E Q U I T I E S

The Effects of Stock Lending on Security Prices

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The impact of short selling is the subject of an ongoing debate among academics, investment committees, corporate boards, and regulators. One view is that short selling helps make markets more efficient by improving price discovery. An alternative view is that short selling distorts markets and adversely affects prices moving them further away from fundamentals. Indeed, short-sellers have often been characterized as immoral, unethical and unpatriotic.

Interest in the effects of short selling has intensified with the sharp drop in asset prices, particularly those of financial institutions, during the mortgage crisis, sparking new discussions of the consequences of short selling among policy makers worldwide.

In this paper, we randomly move the supply of shares available for lending, thereby exogenously shifting the supply of lendable assets. Working with a sizeable (greater than $15 billion in assets), anonymous money manager ("the Manager"), we randomly make available for lending two-thirds of the high-loan-fee stocks in the Manager's portfolio and withhold a characteristic-matched random sample of the other third. Our experiment compares stocks randomly made available for lending to those randomly withheld from lending to identify shocks to supply holding demand and other factors constant.

We find that average loan fees decline significantly (on the order of 2% to 3%) for the stocks that experience supply increases relative to those that do not. We do not find any adverse effects on stock prices from loan supply shocks. Similarly, during the recall period, returns to recalled stocks are not greater than returns to stocks withheld from lending.

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