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Securities lending from a European funds perspective

Joanna Ksenzova, associate director and **Don D'Eramo,** managing director and head of securities finance at RBC Investor & Treasury Services (I&TS) explore the key issues around securities lending from a European funds perspective.

Over the last few years, European funds have increased their focus on gaining a deeper understanding of their securities lending programmes. One of the main drivers for this trend is regulatory compliance, but these funds are also looking to better align lending with portfolio and risk management approaches, evolving investor demands, and – importantly - ESG strategy.

In addition, market volatility caused by the pandemic has made such engagement and understanding even more vital and requires a high degree of client contact to ensure they are kept up to date with market developments and the operation of their programmes.

Due to the high touch point engagement during pandemic, the majority of funds were retained in securities lending and additionally brought in more assets in a measured way, which showed confidence in the product and industry in general. We are witnessing more asset managers who did not have a securities lending programme at that time beginning to incorporate securities lending and Securities Financing Transactions Regulation (SFTR) related wording in their prospectuses, continuing to evaluate business cases, and increasing dialogue with their investors.

Looking specifically at UCITS funds from a lending perspective, it is clear that securities lending can help these funds increase their performance and also contribute to market efficiency and enhanced liquidity. "The more funds that are enrolled, the greater the positive impact on the fund industry in terms of meeting deadlines and avoiding unnecessary penalties or buy-ins," says Joanna Ksenzova, Associate Director, RBC I&TS.

There are highly prescriptive regulatory regimes applicable to UCITS funds. These include collateral rules in relation to acceptable instruments, correlation, concentration, diversification and other parameters as well as limitation of reinvestment and pledge. In some cases, there might be an additional need for stress testing of collateral.

"The agent lender has to consider all these rules when it comes to meeting market demand," says Ksenzova. "In addition, there are other disclosure and reporting requirements, oversight and controls applicable to these types of funds which require agent assistance."

It is therefore advantageous to work with lending agents, custodians and depositories who are familiar with UCITS parameters.

"We spend a lot of time ensuring all these requirements are met and particularly that if services such as stress testing of collateral are required, that these capabilities are bundled with the mandate from a UCITS perspective," explains managing director and head of securities finance at RBC I&TS, Don D'Eramo.

"There is a sound rationale for the regulatory environment, so our job is to balance mandates that we can tailor for this segment versus what that fund can actually achieve," he adds. "We therefore find ourselves engaging in a very proactive way to ensure that information is available, so data and technology capabilities are key requirements."

ESG is a hot topic in the securities lending space and according to the RBC I&TS 2021 Asset and Wealth Manager Survey, ESG investing appears to be a more advanced discussion in the UK/European market. Ksenzova observes that one of the key considerations from a client perspective is corporate governance.

"Corporate governance varies in terms of funds policy and although proxy voting is not new, increased demand, volumes and tailoring creates the need for better automation and flexibility," she says.

"We have not yet seen massive demand for aligning collateral policy

with investment policy of ESG-focused funds, although some discussions have taken place. Our indemnified collateral programme offers collateral profiles applicable to different regulatory regimes and risk appetite (such as UCITS), with the possibility of exclusion based on different criteria."

Lending impact on the market and other participants is the other area where clients want to have more transparency.

When there is a need to interact or monitor lending activity, clients are keen to understand the various drivers behind borrower demand and how it impacts both negatively and positively.

"At the end, there is always an impact on the market - when the decision is not to lend, this impacts liquidity and performance," explains Ksenzova. "We try to understand market behaviour, for example around themes such as sanctions, taxation, distressed stocks or illiquid stocks, to ensure and promote good practice."

The discussion around ESG continues to evolve, notes D'Eramo. "One of the key tenets of our agent programme is the ability to tailor it to client objectives and it is evident that ESG strategies vary from client to client," he says.

"We have enhanced our proxy capabilities to a point where clients are not just looking to make a decision on discretionary events but also events that have an impact given their own policies; they may approach this by restricting availability. We are looking to be more proactive with securities lending data to help clients make those decisions."

The discussion around whether ESG compliance means funds should not be lending their securities and the perception of securities lending that it somehow equates to short selling continue to be the subject of much conjecture.

"This is where enhanced connectivity and education are absolutely vital to ensure that we are talking about facts and the reality of how securities lending could improve liquidity, which is a positive development," says D'Eramo.

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>
> **Joanna Ksenzova,** associate director RBC & ITS

"Securities lending via short selling could be a positive for an ESG outcome," he adds. "I think finding that balance is the discussion that we have had and continue to have in the European market around that intersect between lending and ESG topics."

There is also recognition that ESG is evolving and may not be the same across all stakeholders. For this reason, agent lender engagement with industry bodies is paramount to continue the discussion on the educational front and also on where ESG can migrate to within the securities lending and finance space.

"We have seen examples where there is a very determined view - for example, that if you are an ESG fund you should not be lending," says D'Eramo. "However, we have also seen clients launching ESG funds with active oversight and ensure they communicate that the type of mandate they want to be deployed can work within securities lending."

In light of the above, it is pertinent to discuss potential obstacles on the funds side to joining securities lending programmes.

"One of the concerns which is arising more regularly in Europe is the situation where fund managers, management companies and investors see lending fitting into their strategy, but there are some investors who have the perception of lending being different," says Ksenzova.

"While this perception is not based on the current funds experience with the securities lending product, when some funds are focused on broad, global and – perhaps most importantly - quick distribution, they may look to consider and balance all of their investors' concerns."

In that environment it is clear that together with the funds, agent lenders need to highlight the benefits of lending via broadly recognised agents and point out both investors and funds have control of their programmes.

"To help our clients and prospects, we have increased engagement and provided them with expertise such as thought leadership and other important sources of information," adds Ksenzova. "Via transparency, education and engagement, we can ensure that investors make more informed decisions."

The trade-off between a fund participating and underlying investors having views and those views impacting the decision on participating or not is an important one, says D'Eramo.

"Although we have been talking about education for many years now, as regulations continue to shape the broader financing and investment industry, it is clear that you can never have enough transparency or engagement," he adds.

"I think how that is transposing itself for us is a greater ability to give clients the data they need to make those decisions. The route to market sometimes becomes the topic as opposed to whether you enter or not. Can you give the underlying funds enough information and data points to enter when they want to, as an example, whether it is as specials only, or fixed income only, if it is a financing mandate, or a general programme?"

"Continuing to educate correlates to the data strategy we continue to evolve to ensure clients have that information and empowering them to make their decision based on facts rather than market perceptions," he concludes. ■