



Global Framework for ESG and Securities Lending

May 2021

PASLA

rma[®]
THE RISK MANAGEMENT ASSOCIATION

Background

- Integrating environmental, social and governance factors into securities lending is an important component of the contribution that finance needs to make to the realisation of the United Nations' Sustainable Development Goals. To ensure that securities lending is understood as aligned with ESG investment principles, though, it is essential that lenders and other market participants have a shared decision-making framework for managing ESG considerations in this market.
- The **Global Framework for ESG and Securities Lending** (GFESL) has been developed in partnership by the Pan Asia Securities Lending Association (PASLA) and Risk Management Association (RMA) to meet this need for a globally consistent approach.
- Our intention with the Framework is that it will clarify market participants' understanding of how ESG and securities lending intersect as well as begin to standardise the choices that lenders can make in managing those touchpoints in accordance with their organisational ESG objectives.
- It is intended to be a practical tool that is useful to market practitioners - especially beneficial owners - in developing their own approach, rather than a prescriptive set of guidelines to be adopted.
- A PASLA survey released in April 2020 found that a majority of market participants saw ESG and securities lending as compatible, but also highlighted the need for more clearly-defined options and standards to guide market participants. In the fourth quarter of 2020, PASLA conducted a consultation across Asia Pacific with a view to creating guidelines on the ESG- related aspects of securities lending. This consultation was conducted in partnership with AsianInvestor, a leading industry publication, and took the form of an industry survey as well as interviews with selected lenders.
- The GFESL has been shaped by the insights gained from this consultation as well as research conducted by RMA and the International Securities Lending Association (ISLA). In October 2020, for example, RMA published a paper on whether securities lending and ESG principles could coexist. The paper included a survey of major global asset owners and managers: 95% said they believed ESG investing and securities were compatible, but only 18% said they always applied ESG principles to their securities lending programmes, reinforcing the need for a common approach to integration.
- By putting this research into action via the Framework, PASLA and RMA believe that transparency about ESG factors in securities lending can be significantly enhanced. A clear and widely-accepted decision-making framework should enable lenders to better define their approach, align it with corporate-level objectives, communicate it to other participants in the value chain and monitor its impacts. Ultimately, by facilitating the compatibility of ESG principles with securities lending, the Framework can be instrumental in ensuring the continuing liquidity and efficiency of securities lending markets globally.
- The GFESL is available to all market participants globally and all other securities lending and financial markets industry associations are invited to endorse it, which ISLA has already done.
- We see this initial framework as an important starting point but believe there is great potential to refine and iterate the GFESL in future. This Framework should reflect evolving views about best practice as well as take into account new research and insights. Everyone with an interest in the integration of ESG with securities lending is welcome to contribute.

Important considerations

This Framework aims to encourage lenders to take responsibility for the ESG factors in their securities lending programmes. It provides options and key considerations across the main touchpoints between securities finance and ESG and offers suggestions on best practice in each case. It is intended to offer practical guidance for lenders seeking to establish their own approach, but not to be prescriptive.

By necessity, the Framework separates the relationship between ESG and securities lending into different 'factors.' In reality, of course, these are closely interconnected.

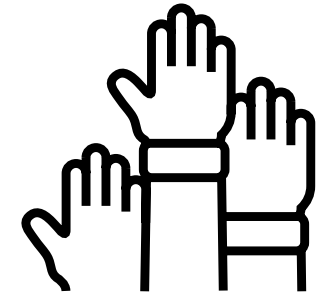
The Framework uses the term "lender" to describe a function in the securities finance market that is usually fulfilled by a beneficial owner or investment manager, but which can be undertaken by any market participant. This role is distinct in our approach from that of an agent lender, which is typically a custodian. We have also defined the intermediary typically between the agent lender and the hedge fund as a "broker" and the participant who borrows from the broker as "the end user."

Options

1 Never recall loaned securities or restrict lending ahead of investee companies' elective events

2 Adopt a targeted recall/ restriction policy that balances ESG objectives against lending opportunity costs

3 Always restrict/recall securities ahead of investee companies' elective events



Background

- In the PASLA/AsianInvestor industry consultation (“the PASLA Consultation”) in late 2020, respondents from beneficial/asset owners identified ‘exercising voting rights’ as the most important factor for securities lending from an ESG perspective.
- The majority suggested leveraging the existing mechanism to enforce the recall of loaned securities to fulfil their ‘stewardship’ responsibility.
- However, only 11% of respondents believed that loaned securities should always be recalled ahead of an investee company’s AGM or EGM.
- There is a lack of consistent and timely information about proxy record dates and questions in some markets. More timely disclosure of proxy information by companies would enable the better integration of ESG principles into securities lending programmes.
- It is an accepted market practice that securities should not be borrowed exclusively in order to exercise the voting rights that come with them.
- This is reflected in regulatory guidelines such as the Bank of England’s UK Money Markets Code and Regulation T in the US.
- Standard legal contracts governing securities lending, notably Global Master Securities Lending Agreements (GMSLA), expressly prohibit borrowing securities for the primary purpose of exercising voting rights and make it clear that lenders cannot exercise voting rights on securities that are loaned out.

Key considerations

- What parameters should be set for a proxy recall policy? Deciding on an approach necessarily involves accepting a trade-off between the income that can be earned through lending and the investment stewardship responsibility to vote on securities.
- What should be added to the traditional list of material events? For example, resolutions on climate or social policy.
- Should lenders recall and vote their securities for the elective events of companies in which their shareholding is above a certain threshold? Or companies in certain sectors?

Best practice recommendations

These choices are the responsibility of each lender, but it is suggested that all lenders seeking to apply ESG best practice to securities lending should consider:

- Assessing or developing a recall policy based on ESG considerations in their proxy voting framework.
- Identifying the types of resolutions on which they want to vote by company and by issue.
- Setting out any other parameters that would trigger a recall or the restriction of further lending e.g. the market capitalization of investee companies or the recommendations of a proxy advisor.
- Consider setting a minimum standard framework for proxy recalls, such as 10 working days, whenever possible.
- Communicating with agent lenders / end users on recall policies to ensure alignment of execution terms.

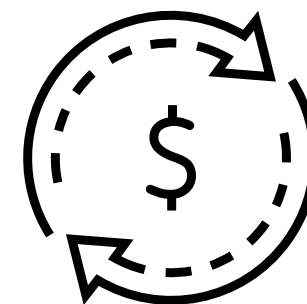
Transparency in the lending chain

Options

1 No monitoring of the lending chain

2 Entrusting monitoring of the lending chain to the discretion of agent lenders or brokers

3 Participating in industry initiatives that apply technology to achieving greater transparency in the securities lending chain



Background

- Respondents to the PASLA Consultation identified transparency in the lending chain as the second most important ESG factor, behind exercising voting rights.
- 54% of participants responded that lenders should define acceptable or unacceptable borrowers.
- 43% believed intermediaries (agent lenders, brokers) should be empowered to exercise greater discretion on lenders' behalf.
- Over two-thirds believed a beneficial/asset owner should be accountable for how its securities are used down the lending chain.
- However, there is at present no technology that allows a lender to track the on-lending of its securities. The fact that securities lending transactions involve a transfer of title also limits an original lender's ability to track onward delivery or use of the securities it loans out.
- While the PASLA Consultation revealed a focus on lending chain transparency among lenders in Asia Pacific, those in North America do not typically express concerns on this topic while disclosure driven by the European Union's Securities Financing Transactions Regulation (SFTR) has enhanced the transparency of securities finance in Europe.
- In many markets, all participants in a securities lending chain will be regulated financial institutions facing similar ESG expectations from their stakeholders.

Key considerations

- Defining a group of "acceptable" or "unacceptable" ESG borrowers or end users raises the question of what criteria would be used to determine their suitability.
- Lenders are obviously in a position to choose their direct counterparts, such as brokers and end users.
- Lenders can also empower their agent lenders with clear guidance and parameters about acceptable direct counterparties, while recognising that it is not possible to influence decisions further along the chain.
- Similarly, brokers can use their discretion in selecting suitable end users given the principal-to-principal nature of their relationship.
- Limiting the universe of brokers / end users or attempting to restrict on-lending could reduce demand to borrow, thereby cutting the overall income a lender generates from securities lending.

Best practice recommendations

We support the ambition to achieve more transparent lending chains and suggest approaching this from both short- and long-term perspectives.

Short-term

- Lenders, via their agent lenders, can consider implementing effective minimum standards, reflecting their corporate-level sustainability framework.
- For example, they could apply an ESG lens to selecting their direct counterparties.
- These considerations are clearly inherently subjective and would involve value judgments about the activity of certain brokers / end users.
- Of course, lenders can also consider lending chain restrictions based on activity rather than the identity of end users. Please see the best practice recommendations on voting rights, facilitating participation in the short side of the market and lending over record date.

Long-term

- All market participants can take steps to learn more about the transparency measures that already exist - and help to educate their clients and counterparts about this.
- Lenders could commit to supporting industry initiatives to develop technology that could deliver visibility over the onward lending of securities.

Options

1 No restrictions on the reinvestment of cash or non-cash collateral eligibility

2 Restrictions applied by a specific market, sector or industry classification

3 Where possible, restrictions applied by security identifier (for equities) or single issuer (bonds)



Background

- This was identified in the PASLA Consultation as the third most important ESG factor for securities lending.
- Interviews during the PASLA Consultation reflected the view that lenders should apply some restrictions to the types of collateral they accept, in alignment with the way that they apply ESG principles to portfolio management.
- Many market participants also believe that there should be ESG considerations for any reinvestment of cash received as collateral.

Key considerations

- Lenders can consider restricting the eligibility of non-cash collateral either at the sector level (for example, by excluding weapons and tobacco securities) or at an individual security level, where possible.
- Lenders may also want to consider whether they should decline to accept securities as collateral over the record dates for dividends, which is already a standard practice for lending facilitated by tri-party agents.
- When receiving cash as collateral, lenders should ensure that their cash reinvestment principles align with their broader ESG investment criteria where possible, and consider any associated impact to the ability to support borrower rebates.

Best practice recommendations

We would suggest that lenders consider a principle of equivalence when it comes to decisions about the eligibility of non-cash collateral or the reinvestment of cash. On this basis:

- Consider applying the same standards to the non-cash collateral that they are prepared to accept when they lend securities as those that they apply to their portfolio investment activity.
- In this regard, lenders could also seek to establish alignment between the ESG guidelines that govern their portfolio management and their approach to cash re-investment, in addition to other risk parameters that they may put in place.
- Lenders could explore using standardised ESG collateral sets as a core option, with a customised overlay where needed.
- Whatever approach they decide to adopt, lenders should set specific parameters and communicate these clearly to their agent lenders.

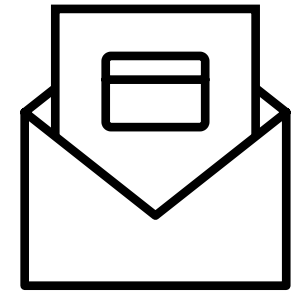
Lending over Record Date

Options

1 Take no action

2 Restrict/recall securities for dividend record dates under specific circumstances

3 Always restrict/recall loaned securities for dividend record dates



Background

- Many market participants believe that structuring a securities lending transaction for the sole purpose of creating a benefit from tax differentials is not compatible with ESG principles.
- However, brokers have a contractual obligation to manufacture dividends back to lenders according to the after-tax dividend entitlements that the lender would have received had the securities remained in their custody.
- Withholding tax rates on dividends vary across jurisdictions due to different tax treaties. As a result, lending activity across multiple jurisdictions can result in different tax obligations for the various participants in a securities lending chain.
- Furthermore, lending securities over dividend record dates does not mean that the participants in the transaction are taking advantage of different tax obligations: there are a host of other potential reasons for such activity.
- In Asia, end users often substitute 'onshore' for 'offshore' inventory due to restrictions in local supply, or to generate efficiencies in manufactured obligations as part of the lifecycle management of securities lending. Switching from onshore to offshore inventory, or vice-versa, can cause demand to fluctuate through the year.

Key considerations

- Lenders should consider whether, as a rule, they are comfortable with lending securities over record dates when the ultimate dividend recipient may (or may not) have a different tax obligation
- Given the vast number of reasons a borrower may request stock over record dates, lenders may also want to consider whether they wish to introduce controls to prevent transactions which they believe are entirely tax motivated (refer to reportable arrangements under "DAC 6" Directive in the EU)
- If they consider restricting lending on tax-related grounds, lenders may want to identify situations in which there is a higher risk that the end user is motivated principally by tax differentials (e.g. outsized loans over higher-yielding equities)
- Lenders are always able to recall loaned securities over dividend dates - or restrict engaging in new lending - but should consider the practicality, opportunity cost and market impact of doing so.

Best practice recommendations

- Establishing a clear policy on lending over record dates and communicating this with their agent lenders to ensure compliance.
- Monitor counterparty exposure in order to identify unusual activity.
- If lenders choose to restrict lending under certain conditions: identifying factors that increase the risk of transactions motivated principally by tax considerations and making specific provisions to recall loaned securities over record dates accordingly.

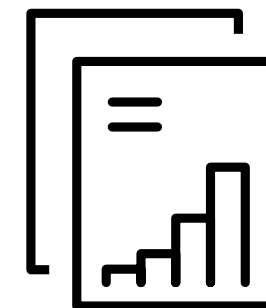
Facilitating participation in the short side of the market

Options

1 No restrictions to securities lending

2 Restrict significant shareholdings*

3 Restrict certain sectors or securities (eg. names with low trading volume)



Background

- Some concerns have been raised about the compatibility of short-selling with ESG principles, although other figures and organisations have argued that short-selling can be instrumental in achieving positive ESG outcomes.
- In the PASLA Consultation, participation in the short side of the market was identified as the least important securities lending factor from an ESG perspective. This likely reflects a broad understanding that loaned securities are used to cover short positions as well as for a variety of other reasons.
- In terms of applying ESG principles to participation in the short side of the market, respondents expressed a preference for restricting the lending of securities in which the beneficial/asset owner has a significant shareholding.

Key considerations

- Regulated and transparent short-selling is widely considered a crucial component of high-quality capital markets. It supports price discovery, creates liquidity and can help to act as a potential red flag against poor corporate governance or even fraud.
- Nonetheless, lenders should consider the implications of lending securities in which they have a significant shareholding when those are securities with less liquidity or lower trading volume.
- Using their corporate-level ESG policy as a guide, lenders will need to consider the trade-offs between what short-selling contributes to the market as a whole and the impact it may have on specific securities, including those in which they have a material ownership interest.

Best practice recommendations

If lenders decide to restrict their participation in the short-side of the market, we recommend that they consider:

- Identifying the areas in which they see a conflict between facilitating short-selling and their corporate ESG commitments.
- Developing a policy to govern their participation that includes specific guidelines on the circumstances under which they would limit their lending or decline to lend securities at all. For example, restrictions could apply in companies where the lender has an ownership interest of a certain percentage or more, or where a specific loan would be more than a certain percentage of the lender's overall position.
- As far as possible, aligning their approach to participation in the short-side of the market via securities lending with their approach to short-selling as an investor (if within their mandate). The goal of this alignment would be to enable lenders to avoid situations in which their lending policy and investment strategies conflict with each other.

*In line with any disclosure thresholds that may apply in local jurisdictions.

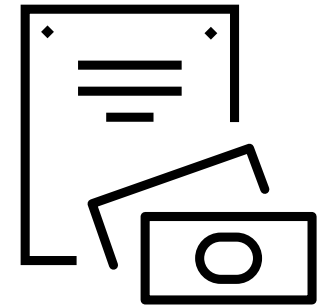
Rehypothecation of non-cash collateral

Options

1 Rehypothecation is permitted

2 Rehypothecation is permitted, with exceptions

3 Rehypothecation is not permitted



Background

- Rehypothecation (also known as “re-use”) can add market liquidity as well as increase returns for lenders, who receive and control collateral.
- However, some market participants believe that rehypothecation increases systemic risk by creating additional lending transactions from the received collateral.
- As such, some lenders prohibit rehypothecation in their securities lending programmes out of governance concerns over market impact.

Key considerations

- Lenders should determine whether the known and potential implications of rehypothecation are compatible with their corporate-level ESG commitments, especially with regard to governance.
- Triparty collateral agents can restrict / allow for rehypothecation/re-use of collateral only within their own platform.
- Collateral rehypothecation may not be an option for all lenders as it may be restricted for certain entity types, programme structures or have contractual limitations.

Best practice recommendations

- Lenders, brokers and end users should incorporate clear guidelines on rehypothecation into the programmes, based on whether they consider the practice to be responsible and compatible with their ESG principles.

Additional information



PASLA/AsianInvestor: ESG and securities lending: Asia charts a course towards alignment, February 2021

http://cdn.haymarketmedia.asia/asian-investor%2fcontent%2fAsianInvestor-PASLA_Consultation_Survey_2020_-_Whitepaper.pdf



PASLA/EY: ESG in securities lending, April 2020

<https://paslaonline.com/pages/public-research-docs.htm>



RMA: Complementary, not Conflicting: Securities Lending and ESG Investing Coexist, November 2020

<https://www.rmahq.org/complementary-not-conflicting-securities-lending-and-esg-investing-coexist/>



ALLEN & OVERY

ISLA/Allen & Overy: Framing Securities Lending for the Sustainability Era

<https://www.allenoverly.com/en-gb/global/news-and-insights/publications/framing-securities-lending-for-the-sustainability-era-isla-ao-white-paper>

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