

SUSTAINABLE FINANCE MARKET UPDATE SERIES

SUSTAINABLE FINANCE ACROSS INSTITUTIONAL INVESTORS



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SUSTAINABLE FINANCE ACROSS INSTITUTIONAL INVESTORS

This work aims to provide an update on the Sustainable Finance Market, including both:

- » A review of main market developments to mobilize green and sustainable finance, and
- » Examples of supporting National and international regulatory developments

MOTIVATION

- Sustainable finance is one of the fastest growing development fields in finance and is quickly becoming mainstream
- Sustainable and green factors are increasingly gaining recognition as being materially relevant for financial products' performance.

SCOPE

ANALYZED MARKET SEGMENTS:

- Institutional investors
- Banking
- Capital Markets
- Insurance

AREAS OF RESEARCH:

- Capital mobilization
- Reporting and disclosure
- Risk management

MAIN INPUTS

THIS WORK INCLUDES INSIGHTS FROM:

- FC4S analysis
- Experts from international organizations, and
- Group consultations and workshops with relevant stakeholders

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SERIES STRUCTURE





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1. Highlights

2. Market development

- Reporting and disclosure
- Risk management
- Capital mobilization

3. Regulatory developments

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HIGHLIGHTS



- **The institutional investors** covered by these series include asset owners, pension funds, sovereign wealth funds, endowment funds, hedge funds, private equity, mutual funds, Exchange Traded Funds and Products (ETFs/ETPs), and index funds.
- **Institutional investors** are actively contributing to the greening of financial markets.
 - *This group of financial actors has the incentives to address and mitigate long-term climate-related risks, particularly pension funds and other long-term-focused investors who cannot easily diversify out of global risks such as climate change and thus have an inherent incentive to address them.*
 - *Asset owners and retail investors (e.g. millennials) are increasingly demanding that their savings be managed taking into consideration sustainability factors.*
- *Institutional investors have started to encourage portfolio investee companies to adopt sustainability reporting and disclosure, as well as embracing Environmental, Social and Governance (ESG) disclosure and reporting themselves.*
- *Investors are increasingly fostering dialogue with companies through both direct corporate engagement and the use of shareholder rights; some are moving out of high-carbon investments to low ESG score investments.*
- **Investors** are realizing that ETFs tracking ESG indices (both equity and fixed income) are performing relatively well and sometimes even better than traditional benchmark indices.
- **Financial authorities** have also been stepping in providing protocols, supervisory guidance and consultations on the adoption of ESG factors, and clarifying that these factors are consistent with fiduciary duty.

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MARKET DEVELOPMENT: REPORTING AND DISCLOSURE



INSTITUTIONAL INVESTORS ARE INCREASINGLY DEVELOPING ESG INVESTMENT STRATEGIES

ESG has become a top priority for institutional investors in recent years.

- A 2019 PwC **report** based on a global survey of 750 institutional investors and 10,000 retail investors found that ESG ranks third in importance among investors surveyed (outranking fees) and that corporations' ESG records are currently being scrutinized by analysts and rating agencies. The report also states that ESG is a key focus for many large pension and sovereign wealth funds, and is also increasingly important to younger generations, who will be receiving large wealth transfers from older ones over the coming years.

- A 2020 Morgan Stanley **survey** polled 110 asset owners (+90% of them had total assets over US\$1 billion) and found that 79% of investors actively integrate ESG factors into their investment process. Asset owners practicing sustainable investing have identified clear benefits to reputation and stakeholder engagement. Moreover, only 31% of interviewed asset owners declare not to have adequate tools to assess how investments align with their ESG goals.
- Globally, the percentage of retail and institutional investors that apply ESG principles to at least a quarter of their portfolios jumped from 48% in 2017 to 75% in 2019, according to **BNP Paribas (2019)**.

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MARKET DEVELOPMENT: REPORTING AND DISCLOSURE



INSTITUTIONAL INVESTORS ARE INCREASINGLY ADOPTING ESG REPORTING FRAMEWORKS AND ENCOURAGING THEIR INVESTEE COMPANIES TO ACTIVELY CONSIDER CLIMATE MITIGATION STRATEGIES

- Institutional investors rely on reporting standards and frameworks to assess the climate-related impact of their investee companies.
 - *A January 2020 survey covering 41 global institutional investors, managing a combined US\$26 trillion in AUM, revealed that 81% of them recommended companies to use the Sustainability Accounting Standards Board (SASB) framework followed by those of the Task Force on Climate-related Financial Disclosures (TCFD, 77%), Integrated Reporting (IR, 36%), Transition Pathway Initiative (TPI, 27%), Sustainable Development Goals (SDG, 27%) and Global Reporting Initiative (GRI, 18%) to communicate ESG information.*
- Institutional investors are encouraging their investee companies to adopt ESG and climate-related reporting and disclosure practices through different initiatives.
 - *The Principles for Responsible Investment (PRI), a universe of over 3,000 asset owners and investment managers representing US\$103 trillion as of September 2020, have committed to seek appropriate disclosure on ESG issues by the entities in which they invest. PRI is also requiring its signatories to report in line with the pillars for governance and strategy of the TCFD recommendation starting in 2020.*
 - *The Climate Action 100+ initiative, which includes 545 investors with over US\$52 trillion in AUM, has committed to engage target companies to strengthen their climate-related financial disclosures. This initiative also aims to engage targeted companies to disclose their CAPEX investments and improve governance, strategy and commitments to reduce their contribution to global GHG emissions.*

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MARKET DEVELOPMENT: RISK MANAGEMENT



INSTITUTIONAL INVESTORS HAVE STARTED TO SYSTEMATICALLY ASSESS THEIR MATERIAL ESG RISKS PORTFOLIO EXPOSURE

"In a scenario with a temperature increase of 3 to 4 degrees Celsius, the world would become uninsurable."

Thomas Buberl, CEO of AXA

- Institutional investors are paying increased attention to physical risks such as wildfires, floods, waste spills, and ecosystem loss, transition risks such as repricing due to expected climate policies (carbon prices), technological change and consumer demand changes and liability risks associated with extreme climate events. This is mainly driven by:

1. EVIDENCE-BASED OBSERVATION that such risks can be material to financial performance.

- *The insurance industry has for many years looked into physical risks. Insurance losses from weather-related catastrophes more than doubled in the 2010-2019 period against 2000-2009.*
- *According to **Munich Re**, 2017 was the costliest year ever in terms of total global weather disasters, with total costs reaching US\$320 billion, of which only US\$130 billion were insured. Insurance industry losses from natural catastrophes and man-made disasters globally amounted to US\$83 billion in 2020. This makes it the fifth-costliest year for the industry since 1970.*
- *A 2019 **study** from the Inter-American Development Bank (IDB) assessed transition risks associated with fossil fuel energy generation in Latin America and the Caribbean and concluded that 10% to 16% of existing fossil-fueled power plants in the region would need to be “stranded” to meet average carbon budgets from the Intergovernmental Panel on Climate Change (IPCC).*
- ***PG&E Corp.’s filing for Chapter 11** bankruptcy in the US after being implicated in California’s devastating wildfires, brought to the forefront of the investment community in the US how extreme climate events can interact with liability risks.*

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MARKET DEVELOPMENT: RISK MANAGEMENT



INSTITUTIONAL INVESTORS HAVE STARTED TO SYSTEMATICALLY ASSESS THEIR MATERIAL ESG RISKS PORTFOLIO EXPOSURE

2. DEMAND from asset owners for better disclosure of environmental and climate related risks.

- The CFA Institute conducted in 2019 ESG integration workshops with PRI and **found** that risk management was the largest driver of ESG integration for equity and fixed income investments, with client demand being the second largest driver.
- A 2020 **survey** from KPMG covering 135 institutional investors, hedge fund managers and pension consultants in 13 countries showed that 44% of surveyed investors said their allocations to ESG-oriented hedge funds were driven by ‘opportunities to generate alpha’ and 34% were driven by ‘evidence of the materiality of ESG issues’.

3. GUIDANCE AND REGULATIONS associated with ESG disclosure and sustainability risk integration.

A 2019 State Street Global Advisors **survey** of senior executives of over 300 private and public institutional investors in Europe, North America, and Asia-Pacific found that the top factors incentivizing the integration of ESG related risks were **fiduciary duty** (46%), **increasing regulatory pressure** (46%), **mitigating ESG risks in the portfolio (44%), keeping up with market standard setters** (34%) and avoiding **reputational risk** (31%). The **PRI**’s more than 3,000 members are actively seeking appropriate disclosure on ESG issues by the entities in which they invest.

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MARKET DEVELOPMENT: RISK MANAGEMENT



INSTITUTIONAL INVESTORS HAVE STARTED TO SYSTEMATICALLY ASSESS THEIR MATERIAL ESG RISKS PORTFOLIO EXPOSURE

- The **PRI**'s more than 3,000 members are actively seeking appropriate disclosure on ESG issues by the entities in which they invest.
- The **Climate Action 100+ initiative** engages targeted companies to disclose their CAPEX investments and improve governance, strategy, and commitments to reduce their contribution to global GHG emissions. The 100+ refers to the companies on the list: a combination of the most polluting companies plus 61 others that are systemically important in some way (e.g. play a key role in the energy transition).
- Although there are several divestment pledges among institutional investors – such as the **UN-convened Net-Zero Asset Owner Alliance**, 34 institutional investors representing \$5.5 trillion of AUM committed to transitioning their portfolios to net-zero GHG emissions by 2050 – some investors **favor shareholder engagement strategies over divestment** ones (they are backed with **academic** as well as market evidence on this regard).
- 86% of respondents of the Morrow Sodali's 5th Annual investor **survey** (41 global institutional investors, totalling US\$26 trillion in AUM) agreed that ESG risks and opportunities played a greater role in 2020 in their investment processes and engagements with companies. Moreover, 91% of respondents said that the engagement at the board level is the most effective way for investors to influence board policies, with almost half of investors declaring that they would consider voting against a director to influence outcomes and 81% agreeing that the stakeholder engagement approach and outcomes should be included in companies' disclosure when they explain their corporate purpose.



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MARKET DEVELOPMENT: RISK MANAGEMENT



INSTITUTIONAL INVESTORS ARE INCREASINGLY PROMOTING ENGAGEMENT WITH COMPANIES THROUGH BOTH DIRECT CORPORATE ENGAGEMENT AND THE USE OF SHAREHOLDER RIGHTS

- **Corporates are also taking action.**

- In December 2020, **Unilever** (£118 billion) **announced** that its climate transition action plan would be placed before a shareholder vote for the first time in Q12021, in a bid to gain a non-binding advisory agreement on the company's decarbonization plans.
- In April 2020, **Royal Dutch Shell** **announced** plans to slash its carbon output, becoming the biggest energy group to introduce a net zero carbon target after a shareholders campaign.
- In January 2020, **ShareAction** filed the first ever climate-related shareholder resolution at a European bank.

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MARKET DEVELOPMENT: RISK MANAGEMENT



INSTITUTIONAL INVESTORS ARE RELYING ON EXTERNAL ESG SERVICE PROVIDERS, BUT THEY ARE ALSO INVESTING TO DEVELOP THEIR ESG ANALYSIS CAPACITIES

- According to a **Deloitte study** (2020) there are over 650 sustainability raters and rankers, and data providers are increasingly supplying more ESG criteria and adding new indicators.
- A **Russel Investment study** (2020), which covers 400 asset managers globally, identified that an increasing number of asset managers are now using external ESG data providers to supplement their in-house views, reflecting growing recognition of the importance of ESG integration.
- Institutional investors are likely to continue demanding external ESG service providers, since collecting and interpreting such data is costly and requires significant expertise and time (for a description of ESG service providers, see Chapter 1 of this series).
- There has been a significant **growth of ESG teams** in global asset managers in the last years. A recent **study** by the Financial Times showed that dedicated stewardship teams responsible for overseeing ESG issues at portfolio companies doubled in the last three years, among them Blackrock, Vanguard, Goldman Sachs, Capital Group and Wellington. A few major investors also created stewardship teams in the last three years, including Amundi, Legg Mason, and UBS.

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MARKET DEVELOPMENT: RISK MANAGEMENT



INSTITUTIONAL INVESTORS ARE RELYING ON EXTERNAL ESG SERVICE PROVIDERS, BUT THEY ARE ALSO INVESTING TO DEVELOP THEIR ESG ANALYSIS CAPACITIES

- These capacities have allowed the development of in-house ratings that also use information from external service providers.
 - An example of in-house ratings is State Street's **R-Factor**, which leverages the SASB standard Materiality Map, corporate governance codes and inputs from four ESG data providers.
 - Also, **AXA Investment Managers** use a **combination** of tools, including their ESG scoring methodology which incorporates different data suppliers, a series of KPIs to assess investee companies against ESG factors, together with detail on engagement, proxy voting statistics, and sustainable development goals, and a dashboard that links all these tools together.
- Investors are also developing investment strategies which target companies with low carbon footprints and have less exposure to stranded assets. The Pension Fund AP4 from Sweden, CalSTRS, the New York State Common Retirement Fund, the New Zealand Superannuation Fund, and many asset managers have built **climate risk hedging portfolios** by having a portfolio of companies that have a lower carbon footprint than benchmarks.



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MARKET DEVELOPMENT: RISK MANAGEMENT



INSTITUTIONAL INVESTORS RELY ON EXTERNAL ESG SERVICE PROVIDERS, BUT THEY ARE ALSO INVESTING IN DEVELOPING ESG ANALYSIS CAPACITIES



- Some investors have started to apply **forward-looking scenario analysis** and **stress testing tools** to assess the potential financial impact of future climate risks and build portfolios that hedge climate risk. For instance, Aberdeen Standard Investments (**ASI**) has developed a climate scenario analysis **framework** to build more resilient portfolios and generate better long-term returns for clients. MSCI has recently **estimated** that under a 1.5°C scenario, the “average” European energy company could lose 67% of its enterprise value due to policy changes, whereas it could gain around 18% because of revenues generated from innovations in low-carbon technology.
- According to the Network for Greening the Financial System (**NGFS**) (2020), the most frequently used environmental risk assessment models by asset managers include Environmental Risk Analysis models, which estimate the changes induced by environmental risks or factors to metrics that later constitute the determinant variables of valuation models of assets.
- Some investors are measuring the carbon sensitivity of portfolio companies by applying the Carbon Betas methodology. The carbon beta is a capital market-based measure of carbon risk that captures the sensitivity of a firm to carbon risk. Using this methodology, investors can assess the transition risk of their portfolio under several carbon price risk scenarios (**BlackRock**).

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MARKET DEVELOPMENT: CAPITAL MOBILIZATION

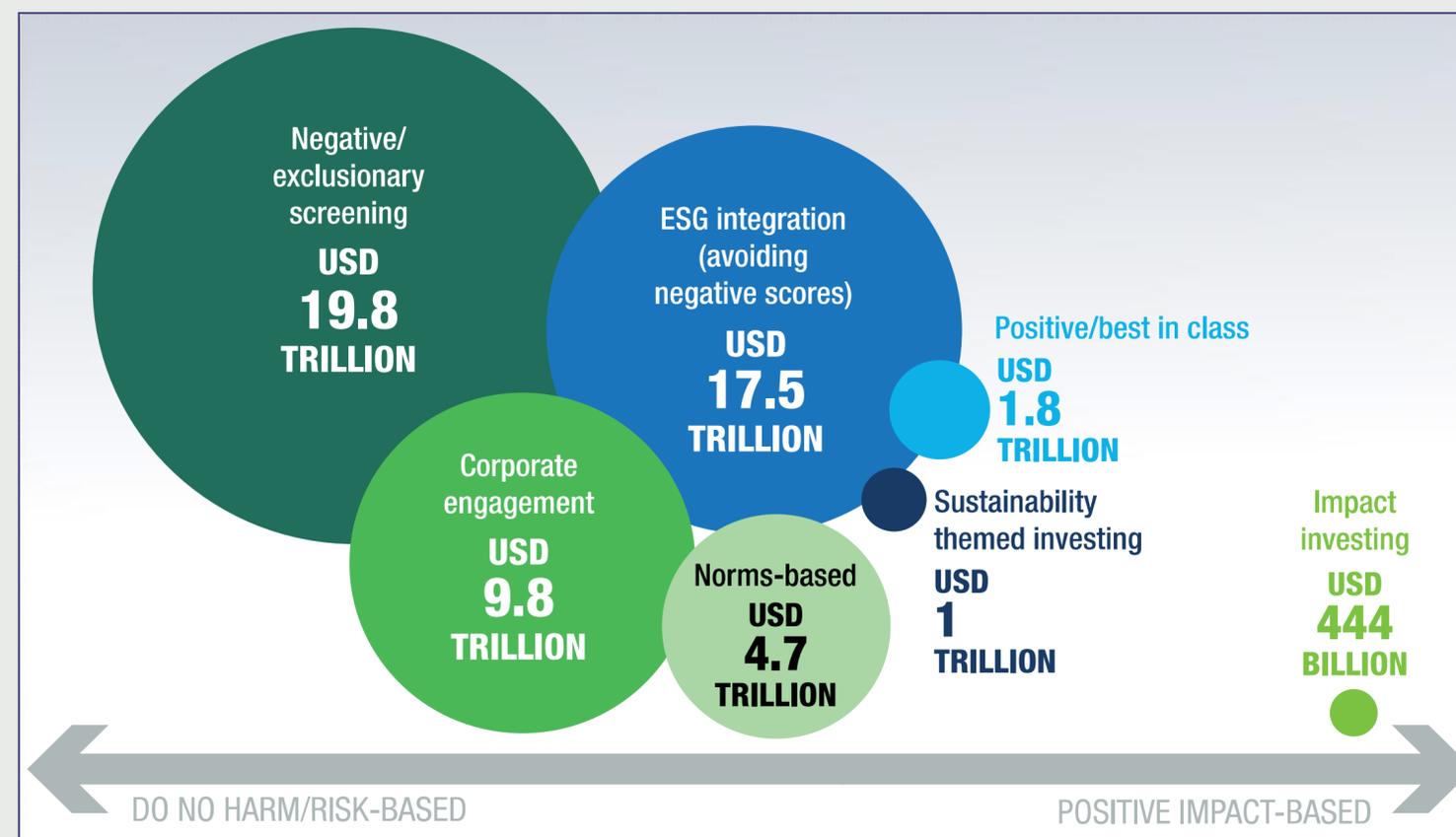


THE WIDE SPECTRUM OF PRACTICES BEHIND SUSTAINABLE FINANCE

- While capital allocation to green and sustainable investing has increased in the last five years, it is challenging to assess by how much because of the variety of definitions and investment strategies used.
- The recently launched UNDP-OECD **Framework for SDG-Aligned Finance** shows that the wide spectrum of what is considered sustainable finance – ranging from exclusionary screening to thematic funds – generates double counting and impairs correct identification between different sustainable finance strategies.

Note: The amounts in the figure do not add up to the estimated USD 30-trillion estimate sustainable investments due to double-counting across several categories.

Source: OECD, 2020, Global Outlook on Financing for Sustainable development 2021, based upon Global Sustainable Investment Alliance (2018), Global Sustainable Investment Review 2018, European Sustainable Investment Forum (2018), European SRI Study 2018, Responsible Investment Association Australasia (2019[36]), Responsible Investment Benchmark Report: Australia 2019,



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MARKET DEVELOPMENT: CAPITAL MOBILIZATION

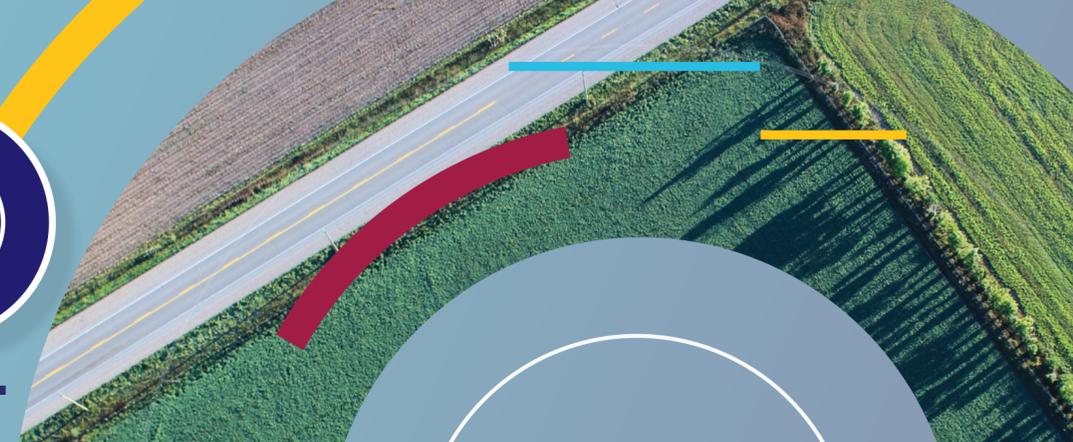


THE WIDE SPECTRUM OF PRACTICES BEHIND SUSTAINABLE FINANCE

- Using a **broad definition** of sustainable investments, the Global Sustainable Investment Alliance **estimated** with 2018 data that sustainable investment could reach US\$30 trillion.
- Recent **estimates** by Opimas indicate that the value of global assets applying ESG criteria to drive investments has almost doubled over four years, and more than tripled over eight years, to US\$40.5 trillion in 2020. Also, active strategies represent the majority of ESG-related AUM (75% in the US and 82% in Europe).
- A 2020 **analysis** of passive sustainable funds by Morningstar shows that there were 534 sustainable index mutual funds and exchange-traded funds globally, with collective AUM of US\$250 billion. Both the number of products and the money invested in them have more than doubled over the past three years. Moreover, Europe remains the largest market accounting for more than 75% of those global assets. The US represents 20%, up from 13% three years ago.

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MARKET DEVELOPMENT: CAPITAL MOBILIZATION

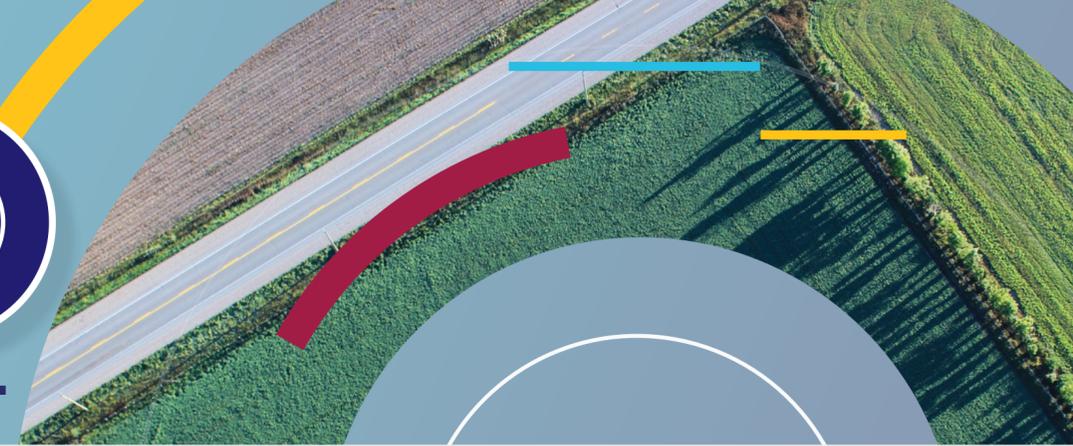


DIFFERENT STUDIES POINT TO A GROWTH IN GREEN AND SUSTAINABLE INVESTMENTS

- The overall market trend shows that institutional investors are allocating more resources to ESG-themed funds, ETFs and indices. One of the fastest growing allocations is listed ESG-themed ETFs/ETPs, which globally reached US\$100 billion at the end of July 2020 (**ETFGI**).
- A PwC **study** found that asset managers have already begun to tackle some of these issues through the promotion of impact investing funds, which specifically prioritize creating a positive impact on society over financial returns. Impact investment funds reached US\$715 billion in 2020, according to GIIN's Investor **Survey**.
- Callan's eighth annual ESG **survey**, conducted in July 2020 among 102 US institutional investors, ranging from less than US\$500 million to US\$20 billion in assets, shows that 42% of US institutional investors surveyed incorporate ESG factors into investment decisions, while 30% who are not yet incorporating them, are considering it, tripling the rate from 2019.
- However, capital allocated to ESG and climate related investments is still a small fraction of global institutional capital. Even using the broad definition of the Global Sustainable Investment Alliance (**GSIA**) (2018), it represents of 8% of global financial assets (including cash, banks, deposits, bonds, stocks, etc.). Moreover, using as reference the **UNDP-OECD Framework for SDG-Aligned Finance** (2020), out of US\$379 trillion in the financial system only US\$3.1 trillion are dedicated to proactively pursue impact.

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MARKET DEVELOPMENT: CAPITAL MOBILIZATION



COLLECTIVE COMMITMENTS FOR “PARIS ALIGNMENT” HAVE ALSO INCREASED DRAMATICALLY IN THE LAST YEARS, WITH MORE INSTITUTIONAL INVESTORS INVOLVED ON THEM

- A 2020 study by Utrecht University and New Climate Institute found that financial institutions with at least US\$47 trillion AUM are currently committed to climate-related investment targets. This represents 25% of the global financial market, which is around US\$180 trillion. The number and growth of such targets is significant and represents considerable momentum – even if the individual targets vary in their ambition and do not cover all AUM.
- Growing numbers of countries, cities and companies have **pledged** to become net zero by 2050 to meet the goals of the Paris Agreement. Estimates suggest that, collectively, these net-zero pledges represent nearly 25% of world emissions and 50% of global output.
- Nonetheless, it is important to highlight that the actual impact on the real economy of these commitments is still to be assessed.

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MARKET DEVELOPMENT: CAPITAL MOBILIZATION



INSTITUTIONAL INVESTORS ARE INCREASING THEIR ENGAGEMENT WITH COMPANIES ON ESG ISSUES



Examples of direct corporate engagement of large institutional investors:

- The CEO of **Blackrock** requested in its 2020 annual letter to CEOs that companies report according to the SASB and TCFD frameworks and disclose plans for operating under a scenario where the Paris Agreement's goal of limiting global warming to less than two degrees is realized.
- The CEO of **Vanguard** requested in 2019 to investee companies that the boards of directors and companies' executives discussions stay focused on effective, long-term oriented governance practices to address climate risk.
- **State Street Global Advisors** declared in 2020 that they will take voting action against board members at companies in the S&P 500, FTSE 350, ASX 100, TOPIX 100, DAX 30, and CAC 40 indices that are ESG laggards based on their R-Factor scores and that cannot articulate how they plan to improve their score.
- **Amundi's** 2021 ESG-related action plan goals are to integrate ESG criteria into its mainstream investment processes and voting policies, screen all companies for ESG factors (+8,000 companies) and integrate ESG factors in voting processes.
- **GPIF's executives** have urged asset managers and the companies in which they invest to rethink their strategy and enhance their disclosures (using frameworks such as the TCFD).

"We believe that addressing material ESG issues is good business practice and essential to a company's long-term financial performance – a matter of value, not values."

- State Street Global Advisors

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MARKET DEVELOPMENT: CAPITAL MOBILIZATION



ACTIVE OWNERSHIP BY INSTITUTIONAL INVESTORS WITH COMPANIES ON ESG ISSUES HAS SYSTEMATICALLY INCREASE OVER THE LAST DECADE



Trends in the use of shareholder rights:

- According to **Morningstar** (2020), from 2005 to 2019 the average support for shareholder resolutions addressing environmental and social issues has increased from about 10% to 29%. Investors have shifted their approach, from recommending specific actions or policies such as disclosure and risk oversight to having an integral discussion of the impact of environmental and social risks on a company's long-term value.
- 2020 saw continued support from climate-oriented shareholder resolutions even under the disruption caused by the COVID pandemic. Climate change resolutions at annual meetings received an average shareholder support of 23% up to 20 May 2020, compared with 16% during all of 2019, according to the **Rocky Mountain Institute**.
- A **report** issued by Share Action in 2019 (reviewing 57 of the world's largest asset managers votes on 65 shareholder resolutions) found that the resolutions on climate-related disclosure filed in 2019 received a higher rate of support than resolutions on political lobbying and on transition planning and/or targets, revealing a growing expectation from investors that companies are transparent about how they manage and price climate-related risks. However, the report also concluded that only a small number of the surveyed asset managers have changed their voting behaviour over the years, suggesting a serially correlated voting path that would represent a challenge to advance climate-risk management.
- A **Russel Investment study** (2020) covering 400 asset managers globally found that engagement was the most frequent source of ESG-related information. Notably, proactive engagement has become a particularly key feature among fixed income managers, with 92% of respondents stating that they regularly engage with the underlying companies they invest in. An increasing number of fixed income managers report using bondholder engagement as a way to gain greater insights into the underlying companies or entities, improve transparency and influence business practices.

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MARKET DEVELOPMENT: CAPITAL MOBILIZATION



WHILE INSTITUTIONAL INVESTORS HAVE AN ENORMOUS POTENTIAL TO MAKE THE REAL ECONOMY MORE SUSTAINABLE, THERE ARE STILL BARRIERS LIMITING THEIR IMPACT

- Key market challenges to sustainable capital mobilization include:

The lack of expertise and historical data of investments in green sustainable projects may lead institutional investors to choose a brown project over a green one. Even in many high-income countries, only the largest institutional investors have the required capacity and knowledge to assess opportunities in innovative sustainable sectors.

The small size of the market for green/sustainable financial products limits participation of institutional investors in many countries. It also raises the relative cost of due diligence of green projects.

A limited coverage of firms (SMEs and non-listed companies) by ESG rating providers is also a deterrent.

- Policy and regulatory uncertainty can additionally hinder capital mobilization when they:

translate into increased risk premiums, higher financing costs and lower funding for green projects, thus deteriorating investor confidence.

favour non-environmentally friendly investments, thus impeding the creation of a sustainable pipeline of bankable projects.

serve as a barrier to effective investor engagement, including preventing shareholders from exercising their voting rights.

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REGULATORY DEVELOPMENTS



INSTITUTIONAL INVESTORS ARE INCREASINGLY BEING REQUIRED TO DISCLOSE ESG FACTORS AND ASSESS ESG RISKS AND OPPORTUNITIES

- In 2020, the International Organization of Securities Commissions (**IOSCO**) stated that issuers' disclosure of material ESG-related matters is important to facilitate market participants' decision-making processes. Such disclosure is also crucial for the credibility of investments that claim to pursue sustainability objectives.
 - *“As investors and asset managers face increasing commercial, supervisory and regulatory pressures to consider ESG matters in their own governance, strategy, risk management and reporting, disclosure of material ESG information plays an increasingly important role, both for issuers vis-a-vis asset managers and investors, and asset managers vis-a-vis (retail) investors.”*
- The EU Sustainable Finance Disclosure Regulation (SFDR) **prescribes** disclosures to be made by asset managers and investment funds relating to sustainable investments and sustainability risks from March 2021. This enhanced transparency will increase awareness of financial products' sustainability credentials. **The Regulation** will be accompanied by Regulatory Technical Standards (RTS), which are being jointly developed by the European Supervisory Authorities, and which will be applicable at a later stage.
- France **requires** asset owners to report their management of climate-related risks and the integration of ESG into investment policies under its 2016 energy transition law.
- UK financial authorities are **developing** supervisory guidance and requirements consistent with the government's commitment to transition to a net zero emissions economy by 2050.

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REGULATORY DEVELOPMENTS



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- In April 2019, Hong Kong Securities and Futures Commission (SFC) **issued** enhanced product-level disclosure requirements for any retail fund with a green/ESG focus evident in its name.
- Mexico’s pension funds must **disclose**, starting in 2022, how they integrate ESG considerations in their investment process.
- Some States in the US have started to design their own requirements for ESG disclosure.
 - California’s 2018 **SB 964** requires the country’s two biggest pension funds *to publicly disclose and analyse their climate-related investment risks. Under the law, CalPERS and CalSTRS must review and report “material climate related financial risks”.*
- The Illinois Sustainable Investing Act (2019), **HB 2460**, requires “all state and local government entities that hold and manage public funds to integrate material, relevant, and useful sustainability factors into their policies, processes, and decision-making”.
- Similar regulations are being considered in states such as Massachusetts, Minnesota, New Jersey, and New York.

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REGULATORY DEVELOPMENTS



REGULATORS AND SUPERVISORS ARE SUPPORTING CAPACITY-BUILDING AND PROVIDING GUIDANCE ON ESG INTEGRATION

- There is increasing understanding that non-consideration of ESG factors in investment decision-making is inconsistent with fiduciary duty.
 - **The International Organization of Pension Supervisors (IOPS)** *recommended* that pension supervisory authorities clarify to asset managers that the integration of ESG factors into investment is in line with their fiduciary duties. It required that pension funds managers report to authorities on how they integrate ESG factors and encouraged them to develop scenario testing of their investment strategy.
- There is an increasing recognition by regulators in some countries (Canada, South Africa, Sweden, and the UK) that the non-consideration of ESG factors in investment decision-making could be a violation of fiduciary duty.
- In the UK, the PRA and FCA have convened the **Climate Financial Risk Forum (CFRF)** to build capacity and share best practice across industry and financial regulators to advance the financial sector's responses to the financial risks from climate change.

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REGULATORY DEVELOPMENTS



REGULATORS AND SUPERVISORS ARE SUPPORTING CAPACITY-BUILDING AND PROVIDING GUIDANCE ON ESG INTEGRATION

- Although there is limited guidance mandating institutional investors to reallocate capital to projects or activities with environmental considerations, the rising regulatory scrutiny of environmental and climate risks through disclosure requirements, along with the advancement in definitional clarity, is likely to encourage capital reallocation for risk management purposes.

In 2016 the California Insurance Commissioner called for the insurance industry to divest from coal and announced new requirements for disclosure of carbon-based investments held by insurance companies. At the end of 2018, he publicly released data on individual insurance companies' oil, gas, coal and utility investments in order to have better insight into climate risks faced by insurer investments.

The Shareholder Rights Directive II (**SRD II**) from the EU strengthens the position of shareholders to ensure that decisions are made for the long-term stability of a company. It amends the original SRD (2007), with the objective of improving corporate governance in companies that have their registered office in an EU Member State and whose securities are traded on the EU's regulated markets. For institutional investors and asset managers, there are additional **requirements** to publish an engagement policy and disclose annually how the main elements of their investment strategy contribute to the medium- to long-term performance of their assets.

- **With the increasing activity from the NGFS, the accent of policy action is shifting from managing current risks to preparedness against broader and new types of risks, and higher resilience of societies and economies.** 18 central banks will **run** climate transition stress tests in 2021. Over time, the tests could be highly catalytic in repricing the cost of capital between high- and low-carbon companies.

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