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Markets - Stock Markets

Stock lending is need of the hour

Jayanth R. Varma

Short selling is extremely important for ensuring price discovery and protecting market integrity. A market without short selling is an open invitation to company managements and other manipulators to rig up the prices of stocks.

WHEN badla and ALBM (automated lending and borrowing mechanism) were abolished in mid 2001, the expectation was that the role performed by these products (and other proposed products such as continuous net settlement) would be performed by single stock futures and stock lending.

Single stock futures have been spectacularly successful in taking over the leverage function of badla and ALBM. But, the stock lending mechanism remains practically defunct and it has become very difficult to short a stock in the cash market.

Short selling is extremely important for ensuring price discovery and protecting market integrity. A market without short selling is an open invitation to company managements and other manipulators to rig up the prices of stocks.

Even without stock lending it may still be possible to short in the derivatives market but then the derivatives market may decouple from the cash market and the short selling in the futures market may fail to thwart the cash market manipulator.

While exploring ways to create a vibrant stock lending mechanism in India, it is worthwhile looking at the US model because stock lending works very well in that country.

A recent paper by Gene D'Avolio shows how easy it is to borrow stocks in the US: most stocks (over 84 per cent by number and 99 per cent by value) can be borrowed (and therefore shorted), the average cost of borrowing stock is less than a quarter per cent per annum (stocks belonging to the S&P 500 index are even cheaper to borrow), and the supply of lendable stock is over fourteen times the actual value borrowed.

Typically, the stock borrower deposits cash collateral equal to 102 per cent of the value of the stocks borrowed. The stock lender might earn an interest rate of say 1.25 per cent on this cash collateral, but would rebate 1.05 per cent out of this to the borrower so that the net income to the lender and the net cost to the borrower is 0.20 percentage point.

However, a closer examination of the US model shows how difficult it would be to apply to India. Most of the stock lending in the US is done by large institutions and most of the borrowing is done by/or through large institutions. If individuals wish to borrow, they have to do so from their broker who in turn might have access to an institutional

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lender. Many stock lenders prefer to lend to A1/P1 counterparties and would not lend at all to those rated below A2/P2.

Many large institutions auction the exclusive right to borrow their portfolio for a guaranteed minimum fee to very large and strong institutions; Calpers, for example, accepts bids in such auctions only from institutions with an A1/P1 rating and minimum total assets of $15 billion.

In India on the other hand, most institutions are not allowed to short and the derivative market also runs largely on retail participation. Thus, the principal demand for stock borrowing is from non-institutional players. We therefore need a transparent stock lending mechanism accessible to non-institutional investors also.

The flip side of this flexibility would of course be much larger collateral requirements. The-102 per cent collateral requirement amounts to a margin requirement of only two per cent, which is minuscule compared to typical margin requirements in the derivatives markets.

In the US, the principal protection against default is the counterparty rating and the collateral is only an additional source of comfort. In India, the collateral would have to provide the main protection against default and would therefore have to be in the range of 125 per cent - 150 per cent for most stocks.

Given these peculiarities, stock lending in India would have to be intermediated by an efficient and reliable collateral manager. The natural choice for this would clearly be the clearing corporation of the exchange.

A stock-lending scheme modelled on such lines would bear some superficial similarities to the erstwhile ALBM. It would, however, be very different in that it would be a pure cash market product without any embedded derivative-like features at all. This is important because as the report of the Joint Parliamentary Committee pointed out quite correctly the derivative and cash sectors must be segregated in a pure securities lending scheme.

India today has electronic trading, rolling settlement, derivatives, dematerialisation and well functioning clearing and settlement processes. The most important thing, which is lacking is a well functioning stock lending scheme. It is time to remedy this shortcoming.

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