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Stock Borrowing what is it and why? By Roy Zimmerhansl

At its most basic level, stock borrowing is the temporary transfer of an asset from an owner to a borrower in return for a fee, with risk managed through the provision of collateral and governed by standard industry documentation.

Borrowing stock for the purpose of satisfying settlement obligations occurs in over 40 markets worldwide solidifying its position as a feature of every developed and many developing markets. Indeed, some index providers have stock lending/borrowing as a qualifying criterion for 'developed market' status.

Stock borrowing can be considered a somewhat opaque support mechanism for efficient market operations. Its historical roots lie in the transfer of assets between securities firms to avoid settlement failures. Especially critical in the days of certificated settlement, this operational aspect has had several revivals over the past dozen years, first driven by the regulatory desire to reduce the systemic risk of increased fails and naked short sales in the immediate aftermath of the Lehman default, and then again over the past decade as many markets reduced their domestic settlement cycles.

Borrowing is not an end-objective, rather it is part of a wider transaction or purpose. For example, market makers' ability to borrow as opposed to buy shares enables them to provide timely liquidity to investors. As long as there are market makers, stock borrowing will be a critical part of their toolkit. In addition to support for market making, it is a part of everyday capital markets life including merger and acquisition deals, algorithmic trading, arbitrage across indices and ETFs as well as outright directional trading.

One reason cash market equity transactions have had higher fail rates compared to bonds is the lower average trade value for equities rendering fail-interest claims uneconomic. Some markets combat this by imposing strict buy-in regimes while others, notably Japan, have cultural expectations of zero-fails. However, most markets have been less stringent with the low, zero or negative interest rate environment that continues today subtly further undermining settlement discipline. It is unsurprising the coming Central Securities Depositories Regulation includes OTC fails reduction through the imposition of buy-ins. Of course, as with many regulations, there may be unintended consequences for the imposition of buy-ins.

Stock borrowing is predominantly part of trading strategies that involve short selling that grew as hedge funds boomed throughout the 1980s. As assets under management grew, so did the need to borrow and they remain the primary end-users of borrowed stock, recently joined by a wider universe of alternative and traditional funds. The 1990s saw the emergence of large-scale proprietary trading by banks, fueling the unprecedented growth of stock borrowing in most developed markets. The Great Financial Crisis led to revised banking regulations, effectively eliminating proprietary trading by banks whose stock borrowing is now largely focused on hedges related to client positions.

Fundamentally, stock borrowing is a servant to the need for liquidity provided by market makers, efficient trade settlement, hedging in rising markets and enhanced price discovery through facilitation of short selling.

About the Author: Roy is an expert on all aspects of Securities Finance. He was vice-chair of ISLA and taught 'An Introduction to Securities Lending' and has recently launched an online version of the course with CISI CPD Accreditation. He was also a board member of PASLA (the Asian securities lending trade association) and a member of the Bank of England Securities Lending and Repo committee.