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INVESTOR SERVICES

SECURITIES LENDING AT CACEIS: COMPATIBLE WITH YOUR ESG PRINCIPLES

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INTRODUCTION

Without a doubt, the current global situation has enhanced our collective awareness of the various socio-environmental challenges we face. In the spirit of the Paris Climate Agreement and the UN Sustainable Development Goals (SDGs) adopted in 2015, society now expects companies to use their investment and innovation capacities to implement solutions that meet these challenges.

To continue operating, companies should integrate more sustainable development into their business strategies, governance, culture and innovation process.

As awareness of these Environmental (E), Social (S) and Governance (G) issues has grown, so too has interest in sustainable finance and responsible investment strategies.

The wave of regulations covering non-financial reporting has sounded the death knell for a model in which a company's performance and the involvement of the various stakeholders (investors, asset managers, analysts, etc.) are based solely on economic and financial criteria. Most investors now want their investments to have an environmental, social or societal impact.

ESG data has become a strategic focus, especially as these standards will increasingly come to define a company's overall value.

As part of its securities lending services, CACEIS therefore faces a question from investors and, more generally, from all players in the temporary sales market: are these activities compatible with an ESG approach?

CACEIS has prepared this information document to help its clients meet the challenges ahead. The aim is to provide insight into ESG as a whole and examine how it relates to securities lending.

Drawing on its expertise in Asset Servicing and in-depth regulatory knowledge, CACEIS hopes to provide the transparency investors need to understand an activity that guarantees market liquidity and generates income for clients.

1 SUSTAINABLE INVESTMENT AND ESG

A CONTEXT THAT CALLS FOR ACTION

For several years, financial players have faced mounting investment challenges. To better understand the current context, we have grouped these challenges into four separate categories.

End-investors' expectations and involvement have gradually changed in recent years. More and more are looking to invest in sustainable products, while maintaining a focus on performance.
More broadly, consumers want to see greater transparency so that they can make informed choices that reflect their personal values, and to protect themselves against misleading advertising, or "greenwashing".

In terms of financial management itself, assessing investment risks and opportunities has become an increasingly complex task thanks to the growing new tendency to take non-financial criteria into account.
New risks have emerged since non-financial criteria were introduced. These include climate risks, which cover physical risk (e.g. the risk incurred when investing in private equity and real estate) and transition risk (whether or not the company will cope with the ongoing energy transition). And in an era of hyper-connectivity and instant information, reputation risk is also becoming increasingly important.

Last but not least, regulation was expected and necessary in order to codify and structure the range of different approaches. The purpose of these regulations is to steer investment flows towards more sustainable assets.
In this respect, regulatory changes in 2021/2022 mainly include the PACTE law in France and the various taxonomies, the Sustainable Finance Disclosure Regulation (SFDR) and the Corporate Sustainability Reporting Directive (CSRD) at European level.

Environment

- Waste
- Environmental risk mitigation
- Choice of suppliers and service providers (local, etc.)

Social

- Respect for employees' rights
- Promotion of social dialogue
- Staff training and prevention of workplace accidents
- Policy for the inclusion of people with a disability

Governance

- Independence of the Board of Directors
- Transparent executive remuneration policy
- Anti-corruption policy
- Gender equality

Climate

- Calculation of the company's carbon footprint (scopes 1, 2 and 3)
- Reduction of CO2 emissions
- Carbon offseting
- Company's energy mix

THE EMERGENCE OF NON-FINANCIAL CRITERIA

The four points mentioned above have prompted the creation and, more importantly, the defintion of non-financial criteria. There are hundreds – if not thousands – of ways to measure an investment's sustainability, but they can generally be grouped into four categories.
The following are some examples of non-financial criteria:

By analysing these criteria, it is possible to start to assess the sustainability of specific investments and therefore the sustainability of the underlying economic activities.
Any investment that meets the double materiality principle is considered sustainable:

- The product has a positive impact on one of the non-financial criteria and does not have a negative impact on other non-financial criteria

ESG STAKEHOLDERS

Entire teams have been set up at companies and investment firms to establish policies comprising criteria that meet their requirements. The ultimate goal is to define a scoring system that indicates the CSR of a company or ESG level of an investment.

However, collecting and analysing data can be a complex process, as is defining standards and methodologies. This has given rise to a number of new labels and certifications.

A variety of labels in Europe that incorporate ESG concepts

France was the first country to set up government-approved labels in this area:

- SRI label: created in 2016 and backed by the French Ministry of the Economy and Finance, this label is awarded for three years (renewable) to funds that invest in companies that have adopted responsible environmental, social and governance practices.
- Greenfin label: created by the French Ministry of Ecological Transition in 2015, this label guarantees the transparency and environmental commitment of financial products
- Finansol label: created in 1997 by Finansol, this label guarantees investment activities with genuine public utility.

In Luxembourg, the LuxFLAG ESG label is awarded by an independent, international non-profit organisation that aims to encourage and promote sustainable investment.

More generally, all of the existing labels are awarded on the basis of guidelines and approaches that might often differ. Assets selected for investment are systematically analysed using Environmental, Social and Governance (ESG) criteria, but the methodologies tend to vary from one label to another.

ESG rating agencies

The rise of responsible investment has created a need – and therefore a market – for non-financial ratings and assessments. These new rating agencies take not only a company's financial and accounting aspects into consideration, but also its conduct in relation to ESG criteria.
Not to be outdone, traditional ratings firms are seeking to catch up with the competition by acquiring existing agencies or by developing their own rating models.
Many asset management companies have also developed proprietary rating systems to support managers in their investment decisions. As such, dedicated ESG teams are being formed.
In short, there is no standard non-financial rating methodology. That said, all agencies lean on the same set of international standards to compile their rating criteria.

ESG data and solutions providers

There is a wealth of data and ESG solution providers on the market. These solutions all meet the varying requirements of financial players:

- Purchase of data, which will then be processed directly by the portfolio manager;
- Use of pre- or post-trade search modules, directly integrating key information related to a sector, issuer, or issue;
- Specific research relating to a non-financial factor or criterion, for example to manage controversies;
- Production of post-trade statistical reports, used to keep end-investors informed or for investment monitoring and portfolio risk analysis.

There are many players in the non-financial sector, all of which are gradually building their business architecture, with the goal of massively redirecting capital towards sustainable investments.

THE CHALLENGES OF THIS NEW PARADIGM

In this new and evolving landscape, there are key challenges relating to two main aspects regarding data collection.

Data availability and cost

Analysing the ESG (or even ESGC) criteria of a portfolio involves collecting a large amount of specific data on each underlying asset. Specific analyses can entail considerable research costs. Where specific analysis of the underlying security is not requested, sector-based data may be sufficient, as it is more readily available and financially accessible.

The need for standardised analysis methodology

Non-financial data poses another challenge in this new paradigm. As we have seen, there is a lack of consistency in the methodology used to analyse and calculate non-financial data. The metrics for determining non-financial indicators still vary widely.

Finally, and beyond methodological biases, calculation algorithms can be extremely complex, and end investors are not always in a position to fully grasp the nuances. This makes the need to harmonise methods and establish a shared and universally understood framework all the more pressing. This will ensure greater transparency and, above all, greater efficiency.

2 ADAPTING THE SECURITIES LENDING PROGRAMME TO MEET ESG REQUIREMENTS

We have discussed the foundations underpinning ESG policies.

With this context in mind, our clients often raise the following question: is securities lending consistent with a responsible investment policy based on ESG principles?

Debates within the industry, as well as discussions with associations and supervisory authorities, suggest that the main market players think that it is, provided that the securities lending policy adheres to certain principles.
The main principles recognised by players in the securities lending sector fall under five categories, detailed below.

TRANSPARENCY AND ETHICS

Transparency

Securities lending is an OTC activity, meaning that available market data is provided by the participants. It is therefore important to give investors access to all information related to their programme (securities lent, collateral received, corporate action reporting, etc.).

Ethics - Securities lending and liquidity

Securities lending is essential for financial markets to run smoothly. The activity is used to hedge pending or short sales, where permitted, to structure indices or as hedging products for investors.
However beneficial for the future they may be, it is clear that responsible management strategies should not disrupt the markets by drying up stocks of securities to lend.

SERVICE PROVIDER SELECTION

As a general rule, the process of selecting the service provider responsible for initiating securities lending is an integral part of clients' ESG policy. Clients will therefore favour providers who understand the challenges and have environmental, social and governance policies in place.

BORROWER SELECTION

In an agency lending model, clients choose the counterparties to which they wish to lend their securities, so it is important that borrower selection is based on the right ESG criteria. These are generally the same as those applied to selecting providers, with the addition of counterparty default risk.

COLLATERAL SELECTION

Securities lenders must be in a position to exclude securities that go against their ESG policy (specific ISIN or country, for example). The system and/or the agent used to manage collateral must be capable of excluding securities according to specific criteria.

VOTING RIGHTS & PARTICIPATION AT GENERAL MEETINGS

As a committed investor, the lender should be able to exercise voting rights on the securities at general meetings. Ownership transfers when securities are lent and the voting right passes to the borrower.

For the lender to retain the voting rights, they must be able to recall or restrict temporary loan of certain securities.

There are several approaches: some decide to recall all of their loanable positions, while others define a set of sensitive securities or set a material percentage not to be lent during a given period. There is lively debate around these approaches, as many market participants are concerned about the rigourous total recall approaches for lent securities.
Such a hard-line process could cause asset liquidity to dry up while general meetings are taking place, which would ultimately impede the smooth functioning of financial markets.

3 CACEIS AND ESG SECURITIES LENDING: SOLUTIONS AVAILABLE TO OUR CLIENTS

1 FULL TRANSPARENCY THROUGHOUT THE PROCESSING CHAIN	▹ Dedicated activity reports (positions, collateral received, etc.) ▹ Performance report (benchmark) ▹ “Liquidity vs risk” securities lending approach
2 CACEIS: A SERVICE PROVIDER WITH A FIRST-CLASS CSR POLICY	▹ With our constantly evolving CSR (Corporate Social Responsibility) policy, your service provider is fully committed to an ESG approach
3 COUNTERPARTY SELECTION	▹ CACEIS applies a strict counterparty approval policy based on quantitative (e.g. financial data) and qualitative criteria
4 MANAGING COLLATERAL CONSTRAINTS AT MULTIPLE LEVELS	▹ Option for lender clients to exclude securities that do not fit with their ESG policy from the collateral received ▹ Option to exclude a specific type of securities (stocks, bonds, etc.) ▹ Option to exclude specific ISIN codes
5 RECALLING SECURITIES TO PARTICIPATE IN GENERAL MEETINGS	▹ At CACEIS, we promote ESG policies by giving clients the option to recall their securities at any time so that they can take part in votes ▹ Another possibility is to set up buffers, or a stock recall quota system

Introducing ESG policy principles reduces the profits from the securities lending programme and is certain to lower revenues from this activity. This is an important point, given that the impact will be seen in the reports provided in compliance with “best execution” requirements. As ESG restrictions are not taken into account in structuring these reports, the assessment of the securities lending programme’s profitability may be distorted.

Finally, these pillars should be seen as indicative. ESG is a hotly debated subject and it is up to lenders to accept these principles and to define to what extent they wish to apply them.

CONCLUSION

ESG has moved to the mainstream. Environment, social and governance concerns are an economic reality – an imperative that market participants must get to grips with, sooner rather than later.

As such, investors and those seeking investors must define an approach in keeping with the principles of responsible investment.

Research and discussions are ongoing in view of the broadening scope of securities lending, but it is already widely recognised as a useful activity for its contribution to the liquidity of financial markets and also for its potential to be tailored to lenders' and borrowers' specific new ESG criteria.

In summary, securities lending can be compatible with ESG imperatives, provided that the parameter of the lending programme is clearly defined early in the process and can be adjusted quickly as the market, regulations and internal policies change and evolve. This task falls to the securities lending provider, which must be able to handle these constraints (that currently vary greatly from one client to another) by adopting a tailored programme and a flexible and robust IT system.

SECURITIES LENDING AT CACEIS

CACEIS has the necessary tools and expertise to put together the right ESG programme for you, based on the securities you hold and how you wish to access the securities lending market.

We are here for our clients across the entire Front-to-Back chain and are actively engaged in market discussions and initiatives. Our aim is to capitalise on our ESG expertise in temporary securities transfers providing clients with the reassurance they need that this activity is in line with their investment goals.

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