ESG Expands into Collateral Management

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Since the term ESG was coined in the study Who Cares Wins in 2005, it has grown from a niche consideration to mainstream trend. It is now a norm for institutional investors to integrate environmental, social and governance (ESG) considerations into their investment decision making, seeking positive returns while keeping in mind the potential long-term risks to the performance of their assets.

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However, the application of ESG to securities lending has been slow. There is no standardized framework, which creates challenges and makes it difficult for industry participants to navigate the 'different shades of green'. Regulation is set to help overcome these challenges and make green labels meaningful for investors.

For example, the European Union's Sustainable Finance Disclosure Regulation (SFDR), which went live in March 2021, aims to establish transparency requirements for financial market participants on the integration of sustainability risks. It also helps participants focus their efforts on the consideration of adverse sustainability impacts in their processes, and the disclosure of the sustainability features of financial products.

With new regulations and changing attitudes, ESG's momentum continues to accelerate. We see this as an opportunity to differentiate ourselves and provide value to our clients. We are moving forward to enable ESG ratings in our Collateral+ triparty service, and we are excited to see progress across financial services.

Industry dialogue

Sam Edwards, head of APAC Collateral, State Street, and Roy Zimmerhansl, practice lead, Pierpoint Financial Consulting, discuss the industry roadmap for accelerating ESG from concept to implementation with a focus on the collateral side of the trade.

Sam Edwards: At State Street, we have been developing our new Collateral+ platform with ESG at the heart of the design process. Why has ESG implementation in securities lending and collateral been so slow within the financial services space?

Roy Zimmerhansl: There are three key aspects that have influenced the initially slow but now rapidly accelerating emergence of ESG. First, as with many new concepts, it took some time for investors to acknowledge, accept and then integrate ESG factors into portfolio construction. Second, critical to all new initiatives, the necessary data and tools have taken a while to become widely available. Finally, in the absence of regulation, there is no standard definition of ESG, which is leading to different interpretations and measurements with multiple indices. This makes comparisons difficult.

Nevertheless, the baseline of ESG in securities finance is gaining clarity. This reflects both the wider investment community ecosystem and specific initiatives within this sector.

Sam Edwards: While regulatory changes have kept financial services firms busy over the last decade, there are clear benefits to be derived from industry collaboration in order to enact change. The approach to managing collateral schedules is usually based on a legacy approach that enables limited changes based on security-level exclusions.

The Collateral+ platform is developing digital schedules that will be easier to update and manage. As part of this, we are advocating the introduction of ESG ratings. To be eligible, a collateral receiver sets a minimum rating level the collateral must meet. We can envisage a dynamic approach whereby changes to ratings immediately update the collateral eligibility set.

When advising your clients, what are the key points Pierpoint looks to for the implementation of their approach?

Roy Zimmerhansl: Most observers acknowledge that sustainable investing is more than a passing trend. Vendors are rising to the challenge by either enhancing existing products or introducing new ones. Inevitably this means there will be an array of service providers feeding institutional investors with ESG-focused ratings for portfolio oversight. In our experience, lending investors are at various stages of their journey of applying guidelines to their collateral. This will be particularly acute for retail-oriented ESG funds such as exchange traded funds (ETFs) or mutual funds.

Imagine two ESG-labelled funds that lend securities. The first one markets an end-to-end ESG solution including securities lending collateral and the second one ignores collateral. The latter scenario is ripe to be challenged for greenwashing.

Meanwhile, consider pension funds for government employees such as the Local Government Pension Schemes in the United Kingdom. Many trustees feel an additional obligation, beyond service to their members and their stewardship requirements, and so are more likely to push the ESG agenda and support global initiatives. This will challenge collateral platform operators – they must be willing to connect with multiple client-selected ratings providers, which is likely to offer a range of acceptable connected ratings vendors.

This flips the traditional method used for pricing where collateral platforms determine the best data providers, add them in efficiently and use those prices to inform the collateral valuation process. Here, there are a few sources feeding many users. In the case of ESG ratings, lenders will demand conformity with the ratings provider used to filter their portfolio investments.

Sam Edwards: At State Street, we will provide access to multiple sources of ESG ratings via established market utilities in order to enable clients to customise their approach and evaluate any differences. This will allow us to enable change while working on the second step, the addition of new providers of ESG ratings.

Providing access to an ESG ratings sources will provide asset owners and collateral receivers with the tools they need to address the wishes of their stakeholders. This will enable our clients to enable customisation of each of E, S and G to match investor preferences, through creating their own bespoke ratings scales.

How do you see this playing out in the next few years?

Roy Zimmerhansl: Investors are continuously refining their approach to the wider sustainable finance initiative. This fluid effort demands a multi-step approach to collateral. Inevitably, this will need to deliver direct control for end-users to reflect their specific E, S and G preferences, or combined ESG criteria.

However, service providers will need to take an agile approach to collateral management. The end objective should be high automation facilitating mass customization by users.

Sam Edwards: With the ever-increasing need to focus on environment, we can see the E playing a significant role over the next decade. But there are also other factors that need to be addressed across the spectrum from asset owners, lenders, borrowers, triparty agents, regulators, rating providers and industry forums.

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Where do you see the driver for implementation coming from, and why?

Roy Zimmerhansl: The pervasive nature of ESG is what makes it different. For example, although changes resulting from SFTR (Securities Financing Transactions Regulation) were driven by regulators and approved by politicians, the reality is that the impact was largely felt by financial intermediaries.

We see many stakeholders wanting to influence the development of ESG. But when you consider local and regional differences and priorities, skewed by political agendas, it's easy to see why there is no straight line to a unified global vision.

Securities finance leaders and influencers must create conditions where participation and inclusion are encouraged and even demanded. We need to listen before deciding, and our actions should be incremental and continuous. Meanwhile, technology must be leveraged to deliver the needs of both ends of the user chain, via the intermediaries that are fundamental to daily financial market infrastructure operations.

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