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## Stock Loan Automation Enters Foreign Markets

U.S. broker-dealers are struggling to expand their borrowing and lending operations for foreign securities with the aid of automated systems such as I.P. Sharp's BLEND and Financial Telecommunications Corp.'s Equiloan.

Shearson Lehman and Morgan Stanley are hoping that BLEND, I.P. Sharp's borrowing and lending automation service, will help them attract the critical mass of users needed to improve loan market liquidity for foreign securities.

Major U.S. broker-dealers average between three and ten thousand domestic securities loan deals daily. The number of foreign securities loans handled daily by U.S. broker-dealers is typically below 100. But the demand for foreign equities is growing and with it the need for loans.

Borrowing and lending markets have a limited cast of characters: *borrowers* -- usually brokers who need additional securities in order to make timely delivery to their customers, and *lenders* -- usually institutional investors, fund managers or the custody operations of banks looking to maximize return from their holdings or raise cash.

Standing between borrower and lender are: *quasi-regulatory bodies* -- the Securities and Exchange Commission, the Bank of England, and the Japanese Securities Finance Corp.; *finders or loan brokers* -- brokers or individuals who locate, borrow and re-loan stocks; and *depositories and clearinghouses* -- such as the Depository Trust Co. and Euro-clear, which hold and account for transfers of securities certificates.

Vendors of borrowing and lending software and systems are the grease between the cogs of the lending market. Domestic vendors include Loanet of Salem, N. H., DML Corp., ADP's Securities Loan Services and Systematics Inc. of Arkansas. Internationally, the key players are BLEND and Equiloan.

Securities loan automation packages vary widely in the scope of their functionality. The most successful services link borrower and lenders with the necessary depositories, with internal accounting and cage systems, and, through a unified database of loan information, with each other. The systems offer order-entry, confirmation, comparison, mark-to-market, multi-currency accounting, availability lists and a variety of messaging functions.

Loanet, the dominant vendor of automation services for domestic securities lending, handles more than \$35 billion of lending every week. In the domestic market, Loanet has focused its automation effort on the back office. But in the new and less liquid foreign lending markets where counterparties are less intimate, automation of the front end of the lending process is emphasized.

### Market Within A Market

In both Japan and the UK, borrowing or lending securities still entails actual movement of certificates. In the U.S., the DTC handles transfers by book entry, obviating the need for physical delivery.

The clearance and settlement obstacles faced by foreign securities traders are well-known. The London Stock Exchange has accumulated nearly \$10 billion of unsettled transactions, some of which will take months to clear. Other European exchanges are similarly overwhelmed.

What is less well-known is the relationship between these unresolved trades and the demand for securities lending. If a broker cannot deliver to a client because of a settlement or clearance delay, it is often less expensive to borrow the security than to miss a delivery.

### A Tough Nut To Crack

In Japan, the JSFC requires minimum collateral of between 120% and 130% of the borrowed equities' market value, and rebates are not permitted. The JSFC is the only dependable source for borrowers of Japanese equities, but its unusually high rates make it the lender of last resort.

Moreover, the JSFC will lend only to members of either the Tokyo or Osaka stock exchanges, and only to prevent local (in-country) fails. Very few U.S. brokers -- including Morgan Stanley, Merrill Lynch, Salomon Brothers and Goldman Sachs -- are members of the Japanese exchanges.

Since much of the borrowing demand of U.S. brokers derives from U.S. customers seeking Japanese equities, alternatives to the JSFC are being sought. The major Japanese brokers -- Nomura, Nikko, Daiwa and Yamaichi -- have been slow to cooperate with would-be borrowers, citing potential legal barriers to direct negotiation of stock loans.

As a result, U.S. brokers seeking loans of Japanese securities to satisfy domestic fails must turn elsewhere. The global custody operations of major U.S. banks such as Chase Manhattan and Citicorp are frequent lenders.

Chase, with more than \$50 billion in its global custody operation, is launching an international securities lending program. Because of the JSFC's lending restrictions, institutional lenders of Japanese equities can command a hefty premium.

If Morgan Stanley and Shearson Lehman have their way, BLEND will attract new sources of Japanese equities, and introduce negotiated rebates to the lending market for Japanese equities. Both BLEND and Equiloan are reported to be holding discussions with the Tokyo Stock Exchange.

### The Old Boy Network

While the United Kingdom offers no impediment to borrowing and lending of non-U.K. securities, only registered stock exchange money brokers are allowed to loan gilts or U.K. shares. Lenders must lend and borrowers must borrow only through money brokers approved by the Bank of England. There are nine such money brokers, including one U.S. firm, Prudential Bache Securities Inc.

The group of nine money brokers smacks of cartel, and the Bank of England is in no hurry to break it up. After entertaining applications later this fall, the Bank of England will add another three firms to the in-crowd. Industry sources indicate that both Shearson Lehman and Morgan Stanley are planning to apply.

One of the new prerequisites for application as a money broker is the development of an automated system for borrowing, lending and brokerage activities. Although existing money brokers are exempted, future applicants must present their systems to the Bank of England for inspection and approval. The Bank of England is currently "vetting the [BLEND] system," according to Brian Traquair, a vice president with I.P. Sharp.

Another drawback to borrowing and lending in the U.K. is the absence of an effective automated settlement process. The Bank of England is responsible for settling gilt trades and the London Stock Exchange is responsible for settlement of U.K. equity trades through the Talisman system.

In both cases, the settlement process often takes weeks, and during the delay certificates are unavailable for lending. The Taurus system proposed by the London Stock Exchange would solve this problem by de-materializing stock certificates.

The Bank of England, which sets collateral requirements for loans of both U.K. shares and gilts, recently raised rates from 100% to 102.5%, and 105% respectively.

### One More River To Cross

A source at Shearson Lehman confirms the firm's goal of opening up a major lending operation in the U.K., adding,

"Shearson is ready to put BLEND terminals on the desks of any of its institutional clients that don't already have them."

Bringing lenders into their camp, though, may be the brokers' toughest assignment. BLEND, Equiloan and their backers need to convince lenders that what they lose by making securities easier to find they will gain by increasing volume and eliminating middlemen.

"BLEND's strategy is to let the lenders drive the market," says Robert Hayim, manager of European sales; but just to help them along, BLEND is planning a series of lending seminars for large U.K. lenders.

For the U.S. brokers, supporting BLEND in the U.K. is a no-lose proposition. If they can't become approved money-brokers, BLEND will improve borrowing conditions. If they do become money brokers, BLEND makes their work that much easier.