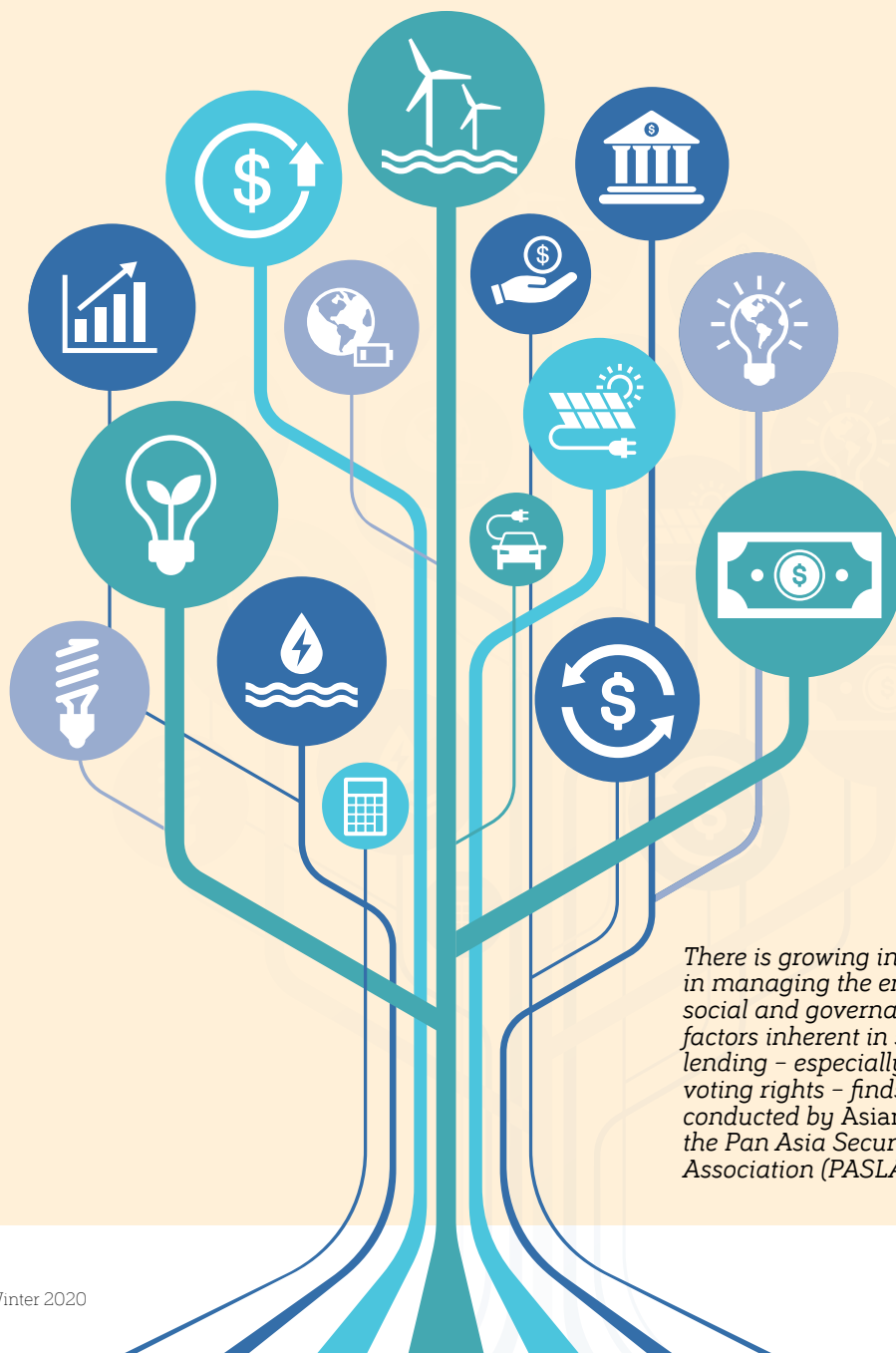


**PASLA**

In partnership with

**AsianInvestor**

## ESG AND SECURITIES LENDING: ASIA CHARTS A COURSE TOWARDS ALIGNMENT



*There is growing investor interest in managing the environmental, social and governance (ESG) factors inherent in securities lending - especially concerning voting rights - finds a consultation conducted by AsianInvestor and the Pan Asia Securities Lending Association (PASLA).*

**A**sset owners and managers across Asia Pacific are becoming increasingly focused on managing their securities lending activity in a way that is consistent with the ESG principles that guide their investment decisions.

**“We are working on a dedicated strategy to incorporate ESG into our securities lending programme,” confirmed a senior investment executive at a leading asset owner in Australia. “Although we want to generate additional returns, this needs to be aligned with our stance on ESG investing.”**

While growing, securities lending by buy-side institutions in Asia is not yet as widespread as it is among their peers in North America and Europe. But, given the momentum behind sustainable investment globally in the wake of Covid-19, there is a growing realisation among Asian investors that they should start considering how ESG and securities lending intersect – and how to manage the ESG variables in lending programmes.

This emerging desire for more clearly defined options and standards to guide participants in the region initially became clear as a result of a PASLA survey released in May 2020.

Following this, PASLA collaborated with *AsianInvestor* to gather insights from more than 150 senior industry executives via a survey conducted in October and November 2020. Over 100 of these individuals represented a total of 65 asset owners and investment management firms across the region. The estimated assets under management (AUM) of those buy-side respondents with a securities lending programme (roughly one-third of the total) is just over \$2 trillion, while those institutions without a programme have a combined estimated AUM of roughly \$1.9 trillion.

At the crux of the survey and consultation were five areas identified by PASLA in which securities lending and ESG considerations come into contact – and a range of proposed options for managing these touchpoints:

1. Participation in the short side of the market
2. Collateral, cash reinvestment and rehypothecation
3. Transparency in the lending chain
4. Different tax liabilities
5. Exercising voting rights

Nearly three-quarters of respondents overall – and 76% of buy-side institutions

who participated – agreed these factors were indeed the key points of contact between securities lending and ESG principles.

**Added one of the respondents: “There is growing momentum towards ESG investing and it is important to find ways to advance it within securities lending programmes.”**

Probing deeper, several consistent themes emerged from this survey along with follow-on discussions with selected market participants:

- Only around one-third of buy-side respondents have established a securities lending programme, suggesting that a majority of Asian investors do not lend their securities at all.
- Investors are only just beginning to consider how ESG principles might be applied to lending programmes. One of the main obstacles to more consistent integration remains the lack of standardised data and a common understanding of what ESG means in a capital markets context.
- Portfolio managers wield the greatest influence when it comes to decision-making on ESG factors in securities lending programmes – ahead of professionals from the ESG and governance teams as well as those from the lending and risk management functions.
- Being able to exercise voting rights, along with the need for transparency in the lending chain, are the two most prominent factors for investors when they consider the relationship between ESG and securities lending.
- To exercise voting rights in line with ESG considerations, respondents said a best-practice approach would require a mechanism for flexibly and efficiently enforcing the recall of loaned stock. At the same time, due diligence to assess the voting intentions of the borrower is important for asset owners and managers.
- To ensure transparency, the vast majority of respondents believe asset owners should have visibility over the entire lending chain for their securities. Around two-thirds overall said an asset owner should be accountable for how its securities are used down the lending chain.
- When it comes to participation in the short side of the market as a result of securities lending, around 85% of respondents at asset owners and

managers agree that certain restrictions should be in place to address their concerns over the compatibility of ESG principles with securities lending. This rises to 94% among investors that already have a securities lending programme.

- When applying ESG principles to participation in the short side of the market, the clear preference among all respondents – whether or not they have lending programmes – is to restrict the lending of securities in which the beneficial owner has significant shareholdings.

### NEW DEMANDS EMERGING

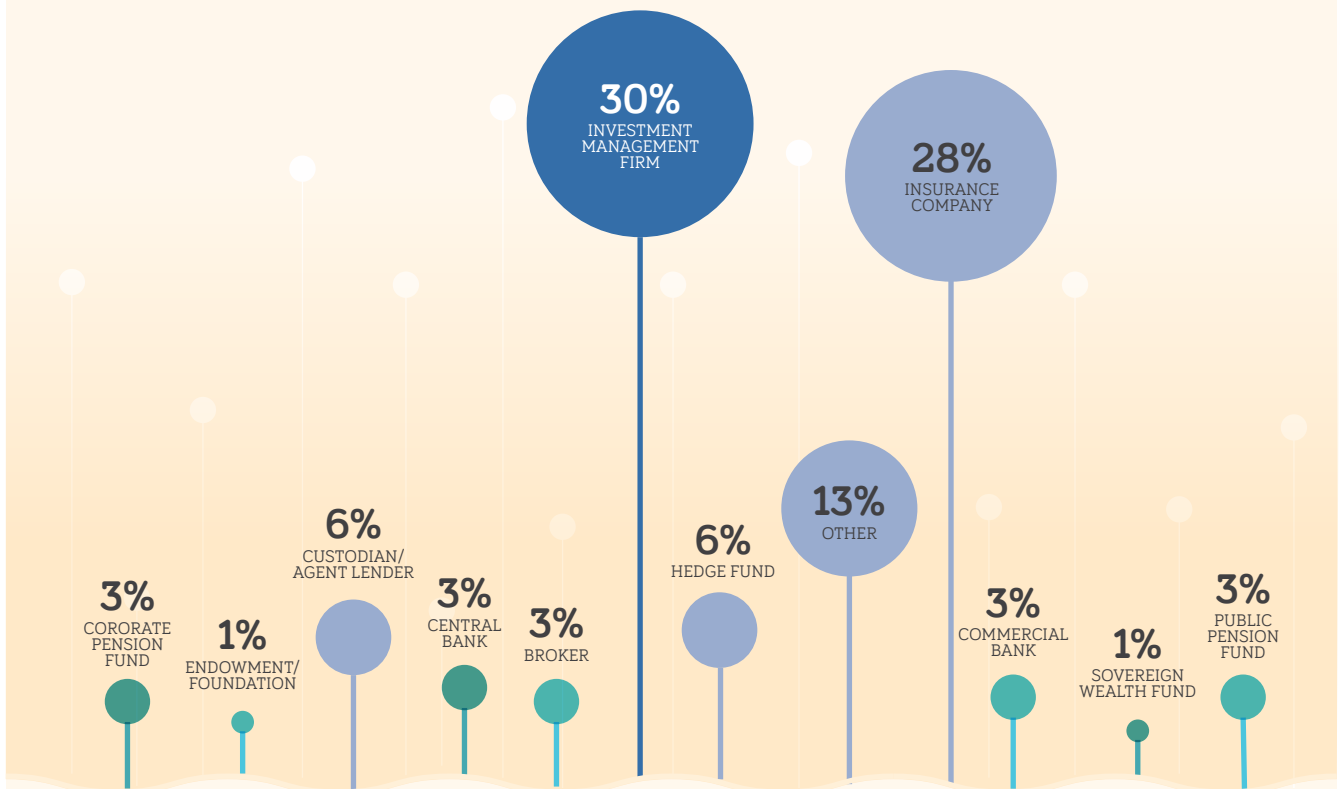
Covid-19 has subdued securities lending activity across Asia Pacific in 2020 by comparison with recent years. The combination of market turbulence with restrictions on short-selling in several regional markets created uncertainty for many institutions, leading them to put lending plans on hold, or even suspend existing programmes, according to several individuals at buy-side institutions who commented as part of follow-up discussions to the survey.

### METHODOLOGY

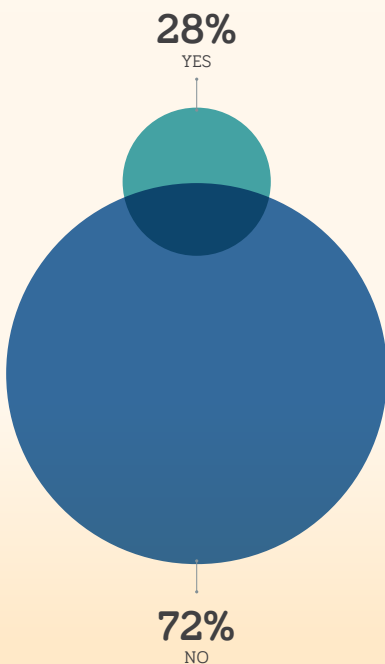
- PASLA and *AsianInvestor* collaborated to create the survey questions and format
- This was sent to a target group of mostly buy-side institutions in Asia Pacific (asset owners and investment management firms), plus some other key market participants in securities lending – such as hedge funds, brokers, agent lenders and investment banks.
- All responses were collected anonymously (analysis of the findings was on an aggregated basis)
- Four investment executives from buy-side institutions were invited to a closed-door roundtable - to discuss the survey findings and also share views on market trends in line with the goal of creating practical guidelines on the ESG-related aspects of securities lending.
- Five one-on-one conversations were conducted with asset owners and managers, on a confidential basis, to get further insights to inform this overall analysis

ESG

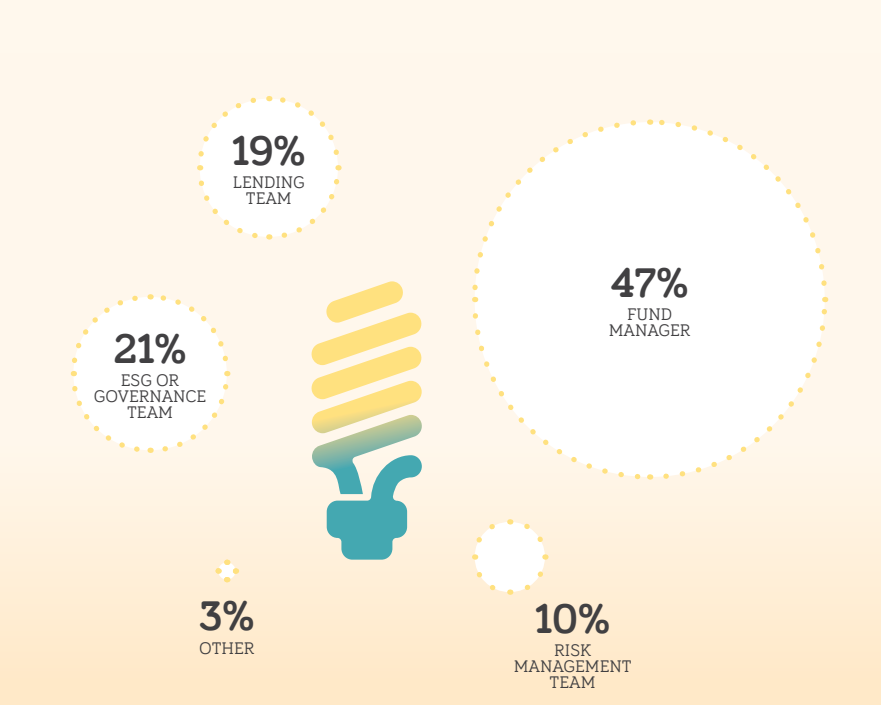
PROFILE OF RESPONDENTS - BY INSTITUTION



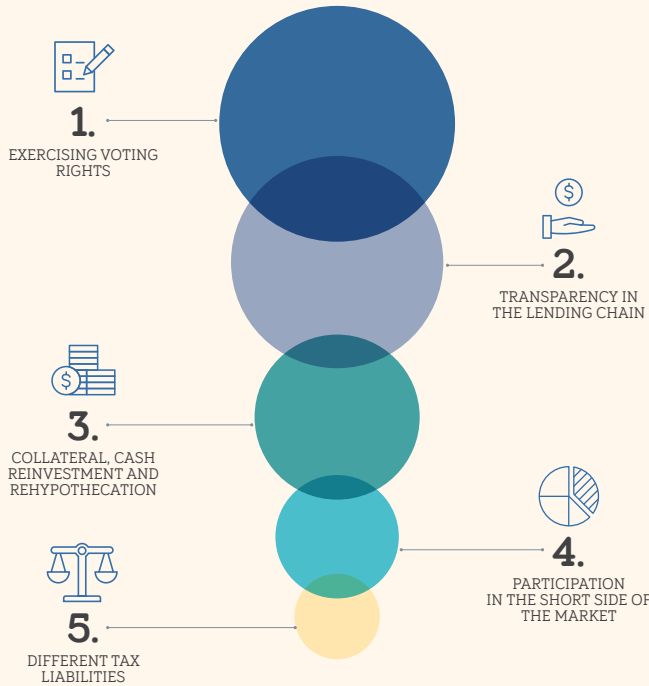
IS YOUR FIRM ACTIVE IN SECURITIES LENDING IN ASIA PACIFIC?



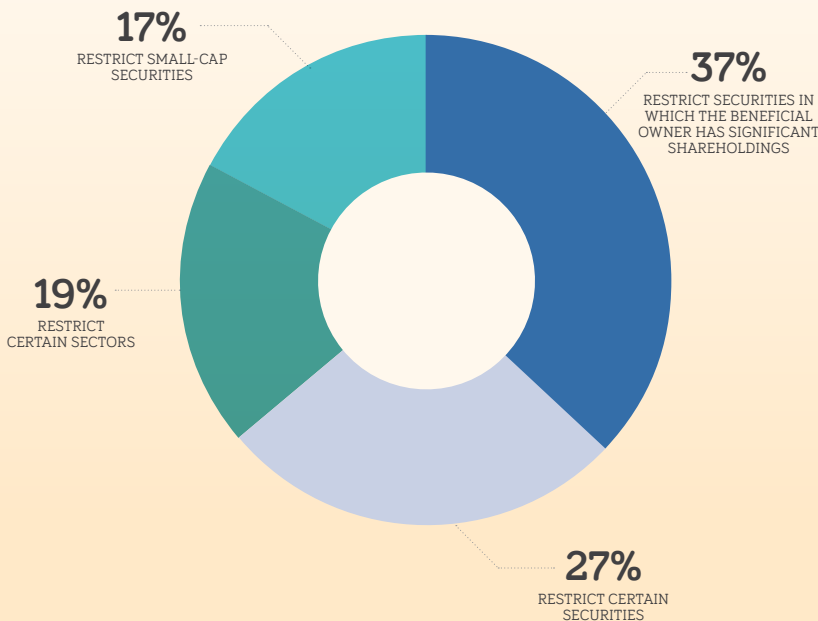
DECISION MAKERS ON ESG FACTORS IN SECURITIES LENDING PROGRAMMES



**FACTORS OF MOST IMPORTANCE FROM AN ESG PERSPECTIVE**



**PARTICIPATION IN THE SHORT SIDE OF THE MARKET - BEST PRACTICE IN APPLYING ESG PRINCIPLES**



This dampened earlier hopes that 2020 would be a stellar year for securities lending revenue and volume in the region. It may also have slowed the establishment of lending programmes by regional asset owners.

Equally, some investors at institutions that are not active in securities lending in Asia Pacific said during informal conversations, based on the survey findings, that the impact of the pandemic on markets had made risk management teams more hesitant about new initiatives, such as securities lending.

Reinforcing this anecdotal evidence of the embryonic state of securities lending among regional investors, just over a quarter (28%) of the 100-plus respondents from buy-side institutions are active in this market. Within this fairly small group, 26% are insurers, 21% are other asset owners and 21% are investment managers.

Yet today's new investment 'normal' offers some reasons for optimism about securities lending becoming more desirable for asset owners and managers. The views of some buy-side practitioners suggest that market realities such as low rates and yields, prolonged market volatility and liquidity concerns, for example, are forcing investors to consider ways to enhance portfolio performance and generate incremental returns.

Furthermore, asset owners in Australia and Japan are already more active lenders, reflecting the relative sophistication of institutional investors in these markets.

At the same time, Covid-19 has accelerated the appetite for sustainable funds in Asia. For example, Morningstar data for the third quarter of 2020 showed a record \$8.7 billion of net inflows into such funds. This boosted total ESG fund assets in the region to \$25.1 billion, up 75% on the previous quarter.

More evidence has also emerged that investing through an ESG lens should matter to investors. Research by Fidelity covering the first nine months of 2020, for instance, shows that companies with good ESG characteristics can be expected to be more resilient during a crisis. An analysis of 2,600 stocks demonstrated that companies with higher ESG ratings outperformed peers with weaker ESG ratings in every month except April.

While these insights indicate the likelihood of growing ESG engagement, comments from several insurance companies during follow-up discussions also emphasised the incipient stage of ESG considerations within securities lending in Asia at present.

ESG

“Sustainable investment is in its infancy but likely to grow quickly,” added one of the investors who commented on the findings.

However, as ESG becomes one of the dominant investment principles of our time, it seems inevitable – and essential – that ESG considerations should increasingly influence securities lending practices in future.

The key question that the PASLA / AsianInvestor survey sought to explore, therefore, was how this should take shape.

**FORCES OF CHANGE**

Amid the overwhelming support for the five areas proposed by PASLA to help investors manage ESG-related securities lending considerations, respondents pinpointed the ability to exercise voting rights as being most important from an ESG perspective. It is notable that this view was consistent across individuals who work for a firm with a securities lending programme and those who do not.

When asked to identify best practice for asset owners and managers to enable voting rights to be exercised, respondents

working for institutions with and without lending programmes agreed there should be a mechanism to enforce the recall of loaned stock in a flexible and efficient manner. This was marginally preferred to undertaking due diligence in order to assess borrowers’ voting intentions.

“As active investors, we take ownership of our securities seriously, so we need to be able to recall loaned stock to vote on it, even if we lose revenue doing so,” explained an executive at a regional insurer during a follow-up interview.

At the same time, there is a need to prioritise exercising voting rights in certain markets and in relation to more important issues for investors, according to some individuals who commented privately on the survey. It is not practical to expect to be involved in every AGM for every stock owned in an investment portfolio, they said.

Transparency in the lending chain came a close second among respondents in terms of its importance as an ESG factor in securities lending programmes.

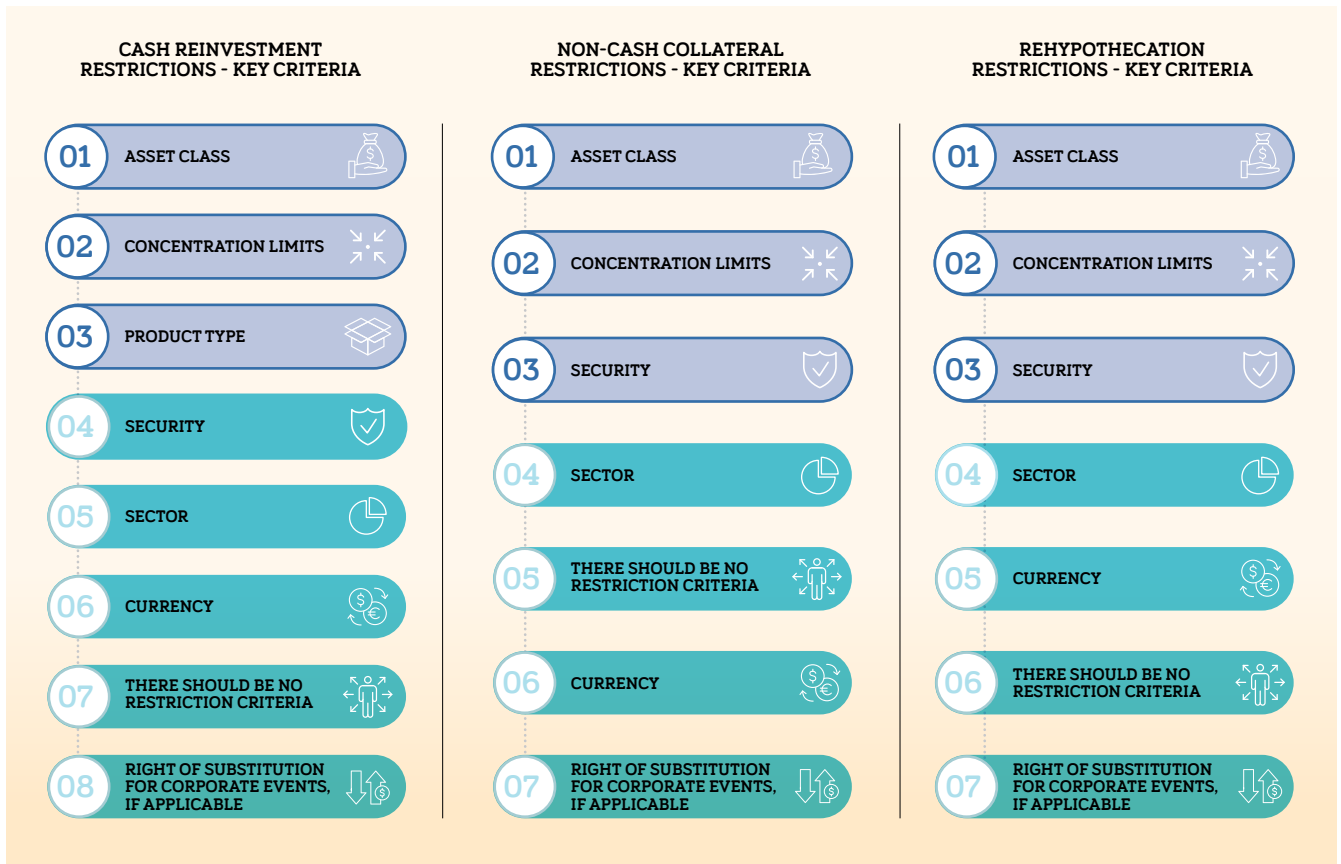
To create greater transparency, there was strong support for asset owners

having visibility over their entire lending chain – although industry specialists acknowledged during subsequent closed-door discussions that it is not clear how this can be achieved using the technology available at present.

Meanwhile, just over two-thirds of respondents believe an asset owner should be accountable for how its securities are used down the lending chain.

Such enhanced visibility, if the technology became available to achieve it, would also likely address some of the concerns within risk management teams at certain asset owners that have not yet started lending, according to two of the insurers who shared their views based on findings.

A majority of survey respondents also pointed to the need for lenders to enhance transparency in the lending chain by defining the borrowers that they consider acceptable or unacceptable, which is already an established market practice. There was also significant support for agent lenders and investment banks to be empowered to exercise greater discretion on behalf of their lender clients.



Securities lending facilitates borrowers' participation in the short side of the market. When considering best practice in applying ESG principles to this, just over one-third of respondents said they would opt to restrict the lending of securities in which the beneficial owner has significant shareholdings. Again, the view was similar regardless of whether the institution has a securities lending programme or not.

However, among individuals working at institutions with a programme, restricting loans of small-cap securities appears to be far more important than for respondents at firms without programmes.

### CREATING A NEW ROADMAP

Despite the lower volume of securities lending activity in Asia in 2020, the rise of investment in line with ESG principles points towards the need to integrate those same principles into investors' securities lending programmes.

And for investors that do not yet lend, the knock-on effect of the pandemic in spurring demand for sustainable investment strategies now requires a close look into the prospect of ESG-friendly securities lending activity.

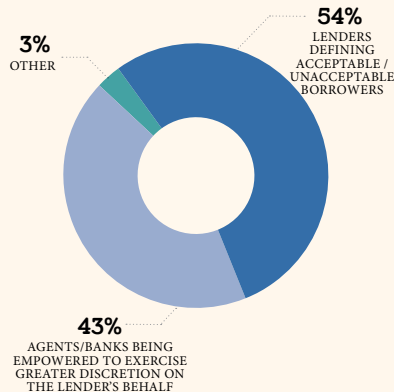
More broadly, it was notable during discussions with some buy-side participants in this consultation how focused they are on their stewardship responsibilities as asset owners.

For example, a senior investor at an asset owner explained that as a firm, they would not accept as collateral securities that they would not invest in for ESG reasons.

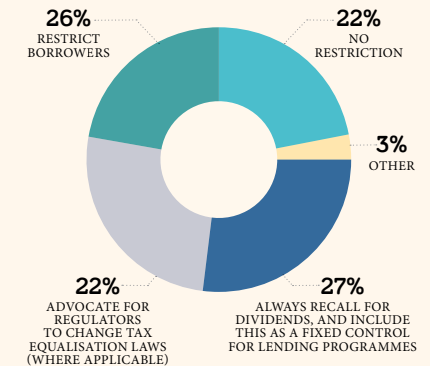
Implementing approaches to managing the five areas identified by PASLA might take some time to permeate the securities lending landscape in Asia. And while the survey found that exercising voting rights and ensuring transparency in the lending chain were the clear priorities for respondents, industry participants point out that one of these ambitions will be easier to fulfil than the other: today's lending programmes typically make it possible for asset owners or managers to recall loaned stock whenever they want, but the technology that could provide a lender with complete visibility over its lending chain does not yet exist.

Looking ahead, the industry should benefit from practical and commercially focused guidelines that provide standardised options for aligning ESG investing with securities lending. These will take some time to develop and become widely adopted, but a starting point – according to individuals at

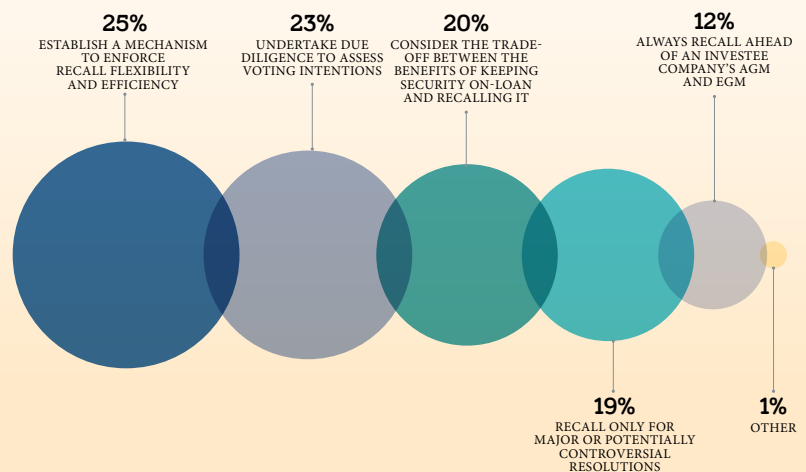
#### TRANSPARENCY IN THE LENDING CHAIN - KEY IMPROVEMENTS NEEDED



#### DIFFERENT TAX OBLIGATIONS - BEST PRACTICE IN RELATION TO LENDING OVER RECORD DATES



#### EXERCISING VOTING RIGHTS - BEST PRACTICE FOR ASSET OWNERS/MANAGERS



several prominent lenders – would be more effective communication between investors, borrowers and custodians on this previously neglected topic.

Ultimately, those industry standards and guidelines can build on that collaboration to enable buy-side participants to align the ESG variables in their lending programmes with their institutional commitment to ESG principles – fulfilling an ambition that was clearly articulated in this consultation.

“We want to adapt our programme so it becomes less passive,” added a key investor at a pension fund in Australia, reflecting on the findings. “We want to take more control over arranging the loans and tailoring trades based on our preferred approach [to ESG investing].”

“It is clear from this consultation that Asian investors want to take a more proactive approach to managing ESG factors in their securities lending programmes,” said Paul Solway, Communications Officer for PASLA. “Some of the issues identified, such as exercising voting rights, can be addressed straight away. For some other ambitions, especially ensuring an asset owner has visibility over its entire lending chain, the industry will need to work together over the long-term to develop the technology necessary to achieve this. We hear the statement of intent loud and clear, and will ensure these views are reflected in the framework we are developing as the next stage of our consultation.”