Going green

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Broadridge investigates the practical implications of ESG for securities finance and collateral management

Socially responsible strategies now account for 26 percent of UK's assets under management. The total value of global assets invested according to the criteria coming from the environmental, social and governance (ESG) movement is soon likely to reach trillions of dollars. While ESG is already having a major impact on investment decisions in both primary and secondary investment markets, areas coming under greater spotlight now include securities finance and collateral management.

This article examines the practical impact of ESG on the securities finance trade lifecycle and discusses the technology implications of managing ESG in a way that minimises operational workload.

While ESG as a concept has gained most of its momentum in the past decade, ethical investment, more commonly called "social impact investing", dates back hundreds of years. One of the first targets of ethical investment policies was the slave trade. Quaker businessmen in England and America not only refused to invest in businesses that profitted from the slave trade but ultimately provided much of the funding for the abolitionist movement.

One of the simplifying aspects of ethical investment strategies was that they typically involved avoiding investment in very specific types of business such as tobacco and armaments of firms trading with Apartheid-era South Africa. Another class of ethical investment were those that targetted types of businesses that positively worked to protect the environment or to increase diversity in the workforce.

Why ESG?

The growth in ESG came from some different perspectives to purely ethical investment. One of those insights was that an investment strategy to achieve socially worthwhile objectives did not have to be done at the expense of returns to investors. What is the point of enhanced returns over the short term if they come at the expense of fundamental environment or social destruction? Many of the new technologies such as renewable energy or more sustainable farming combine both a concern for the environment and the creation of businesses that may be commercially successful in the long term.

There was also the realisation that increasing the overall welfare of society did not just depend on the binary choice of whether to invest or not but on the overall ethos of a company. Including both the business areas in which a firm operated and the manner in which they did business, bringing together both the social and governance aspects of ESG.

ESG is also looked at by some providers of ESG-related services as a form of risk management. For any firm, ESG concerns can be looked at in terms of risks that can damage the performance of a firm if not managed correctly. Environmental impacts including climate change may have a major impact on the bottom line, governance concerns can have an impact on the quality of management (ultimately impacting performance) and public perceptions of firms' overall policies in ESG can have a direct impact on the willingness of customers to buy their goods and services.

The net result was the identification of a whole range of considerations related to ESG. The table below shows a small subset of the areas that can be grouped under the main dimensions of ESG.

Implications for securities finance and collateral management

Here are some key factors that make ESG relevant to securities finance:

- The receipt of securities as collateral in relation to securities lending transactions, derivatives or other business areas means that firms or funds may potentially end up as the legal owner of securities that do not meet their ESG requirements. Even if their legal ownership is transitory and may not represent a real economic stake in the issuer of the securities the ownership may be visible in a public access medium such as share registrars.
- One of the key mechanisms for influencing both the business direction and governance of corporations is exercising the right as a shareholder to vote on key issues. If shares are on loan it means the lender cannot vote since they are not at that point the legal owner.
- Where securities are lent out, according to some ESG criteria, it is important who the securities are lent to and for what purpose. There have been multiple actions taken by regulators and/or tax authorities against those borrowing of shares over the dividend season to exploit grey areas in tax law.

However, trying to make decisions based on more general concepts of ESG can be much more problematic. The fundamental problem is that there is a huge range of definitions of ESG and the more granular factors considered in creating ESG ratings. Including or excluding specific securities from investment/trading activity based on the preferences of investors or the criteria of a mandate is relatively straightforward. However, for ESG there are a great many overlapping or even conflicting definitions with different sets of criteria. Analysis on the ESG characteristics may also be represented in terms of an overall ESG rating, a set of ESG risks/opportunities or the exclusion of securities from a portfolio. One analysis may recommend excluding all companies involved in the extraction of fossil fuel, but another may allow investment in energy companies that have a lower carbon footprint resulting from more efficient extraction processes or efforts to offset their contribution to the production of greenhouse gasses.

Fundamentally there is no true "golden source" of ESG data and what is valid depends as much on the investors attitude to ESG issues as the quality of the data they purchase or collect.

Once investors have reached a view on both their own policies and the most suitable sources of data at the system level firms need to record the data required to automate trading, lending and collateral processes. This includes storing reference data about counterparties, issuers, securities and legal agreements such as credit support annexes. Supporting ESG policies can be challenging but to do so in a supportable way requires thought to be given to business processes, systems and reference data.

Environmental	Social	Governance
Climate change	Diversity	Ownership and control
Sustainability	Human rights	Tax transparency
Pollution and waste	Consumer protection	Executive compensation
Environmental opportunities	Animal welfare	Business ethics including corruption

The practical challenges

At the most basic level, systems and processes need to be modified to exclude or give preference to securities issued by specific parties. This can be relatively straightforward depending on how mature a firm's processes are for managing reference data and the number of securities/issuers involved.

As ESG grows in significance, market practitioners should define an operating model and technology strategy that ensures adherence to the firm's ESG policy, while also maximising automation and minimising operational workload.