexibility a lender can offer a borrower is a key factor in enhancing revenue from securities lending. As with all other financial markets, the securities lending market is a meeting place for organisations with diverse collateral and risk profiles.

There is currently little or no reliable published price information relating to securities lending. Fees are negotiated on trade by trade basis and depend on factors such as particular market, types of security lent, loan size, duration, liquidity, collateral required and special situations. General collateral (GC) names provide lower returns than 'special' or hard to borrow names. Key factors in determining the revenue potential of any given portfolio include:

- Overall value of the portfolio available to lend
- Size of individual holdings of stocks
- Active or passive investment strategy
- Geographical diversification of the portfolio
- Tax profile of the underlying owner of the securities

## Global Markets – Legal Considerations

Securities lending transactions are typically covered by one legal agreement.

Questions on matters such as definitions, default procedures, confirmations, margin calls and entitlements are usually best answered by an established legal document.

Outside the USA, a Global Masters Securities Lending Agreement (GMSLA) is generally deployed.

This contract has been drafted on behalf of the International Securities Lenders' Association (ISLA) and has been widely adopted both by borrowers and lenders.

Standard form documents can be found on the International Securities Lenders' Association website at [www.isla.co.uk](http://www.isla.co.uk)

## Glossary<sup>1</sup>

### Agent

A party to a loan transaction that acts on behalf of a client. The agent typically does not take risk in a transaction.

### All-in dividend

The sum of the manufactured dividend plus the fee to be paid by the borrower to the lender, expressed as a percentage of the dividend on the stock on loan.

### Basis point

One one-hundredth of a percent, or 0.01%

### Bearer Securities

Securities that are not registered to any particular party on the books of the issuing company and hence are payable to the party that is in possession of them.

### Beneficial Owner

A party that is entitled to the rights of ownership of property. In the context of securities, the term is usually used to distinguish this party from the registered holder (a nominee for example), which holds the securities in trust for the beneficial owner.

### Benefit

Any entitlement due to a stock or shareholder as a result of purchasing or holding securities, including the right to any dividend, rights issue, scrip issue etc, made by the issuer. In the case of loaned securities or collateral, benefits are passed back to the lender or borrower (as appropriate), usually by way of a manufactured dividend or the return of equivalent securities or collateral.

### Buy-in

The practice whereby a lender of securities enters the open market to buy securities to replace those that have not been returned by a borrower. Strict market practices govern buy-ins. Buy-ins may be enforced by market authorities in some jurisdictions.

### Carry

Difference between interest return on securities held and financing costs.

**Negative carry:** net cost incurred when financing cost exceeds yield on securities that are being financed.

**Positive carry:** net gain earned when financing cost is less than yield on financed securities.

### Cash trade

A non-financing purchase or sale of securities.

### Clear

To complete a trade, i.e. when the seller delivers securities and the buyer delivers funds in correct form. A trade fails when proper delivery requirements are not satisfied.

### Close-out (and) netting

An arrangement to settle all existing obligations to and claims on a counterparty failing under that arrangement by one single net payment, immediately upon the occurrence of a defined event of default.

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<sup>1</sup> Produced by the **UK Stock Lending and Repo Committee, Bank of England**

**Collateral**

Securities or cash delivered by a borrower to a lender to support a loan of securities or cash.

**Corporate Event**

An event in relation to a security as a result of which the holder will be or may become entitled to:

- A benefit (dividend, rights issues etc.); or
- Securities other than those which he holds prior to that event (takeover offer, scheme of arrangement, conversion, redemption etc). This type of corporate event is also known as a stock situation.
- A corporate action is a corporate event in relation to which the holder of the security must or may make an election to take some action in order to secure his entitlement or to secure it in a particular form (see also *equivalent*)

**Conduit Borrower**

See *intermediary*

**Custodian**

An entity that holds securities of any type for investors, effects receipts and deliveries and supplies appropriate reporting.

**Delivery by value (DBV)**

A mechanism in some settlement systems (including CREST) whereby a member may borrow or lend cash versus overnight collateral. The system automatically selects and delivers securities and retrieves them the following day over the term of the transaction.

**Delivery versus payment (DvP)**

A link between a securities transfer system and a funds transfer system that ensure that delivery of securities occurs if, and only if, payment occurs.

**Distributions**

Entitlements arising on securities that are loaned out, e.g., dividends, interest and non-cash distributions

**ERISA**

The Employee Retirement Income Security Act, a U.S. law governing private U.S. pension plan activity, introduced in 1974 and amended in 1981 to permit plans to lend securities in accordance with specific guidelines.

**Equivalent (securities or collateral)**

A term denoting that the securities or collateral returned must be of an identical type, nominal value, description and amount to those originally provided. If, during the term of a loan, there is a corporate action in relation to loaned securities or collateral, the lender or borrower (as appropriate) is normally entitled to specify at that time the form in which he wishes to receive equivalent securities or collateral on termination of the loan. The legal agreement will also specify the form in which equivalent securities or collateral are to be returned in the case of other corporate events.

**Escrow**

See *triparty*

**Fail/failed delivery**

The failure to deliver cash or securities in time for the settlement of a transaction.

**Free-of-payment delivery**

Delivery of securities with no corresponding payment of funds

**General collateral (GC)**

Securities that are not special in the market and may be used, typically, simply to collateralise cash borrowings. Also known as stock collateral.

**GMSLA**

Global Master Equity Finance Agreement

**Gross-paying securities**

Securities on which interest or other distributions are paid without any taxes being withheld.

**Haircut**

Initial margin on a repo transaction. Generally expressed as a percentage of the market price.

**Hard/hot stock**

A particular security that is in high demand relative to its availability in the market and is thus difficult to borrow. See also specials

**Hedge Fund**

A specialist investment fund that engages in trading and hedging strategies, frequently using leverage.

**Hold in custody**

An arrangement under which securities (collateral) are not physically delivered to the borrower (lender) but are simply segregated by the lender (borrower) in an internal customer account.

**Holding arrangements/holds**

See *putting stock on hold*

**Icing**

See *putting stock on hold*

**Intermediary**

A party that borrows a security in order to on-deliver it to a client, rather than borrowing it for its own in-house needs. Also known as a conduit borrower.

**Interdealer Broker**

Agent or intermediary that is paid a commission to bring buyers and sellers together. The broker's commission may be paid either by the initiator of the transaction or by both counterparts.

**International Securities Lenders Association (ISLA)**

The trade association for securities lenders.

**London Investment Banking Association (LIBA)**

The principal trade association in the UK for firms active in the investment banking and securities industry. LIBA members are generally borrowers and intermediaries in the stock lending market.

**Manufactured dividend**

When securities that have been lent out pay a cash dividend, the borrower of the securities is generally contractually obligated to pass on the distribution to the lender of the securities. This payment "pass through" is known as a manufactured dividend.

**Margin, initial**

Refers to the excess of cash over securities or securities over cash in a repo/reverse repo, sell and buyback/buy and sellback or Equity Finance transaction. One party may require an initial margin due to the perceived credit risk of the counterpart.

**Margin, variation**

Once a repo or Equity Finance transaction has settled, the variation margin refers to the band within which the value of the securities used as collateral may fluctuate before triggering a margin call. Variation margin may be expressed either in percentage or absolute currency terms.

**Margin call**

A request by one party in a transaction for the initial margin to be reinstated or to restore the original cash/securities ratio to parity.

**Mark to market**

The act of revaluing the securities collateral in a repo or Equity Finance transaction to current market values. Standard practice is to mark to market daily.

**Market value**

The value of loan securities or collateral as determined using the last (or latest available) sale price on the principal exchange where the instrument was traded or, if not so traded, using the most recent bid or offered prices.

**Master Equity and Fixed Income Stock Lending Agreement (MEFISLA)****Net-paying securities**

Securities on which interest or other distributions are paid net of withholding taxes.

**Open transactions**

Trades done with no fixed maturity date

**Overseas Securities Lender's Agreement (OSLA)****Pair off**

The netting of cash and securities in the settlement of two trades in the same securities for the same value date. Pairing off allows for settlement of net differences.

**Partialling**

Market practice or a specific agreement between counterparts which allows a part-delivery against an obligation to deliver securities.

**Pay for hold/pay to hold**

The practice of paying a fee to the lender to hold securities for a particular borrower until the borrower is able to take delivery.

**Prime brokerage**

A service offered to clients by securities houses to support clients' trading, investment and hedging activities. The service consists of clearing, custody, Equity Finance, and financing arrangements.

**Principal**

A party to a loan transaction that acts on its own behalf or substitutes its own risk for that of its client when trading.

**Proprietary trading**

Trading activity conducted by a securities firm for its own account rather than for its clients.

**Putting stock on hold**

The practice whereby a lender holds securities at borrower's request in anticipation of that borrower taking delivery. Also known as icing.

**Rebate rate**

The interest paid on the cash side of a Equity Finance transaction. A rebate rate of interest implies a fee for the loan of securities and is therefore regarded as a discounted rate of interest.

**Recall**

A request by a lender for the return of securities from a borrower

**Repricing**

Occurs when the market value of a security in a repo or Equity Finance transaction changes and the parties to the transaction agree to adjust the amount of securities or cash in a transaction to the correct margin level. **Revaluation** (see repricing)

**Roll**

To renew a trade at its maturity

**Shaping**

A practice whereby delivery of a large amount of a security may be made in several smaller blocks so as to reduce the potential consequences of a fail. May be especially useful where partialling is not acceptable.

**Specials**

Securities that for several reasons are sought after in the market by borrowers. Holders of special securities will be able to earn incremental income on the securities by lending them out via repo, sell/buy, or Equity Finance transactions.

**Spot**

Standard non-dollar repo settlement two business days forward. A money market convention.

**Stock Lending and Repo Committee (SLRC)**

A UK-based committee of international repo and Equity Finance market practitioners, chaired and administered by the Bank of England.

**Stock situation**

See *corporate event*

**Substitution**

The ability of a provider of general collateral to recall securities and replace them with other securities of the same value.

**Term trades**

Transactions with a fixed maturity date

**Third-party lending**

System whereby an institution lends directly to a borrower and retains decision-making power, while all administration (settlement, collateral monitoring, and so on) is handled by a third party, such as a global custodian.

**Triparty**

The provision of collateral management services, including marking to market, repricing and delivery, by a third party. Also known as *escrow*.

## Useful links

### Nomura Securities, Inc., New York

[www.stocklend.com](http://www.stocklend.com)

### International Securities Lenders Association

[www.isla.co.uk](http://www.isla.co.uk)

ISLA is the trade association for Securities Lenders. It was setup in 1989 and now has around 50 members, mostly, but not exclusively, based in the UK. The objects of the Association are to represent the common interests of securities lenders; to assist in the orderly, efficient and competitive development of the Equity Finance market and to provide its members with a forum for the development of ideas relating to the market.

### Pan-Asia Securities Lending Association

PASLA was incorporated in Hong Kong in 1995, and is an association of firms that are active in the business of borrowing and/or lending securities of Asian markets. At present, there are 39 member firms, 25 of which are represented by their company's Hong Kong offices, with the 14 other members domiciled across six other countries - Australia, Japan, Malaysia, Singapore, the UK and the US. PASLA Membership is open to both "international" firms, which are active in several markets, and "local" firms, which are active primarily in their home market.

### Australian Securities Lending Association

[www.asla.com.au](http://www.asla.com.au)

ASLA, the Australian Securities Lending Association, was formed in August 1991 in response to a perceived need amongst industry participants for unified representation in regulatory and other issues relevant to its members. In addition to ASLA's role of assisting regulatory development, the Association also promotes standardisation throughout the industry in terms of documentation and market practice

### London Investment Banking Association

[www.liba.org.uk](http://www.liba.org.uk)

LIBA is the principal trade association in the United Kingdom for firms which are active in the investment banking and securities industry. Its objective is to ensure that London continues to be an attractive location for the conduct of investment banking business.

### RMA

[www.rmahq.org](http://www.rmahq.org)

The Risk Management Association, is the leading association of lending, credit, and risk management professionals, serving the financial services industry.

By advocating the best risk/reward practices, RMA enables each member to build a sound business culture that both safeguards and enhances value. They accomplish this through:

- High value products
- Professional development and networking opportunities
- State-of-the-art benchmarking tools

RMA delivers value by focusing its resources and adhering to a policy of sound financial discipline