

CONSULTATION ON
VARIATION OF THE
FINANCIAL STABILITY
STANDARD FOR SECURITIES
SETTLEMENT FACILITIES:
DISCLOSURE OF EQUITIES
SECURITIES LENDING

OCTOBER 2008

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Reserve Bank

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Consultation on Variation of the Financial Stability Standard for Securities Settlement Facilities: Disclosure of Equities Securities Lending

1. Introduction

Under powers set out in the *Corporations Act 2001*, the Reserve Bank has determined *Financial Stability Standards* for both central counterparties and securities settlement facilities which aim to ensure that licensed facilities conduct their affairs in a way that promotes overall stability in the Australian financial system. In accordance with the *Corporations Act*, the Reserve Bank assesses licensed facilities against these standards, reporting its findings annually to the Minister with portfolio responsibility for financial markets, and to the Australian Securities and Investments Commission (ASIC). These assessments are also released publicly.

The standards are supported by a set of minimum measures that the Reserve Bank considers relevant in determining whether a licensee has met the relevant standard. The Reserve Bank is proposing to modify one of the measures underpinning the *Financial Stability Standard for Securities Settlement Facilities* to clarify that, in assessing compliance with the Standard, the Reserve Bank will consider whether a facility that settles cash equity transactions collects and publishes data on equities securities-lending activity. This consultation document seeks views from interested parties on the Reserve Bank's proposed modification.

The document is structured as follows. Section 2 provides an overview of the Reserve Bank's objectives in seeking greater transparency and disclosure of securities-lending activity. Section 3 then details the specific proposed variation to the Standard, with Section 4 discussing some practical considerations. Section 5 concludes with some specific issues on which those making submissions might wish to focus.

Interested parties are invited to make submissions by 21 November 2008. Submissions will be placed on the Reserve Bank's website and those making submissions will be offered the opportunity to discuss their views with Reserve Bank staff. Submissions should be sent to:

Head of Payments Policy Department or pysubmissions@rba.gov.au
Reserve Bank of Australia
GPO Box 3947
Sydney NSW 2001

2. Securities-lending Disclosure

In late January 2008, there were significant delays to settlement in the cash equities market. These delays arose, in part, from a participant's inability to meet obligations arising from a series of securities-lending transactions. These types of transactions are currently settled in a batch process operated by the ASX Settlement and Transfer Corporation (ASTC) alongside equity trades novated to the central counterparty, Australian Clearing House (ACH). However, in contrast to transactions undertaken on the exchange, about which there is considerable transparency, securities-lending activity is much more opaque. Reflecting this lack of transparency, the Reserve Bank's *Review of Settlement Practices for Australian Equities* conducted earlier in the year concluded that further steps needed to be taken to improve the disclosure of information about equities securities-lending activity.¹ In particular, the Reserve Bank concluded that there was a strong case for the publication of data on the aggregate accumulated outstanding on-loan position, by stock.

The Reserve Bank's main objective in seeking greater transparency is to improve participants' understanding of the potential settlement risks arising from securities-lending activities, thereby improving the overall functioning and stability of the market. Greater transparency would:

- *assist the system operator in managing the settlement process.* Separate identification of securities-lending transactions would improve the system operator's understanding of the composition of the daily settlement schedule, facilitating analysis of dependencies within the settlement process, and providing important input to back-out and batch-recalculation processes in the event of problems;
- *assist both the system operator and participants in identifying potential settlement risks arising from securities-lending positions.* Observation of a large outstanding on-loan position in a stock relative to its market capitalisation, or average daily turnover, might give some indication of the potential difficulty in covering that position to return the loan, particularly in the event that the loan was recalled unexpectedly. Separate identification of loans directly from custodians' established loan programmes and those on-lent via an intermediary might also be useful in understanding risks and dependencies arising from 'chains' of loans;
- *improve the quality of analysis of settlement fails.* Recourse to a deep and liquid securities-lending market can help to prevent settlement fails when a participant is otherwise unable to deliver, perhaps due to an operational problem at a client or a custodian. On the other hand, vulnerability to the large-scale recall of loaned securities or to 'chains' of loans could, in some circumstances, lead to a higher incidence of fails. Bringing comprehensive data on securities lending together with settlement fails data could therefore assist in analysing the role of securities lending in the incidence and management of settlement fails;
- *lead to a better understanding of the way the market functions.* More generally, these data could be applied in broader analysis of the functioning of markets, assisting in ex-post analysis of market events and in the empirical study of the role played by securities lending in improving market functioning. In particular, the data could be applied in: analysing the relationship between price moves and changes in securities-lending activity; explaining

¹ The report is available at: http://www.rba.gov.au/PaymentsSystem/StdClearingSettlement/Pdf/review_sttlmt_prac_aus_equities_052008.pdf

seasonal patterns; and understanding the role of intermediaries in this market. Over time, such analysis could, by improving knowledge and understanding of the role of this market, help to improve overall market efficiency; and

- *ensure a balance in the availability of information to market participants.* Public dissemination of these data could help to ensure that all participants in the market had access to data on the volume and value of securities lending, rather than just those directly involved in such transactions or subscribers to proprietary services.

A high proportion of securities-lending transactions are motivated by the need to cover short-sold positions, whether these are directional trades, hedging transactions, or trades executed as part of an arbitrage strategy involving an offsetting derivatives position. Unless a trader is expecting an offsetting incoming delivery of a security, any short-sold position must ultimately be covered by securities borrowing if the trade is to settle as scheduled at T+3. Disclosure of securities lending is therefore complementary to short-selling disclosure, in respect of which ASIC has been working on improvements with ASX, and on which the Government is developing legislative reforms. In addition to covering short sales, other motivations for securities borrowing and lending exist, including borrowing to cover potential failed trades, dividend-driven activity, and some financing trades.

While the Reserve Bank's *Review of Settlement Practices for Australian Equities* concluded that transparency of securities-lending activity should be improved, it also concluded that securities lending and short selling support the efficient functioning of the equity market in normal market circumstances. Both practices add to market liquidity and to the efficiency of pricing, contributing to lower bid-offer spreads and helping to ensure that prices reflect the views of both bullish and bearish investors. Securities lending also plays an important role in ensuring that trades settle on time, even when market participants experience operational problems. However, as illustrated by recent experience, a lack of transparency over short selling and securities-lending activity can undermine confidence in the functioning of the market during periods of turbulence.

Since the publication of its review, the Reserve Bank has been in discussion with ASX and industry participants about how best to improve disclosure of securities lending. Following these discussions, the Reserve Bank is of the view that the most effective way of proceeding is to amend the *Financial Stability Standard for Securities Settlement Facilities* to make it clear that it expects ASX to collect and publish the relevant data. ASX indicated support for this proposal in a recent position paper.²

3. Variation of the Financial Stability Standard for Securities Settlement Facilities

In May 2003, the Reserve Bank determined *Financial Stability Standards* for central counterparties and securities settlement facilities. The standards reflect the critical role played by clearing and settlement facilities in the functioning of the financial markets and are intended

² This paper, released on 2 October 2008, is available at: http://www.asx.com.au/about/pdf/transparency_of_short_selling_and_securities_lending.pdf

to ensure that they conduct their affairs in such a way as to promote overall stability in the Australian financial system.

The *Financial Stability Standard for Securities Settlement Facilities* reads as follows:³

A CS facility licensee must conduct its affairs in a prudent manner, in accordance with the standards of a reasonable CS facility licensee in contributing to the overall stability of the Australian financial system, to the extent that it is reasonably practicable to do so.

The Standard is underpinned by a set of principles-based measures that the Reserve Bank considers relevant for meeting the Standard. These measures cover matters such as: the legal framework; participation requirements; settlement arrangements; and operational risk. The full text of the measures and associated guidance is available on the Reserve Bank's website.

Under the *Corporations Act*, the Reserve Bank is obliged to assess licensed securities settlement facilities' compliance with the Standard at least once a year, and also to assess whether each licensed facility is 'doing all other things necessary to reduce systemic risk'. Although these are separate obligations, the Reserve Bank in practice conducts both assessments by reference to the measures underpinning the Standard, as these comprehensively cover issues pertaining to the management of systemic risk.

In pursuing greater transparency of securities-lending activity, the Reserve Bank proposes a variation of the 'Understanding Risks' measure (Measure 3) of the Standard and associated guidance. The objective of the proposed variation is to clarify that, in assessing compliance with the Standard, the Reserve Bank will consider whether a facility that settles cash equity transactions collects and publishes data on equities securities-lending activity. This would, in turn, have the effect of requiring that a licensed securities settlement facility providing settlement services to the cash equity market amend its rules to require that settlement participants make these data available.

Measure 3, *Understanding Risks*, currently reads:

The securities settlement facility's rules and procedures must enable each participant to understand the securities settlement facility's impact on each of the financial risks the participant incurs through participation in the facility.

Measure 3 is therefore currently focused on the information provided by the securities settlement facility in its rules and procedures to enable participants to understand the financial risks incurred through participation. The guidance supporting this measure focuses primarily on: the availability of clear, comprehensive and up-to-date operating rules; the provision of sufficient procedural information to enable participants to understand the basic design of the system; and the description of the respective roles of participants and the system operator in various circumstances.

The Reserve Bank proposes that the measure be varied in such a way as to require that additional information and data be made publicly available to give participants a more

³ The original *Standard for Securities Settlement Facilities* was varied in June 2005 to ensure that small securities settlement facilities, which are unlikely to affect the overall stability of the Australian financial system, are not subject to unnecessary regulation.

comprehensive understanding of the risks associated with participation. Specifically, the following variation is proposed:

The securities settlement facility must make sufficient information publicly available, via its rules and procedures and the provision of relevant information on settlement activity, such that each participant is able to understand the securities settlement facility's impact on each of the financial risks the participant incurs through participation in the facility.

Further, it is proposed that the following be added beneath the first paragraph of the guidance for Measure 3:

The operator of a securities settlement facility should supplement clear, comprehensive and up-to-date rules and procedures with other information and data relevant to a participant's understanding of the risks associated with participation in the facility. For instance, participants should have access to sufficiently timely and comprehensive securities-lending data to enable them to assess the potential implications for settlement risk. This is particularly important where equities securities loans are bilaterally negotiated and not novated to a central counterparty, but nevertheless settled alongside novated exchange-traded transactions.

The proposed wording of the variation reflects the Reserve Bank's preference to retain a principles-based approach within the measures underpinning the Standard. Such an approach allows licensed facilities some flexibility within broadly stated parameters, recognising that the precise details of system design are best worked out in consultation with industry participants.

4. Practical Considerations

The effect of the proposed variation is that ASX would be required to make arrangements to facilitate the disclosure of securities lending, relying on its Settlement Rules to enforce this obligation on its settlement participants. Under Section 822B of the *Corporations Act*, these rules have effect as a contract under seal between ASTC and each of its participants, and between each participant and each other participant.

The Reserve Bank and ASX will continue to consult directly with market participants and vendor service providers to establish the technical details of implementation of this disclosure requirement. One mechanism for such disclosure is the activation of a matching field in the securities settlement system, Clearing House Electronic Sub-register System (CHES), which could be used to identify whether a settlement instruction entered into the system is related to a securities loan – either a new loan or a loan return. The data could then be aggregated, stock-by-stock, across participants to produce a net daily flow by stock, which could in turn be added to, or subtracted from, the previous day's outstanding on-loan position. This could be published daily in a table alongside other relevant metrics, such as market capitalisation and average daily turnover.⁴

The Reserve Bank understands that a currently redundant field in CHES could be applied for this purpose. This field had previously been applied for a similar purpose when securities loan-

⁴ Euroclear UK and Ireland currently collects and disseminates data on securities lending, presenting the aggregate on-loan position in each security alongside the outstanding number of that security held in the depository. The full dataset is made available to market participants on a subscription basis, with a 3-day lag. Average monthly data are available without subscription.

related transactions were separately identified so as to attract an exemption from stamp duty. Preliminary consultation with ASX, market participants and software vendors suggests that it would not be particularly costly to reactivate such a field and to modify systems and operational processes to populate it. Indeed, the Reserve Bank understands that some participants' systems continue to populate this field. Some challenges have been identified, however, most notably in respect of the flow of information from offshore borrowers and lenders to onshore brokers and sub-custodians.

If this approach were to be adopted, it would be necessary to take a snapshot of the initial outstanding on-loan position to provide a starting point for such a series. This could be achieved via direct reporting by participants engaged in lending activity. Furthermore, given that any gaps in daily reporting could lead, over time, to deviation of the calculated on-loan position from the 'actual' position, participants might also be requested to directly report an updated on-loan position periodically, perhaps on a semi-annual basis.

Internalised securities-lending activity would not be captured by such arrangements, but to the extent that these do not give rise to settlement risks, this should not undermine the primary objectives of the disclosure detailed above. It might, however, limit the applicability of the dataset to other more broadly scoped analysis of market functioning.

To improve the quality of the dataset, it would be useful to distinguish between initial loans from established lending programmes and loans extended by intermediaries. This might be achieved by separately aggregating across positions by reference to the identity of the lending party. Separate identification of intermediary lending would, as noted in Section 2, assist in analysing potential risks and dependencies arising from 'chains' of loans.

The Reserve Bank sees a strong case for this disclosure requirement to be implemented as soon as possible – certainly by the end of the first quarter of 2009. Should operational and technical constraints prevent full implementation of a system-based solution on this time-frame, the Reserve Bank would expect the disclosure requirement to be satisfied by an interim direct-reporting alternative.

5. Key Issues for Respondents

Respondents are invited to comment on any issue in relation to the proposed variation. The Reserve Bank is, however, particularly keen to receive views on the following issues:

- the precise wording of the proposed variation to Measure 3 of the Standard and associated guidance;
- alternative arrangements for disclosure;
- the potential scale and cost of any systems and operational changes required to implement a disclosure regime on the basis described in Section 4; and
- the time-frame outlined by the Reserve Bank for implementation of the new disclosure arrangements.

