Sustainable finance moves into the regulatory mainstream

Chapter 7

Part of the Evolving Asset Management Regulation report

June 2018

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Sustainable finance moves into the regulatory mainstream

Until recently, sustainable investing was considered a matter only for asset managers and investor preferences. This is changing, as regulators increasingly see it as their business to promote asset management that does societal good (or, at least, does not do bad).

Sustainable finance has become a regulatory imperative. Initiatives relating to environmental, social and governance (ESG) factors and socially-responsible investing (SRI) have received regulatory support in several countries.

As institutional investors increasingly ask more questions about ESG and SRI – in part prompted by their own beneficiaries' demands, in part by regulatory suasion – the long-standing debate about whether consideration of ESG factors or SRI fits with fiduciary responsibility is evolving.

ESG and fiduciary responsibility – the tide is turning

Does consideration of ESG factors fit with fiduciary responsibility? This question – which has vexed pension funds, investment managers and lawyers for many years – was raised again by an OECD[1] report in 2017 on investment governance and the integration of ESG factors. It drew a distinction between SRI and the consideration of ESG factors in investment decisions.

The key message was that ESG issues are now critical to the health and prospects of any company. Their consideration therefore sits squarely within an institution's fiduciary duty.

This evolving view has profound implications for firms' investment decision-making processes and has prompted new activity by regulators and policy makers.

Fiduciary standards and their application vary across different legal systems, cultures and contexts, but the common aspects are duties of care and loyalty on fiduciaries to beneficiaries, a focus on behavior and processes rather than outcome, and flexible and adaptable interpretations of fiduciary duty. Historically, courts of law and investors have interpreted the duties of care and loyalty as requiring fiduciaries to consider only the financial interests of beneficiaries, but the definition of beneficiaries' financial interests is evolving.

Rather than fiduciary duty being a barrier to the integration of ESG factors in investing, the changing tide of social and investor sentiment and new laws indicate that consideration of ESG factors will soon become a must for all fiduciaries.

Climate change, for example, is increasingly seen as an important driver of portfolio risk and return. According to the OECD, research suggests that the potential long-term economic cost of climate risks in particular could be high and that pension fund portfolios are especially susceptible given that the bulk of their returns are explained by market movement.

The OECD observed a growing consensus, supported by academic research, that financial markets reward good ESG performance by companies. It recognized, though, that a lack of commonly accepted analytical methods was hampering wider integration of ESG factors into investment processes.

Linking corporate responsibility activity to the UN Sustainable Development Goals (SDGs)

The SDGs have resonated strongly with businesses worldwide in less than two years since their launch. Many already connect their CR activities to the SDGs.

43%

of G250 reporters

39%

of N100 reporters

This is a clear trend that has emerged in a short space of time and strongly suggests that the SDGs will have a growing profile in CR reporting over the next two to three years.

A revision to Japan's Stewardship Code demands:

- Effective oversight by asset owners
- Management of conflicts of interest
- Engagement in passive management
- Enhanced disclosure of voting records
- Self-evaluation by asset managers.

The **Netherlands**, too, has enhanced its corporate governance code to encourage long-term value creation and high-quality corporate culture within investment firms, including fund management companies. Institutional investors and investment companies must give notice, in the director's report or on the website, of compliance with the principles and best practice provisions of the code.

[1] Organisation for Economic Co-operation and Development

Regulators take up the ESG baton

The Government Pension Investment Fund in **Japan** set up a partnership with World Bank Group in late 2017 to promote sustainable investments. Joint research is being conducted on practical issues, such as benchmarks, guidelines, rating methods, publication frameworks, report templates and risk analysis. And in September 2017, the first ETF[2] dedicated to ESG investments was listed on the Tokyo Stock Exchange.

Guernsey has launched a new initiative called the Guernsey Green Fund and is consulting with industry to establish a bespoke regulatory framework for sustainable and impact investments, which they hope to launch in late 2018.

The **European** Commission carried out a study, which ended in early 2018, into institutional investors' and assets managers' duties regarding sustainability. The high-level expert group on sustainable finance, appointed by the Commission, made eight recommendations, one being that the Commission should clarify that the fiduciary duties of institutional investors and asset managers explicitly integrate ESG factors.

The objective is to ensure that material sustainability factors are consistently taken into account and disclosed by institutional investors and asset managers. It is argued that this will improve investment processes, increase transparency around sustainability in the investment process and reduce costs for end-investors.

The duties of care, loyalty and prudence are already embedded in obligations under various pieces of EU regulation. However, the Commission believes it is unclear that these obligations require assessment of the materiality of sustainability risks. In addition, there is a lack of transparency on how sustainability factors are factored into the investment process. End-investors may not get the full information they need to inform their own investment decisions.

The Commission was also concerned that the interpretation of institutional investors' and asset managers' ESG duties left too much room for differing approaches by member states.

In the event, the Commission's action plan for sustainable finance, published in March 2018, steered clear of strict legal ESG requirements. Instead, it proposes to ensure that ESG factors are "consistently taken into account" in the investment process of institutional investors and asset managers.

In their April 2018 report on risks and vulnerabilities in the financial services sector, the European Supervisory Authorities recommended that financial institutions consider sustainability risk in their governance and risk management frameworks and develop responsible, sustainable financial products.

[2] exchange-traded fund

> "consideration of ESG factors will soon become a must for all fiduciaries."

And in May 2018, the Commission issued legislative proposals to implement its Action Plan. The proposals include requirements on the labeling of products (to enable investors to identify which are "green"), new categories of benchmarks and incorporating sustainability considerations in investment advice.

Initiatives have also taken place at individual member state level.

In **Sweden**, the results of a public inquiry published in 2017 led to a standard for reporting to improve transparency in sustainable investment. The standard asks for information on:

- The sustainability aspects taken into account in management
- The methods used for sustainability investment
- Information to be available on the fund company website.

The Swedish regulator has decided not to regulate so far, allowing the Swedish Investment Fund Association to take the lead through the standard.

Luxembourg sought to deepen its offering by agreeing climate finance initiatives with **China** in September 2017. The International Institute of Green Finance, the Central University of Finance and Economics, the Luxembourg Stock Exchange and China Securities Index jointly launched the CSI 300 Green Leading Stock Index. The index is intended to be a benchmark for measuring the performance of green Chinese-listed companies.

The Luxembourg and Shanghai Stock Exchange also launched the first green bond channel between the two countries, enabling SSE-listed green bonds to be displayed on the Luxembourg Green Exchange.

In December 2017, **France**'s AMF[3] published its second report on SRI, including compliance with the requirement for institutional investors and asset managers to publish an annual report explaining how they incorporate ESG criteria in their investment policies and their exposure to climate risks, as well as their contribution to achieving the objectives of energy transition (i.e. comply or explain).

It found that one-third of management companies complied, one-third explained and the remaining one-third were non-compliant within the deadlines. The AMF is concerned that SRI market is "dominated" by institutional investors, with the wide range of SRI vehicles making the market "difficult to understand" for non-professional investors.

[3] Autorité des Marchés Financiers

To make it easier for investors to differentiate between SRI funds and conventional funds, the AMF urges fund managers to publish their voting at the general meetings of the underlying companies, to draw up a report on their dialogue with firms and to publish portfolio securities on their websites.

Nevertheless, **Germany** and France have both argued against introducing new EU rules and capital requirements to boost green and sustainable finance in the EU. Better exchange of market information was more desirable, they said.

"Financial regulation or deregulation is not the appropriate tool to … stimulate specific types of green or punish brown investment," said Levin Holle, director general of financial markets policy at the German finance ministry. By way of example, Holle highlighted the FSB's creation of the Task Force on Climate-related Financial Disclosures, which has commented on opportunities and financial risks from climate change.

The European Commission was listening. Its May 2018 package of legislative proposals did not include provisions on reductions to capital requirements. The Commission is discussing with the European Parliament whether to take this proposal forward given the views among the Finance Ministries.

Workforce diversity moves onto the regulatory agenda

Alongside ESG, regulators are calling for greater diversity in the investment industry. In **Europe**, ESMA[4] wants investment managers to set diversity targets for their workforce. The drive, announced in September 2017, comes via corporate governance guidelines issued by ESMA and the European Banking Authority (EBA), and were set to enter into force in June 2018.

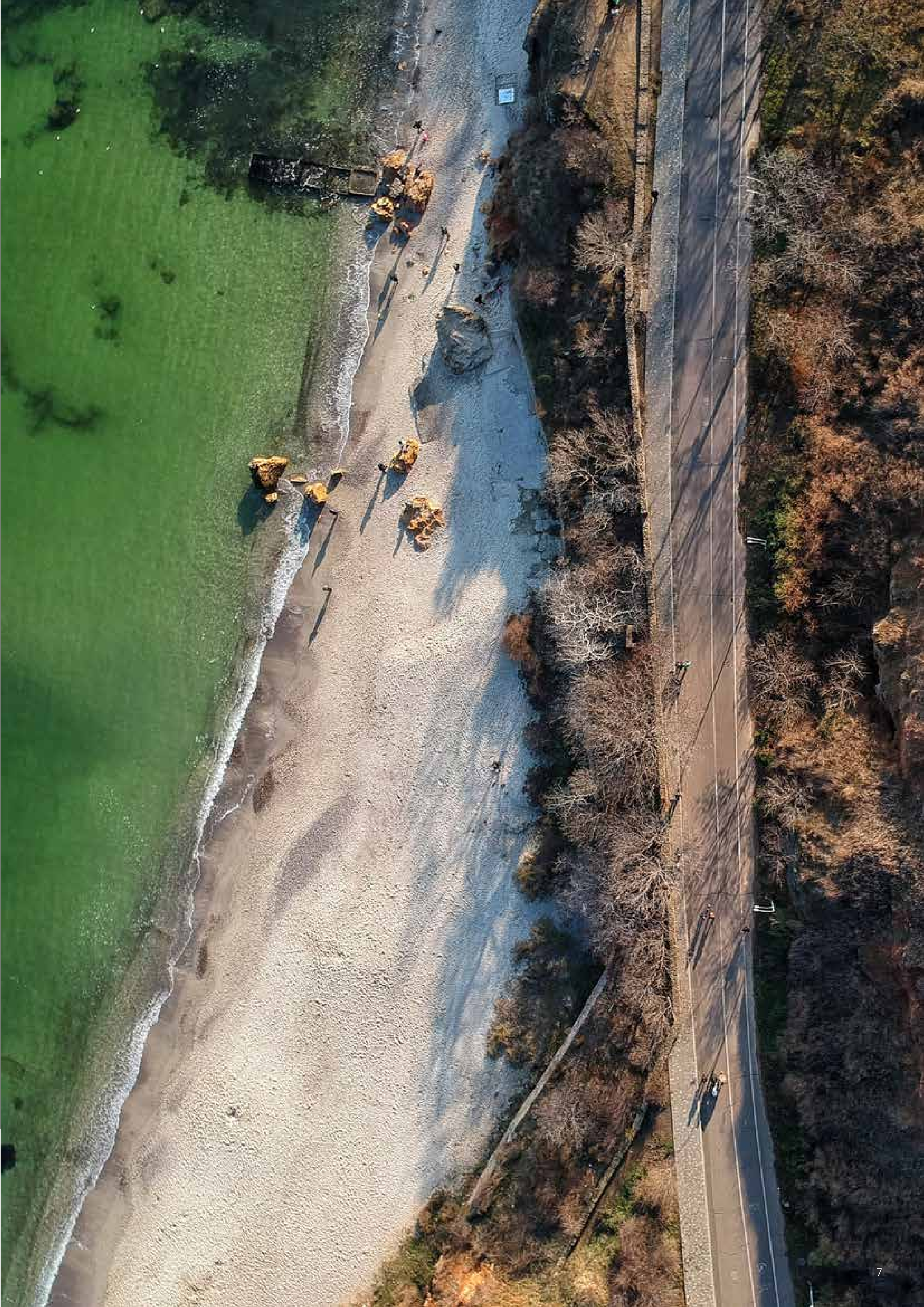
ESMA and the EBA said diversity should be "taken into account in the process for selecting members of the management body". Financial institutions should "engage a broad set of qualities and competences" when recruiting members to the management body and implement policies to promote diversity. Greater diversity, they argue, reduces "group think" and fosters "independent opinions and constructive challenging in the process of decision making".

The Central Bank of **Ireland** has warned firms that it will consider introducing new gender diversity requirements if regulated firms do not take steps to increase diversity levels on a voluntary basis. It believes that an increased gender balance in firms' boards and management can help ameliorate issues such as "groupthink, insufficient challenge, poorly assessed risk and problems with culture."

"This issue is simply too important to overlook. So regulatory tools clearly have their place.", said deputy governor, Sharon Donnery.

> "Financial regulation or deregulation is not the appropriate tool to … stimulate specific types of green or punish brown investment." Levin Holle, German Finance Ministry

[4] European Securities and Markets Authority



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