Beyond Mechanics: The Intersection of Securities Lending and ESG Investing

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In early December 2019, one of the world's largest pension funds announced that it "decided to suspend stock lending until further notice."[1] This is one example of a growing number of asset owners evaluating their securities lending practices due to environmental, social and governance (ESG) concerns as long-term investors.[2] Concerns have been raised that short sellers (borrowers) could potentially undermine long-term stewardship efforts by mispricing or not considering ESG characteristics.[3]

The immediate impact of these events on the world's lending supply was limited. For context, in June 2019, global on-loan balances were around US $2.45 trillion, representing a small proportion of the US $18.47 trillion available within lending programs.[4]

However, as the number of asset owners with these ESG-related concerns grows, the lending supply may further decline. And, between 2018 and 2019 the United Nation's Principles for Responsible Investment (UNPRI) reported a 16% increase in the number of asset owner signatories committed to ESG investing, bringing the total to over 2,300 signatories with more than US $86.3 trillion in assets under management.[5, 6]

In this editorial, we attempt to form a perspective on the intersection of ESG investing and securities lending based on academic findings. After an extensive literature review, there are four main findings that we cover:

- Empirical evidence supports foundational assumptions in financial theory, which suggests that short selling, facilitated by securities lending, improves market efficiency and allows for the proper allocation of capital
- Increasing number of regulations and investor demands are driving the adoption of sustainable investment strategies
- Lenders have attempted to integrate ESG, but with fewer examples of borrowers with ESG investment philosophies, some lenders are concerned about the potential negative impacts on their long-term ESG stewardship efforts due to borrowers mispricing these characteristics
- While research indicates that short selling does not destroy a company's long-term value, the relationship between short selling and material ESG performance is unclear

What are the ESG concerns of long-term investors?

A growing number of asset owners and managers are voicing concerns that securities lending limits their ability to exercise proper stewardship on underlying investments, highlighting three key concerns:

1. The transfer of stock ownership rights. When stocks are on loan, the voting rights for those shares are also transferred. This is inconsistent with the wishes of asset owners who mandate that their asset managers need to conscientiously exercise voting rights on all their shares.
2. There is a transparency concern because owners do not have clarity on who borrows shares nor the reasoning behind those decisions.[7]

3. Underlying these points is the perception that short sellers (borrowers) destroy long-term value due to a misalignment in the longer-term investment time-horizon of lenders (beneficial owners). This raises issues of "short-termism," which can be defined as the "excessive focus on short-term results at the expense of long-term interests."[8]

Asset owners are not the first institutions to direct concerns at short sellers. Financial regulators have historically viewed short selling with a level of skepticism, especially during times of financial turmoil. For example, in the 2008 financial crisis, the Securities and Exchange Commission (SEC) pointed to short sellers as a reason behind the sharp decline in prices and banned short selling on 799 financial stocks.[9] The continued debate has attracted interest from academics, which we can turn to for a better understanding of the role of short sellers in capital markets.

What is short selling's role in capital markets?

Before tackling whether short selling harms long-term value, we need to understand its role in capital markets. Empirical studies that explore short selling's role in markets tend to fall into three main categories: (1) cross-country variation, (2) event studies and (3) time-series and cross-sectional analyses. Each research methodology provides a different perspective on the securities lending market.

Cross-county variation studies use variations in regulations and market practices across countries to study the impact short selling has

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on market efficiency. Event studies analyze the impact of short-selling constraints and regulations on various events (e.g., bans during the 2008 financial crisis). Lastly, time-series and cross-sectional analysis uses daily or intra-day stock-loan data to examine the impact of shorting flow at securities level.

The two primary considerations when examining short selling's impact on capital markets are liquidity and price discovery. **Liquidity** is the ease with which an asset can be sold or bought and is commonly proxied for by the bid-ask spread. In illiquid markets, bid-ask spreads are wider resulting in costlier trades. **Price discovery** is a critical process in financial markets in which the proper price of an asset is determined based on the incorporation of all available public information.

Liquidity: In theory, the impact of short-selling constraints on liquidity is ambiguous. Numerous studies have shown that short sellers are informed market participants – increases in borrowing rates or shorting demand are correlated with abnormal negative returns.[10, 11] Removing informed sellers reduces the asymmetry of information and narrows bid-ask spreads. At the same time, the market mechanism is disrupted and revelation of information is slower, which could widen spreads.

Empirical findings from all three types of academic studies tend to agree that short selling constraints reduce liquidity at the single-stock and broader market level:

1. **Cross-county variation:** A study of 111 countries found that in countries where short selling is more feasible, turnover, a proxy for liquidity, was 15% higher. That is, there is increased liquidity of market indices when short selling is possible.[12]

2. **Event studies:** Financial stocks subject to shorting bans during the 2008 financial crisis resulted in spreads that were two to three times wider while controlling for previous behavior.[13, 14, 15]

3. **Time-series:** Suggest that short sellers can be liquidity suppliers when spreads are especially wide, providing a stabilizing force in the stock market.[16]

Price discovery: The theoretical impact of short selling on the speed of price discovery is clearer than it is for liquidity. Short-selling constraints restrict traders with negative information from expressing their sentiment, slowing the speed with which bad news is incorporated into market prices.

Empirical evidence from the three categories tends to agree with this theory:

1. **Cross-county variation:** An analysis of 46 equity markets reveals that countries that permit short selling, incorporate information into prices quicker. Additionally, short sales restrictions don't reduce negative skewness of returns at the stock level.[17]

2. **Event studies:** Price discovery was slower for stocks impacted by the short-selling bans during the 2008 financial crisis, especially where negative news was concernced.[15]

3. **Time-series:** Prices of stocks with short-selling *constraints* (such as low lending supply) are less informative. Evidence also suggests increased "shorting flow reduces post-earnings-announcement drift for negative earnings surprises".[18, 19, 20]

Is short selling detrimental to long-term value?

The studies cited above provide empirical evidence that short selling is important for efficient capital markets and when viewed holistically, suggest that short selling is not detrimental to long-term value. Additionally, there are several specific studies that found no statistical difference in excess returns of stocks for which short sales were banned and for those stocks in which short selling was permitted.[21, 22,15] To summarize, a body of academic evidence indicates that short sellers are informed in that they anticipate price declines. However, they are not responsible for driving asset prices down.

What does this mean for investors?

While it is often claimed that the short-term horizon of borrowers is at odds with long-term objectives, existing literature suggests this is not the case and instead, reveals short selling to be an important market mechanism. Moreover, evidence indicates that short sellers' presence in a market increases liquidity.

Increased liquidity means reduced transaction costs on average, while price discovery helps investors get more accurate prices and potentially prevents disruptive price bubbles.

Basic financial theory suggests and empirical evidence supports the idea that short selling, facilitated by securities lending, improves market efficiency and allows for the proper allocation of capital.[23]

With that said, this view only looks at short selling from a purely economic perspective but does not necessarily speak to the interplay between short selling and ESG characteristics of securities.

The growing presence of ESG in investing

To understand the intersection of ESG and securities lending, we pull insights from empirical studies on investor behavior in climate finance and ESG investment management of listed equities.

In our 2019 paper, *Decarbonization Factors*, a collaboration with Harvard Business School professor, George Serafeim, we shed light on how active institutional flows move around environmental characteristics, specifically operational carbon intensity, and the long-term implications of such patterns of flow.[24] This seminal work on decarbonization factors and investor behavior revealed that active institutional investor flows contain information about anticipated climate-related fundamentals and returns. To put it simply, for those seeking alpha opportunities, tilting towards low carbon strategies experiencing positive contemporaneous flows improves returns. In addition, we observed a low correlation between strategies in the United States and Europe. This was particularly salient after 2016, when almost all US decarbonization factors experienced outflows after the change in presidential administration, an effect not seen in Europe.

There is regional specificity seen in investor behavior as well as regulation. For environmental metrics, such as carbon emissions, companies are increasingly paying the price through the 58 sovereign and sub-sovereign pricing schemes globally.[25] Additionally, the EU Commission has set legislation around the Task Force for Climate Related Financial Disclosure (TCFD), Japan's stewardship code recommends company engagement to promote sustainable growth and France's Energy Transition Law (Article 173) requires institutional investors to disclose information on their ESG integration and how strategies align with an energy and ecological transition.[26] Companies are disclosing more ESG metrics to be listed on any of the 94 sustainable stock exchanges requiring some level of ESG disclosure, a number that has

The EU Commission has set legislation around the Task Force for Climate Related Financial Disclosure (TCFD).

significantly increased over the last 10 years.[27] ESG characteristics are being considered throughout the investment landscape. For example, recently Goldman Sachs announced that they will not "take a company public unless there is at least one diverse board candidate."[28]

These efforts are extensions of empirical research revealing that investors are focusing on material "E," "S" and "G" metrics. Leading frameworks, most notably the Sustainability Accounting Standards Board identifies material ESG metrics as meaningful to the financial or operational performance of a company.[29] In Serafeim's foundational paper, *Corporate Sustainability: First Evidence on Materiality*, he and his co-authors, Mozaffar Khan and Aaron Yoon, studied novel materiality sustainability characteristics to discover value implications of ESG investments.[30] To understand how public sentiment has changed over the years, in 2018 Serafeim found that the valuation premium of strong material ESG performance has increased over time as a function of "positive public sentiment momentum."[31] Alpha was recognized through the creation of a low sentiment ESG factor, designed to identify firms improving ESG performance with low public sentiment. This research found that public sentiment on ESG has indeed changed and that this perception influences investor views on the value of ESG performance. This ESG investing literature and our climate finance research suggest that investors are increasingly incorporating material ESG characteristics into their investment decisions and diving deeper into these characteristics with company fundamentals.

Some long-term investors hold companies responsible for key ESG characteristics in an effort to improve performance over time.

Can ESG investing and securities lending co-exist?

To some extent, investors are already integrating ESG metrics into their lending (borrowing) strategies. We know this through Harvard case studies and public reporting to UNPRI. Asset owners currently exercise their shareholder rights by recalling securities on loan or by setting a threshold on how many shares can be on loan at a given time. For example: some Swedish asset owners have instituted a policy of recalling all securities on loan prior to annual general meetings, some Australian asset owners recall domestic securities on loan to vote prior to key votes and some French asset owners limit the percentage of a holding on loan to 90% when a vote is considered to be "high impact."[32]

Shareholders looking to communicate their views on a company's performance and governance regarding material metrics vote on key themes and engage with companies on those themes. The demand for transparency from some long-term investors (lenders) stems from thinking about fiduciary duty across generations, which raises concerns that lenders are undermining their own long-term ESG stewardship efforts by loaning stocks to borrowers who potentially disagree with (or ignore) the value of those

ESG characteristics.[33] These lenders hold companies responsible for key ESG characteristics in an effort to improve performance over time.

Currently, lender to borrower transparency is limited due to privacy agreements between brokers and borrowers. ESG investors lending stocks may appreciate information about the borrower or request ESG collateral of those borrowing their stocks. These requests and the solutions could take many forms and may change the pricing of the stock being lent.

While limited literature exists on borrowers integrating ESG, a recent paper published by AQR, illustrates a borrower's perspective on ESG short-selling opportunities.[34] This borrower looked to improve performance by shorting poorly ESG ranked stocks (as a proxy for ESG performance), relative to an ESG-screened long-only strategy (or long/ short ESG-screened strategy). Mirroring the ESG concerns and views on stewardship of long-term ESG beneficial owners (lenders), these short positions exert pressure on the corporate boards of companies with poor ESG rankings, as boards are aware of the percentage of their stock being shorted. While not a prevalent approach for borrowers, this sheds light on how long-term ESG investors can take part in the securities lending market.

16%

increase in the number of asset owner signatories committed to ESG investing between 2018 and 2019 was reported by UNPRI.

Conclusion

Empirical evidence indicates that short selling, facilitated by securities lending, improves market efficiency and market liquidity. A holistic view of academic studies suggests that constraints on short selling can lead to overpricing. This alleviates concerns of short-termism stemming from time horizon misalignment of short sellers with long-term ESG investors.

Leveraging empirical ESG and climate finance research, we know that investors are using material ESG metrics in their investment decisions to improve their risk and return profiles. An increasing number of lenders and some borrowers apply these characteristics when considering what they loan (borrow) and to whom.

We do not yet know the impact that short selling has on a company's material ESG performance in the long term. New insights will come from studying the changing dynamics between lenders and borrowers and the potential impact on a company's material ESG performance. Through systematic empirical research, we may find ways and opportunities for the securities lending market to evolve and potentially grow. We look forward to approaching these questions and continuing to apply a rigorous data-driven approach to understanding this space.

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