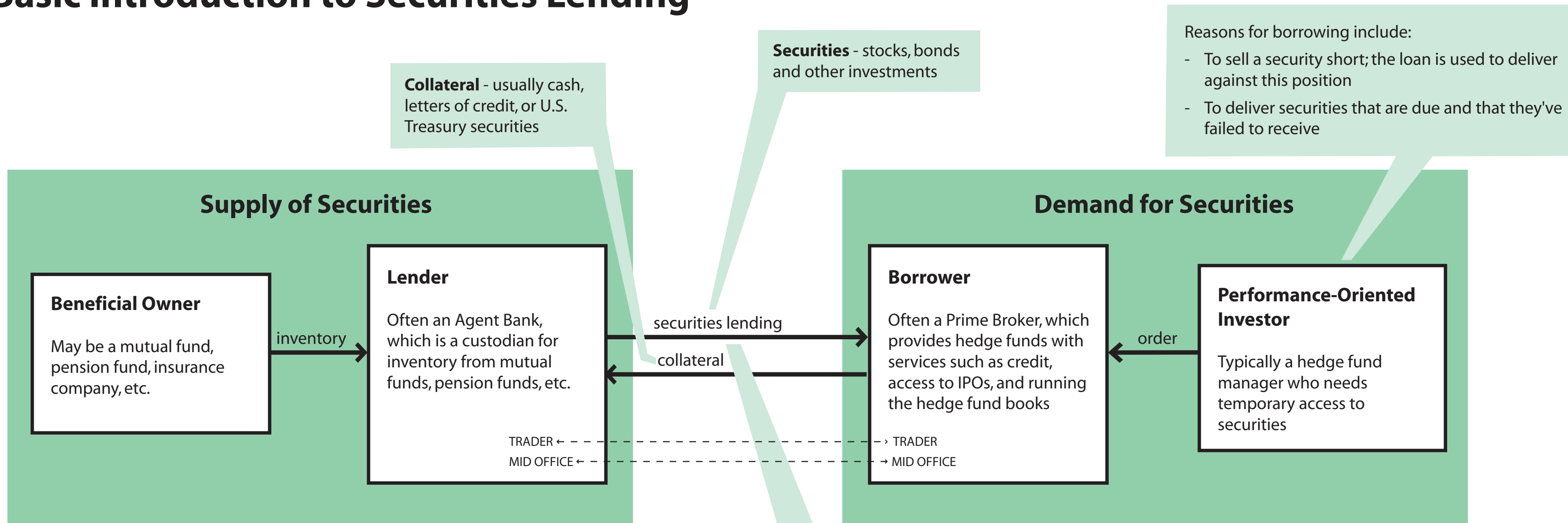
Basic Introduction to Securities Lending



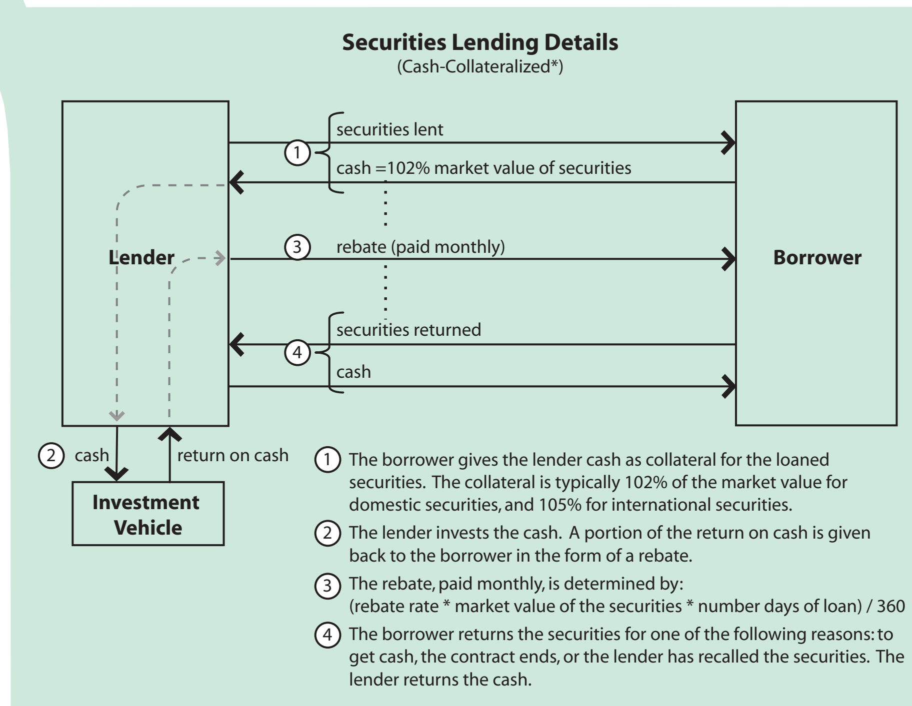
Securities Lending Overview

SUPPLY: Beneficial owners of securities keep them in agent banks. This is similar to consumers keeping money in savings accounts.

To earn extra revenue on the securities prior to their sale, some beneficial owners allow the agent banks to lend their securities. The extra revenue is generated by investing cash that borrowers give as collateral for the loaned securities. The revenue is shared - typically 60% goes to the beneficial owner and 40% to the agent bank.

DEMAND: Performance-oriented investors, such as hedge fund managers, want temporary access to securities to back a position (for example, shorting a stock). Although agent banks have the inventory, they generally won't lend securities directly to hedge funds because of the risk the loan won't be returned.

Therefore, a borrower, such as a prime broker, who has an established business relationship with the agent bank, borrows the securities on behalf of the hedge fund. This way, the prime broker protects the lender from the risk of a bad loan.



***Non-cash-collateralized securities lending**, common outside the U.S., is nearly the same as the details above except the lender does not invest the collateral. Therefore, instead of receiving a rebate, the borrower pays a monthly fee.

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