ESG in securities lending

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EY
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PASLA

Foreword

Stuart Jones
Chairman, Pan Asia Securities Lending Association (PASLA)

The benefits of short selling and securities lending continue to bifurcate the market. Given the events of the past few months, it is encouraging to hear many voices highlighting those benefits and its importance to the functioning of capital markets. While recently there have been a handful of markets around the world temporarily banning the practice of short selling, we have also witnessed the majority of markets declining to follow suit. Opinions on the topic are clearly divided but there are many academics, media outlets and regulators who have highlighted how important short selling is to market pricing and efficiency.

PASLA and our global peer associations are always keen to educate market participants on the benefits of securities lending as well as the importance of good governance and appropriate policies in any securities lending business.

With a slew of commentary on the topic and with some asset owners even choosing to suspend securities lending in the recent past, we felt it timely to address a specific focus on ESG. Our aim is not to tell you what to do or influence policy. Rather, we want to inform you where our membership's views are on the topic and what others are thinking.

Working with Ernst & Young Advisory Services Limited provided us with the experience to make this a relevant and professional project. We felt it is important not to just speak for ourselves but to have an independent perspective on this increasingly important topic. The PASLA Business Development Team has worked closely with EY throughout this process and, in our view, this is the first of many steps as the topic evolves and views change. We have long said that one of the benefits of short selling is that it forces good corporate governance through greater price discovery. Its therefore natural that short selling and securities lending can also be a mechanism for influencing change in corporate ESG policies and, in our view, for the better.

Josh Lewsey
Partner, EY Advisory Services Limited

At the time of writing, the impact of Covid-19 on global markets has heightened the focus on the securities lending industry. Despite the World Economic Forum's 2020 Global Risk Report mis-identifying the likelihood of the risk posed by an infectious disease, it was nonetheless a top 10 risk. The most significant long-term risks remained climate change, extreme weather and biodiversity loss. This disruption, then, comes at a time when public sentiment and capital markets participants have already acknowledged the need for better approaches to long-term value creation and sustainability, hence the growing focus on ESG.

Therefore in facing historically low interest rates and the rise of passive funds, this creates both the need and opportunity for the investment community and market participants to reconsider how they add value and how they can positively influence both the mechanisms of investing and the leadership of the underlying companies.

ESG in Securities Lending

Introduction

The growing focus on ESG has prompted increased scrutiny on the securities lending industry. Whilst many market participants and academics point to the benefits of securities lending, others convey a more negative perception, believing it contravenes ESG principles. These diverging views have raised a number of topical questions:

- Why does this difference of opinion exist?
- What are the potential solutions?
- What impact will a growing focus on ESG have on the securities lending industry?

PASLA has engaged EY teams to explore this subject by conducting an independent survey among its members and selected market participants. A summary of the findings and supporting narrative are provided in this report.

Contents of this paper

Executive Summary

- Most market participants and academics view securities lending as a key element of healthy functional markets and believe it can be compatible with ESG principles.
- The broader benefits of securities lending, however, are not well known nor well understood by the conventional investment community. Instead, securities lending is predominantly associated with only the more polarizing topic of short selling.
- There is overall agreement that short selling can be positively leveraged to reinforce ESG principles and in particular act as a threat to companies that are not transparent in their governance or effective in their ability to execute it. However, opponents are keen to disassociate themselves from this practice believing that on the balance of factors this is too blunt an instrument and that there are more constructive mechanisms to achieve the same aims.
- ESG provides a timely opportunity for the asset management industry to exercise qualitative judgment and therefore add value and justify fees. This is pertinent at a time when passive funds are rising. This principle also applies to participants of securities lending who can demonstrate greater value by implementing ESG controls across the lending value chain.
- The study highlighted how most view a separation between the “ES” from the "G." The "ES" is viewed in line with what nature of work a company operates in and the policies it implements. The "G" was viewed in terms of a company’s overall governance and the effectiveness and transparency thereof. Most participants acknowledged how evaluation of the "G" was in general more developed and that the entire industry is still early in the journey of interpreting ESG principles into tangible actions.
- Opportunities exist for the securities lending industry (via PASLA, ISLA, etc.) to portray itself in a more transparent manner beyond purely short selling, without which many warn of the likely emergence of “well-intentioned but ultimately misplaced” regulation.
- Specific recommendations centered around improving the transparency of mechanisms and processes, validating counterparty aims and motivations, ensuring collateral is ESG compliant and using blockchain (or equivalent technology) to verify ownership and accountability at each stage of the lending chain.
- Most participants would welcome further convergence and standardization of ESG principles, codes of conducts, controls and ways of working. However participants also warned of the dangers associated with the universal quantification of ESG concepts, especially measurement. Proponents of this view fear standardization could lead to capital concentration and thereby undermine the purpose of active investing - responsibly generating alpha returns.

2 Market Insights

I. Growing demand for investing to incorporate ESG

What is ESG investing?

Responsible investing refers to the integration of environmental, social and governance factors into investment and related decision-making. While ESG is not always part of mandatory financial reporting, both investors and companies are beginning to disclose this information as part of their approach to identify material risks and opportunities.

An increased focus without clarity

Consideration of ESG factors has grown, driven by recognition of its intangible value to an organization's long-term potential, shifting public sentiment, government expectations and consequent pressure from regulators. Whilst investors increasingly convey their efforts to adhere to ESG principles, how these are classified, defined and measured vary greatly. Therefore, much is still left to interpretation, leading some to a more cynical view of those promoting their ESG credentials as "greenwashing."

> "This isn't new. We have been ethically investing for decades. ESG is just another label to appease the misplaced sentiment of populism
>
> Head of Global Portfolio

What has driven this changing sentiment?

Changing investor sentiment

Individual investors are increasingly looking for investment opportunities that reflect their personal beliefs and are demanding that ESG factors are taken into consideration, for example implementing measures such as negative screening to exclude poor ESG performing companies.

Retiree and millennial influence

The changing sentiment is in part, driven by retirees, who constitute an influential portion of the investor community and millennials, who are beginning to enter into their prime earning years. These preferences are driving the industry to develop more sustainable products to capture this significant market.

Correlation between ESG performance and returns

From a business perspective, ESG is not only becoming more relevant from a reputational and financial performance standpoint. There is now a body of evidence that well-governed companies benefit from long-term performance and reduced risks.

~97%

of investors are formally or informally **incorporating ESG into their investment decision-making**[1]

(Based on a 2018 EY survey with over 260 responses from senior institutional investors)

10x

Global green bonds issuance **increased tenfold within 5 years**[2]

2x

Millennials are **twice as likely** to invest in companies that **target social or environmental outcomes**[3]

~41%

of 189 funds that meet ESG criteria **outperformed the S&P 500 in 2019**[4]

[1] "Does Your Nonfinancial Reporting Tell Your Value Creation Story?," EY report 2018
[2] "Accounting for climate - the next frontier for ESG," S&P Global website, https://www.spglobal.com/en/research-insights/featured/accounting-for-climate-the-next-frontier-in-esg
[3] "Are Millennials Democratizing Sustainable Investing?," Morgan Stanley website, https://www.morganstanley.com/ideas/millennial-sustainable-investing/
[4] "Mutual Funds That Rank High on Sustainability Are Outperforming the Market," Barrons website, https://www.barrons.com/articles/top-esg-funds-our-annual-ranking-finds-sustainable-funds-are-increasingly-beating-the-market-51579301101

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ESG is becoming a priority for CEOs and boards

In correlation to the growing social focus there has been substantial growth in the reference to ESG credentials in the quarterly earnings calls of S&P 500 companies.

This highlights both the increasing interest in the topic from the investment community and the active approach corporations are taking to convey their efforts.

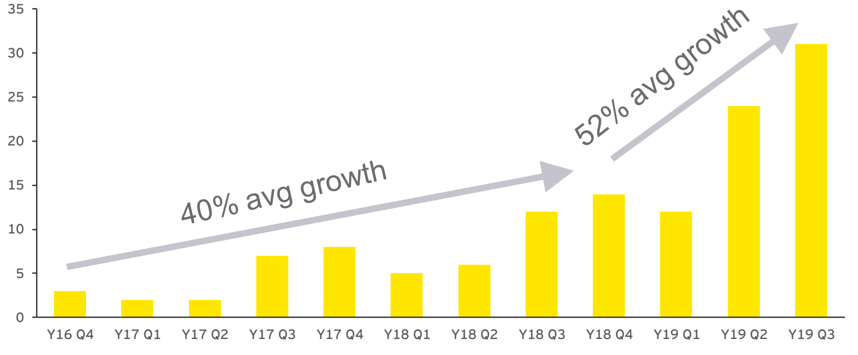

Figure 1: Number of S&P 500 companies mentioning at least 1 key ESG issue in quarterly earnings calls[5]

Will ESG investing become the industry standard?

Figure 2: % of investors who believe ESG investing will become industry standard[6]

As ESG becomes an increasingly important component for investors, many are wondering if and when ESG investing will become an industry standard. A study by Natixis found that two-thirds of market participants believe this to be the case.

One key challenge to this observation is that in order for this to happen, a higher degree of consistency is required, especially from regulatory bodies and associations. The next section explores this topic in more detail.

> "ESG factors relevant to a company's business can provide essential insight into management effectiveness and thus a company's long-term pros
>
> Larry Fink
>
> Global CEO, BlackRock

It is inevitable that everyone, to an extent, will have to adopt a policy in relation to ESG. Having no opinion or view on it will be viewed as negatively as supporting the wrong environmental and social issues

Companies are taking ESG seriously because they fear repercussions, by both consumers and regulators. Unsustainable practices, such as significant environmental damage, are no longer a viable option

> "Sustainability was the star at Davos 2020
>
> – Forbes

> "All sectors will face significant impact due to a transition to a net zero carbon economy, from both physical impacts and the transition itself; yet this will play out as both risk and opportunity. Understanding how companies and their assets fare under future climate scenarios will be critical for investors to understand
>
> Dr Matthew Bell
>
> EY Asia-Pacific Climate Change and Sustainability Services Leader

US$30 trillion

AUM in ESG investing[7]

71% of investors are interested in sustainable investing[8]

34% growth in responsible investments over past 2 years[9]

56% of investors believe companies with better ESG standards perform better than those without[10]

[5] "KeyMetrics – Earnings Insight," Factset website, https://www.factset.com/hubfs/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_120619.pdf
[6, 10] "Looking for the best of both worlds," Natixis website, https://www.im.natixis.com/us/resources/esg-investing-survey-2019
[7, 9] "Global sustainable investments rise 34% to $30.7 trillion," Bloomberg website, https://www.bloomberg.com/news/articles/2019-04-01/global-sustainable-investments-rise-34-percent-to-30-7-trillion
[8] "Morgan Stanley survey finds sustainable investing poised for growth," Morgan Stanley website, https://www.morganstanley.com/press-releases/morgan-stanley-survey-finds-sustainable-investing-poised-for-growth_06490ef0-a8b2-4a68-8864-64261a4decd0

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II. The evolving landscape of ESG regulation

Figure 2: Timeline highlighting key regulatory changes involving ESG globally[11]

The ESG regulatory landscape has evolved significantly in recent years

Over 150 policy instruments were created between 2013 – 2015 in response to the mounting pressure from investors, inter-governmental organizations and NGOs for more consistent ESG standards[12].

Whilst regulators have responded with evolving ESG policies in each market, there is still no cohesive international standard. Furthermore, many of the regulatory efforts to date are either optional guidelines or, when mandatory, allow for a high degree of discretion (e.g., limited or no guidelines provided on which indicators should be included).

Despite the lack of mandatory ESG disclosures, companies are increasingly disclosing ESG-type metrics and incorporating these indicators in their risk and growth assessments.

Japan's Financial Services Agency (FSA) incorporates ESG principles into new definition of stewardship responsibilities

In March 2020, the FSA updated the latest version of the country's stewardship code to include the requirement of considering ESG factors in medium to long-term sustainable investment strategies.

The lack of standardization is leading to challenges in accessing and interpreting ESG information

Whilst increased ESG disclosures and ESG assessment mechanisms (e.g., rating agencies, ESG indexes) are enabling investors to make more informed decisions, the inconsistency of assessment methodologies and outcomes remains a challenge which requires case-by-case interpretation.

An MIT paper found that in a dataset of five ESG raters, correlations between scores on 823 companies averaged ~61%[13]

The market shows natural convergence

Despite the noted lack of standardization, market participants seem to be naturally converging to certain ESG reporting practices.

For example, the Singapore Exchange noted that whilst they did not prescribe a specific ESG framework, over 91%14 of companies deferred to Global Reporting Initiative (GRI).

> "From the Exchange's perspective, ESG information of our companies completes the information mix and helps investors in making important investment decisions
>
> Michael Tong
> Head, Listing Policy & Product Admission, SGX

Views remain polarized as to whether ESG reporting should be more standardized or remain bespoke

Whilst natural convergence occurs, market participants' views on whether standardization can, or should, be achieved remain polarized.

For standardization:

- Mandatory reporting increases accessibility and transparency of ESG data for investors to make more informed decisions.
- Standardized frameworks provide market participants with a comparative and consistent benchmark that increases investor confidence and validity on ESG disclosures.

For bespoke:

- Standardization and quantification of ESG concepts will likely create concentration of capital, undermining the purpose for many investors – to generate alpha returns.
- Standardized frameworks are not always appropriate due to the variance in companies' values, strategies and investment approaches.
- Qualitative validation of ESG credentials allows asset managers to pass subjective judgment, thereby adding value, differentiation and justification on their fees.

[11, 12] "Responsible investments regulation map", UNPRI website, https://www.unpri.org/sustainable-markets/regulation-map
[13] "Conflicting ESG Ratings Are Confusing Sustainable Investors", Bloomberg website, https://www.bloomberg.com/news/articles/2019-12-11/conflicting-esg-ratings-are-confusing-sustainable-investors?fireglass_rsn=true
[14] "Sustainability Reporting - Progress and Challenges", SGX online article, https://api2.sgx.com/sites/default/files/2019-12/Sustainability%20Reporting%20-%20Progress%20and%20Challenges.pdf

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III. Is securities lending compatible with ESG?

Securities lending is coming under increased scrutiny due to its perceived incompatibility with ESG

As investors increasingly focus on sustainability, there is a growing perception that securities lending is fundamentally misaligned with long-term sustainability, primarily due to the widely held view that it purely equates to short selling.

> There is still much work to be done in terms of educating the public on the processes of the securities lending industry

Proponents advocate that securities lending is not merely limited to facilitating short selling but plays an important role in promoting healthy and functioning markets. Some examples include:

- Transaction settlement (whereby sellers can borrow securities to honor a trade)
- Arbitrage (by profiting from unjustified price fluctuations)
- Balance sheet management (enabling lenders to achieve appropriate liquid coverage ratios by temporarily borrowing high quality liquid assets)
- Hedging risk and reducing the cost of investing
- Price discovery
- Increase liquidity

> Whilst equating securities lending solely with short selling might be naive, the fact remains that without securities lending there is no short selling
>
> Having been in the markets for over 32 years, I still don't know what securities lending involves apart from the facilitation of short selling

There are polarizing views on the role and perception of securities lending

Whether fairly or otherwise securities lending is mostly associated with the activity of short selling. The merits of this practice divide opinion whereas other associated benefits of securities lending are less well-known or understood.

Nature of short selling

- Due to its aggressive and opportunistic nature, short selling is considered by many to be fundamentally incompatible with sustainable finance and broader ESG principles.
- Critics believe short selling is not a responsible or constructive method for influencing positive change.
- Short selling increases overall market liquidity by providing institutional investors with access to a secondary market.
- Short selling facilitates price discovery and can highlight otherwise hidden ESG issues that fundamentally change an organization's value proposition.

> "There is nothing socially useful in trying to undermine and potentially destroy a company purely for profit reason. Even if used to damage an unethical company, it is a destructive mechanism no matter how positive the motivation
>
> Stuart Dunbar
> Partner, Bailie Gifford

Voting manipulation

- The passing of voting rights from lender to borrower upon lending stock is often cited as a key concern for potential manipulation. In 2018, Oasis hedge fund borrowed Premier Foods stock to vote against the company's CEO.[15]

> Securities lending can represent a substantial portion of market liquidity. For example, in the week of 8 June 2015, short sales supported by securities loans contributed between 33% to 41% of total US equity market volume.[16]

- Voting manipulation is mitigated through the lender's right to recall or restrict their securities ahead of key AGMs. This matter is addressed in many existing regulatory guidelines (e.g., UNPRI Guidance on Securities Lending, Global Masters Securities Lending Agreement, Permitted Purpose rule).[17]

> Everyone always brings up the voting manipulation… however I think they would be hard pressed to find an example of successful manipulation due to securities lending

Acceptance of non-ESG collateral

- Many are concerned that non-ESG collateral might be taken against lent securities (e.g., collateral in the form of government bonds from a country with known human rights issues).
- Lenders argue that the same ESG screening applied to securities can and in many instances is applied to collateral.

Lack of transparency and inability to monitor

- It is currently difficult to track lent assets and the underlying motivation of borrowers in terms of their compliance with ESG principles.
- Lenders can implement measures to screen borrowers. For example, NN Investment Partners developed an internal counterparty rating system to review potential borrowers' code of conducts.[18]

[15, 17, 18] "Progressing the conversation on ESG and sec lending," Global Investor Group website, https://www.globalinvestorgroup.com/articles/3692630/progressing-the-conversation-on-esg-and-sec-lending
[16] "Securities Lending, Market Liquidity and Retirement Savings: The Real World Impact," Statestreet online article, https://www.statestreet.com/content/dam/statestreet/documents/RIGA/WhitePapers/Finadium_SecuritiesLending.pdf

Legend:
- Publicly available
- Insights from "2020 PASLA – EY ESG in Securities Lending" survey / interviews

How does the market react to this perception?

> When trouble strikes, policy-makers like to fall back on old playbooks, like banning short selling of shares

Neil Wilson

Chief Market Analyst, Markets.com

Whether or not banning short selling is justified or is an effective market stabilization mechanism, it is evident that scrutiny on the industry is likely to continue unless the persisting negative perceptions are effectively addressed.

Examples of short selling bans[19]

Australia–2008

ASIC temporarily banned short selling during GFC

USA–2008

SEC temporarily banned short selling in 1000 stocks during GFC

South Korea–2020

Banned short selling for 6 months following the COVID-19 virus

One way in which industry perceptions can be shifted is through illustrating with more transparency and evidence how securities lending is compatible with ESG principles.

> Research conducted has shown that short selling does not systematically drive down asset prices and that restricting short selling can actually lead to reduced liquidity and higher transaction costs for investors

R. Battalio, H.Mehran and P. Schultz

Notre Dame University and New York Federal Reserve[20]

89%

study participants believe securities lending is ESG compatible

Source: PASLA - EY Study

How can securities lending be more ESG compatible?

It appears there are a number of areas the industry can focus on to address the persisting market concerns on the compatibility of securities lending and ESG:

- Improve the transparency and education around securities lending, its broader processes and its role in capital markets.
- Encourage and facilitate open communication between market participants to enable discussion and alignment on ESG matters (see ICSF case study below).
- Explore practical ways to incorporate ESG controls within the securities lending value chain (see to the right).

Introduction of PSSL (Principles of Sustainable Securities Lending)

In 2020, the ICSF introduced wide-ranging solutions for its Principles for Sustainable Securities Lending (PSSL).

The PSSL is a voluntary rules framework aimed at promoting ESG, sustainable development goals and long-term thinking into securities lending activities.

Create transparency by demonstrating ESG controls in the value chain

With the emergence of passive and index-linked funds, active managers are increasingly under pressure to justify their management fees.

Passive US equity funds surpassed active equity funds in August 2019

Morningstar[21]

ESG therefore provides a timely opportunity for active managers to demonstrate their value by exercising their qualitative judgment.

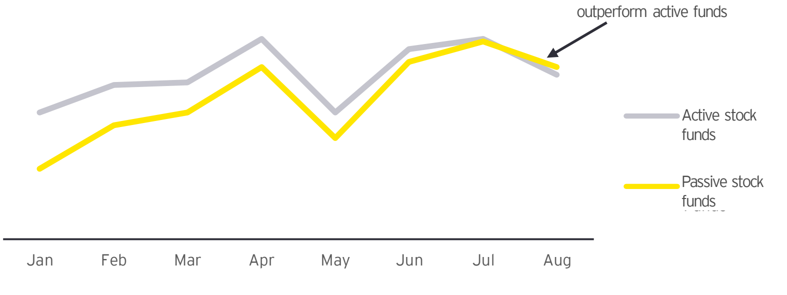
ESG has been a blessing at a time when the active management industry has not proven its value from an investment performance perspective. Now they can justify their fees by performing ESG governance on behalf of their clients

Therefore participants in the securities lending industry can begin to apply ESG protocols and screening in the same way as conventional long only investors.

More specifically, securities lenders can add value by exercising ESG controls across their value chain by verification of the process, collateral, counterparties and motivations.

Figure 3: Passive funds outperform and overtake active funds for the first time in 2019

Source: Morningstar[22]



[19] "Countries curb short selling to stem steep market drops", Wall Street Journal website, https://www.wsj.com/articles/countries-curb-short-selling-to-stem-steep-market-drops-11584112007
[20] "Market Declines: Is Banning Short Selling the Solution?", Academic research paper, https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr518.pdf
[21, 22] "2020 will not be kind to active fund managers", Financial Times website, https://www.ft.com/content/da82a393-e071-4ab4-ab87-5212479d7f25

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Insights from "2020 PASLA - EY ESG in Securities Lending" survey / interviews

IV. Where does the ethical responsibility lie in the securities lending value chain?

Who is ethically responsible for ESG compliancy?

With the involvement of many parties, one particularly polarizing aspect of ESG is where in the value chain does the ethical responsibility lie?

?

Does the lender have the ethical responsibility to ascertain and assess the motivations of all parties?

Is it the ethical responsibility of the lender to track the activity of his/her loaned stock?

When asked, the study's participants offered wide ranging views:

Lenders cannot be expected to understand, nor second guess, every motive of a trade

Clients choose their approved borrowers. What they do with the securities or who they then in turn lend it to, is of secondary or little concern

The burden of responsibility for validating lending motivations comes down to the borrowers

Ethical responsibility lies on everyone in the value chain, including the general public (e.g., when investing in a pension fund)

"

> Lending to sellers who try to influence the price of an issuer's security for short or very short-term purposes, is not compatible with ESG
>
> Guillaume Prache
>
> Managing Director, Better Finance

How much transparency is necessary and possible, when it comes to validating borrowers' motivations?

Survey participants were asked how important to them and their clients is knowing the identity and intentions of a borrower in a securities lending transaction. The responses varied:

Figure 4: Importance of borrowers' motives

Source: PASLA – EY Study

Whilst the ability to identify borrowers and understand their motives can be beneficial for lenders from a risk management and quality perspective, obtaining this information can be challenging due to confidentiality and IP protection concerns.

It is important from a credit risk and counterparty quality perspective that we and our clients know the identity of the borrower. However, it is less important for any other perspective

Responsibility still remains unclear

While the views on where the ethical responsibility lies within the securities lending value chain is divided, most respondents agreed on the need to implement some level of control and accountability throughout the value chain to ensure ESG compliance where this is required. Technology is likely to assist as the focus on this process continues to grow.

Where does the ethical responsibility lie?

Source: BlackRock[23]

[23] "Securities lending viewed through the sustainability lens", BlackRock website, https://www.blackrock.com/corporate/literature/publication/securities-lending-viewed-through-the-sustainability-lens.pdf

Legend:

Publicly available

Insights from "2020 PASLA - EY ESG in Securities Lending" survey / interviews

V. What else can PASLA do to support its members and the wider industry on this matter?

What can PASLA and other industry associations do to support their members?

Participants of this study almost unanimously agreed on the timeliness of this exercise and the relevance of the topics covered.

They were also forthcoming around the type of support they would like PASLA and other industry bodies to provide in clarifying and addressing the compatibility of securities lending with ESG.

Inform market participants that there is more to securities lending than shorting

Focus on initiatives whereby associations and regulators work together to design new frameworks and principles

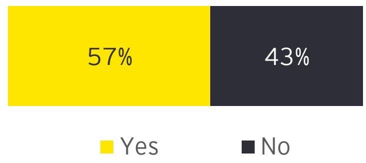
Address global securities lending questions to help dispel the negative perceptions and incompatibility with ESG

It would be helpful to run this survey every 2 years to see how perspectives have changed during that timeframe

Specifically, the following were requested:

- More visible and effective advocation to all market participants on the benefits of securities lending.
- Ongoing education to the securities lending community on the relevance and benefits of ESG integration.
- Working with regulators and industry participants to define ESG requirements across the industry and establish common policies and frameworks .
- Working with other associations to progress core principles to implement as an initial benchmark.
- Conducting studies similar to this one on a regular basis to capture the evolving market perspectives and practices. Regular reviews would also help assess whether meaningful progress is being made on this topic.

Figure 5: Do you think future corporate policies toward ESG should include specific provisions relating to borrowing/lending?



Source: PASLA - EY Study

What's next?

As interest in ESG continues to grow, so will the demand for greater transparency and consequent reporting.

This continued interest provides associations such as PASLA an opportunity to:

- Act as a conduit between the regulators and the market to educate participants on the importance of securities lending in maintaining healthy and functioning markets.
- Lead its members in ensuring the highest possible standards of self governance and compliance.

SURVEY QUESTION **Beyond working with other associations (e.g., ISLA, ASIFMA), what other efforts should PASLA be undertaking in order to help our industry with ESG?**

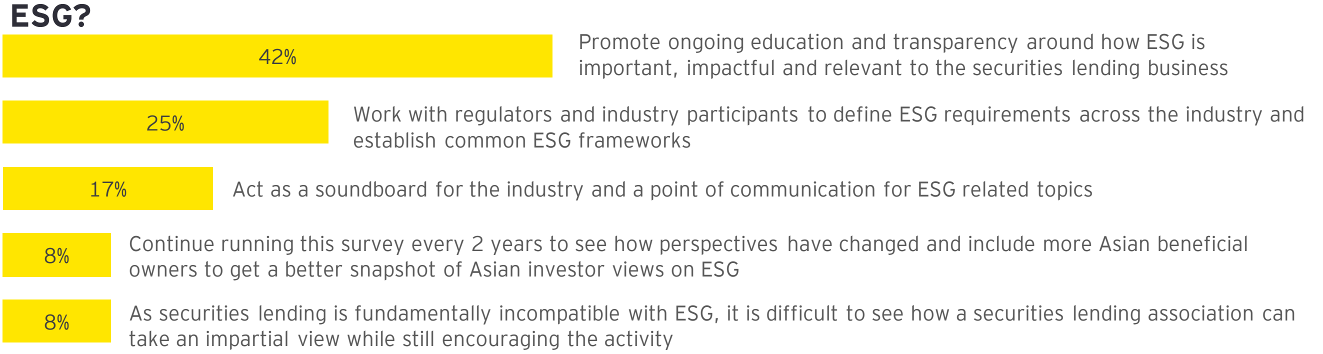


Figure 6: What other efforts should PASLA be undertaking in order to help our industry with ESG?

Source: PASLA - EY Study

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3 Survey Results

- **3 key topics**
- **ESG overview**
- **ESG and securities lending**
- **Steps moving forward**

- **18 questions**

- **29 participants** among both PASLA members and other industry participants

- **Almost 50%** representing either **banks or broker dealers**

- **Over 60%** from organizations **with over 10,000 employees**

- **Over 75% participants** based in **APAC**

- **11 interviews** with PASLA members and other industry participants

About this survey

This section outlines the survey responses, voluntary survey commentary and insights from selected interviews.

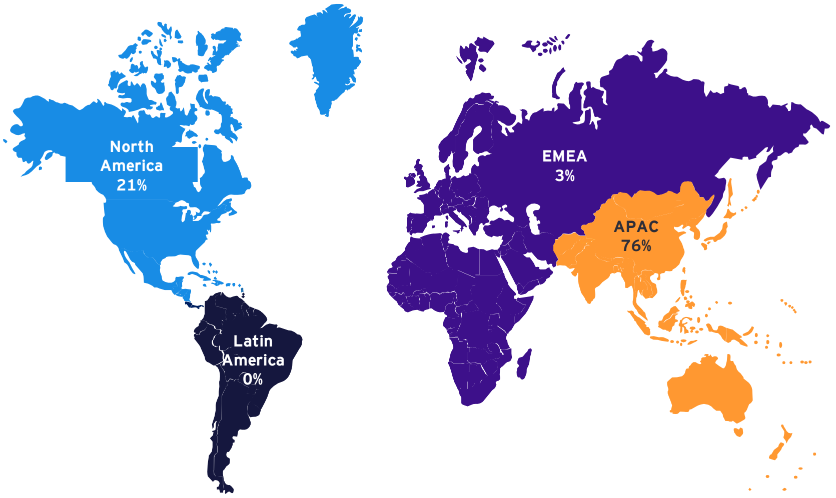
Q1. What type of organization do you work for?

Bank / Broker dealer	48%
Asset lender / Custodian bank	24%
Vendor	14%
Central bank / Sovereign wealth fund	7%
Asset manager / Direct lender	7%

Q2. How many employees does your organization have?

10,001–100,000	35%
> 100,001	21%
101–1,000	17%
1,001–10,000	17%
< 100	10%

Q3. Where are you based?



I. ESG overview

Key survey findings

- Participants overwhelmingly recognize the importance of ESG and the majority are already incorporating ESG in their decision-making
- Governance (G) is perceived as the most important ESG theme (61%), followed by environmental (36%) and social (4%)
- Almost two-thirds of participants consider non-ESG compliance as a risk to their business, especially in terms of long-term growth, sustainability and risk management
- Despite agreeing on the importance of ESG, less than one-third of participants currently have an ESG control system in place

Key interview findings

- Regarding the incorporation of ESG into business decisions, some interviewees have established processes in place, whilst others consider ESG on a case-by-case basis or when specifically requested by clients
- Most interviewees however do not yet have a dedicated internal team to manage internal ESG issues
- Whilst many believed that ESG provides an opportunity to add further value, the majority felt that there are still major challenges to overcome first
- These challenges highlighted the lack of a formulated view on how ESG is defined and incorporated, opacity around how ESG related issues are managed and addressed and difficulty in measuring and assessing ESG

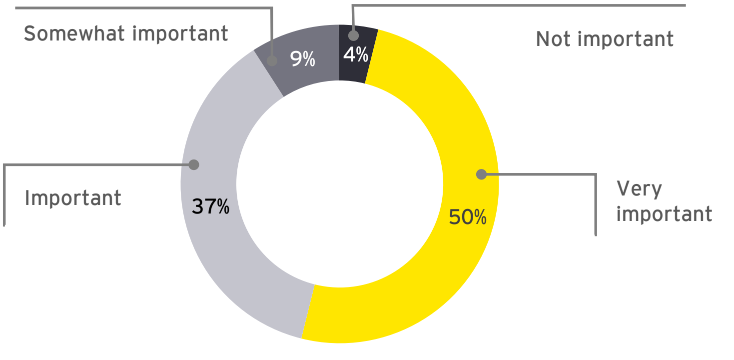
I. ESG overview

Q4. Is ESG incorporated into investment, trading, and lending decision-making in your organization?

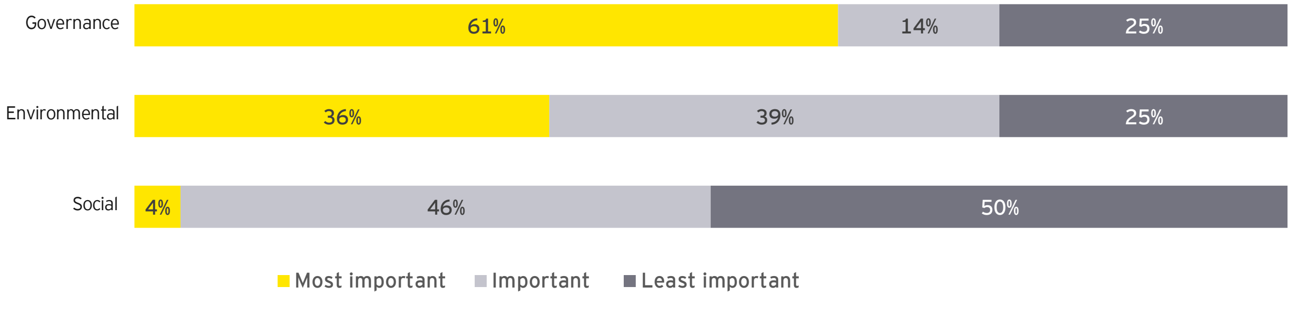
Over 80% of respondents are **incorporating ESG into their decision-making processes**

Q5. How important do you think ESG will be in terms of the decision-making within your organization in the next 5 years?

Almost 90% of respondents view **ESG as either very important or important** to decision making within their organization **in the next 5 years**



Q6. Rank the ESG themes based on how strongly you feel about each theme

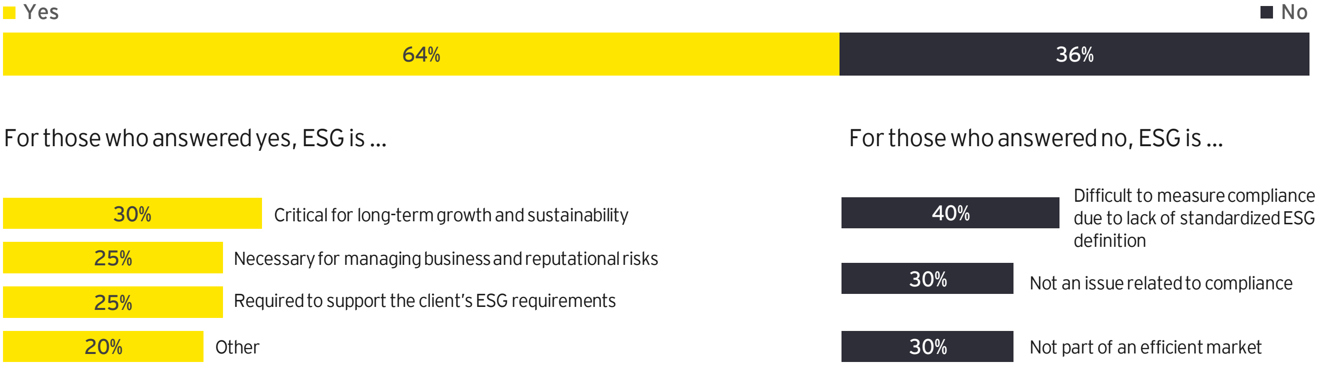


Over 60% of respondents view **governance** as the most important ESG theme

75% of respondents view **environmental** as either the most or second most important ESG theme

Only 4% consider **social as the most important theme,** compared with **50%** who consider it as the **least important theme**

Q7. Do you see non-compliance to ESG principles as a risk to your business?



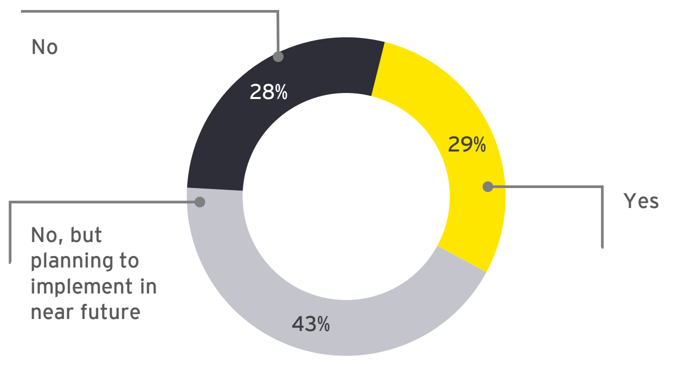
Almost 66% of respondents view **ESG non-compliance as a risk to their business**

Of those, almost **33%** believe ESG is critical for **long-term growth and sustainability**

Q8. Do you have an ESG control system such as policies, principles and reporting in place?

Under 30% of respondents currently **have an ESG control system in place**

However **over 40%** are **planning to implement one** in the near future



II. ESG and securities lending

Key survey findings

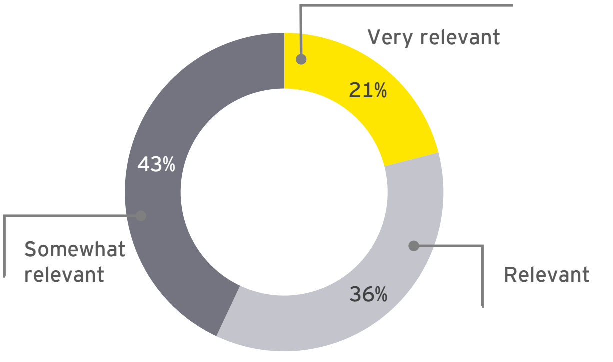
- Whilst almost 90% of participants see ESG as compatible with securities lending, less than 60% consider it to be relevant or very relevant to the industry
- Around one-third of participants either have an ESG specialist in their securities lending business or are planning to appoint one
- Although over 50% of respondents consider ESG factors into their security lending programs, in particular within lending and collateral, only 20% have considered suspending lending / borrowing activities due to ESG non-compliance
- Almost 80% of participants believe that knowing the identity and intentions of the borrower has a degree of importance in securities lending transactions
- Two-thirds of respondents consider recalling shares ahead of proxy votes

Key interview findings

- When asked why a negative perception of securities lending exists, most highlighted how the association between securities lending and short selling is perceived as inherently aggressive, opportunistically driven and thereby incompatible with responsible investing
- Interviewees instead stressed the benefits of securities lending which include: improving market liquidity, reducing bid-ask spreads, fraud discovery and price stabilization
- Responses were fragmented around the ethical responsibility of validating borrowers' motivations. Some argued that borrowers have sufficient market information (provided by institutions and regulators) to make informed, responsible decisions. Others argued for regulators or exchanges to undertake a bigger role in governing ESG

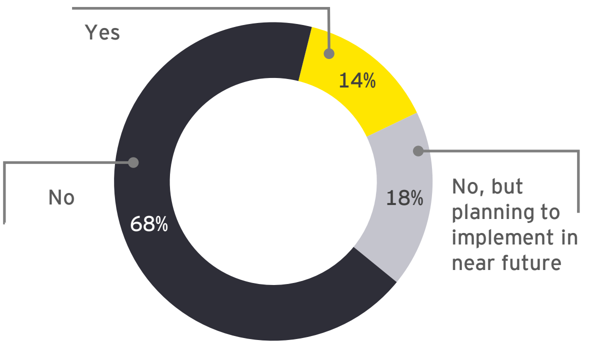
II. ESG and securities lending

Q9. How relevant is ESG to the securities lending industry?



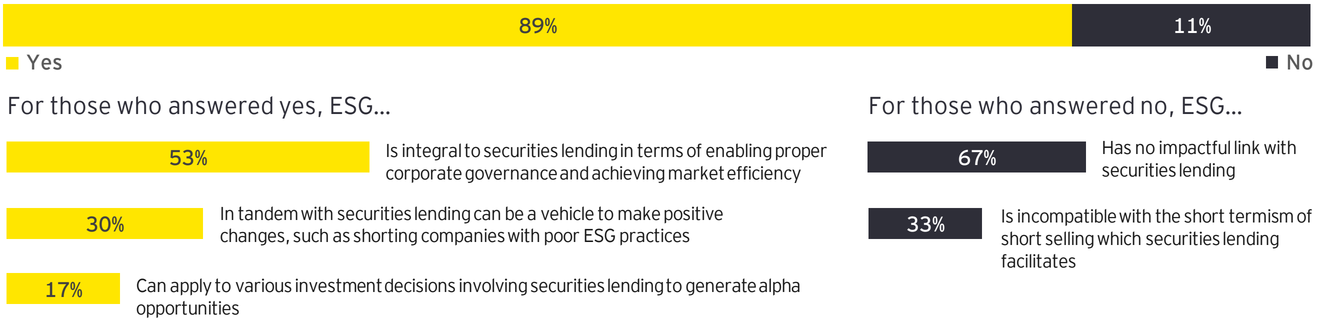
Over 50% of respondents perceive **ESG as very relevant or relevant to the securities lending industry**

Q10. Do you have a dedicated ESG team or specialist in your securities lending business?



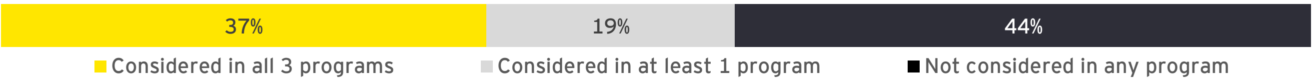
Close to 70% of respondents **lack a dedicated ESG team or specialist** in their securities lending business, compared with **less than 20% who currently have one**

Q11. Is ESG compatible with securities lending?



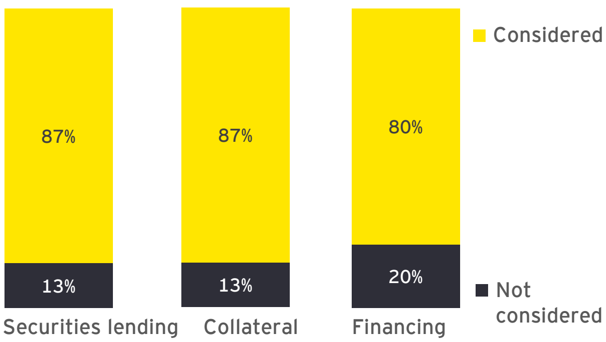
Almost 90% of respondents view **ESG as compatible with securities lending**, with over half perceiving ESG as integral to enabling market efficiency and appropriate corporate governance

Q12. Do you consider ESG factors in your securities lending, financing and collateral programs?



Almost 60% of respondents consider **ESG factors in at least one program,** with fairly equal distribution across lending, collateral and financing

For those who consider ESG in at least 1 program, which program is ESG considered in?



Key responses from survey participants

Securities lending

"We have policies and procedures that allow clients to adapt and customize their program to their ESG requirements"

Collateral

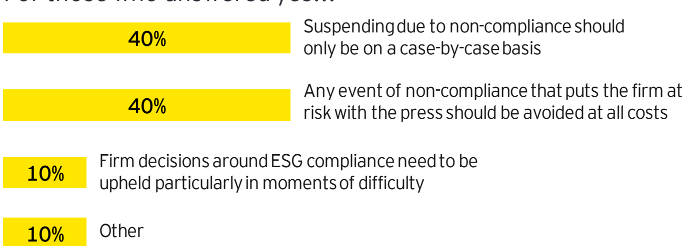
"We consider the requirements of ESG when adding new collateral sets to our program"

Financing

"Financing is not a high priority in terms of including ESG factors"

Q13. Have you ever considered suspending lending / borrowing activities due to non-compliance with ESG principles?

For those who answered yes...

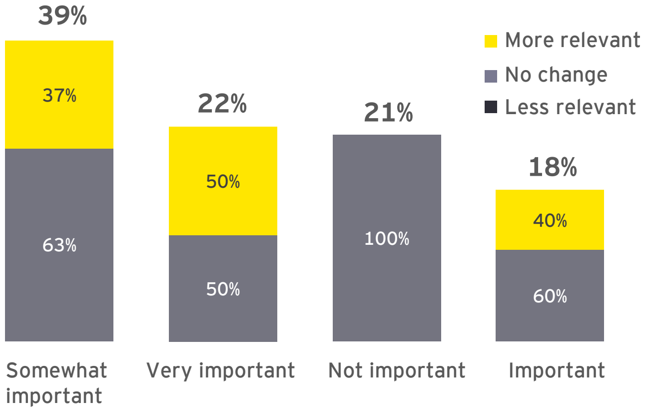


Less than 20% of respondents have **considered suspending their activities due to ESG non-compliance**

40% of those who would consider it, do so only on a **case-by-case basis**

Q14. How important to you / your clients is knowing the identity and intentions of the borrower in a securities lending transaction?

Has this become more relevant, less relevant or much the same in the last 6 months?



Almost 80% of respondents believe **knowing the intentions and identity** of the borrower is at least **to some extent important**

Over 30% of respondents believe this is becoming **more relevant over time**

Only 21% of respondents **do not consider it important**

Key responses from survey participants

Very important

"To support short selling effectively, we require comfort knowing the intentions of the end-user

Understanding the intentions of the borrower helps to screen potentially negative activity

Important

"It is important but not vital, we cannot expect to understand everything in a trade

Important for credit risk / counterparty quality but less important for other perspectives

Somewhat important

"What clients do with their securities is of secondary concern

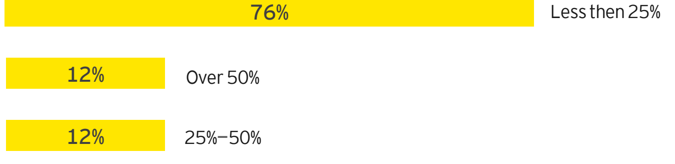
Some clients expressed strong views in this area, whilst others remain cautious

Not important

"Clients don't monitor the intentions in their securities lending programs and care more about lending fees

Q15. Do you / any of your clients proactively consider recalling shares ahead of proxy votes?

If they do, what proportion of your clients ask for such recalls?



66% of respondents have clients **who consider proactively recalling shares ahead of proxy votes**

However, for the majority this only applies to **25% of their client base**

III. Steps moving forward

Key survey findings

Ask of organizations:

- 60% of participants would like their organizations to improve access to better quality ESG data
- 56% would like wider access to ESG related education
- 36% would like more ESG integration into organizational decision making processes
- Only 12% believe no additional measures are required

Ask of PASLA:

- Over 40% of respondents would like PASLA to promote better education and transparency around ESG
- 25% would like PASLA to work closely with regulators and other parties in defining and establishing common ESG framework

Key interview findings

- Most recognized the benefit of standardized ESG frameworks, but warned of concentration risk and the issues associated with oversimplifying a multifaceted and nuanced topic that is yet to be properly defined
- Most recognized that ESG cannot be addressed by a "one size fits all" method. Rather, most agreed that a combination of standardization as a baseline followed by case-by-case analysis may be more appropriate for an evolving ESG landscape

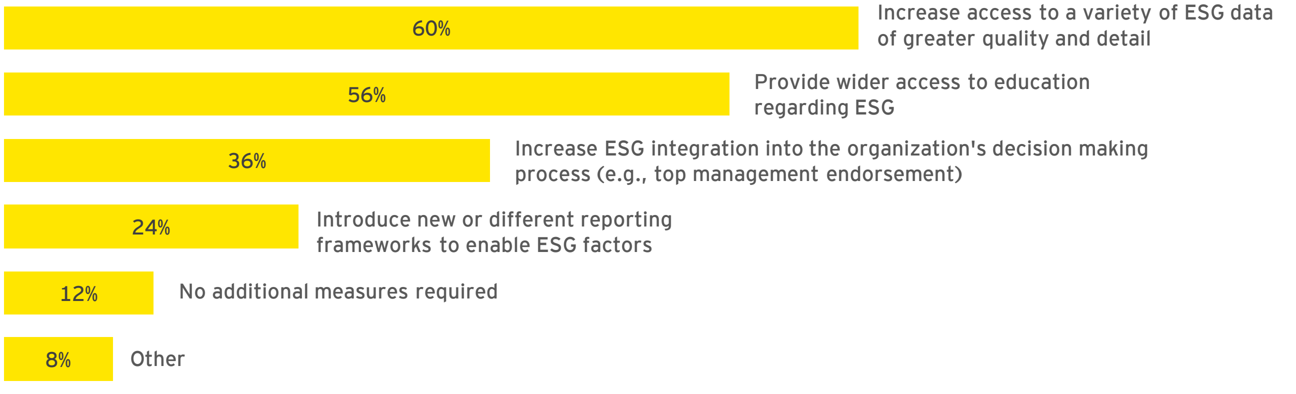
Ask of PASLA:

- Most respondents believe PASLA can play a bigger role in educating ordinary investors and larger institutions on the benefits of securities lending and its compatibility with ESG. Others called for PASLA to facilitate the self governance of best practices between market participants - namely designing new frameworks together

III. Steps moving forward

Q16. What kind of ESG measures would you like your organization to adopt that are specific to securities lending?*

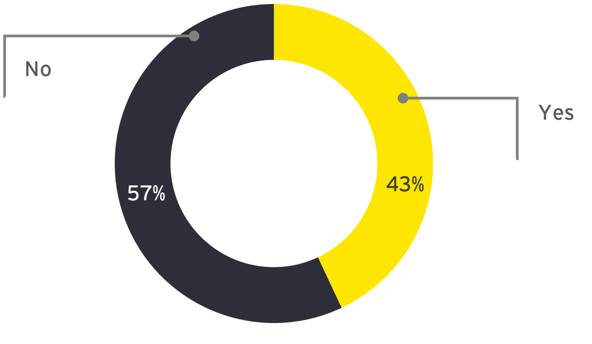
**As respondents were able to choose more than one response, the results shown are % of total responses rather than total participants and hence do not add up to 100%*



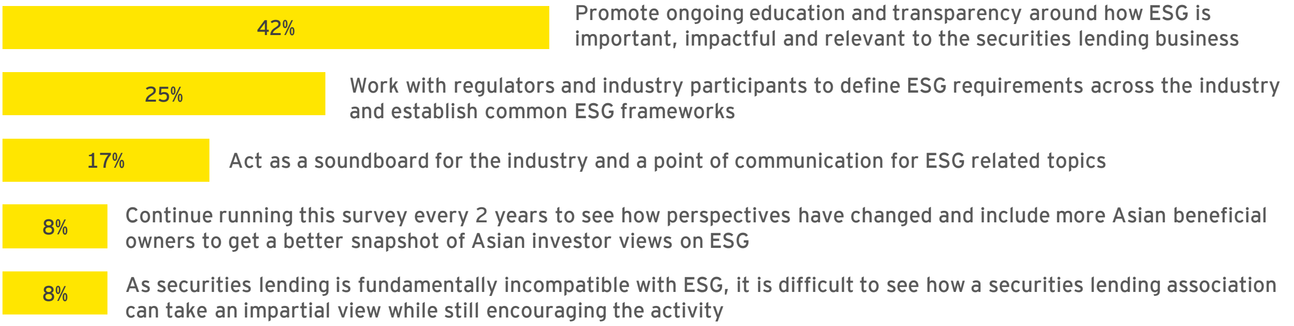
- **Over 50%** of respondents would like their organization to **increase access to ESG data** of greater quality and detail and **provide wider access to ESG related education**
- **Only 12%** of respondents believe that **no additional measures are required**

Q17. Do you think future corporate policies toward ESG should include specific provisions relating to borrowing / lending?

- **Over 50%** of respondents **do not feel that there should be specific ESG provisions relating to borrowing / lending**



Q18. Beyond working with other associations (e.g., ISLA, ASIFMA), what other efforts should PASLA be undertaking in order to help our industry with ESG?



- **Over 40%** of respondents would like to see PASLA promote **better education and transparency** around ESG related topics

- **25%** of respondents would like PASLA to **work with regulators and industry participants** to **define and establish ESG requirements and frameworks**

- **Close to 20%** of respondents would like PASLA to play a bigger role as a **communicator and intermediary** between industry participants for ESG related topics

- Others would like PASLA to **regularly conduct similar surveys** in order to gauge **changes in perspectives** and obtain a **comprehensive view of Asian investors' evolving perceptions toward ESG and securities lending**

- One notable opponent believed that as securities lending is **fundamentally incompatible** with ESG, it is **difficult to see how PASLA could take an impartial role whilst supporting the industry**

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About PASLA
PASLA is an association of over 60 institutions that are active in the business of securities borrowing and lending (SBL) in Asian markets. PASLA's aims, amongst others, are to liaise with regional market participants to promote and develop appropriate regulatory frameworks for the industry, to represent the common interests of institutions engaged in SBL and to assist in efficient and competitive market developments.

For more information about our association, please visit www.paslaonline.com

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