Why asset management arms of banks should continue to lend bank shares

Robert Peston of the BBA and Jeremy Warner of the Independent have recently asked why the asset management arms of banks continue to lend bank shares. It is perverse – so the argument goes – to lend shares at small fees to hedge funds so that they can sell those shares shorts on a massive scale and drive prices downwards, frustrating the plans of those banks to raise new capital through rights issues. It looks a no-brainer. But the argument is nonetheless mistaken. Look at it in three parts:

1. **'Lending shares facilitates short selling by hedge funds that want bank share prices to fall'**

- That is true but it is very far from the whole truth. In fact, only a fraction of securities borrowing is to cover short sales by investors with a simple directional view that a share price will fall.
- Much more commonly, securities are borrowed to cover short positions taken to hedge long positions in a share or a related instrument. For example, dealers will enter into short positions to hedge long positions taken when they buy shares from a client. Their ability to provide liquidity to clients as market makers in this way relies on a well-functioning share borrowing market.
- Similarly, short positions are taken to hedge positions in equity derivatives related to share indices. Without a liquid securities borrowing market, traders would be unable to keep the value of the FTSE 100 futures contract in line with the prices of the component shares by arbitraging between them. Liquidity in the futures contract would deteriorate.
- Shares are also borrowed for settlement reasons. Without share borrowing, chains of failed trades would be common as market participants were unable to deliver shares themselves because other counterparties had failed to them.

2 **'Hedge funds can drive share prices downwards by selling shares short'**

- Short sellers have no more influence over share prices than any other traders. If selling pressure caused a share price to fall below what other investors judged to be its fair value, they would buy and the share price would correct. Those who argue that short sellers can drive a share price below its fair value need to explain why other investors do not take that buying opportunity. After all, the universe of potential buyers of shares is much larger than that of potential short sellers. Most institutional investors are still constrained to be long only.

- More fundamentally, they need to explain why they do not believe the market is efficient and how a share price can move away from fair value for a sustained period of time. Academic theory and common sense suggests that the best way to get a fair price for a share is to allow all market participants, with their varying views, to trade in the shares[1]. Putting obstacles in the way of those that believe share prices are over-valued will only make prices less efficient. In effect, it removes a class of traders from the market who believe shares are overvalued but do not currently own them. In the long run, all investors will then be worse off because they are more likely to trade at prices that are too high in relation to underlying fundamentals.
- Short selling is certainly not a one-way bet. Buyers of shares can only lose the amount of money they invest and they benefit from the long-run bias for share prices to rise as economies grow. By contrast, short sellers face potentially unlimited losses and that bias is against them. Nor is it obvious how the rights issue process creates a one-way opportunity for short sellers. They may benefit if the share price falls below the rights price. But they have no magical powers to keep it there. The rights process does not prevent buying by investors who believe the share price is too low.

3 'Short selling on a massive scale has driven bank share prices lower in order to frustrate rights issues'

- The UK settlement system Euroclear UK and Ireland publishes data on outstanding securities lending positions in UK equities. As explained above, far from all securities lending is to facilitate directional short positions. But a massive wave of short selling would be expected to lead to an increase in securities lending. It is interesting therefore to look at the data for lending of shares in the UK banks involved in rights issues (see charts attached[2]).
    - Lending of HBoS shares has been more or less constant at around 6.5-7.0% of market capitalisation since its rights issue was announced on

[1] See the paper at http://www.isla.co.uk/docs/Securities%20Lending%20and%20Short%20Selling.pdf for a summary of the academic work on short selling and market efficiency.
[2] Provided by Data Explorers.

29 April. That equates to around five times average daily turnover in HBoS shares, which is well below the average level for FTSE 100 shares of around fourteen times.

- Lending of RBS shares actually fell sharply after the announcement of its rights issue on 22 April. It did then rise from around 2% of market capitalisation to 6.5% between mid-May and early June. But, even on the extreme (and almost certainly wrong) assumption that this increase was entirely to facilitate directional short positions, it represents only about 15% of market turnover over the period in which the rise occurred.
- Lending of Bradford and Bingley shares, although much lower in absolute terms (around £75mn) is significantly higher than that of RBS and HBoS shares as a percentage of market capitalisation. Lending did rise after the announcement of the rights issue on 14 May. Again, however, making the same extreme assumption that all stock borrowing was to finance directional short positions, the rise accounted for only about 20% of market turnover over the week in which it happened.

- In sum, nothing in the data supports suggestions that falls in bank share prices have been caused by a wave of short selling so large that it has temporarily swamped all other trading and distorted the market.

So what would be the effect of the asset management arm of a bank ceasing to lend bank shares?

- *On bank share prices*: if the supply of shares to the securities lending market was reduced significantly, the immediate effect might be a short squeeze as those traders that had sold the shares short were obliged to close out those positions and buy shares in order to return them to the lenders. But the spike would probably be short-lived as share prices re-adjusted. Over a period of time, the effect on share prices would be, in all likelihood, zero.
- *On the liquidity of the market for bank shares*: if liquidity in the market to borrow shares fell permanently, dealers would be less able to hedge trading positions in those shares or related derivatives. Settlement would

also be more risky. Cash and derivatives market liquidity would fall, raising the cost of trading in the shares.

- *On the earnings of the asset management arm of the bank on behalf of its customers*: Those customers are likely to be long-term investors in pensions and savings products. Any short-term spike in bank share prices would be of no value to them. But they would miss out on the revenue from lending the shares. The intrinsic value to lending a share is part of the overall return on that share, along with dividends and capital appreciation. Giving up that revenue would be failing in their fiduciary obligation to their customers.

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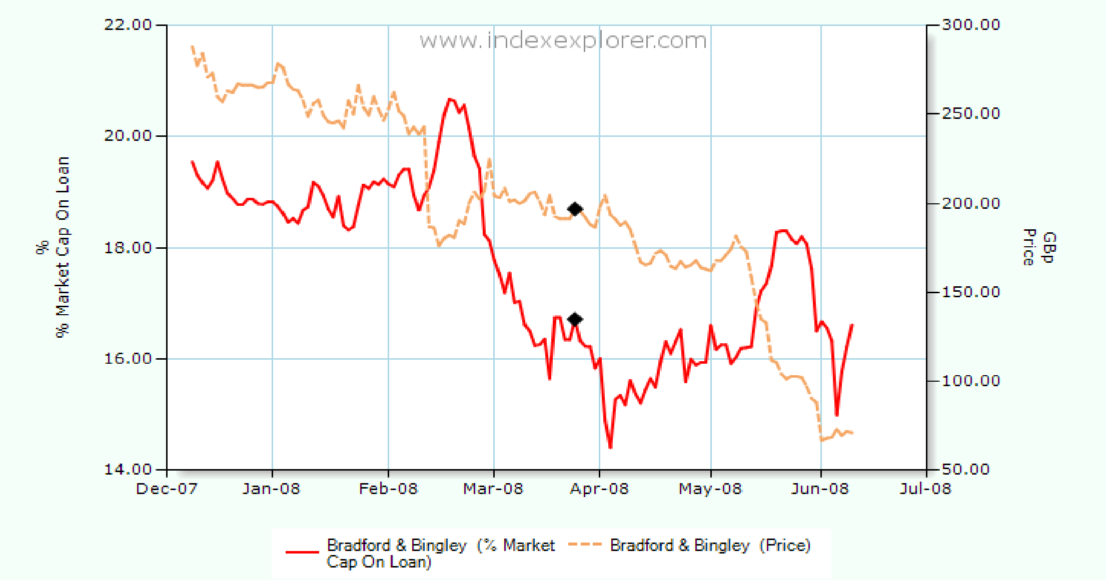
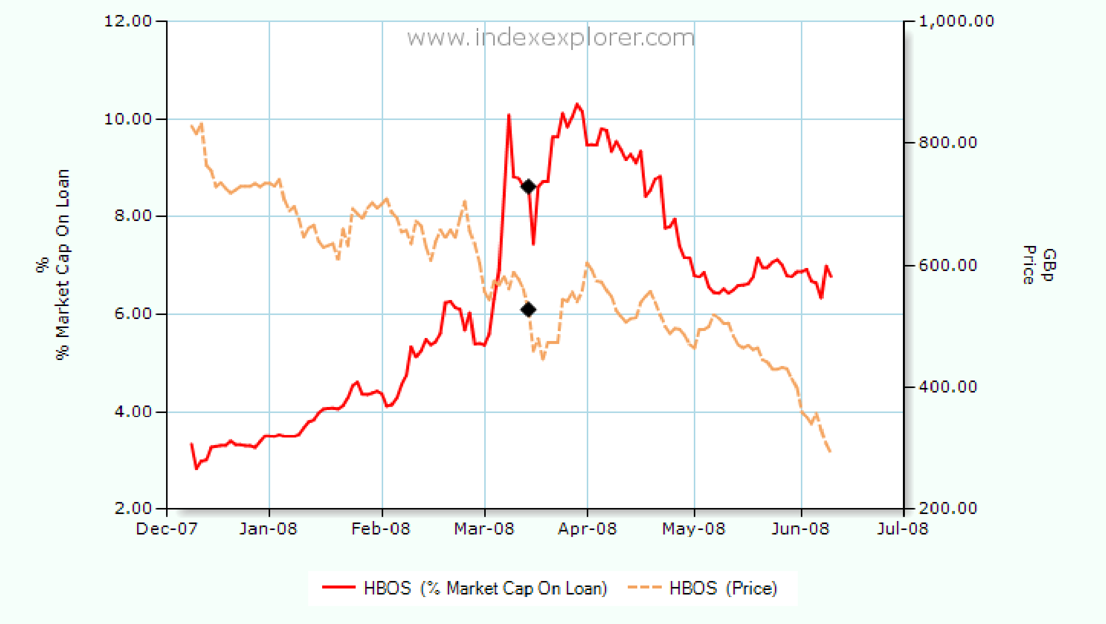
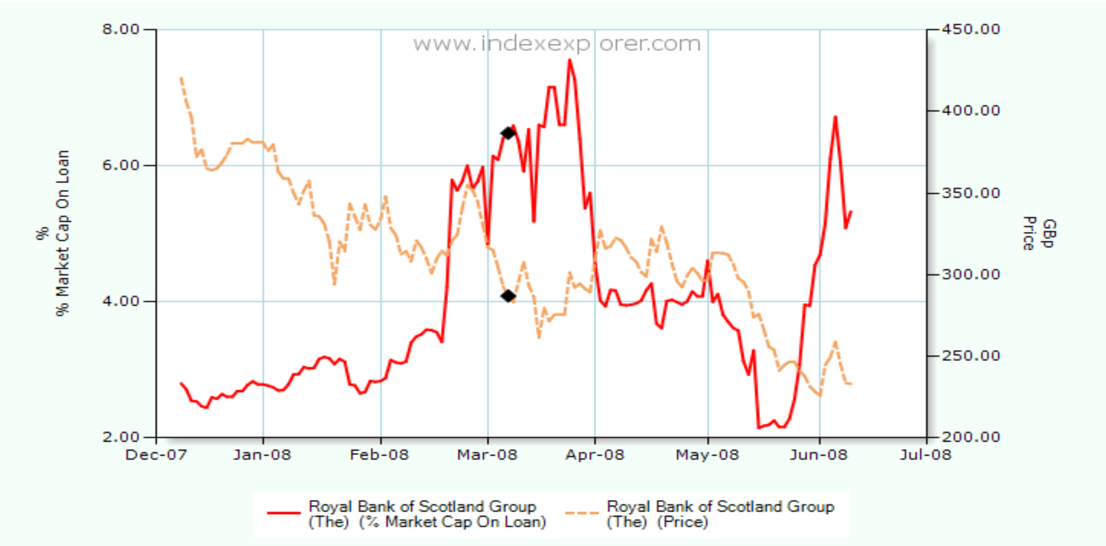
Appendix: Securities lending in bank shares







Note: The diamonds indicate dividend payment dates which can lead to increased securities lending if banks pay more valuable scrip than cash dividends.