# CHAPTER 2
# THE ESG MARKET

The ESG investing market has become mainstream. A growing number of institutions assert that they integrate ESG into their investment decisions and into their ownership activity. ESG investing commands a sizeable 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 has been proliferating across various regions, while information from non-governmental organisations (NGOs) and other members of civil society has also stimulated the market's growth.

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

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## 1 HISTORY

**2.1.1** Explain the history of ESG investing in brief, including its roots and modern responsible investment.

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

### 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 and described how it 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 then 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* states that businesses have a responsibility to ensure that activities within their own operations do not cause harm to the environment as 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 over 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)** in the early days. Because of these historic roots of ESG investing, with it being grounded in ethical issues of a societal nature and environmental issues coming to the fore in a later period, the term SRI came in use.

One of the first ethical mutual funds that moved to screens based on religious traditions was the Pioneer Fund that was launched in 1928.[1] The modern institutionalisation 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 globalised through the divestment campaign in protest at 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 by governments and corporates as well, 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, primarily considered ethical behaviour.

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 the growth in shareholder activism, the more widespread consideration of environmental factors and the introduction of positive-screening investing, which seeks to maximise financial return within a socially aligned investment strategy. This way, SRI ultimately amalgamates ESG factors into the traditional investing framework focused only on profit and risk-adjusted return. This 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 and other companies resulted in an increasing emphasis on the importance of good corporate governance and in specific regulation such as the USA's **2002 Sarbanes-Oxley Act**.

The modern form of ESG investing began with a letter and call to action. In January 2004, the 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 into capital markets. The initiative produced a report entitled *Who Cares Wins*, 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.

Of the many issues concerning ESG, 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 Report*, 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 review, 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 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 UK and globally.

The global financial crisis of 2008 and the COVID-19 pandemic of 2020 and 2021 provided another stark reminder of the interdependence between societies, economies and financial markets. It also provided clear evidence that market pressures do not always result in ideal outcomes for the wider good.

This 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', tied to the performance of markets and economics as a whole.

## 2 ESG INVESTING IN NUMBERS

**2.1.2 Explain the size and scope of ESG investing in relation to: geography; strategy; investor type; 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, USA, Japan, Canada and Australia/New Zealand) every two years. Its most recent report[3] shows sustainable investing assets in the five major markets stood at US$30.7 trillion (£22.1tn) at the start of 2018, a 34% increase in two years. In all the regions except Europe, the market share of sustainable investing has grown, as seen in Table 2.1. In terms of where sustainable and responsible investing assets are domiciled globally, Europe (46%) and the USA (39%) continue to manage the highest proportions.

**Table 2.1: GROWTH OF ESG ASSETS BY REGION**

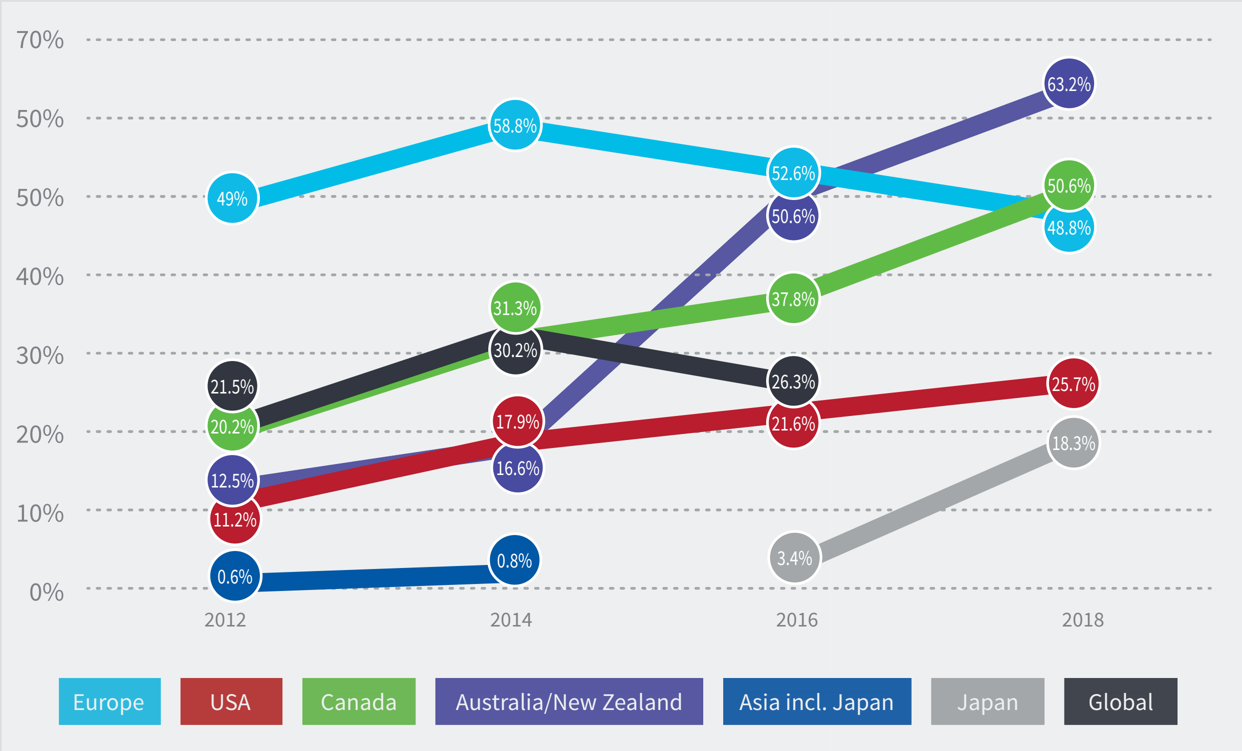
| REGION | 2012 (US$BN) | 2014 (US$BN) | 2016 (US$BN) | 2018 (US$BN) |
|---|---|---|---|---|
| Europe | 8,758 | 10,775 | 12,040 | 14,075 |
| USA | 3,740 | 6,572 | 8,723 | 11,995 |
| Japan | | 7 | 474 | 2,180 |
| Asia excl. Japan | | 45 | 52 | |
| Asia incl. Japan | 40 | | | |
| Canada | 589 | 729 | 1,086 | 1,699 |
| Australia/New Zealand | 134 | 148 | 516 | 734 |
| Total | 13,261 | 18,276 | 22,891 | 30,683 |

**Note**: Asia ex 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, are converted to US dollars based on exchange rates at year-end 2015. All 2018 assets are converted to US dollars at the exchange rates at the time of reporting.

*Source: GSIA.[3]*

Responsible investment directs a sizable share of managed assets in each region, as can be seen in Figure 2.1. That ranges from 18% in Japan to 63% in Australia and New Zealand. Clearly, sustainable investing constitutes a major force across global financial markets. 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 total assets under professional management. The exception to this trend is Europe, where sustainable investing assets have declined relative to total managed assets since 2014. At least part of the market share decline in Europe stems from a shift to stricter standards and definitions for sustainable investing in that market.

**Figure 2.1: PROPORTION OF SUSTAINABLE INVESTING RELATIVE TO TOTAL MANAGED ASSETS**

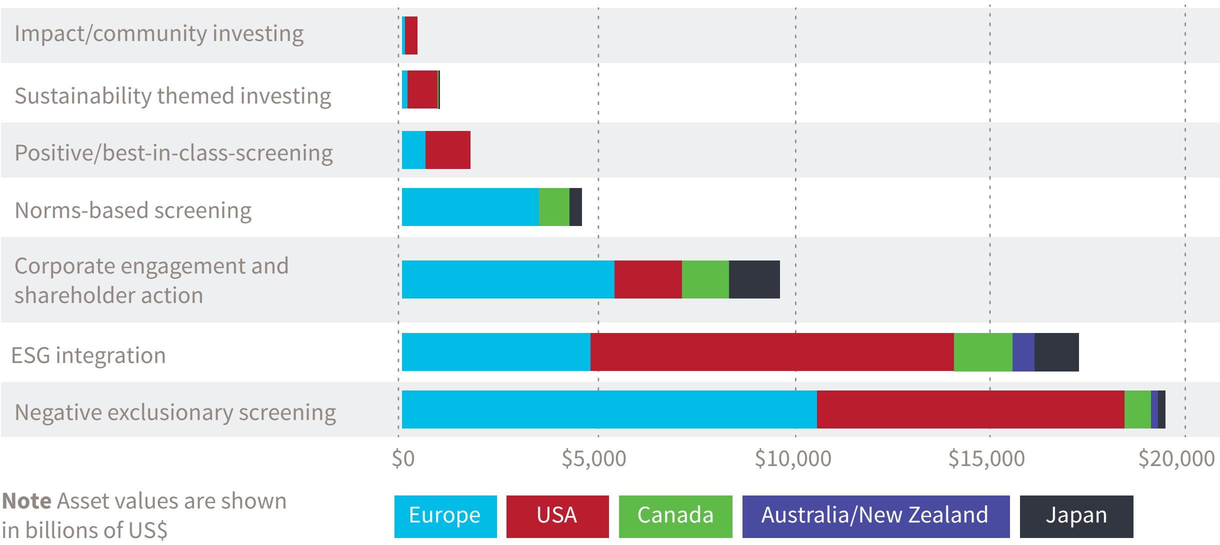



*Source: GSIA.*[3]

As of 2018, the largest sustainable investment strategy globally continued to be negative, or exclusionary, screening, as shown in Figure 2.2, with a combined US$19.8tn (£14.2tn) in assets under management (AUM). This is followed by ESG integration, which had grown by 69% over the prior two years, to US$17.5tn (£12.6tn) in assets.

- Negative screening is the largest strategy in Europe.
- ESG integration commands most assets in the USA, Canada, Australia and New Zealand.
- Corporate engagement and shareholder action constitute the predominant strategy in Japan.

**Figure 2.2: RESPONSIBLE INVESTMENT ASSETS BY STRATEGY AND REGION**




**Note** Asset values are shown in billions of US$

*Source: GSIA.*[3]

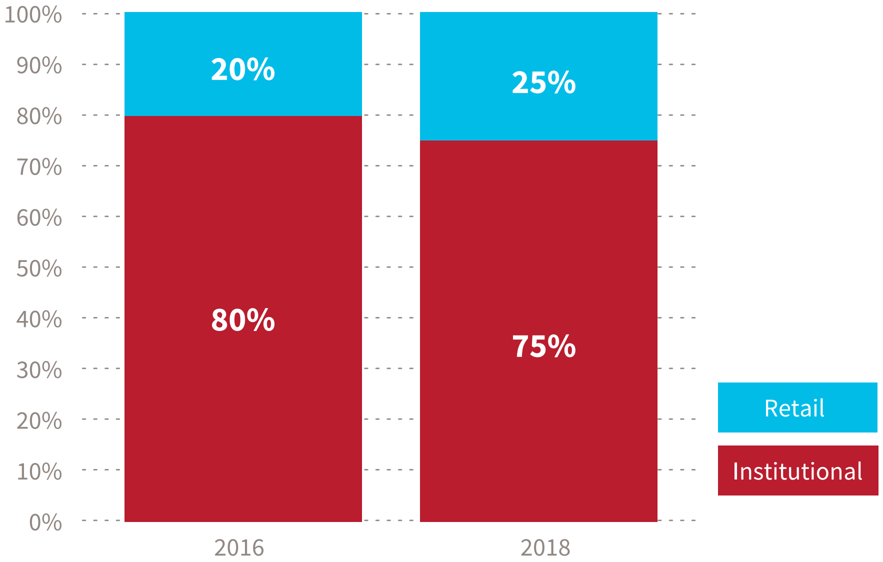
Investments managed by professional asset managers are often classified as either:

- 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 Figure 2.3.

**Figure 2.3: 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: GSIA.*[3]

Responsible investments now extend across the range of asset classes commonly found in diversified investment portfolios, as shown in Figure 2.4, which shows the asset class allocation reported in Europe, the USA, Japan and Canada in 2018. Collectively in these regions:

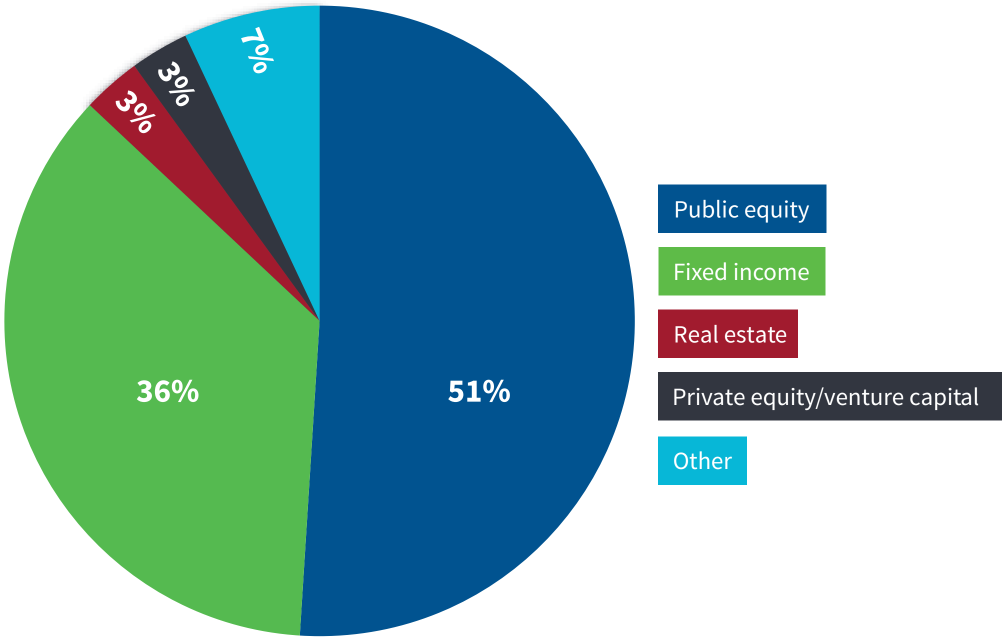
- most assets were allocated to public equities: 51% at the start of 2018; whereas
- the next largest asset allocation is in fixed income, with 36%.

This is a reversal from 2016 when, with only Europe and Canada reporting on asset class allocation:

- 64% of sustainable investing assets were in fixed income; and
- 33% were in public equities.

In 2018, real estate/property and private equity/venture capital each held 3% of global sustainable investing assets. Sustainable investments can 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 Figure 2.4.

**Figure 2.4: ASSET CLASSES IN GLOBAL ESG INVESTING (2018)**




*Source: GSIA.*[3]

## 3 MARKET DRIVERS OF ESG AND CHALLENGES IN ESG INTEGRATION

| | |
|---|---|
| 2.1.3 | Explain key market drivers in favour of ESG integration: investor demand/intergenerational wealth transfer; regulation and 'soft law'; public awareness; data sourcing and processing improvements. |
| 2.1.4 | Explain the key drivers and challenges for ESG integration among stakeholders within the investment industry: asset owners; asset managers; fund promoters; financial services; policy makers and regulators; investees; government, civil society and academia. |
| 2.1.5 | Explain how ESG issues are related to sustainability trends and themes within the investment industry, including: the longer-term nature of ESG investing; ESG-driven market, organisational and cultural changes. |

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 the information they provide.

The main stakeholders are:

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 labellers.

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.

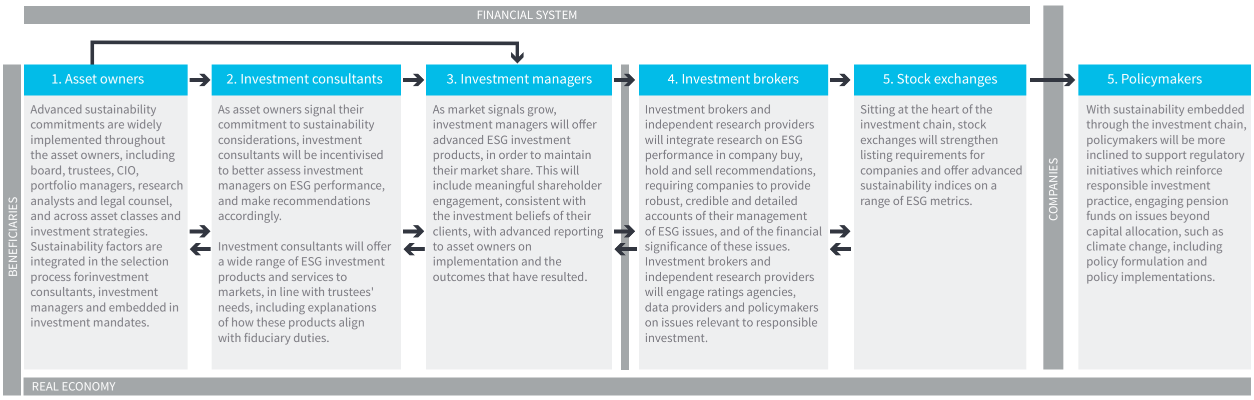
→ *All of the above stakeholders are covered in sub-sections A to H.*

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. Figure 2.5 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. As these 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** refer to a person or an organisation who/that invests on behalf of their/its clients under an investment mandate that has been agreed with those clients.

**Figure 2.5: FINANCIAL SYSTEM VALUE CHAIN**

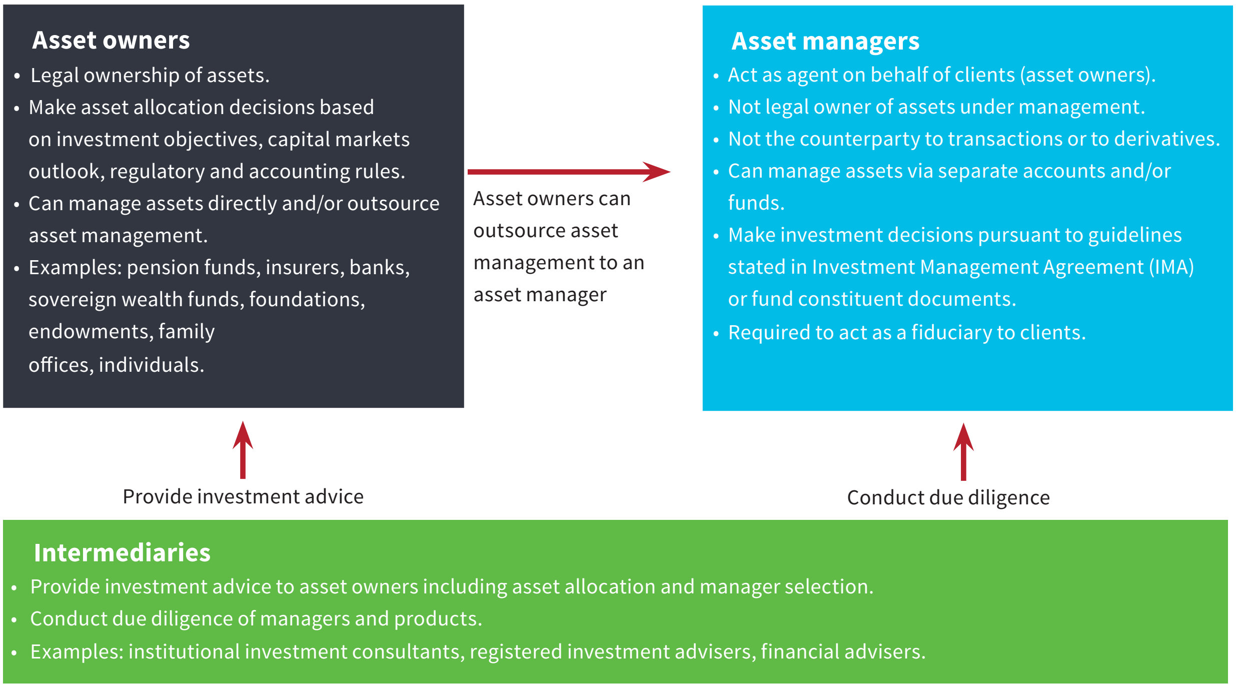



*Source: PRI.*[4]

## A. Asset owners

Asset owners include pension funds, insurance companies, sovereign wealth funds, foundations and endowments. They generally invest their assets into some investment vehicle with the goal of getting returns from the invested capital. They seek to minimise risks or maximise the returns, 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. Figure 2.6 presents the differences between asset owners, asset manager and intermediaries. Institutional asset owners account for US$54tn (£38.8tn), of which 35% (around US$19tn (£13.7tn)), are concentrated in the 100 largest asset owners.[5]

**Figure 2.6: 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 impacts the real economy can significantly drive the amount and quality of ESG investing from the investment value chain.

The approach that each owner takes to ESG investing and how meaningful they are in steering the investment value chain is 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 towards an increased integration of ESG depends on:

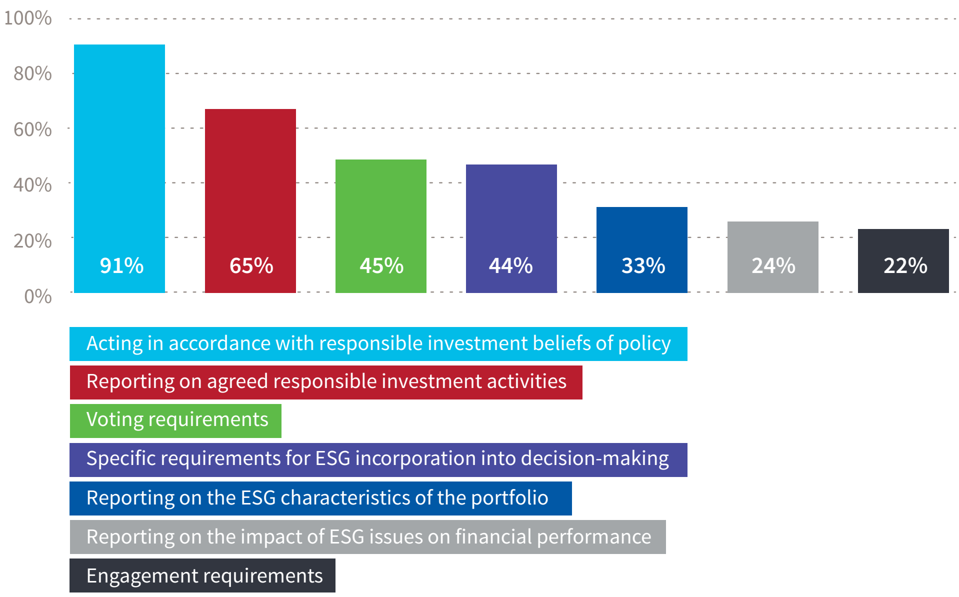
- the number of asset owners implementing responsible investment;
- the total AUM of these assets; and
- the quality of implementation across the different asset classes.

This 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 as they define the expectations around the investment product, and at times even aspects around the manager's processes and resources more broadly.

Figure 2.7 shows the expectations that asset owners' signatories of the PRI have included as explicit expectations within clauses of investment mandates. The large majority (91%) require 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. The survey was conducted in 2015 and therefore is a bit older, but there is no reason to believe much has changed in this regard in the industry. Rather, given the increasing voluntary and mandatory guidance around stewardship, it is reasonable to expect that requirements around engagement have since increased.

Figure 2.7: **RESPONSIBLE INVESTMENT CLAUSES IN ASSET OWNER CONTRACTS WITH THEIR INVESTMENT MANAGERS**




*Source: PRI.*[3]

One of the challenges asset owners occasionally face integrating ESG is a hesitancy on the part of consultants and retail financial advisors to integrate ESG investing into their offerings and/or assess the ESG characteristics of funds, leading to fewer options for the asset owners to choose from in the market. Related to that, some asset owners also feel that 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 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.

## 1. Pension funds

Of the 100 largest asset owners, 59% are pension funds.[5] 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. They 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 benefitting 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 matters such 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 engaging 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 towards ESG integration. Some governments and investment funds have recognised this.

### Long-termism and ESG

Many actors in the investment value chain have recognised the shortfalls of **short-termism** in investment practice and have sought to increase awareness of the value of **long-termism** and encourage this approach.

Short-termism covers a wide range of activities; for the purpose of this topic, the most relevant one is related to trading practices, where investors trade based on short-term momentum and price movements rather than long-term value. These short-term investing strategies might offer rewards but may have consequences for the long-term. With its disproportionate focus on quarterly returns, 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. This was indeed 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.[7] Instead of productive investment in the real economy, short-termism may promote bubbles, financial instability and general economic underperformance. Furthermore, short-term investment strategies tend to ignore factors that are considered more long-term, such as ESG factors. Because of the adverse effects mentioned, regulators are catching up and taking action. For example, the **Shareholder Rights Directive (SRD)** was issued by the European Union (EU) in September 2020, requiring investors to be active owners and to act with a more long-term focus.

In theory, asset owners with long-term liabilities (like 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 behaviour.

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.

Case studies

## HSBC Bank UK Pension Schemes

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 by embedding climate tilts.

An HSBC comment piece on the product notes:

“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 give scheme members greater relative exposure to firms less at risk from climate change.

## 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 indices. 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 in both their domestic and foreign portfolios. In choosing the ESG indices, GPIF emphasised that:

1. ‘positive screening’ that determines which 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 conflict of interests should be properly managed.[8]

## UK Environment Agency Pension Fund

In 2014, the £2.4bn 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, both with regards to the contract itself and the investment horizon, and ESG.

More recently, in 2018, the EAPF investment pool became a part of Brunel Pension Partnership and published an *Asset Management Accord*, which sets out expectations for long-term manager relationships.[9] 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 feel they can, must, or must not integrate ESG within 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 UK to assess the matter. They have found that pension fund trustees may be failing to take sufficient steps to address climate risk and therefore, fail to manage the scheme's investments in a manner consistent with the members' best interests. This could result in trustees exposing themselves to the possibility of legal challenges for breach of their fiduciary duties.

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.[10] Also in 2019, 14 of the UK'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. A survey which was conducted among more than 300 global institutional investors, reveals that 46% of respondents cited the need to meet fiduciary duty and regulations as a key driver for adopting ESG principles.[11]

## Pension fund members

While pension fund members are not investment professionals, they can influence pension fund decisions as they are the ultimate beneficiaries. Interpretation of fiduciary duty in some jurisdictions recognises 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 study

### Surveys by Dutch pension funds[12]

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

For example, 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.

The €9.9bn (£8.6bn) 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 labour conditions, environment, fraud and corruption mattered the most to them. As a result of the consultation, the scheme excluded companies that violated the UN's Global Compact Principles and aimed to reduce carbon emissions from its investment portfolio by 20% in the next two years.

## 2. Insurance

Insurance is divided into:

- **property and casualty (P&C)**. This includes insurance from liabilities and damages to property (due to calamities or from legal liabilities in the home, vehicle, etc.).
- **life**. This 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 aspects of ESG due to factors impacting insurance products, such as:

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

This has contributed to insurers having developed a very advanced understanding around 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.

Case study

### Insurers and ESG

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, blizzards, etc., increasing the cost for re-insurers.

An easy 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.[13]

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

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 modelling;
» built a climate change research centre; and
» established an extensive natural catastrophe database.

In 2016, Axa was one of the global insurers and investors to divest from tobacco, valued at the time at €1.8bn (£1.3bn). At the launch of the *Tobacco Free Finance Pledge*,[14] Axa's CEO specifically noted that, "as a health insurer, we see every day the impact of smoking on people's health and wellbeing", recognising the influence that Axa's life insurance business was having on its investment arm.[15]

## 3. 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$8tn (£5.8tn) in 2020.[16]

Often the wealth comes from such a state's capital surpluses.

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

- economic stabilisation;
- securing wealth for future generations;
- strategic development of the state's territory; and
- other objectives.

These objectives can, but don't necessarily have to, align with ESG concerns. There is some evidence that SWFs take ESG 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.[16]

### 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 topics such as divestment. Examples of this debate can be found in the UK where universities are pressured by their students to have more sustainable investments in their endowments.[17]

### Foundations and public charities

In countries such as the USA, private foundations and public charities are charitable organisations that invest their capital to fund charitable causes. Usually for both, the legal form of organisation (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.

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

## 4. Individual (retail) investors and wealth management

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

In the USA, only US$161bn (£115.7bn) of the USA's US$22.1tn (£15.9tn) in assets have gone to those referencing ESG at the end of 2018. This percentage is much smaller than institutional investors.

However, inflows in open-ended and exchange-traded funds (ETFs) have been increasing: in 2020, they attracted a record US$51.1bn (£36.7bn) in net flows. This is more than twice the previous record set in 2019 when they were at a record US$18bn (£12.9bn) while inflows in 2018, then at a record high, reached US$5.5bn (£4bn). Moreover, in 2020, sustainable fund flows accounted for nearly one-fourth of overall flows into funds in the USA. Morningstar, a research firm which offers an investment platform for retail investors, reports 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.[18]

### Generational differences

Millennials are usually defined as those born after 1980 and who reached adulthood in the 2000s. 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.[19]
- Another study found that 75% of individual investors in the USA were interested in sustainable investment; the percentage of millennials was higher, at 86%.[20]
- 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.[21]

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

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

## B. Asset managers

Asset managers select securities and offer a portfolio of those 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, they can also play a key role in proposing new products and approaches to considering ESG. Asset managers are central in the investment value chain.

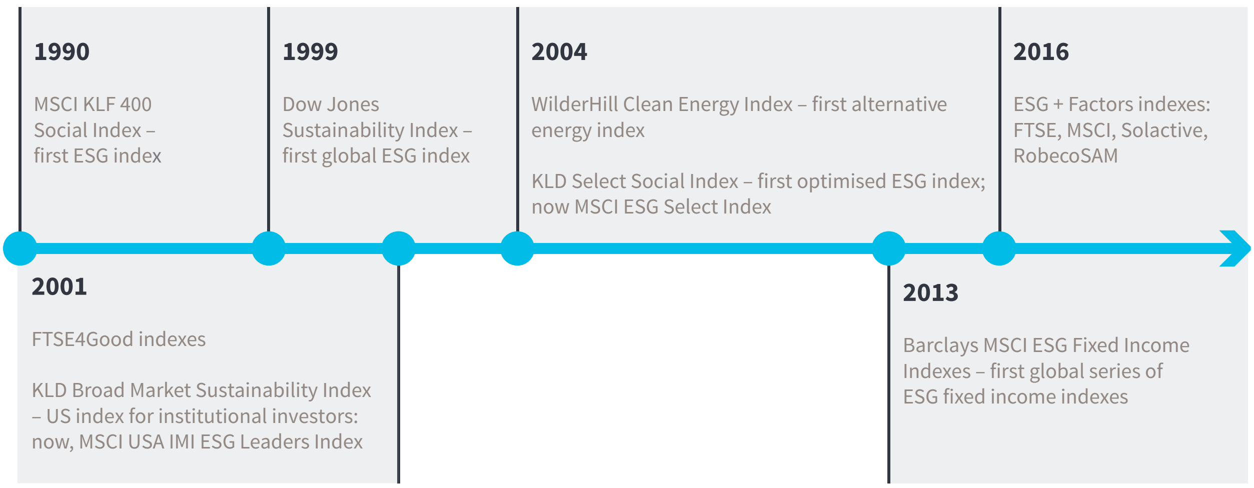
ESG offerings by asset managers generally began with active-listed equities, but recently evolved to other asset classes. The knowledge gained with integrating ESG within the equity valuation of companies was, to a certain extent, transferred to that of corporate bonds. As fixed income funds also include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

Over the past ten 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 indices and passive funds with ESG integration by asset managers started 20 years after that of active investments. The use of indices is nonetheless critical for the investment industry – they are performance benchmarks and 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 seen the market's development of ESG indices (see Figure 2.8 for further detail).

Today, there are over 1,000 ESG indices (roughly 1% of the 3.7m indices that are globally available according to the Index Industry Association),[22] reflecting the growing appetite of investors for ESG products and the need for measurement tools that accurately reflect 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.

**Figure 2.8: THE ORIGINS OF ESG INDEXES**




*Source: BlackRock.*[23]

Asset managers who wish to differentiate themselves have been investing significantly in ESG-related resources. Some have merged with, or acquired, asset managers specialising 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 include:

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

## C. Fund promoters

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

1. investment consultants and retail financial advisers;
2. investment platforms; and
3. fund labellers.

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 labellers can set standards to award labels to investment vehicles after the assessment of its ESG process and performance.

## 1. Investment consultants and retail financial advisers

Ensuring that **investment consultants** and **retail financial advisers** 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, as 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, as their advice is often accepted with little hesitation.

However, a review by the PRI in 2017 concluded that most consultants are failing to consider ESG issues in investment practice.[24] The PRI found that often the advice they give to investors did not support products that integrate ESG. While this review was conducted a couple of years ago, only a few consultants have done significant work to integrate ESG within their screening since then. To address this issue, the PRI published guidance in 2019 for asset owners to request ESG from consultants.[25] Further challenges emerge because consultants and financial advisers often base their advice on a narrow interpretation of investment objectives. What they perceive a lack of appetite by asset owners in responsible investment has also led them to being less keen to integrate ESG investing into their mainstream offerings.

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

- aid trustees in understanding their fiduciary obligations;
- formulate a strategy inclusive of ESG; 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 as well as expectations on implementation.

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

## 2. Investment platforms

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

Morningstar, one of the main investment platforms, offers a service where it rates asset managers and their funds. In 2016, the platform started integrating ESG ratings within its offer. Investment platforms can integrate the extent and depth which funds integrate ESG to:

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

## 3. Fund labellers

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 specialised labels just in Europe. Labels are usually either general, looking at ESG 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 thirty are thematic environmental funds.[26]

## D. Financial services

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 as 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).
- Sell-side analysts and rating agencies can consider ESG 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 within 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 specialised 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 rise and consolidation (through partnerships, mergers and acquisitions) has increased investors' ability to further implement ESG. It has also helped policymakers and regulators reassure themselves that requirements to assess ESG risk and reporting on it is increasingly possible.

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

## E. Policymakers and regulators

The **financial regulators'** objectives 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, labour, communities and governance, and require further disclosure on those.

**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, as well as emerging issues such as biodiversity and resource scarcity); or
- the risks to an individual investor's portfolio.

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 within 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 was recently approved in Europe.
3. **Asset owners**. Regulation on asset owners typically focuses on pension funds, requiring them to integrate ESG and disclose the process and outcome. Some regulators, such as those in the UK, are also beginning to consider climate risk for the insurance market and the financial industry more widely.

→ *Stewardship is closely linked to shareholder engagement and further details can be found in Chapter 6.*

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.

In 2016, the People's Bank of China, in collaboration with six other government agencies, issued guidelines establishing the green financial system. These guidelines marked a turning point for sustainable finance policy. Previous policy reforms had tended to be reactive to financial crises. The new generation of policy recognises that to be effective, reforms need to tackle multiple aspects of interconnected and complex capital markets. These national 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*.

In certain regions, particularly in North America, policies remain voluntary or 'comply or explain', which led some investors to continue to challenge the assertion that ESG integration is a requirement. However, it is anticipated that as policies on ESG and financial regulation reach maturity, an increasing number of governments will recognise the importance of moving to stronger requirements, moving away from:

- 'comply or explain' to 'comply and explain';
- voluntary to mandatory; and
- policy to implementation and reporting.

For example, the Network for Greening the Financial System, a group of 102 central banks and supervisors established in 2017, explicitly recognises 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.

## 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 environmental objectives;
- 'doing no significant harm' to any of the other environmental objectives; and
- complying with minimum 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 ecosystem.

*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 principal adverse indicators that have a negative impact on the environmental and social issues stemming from investment decisions.

## 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 disclose information to support capital allocation. The TCFD recommendations centre on four key areas:

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

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) 2020 ruling on fiduciary duty and non-financial objectives (see the following **Case studies**).

Case studies

## USA

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

The US Department of Labor (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 as the public sector often look to ERISA principles as a benchmark for best practice in meeting common law fiduciary standards in their governance.

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:

1. Act solely in the interest of the 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 minimise 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 matters regarding ESG within ERISA back in the 1990s.[27] 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 a discouraging effect on 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."[27]

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CHAPTER 2

Case studies

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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 belief 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 are further imposed, such as documentation requirements, on ERISA plan fiduciaries considering ESG-oriented investing.

It remains unclear as to how the regulations governing fiduciary standards for US pensions schemes will evolve as the Biden administration directed the DOL to review the 'final' rule in a fact sheet issued in January 2021.[28]

## UK

There has been an extensive discussion in the UK 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, emphasised the need for a culture of long-term decision-making, trust and stewardship to protect savers' interests.[7] The report recognised 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."[29]

On non-financial factors, the Law commission's term for ESG factors, the report concludes that:

> "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

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Case studies

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2. the decision should not involve a risk of significant financial detriment to the fund."

## EU

The *EU Action Plan on Financing Sustainable Growth*, agreed 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 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 *Technical Report on EU Taxonomy* aimed to significantly advance a shared understanding across investors on activities and sectors that contribute to climate change mitigation and adaptation.[30]

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

» how this is integrated into their investment strategy;

» how the dialogue is done;

» 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.

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Case studies

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### China

In 2018, the Asset Management Association of China (AMAC) released the *Guidelines for Green Investment*, which states 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".

Foreseeably, the AMAC will make great efforts to facilitate the implementation of the Guidelines.

## F. Investees

Investees include all entities in which investments can be made. Among others, these include:

- companies;
- projects (such as infrastructure projects and joint-ventures);
- agencies (including 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.

## G. Government

Governments in general have recognised three main ways in which the investment industry, and responsible investment more specifically, 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 recognised 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 financial materiality of ESG and social and environmental impact of investments to advance national priorities.

## H. Civil society and academia

Civil society, including non-governmental organisations (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.

Academic research has been influential in validating the business case for integrating ESG within the investment process. Academia can continue to increase the studies focusing on the various aspects of ESG factors and their integration to investment decisions, as well as their impact on investment returns and the financial market 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 that was launched in 1928. The modern institutionalisation 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* encourages financial institutions to integrate ESG into capital markets. Concurrently, the 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 (GSIA) most recent report shows sustainable investing assets in the five major markets stood at US$30.7 trillion (£22tn) at the start of 2018, a 34% increase in two years. 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 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 totalled 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, with 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 as 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 recognised 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 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 (like 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 behaviour.

11. Insurers are by nature sensitive to certain aspects of ESG due to factors impacting insurance products, such as the frequency and strength of extreme weather events (P&C – property and casualty) and demographic changes (life insurance).

12. The adoption by retail investors has been generally slower than that of institutional investors. Surveys have generally found that millennials are interested in ESG investing, which may increase ESG assets in retail investing in the near future.

13. Asset managers 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, they can also play a key role in proposing new products and approaches to considering ESG.

14. ESG offerings by asset managers generally began with active-listed equities, but recently evolved to other asset classes, especially fixed income. The offering of indices and passive funds with ESG integration by asset managers started 20 years after that of active investments. The use of indices is nonetheless critical for the investment industry – they are performance benchmarks and the basis for passive investment funds, such as exchange-traded funds (ETFs).

15. 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.

16. 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.

17. Over 95% of the new or revised policies were developed after 2000, driven by the rapid development in Europe and Asia, as well as the rise of stewardship and corporate governance codes, with national authorities introducing or periodically strengthening ESG expectations.

18. Companies and other investees can contribute to the growth of ESG investing by how they manage ESG risks, the impact they have on the environment and society, and the level of disclosure they provide on these matters.

19. Governments have recognised that responsible investment can play a role in funding both public infrastructure and the transition to a low-carbon society. They also recognise that responsible investment can play a role in the transition of pension systems whereby citizens rely more heavily on private pension plans.

20. Civil society and NGOs can help increase the awareness of companies on their ESG risk. They can also help with improving disclosure. The outcomes of academic research can increase focus on the various aspects of ESG and investment decision-making.

21. Some investors still question whether considering ESG issues can add value to investment decision-making despite wide dissemination of research that demonstrates that ESG integration can help limit volatility and enhance returns.

22. Some investors also still question whether their fiduciary duty allows them to implement ESG investing. Internal evidence on the impact of considering ESG and engaging with direct peers can help address these barriers.

23. The advice given by investment consultants and retail financial advisers has, many times, not been supportive of products which integrate ESG. Investor-led initiatives that engage with these actors have contributed to that gradually changing.

24. Lack of understanding of how to implement ESG in the different phases of the investment process, as well as perceptions around the cost and availability of data and tools, can limit the growth of ESG investing.

25. The rise of funds labelled ESG also increased the risk of 'greenwashing'. Further work by regulators combined with the development of voluntary market standards would make it easier for investors to understand the characteristics of responsible investments and the differences between different types of responsible investment, helping to build trust in the market.

CHAPTER 2

# SELF-ASSESSMENT

These self-assessment questions are provided only to enable you to test your understanding of the chapter content. They are not indicative of the types and standard of questions you may see in the examination.

## Questions

1. **Which regions manage the highest proportion of sustainable and responsible investing assets?**

    (a) Asia and North America.

    (b) Australia and USA.

    (c) USA and Europe.

    (d) Asia and Europe.

2. **What is the largest sustainable investment strategy globally?**

    (a) Impact investing.

    (b) Best-in-class.

    (c) ESG integration.

    (d) Negative screening.

3. **The largest and second largest asset classes, which implement responsible investment, are respectively…**

    (a) …public equities and fixed income.

    (b) …passive equities and active equities.

    (c) …fixed income and infrastructure.

    (d) …hedge funds and commodities.

4. **Why are investment mandates important for ESG investing?**

    (a) They define the expectations of asset owners who are signatories of the PRI.

    (b) They are contracts which define the requirements of the asset manager with regards to ESG.

    (c) They require asset managers to report on the ESG rating of their funds.

    (d) They have limited the implementation of stewardship.

5. **Which of the following is not an outcome of short-termism?**
   (a) Disproportionate focus on quarterly returns.
   (b) Companies are more willing to take on projects, such as research and development.
   (c) ‘Patient capital’ is less likely to develop.
   (d) Less investment in long-term assets, such as infrastructure.

6. **How are pension fund members most likely to influence responsible investment?**
   (a) Their formal investment advice to pension fund executives must be implemented.
   (b) They monitor company controversy through social media and inform asset managers.
   (c) They act in the interest of sustainable companies.
   (d) Their ethical preferences may be taken into account.

7. **Which of the following is not among the challenges limiting the development of ESG investing?**
   (a) Lack of regulation and voluntary initiatives.
   (b) The availability of expertise and skilled individuals.
   (c) The quality of data, research and analysis.
   (d) Limited tools to assist with portfolio construction and management.

8. **In what way can an investment consultant be a barrier to the growth of the ESG investing market?**
   (a) By not considering ESG characteristics of the funds in their screening.
   (b) By setting poor standards for ESG fund labels.
   (c) By short-listing only ESG funds.
   (d) By helping trustees understand their fiduciary duties.

9. **What is the main challenge with policies that are ‘comply or explain’ regarding ESG?**
   (a) It is the sole indication that the policy has not reached maturity.
   (b) It leads to investors challenging the assertion that ESG integration is a requirement.
   (c) It allows investors to explain all kinds of behaviour away.
   (d) It completely excuses investors from reporting on ESG practices.

**10. What is the highest risk to the industry regarding greenwashing?**

(a) The overestimate of the ESG investing market.

(b) The disappointment of clients with quarterly financial returns.

(c) The negative impact on the industry's credibility.

(d) The increased challenge to standardisation.

**11. Why is ESG investing a concern for investors who are cautious of high tracking error?**

(a) The perception that exclusion resulting from ESG will distort the weight of sectors and countries in the portfolio in comparison to the benchmark.

(b) The understanding that exclusion results in fewer available securities to invest in and thus, a more limited investment universe.

(c) The belief that high-performing stocks may be excluded due to negative ESG characteristics, resulting in underperformance in comparison to the benchmark.

(d) The awareness that ESG investing requires a redefinition of active risk.

**12. Which matters does the EU Taxonomy address?**

(a) Green bonds and engagement.

(b) Green bonds and low-carbon benchmarks.

(c) Carbon disclosure and long-termism.

(d) Climate risk and fiduciary duty.

**13. Why was the US Department of Labor's clarification of fiduciary duty in 2015 welcomed by the ESG investing industry?**

(a) It allowed plans to invest in generating societal benefits in addition to financial return, as long as they were deemed appropriate for the plan's investment objectives, return and risk.

(b) It provided a standard for economically targeted investments (ETIs).

(c) It specified that, as long as the expected rate of return was commensurate with the rates of return offered by alternative investments with similar risk characteristics, ETIs were compatible with fiduciary duty.

(d) It incentivised pension funds subject to ERISA to invest in ETIs.

**14. In what way can stock exchanges support the advancement of ESG investing?**

(a) By rating the ESG characteristics of a listed security.

(b) By increasing the requirement on the disclosure of ESG data by listed securities.

(c) By structuring and issuing green bonds.

(d) By integrating ESG considerations within its voting recommendations.

**15. What is the least likely reason why a pension fund trustee may consider ESG investing?**

(a) Pension fund trustees should act in the interest, including non-financial interests, of pension fund members; and the members have voiced their interest in social and environmental impact.

(b) Pension fund trustees have the fiduciary duty to consider factors that are financially material to the long-term returns of the pension fund.

(c) Pension fund trustees risk legal action by not managing climate change-related risks.

(d) Pension fund trustees are the ultimate beneficiaries of pension funds and, as a result, should act in their interest.

CHAPTER 2

# SELF-ASSESSMENT **ANSWERS**

1. c.
2. d.
3. a.
4. b.
5. b.
6. d.
7. a.
8. a.
9. b.
10. c.
11. a.
12. b.
13. a.
14. b.
15. d.

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