



# **COMPLEMENTARY, NOT CONFLICTING:**

## SECURITIES LENDING AND ESG INVESTING COEXIST





# CONSIDERATIONS FOR THE INTERSECTION OF ESG AND SECURITIES LENDING

## Foreword

Can securities lending and Environmental, Social, and Governance (ESG) principles coexist? Our survey of major global asset owners and managers shows that they can, and this reflects a growing recognition that securities lending can be aligned with – and even enable – positive ESG outcomes.

Of course, as with all important endeavors, differing goals and considerations must be carefully weighed. That is why the Risk Management Association (RMA) has produced this paper, bringing together the questions that institutions need to ask and insight into existing best practices to help investors craft a securities lending strategy that is best suited to their ESG goals and risk appetite.

The paper addresses short selling, the need for engagement with portfolio companies in order to follow through on ESG principles, the importance of proxy voting, implementation challenges, and other considerations. Although we are living in a time of great uncertainty and change, it is clear that the focus on ESG principles is here to stay. As well as enabling positive environmental and social outcomes, there is also a growing body of evidence that ESG investments can outperform other funds in their categories.

As climate change, Diversity, Equity, and Inclusion, and data privacy become defining issues for our economy and society, ESG will only become more strategic for every institution. We hope that this paper can help investors everywhere integrate their approaches to ESG and securities lending.



*Fran Garritt, Director, Securities Lending &  
Global Markets Risk*





Sustainable investing and the value of assets managed with ESG considerations is a growing segment of the investment universe. As of June 2020, ESG funds' assets under management totaled \$1.06 trillion, accounting for approximately 13% of the funds industry. RMA's Council on Securities Lending felt that it could contribute to the discussion on ESG investing by exploring questions around securities lending and the application of ESG principles. This paper provides insights and perspectives from a range of different investor segments including asset managers, insurance companies, pensions, sovereign wealth funds, and central banks. We conducted interviews with a number of institutional investors and also surveyed 44 institutions to gather information about the intersection of ESG principles and securities lending. The interviews and survey data provide new perspectives on this relationship. The paper also explains the benefits of securities lending and provides answers to questions about different approaches to the integration of ESG principles into lending programs. RMA would like to thank Tred McIntire, Managing Director of Royal River Consulting, LLC, who led this effort with significant input from the Council. Tred has more than 30 years of experience with Goldman Sachs and formerly led the Goldman Sachs Agency Lending business. He also served on RMA's Council on Securities Lending for 16 years, including two years as its Chairman.



*Glenn Horner, Chair of RMA's Council on Securities Lending*



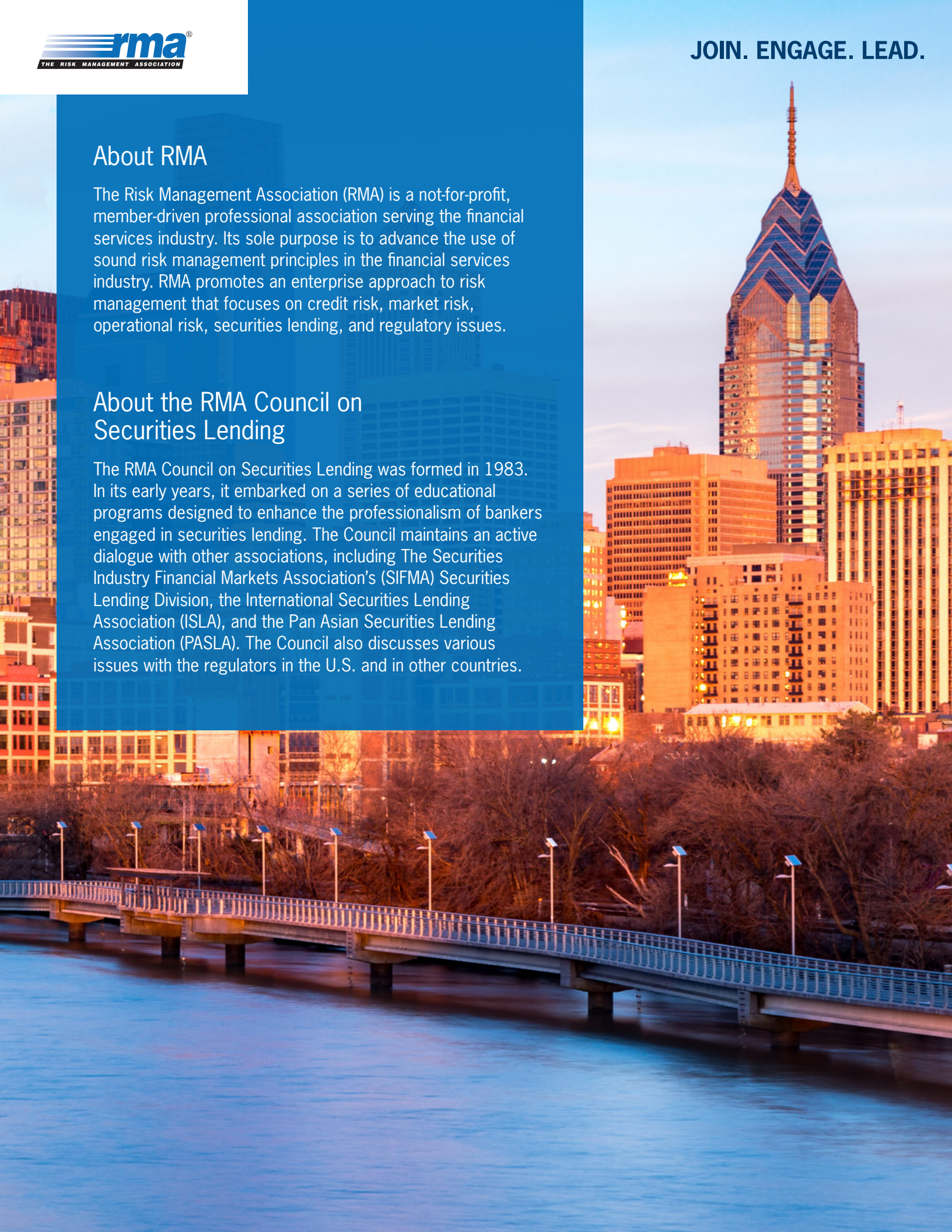


## About RMA

The Risk Management Association (RMA) is a not-for-profit, member-driven professional association serving the financial services industry. Its sole purpose is to advance the use of sound risk management principles in the financial services industry. RMA promotes an enterprise approach to risk management that focuses on credit risk, market risk, operational risk, securities lending, and regulatory issues.

## About the RMA Council on Securities Lending

The RMA Council on Securities Lending was formed in 1983. In its early years, it embarked on a series of educational programs designed to enhance the professionalism of bankers engaged in securities lending. The Council maintains an active dialogue with other associations, including The Securities Industry Financial Markets Association's (SIFMA) Securities Lending Division, the International Securities Lending Association (ISLA), and the Pan Asian Securities Lending Association (PASLA). The Council also discusses various issues with the regulators in the U.S. and in other countries.





# EXECUTIVE SUMMARY



**Complementary, not conflicting:** Ninety-five percent of survey respondents said ESG investing and securities lending can coexist. But only 18% always apply ESG principles to their securities lending programs. Another 25% do so on a case-by-case basis, 18% don't but are planning to and 39% simply don't.



**Proxy problems:** A lack of timely information about proxy record dates and voting questions complicates the process of recalling stock that is on loan. When survey participants were asked to name “measures that might facilitate the application of ESG principles to their securities lending program,” 43% said that they want more transparency around proxy record dates and questions.



**Coordinated approach:** Sixty-three percent of respondents said that there is interaction in their institution between those who manage securities lending and those who manage ESG issues on either a “regular” basis (19%) or from “time to time” (44%).



**Show me how:** Fifty-five percent of participants ranked “greater education about available options” as the top priority when it comes to applying ESG principles to their lending program.



**The way forward:** RMA strongly supports and encourages the collaborative coexistence of ESG principles and securities lending, so that investors will continue to reap the benefits of lending while accommodating the beneficial owner's ESG priorities.





# INTRODUCTION:

Given the growing interest in sustainable investing and the value of assets invested in accordance with ESG considerations, the Risk Management Association believes that this is a good time to share our views on how ESG principles can be applied to securities lending and to provide answers to some of the questions that arise.

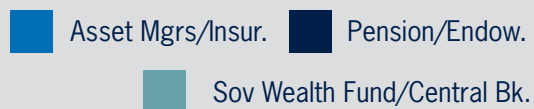
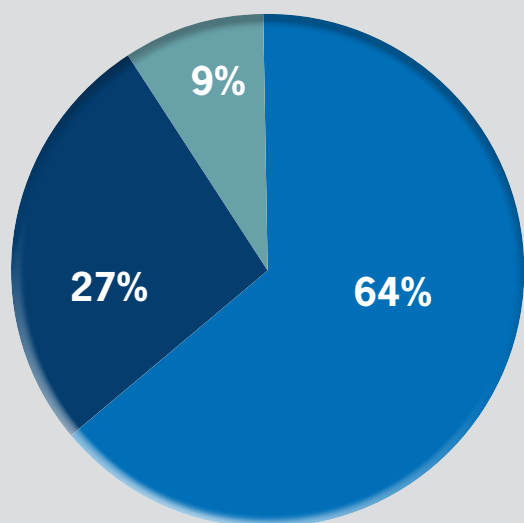
In conjunction with drafting this paper, RMA conducted a survey of 44 institutional investors to better understand how they view the intersection of ESG principles and securities lending. We also held detailed interviews with nine firms.

The survey participants included:

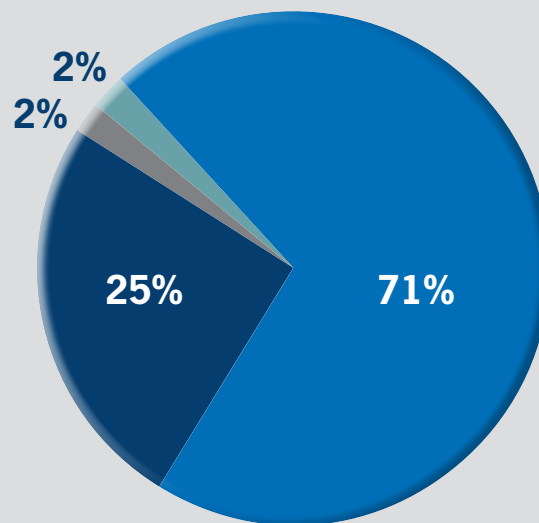
- Five of the 10 largest global asset managers;
- Two of the top 10 U.S. retirement plans; and
- Two of the top five sovereign wealth funds.



Survey Participant Roles



Survey Participant Region



As well as sharing RMA's perspectives and feedback from this survey, we hope this paper will help portfolio managers and institutional investors reach more informed decisions on questions about the relationship between ESG and securities lending.



# ESG PRINCIPLES AND SUSTAINABLE INVESTING:

## What is meant by the terms ESG and Sustainable Investing?

Sustainable investing is an investment discipline that considers environmental, social, and corporate governance (ESG) criteria to generate long-term competitive financial returns and positive societal impact (per the **Forum for Sustainable and Responsible Investment**).

## Why is ESG investing relevant to the financial markets?

Investment which considers ESG principles is gathering momentum across the spectrum of investors and generating discussion about how it can be applied to various aspects of the investment process.

- According to a **Morningstar** report,<sup>1</sup> as of the end of June 2020, the amount of money allocated to ESG funds totaled \$1.06 trillion, approximately 13% of the entire funds industry. Global inflows to sustainable funds were up 72% in the second quarter of 2020.
- During the Covid-19 pandemic, many ESG funds have consistently outperformed other funds in their categories. According to a **Wall Street Journal**<sup>3</sup> article, “more than 70% of ESG funds across all asset classes performed better than their counterparts during the first four months of 2020.”
- A recent **BNY Mellon Survey**<sup>2</sup> of 27 pension and sovereign wealth funds (representing \$4.7 trillion of assets under management) found that more than 90% have specific ESG investment policies in place or are in the process of developing them.
- “Research using **State Street** data shows that the stocks of companies with strong ESG characteristics, such as good employee safety practices, effective supply chains, and agile operations able to repurpose products to meet new market needs, suffered lower declines during the March equity sell-off than the shares of competitors with comparatively weaker ESG characteristics.”(**Financial Times**, 5/12/20)<sup>4</sup>

The rise of ESG investing has led to questions about its relationship with securities lending that include:

- Does the pursuit of ESG principles limit securities lending?
- What are the main considerations around applying ESG principles to a securities lending program?

These are some of the questions that we address in the body of this white paper.



# SECURITIES LENDING: THE BASICS

## What is securities lending?

Securities lending is the market practice whereby securities are temporarily lent by a lender to a borrower versus collateral. In return for lending the security, the lender earns a fee that is negotiated based on supply and demand of the specific security. While the security is out on loan, the lender retains full exposure to the market performance of the security. However, it loses the right to vote proxies if it is on loan over the proxy record date.

## What are the risks of lending?

Two important considerations are the potential for borrower default and risks surrounding collateral. Borrower risk is managed through a careful screening and selection process coupled with over-collateralization of each loan. The risks around collateral are addressed with prudent management and daily marking to market.

## Why should an investor lend its securities?

The primary driver for lending securities is to generate incremental yield on long positions. In 2019, securities lending generated \$8.7 billion of revenues for lenders, down from \$10.7 billion in 2018 (according to DataLend). It is a relatively low-risk activity as loans are typically over-collateralized with 2-5% of margin above the value of the loaned securities.





# KEY CONSIDERATIONS:

**As we consider the intersection of ESG principles and securities lending, there are a number of aspects to take into account:**

- 1** Engagement with portfolio companies and proxy voting as a means of expressing ESG principles;
- 2** Participation in securities lending and, indirectly, the short side of the market;
- 3** The benefits of securities lending to:
  - Shareholders, pensioners, and other stakeholders; and
  - The broader financial markets.
- 4** Implementation challenges and considerations.



# 1. PROXY VOTING AND ENGAGEMENT

Proxy voting is an important and direct way to engage with companies. It is also a critical element of implementing a lending program that reflects ESG principles since a lender gives up the right to vote while a security is out on loan. The right to vote accompanies the shares that have been delivered to the entity that has acquired the loaned securities. Beneficial owners should weigh the importance of voting their shares, which is also a direct way to express their ESG agenda, against the foregone lending revenue from either restricting a position or recalling on-loan securities before proxy record dates.

## POTENTIAL ACTIONS:

1. The lender always has the right to recall securities prior to record date in order to vote on a material issue. However, doing so as a matter of routine may impact lending revenue to some degree since this supply may be regarded as “unstable” given the ongoing recall risk.
2. The lender has the ability to restrict the lending of certain positions where the record date is uncertain, or it expects controversial proxy issues. The lender can also keep a list of securities that touch certain ESG criteria to withhold or restrict from lending on all votes.

## DIFFERENT APPROACHES:

There are a range of policies in place at different organizations.

- According to its Sustainable Investment Stewardship Strategies<sup>5</sup> document, the **California State Teachers’ Retirement System** (“CalSTRS”), the third-largest retirement plan in the U.S., “will make a best effort to vote all domestic and non-U.S. proxies.”
- In its Corporate Governance Principles,<sup>6</sup> the **State Board of Administration of Florida** states that it “shall reserve the right to recall shares.” However, it further notes that “the circumstances required to recall loaned securities are expected to be atypical.” It also cites mergers or proxy contests as examples of situations which might lead to a recall.
- One large European institution maintains a priority list of companies targeted for engagement. Some of these are excluded from lending, while others on the list are subject to closer review for lending opportunities.
- In RMA’s recent survey, 63% of respondents in the Asset Manager/Insurance peer group confirmed that their ESG policy includes parameters and principles on loan recalls and proxy voting.



## PROXY RECORD DATES AND QUESTIONS

For many institutions, a lack of timely information about proxy record dates and voting questions complicates the process of recalling stock that is on loan. Many proxy advisory firms simply reference the prior year's record date as guidance. Lenders who want to vote must either recall in advance of the estimated record date or block the position entirely, reducing the revenue opportunity for the lender and taking supply out of the market.

RMA survey data confirms the belief that there is a lack of clarity around proxy record dates. When survey participants were asked to name "measures that might facilitate the application of ESG principles to their securities lending program," 43% responded that they want more transparency around proxy record dates and questions. In follow-up interviews, several European managers cited frustration with U.S. companies' lack of timely disclosure of proxy information, much of which is subject to a combination of state regulations and exchange rules.



# 43%

responded that they want more transparency around proxy record dates and questions.





## 2. PARTICIPATION IN LENDING AND THE SHORT SIDE OF THE MARKET

Some critics of securities lending cite “short-termism” and empty voting (which occurs when a shareholder has voting rights without full economic interest) as reasons not to lend. In December 2019, Japan’s \$1.6 trillion **Government Pension Investment Fund** (“GPIF”) withdrew its non-Japanese assets from the lending markets, citing the short-termism of short sellers.

Each beneficial owner organization needs to assess its own ESG objectives, risk tolerance, and the best interests of its stakeholders. Many ESG-oriented investors follow an “exclusionary approach” by not investing in companies whose businesses they perceive as conflicting with their ESG principles (for example, those in the tobacco, nuclear, or coal sectors). Many do not go as far as selling these companies short, but lending stock allows other investors to pursue a more active approach.

An example of how two important institutional investors follow different paths to address the “short-termism” issue involves GPIF and CalSTRS. CalSTRS joined with GPIF and **USS Investment Management** (a UK retirement plan) to author a letter that the **Financial Times** described as an “attack on short-termism by companies and asset managers” in an article dated March 3, 2020.<sup>7</sup> Despite sharing views on short-termism with GPIF, it is important to note that CalSTRS continues to lend its securities in accordance with a detailed sustainable investment policy that allows it to earn significant lending revenues while remaining engaged with portfolio companies by voting all proxies.

**The European Securities and Markets Authority** (ESMA), a European Union financial regulatory agency, also countered the short-termism critics with a report from its Securities and Markets Stakeholders’ Group. According to a **Securities Lending Times** article<sup>8</sup> in December 2019, the report said that securities lending, “if done in a controlled way, is an opportunity to add value for fund investors and is compatible with long-term investment strategies, and contributes to market liquidity and price discovery.”





# PROTECTIONS: LEGAL, REGULATORY, AND BEST PRACTICE PRINCIPLES

As well as the specific actions that a lending organization may incorporate into its sustainable investing program, it is important to recognize that there are legal and regulatory protections, as well as market best practice principles (in Europe) that exist to guard against the borrowing of shares to influence the outcome of proxies.

## U.S. Regulations

- Federal Reserve Regulation T requires a “permitted purpose” for borrowing securities. It stipulates that a security may only be borrowed for the purpose of making delivery in the case of a short sale or a failure to receive a security required to be delivered. The rule effectively precludes the possibility of borrowing securities for voting proxies.
- SEC Regulation SHO is designed to prevent naked short sales by adding teeth to regulatory measures with specific criteria for enforcement.
  - » Rule 203(b) requires a broker to have reasonable grounds to believe that a security can be borrowed before effecting a short sale.
  - » Rule 204 requires brokers to close out “fail to deliver” positions, thereby further restricting the potential for unintended naked short-selling to occur.

## Outside the U.S.

- The standard legal agreement for lending outside the U.S., the **Global Master Securities Lending Agreement 2010** (GMSLA), prohibits investors from borrowing shares for the primary purpose of voting, by way of a standard warranty from borrowers.
- The **Bank of England's** UK Money Markets Code (the “Code”) states a best practice of “not borrowing for the sole purpose of voting.” Although it is not considered a regulation as such, it does carry substantial weight in market practice. UK market participants are expected to formally adhere to the Code and conduct securities lending in accordance with the guidance.
- The **International Securities Lending Association's** Council for Sustainable Finance (ICSF) has stated in its *Principles for Sustainable Securities Lending*<sup>9</sup> that “borrowing securities for the purpose of using them for their voting rights is not acceptable market practice.”
- In the UK, the adoption of the EU Short Selling Regulation restricts uncovered short sales in shares to prevent naked short-selling, which could harm market integrity and disrupt settlement. The Financial Conduct Authority (FCA) reminded the market of this requirement recently in its Market Watch 63, issued in May 2020. In that document, the FCA also said it considers “that short selling can contribute usefully to liquidity and price discovery, and therefore support open, effective markets that operate with integrity.”



### 3. BENEFITS OF LENDING

#### TO SHAREHOLDERS, PENSIONERS, AND OTHER STAKEHOLDERS

- As mentioned above, the financial return to stakeholders is a key factor for most investors who are considering the application of ESG principles to their lending programs. The challenging question for all lenders is how to weigh the value of following the organization's ESG principles against the direct monetary return of lending a security, combined with the less direct value that accrues from tighter bid-ask spreads and improved market liquidity.
- **Norges Bank**, the world's largest sovereign wealth fund, summarized how it views the benefits of securities lending in the context of responsible investing in an article titled *The Role of Securities Lending in Well-Functioning Markets*.<sup>10</sup> "We argue that an asset owner's stock lending activities are the result of an interplay between three separate objectives – contributing to well-functioning markets through an efficient stock lending market, generating income from the portfolio inventory, and ensuring that the relationship with corporates and exercising voting rights as a responsible investor is maintained," it said.

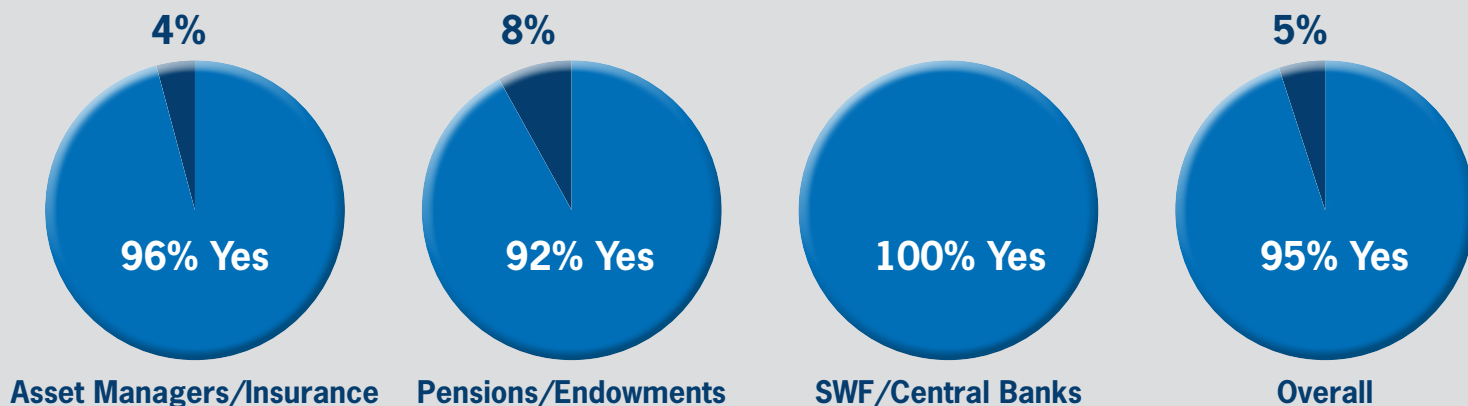
#### TO THE BROADER FINANCIAL MARKETS

- Increased liquidity and reduced transaction costs. In its study of short-selling bans in 2008, the **Federal Reserve Bank of New York** concluded that "the bans lowered market liquidity and increased trading costs." It estimated that the increase in trading costs over a three-week period in 2008 totaled more than \$1 billion.<sup>11</sup>
- Facilitating the hedging of risk.
- Uncovering the risks of certain companies, such as accounting inconsistencies or other questionable practices. Examples of companies where short-sellers have played such a role include Wirecard, NMC Health, and Luckin Coffee. In regards to Wirecard, which filed for bankruptcy in June, hedge funds began shorting this stock as long ago as 2014, in the case of Ennismore Fund Management.
- Improved settlement efficiency by covering the failure to deliver securities on sale transactions (trade fails).
- Furnishing collateral, such as high-quality liquid assets (HQLA) to meet regulatory needs and secure transactions such as repurchase agreements and derivatives.
- Deepening trading liquidity by market makers.



## 4. IMPLEMENTATION CHALLENGES AND CONSIDERATIONS

RMA believes that securities lending activities can be organized in ways that are sensitive to an investing organization's broader ESG investing principles. One of the key findings in the recent RMA survey was that 95% of the respondents answered "yes" to the question, "can ESG investing and securities lending co-exist?"



When applying ESG principles to a lending program, numerous implementation questions can arise. A senior consultant to many public pension plans in the U.S. posed a number of questions with regard to lending and ESG:

- How does a beneficial owner measure the effectiveness of its ESG efforts in the securities lending program?
- How deep into the securities lending flow do you want to pursue your ESG principles?
  - » With a cash collateralized program, do you look at the ESG suitability of issuers whose securities you are purchasing?
  - » With repo, do you consider the ESG profile of the repo counterparty?
  - » With the growing possibility of non-cash collateral use in the U.S., as well as repo collateral, would a lender look at each component of a basket of equities received as collateral?





## OTHER QUESTIONS MIGHT INCLUDE:

- How can we develop a policy on when to recall on-loan securities?
- Are there certain securities that should never be lent?
- How do you implement these customizations and what are the implications for the overall flow and revenue?
- How can we develop communications between securities lending management and those who manage ESG issues for the organization?

Although only 19% of the RMA survey participants said that there is “regular” interaction between those who manage lending and those who manage ESG issues, another 44% responded that interaction occurs “from time to time.”





## OTHER AREAS:

Two other areas where a lender may express its ESG principles involve acceptable non-cash collateral and borrowing counterparties.

### NON-CASH COLLATERAL

- In the U.S., most lenders who accept non-cash collateral only take U.S. government debt so there isn't really an opportunity to apply ESG-related filters. However, they may be taking equity and corporate bonds as repo collateral in their cash reinvestment program. The following factors from outside the U.S. may apply to repo collateral.
- Outside the U.S., there is considerably more latitude, including the use of equities and a range of bonds from both corporate and sovereign issuers.
  - » This can afford the lender the opportunity to filter acceptable collateral based on its ESG criteria.
  - » Exclusion filters may be designed to avoid companies involved with nuclear energy, tobacco, pollution, or child labor, or sovereign issuers involved with these industries or with a poor human rights record, for example.
  - » Filtering ESG-acceptable sovereign debt may reflect the exclusion of debt from a country with a poor human rights record. However, certain countries' debt may already be excluded based on an unacceptable credit rating.
  - » One surveyed organization cited an "ESG tilt" in its investment strategy and linked its securities lending collateral universe to its investment universe.
  - » Several survey participants noted challenges with implementing collateral filters with their tri-party collateral agents.

### BORROWING COUNTERPARTIES

Lenders may also apply an ESG filter to acceptable borrower counterparties based on their stated ESG principles.

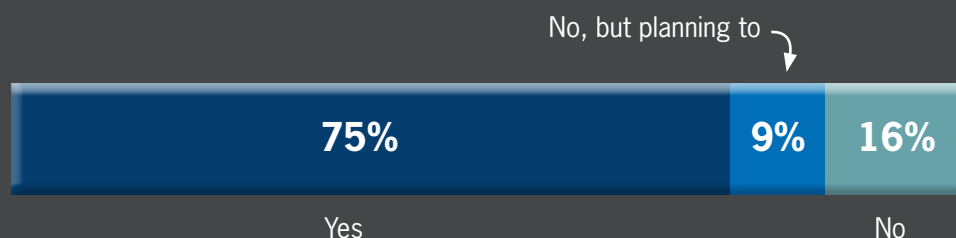
Applying ESG principles to a securities lending program also requires a level of resource commitment to understand the available options and develop ways to implement and measure results. In the RMA survey, 55% of participants ranked "greater education about available options" as the most important factor when it comes to applying ESG principles to their lending program. Since only two of the 10 largest organizations ranked education as important, we believe that this supports the view that access to resources may play a role in applying ESG principles to lending.



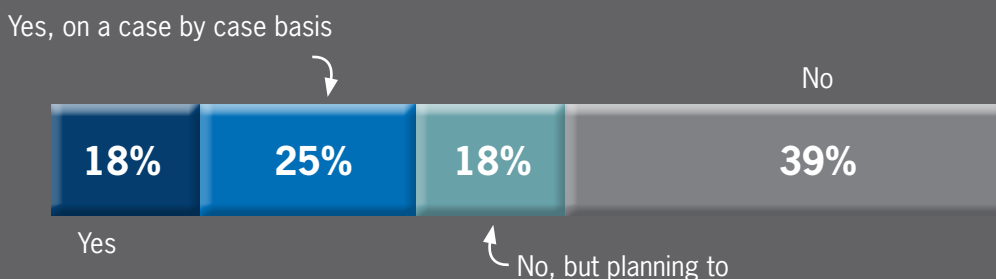
# CONCLUSIONS:

As reflected by the data collected in our survey and in discussions with a number of the survey participants, it is clear that many institutional investors believe that ESG investing and securities lending can coexist. Responses to the following RMA survey questions highlight this perspective:

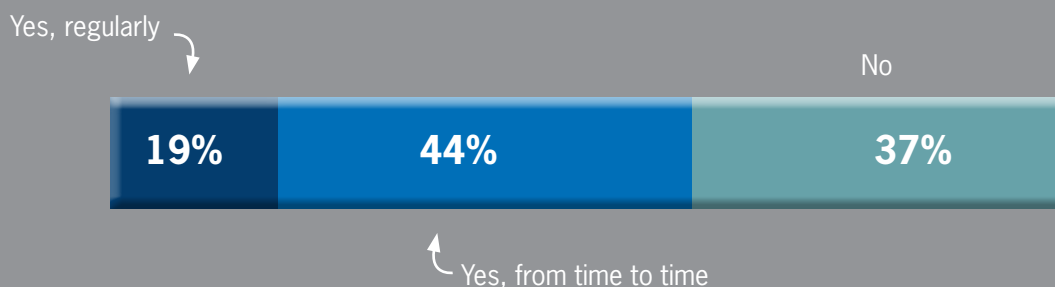
1. Does your organization have a stated ESG policy and/or principles?



2. Does your securities lending program apply ESG principles to the management of the securities lending program?



3. Does securities lending management interact with someone managing ESG issues for your organization?



There is little doubt that investor demand for ESG investment strategies will grow and institutional investors must respond to stakeholders. Some believe it will be the most important dynamic to impact investing over the next few decades. RMA strongly supports and encourages the collaborative coexistence of ESG principles and securities lending, so that investors will continue to reap the benefits of lending while accommodating the beneficial owner's ESG priorities.



## FOOTNOTES/OTHER LINKS:

- <sup>1</sup> Morningstar Manager Research, July 2020, Global Sustainable Fund Flows.
- <sup>2</sup> Bank of New York and Official Monetary and Financial Institutions Forum Survey, <https://www.omfif.org/esg2020/>
- <sup>3</sup> Wall Street Journal; May 12, 2020; Caitlin McCabe; “ESG Investing Shines in Market Turmoil, With Help From Big Tech”
- <sup>4</sup> Financial Times, August 2, 2020; Cyrus Taraporevala; “US regulators wrong to dismiss ESG investing for pensions”
- <sup>5</sup> California State Teachers Retirement System, <https://www.calstrs.com/sites/main/files/file-attachments/sustainableinvestmentandstewardshipstrategiespolicy.pdf?1583435207>
- <sup>6</sup> State Board of Administration of Florida, [https://www.sbafla.com/fsb/Portals/FSB/Content/CorporateGovernance/ProxyVoting/2016\\_SBACorpGovPrinciplesProxyVotingGuidelines.pdf](https://www.sbafla.com/fsb/Portals/FSB/Content/CorporateGovernance/ProxyVoting/2016_SBACorpGovPrinciplesProxyVotingGuidelines.pdf)
- <sup>7</sup> Financial Times, March 3, 2020, Leo Lewis and Patrick Temple-West, “Pension fund giants team up in attack on ‘short-termism’”
- <sup>8</sup> Securities Lending Times, December 18, 2019; “ESMA bats away claims of link between securities lending and ‘short-termism’” [http://www.securitieslendingtimes.com/securitieslendingnews/article.php?article\\_id=223554](http://www.securitieslendingtimes.com/securitieslendingnews/article.php?article_id=223554)
- <sup>9</sup> International Securities Lending Association, [https://www.isla.co.uk/wp-content/uploads/2020/02/ICSF\\_Principles.pdf](https://www.isla.co.uk/wp-content/uploads/2020/02/ICSF_Principles.pdf)
- <sup>10</sup> Norges Bank, October 11, 2016, “The Role of Securities Lending in Well-Functioning Markets”; [https://www.nbim.no/contentassets/fa779bdb63724b13a0b25fb976212a13/assetmanagerperspective\\_2-16\\_the-role-of-securities-lending.pdf](https://www.nbim.no/contentassets/fa779bdb63724b13a0b25fb976212a13/assetmanagerperspective_2-16_the-role-of-securities-lending.pdf)
- <sup>11</sup> Federal Reserve Bank of New York; Current Issues in Economics and Finance, Volume 18, Number 5, 2012; Robert Battalio, Hamid Mehran and Paul Schultz; “Market Declines: What is Accomplished by Banning Short-Selling?”

## OTHER HELPFUL LINKS:

1. BlackRock: <https://www.blackrock.com/corporate/literature/publication/securities-lending-viewed-through-the-sustainability-lens.pdf>
2. BNY Mellon: <https://www.bnymellon.com/us/en/what-we-do/markets/aerial-view-magazine/stock-lending-dispelling-the-myths.jsp>
3. Brown Brothers: <https://www.bbh.com/en-us/insights/securities-lending-or-esg-investing-both-40508>
4. Deutsche Bank: <https://cib.db.com/insights-and-initiatives/flow/securities-services/demystifying-esg-in-securities-lending.htm>
5. European Securities and Markets Authority: [https://www.esma.europa.eu/sites/default/files/library/press\\_release\\_report\\_on\\_undue\\_short-termism.pdf](https://www.esma.europa.eu/sites/default/files/library/press_release_report_on_undue_short-termism.pdf)
6. StateStreet: [https://www.statestreet.com/content/dam/statestreet/documents/Articles/SSA\\_ESG\\_SF\\_paper.pdf](https://www.statestreet.com/content/dam/statestreet/documents/Articles/SSA_ESG_SF_paper.pdf)





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