FOR PROFESSIONAL CLIENTS, QUALIFIED CLIENTS AND QUALIFIED INVESTORS ONLY

SECURITIES LENDING UNLOCKS THE POTENTIAL OF PORTFOLIOS

BlackRock Securities Lending

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Securities lending can unlock additional revenue for portfolios...

This paper explains the basics of securities lending and descibes BlackRock's leading approach. Securities lending is a long and established practice in the investment management industry to generate additional revenue. This involves the transfer of fund securities (such as shares or bonds) to a third party (the borrower). The borrower gives the lender collateral and pays the lender a fee. The extra revenue generated can be used to effectively reduce the Total Cost of Ownership of an ETF and therefore increase the cost effectiveness of ETF ownership for investors. In four decades of lending securities on behalf of clients, our lending program has focused on delivering competitive returns while balancing return, risk and cost. Since the inception of our lending program in 1981, we have delivered positive securities lending income for every fund participating in securities lending.[1]

1 BlackRock acquired the program from BGI in 2009.

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So, how exactly does securities lending work?

In securities lending transactions, lending ETFs make loans of securities to borrowers in exchange for a fee in order to generate additional returns for the lending ETF.

For example, a large financial institution asks to temporarily borrow a security (see page 4 for reasons why this might occur). In order to borrow the security, the borrower must pay a fee and provide collateral to the lending ETF. The lending ETF keeps the collateral for the entire period that the security is out on loan. This is to ensure the lending ETF is protected, in case the borrower fails to return the loaned security. The value of the collateral must exceed the value of the loaned security, to provide the lending ETF with a 'safety cushion'. This 'safety cushion' acts as a shock absorber for changes in asset values. As an additional safeguard in the event of a borrower default, BlackRock provides an indemnity for its ETFs domiciled in Europe – if a shortfall existed between the collateral and the cost to repurchase a loaned security, BlackRock would reimburse the ETF in full under the terms of the indemnity.

See the flow chart for an example of how a lending transaction works.

Here's an example of how it works:

1 A large financial institution asks to borrow a security from a fund. The fund company asks for collateral, which in the European market is primarily equities and government bonds, to secure the loan.

2 Once it receives collateral, the fund company lends the security to the financial institution (the borrower).

While the security is out on loan:

3 The collateral is held for the benefit of the fund, separately from the custodian's and fund manager's assets.

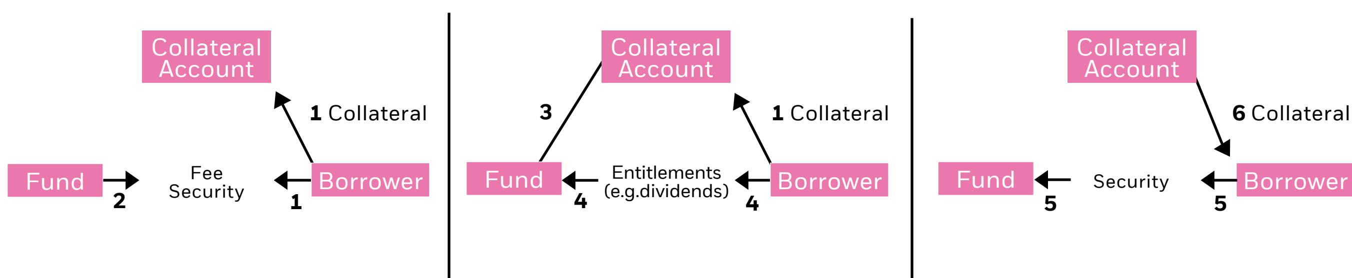
4 If the security pays dividends or coupons while it's out on loan, the financial institution pays the fund amounts equivalent to such income.

To complete the process:

5 At the end of the loan (or when the fund company requests), the financial institution must return the securities back to the fund.

6 The fund then releases the collateral back to the financial institution to close out the process.

7 Through the process, the fund generates additional income for fund shareholders, due to the fee paid by the borrower.



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Why do our investors choose to participate in securities lending?

Securities lending is a way to unlock additional value from a portfolio. A lending ETF may generate additional income through the fee that it charges for loaning securities. Securities lending returns vary according to the specific securities an ETF holds and the demand to borrow them.

As an investor in a lending ETF, this differentiated income stream can offset your running costs and help you reach your objectives faster.

Within our lending program, your loan is protected by an indemnity policy that protects you from the unlikely event of a borrower default. The investment management approach of our lending program is focused on delivering competitive returns while balancing return, risk and cost.

From the borrower's perspective, they typically use the loaned securities for four reasons: to facilitate a short sale, to hedge against market risks, to use as collateral in another transaction, or to meet the liquidity standards they are required to meet by financial regulators.

Are there any reasons to be cautious?

The key risk of securities lending is that a borrower fails to return a borrowed security. In this case, the lending ETF would use the collateral given by the borrower in order to purchase replacement securities. There are several processes in place to ensure that lending ETFs do not experience financial loss in the event of borrower default:

1. The Risk and Quantitative Analysis group (independent from the securities lending team) determines whether firms may be approved as borrowers. They monitor existing borrowers and perform regular borrower reviews. New transactions are systematically prevented if a borrower reaches their risk-approved borrow limit.
2. To minimize risk to investors, it is important that any collateral received be of high quality and liquidity.
3. There are daily mark-to-market checks to ensure that the value of the collateral exceeds the value of the loaned security.
4. As an additional safeguard, we fully indemnify our ETFs domiciled in Europe. If a shortfall existed between the collateral and the cost to repurchase a loaned security, we would cover this cost in full.

We encourage our investors to learn more about how we run our lending programme and compare us to other ETF providers. While every investment bears some risk, we take a rigorous hands-on approach to risk management and as a result we have delivered positive lending income for every fund that has participated in our lending program since its inception in 1981.

How do we run our securities lending program?

We believe in managing our securities lending operations on our proprietary platforms rather than outsourcing this important function to a third party. To that end, we have built a proprietary securities lending infrastructure so that lending activity is executed in our clients' best interests and with prudent risk management.

- **Skillful risk management.** BlackRock is hired by some of the largest companies and governments in the world to manage risk. Our approach to securities lending is no different. We take a conservative, low-risk approach and use our proprietary risk and investment management platform, Aladdin, to integrate the capabilities of our dedicated research, trading and risk management teams.

  All investment and trading teams, across asset classes and around the globe, work on Aladdin to capture opportunities for our clients in a highly risk-controlled environment. This synergy among

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our securities lending team, portfolio management, and risk management teams enables us to reduce the operational risks of securities lending in a way that a third-party custodian or lending agent may not.

- **Proprietary technology.** Our dedicated team works on custom-built reporting, operations and trading systems to help ensure transparency and operational efficiency.

  Our core trading system enables our traders to extract value for our clients in rapidly changing markets by incorporating proprietary trading research and securities lending supply and demand data in a rapid, consistent and scalable manner.

  Capturing re-pricing opportunities is a key component in outperforming competitors; with tens of thousands of loans outstanding at any given time, our trading system helps ensure that traders focus on the most significant opportunities.

  Our proprietary collateral and loan processing application delivers a seamless exception-based process for loan management. While borrower default is rare, the application is designed to manage the default process systematically and mitigate risk to the investor. Though risk cannot be eliminated entirely, proprietary technology platforms may help manage it.

- **Robust assessment of borrowers.** We select highly creditworthy borrowers based on conservative credit standards defined by our risk team, which operates independently from our securities lending business. We regularly monitor the financial performance of borrowers and set individual credit limits for every borrower to help minimize default risk. We monitor all trading activity against these limits and systematically prevent new transactions if the limits are reached. We also reserve the right to recall a security or require a borrower to provide additional collateral at any time.

- **Collateral standards.** For lending funds domiciled in Europe, equities, government bonds, supranational and agency bonds are the most common forms of collateral. We require borrowers to post excess collateral of at least 102.5% of the loan value and retain the borrower's collateral until the borrower has returned the loaned stock or bond. Collateral is also segregated from the borrower's or BlackRock's assets.

"Since 1981, BlackRock has delivered positive lending income for every fund that has participated in securities lending"

BlackRock's conservative approach to risk, alongside our innovative lending infrastructure, enables us to maximise value to investors in the form of net return. An absence of commoditisation in the securities lending market allows a skilful lender to benefit from superior pricing and outperform peers, even within a similar asset base.

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WHAT DO OUR INVESTORS USUALLY ASK US?

How can securities lending benefit the financial markets?

Securities lending has evolved into a vital component of the financial markets. As of December 2020, more than US $29.1 trillion of assets were available for lending globally, with over US $2.7 trillion on loan on an average day (Source: Markit, 1 December 2020 to 31 December 2020).

Securities lending may increase liquidity and therefore facilitate transactions. This helps to mitigate price volatility and reduces transaction costs for all market participants.

Since securities lending transactions may lead to short sales (where investors sell borrowed securities in anticipation of price declines) some have criticized securities lending as a risk to market stability. In contrast to this, research by the Federal Reserve has found that short sales improve market stability. Their research has shown that short selling does not systematically drive down asset prices and that restricting short selling could actually lead to reduced liquidity and higher transaction costs for investors. These findings are driven by the dynamics mentioned above: securities lending and short sales help to improve liquidity and enable investors to hedge risk (Source: Federal Reserve Bank of New York Staff Report no. 518, 'Market Declines: Is Banning Short Selling the Solution?' September 2011).

Has there ever been a borrower default in BlackRock's history?

Since our lending program started in 1981, only three borrowers with active loans have defaulted. In each case, we were able to repurchase every security out on loan with collateral on hand and without any losses to our clients.

Although borrower defaults are infrequent, how well prepared is BlackRock in the event it happens?

BlackRock's integrated technology platform, alongside an experienced team of over 400 professionals focused on all aspects of markets, trading and liquidity, puts us in a strong position to manage collateral in the rare event of a borrower default. Additionally, our securities lending, operations, portfolio management and trading teams regularly assess our readiness to respond to a borrower default using various tools. Each year this may include a borrower default simulation.

What proportion of securities lending proceeds are returned to iShares ETFs domiciled in Europe?

iShares ETF shareholders receive 62.5% of the income from securities lending. A BlackRock affiliate serves as the lending agent and retains 37.5% of the gross revenues. All costs of running the program are paid from the lending agent's portion of the income. This includes all direct operational and custodial costs, such as:

- **Platform maintenance.** BlackRock's team of investment professionals in London, New York, San Francisco, Hong Kong and Tokyo use advanced risk management technology to monitor risks and extract value for our clients. We believe that our proprietary technology is a key differentiator that seeks strong performance and lower risk.
- **Indemnity against the risk of borrower default.** At no additional cost, BlackRock provides an indemnity against losses for investors in the rare

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event that a borrower fails to return a security. We encourage investors to ask ETF managers for detail on their securities lending program, and most importantly, the net returns to investors. When some ETF providers may report paying out a higher percentage of the net proceeds from securities lending, they may not be disclosing the portion of the gross proceeds they pay to their lending agents.

BlackRock believes the net returns to investors, balanced with appropriate risk and fee disclosure, is the best gauge of investor benefits from securities lending. It is important to remember that some lenders are able to generate more return from a given basket of securities due to their scale and skill. We periodically benchmark our performance versus competitors using data from independent third-party providers. Over three decades, BlackRock has focused on delivering competitive returns while balancing return, risk and cost.

How is securities lending regulated?

Securities lending is a well-established and regulated activity. For EU-based iShares ETFs, rules and guidelines applicable to UCITS set out specific standards as to how securities lending activities shall be carried out, including what types of collateral are acceptable and which disclosures are required. The primary regulator for Irish iShares is the Central Bank of Ireland (CBI) and for Swiss ETFs it is the Swiss Financial Market Supervisory Authority (FINMA).

What is the maximum percentage of assets that can be on loan?

On average, iShares ETFs domiciled in Europe had 11% of their aggregate net asset value (NAV) on loan in the year ending 31 December 2020. For ETF specific lending limits, please refer to the relevant ETF prospectus (Source: BlackRock, unaudited figures 1 January 2020 to 31 December 2020).

Transparency into iShares ETF securities lending practices

The following are published on our EMEA iShares websites on a regular basis:

1. The returns an ETF generated from securities lending for the most recent five 12-month periods.
2. The counterparties that borrowed securities from iShares ETFs in the previous quarter.
3. Percentage of an ETF's assets that were lent and the average level of over-collateralization.
4. The collateral received daily and the collateral framework.

Any more questions for us?

We encourage all investors to ask their ETF managers about securities lending practices and seek information about the fees managers earn or payments they make to third-party lending agents. For every iShares ETF that engages in securities lending, BlackRock publishes securities lending revenues in the ETF's annual report, and includes a separate line item that details BlackRock's share of revenues that are used to administer the program.

CONCLUSION

At BlackRock our priority is acting in the best interest of our clients. Securities lending is an additional, relatively low-risk, way to tap into additional revenue for an ETF and unlock a portfolio's full potential. We believe securities lending can directly benefit ETF investors by increasing the cost effectiveness of ETF ownership. Over three decades of lending securities on behalf of clients we have focused on delivering competitive returns while balancing return, risk and cost. Since the inception of our lending program in 1981, we have delivered positive securities lending income for every ETF participating in securities lending (BlackRock acquired the program from BGI in 2009).

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