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THOUGHT LEADERSHIP:
SQUEEZING THE SECURITIES LENDING LEMON

WHITEHELM
ADVISERS

INTRODUCTION

With pressure on future asset class returns increasing following the post pandemic surge in global equities and yield curves pushed ever lower by central banks, the hunt is on to find new sources of return and portfolio efficiency for institutional asset owners that strive to deliver real returns to meet their expected liabilities in future years.

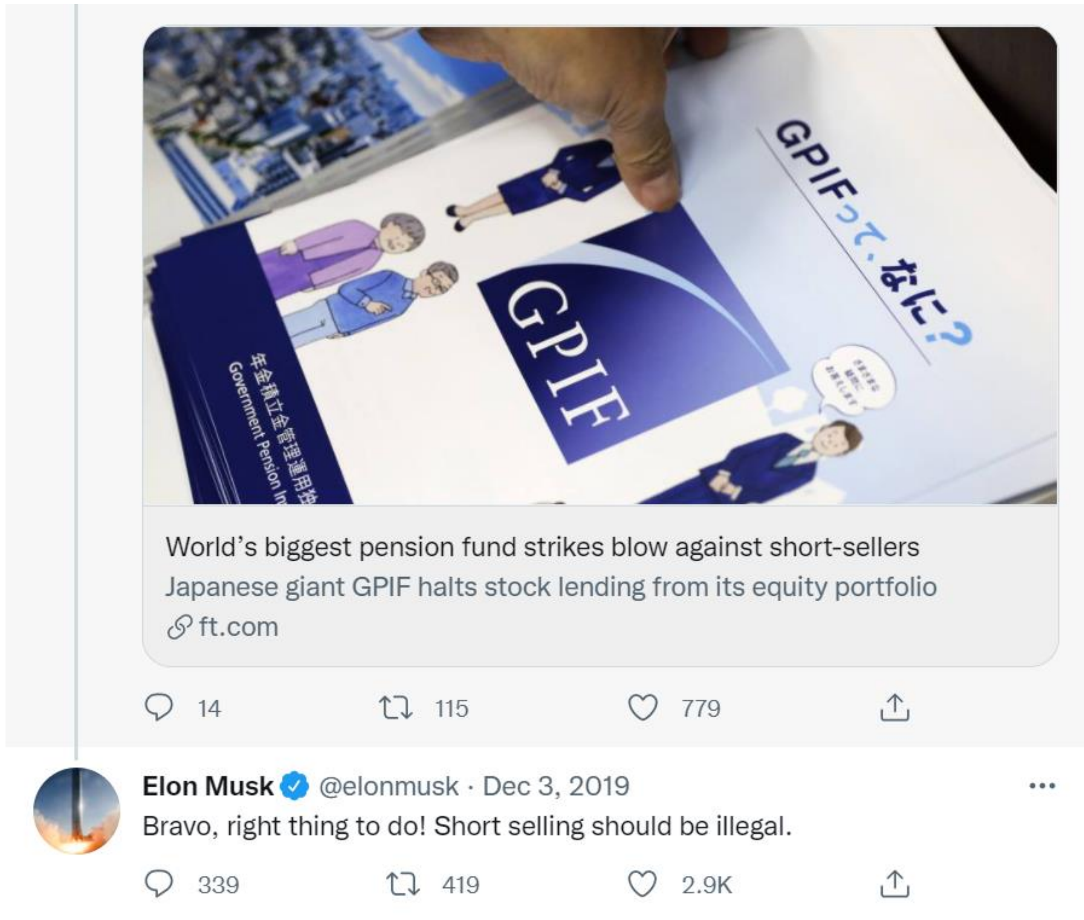
One source of additional return for a portfolio is securities lending, which offers the potential to generate extra revenues from portfolios. Asset owners can temporarily lend out securities to borrowers, that in turn use the stock to make short sales or meet trade settlement obligations. The borrower of securities must pay a fee to its lender, much in the same way as a borrower pays interest on a loan to a bank taken out to purchase a car, and of course, the borrower needs to give back the securities when the loan term is up. In this article we take a closer look at securities lending, and the potential benefits to asset owners by way of the revenues from lending fees.

We start by describing the process of securities lending, highlighting the amount of securities lending revenues portfolios can generate. As we will see, this is difficult to assess without a detailed knowledge of the portfolios and the supply and demand for the loanable securities within those portfolios. For many institutional investors, securities lending can be a potential source of modest but relatively stable revenues. However, the expected revenues need to be balanced against the potential risks involved, and we emphasise the need for effective management of the risks that securities lending brings; if not well mitigated, these risks could give rise to losses that well exceed the modest revenues on offer.

One such risk relates to the involvement of securities lending with short selling, which is one of the main reasons investors borrow securities; in this article we review both the positive and negative aspects of this type of trading. While short selling is well recognised by global regulators and market operators as fulfilling important functions in providing liquidity and enhancing market efficiency, short sellers of equities can attract the anger and indignation from the companies that are the subject of the trades, particularly when the reasons for the trades are made public. Elon Musk, the CEO of Tesla, sensationally tweeted in 2019 'short selling should be illegal!' after Tesla had been singled out by various short sellers (see Figure 1). More often than not, however, short sales are made without a public airing of grievances by the short seller; most of the time they are simply made by market participants seeking to hedge portfolio risks, or investors identifying securities they believe to be overvalued, or are undertaken to meet trade settlement needs. Nevertheless, the public instances of short selling have attracted scrutiny by aggrieved stakeholders. We canvass the implications for the securities lender that facilitates the short sales, looking at how different global pension funds have responded to these issues.

For the institutional investor seeking additional return from a portfolio, securities lending can be a useful source of revenue, when the associated risks are appropriately managed, and with the program undertaken in a way that is consistent with good practices around the stewardship of investors' assets.

Figure 1: Short Selling Has its Detractors



Source: Twitter. https://twitter.com/elonmusk/status/1201781489639161856?lang=en

SECURITIES LENDING: AN OVERVIEW

Securities lending is a process by which the owners of securities temporarily lend out a portion of their securities to borrowers in return for a fee. The purpose of borrowing securities is often to complete short sales, referred to as 'covered' short sales when they are backed by borrowed securities. Securities lending is therefore intertwined with short selling, in that it facilitates this type of trading. In other cases, securities lending can also be used by market participants to avoid failed trades during trade settlement processes[1].

As can be seen from Figure 2, securities lending is a highly intermediated activity; many asset owners choose to outsource the management of securities lending programs to financial intermediaries. The lender intermediaries are predominantly the major custodian banks or other investment banks that offer securities lending services. The intermediary can absorb the considerable complexity and risk involved in lending and collateral management in return for a fee. Pooling stock across multiple asset owners also allows the intermediary to better manage the supply of stock to borrowers, particularly if some lenders wish to recall stock at different points in time.

In turn, the borrowers of securities also rely on intermediaries that manage the needs of a range of borrowers by sourcing stock from a variety of lenders; these borrower intermediaries are often prime brokers. A prime broker combines scrip access with ancillary services including financing, risk management and operational support in return for a commission. The borrower receives stock from the prime broker (or other intermediary) and pays the loan fee back through the intermediaries to the asset owner. In addition, the borrower pledges collateral to mitigate against the risk of default, as a lender would be exposed in the event a borrower failed to deliver the securities back when the loan ends. Where non-cash collateral is pledged, a haircut can be applied, such that the borrower pledges more collateral than the amount it has borrowed, given the potential for non-cash collateral to experience mark-to-market movements. The borrower also pays back to the lender any dividends that are declared during the tenor of an equity loan.

It is important to note that the management of borrower collateral can introduce additional risks for the lender when this collateral is reinvested, reused as collateral, or on-lent in the case of non-cash collateral[2]. These reinvestment risks were very painfully exposed for some securities lenders during the global financial crisis, which we discuss in more detail later in the article.

The securities loan concludes when either the lender decides to recall its securities or when the borrower decides to cover its short position; the loaned securities are then returned through the intermediaries to the lender, and the collateral returned to the borrower by the lender.

[1] "The Equity Securities Lending Market", RBA, 2014.

[2] 'Rehypothecated' to use the technical term.

Figure 2: Securities Lending Overview

Asset Owners
(e.g., pension funds, fund managers, other asset pools)

Revenue share (of lending fees), dividends

Securities (stocks, bonds)

Collateral management
(reinvestment, rehypothecation)

Lender Intermediaries
(e.g., custodian banks, other third party lenders)

Lending fees, dividends, collateral

Borrower Intermediaries
(e.g., prime brokers, stock providers)

Securities (stocks, bonds)

Collateral

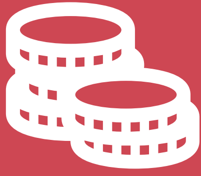
Lending fees, dividends, broker commissions, collateral

Borrowers (e.g., fund managers, investment banks)

Short Sale

Borrower Short Cover/ Lender Recall

Source: Whitehelm Advisers



POTENTIAL REVENUES AND PITFALLS

Potential Revenues

Globally, securities lending market revenues have been relatively consistent over the past ten years at circa US$9-11 billion annually, with equities accounting for around 80% of total revenues through time[3]. Securities lending revenues are a function of the size of the portfolio (which determines the amount of loanable assets), the utilisation rate (how much of those loanable assets are borrowed by investors), and the weighted average lending fee (paid by the borrower to the lender, less fees paid to intermediaries). A portfolio's securities lending revenues will tend to depend on a few key drivers, which we highlight below and in Table 1.

Asset class. Borrower demand for securities varies by asset class; fixed interest securities (mainly bonds rather than credit instruments) attract significant demand, with the asset class enjoying comparatively high rates of utilisation. Conversely, emerging markets equities are usually a small portion of the market and have very low rates of utilisation; short selling and securities lending are restricted in many of them. For an equity portfolio in aggregate, utilisation rates can broadly range from 2% to 10% for a portfolio focussed on developed markets. That is, while a lender may offer its whole portfolio out for loan, only a fraction may end up being borrowed. For example, for a US$1 billion portfolio with a utilisation rate of 5% and a securities lending fee of 0.5% per annum, this would produce revenues of US$250,000 each year, or 2.5 basis points of additional return.

Individual security supply/demand. Within each asset class certain securities will be in more demand and command higher lending fees than others. Large, well traded securities in developed markets should have good supply available at lower fees, whereas smaller, less liquid securities can have much higher lending fees at times and high rates of utilisation. Typical lending fees by asset class are shown in Table 1, with equities commanding much higher average lending fees than bonds, on average. Overall securities lending revenues will vary with the interaction between the rate of utilisation and the lending fees obtained from the securities held.

Lender recall behaviour. Borrowers generally value reliable suppliers of stock and lenders that frequently recall stock to vote are likely to receive lower revenues than lenders that do not[4], through a lower utilisation and/or lending fee. In its publication, 'A Practical Guide to Active Ownership in Listed Equity', the UNPRI outlines some ways in which institutional investors can manage the responsibilities of active ownership while generating revenues from securities lending[5]. For example, given a low overall rate of utilisation for an equity holding, an asset owner can choose to vote only on stock that has not been lent, or alternatively, only recall stock where their participation is expected to be material to the outcome of the vote.

[3] Securities Finance 2020 Snapshot, IHS Markit, 31 December 2020.

[4] The lender loses the revenue that would have been earned while the stock is recalled. In addition, lending fees may be lower; effectively this compensates the borrower for the need to locate new stock to replace the recalled stock if it needs to maintain the short position.

[5] "A Practical Guide to Active Ownership in Listed Equity", UNPRI, 2018.

Table 1: Typical Securities Lending Characteristics by Asset Class

ASSET CLASS	UTILISATION	LENDING FEE
Equities – developed	2 - 10%	0.30 – 1.00%
Equities – emerging	0 - 5%	1.00 - 3.00%
Fixed interest	20 - 50%	0.05 - 0.25%

Source: Whitehelm Advisers, IHS Markit. Ranges shown are approximate and will vary.

Potential pitfalls and risks

While the revenues associated with securities lending are modest, they do involve certain risks.

Reinvestment risk for collateral pools. Investors may be tempted to enhance the revenues from securities lending by reinvesting the collateral of borrowers (where the collateral pledged is cash). If these reinvestments suffer capital losses or become illiquid, the lender is exposed when the securities loan matures, having to return the amount of collateral pledged. Major securities lenders, including State Street Bank & Trust, Northern Trust Corp and J.P. Morgan, were reportedly involved in large lawsuits in the wake of the global financial crisis[6]. Collateral pools in some of the programs were reported to have been reinvested in securitised credit instruments, RMBS, CMBS, ABS, CDOs and CLOs, which suffered large mark-to-market losses during the market volatility of 2008 and became illiquid. As borrowers ended their loans, the lenders (the funds that loaned the securities) suffered significant losses on the return of collateral. Reinvestment risk on the collateral pools associated with securities loans was also one of the lesser-known contributors to the collapse of the American International Group (AIG), which operated a securities lending business that incurred losses of US$21 billion during the global financial crisis[7].

Reputational risk. This is the risk that the asset owner's reputation and/or commercial standing is compromised by adverse publicity associated with its involvement in securities lending facilitating equity short sales. We discuss the reputational risks of short selling and securities lending in further detail below.

Inability to vote on lent stock. The new owner of the borrowed shares is entitled to vote, which risks placing stock in the hands of unaligned investors during votes on company board resolutions. Some institutional investors have highlighted this as a fiduciary conflict, which could compromise the overall ESG objectives of the lender. Hence, securities lending programs need to be configured to enable the lender to meet corporate governance responsibilities and opportunities, principally by managing the recall of lent equity securities for voting purposes.

Facilitating short sales that could damage the prospects of the long positions of the asset owner. The stocks being shorted are positions that are currently held within the asset owner's long portfolios. While it is widely accepted that short selling contributes to improved price discovery and market efficiency overall, for specific stocks there is a risk that targeted short selling could create price distortion or panic selling, though in the same way, long only investing can create overbought stocks and trigger irrational buying.

Counterparty credit risk. This is the risk that the borrower fails to deliver stock when recalled or does not pay the lending fee. If these risks are not appropriately managed, they can result in losses for the investor that exceed the potential securities lending revenues. However, with appropriate mitigation strategies, the risks of securities lending can be significantly reduced. How best to mitigate these risks will depend on the nature of the securities lending program, the internal capabilities of the asset owner, the constituents of the portfolios, and the needs and views of the asset owner's stakeholders.

[6] "Missouri Fund Scores Big Securities Lending Payout", Pensions & Investments, 29 May 2017.

[7] "What Went Wrong at AIG?", Robert McDonald & Anna Paulson, Kellogg School of Management, 3 August 2015.

SHORT SELLERS: VIGILANTES OR VILLAINS?

Given the primary function of securities lending is to facilitate short sales, it is important to consider the role of short selling within capital markets more broadly. A well-functioning short selling market infrastructure and ecosystem can confer useful benefits to a capital market – indeed, for global index provider, MSCI, an active short selling market and related securities lending process is one of the 18 distinct measures it considers when evaluating overall market accessibility. It regards short selling and securities lending to be 'a clear standard in developed markets in support of direct hedging practices and quantitative asset management'[8].

However, short sellers are commonly demonised by company boards, executive management teams, and disgruntled shareholders alike – which has the potential to generate negative publicity for short sellers and those who form part of their supply chain. In this section, we briefly canvass the advantages and disadvantages of short selling before assessing the implications for those undertaking securities lending.

Advantages of short selling

Improved market efficiency. Short sales are generally regarded by regulators and exchanges as contributing to market efficiency when appropriately regulated, a view that is generally supported by academic research. During the global financial crisis, regulators enforced restrictions on short selling, events which can be analysed to ascertain the impact of short selling restrictions on market efficiency measures[9]. Researchers have confirmed that those short selling restrictions imposed had a negative effect on market liquidity (i.e., increased bid-ask spread), and did not have a measurable impact in supporting share prices. Similar research on the Australian equity market provides evidence that short selling bans in that market also increased market volatility and reduced liquidity[10]. The European Securities and Market Authority reviewed short selling as part of a review on short term pressure on corporations in 2019 and reiterated a view that 'short selling and securities lending are key for price discovery and market liquidity'[11].

Better price discovery in single names. Short sellers often see themselves as improving price discovery; the argument goes that short selling can 'uncover the bad eggs', that would be identified more slowly without their input. They see a vital role for short sellers in the capital allocation process, with uninformed or passive long-only investors exposed to the risk of over-valuation, poor governance, and in the worst case, fraud.

Enron Corporation became one of the United States' largest bankruptcies in December 2001; it was identified early by legendary short seller Jim Chanos of Kynikos Associates. Chanos revealed his firm's research into the company that led to his firm's short position before a roundtable held by the US Securities and Exchange Commission (SEC) in 2003[12]. Nineteen years later, Chanos was short a Chinese version of Starbucks, Luckin Coffee, that collapsed following an accounting scandal in February 2021[13]. There are countless other

[8] "MSCI Global Market Accessibility Review", MSCI Inc., June 2020.
[9] "Short-Selling Bans Around the World: Evidence from the 2007-09 Crisis", Journal of Finance, August 2011.
[10] "Effect of the ban on short selling on market prices and volatility", U. Helmes, J. Henker, T. Henker, Accounting and Finance, September 2017.
[11] "Undue short-term pressure on corporations", European Securities and Market Authority, 18 December 2019.
[12] "Hedge Fund Strategies and Market Participation", Roundtable on Hedge Funds, US Securities and Exchange Commission, 15 May 2003.
[13] https://www.cnbc.com/2020/04/02/jim-chanos-says-he-covered-bet-against-chinas-luckin-coffee-amid-70percent-plunge-thursday.html

examples of short sellers being the first to identify overpriced stocks in different corners of global equity markets, whether due to fraud, accounting irregularities, poor governance, or simply companies trading above where the fundamentals would indicate.

The claim regarding improved price discovery is a claim that has, to an extent, been verified by empirical research; one study demonstrates that for NYSE listed stocks information efficiency increased with short trading volume[14]. Another study analysed the predictive power of accounting fraud allegations by short sellers. The study showed that short sellers are informed investors on average, and among the stronger signals of accounting fraud when claims are substantiated (the same study revealed that short selling can impose costs on businesses when claims are unsubstantiated or false, however[15]).

Disadvantages of short selling

Potential for mispricing in single names. Well substantiated and accurate research produced by short sellers has the potential, if it is published, to trigger widespread selling by investors. To the extent this selling becomes driven by panic, this can potentially prompt the market to overreact, particularly in smaller, less liquid names. Shareholders in these businesses that do not sell can also suffer from depressed prices. This behaviour is analogous to the irrational exuberance that can lead to investors overpaying for shares.

The other way in which short selling can trigger temporary volatility in the share price of an individual company is through a 'short squeeze'. A short squeeze arises when market participants race to cover their short positions and are compelled to pay increasingly higher prices to buy back stock to deliver to their lenders. Unlike a long trade which has a maximum loss equal to the amount of the initial investment, a short sale carries limitless losses as share prices rise. As losses mount, more and more short sellers are forced to close out positions and buy stock to cover shorts. The feedback loop can lead to sharp increases in price volatility for highly shorted stocks that announce unexpectedly good news.

A famous short squeeze occurred in the depths of the global financial crisis, which saw the German auto manufacturer, Volkswagen, briefly become the world's largest company, before the squeeze subsided, and the price returned closer to a level determined by fundamentals. The unexpectedly good news in this case was the announcement by rival German auto maker, Porsche, that it had used derivatives to acquire a total interest of 74% in the company. On 28 October 2008, shares in Volkswagen closed at €912.68, a price that remains more than three times the share price nearly thirteen years later.

Chart 1: Volkswagen Short Squeeze

Source: Whitehelm Advisers, Bloomberg

Potential for misconduct. As with any type of trading activity, there is the potential for misbehaviour by market participants. The 'activist' approach to short selling is among the more

[14] "Short Selling and the Price Discovery Process", E. Boehmer and J. Wu, EDHEC-Risk Institute, May 2010.
[15] "Activist Short-Sellers and Accounting Fraud Allegations", A. Kartapanis, University of Texas, January 2019.

contentious trading strategies, and largely responsible for the negative stigma associated with short sales. The business model of the activist short seller involves publishing a 'short thesis' to convince market participants to reprice a security lower, thereby generating the opportunity to realise a profit on short positions. It is important to note that many short sellers do not endorse this approach and are careful to keep trading intentions and research private.

So called 'short and distort' campaigns take the activist approach even further and seek maximum publicity using unsubstantiated or exaggerated claims to encourage investors to sell, and risk breaching regulations, especially those relating to misleading or deceptive conduct and market manipulation. The Australian securities regulator, ASIC, recently published an information sheet outlining its practice guidelines for activist short sellers in May 2021[16], and similar regulatory reviews have commenced in the US[17] and Canada[18]. Additional oversight of activist short selling might improve the market's perception of short sellers in future.

[16] INFO 255, Activist Short Selling Campaigns in Australia, ASIC, May 2021.
[17] Testimony Before the House Committee on Financial Services, US SEC Chair Gary Gensler, 6 May 2021.
[18] Consultation Paper 25-403, Activist Short Selling, Canadian Securities Administrators, 3 December 2020.

REPUTATIONAL RISK AND SECURITIES LENDING

In early 2019, an Australian company, Corporate Travel Management, reportedly threatened a short seller, VGI Partners (VGI), with legal action that would allege misleading statements and market manipulation[19]. VGI had previously published a short thesis on the company and continued to publish research on the company afterward. The reports highlight the negative press short selling can generate when the research or trades are made public. While some short sellers make public claims about target companies, many investment managers are sensitive to reputational risks associated with short selling and avoid disclosure of their trading and investment rationales.

A key question for asset owners is whether securities lending, which facilitates short selling, entails reputational risk. While it is certainly possible, we consider it has a low likelihood, largely due to the level of intermediation between the lender and borrower. Securities lending is more than one step removed from the short selling that follows. Borrowers do not know which lender is providing stock for a given short trade, and similarly, intermediated lenders do not know in advance who will be borrowing their stock and for what purpose. This is similar to the level of intermediation that exists for normal long trades; the buyer seldom knows who is selling and why.

Some global pension funds have made public statements about suspending securities lending programs, whereas others have been vocal in support. The Japanese sovereign wealth fund GPIF publicly announced the suspension of its equity stock lending program in December 2019[20]. One of the reasons GPIF made its decision is that it was unsatisfied with the transparency of the securities lending process and was unable to determine in advance how short sellers would use their stock. In our view, the intermediation within the securities lending process is essential and consistent with the level of intermediation for purchases. The move by GPIF followed a decision by the Korean National Pension Service to halt its domestic securities lending activity in October 2018, in response to public criticism of its involvement in the process of short selling[21].

In Australia, the superannuation fund UniSuper announced it had suspended its stock lending programs amid the market volatility in March 2020[22] (it restarted its program in the fourth quarter of 2020, however)[23]. Another fund, QSuper, also cancelled its securities lending arrangement with State Street Bank and Trust Company in April 2020[24].

In contrast, other pension funds have been public in their defence of securities lending. The giant Norwegian sovereign wealth fund, Norges Bank Investment Management, cites securities lending as a 'one of our core investment strategies'[25]. Examples in the Australian market have included

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[19] "Corporate Travel Management lobs landmark legal threat at short-sellers", Sydney Morning Herald, 28 February 2019.

[20] "World's Biggest Pension Fund Strikes Blow Against Short-sellers", Financial Times, 3 December 2019.

[21] "National Pension Service Stops Lending Stocks to Short Sellers", BusinessKorea, 23 October 2018.

[22] "Unisuper suspends stock lending program", Unisuper, 16 March 2020: https://www.unisuper.com.au/en/about-us/media-centre/unisuper-suspends-stock-lending-program

[23] "Super funds stop lending stock to short sellers", The Australian, 14 February 2021.

[24] QSuper Annual Members' Meeting, Questions from Members, 2020.

[25] "Investing in equities", Norges Bank Investment Management, 2020.

Hostplus, Aware Super and AustralianSuper[26]. Large global investment managers such as BlackRock and Vanguard have also been advocates for stock lending. The fact that large and well-established asset owners and investment managers have publicly advocated for securities lending speaks to a lower reputational risk for the securities lender compared to the short seller.

GameStop– revenge on the shorts

In this section we consider a market event relating to short selling and review the response from regulators. Short selling was again under the spotlight in early 2021 following the widely reported GameStop events, which saw the GameStop share price rise from US$16.56 on 30 November 2020 to US$347.51 on 27 January 2021, a rise of 21 times in less than two months. GameStop shares then plummeted back down to US$40.59 on 19 February 2021, before a second surge saw the share price spike back to US$205 by end August 2021.

The GameStop share price action is interesting in three respects; the first is the apparent conspiracy of retail investors to damage institutional short sellers by engineering a short squeeze on a heavily shorted name through online media platforms – almost a form of 'activist long' investing. Secondly, retail investors in the US were able to obtain leverage through derivatives purchases (equity options) that compelled the derivative issuers to buy stock to hedge their risk exposure as the share price rapidly rose[27], which compounded the short squeeze once it had started in January 2021. Lastly, as we show in Chart 2, the reported short interest on GameStop had exceeded its free float by 45% and toward the end of 2020 was even higher than its shares on issue. This means there were more reported securities shorted than could be lent. This matters because the US SEC enacted rules in 2005[28] aimed at prohibiting naked short selling, the practice of shorting stock that has not been borrowed first. Naked short selling came under significant regulatory scrutiny during the global financial crisis due to the perceived instability it created within the financial system. Naked short selling is banned or severely limited in many other markets, including Europe, Japan, Australia and Hong Kong.

It seems likely that the GameStop events will ultimately prompt the relevant US regulators to strengthen the disclosure regime for short trades, short positions, and stock lending activity. The US House of Representatives Committee on Financial Services held a hearing on GameStop trading in February 2021[29], and the Chair of the SEC, Gary Gensler, has subsequently given testimony to that Committee confirming that the SEC will be reviewing the disclosure regime, along with other initiatives[30].

In June 2021, the US Financial Industry Regulatory Authority (FINRA) published a notice requesting consultation on, among other items, proposals to increase the frequency of short interest reporting from twice per month to weekly or daily, and report more details on aggregate stock lending activity for regulatory purposes [31,32]. As at end August 2021, more than 1,800 comments had been submitted on the proposed regulations.

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26 "UniSuper alone in suspending securities lending", AFR, 17 March 2020.

27 "GameStop: Were the Short Sellers Routed? Does it Matter? (Beware the 'Gamma')", Forbes, 19 March 2021.

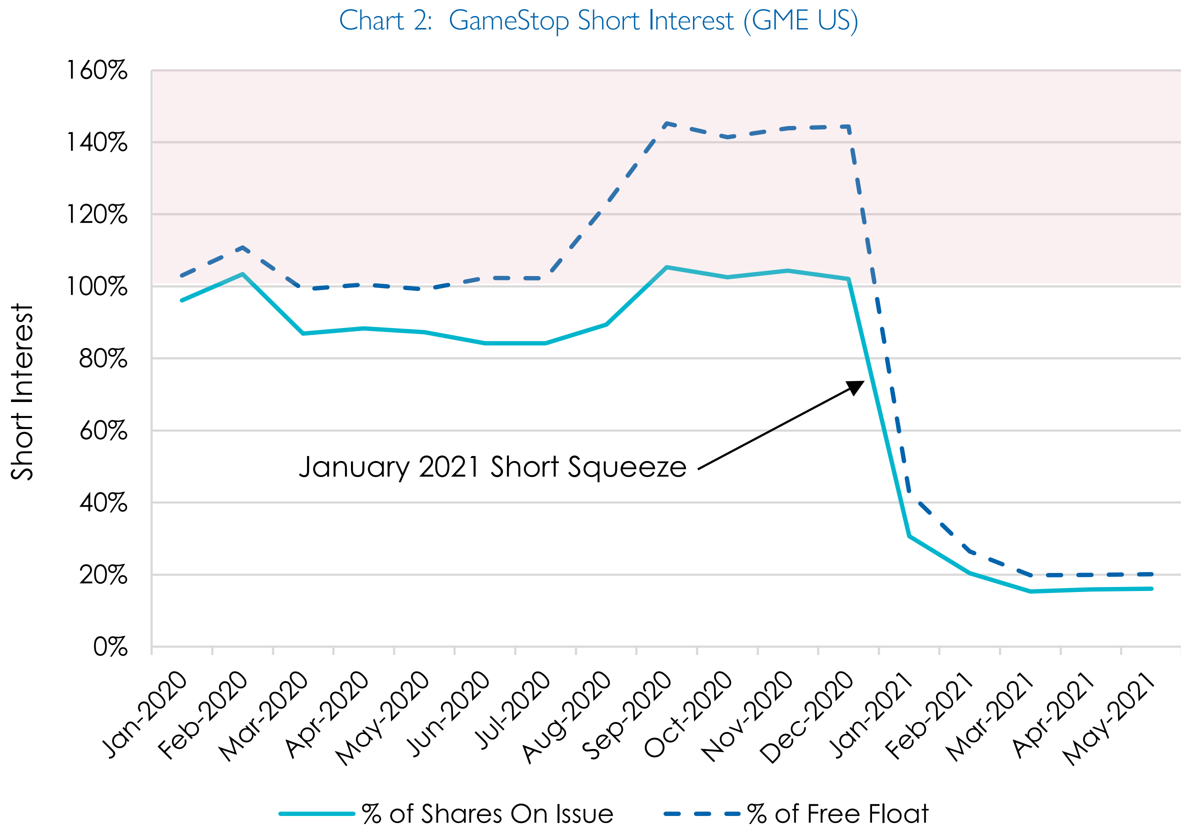
28 "SEC Brings "Naked Short Selling" Case", The National Law Review, June 2021.

29 "Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide?", US House of Representatives Committee on Financial Services, 15 February 2021.

30 "Testimony Before the House Committee on Financial Services", Gary Gensler, 6 May 2021.

31 "'Get Shorty' – FINRA requests comments on proposed Significant Changes to short position and stock loan reporting", Lexology, 7 June 2021.

32 "Regulatory Notice 21-19, Short Sales", FINRA, 4 June 2021.



Source: Whitehelm Advisers, Bloomberg.

CONCLUSION

This article has taken a closer look at securities lending, the practice of institutional asset owners temporarily lending out their assets in return for fees. Securities lending can be a useful source of additional revenues for institutional asset owners, albeit noting that the revenues can be small relative to the size of portfolios, depending on the underlying demand for the portfolio holdings.

The expected revenues also need to be weighed against the potential risks, which require appropriate mitigation, including with regard to managing collateral pools. In addition, securities lending is not contrary to good stewardship, provided asset owners configure their securities lending programs to appropriately manage corporate governance risks and opportunities.

This is especially the case for programs involving equities, where lent securities can be recalled enabling the asset owner to vote on resolutions put before investee company boards.

While some groups have perceived a reputational risk for securities lenders because it facilitates short selling, we consider that the level of intermediation between the lender and borrower reduces this dramatically, while recognising the improved market efficiency and price discovery that short selling can bring to capital markets more broadly.

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