

Aligning Collateral Management with ESG Principles

Retain Your Collateral's Voting Rights with ESG-Compatible Prime Services

Introduction

As environmental, social and governance (ESG) principles have placed increased importance on shareholder engagement, asset managers and owners are seeking ways in which to regain control over their non-cash collateral.

This has significant implications on the traditional prime services industry, which requires clients to post collateral – cash or non-cash assets (e.g., equities, corporate debt or United States treasuries) – for services such as cash management, securities lending and other financing solutions.

The memo-pledge feature provides clients transparency, flexibility and ownership of their non-cash collateral, enabling engagement on proxy votes.

When non-cash collateral is posted in a typical prime broker transaction, borrowers lack transparency and control over how those securities are used. Often, the collateral posted to a prime broker is rehypothecated and leveraged in a variety of ways without transparency to the beneficial owner or that the beneficial owner is unaware of.

This presents a challenge to the ESG goals of borrowers. When borrowers post their non-cash collateral to prime brokers, they are inherently transferring shareholder rights to the prime broker as well.

Ultimately, borrowers lose their ability to be an active shareholder and influence outcomes in line with their ESG objectives, which is an important aspect of sustainable investing.

As a result, buy-side institutions may seek ways in which they can maintain control and transparency over their non-cash collateral while continuing to utilize a prime broker service.



Maintaining Control Over Collateral with a Prime Brokerage-Like Service

The importance of prime brokers should not be understated. In many ways, they serve as a manager's key entry point into global capital markets, providing critical functions such as executing trades, consolidating operations and financing investment strategies. As a result, asset owners and managers may feel that forgoing control of their collateral is a necessary trade-off when using prime services. However, this isn't always the case.

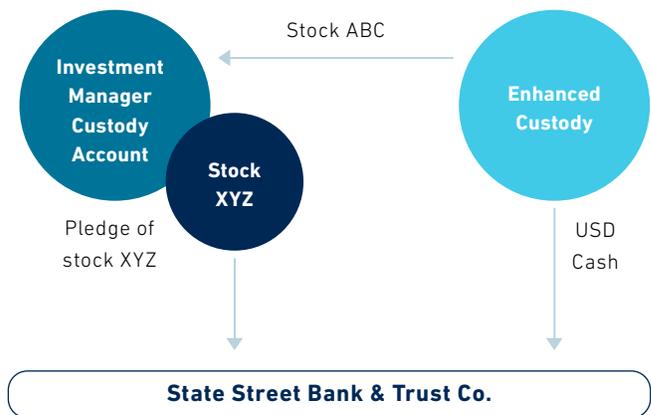
Custody prime brokers, such as **State Street's Enhanced Custody** solution, can alleviate this friction. Enhanced Custody provides clients with greater control and transparency over their pledged collateral by supporting their portfolio financing arrangements within a single, segregated custody account. Unlike a traditional prime brokerage where clients lack certainty over the rehypothecation of posted securities, Enhanced Custody utilizes real-time custody reporting to offer full transparency into their collateral and the rehypothecation process.

Buy-side institutions that want to maintain control over their collateral may be keen on financing their portfolio through memo-pledging. Memo-pledging allows borrowers to post non-cash collateral to Enhanced Custody, which supplies the lender with State Street Treasury-funded cash. The memo-pledged collateral is earmarked, segregated and never leaves the client's custody account. Unique from other prime brokers, this allows participants to maintain control of the voting rights of their collateralized securities. By retaining the ability to vote, borrowing firms can take full advantage of borrowing transactions without hindering their ability to be responsible asset stewards.

The memo-pledge feature provides clients transparency, flexibility and ownership of their non-cash collateral, enabling engagement on proxy votes to drive positive change in line with ESG objectives.

In Figure 1, we demonstrate how State Street earmarks a long security held in a State Street custody account as collateral being 'pledged' to Enhanced Custody.

Figure 1: State Street Memo-Pledging



Ease of Operations

State Street handles all collateral movements and pledging in the custody account at State Street Bank & Trust Co.



Lower Risk

Memo pledged securities do not leave the custody account and remain in the client's name and control. Client's exposure is to State Street as principal.

Source: State Street Global Markets

Conclusion

Prime brokers play a key role in well-functioning capital markets and are critical to efficient buy-side funding. These transactions not only finance trading strategies but also improve price efficiency and overall market liquidity.

However, key ESG principles, such as shareholder engagement and transparency, may conflict with the way non-cash collateral is transferred in traditional prime broker transactions.

This may leave some asset owners and managers seeking more ESG-friendly ways to finance their portfolios.

As part of State Street's global Enhanced Custody solution, the memo-pledge product is an attractive solution for borrowers who want to retain control and transparency over their collateral while continuing to finance their strategies.

Memo Pledge: A flexible, ESG- friendly solution for posting non-cash collateral



State Street's Memo Pledge Program allows Enhanced Custody clients the option to use their own custodied securities as collateral during financial transactions.



Clients maintain flexibility to vote on material ESG proxy votes at their discretion, facilitating ESG engagement.



Retaining the ability to vote provides clients with a way to enact positive change in portfolio companies.



This collateral program allows clients an option to use non-cash collateral in an operationally seamless manner that fits with other collateral methodologies utilized by Enhanced Custody.

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