New standards of measurement

2020 marks the start of a new year and a decade. Much has changed and more is due to change both economically and politically as the new year gets under way.

One of the most significant changes specific to the securities finance industry, the Securities Finance Transaction Regulation (SFTR), representing the first implementation of the Financial Stability Boards (FSB) Transparency Directive, commences in April. Few would argue that there isn't still a great deal of work to do before then to get the market live and compliant with the new era of transparency, but this is just one of the many changes that will be impacting our industry in the coming months and years.

However, there are other changes afoot reflecting trends in the wider financial markets. These may well be a little less tangible than SFTR but are nonetheless important. In fact, the convergence of certain, sometimes conflicting, market influences are potentially creating negative impacts to the very markets that they are, at least individually, supposed to be improving.

Passive investment levels have risen dramatically over recent years. In 2017, according to the FCA, passive investment funds in the EU accounted for 30 percent of total investment, up from 15 percent in 2007. In the US, as of 2018, passive funds control 43 percent of the total investment market. The UK has seen passive funds rise from 6 percent in 2006 to 16 percent in 2016. Part of the driver for this is the pressure to reduce fees; many large investment managers now provide zero fee investment funds and others zero fee brokerages. To achieve this, cheaper to run passive funds are promoted, along with securities lending vehicles to raise cost offsetting additional revenues.

In a zero-sum game, rising passive investment must replace actively invested funds. This process, in short, crowds index equities while removing analysis and research bandwidth from the wider investment market, previously driven by the active funds. Neither are attractive outcomes, and the former would arguably drive more hedge fund activity as funds seek over valued shares to short, driving demand in the securities lending world. This outcome might be positive for securities lending but could represent a fall in overall market efficiency and transparency.

However, as many of these new zero fee funds join the securities lending supply, some notable funds are leaving and leaving very publicly. The Government Pension Investment Fund (GPIF) of Japan, reputed to be the world's largest pension fund managing $1.4 trillion of assets, mostly through outsourced fund managers, announced recently that it had decided to cease lending its foreign equity assets. Debt instruments will continue to be lent and domestic Japanese equities remain unavailable to borrowers. The decision to abandon around $115 million of annual revenue (averaged over 2015 to 2018) attributed to this activity was considered a price worth paying to support their Environmental, Social and Governance (ESG) objectives.

Explaining the decision to curtail lending, the executive managing director and chief investment officer of GPIF, Hiro Mizuno, cited a lack of transparency with regard to who is borrowing shares and for what purpose as a significant factor.

Further, with an investment time horizon of 100 years, the GPIF has made it clear that focusing on short-term gains and strategies conflict with meeting its overall investment objectives, including ESG considerations. With such a bold move, just as other funds and fund managers are increasing their involvement in securities lending to boost revenues, it begs the market to question whether there has been a fundamental shift away from simply measuring the financial returns of a fund in basis points. Meeting ESG objectives and expectations of responsible investing may well replace the simple financial results by which funds are measured.

Applying ESG-like principles to investing might appear to be a relatively simple process to undertake. Restricting investments in tobacco companies or weapons manufacturers, for example, is a binary decision once a fund has determined its investment principles. However, the physical lack of eligible securities to invest in could lead to crowding and the resultant over inflation of asset prices. If this does occur, it could become a serious issue that, in fact, fuels additional short selling activities. It is telling that the $1.4 trillion GPIF fund states that $28 billion is invested in ESG compliant funds: just 2 percent of its total portfolio. This fact lays bare the conflict between the demand for lower cost fund management and ESG principles. Most passive funds are index trackers and main indices contain the most profitable and valuable companies. The most profitable and valuable companies in the world are, at least currently, fossil fuel extractors and processors. Investing in a passive fund may well get a piece of Apple, Google and Facebook, but will also undoubtedly include ExxonMobil and Chevron.

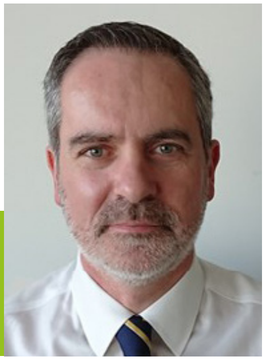
The International Securities Lending Association (ISLA) launched the ISLA Council for Sustainable Finance (ICSF) last December. The announcement indicated that this launch had been the culmination of some 16 months of preparation work, suggesting that this was not a knee jerk reaction, but the recognition of forthcoming changes in the market. The stated objective of this council of experts is the promotion of "sustainable securities lending" through the promotion of new and relevant principles that will assist the adoption of ESG principles into securities lending practices.

It will be interesting to see how this works in practice and how such principles can be implemented, particularly when many consider there to be a potential conflict between a fund managers fiduciary responsibility to its clients to make the best returns possible and some of the new ESG objectives.

The GPIF has stated that transparency was a key issue for it, and specifically the impact of not knowing whether its assets were being borrowed to facilitate short selling activities. Given the implication that the GPIF may have continued to lend its assets if it could guarantee they would not be used for short selling exposes the real underlying reason for this decision – the belief that such actions can drive prices of assets downward. For such an argument to be true goes against most fundamental asset pricing principles, not to mention ignoring the existence of many alternative mechanisms through which an investor can profit from a falling asset price. What it does highlight is the almost sentimental view that it is somehow distasteful to profit from an asset falling in value.

On that measure, the GPIF has likely erred in its logic. Having a 100-year investment time horizon makes the value of an asset from one day, week or month to the next almost completely irrelevant to its long-term strategy. Refusing the available securities lending revenue is, therefore, arguably a fiduciary mistake but only if the measure of success of the fund is no longer accounted for in terms of overall financial provision for the pensioners it serves, but instead includes a measurement of compliance with ESG principles.

Few can claim to have not noticed the general shift in investment funds on offer today, including the rise in ESG-style funds and responsible investing as a new age mantra. For some, the simple financial returns of an investable asset are not the sole, or perhaps even key, determinant in the decision to invest. Balancing the activities of the securities finance industry with ESG principles will not be an easy task, but the opening of ideas for fund performance beyond the traditional basis point returns is likely part of the solution.



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