

Market Power in the Securities Lending Market

Shuaiyu Chen, Ron Kaniel, and Christian C. Opp

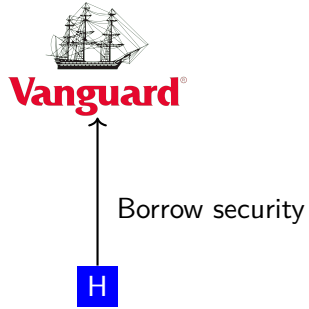
Discussion: Chaojun Wang
The Wharton School, University of Pennsylvania

NFA
September, 2023

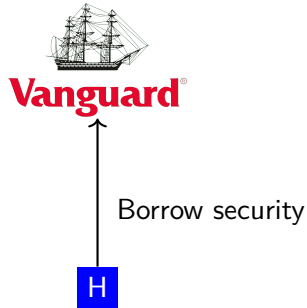
Short Selling



Short Selling



Short Selling



Secondary Market



Market Power by Security Lenders

Evidence:

High market concentration: The two largest security lenders have market shares 50%-85%

High lending fee: Especially for smaller-cap stocks (75.14% for nano-cap)

High excess inventory: 15.17% (for high-fee stocks)–97.6% (for low-fee stocks)

High correlation between fee and informed trading: 93.3%.

Market Power by Security Lenders

Evidence:

High market concentration: The two largest security lenders have market shares 50%-85%

High lending fee: Especially for smaller-cap stocks (75.14% for nano-cap)

High excess inventory: 15.17% (for high-fee stocks)–97.6% (for low-fee stocks)

High correlation between fee and informed trading: 93.3%.

Question: Why not having a more competitive security lending market?

Market Power by Security Lenders

Evidence:

High market concentration: The two largest security lenders have market shares 50%-85%

High lending fee: Especially for smaller-cap stocks (75.14% for nano-cap)

High excess inventory: 15.17% (for high-fee stocks)–97.6% (for low-fee stocks)

High correlation between fee and informed trading: 93.3%.

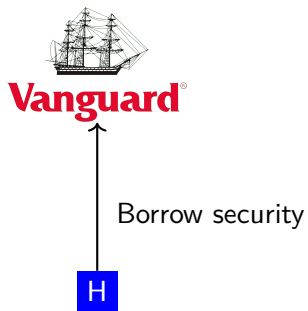
Question: Why not having a more competitive security lending market?

Answer: To avoid information leakage

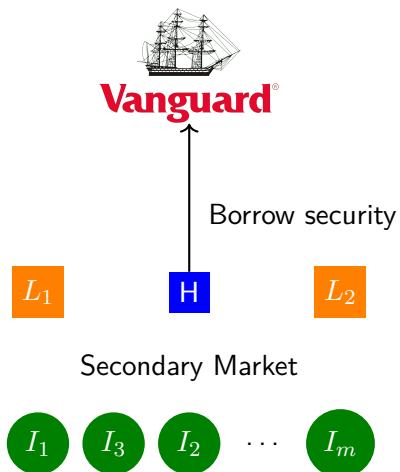
Model: Monopolistic lending + Gosten-Milgrom (1985)



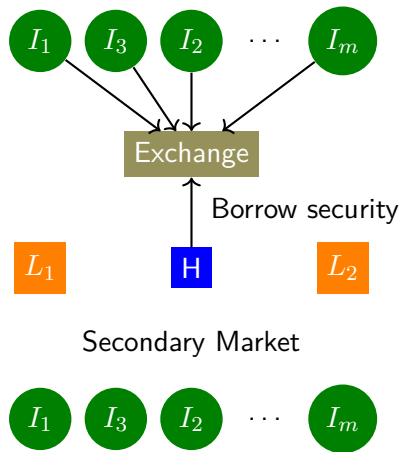
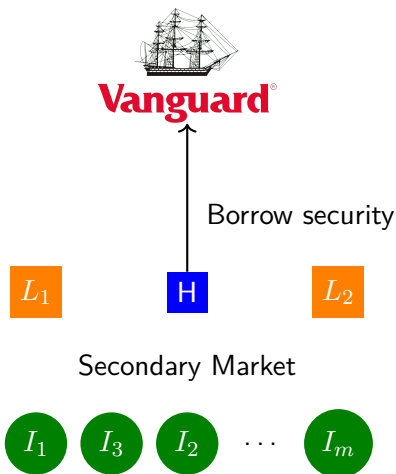
Model: Monopolistic lending + Gosten-Milgrom (1985)



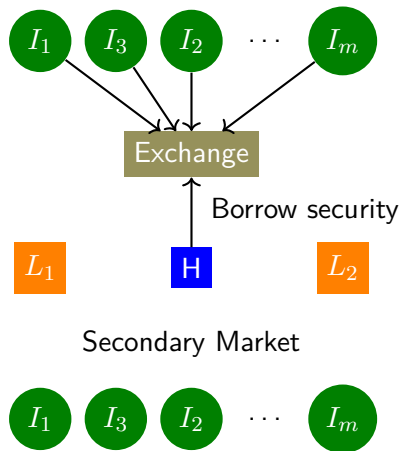
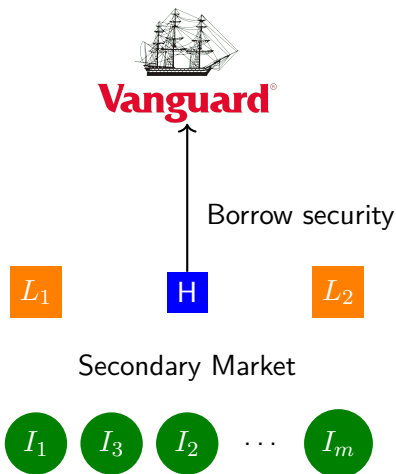
Model: Monopolistic lending + Gosten-Milgrom (1985)



Model: Monopolistic lending + Glosten-Milgrom (1985)



Model: Monopolistic lending + Glosten-Milgrom (1985)



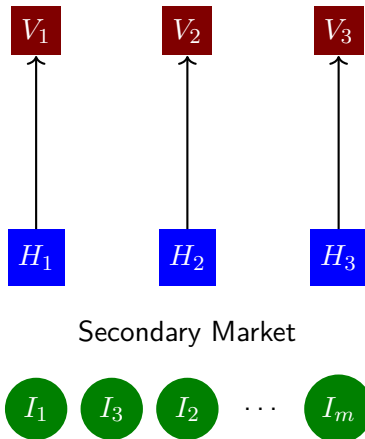
Extensions: Micro-foundation for custodian commitment, opaque yet competitive platform, options trading

Suggestion #1: Comparison to bonds?

- Large security lending market for bonds (e.g. repo)
- Bonds are less informationally sensitive than equities
- Is security lending for bonds more competitive?
- Good “control”

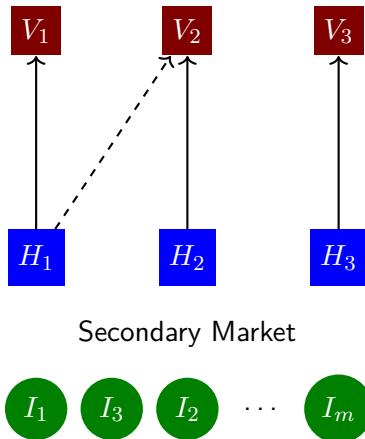
Suggestion #2: Why the same two security lenders?

Security lending as a standard OTC market (core-periphery)



Suggestion #2: Why the same two security lenders?

Security lending as a standard OTC market (core-periphery)



Suggestion #3: Scale of economy

Suggestion #3: Scale of economy

Security lending through large custodian may

- 1 be less likely to be recalled (forced buy-in)
- 2 have less risk of front run (agency friction between custodian and security owner)

Suggestion #4: Relationship between quantity and fee?

- Standard OTC trading has size discount across clients and size penalty within client (Pinter, Wang, Zou, 2022)
- Possible to observe and control for quantity?
- Endogenize quantity?
- Endogenize entry by hedge funds (π)?

Suggestion #5: Pool with uninformed hedgers in security lending?

Suggestion #5: Pool with uninformed hedgers in security lending?

- 1 Option sellers need to hedge \implies borrow securities to short
- 2 Some investors borrow to deliver underlying securities
- 3 Pooling with uninformed hedgers reduces information leakage in an exchange?

Summary

- Striking concentration and market power in security lending for equities
- Convincing explanation: Avoidance of information leakage
- Main suggestions: Scale of economy