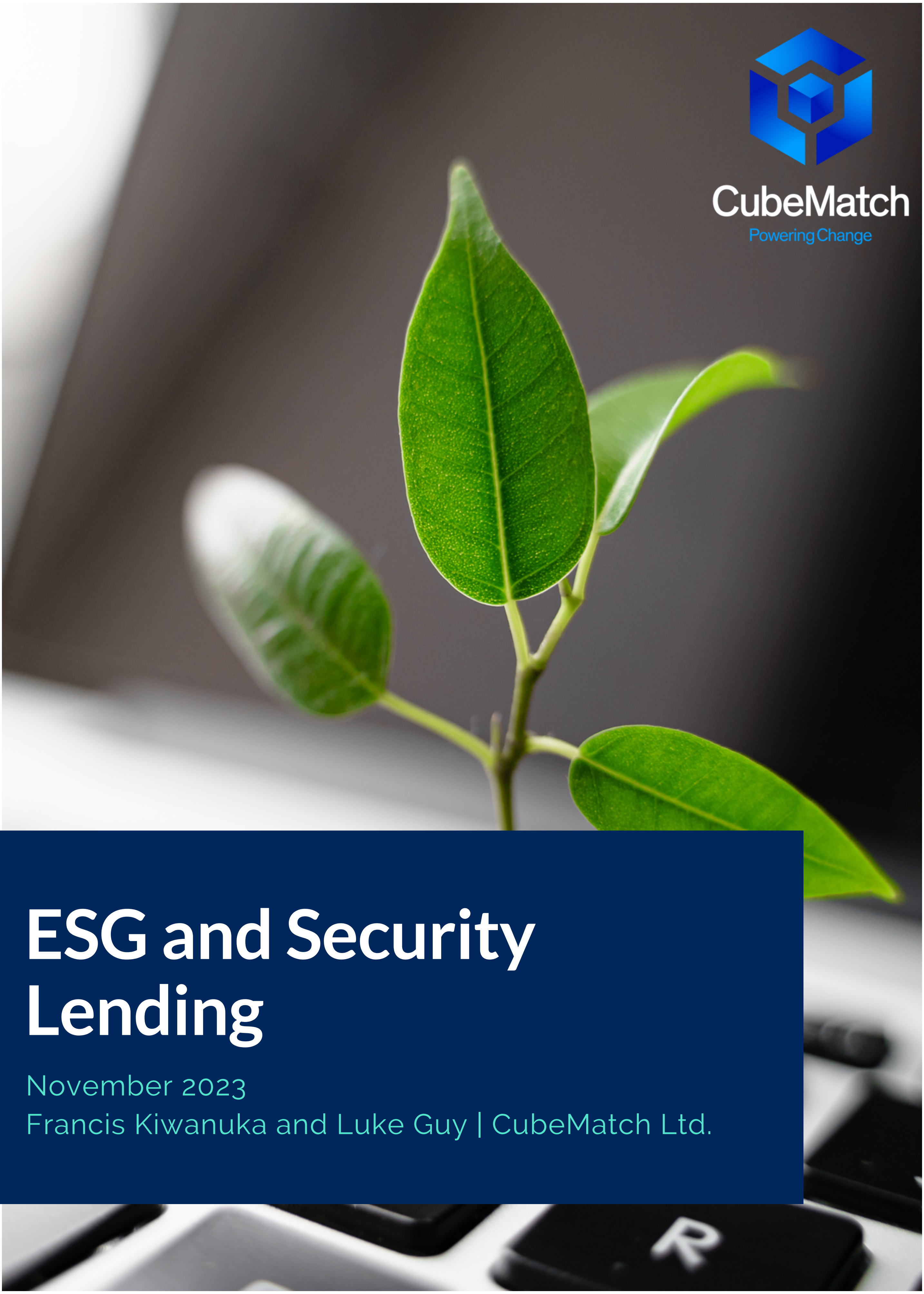

ESG and Security Lending

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Francis Kiwanuka and Luke Guy | CubeMatch Ltd.

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INTRODUCTION

Organisations in the finance industry are becoming more aware of the climate-related financial risks they are increasingly facing. The securities lending market has several mechanisms in place to protect the security owner from these risks.

Given the notable high value of securities on loan, which was estimated to be $3.1 trillion at the end of September 2021, this sub industry also has a certain responsibility when it comes to making their transactions and use of securities as ESG-friendly as possible.

INTRODUCTION OF GASLA AND THEIR UPDATED ESG RECOMMENDATIONS

The Global Alliance of Securities Lending Associations (GASLA) manages the Global Framework for ESG and Securities Lending (GFESL), which evaluates securities lending in the context of financial institutions' ESG policies. The GFESL highlights the most critical factors to consider at the five main intersections of securities finance and ESG. These touchpoints include voting rights, collateral, lending over record dates, facilitating participation in the short side of the market, and transparency in the lending chain.

GFESL RECOMMENDATIONS FOR LENDERS OF SECURITIES[1]

a. Voting rights:

Lenders should develop a recall policy for their securities lending programme that is communicated to their agent lender. It is currently not standard practice for lenders to recall all lent securities before every corporate event. Instead, it is pragmatic for lenders to evaluate the materiality of the vote versus the potential securities lending revenues that would be foregone when making decisions on whether to recall securities or lend them.

There is currently a lack of consistent and timely information regarding proxy record dates in several markets. Limited data on voting dates and AGM agendas is a challenge at present.

The GASLA recommends the following steps to establish an ESG-based recalling system:

1. Recall policy: Assess or develop a recall policy based on ESG considerations in a proxy voting framework.
2. Materiality: Identify the types of resolutions on which to vote, by company and by issue.
3. Defining parameters: Set out any other parameters that would trigger a recall or the restriction of lending, such as a significant ESG-related vote. Decisions may require the use of specialist ESG teams/advisors.

1. https://www.islaemea.org/wp-content/uploads/2023/03/Global-Framework-for-ESG-and-Securities-LendingGFESL_GASLA_Second-Edition_7-March-2023.pdf

4. Impact: Consider whether the voting outcome would result in material financial or non-financial impact to the lender.
5. Minimum standards: Consider setting a minimum standard framework for proxy recalls, depending on market and liquidity conditions.
6. Title: When wishing to vote, lenders should ensure they have title to all securities in scope, which may require initiating a recall through the agent lender.

b. Non-cash collateral, cash reinvestment and reuse:

While GASLA considers it essential that ESG-related risks should be considered in all aspects of an asset owner or managers' investment portfolio, it should be recognised that collateral guidelines be adequately diversified with a key aim of properly mitigating credit risk, as well as ensuring collateral is liquid and can be realised in the event of default. This approach will assist in mitigating the risk of creating stranded assets in the market and support an orderly transition in respect of environmental factors in particular.

Where lenders wish to embed ESG principles into their collateral management, they should work with their credit teams and ESG specialists in setting acceptable tolerance levels and evaluating appropriate diversification of collateral guidelines. Lenders should then ensure clear communication of their tolerance levels and collateral requirements to agents and collateral managers, where applicable.

Lenders and agents may use third party ESG data providers to evaluate collateral through an ESG lens. Lenders should understand the methodologies utilised by the ESG data provider to determine whether these meet the requirements of their own sustainable investment policies.

Lenders may seek to establish alignment between their own ESG guidelines that govern their core investment portfolio and their approach to cash re-investment. In the EU, lenders should consider the extent to which they may be subject to the disclosure requirements of the Sustainable Finance Disclosure Regulation (SFDR).

c. Lending over record date:

Securities lending involves multiple jurisdictions, which can result in varying tax obligations for the participants involved in the lending process. Therefore, lenders should ensure compliance with both the letter and spirit of the law regarding tax-related regulations and initiatives across global jurisdictions.

d. Facilitating participation in the short side of the market:

Aside from its positive impact on price discovery and market liquidity, short selling can create a positive ESG impact. For instance, the successful short selling of high emitting companies' stock makes two key impacts:

- Hedge against carbon risks, lowering the investment fund's overall exposure to loss of value caused by carbon risk.
- If performed by enough market participants, short selling can increase the cost of capital for the targeted issuer, thus incentivising that issuer to protect itself against carbon risks by actively transitioning its business model to be less carbon-intensive.[2]

e. Transparency in the lending chain:

The aim of GASLA is to provide regulators and issuers with the necessary transparency regarding securities lending. Lenders, through their agents, can adopt a set of minimum standards that align with their corporate sustainability framework when selecting their direct counterparties. This will help them integrate their ESG policies into their approved borrower lists.

CONCLUSION

Through these mechanisms, security lenders can achieve climate risk mitigation while also protecting our society from unsustainable practices as a whole.

With upcoming and increasingly stricter disclosure regulation, financial institutions in this industry should get a head start on establishing ESG-friendly security lending practices and policies.

2. https://esgclarity.com/how-can-short-selling-help-hedge-against-esg-risks/

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CubeMatch is an international brand continuously expanding with **six offices** worldwide : **Dublin, London, Amsterdam, Frankfurt, Singapore and Chennai**. Combining our world class expertise in Financial Services with our rich capabilities in all aspects of change and transformation, we apply a **Multiplier Effect**, helping clients to be more effective today while creating value for tomorrow.

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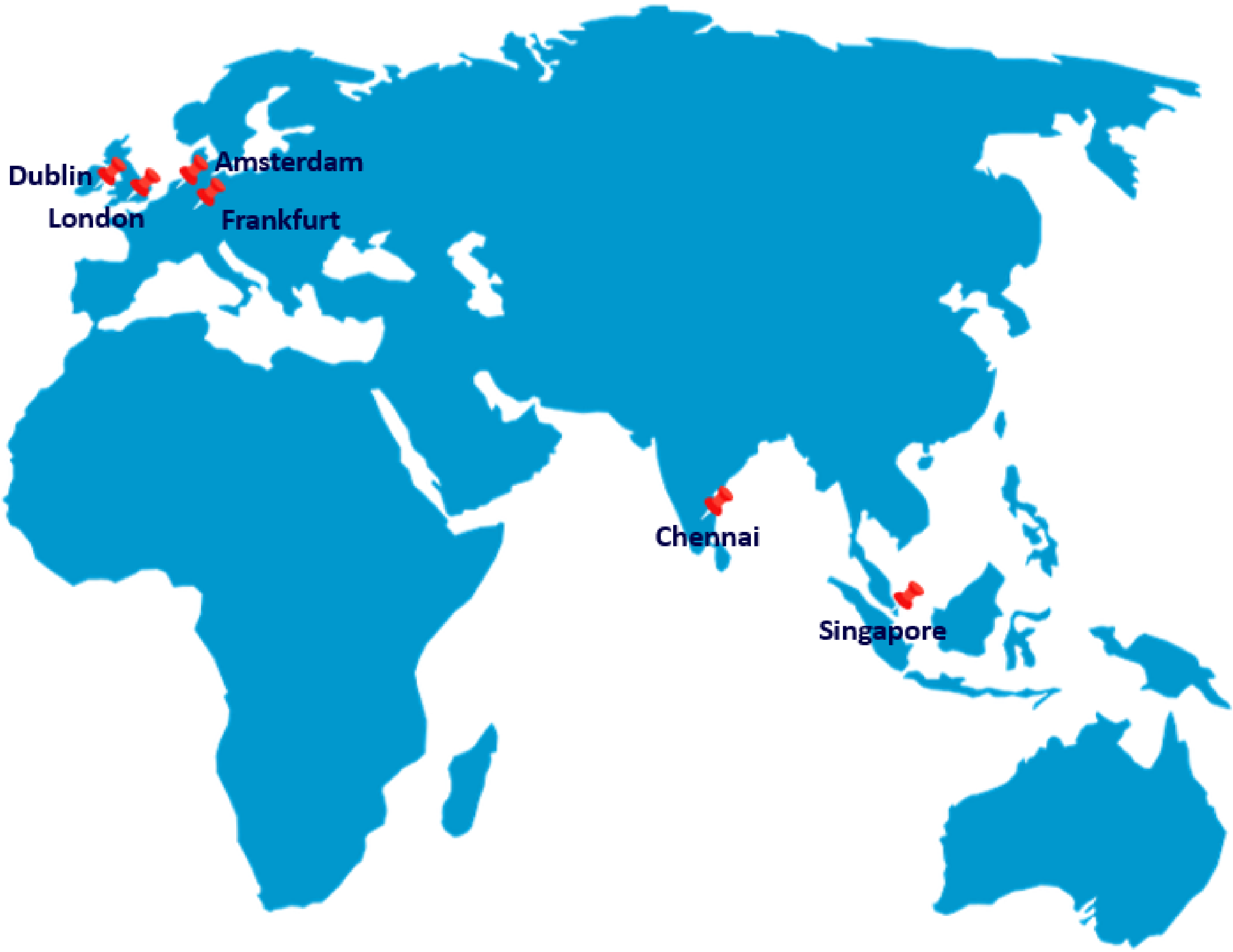

CubeMatch (Ireland) Ltd
+353 1 253 0020
Ireland@cubematch.com

CubeMatch Ltd (UK)
+44 20 3004 8098
UnitedKingdom@cubematch.com

CubeMatch B.V. (Benelux)
+31 20 312 0404
Benelux@cubematch.com

Other Locations
CubeMatch GmbH (Germany): Germany@cubematch.com
CubeMatch APAC Pte Ltd (Singapore): Singapore@cubematch.com
CubeMatch Claritaz (India): India@cubematch.com

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