The road ahead

All industries have been faced with the need to integrate environmental, social and governance (ESG) policies in everything they do. Securities lending has also had to tackle the issue. What are some of the unique considerations that this industry is faced with?

Global Investor speaks to **Ina Budh-Raja,** EMEA Head of Product & Strategy Securities Finance & Markets ESG, BNY Mellon

We have seen interest in and uptake of ESG accelerate over the last couple of years across the financial services industry. Our industry, securities lending, is no different: we are having the same conversations about the sustainable agenda and about embedding sustainability in what we do. In that context, there is a lot of debate about how securities lending should operate in this new environment.

I would start by saying that in securities lending, the transaction itself is not a sustainable product or part of one - it is a key component of capital markets infrastructure that supports trading and financing by providing liquidity. As such, you need to look at different points in the securities financing chain to see where they intersect with ESG.

Take collateral as an example. An asset owner will consider ESG factors when constructing its long portfolio. There will be bespoke ESG requirements, depending on the focus and principles that are set in-house, and they will apply that strategy to their loan portfolio. But when it comes to collateral, how should they consider ESG? The question has arisen as to whether asset owners should apply their long portfolio ESG strategy to collateral, or whether they should develop a separate ESG strategy specific to collateral, given that collateral is not a long holding.

A specific situation arises when a party receives the collateral in a securities lending contract: they don't get the related voting rights. In practice, it's a temporary transfer with a primary purpose of risk mitigation.

One issue we are faced with is reconciling this situation with the increasing focus by regulators and asset owners on the need to be active stewards and drive change through engagement with corporates. There is a strong emphasis by regulators, particularly in the UK and the EU, on engagement and voting stewardship rather than on the more direct approach of divestiture. Asset owners should not simply divest interests in lower rated ESG securities, and potentially create liquidity issues around particular stocks and stranded assets. Rather, they are being encouraged to actively engage and vote to push that transition.

But the question that we're addressing as an industry remains: when you're lending out securities, are you able to vote? The answer is: absolutely, you can vote on the securities, you will not lose the right to vote. However, you need to recall your securities, and develop

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a thoughtful approach to an ESG policy around recalling for voting purposes. You also need to be working closely with your agent lender, to communicate that so that so those policies are well understood and flowing through your agency lending programme.

As an agent lender, we're certainly very conscious of this and working closely with our clients to understand their ESG policies, including how they approach voting and recall processes.

How advanced are market participants engaging in securities financing in the integration of ESG standards to lending programmes?

It's very much a journey and many asset owners are still in the earlier stages. The whole ESG topic is a long-term journey.

Part of our role as agent lender is to work with clients so that we're helping them execute their ESG strategies as they engage in securities lending. Securities lending is an important tool for the capital markets, and it should happen smoothly without impeding the asset owners' ability to vote and engage. It's also vital to the general financial market infrastructure and supports market integrity, price discovery and liquidity. This last point is important as it underpins the success of the sustainable agenda.

It's critical for us as agents to understand the appetite that a particular asset owner has for ESG and to be able to respond to that in the investment process and on the lending side.

A fundamental focus for BNY Mellon, as agent lender, is transparency: giving clients reliable and transparent data on their securities, collateral and cash investments so that they're able to assess their lending programme from an ESG lens. That lens will be different for each asset owner but all of them must have that visibility, so they are empowered to make informed decisions to fulfil their fiduciary duties, including the duty to generate revenue for their underlying investors, alongside incorporating ESG factors appropriately.

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There is a plethora of standards and initiatives that has been developed to formalise ESG standards. What is the situation for the securities lending space?

We have seen many initiatives develop rapidly over the last couple of years and an increasing uptake of those initiatives from the market.

Two years ago, we were seeing several different nascent frameworks with regional differences - both regulatory and voluntary initiatives. We've seen the TCFD [Task Force on Climate-Related Financial Disclosures developed by the Financial Stability Board], for example, being very foundational. More recently, we've seen the IFRS Foundation's International Sustainability Standards Board [ISSB] which are intended to foster further harmonisation of standards that can be applied on a global basis. A very positive move has been the drive by organisations to create a harmonised approach globally with some necessary regional nuances.

Focusing on the intersections of ESG with securities lending, some aspects that need to be taken into consideration include transparency, purpose for lending and borrowing, collateral, cash reinvestment and proxy voting.

As an industry, we have set up working groups through the various regional trade associations to develop best practice for ESG. Given the breadth and global reach of ESG, it's one of those topics without borders that needs to be considered in a collaborative way across regions.

I am directly involved as I sit on the International Securities Lending Association's [ISLA] board of directors and co-chair its ESG Steering Committee. Alongside other regional trade associations, we formed the Global Alliance of Securities Lending Associations [GASLA] in September 2021: part of its mandate is to advocate for harmonised standards and promote best practice for ESG across our industry. This initiative has been so well received because it provides a continuous discussion forum on the touch points between securities lending and ESG. The intention is to create a best practice framework that is not prescriptive, but takes lenders through various considerations that they may want to apply when making decisions about their lending programmes.

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The initiative also reflects the specificities of the industry. Generally, ESG policies are being developed at a corporate level, and then permeated through organisations, to be embedded within the individual lines of business including the securities lending product. But those corporate level policies do not necessarily consider the specifics of securities lending at the outset. The intention is to drive best practice and encourage asset owners to think through some of the issues I highlighted earlier: voting and active engagement, while remaining a lender of securities and driving revenue for underlying investors, and; considering necessary ESG requirements applicable to collateral, while at the same time, balancing the need to adequately diversify collateral and mitigate risk, which is the primary purpose of that collateral.

Through the ISLA ESG Steering Committee, the industry has also been engaging with the United Nations' PRI [Principles for Responsible Investment] and various voluntary green-labelling bodies in the UK and EU. We've received resoundingly positive feedback from them on the compatibility of securities lending with ESG. This is a big step forward.

The fundamental point for us goes back to ensuring that securities lending operates in support of and harmoniously with the ESG landscape and is not inadvertently constrained, as it is a critical tool for market liquidity and market efficiency and therefore vital to support the broader sustainable finance agenda.

What are some of the typical questions clients who lend their assets out ask you when it comes to ESG? Are there some recurring themes that you're seeing?

Absolutely, some themes are emerging, and, as I said, this really is a journey. Currently, a question I get asked regularly is: can we vote on the securities that we own if they're on loan, what's the recall process, and how reliable is it? Lenders are keen to understand that they can vote for any purpose that they feel is important to them so that there aren't restrictions on recall and we're seeing there are some ESG topics upon which lenders will chose to prioritise voting over the lending revenue.

On the collateral side, we're starting to see more questions around collateral eligibility. We're not seeing collateral being fragmented at this stage – however, lenders want to understand what their collateral looks like from an ESG standpoint. The demand at this point is around transparency; there is generally an understanding that collateral needs to be broad enough to mitigate risk, but at the same time, lenders need to embed their broader ESG policies, so visibility into the ESG metrics around collateral is important to evidence alignment with board-level ESG priorities. ■

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Ina Budh-Raja

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Ina Budh-Raja has been BNY Mellon's Head of Product & Strategy Securities Finance & Markets for EMEA since October 2018, responsible for regulatory strategy and ESG product development for securities finance. In her capacity as member of the BNYM ESG Corporate strategy team, she co-leads the BNYM ESG Partnership Strategy and is co-chair of BNYM's Global Markets ESG working group.

She previously spent nearly 15 years at State Street in various roles, including as Head of Regulatory Affairs for Securities Finance, EMEA and, most recently, as Managing Director - Global Markets EMEA Head of Regulatory Strategy until her departure from the bank in 2018. She also previously worked at Deutsche Bank as legal counsel.

Ina also sits on the International Securities Lending Association's board of directors and is chair its ESG committee. She also is part of the Bank of England's Money Markets Committee, the Securities Lending Committee and is Co-Chair of the Money Markets Code Sub-Committee.

She is Co-Chair of the London Chapter of the Women in Securities Finance group, created in 2018 promote the advancement of women in the securities finance industry.

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