Finance Train

Menu

Jones Day – Internet Security Warning

Short Selling and Stock Borrowing Costs

FINANCIAL MARKETS, PRM EXAM, PRM EXAM I

This lesson is part 8 of 8 in the course The Stock Market

Short selling refers to the process of selling a security not owned by the investor with the intention of buying it back at a later date at a cheaper price.

Since the investor doesn't own the security, he typically borrows it from a broker/dealer and short sells it in the market. On the future date, the investor will purchase the security from the market at the current market price and return it to the lender. If the stock price has fallen, the investor will make a profit in the deal.

The investor also has to pay a fee to the lender for the borrowed stock, which is known as the borrowing costs.

Restrictions on short sales

Different markets place certain restrictions on short sales.

In the USA, a stock is eligible for short sale only if the last price movement is positive. This is called the uptick rule. This rule is put in place to limit the volatility of fluctuations in the market.

Another rule prevents the brokers/dealers from investing the proceeds of short sales in other positions. With this rule in place, the brokers can create only a limited amount of leverage.

In the UK, instead of uptick rule, the leverage is limited using the capital adequacy norms. Since the capital of a firm is limited, there is a limit on the total risk and the degree of leverage.

Similar to margin trading, an investor is required to deposit a margin in case of short selling also. This is because the rise in the stock price, instead of fall as expected by him, will expose the investor to losses, which otherwise will have to be covered by the broker/dealer. So, both the initial margin and maintenance margin apply to short selling.

Stock Borrowing

As we said before, the investor borrows the stock from a broker dealer for the purpose of short selling.

The broker lends these stocks from the securities that he holds or are in his custody on behalf of his clients. Some large investors owning their own stocks will directly lend in the market.

There are two types of loans:

Call loans: The lender can terminate such loans anytime. This is the most common type of loan.

Term loans: These loans are provided for a specified period, for example, one month.

These loans are for a given number of stocks rather than a particular value.

This are secured loans as when shares are borrowed, cash or another security is pledged as collateral.

The typical fee for a stock loan is 0.30% per annum. In case of short supply, when many investors are going short on a stock, the fee may go up to 20-30% per annum.

Even though the stock is borrowed by an investor, the dividends still belong to the lender. So, while returning the stock, the investor has to pay the fee along with any dividend received.

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