CHAPTER

2

The ESG Market

LEARNING OUTCOMES

Mastery	The candidate should be able to:
☐	**2.1.1** explain the history of ESG investing
☐	**2.1.2** explain the size and scope of ESG investing in relation to geography, strategy, investor type, and asset class
☐	**2.1.3** explain key market drivers of ESG integration: investor demand/intergenerational wealth transfer, regulation and policy, public awareness, and data sourcing and processing improvements
☐	**2.1.4** explain the key drivers and challenges for ESG integration among key stakeholders: asset owners, asset managers, fund promoters, financial services, policymakers and regulators, investees, government, civil society, and academia

INTRODUCTION

1

The environmental, social, and governance (ESG) investing market has become mainstream. A growing number of institutions assert that they integrate ESG considerations into their investment decisions and into their ownership activity. ESG investing commands a sizable share of professionally managed assets across all regions and constitutes a major force across global financial markets.

This chapter traces the roots of ESG investing back to the 16th century and presents its transformation to its modern interpretation and implementation, which is still evolving. The size and scope of ESG investing, as well as its characteristics, have been developing quickly, and this chapter highlights some of the numbers regarding the ESG market.

The drivers for the growth in assets managed under an ESG approach in recent years are both intrinsic and extrinsic to the investment industry. The growing demand from institutional asset owners and individual retail investors is a driving force, providing direct commercial incentives for asset managers to engage. Government policy and regulation have been proliferating across various regions, while information from non-governmental organizations (NGOs) and other members of civil society has also stimulated the market's growth.

Finally, this chapter discusses the challenges to further growth and enhanced quality of ESG investing, as well as some of the ways these barriers can be overcome.

2 HISTORY OF ESG INVESTING, INCLUDING MODERN RESPONSIBLE INVESTMENT

☐ **2.1.1** explain the history of ESG investing

In this section, we will look at the history of environmental, social, and governance investing, covering its roots and development into what ESG investing is today.

A Brief History of Sustainability

In 1983, in response to mounting concern surrounding ozone depletion, global warming, and other environmental problems associated with raising the living standards of the world's population, the United Nations (UN) General Assembly convened the **World Commission on Environment and Development (WCED)**, an international group of environmental experts, politicians, and civil servants. The WCED (also called the Brundtland Commission) was charged with proposing long-term solutions for bringing about sustainable development. In 1987, the commission issued the Brundtland Report, also called *Our Common Future*, which introduced the concept of sustainable development: "meeting the needs of the present without compromising the ability of future generations to meet their own needs." The Brundtland Report also described how sustainable development could be achieved.

The report laid the foundations for the **Rio de Janeiro Earth Summit**, also known as the **Rio Summit** or the **UN Conference on Environment and Development (UNCED)**, held in 1992, which ultimately led to the creation of the UN Commission on Sustainable Development that same year. The summit spelled out the role of business and industry in the sustainable development agenda. Its Rio Declaration on Environment and Development states that businesses have a responsibility to ensure that activities within their own operations do not cause harm to the environment because businesses gain their legitimacy through meeting the needs of society.

Early Phase of ESG Investing

The concept of ESG investing is not a recent phenomenon: responsible investing dates back as far as investing itself. In the 17th and 18th centuries, religious groups, such as the Quakers and Methodists, already laid out guidelines to their followers about the types of activities in which they should or should not invest. Negative screening (in other words, deliberately opting not to invest in companies or industries that do not align with values) was the most popular form of **socially responsible investment (SRI)**, or ethical investing, in the early days. Because of these historical roots of ESG investing, with it initially being grounded in ethical issues of a societal nature and environmental issues coming to the fore in a later period, the term *SRI* came into use.

One of the first ethical mutual funds that moved to screens based on religious traditions was the Pioneer Fund, which was launched in 1928.[1] The modern institutionalization of ethical exclusions arguably began at the height of the Vietnam War in 1971 with the establishment of the Pax World Fund (now IMPAX Asset Management).[2] At the time, the fund offered an alternative investment option for those opposed to the production of nuclear and military arms.

In the late 1970s, the divestment movement became increasingly globalized through the divestment campaign in protest of South Africa's system of apartheid. **The Sullivan Principles**, used by investors to engage and divest, required that a condition for investment for the investee company was to ensure that all employees, regardless of race, are treated equally and in an integrated environment as a condition for investment. The disinvestment campaign, which was implemented not only by investors but also by governments and corporates, was credited by some as pressuring the South African government to embark on the negotiations ultimately leading to the dismantling of the apartheid system, resulting in real-world change. This form of SRI, referred to as value-based or exclusionary SRI, primarily considered ethical behavior.

Mainstream popular and political support for sustainable development gained further momentum following the 1992 Rio Summit.

Modern Responsible Investment

The key developments between early and modern SRI have been (1) the growth in shareholder activism, (2) the more widespread consideration of environmental factors, and (3) the introduction of positive-screening investing, which seeks to maximize financial return within a socially aligned investment strategy. In this way, SRI ultimately integrates ESG factors into the traditional investing framework focused only on profit and risk-adjusted return. This situation paved the way for *responsible investment*, which considers financial and ESG factors when valuing companies.

In the early 2000s, a renewed interest and desire for a more concrete definition of SRI (including corporate governance) emerged, in addition to financial, social, and environmental factors. The widespread fraud at Enron Corporation and other companies resulted in an increasing emphasis on the importance of good corporate governance and in specific regulations, such as the **Sarbanes–Oxley Act of 2002** in the United States.

The modern form of ESG investing began with a letter and call to action. In January 2004, UN secretary-general Kofi Annan wrote to the CEOs of significant financial institutions to take part in an initiative, under the authority of the UN Global Compact and with the support of the International Finance Corporation (IFC), to integrate ESG factors into capital markets. The initiative produced a report titled "Who Cares Wins — Connecting Financial Markets to a Changing World," which effectively coined the term "ESG."

The report made the case that embedding ESG factors in capital markets makes good business sense and leads to more sustainable markets and better outcomes for societies. At the same time, the UN Environment Programme Finance Initiative (UNEP FI) produced the so-called Freshfields Report, which showed that ESG issues are relevant for financial valuation and, thus, fiduciary duty. These two reports formed the backbone for the launch of the **Principles for Responsible Investment (PRI)** at the New York Stock Exchange in 2006 and the launch of the **Sustainable Stock Exchange Initiative (SSEI)** the following year.

1 L. Renneboog, J. Ter Horst, and C. Zhang, "Socially Responsible Investments: Institutional Aspects, Performance, and Investor Behavior," *Journal of Banking & Finance* 32 (September 2008): 1723–42. www.sciencedirect.com/science/article/abs/pii/S0378426607004220.

2 IMPAX Asset Management, "History" (2021). https://impaxam.com/about-us/history/.

Of the many issues concerning ESG considerations, climate change has gained particular attention in the eyes of governments, regulators, businesses, and investors. The Stern Review on the Economics of Climate Change, known simply as the Stern Review, was a particular influence on the investment industry. At the request of the UK government, economist Sir Nicholas Stern led a major review of the economics of climate change to understand the nature of the economic challenges and how they can be met. The report, published in 2006, concluded that climate change is the greatest and widest-ranging market failure ever seen, presenting a unique challenge for economics, and that early action far outweighs the costs of not acting. According to the report, without action, the overall costs of climate change would be equivalent to losing at least 5% of global gross domestic product (GDP) each year, now and forever. Including a wider range of risks and impacts could increase this number to 20% of GDP or more. Although not the first economic report on climate change, it had an important influence on how investors understand climate change, in the United Kingdom and globally.

The Global Financial Crisis of 2008, the COVID-19 pandemic beginning in 2020, and increased geopolitical tensions leading to war in Ukraine in 2022 provided stark reminders of the interdependence between societies, economies, and financial markets. They also provided clear illustrations that market pressures do not always result in ideal outcomes for the wider good.

These situations reignited institutional investors' interest in the risks and opportunities presented by the extra-financial performance of a company, enhanced by the growing perception of large asset owners as "universal owners"—that is, owners that are tied to the performance of markets and economics as a whole.

3 ESG INVESTING IN NUMBERS

☐ **2.1.2** explain the size and scope of ESG investing in relation to geography, strategy, investor type, and asset class

Given the many definitions of responsible investment, there is a range of data regarding the responsible investment market. One of the most comprehensive market reviews is conducted by the Global Sustainable Investment Alliance (GSIA), which conducts research in the five major markets for responsible investment (Europe, the United States, Japan, Canada, and Australia/New Zealand) every two years. Its most recent report[3] showed sustainable investing assets in the five major markets stood at US$35.3 trillion (£2781 trillion) at the start of 2020, a 15% increase in two years. In all the regions except Europe, the market share of sustainable investing has grown, as seen in Exhibit 1. In terms of where sustainable and responsible investing assets are domiciled globally, the United States (48%) and Europe (34%) continue to manage the highest proportions.

3 Global Sustainable Investment Alliance, "Global Sustainable Investment Review 2020" (2021). www.gsi-alliance.org/wp-content/uploads/2021/08/GSIR-20201.pdf.

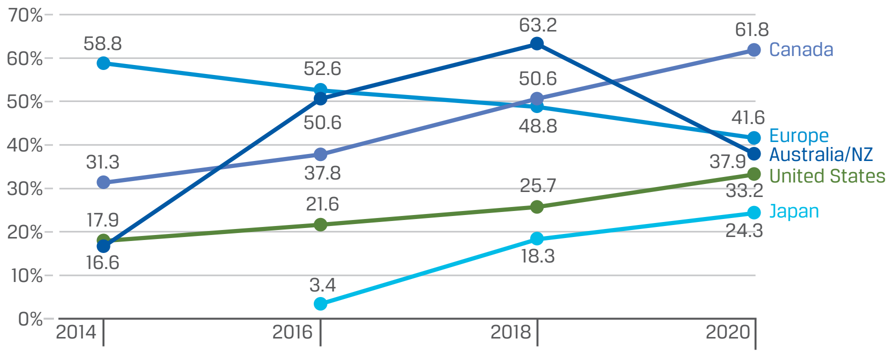
Exhibit 1: Growth of ESG Assets by Region

Region	2012 (US$ bn)	2014 (US$ bn)	2016 (US$ bn)	2018 (US$ bn)	2020 (US$ bn)
Europe	8,758	10,775	12,040	14,075	12,017
United States	3,740	6,572	8,723	11,995	17,081
Japan		7	474	2,180	2,974
Asia excl. Japan		45	52		
Asia incl. Japan	40				
Canada	589	729	1,086	1,699	2,423
Australia/New Zealand	134	148	516	734	906
Total	13,261	18,276	22,891	30,683	35,301

Notes: Asia excluding Japan 2014 assets are represented in US dollars based on the exchange rates at year-end 2013. All other 2014 assets, as well as all 2016 assets, were converted to US dollars based on exchange rates at year-end 2015. All 2018 assets were converted to US dollars at the exchange rates at the time of reporting. Assets for 2020 were reported as of 31 December 2019 for all regions except Japan, which reported as of 31 March 2020.
Source: GSIA, "Global Sustainable Investment Review 2020," "Global Sustainable Investment Review 2018," "Global Sustainable Investment Review 2012."

Responsible investment directs a sizable share of managed assets in each region, as can be seen in Exhibit 2. This share of assets ranges from 24% in Japan to 62% in Canada. Clearly, sustainable investing constitutes a major force across global financial markets. The proportion of sustainable investing relative to total managed assets grew in most regions, and in Canada, responsible investing assets now make up most of the total assets under professional management. The exceptions to this trend are Europe and Australia/New Zealand, where sustainable investing assets have declined relative to total managed assets since 2018. At least part of the market share decline in Europe and Australia/New Zealand stems from a shift to stricter standards and definitions for sustainable investing in those markets.

Exhibit 2: Proportion of Sustainable Investing Relative to Total Managed Assets

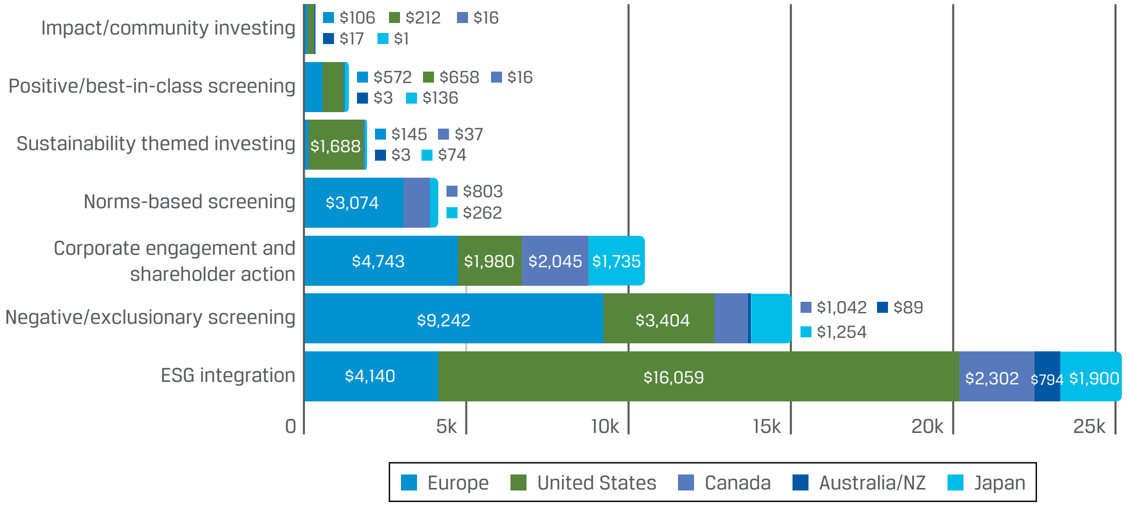


Source: GSIA, "Global Sustainable Investment Review 2020."

As of 2020, the largest sustainable investment strategy globally was ESG integration, as shown in Exhibit 3, with a combined US$25.1 trillion (£19.2 trillion) in assets under management (AUM). This is followed by negative, or exclusionary, screening, which had remained roughly stable in terms of AUM over the prior four years at US$15.0 trillion in assets.

- Norms-based and negative/exclusionary screening is the largest strategy in Europe.
- Sustainability thematic investing, impact/community investing, positive/best-in-class investing, and ESG integration command most assets in the United States.
- Corporate engagement and shareholder action constitute the predominant strategy in Japan.

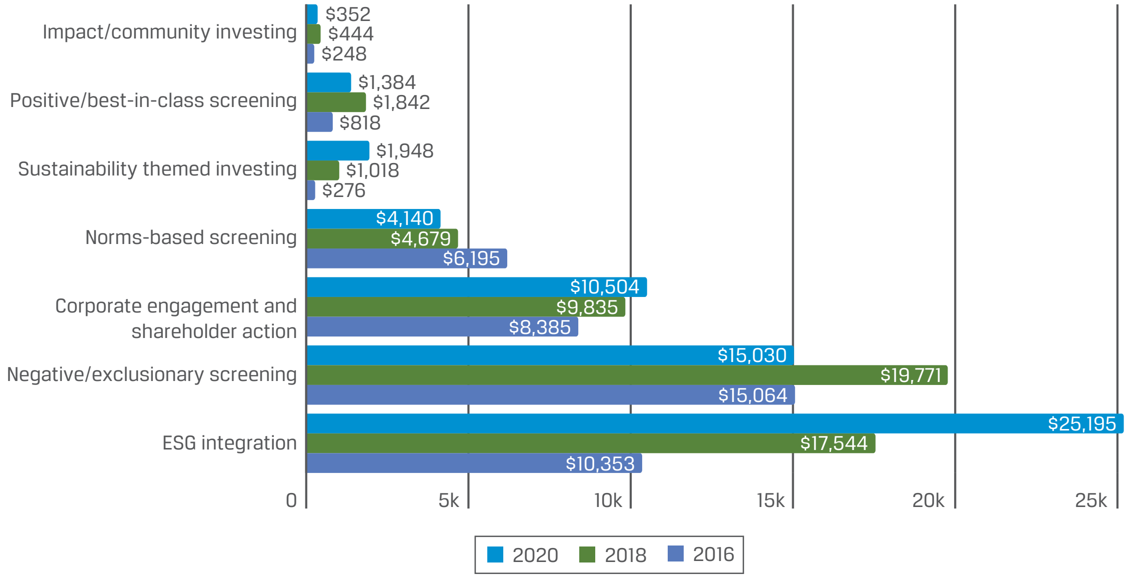
Exhibit 3: Responsible Investment Assets by Strategy and Region in 2020 (US$ billions)



Source: GSIA, "Global Sustainable Investment Review 2020."

Over the 2016–20 period, as shown in Exhibit 4, the ESG integration strategy had the largest growth, which was mostly driven by the US market. Anecdotally, this growth is attributable to "relabeling" or "recycling" of already-existing funds by fund managers, with an open debate as to what extent such relabelings lead to increased greenwashing.

Exhibit 4: Global Growth of Sustainable Investing Strategies, 2016–2020 (US$ billions)



Source: GSIA, "Global Sustainable Investment Review 2020."

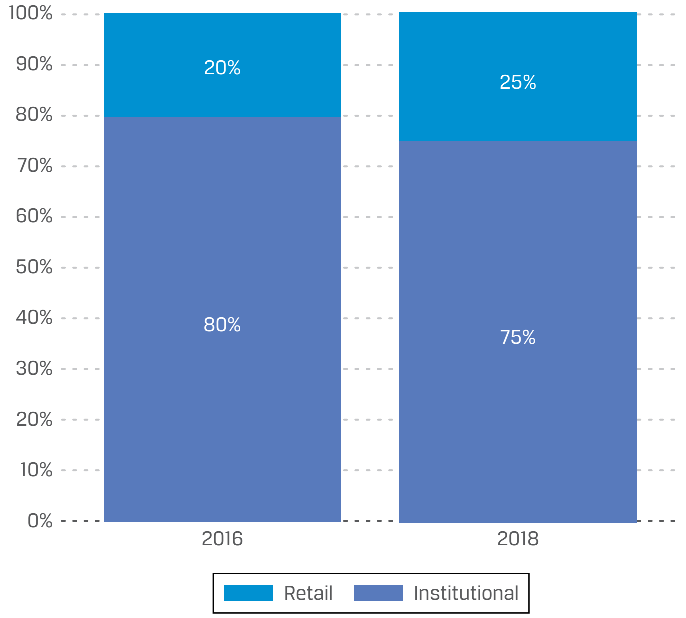
Investments managed by professional asset managers are often classified as either

- retail (investment by individuals) or
- institutional (investment firms).

Although institutional investors tend to dominate the financial market, interest by retail investors in responsible investing has been steadily growing:

- In 2012, institutional investors held 89% of assets, compared with 11% held by retail investors.
- In 2018, the retail portion had grown to one quarter, as seen in Exhibit 5.

Exhibit 5: Global Shares of Institutional and Retail Sustainable Investing Assets, 2016–2018



Note: Institutional and retail investor data were not collected in Australia or New Zealand.

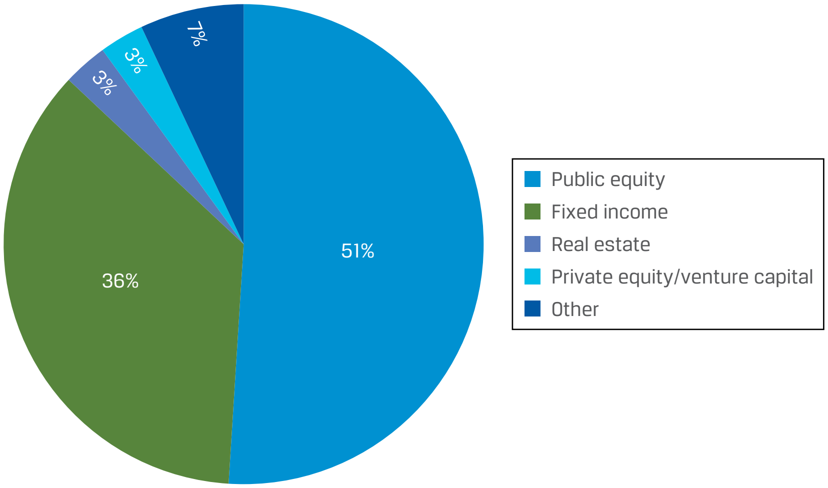
Source: Global Sustainable Investment Alliance (2018). *2018 Global Sustainable Investment Review*. Available at: www.gsi-alliance.org/wp-content/uploads/2019/06/GSIR_Review2018F.pdf

Responsible investment extends across the range of asset classes commonly found in diversified investment portfolios, as shown in Exhibit 6 which shows the asset class allocation reported in Europe, the United States, Japan, and Canada in 2018. In that year, collectively in these regions,

- most assets were allocated to public equities (51% at the start of 2018), whereas
- the next largest asset allocation was in fixed income (36%).

In 2018, real estate/property and private equity/venture capital each held 3% of global sustainable investing assets. Sustainable investments could also be found in hedge funds, cash or depository vehicles, commodities, and infrastructure. These assets are reflected in the “other” assets category; for further details, see Exhibit 6.

Exhibit 6: Asset Classes in Global ESG Investing, 2018



Source: GSIA, "Global Sustainable Investment Review 2018."

MARKET DRIVERS OF ESG AND CHALLENGES IN ESG INTEGRATION

4

☐ **2.1.3** explain key market drivers of ESG integration: investor demand/intergenerational wealth transfer, regulation and policy, public awareness, and data sourcing and processing improvements

Various stakeholders shape the push and pull for responsible investment, steering its demand and supply. There are a significant number of actors involved. This section presents the main stakeholders, focusing on the actors that influence investment decisions more directly, either by

- the choices they make or
- the services and/or information they provide.

The main stakeholders are as follows:

A. Asset owners
   1. Pension funds
   2. Insurance
   3. Sovereign wealth funds, endowment funds and foundations
   4. Individual (retail) investors and wealth management

B. Asset managers

C. Fund promoters
   1. Investment consultants and retail investment advisers

2. Investment platforms
3. Fund labelers

D. Financial services (investment banks, investment research and advisory firms, stock exchanges, financial and ESG rating agencies)
E. Policymakers and regulators
F. Investees
G. Government
H. Civil society and academia

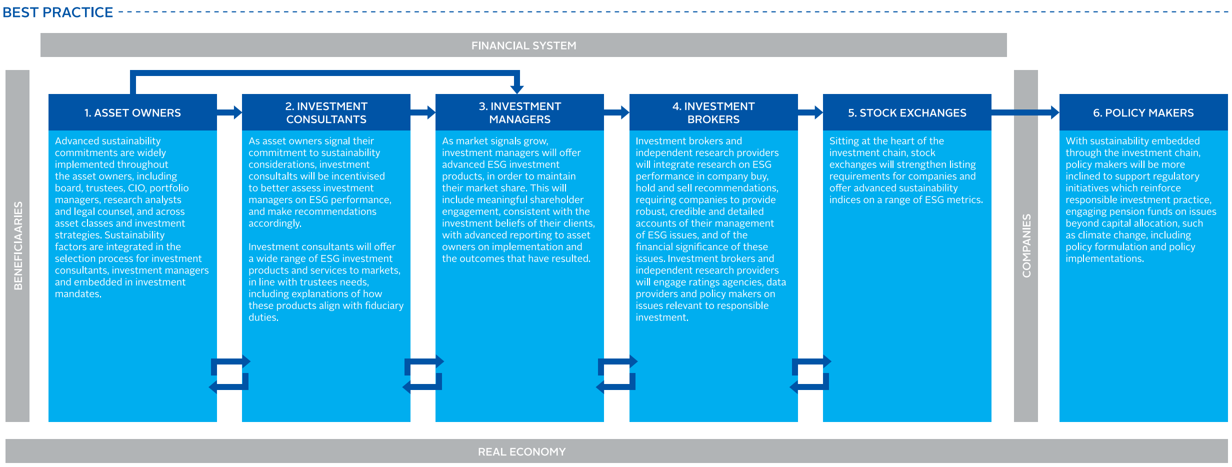
All these stakeholders are covered in detail later in this chapter.

There is no standard way of dividing up the investment value chain; the main actors were aggregated in this manner for the purpose of discussing their role within responsible investment. Exhibit 7 provides an example of the investment value chain for listed equities. The value chain for other asset classes may differ slightly, with more or fewer intermediaries between the assets and the final owner of capital.

It is, however, worthwhile to generally clarify the roles of shareholders, investors, and investment managers.

- **Shareholders** hold a direct equity position in a firm, and both individual persons and financial institutions can be shareholders. The term comes from the individual or investment firm literally having a share of the company. It is most commonly used when talking about the rights and responsibilities that come with being an "owner" of a company, such as stewardship, voting, and engagement. This differentiates it from a situation where an individual or an investment firm lends money or invests in a bond (in other words, they are not an equity holder of a company). Because bond investors do not have a share and are not owners of a company, they cannot vote. Nonetheless, expectations around engagement are increasing for those who invest in loans and bonds as well, making the difference between the two terms more subtle.
- **Investors** is a very generic term that refers to parties—both retail investors and institutional investors—that hold a financial stake in an asset. Investors can invest in any type of asset class, be it debt or equity, and an investor can be an asset owner or an asset manager.
- **Investment managers** refers to people or organizations that invest on behalf of their clients under an investment mandate that those clients have agreed to.

Exhibit 7: Financial System Value Chain



Source: PRI.[4]

ASSET OWNERS

5

☐ **2.1.3** explain key market drivers of ESG integration: investor demand/intergenerational wealth transfer, regulation and policy, public awareness, and data sourcing and processing improvements

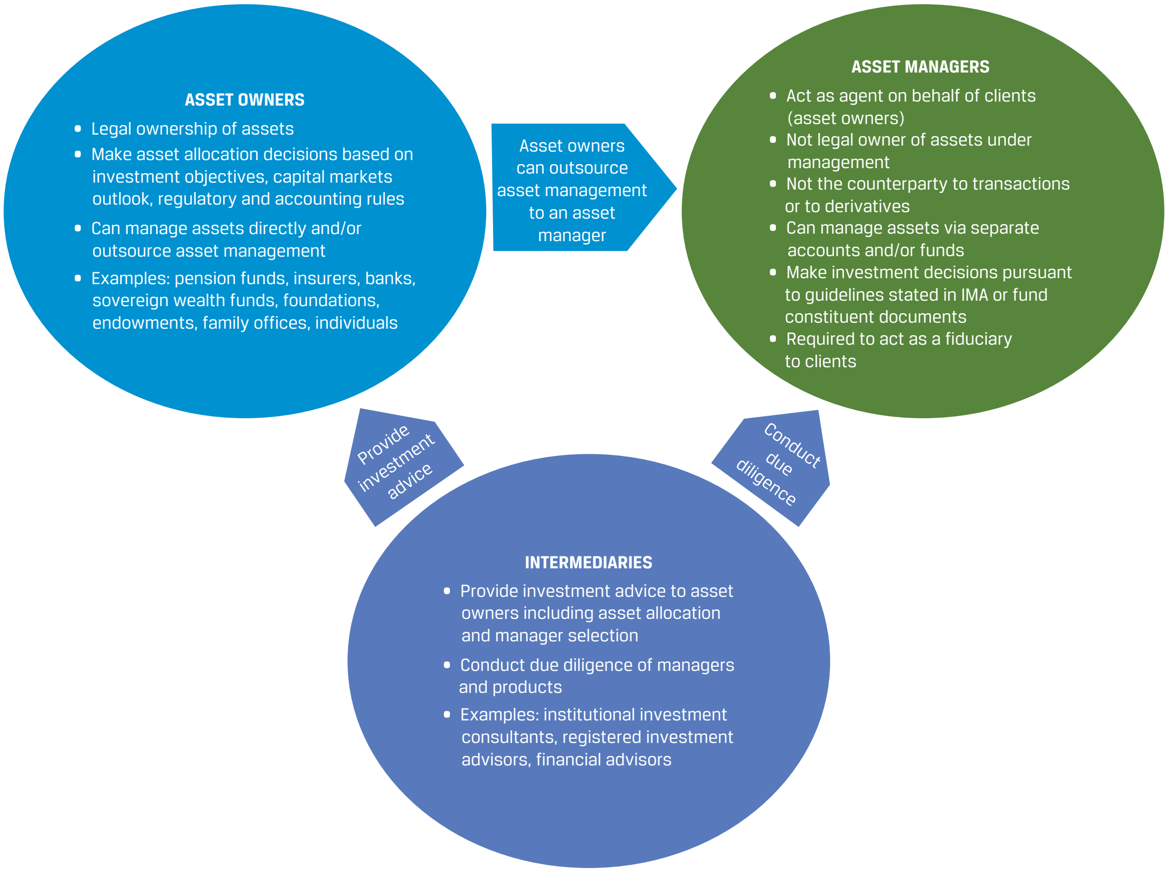
☐ **2.1.4** explain the key drivers and challenges for ESG integration among key stakeholders: asset owners, asset managers, fund promoters, financial services, policymakers and regulators, investees, government, civil society, and academia

Asset owners include pension funds, insurance companies, sovereign wealth funds, foundations, and endowments. They generally invest their assets in an investment vehicle with the goal of getting returns from the invested capital. They seek to maximize returns at a given level of risk, and some derive utility from non-financial impacts as well. In practice, asset owners have legal ownership of their assets and make asset allocation decisions. Many asset owners manage their money directly, while others outsource the management of all or a portion of their assets to external managers. Exhibit 8 presents the differences between asset owners, asset managers, and intermediaries. In 2019, institutional asset owners accounted for US$54 trillion (£38.8 trillion), of which 35%—around US$19 trillion (£13.7tn)—was concentrated in the 100 largest asset owners.[5]

4 PRI, "How Asset Owners Can Drive Responsible Investment: Beliefs, Strategies and Mandates" (2016). www.unpri.org/download?ac=1398.

5 Willis Towers Watson, "Largest Asset Owners Are Critical to Aiding Society's Biggest Issues," press release (14 November 2019). www.willistowerswatson.com/en-SG/News/2019/11/largest-asset-owners-are-critical-to-aiding-societys-biggest-issues.

Exhibit 8: Differentiating Asset Owners, Asset Managers, and Intermediaries



Source: BlackRock.[6]

Asset owners set the tone for the investment value chain. Their understanding of how ESG factors influence financial returns and how their capital affects the real economy can significantly drive the amount and quality of ESG investing from the investment value chain.

The approach that owners take to ESG investing and how meaningful they are in steering the investment value chain are influenced by the type of investor they are. This includes, in particular, whether they are investing

- directly or via external asset managers or
- out of their own account or acting on behalf of (or in trust for) beneficiaries.

The effectiveness of asset owners in steering the investment value chain toward an increased integration of ESG depends on

- the number of asset owners implementing responsible investment,
- the total AUM of these assets, and
- the quality of implementation across the different asset classes.

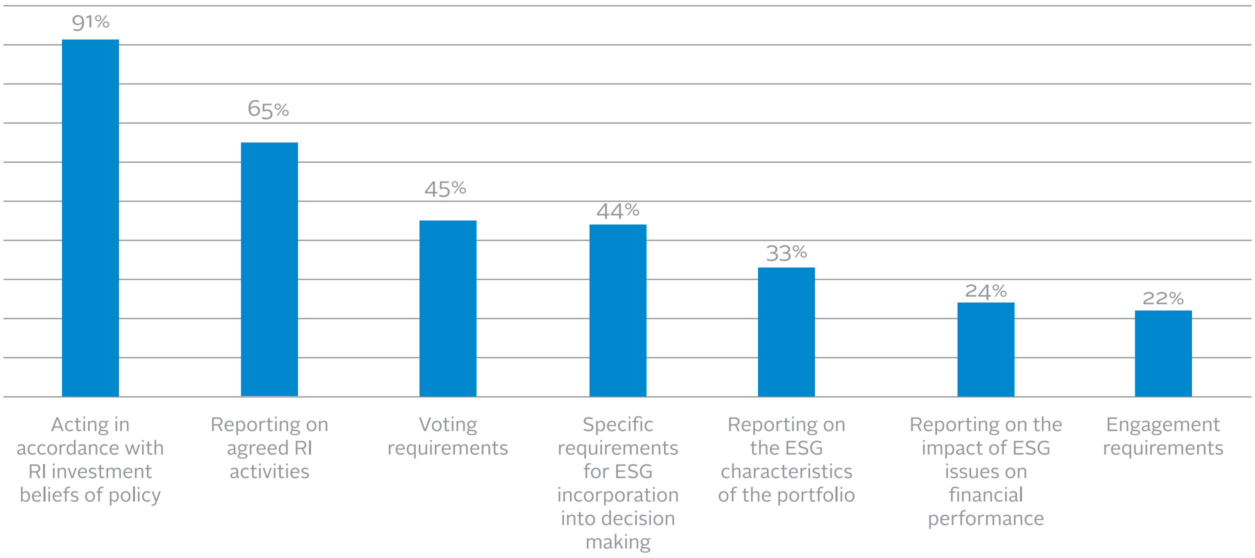
6 BlackRock, "Who Owns the Assets? Developing a Better Understanding of the Flow of Assets and the Implications for Financial Regulation" (May 2014). www.blackrock.com/corporate/literature/whitepaper/viewpoint-who-owns-the-assets-may-2014.pdf.

This situation creates a multiplier effect throughout the investment market. Effective implementation of responsible investment by individual asset owners signifies to the market that responsible investment is a priority for asset owners. In turn, this influences the willingness of investment consultants and investment managers to focus on responsible investment and ESG issues in their products and advice. By implementing their commitments to responsible investment with enough scale and depth, asset owners can accelerate the development of responsible investment through the investment chain.

Institutional asset owners establish contracts, known as **investment mandates**, with asset managers. These are important because they define the expectations around the investment product and, at times, even aspects around the manager's processes and resources more broadly.

Exhibit 9 shows the outcomes of an older (from 2015) survey by PRI of its asset owners' signatories about explicit expectations they have included within clauses of investment mandates. The majority had made some form of expectations explicit, and given the increasing voluntary and mandatory guidance around stewardship, it is reasonable to expect that asset owners' requirements around engagement have since increased.

Exhibit 9: Responsible Investment Clauses in Asset Owner Contracts with Their Investment Managers



Source: PRI.[7]

One of the challenges asset owners occasionally face in integrating ESG considerations is a hesitancy on the part of consultants and retail financial advisers to integrate ESG investing into their offerings or to assess the ESG characteristics of funds, leading to fewer options for the asset owners to choose from in the market. Related to this issue is that some asset owners also believe they do not have the scale or capacity to influence the products offered by fund managers or these managers' interpretation of fiduciary duty. Other asset owners are unsure of how to integrate ESG considerations

7 PRI, *How Asset Owners Can Drive Responsible Investment: Beliefs, Strategies and Mandates* (2016). https://www.unpri.org/download?ac=1398

within requests for proposals or mandates. Finally, there can be challenges for smaller asset owners who have limited resources to conduct their own ESG assessment of managers and their funds.

Pension Funds

Of the 100 largest asset owners, 59% are pension funds.[8] For their size, as well as the long-term nature of their investment, pension funds play a key role in influencing the investment market.

Pension funds are responsible for the management of pension savings and pay-outs to individuals. Given the long-term nature of their liabilities, ESG factors—more long term in nature—are particularly relevant to their investments.

Pension funds as institutions are driven by three internal players:

1. *Executives*, who manage the fund's day-to-day functioning
2. *Trustees*, who hold the ultimate fiduciary responsibility, act separately from the employer, and hold the assets in the trust for the beneficiaries of the scheme
3. *Beneficiaries* (or *members*), who pay into the fund or are pensioners benefiting from the assets

Similar to the board of a company, the board of trustees is responsible for ensuring that the pension scheme is run properly and that members' benefits are secure. The level of delegation between trustees and executives (on such matters as policy and asset manager selection) varies depending on the governance of the pension fund. The level of alignment between them also varies significantly across pension funds.

Beneficiaries are generally not aware of the details of investment decisions but may enquire why their pension funds are invested in a company that is violating human rights or engage with their pensions to divest from nuclear weapons. As a result, these actors have different roles and, at times, different interests but may all help advance pensions' fund policy and implementation of responsible investment.

Federal and state governments are also often among the largest institutional investors—typically through pension schemes or sovereign wealth funds. When governments align their policy intent with their own direct investment influence, there is scope for significant impetus to be added toward ESG integration. Some governments and investment funds have recognized this fact.

In theory, asset owners with long-term liabilities (such as pension funds) are well aligned with long-term investing and are due to benefit from it. In practice, they at times help create the problem by rewarding managers and companies for short-term behavior.

Pension funds can, however, integrate long-termism into their investment belief statements. They can, for example, set up investment mandates that place value on long-termism and demand long-term metrics from asset managers and underlying assets. The requirement to consider ESG factors within investment mandates also reinforces the asset owners' appreciation for the link between ESG factors and long-term returns.

8 Willis Towers Watson, "Largest Asset Owners Are Critical to Aiding Society's Biggest Issues."

CASE STUDIES

ABP Pension Fund

In September 2021, ABP, the Dutch pension fund for educational workers and civil servants, announced that it will divest its entire EUR15 billion worth of investments in fossil fuel producers by 2023. ABP is the fifth largest pension fund in the world and stated that "radical change" is needed because global temperatures are projected to rise beyond 1.5°C in the next seven years.

At the time of the statement, the holdings in about 80 companies accounted for almost 3% of ABP's total assets.[9] The fund stated that it did not expect the divestment to have a negative effect on its long-term returns.

"We [will exit] our investments in fossil fuel producers because we see insufficient opportunity for us as a shareholder to push for the necessary significant acceleration of the energy transition at these companies," said Corien Wortmann-Kool, ABP's chair.

ABP was facing the risk of legal action in the Netherlands over its earlier refusal to divest from fossil fuels.

CASE STUDIES

HSBC Bank UK Pension Scheme

In 2016, the HSBC Bank UK pension schemes transitioned the equity component of its defined contribution (DC) default investment strategy to a passive smart-beta fund that integrates ESG factors by embedding climate tilts.

An HSBC comment piece on the product noted, "Investment performance does not need to be negatively impacted. . . . This is critical, because although investors are increasingly demanding that funds are allocated responsibly, they are not necessarily prepared to compromise on performance."

In fact, the scheme aims to provide a better risk-adjusted return than is available from a conventional market cap–weighted index. The inclusion of the climate tilts gives scheme members greater relative exposure to firms less at risk from climate change.

CASE STUDIES

Government Pension Investment Fund

Between 2017 and 2020, the Government Pension Investment Fund (GPIF), an influential universal owner from Japan with investments worldwide, invested in nine different ESG-themed indexes. GPIF promotes ESG investment for the purpose of improving the long-term return of the whole asset by reducing the negative externality to the environment and society.

GPIF holds the view that among important ESG issues, environmental concerns, such as climate change, represent a cross-border, global challenge. Therefore, it has embarked on investment that incorporates all elements of ESG investing in both their domestic and foreign portfolios. In choosing the ESG indexes, GPIF emphasized the following:

9 Chris Flood, Josephine Cumbo, "Dutch Pension Giant ABP to Dump €15bn in Fossil Fuel Holdings," *Financial Times* (26 October 2021).

1. "positive screening" that determines constituent companies based on their ESG evaluation should be adopted;
2. the evaluation should be based on public information, and its method and results should be publicly disclosed; and
3. ESG evaluators and index providers should be properly governed, and their conflicts of interest should be properly managed.[10]

CASE STUDIES

UK Environment Agency Pension Fund

In 2014, the £2.4 billion UK Environment Agency Pension Fund (EAPF) launched a formal search for investment managers to manage a portfolio of sustainable, global listed equities, with a specific focus on the long-term contract with the appointed manager. Candidates were expected to

- have a long-term strategic approach to sustainability,
- integrate ESG considerations broadly, and
- have a strong commitment to non-financial research, which should go beyond short-term considerations of ESG risk factors and "standard" corporate governance.

The request for proposal (RFP), known at the time as the "RFP for a long-term mandate," sent a strong signal to the market of the link between long-termism, with regard to both the contract itself and the investment horizon, and ESG investing.

In 2018, the EAPF investment pool became a part of Brunel Pension Partnership and published the Asset Management Accord, which sets out expectations for long-term manager relationships.[11] Of note, the accord highlights long-term value creation and stewardship and clarifies that frequent communication should not lead to short-term pressure.

Pension Fund Trustees

Pension fund trustees, as fiduciaries of the pension fund members, have a responsibility to act in the best interests of the beneficiaries. Regulation regarding fiduciary duty defines a significant part of their role and responsibilities, and thus, its interpretation can have a significant impact on whether trustees believe they can, must, or must not integrate ESG considerations into their fund policies and processes.

Litigation

Pension fund trustees may face fiduciary legal risks from financial losses caused by climate change. Lawyers have been commissioned in Australia and the United Kingdom to assess the matter. They have found that pension fund trustees may be failing to take sufficient steps to address climate risk and, therefore, may be failing to manage the scheme's investments in a manner consistent with members' best interests. This situation could result in trustees exposing themselves to the possibility of legal challenges for breach of their fiduciary duties.

10 Government Pension Investment Fund: www.gpif.go.jp/en/investment/esg/.
11 Brunel Pension Partnership, "Brunel Launches Pioneering Asset Management Accord," press release (29 November 2018). www.brunelpensionpartnership.org/2018/11/29/brunel-launches-pioneering-asset-management-accord.

The risk of legal action is highlighted by a 2019 case in Australia where a member of the Retail Employees Superannuation Trust took his pension fund to court for failing to disclose information on the impact of climate change on his investments and how they were addressing the issue.[12] Also in 2019, 14 of the United Kingdom's biggest pension funds were warned by lawyers that they risk legal action if they fail to consider the effects of climate change on their portfolios. As a result, fiduciary duty is a driver for trustees and their pensions to act on ESG issues. In a survey that was conducted among more than 300 global institutional investors, 46% of respondents cited the need to meet fiduciary duty and regulations as a key driver for adopting ESG principles.[13]

Pension Fund Members

Although pension fund members are not investment professionals, they can influence pension fund decisions because they are the ultimate beneficiaries. Interpretation of fiduciary duty in some jurisdictions recognizes that "acting in the interest" of pension fund beneficiaries is not necessarily restricted to financial outcomes and may incorporate their other interests, such as ethical preferences. Though still rare in the industry, some pension funds have started to use feedback from members to fine-tune their sustainable investment policies.

CASE STUDIES

Surveys by Dutch Pension Funds

The €26.2 billion (£22.9 billion) Dutch multi-sector pension fund PGB conducts an annual survey on responsible investment among its participants.[14] In order to make decisions based on its members' input, the fund conducted a mandatory survey on members' risk appetite and included an additional questionnaire that related to ESG issues.

Of the 3,500 respondents, 90% indicated a preference for investments in sustainable energy, whereas just 14% supported investments in arms and only 17% supported investments in tobacco. As a result of the input from the respondents, PGB excluded tobacco firms and companies selling firearms to civilians from its investment universe. In 2020, PGB transitioned to a fully integrated ESG strategy, with all of its AUM falling in the scope of a new ESG policy.[15]

The €9.9 billion (£8.6 billion) Dutch hospitality pension fund Horeca & Catering conducted its most recent survey at the end of 2017, generating a response from 9,500 members and 526 employers. Its participants indicated that labor conditions, environment, fraud, and corruption mattered the most to them. As a result of the consultation, the scheme excluded companies that violate the UN's Global Compact Principles and aimed to reduce carbon emissions from its investment portfolio by 20% in the next two years. And in 2021, Horeca & Catering divested from companies with more than 50% of revenue coming from fossil fuel production.[16]

12 Jennifer Thompson, "Pension Funds Warned of Legal Action over Climate Risk," *Financial Times* (12 August 2018).

13 James Comtois, "Institutional Investors See ESG as Part of Their Fiduciary Duty – Survey," *Pensions & Investments* (12 November 2019). www.pionline.com/esg/institutional-investors-see-esg-part-their-fiduciary-duty-survey.

14 Sameer Van Alfen, "Dutch Schemes Fine-Tune ESG Investments Following Member Feedback," *IPE* (7 November 2018). www.ipe.com/dutch-schemes-fine-tune-esg-investments-following-member-feedback/10027711.article.

15 See www.pensioenfondspgb.nl/en/about-pensioenfonds-pgb/investing/SRI/.

16 See www.phenc.nl/over-ons/nieuws/PensioenfondsHoreca&Catering-stapt-uit-fossiel.

Insurance

Insurance is divided into the following categories:

- **Property and casualty (P&C).** This category includes insurance from liabilities and damages to property (due to calamities or from legal liabilities in the home, vehicle, etc.).
- **Life.** This category covers financial losses resulting from loss of life of the insured, as well as offering retirement solutions.
- **Re-insurance.** In other words, a reinsurer provides insurance to an insurer, sharing a portion of an insurer's risk against payment of some premium.

Insurers are by nature sensitive to certain ESG issues due to factors affecting insurance products, such as

- the frequency and strength of extreme weather events (P&C) and
- demographic changes (life insurance).

This sensitivity has contributed to insurers having developed a very advanced understanding of these issues. Many insurers have an (internal) asset management business that invests the insurance premiums. The interactions between the insurance business and the internal asset management business within insurance companies led to these asset managers advancing rapidly in their understanding of ESG issues.

Importantly, in terms of climate risks, insurers are double exposed because both sides of their balance sheet can be hit by climate risks: the asset side via transition risks and the liability side via physical risks.

CASE STUDIES

Insurers and ESG Issues

Munich Re, a re-insurer, felt the repercussions of climate change on its business model. Research suggests that climate change is shifting the probability distributions of natural catastrophes, such as hurricanes and blizzards, increasing the cost for re-insurers.

An example of the dire impact of even the slightest change in weather patterns for hurricanes highlights the challenges climate change imposes on this industry: a change of 5%–10% in wind speed during hurricane season will lead to damages amounting to roughly 0.13% of total US GDP.[17]

Similarly, in a worst-case scenario assuming a change in average temperature by 3°C–4°C (5.4°F–7.2°F), damages caused by natural catastrophes (e.g., flooding) would quadruple in the United Kingdom.

Pricing for re-insurance is thus heavily reliant on knowledge of these exact probabilities. As a result, Munich Re has

- invested significantly in climate change research and modeling,
- built a climate change research center, and
- established an extensive natural catastrophe database.

17 N. Stern, *The Economics of Climate Change: The Stern Review* (Cambridge, UK: Cambridge University Press, 2007).

> In 2016, Axa, valued at the time at €1.8 billion (£1.3 billion), was one of the global insurers and investors that divested from tobacco. At the launch of the Tobacco Free Finance Pledge,[18] Axa's CEO noted that "as a health insurer, we see every day the impact of smoking on people's health and wellbeing," recognizing the influence that Axa's life insurance business was having on its investment arm.[19]

Sovereign Wealth

Sovereign wealth is wealth managed through a state-owned investment fund—a **sovereign wealth fund (SWF)**. The amount of investment capital is usually large and is held by a sovereign state. The global volume of assets under management by sovereign wealth funds was estimated to be US$8 trillion (£5.8 trillion) in 2020.[20] Often the wealth comes from a sovereign state's capital surpluses.

Sovereign wealth funds are often mandated in line with the mid- to long-term objectives of their state, which might go beyond optimizing financial return and include broader policy objectives, such as

- economic stabilization,
- securing wealth for future generations, and
- strategic development of the state's territory.

These objectives can but don't necessarily have to align with ESG concerns. There is some evidence that SWFs take ESG issues into account in asset selection and investor engagement in listed equities, but this evidence is mainly driven by observation of the practices of some of the more transparent SWFs.[21]

Endowment Funds

Endowment funds are funds set up in a foundation by institutions (universities or hospitals, for example) that wish to fund their ongoing operations through withdrawals from the fund. Given the often societal purpose of endowments, there is an active debate on how to align the ongoing operational funding with such topics as divestment. Examples of this debate can be found in the United Kingdom, where universities are pressured by their students to have more sustainable investments in their endowments.[22]

Foundations and Public Charities

In such countries as the United States, private foundations and public charities are charitable organizations that invest their capital to fund charitable causes. Usually for both, the legal form of organization (LFO) is a "foundation," but the difference between the two is that

- private foundations originate their capital through one funder (typically a family or a business), whereas
- public charities originate their capital through publicly collected funds.

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18 Principles for Sustainable Insurance, "The Tobacco-Free Finance Pledge." www.unepfi.org/psi/tobacco-free-finance-pledge/.

19 AXA, "AXA Signs the Tobacco Free Finance Pledge" (26 September 2018). www.axa.com/en/magazine/axa-signs-the-tobacco-free-finance-pledge.

20 H. Liang and L. Renneboog, "The Global Sustainability Footprint of Sovereign Wealth Funds," European Corporate Governance Institute Finance Working Paper No. 647/2019 (10 January 2020).

21 H. Liang and L. Renneboog, "The Global Sustainability Footprint of Sovereign Wealth Funds."

22 A. Mooney and S. Riding, "Students Call on UK University Endowments to Invest Responsibly," *Financial Times* (3 October 2020).

Foundations can have ESG exposures through their investment, as well as ESG objectives through their charitable work.

Individual (Retail) Investors and Wealth Management

The adoption of ESG investing by retail investors has been generally slower than for institutional investors.

At the end of 2018 in the United States, only US$161 billion (£115.7 billion) of the total US$22.1 trillion (£15.9 trillion) in assets have gone to those referencing ESG considerations. This percentage is much smaller than for institutional investors.[23]

However, inflows in open-ended and exchange-traded funds (ETFs) have been increasing: In 2020, they attracted a record US$51.1 billion (£36.7 billion) in net flows. This amount is more than twice the previous record set in 2019, when they were at a record US$18 billion (£12.9 billion); inflows in 2018, then at a record high as well, amounted to US$5.5 billion (£4 billion). Moreover, in 2020, sustainable fund flows accounted for nearly one-fourth of overall flows into funds in the United States. Morningstar, a research firm that offers an investment platform for retail investors, reported that in 2020, 71 sustainable funds were launched in the US market, easily topping the previous high-water mark of 44 set in 2017, with at least 30 funds launched each year from 2016 to 2020.[24]

Generational Differences

Millennials are usually defined as those born between 1981 to 1996. Studies and surveys have generally found that millennials are quite interested in ESG investing:

- A 2017 study of high-net-worth investors stated that 90% of millennials want to direct their allocations to responsible investments in the next five years.[25]
- Another study found that 75% of individual investors in the United States were interested in sustainable investment; the percentage of millennials was higher, at 86%.[26]
- Younger high-net-worth investors are most likely to review the ESG impact of their investment holdings, including 88% of millennials and 70% of Generation X; 82% of high-net-worth investors who make investment decisions based on ESG factors see investing as one way of expressing their personal values.[27]

Millennials are a large demographic, representing 75 million people in the United States alone, and are the future recipients of an expected US$30 trillion (£21.6 trillion) intergenerational wealth transfer through inheritance from baby boomers.

23 GSIA, "Global Sustainable Investment Review 2018" (2019).
24 Morningstar, "Sustainable Funds U.S. Landscape Report" (2021). www.morningstar.com/lp/sustainable-funds-landscape-report.
25 Bank of America Corporation, "2016 Environmental, Social & Governance Report" (2016). https://about.bankofamerica.com/assets/pdf/Bank-of-America-2016-ESG-Summary-Report.pdf.
26 Morgan Stanley Institute for Sustainable Investing, "Sustainable Signals: New Data from the Individual Investor" (2017). www.morganstanley.com/pub/content/dam/msdotcom/ideas/sustainable-signals/pdf/Sustainable_Signals_Whitepaper.pdf.
27 Bank of America, "Putting Wealth into Action: Competing Priorities and Lack of Time to Comprehensively Plan Are Top Reasons Why Good Intentions Fall Short" (26 June 2018). https://newsroom.bankofamerica.com/press-releases/global-wealth-and-investment-management/putting-wealth-action-competing-priorities.

Bank of America Merrill Lynch has predicted that over the next two or three decades, millennials could put between US$15 trillion (£10.8 trillion) and US$20 trillion (£14.4 trillion) into US-domiciled ESG investments, which would roughly double the size of the entire US equity market.[28]

6 ASSET MANAGERS, FUND PROMOTERS, AND FINANCIAL SERVICES

- ☐ **2.1.3** explain key market drivers of ESG integration: investor demand/intergenerational wealth transfer, regulation and policy, public awareness, and data sourcing and processing improvements
- ☐ **2.1.4** explain the key drivers and challenges for ESG integration among key stakeholders: asset owners, asset managers, fund promoters, financial services, policymakers and regulators, investees, government, civil society, and academia

Asset managers select securities and offer a portfolio consisting of those securities to asset owners. They influence the ESG characteristics of the portfolio through selection, as well as engaging with investee companies to improve their ESG performance. While they react to asset owners' interest in ESG issues, they can also play a key role in proposing new products and approaches to considering ESG factors. Asset managers are central in the investment value chain.

ESG offerings by asset managers generally began with active-listed equities but recently evolved to other asset classes. The knowledge gained by integrating ESG considerations in the equity valuation of companies was, to a certain extent, transferred to that of corporate bonds. Because fixed-income funds also include non-corporate issuers (such as supranationals, governments, and municipalities), methodologies to integrate ESG considerations expanded to enable the ESG analysis to incorporate all the issuers of the fund.

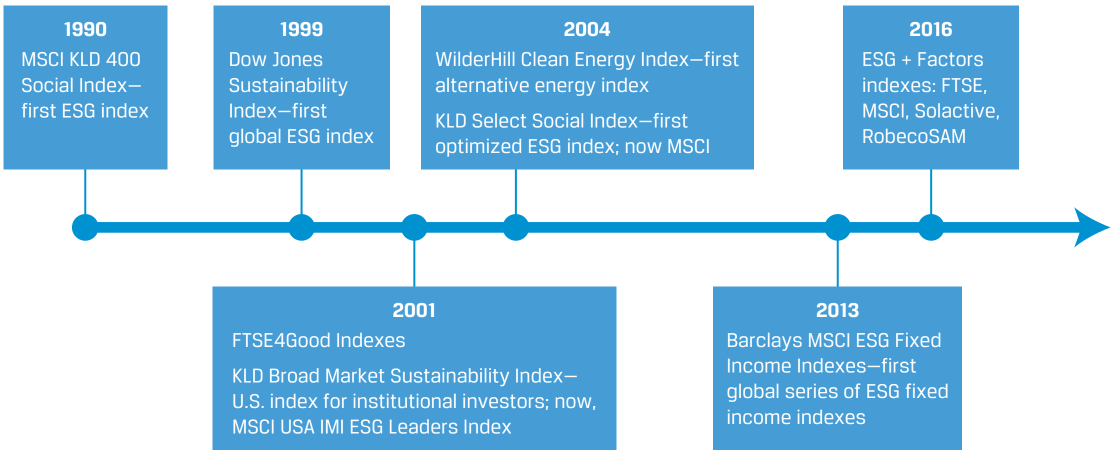
Over the past 10 years, the rise of green bonds has further propelled fixed-income as an asset class of interest to responsible investors. Funds of infrastructure, real estate, private equity, and private credit have been slower to systematically and explicitly conduct ESG integration. Nonetheless, real estate, private equity, and private credit have been instrumental in the structuring of impact investing funds.

The offering of indexes and passive funds with ESG integration by asset managers started 20 years after that of active investments. The use of indexes is nonetheless critical for the investment industry: They are performance benchmarks and serve as the basis for passive investment funds, such as ETFs. The first ESG index, the Domini 400 Social Index (now called MSCI KLD 400 Social Index), was launched by KLD Research & Analytics in 1990. In recent years, the trend toward passive investment and, particularly, investors' preferences for ETFs, together with the increased availability of ESG data and research, have spurred the market's development of ESG indexes (see Exhibit 10 for further detail).

28 Bank of America Corporation, "2016 Environmental, Social & Governance Report."

As of 2021, there were over 1,000 ESG indexes (of the 3.3 million indexes that were globally available according to the Index Industry Association, or IIA),[29] reflecting the growing appetite of investors for ESG products and the need for measurement tools that accurately represent the objectives of sustainable investors. ESG factors have also been successfully integrated into factor investing, smart beta funds, and derivatives, reflecting the penetration of ESG within a much more complex product offering by asset managers. IIA reported in the 2021 edition of its annual survey that the number of ESG-themed indexes grew by 43%, surpassing the 2020 growth figure of 40%.[30]

Exhibit 10: The Origins of ESG Indexes



Source: iShares by BlackRock, “An Evolution in ESG Indexing” (2019).

Asset managers who wish to differentiate themselves have been investing significantly in ESG-related resources. Some have merged with or acquired asset managers specializing in ESG or impact investing; others have invested significant amounts in technology, using data science to develop their in-house scoring systems and dashboards. One global investor, for example, has built a proprietary system to measure the progress of fixed-income issuers against specific ESG-related objectives. Asset managers have also expanded their human resources, with some responsible investment teams increasing to over 20 people.

Some of the challenges faced by asset managers in integrating ESG issues include

- a lack of clear signals from asset owners that they are interested in ESG investing,
- a very narrow interpretation of investment objectives on which consultants and advisers base their advice for owners, and
- resource challenges, especially for investors who see ESG investing as separate from the core investment process (e.g., engagement, marketing, or compliance).

29 C. Svaluto Moreolo, “The Origin of ESG Indices,” *IPE* (magazine, June 2019). www.ipe.com/the-origin-of-esg-indices/10031442.article.

30 IIA, “Fifth Annual Benchmark Survey Shows Record Growth in Number of ESG Indices, Alongside Broadening of Fixed Income Indices.” www.indexindustry.org/2021/10/25/fifth-annual-iia-benchmark-survey-reveals-significant-growth-in-esg-continued-multi-asset-innovation-heightened-competition/.

For this purpose, the **fund promoter** is defined as including:

- investment consultants and retail financial advisers,
- investment platforms, and
- fund labelers.

Investment consultants and retail financial advisers are investment professionals who help institutions and individuals, respectively, set and meet long-term financial goals, usually through the proposal of investment funds. They can consider ESG characteristics of the funds in their screening and short-listing of funds to clients. Fund labelers can set standards to award labels to investment vehicles after the assessment of their ESG processes and performance.

Investment Consultants and Retail Financial Advisers

Ensuring that **investment consultants** and **retail financial adviser**s incorporate ESG factors into their core service provision is crucial for the next wave of responsible investment. These two groups are considered the gatekeepers for the expansion of ESG investing, since they advise asset owners and individual investors, respectively. As a trusted source of knowledge to trustees (particularly for small and medium-sized asset owners) and retail investors, the PRI's aim is for consultants and advisers to understand the investment implications of ESG issues and turn them into investment recommendations, because their advice is often accepted with little hesitation.

This focus of the PRI was prompted by a its review in 2017 concluding that most consultants were failing to consider ESG issues in investment practice.[31] The PRI found that often the advice it gives to investors did not support products that integrate ESG factors. To address this issue, the PRI published guidance in 2019 for asset owners to request ESG information from consultants.[32] Further challenges could emerge because consultants and financial advisers often base their advice on a narrow interpretation of investment objectives. What they perceive as a lack of appetite by asset owners in responsible investment has also led historically to them being less keen to integrate ESG investing into their mainstream offerings. some jurisdictions, such as the EU, are sidestepping this conundrum by introducing mandatory regulation for investment funds and rating agencies to explicitly consider ESG issues (Sustainable Finance Disclosure Regulation, or SFDR, and EU Credit Rating Guidelines) and for financial service providers to explicitly take stock of investors' ESG preferences across various investor categories and asset classes (Markets in Financial Instruments Directive, or MiFID, Undertakings for the Collective Investment of Transferable Securities, or UCITS; Alternative Investment Fund Managers Directive, or AIFMD).

There is much that consultants can do. With regard to investment strategy, they can

- aid trustees in understanding their fiduciary obligations,
- formulate a strategy inclusive of ESG considerations, and
- draft investment principles and policies in line with the strategy and fiduciary obligations.

Within their manager selection role, consultants can help asset owners design a proposal and formulate a mandate that integrates their investment beliefs on ESG issues and expectations on implementation.

31 PRI, "Investment Consultants Services Review" (2017). www.unpri.org/sustainable-financial-system/investment-consultants-services-review/571.article.

32 PRI, "Investment Consultants and ESG: An Asset Owner Guide" (2019). www.unpri.org/asset-owner-resources/investment-consultants-and-esg-an-asset-owner-guide/4577.article.

Finally, consultants can include asset managers' capabilities and processes related to ESG investing within their research, screening, selection, and appointment processes. Advisers can play a similar role with individual investors, proactively providing relevant ESG information and including ESG investments in their offerings and advice.

Investment Platforms

The research and recommendations of **investment platforms** can be highly influential in the asset management industry and can be a positive or negative recommendation driving a significant amount of capital into or away from any given fund.

Morningstar, one of the main investment platforms, offers a service that rates asset managers and their funds. In 2016, the platform started integrating ESG ratings in its offerings. Investment platforms can integrate the extent and depth that funds integrate ESG investing to

- increase awareness of ESG funds for both retail and institutional investors and
- enable easier identification of and information on these funds.

However, in February 2022, Morningstar reclassified almost 1,700 funds, worth US$1.2 trillion, away from its list of sustainable funds. It cited its own research analyzing additional criteria provided by funds following the implementation of new EU disclosure rules called "SFDR."

Fund Labelers

Labels provide benchmarks and quality guarantees for both practitioners and clients. In just over a decade, sustainable finance has led to the creation of eight specialized labels in Europe alone. Labels are usually either general, looking at ESG investing as a whole, or thematic, usually focused on environment or climate. Few labels have been applied to multiple countries, creating challenges for global investors seeking to offer certified ESG funds across multiple jurisdictions. Certifications have been perceived as a marketing tool by some actors. Nonetheless, in practice, it is not necessarily associated with a marketing strategy in line with the fund's promises. A quarter of the funds certified on ESG criteria in Europe do not have a name reflecting a sustainable approach, and around 30 are thematic environmental funds.[33]

Financial services are defined as including

- investment banks,
- custodial banks,
- investment research and advisory firms,
- stock exchanges, and
- financial and ESG rating agencies.

Financial service companies are important enablers of responsible investment because they make significant contributions to the availability of securities with higher ESG quality and increase the quality of information about ESG characteristics of securities and assets in general. For example:

- Investment banks can support a company issuing a green bond (a bond where proceedings are specifically earmarked to be used for climate and environmental projects).

33 Novethic, "Overview of European Sustainable Finance Labels" (2019). www.novethic.com/sustainable-finance-trends/detail/overview-of-european-sustainable-finance-labels.html.

- Sell-side analysts and rating agencies can consider ESG factors within their analysis, recommendations, and ratings.
- Stock exchanges can increase disclosure requirements on ESG data by listed companies (as encouraged by the Sustainable Stock Exchange Initiative).
- Proxy voting service providers—those who vote on behalf of shareholders at companies' annual general meetings—can integrate ESG considerations in their voting and voting recommendations.

Improvements in ESG data sourcing and analysis have contributed to the growth of the ESG market. Analysis and ratings of investees from an ESG perspective have been dominated by traditional credit rating companies, as well as a handful of specialist firms. One-theme consultants, such as those specializing in helping investors understand and quantify the risk posed by climate change to their portfolios, are also well established, though many new ones continue to enter the market. The growth of the industry and its consolidation (through partnerships, mergers, and acquisitions) has increased investors' ability to further implement ESG investing. It has also helped policymakers and regulators reassure themselves that requirements to assess ESG risk and reporting on it are increasingly possible.

Further details on ESG rating agencies and suppliers can be found in Chapter 7.

7 POLICYMAKERS, REGULATORS, INVESTEES, GOVERNMENTS, CIVIL SOCIETY, AND ACADEMIA

- ☐ **2.1.3** explain key market drivers of ESG integration: investor demand/intergenerational wealth transfer, regulation and policy, public awareness, and data sourcing and processing improvements
- ☐ **2.1.4** explain the key drivers and challenges for ESG integration among key stakeholders: asset owners, asset managers, fund promoters, financial services, policymakers and regulators, investees, government, civil society, and academia

Financial regulation is downstream from policy choices. Financial supervision is downstream from financial regulation. This section highlights the various roles of policymakers and regulators and provides some examples of sustainable finance regulation from across the globe.

Policymakers are responding to the growing urgency of sustainability topics. Some issues can have a profound impact on:

- the stability of the financial system (for example, climate change and emerging issues, such as biodiversity and resource scarcity) and
- the risks to an individual investor's portfolio.

The objectives of **financial regulator**s are to:

- maintain orderly financial markets,
- safeguard investments in financial instruments, savings/pensions, and investment vehicles, and
- bring about an orderly expansion of activities of the financial sector.

Financial regulators consider how ESG factors might impact the stability of economies and the financial markets and how these factors might influence the long-term risk–return profile of financial instruments. They also encourage and enable the growth of certain ESG products, such as green bonds, and require disclosure on ESG characteristics.

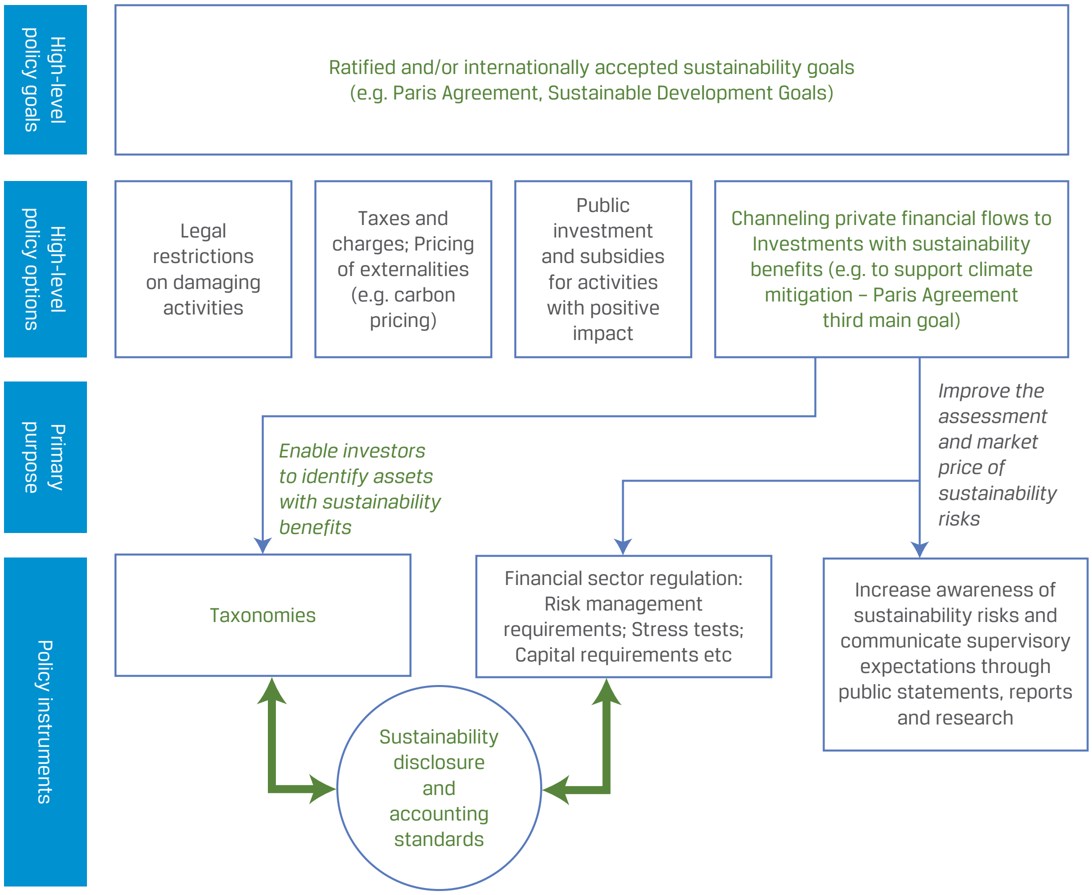
Other regulators can influence the ESG characteristics of companies by strengthening matters regarding environment, labor, communities, and governance and can require further disclosure on those issues.

Regulations generally involve three themes:

1. **Corporate disclosure**. Guidelines on corporate disclosure typically come from government or stock exchanges to encourage or require investee companies to disclose information on material ESG risks. While this does not impose any requirement on investors themselves, it improves their ability to consider these risks in their investment decisions.
2. **Stewardship**. Regulation on stewardship governs the interactions between investors and investee companies and seeks to protect shareholders and beneficiaries as well as the health and stability of the market. In most jurisdictions, stewardship codes remain voluntary, though mandatory regulation has been approved in Europe.
3. **Asset owners**. Regulation on asset owners typically focuses on pension funds, requiring them to integrate ESG factors and disclose their process and outcome. Some regulators, such as those in the United Kingdom, Australia, and Singapore, are also beginning to consider climate risk for the insurance market and the financial industry more widely.

Exhibit 11 illustrates how policymakers and regulators tie together varies sustainability policy objectives with regulatory interventions.

Exhibit 11: Relation between High-Level Sustainability Policy Targets and Toolkit of Financial Regulators



Source: Torsten Ehlers, Diwen (Nicole) Gao, and Frank Packer, "A Taxonomy of Sustainable Finance Taxonomies," Bank for International Settlements, BIS Papers No 118 (2021). www.bis.org/publ/bppdf/bispap118.pdf.

Examples of Policy and Regulatory Developments across the Globe

In a review conducted by the PRI on sustainable finance policy in 2019, 97% of the new or revised policies were developed after 2000. The continued acceleration has been driven by the rapid development in Europe (with many initiatives being developed under the EU Action Plan on Financing Sustainable Growth) and Asia (where markets have seen significant updates to reporting requirements and corporate governance expectations). Another significant factor has been periodic revisions of stewardship and corporate governance codes, with national authorities introducing or periodically strengthening ESG expectations. Stewardship is closely linked to shareholder engagement. Further details can be found in Chapter 6.

Global—Task Force on Climate-Related Financial Disclosures

In 2017, the **Task Force on Climate-Related Financial Disclosures (TCFD)** released climate-related financial disclosure recommendations to help firms voluntarily disclose information to support capital allocation. Since its launch, the TCFD recommendations have been made mandatory in various jurisdictions, including New Zealand, Switzerland, Hong Kong SAR, Japan, Singapore, and the United Kingdom. In the EU, SFDR, which has a broader scope than TCFD in terms of sustainability topics, effectively made TCFD mandatory. In the near future, wider TCFD implementation is expected, with all of the G–7 countries backing mandatory reporting, meaning that Canada and the United States will also move to mandatory TCFD reporting.

The TCFD recommendations center on four key areas:

1. Governance
2. Strategy
3. Risk management
4. Metrics and targets

Europe—EU Taxonomy Regulation

The EU Taxonomy Regulation, published on 22 June 2020, established a framework that states conditions for an economic activity to be considered environmentally sustainable. These include

- contributing substantially to at least one of the six environmental objectives listed in the next paragraph,
- "doing no significant harm" to any of the other environmental objectives, and
- complying with minimum, EU-specified, social and governance safeguards.

The Taxonomy Regulation establishes six environmental objectives:

1. Climate change mitigation
2. Climate change adaptation
3. The sustainable use and protection of water and marine resources
4. The transition to a circular economy
5. Pollution prevention and control
6. The protection and restoration of biodiversity and ecosystems

Europe—EU Sustainable Finance Disclosure Regulation

SFDR, published in December 2019, created requirements to promote consideration of environmental and social risks that may affect investments. These disclosures aim to enhance transparency of sustainably invested products to prevent green washing. It identifies so-called *principal adverse impacts* that have a negative impact on the environmental and social issues stemming from investment decisions.

China—Guidelines for Green Financial System, Green Asset Taxonomy, and PBOC 2021–25 Strategy

In 2016, the People's Bank of China (PBOC), in collaboration with six other government agencies, issued guidelines establishing the green financial system. These guidelines marked a turning point for China's sustainable finance policy. Previous policy reforms tended to be reactive to financial crises. The new generation of policy recognizes that to be effective, reforms need to tackle multiple aspects of interconnected and complex capital markets. In addition, in 2021, China launched the Common Ground Taxonomy with the EU, and in that year, the PBOC announced a new, five-year strategy with strong support for the origination of green loans, bonds, insurance, and derivatives.

The United States—2022 SEC proposal

In the United States policies have long remained voluntary or based on a "comply or explain" expectation, which led some investors to continue to challenge the assertion that ESG integration is a requirement. However, in April 2022, the US SEC proposed far-ranging disclosure requirements for climate risks. This proposal was open to a 60-day consultation process, but in its initial version, it governs how a regulated firm is to report on the following:[34]

- How climate related risks are governed by a firm's board and management
- The firm's climate-related impacts, goals, targets, and transition plans
- The firm's Scope 1 (direct operational emissions) and Scope 2 (emissions from energy used by the firm) greenhouse gas emissions
- The firm's Scope 3 emissions if material—that is, the emissions in its upstream and downstream supply chains

Combined Effect of Regional Strategies

Combined, these regional strategies have been a significant driver in the overall policy growth in in this space—in particular, the EU Action Plan on Financing Sustainable Growth. Moreover, it is anticipated that as policies on ESG issues and financial regulation reach maturity, an increasing number of governments will recognize the importance of moving to stronger requirements in the following ways:

- moving away from "comply or explain" regulation and to "comply and explain" regulation,
- changing from voluntary to mandatory disclosures, and
- moving from policy to implementation and reporting.

For example, the Network for Greening the Financial System, a group of 127 central banks and supervisors established in 2017, explicitly recognizes climate risks as relevant to a supervisory mandate, and it has challenged policymakers, other central banks, and supervisors to act to limit the catastrophic impacts of runaway climate change.

Challenges to ESG investing can emerge if regulators hold a narrow interpretation of fiduciary duty, such as with the US Department of Labor's (DOL's) 2020 ruling on fiduciary duty and non-financial objectives (see the following case studies).

CASE STUDIES

The United States

In the United States, private sector retirement plans are subject to the provisions of the **Employee Retirement Income Security Act (ERISA)**. ERISA sets standards for fiduciaries of defined benefit and defined contribution plans based on the principle of a prudent-person standard.

The DOL is responsible for issuing regulation and guidance on fiduciary responsibility provisions. While only pension plans in the private sector are under the jurisdiction of the DOL, it is of great influence because the public sector often looks to ERISA principles as a benchmark for best practice in meeting common law fiduciary standards in their governance.

34 SEC, "Fact Sheet: Enhancement and Standardization of Climate-Related Disclosures." www.sec.gov/files/33-11042-fact-sheet.pdf.

ERISA defines the responsibilities of institutional investors entrusted with retirement assets. Chief among these is the obligation to always act to protect the interests of plan participants and beneficiaries. Under ERISA, plan sponsors and other fiduciaries generally must do the following:

1. Act solely in the interest of plan participants and beneficiaries.
2. Invest with the care, skill, and diligence of a prudent person with knowledge of such matters.
3. Diversify plan investments to minimize the risk of large losses.

Plan sponsors that breach any of these fiduciary duties may be held personally liable.

To some extent, the DOL started addressing ESG matters within ERISA in the 1990s.[35] In its Interpretive Bulletin (IB) 1994-1, issued under the Clinton administration, it corrected a popular misperception at the time by establishing that economically targeted investments (ETIs), which generate societal benefits in addition to financial return, are compatible with ERISA's fiduciary obligations as long as their expected rate of return is commensurate with the rates of return offered by alternative investments with similar risk characteristics. This was referred to as the "all things being equal" test.

In 2008, the DOL under the George W. Bush administration replaced IB 1994-1 with IB 2008-01, which stated that the fiduciary consideration of collateral, non-economic factors in selecting plan investments should be rare and, when considered, documented in a manner that demonstrates compliance with ERISA's rigorous fiduciary standards. This publication had the effect of discouraging fiduciaries from considering ETIs and ESG factors.

Thus, the responsible investment community welcomed the DOL's IB 2015-01 under the Obama administration, which significantly expanded the use of ESG investing principles under ERISA:

> *IB 2015-01 confirms the Department's longstanding view that plan fiduciaries may invest in ETIs based, in part, on their collateral benefits so long as the investment is appropriate for the plan and economically and financially equivalent with respect to the plan's investment objectives, return, risk, and other financial attributes as competing investment choices. The IB also acknowledges that in some cases ESG factors may have a direct relationship to the economic and financial value of the plan's investment. In such instances, the ESG issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary's primary analysis of the economic merits of competing investment choices. When a fiduciary prudently concludes that such an investment is justified based solely on the economic merits of the investment, there is no need to evaluate collateral goals as tie-breakers."* [36]

35 US Department of Labor, "Economically Targeted Investments (ETIs) and Investment Strategies That Consider Environmental, Social and Governance (ESG) Factors" (2015). www.dol.gov/sites/dolgov/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/etis-and-investment-strategies-that-consider-esg-factors.pdf.

36 US Department of Labor, "Economically Targeted Investments (ETIs) and Investment Strategies That Consider Environmental, Social and Governance (ESG) Factors."

Yet in 2020, the pendulum swung back, under the Trump administration, when the DOL issued the so-called final rule, 85 FR 72846. This ruling removed all mention of ESG concepts and replaced it with the words "non-financial objectives" on the basis that the term "ESG" lacks uniform usage and a precise definition. This rule included the following ideas:

- The DOL believed that "tie-breaker" scenarios permitting investment decisions based on non-financial factors are extremely rare, and therefore, as a practical matter, ERISA fiduciaries should continue to refrain from making investment decisions based on non-financial factors.
- Fiduciaries must evaluate investments based solely on financial factors that have a material effect on the return and risk of an investment, and ESG factors may be considered as financial factors in evaluating an investment only if they present material economic risks or opportunities.
- Specific obligations were further imposed, such as documentation requirements, on ERISA plan fiduciaries considering ESG-oriented investing.

The Biden administration directed the DOL to review the final rule in a fact sheet issued in January 2021.[37] In March 2021, the DOL released a statement of non-enforcement, and in October 2021, it issued a new rule to allow consideration of ESG criteria and proxy voting in private sector retirement plans.

CASE STUDIES

The United Kingdom

There has been an extensive discussion in the United Kingdom about the fiduciary duties of institutional investors. In the wake of the 2008 global financial crisis, Professor John Kay was commissioned by the UK government to conduct a review of the structure and operation of UK equity markets. His report, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report*, published in July 2012, emphasized the need for a culture of long-term decision making, trust, and stewardship to protect savers' interests.[38] The report recognized the essential role that fiduciary duties play in the promotion of such a culture but highlighted the damage being done by misinterpretations and misapplications of fiduciary duty in practice.

In response, the government asked the Law Commission to investigate the subject of fiduciary duty in more detail. In 2014, the Law Commission published its report, "Fiduciary Duties of Investment Intermediaries." On financial factors, the report concluded that "whilst it is clear that trustees may take into account environmental, social and governance factors in making investment decisions where they are financially material, we think the law goes further: Trustees should take into account financially material factors." [39]

On non-financial factors, the Law Commission's term for ESG factors, the report concluded,

37 White House, "Fact Sheet: List of Agency Actions for Review" (20 January 2021). www.whitehouse.gov/briefing-room/statements-releases/2021/01/20/fact-sheet-list-of-agency-actions-for-review.

38 John Kay, "The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report" (July 2012).

39 Law Commission, "Fiduciary Duties of Investment Intermediaries" (2014). www.lawcom.gov.uk/app/uploads/2015/03/lc350_fiduciary_duties.pdf.

By "non-financial" factors we mean factors which might influence investment decisions motivated by other (non-financial) concerns, such as improving members' quality of life or showing disapproval of certain industries. In broad terms, trustees should take into account financially relevant factors. However, the circumstances in which trustees may make non-financially related decisions are more limited. In general, non-financial factors may only be taken into account if two tests are met:

1. *trustees should have good reason to think that scheme members would share the concern; and*
2. *the decision should not involve a risk of significant financial detriment to the fund.*

CASE STUDIES

The EU

The EU Action Plan on Financing Sustainable Growth, agreed on in 2019, requires the following:

- Mandatory disclosure of policies in relation to ESG risk (consistent with the PRI's fiduciary duty recommendations) for all firms and financial products
- Comply or explain disclosure of the principal adverse impacts of the investment on sustainability factors (mandatory for firms with more than 500 staff) at the firm and product level
- Enhanced disclosure obligations for firms promoting specific environmental or social objectives

The **Technical Expert Group (TEG)** was established to assist the European Commission in the technical development of various delegated aspects of sustainable finance regulation. In June 2019, the TEG issued reports on an EU Taxonomy, a voluntary EU Green Bond Standard, and voluntary low-carbon benchmarks. The "Taxonomy Technical Report" aimed to significantly advance a shared understanding among investors on activities and sectors that contribute to climate change mitigation and adaptation.[40] When the TEG concluded its work, it was succeeded by the Platform on Sustainable Finance, a permanent expert group of the European Commission that established, under Article 20 of the Taxonomy Regulation.

The EU's **Shareholder Rights Directive** II, which came into force in 2019, seeks to improve the level and quality of investors with their investee companies, better aligning executive pay with corporate performance and increasing disclosure on how an asset manager's investment decisions contribute to the

40 EU Technical Expert Group on Sustainable Finance, "Financing a Sustainable European Economy: Taxonomy Technical Report" (June 2019). https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190618-sustainable-finance-teg-report-taxonomy_en.pdf.

medium- and long-term performance of investee companies. In order to achieve that, it requires investors to have an engagement policy and annually report on the following:

- how this is integrated into their investment strategy,
- how the dialogue is carried out,
- how voting rights and shareholder rights are being executed,
- how the manager collaborates with other shareholders, and
- how potential conflicts of interest are dealt with.

Of note, Article 173 of the French Energy Transition Law, which came into force in 2016, strengthened mandatory carbon disclosure requirements for listed companies and introduced carbon reporting for fund managers and asset owners.

CASE STUDIES

China

In 2018, the Asset Management Association of China (AMAC) released the Guidelines for Green Investment. These guidelines state that "ESG is an emerging investment strategy in the asset management industry and an important initiative for the investment fund industry to implement the green development concept and establish a green financial system."

It is anticipated that the AMAC will make great efforts to facilitate the implementation of the guidelines.

In June 2021, the China Securities Regulatory Commission issued a set of ESG disclosure guidelines. The guidelines entail mostly voluntary reporting on climate risks; biodiversity risks; pollution of air, water, and soil; and waste management.

Investees

Investees include all entities in which investments can be made. These include

- companies,
- projects (such as infrastructure projects and joint ventures),
- agencies (including the World Bank and International Finance Corporation), and
- jurisdictions (for instance, countries/regions, provinces, and cities).

Decision makers in these entities can influence how they manage ESG risks and the impact they have on the environment and society. Furthermore, they decide on the level of disclosure of ESG factors to provide to existing and potential investors. In fact, one of the most pressing issues for ESG investing is a lack of access to reliable and consistent ESG data. Various reporting initiatives exist to try to address this issue.

Governments

Governments in general have recognized three main ways in which the investment industry and, more specifically, responsible investment play a significant role in achieving positive outcomes for society.

1. Social security systems and public pensions are in a predicament in many countries, and their citizens are thus turning to corporate or private pension plans for financial stability later in life.
2. Many countries, developed or developing, need to build or restore public infrastructure (such as water systems, transportation means, and energy distribution), which is usually costly for government treasuries.
3. Many governments have recognized that a transition to a low-carbon economy will require significant shifts in capital. These are all areas where governments can encourage the consideration of the financial materiality of ESG issues and the social and environmental impact of investments to advance national priorities.

Civil society

Civil society, including non-governmental organizations (NGOs), has played a major role in pushing for increased sustainability at company level and, more recently, in demanding increased transparency and consideration around the impact that investment has on society and the environment. Some partner with investment firms and regulators to help improve their understanding of specific ESG matters, while others bring to light actions that are deemed insufficient to address global challenges.

Academia

Academic research has been influential in validating the business case for integrating ESG factors into the investment process. Academia can continue to conduct studies focusing on the various aspects of ESG factors and their integration into investment decisions, as well as their impact on investment returns and the financial markets more broadly.

KEY FACTS

1. In 1987, a commission put together by the UN issued the Brundtland Report, also called *Our Common Future*, which introduced the concept of sustainable development and described how it could be achieved.
2. The concept of responsible investing dates back to the 17th century. One of the first ethical mutual funds that moved to screens based on religious traditions was the Pioneer Fund, which was launched in 1928. The modern institutionalization of ethical exclusions arguably began at the height of the Vietnam War in 1971, with the establishment of the Pax World Fund.
3. In the early 2000s, the UN Global Compact's report "Who Cares Wins" encouraged financial institutions to integrate ESG factors into capital markets. Concurrently, UNEP FI produced the so-called Freshfields Report, which showed that ESG issues are relevant for financial valuation and thus, fiduciary duty. These two reports formed the backbone for the launch of the Principles for Responsible Investment (PRI) in 2006.
4. The Global Sustainable Investment Alliance's most recent report shows sustainable investing assets in the five major markets stood at US$30.7 trillion (£22 trillion) at the start of 2018, a 34% increase from two years before. The proportion of sustainable investing relative to total managed assets grew in almost every region, and in Canada and Australia/New Zealand, responsible investing assets now make up most of the total assets under professional management.
5. Although institutional investors tend to dominate the financial market, interest by retail investors in responsible investing has been steadily growing; in 2018, the retail portion of total ESG assets totaled one quarter.
6. Most ESG assets are allocated to public equities (over 50% at the start of 2018). The next largest asset allocation is in fixed income (36%).
7. Asset owners set the direction of the investment value chain. Asset owners' understanding of how ESG factors influence financial returns and how their capital impacts the real economy can significantly drive the amount and quality of ESG investing from the investment value chain.
8. Institutional asset owners establish contracts, known as investment mandates, with asset managers. These are important because they define the expectations around the investment product and at times even aspects about the manager's processes and resources more broadly. The large majority (over 90%) of asset owner signatories of the PRI require in their investment mandate that asset managers act in accordance with the asset owner's responsible investment policy, and over half of the asset owners (65%) also require reporting.
9. Many actors in the investment value chain have recognized the shortfalls of short-termism in investment practice and have sought to increase awareness of the value of long-termism and encourage it. Short-termism may leave companies less willing to take on projects (such as research and development) that may take multiple years—and patient capital—to develop. Furthermore, short-term investment strategies tend to ignore factors that are considered more long term, such as ESG factors. This assertion was confirmed by a review conducted on the UK equity market and long-term decision making by Professor John Kay for the UK Government in 2012.
10. In theory, asset owners with long-term liabilities (such as pension funds) are well aligned with long-term investing and are due to benefit from it. In practice, they at times help create the problem by rewarding managers and companies for short-term behavior.