The Impacts, Challenges and Opportunities of Sustainability within Securities Services

December 2024

DISCLAIMER

It is ISSA’s intention that this report should be updated periodically. This document does not represent professional or legal advice and will be subject to changes in regulation, interpretation, or practice. None of the products, services, practices or standards referenced or set out in this report are intended to be prescriptive for Market Participants. Therefore, they should not be viewed as express or implied required market practice. Instead they are meant to be informative reference points which may help Market Participants manage the challenges in today's Securities Services environment. Neither ISSA nor the members of ISSA's Working Group warrant the accuracy or completeness of the information or analysis contained in this report.

Table of Contents

0. Foreword 6
   - 0.1 Introduction 6
   - 0.2 The Interconnected Fabric of ESG 6
1. Sustainability in Context 8
   - 1.1 Introduction 8
   - 1.2 Latest Regulations and Principles 8
   - 1.3 Focus on MENA & APAC regions 9
2. First Line of Defence 13
   - 2.1 Introduction 13
   - 2.2 Stakeholders' expectations on Sustainability 14
   - 2.3 Design and implement Securities Services solutions with ESG criteria in mind 17
   - Evolution of the impact of Sustainability on the First Line of Defence 21
3. Second Line of Defence 23
   - 3.1 Introduction 23
   - 3.2 ESG Risks 23
   - 3.3 Role of the Second Line of Defence in Managing ESG Risks in Securities Services 25
   - 3.4 Navigating the Regulatory Landscape and ESG Compliance Requirements 26
   - 3.5 Developing Robust ESG Risk Frameworks and Monitoring Mechanisms 27
   - 3.6 Integrating ESG Considerations into Compliance Programmes for Securities Services 27
4. Third Line of Defence 30
   - 4.1 Introduction 30
   - 4.2 Evaluating ESG Impact through Internal Audit in Securities Services 30
   - 4.3 Assurance Mechanisms for Validating ESG Reporting and Disclosure in Securities Services 32
   - 4.4 Recommendations for Strengthening ESG Governance in Securities Services 33
   - 4.5 Enhancing Stakeholder Confidence through ESG Assurance in Securities Services 34
5. Conclusion 36
   - 5.1 Introduction 36
   - 5.2 ESG Opportunities and the Costs of Non-Compliance 36

Executive Summary

Introduction

The International Securities Services Association (ISSA) is a global association that supports the Securities Services industry. ISSA's members include CSDs, custodians, technology companies and other firms who are actively involved in all aspects of the Securities Services value chain. By connecting its members and facilitating collaboration, ISSA provides the leadership necessary to drive change in the Securities Services industry. The focus is on finding progressive solutions to reduce risk and improve efficiency and effectiveness – from issuer through to investor – as well as on providing broader thought-leadership to help shape the future of the industry.

Background

Amidst the evolving landscape of global markets, the integration of sustainability and Environmental, Social, and Governance (ESG) factors has emerged as a pivotal force reshaping businesses worldwide. Nowhere is this transformation more profound than within the Securities Services industry, where the principles of sustainability are catalyzing a paradigm shift in business practices, product strategies and compliance and regulatory frameworks. As a result, ISSA created the Sustainability and Securities Services Working Group (WG) whose aim is to help both its members and the broader industry better understand sustainability and ESG in the context of Securities Services.

As stakeholders increasingly recognize the imperative of sustainability and ESG integration, this white paper stands as a beacon, guiding the Securities Services industry toward a future defined by resilience, transparency and ethical leadership. By understanding and embracing the principles outlined herein, industry professionals can pave the way for sustainable growth, bolster stakeholder trust, and contribute meaningfully to global efforts towards a more equitable and sustainable future.

Objective

The primary objective of this paper is to serve as an educational resource for professionals navigating the intricate intersection of sustainability, ESG principles and Securities Services. It endeavours to explain how sustainability considerations permeate every facet of industry operations, from governance structures and risk management frameworks to stakeholders' preferences and regulatory compliance mandates. By providing comprehensive insights and practical guidance, this paper aims to empower industry professionals to effectively harness ESG factors as drivers of sustainable growth and resilience.

Central to our exploration is a comprehensive examination of how sustainability influences business operations and strategic decisions across Securities Services and the regulatory landscape across diverse global regions. The paper delves into the transformative potential of sustainability in fostering innovation, mitigating risks and enhancing long-term value creation within the Securities Services industry. Through rigorous analysis and case studies, the aim is to highlight both the challenges and opportunities presented by the integration of ESG criteria, offering actionable strategies for adapting to this new paradigm.

Ultimately, this paper seeks to equip industry professionals with the knowledge and tools necessary to navigate the complex terrain of sustainability related challenges and capitalize on emerging opportunities. By fostering a deeper understanding of the interconnected nature of environmental stewardship, social responsibility, and effective governance, the aim is to foster a culture of sustainable practices and responsible investment within the Securities Services industry.

Key Points of Note

The following key points should be noted when reading this document:

- The content of this whitepaper has been constructed and analysed through the lens of the three lines of defence framework to offer a comprehensive view of the impact and opportunities of sustainability and ESG across organizations
- While this white paper aspires to be an educational tool for professionals in the Securities Services industry worldwide, it maintains a specific emphasis on Europe. This is because the European Union's is recognised as a leader in ESG regulation and best practices in the financial sector, including Securities Services. The EU's robust regulatory framework and initiatives serve as benchmark for ESG integration that is highly relevant to the themes explored in this paper

To support readers who may not be familiar with sustainability and ESG concepts, a glossary of terms and definitions is available on the ISSA website at Sustainability and Securities Services Working Group - ISSA.

Target Audience

As outlined above, this paper is born out of the Sustainability and Securities Services WG's dedication to fostering a comprehensive understanding of the challenges, impacts and opportunities of sustainability within the Securities Services industry. Created by the WG participants, this white paper represents a collaborative effort to illuminate the multifaceted impacts of sustainability on the Securities Services sector.

It will be attractive to the following:

- Any Securities Services providers including market intermediaries such as custodians and brokers, asset managers, issuers, market infrastructures, third-party providers (such as technology providers and outsourcers) and, potentially, industry associations and regulators
- Those who are entering the industry – as well as existing industry employees – who are seeking to broaden their understanding of sustainability and its impact on the Securities Services environment

Acknowledgements

This report is the result of efforts by a team of experts drawn from ISSA, that participated in the Sustainability and Securities Services WG. This included Operating Committee members and other ISSA member firms. The names of firms that have participated in creating this report are provided below. The ISSA Executive Board wishes to thank the WG members for their contributions as well as their firms for having enabled their participation.

ABN Amro
BNP Paribas
Bloomberg
Central Securities Clearing System
Chongwa (Macao) Financial Asset Exchange Co.
Datos Insights
Deutsche Bank
Deutsche Börse Group
Euroclear
McKinsey
MYRIAD Group Technologies
Nasdaq
Northern Trust Corporation
Now CM
Proxymity
S&P Global
SWIFT
Taiwan Depository & Clearing Corporation
Tata Group
The Standard Bank of South Africa
UBS

0. Foreword

0.1 Introduction

Those closest to the concepts of sustainability and Environmental, Social and Governance (ESG) will be familiar with the conceptual difference between the two terms. For everyone else, here is a – hopefully - helpful explanation. Though they are related concepts, sustainability is a broad term referring to practices that support long-term environmental, social and economic health. It encompasses efforts to meet present needs without compromising future resources, often focused on environmental impact and social welfare. ESG, on the other hand, specifically refers to measurable criteria that investors and companies use to evaluate sustainability risks, opportunities and ethical impact. ESG is effectively a framework that quantifies aspects of sustainability for use in analysis and decision-making, making it more actionable and measurable in corporate contexts.

In the intricate tapestry of sustainability, and specifically ESG principles, there is an interconnection that goes deeper than the surface-level distinctions often perceived among them. While these three pillars are commonly perceived as distinct domains, a closer examination reveals strong synergies between them.

Central to this paper is an in-depth analysis of how environmental sustainability, social responsibility and effective governance converge within the Securities Services sector. It highlights how these interrelated factors not only mitigate risks and enhance operational efficiency but also drive innovation and bolster stakeholder trust and market innovation in support to a more sustainable future. By elucidating these interconnected dynamics, the aim is to educate and, where possible, inspire proactive responses to evolving market expectations and regulatory frameworks, positioning industry professionals as catalysts for positive change.

0.2 The Interconnected Fabric of ESG

At first glance, environmental concerns, social dynamics and governance structures may appear disparate, each with its own set of imperatives and considerations. However, upon closer scrutiny, the boundaries between them blur revealing a complex web of interactions and dependencies.

Consider the realm of environmental governance, where the stewardship of natural resources and mitigation of ecological impacts converge with the mechanisms of corporate governance. Here, the decisions made by firms regarding resource utilization, emissions reduction and sustainable practices are intricately linked to governance frameworks. Effective environmental governance, for example, necessitates robust structures to support increased active ownership and cost-effectively achieve compliance with ESG regulatory requirements, stewardship codes and best practice guidelines.

Similarly, the social dimension of ESG intersects profoundly with governance mechanisms within organizations. Social responsibility entails considerations of labour practices, diversity and inclusion, community engagement and ethical conduct. Within the governance framework, these social imperatives manifest in policies and practices that prioritize stakeholder welfare, foster inclusive cultures and uphold ethical standards. Governance mechanisms serve as the bedrock for embedding social responsibility into the fabric of organizational operations, ensuring alignment with societal expectations and values.

Furthermore, the environmental and social dimensions of ESG are deeply intertwined, forming a symbiotic relationship that underscores the interconnectedness of human and ecological well-being. Environmental degradation often

disproportionately impacts marginalized communities, exacerbating social inequities and injustices. Conversely, social dynamics such as community activism and stakeholder engagement play a pivotal role in driving environmental awareness and advocacy. The integration of environmental and social considerations within governance frameworks fosters holistic approaches to sustainability, addressing both ecological imperatives and social equity concerns. Here again, notions - such as green indexes, low-carbon strategies and calls for generally increased transparency and accountability from regulatory bodies and stakeholders - serve as catalysts for stakeholders demanding access to comprehensive ESG data, reporting and distribution. Securities Services providers play a vital role in this field and access to proprietary and third-party data sources across all asset classes become essential resources.

In conclusion, the notion of ESG transcends the sum of its parts, embodying a holistic framework that acknowledges the intrinsic interdependence of environmental, social, and governance principles. By recognizing the interconnected nature of these domains, and seizing the opportunities that lie ahead, organizations operating within the Securities Services industry can cultivate resilience, innovation and long-term value creation and act as powerful catalyst for change. In the subsequent sections of this paper, the following are explored: the ramifications of ESG integration within Securities Services as well as examining ESG's impact on risk management, stakeholder engagement, commercial strategy evolution and operational resilience on a global scale.

Flora Belladonna, Working Group Co-Chair

1. Sustainability in Context

1.1 Introduction

The integration of sustainability into financial services is no longer a matter of preference but a global imperative. As environmental, social, and governance (ESG) considerations reshape economies and industries, the securities services industry stands at the intersection of finance, operations, and accountability. This pivotal role places the sector under increasing scrutiny to align with sustainable practices, regulatory demands, and stakeholders' expectations.

Sustainability within securities services encompasses not only reducing environmental impact but also fostering responsible governance, equitable practices, and robust risk management. The challenges and opportunities in this space are significant, with the sector uniquely positioned to influence capital flows, operational frameworks, and stakeholder outcomes.

This white paper explores the profound implications of sustainability through the lens of the three lines of defence framework. Each chapter examines how sustainability influences governance, risk management, and operational resilience at every level. Before delving into this analysis, we provide an overview of the latest regulatory developments and guiding principles shaping sustainability practices across securities services. This context sets the stage for understanding how these frameworks can unlock value while addressing risks in a rapidly evolving landscape.

1.2 Latest Regulations and Principles

The number of new ESG-related and climate-focused policies and regulations has been increasing year on year. According to the Principles for Responsible Investment (UNPRI) tracker, there was a total of 460 counted in 2024 – up from 133 ten years ago. Over half of these are now designed to support the economic transition.

From a Securities Services perspective, two main groups of external stakeholders are impacted – institutional investors and corporate entities. Investors need quality, standardized disclosures on companies and their assets in order to allocate capital efficiently. Client-facing teams must be aware of the latest and upcoming changes in the regulatory landscape to best support their clients with solutions to help meet local (and global) requirements.

The list below summarizes many of the latest regulations and principles that are at the top of many people's priority lists:

- CSRD (EU)
  The Corporate Sustainability Reporting Directive (CSRD) increases the amount of sustainability data to be disclosed by companies. It is a regulation that went live at the start of 2023. The first companies will have to apply the new rules for the first time in the 2024 financial year, for reports published in 2025. It is expected to increase the number of firms subject to EU sustainability reporting requirements to approximately 49,000 (*source: KPMG*).

- CSDDD (EU)
  The Corporate Sustainability Due Diligence Directive (CSDDD or CS3D) will require (as legislation) in-scope companies (both EU and non-EU) to set up due diligence processes to identify adverse human rights and environmental impacts within their own operations and within those across their entire supply chain. The Directive was formally adopted in April 2024. It is designed to work alongside the CSRD regulation.
- SFDR (EU)
  First introduced in 2021, the Sustainable Finance Disclosure Regulation (SFDR) imposes mandatory ESG disclosure obligations for asset managers and other specified financial markets participants, with the aim of standardizing the

disclosure of potential adverse sustainability impacts and reporting of other sustainability-related information. There have been numerous challenges to the different fund category definitions; challenges that continue today. It is different but related to the EU Taxonomy Regulation designed to address greenwashing. In the EU, over 40% of funds are now classified as Article 8 or 9 under the SFDR (*source: Morningstar, 2023*).

- SDR (UK)
  The UK's Sustainability Disclosure Requirements (SDR) introduces a set of sustainability-related product labels, product- and entity-level disclosures, an anti-greenwashing rule and additional rules regarding sustainable investing for the UK. The SDR includes regulations and disclosures that will apply to many financial services entities as well as many of their products and activities. The application of sustainability labels is voluntary and first became available for use from 31 July 2024.

- SEC Climate Disclosure Rule (US)
  The Securities and Exchange Commission in the US recently adopted rule changes requiring companies to disclose climate-related information that includes greenhouse gas emissions and other climate risks. It is adopting amendments to its rules under the Securities Act of 1933 ("Securities Act") and Securities Exchange Act of 1934 ("Exchange Act"). Consistent with other regulations, the goal is to provide investors with consistent, comparable and decision-useful information for making investment decisions. Disclosures are to be included in annual reports beginning for the year ending 31 December 2025.

- ASIC (Australia)
  The Australian Securities and Investments Commission (ASIC) emphasizes the integration of climate risk into corporate governance and financial disclosures. From 1 January 2025, many large Australian businesses and financial institutions will need to prepare annual sustainability reports containing mandatory climate-related financial disclosures, following the passage of a major bill through Parliament. It provides guidance for companies to assess and disclose climate-related risks and opportunities, in line with the Task Force on Climate-related Financial Disclosures (TCFD).

- Corporate Governance Principles and Recommendations (Australia)
  The Australian Stock Exchange (ASX) promotes ESG reporting through its Corporate Governance Principles, encouraging listed companies to disclose their sustainability practices and risks in annual reports. These principles are voluntary but form a best practise approach for participants to follow.

Please note, however, that this list clearly does not cover all requirements in all jurisdictions. There are many other regulations directed at issuers and investors in most major markets around the world.

1.3 Focus on MENA & APAC regions

The Middle East and North Africa (MENA) region is witnessing a surge of interest in sustainability, driven by economic diversification efforts and the pursuit of sustainable development goals.

The UAE, in particular, has made significant strides in embedding ESG principles within its financial markets. One core aspect of the UAE's Vision 2031 is the establishment of a green economy that underpins sustainable development and infrastructure. This vision is reflected in the operations of major financial exchanges such as the Dubai Financial Market (DFM) and the Abu Dhabi Securities Exchange (ADX) as well as the Securities and the Securities and Commodities Authority (SCA):

- DFM and ADX ESG Initiatives
  Both exchanges mandate annual sustainability reporting in alignment with the Global Reporting Initiative (GRI) standards. They have also introduced training programmes to assist listed companies in enhancing their ESG reporting capabilities.

- SCA Guidance
  The SCA has introduced a set of 32 ESG metrics that companies must disclose, fostering transparency and accountability. Additionally, the DFM has launched an ESG stock index, enabling investors to track companies excelling in sustainability practices.

The adoption of the Global Standards for Sustainability Impacts (GRI) in the MENA region represents a significant step towards harmonizing ESG disclosures with global benchmarks. GRI provides a structured framework for reporting environmental and social impacts, helping financial institutions in the MENA region align with international expectations. The Asia-Pacific (APAC) region is rapidly advancing in integrating ESG principles into its financial systems, with countries like Australia and Japan taking a leading role. This evolution is driven by a mix of regulatory mandates, market-driven initiatives and increasing stakeholder awareness of sustainability issues. Financial institutions in these countries are actively aligning with global ESG standards while addressing regional-specific challenges and opportunities. In one such country, Australia has made significant strides in embedding ESG considerations into its financial services industry, reflecting a growing commitment to sustainable finance. The regulatory landscape in Australia is characterized by a combination of mandatory disclosure requirements, voluntary guidelines and industry-led initiatives that together shape the ESG agenda.

Illustration 2.2.2a Sustainability Regulation – Focus on EU and UK

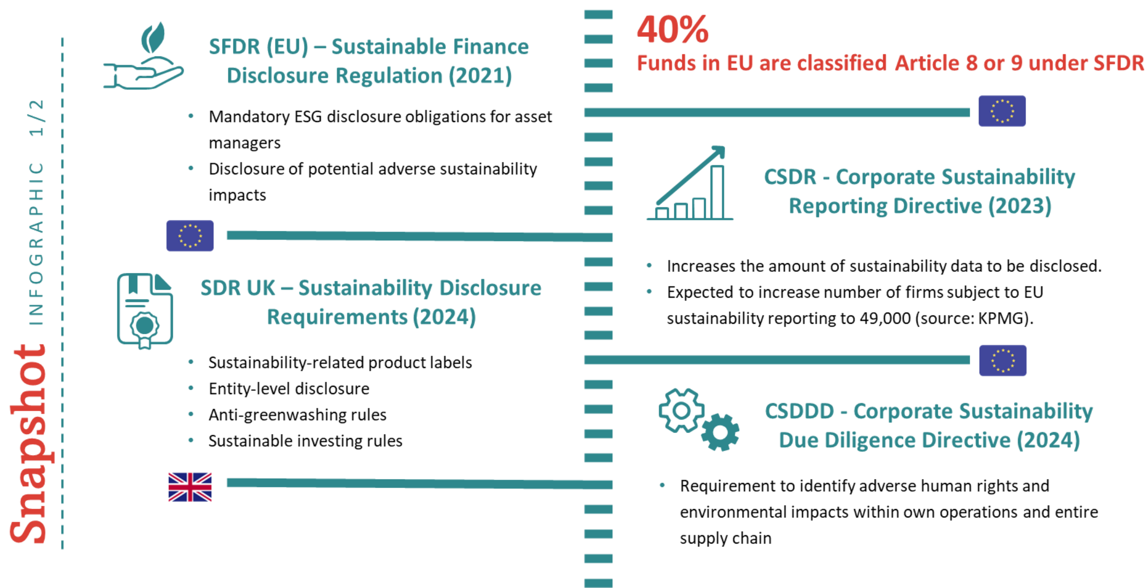
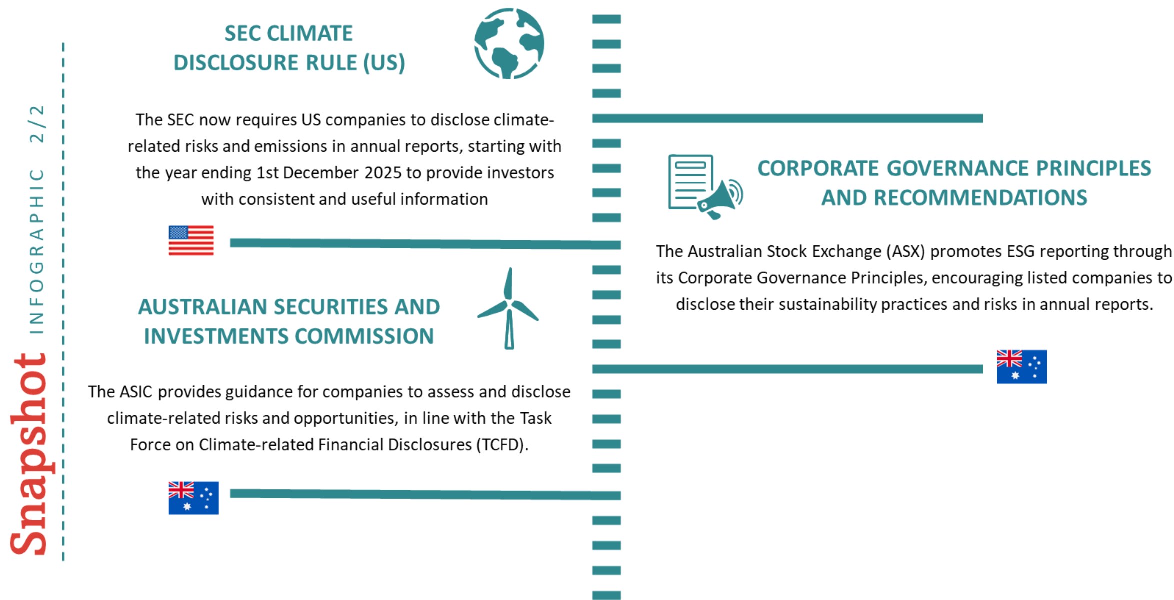


Illustration 2.2.2b Sustainability Regulation – Rest of the World

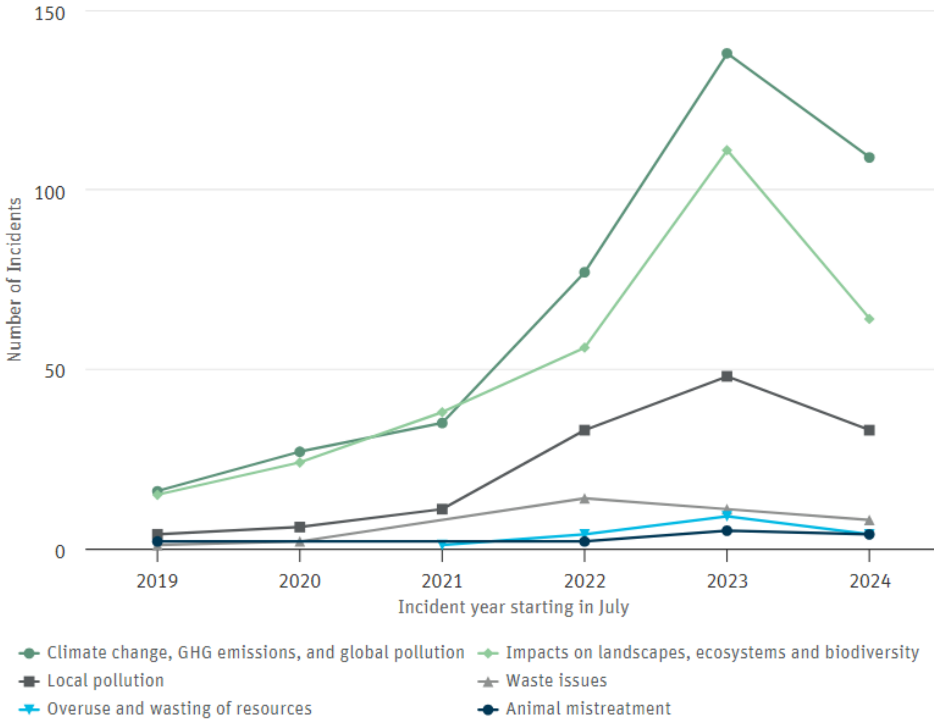


In addition to the focus on climate risk and plans for a successful transition, there is also increasing support for biodiversity- and nature-related policies and regulations. For example, the Taskforce on Nature-related Financial Disclosures (TNFD) was launched in 2023 and this set of recommendations (currently voluntary) already has a significant volume of assets ($16 trillion of AuM in June 2024) committed to its cause. There has also been the significant introduction of two new Sustainability Standards (S1 and S2) from the International Sustainability Standards Board (ISSB) that aim to foster global standardization for company disclosures. The successful efforts of the Taskforce on Climate-related Financial Disclosures (TCFD) have now been absorbed into this larger effort by the ISSB. Individual jurisdictions are beginning to embed these standards into regulatory activities.

The impact of increased regulation and market scrutiny is significant. For example, according to the 2024 RepRisk's annual greenwashing report, climate-related greenwashing incidents in the EU's Banking and Financial Services sector have declined by 20% in the last year, as a likely consequence of stricter regulations (Illustration 2.2.2a) [1]

[1]RepRisk | A turning tide in greenwashing? Exploring the first decline in six years

Illustration 2.2.2c- Environmental issues linked to greenwashing in the Banking and Financial Services sector



2. First Line of Defence

2.1 Introduction

In the context of the Securities Services industry, the first line of defence refers to the front-line functions responsible for identifying, assessing and managing risks within an organization. These functions are typically involved in day-to-day operations and have direct contact with clients and transactions.

Like in any other functions, for sustainability and ESG, the first line of defence plays a crucial role in maintaining the security and integrity of the organization's operations. It is responsible for implementing and adhering to risk management policies, procedures, and controls to ensure compliance with regulatory requirements and industry best practices.

Some key functions involved in the first line of defence in the Securities Services industry include:

- Incident Management
  Incident management is responsible for promptly identifying and responding to security incidents or breaches. This includes investigating and resolving incidents, as well as implementing measures to prevent their recurrence. In the context of sustainability, ESG data breaches would be investigated by the First Line of Defence.

- Risk First Identification and Assessment
  This function identifies and assesses risks associated with various activities, such as trade execution, custody services and fund administration. This involves evaluating potential risks and their potential impact on the organization.

- Compliance Monitoring
  This function monitors compliance with regulatory requirements, internal policies, and industry standards. This involves conducting regular reviews and assessments to ensure adherence to applicable rules and regulations.

- Due Diligence Implementation
  The due diligence function implements controls and measures to mitigate identified risks. This includes establishing robust processes, procedures and systems to ensure the accuracy, confidentiality and availability of client data and assets.

Currently, some of the broader sustainability regulatory developments regarding environment, social and governance considerations are derived from the European Central Bank's "Guide on climate-related and environmental risks" dated November 2020 and the "Guide for Supervisors: integrating climate-related and environmental risks into prudential supervision" published in May 2020 by the Network of Central Banks and Supervisors for Greening the Financial System (NGFS).

As an example, Luxembourg's CSSF, the local financial regulatory body responsible for supervising the financial sector (which includes banks, investment firms, insurance companies and other financial service providers) devised the following rules for the first line of defence: "Business line staff, acting as First Line of Defence, shall perform its duties in accordance with any climate-related and environmental policy, procedure or limit.

More specifically, the first line of defence is expected to identify, assess and monitor any climate-related and environmental risks relevant for the creditworthiness and the scoring/rating of a client or counterparty, as well as to conduct proper due diligence on climate-related and environmental risks that the institution is or will become exposed to."[2]

The first line of defence is responsible for performing their duties in accordance with any climate-related and environmental policy, procedure or limit. Their specific responsibilities include:

- Identifying, assessing and monitoring climate-related and environmental risks that are relevant to the creditworthiness and scoring/rating of a client or counterparty
- Conducting proper due diligence on climate-related and environmental risks that the institution is currently exposed to or may become exposed to in the future

These responsibilities aim to ensure that the institution effectively manages and mitigates climate-related and environmental risks. It is important for the first line of defence to adhere to the established policies and procedures in order to maintain the institution's sustainability efforts and protect the firm from any operational, regulatory and reputational risks.

2.2 Stakeholders' expectations on Sustainability

2.2.1 Expectations

Stakeholders in the Securities Services industry seek to provide strong performance and reporting around sustainability issues within Securities Services and the financial ecosystem. The key sustainability stakeholders within Securities Services include, corporates and issuers, central depositories, custodians, asset managers, institutional and retail investors, technology providers, ESG data and rating providers, regulators, exchanges, and climate and social advocacy non-governmental organizations. Each of these stakeholders have unique but related expectations in managing the ESG impacts, risks and opportunities within the lifecycle of securities. The management of stakeholder's expectations on ESG issues should be to ensure that financial markets remain safe and profitable, not simply for earning a sustainability designation.

Below are examples Securities Services stakeholders and their primary ESG considerations:

- Corporates and issuers

  Corporates and issuers exist to earn maximum profit for their owners and, as such, those who consume their services and products expect them to demonstrate ethical business practices that are free of corruption and bribery, take care of the wellbeing of their employees, ensure fair treatment and representation from the leadership to every level of the organization, make a positive impact in their surrounding communities, use natural resources such as water and energy efficiently and reduce their impact on climate change. They are also expected to accurately report on ESG performance to their stakeholders and the public.

- Central depositories

  Central depositories are responsible for the smooth and accurate flow of securities clearing and settlement process, safety of securities, accuracy of issuance and tracking of securities and their ownership, smooth transfer

[2] CSSF 21/773

of ownership, accuracy of payments and accuracy of book entries. As a core part of the Securities Services value chain, central depositories play a critical role in the provision of ESG-related information from the local market to custodians and investors.

- Custodians

  The focus of custodians is on the safety of securities, smooth and accurate flow of securities clearing and settlement process, compliance with regulatory requirements, accurate execution of corporate actions, and accurate accounting of collateral. As key data aggregators, custodians also play a vital role on ESG reporting and access to data.

- Asset managers

  The primary ESG responsibility of asset managers is the profitability of their clients' portfolios. However, many clients are also keen to ensure that their asset managers are investing responsibly. ESG risk mitigation is a strong responsibility alongside delivering strong investment outcomes and therefore assets managers will need to ensure that they review sustainability policies, perform ESG risk evaluations, evaluate industry restrictions and screen assets in order to more effectively manage risk within their own organizations for themselves, their stakeholders and their clients.

- Investors

  Sustainable-minded investors are increasingly eager to align their portfolios with ESG-related companies, with a focus on positive impact on society and the environment, in line with their personal values. ESG investments are also considered less risky by investors as it is expected that companies achieving profitability will have better long-term growth or returns while minimizing the impact on the environment. This ensures high standards in managing human capital and, with strong corporate governance, means these companies better prepared for uncertainty and better positioned to avoid reputational damage – reputational damage which can lead to decreased profitability.

- Exchanges

  The safety and accuracy of marketplace listings and transactions are the primary ESG considerations for exchanges.

- Technology providers

  Technology providers consider the data safety and accuracy, increasing cost of computing, increased demand for reliable energy and continuity of service in extreme natural or geopolitical events.

CASE STUDY: Sustainability Expectations

A notable example that highlights the impact of sustainability expectations on firms in the Securities Services industry is the case State Street Global Advisors (SSGA), a firm that gained attention for promoting ESG principles through its investment practices. In 2017, the firm launched a campaign centred around the installation of a statue of a young girl standing boldly in front of a well-known symbol of financial strength in New York. This initiative was a symbolic effort to advocate for greater gender diversity on corporate boards. Alongside the public campaign, the firm used its influence as a major shareholder to push companies to increase the number of women on their boards and strengthen their gender diversity policies. The campaign responded to growing pressure from ESG stakeholders—particularly institutional investors—demanding more transparency and accountability on social issues, including gender equality.

SSGA's strong stance on gender diversity led to tangible outcomes within the Securities Services sector, creating a ripple effect throughout the industry. Other asset managers and Securities Services providers began adopting similar ESG-focused initiatives, highlighting the increasing importance of ESG considerations among investors. The widespread attention and support for these initiatives prompted discussions on regulatory frameworks concerning board diversity.

2.2.2 Importance of Stakeholder Engagement and Relations

Stakeholder engagement and relations are fundamental aspects of any successful business strategy. An organization's primary goal in stakeholder engagement and relations is to ensure that stakeholders' perspectives are considered and their input incorporated into decision-making processes.

The importance of effective stakeholder engagement and relations cannot be overstated in today's business environment, with ESG serving as a key reminder of this. Organizations that actively engage with their stakeholders can gain significant advantages, such as enhanced reputation, increased customer loyalty and improved risk management. By integrating stakeholder views and fostering strong relationships, businesses are better equipped to anticipate and adapt to changes, ultimately driving long-term success and sustainability.

ESG can also act as a powerful communication tool, informing stakeholders about a company's commitments and actions towards sustainable and responsible business practices and encouraging their active participation and dialogue with the company.

CASE STUDY: Stakeholder Engagement and Relations

A well-known example of stakeholder engagement and influence is the case of Blackrock whose CEO made headlines in 2020 by declaring that climate change had become a defining factor in companies' long-term prospects. The firm announced that it would place sustainability at the core of its investment strategy, beginning to divest from investments with high sustainability risks, such as coal producers, and launching new products that exclude fossil fuels.

This shift was a direct response to mounting pressure from ESG stakeholders, including institutional investors, clients, and advocacy groups, who voiced concerns about the risks posed by climate change and the need for corporate action. The firm's public commitment to sustainability spurred other asset managers and Securities Services providers to adopt more rigorous ESG policies to remain competitive and meet evolving investor expectations. It also contributed to a broader conversation in the financial sector about the role of asset managers in addressing climate change, leading to increased regulatory scrutiny and the creation of new standards for ESG reporting and climate risk disclosures.

Conversely, ignoring ESG stakeholder expectations can result in significant negative consequences, particularly in the Securities Services industry, where trust and risk management are critical. In the minds of ESG stakeholders, financial institutions are a single entity, whereby the Securities Services provider is considered part of the overall institution and therefore is affected by the perception of the parent organization. Scandals in any part of a financial institution, related to ESG issues, can cause financial and reputational harm, legal penalties and client losses. Examples of this include controversies involving financial institutions with connections to environmental and governance issues, such as financing fossil fuel projects, weak risk governance and controls frameworks and allegations of greenwashing.

There have been a number of high-profile cases where greenwashing by financial institutions has been exposed, such as the two examples below:

- In 2023 a prominent investment firm, backed by a major bank, agreed to pay a USD 25 million settlement to the U.S. Securities and Exchange Commission (SEC) over allegations of greenwashing for misleading statements about its integration of ESG factors in its investment practices between 2018 and 2021.
- In September 2024, Australia's federal court imposed a fine of AUD 12.9 million against a well-known investment management firm for misleading claims about its ethical fund, which was found to include companies in fossil fuels and firearms despite stated exclusions

2.3 Design and implement Securities Services solutions with ESG criteria in mind

2.3.1 Introduction

With the increasing prevalence of ESG regulatory pressures/requirements, alongside the growing public and corporate awareness of our impact on the world, it is important consider whether Securities Services providers have taken on the challenge of incorporating ESG into their product offerings. Additionally, they need to consider if they are doing enough and how can they help to support the wider financial world in a transfer to a lower carbon, more socially responsible world.

As part of the industry wide focus on ESG, with its growing importance as a value add for clients and maintaining regulatory compliance, Securities Services providers have a key role to play. They can help clients to understand, visualize and contextualize how their investments fit into ESG structures and, further, provide solutions that enable greater incorporation of ESG factors into the Securities Services value chain.

CASE STUDY: Impact of ESG on Product Governance

As the financial services industry continues to play a crucial role in fostering a responsible and sustainable economy in response to growing demand from its stakeholders, institutional investors increasingly focus on ESG integration through their investment processes. This journey is not without obstacles – inconsistent ESG data and various regulatory frameworks – but the continued growth of ESG presents great impacts, challenges, and opportunities, to the securities services industry.

Institutions are looking for "fit for purpose" solutions. Not only do they need to fulfil regulatory demands, but also be able to evolve with its ever-changing needs. At BNP Paribas' Securities Services business, the continuous feedback and collaboration with clients, alongside the insights from its Global ESG Surveys, has enabled the team to have a comprehensive view of industry trends, then to adapt solutions to its stakeholders' needs.

Looking at the wider ESG integration process, the team has adopted a holistic approach in supporting its clients in their transition, taking all its internal and external stakeholders into consideration. They have incorporated ESG data in decision-making processes, for example, product validation, risk framework, and human resources. Such assessment is also extended to all external ecosystems, including suppliers and sub custodians. To help clients accelerate their sustainability journey, the bank continues to support them in both pre- and post-trade activities, such as the launch and custody of sustainable funds, ESG reporting, and monitoring of business practices from an ESG perspective.

For new product development, the team regularly reviews its approach, adding sustainability criteria to mitigate ESG risks or contribute to broader sustainability objectives.

For example, to support clients better integrate ESG into their operations, the team has developed specific tools, from portfolio look-through to reporting, helping firms distributing sustainable funds comply with relevant regulations, such as the European SFDR and SDR. Through its investment compliance monitoring solution, clients can incorporate customisable ESG criteria into the monitoring of their investment guidelines. For scenario planning, they can estimate the sensitivity of their portfolio to rapid climate change. In addition, as institutions are increasingly keen to have their voice in corporates they invest in, proxy-voting and class actions services have also been enhanced to enable clients to share their views in a more seamless way.

The developments and innovations within BNP Paribas' Securities Services business stemmed from its commitments to a more sustainable future. As the business continues to focus on embedding ESG principles into its core activities, it remains diligent in helping clients achieve their sustainability goals while encouraging the broader securities services industry to adopt a robust ESG product governance.

2.3.2 Reporting

One area in which Securities Services providers can add significant value to clients is in the reporting of ESG factors alongside the more traditional metrics provided in reporting tools or portals. Whilst the Securities Services industry does not own the ESG data itself - usually receiving it from upstream business lines or external parties - incorporating it closely into existing reporting tools and providing easy access to this data is a vital service. Providing this information enables clients to monitor and understand their portfolios against ESG benchmarks and, increasingly, regulatory requirements.

This value has been achieved in a number of ways:

- Incorporation of external ESG data providers tools to enable analysis of ESG criteria at either securities or portfolio level
- Provision of reporting in line with regulatory requirements e.g. Sustainable Finance Disclosure Regulation (SFDR) and the European ESG Template (EET)
- Investment Compliance tools to screen and monitor client portfolios against predefined ESG criteria

2.3.3 Proxy Voting and Class Actions

A crucial, but often overlooked, element to ESG is the 'G' – Governance. Securities Services providers, as the custodians of multiple asset types, can help clients be active partners in the governance of the companies which they hold in their portfolios. Increasingly, Securities Services providers are focusing on enabling efficient and timely access to proxy voting and class action information, where previously this was not a product provided.

Solutions include:

- Providing integrated access to proxy voting to enable clients easy access and voting solutions
- Enabling clients to take an active part in companies strategic decisions and get involved in ESG related class action claims
- Providing clients with access to outsourced proxy advisors to help make recommendations on voting

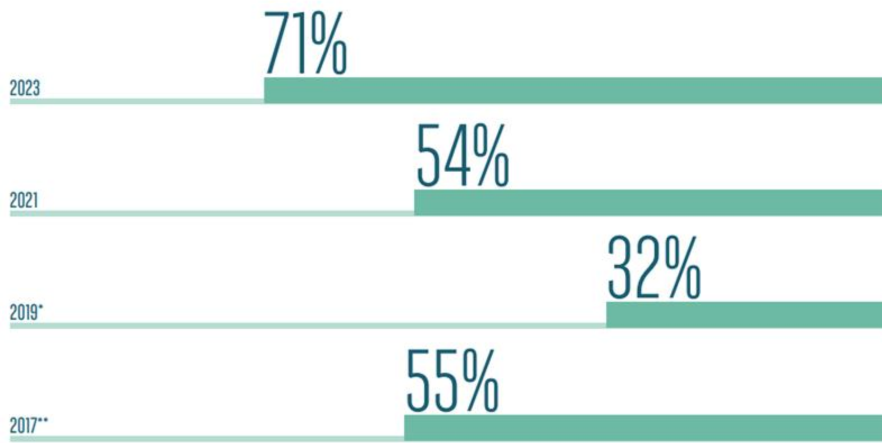
2.3.4 Data

As the amount of ESG data available to financial market participants continues to grow, Securities Services providers have found themselves needing to incorporate and aggregate data from many different sources. Whilst time-consuming, this data collation provides an opportunity for organizations to become information aggregators and provide ESG data at a greater level of specificity to meet client and regulatory requirements. However, it should be noted that both access to, and the quality of, data remain a big barrier to a wider adoption of ESG data provision to clients from Securities Services organizations.

Current solutions include:

- Integrating company-wide ESG taxonomies of aggregated data to enable consistent reporting across business
- Open-architecture tools to enable client led portfolio analysis

Figure 2.4.4 - "The significance of inconsistent and incomplete ESG data as a barrier to the greater adoption of ESG"[3]



2.3.5 Securities Lending

Historically, concerns were raised about securities lending and it being inconsistent with the requirements of ESG responsible investment. However, there are Securities Services providers looking to provide solutions both that enable lending as part of a responsible investment strategy and maintain strong governance links to the underlying companies.

Solutions should include:

- Making sure that ESG policies between client and lender are aligned
- Protection of proxy voting rights via recalls or restrictions
- Selection of counterparties and collateral against ESG requirements

2.3.6 Green Bonds

The Securities Services industry has long provided issuer services to the financial markets. Since 2007, there has been a new type of bond - the 'ESG' bond - which includes green, sustainable and ESG linked bonds that are geared towards funding outcomes linked to sustainability. With the growth of sustainable bond issuance over the last few years - which passed USD 3 Trillion in 2022 - and the increasing appetite from investors to align their investments with sustainability goals, Securities Services providers are well placed to facilitate an enhanced service for 'ESG' bonds.

[3] BNP Paribas ESG Global Survey 2023 LINK

Solutions should include:

- Greater integration with origination teams to support the ESG focused debt solutions throughout their life cycle
- Data integration and analytics reporting to streamline due diligence, monitoring and reporting

2.3.7 ESG Training and Education

As ESG data becomes an ever more important factor in investors' decision-making processes, the need for greater regulatory and inter-organization agreement over ESG data standards has grown. Initiatives, like the European ESG Template (EET), act to create a harmonized template through which ESG data can be standardized and distributed between manufacturers and financial services. Regulatory initiatives, like the FCA's Sustainability Disclosure Requirements Act, enforce a more standardized and clear approach to ESG data provided to clients. However, as this data standardization grows, the process to gather and report this data becomes more onerous, with differing requirements and diverse areas in which this data has been stored. For their part, Securities Services providers can help to bridge the gap between current and future state requirements by providing training and education around reporting and the tools available to aggregate this information.

Potential solutions could include:

- Providing training on propriety digital solutions offered to clients that help to make this data easier to access and upload
- Include training packages to clients around ESG data and upcoming regulatory requirements

Evolution of the impact of Sustainability on the First Line of Defence

Historically centred on risk management and compliance, the first line of defence now plays a pivotal role in embedding sustainable and ethical practices throughout the Securities Services industry. An increasing number of organizations are creating dedicated ESG roles to oversee and manage the incorporation of sustainability topics into their operations and financial reporting processes. This evolution is characterized by a series of forward-looking developments that are poised to shape the future of sustainability integration.[4]

Initially, the first line of defence focused on managing traditional financial and operational risks. However, the escalating importance of sustainability considerations, along with increasing regulation, has expanded these responsibilities to encompass climate-related and environmental risks but also social and governance risks, such as labour practices, diversity, corporate ethics and compliance with governance frameworks. Many Securities Services providers are implementing comprehensive ESG risk management frameworks to address issues such as carbon emissions, resource utilization and biodiversity impacts. This proactive engagement with sustainability outlines a shift from mere compliance to a strategic integration of ESG principles. It also prepares the industry to meet future regulatory requirements and societal expectations with greater agility and resilience.

As outlined above, stakeholder engagement has also evolved significantly within the first line of defence. Sustainability considerations now necessitate a broader evaluation of actions on various stakeholders, including clients, investors and the wider community. Integrating ESG criteria into client interactions, investment and credit decisions, as well as service offerings has become crucial. Moving forward, we can expect more sophisticated ESG data platforms and tools that

[4]https://www.thomsonreuters.com/en-us/posts/esg/controller-role/

enable real-time tracking and reporting, enhancing transparency and fostering stronger stakeholder trust and engagement. These innovations will empower front-line teams to better address stakeholder expectations and drive responsible investment practices.

The emphasis on data management and reporting has intensified as well. The demand for transparency and accountability has led to the integration of ESG data aggregation and analysis tools. Front-line teams are tasked with ensuring the accuracy and comprehensiveness of ESG data to meet regulatory requirements and inform strategic decisions. The future will likely see the adoption of cutting-edge technologies such as artificial intelligence (AI) and blockchain to revolutionize ESG data management, making it more accurate, secure and accessible. According to the 2024 ESG Organization Survey by KPMG, 62% of financial services organizations plan to improve ESG data collection with AI and machine learning (ML) in the next three years. Needless to state, such advancements will enable more effective monitoring and reporting, supporting the industry's commitment to sustainability.

In conclusion, the evolution of ESG's impact on the first line of defence reflects a broader transformation within the Securities Services industry. From risk management and stakeholder engagement to data transparency and governance, front-line functions are now at the forefront of implementing and advancing sustainability practices. This evolution not only enhances the resilience and integrity of the financial system but also positions the industry to contribute meaningfully to global sustainability efforts. By embracing emerging technologies and innovative strategies, the roles of the First Line of Defence will continue to bring new opportunities to evolve, supporting the broader financial industry in its efforts to advance sustainability and equity. [5]

[5] KPMG, Addressing the Strategy Execution Gap in Sustainability Reporting 2024, KPMG, 2024, accessed 26 August 2024, https://kpmg.com/us/en/media/news/addressing-the-strategy-execution-gap-in-sustainability-reporting-2024.html

3. Second Line of Defence

3.1 Introduction

The second line of defence, in managing ESG risks within the Securities Services industry, is a critical component of an organization's risk management framework. This line of defence provides oversight and support to the first line of defence, which includes business units and management responsible for day-to-day operations. The second line of defence is tasked with developing and implementing comprehensive ESG risk frameworks that integrate ESG considerations into the core business strategies and operations. By doing so, it ensures that ESG risks are effectively identified, assessed and mitigated.

In addition to risk management, the second line of defence plays a key role in monitoring compliance with regulatory requirements and internal policies. It establishes key performance indicators (KPIs) to track ESG performance, conducts internal audits and third-party assessments and provides regular reports to senior management and the board. This proactive approach helps organizations stay ahead of potential ESG-related challenges, enhance transparency and build resilience. Ultimately, the second line of defence is essential for maintaining the integrity and sustainability of Securities Services providers in an increasingly ESG-conscious world.

3.2 ESG Risks

ESG Risk refers to the potential negative impact that environmental, social, and governance factors can have on an organization's financial performance, reputation and overall sustainability. Here's a breakdown of each component:

- Environmental Risks

  These risks cover the potential adverse effects of environmental factors such as climate change, resource depletion, pollution and waste management on an organization's operations and assets.
  - Carbon Footprint: Assessing and reducing the carbon footprint of operations, including data centres and trading activities, as well as managing carbon emissions
  - Resource Consumption: Monitoring and optimizing the use of natural resources to minimize environmental impact
  - Climate Change: Evaluating the impact of climate change on the value of assets under custody and making necessary adjustments

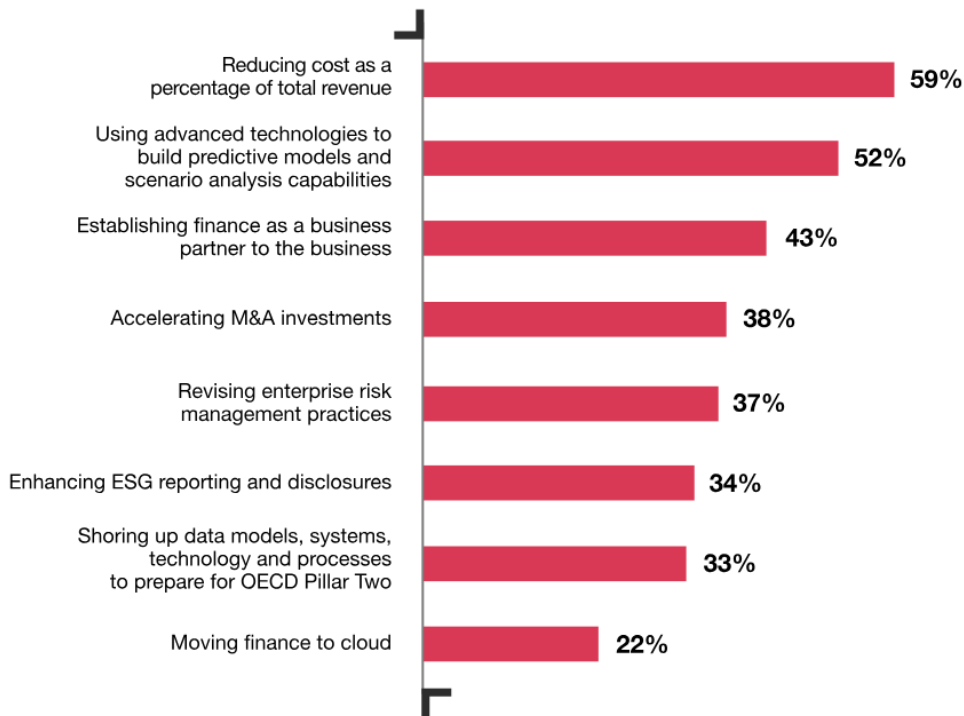
- Social Risks

  These encompass issues related to human rights, labour practices, community relations, diversity and inclusion and overall social responsibility. Social risks can affect an organization's reputation and operational stability.
  - Cybersecurity: Ensuring robust measures to protect client data, maintain data privacy, and secure data storage
  - Supply Chains: Monitoring supply chain practices to ensure ethical labour standards and sustainability
  - Diversity, Equity and Inclusion (DE&I): Promoting a diverse and inclusive workforce within the organization and in the companies, they invest in:
    - Client Protection: Safeguarding client interests and ensuring fair treatment
    - Staff Wellbeing: Fostering a healthy and supportive work environment for employees

- Governance Risks

  These pertain to the quality of corporate governance, including board structure, executive compensation, transparency, ethical behaviour and compliance with laws and regulations. Poor governance can lead to financial mismanagement and loss of stakeholder trust.
  - Regulatory Compliance: Staying updated with evolving ESG regulations and ensuring full compliance
  - Transparency: Maintaining high standards of transparency in corporate practices and financial reporting
  - Quality of Reporting: Ensuring accurate, transparent and comprehensive ESG reporting
  - Anti-Money Laundering (AML): Implementing strong AML measures to prevent financial crimes
  - Ethical Investment: Prioritizing investments in companies with strong ethical practices
  - Long-Term Strategy: Integrating ESG factors into the long-term strategy and decision-making processes
  - Executive Compensation: Aligning executive compensation with long-term ESG performance to promote sustainable growth

Figure 3.2 – Enhancing ESG reporting and disclosure is one of the top 8 priorities for CFOs [6]



*Note: Showing top 8 choices from a list of 10 options.
Q: What are your priorities for your finance function for the next 12 months? *(Select all that apply)*
Source: PwC Pulse Survey, August 22, 2023: base of 609, CFO base of 87

[6] PwC's August 2023 Pulse Survey

3.3 Role of the Second Line of Defence in Managing ESG Risks in Securities Services

By establishing robust oversight and reporting mechanisms, the second line of defence ensures that risk and compliance issues are tracked and reported to senior management and the board of Securities Services providers. This enables the organization to make informed decisions and maintain a strong risk management culture. Overall, the second line of defence is essential for maintaining the integrity and resilience of the Securities Services provider, ensuring long-term sustainability and success.

Below are the key roles and responsibilities for Securities Services providers in relation to ESG:

- Developing ESG Risk Frameworks
  - Integrate ESG considerations into core business strategies and operations and ESG staff Training
  - Conduct thorough risk assessments to identify potential ESG risks
  - Engage with stakeholders and understand the regulatory landscape
  - Develop specific policies and procedures to address identified risks
  - Set clear objectives, define roles and responsibilities, and establish reporting mechanisms.

- Need for ESG training
  - Awareness: Increase the awareness and understanding of ESG consideration among employees which is crucial for integrating ESG considerations into daily operations.
  - Regulatory Compliance: Training ensures that employees are up to date with the latest ESG regulations and standards, helping the organization remain compliant and avoid potential penalties.
  - Risk Management: Equipping employees with the knowledge and skills to identify, assess, and manage ESG risks effectively. This includes understanding how to conduct ESG risk assessments and implement mitigation strategies
  - Data Management: Training on how to collect, analyse, and report ESG data accurately. This is essential for maintaining transparency and meeting stakeholder expectations
  - Cultural Integration: Promoting a culture of sustainability within the organization. ESG training fosters a shared commitment to sustainable practices and ethical behaviour among employees[7]

- Monitoring and Reporting ESG Performance
  - Establish key performance indicators (KPIs) to track progress and measure the impact of ESG initiatives
  - Regularly monitor and report ESG performance to ensure compliance with relevant regulations
  - Conduct internal audits and third-party assessments to evaluate the effectiveness of the ESG risk framework
  - Identify areas for improvement and implement continuous improvement processes

[7] ESG Risk Practices (kpmg.com)

- Enhancing Transparency and Building Resilience
    - Ensure effective management of ESG risks
    - Enhance transparency in ESG practices and reporting
    - Build resilience against ESG-related challenges
    - Contribute to the long-term sustainability and success of the organization

3.4 Navigating the Regulatory Landscape and ESG Compliance Requirements

3.4.1 Introduction

How a firm is classified by sector and industry type will play a big part in determining the mandatory ESG compliance requirements that they are in scope for. Securities Services providers need to navigate this changing landscape to remain compliant across all jurisdictions that they do business in and where they are subject to regulatory oversight.

3.4.2 Impact Areas

Risk management and compliance teams are focused on a range of ESG impact areas. These include:

- Enhanced Transparency
  Regulatory frameworks are driving an increased transparency on ESG factors, requiring firms to disclose more detailed information about risks, impacts, opportunities and objectives.

- Data and Reporting Challenges

  Meeting the complex and evolving disclosure requirements poses challenges in data collection, analysis, and reporting. Firms need to invest in technology and expertise to ensure compliance. Data models are increasingly subject to oversight by internal groups to mitigate the risk of inaccurate outputs causing material impact.

- Product Development

  The focus on sustainable finance is driving the development of new financial products for investors that align with ESG objectives. Securities Services providers need to adapt their product offerings to meet this demand.

- Risk Management

  ESG risks are increasingly integrated into risk management frameworks. Firms need to assess and manage these risks alongside the more “traditional” financial risks. Risk teams need to manage the ongoing and evolving oversight and disclosure requirements.

- Client Engagement

  Clients are demanding greater transparency and engagement on ESG issues. Securities Services providers need to proactively communicate with clients about their own ESG strategies and offerings to maintain relationships over the long-term.

Illustration 3.4.2 – ESG Focus areas across different regions

Region	Key Areas of Focus	Regulatory Approach	Impact on Securities Services
EU	Transparency, comparability, integration of ESG	Comprehensive and prescriptive	Significant impact on product classification, disclosure, risk management, client engagement
UK	Alignment with EU, growing emphasis on climate risk	Similar to EU, but with potential for divergence	Similar to EU, but with potential for future differences
US	Investor protection, materiality, climate risk	Fragmented, less prescriptive	Increasing pressure for climate risk disclosure and ESG integration
APAC	Sustainability reporting, disclosure, varying approaches	Diverse, with growing momentum	Need to navigate patchwork of regulations and adapt to market expectations
MENA	Emerging regulations, focus on climate and sustainability	Early stages of development	Need to monitor regulatory developments and prepare for increased requirements

3.5 Developing Robust ESG Risk Frameworks and Monitoring Mechanisms

Developing robust ESG risk frameworks and monitoring mechanisms are essential for Securities Services providers to effectively manage and mitigate potential risks. These frameworks should be comprehensive and integrate ESG considerations into the core business strategies and operations.

3.5.1 Risk Framework

The first step in developing an ESG risk framework is for the Securities Services provider to identify and assess the relevant ESG risks that could impact the organization. This involves conducting thorough risk assessments, engaging with stakeholders and understanding the regulatory landscape. Once the risks are identified, the framework should outline specific policies and procedures to address these risks, including setting clear objectives, defining roles and responsibilities and establishing reporting mechanisms.

3.5.2 Monitoring Mechanisms

Monitoring mechanisms are crucial for ensuring the effectiveness of the ESG risk framework. These mechanisms should include regular monitoring and reporting of ESG performance, as well as continuous improvement processes. Key performance indicators (KPIs) should be established to track progress and measure the impact of ESG initiatives. Additionally, internal audits and third-party assessments can provide valuable insights into the effectiveness of the framework and identify areas for improvement. By implementing robust monitoring mechanisms, Securities Services providers can ensure that they are effectively managing ESG risks, enhancing transparency and building resilience against ESG-related challenges. This proactive approach helps organizations stay ahead of potential ESG-related issues and contributes to long-term sustainability and success.

3.6 Integrating ESG Considerations into Compliance Programmes for Securities Services

ESG integration in Governance, Risk and Compliance (GRC) frameworks involves aligning a Securities Services provider's governance, risk management and compliance strategies with its ESG objectives. By embracing this holistic approach,

companies can not only mitigate risks and ensure compliance but also create long-term value for stakeholders and contribute positively to society and the environment.

3.6.1 Integration into GRC Frameworks

As stakeholders - including investors, clients and regulators - place greater emphasis on corporate responsibility and transparency, the need for effective ESG integration in GRC frameworks has become increasingly crucial. Securities Services providers that proactively address ESG concerns can enhance their reputation, attract and retain top talent and gain a competitive advantage in the market.

To successfully integrate ESG practices into GRC frameworks, a Securities Services provider will need to establish an effective, sustainable compliance programme. This programme should include several key elements:

- A comprehensive assessment should be conducted to identify the relevant ESG risks and opportunities specific to their industry and operations
- Clear governance structures and accountability mechanisms should be established to ensure that sustainability objectives are integrated into decision-making processes
- Policies, procedures, and training programmes should be developed to promote awareness and understanding of sustainable compliance across all levels of the organization

Key components of ESG Integration with compliance frameworks should include:

- Robust data collection mechanisms and alignment with regulatory requirements
- Fostering a culture of transparency and accountability supported by clear policies and procedures and continuous training[8]

3.6.2 ESG Compliance

Securities Services providers can become ESG compliant by paying attention to the evolving landscape of ESG regulations and frameworks, implementing controls and audit capabilities within their organizations, creating meaningful and ethical policies and practices and reporting transparent disclosures according to globally accepted frameworks. In practice, ESG compliance:

- means creating and executing ethical policies under each category of ESG and managing these disclosure areas in annual reports to reduce negative impacts. ESG reporting for compliance means aligning ESG disclosures according to a framework or regulation that best fits the Securities Services provider and exercising transparency, balance and clarity to represent the organization's sustainability efforts

- means creating comparability of ESG factors amongst companies for consumers, investors and other stakeholder groups to enable better decision making as well as ensuring companies are taking responsibility for their impact and actions on the environment and the communities in which they operate

[8] https://community.trustcloud.ai/docs/grc-launchpad/grc-101/compliance/integrating-esg-practices-into-grc-frameworks-for-sustainable compliance/#:~:text=Integrating%20environmental%2C%20social%2C%20and%20governance,ensuring%20alignment%20with%20regulatory%20requirements

- can sometimes feel like a guessing game. Unless there are concrete rules followed in regard to ESG frameworks, ensuring appropriate disclosures can be confusing, messy and draining. By having clarity on the rules and then utilizing advanced technology to manage and collect ESG data, the Securities Services provider can have a clear path forward with framework alignment, audit preparation and regulatory compliance

While data collection is often the most resource-intensive stage of the ESG reporting process, frustrations can be alleviated through ESG management software. The reporting world is moving away from manual spreadsheets passed amongst countless teams. The shift is towards advanced data collection, storage and analytics systems which can streamline the entire reporting process by comparing year-over-year data, improving disclosures and presenting ESG criteria in a more manageable way.[9]

[9] https://www.auditboard.com/blog/esg-compliance/ - May 2024

4. Third Line of Defence

4.1 Introduction

The third line of defence, typically represented by internal audit, plays a critical role in providing independent assurance over the robustness and effectiveness of ESG frameworks and controls within Securities Services.

As ESG factors evolve from voluntary initiatives to formal accountability, as the result of increased regulatory scrutiny and investor decision-making, the role of internal audit has expanded accordingly. This evolution reflects the growing importance of ESG in mitigating risks and enhancing transparency in the Securities Services industry, where stakeholders demand greater accountability and sustainable practices, as well as strong and verifiable commitment from the organizations they relate to.

In this context, the third line of defence must not only ensure compliance with existing and emerging ESG regulations but also assess the integration of these principles into daily operations and long-term strategies. Internal audit is now tasked with evaluating the accuracy and reliability of ESG reporting, verifying the alignment of sustainability initiatives with business objectives and identifying potential gaps in the approach to risks. The impact of the expanded third line of defence mandate on resources and skill set required are evident. Moreover, as Securities Services providers increasingly embed sustainability considerations into their product governance and solutions, auditors must assess how successfully these innovations contribute to sustainable financial ecosystems.

4.2 Evaluating ESG Impact through Internal Audit in Securities Services

Evaluating the sustainability impact through internal audit in Securities Services is becoming increasingly important as stakeholders demand more transparency and accountability. Below are four key points outlining how internal audit can play a crucial role in this process:

- Objective Assurance and Advisory
  Internal audit provides objective assurance on the accuracy and reliability of ESG reporting. This includes verifying that the data is complete, neutral and accurate, which is essential for building trust with investors and other stakeholders. Audit, as an example, collect sustainability information and reconcile the data with ESG policies and procedures.

- Governance and Control
  Internal audit evaluates the effectiveness of governance structures and internal controls related to ESG initiatives. This includes assessing the roles and responsibilities of various stakeholders, ensuring transparency and monitoring compliance with ESG standards and regulations related to Security Services.

- Reporting and Disclosure
  Internal auditors review ESG disclosures to ensure they are consistent, accurate and aligned with regulatory requirements and stakeholder expectations. This helps in enhancing the credibility of the Securities Services provider’s ESG reports. An example could be the reporting checks done for the European Banking Authority (EBA) Pillar III reporting.

- Continuous Improvement
  Internal audit can provide recommendations for improving ESG practices and reporting processes. This includes advising on best practices, identifying gaps, and suggesting enhancements to ensure continuous improvement in ESG performance. By assessing on a regular basis, internal audit is able to measure the weaknesses and do gap analysis.

To assist internal auditors, the below checklist can be a quick kick-off to allow efficient controls by the third line of defence:

- Understand ESG Frameworks: Familiarize yourself with various ESG frameworks and standards, such as CSRD, GRI and all Securities Services-relevant policies
- Engage with Stakeholders: Collaborate with different departments and stakeholders within the Securities Services provider to understand their ESG goals and challenges
- Develop ESG Audit Plans: Create comprehensive audit plans that include ESG criteria and metrics as well as timeline for assessment
- Training and Development: Invest in training programmes to enhance the skills and knowledge of internal auditors in ESG matters

Figure: ESG consideration during the audit activities[10]

[10] KPMG ESG and Internal Audit March 2023 ESG and Internal Audit (kpmg.com)

4.3 Assurance Mechanisms for Validating ESG Reporting and Disclosure in Securities Services

Consider that 75 percent of businesses feel they do not have the policies, skills and systems in place to meet ESG assurance requirements, according to a KPMG survey of 750 companies with an average revenue of $15.6 billion, conducted from April to June 2024. Securities Services providers can prepare for ESG assurance requirements by consulting the people, processes and partners that drive their financial assurance as a starting point and then filling in any gaps with new roles, tools and professional services. Internal audit teams are responsible for monitoring an organization's systems and processes for collecting, verifying, managing and reporting relevant information to stakeholders. When designing an ESG strategy, internal audit teams can help identify and understand risks, design controls and work to manage the cost of current and future ESG data compliance by the Securities Services provider.[11]

Here are some proactive steps the Securities Services provider can take to prepare for the ESG data assurance requirements:

- Stay informed
  Monitor emerging standards for ESG data assurance, including the proposed International Standard on Sustainability Assurance (ISSA) 5000 and legislative developments. Become acquainted with relevant regulations in all jurisdictions of business.

- Conduct a risk assessment
  Find areas where ESG data collection, management and reporting practices might be vulnerable to legal risks because of possible inaccuracies.

- Develop robust internal controls
  Establish strong data governance policies and internal controls to confirm data accuracy and consistency within the Securities Services provider.
- Invest in data management systems
  Upgrade technology and data infrastructure to assist in effective and trustworthy data collection, retrieval and storage.

- Examine disclosure obligations
  Recognize the legal responsibilities for ESG data disclosure, both mandatory and voluntary, under stock exchange listing requirements and relevant regulations.

- Establish ESG reporting policies
  Create thorough policies for ESG data collection, verification, aggregating and reporting. Ensure they support recognized standards and best practices.

- Provide training
  Offer training for employees engaged in ESG data collection, management and reporting to guarantee compliance with internal policies and legal requirements.

[11] https://trellis.net/article/esg-reports-will-soon-require-third-party-assurance-heres-how-get-ready/

- Consider independent assurance
  Evaluate the need for independent third-party assurance of the organization's ESG data to enhance stakeholder confidence and mitigate legal risks. Select reputable assurance providers who adhere to relevant standards and ethical codes.

- Conduct due diligence with suppliers and partners
  Assess the ESG practices of all Securities Services provider suppliers and partners to ensure alignment with stated commitments to avoid reputational risks.

- Partner with legal experts
  Consult with legal professionals specializing in ESG and sustainability to guarantee compliance with relevant laws and regulations and navigate potential legal risks associated with ESG data disclosures.[12]

4.4 Recommendations for Strengthening ESG Governance in Securities Services

Enhancing ESG governance involves a strategic focus on board oversight and management accountability, with practices tailored to the unique dynamics of the sector in which firms operate. Within the Securities Services industry considerations for strengthening governance include:

- Establishing an established framework for ESG oversight:
  Forming a dedicated ESG committee within the board may be beneficial. Such a committee, comprised of members with diverse expertise in sustainability, finance and Securities Services, could play a pivotal role in reviewing ESG policies, initiatives and performance metrics ensuring alignment with industry standards and regulatory requirements.

- Integrating ESG into strategy:
  Embedding ESG considerations into corporate strategy and decision-making processes is an essential requirement to the establishment of an ESG conscious risk framework. Incorporating ESG objectives into business strategy, risk management frameworks and operational protocols helps align the organization's goals with long-term sustainable outcomes, preventing economical and reputational risks which could put at risk the firm's activity and jeopardise its survival.

- Board expertise and ongoing training:
  Ongoing education and training for board members on emerging ESG trends, regulatory changes and best practices in the Securities Services industry can enhance the board's ability to make informed ESG-related decisions.

- Management Accountability
  Clearly defined ESG responsibilities and key performance indicators (KPIs) for senior management are crucial. Linking executive compensation to ESG performance may align incentives with sustainable business practices. Regular assessments of ESG initiatives' progress against set targets are also important.

[12] https://www.pastore.net/esg-data-assurance-requirements-10-steps-to-prepare-for-the-legal-implications/ (January 2024)

- Sustainability policies and procedures
  Comprehensive sustainability policies covering environmental impact, social responsibility and governance practices should be developed and integrated into all aspects of operations, including client onboarding and credit, asset servicing, custody, and settlement processes.

- Transparency and reporting
  Adopting rigorous ESG reporting standards and frameworks, such as the GRI or the Sustainability Accounting Standards Board (SASB), ensures comprehensive and accurate disclosure of ESG performance, risks and opportunities. Transparent reporting enhances stakeholder trust and accountability and aligns with the growing expectations of the regulators.

- Stakeholder engagement
  Engaging with clients, investors, regulators and employees to gather input and feedback on sustainability initiatives fosters transparency and aligns efforts with stakeholder expectations. This engagement is critical for building trust and ensuring that sustainability strategies are responsive to stakeholder needs and expectations.

- Technology and data analytics
  Leveraging advanced technologies, such as artificial intelligence and data analytics to enhance ESG monitoring, reporting, and decision-making can provide real-time tracking of ESG metrics, identify potential risks and offer actionable insights for improving performance.

By considering these approaches, Securities Services providers can enhance their sustainability governance frameworks, ensuring effective oversight and management of sustainability initiatives. This not only supports regulatory compliance and enhances reputation but also contributes to sustainable growth and long-term value creation within the industry and the overall financial ecosystem.

4.5 Enhancing Stakeholder Confidence through ESG Assurance in Securities Services

Enhancing stakeholder confidence through robust ESG assurance involves transparent communication of ESG objectives, audit findings and outcomes. Key considerations for Securities Services providers to help achieve this include:

- Establishing a robust ESG auditing framework that aligns with recognised standards and practices
- Ensuring independent verification via third-party auditors to conduct independent ESG assessments which, in turn, can significantly enhance credibility. Independent verification provides stakeholders with confidence in the accuracy and integrity of reported ESG information, reducing concerns about potential biases or inaccuracies
- Ensuring clear communication of audit findings and remediation process. Summaries of audit outcomes should be made accessible through various channels, such as annual reports, corporate websites and dedicated ESG reports
- Adopting a structured reporting schedule, such as quarterly or bi-annual updates, ensures stakeholders remain informed about ongoing ESG performance and initiatives
- Ensuring stakeholder engagement to enhance confidence and trust. This might include soliciting feedback on ESG priorities, addressing stakeholder concerns in audit reports, and conducting forums or meetings to discuss audit findings and their implications
- Including detailed ESG metrics and KPIs in audit reports to allow stakeholders to evaluate the organization’s ESG performance quantitatively. Digital reporting platforms, interactive online reports, such as dashboards, and data visualisation tools, should also be considered

- Implementing training and capacity building for internal audit teams on ESG-specific issues to ensure that audits are conducted with a thorough understanding of ESG factors relevant to the securities services industry
- Encouraging and sponsoring cross-industry collaboration efforts to achieve consistency and comparability in ESG reporting across different providers as a tool to enhance stakeholder confidence. This could involve adhering to standardized reporting frameworks and providing comparative data to illustrate progress over time

5. Conclusion

5.1 Introduction

The integration of ESG principles within the Securities Services industry represents a pivotal opportunity for sustainable transformation - not only for individual firms but also for the broader financial ecosystem and the communities it serves.

By embedding ESG considerations into the three lines of defence, Securities Services providers can enhance operational resilience, foster trust among clients and champion the shift toward responsible finance while preserving their firms against impactful ESG risks. This commitment advances sustainable practices, supports transparency and aligns financial goals with stakeholders' expectations for a more equitable and sustainable economy.

5.2 ESG Opportunities and the Costs of Non-Compliance

The forward-looking landscape of ESG creates avenues for Securities Services providers to introduce innovative products such as green bonds, ESG-linked asset servicing and enhanced look-through and reporting mechanisms for sustainable investments. For instance, some firms have already launched platforms offering real-time ESG data integration and analytics, helping clients make better-informed sustainable investment decisions. These products not only provide new revenue streams but also respond to a growing investor base that prioritizes environmental and social responsibility.

Additionally, ESG-focused training for professionals within the Securities Services industry offers another layer of value. Equipping teams with the skills to navigate ESG compliance and reporting requirements ensures firms can confidently address client and regulatory demands and drive product development in line with evolving market standards.

Failure to comply with ESG growing market expectations comes with escalating costs and risks, particularly as regulatory frameworks tighten and investor expectations grow. Firms that do not embrace ESG principles face increasing regulatory scrutiny, fines, operational inefficiencies and potential exclusion from valuable investment pools. Some industry examples underscore the impact of non-compliance, where entities failing to align with ESG expectations have faced reputational setbacks, lost clients and encountered diminished access to financing.

ESG is rapidly becoming a vital industry benchmark, being critical for maintaining a competitive advantage and securing long-term growth. Firms that do not prioritize sustainable practices may find themselves unable to compete in a market where sustainable practices are paramount. Conversely, those organizations embracing ESG - and fully embedding sustainability into their processes - help drive meaningful change, positioning the company as a leader in shaping a more responsible and resilient future.