

ESG/sustainable finance in securities lending

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ABSTRACT

Today, more and more investment strategies are not only led by profit considerations but, also by the incorporation of environmental, social and governance factors and their effect on our planet and society. Sustainable investment strategies are not only limited to the relationship between client advisers and investors but also need to be considered in other business areas, such as lending/borrowing and securitisation/collateralisation. Achieving an effective incorporation of sustainability risks and opportunities to the regulatory framework requires collaboration between global and national policy makers, regulatory and industry bodies. This paper provides the current status regarding global developments — geographically, regulatory and industry driven — in incorporating ESG factors to the securities lending business/process, the current holistic regulatory environment and the current data requirements and challenges, together with suggested guidance for compliance personnel. As a final remark, all financial initiatives and regulations require data — key factors are generation, collection, enrichment, processing and distribution in a timely manner and of top quality — not only as part of the investor's advisory process, but also when it comes to the integration of ESG into the securities lending process.



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INTRODUCTION

Responsible investing is an increasingly important topic — climate change, diversity, equality and data privacy are defining issues for our economy and society¹ — demonstrated by asset owners, investors, lenders and borrowers showing an elevated desire to incorporate environmental, social and governance (ESG) ethics into their investment strategies. This view is additionally supported by a survey carried out in winter 2020 by PASLA (Pan Asia Securities Lending Association) in partnership with AsianInvestor. Addressees of the survey were mostly buy-side institutions in the Asia-Pacific region, such as asset owners, investment management firms, and other key market participants in securities lending, for example hedge funds, brokers, agent lenders and investment banks. Given the situation that currently the securities lending activity among buy-side institutions in Asia is not yet as widespread as it is among their peers in North America and Europe, there are considerations among Asian investors as to how to manage and integrate ESG variables into their lending programmes. Insights were gathered from more than 150 senior industry executives, where over 100 of these individuals represented a total of 65 asset owners and investment management firms across the region. The estimated assets under management (AUM) of those buy-side respondents with a securities lending programme (roughly one-third of the total) is just over US\$2tn, while those institutions without a programme have a combined estimated AUM of roughly US\$1.9tn.²

The definition of what sustainability and sustainable finance means is not only restricted to the EU but also discussed in the different regions on the planet, eg regulators

and industry bodies across the Americas, Asia and Australia are introducing regulatory frameworks to address climate and environmental risks to investors in order, for one thing among others, to facilitate the development of sustainable finance.

The effect of including ESG/sustainable finance considerations is a combination of the economic framework conditions set by governments and the efficiency and proper functioning of the capital markets — especially when it comes to the asset classes that are mainly being used within the context of securities lending, equities and bonds. When it comes to bonds, it affects corporates and supnationals in particular.³

With these pre-conditions met and governments and policy makers advancing sustainability policies worldwide, the next step is on incorporating sustainability related risks and opportunities in the financial services' regulatory framework.

The efficient implementation of the regulatory framework is not only dependent on adaption of the requirements within the affected industry, but also on collaboration with the relevant industry bodies, such as ISLA (International Securities Lending Association), PASLA, ICMA (International Capital Market Association) and SFI (Swiss Finance Institute).

Finally, to adopt and, therefore, to comply with the rules, regulations and behaviours within the investment strategies, there is a need for standardisation supported by high quality data availability at instrument and institution levels, inclusive ownership structure (Figure 1).

ESG SUSTAINABLE FINANCE IN SECURITIES LENDING

The importance of securities lending can be seen in the context of meeting settlement and collateral requirements, provision of liquidity, price discovery, facilitating hedging and investment strategies. Among others, securities lending is used by central banks as

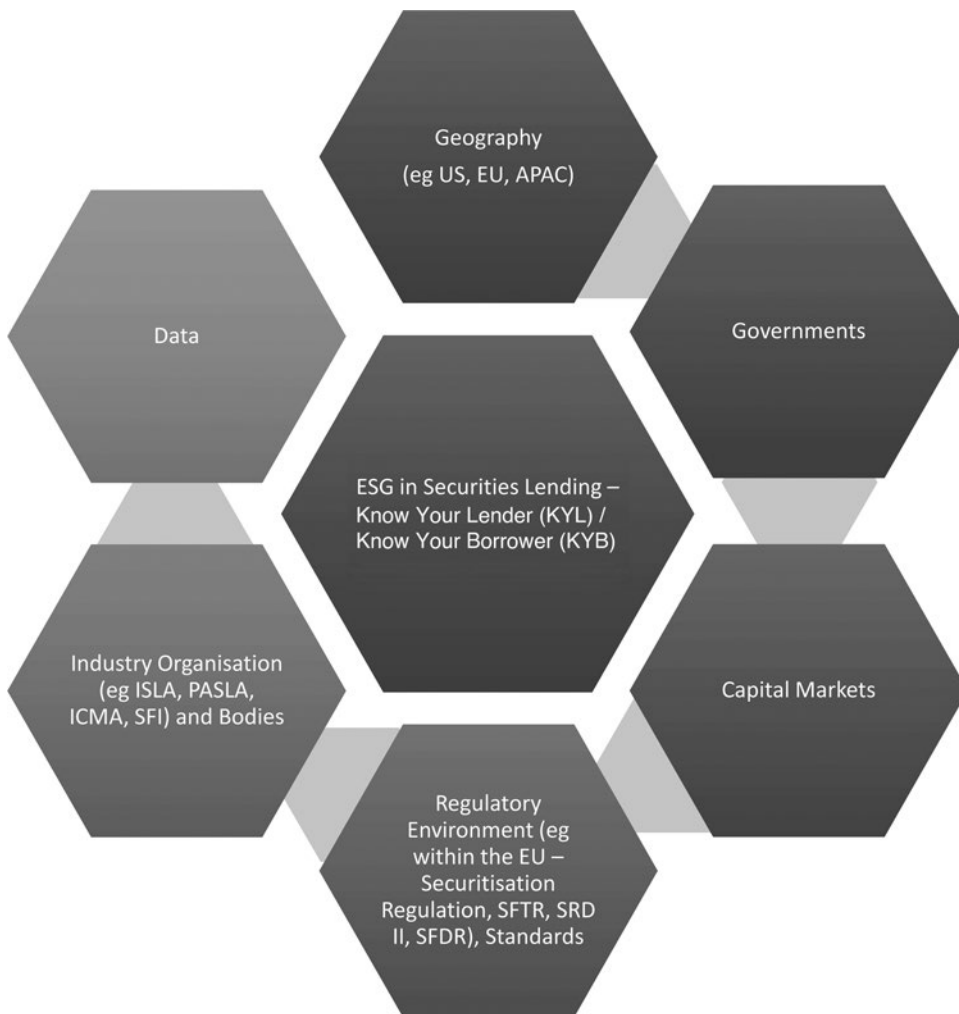


Figure 1 Key impact factors on ESG consideration within securities lending and borrowing

a tool to implement their monetary policy. As of December 2020, equities as a proportion of all collateral held in European tri-party was around 44 per cent, with government bonds and corporate bonds at 45 per cent and 10 per cent, respectively.⁴ As of June 2020, ESG funds' assets under management totalled US\$1.06tn, accounting for approximately 13 per cent of the funds industry.⁵

Before ESG considerations and parameters can be integrated within securities lending activities, there must be a common understanding of what ESG means. ESG and

sustainable finance are addressed by governments and policy makers worldwide. The focus has been on incorporating sustainability related risks and opportunities in the financial services regulatory framework.⁶

In addition, it is worth identifying the areas where securities lending and ESG considerations have touchpoints — and a range of proposed options for managing them:⁷

- Participation in the short side of the market.
- Collateral, cash reinvestment and rehypothecation.

- Transparency in the lending chain — asset owners should have visibility over the entire lending chain for their securities.
- Different tax liabilities.
- Exercising voting rights.

Currently, the sustainability regulation is not embedded in the securities lending regulatory framework. Under the EU regulatory framework, there are not directly connected regulations such as the Securities Financing Transactions Regulation (SFTR), MiFID II (Directive 2014/65/EU), where certain aspects like cash reinvestment and portfolio management are covered, and the Sustainable Finance Disclosure Regulation (Reg (EU) 2019/2088).

Further international regulatory developments in the UK, Singapore, Canada and Malaysia are now working on their own regulations. China, Bangladesh and Mongolia have existing definitions of what comprises 'green' activity. Industry and academic groups have called for taxonomies in Japan and Australia.

Even if there are regulatory initiatives to define the scope of ESG (eg the Financial Stability Board's (FSB), Task Force on Climate Related Financial Disclosures (TCFD); the UN's Principles for Responsible Investment (PRI) and Sustainable Development Goals (SDGs); the EU's incoming ESG taxonomy; the COP 25/26 principles, etc), the securities lending industry is trying to apply ESG principles in the corresponding lending programmes.

A good example for moving ahead with sustainable finance is the ICSF (ISLA Council for Sustainable Finance) and the introduction of its PSSL (Principles for Sustainable Securities Lending).⁸ Contributors were six prominent beneficial owner institutions (Aberdeen Standard Investments; Aviva Investors; BlackRock; KBC Asset Management NV; NN Investment Partners; and PGGM) and four partner organisations (ESRC funded Sustainable Finance — Law

— Stakeholders (SFLS) Network of Exeter Law School; the World Pensions Council (WPC); Financial Decisions, LLC; and PASLA).⁹

Furthermore, in December 2020, ISLA created an ESG steering group to consider the role that ESG plays in securities lending. The aim of this approach is to work with industry stakeholders, regulators and the legal community to develop and maintain an ESG policy framework and best practice standard for recalling securities and to create industry standards around voting in line with good governance principles that aid transparency to regulators around shareholder disclosure and identification, as covered under the EU's Shareholder Rights Directive (SRD) II.

Additionally, ISLA, in cooperation with its working groups, intend to develop high-level standards for collateral selection and to align cash reinvestment with the lender's ESG objectives.

In the absence of global regulatory taxonomy or standard, there are discussions within the industry to define sustainability objectives such as thresholds for diversity in management and identification of metrics for measuring compliance (reaching a specific diversity quote in senior management within a given time frame).¹⁰

Another example where an industry organisation is recognising the importance of the discussion about integrating ESG considerations into securities lending is the Council of Securities Lending of the Risk Management Association (RMA). The Council maintains relationships with other associations such as the Securities Industry Financial Markets Association's (SIFMA) Securities Lending Division, ISLA, and PASLA, as well as with regulators all over the globe.

Key findings of the survey carried out by the RMA published in October 2020 were:

- 95 per cent of survey respondents said ESG investing and securities lending can

coexist. But only 18 per cent always apply ESG principles to their securities lending programmes. Another 25 per cent do so on a case-by-case basis, 18 per cent do not but are planning to, and 39 per cent simply do not.

- A lack of timely information about proxy record dates and voting questions complicates the process of recalling stock that is on loan. When survey participants were asked to name ‘measures that might facilitate the application of ESG principles to their securities lending programme’, 43 per cent said that they want more transparency around proxy record dates and questions.
- Just 20 per cent of respondents said that there is ‘regular’ interaction in their institution between those who manage securities lending and those who manage ESG issues. Another 44 per cent responded that interaction occurs ‘from time to time’.
- 55 per cent of participants ranked ‘greater education about available options’ as the top priority when it comes to applying ESG principles to their lending programme.¹¹

RMA mentions an exclusionary approach by investors who are focused on sustainability. Companies doing business that is perceived as conflicting with ESG principles, such as tobacco, nuclear and coal, are often excluded from investment advisory and, therefore, securities lending.

Here are two more examples of exclusion filters:

- companies involved with nuclear energy, pollution, child labour;
- sovereign issuers involved with these industries or with a poor human rights record.

As mentioned earlier, there is no direct regulatory implication of sustainable finance in securities lending but, there are regulations or codes of conduct around the short

side of the market, such as, in the USA, Federal Reserve Regulation T, SEC Regulation SHO (Rule 203(b) and Rule 204, the standard legal agreement for lending outside the US, the Global Master Securities Lending Agreement 2010 (GMSLA), the Bank of England’s UK Money Markets Code (the Code).

In order to apply ESG principles in securities lending programmes, some questions from industry participants/stakeholder might be of interest:

- How does a beneficial owner measure the effectiveness of its ESG efforts in the securities lending programme?
- Do you look at the ESG suitability of the issuers whose securities you are purchasing?
- Do you consider the ESG profile of your counterparty?
- Would a lender look at each component of a basket of securities received as collateral?
- How can the industry participants develop a policy on when to recall on-loan securities?
- Are there certain securities that should never be lent?
- How are these customisations implemented and what are the implications for the overall flow and revenue?
- How can the industry participants develop communication and reporting lines between securities lending and ESG management for the organisation?¹²

It would also be helpful to refer to the article ‘Global principles for sustainable securities lending’.¹³

Finally, what are the reasons for incorporating sustainability considerations into lending and investment decisions?

1. To avoid future financial losses through avoiding eg reputational risks.
2. To avoid investments and other financial decisions that cause environmental or

- social harm or, said positively, investments aimed at achieving positive environmental or social impacts.
3. To influence firms' behaviour by directing capital in ways that change that behaviour (eg by raising the cost of capital for firms whose activities are deemed unsustainable).
 4. To derive their social identity in part from their investments in, and association with, good causes and, therefore, seek to invest sustainably.¹⁴

However, on the fixed income side, there are more complex issues when compared with equities.

Fixed income management and investment, for example, includes the analysis of interest rates, inflation, credit quality and liquidity risks and is a quantitative process. To include ESG criteria in the financial models of fixed income management and investment is, therefore, more challenging.

For example, the ESG analysis of sovereign bonds leads to the following conclusions:

- The political and institutional system, macroeconomic development and government policies play a key role in assessing a country's ability and willingness to repay its debt on time.
- Governance is reflected by the rule of law, the strength of the country's institutions, political stability, regulatory consistency and corruption. Energy, water and other resource reserves and management, as well as green/climate change policies are of varying importance for creditworthiness across countries and periods.
- Social factors tend to be given greater weight by analysts than environmental factors because of links between political stability, governance and a country's ability to amend tax regimes or make reforms. Key social factors include human rights, labour standards, education system, health care and demographics.

- One of the few academic research papers to study the relationship between ESG and sovereign bond performance is that by Capelle-Blancard et al.¹⁵ In a comprehensive analysis of Organisation for Economic Co-operation and Development (OECD) sovereigns, it concludes that countries with good ESG performance tend to have less default risk and, thus, lower bond spreads. Moreover, the economic impact is stronger in the long run, suggesting that ESG performance is a long-lasting phenomenon. The environmental dimension appears to have no financial effect, whereas governance weighs more than social factors.

Regarding corporate bonds:

- Issuers with high G (governance) scores experienced lower incidences of downgrades by credit rating agencies.
- For corporate bond issuers, good/bad ESG management corporate social responsibility (CSR) behaviour is rewarded/penalised by lower/higher bond yield spreads, according to research by Oikonomou, Brooks and Pavelin.¹⁶
- Similar results apply to bond ratings. In their research, Bauer and Hann conclude that environmental concerns are associated with a higher cost of debt financing and lower credit ratings, and that proactive environmental practices are associated with a lower cost of debt.¹⁷

Main research findings:

- Both academic and market research supports the notion that there is a link between ESG factors and the credit risk of a borrower.
- Anecdotal observation of defaults, particularly of investment-grade corporates, highlight that governance has a clearer link to corporate failures, while environmental and social issues are more difficult to capture.

- Academic research exploring the link between ESG factors and sovereign creditworthiness is less well supported. Nevertheless, there is evidence of the effect of ESG factors on macroeconomic variables and potential growth;
- Most of the ESG research uses past data. Past results may not hold in future. Investment policy cannot solely rely on a ‘majority vote’ of past research results.
- There is still little understanding and consistency about how ESG ‘factors’ relate to the established factors in asset pricing models, such as value/growth, size and liquidity.
- Research on ESG in fixed income is still very limited. Most of it is focused on credit risks. There is still little analysis of the relationship of ESG factors to market risks, inflation, liquidity, maturity, term structures and yield curves, income stability, total returns, and other risks/opportunities such as default risk or recovery rates.¹⁸

With ESG on top of the global regulatory agenda, lenders might face challenges with the borrowers. For example, in a case where the securities have voting rights, would the borrower use their voting rights? If yes, how? Would they vote against the lender’s ESG principles/intention? What are the borrower intentions? Who is/are the beneficial owner/s of the borrower? What are the borrower’s ESG parameters/ratings (if applicable)?

These questions are important for lenders who are investing, as policy, solely in sustainable products and would not like the borrower to use the borrowed securities in a way that would not equate to ESG values. In order to mitigate such risk, one could use the KYB approach, where the lender approves the transactions only after a solid borrower screening (for example, screening the borrower’s beneficial owner/s against sanctions lists) and evaluation of their

intentions in using the borrowed securities, and particularly where voting rights are granted.

Such controls will assure lenders that borrowers will not use the securities for activities that are not in line with the lender’s ESG objectives. Obviously, borrowers can do similar checks on the lenders (KYL), thus ensuring that the lenders ESG principles are also in line with those of the borrower.

The KYB and KYL due diligence checks could be supported by data on the corporate level (lender, borrower, ‘investee companies’) as well as on the underlying securities of the securities lending transaction.

Data is a key supportive factor for an adequate due diligence process, among others, data related to:

- **Sanctions** — is one of the companies or its owners involved in the transactions sanctioned by any regulatory body?
- **ESG data** — what are the ESG indicators/ratings of the firm (in the case where the borrower/lender is a legal entity)? For example, what are the EU SFDR Principal Adverse Impact indicators (PAI) of the company?
- **Corporate actions** — in the case where the securities have voting rights and will be used in general meetings — what are the agenda points of the investee company in which the securities are intended to be used by the borrower for voting in general meetings?
- **Basic reference data** — it is important to have basic reference data of the securities involved in the transaction — such as voting rights, trading venues, restrictions, ESG data, etc.

As can be seen, data is a key factor in ensuring an adequate lending process. Ensuring high quality and accurate data is a challenging task and requires a lot of resources and expertise. There are specialised data

vendors who can offer the required data supporting firms with their lending processes. It is highly recommended that firms will use this valuable data in their processes, which will reduce the process costs of ensuring an adequate securities lending transaction.

IMPACT ON REGULATORY REPORTING, FOR EXAMPLE, SFTR, SECURITISATION REGULATION

Looking into the global regulatory landscape, it can be seen that currently there is no regulation that combines the requirements of sustainable finance with those of securities lending.

The regulatory landscape for securities lending is complex because the involved parties are acting in a highly regulated financial sector environment. For example, public pension funds will face strong regulatory oversight with regard to fiduciary duties, whereas globally, systemically important banks are restricted by strong regulatory/central bank oversight when it comes to market liquidity and 'too-big-to-fail' (Basel III) requirements. It is becoming even more complicated for cross-border securities lending transactions, due to different regulatory requirements. The exchange of information and collaboration between regulators and international standard organisations play an important role in shaping sustainable finance agenda.

A good starting point to bring the two aspects of sustainable finance and securities lending together would be to build on data/reports generated under SFTR.¹⁹

Based on a research report provided as a result of a partnership between the World Bank Group (WBG) and the Government Pension Investment Fund (GPIF) of Japan, initiated by the World Bank Group's President, Jim Yong Kim, and GPIF's Chief Investment Officer, Hiro Mizuno, specific regulations and guidelines at company/sector/project level are expected on carbon emissions, environmental footprint, energy

efficiency, governance practices and workplace standards. Furthermore, regulatory disclosure requirements will tighten for both investee companies and investors.²⁰

DATA REQUIREMENTS

One of the most complex challenges when it comes to defining and implementing regulations is not only constrained to processes but also to data. Where do we get the data from (availability), from whom (sourcing) and in what quality (data accuracy, ownership, quality control, maintenance)?

But all the questions raised above are obviated when standardised data and a common understanding of what ESG really means in the capital markets context are missing.²¹

According to feedback provided by different investor groups, they would also like to get stock lists, indices adhered to standardised ESG definitions.

The main concerns regarding ESG data are:²²

- Lack of available data; timeliness; coverage of regions/market segments/instruments.
- Quality of data inputs (inconsistencies; incompleteness; reliance on self-reported data; subjective and unaudited information; obvious errors).
- Big Data may also imply big risks. Issues such as cyber-crime, data ownership, theft and misuse have already shown massive financial relevance.

State Street Associates (SSA) have taken an academic, data-centric approach to propose a framework that asset owners and agent lenders can use to navigate the integration of ESG into their lending programmes.²³

By aggregating information from existing reports and studies, we clarify the different types of ESG data and their various attributes and challenges, including adoption, coverage, input data sources and

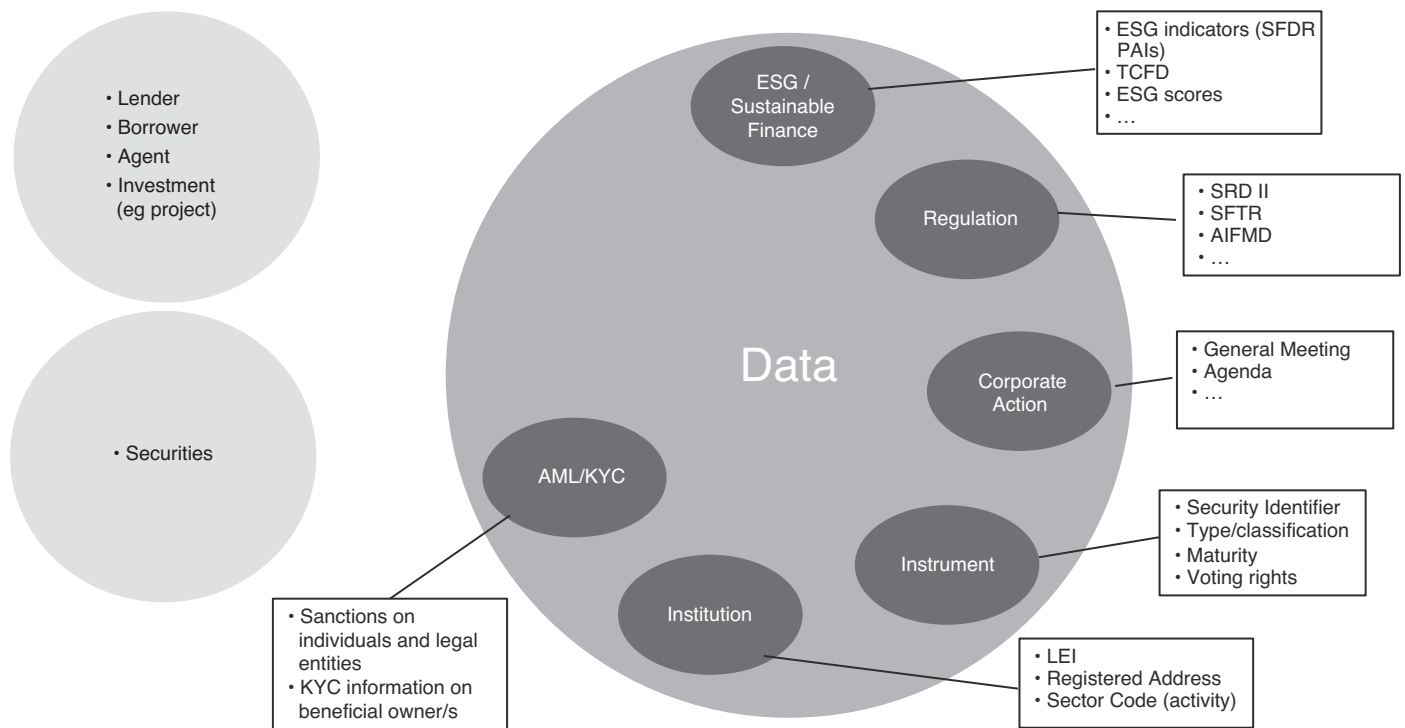


Figure 2 Data as a substantial part of securities lending

metric offerings. What we found is that market participants are often unsure how best to align lending programmes with their ESG objectives. With an open dialogue on how to balance both lending decisions and ESG philosophies, agent lenders will be in a stronger position to capture a rare opportunity to distinguish their programmes from their peers (Figure 2).²⁴

PRACTICAL GUIDANCE TO COMPLIANCE PERSONNEL

Based on long experience in the investment banking industry and compliance management in the financial industry, it is suggested that compliance personnel should monitor the securities lending process in the pre and post-transaction processes in the following areas:

— **Sanctions monitoring:** ensuring that not only the lender and borrower —

considered to be legal entities or private persons — are constantly screened, but also the securities that are part of the transactions. This must be part of the pre-contractual process (KYL, KYB and know your customer [KYC]) and during the contract life cycle and, if required, compliance personnel should alert the responsible and involved business units accordingly.

— **ESG data preferences of the lender and borrower:** in general, investment firms should first identify, define and understand ESG preferences based on regulatory (eg EU SFDR) and industry standards (eg EU European ESG Template [EET]), reflected in the investment firms' ESG questionnaires and IT systems, for example customer relationship management (CRM) and core banking systems. Secondly, that the lending transaction matches with these preferences during the entire life cycle of the transaction.

- **ESG factors on issuers and securities:** define and introduce a process ensuring that the ESG indicators are sourced on issuer and security levels. Furthermore, it is important to monitor any severe change (according to the lender/borrower preferences) in these indicators, and in the case of such change to alert the relevant business units and trigger required actions — eg in the case of positive developments, the modification of transactions such as reduction of credit spreads and in the case of negative developments, the cancellation/offset of the transaction.
- **Involvement in projects:** it is highly recommended that the compliance team is involved in all internal ESG and securities lending projects, ensuring that the compliance requirements are part of the project permanently, as that will ensure a compliant implementation.

CONCLUSION

Looking into the ESG global regulatory framework, academic literature, surveys and discussions, it is obvious that ESG considerations will find their way into the securities lending business.

It requires combining the objectives/purposes of securities lending with the efforts to transform the financial industry to becoming sustainable. Issuers, lenders and borrowers of financial instruments will investigate the environmental, social and governance footprint of their investment processes and decisions in order to avoid the risk of dealing with stranded assets that are difficult to sell.

Due to the absence of global ESG and securities lending standards and regulations, the securities lending industry is adapting ESG in the securities lending processes by defining criteria for:

- approved counterparties;
- restrictions;
- accepting collateral;

- recalling for proxy voting;
- rules for reinvestments.

There are no specific regulations covering ESG in securities lending. However, the regulatory base is there. Now, it is time to get the most out of it and bring the different regulatory initiatives together in a more holistic way. Therefore, the industry bodies all over the world — eg RMA, ISLA, PASLA — are in the driving seat to set standards for efficiently implementing ESG considerations in the securities lending process.

Data generation, collection, enrichment, processing and distribution on time and at top quality will be the key factors for the integration of ESG in the securities lending process.

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