ISLA INTERNATIONAL SECURITIES LENDING ASSOCIATION

ALLEN & OVERY

Framing securities lending for the sustainability era

ISLA and Allen & Overy white paper

March 2021

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Foreword

The impact of the pandemic in 2020 has certainly pushed securities lending activity and the short side of the market under a microscope.

Unprecedented market volatility resulting in investors suffering significant losses led to direct intervention from central banks and, in March 2020, the CBOE VIX (an index measuring levels of market stress on the S&P 500), was at an all-time high, reaching levels greater than seen in the 2008 financial crisis.

The imposition by some European regulators of short selling bans in an attempt to reduce volatility took its toll on those markets, while the FCA, in the UK, did not issue any restrictions on short selling, issuing a statement on 23 March 2020 to the effect that it considered there was "no evidence that short selling had been the driver of recent market falls". It went on to say that short selling, facilitated by our industry was "a critical underpinning of liquidity provision"[i]. In any event, the soaring utilisation rate of loaned securities, with a corresponding decrease in market liquidity, clearly illustrated the vital role that our industry has performed in maintaining a smooth and stable market.

With 2021 set to be the year of economic recovery and with an immense focus on the global sustainability agenda, accelerated as a result of Covid-19, this paper looks to explore the real meaning of sustainability within the securities lending industry and the means by which it can continue to operate effectively, and in a synchronised fashion, with investors' ESG philosophies and regulatory requirements in mind.

As responsible investing becomes an increasingly hot topic, demonstrated by asset owners showing an elevated desire to incorporate Environmental, Social and Governance ethics into their investment strategies, and as the every-day man on the street's aspiration to live a greener lifestyle becomes increasingly apparent, whether through shopping for sustainable clothing brands like Conscious at H&M or purchasing Fairtrade chocolate & coffee, I think it's safe to say that the passage to a more sustainable future is no longer just on the horizon but is now clearly in view.

The extraordinary events of the last year have altered society's values in immeasurable ways, placing more of a focus on the "S" of ESG, including on how we invest. The severe economic downturn in wake of the pandemic certainly instigated a trend for investing with a conscience and we are now starting to see progressively more financing being channelled into sustainable funds, which are expected to outperform the wider market[ii]. The "E", which was often seen as the core of the well-known acronym, has also benefitted from a "silver lining" of cumulative positive effects of the pandemic, such as the reduction of air pollution and greenhouse gas emissions resulting from the imposition of restrictions on travel, people being obliged to remain indoors in their homes and the consequent complete closure of production lines by numerous factories around the world. Nature and wildlife have returned to what were often overcrowded tourist attractions, water quality has improved, and aquatic life has also been boosted. With the world focused now, more than ever, on investment supporting a resilient and sustainable economy for future generations, it would appear that what many had once assumed to be a fad or passing phase is now becoming ingrained in company culture.

So, how do we ensure that the considerable momentum that has been building up continues to transition into the securities lending industry? It is understandable that, for asset owners, the concept of securities lending can raise several challenges. The temporary transfer of shares to the borrower, including the voting rights attached to the transferred shares, poses several questions as to whether the activity has a valid place within a long-term investment strategy. Among other things, this paper investigates how investors can engage in a securities lending programme without impeding responsible voting and stewardship criteria. It is also important to remember that the core purpose of a lending programme must not impact day-to-day trading activities.

The practice of short selling that is facilitated by our industry is often misconstrued and is sometimes portrayed as having zero correlation with the principles of ESG. However, short selling can highlight problems in companies, including the deceptive practices of "greenwashing" and corporate misrepresentation of sustainability. A serious concern for long-term investors is whether they are undermining themselves by lending their assets. Another is whether borrowers are incorporating the same ESG practices into their calculations. With the flurry of regulation blasting out from the European Union, world leaders setting the green agenda and the increased level of sustainability-linked disclosures required from corporates, I believe that no financial market participant will be able to evade or delay the inevitable integration of ESG into business models, essentially making it easier for lenders of assets to screen potential borrowers.

> "ESG principles are increasingly being integrated into the whole investment process. Securities lending should not be left out of this. All securities lending programs are therefore strongly encouraged to incorporate these principles into their lending activities."
>
> Matthew Chessum, Investment Director of Liquidity Management for Aberdeen Standard Investments and Co-Chair of ISLA's Beneficial Owner forum

I consider the industry to be at a key stage of its development, and securities lending must evolve with the here and now. We must help asset owners to better understand their options for embedding ESG aspects into lending programmes, without harming their sustainable objectives. The association is working with member firms to perfect best practice policies around securities lending activity in order to put responsible investors at ease, as well as interpreting the incoming regulatory agenda and demonstrating how securities lending fits into this new world.

Farrah Mahmood
Senior Regulatory Analyst, ISLA

The rise of sustainability/ESG

Sustainability is rising to the top of the global agenda.

Whilst regulation has existed in relation to environmental, social and governance (ESG) issues for decades, the commitments to limit global warming under the Paris Agreement and to the UN Sustainable Development Goals (SDGs) have galvanised political will to re-examine the approach to these topics in many quarters.

The cost of meeting these commitments is enormous. The OECD predicted[1] in 2017 that USD6.9 trillion is needed each year until 2030 to meet the Paris Agreement goals and UN SDGs. Policymakers are using a combination of regulation and non-legislative interventions to mobilise the capital required, as well as seeking to address the threats to financial stability posed by the physical and transition risks of climate change and environmental degradation.

> "Climate change and environmental degradation are existential threats to Europe and the world. To overcome these challenges, Europe needs a new growth strategy that transforms the Union into a modern, resource-efficient and competitive economy that works for people."
>
> Ursula von der Leyen

The EU's 2018 Sustainable Finance Action Plan, the European Green Deal, the UK Green Finance Strategy and the UK Green Industrial Revolution[2] have resulted in a plethora of new proposals and requirements. These comprise over 80 policy workstreams directly or indirectly affecting financial services – ranging from changes to disclosure, classification, standards and labels, to investment strategies and investor preferences, to risk management and corporate governance, and changes to the real economy.

[1] OECD, UN Environment Programme and World Bank Group (2017), *"Financing Climate Futures: Rethinking Infrastructure"*. The Global Financial Markets Association and the Boston Consulting Group recently estimated that the capital required for the Paris Agreement alone is in the order of USD 3-5 trillion per year (*"Climate Finance Markets & the Real Economy"* (2020) p.8).

[2] We refer to regulation arising from these policy programmes in this paper as "sustainability regulation".

Whilst the EU has been the most ambitious policymaker to date, the tide of sustainability is by no means limited to Europe. Regulators across Asia and Australasia are introducing requirements to address climate and environmental risk and to facilitate development of sustainable finance. Several countries have enshrined, or are planning to enshrine, their Paris Agreement commitments into law. And, with the change of administration in the United States, President Biden has signalled a radical change of approach towards sustainability, putting climate change at the centre of US foreign policy, national security and domestic policy.

> "The United States and the world face a profound climate crisis. We have a narrow moment to pursue action at home and abroad in order to avoid the most catastrophic impacts of that crisis and to seize the opportunity that tackling climate change presents."
>
> Joseph Biden

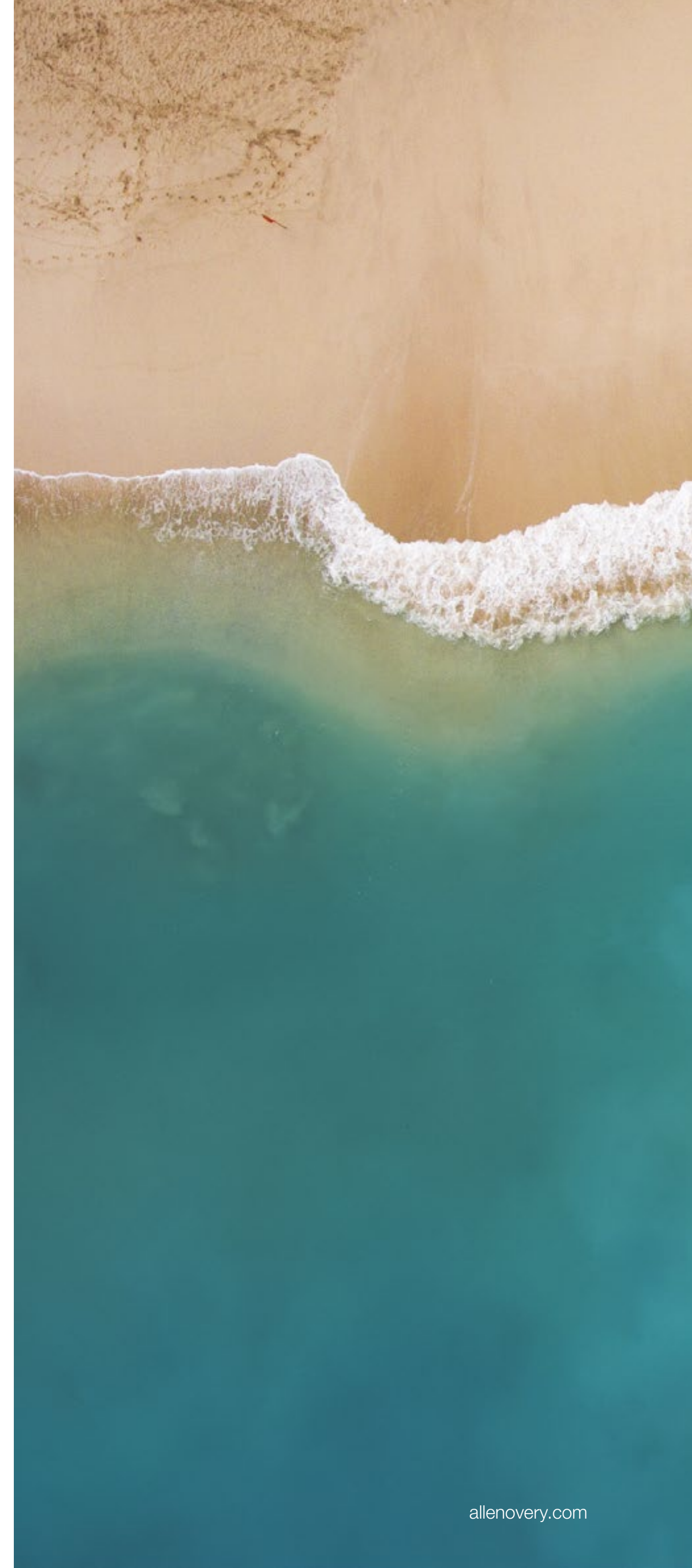
A unique compliance challenge

Sustainability policy is unlike previous significant policy programmes to affect financial services, such as those deployed in response to the 2007-2008 global financial crisis.

The overarching objectives are in some cases time-pressured. For instance, the UN IPCC 1.5^0 Report[iii] has escalated the trajectory of emissions reductions, with many governments looking to make significant cuts by 2030, meaning traditional regulatory reform can be too slow and too sclerotic.

Many of the tools, practices, data and metrics are nascent and not amenable to detailed rules yet. Priorities and preferences in relation to the environmental and social objectives central to sustainability will vary from region to region, industry to industry and investor to investor. These will continue to shift as the transition policy for the real economy continues to develop.

Rather than implementing sets of granular rules with distinct compliance points, firms need to respond to a blend of soft policy and hard regulation, often initially principles-based, which is evolving over time. To add to the complexity, many policy interventions might be ostensibly aimed at one industry, but aim to have indirect impacts up- and down-stream.



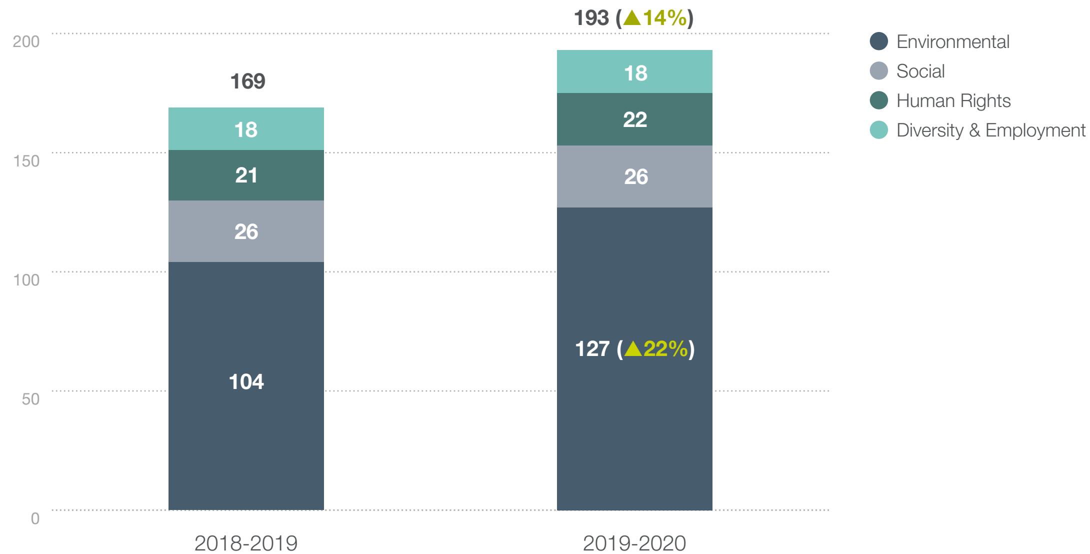
Non-regulatory drivers

Non-regulatory factors also play a significant role in driving the sustainability agenda.

Litigation around climate, social and environmental issues is on the rise, with a greater focus on "greenwashing"[3] where firms mislead clients or counterparties about the sustainability attributes of a product or service[iv].

Shareholder and non-governmental organisation (NGO) activism is also shaping firms' responses to sustainability, leading to increased reputational risk or even changes in business strategy, as well as raising the profile of sustainability issues in investor and consumer consciousness.

Investor appetite for sustainable investments has been increasing over the past few years. In some cases, this is generated by policy interventions specifically targeted at asset owners but, even in jurisdictions where these are absent, there is evidence of growing demand for investments in sustainable companies.



Type of demand by year. Source: Proxy Insight, 2020 Voting Annual Review

[3] "Greenwashing" is sometimes used to refer to this practice only in respect of positive environmental attributes, with the term "bluewashing" used for social; "greenwashing" can also refer to both environmental and social.

Impact of Covid-19

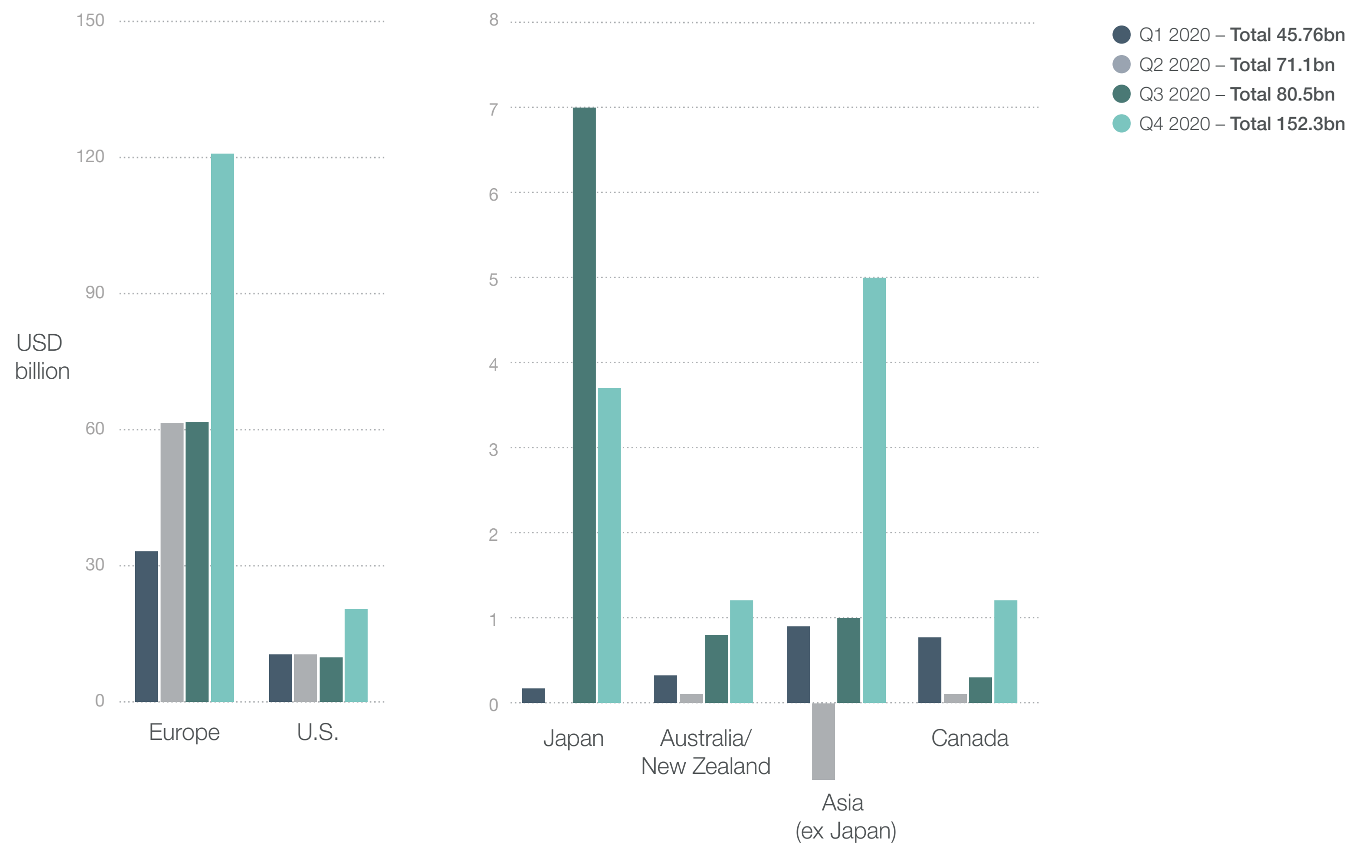
It may be too early to quantify the financial and political consequences of Covid-19, but the pandemic could be seen as a test case for how a global existential threat could impact the economy.

Governments have committed to incorporating sustainability considerations in their recovery programmes. For instance, over 30% of the EUR 1.8 trillion Recovery Plan for Europe – the EU's largest ever stimulus package – is dedicated to fighting climate change. The UK Government is aiming to mobilise GBP 12 billion as part of its Green Industrial Revolution and to issue its first ever green gilt in 2021. Canada has made mandatory reporting of climate risks a condition of the Bank of Canada Covid-19 bail-outs. South Korea's Green New Deal commits part of its Covid stimulus package to investments in green cities, infrastructure and industry.

Whilst the pandemic slowed policymakers' timetables to some extent in 2020, 2021 looks to be one of the busiest years for sustainability policy and regulation. The next iteration of the Action Plan for the Von der Leyen Commission, the Renewed Sustainable Finance Strategy, was originally due to be published last quarter but is now expected in the second quarter of 2021. The updated Strategy is expected to cast the net even wider than the Sustainable Finance Action Plan, with over 50 areas for potential action under consideration. The 26th UN Climate Change Conference (COP26) was originally scheduled to be held in November 2020 but was delayed until this autumn owing to the pandemic. The summit is the biggest ever to be hosted by the UK, and is considered to be one of the most important since the signing of the Paris Agreement. Countries around the world are expected to announce new sustainability policies in the lead-up to this November.

The causes and consequences of Covid-19 have drawn attention to the underlying objectives of sustainability. The link between biodiversity loss and rise in pandemic risk has focused interest in the environmental objectives beyond climate change[v]. Social objectives have also received greater awareness, with social bond issuance increasing by a factor of seven to a record USD732 billion[vi].

> "Companies will have to adapt their strategies to [the] new realities."
>
> Mark Carney



Global quarterly sustainable fund flows. Source: Morningstar

ESG has moved beyond being a label for certain products or investment strategies. It has become a pivotal shift in the way businesses and the economy operate. As one of the fundamental sectors in the economy, financial services is one of the key levers for change.

In this paper, we will consider what role securities lending will play in this transition and how market practices may need to adapt.

The role of securities lending in the transition to a sustainable economy

Securities lending plays a fundamental role in today's global capital markets. It has long been used as a means of meeting settlement and collateral requirements, as well as providing vital liquidity and efficiency to secondary markets. It also promotes price discovery and market making, as well as facilitating important hedging and investment strategies, such as short selling and arbitrage. As of December 2020, total securities on loan was EUR 2.3 trillion, with EUR 24 trillion of securities being made available for securities lending by institutional investors[vii]. Many European and other central banks use securities lending as part of their implementation of monetary policy, which helps financial markets function more smoothly.

Securities lending can be used as a tool to generate incremental income and to reduce overall costs for investors and pensioners, without losing any economic benefit, such as dividends or interest payments. For asset managers, it can be an additional source of alpha. In addition to the fee, the borrower provides the lender with collateral in the form of other securities or cash. This deems it a relatively low-risk activity, as the lender is protected for potential loss if the borrower is unable to return the securities. The value of the collateral is normally greater than the value of the borrowed securities and both are revalued on a daily basis.

Securities lending is also used as a key tool around the mobilisation of collateral, including High Quality Liquid Assets (HQLA), within the financial ecosystem. The efficient mobilisation of collateral is important not only in the context of the smooth running of traditionally collateralised markets such as securities lending and repo, but collateral increasingly underpins many derivatives markets. The development of a collateralised market around securities lending is primarily driven by a lender's desire to mitigate any counterparty credit risk, through the provision of either cash or non-cash collateral. As of December 2020, equities as a proportion of all collateral held in European tri-party was circa 44%, with government bonds and corporate bonds at 45% and 10% respectively[viii]. Securities lending has traditionally been at the forefront of innovation around how market participants can better optimise collateral usage and drive the development of new products.

"With governments and policy makers advancing sustainability policies worldwide, much of the focus has been on incorporating sustainability-related risks and opportunities in the financial services regulatory framework. As the focus shifts more broadly across the investment chain, a growing number of asset owners and asset managers are evaluating their securities lending practices due to environmental, social and governance issues as long-term investors. It is therefore crucial that securities lending practices are recognised for their role in providing liquidity to and facilitating price discovery within capital markets."

Ciara Horigan, Regulatory, Industry & Government Affairs, State Street Chair of ISLA's ESG Steering Group

Securities lending as a facilitator of capital needed for the transition

As noted above, the capital requirements for the transition to net zero[4] and other sustainability objectives are substantial, and beyond the means of public finance alone. Private funding for the public infrastructure and private investment needed will be critical, and well-functioning capital markets are essential to generate that funding. Securities lending and the related practice of short selling play an important role in those markets.

> "Securities lending is a useful source of low-risk incremental revenue for our clients. In addition, an orderly and efficient securities lending market is a key component of liquid, efficient and sustainable capital markets."
>
> Mick Chadwick, Director, Global Head of Securities Finance, Aviva Investors

As noted by the European Securities and Markets Authority (ESMA)[ix], securities lending and short selling are key to price discovery and market liquidity. Short selling assists with incorporation of negative information into market prices more quickly, reducing the risk of price bubbles[x]. The evidence suggests that restricting short selling reduces liquidity[xi] as well as significantly increasing the costs of liquidity[xii].

Securities lending and short selling might also contribute to market stability. Research shows that markets might be more volatile where short sales are banned[xiii].

In line with the aims of the Capital Markets Union (CMU), securities lending helps create a more resilient economy, which in turn will help the EU deliver on its objectives under the European Green Deal.

> "Market financing will be the lifeblood that sustains the recovery and future growth over the long-term… An efficient single market for capital is needed to mobilise the necessary funds and to ensure that sustainability considerations are rigorously incorporated in financing decisions."
>
> 2020 CMU Action Plan

[4] "Net zero" refers to the target of reducing greenhouse gas emissions to an extent that they can be offset with actions to remove emissions from the atmosphere, reflecting commitments that governments have made to decarbonise economies under the Paris Agreement.

Compatibility with long-termism

The time horizon of climate change and environmental degradation is central to sustainability policy. The catastrophic consequences of climate change are predicted to occur beyond the usual time horizons of business, political and monetary policy planning, however the action needed to mitigate these consequences needs to take place today[xiv].

The need to attenuate short-termism was one of the primary action points under the EU's 2018 Sustainable Finance Action Plan. The European Commission was concerned that activities within capital markets are inducing companies to prioritise short-term profit at the expense of the long-term success of businesses, the latter of which will require consideration of threats such as climate change[xv]. It mandated the European Supervisory Authorities to review the evidence and report on whether practices within capital markets are generating undue short-term pressure in the real economy, including in relation to securities lending.

ESMA did not find concrete evidence for a causal connection between securities lending and undue short-term market pressures and did not recommend changes to policy in this area[xvi]. This aligns with research by the Federal Reserve Bank of New York[xvii] that found short sales do not, in the long term, affect market declines, and by the European Systemic Risk Board[xviii] that found that short sale bans tend to be associated with greater return volatility and steeper share price declines.

> "The evidence does not suggest that short sellers are the problem. They are the messengers with bad news about companies' prospects. They are unpopular because they deliver messages that people would rather not hear."
>
> FRBNY Staff Paper

When viewed holistically, securities lending can be seen as playing an important role in creating long-term stability of the capital markets, which will be critical to the successful transition of the economy to a more sustainable basis.

Optimising market practice to support the transition

Securities lending can play an important role, both with the functioning of capital markets more broadly as noted above but also in assisting with individual ESG investment strategies.

In December 2020, ISLA created an **ESG Steering Group** to consider the role that ESG plays in securities lending. The Group includes a wide representation of both buy-side and sell-side members as well as market vendors and tri-party collateral managers. Working with relevant industry stakeholders as well as the regulatory and legal community, the group's aim in 2021 is to develop an "ESG Policy Framework" for securities lending around four key pillars:

There are certain considerations that market participants will need to take into account to ensure that securities lending in practice aligns with expectations around sustainability. We turn to consider these below.

Is securities lending an "ESG" product?

Given the historic conception of ESG as essentially a product label for certain investment strategies, there can be some confusion around how the term is used in the new sustainability era.

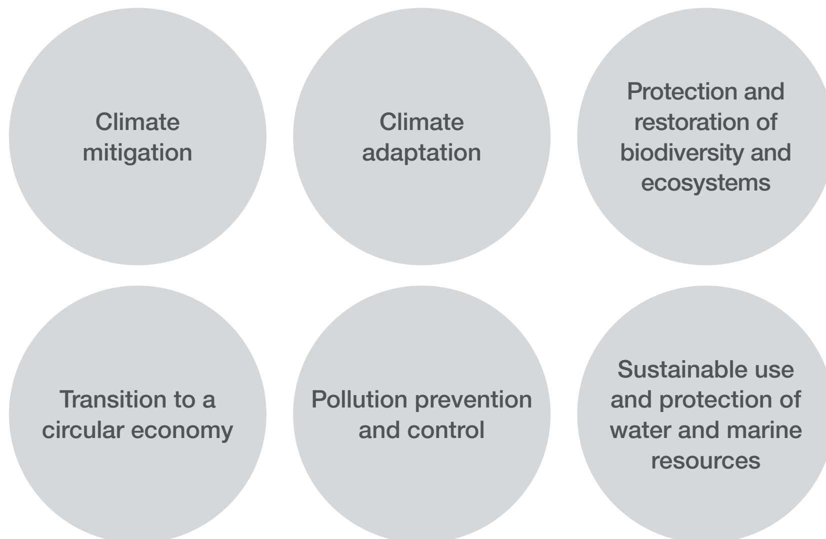
There is no legal or regulatory definition of an "ESG compliant" product or activity. Firms may need to comply with one or more requirements under various regulations related to the sustainability policy programmes, but there is currently no regulatory test of "ESG compliant" – any more than complying with financial services regulation can be said to make a product "financial services compliant". The better understanding is whether an activity or firm can be said to comply with a specific sustainability regulatory requirement[5]. Securities lending per se is not currently one of the activities specifically regulated under sustainability regulation[6].

Whilst it is not meaningful therefore to describe securities lending as "ESG compliant", it can however serve to facilitate a lender's specific ESG objectives.

Creating a common understanding of what ESG means in the context of securities lending

Equally, there is no one universal definition of what "an ESG objective" is.

Within the EU and UK, there is currently only one regulatory definition of "green": the EU Taxonomy Regulation[xix]. The regulation defines what activities can be said to be environmentally sustainable in the context of six specified environmental objectives:



[5] For instance, a "comply or explain" statement about climate financial risk disclosure might be capable of being described as complying with LR 9.8.6 (8).

[6] The full range of supervisory, regulatory and legal obligations applying to any securities lending arrangement and market participant will be fact dependent. For instance, where a market participant categorises securities lending, or an aspect of it such as cash reinvestment, as portfolio management under MiFID II (Directive 2014/65/EU), the Sustainable Finance Disclosure Regulation (Reg (EU) 2019/2088) will apply, which imposes certain disclosure obligations. Other firms may be expected to consider the climate or environmental financial risk associated with these activities under prudential supervisory expectations. In all cases, specific advice should be obtained.

At present, only the framework (level 1) regulation is in force, with the technical detail expected to be published for the various environmental objectives over the course of the next year. As such, the EU Taxonomy Regulation is currently of limited help in defining ESG objectives between securities lending parties.

Even when the EU regulation is further developed, it is only one of a number of taxonomies in development internationally[7]. Some of these taxonomies have some common ground – for instance, a proposed Singapore green taxonomy largely shares the same objectives as the EU regulation – but there is otherwise no single approach. There are some efforts to create more consistency: the International Platform on Sustainable Finance, currently comprising 16 countries and the EU, has initiated a taxonomy working group[8]. Agreeing one global framework, however, remains a distant point on the horizon.

The policymaker focus so far has been on the development of taxonomies related to environmental objectives. There is currently no single articulation in EU or UK regulation of what social objectives are, let alone detail of how activities will be measured against them, nor what constitutes good governance practices[9].

To add to the complexity, it is not always possible to isolate the different pillars of ESG. For instance, the EU Taxonomy Regulation allows for a focus on just one of the environmental objectives, but in order to meet the standard of being environmentally sustainable the activity must also not significantly harm any of the other objectives and must comply with certain social and good governance safeguards.

It is therefore critical that securities lending parties establish between them what is meant by the lender's ESG objectives at the outset. In the absence of an appropriately developed regulatory taxonomy or other standard, this can be achieved by using the following approach:

- **Define the sustainability objective(s)** (e.g. diversity in management).
- **Define the target or threshold for achieving the objective** (e.g. 50% women in senior leadership).
- **Identify the metrics for measuring compliance** (e.g. board positions and ExCo positions held by women for a 12-month continuous period, with less than 50% serving on three or more boards).

Action 1

ISLA will work with members and industry stakeholders towards development of a best practice standard on creating a common understanding of ESG objectives in the context of securities lending arrangements.

[7] The UK, Singapore, Canada and Malaysia have committed to or are developing their own regulations. China, Bangladesh and Mongolia have existing definitions of what comprises "green" activity. Industry and academic groups have called for taxonomies in Japan and Australia.

[8] See also the *World Bank guide to developing a national green taxonomy*.

[9] The EU is considering expanding the Taxonomy Regulation framework to include social objectives (see the Renewed Sustainable Strategy Consultation and the mandated review in art.26(2)).

Role in stewardship

Shareholder engagement is considered an important tool in driving greater long-term value creation and a more sustainable foundation to businesses. In addition to regulatory interventions aimed at promoting stewardship more broadly, measures specifically focusing on the role of engagement in sustainability have emerged recently[10]. Asset managers and institutional investors are under increasing pressure to ensure that their corporate engagement record matches their stated policies.

Under standard securities lending agreements (both title transfer and pledge), the voting rights for loaned securities transfer to the borrower, which has led to the charge that securities lending is not compatible with active shareholder engagement. This need not be the case.

As the EU explores avenues for greater interaction between companies and stakeholders on topics such as environmental and human rights issues[11], the role of voting in driving long-termist considerations may evolve in the coming years. In the short-term, securities lending agreements and internal governance processes can be adapted to ensure that, where necessary, securities can be recalled for key shareholder meetings where lenders need to vote with sufficient time to allow all parties in the chain to accommodate the request. This is also relevant in the context of Transparency, for which, see further the discussion below.

Action 2

ISLA intends to work with the membership to update current best practices for recalling securities and to create industry standards around voting in line with good governance principles.

Transparency

A key concern of sceptical lenders is the purpose for which their securities are being borrowed – for instance, borrowing a share to be able to vote according to a short-termist or non-ESG aligned strategy.

This concern should be mitigated by regulation and guidance. For instance, such behaviour would contravene the UK Money Markets Code, which stipulates that securities should not be borrowed solely for the purposes of exercising voting rights. Equally, market intermediaries are expected not to exercise voting rights on borrowed stock that they temporarily hold unless instructed to do so by the original beneficial owner[xx].

From the EU perspective, in September 2020, the Shareholders Rights Directive II[xxi] (SRD II) entered into force, which forms part of the European Commission's Corporate Governance Action Plan 2012 to promote longevity and stability in EU capital markets. SRD II aims to improve shareholders' ability to exercise their rights across multiple markets, whilst utilising technology to enhance communication between firms, intermediaries, and the shareholders. Recital 12 of SRD II states that "It is therefore important that the asset manager reports on its policy on securities lending and how it is applied to fulfil its engagement activities, particularly at the time of the general meeting of the investee company".

[10] In its supervisory statement on climate financial risk for banks and insurers (SS3/19), the UK Prudential Regulation Authority stated that firms are in a strong position to encourage greater climate disclosure through their ownership of financial assets. The UK Stewardship Code 2020 includes a new requirement for signatories to include material ESG issues in their integration of stewardship and investment.

[11] The EU is considering interventions into corporate governance across the economy under Action 10 of the Sustainable Finance Action Plan.

Action 3

ISLA intends to adapt current best practices that aid transparency to regulators around shareholder disclosure and identification, keeping in line with the regulatory requirements of SRD II.

Asset owners seeking to align securities lending with their ESG objectives may be concerned with the identity of counterparties in back-to-back arrangements, on the basis that they would not want to support certain businesses that were not aligned with their own sustainability standards or aims.

It is possible that market transparency and financial stability mechanisms could be adapted to allow regulators a better view of potential sustainability-related issues in the chain. For instance, as climate and nature-based risks are incorporated further into companies' risk management frameworks, climate change risk will become, inter alia, a species of credit risk.

This concern may also potentially be addressed in proposals that the European Commission is presently considering relating to sustainable corporate governance. It is envisaged that the Commission will introduce mandatory due diligence requirements for environmental and human rights issues, both in relation to companies' own operations and within their supply/value chain. At the time of writing, the detail of the proposed legislation has not been published, however the wording of the initial consultation and the European Parliament's own initiative report on the topic indicates that it will likely apply to financial services firms as well.

Action 4

ISLA will work with members and industry stakeholder groups to engage in a feasibility study on how current market practice could be optimised to increase transparency.

Collateral and cash reinvestment selection

The most prominent and potentially radical impact on our markets is the increasing number of institutional clients who are adopting ESG objectives within their investment process. Determining whether securities collateral is equivalent to the loaned securities, and whether cash is reinvested consistently with these ESG objectives, will present an important challenge.

Given the wide range of potential combinations of ESG objectives and lack of standardised definitions, standardisation of collateral selection or appropriate reinvesting of cash may prove unwieldy. Any selections would still require regular fine-tuning as the effects of transition policy are felt in the real economy, disclosure becomes more widespread and detailed, and climate and nature-based financial risk become fully incorporated into corporate strategy and risk management. An industry that is considered inconsistent with, say, carbon mitigation objectives today may evolve significantly as they seek to transition their businesses.

> "It's imperative as an agent lender, to work cohesively with our clients to develop a securities lending programme that aligns with their ESG objectives. We expect requirements to differ depending on clients' bespoke investing strategies, therefore solutions that enable the industry to balance customisation with efficiency and scale will become vital, especially in relation to collateral."

Rickie Smith, Collateral Services Product Manager, JP Morgan Chase Chair of ISLA's Collateral Management Steering Group

This suggests that a more bespoke approach may be warranted. Identifying the necessary data for the metrics and assessing whether the necessary target has been achieved for particular securities requires resources and expertise that market participants may not have in-house. It is therefore likely that participants will use third party assessments and verifications, which might include ESG ratings, using particular benchmarks as a proxy for rating or other third party tools.

Variation between results in ESG ratings is significant – correlations between major ESG ratings providers can range from 38% to 71%[12], as compared with credit ratings which have a 99% correlation, according to one study[xxii]. Unlike the credit ratings world, where ratings agencies are regulated and creditworthiness is more clearly defined, variances in data standards and differences in governance of the ESG ratings agencies may mean that assessments as to whether a security is aligned with a particular sustainability objective may be broad. It is anticipated that upcoming EU policy interventions will seek to regulate the ESG ratings market, which may create more transparency. Efforts to create an international standard around sustainability disclosure, coupled with growing mandatory disclosure requirements, are also likely to assist with the development at this point.

Whilst it may not be feasible to achieve standardisation of outcome, consistency of process could be achieved by agreeing principles as to how a security or investment is determined to meet the lender's ESG objectives.

Action 5

ISLA intends to work with its Collateral Management Steering Group, with a mandate from ISLA's Beneficial Owner Steering Group, to develop high level standards for collateral selection and around the approach to cash re-investment to align with the lender's ESG objectives.

[12] Correlation between ratings focusing on social objectives or governance is lower still, with an average of 42% and 30% respectively.

Conclusion

The sustainability agenda is forcing all of us to rethink many facets of our day-to-day lives, as we think about responding to the challenges presented by issues such as climate change and the consumption of the earth's natural resources. At a personal level, sustainability can manifest itself in numerous ways ranging from how we consume products and services through to decisions about how we support our elected representatives, who will take these issues forward on our behalf.

Reflecting this mood for change from their electorates, governments have not been idle in this area with the European Union being one of the most ambitious from a policy perspective, although others, including the United Kingdom and various countries across Asia, are introducing green strategies with broadly similar objectives. The recent change of administration in the US will only add weight to these initiatives, as governments globally increasingly coalesce around important sustainable policy frameworks such as the Paris Agreement. The pace of change is only expected to increase and expand around the globe.

The cost to society of transitioning to a sustainable economy cannot be met by governments alone and therefore, well-functioning and efficient capital markets will be a crucial part of the transition process. The provision of secondary market liquidity and the support for short selling and other hedging techniques through securities lending leads to better and more transparent price discovery, deeper and more liquid markets, and narrower bid offer spreads. Through efficient and transparent markets that allow investors to make better and more informed decisions we will see greater participation by retail investors, particularly in those markets or areas where retail participation in the wider capital markets is less developed.

The challenge presented by sustainability to our market – and financial services more broadly – is unprecedented. Solutions that worked for previous regulatory changes may not work with something as complex, evolving and sprawling as ESG. There may never be a neat, globally accepted regulatory definition of what ESG means, or a clear set of hard-and-fast rules to comply with. Securities lending however has proved itself capable of innovation in the past, and will do so again.

Upon conclusion, I would stress the significant role that securities lending plays in promoting the smooth running of capital markets. The fundamentals of secondary market liquidity, effective price discovery and efficient settlements should be expected and demanded by all relevant stakeholders across the ESG investment value chain. At ISLA we strongly believe that securities lending has an important role to play in both meeting individual market participants' ESG objectives and in aiding the wider transition of the economy towards Paris-aligned and other sustainable goals. ISLA believes that the industry can support the growing concerns of asset owners around sustainability and coevolve, by helping them achieve liquidity and growth in these markets.

Next steps

This paper has raised several points that market participants will need to consider in the new sustainability era. To facilitate reaching industry consensus and help our market shape best practice in this area, ISLA via the ESG Steering Group will lead a number of workstreams on the action points set out below. We will aim to bring together wider participation from members, market participants and other stakeholder groups to advance our market's response to these challenges.

Action 1

ISLA will work with members and industry stakeholders towards development of a best practice standard on creating a common understanding of ESG objectives in the context of securities lending arrangements.

Action 2

ISLA intends to work with the membership to update current best practices for recalling securities and to create industry standards around voting in line with good governance principles.

Action 3

ISLA intends to adapt current best practices that aid transparency to regulators around shareholder disclosure and identification, keeping in line with the regulatory requirements of SRD II.

Action 4

ISLA will work with members and industry stakeholder groups to engage in a feasibility study on how current market practice could be optimised to increase transparency.

Action 5

ISLA intends to work with its Collateral Management Steering Group, with a mandate from ISLA's Beneficial Owner Steering Group, to develop high level standards for collateral selection and around the approach to cash re-investment to align with the lender's ESG objectives.

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About ISLA

Who are we?

The International Securities Lending Association (ISLA) is a leading industry association, representing the common interests of securities lending and financing market participants across Europe, Middle East and Africa. Its geographically diverse membership of over 160 firms includes institutional investors, asset managers, custodial banks, prime brokers and service providers.

What do we do?

Working closely with the global industry as well as regulators and policy makers, ISLA advocates the importance of securities lending to the broader financial services industry. ISLA supports the development of a safe and efficient framework for the industry, by playing a pivotal role in promoting market best practices and processes, amongst other things. ISLA sponsors the Global Market Securities Lending Agreement (GMSLA) and the annual enforceability review in over 65 jurisdictions globally.

How do we do it?

Through member working groups, industry guidance, consultations and first-class events, ISLA helps to steer the direction of the industry by developing Thought Leadership, standards for Legal Frameworks and Industry Guides & Best Practice documentation. ISLA is one of its most influential voices on the European and global stage.

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About Allen & Overy

Allen & Overy is a market leader in Sustainability/ESG, with extensive experience advising corporates, private equity sponsors, investors, lenders and portfolio companies on the full spectrum of compliance matters across the life cycle of a project. The combination of our multi-jurisdictional capital markets, derivatives, M&A, leveraged finance, high yield, securitisation and investment funds expertise is supported by a full range of complementary and specialist practices including environmental and climate law, business and human rights, climate financial risk management, corporate governance, pensions, employment, retail financial products, competition, data and digital transformation, financial services regulatory and insurance.

We are one of few firms approaching this topic from a holistic perspective, with a global bench of experts focusing on the full range of developments in the sustainability/ESG agenda across the globe.

End notes

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CS2103_CDD-63404_ADD-94813