A GLOBAL SHIFT TO AN ESG MINDSET

Surveying the global regulatory landscape for investors

THE RISE OF ESG

Over the last ten years, ESG investing - the incorporation of environmental, social and corporate governance considerations into an investment strategy-has picked up momentum in the global asset management community, with many regions and governments leaning deeper and more meaningfully into the strategy.

Moving into the current decade, the industry faced a disparate ESG adoption across the globe. While many European markets have long made ESG a focus in their investment strategies, other mature markets in parts of North America and Asia have had a less straightforward approach. The U.S. focus on ESG investing, for example, lost steam during the Trump presidency, but has picked up again under the Biden administration. Meanwhile, several of Asia's host of developed countries are beginning to make headway on their own policies while striving to be attractive locations for domiciling ESG investment funds.

As 2020 unfolded, regions that previously moved slowly to adopt ESG considerations began to take more meaningful action. Following the impact of an unforeseen, catastrophic event - the COVID-19 pandemic - as well as its accompanying economic recession, firms have made connections from the current experience to the challenges the industry and the world would face if issues like climate change advance unabated. An MSCI survey found that asset owners across the globe planned to increase their ESG investments as a response to COVID-19 - 78% in the U.S., 68% in EMEA, and 79% in APAC.[1]

Alongside the pandemic, the summer of 2020 brought a global reckoning with racism, originating in the U.S. with multiple protests and marches. The tumult brought on by the combination of these two events led many investors who had previously not emphasized ESG factors to take a closer look at the positive impact on the world that environmental, social and corporate governance perspectives could bring.

Today, all regions are looking closer at their ESG practices, and the industry consensus is that the emerging social responsibility emphasis will stick. A global survey of fund buyers responsible for evaluating and selecting funds for wealth management firms, insurers, retirement plans, and others found that 63% believe all funds would incorporate environmental, social, and governance factors in five years.[2]

Though certain geographic regions are more advanced in their incorporation of ESG factors than others, regional differences are quickly reducing as global frameworks and standards develop. As asset owners put more emphasis on ESG investing globally and asset managers answer this rise in demand, they'll need to ensure they have a grasp on the varying regulations across the globe, especially if more regions follow the European Union (EU) lead by building out a framework of multiple ESG regulations, which to date includes the Taxonomy Regulation,

the Non-Financial Reporting Directive, the Sustainable Finance Disclosure Regulation (SFDR), and the Pensions Directive. They should also seek to have their data management capabilities in place, working with partners who have the expertise to assist them as they take on the challenges of incorporating global ESG strategies.

TAKING STOCK OF ESG ACROSS THE GLOBE

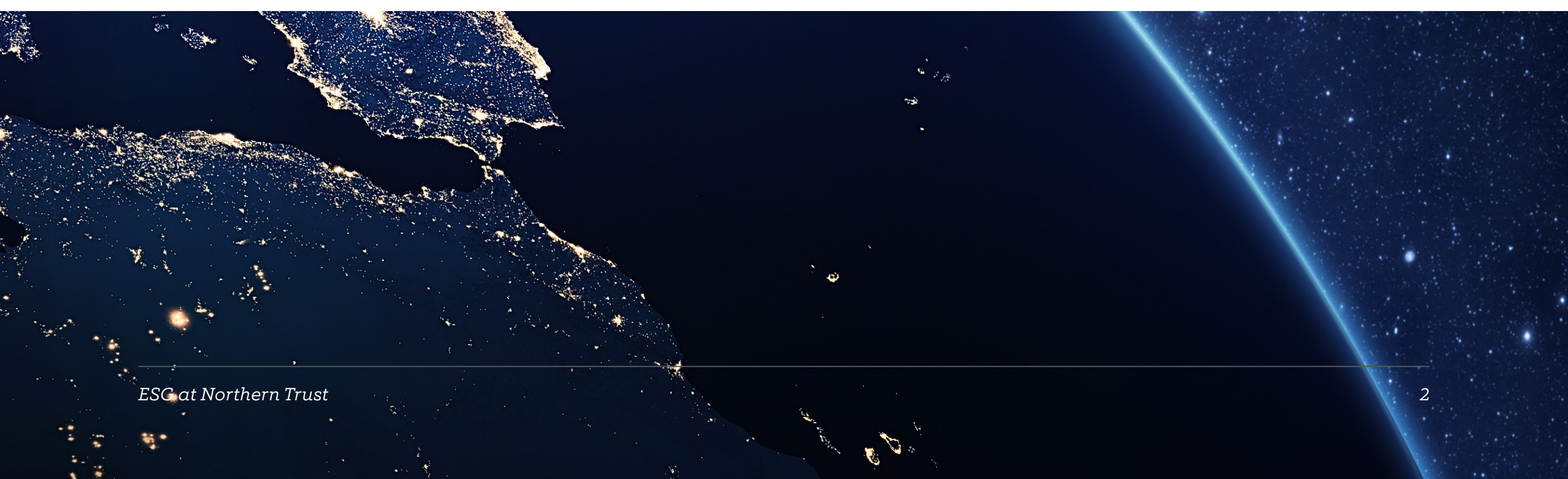
When examining each region's current standing on ESG investing practices, the varying levels of preparedness quickly become apparent.

EUROPE

Europe is known as a global leader for ESG, and more than 80% of the world's sustainable assets are in Europe.[3] Its Nordic countries in particular - Sweden, Denmark, Norway, Iceland and Finland - as well as the Netherlands are considered the original ESG investing advocates as the first ones to embrace the approach, influencing the rest of Europe and other regions to follow. Morningstar's 2021 Sustainability Atlas named the Netherlands as the best scoring country in terms of sustainable investing, and Finland and Sweden followed to round out the top three rankings.[4]

The rest of Europe has begun to enact policy standards covering ESG practices, seeing progress as the EU has made it a focus. Several key pivotal legislative policies that have passed in the last five years have particularly marked the EU as a global leader in ESG today. This collection of legislation includes the EU Taxonomy Regulations, aimed at asset managers; the Non-Financial Reporting Directive, aimed at corporations; the Sustainable Finance Disclosure Regulation, seeking to combat greenwashing of financial products; and the Pensions Directive or IORP II, aimed at regulating financial institutions' management of collective retirement schemes.

The UK, which holds £56 billion in sustainable assets, also follows its own version of the Pensions Directive policy for pension schemes, requiring that plans include ESG in their statement of investment principles and report on how they invest from an ESG perspective.5 In June 2021, it added additional disclosure requirements for pension funds with more than £5 billion in assets, mandating the schemes to report specifically on how they will manage their climate risk in line with the Task Force on Climate-Related Financial Disclosures (TCFC). Eligible pension schemes must start complying in October 2021.[6]



BREAKING DOWN KEY EU ESG REGULATION

The EU has approached ESG regulation from its high-level goal of reallocating capital to more sustainable investments in order to achieve net-zero targets and other positive impacts. In working toward this goal, it has designed a structured, intentional, and growing web of policies hitting on different groups and concerns, covering its bases and defining itself as a global leader in socially responsible investing. The EU's approach to ESG regulation serves as a well-designed plan for other regions to emulate when developing their own regulatory frameworks.

TAXONOMY REGULATION

Adopted in 2020, the EU Taxonomy Regulation provides a framework to identify to what degree asset managers' financial products are living up to environmentally sustainable values. The framework applies to all financial products which set an environmental sustainability objective or promote environmental characteristics. Financial products that do not take environmental sustainability into consideration must make a statement acknowledging this.

NON-FINANCIAL REPORTING DIRECTIVE

The Non-Financial Reporting Directive requires large companies with more than 500 employees to report on practices including environmental matters, social matters and treatment of employees, respect for human rights, anti-corruption and bribery, and diversity on company boards so that investors, consumers, policy makers and other stakeholders can gauge an organization's non-financial ESG performance.

SUSTAINABLE FINANCE DISCLOSURE REGULATION

Put into effect in March 2021, the SFDR aims to promote ESG investing while combatting the potential for 'greenwashing' - when funds or companies communicate sustainable values from a marketing perspective without actually living up to those claims - by putting specific transparency stipulations on asset managers, requiring them to report on how they make sustainable investments. While "Level 1" disclosures went into effect in March 2021, financial market participants will face "Level 2" disclosures starting on January 1, 2022, which requires compliance explanations on a product level.

PENSIONS DIRECTIVE (ALSO KNOWN AS IORP II)

The Pensions Directive (also known as Institutions for Occupations Retirement Provision II, or IORP II) regulates how financial institutions manage collective retirement schemes for employers who then provide retirement benefits to employees. The directive requires financial institutions to disclose where ESG factors are considered in investment decisions and what role they play in a risk management system. The directive went into effect in 2019.

MIDDLE EAST

In the Middle East, many countries have adhered to Islamic finance for decades, an outlook that emerged in the investing world in the 1970s and which operates in accordance with Shariah, Islamic law. According to the Principles for Responsible Investing (PRI)[7], Islamic finance is driven by the following principles:

- Transactions should promote equality, social justice and inclusion, and economic prosperity. They must demonstrate accountability, transparency, and legal protection for all parties.
- Investment in certain industries, products, and services (haram) is prohibited.
- Interest (riba), uncertainty (gharar), and gambling (maysir and qimar) are prohibited.
  - The prohibition of riba stems from the notion that money is only a means of exchange with no intrinsic utility and that financial transactions should ultimately be tied to real assets and cater to the real economy.
  - Gharar is believed to feed fraudulent and antisocial behavior by encouraging excessive risk taking. This rule prohibits the finance of risk trade.
  - Maysir and qimar are transactions that involve gambling and are based on uncertainty. Maysir refers to the acquisition of assets by chance; qimar refers to a game of chance.
- All parties are participants in the transaction and share the risk and reward.
- The underlying asset, project, or joint venture is owned by one or more of the parties.

(credit: Principles for Responsible Investing)

Islamic finance and shariah investing have much in common with the ESG approaches growing in popularity today with asset owners and asset managers, including the practices of setting a list of responsible principles for investors with and the implementation of negative screening - a form of investing which excludes categories deemed irresponsible, such as pork products, arms manufacturing, the gambling industry and alcohol products. With a global Muslim population of 1.8 billion[8], Islamic finance's impact extends beyond just the Middle East and is particularly central to Malaysia, Indonesia and Brunei's investment practices.

Aside from an Islamic finance focus, some key groups and countries in the Middle East are accelerating their own ESG developments. Abu Dhabi's Mubadala sovereign wealth fund is looking to build out a new ESG unit and Saudi Arabia's sovereign wealth fund has recently prioritized establishing its own ESG framework, potentially opening its funding to a broader set of investors who value ESG principles.[9,10] Additionally, the Saudi stock exchange, Tadawul, plans to issue an ESG index in partnership with MSCI this year.[11]

Between the Middle East's longtime adherence to Islamic finance values and a newer focus on ESG, the region promises to keep on track with the growing global interest in centering responsible investing.

NORTH AMERICA

The region's two largest players, the U.S. and Canada, vary in their approach to ESG investing and guidance designed to regulate it. While the U.S. serves as a global hub of financial industry innovation, when it comes to established ESG policy framework, it lags its northern neighbor.

In 2016, Canada's Ontario Parliament amended its Pension & Benefit Act to require disclosure in a plan's statement of investment policy and procedures (SIPP) information as to whether environmental, social and governance (ESG) factors are incorporated and, if so, how these factors are incorporated.[12]

The country's latest ESG embrace has coincided largely with the pandemic, as investments in sustainable funds and ESG ETFs in Canada grew an estimated 67% in 2020 alone.[13] Then, in November 2020, several major Canadian asset owners made a high-profile stand for ESG standardization to be passed into law. The CEOs of Canada's eight leading pension plan managers with combined assets of approximately CAD$1.6 trillion signed a statement pushing for a more complete and consistent disclosure on ESG practices from investors and corporations. Each of these entities typically compete against each other but in this case joined forces with a goal to bring real change in how the country takes ESG into account.[14]

In the U.S., there is renewed focus on ESG, and ESG assets now make up 33% of all U.S. assets under management.[15] The U.S. Securities and Exchange Commission is working through its regulatory plans for ESG investing. Given that the current U.S. presidential administration has brought in a new SEC chairman in Gary Gensler, emphasis on ESG is likely to accelerate.[16] In fact, the SEC has named ESG matters - including disclosures, adherence to policies, and operations - as a priority in 2021.[17]

The administration is also taking steps to include an environmental perspective in its oversight of U.S. financial markets. In May, President Joe Biden signed Executive Order 14030, which addresses the risks that climate change poses to financial markets. The order places certain obligations on the Financial Stability Oversight Council (FSOC) to assess climate-related financial risks and report on the risks, and then monitor and report on the progress of FSOC member agencies (for example, the Securities and Exchange Commission or the Consumer Financial Protection Bureau) as they integrate climate-related financial risk considerations into their practices.[18]

The U.S. Department of Labor (DOL) continues to grapple with ESG rules governing defined contribution plans and sanctions for violations, and the outcome of future DOL decisions will impact the growth of ESG funds in the U.S. Rules that were imposed under the previous administration have been revisited by the current administration's DOL which has stated that they will not enforce them going forward.

While there is growing policy momentum on legislation at the federal level, state governments vary widely in their approach to ESG, which could prevent the U.S. ESG marketplace from growing as quickly and meaningfully as it has in other countries and markets.

ASIA-PACIFIC

In the Asia-Pacific region (APAC), 79% of investors increased ESG investments moderately or significantly in response to Covid-19.[19] Across APAC nations, regulators are beginning the process of standardizing ESG practices.

Australian superannuation funds are already well engaged with ESG issues and policies, and the Australian Prudential Regulation Authority (APRA) has plans for new ESG policies and procedures following the release for industry consultation of the draft prudential practice guide on managing the financial risks of climate change.

In South Korea, the National Pension Service Act of Korea requires the National Pension Scheme to consider ESG issues and declare how they take them into account,[20] while in Japan, the Financial Services Agency (FSA) encourages institutional investors to publicly disclose ESG principles and monitors their implementation.

Starting in 2016, Singapore institutional investors have had access to Singapore's Stewardship Principles (SSP) for Responsible Investors, which sets in place a framework for strong governance for investors.[21] The Monetary Authority of Singapore also set forth Environmental Management Guidelines for asset managers and other financial institutions to "drive the transition to an environmentally sustainable economy by enhancing the integration of environmental risk considerations in FIs' financing and investment decisions and promoting new opportunities for green financing."[22]

As ESG emphasis accelerates in APAC, an interesting dynamic is evolving between Singapore and Hong Kong as they strive to be attractive home bases for domiciling ESG funds. The Monetary Authority of Singapore announced a green investments program in November 2019 that would give up to US$2 billion to asset managers that have designated Singapore as their sustainability hub in Asia Pacific. Meanwhile, Hong Kong's ESG framework is considered one of the strongest globally outside of Europe with mandatory ESG disclosure requirements and strong fund labeling.[23]

APAC's host of independent, developed countries makes for a compelling ESG growth scenario. With a variety of sophisticated players and no uniting political or economic union (such as the European Union within EMEA), APAC could foster healthy competition and impressive ESG progress as independent countries race to become ESG leaders within the region and be regarded as a hospitable locales for ESG investments and funds, like Singapore's and Hong Kong's current ESG dynamic.

When it comes to ESG awareness and regulatory oversight, Europe has long led the pack of these global regions. But as we see asset managers, asset allocators and corporations in the Americas and APAC increase interest in ESG opportunities, regulators will follow to keep up with the growing pace.

SUPPORTING ESG STRATEGIES

Regulators will guide the global frameworks, but as asset owners place more of an emphasis on investing in sustainable assets, and as asset managers survey their preparedness for supporting ESG investing in this sought-after strategy, they should consider the ways their own defined ESG policies and emerging regulatory reporting requirements will impact their portfolios.

As ESG comes to the forefront on a global stage, each region will continue to define and expand its own regulations on the matter. Institutional investors operating on a global scale will need a deep knowledge of the increasingly complex global patchwork of legislation governing ESG investing, as well as the ability to stay on top of legislation on the horizon. Working with a partner that provides guidance on regulatory issues across the globe can offer the peace of mind needed to build, launch and manage new ESG options.

Beyond staying on top of the regulations that an asset manager or asset owner faces, data management and leveraging emerging technologies such as machine learning will be key in keeping on top of all facets of a sprawling and complex portfolio. A core goal of regulators in creating guardrails around ESG investing and products is to ensure that asset managers and asset owners are not greenwashing - presenting a façade of responsible investment practices through marketing and external communications while taking shortcuts with their actual investment decisions. Taking advantage of AI solutions to verify that ESG funds and operations are adhering to set guidelines from a post-trade and pre-trade perspective keeps firms on track with their own operations and provides transparency to stakeholders and regulators. Investors that are unable to build these data management capabilities on their own should seek out the expertise of service partners that have ready-made solutions.

1. In November 2020, Canada's eight largest pensions called for deeper ESG disclosure requirements to be placed on investors and corporations.

2. U.S. SEC has named ESG a key focus for 2021

3. Ontario Parliament amended its Pension & Benefit Act to require disclosure as to how a plan incorporates ESG factors.

4. European Union's core ESG policies:
   - Taxonomy Regulation
   - Non-Financial Reporting Directive
   - Sustainable Finance Disclosure Regulation
   - IORP II / Pensions Directive

5. In South Korea, the National Pension Service Act of Korea requires the National Pension Scheme to consider ESG issues and declare how they take them into account.

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PLANNING FOR AN ESG FUTURE

The industry consensus is that the growing emphasis on sustainable investing isn't going away, and asset managers and asset owners must be on top of the regulations, stakeholder concerns, and industry pressures they'll face. On top of that, industry players in regions that are newer to an ESG approach should evaluate whether they have the right resources and partners on their side to support their chosen ESG strategies.

Ultimately, the process of adopting sustainable investing principles on a global scale is a journey. ESG in the future may look very different from today, particularly as all regions continue their commitment to responsible investments, but getting started today is key to keeping pace with this global force.

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