ISLA INTERNATIONAL SECURITIES LENDING ASSOCIATION

ALLEN & OVERY

Applicability of ESG to Collateral in the Securities Lending Context

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Contents

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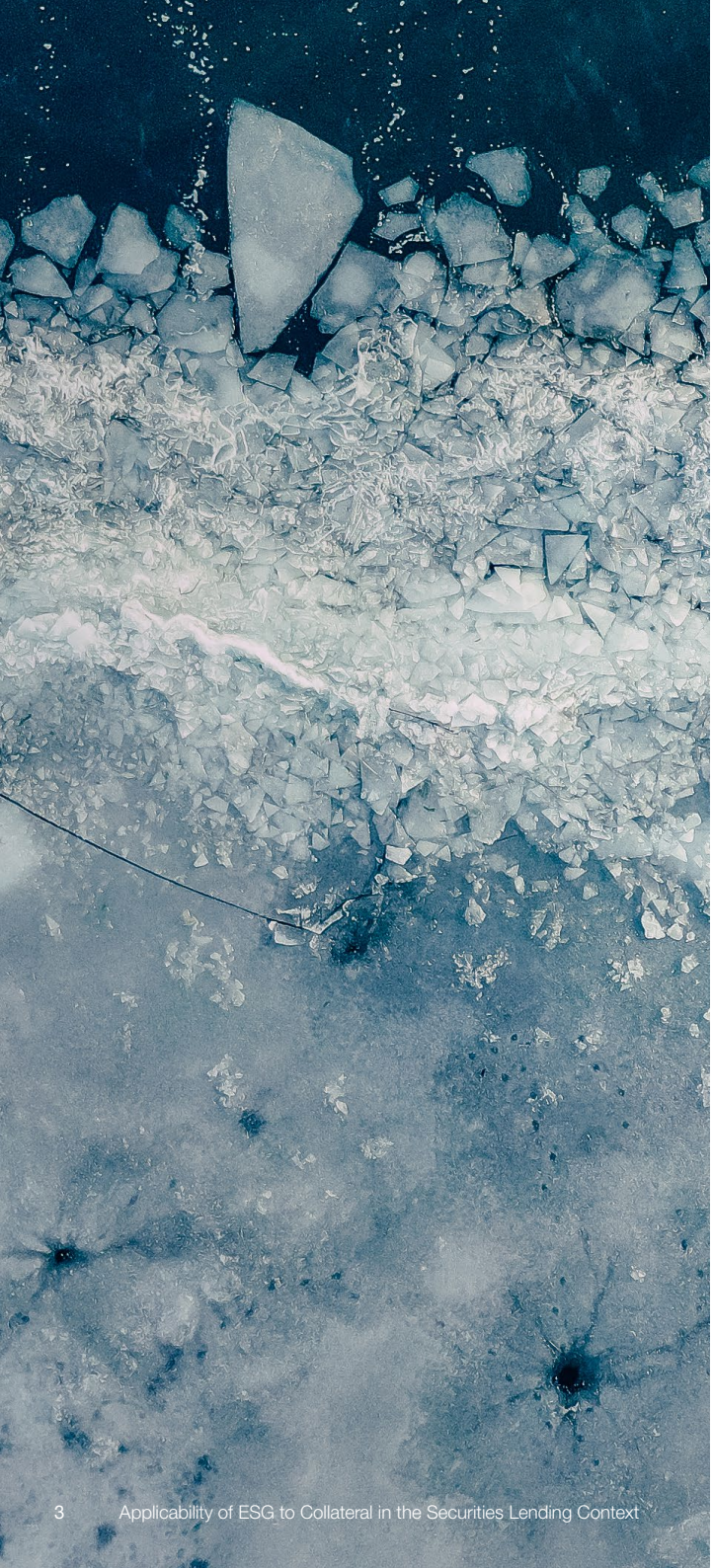


1. Introduction

Market participants are currently under increasing pressure to incorporate environmental, social and governance (**ESG**) factors into all aspects of their financial activities.[1] This includes asset managers, who are being encouraged by regulators to incorporate ESG factors across their portfolios and, by extension, to their securities lending activities.

There are a number of factors to consider when deciding whether and how to apply ESG policies to securities lending in practice. Indeed, whilst ESG regulation may apply to securities lending businesses in certain circumstances, regulatory materials published in the European Union (**EU**) and the United Kingdom (**UK**) to date (bar a Financial Conduct Authority (**FCA**) discussion paper – as to which, see further below) do not directly reference the sustainability treatment of securities lending transactions. Climate financial risk and other sustainability risk considerations will often already be factored effectively into securities lending activities (including the acceptability framework for collateral) as a result of supervisory expectations (including emerging prudential supervisory requirements).[2] ESG standards applicable to collateral selection may also be further refined through investor/owner-led requirements. However, there is no specific guidance or indication in respect of how collateral posted in the context of securities lending transactions should be categorised or treated for sustainability purposes including whether collateral should be subject to the same sustainability standards as the securities lent. This question is also of wider relevance in the context of other markets, such as the derivatives and repo markets. Such absence of specific guidance has resulted in a lack of clarity and consistency in the market,[3] in particular with respect to collateral and the extent to which ESG policies should play a role in governing it.

Given the current uncertainty in the market, ISLA considered it helpful to examine whether in a securities lending context, collateral, which is primarily a risk management tool, should integrate the same level of ESG screening as the remainder of an entity's portfolio or whether it is pragmatic to apply a broader view with respect to collateral to ensure proper risk management.[4] In doing so, this discussion paper sets out the key arguments in detail in Section 4 (Discussion points), whilst including additional relevant background in Appendix 1 (Background to securities lending) and Appendix 2 (How does ESG regulation apply to collateral in securities lending transactions).

[1] This pressure may stem from a number of sources, including coordinated global action such as COP26 and regional or national political pressure, as well as pressure from clients, shareholders, investors and industry more generally.

[2] For example, the ECB prudential guidelines or the PRA prudential guidelines on climate risk.

[3] For example, whilst some asset managers apply negative exclusions to their acceptable collateral guidelines in relation to certain sectors (eg fossil fuels, tobacco, etc), others apply thresholds of acceptable limits or other risk-based approaches to align their eligible collateral guidelines with internal ESG policies.

[4] Certain of the challenges regarding the application of ESG policies to collateral selection are explored in further detail in the "*Collateral and cash reinvestment selection*" section of ISLA's and Allen & Overy's White Paper published in March 2021 entitled "*Framing securities lending for the sustainability era*" (the ISLA March White Paper). Extracts from the ISLA March White Paper are included in this discussion paper.

2. Executive summary

The industry is increasingly factoring climate financial risk and other sustainability risk considerations into collateral selection. However, any new ESG criteria applicable to collateral selection must not result in a collateral set which is too narrow as this could disrupt financial stability and liquidity as well as the ultimate goal of an orderly transition process to a sustainable economy.

The paper submits the primary role of collateral is as a risk management tool for the market. It therefore remains vital to ensure adequate diversification of collateral guidelines. Accordingly, the risk analysis for collateral acceptability should continue to take into account all relevant risks, including, but not limited to, sustainability and ESG risks.

The securities lending industry is in a transition phase. Instead of implementing exclusion policies or narrow lists of favoured collateral assets with potentially adverse impacts on risk management and market stability, ISLA considers that appropriate, achievable guidance from regulators and central banks in relation to securities lending and collateral would help to accelerate market participants to the next stage of the path to net zero.

The paper therefore concludes by noting that ISLA considers that the following confirmation/guidance from regulators and central banks in relation to securities lending and collateral would be useful:

– as an investment tool, securities lending transactions (including any associated collateral) do not constitute sustainable investments in their own right, even though they can successfully integrate the sustainability preferences of the lender/asset owner;

– collateral, as a risk management tool, does not need to integrate the same level of ESG screening as the long portfolio of the fund. Eligible collateral guidelines should intentionally constitute broader and more liquid parameters, in order to effectively manage risk; and

– recommended best practice (ideally endorsing industry-led recommendations), as to how businesses that engage in securities lending can convey their incorporation of sustainability factors into collateral eligibility criteria.

3. The role of securities lending in the transition to a sustainable economy

This discussion paper takes as its starting point the argument that "when viewed holistically, securities lending can be seen as playing an important role in creating long-term stability of the capital markets, which will be critical to the successful transition of the economy to a more sustainable basis [...] but also in assisting with individual ESG investment strategies."[5] ISLA believes that securities lending can act as a capital facilitator or ancillary service[6] that will be required for the transition to net zero and other sustainability objectives.

As discussed in the ISLA March White Paper, the cost of transitioning to a sustainable economy is enormous:

> "The OECD predicted in 2017 that USD 9.6 trillion a year is needed to meet the Paris Agreement goals and UN Sustainable Development Goals. The costs of the transition to net zero are beyond the means of public finance alone. Private funding and private investment will be critical and well-functioning capital markets are essential to generate that funding. Securities lending and the related practice of short selling play an important role in those markets."

[5] For further detail as to the arguments underpinning this statement, see the ISLA March White Paper.

[6] As distinct from derivatives that can be used as an investment strategy that can achieve a sustainable outcome.

Securities lending has long been used as a means of meeting settlement and collateral requirements, as well as providing vital liquidity and efficiency to secondary markets. It also promotes price discovery and market making, as well as facilitating important hedging and investment strategies, such as short selling. In fact, many central banks across the globe use securities lending as part of their implementation of monetary policy, which helps financial markets function more smoothly. As of December 2021, total securities on loan was EUR 2.4tn, with EUR 24tn of securities being made available for securities lending by institutional investors.[7]

As noted by the European Securities and Markets Authority (**ESMA**)[8], securities lending and short selling are key to price discovery and market liquidity. Short selling assists with incorporation of negative information into market prices more quickly, reducing the risk of price bubbles.[9] The evidence suggests that restricting short selling reduces liquidity[10] as well as significantly increasing the costs of liquidity.[11]

Securities lending and short selling might also contribute to market stability. Research shows that markets might be more volatile where short sales are banned.[12]

In line with the aims of the Capital Markets Union (**CMU**), securities lending helps create a more resilient economy, which in turn will help the EU deliver on its objectives under the European Green Deal.

Securities lending is also used as a valuable tool in the mobilisation of collateral, including High Quality Liquid Assets (**HQLA**), within the financial ecosystem. The efficient mobilisation of collateral is important, not only in the context of the smooth running of traditionally collateralised markets such as securities lending and repo, but collateral increasingly underpins many derivatives markets.[13]

As indicated, climate financial risk and other sustainability risk considerations will often already be factored effectively into securities lending activities (including the acceptability framework for collateral). It is therefore vital that collateral in a securities lending transaction is able to continue to fulfil the function it is intended for – effectively managing risk. Otherwise the role that securities lending can play in the transition to net zero may be hindered.

[7] ISLA (2022), Securities Lending Market Report, 16th ed. p.6.

[8] ESMA (2019), Report on undue short-term pressure on corporations ESMA30-22-762, para. 308.

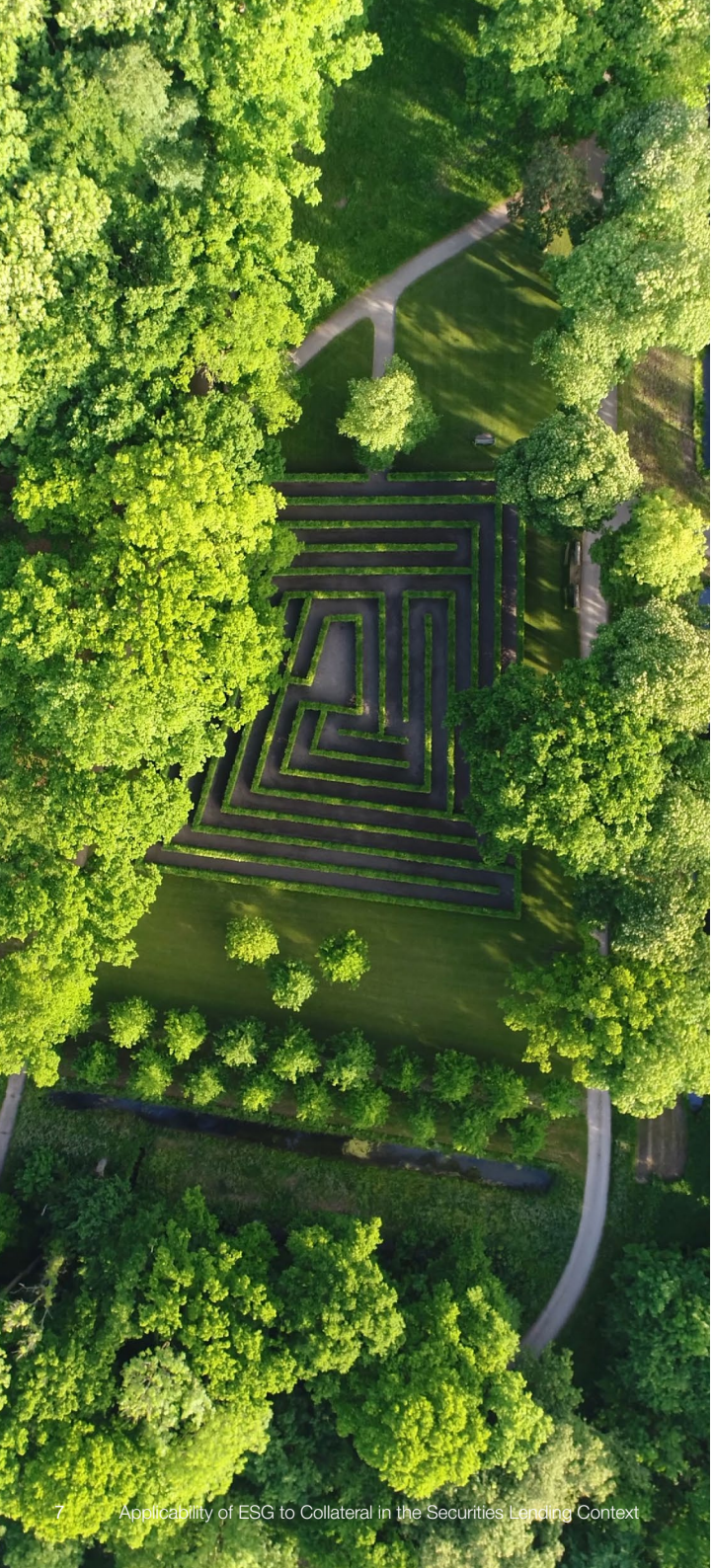
[9] Boehmer E and Wu J (2012), Short Selling and the Price Discovery Process. Review of Financial Studies; Bris A, Goetzmann W and Zhu N (2003 updated to 2009), Efficiency and the Bear: Short sales and markets around the world, National Bureau of Economic Research Working Paper.

[10] Beber A and Pagano M (2011), Short-Selling Bans Around the World: Evidence from the 2007-09 Crisis, Journal of Finance.

[11] Battalio R, Mehran H and Schultz P (2011), Market declines: is banning short selling the solution?, Federal Reserve Bank of New York Staff Report.

[12] Beber A, Fabbri D, Pagano M and Simonelli S (2020), Short selling bans and bank stability, European Systemic Risk Board.

[13] See the ISLA March White Paper for further details, including on the role of securities lending in the transition to a sustainable economy.



4. Discussion points

This section of the paper discusses a number of issues with respect to the question of whether the ESG screening applicable to the selection of collateral in the securities lending context should match the ESG screening applicable to the long holding of the fund or whether it is pragmatic to apply a broader view with respect to collateral to ensure proper risk management. It then goes on to discuss the regulatory guidance/endorsement of industry best practice that would be useful to enable businesses that engage in securities lending to be confident that their approach to collateral selection is aligned with regulatory expectations.

4.1 Lender's long holdings versus securities lending collateral requirements – feasibility of applying the same ESG parameters?

Currently, as indicated above, whilst increasingly climate risk and other sustainability risk considerations are factored effectively into securities lending activities, there remains a lack of clarity and consistency on the extent to which ESG policies and regulations should apply to collateral. This uncertainty is leading some market participants to apply the ESG parameters set in respect of their long holdings to securities lending collateral requirements. However, other market participants have previously noted that this approach may be too restrictive, threaten liquidity and risk undermining the primary purpose of the collateral to mitigate credit risk. Ultimately, the market would benefit from regulatory certainty on this issue, indicating the extent to which ESG risks are to be considered with respect to collateral, whilst ensuring that the primary purpose of the collateral to mitigate credit risk is not undermined.

As introduced in section 1 above, it has been common practice for certain asset managers to apply negative exclusions to their acceptable collateral guidelines, in relation to certain types of industry sectors (such as fossil fuels and tobacco), whilst others apply threshold limits to various sectors. Some asset managers and agents have also adopted ESG screening requirements and/or systems for collateral assets by leveraging access to third party ESG data analytics.

However, given the current lack of regulatory certainty on the treatment of collateral under ESG-related regulations globally,[14] and decreasing support for reliance on negative exclusions and divestment strategies, asset managers are increasingly taking a risk-based approach to align their eligible collateral guidelines with the ESG parameters in respect of their long holdings.

[14] As discussed in Appendix 2, securities lending per se is not currently one of the activities specifically regulated under sustainability regulation. The full range of supervisory, regulatory and legal obligations applying to any securities lending arrangement and market participant will be fact dependent. For example, some firms may be expected to consider the climate or environmental financial risk associated with these activities under prudential supervisory expectations. In all cases, specific advice should be obtained.

This risk-based approach is driven by internal corporate principles and policies, as well concerns around reputational risks and the regulatory focus on preventing "greenwashing".[15] For example, in September 2021, the UK Competition and Markets Authority published a Green Claims Code to provide practical guidance for businesses to help them ensure any environmental claims do not fall foul of regulatory expectations. The code provides six key principles, including that claims must be truthful and accurate, clear and unambiguous and claims must not omit or hide any important relevant information.[16] The European Commission also recently published guidance on the application of the Unfair Commercial Practices Directive[17] to sustainability and environmental claims. Further detail applies, but the main principle of the guidance is that green claims[18] in the context of business-to-consumer relations must be truthful, not contain false information and be presented in a clear, specific, accurate and unambiguous manner, so that consumers are not mislead. It may, therefore, be possible to argue that greenwashing risk can be acceptably dealt with through disclosure in relevant product documentation to ensure the position is clear. The prominence of this may also have to be proportionate to the circumstances to mitigate the risk of investors being misled in practice. Alternatively or in addition, negative screens could be used to avoid collateral being held in certain investments or asset classes that may be viewed as particularly problematic from an ESG perspective. Nonetheless, in the absence of clear regulatory guidance, the risk of regulatory sanction, as well as reputational and litigation risk, may deter market participants from accepting a broader collateral range.

However, whilst it is recognised that sustainability should be embedded into the acceptability framework for collateral, some market participants have noted that aligning the ESG parameters applicable to the long holding of the fund to securities lending collateral can be problematic. They argue that the ESG parameters applicable to collateral need to be broader than those applicable to the long holding of the fund in order for collateral to serve its primary purpose of credit risk mitigation. For example, if the fund is investing in an ESG equity index, it is not necessary, or appropriate, for securities lending collateral also to be limited to ESG compatible equities. It may, however, be appropriate to apply some of the same standards they apply to their portfolio investment activity to collateral (eg to exclude certain controversial sectors). By adopting a broader acceptable collateral schedule, lenders are able to diversify their risk effectively. This approach, balancing competing policy objectives, is in line with that previously identified by regulators in the context of collateral received by a UCITS.[19]

Taking into account the above arguments, for collateral to continue to serve as an effective risk management tool for the market, the risk analysis for collateral acceptability in ESG securities lending must consider all relevant risks. Indeed, sustainability and ESG related risks must be (and to an increasing extent already are) taken into account. In parallel however, collateral guidelines should also be adequately diversified with a key aim of properly mitigating credit risk and ensuring collateral is liquid and can be realised in the event of default, thereby providing the lender with effective protection against counterparty exposure.

4.2 The nature of securities lending – an investment tool, not a direct investment in itself

There are good arguments for distinguishing the ESG parameters applicable to securities lending, as an investment tool, from those applicable to the direct investments of a fund. Arguably securities lending (including any associated collateral) should not be considered comparable to derivatives in the context of ESG. Derivatives can be used as an investment strategy that can achieve a sustainable outcome, for example, trading a sustainability-linked derivative.

By contrast, securities lending is an ancillary service, or an investment tool, whose purpose is to assist investment managers with their investment strategies, as opposed to constituting a direct investment in itself.[20] As indicated in section 3 above, securities lending acts as a capital facilitator that will be required for the transition to net zero and other sustainability objectives. As an ancillary service or investment tool as opposed to a direct investment, arguably it is appropriate that the ESG parameters applicable to collateral in a securities lending context, are distinct from the ESG parameters applicable to the long holding, or direct investments of a fund.

[15] "Greenwashing" is the practice of conveying a false or misleading impression in respect of the ESG performance of a financial product in order to gain a competitive advantage.

[16] See the Allen & Overy LLP bulletin "Greenwashing – key risks and issues in financial services" for additional background on legislative and regulatory initiatives intended to prevent or mitigate the risk of greenwashing.

[17] Directive 2005/29/EC.

[18] The expressions 'environmental claims' and 'green claims' refer to the practice of suggesting or otherwise creating the impression (in a commercial communication, marketing or advertising) that a good or a service has a positive or no impact on the environment or is less damaging to the environment than competing goods or services. This may be due to its composition, how it has been manufactured, how it can be disposed of and the reduction in energy or pollution expected from its use. When such claims are not true or cannot be verified, this practice is often called 'greenwashing'. The coordinated screening of websites ('sweep') that the Commission and national consumer authorities carried out in 2020 confirmed the prevalence of vague, exaggerated, false or deceptive green claims.

[19] See, for example: here.

[20] See ISLA's response to FCA Discussion Paper 21/4 for additional background on this argument.

4.3 The nature of collateral – distinct from the lender's assets?

Whilst it is recognised that sustainability should be embedded into the acceptability framework for collateral, arguably collateral should not be subject to the same ESG parameters as the long assets of the fund both because it serves a different primary purpose (credit risk mitigation) and because collateral does not form part of the fund's assets, to the full extent of the portfolio assets.

As indicated in Appendix 1 (Background to securities lending), in the context of a title transfer securities lending arrangement, full legal ownership and beneficial interest in the collateral is transferred to the lender. However, this is only a temporary transfer as the lender has an obligation to return equivalent collateral in accordance with margining mechanics if the value of the collateral or the loaned securities fluctuates in favour of the borrower and at the end of the transaction. Upon a borrower event of default, a lender will typically liquidate the collateral immediately and use the proceeds to buy back their original loaned securities in the market or equivalent securities. Whilst legal and beneficial interest in the collateral passes to the lender, it does not have the same exposure to those assets as to the assets in its long portfolio, given interest on cash collateral is passed on to the borrower[21] and income and capital benefits which accrue on the collateral are made available to the borrower when the stock is returned. This is because the primary purpose of the collateral is credit risk mitigation to protect against the default of the borrower.

Where a lender acts through an agent, which is common in practice, the lender is unlikely to ever take possession of the collateral itself. As indicated above, the agent will typically: (i) reinvest cash collateral into a cash reinvestment vehicle in accordance with the lender's guidelines; and (ii) not rehypothecate non-cash collateral but hold it separately on behalf of the lender. Many agents offer lenders varying levels of indemnification. The agent indemnity[22] often means that upon a default, the agent will liquidate the collateral, passing the cash equivalent to the lender (making up any insufficiency with its own capital), such that the likelihood of the lender taking ownership of the collateral, even on a default, is low. Typically, in the agency lending scenario, the lender will agree contractually not to take control of or deal in the collateral during the lifecycle of the transaction and furthermore, will agree with the agent that any close out and liquidation process upon counterparty default, will be conducted by the agent, with the lender receiving proceeds from the liquidation of collateral, as opposed to the collateral itself.

It has been argued that in a pledge structure, collateral is even further removed from the fund's assets as legal title to the collateral remains with the borrower. Dividends or distributions received on collateral are added to the collateral pool and there are no manufactured payments in respect of them. Under a pledge structure, the lender is not entitled to rehypothecate or re-use the collateral and, on enforcement, will need to follow an enforcement procedure in order to access the collateral so as to liquidate it.

[21] Lenders may re-invest cash collateral in the expectation of earning a greater return than the return on cash held on deposit.

[22] Indemnification typically means that, in the event of a borrower default, the agent would first use the available collateral to repurchase the lender's securities or return an equivalent amount of cash to its account. If the collateral were insufficient to make the lender whole, then the agent would use its own capital to repurchase the lender's securities or return an equivalent amount of cash to its account.

Nonetheless, in the case of the pledge structure,[23] an event of default will trigger an enforcement event under the security agreement resulting in the lender having the right to access and liquidate the collateral in the secured account. The timeline between an event of default occurring and the time when the lender can commence liquidating collateral may well be a number of days longer in the case of a pledge structure than it is in the case of a title transfer security lending arrangement.

Ultimately, however, the collateral in respect of a lender's security lending arrangements (however structured) does not form part of the fund's assets, to the full extent of the portfolio assets. As a result, it seems reasonable for such collateral assets to be filtered through a separate ESG lens as compared to that applicable to the long portfolio of a fund.

4.4 Risk of creating stranded assets

Where the ESG parameters applicable to collateral pools are excessively narrow, there is a risk of creating asset bubbles or (conversely) accelerating the creation of stranded assets.

Negative exclusions can lead to stranded assets. Stranded assets can lead to potential credit concerns, corporate defaults and market disruption. It is likely that the stranded assets would be located in sectors and/or companies which are vulnerable to ESG (such as tobacco, oil and gas) and which may already be facing challenges as a result of the ESG focus. The creation of stranded assets would undermine the ability for certain sectors to successfully execute their transition plans to sustainable outcomes, for example, the transition pathway to a net zero economy. Regulators are particularly focused on ensuring that transition plans are being implemented, with defined pathways to net zero, in order to ensure an orderly transition.

In parallel, there is a risk of creating an asset bubble in sectors which are seen favourably or in securities which have good ESG ratings, especially where a limited amount of securities are issued, for example, in nascent markets for ESG compatible assets.

Both stranded assets and asset bubbles risk contributing to a lack of liquidity in the market which could hinder the transition to net zero.

4.5 Lack of standardised ESG taxonomy and ESG data

There is increased interest in achieving appropriate standards of ESG integration for securities lending collateral assets[24] and increasingly climate financial risk as well as other sustainability risk considerations being factored into collateral selection effectively already. At present, however, there are no consistent common ESG measuring tools for defining and screening ESG collateral assets. Bespoke ESG collateral solutions are therefore required.

As indicated in the ISLA March White Paper, there is no legal or regulatory definition of an "ESG compliant" product or activity:

> "Firms may need to comply with one or more requirements under various regulations related to the sustainability policy programmes, but there is currently no regulatory test of "ESG compliant" – any more than complying with financial services regulation can be said to make a product "financial services compliant". The better understanding is whether an activity or firm can be said to comply with a specific sustainability regulatory requirement…"[25]

[23] Such as the GMSLA 2018 for example.

[24] ISLA welcomes the recent ESMA call for evidence on market characteristics for ESG rating providers in the EU, the European Commission targeted consultation on the functioning of the ESG ratings market in the European Union and on the consideration of ESG factors in credit ratings and other action to improve the reliability, comparability and transparency of ESG ratings, including in the UK through publications such as CP 21/18 Enhancing climate-related disclosures by standard listed companies and seeking views on ESG topics in capital markets and Greening Finance: A Roadmap to Sustainable Investing.

[25] For instance, a "*comply or explain*" statement about climate financial risk disclosure might be capable of being described as complying with LR 9.8.6(8).

There is also no common global taxonomy:

"Even when the EU [Taxonomy] regulation is further developed,[26] it is only one of a number of taxonomies in development internationally.[27] Some of these taxonomies have some common ground – for instance, a proposed Singapore green taxonomy largely shares the same objectives as the EU regulation – but there is otherwise no single approach. There are some efforts to create more consistency: the International Platform on Sustainable Finance, currently comprising 16 countries and the EU, has initiated a taxonomy working group.[28] Agreeing one global framework, however, remains a distant point on the horizon.

The policymaker focus so far has been on the development of taxonomies related to environmental objectives. There is currently no single articulation in EU or UK regulation of what social objectives are[29], let alone detail of how activities will be measured against them, nor what constitutes good governance practices."

Given the current range of labelling options and taxonomies, as well as the lack of international consistency, it is difficult for market participants to identify consistently ESG-compatible collateral. Accordingly, different counterparties may have different standards that they consider acceptable. Similarly, it is difficult for market participants to know with any degree of certainty what collateral satisfies any given ESG framework.

As indicated in the ISLA March White Paper, it is therefore critical that securities lending parties establish between them what is meant by the lender's ESG objectives at the outset. In the absence of an appropriately developed regulatory taxonomy or other standard, this can be achieved by using the following approach:

"Define the sustainability objective(s) (eg diversity in management).

Define the target or threshold for achieving the objective (eg 50% women in senior leadership).

Identify the metrics for measuring compliance (eg board positions and ExCo positions held by women for a 12-month continuous period, with less than 50% serving on three or more boards)."

ISLA plans to work with members and industry stakeholders towards the development of a best practice standard on creating a common understanding of ESG objectives in the context of securities lending arrangements.[30]

[26] At present only the framework (Level 1) regulation is in force, with the application of the regulatory technical standards having been deferred until 1 January 2023.

[27] The UK, Singapore, Canada and Malaysia have committed to or are developing 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. There are also a number of other competing ESG standards such as the Financial Stability Board's Task Force on Climate-Related Financial Disclosures; the UN's Principles for Responsible Investment, the UN's Sustainable Development Goals and the COP25's principles.

[28] See also the World Bank guide to developing a national green taxonomy.

[29] The EU is considering a structure for a social taxonomy within the present EU legislative environment (see the Renewed Sustainable Strategy Consultation and the mandated review in art.26(2) and the Draft Report by Subgroup 4: Social Taxonomy and the Final Report on Social Taxonomy). However, there is no usable social taxonomy at present.

[30] See the ISLA March White Paper.

ISLA has already taken steps to align market practices globally. In September 2021, a collaborative global working group, now formally known as the Global Alliance of Securities Lending Associations[31] (**GASLA**) was created to provide a single voice across global securities lending markets. The group is a collaboration of leading industry associations comprising five founding members: Canadian Securities Lending Association (**CASLA**), International Securities Lending Association (**ISLA**), Pan Asia Securities Lending Association (**PASLA**), Risk Management Association (**RMA**) and, South African Securities Lending Association (**SASLA**). The group is currently working towards a Global Framework for ESG in Securities Lending (**GFESL**) to address ESG challenges that transcend regional boundaries.

In the absence of a common and consistent standard and infrastructure for defining and screening collateral assets specifically, constructing collateral schedules containing ESG compatible assets currently requires bespoke solutions to accommodate client (lender) preferences. However, managing a bespoke schedule can be operationally heavy and impacts scalability, which creates limitations on utilisation and reduced revenue for underlying asset owners.

4.6 Importance of liquidity of collateral assets

Any excessive narrowing of securities lending collateral schedules to accommodate ESG screening in the same way as a fund's long holdings could negatively impact the core purpose of collateral to provide liquid assets to cover the credit risk exposure of the lender to the borrower as a result of the securities lent at a time when liquidity of collateral assets has never been more critical. The introduction of uncleared margin rules for derivatives transactions post the financial crisis has significantly increased the amount of collateral in the system. Furthermore, the Covid-triggered volatility of early 2020 triggered colossal increases in collateral demands.[32]

Further narrowing securities lending collateral schedules to accommodate ESG screening could reduce diversification of risk (to diversify risk, typically collateral assets give exposure to different sectors, countries, markets and issuers as compared to the long holding of the fund) and negatively impact both the risk mitigation and secondary market liquidity. The fact that many ESG bonds are long-term instruments (as opposed to more liquid short-term instruments) heightens this liquidity risk. Ultimately, a liquid secondary market is crucial for overall market stability and the issuance of ESG securities in the primary market.

Added to this, asset managers and agent lenders need to be cognisant of their fiduciary duty to protect the interests of their clients. A lack of diversification in collateral selection increases liquidity risks for clients. Increased liquidity risks necessitate higher haircuts on collateral assets.

[31] See here.

[32] See the Special Report 2021 published by Global Investor Group entitled "Collateral in 2021".

4.7 Advantages of industry-led self-governance on ESG compatible collateral

In order to mobilise the capital required to transition to a sustainable economy, arguably industry-led self-governance and/or best practice endorsed by policymakers, in relation to collateral selection is required, rather than prescriptive/or granular rules which could threaten liquidity. As indicated in the ISLA March White Paper:

> "Many of the tools, practices, data and metrics are nascent and not amenable to detailed rules yet. Priorities and preferences in relation to environmental and social objectives central to sustainability will vary from region-to-region industry to industry and investor to investor. These will continue to shift as the transition to the real economy continues to develop."

In the first instance, ISLA considers that principles-based industry best practice is the most appropriate medium for guidance on collateral in a securities lending context.

As indicated in the ISLA March White Paper, ISLA intends to work with its Collateral Management Steering Group and the GASLA forum, to develop high level standards for collateral selection as part of the GFESL.

ISLA proposes that such standards will seek to complement existing collateral management business models rather than seeking to standardise these, whilst also ensuring that the safety and liquidity of collateral is not compromised.

4.8 Regulatory guidance/endorsement of industry best practice

ISLA considers that it would be helpful for any proposed industry guidance to be endorsed by regulators and central banks and considers it would be useful to assist investors and asset owners in setting pragmatic and consistent best practices to lend their securities whilst taking ESG factors into account in an appropriate and consistent manner.

ISLA has also requested regulatory guidance[33] on the classification and treatment of products such as securities lending which are tools that can facilitate sustainability objectives of the investor or asset owner but are in themselves not (and not marketed as) a sustainable product and cannot contribute to a sustainable outcome in itself.

[33] See ISLA's response to FCA Discussion Paper 21/4 for additional background on this argument.

5. Conclusion

Whilst ISLA considers it essential that sustainability and ESG-related risks must be considered in all aspects of an asset owner's portfolio, it should be recognised that collateral guidelines should also 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. Such an approach will also assist in mitigating the risk of creating stranded assets in the market and will safeguard financial stability and support an orderly transition to a net zero economy.

Increasingly, climate financial risk and other sustainability risk considerations are already factored into securities lending activities (including the acceptability framework for collateral) as a result of regulatory expectations, including emerging prudential supervisory requirements. However, the industry now needs clarity on the extent to which ESG factors should be applied to securities lending collateral, in the form of regulatory guidance coupled with globally applicable best practice, to assist asset owners in setting acceptable tolerance levels so they can exercise their fiduciary duties to appropriately manage risk, to generate revenue and to consider ESG criteria. In the absence of common standards for screening and categorising ESG collateral and concerns relating to the current quality of data available with respect to ESG assets (given the range of labels, taxonomies and lack of international consistency), there may be difficulties in defining a consistent approach. Any transition in approach to incorporating ESG factors into securities lending collateral must therefore necessarily be step-by-step, principles-based and industry-led, with a view to ensuring that movements to align collateral with ESG standards do not constrain liquidity, financial stability or global efforts to transition to a more sustainable economy in an orderly fashion.

ISLA considers that it would be useful for any such guidance to be endorsed by regulators and central banks.

Appendix

Appendix 1

1. Background to securities lending

1.1 How does securities lending work?

A securities lending transaction involves the transfer of securities[34] by a lender in exchange for a fee and the transfer of collateral by a borrower, with a simultaneous agreement by the borrower to transfer equivalent securities back to the lender either on demand or on a pre-determined date in exchange for the return of the collateral (or equivalent) to the borrower. A securities lending transaction is generally short term in nature and is documented in the European market through the use of a Global Master Securities Lending Agreement (**GMSLA**).[35]

Notwithstanding that a lender transfers full legal ownership and beneficial interest in the securities to a borrower under a title transfer securities lending transaction[36], a fundamental principle of securities lending is that the lender's position should remain as similar as possible to the position it would have been in had it not done so. For example, under a title transfer securities lending transaction, the borrower will pass through any interest, dividend, coupon payments or other amounts received on the loaned securities to the lender.

1.2 Who are the parties involved?

All securities lending transactions include both a lender (being the original owner of the securities) and a borrower. In addition, lenders[37] will often use an agent to facilitate their securities lending transactions, including with respect to securities and collateral management.

The incentives for a lender in entering into securities lending transactions include generating additional alpha, covering operational and administrative costs and providing incremental revenue for long-term investors. In each case, this is achieved via the receipt of the fee paid by the borrower, which is additional to any other amounts received on the loaned securities and passed through by the borrower.

Meanwhile, a borrower may choose to enter into securities lending transactions to meet its settlement or collateral obligations under other agreements, to support its hedging activity or as part of an overall investment strategy.

[34] The lender transfers full legal ownership and beneficial interest in the securities to the borrower. The type of securities which may be loaned under a securities lending transaction include equities, corporate bonds, government securities and supranational debt.

[35] In the European market, which is the focus of this discussion paper, parties generally choose to document their securities lending transactions through a GMSLA 2000, GMSLA 2010 or GMSLA 2018. Elsewhere, parties may rely on different documentation, for example, in the U.S. market, the Master Securities Loan Agreement is widely used.

[36] See sections 1.3 (How does collateral work?) of this Appendix and Section 4.3 (The nature of collateral – distinct from the lender's assets?) of this discussion paper for further background on the differences between title transfer securities lending transactions and securities lending transactions based on a pledge type arrangement.

[37] Where a lender acts through an agent, the lender is the beneficial owner of the securities.

1.3 How does collateral work?

As indicated above, under a securities financing transaction, the lender temporarily transfers the securities in exchange for the provision of collateral by the borrower. The collateral provided by the borrower may be in the form of securities or cash and is designed to protect the lender from any losses which may arise were the borrower to default on its obligations under the securities lending transaction. In other words, collateral is designed to be a counterparty credit risk mitigation tool for the lender and indeed

"the development of a collateralised market around securities lending is primarily driven by a lender's desire to mitigate any counterparty credit risk, through the provision of either cash or non-cash collateral".[38]

The risk mitigation purpose underpinning the provision of collateral drives certain trends in the market, primarily overcollateralisation by the borrower and diversification of the eligible collateral accepted by the lender. Indeed, a borrower will often be required to post collateral exceeding the current market value of the loaned securities in order to provide the lender with additional protection against any loss resulting from fluctuations in the value of the collateral. In addition, adopting a broader acceptable collateral schedule allows a lender to diversify its risk and better protect against a potential borrower default by ensuring collateral liquidity.

There are two ways in which the provision of collateral under a securities lending transaction can be structured, being a title transfer mechanism or a pledge type arrangement.[39] The GMSLA 2000 and GMSLA 2010 function on a title transfer basis, whilst the GMSLA 2018[40] incorporates a pledge structure. The GMSLA 2018 was developed to provide an alternative for market participants, given the regulatory capital treatment of collateral under the GMSLA 2000 and GMSLA 2010, which was less attractive to large financial institutional borrowers and the fact that accepting equities as collateral on a title transfer basis could, in certain scenarios, lead to a disclosure requirement on the part of the lender.

In a title transfer arrangement, legal title to the collateral is temporarily transferred to the lender and the lender will hold the collateral for the duration of the transaction in its own proprietary account. Accordingly, the lender has full control over the collateral and is entitled to rehypothecate it during the life of the securities lending transaction. Where a lender acts through an agent however, which is common in practice, the agent will typically: (i) reinvest cash collateral into a cash reinvestment vehicle in accordance with the lender's guidelines; and (ii) not rehypothecate non-cash collateral but hold it separately on behalf of the lender.[41]

By contrast, in a pledge structure, legal title to the collateral remains with the borrower and the collateral is instead transferred to a segregated account with a tri-party custodian, which acts in accordance with the tri-party custody documentation entered into by the lender, borrower and custodian. The segregated account is held in the borrower's name and a security interest is created over the account in favour of the lender. Under a pledge structure, the lender is not entitled to rehypothecate or re-use the collateral and, on enforcement, will need to follow an enforcement procedure in order to access the collateral so as to liquidate it.

[38] See page 10 of the ISLA March White Paper.

[39] Further detail on the differences between the two can be found in section 4.3 above.

[40] In conjunction with the relevant security document and tri-party custody agreement.

[41] See further, paragraph 148 of the European Securities and Markets Authority's "*Report on securities financing transactions and leverage in the EU: report prepared under the mandate in Article 29(3) SFTR*" published on 4 October 2016.

Appendix 2

1. How does ESG regulation apply to collateral in securities lending transactions

As investor demand for "green" products continues to grow, so does global regulation aimed at combatting the issue of greenwashing. Addressing greenwashing issues increases investor confidence in investing in sustainable financial markets, which is critical in supporting the transition to a net zero economy.

Consequently, a key part of financial services regulation in this area relates to transparency and disclosure, and in some cases, ensuring that sustainability factors are integrated into financial services firms' decision making processes and product design. Whilst sustainability regulation is still developing in many jurisdictions, it is clear that sustainability is firmly at the top of the global regulatory agenda and it will become increasingly important that firms embed sustainability risks and considerations into all aspects of their business.

The discussion below focuses on sustainability regulation in the EU and the UK. However, there are a number of global initiatives in this area,[42] which often inform the position at national level, as well as market-led initiatives to encourage consistent minimum standards (such as the UN Principles for Responsible Investment[43]). Firms engaging in securities lending activity will, in practice, need to consider relevant industry standards and firms which operate globally will need to consider all relevant regulatory regimes.

As discussed above, the key point is that, whilst ESG regulation may apply to securities lending businesses in certain circumstances, regulatory materials published in the EU and the UK to date (bar one FCA discussion paper – as to which see further below) do not directly reference the sustainability treatment of securities lending transactions. Consequently, there is no specific guidance or indication in respect of how collateral posted in the context of securities lending transactions should be categorised or treated for sustainability purposes including whether collateral should be subject to the same sustainability standards as the loaned securities. In addition, we are not currently aware of any regulation in non-EU/UK jurisdictions that specifically references securities lending and/or the related treatment of collateral in an ESG context.

Sustainability regulation in the EU

The EU is already leading the way on sustainability regulation. Amongst other things, the European Commission has introduced a package of reforms relating to sustainable finance. These measures include:

(a) the Sustainable Finance Disclosure Regulation (**SFDR**)[44] which introduces certain transparency and disclosure requirements relating to financial products for certain financial market participants[45] and financial advisers; and

(b) the Taxonomy Regulation[46] which introduces a classification framework for assessing environmentally sustainable activities and various disclosure requirements, including disclosure requirements relating to how a financial product is aligned with the taxonomy (this aspect of the regulation is broadly aligned with the SFDR in respect of scope).

The definition of "financial products" is relatively limited and covers portfolio management,[47] alternative investment funds, IBIPs, pension products, pension schemes, UCITS, and PEPPs. Consequently, it does not explicitly include securities lending transactions.[48]

[42] Such as the recommendations of the Financial Stability Board Task Force on Climate-related Financial Disclosures (**TCFD**) and the Basel Committee consultation on principles for the effective management and supervision of climate-related financial risks.

[43] See here.

[44] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.

[45] The definition of "financial market participant" is limited to insurance undertakings which make available insurance-based investment products (**IBIPs**), investment firms which provide portfolio management as defined in the Markets in Financial Instruments Directive (**MiFID**), institutions for occupational retirement provision, manufacturers of pension products, alternative investment fund managers, pan-European personal pension product (**PEPP**) providers, managers of certain qualifying venture capital funds, managers of certain qualifying social entrepreneurship funds, management companies of UCITS, and credit institutions which provide portfolio management as defined in MiFID.

[46] The Taxonomy Regulation.

[47] "Portfolio Management" is as defined in MiFID as "managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments".

[48] The full range of supervisory, regulatory and legal obligations applying to any securities lending arrangement and market participant will be fact dependent. In all cases, specific advice should be obtained. For example, the requirements of SFDR may have relevance to a securities lending business in certain limited fact patterns if it involves an element of "portfolio management" for MiFID II purposes. This requires a case-by-case analysis and will not be the conclusion in every instance.

With regards to the EU's SFDR, the European Commission published a Q&A in 2021 concerning Article 9 products, in which they stated: *"A financial product, in order to meet requirements in accordance with prudential, product-related sector specific rules may, next to 'sustainable investments', also include investments for certain specific purposes such as hedging or liquidity which, in order to fit the overall financial product's sustainable investments' objective, have to meet minimum environmental or social safeguards, ie investments or techniques for specific purposes must be in line with the sustainable investment objective."*

ISLA is encouraged by the fact that the European Commission has acknowledged the need for other investments to be used for 'liquidity and hedging purposes', alongside investments with sustainable objectives, although the guidance from the European Commission is still unclear. ISLA considers that similar guidance from the FCA (and other regulators), that a securities lending product can be treated as an investment tool for liquidity and hedging purposes and not as a sustainable investment in its own right, would be beneficial. It can, however, successfully integrate the sustainability preferences of an investor/asset owner.

Sustainability regulation in the UK

In the UK, regulatory initiatives are less developed but are expected to pick up pace during 2022 and beyond.

In December 2021, the FCA published its policy statement[49] setting out final rules and guidance relating to the requirements under a new climate-related disclosure regime for asset managers and certain FCA-regulated asset owners to make disclosures consistent with the recommendations of the TCFD.

In October 2021, HMT published *"Greening Finance: A roadmap to sustainable investing"*[50] which sets out actions that the UK government is taking to provide clearer information for investors on sustainability.[51] The Prudential Regulation Authority (**PRA**) and the Pensions Regulator have set out their expectations as to how banks, insurers and pension schemes should be managing the financial risks from climate change and embedding these throughout their organisations. In addition, the FCA Climate Adaptation Report[52] sets out the FCA's regulatory objectives and how it plans to use its regulatory and supervisory tools to achieve ESG outcomes. It is clear from the report that addressing greenwashing risk via sustainability disclosures, ensuring firms are managing ESG risks and integrating these into their culture and governance frameworks, encouraging active investor stewardship and promoting integrity in the market for ESG-labelled securities (including via supporting the growth of ESG data and ratings providers) are critical to the FCA's strategy. The FCA is also considering future policy work on requiring firms to publish transition plans taking into account net zero commitments and incorporating sustainability expectations into the authorisation and supervisory assessment process.

The FCA has produced guidance for UK authorised fund managers setting out expectations as to the design, delivery and disclosure of sustainable investment funds.[53] The overarching principle is **consistency** and specifically that, *"[a] fund's ESG/sustainability focus should be reflected consistently in its design, delivery and disclosure. A fund's focus on ESG/sustainability should be reflected consistently in its name, stated objectives, its documented investment policy and strategy, and its holdings". The FCA has also flagged as follows: "[w]here a fund might hold securities, potentially at a reduced weighting, that an investor might not expect, given the ESG/sustainability focus of the fund, this should be made clear in the prospectus, including the circumstances when such securities might be held and the purposes for which they would be held."*

In contrast to EU regulators to date, as part of its discussion paper (**DP21/4**) on sustainability disclosure requirements and investment labels (the **FCA Discussion Paper**),[54] the FCA has specifically asked for views on securities lending in the context of sustainable investing (although we note there is no detailed discussion of the FCA's thinking including in respect of collateral). ISLA's response to the FCA Discussion Paper[55] included it seeking guidance on whether collateral, as a risk management tool, should integrate the same level of ESG screening as the long portfolio of the fund or, alternatively, whether eligible collateral guidelines should intentionally constitute broader and more liquid parameters, in order to effectively manage risk.

[49] PS21/24: Enhancing climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers.

[50] See here.

[51] Broadly: (i) certain UK-registered and listed companies will be required to disclose information about how they identify, assess and manage sustainability factors arising from their global operations in their annual reports; (ii) building on TCFD requirements, certain asset managers, insurance companies and pension schemes will be required to disclose the sustainability-related information that clients and end-users need to make informed decisions about their investments via the introduction of a new sustainability disclosure requirements (**SDR**) regime (see further FCA DP21/4 below); (iii) firms will be required to disclose the sustainability attributes of the investment portfolios and products they offer; (iv) a UK green taxonomy will be developed (based on the EU Taxonomy Regulation) setting out which economic activities are regarded as sustainable (to be taxonomy-aligned, an activity must make a substantial contribution to one of six environmental objectives, do no significant harm to the other objectives and meet a minimum set of safeguards) – SDR disclosures will be made based on the taxonomy; (v) a sustainable investment labelling regime will be introduced to provide a classification system for investment products (see further FCA DP21/4 below); (vi) sustainability-related requirements for financial advisers will be introduced; and (vii) action will be taken to support investment stewardship. ESG ratings providers may also be brought within the remit of regulation.

[52] See here.

[53] See here.

[54] See here.

[55] See here.

Appendix 3

International Securities Lending Association (ISLA)

The International Securities Lending Association (**ISLA**) is a leading non-profit industry association, representing the common interests of securities lending and financing market participants across Europe, Middle East and Africa. Its geographically diverse membership of over 180 firms includes institutional investors, asset managers, custodial banks, prime brokers and service providers.

Working closely with the industry, as well as national, regional, and global regulators and policy makers, ISLA advocates for, amongst other things, the importance of securities lending to the broader financial services industry. It supports both the Global Master Securities Lending Agreements (**GMSLA**) legal framework, including the Title Transfer and Securities Interest over Collateral variants, as well as the periodical enforceability and security enforcement across global jurisdictions.

Through member working groups, industry guidance, consultations and first-class events, ISLA plays a pivotal role in the creation and promotion of market best practices and processes, thought leadership, standards for legal frameworks, and securities lending guides and related documents.

For more information visit: About ISLA

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