Creating a Global ESG Market Standard
for Owners, Lenders, Borrowers and
Impact Creators.

Gateways to success: ESG-driven securities lending and borrowing in emerging markets.

A forward-looking market standard

Consultation paper

Comments

We welcome comments on this paper and may invite you to participate in the workstream. Please provide comments on this paper directly to Global PSSL (radek.stech@gpssl.org). Global PSSL will also actively encourage feedback from workstream participants and the College of Advisors. Workstream participants will also collect feedback in their respective jurisdictions.

Consultation timeline

We intend to end the consultation by 15 November 2021. We will continue internal work as part of the workstream and broader roundtables organised by Global PSSL and other market participants.

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Key background facts

Global Principles for Sustainable Securities Lending represents a holistic and principle-based approach to sustainability in the field of securities lending and borrowing. It unifies global markets at a high level of policy coordination, increases trust, confidence and transparency alongside advancing the integration of ESG.

Draft Principles were developed, with inputs from the South African banks, and issued for consultation in December 2020. Thereafter, Global PSSL convened a dedicated workstream to focus on emerging markets (EMs) and strengthen the debate in this field. The final Principles were issued alongside 17 opening signatories on 7th September 2021.

This new market standard is important because securities lending and borrowing (SLB) has become an increasingly important element in emerging markets, especially those seeking to boost liquidity and attract international investors. SLB is an important enabler for short-selling and market-making programs as well as the introduction of products such as equity derivatives, and exchange traded funds. In Africa, two markets, i.e. South Africa (more advanced) and Nigeria (nascent) have operational SLB programmes whilst Kenya is looking to launch soon. However, unlike their developed market counterparts' certain additional and rapid changes across market structure, institutional and regulatory frameworks are required to have well-functioning securities lending and borrowing program.

For securities lending to grow in Emerging Markets, there must be the end-users, typically borrowers and lenders, who have capacity and are willing to participate in the programme for different reasons or are incentivised to do so. Also depending on the model adopted, there should also be market intermediaries who facilitate lending activities such as brokers, third party agents and central clearing counterparties (clearing company). Nigeria was launched under a tri-party model where third-party lending agents intermediate between lenders and borrowers. Both retail and institutional investors are permitted to participate as lenders (beneficial owners).

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Objectives

To create a market standard that is:

Forward-Looking: that will set out key recommendations for the design, implementation and maintenance of sustainable securities lending/borrowing programmes in EMs.

Universal**:** a minimum standard that is focussed, practicable, current, and relevant to worldwide emerging markets; a standard that can connect with developed markets and global counterparties through Global PSSL.

Fit for Purpose: embed ESG at the early stages of design and implementation to create a standard that is effective but free of complexity or unnecessary bureaucracy. In doing so, identify potential impact points that can contribute to enhancing liquidity, increasing private investments and benefiting individuals through sustainable programmes [e.g. pension funds' savers].

Dynamic: provide means for constant review and evaluation in the spirit of voluntary collaboration with key stakeholders, including regulators and international organisations.

Aligned with Global PSSL themes:

Structure of the Minimum Standard

The minimum forward-looking standard should be clear and concise. The following structure is offered as an example:

1. Objectives and key background information.
2. Major challenges and more detailed benefits of:
    a. integrating ESG into emerging markets;
    b. securities lending borrowing with ESG tenets in those markets;
    c. aligning with Global PSSL and its infrastructure.
3. The core part: minimum requirements for effective sustainable securities lending in emerging markets.
4. A clear pathway for future collaboration organised through the Global PSSL workstream.

Q1. Do you agree with the suggested overall design and structure?

Objectives and key background information

We will build upon the above objectives and key background facts.

Q2. Would you have any comments on this section of the standard?

Major challenges for this agenda

There is limited awareness of ESG in general and securities lending more specifically across certain markets. There is also stigma attached to some areas of securities lending/borrowing (especially short selling) and little awareness of the benefits, from the holistic perspective, that encourage good governance. In addition, in many developing countries the depth of the securities markets and illiquidity make it difficult to put ESG in the forefront of investment decisions.

Inconsistent and fragmented regulation across economic regions can prevent some stakeholders (e.g. pension funds' savers) from exploiting opportunities to their fullest extent (i.e. increased set-up/operational/legal risks, or requirements to produce an addendum to standard agreements).

Tax differences that may increase transactional costs.

Limited participation of beneficial owners in securities lending programmes.

Benefits

Emerging markets could have an advantage over developing economies where best practices could be taken up and more easily embedded from the get-go if these SLB programes are being developed only now.

As the existing literature is rich and extensive, this is a summary of the key arguments (Global PSSL may issue a separate research/academic paper with a more detailed analysis):

Integrating ESG into emerging markets reacts to the following trends:

a) Interest in the sustainable finance agenda is global. This is demonstrated by key developments such as the UN Sustainable Development Goals, The Paris Agreement, and recent moves by the most powerful governments (such as the US) to align with this agenda;
b) Foreign private and public investments increasingly carry ESG conditions/requirements (ESG as part of bankability of projects); enhancing right social and environmental culture (often 'unspoiled') in emerging markets and, in turn, strengthening their export/import capabilities (e.g. organic/fair trade produce; tourism);
c) There are post COVID-19 possibilities of integrating ESG into existing informal economies;
d) Embedding ESG in EMs can strengthen capacity and awareness, inclusive of better governance in EMs.

Securities lending/borrowing programmes with ESG tenets can lead to:

a) Increased market liquidity and overall market activity; decreased spreads
b) Liquid markets that are better at accommodating innovative ESG solutions, asset classes, and ESG-driven capital flows;
c) Stock market growth through indexing opportunities (securities lending as part of index requirements);
d) Future-proof securities lending programmes that align with good governance and embed social/environmental matters to the appropriate and acceptable limits within local/regional rules.

Alignining with the high-level Global PSSL and its infrastructure: Global PSSL is a holistic and unifying market standard for sustainable securities lending that provides a clear cut 'anchor' for securities lending programmes. As this standard has identified, fragmentation is one of the barriers that increases costs and inhibits innovation. Global PSSL brings a broader community of practitioners (also ESG experts) and, in turn, increases trust and confidence in the markets .

Q3. Would you have any comments on this section of the standard?

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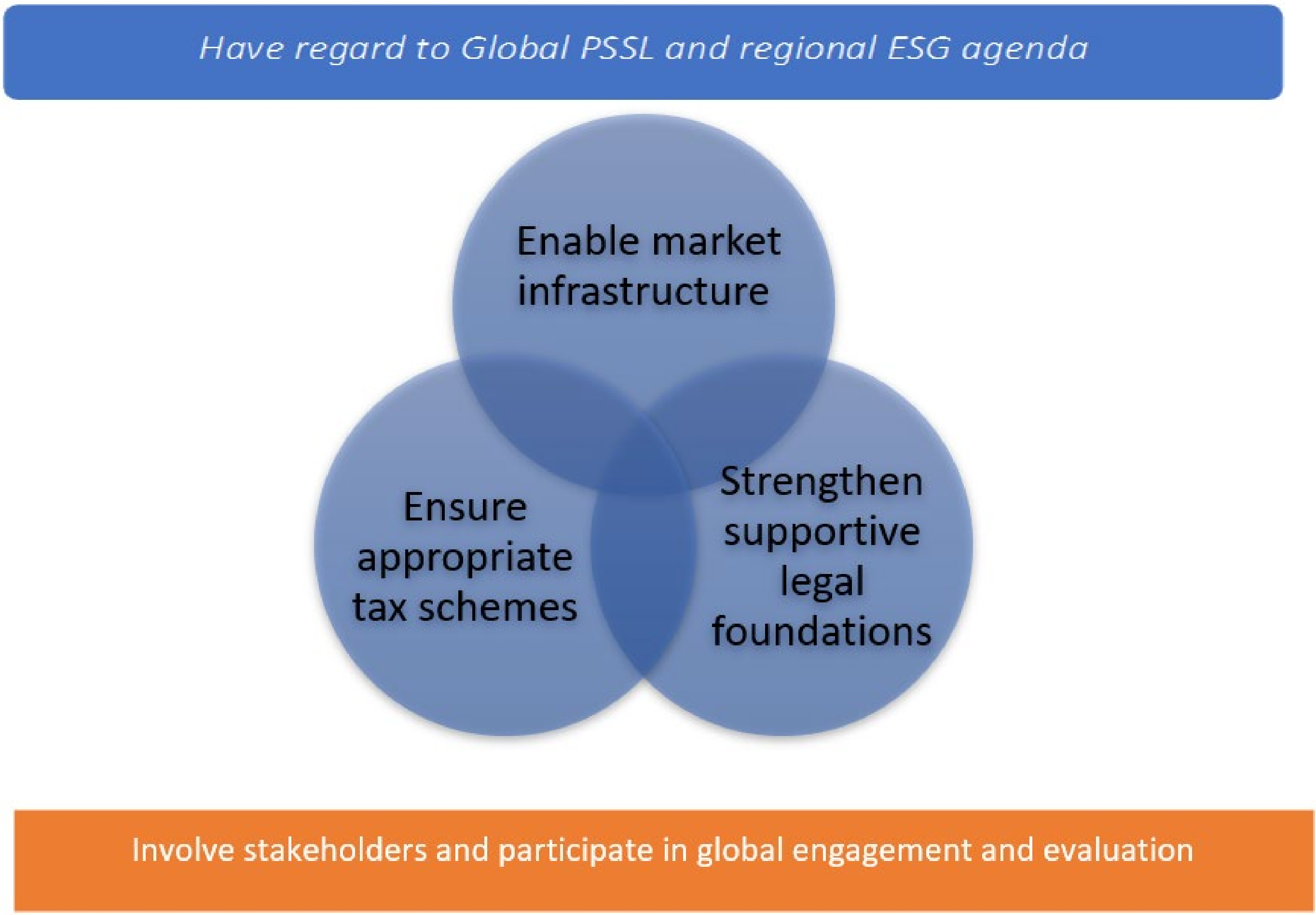
The components of the standard



Each component is divided into three sections: 1) brief definition; 2) minimum requirements; 3) outstanding questions/considerations.

In implementing these components, parties should have regard to Global PSSL and local ESG criteria and involve stakeholders and participate in global engagement and evaluation through Global PSSL roundtables.

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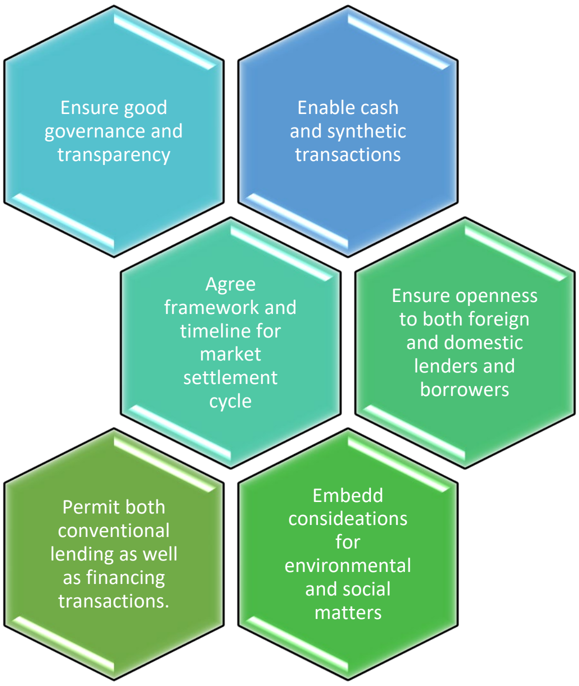
Enable market infrastructure

By creating an enabling market infrastructure, emerging markets provide the key foundation that will facilitate the lending and borrowing of securities. This includes the key roles and responsibilities, processes, bilateral and/or triparty arrangements, central clearing counterparties, voting recall procedures and avenues for cash reinvestments.

Minimum requirements:



Key questions and considerations that should be asked at the outset:

- ✓ Is the market SWIFT enabled and if not, how will settlement be communicated between CSD and CSDP's? (what systems do they have to instruct settlement if not SWIFT enabled and operational process)?
- ✓ Does the market allow for a bi-lateral module or should it consider tri-party?
- ✓ If tri-party, what criteria exists and should it be a local provider vs. a foreign more experienced provider?
- ✓ Should cost vs. benefit of both modules be considered?
- ✓ Is the module of the foreign provider compatible for the local market? – e.g.: all transactions have to be settled via the CSD and CSDP in South Africa creating barriers for some tri-party providers.
- ✓ Current market settlement cycle – should framework and timelines be agreed by all market participants?
- ✓ ESG – what is the framework in the market and how does this impact securities lending or the collateral held?
- ✓ Should shares be recalled for every voting event?
- ✓ Cash collateral reinvestment – what are the options and risks? Is this allowed and who takes the risk?
- ✓ Ease of business for non-local counterparties in integrating to existing global processes as well as risk appetite to enter these markets.
- ✓ Do corporate governance frameworks strengthen trust and support transparent markets?

Ensure appropriate tax schemes

By ensuring appropriate tax schemes, emerging markets impact the success of launching securities lending products on a market.

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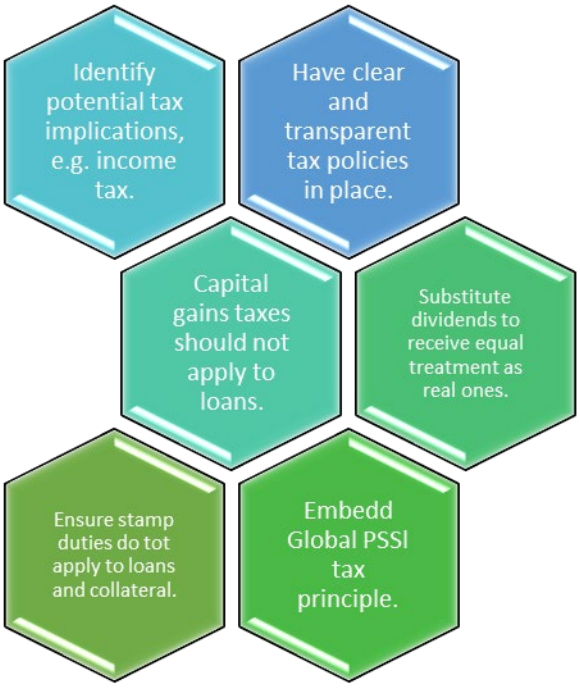
Minimum requirements:



Key questions and considerations that should be asked at the outset:

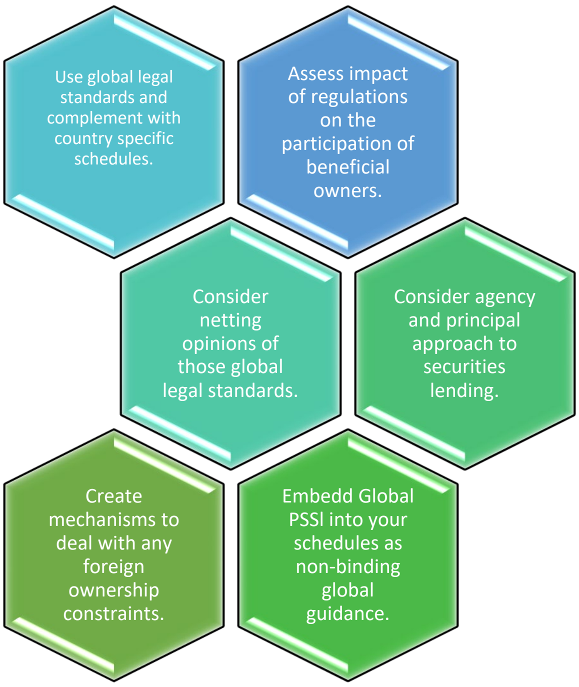
- ✓ Would a securities lending transaction be considered a sale or indeed a loan and how will this be treated from a tax perspective given that the borrower will return it at a future point in time?
- ✓ Should the same be considered when collateral is placed outright – will it be taxed if deemed a sale?
- ✓ Manufactured dividends or compensating payments – how is this treated and can one apply a look-through principal to avoid cascading of dividends and recalling prior to each corporate event?
- ✓ VAT – would securities lending fees be deemed vatable or non-vatable?
- ✓ Reporting requirements to the Tax authorities.
- ✓ When lending out a bond – would capital gains tax apply?
- ✓ Interest income – on cash collateral – how will this be treated?

- ✓ In the event that an intermediary takes a cut on the interest earned vs. interest paid to the borrower – how is this treated from a tax perspective – fee or interest income?
- ✓ What should be tax treatment of different potential lenders in the market – Pension Funds / CIS / Life Insurance companies? – For example in SA, CIS's would be deemed "tax stock" because of the gross up which applies to compensating payments / or manufactured dividends.

Strengthen supportive legal foundations

By strengthening supportive legal foundations, emerging markets ensure well-functioning and predictable legal, regulatory and judicial foundations (often in collaboration with international organisations). Crucially, they align with well-developed legal standards such as GMSLA, whilst still accommodating their country specific schedules. This is also an opportunity to embrace the principle-based approach to ESG and include as non-binding components into the schedules.

Minimum requirements:



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Key questions and considerations that should be asked at the outset:

- ✓ Would the intermediary be able to act as agent for lender and borrower but not in the same transaction?
- ✓ When appointing an intermediary, to manage the securities lending programme, what are the capital and balance sheet requirements and could the intermediary provide a guarantee against borrower or lender default if the law allows for the intermediary to act as agent for a borrower or a lender? – For example in SA, an intermediary can be agent for borrower or lender but in other jurisdictions, an intermediary can only be agent for the borrower.
- ✓ Collateral – local vs. foreign currencies and/or securities as collateral.
- ✓ If foreign currency, what is the process of getting the collateral out of the country? (maturity of the FX market).
- ✓ Cash collateral reinvestment – is this allowed and what are the risks?

Involve stakeholders and participate in global engagement and evaluation

Finally, emerging markets should develop their securities lending programmes with a view to engaging a broader stakeholder base and engage in global evaluation.

In practice, this means consulting key stakeholders when developing the strategies and programmes but also enabling those stakeholders to take part in securities lending programmes (e.g. pension funds).

Global engagement and evaluation means working with global players, including Global PSSL, through roundtables, workshops and joint seminars.

Q3. Would you have any comments on this section of the standard?

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Disclaimer :

Global PSSL and this minimum standard are voluntary and do not create any legal rights or obligations. Global PSSL will work on the recognition scheme in due course.

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Funding:

Funded by the Economic and Social Research Council (ESRC), part of UK Research and Innovation, through Sustainable Finance – Law – Stakeholders (SFLS) Network at Exeter Law School.