FINANCIAL TIMES

Andrew Jack focuses on the practice of stock lending in the UK

Code of practice demanded

STOCK LENDING has risen from the depths of obscurity to new heights of public awareness in the past few months – but for all the wrong reasons.

The legacy of the late Mr Robert Maxwell has done more to publicise and in some ways more to damage the reputation of the activity than millions spent on advertising could ever have achieved.

Poor controls on stock lending at Bishopsgate Investment Management, the trustee and manager of Maxwell pension funds, with widely-known consequences, have helped further stoke existing fears from lenders that stock lending is a high-risk business.

Yet Mr Simon Thomas of Davis International Banking Consultants believes the practice has suffered unfairly as a result. "Maxwell has dented people's confidence," he says. "But it has been totally misunderstood by commentators. The market has been rather weak at defending itself."

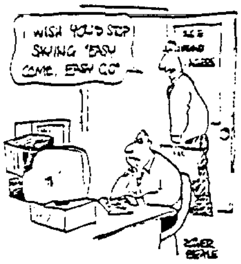
He argues that the episode highlights the lack of supervisory control over pension fund management, and the value of dealing with well-regulated counter-parties. "What is quite clear is that there are no standard legal agreements for stock lending," he adds. "It has to be improved."

Nevertheless, the role and growth of international stock lending is widely endorsed by market professionals. As Mr Ian Plenderleith, an associate director of the Bank of England and chairman of its stock borrowing and lending committee, said at a conference this summer, it has helped provide both timely settlement and liquidity.

Timely settlement, he said, resulted in improved market safety, cost savings and ultimately enhanced investor protection. Liquidity could only be assured in bear markets if securities could be borrowed.

Stock lending also helped channel savings into investment, he added, by bringing together lenders with borrowers where they can raise funds on finer terms.

He called on the industry to boost its public information efforts and to develop a code of



good practice to help counter what he called public "misunderstanding".

In spite of the reservations expressed in some quarters, there has certainly been a significant growth in demand for international stock lending over the past few years, driven directly by the expansion of cross-border investment and international securities trading.

There have been considerable technological advances,

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product innovation, and progress towards more efficient clearing and settlement on most of the world's stock exchanges, driven by the pressure since 1989 from the G30, the Group of 30 financial and economic experts.

There has also been a growth in competition, with an expansion in the range of lenders such as UK unit trusts, and of specialist intermediaries.

Future growth, according to Mr Plenderleith, will in part be constrained by tax reform. He highlights the achievement early last year for UK lenders of new accounting arrangements for pools of participants with the Inland Revenue.

Now efforts are being directed towards overseas lenders. He says that agreement on a relaxation of restrictions on the range of international securities borrowers and on the number of parties involved in lending transactions depends on arrangements on the tax treatment of manufactured dividends.

In many other countries, stock lending has been hindered by demanding tax requirements. For instance, the practice only began to develop in France in 1987, and in Switzerland in 1990 with the introduction of a more favourable regime.

Mr Thomas questions how far lending will continue to grow in the UK. "There is so much resistance," he says. "People have been nervous about stock lending. There are stories of it taking 20 years for a mandate to be signed." He argues that while UK major funds are over-funded and their performance is so good, companies do not see the need. "The pressure just hasn't been there."

Elsewhere, he points to developments in Italy and Germany. Now attention is beginning to focus on Spain. Growing competition puts pressure on margins, which he says can be 100-250 basis points for some international lending arrangements, compared with 30-50 points in the UK.

He sees substantial changes taking place in the future, fuelled in part by Taurus, the Stock Exchange's electronic settlement system, the relaxation of restrictions on international lending, and changing market structures.

In the US, Ms Cindy Gall of Citibank points to the growing role of international stock lending, particularly with European markets such as the UK and Germany. "With a 24-hour book, European centres are becoming very important," she says.

Mr Thomas says it is both a good time and a bad time to review developments in the sector. A series of regulatory changes are underway, many of which still wait to come to fruition.

Mr Plenderleith highlighted three types of safeguards which he said ensured that the inherent risks of stock lending were "identified, controlled and covered":

- Bilateral legal agreements signed by the counterparties to ensure adequate collateral, proper authorisation by agents and clear understanding responsibilities.
- Industry-wide rules, agreed practices and tax regulations which govern activity, conduct and appropriate treatment.
- Supervision from different national regulatory authorities to maintain standards and require adequate capital to cover the risks undertaken.

Maxwell has had some positive effects. It is widely credited with pushing forward legislative change, moving the UK more towards the degree of regulation found in the US. Mr Thomas says it is increasingly focusing on the need for separate professional trustees, and the separation of asset management from custody.

At the moment, he says there is already considerable discretionary power in the UK, but it is not exercised. But he adds: "Some people say it may need another Maxwell scandal to force the whole thing through."