



**UK-China Green
Finance Centre**



A report for the UK-China Green Finance Centre

Resilience: Lessons to scale responsible investing

June 2020



welcome to brighter

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About the UK-China Green Finance Centre

The **UK-China Green Finance Centre** is the evolution of a long-standing partnership between the City of London Corporation's Green Finance Initiative (GFI), which ran from 2016 to 2019, and the Green Finance Committee (GFC) of the China Society for Finance and Banking.

The GFI-GFC partnership — which became known as the UK-China Green Finance Taskforce — has rapidly accelerated awareness of green finance opportunities in China and identified critical regulatory and market barriers to mainstreaming green investment flows.

With support from the UK Government's Partnering for Accelerated Climate Transitions (PACT) programme, this partnership has now been formalised under the banner of the UK-China Green Finance Centre.

The Centre's overarching mission is to enhance UK and China green finance cooperation to accelerate the global transition to an environmentally sustainable future.

The Centre is co-chaired by Sir Roger Gifford, Chair of the UK Government's Green Finance Institute, and Dr MA Jun, Chairman of the Green Finance Committee (GFC) of the China Society for Finance and Banking.



Foreword

For many investors, 2019 was the year when responsible and sustainable investing went mainstream. From what we have seen so far, 2020 will only serve to accelerate that trend and indeed the current crisis has demonstrated the resilience of sustainable investment strategies. We have seen the core thesis of ESG integration — managing risk — validated as associated strategies outperform in the global economic downturn. Yet we are still in the early days of the sustainable revolution.

The UK and China have been leading this agenda globally. Our investors have embraced the financial materiality of ESG risk factors and have shown the way on disclosure. Yet as the world seeks to recover from the COVID-19 pandemic, it is vital that investors play their part in ensuring that the recovery is sustainable. This means allocating capital to a whole-of-economy transition aligned with net zero commitments and tackling social inequality to support long-term sustainable growth.

Investors want to focus on real solutions and real actions. Collectively, we must double down on proactive and positive efforts to allocate capital — actively financing green in parallel with the ongoing greening of finance. To identify an effective approach to guide these efforts, we in the UK-China Green Finance Centre invited Mercer to unpack the barriers investors face in scaling their sustainable asset allocations and suggest practitioner-driven ways to overcome them.

This report calls on leading asset owners and asset managers in the UK and China to come together and form the ESG Leaders Forum under the banner of the UK-China Green Finance Centre. The Forum will focus on enabling the strategies, capabilities and products needed to drive capital allocation and to amplify impact across the real economy. In the months ahead, we will partner with pioneers to take forward priorities around solutions, stewardship and risk management.

In these unprecedented times, we have the opportunity to chart a sustainable pathway to recovery. Building back better is both the challenge and our goal. And one we must strive towards together.

Finally, special thanks must go to Rongrong Huo, Executive Director at Ninety One and UK chair of the ESG Leaders Forum, for driving this agenda forwards.

Sir Roger Gifford

Co-chair, UK-China Green Finance Centre



Dr MA Jun

Co-chair, UK-China Green Finance Centre



Responsible investing is used throughout this report to describe the integration of environmental, social and corporate governance (ESG) issues into investment decision-making and encompasses the approaches described below.

Approaches to ESG and sustainable investing have historically focused overly on strategies that employ negative screening. However, today sustainable investing can be characterised as follows:

- **ESG integration:** Systematic inclusion of ESG risks and opportunities into traditional investment analysis, portfolio construction and risk management.
- **Thematic investment:** Investment in themes and assets specifically related to sustainability (for example, green energy, green infrastructure, clean technology, energy efficiency, sustainable agriculture, mobility, education, health and development).
- **Impact investment:** Investment strategy designed to produce measurable financial and non-financial returns.
- **Stewardship:** Exercising active ownership through voting and engagement with underlying investee companies as well as engagement with policymakers with the objective of financial system improvement.
- **Negative/positive screening:** Excluding securities of specific activities or industries, or positively selecting companies or countries with better or improving ESG performance relative to sector peers.

This terminology framework is consistent with that of the UN-backed Principles of Responsible Investment (PRI), which defines responsible investment as a strategy and practice to incorporate environmental, social and corporate governance (ESG) factors in investment decisions and active ownership.

Similarly, UK institutions such as the British Standards Institution and the Investment Association likewise have established frameworks defining responsible investment.

In China, the 2018 revised Code of Corporate Governance for Listed Companies (issued by the China Securities Regulatory Commission) and the 2019 China Sustainable Investment Review (published by the China Social Investment Forum) are two examples of the market coalescing around a developing set of common definitions and approaches to responsible investment.

Executive summary

Investors today are facing a rapidly evolving financial landscape in which environmental, social and corporate governance (ESG) issues have been brought to the fore. In these unprecedented times, it is more critical than ever for investors to take a broader view of performance — its drivers and consequences — and recognise the financial materiality of ESG factors. Only then can we deliver on the potential to build back better after the COVID-19 pandemic.

Delivering a green and equitable recovery will require institutional investors to enhance the scale and sophistication of their responsible investment allocations. Two key factors are driving behaviour here. First, the push from global policy commitments and associated regulation. Second, the pull from client demand. Both are supported by the growing evidence of the financial materiality of ESG issues and the notion that their integration leads to better business and investor outcomes.

This report seeks to shine a light on the road less travelled — a deeper dive into the practical considerations and challenges facing asset owners and managers when considering proactive steps to allocate capital to sustainable solutions. Much of the pathway to a sustainable recovery has already been illuminated — investors know risk management must integrate ESG issues, and they have embraced disclosure in recent years. However, capital is still not moving at the pace at which we need.

To unpack the barriers investors face in scaling their sustainable asset allocations, we seek to answer three questions:

1. What does best practice responsible investing look like for asset owners and asset managers?
2. How do investors allocate to sustainable strategies, and where are the gaps?
3. How can the UK and China collaborate to shift the global agenda?

Through interviews with leading investors in both the UK and China, including recognised global leaders in ESG integration and climate change investing, we have sought to identify common success factors as recommendations for institutions to improve existing responsible investment (RI) practices.

We have also sought to highlight areas where financial markets could evolve to better serve investors' RI ambitions as well as identify actions that UK and Chinese financial regulators could take to improve asset owners' RI practices and encourage innovation.

The interview findings reflected a clear willingness and appetite for change across the industry in both countries. However, investors noted several barriers to scaling RI opportunities.

To help address these barriers, we support the establishment of an ESG Leaders Forum (ELF) under the banner of the UK-China Green Finance Centre. The ELF would be a practitioner-driven group focused on advancing the frontier of responsible investing for UK and Chinese investors.

We recommend the ELF prioritises the following areas:

1. **Developing pioneer-led scalable solutions:** Solutions remain underdeveloped in various asset classes, particularly fixed income, equities (particularly index-based) and real assets. Pioneering asset owners need to partner with managers to create investable solutions that will enable the market to scale and support their peers to adopt new products as their approaches mature.
2. **Accelerating stewardship through a new stewardship code:** Stewardship and governance are underappreciated value drivers in the Chinese market. A Chinese stewardship code for asset managers, asset owners and service providers would catalyse innovation, build resilience and preserve long-term value — all prerequisites to a sustainable recovery. This will also help drive changes at the most senior levels.
3. **Reiterating the financial materiality of ESG risk factors:** Regulators, advisors and investors must continue to impress and buttress the materiality of sustainability risks through new financial analysis and regular market engagement.
4. **Doubling down on transparency and disclosure:** Building on the success of the UK-China Environmental Information Disclosure Pilot, investors should continue to engage in the evolution of TCFD and play their part in aligning their activities with a sustainable future. In particular, investors should be moving towards integrated disclosures in their financial reporting, rather than standalone sustainability reports.



1

Scaling responsible investing at pace

This report seeks to shine a light on the road less travelled — the practical considerations and challenges facing asset owners and managers when considering proactive steps to allocate capital to sustainable solutions. Much of the pathway to a sustainable recovery has already been illuminated — investors know risk management must integrate ESG issues, and they have embraced disclosure in recent years. However, capital is still not moving at the pace at which we need. The scaling of sustainable investment solutions is vital to drive the transition to a sustainable future.

Both the UK and China are leading on efforts to “green” their respective financial systems in order to meet country level commitments on climate change. Both are actively looking to mobilise more private finance to build back better from the COVID-19 crisis.

In the UK, key developments include:

- UK Law to Achieve Net Zero GHG Emissions by 2050 (to become carbon neutral by 2050)
- UK Green Finance Strategy
- DWP Regulations 2018 (trustee disclosure of material ESG considerations and climate change)
- UK Stewardship Code 2020
- Bank of England’s Climate Financial Risk Forum
- EU High-Level Expert Group on Sustainable Finance
- The EU Green Taxonomy (classification system for sustainable activities)
- The EU Shareholder Rights Directive (to improve transparency of engagements as shareholders)

China has seen a number of key developments in the last five years, including:

- A national green finance system as part of China’s 13th five-year plan (2016–2020)
- “Guidelines for Establishing the Green Financial System” issued by the People’s Bank of China in 2016
- Environmental Ministry/China Securities Regulatory Commission (CRSC) mandatory environmental disclosure system for listed companies and bond-issuing enterprises to be implemented in the near future
- CRSC “Code of Corporate Governance for listed Companies” 2018
- Asset Management Association of China (AMAC) “Guidelines for Green Investment (Trial version)” 2018
- Shanghai and Shenzhen Stock Exchanges have joined the Sustainable Stock Exchange Initiative and have provided guidance to companies on how they should report on ESG issues

- The People’s Bank of China excluding “clean coal” from the list of projects eligible for green bonds in 2020

Our observations and recommendations are made in the context of the many activities that are currently underway in both the UK and China.ⁱ

Best practice — what sets industry pioneers apart?

Industry leaders have played a critical role in driving the responsible investing agenda to date. In our study, we have sought to identify common characteristics of pioneers to draw distinctions between those asset owners and managers who continue to innovate, those in the mainstream and those yet to start their RI journey. This synopsis of best practice, summarised in the following tables, is intended to support aspirational investors and firms move rapidly up the curve towards the frontier.



Asset owners

	Laggard — Yet to make progress on ESG	Mainstream Middle — Making strides on ESG	Advanced — Progressive on ESG	Best Practice ESG Leader — Innovator/early adopter
Beliefs 	May view ESG issues as separate to financially material issues.	Some recognition that ESG issues may be financially material.	Recognises financial materiality of ESG issues and integrates into strategic investment decision-making.	Actively influences markets for change — engages with policymakers and other stakeholders to drive innovation. Systematic integration of ESG issues, with focus across a broad spectrum of E, S and G issues.
Policy 	No policy on ESG integration, with no action taken until required by regulation.	May include reference to ESG in broader investment policy documentation. Limited disclosure of approach to engagement with members.	Detailed policy on ESG, climate change and stewardship, but may not be publicly available. Some engagement with underlying members and beneficiaries.	Detailed public policy outlining approach to ESG integration, climate change and stewardship. Engages with underlying members and end investors.
Process 	May take a short-term approach. Does not participate in collaborative industry initiatives.	Making efforts to take a longer-term approach. Exploring opportunities to participate collaboratively.	Likely to take a longer-term approach to investment. Some participation in collaborative industry initiatives.	Long-term approach to investment. Collaborates effectively to drive market and behavioural change.
Portfolio 				
Investment strategy 	ESG issues not considered when setting strategic asset allocation.	Typically focused on ESG integration in equities, but little attention given to other asset classes.	Tailors approach by asset class, with some consideration of industry exposure.	Tailors approach by asset class and industry. Sustainability considerations inform strategic allocations.
Manager selection 	Does not include ESG considerations in strategic or manager selection decisions.	Limited consideration of ESG issues when selecting investment managers.	ESG issues important in the selection of managers. Preference for high ESG rated approaches.	Partnership mentality in selecting investment managers and innovating new solutions. Aligned incentive structures in place.
Monitoring and stewardship 	Little or no monitoring or assessment of ESG issues or stewardship activities.	Limited monitoring of ESG integration and stewardship activities.	Detailed monitoring of ESG and stewardship activities.	Detailed and thorough monitoring of ESG and stewardship activities — with an expectation for ongoing improvement and innovation (e.g. impact reporting).

Asset managers

	Laggard — Yet to make progress on ESG	Mainstream Middle — Making strides on ESG	Advanced — Progressive on ESG	Best Practice ESG Leader — Innovator/early adopter
Idea generation 	<p>Views ESG issues as separate from financially material issues</p> <p>May take a short-term approach to investment decision-making.</p>	<p>Some integration of ESG issues into financial analysis, but not systematic.</p> <p>Largely focused on governance-related issues.</p>	<p>Recognises financial materiality of ESG issues and systematically integrates them into financial analysis.</p> <p>Focus on E as well as G, with some focus on S.</p>	<p>Recognises ESG issues as financially material and embedded throughout investment strategy and financial analysis.</p> <p>Systematic integration of ESG issues, with focus across a broad spectrum of E, S and G issues.</p>
Portfolio construction 	<p>May negatively screen based on client requirements, but does not give thought to the underlying development of screens.</p>	<p>Typically uses “off the shelf” third-party ESG data.</p>	<p>Typically uses a combination of ESG data sources.</p>	<p>Proprietary ESG data sets, research and tools.</p> <p>ESG philosophy clearly demonstrated by portfolio construction.</p>
Implementation 	<p>Limited stewardship activity.</p>	<p>Typically focused on ESG integration in equities, but little attention given to other asset classes.</p> <p>Stewardship activity largely limited to governance-related topics.</p>	<p>Considers ESG across asset classes.</p>	<p>Tailors approach by asset class and industry.</p> <p>Feedback loop between engagement activity and proprietary ESG scoring.</p>
Firm-wide commitment 	<p>Views ESG and sustainability as distinct from investment decision-making, with no firm-wide commitment.</p> <p>Limited or no participation in collaborative engagement initiatives.</p>	<p>ESG and sustainability interest limited to a small number of individuals or strategies, with limited firm level commitment.</p> <p>Some participation in collaborative engagement initiatives.</p>	<p>ESG and sustainability important to firm culture.</p> <p>Active participation in collaborative engagement initiatives.</p> <p>Publicly detailed policy outlining approach.</p>	<p>ESG and sustainability embedded throughout firm culture, with top-down leadership.</p> <p>Collaborates effectively to drive market and behavioural change.</p> <p>Aligned incentive structures in place.</p> <p>Publicly detailed policy outlining approach.</p> <p>Strong alignment between policy and practice.</p>

Four priorities to unlock capital at scale

1. **Developing pioneer-led scalable solutions:** Solutions remain underdeveloped in various asset classes, particularly fixed income, equities (particularly index-based) and real assets. Leading asset owners need to partner with managers to create investable solutions that will enable the market to scale and support their peers to adopt new products as their approaches mature.
2. **Accelerating stewardship through a new China stewardship code:** Stewardship and governance are underappreciated value drivers in the Chinese market. A Chinese stewardship code for asset managers, asset owners and service providers would catalyse innovation, build resilience and preserve long-term value — all prerequisites to a sustainable recovery. This will also help drive changes at the most senior levels.
3. **Reiterating the financial materiality of ESG risk factors:** Regulators, advisors and investors must continue to impress and buttress the materiality of sustainability risks through new financial analysis and regular market engagement.
4. **Doubling down on transparency and disclosure:** Building on the success of the UK-China Environmental Information Disclosure Pilot, investors should continue to engage in the evolution of TCFD and play their part in aligning their activities with a sustainable future. In particular, investors should be moving towards disclosures in their financial reporting, rather than standalone sustainability reports.

1: Developing pioneer-led scalable solutions: Facilitating partnerships to break barriers to innovation at scale

Solutions remain underdeveloped in fixed income, real assets and index-based equity products. Pioneering asset owners need to partner with managers to create investable solutions that will enable the market to scale and support their peers to adopt new products as their approaches mature.

Leading asset owner interviewees consistently highlighted the importance of carefully selecting investment managers to ensure their ESG expectations are embedded in their portfolios. By developing a partnership approach, the asset owners highlighted that investment managers have been able to evolve existing approaches or develop new strategies to better meet their ESG and investment needs.

Pioneers in responsible investing seek to innovate and deploy capital into investments offering sustainable investment returns. While regulation can play its part in setting minimum standards and moving laggards to take action, industry leaders tend to take the following approach:

- Implementing improvements prior to regulation by pushing existing boundaries and engaging with regulators and policymakers to improve the wider market approach
- Developing new investment solutions to meet their own needs as well as those of their clients

Leading UK investors highlighted both the importance of the following areas to the development of portfolio-wide sustainable approaches as well as existing barriers.

We support the aims of the Forum in encouraging innovation and capacity-building in ESG solutions in fixed income, real assets and ESG index solutions. These have been consistently identified as areas where asset owners are seeking to invest capital but are currently restricted by the lack of solutions or lack of capacity in these solutions.

Fixed income

Fixed income is an area where asset owners are keen to do more from both an ESG integration perspective as well as through increased allocations to environmental or social bonds. However, the market does not yet offer the types of solution they are seeking within the areas of multi-asset credit, private debt and loans. Fixed income is typically a significant proportion of most long-term institutional investor portfolios, particularly for insurers and pension funds looking to better match their liabilities. In addition, the sheer scale of fixed income markets should allow it to better accommodate sustainable finance than it currently does.

Both the UK and China should continue working in collaboration to encourage investment in green bonds and increase the scale of the opportunity. Green bonds have an important role to play in providing capital for the transition to a low-carbon economy.

The UK can learn lessons from China about successfully scaling up domestic issuance of green bonds. This could include finding innovative ways to subsidise the cost of green bonds through tax breaks and other incentives, and encourage the issuance of green mortgages and asset-based securities. It should continue to keep the issuance of a sovereign green bond under review as this would send a positive policy signal and help catalyse domestic issuance which has lagged other countries.

Sustainable and low-carbon real assets

Investors should understand how investing in real assets can provide meaningful contribution to mitigating climate change. In particular, the Forum should encourage investors to consider the risks and opportunities in terms of the low-carbon transition and physical impacts when making investments in sustainable real assets. As an example of innovation, we are seeing a growing number of energy transition-focused funds being launched in France.

The physical resilience of real assets in light of climate change is increasingly an area of focus for investors, and policymakers and regulators need to ensure this continues to receive attention. The physical impacts of climate change are already being felt, but the market is not necessarily adopting a long-term approach to the management of this risk.

UK asset owners highlighted that they are increasingly seeking new ways of measuring the exposure of their investments to the physical impacts of climate change. To date, much of the focus has been on risk mitigation with respect to transition risks. Investors are seeking to identify whether their portfolios are “Paris Aligned”, considering decarbonisation, resilience against the physical impacts of climate change and green revenue-aligned solutions, with low-carbon real assets identified as a critical aspect of achieving alignment.

Reviewing benchmarks and ESG-index solutions

While investors identified innovation in this area, they highlighted that more needs to be done to shift the focus away from traditional market cap global equity benchmarks to more sustainable solutions. It was noted that by removing the constraints of investing to a mainstream benchmark, investors are better able to invest in a long-term sustainable manner.

Policymakers should encourage the use and development of low-carbon equity benchmarks and indices to be Paris Agreement/2°C aligned. For example, this is currently an area of focus for the EU Technical Expert Group on Sustainable Finance.

Asset owners and asset managers creating innovative new benchmarks should be championed, and best practice should be highlighted to the rest of the market. For example, the Transition Pathway Initiative, co-founded by the EAPF and the Church of England Pensions Board, is an example of an innovative tool and methodology that has been used as the basis for a low-carbon index.

EAPF and the Church of England Pensions Board founded the Transition Pathway Initiative (TPI) that assesses and tracks how companies are preparing for the transition to a low-carbon economy. This initiative, supported by over 60 investors globally, with over \$18 trillion in combined assets under management and advice, has further led to the Church of England Pensions Board, in partnership with FTSE, developing the FTSE-TPI Climate Transition Index, which is a global equity index that aims to capture company alignment to the Paris Climate Agreement.

While Mercer generally encourages the use of active management when it comes to managing sustainability-themed portfolios, we recognise the importance of developing index-tracking approaches for those asset owners that require lower cost solutions.

2: Accelerating stewardship and active ownership by introducing a China stewardship code

We recommend that the Forum support the introduction of a China stewardship code for asset managers, asset owners and service providers. Strong stewardship is fundamental to the success of sustainable financial markets, and the importance of stewardship has increased in light of the COVID-19 pandemic. Strong stewardship builds resilience and preserves long-term value, both crucial as the world turns its attention to the post-COVID recovery.

Effective stewardship is a skilled and resource-intensive activity, and, as such, offers competitive advantages for those managers able to do it well. It is increasingly used by investors to differentiate between managers, particularly for passive equity management. In addition, it is increasingly becoming a “must have” for UK, European and Australian asset owners in particular. Governance concerns have been cited by overseas investors as a barrier to investing in China, and strong stewardship, drawing on international best practice, would further aid investor confidence and diversify the client base of Chinese asset managers for non-domestic investors.

ESG best practice leaders consistently highlight the importance of being long-term stewards of capital and active owners, choosing to exercise voting, engagement and other ownership rights while taking a long-term approach.

The UK introduced the first stewardship code in 2010, and over the last decade similar codes have been introduced across the globe, with more than 20 countries and jurisdictions globally having published stewardship codes. Over recent years, there has been a notable rise of such codes in South East Asia in particular.

The UK has recently published its ambitious Stewardship Code 2020, redefining and strengthening its approach for the new decade. The code has been overhauled to ensure it remains fit for purpose in an environment of increased investor expectations on ESG integration, stewardship and climate change. The 2020 Code takes a broader, more comprehensive approach than previous iterations, which largely focused on voting and engagement activity with respect to equity assets. The latest code defines

stewardship as “the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.” Further, the new code requires investors to explain how they are exercising their stewardship duties across asset classes.

Similar to the initial approach adopted in other regions, China may wish to focus its first code on the exercise of voting and engagement activities in relation to listed equities, and could make China A-shares a specific focus within this. Alternatively, China could consider a more ambitious approach by introducing a code consistent with the UK’s 2020 Code. Any China stewardship code should be sympathetic to the existing ownership structure of the China share market by encouraging large asset owners (sovereign wealth funds and wealth managers of large commercial banks) to lead, while recognising the often significant state ownership of some companies and strong domestic retail participation.

China interviewees noted stewardship activities remain relatively nascent in the Chinese market, given low levels of shareholder involvement. The asset manager focus is primarily on the monitoring and evaluation of companies to meet fund objectives. There is, however, evidence that Chinese asset owners are starting to increasingly focus on stewardship, with one interviewee citing the presence of internal policies on engagement and voting — and outsourcing these responsibilities to appointed managers, with the exception of large exposures where such stewardship activities are retained.

Increasingly, we are seeing the emergence of investment strategies where ownership and intensive engagement is fundamental to the investment philosophy and a driver of alpha. We are seeing demand from asset owners for this type of innovative approach.

3: Reiterating the financial materiality of ESG and its links to improved investor outcomes

Acceptance and understanding that ESG issues are financially material, both from a risk management perspective and investment returns perspective, is the most important step in successfully developing an ESG investment approach.

The last decade has seen an about-turn in the attention paid by UK investors to ESG issues. Whereas previously responsible investment considerations may have been optional and supplementary to consideration of financial risks, they are increasingly becoming firmly embedded into core investment strategies.

The leading edge of the responsible investment landscape is characterised by the use of proprietary research, ESG ratings and assessment tools to assess investee companies, and ESG-integrated investment solutions. Where existing tools do not exist, leaders seek to develop them, either individually or collectively. As indicated in the ESG progress table for investment managers, a first step to this is often to make use of third-party ESG data before evolving to systematic integration of responsible investment through the development of proprietary assessment methodologies.

There is increasing evidence, both from industry and academia, that incorporating ESG issues leads to better investment outcomes. Yet many institutional investors still view ESG as separate to financial analysis.ⁱⁱ

In order to scale ESG investing in China, investors need to be convinced that ESG issues are financially material. This belief is starting to become mainstream among UK investors. Without this underpinning, ESG issues will never truly be considered in a systematic and integrated manner.

Many UK-based investors have sought to develop proprietary ESG ranking systems and tools to generate competitive returns. In China, this trend has not materialised as many Chinese investors have raised concerns about additional costs associated with this approach to ESG integration. The experience of ESG leaders in the UK has demonstrated that the benefits have outweighed additional costs.

The COVID-19 crisis has further demonstrated that taking a sustainable investment approach and a long-term mindset can benefit investors. Investment strategies with a high level of ESG integration tend to be less cyclical and are more likely to have exposure to technology and healthcare sectors, which have performed relatively well in the recent market environment. COVID-19 may well accelerate interest in creating mandates that make economies and society more sustainable, resilient and equitable.

We believe the Forum should prioritise industry and practitioner-led evidence to clarify that ESG integration is not detrimental to investment returns. Rather, it generates better risk-adjusted return outcomes over the long term. By sharing evidence and collaborating on practical ESG integration actions, China will be able to make quicker strides and learn lessons from the UK, where indecision and conflicting messages led to a decade of misunderstanding on the importance of ESG issues.

4: Doubling down on transparency and disclosure

We recommend that the Forum encourages investment managers and asset owners to adopt standardised ESG and green finance-related metrics. Transparency and disclosure of ESG-related metrics is an essential requirement for ensuring investors can make well-informed decisions.

Specifically, we recommend that as a first step the Forum encourages the adoption of a set of environmental disclosures for investors aligned with the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD), which was repeatedly cited throughout the interviews as being beneficial.

At present, China's progress on environmental disclosure has been targeted at Chinese listed companies, with mandatory disclosure expected in the near future. At the same time, it is important that investment managers disclose the ESG credentials of their portfolios to potential investors.

UK investors noted that the evidencing of ESG benefits through reporting increasingly differentiates the strongest and weaker investment managers (e.g. reporting within investment memos and client reports). As such, transparency is one of the key indicators asset owner clients are looking for when partnering with investment managers.

But why is the TCFD framework useful, and how can investors benefit from using it? The TCFD is an industry-developed framework and applies to companies, investment managers and asset owners. This has been crucial to its success — it has been developed by those that will use it. It provides a high-level framework for managing environmental and specifically climate-related financial risks while also

providing detailed guidance for different financial market participants tailored to how these participants use the data in practice. It details recommended metrics for different participants and reviews these periodically to ensure the recommendations remain current.

With asset owners increasingly seeking to report against the TCFDⁱⁱⁱ and TCFD disclosure being considered a prerequisite to COVID-19 recovery support in Canada (and likely other jurisdictions), we believe there is a competitive advantage for those managers who actively seek to align to this framework, in both determining underlying portfolio exposure and in meeting increased client demand.

Consistency of approach and coordination will be vital to successful management of climate-related financial risks, and the TCFD offers a globally recognised set of industry-developed recommendations. By encouraging investment managers and asset owners to formally adopt the recommendations, both the UK and Chinese regulators will enable increased disclosure and management of climate-related risks across the investment chain, expected in turn to increase exposure to green finance-related investments.

In addition, transparently reporting key ESG performance and portfolio metrics can help protect against “greenwashing”. This is the term given to superficial attempts to present an environmentally responsible image without substance or merit in practice, and remains a concern for investors in the UK and China. The increased transparency of investment products is vital to enable investors to more easily identify those investments that comply with sustainability criteria. Work being undertaken by ISO (on ISO/ TC322) in which both the UK and China are participants, is expected to further reinforce standardisation and transparency.

In time, the Forum could consider encouraging China to adopt a similar approach to the EU’s recently published sustainable finance taxonomy to help lay the foundation for effectively understanding exposure to green or low-carbon investments and labelling of products. Environmental company disclosure requirements under the Guidelines for Establishing a Green Financial System can support these efforts. As a centrally planned economy, and with the right disclosure policies in place, China has the ability to overtake many developed markets on disclosure in the medium term and become a leader in this area.

Broad commonality was found for asset owners and managers in the UK and China alike in perceiving climate change to be a global systemic risk which needs to be addressed by the finance sector. In the UK, asset managers are taking a proactive stance in developing in-depth approaches to mitigating climate change — including stewardship approaches and climate change product ranges. In China, climate change beliefs for leading investors are being informed by TCFD developments, with asset owners focusing on analysing climate change risk through the TCFD recommendations, while asset owners (and in particular government investors) are proactively increasing demand for low-carbon investments.

2

ESG across the asset class landscape

In this section, we explore the integration of ESG across the asset class landscape. This analysis draws on Mercer's ESG ratings distribution by asset class. We also provide more information on specific asset classes that would benefit from an acceleration in the application of ESG integration and sustainable strategies. These areas were all identified as being of specific interest for furthering asset owner's ability to take a "whole of portfolio" approach to sustainability.

Assessing investment managers for ESG best practice

ESG factors can be incorporated into manager selection and monitoring exercises by using third-party ESG ratings, such as Mercer's ESG ratings applied to investment strategies. In this section, we use Mercer's ESG ratings framework to highlight how investors can think about ESG best practice when assessing investment managers. These ratings provide a useful insight into the current state of ESG integration and the availability of sustainable offerings by asset class.

This section provides useful context for our first priority, "developing pioneer-led scalable solutions", which discusses fixed income, sustainable and low-carbon real assets and ESG benchmarks and indices (including low-carbon indices).

ESG ratings are standard within Mercer's manager research process across most asset classes. Mercer has been assigning ESG ratings at the investment-strategy level since 2008, assessing the extent to which asset managers integrate ESG factors and active-ownership activities into their investment decision-making framework.

The ESG rating ranges from ESG1 to ESG4 and represents Mercer's view on the extent to which ESG and stewardship practices are integrated into the investment manager's strategy. An ESG1 rating reflects an investment strategy that actively incorporates ESG factors and active ownership into the decision-making process. An ESG4 rating suggests little to no action by the portfolio manager to integrate such factors (see figures on next page for more detail). Below we provide general guidance on what the different ESG ratings represent for active and passive strategies.



Overview of Mercer ESG ratings

ESG ratings are undertaken by Mercer’s global manager research team. They are on a scale from 1 (highest) to 4 (lowest) and assess how well managers integrate ESG factors into investment processes.

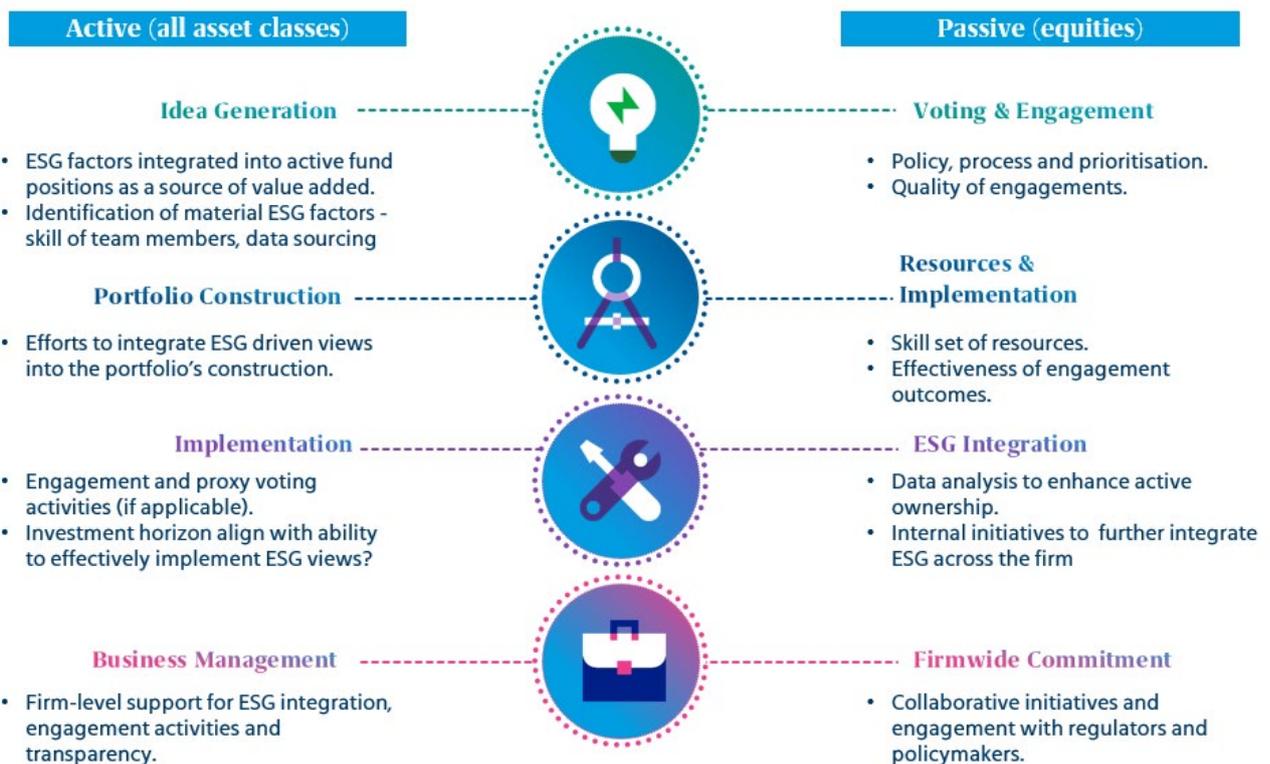
Active	ESG1	ESG2	ESG3	ESG4
	Leading approach to integration, where ESG is embedded in investment philosophy ; strong on stewardship which is a core part of process	Consistent and repeatable process to ESG integration (focus on risk management); well-developed evidence of stewardship.	Well-developed G integration; less consistency in E&S stewardship process is ad hoc, but indications of progress.	Little or no integration of ESG factors or stewardship into core processes and no indication of future change.

Ratings for passive equity strategies differentiate how well firms undertake their stewardship activities such as voting, engagement, industry collaboration and reporting.

Passive	ESGp1	ESGp2	ESGp3	ESGp4
	Leaders in V&E across ESG ; stewardship activities and ESG initiatives undertaken consistently at a global level; clear link between engagement & voting actions	Strong approach to V&E across ESG topics, and initiatives at a regional level, with progress made at a global level; working towards clearer links between V & E	Focus of V&E tends to be on governance topics only , or more regionally focused with less evidence of E&S (in voting & engagement, as well as other internal ESG initiatives)	Little or no initiatives taken on developing a global V&E capability, reactive engagements; and little progress made on other ESG initiatives

ESG ratings are derived from assessment criteria that vary according to asset class and are relative to what Mercer believes is best practice ESG integration. This assessment typically follows the overall manager research approach to investment ratings, with a focus on four key factors that derive the overall view and rating for a strategy. We lay out the four factors for active and passive strategies below.

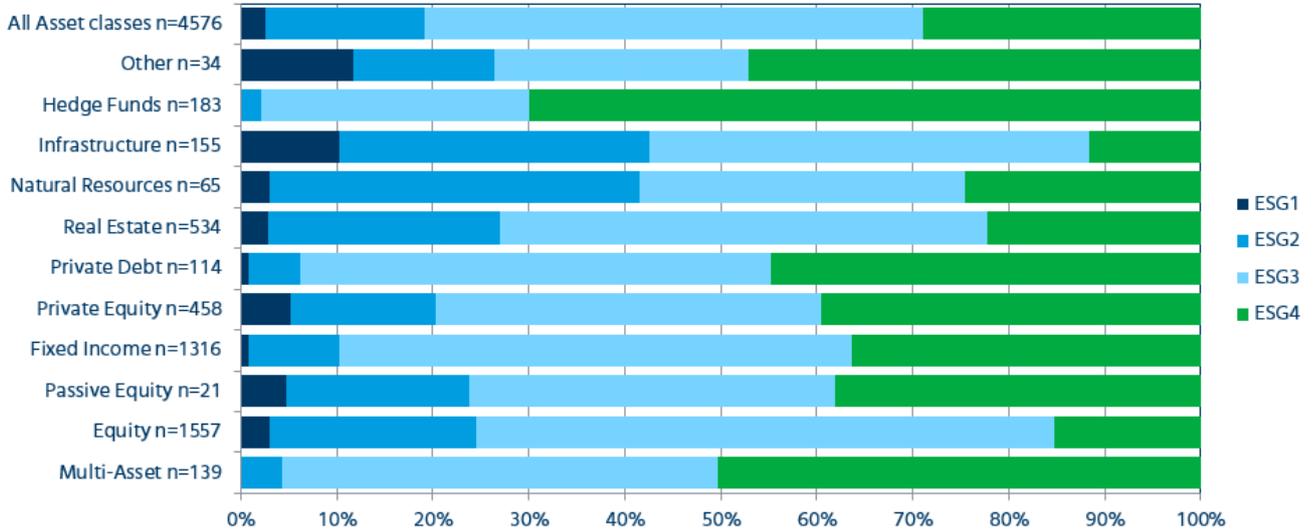
Mercer ESG Ratings: the four factors



The following chart illustrates the current state of ESG ratings distributions by asset class across more than 4,500+ strategies. Approximately 19% of strategies achieve an ESG1 or ESG2 rating. Some asset classes, such as infrastructure and property, have a higher proportion of highly rated ESG strategies than others, such as fixed income or hedge funds.

Mercer’s ESG ratings distribution across Asset Classes

Distribution of 4,500+ Mercer ESG ratings*



- Over 4,500 strategies rated currently – ratings began in 2008
- Approximately 19% achieve an ESG1 or ESG2 rating
- ESG ratings for passive equity introduced in 2014

Source: Mercer. Notes: ESGp ratings for passive equity are applied at manager level and are not included in the total strategy count. ESG ratings on sub-advised strategies are also excluded from the total to avoid double counting. All “Other” predominantly includes multi-asset strategies. Analysis as at March 2020

The figure below summarises Mercer’s view on the current state of ESG integration as reflected by Mercer’s ESG ratings across mainstream strategies and the range of sustainability-themed investment strategies available.

ESG Integration and the Availability of Sustainability Themed Strategies by Asset Class

	Manager Progress on ESG Integration*	Availability of Sustainability Themed Strategies **
Public Equity (Active)	Medium/High	Low/Medium
Fixed Income	Low/Medium	Low
Real Estate	Medium/High	Low
Private Equity and Debt	Medium	Low/Medium
Infrastructure	High	Medium/High
Natural Resources***	Medium	Medium / High
Hedge Funds	Low	Low

Source: Mercer. Note: Low: <5%; Low/Medium: 5-10%; Medium: 11-20%; Medium/High: 21-40%; High: >40% (As at December 2018). *Refers to the percent distribution of ESG1 and 2 rated strategies in GIMD, where available. **Refers to the percent distribution of sustainability themed strategies compared to mainstream by asset class – noting equities is a large universe so the low relative number is not actually a low absolute number. ***Conservative view - research updates in this asset class may result in a more favourable view than is currently held.

Opportunities to deepen sustainability within asset classes

Leading UK investors interviewed for this project highlighted both the importance of three areas to the development of portfolio-wide sustainable approaches as well as barriers to investing in each of these. Therefore, we provide more information on the state of ESG integration and opportunities for fixed income, real assets and low-carbon indices below.

Sustainable listed equity, private equity and private debt

Sustainable listed equity, private equity and private debt all came up as part of our interviews.

Listed and private equity both offer sophisticated sustainable strategies focused on climate change solutions and broader environmental and social opportunities.

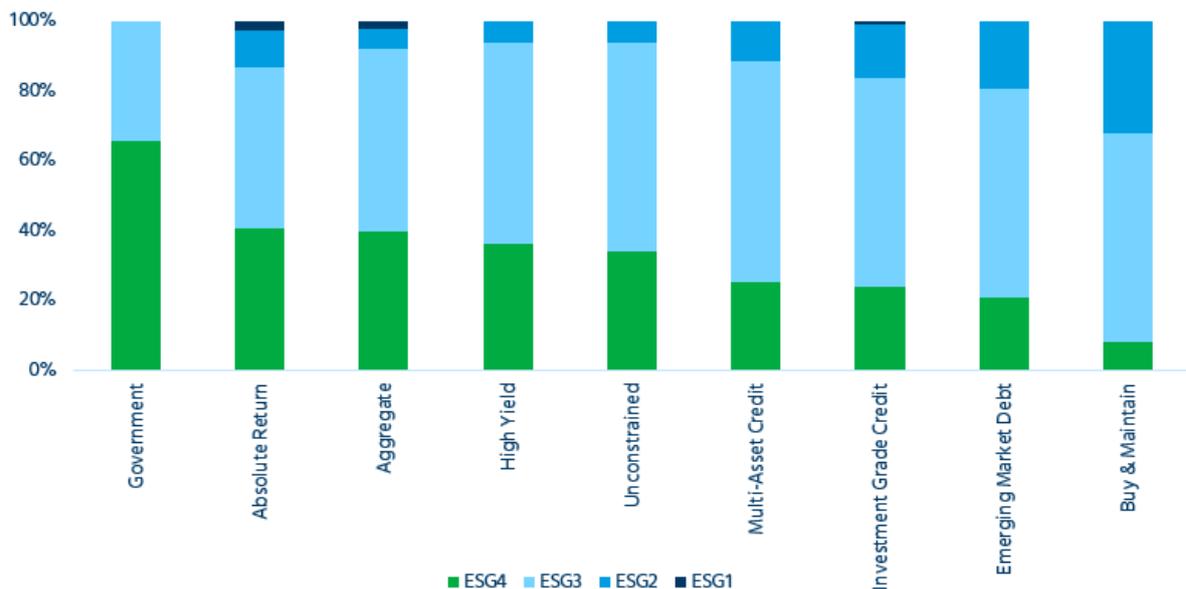
At the same time, there is a small but growing number of private debt funds focused on financing the low-carbon transition. Some offer niche strategies providing capital specifically for the low-carbon energy transition. A number of these funds are based in France.

Providing more detail on these allocation is beyond the scope of this paper, but may well be areas for further exploration by the Forum.

Unrealised potential in fixed income

Fixed income is typically a significant proportion of most long-term institutional investor portfolios, particularly for insurers and pension funds looking to better match their liabilities. However, historically, ESG integration in fixed income has lagged other asset classes such as listed equity. However, fixed income strategies are playing catch-up on ESG integration. Below we show the ESG ratings across sub-asset classes.

ESG across sub-asset classes as at 1 December 2019



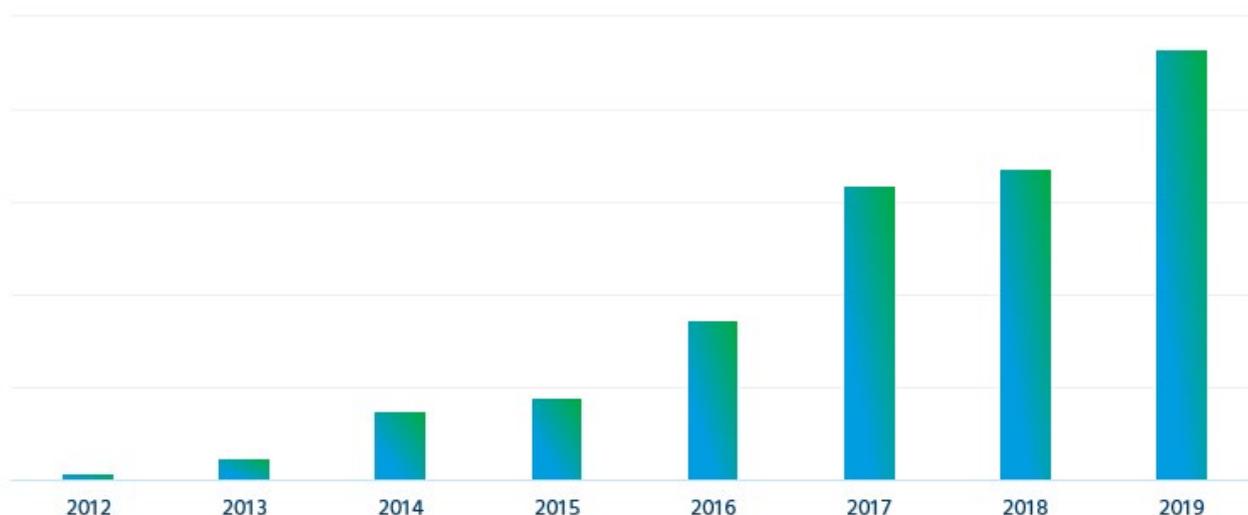
Source: MercerInsight. Information on the aggregation methodology can be found in Mercer’s report on *Responsible Investment in Fixed Income*. All data as of December 1 2019.

These considerations are important as incorporating financially material ESG issues can complement and reinforce the credit rating process. Fundamental credit research is used to assess the fundamental creditworthiness of bond issuers. Therefore, seeking to understand how material ESG factors might influence the willingness and ability for issuers to pay what they owe can add significant value and minimise downside risk. Supply chain management, labour relations and environmental risks are all ESG issues that could impair an issuer’s ability to repay its debt.

Fixed income strategies, such as buy and maintain credit mandates, often show the highest degree of ESG integration. These have long time horizons that makes it more likely for different ESG theses and risks to play out, and, by extension, it forces the manager to consider how ESG risks might materialise over the duration of the investment.

Fixed income has also lagged other asset classes in terms of access to sustainability themes. The most well known of these sub-sectors is the green bond universe. The difference between green bonds and more traditional bonds lies in how the proceeds of the bond issue are used and what project this ultimately funds. There are many types of projects, such as those related to clean water and renewable energy or those that mitigate the impact of climate change. The figure below shows the rapid growth in this market in recent years.^{iv}

Green Bond Issuance (in USD bn)



Source: Climate Bonds Initiative and BNPP AM Sustainability Centre

Accelerating sustainable real assets

Sustainability is intuitively linked to risk/return drivers and opportunities in infrastructure (for example, environmental and community impact) and property (for example, energy efficiency of buildings).

In the case of infrastructure, the obvious thematic opportunity is through clean energy generation renewables, but assets providing waste recycling and energy efficiency grid solutions and broader social infrastructure projects (rail and better public health systems) offer other sustainable ways, among others, to invest in this asset class. In terms of property funds, there are a number focused on sustainable opportunities, such as highly energy efficient buildings and social housing.

Investing in real assets (infrastructure and property), which directly finance the “real economy”, can provide a meaningful contribution to mitigating climate change. Investors should consider the risks

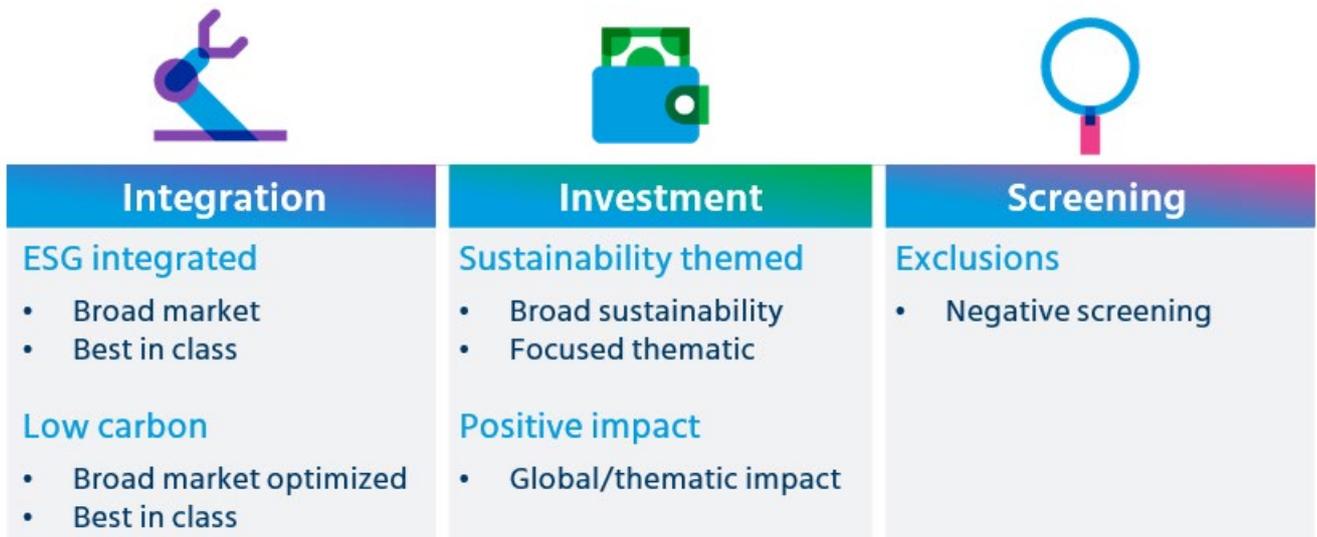
and opportunities in terms of the low-carbon transition and physical impacts when making investments in sustainable real assets. This includes appointing and working with investment managers who integrate ESG into their investment process and engage meaningfully on decarbonisation of assets (for example, decarbonisation of coal power plants).

Some investors are paying particular attention to physical impacts when making investments in sustainable real assets. This might assess how vulnerable their assets are to natural catastrophes such as flooding on a forward-looking basis.

Driving the transition through low-carbon indices

The ever-rising focus of the investment industry on sustainability issues combined with the shift to low-cost index tracking options has led investors to increasingly implement their responsible investment beliefs via enhanced equity indices. As investor interest continues to grow, index providers are developing more responsible investment solutions to address the greater level of demand.

Investors to date have primarily used RI indices as a low-cost investment to reflect their RI beliefs. The opportunity set for responsible investment indices can be grouped into three main categories as shown in the diagram below:



Low-carbon indices, which fall under the integration category and were highlighted numerous times as part of the interviews, aim to reduce exposure to carbon emissions and fossil fuel reserves relative to a market cap index through various construction methodologies. Innovation has been rapid over the past few years, as the range of indices has evolved to incorporate more forward-looking aspects of both decarbonisation pathways and green revenue opportunities into the methodology. More recently, fossil fuels and coal are increasingly being excluded from indices as investors come under increasing pressure from divestment campaigns.

In our view, these indices are now on their third generation. The first generation sought reduced exposure to carbon emissions and fossil fuel reserves. The second aimed to increase exposure to green revenues while also targeting lower exposure to carbon. The third and current generation seeks a more sophisticated approach by overweighting companies best positioned for the low-carbon transition using a range of forward looking methodologies.

Although we believe low-carbon indices can be useful in hedging carbon risks for a wide range of investors, in our view, accessing low-carbon opportunities is, at times, best reflected through an active management approach.^v



3

Insights from asset owners

In this section, we draw out insights and best practice findings from our interviews with leading UK and China asset owners. We summarise the key findings on ESG best practice below:

- **Clear beliefs on ESG and its financial materiality underpin the overall approach to ESG.** ESG leaders work to develop a clear set of beliefs underpinning their investment strategy and practices. While no two asset owners held the exact same beliefs, there was shared conviction in the link between ESG, long-term returns and fiduciary duty, and the importance of climate change as a systemic risk.
- **Transparent policies and processes help embed ESG throughout the investment process.** Thoughtful policies that articulate clear goals and objectives, and are supported by effective processes to ensure the implementation of sustainable approaches throughout the investment process, lead to improvements over time. Two areas stand out:
 - Investors place strong emphasis on ESG capabilities as part of the manager selection process and ongoing monitoring.
 - Policies and processes rely on accurate data and disclosures so asset owners are proactively seeking out quality data and even creating their own tools where they do not exist.
- **Leaders take a “whole of portfolio” approach and collaborate with asset managers to create the products they need.** Asset owners are constantly exploring how deeply and widely they can express their sustainability ambitions across different asset classes and strategies. This holds true for parts of the portfolio where ESG is more developed, such as listed equities and real assets. For asset classes such as fixed income, where market practice, scale and opportunities all currently present barriers, asset owners are driving innovation by working with managers to create products and strategies that meet their evolving needs.

Beliefs

Asset owners need to develop and articulate a set of ESG beliefs specific to them to lay a foundation and ultimately guide their ESG practices, products and investment strategies.

Market participants should develop and articulate their unique ESG beliefs, with climate change deserving a special focus

Our interviews found leading asset owners explore, formulate and articulate their ESG investment beliefs and philosophy, refreshing them periodically as the pace of change accelerates. This is most effective when these initiatives are driven by senior leaders, reflect the overall values and purpose of the organisation and take into account key stakeholders, including the ultimate beneficiaries. Given the breadth and depth of ESG issues, no two investors have exactly the same beliefs.

In terms of being aspirational, investors are increasingly framing their beliefs to reflect the type of world they want their beneficiaries, clients and society to enjoy in the future. RI leaders are positioning themselves as “future makers” and are asking themselves what their responsibilities are as universal asset owners.

Despite a range of philosophies and views, all UK interviewees had deeply held beliefs on the importance of ESG with respect to long-term returns and fiduciary duty, and the importance of climate change as a systemic risk. ESG integration, stewardship and thematic investments were seen as universally important approaches, contributing to risk management and helping capture opportunities (or alpha). However, there were divergent views on the approach to screening, with this being an investor-specific consideration.

Asset owners benefit from being clear on where their ESG considerations are predominantly driven by risk and/or opportunities (or alpha). This helps in investment decision-making, including where specific approaches are deployed by asset class and strategy.



Climate change is an existential threat to our economy.

Thought leaders clearly identify systemic risks and megatrends, such as climate change, with beliefs articulated in relation to the most pressing and material ones. In terms of climate change, investors are increasingly articulating their view on the need to limit global warming to well below 2⁰C relative to pre-industrial levels in line with the Paris Agreement and are seeking to adopt net zero emissions targets for their overall portfolio.

Clearly, the sponsor can play a key role in driving beliefs and ambition. It is no coincidence that EAPF, with the Environment Agency as its sponsor, has such a developed approach to climate change and the environment more generally. Cultural and religious issues can also be important in informing beliefs, such as the Christian and ethical values that underpin CEPB's investments.

In China, ESG beliefs are less well developed, with many asset owners focusing on education and exploring the effectiveness of different ESG approaches. For those that have ESG beliefs, they are typically focused on risk management and, by extension, avoiding the losers. In situations where ESG is seen as an investment opportunity, it is typically thematic — for example, renewable energy.

Beliefs inform approaches



ESG philosophy and beliefs need to drive internal ESG functions and strategies.

The link between beliefs and approaches is particularly evident in the UK market.

While EAPF focuses on delivering their climate change beliefs through the use of environmental and climate change-focused investment strategies, the CEPB also focuses on exclusions for investments deemed to be inconsistent with their Christian and ethical beliefs (e.g. gambling, pornography, tobacco).

One area that continues to generate significant debate in the UK is discussion on exclusions versus engagement. Much of this has been driven by fossil fuel exposure and demands that investors go “fossil free”. While all asset owners believed deeply in the merits of engagement, some were more willing to also include explicit exclusions. Others felt they could better influence outcomes by remaining invested and engaging the companies in question. Interestingly, while all investors were willing to engage on climate change, there is a perceptible hardening of stance, with many exploring how to escalate their engagement activities with companies over the medium term where they are simply not willing to change their behaviour. In China, exclusion is much more common because it’s easier than engagement, even though engagement could be more effective.

Government regulation is forcing a rethink on beliefs

Asset owners in the UK and China are revisiting their beliefs in response to the shifting macroeconomic environment and, in particular, the role of governments in trying to green their economies and finance sectors. In China, the government focus on cultivating a green finance sector is driving government asset owners to create demand for green investments — in particular, within infrastructure and sustainable energy. In the UK, regulations brought in over 2019 focused on pension scheme policy disclosures, which are driving a growing set of investors with less developed approaches to revisit (or consider for the first time) their ESG and climate change beliefs.

Policies

Policies capture and formalise beliefs, making them tangible. They document the approach to ESG.

ESG policies should capture beliefs, outline the approach to responsible investment and be underpinned by specific detail on areas of particular focus and importance

Our interviews found leading asset owners benefit by having meaningful, comprehensive and clearly written ESG policies. These incorporate investment beliefs and provide a framework for understanding the organisation’s approach to implementing and monitoring ESG practices.

Some investors have a single central policy while others, as they identify key themes, find it useful to have separate policies covering different areas. Between them, asset owners interviewed for this project had standalone policies for responsible investment, stewardship, voting, climate change and ethical investment.

All of the UK asset owners had detailed stewardship policies. This is in no small part due to the success and adoption of the UK Stewardship Code. Those interviewed paid close attention to whether their stewardship policies aligned with those of the manager.

A number of leading UK asset owners are exploring what it means to have an investment portfolio aligned with the Paris Agreement. In the case of EAPF, its sponsor, the Environment Agency, recently set itself the decarbonisation objective of becoming Net Zero by 2030, 20 years earlier than the government target for the UK. This market leadership by the sponsor reinforces the policy approach of the investor.

While a small number of Chinese investors have ESG policies, the interviews found that many were currently spending time educating themselves about ESG issues before developing their policy approach. In China, the policy focus is on underpinning the growing ESG ambition at a government and market-wide level. The majority of Chinese interviewees cited that they are currently developing in-house policies. Some are developing business plans for 2020 that incorporate ESG issues.

Underpin policies with specific measurable goals

Leading RI investors have specific measurable goals and targets against which they can measure progress. These may include metrics in relation to:

- Portfolio decarbonisation and fossil fuel exposure
- ESG ratings
- Sustainable allocations and green revenues
- Stewardship activities and outcomes
- Exposures to controversial areas such as controversial weapons, alcohol, pornography, gambling and tobacco

Demonstrating progress against these goals is an important way to ensure accountability to a wide range of stakeholders.

Reinforce policies by supporting key initiatives and frameworks

Leading investors support a range of initiatives and frameworks promoting ESG best practice such as UN PRI, TCFD and local stewardship codes. They are active in joining collaborative engagement-focused initiatives, such as Climate Action 100+, where these align with their priorities.

While leading investors in the UK participate in a wide range of initiative and frameworks, in China the initial focus remains on TCFD and UN PRI. In addition to being a signatory to UN PRI and adopting TCFD recommendations, Ping An became the first Chinese signatory to Climate Action 100+ in January 2020.



Benefits of adopting the recommendations of the TCFD

One framework that came up time and again in our asset owner interviews was TCFD. There was universal agreement from the UK asset owners that TCFD provides a useful framework to govern, think about and drive actions in relation to managing climate change risks. It does this by framing climate change in two ways: the transition to a low-carbon economy and the physical risks presented by climate change. As a result of adopting the recommendations, assets owners are:

- Undertaking scenario analysis to consider the investment implications of different climate change scenarios and are stress-testing their portfolios.
- Focusing on key metrics, such as carbon footprinting, to understand and manage their exposures and risks.
- Better able to prioritise engagement focused on high-quality and timely climate change data disclosure from investment managers and holding companies.

The diagram below captures how the four pillars and recommendations fit within the context of Mercer’s Pathway to Responsible Investment.

Category	TCFD Recommendations			
Governance	Who has oversight of climate change-related risks and disclosures (board / management)?	1		Beliefs
	Is this documented ?	2		Policy
Strategy	Have you considered climate change- related risks and opportunities for investment strategy ?	3		Process
	Different climate change scenarios ?			
Risk Management	Have you established risk assessment and reduction processes , including engagement with managers and low carbon allocations?	4		Portfolio
Metrics & Targets	Have you assessed your portfolio carbon emissions (e.g. carbon footprinting) and considered targets for improvements?	4		Portfolio

Source: TCFD 2017

One of the suggestions from the interviews was that, as a first step, investment managers in China should consider adopting TCFD recommendations or developing their own version, if this was more appropriate.

It is important for investors to maintain pace with disclosure developments in such a rapidly evolving area, and investors should contribute to refining the current recommendations of the TCFD as they evolve. Investors should consider credible transition plans for their own portfolios and underlying investee companies, as well as considering setting net zero targets and portfolio alignment to the aims of the Paris Agreement.

Making policies publicly available signals a commitment to transparency and keeps stakeholders, including beneficiaries, informed

Transparency is incredibly important. Making policies publicly available is critical for sharing best practice, maintaining accountability and ensuring beneficiaries understand the approach their pension scheme, for example, is taking on their behalf. Engaging members, for example, through focus groups on the pension scheme's approaches to responsible investment is a growing area of attention for a number of those interviewed. Initial focus groups had shown strong demand from members in this regard.

Processes

For policies to be implemented, they require effective processes.

ESG should be embedded within all relevant investment processes — from beliefs and policy setting, to due diligence and manager selection, to monitoring and evaluation

Leading investors adopt firm-wide processes to embed ESG practices throughout the investment portfolio. These should be consistent with policy goals and targets, and should be underpinned by an appropriate monitoring framework to ensure they are being effectively implemented.

Those interviewed in the UK highlighted the need to integrate ESG within due diligence and manager selection, stewardship, and monitoring and evaluation processes.

Selecting managers

Asset owners in China and the UK are incorporating ESG considerations into their manager selection exercises. Firm-wide commitment to ESG, often partly signalled through being a signatory to UN PRI and having adopted TCFD recommendations, is an important part of the process. However, for pioneers within the UK, these are minimum requirements, with due diligence often extending to an in-depth assessment of how effectively ESG integration and active ownership are embedded within the investment process and whether the managers ESG philosophy aligns with the asset owner.

We see this as an area for future collaboration for the Forum.

Working with managers to improve over time

Ongoing manager monitoring and evaluation is a particularly important part of the investment process from an asset owner perspective to ensure that investment managers are effectively incorporating ESG considerations.

In the UK, asset owners show flexibility in their approach depending on how well ESG is integrated into different asset classes and strategies. For asset classes where it is well developed, asset owners

appoint asset managers that can demonstrate that ESG is “part of their DNA”. Whereas in asset classes where ESG is generally lagging, they often display flexibility to work with the manager to develop their capabilities over time, where there is the ability and willingness to do so.

It is okay for managers not to be perfect on ESG, provided they are willing to improve and have the capability to get there.

Leading investors often commit to quarterly or annual reviews and reporting cycles as appropriate for the areas under consideration. They then work with their investment managers to drive progress.

One area of agreement is the need for asset owners to understand their investment managers well and create synergistic relationships in order to achieve ESG objectives. All UK asset owners interviewed focus significant efforts on this. After appointing an investment manager, asset owners seek to develop a strong relationship with them, ensuring that they both understand one another’s approach. This is mutually beneficial and helps drive meaningful progress against objectives such as portfolio decarbonisation. This partnership requires asset owners to keep asset managers accountable in meeting objectives, and may require the education of asset managers in key areas of asset owner beliefs. For example, one interviewee educates managers on their climate change approach. Asset owners may also have specific requirements for managers to comply with. This may include that they report in line with TCFD, are signatories to UN PRI, the UK Stewardship Code, and are encouraged to be active members of wider initiatives such as Climate Action 100+, or TPI.

In China, government-owned asset owners are engaging with asset managers on ESG as part of the manager selection processes. One government-owned asset owner referred to the role of ESG in Investment Management Agreements, in particular for engaging international asset managers, with a focus on child labour in the supply chain and employee rights as key issues of concern.

Stewardship plays a central role in preserving and enhancing long-term value for asset owners

For UK asset owners, stewardship is an incredibly important area of focus. From our interviews, we found investors monitor their managers to ensure they are voting where they are able to, and voting in a thoughtful way and engaging meaningfully to ensure that companies are being held to account.

In the UK, leading asset owners are signatories to the UK Stewardship Code, which seeks to promote the quality of engagement between investors and companies to help improve long-term risk-adjusted returns. Active asset owners are often involved in:

- Closely monitoring asset managers’ voting and engagement activity
- Using a third-party voting and engagement service to meet their needs
- Holding their asset managers to account on their engagement activity in relation to various themes, including executive pay, climate change and diversity, among others.
- Drafting and co-filing resolutions

- Attending annual general meetings (AGMs)
- Actively supporting initiatives/organisations which support better, higher-quality disclosure standards

Those interviewed in China noted stewardship activities remain relatively nascent in the Chinese market, given low levels of shareholder involvement. The asset manager focus is primarily on the monitoring and evaluation of companies to meet fund objectives. However, there is evidence that Chinese asset owners are starting to increasingly focus on stewardship, with one interviewee citing the presence of internal policies on engagement and voting — and outsourcing these responsibilities to appointed managers, with the exception of large exposures where such stewardship activities are retained.

In China, stewardship is concentrated on governance issues, whereas in the UK efforts are also increasingly focused on social and environmental concerns, such as diversity and climate change.

Many UK asset owners identify specific themes or investor initiatives that link closely to their particular areas of focus. Examples included climate change, mining and tailings safety, plastics and diversity.

We provide more detail on two stewardship activities undertaken by EAPF and CEPB below:

Asset owner	Topic	Stewardship approach
EAPF	Climate Change	<p>EAPF is using its influence to shift the financial market response to climate change through:</p> <ul style="list-style-type: none"> — Actively supporting the organisations that focus on better, higher-quality disclosure standards — Adopting TCFD recommendations — Co-founding the TPI with CEPB — Engaging with company boards, asset managers, and actuaries on how they are responding to climate change, with an increasing focus on adaptation and resilience
CEPB	Investor Mining & Tailings Safety Initiative	<p>CEPB founded the Investor Mining & Tailings Safety Initiative, an investor-led engagement platform for improving mining safety through improved disclosure from mining companies.</p> <p>The CEPB has worked with others to launch this initiative, targeting approximately 700 companies on improved data disclosure. This will allow investors to work with mining companies to identify and improve risk management by reducing the risk of future disasters.</p>

Source: Interviews and background research

Underpinning effective ESG processes with strong data

Effective processes are dependent on the quality of underlying ESG data. Asset owners are using different metrics, such as carbon intensity, ESG scores, physical risk assessments for real assets, stewardship assessments and others to challenge their managers' views and interrogate their own portfolio from different angles.

One trend that emerges repeatedly is the need for better ESG data through increased disclosure and transparency. This holds true in relation to almost all aspects of ESG data, from climate change to impact investment, to voting and engagement reporting.

A number of the asset owners interviewed used ESG data from third-party providers to challenge their managers. For example, one interviewee requests that asset managers explain meaningful deviations between their proprietary ESG views and MSCI ESG ratings. Assessing managers in this way can help protect against “greenwashing”.

UK asset owners have been playing a central role in the development of ESG data where they perceive market data gaps to exist. For example, the Transition Pathway Initiative, co-founded by EAPF and CEPB, is an example of an innovative climate change methodology and tool. This allows investors to form a view on companies' preparedness for the transition to a low-carbon economy by assessing how well management are addressing climate change risks and the carbon performance of the company (i.e. whether it is on a 2°C or 4°C trajectory or somewhere in between). This tool is rapidly becoming an important climate benchmark for investors. Supporters are using the TPI tool in a range of ways, including informing investment research, engaging with companies and decarbonisation efforts. As explained later in this section, it has been used as the basis for a low-carbon index in which CEPB now invests.

In addition, UK asset owners highlighted that they are increasingly seeking new ways of measuring the exposure of their investments to the physical impacts of climate change, particularly in relation to real assets such as property and infrastructure. To date, much of the focus has been on risk mitigation with respect to the low-carbon transition.

Another example of this is work the CEPB has spearheaded on mining and tailings safety. As described earlier, it has founded the Investor

Mining & Tailings Safety Initiative, an investor-led engagement platform for improving mining safety through improved disclosure from mining companies to minimise the risk of a repeat of recent tailings mine disasters and help investors manage their risks in this area.

This proactivity remains important as all interviewees in the UK and Chinese markets cited problems with ESG data availability. In China, asset managers cited issues around insufficient data quality for social issues, in particular, and distrust of published data by companies. In China, those interviewed believe that regulation and international market demand are the underlying forces driving increased company ESG disclosures. Due to the lack of standardised disclosures at the present time, developing proprietary databases and analytical tools has come to the forefront. Some are resorting to technology to help them – for example, by considering how AI (artificial intelligence) can help them analyse individual company’s ESG credentials from public data.

Training and resources

To support these processes, appropriate incentive structures should be in place, ESG responsibilities should be written into job descriptions and ongoing education and training should be provided.

Sufficient resources and skill should support processes. Diversity of skillset, experience and background is a key differentiator between asset owners with a strong team and those without. The number of staff and their skillset dedicated to delivering the ESG vision must therefore be sufficient for the scope of the ESG beliefs and policies set out by the firm. UK asset owners make use of external expertise or committees where needed.

For the UK asset owners, ESG and climate change is often a standing point of discussion or training for trustee meetings. What is more, in both the UK and China significant effort is being put into ongoing education for in-house teams.

Going through the process of understanding ESG issues might be costly, but the cost of not doing anything might be higher.

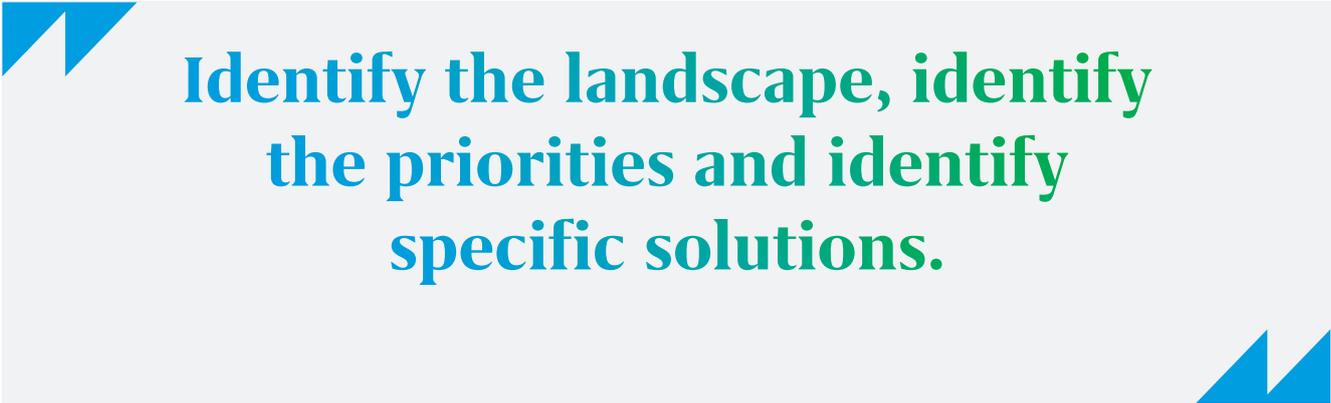
Where this is done well, members of the investment team and governing committees are able to articulate why ESG is financially material to the investment process and how it shapes the investment portfolio.

Portfolio considerations

Investors' portfolios should reflect their philosophy and beliefs, while being supported by their policies and processes.

Adopting a “whole of portfolio” approach

Leading asset owners are taking a “whole of portfolio” approach to the greatest extent possible, whether this be in terms of 1.5-2°C alignment or ensuring that ESG integration and sustainable allocations are reflected throughout strategies and across portfolios. EAPF is an example of a pension fund that, in addition to integrating ESG considerations throughout its portfolio, has set itself the ambitious target of having 33% of its assets in sustainable and low-carbon assets by 2025, with 17% of assets directly tackling climate change.



Identify the landscape, identify the priorities and identify specific solutions.

Product creation through partnership and the value of cross-border collaboration

The interviews highlighted the importance of asset owners collaborating with investment managers and other investors to create products to meet their needs where suitable products don't already exist. As part of this mindset, some leading investors look to support emerging managers and nascent sustainable strategies where they align with their objectives.

EAPF and CEPB both have histories in developing sustainable products. Both have helped design and seed separate low-carbon equity indices in collaboration with index providers and managers. Most recently, CEPB helped design and seed the FTSE TPI Climate Transition Index. The index uses the Transition Pathway Initiative methodology to overweight companies that are aligned with the Paris Agreement goals at the expense of those that are not. Investors see low-carbon indices as important tools for achieving Paris Agreement-aligned portfolios.

By increasing cross-border collaboration and investment between the UK and China, investors from both countries will be able to benefit from this innovation.

ESG practices are further developed within listed equity, property and infrastructure, but there is still some way to go for fixed income

Asset owners recognise that different asset classes such as listed equities and real assets are further progressed in terms of ESG integration and thematic opportunities, and they push investment managers for ever more best practice. Likewise, they often partner closely with investment managers when they are investing in asset classes such as fixed income, where the approach to ESG integration in general and the availability of opportunities are less well developed.

In terms of indices more generally, our interviews highlighted that more needed to be done to shift the focus away from traditional market cap global equity benchmarks to sustainable alternatives. One interviewee in particular noted that by removing the constraints of investing to a mainstream benchmark, they were better able to invest in a long-term sustainable manner.

Fixed income is a growing area of focus both from an ESG integration perspective as well as through increased allocations to green and/or sustainable bonds. For example, one interviewee is currently working with its consultants and appointed managers on developing a sustainable multi-asset credit product, while others were focused on improving ESG integration and accessing thematic opportunities within private debt and loans. Another UK asset owner noted that while credit has lagged behind, the market is catching up quickly, particularly in Europe.

While there is growing demand for green bonds, none of those interviewed felt the universe was sufficiently developed to have a dedicated allocation to this opportunity. Instead, investment managers were encouraged to consider their inclusion in various relevant mandates. This includes corporate bonds, buy and maintain, and multi-asset credit where they meet the existing investment criteria, and communicating exposure to these opportunities as part of ongoing reporting.



**Sustainability is best captured
through active management.**

As part of our interviews, we also identified strong asset owner demand for sustainable real assets and private equity strategies. The ability to invest in the real economy and to generate positive social and environmental impacts were important drivers behind this demand. When viewed through a climate-change lens, investments in infrastructure were expected to play an important role in both mitigating climate change and adopting to the physical impacts as well. This has important implications for the investments in the Belt and Road Initiative.

Given the level of impact one can have in private markets – where you might be the difference between sufficient and insufficient investment – one can have a stronger influence on companies' ESG impact.

In China, the interviews highlighted an increasing focus on thematic investments, in particular to meet government demand for investments in infrastructure and clean energy.

In terms of other countries, those interviewed felt that Dutch and Nordic investors were at the forefront on ESG exclusions and had best-in-class/positive tilting approaches. While French investors, by comparison, were creating demand for fully rounded ESG propositions covering ESG risks and opportunities, including climate change. This was in large part driven by government regulations. This has led to the situation where Aviva Investors is currently developing a range of socially responsible investment (SRI) Funds for the French market. As an example of innovation, there also to be a growing number of energy transition-focused funds being launched in France. These countries offer lessons for the UK and China.

Short-termism, scale and greenwashing represent barriers

A long-time horizon should pervade everything.

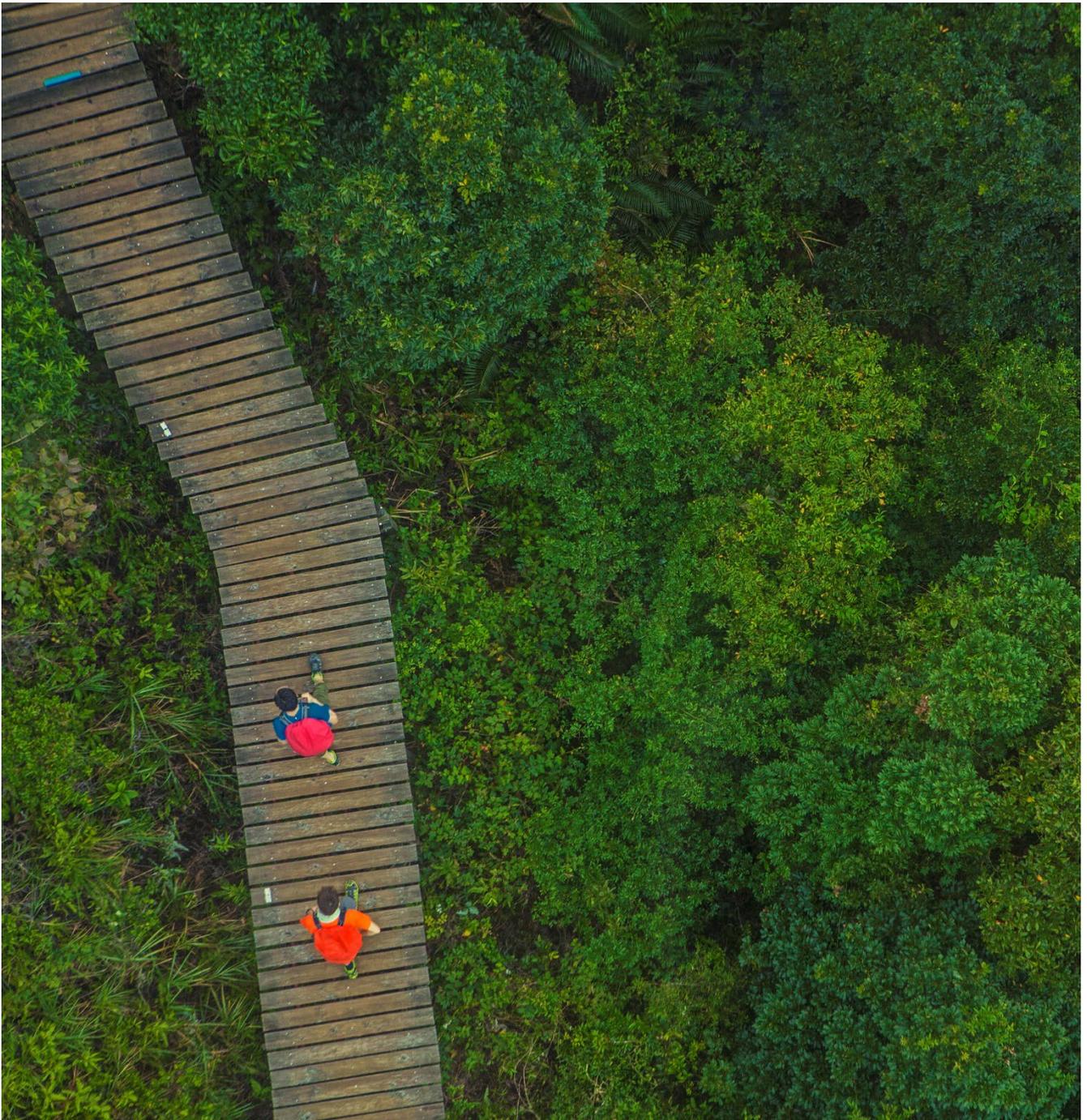
Despite the demand for sustainable products and solutions, the interviews highlighted a number of barriers to sustainable investment.

One UK interviewee noted that short-termism still represented a problem, and this appeared to mirror the view of most Chinese investors. Asset owners and asset managers are overly focused on short-term returns at the expense of long-term sustainable outcomes. This presented opportunities for sustainable investment managers, but it was also driving destructive market behaviour by companies.

The retail-driven nature of the Chinese asset management market means that short-termism might be here for some time, and the prevailing view was that it was down to institutional asset owners to drive the change to long-term thinking.

Other issues related to scale. Green bonds markets were lacking in depth, while sustainable real asset opportunities are insufficient to meet wider market demand. Where larger asset owners are looking to invest in opportunities, the scale may not exist. One asset manager cited their desire to invest in sustainable forestry, but their size meant the scale of the opportunity prevented them from investing.

Greenwashing, as demonstrated by managers calling strategies sustainable when they are not, was also a common concern. An example of this was the renaming of core strategies to sustainable variants, with little meaningful change to the process.



4

Insights from asset managers

In this section, we draw out insights and best practice findings from interviews with leading UK and China asset managers undertaken as part of this project. We summarise the key findings on ESG best practice below:

- **ESG as a source of competitiveness.** UK asset managers now operate in a market where institutional (and retail) investors expect ESG as a matter of course. Businesses with senior leaders that drive best practice and offer truly sustainable products expect to have a competitive advantage over their peers. Interestingly, rather than seeing transparency as a threat to their business and intellectual capital, as some China interviews highlighted, managers operating in the UK welcomed the opportunity to showcase their policy approaches and stewardship activities, believing this to be advantageous.
- **Managers see ESG as a source of alpha and/or risk management that can improve idea generation and portfolio construction.** Leading managers have developed their own proprietary approaches to ESG ratings and integration across asset classes and strategies. These offer insights that can be used to better manage risks in fixed income and help capture opportunities in listed equities and real assets.
- **Stewardship is key to preserving and enhancing value.** Our interviews consistently highlighted the importance of taking a long-term approach to being stewards of capital, choosing to exercise voting, engagement and other ownership rights.

Differentiation through idea generation and portfolio construction

In our experience, one way to clearly differentiate managers' approaches to ESG is to better understand how they incorporate ESG into idea generation and portfolio construction. Our interviews offered insight in this regard. In terms of idea generation, investors should focus on how the manager identifies ESG risks and opportunities at the portfolio level; how ideas are sourced; how the materiality is determined and incorporated into financial analysis. When exploring portfolio construction, we seek to better understand how effectively the portfolio manager translates ESG views into active positions in the portfolio.

Investment managers should embed ESG into the investment philosophy of their funds

Both UK managers interviewed for this project had spent significant amounts of time and resources in developing their approaches to ESG integration. Leading asset managers embed ESG into the investment philosophy of their funds. They have the conviction that ESG integration improves idea generation and portfolio construction, which ultimately leads to better long-term risk-adjusted returns. ESG cannot be an afterthought. Nor can it take an "off the shelf" approach.

Managers have unique approaches underpinned by proprietary ESG approaches and ratings

Both managers had developed their own proprietary approaches; a number of Chinese asset managers we interviewed had as well. None of these relied on a single third-party ESG data provider. Instead, the

The ESG team at Aviva Investors has developed an ESG heatmap incorporating a variety of ESG data points and including their own proprietary ESG score (ESG Elements*, formerly known as AHA). All managers of active liquid strategies are expected to integrate these ratings in to their strategies where relevant.

Example Aviva Investors ESG heatmap

	Company A	Company B
Average Final Voting Score	F	D
Latest Voting Score	F	D
Governance Rating Global	C	B
Governance Rating Home	C	B
ESG Rating	A	BBB
Controversies Overall Flag	Green	Yellow
Accounting Governance Risk Rating	B	C
Carbon emissions exposure	5.9	5
Carbon emissions management	5.7	5.8
Water stress exposure	3.9	3.5
Water management	3.4	1.4
AHA score	6.38	6.03

Source: Aviva Investors. As of 1 May 2020 Aviva Investors has upgraded and rebranded the AHA score to the ESG Elements score. The score harnesses underlying ESG data provided by MSCI, from which its in-house data scientists have identified the environmental, social and governance factors that have the most influence over the financial market performance of individual industry sectors. It also includes numeric representations for its voting activities.

The managers' approaches to ESG ratings were adapted for different strategies and asset classes depending on materiality.

There is more consensus on ESG's role in risk management than in alpha generation

Managers agreed ESG plays a crucial role in risk management and alpha (outperformance) generation; although there was consensus that the approach to risk management was better developed. While some strategies focus on risk management over alpha, others incorporate both. For example, in fixed income, risk management is often the key focus, whereas in listed equities and real assets, there are more opportunities to generate outperformance. This may be through investing in companies offering

sustainable products or services, or investing in those companies more operationally efficient from an ESG perspective. Leading portfolio managers are acutely aware of ESG risks as well as opportunities within the companies they hold in their portfolio.

The role of ESG in alpha generation is an area of continuing interest for investment managers. We found Chinese asset managers were particularly focused on this question. One UK manager's in-house model found outperformance for listed equities with above-average ESG ratings over three-, five- and seven-year time horizons. The investment manager aims to expand this analysis to include credit. An ESG "lens" also reveals inefficiencies that active managers can exploit. Examples provided include different investment horizons leading to inefficiencies, as well as mispricing of market failures.

LGIM's ESG ratings applied to their passive funds were more focused on beta or risk management. The LGIM Future World strategies integrate ESG considerations through tilting, with an emphasis on climate change considerations. However, they also offered a number of sustainable thematic funds for investors wanting to access opportunities across artificial intelligence, healthcare and clean water.

UK and Chinese asset owners and investment managers alike, along with other market participants, are continuing to explore the relationship between ESG and alpha. One Chinese participant interviewed is dedicating resources to assess the impact of ESG integration on returns. From the UK perspective, more work needs to be undertaken to understand how to disentangle ESG impacts from other factors. Interviewees noted the focus should be on narrowing the universe of explanatory factors to demonstrate causality.

Developing sustainable products in collaboration with investors

Leading investment managers recognise the best sustainable solutions are often developed in collaboration with asset owners. Both managers have demonstrated this in the past. Aviva Investors has resources dedicated to developing new products. We provide examples of collaborative product creation in Section 3, under the heading "Portfolio".

Implementation — stewardship with a long time horizon

Stewardship, or active ownership, is a critical part of the investment process for those managers committed to positively influencing companies and markets over the long term.

Transparent voting policies with a clear link to engagement and outcomes-focused reporting

Our interviews found policies should be clear and transparent, with the resources, expertise and systems in place to ensure these activities are implemented effectively. Managers should make policies and reporting publicly available.

Through their reporting, leaders demonstrate a clear link between voting policies, voting activities and engagement outcomes. Reporting is incredibly important in communicating the effectiveness of stewardship activities to clients. Reporting should explain stewardship priorities, contain voting records and provide case studies on engagement activity. In line with the 2020 UK Stewardship code, an increasing focus on "outcomes" and reporting is playing a key role in demonstrating how, for example, engagement activities have been escalated to achieve success.

Prioritising active ownership activities, ensuring they cover “E” + “S” as well as “G” and consider wider stakeholders

Voting policies should proactively address environmental and social issues rather than focusing solely on governance issues. As part of this, proprietary ESG scores and key themes help managers prioritise their engagement activity.

More generally, UK managers are evolving their approach from one that focuses exclusively on shareholders to one that incorporates broader stakeholder interests. LGIM and Aviva Investors recognise that investments do not operate in a moral vacuum and that investment managers and companies in their portfolio that ignore wider stakeholder needs will eventually see the consequences spill over onto their balance sheet. Chinese asset managers were increasingly adopting similar views.

Adopting a long time horizon, harnessing the power of collaboration and escalating engagement

Adopting a long time horizon is important for creating sustainable investment returns over the long term. As investors lengthen their investment period, they can develop relationships and more effectively work with companies to improve their practices and hold them to account.

Collaboration is key to success. Aviva Investors and LGIM have considerable assets under management, but they recognise the importance of pooling their influence and working with other investors and stakeholders to bring about change. LGIM’s involvement with the Institutional Investor Group on Climate Change (IIGCC) and Aviva Investors’ membership on the EU High-Level Expert Group on Sustainable Finance (HLEG) are two examples of this.

Managers should not be afraid to escalate their activity. For example, in recent years LGIM has started to vote against the reappointment of Chairs where they are not seeing sufficient diversity at the board level. For active strategies, the final step may be divesting from the company.

Engaging on three levels and beyond equities

Leaders engage on three levels: the company, industry and regulatory. Both managers offer a wide variety of strategies, including passive equity offerings, so it is right their focus should not stop at the company level but ensure that they use their influence more broadly to improve market-wide practice and policy.

Managers are keen to expand their engagement activities beyond just listed equities. As long-term providers of capital, managers use their influence to positively impact the companies they hold, regardless of whether or not they have a right to vote.

Passive investors can be active owners

Passive strategies can benefit from active ownership. Both managers offer passive equity offerings. Passive owners make up a large proportion of equity holdings and, by their nature, are long-term investors. These two aspects mean that passive managers can be very influential stewards. Reflecting this importance, Aviva Investors, despite delegating the management of their passive mandates to another manager, retains the right to vote.

There needs to be a clearly identifiable link between the engagement agenda and the voting policy and voting execution, with strong transparency.

We provide more detail on two stewardship initiatives undertaken by LGIM and Aviva Investors below:

Investment manager	Topic	Stewardship Approach
LGIM	Climate Change	<p>LGIM engages the world’s largest companies on climate change.</p> <p>LGIM’s Climate Impact Pledge is focused on assessing, scoring and engaging with 84 of the world’s largest companies on addressing climate change.</p> <p>To emphasise the seriousness of climate change, they divest within their Future World strategies from those companies that fail to demonstrate sufficient action and vote against the re-election of their board chairs across all funds where they hold voting rights.</p>
Aviva Investors	UN Sustainable Development Goals	<p>In September 2018, Aviva Investors launched the World Benchmarking Alliance (WBA) as a founding partner.</p> <p>The initiative will publish free and transparent benchmarks to the public which rank companies on their contributions towards achieving the SDGs. It aims to empower investors and other stakeholders to better understand how different companies are contributing (or not) to the SDGs. In 2019, the WBA published its first two rankings on sustainable seafood and climate change.</p>

Business management

Understanding the extent to which business leaders understand and support RI, and to what degree these considerations are integrated across the business, are crucial for gaining insight into whether the business is supporting or hindering responsible investment.

Ensuring the firm-wide adoption of beliefs and philosophy through senior management buy-in

Our interviews highlighted the importance of business leaders understanding and supporting responsible investment. As with any firm-wide focus or objective, the leaders need to create the vision and then execute on it.

ESG beliefs should be driven by senior-level management, with mechanisms to ensure accountability. This point was as valid for Chinese firms as for UK firms, if not more so. It was apparent in a number of instances in which Chinese investment teams were keen to do more work on ESG, but were waiting for instructions from the top to do so. Those interviewed for this project were largely senior executive or management representatives who all demonstrated strong ESG knowledge. This was particularly evident in the UK market interviews.

As part of this focus, key ESG risks and themes are clearly identified. For example, Aviva Investors identifies its main themes and risks as climate change, the Sustainable Development Goals, good governance, human rights, communities and employees, and diversity. LGIM believes ESG themes and risks require them to take the long-term view within their investment approach and culture, particularly for structural issues such as climate change, demographics, future cities and changes in technology, which drive the group investment strategy.

ESG capabilities perceived as a competitive advantage

UK asset managers now operate in a market where clients expect ESG as a matter of course, but managers that can demonstrate best practice and offer truly sustainable products expect to have a competitive advantage over their peers.

From a reputation perspective, investment managers were keen that their investments were not seen as “devoid of morals”. One Chinese asset manager believed that ESG was central to avoiding reputational risks, particularly in relation to social issues, for the firm.

Interestingly, rather than seeing transparency as a threat to their business, managers operating in the UK welcomed the opportunity to be transparent and share their policies and stewardship activities publicly. In China, there remain concerns that transparency of policies and approaches can lead to competitive disadvantage and loss of intellectual capital. However, the UK experience generally highlights that transparency has been a positive driver of change and has helped investment managers signal their leadership to the market.

In China, the senior executives or management representatives interviewed perceive ESG to be increasingly important for their business. They believe they need to keep pace with global ESG market developments and international ESG competitors, although they are clear this should not be at the expense of returns.

As with asset owners, it is important for investment managers to have clear beliefs and policies

Investment managers, like asset owners, need to have a coherent set of underlying beliefs and policies that guide their approach to responsible investment. We do not repeat the asset owner findings found in Section 3 both here, but they largely apply. Our interviews found comprehensive policy approaches by both managers across key areas driven by underlying ESG beliefs on integration, risk management, alpha generation, stewardship, key themes and systemic challenges such as climate change.

Structures, training and incentives

Aviva Investors and LGIM have central teams focused full time on ESG integration and stewardship. A number of Chinese asset managers interviewed for this project have focused on forming ESG teams as well. However, both UK managers spoke of the need to embed ESG throughout the organisation, rather than solely relying on one central team. Further integrating ESG across the firm and different strategies was an area of focus for both managers, which is not surprising given the pace of change, size of each organisation and the breadth of offerings.

LGIM spoke of the expectation that all analysts across the firm, whether or not they have an explicit ESG focus, “be able to discuss ESG risks, stewardship activities and how ESG is incorporated into investment processes”.

Aviva Investors uses a system of ESG champions to help embed ESG throughout the organisation and has embedded its dedicated ESG specialists into its investment functions to collaborate with investment professionals. Aviva Investors noted that ESG knowledge cannot reside exclusively within dedicated ESG roles, and firms need to recognise and encourage knowledge sharing. As one example of this, a number of Aviva Investors’ Asian investment analysts are engaging on the growing plastics pollution issue, working alongside their dedicated stewardship team.

Broad foundational ESG knowledge is required to drive ESG integration at a firm-wide level, across both UK and China markets. Interviews in both markets revealed a current focus on ESG education and training for staff.

Aviva Investors is integrating ESG metrics into performance appraisal, thereby linking ESG and incentives. This is an interesting innovation and one that should help integrate ESG considerations more widely. The need to develop an internal ESG incentive framework was a finding from one of the Chinese interviews. Targeting these incentives at senior management before firm-wide rollout could be an effective way to kick-start a firm’s ESG journey towards global best practice.



Appendices

Appendix A

Global drivers of responsible investing

Current landscape — UK and China

The recommendations in this report are made in the context of the considerable policy and regulatory developments already underway across both the UK and China.

In the following table, we capture key policies and trends driving ESG developments at the national level in the UK and China. More information on these trends and developments is provided below.

UK	China
Green finance initiatives	
<p>UK Green Finance Strategy</p> <p>This aims to “align private sector financial flows with clean, environmentally sustainable and resilient growth, supported by Government action” and to “strengthen the competitiveness of the UK financial sector”. It covers three areas:</p> <ul style="list-style-type: none"> • Greening finance — mainstreaming climate and environmental factors as a financial and strategic imperative • Financing green — mobilising private finance for clean and resilient growth • Capturing the opportunity — cementing UK leadership in green finance <p>UK government carbon neutral target by 2050</p> <p>It was the first developed country to set such a legally binding target.</p> <p>EU Sustainable Finance Action Plan</p> <p>Designed to further connect finance with sustainability, the plan is expected to have far-reaching impacts for asset managers and asset owners alike. It has three work streams:</p> <ul style="list-style-type: none"> • Environmentally Sustainable Taxonomy • EU Green Bond Standard • Low-carbon Benchmarks 	<p>National Green Finance System</p> <p>Key to recent sustainability developments was President Xi Jinping prioritising the development of a national green finance system as part of China’s 13th five-year plan (2016–2020).</p> <p>There have been many developments in China in response to the call for the “scaling up” of green finance, particularly after the People’s Bank of China, along with six other government agencies, issued the “Guidelines for Establishing the Green Financial System” in 2016. The guidelines stress that the primary purpose of establishing the green financial system is to mobilise and incentivise more social (or private) capital to invest in green sectors, while restricting investment in polluting sectors.</p> <p>Beautiful China</p> <p>As part of this drive, there has been emphasis on “Beautiful China”. Beautiful China represents a shift in focus from seeking growth in absolute terms to a higher quality of sustainable growth and the associated increased focus on the environmental and social implications of economic growth.</p>

UK	China
ESG disclosure regulations	
<p>Pension scheme ESG policy enhancements and implementation statements</p> <p>Regulations introduced in 2018 by the UK government require pension scheme trustees to set out how they take account of financially material considerations, including ESG considerations and explicitly climate change, as well as the approach to stewardship of investments in their investment policy statements.</p> <p>Further legislation introduced in June 2019 requires pension scheme trustees to publicly publish their investment policy statements, and develop and publish implementation reports to demonstrate how they have carried out their policy statement in practice. These regulations were driven by the EU Shareholder Rights Directive II that seeks to establish shareholder rights attached to listed companies and encourage long-term, focused shareholder engagement.</p>	<p>CRSC mandatory environmental disclosure system for listed equities and bonds</p> <p>The Environmental Ministry and the Securities Regulator China Securities Regulatory Commission or “CSRC” have jointly established a mandatory environmental disclosure system for listed companies and bond-issuing enterprises. The CSRC is pushing for these environmental disclosures to become a mandatory requirement for 3,000 of China’s listed companies and bond issuers in the near future.</p> <p>CSRC revised Code of Corporate Governance</p> <p>CSRC issued a revised “Code of Corporate Governance for listed Companies” in September 2018 that established further ESG requirements and a reporting framework for listed companies covering environmental and social issues.</p> <p>AMAC and Stock Exchange developments</p> <p>In November 2018, the Asset Management Association of China (“AMAC”) released “Guidelines for Green Investment (Trial version)” which seeks to standardise green investment activities within investment funds. Further, both the Shanghai and Shenzhen Stock Exchanges have joined the Sustainable Stock Exchange Initiative and provided guidance to companies on how they should report on ESG issues.</p> <p>Hong Kong SAR’s stock exchange, HKEX, is launching new company ESG disclosure requirements in July 2020 to increase transparency and accountability.</p>

UK	China
Stewardship	
<p>2020 UK Stewardship Code</p> <p>The more ambitious 2020 Code takes a broader, more comprehensive, approach than previous iterations, which largely focused on voting and engagement activity with respect to equity assets. The latest code defines stewardship as “the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.” Further, the new code requires investors to explain how they are exercising their stewardship duties across asset classes.</p>	<p>Stewardship challenges</p> <p>Voter turnout at mainland-listed companies is lower than developed markets. While shareholder proposals are not uncommon in China, nearly all are presented by controlling shareholders, and typically receive more than 95% support. Because of the controlling stakes held by the state in many Chinese companies, particularly the large-cap companies, Chinese institutional investors may feel their vote will not affect the outcome. Many non-SOEs also have a concentrated shareholder structure (e.g. the founder has an overwhelming proportion of voting shares), which makes active engagement difficult.</p> <p>Retail investors that make up a large proportion of the overall investor base, tend not to make the effort to vote at shareholder meetings.</p> <p>In an ISS study, governance concerns were cited as the main reason for international investors not investing in China. Transparency and abusive related-party transactions were cited as the top corporate governance concerns by overseas institutional investors.</p>
International markets	
<p>London is a leading international hub for green finance, offering deep and liquid capital markets, with a well-educated group of global investors.</p> <p>This has helped generate innovation within the UK market and has seen investors and managers come to the UK to raise capital for green issuances (such as Chinese green bonds) and to launch sustainable products.</p>	<p>Desire from the government and regulators to reach international standards has been instrumental in driving much of the recent regulatory change. China’s focus on aligning green bond guidance with international best practice is one example of this focus.</p> <p>The inclusion of the China A-share market in major emerging market and global indices has also brought in new international investors to the market, which has traditionally been dominated by domestic asset owners. Some of these international investors with strong ESG disciplines have applied their ESG policies and practices to their analysis of Chinese companies. This has led to greater demand for ESG information from companies and fostered increased ESG integration by local investors.</p>

ESG in the UK and China: Understanding key drivers

There is no doubt that investors are facing a rapidly evolving landscape in which environmental, social and corporate governance (ESG) issues have been brought to the fore.

Two key levers are influencing investors globally: first, the push from global policy commitments and associated regulation, and second, the pull from client demand —with both supported by increasing evidence of financial materiality and ESG integration leading to better business and improved investor outcomes.

Top five global risks in terms of likelihood



Top five global risks in terms of impact



Source: World Economic Forum, *Global Risks Report 2020*

2015 global tipping point: The Paris Agreement and Sustainable Development Goals

Asset managers and asset owners in the UK and China alike are facing a rapidly evolving global landscape in which ESG issues have been brought to the fore. Arguably, 2015 reflects a tipping point for ESG investing, with global governments agreeing both the Paris Agreement on Climate Change and the Agenda 2030 setting out the framework for achieving the 17 Sustainable Development Goals (“SDGs”) by 2030.

The Paris Agreement reflects a collective goal to limit the increase in the earth’s global mean surface temperature to “well below 2⁰C above preindustrial levels and to pursue efforts to limit the temperature increase to 1.5⁰C”, as well as “increasing the ability to adapt to the adverse impacts of climate change and foster climate change resilience”.^{vi}

The SDGs outline 17 development goals to attain by 2030 related to social, environmental and economic aspects of development (see figure below), designed to be a "blueprint to achieve a better and more sustainable future for all".^{vii}

Both agreements, which arguably capture the most pressing issues of our time, envisage a role for the "private sector" or "private entities" and, in particular, the finance sector in mobilising capital to achieve these global goals.

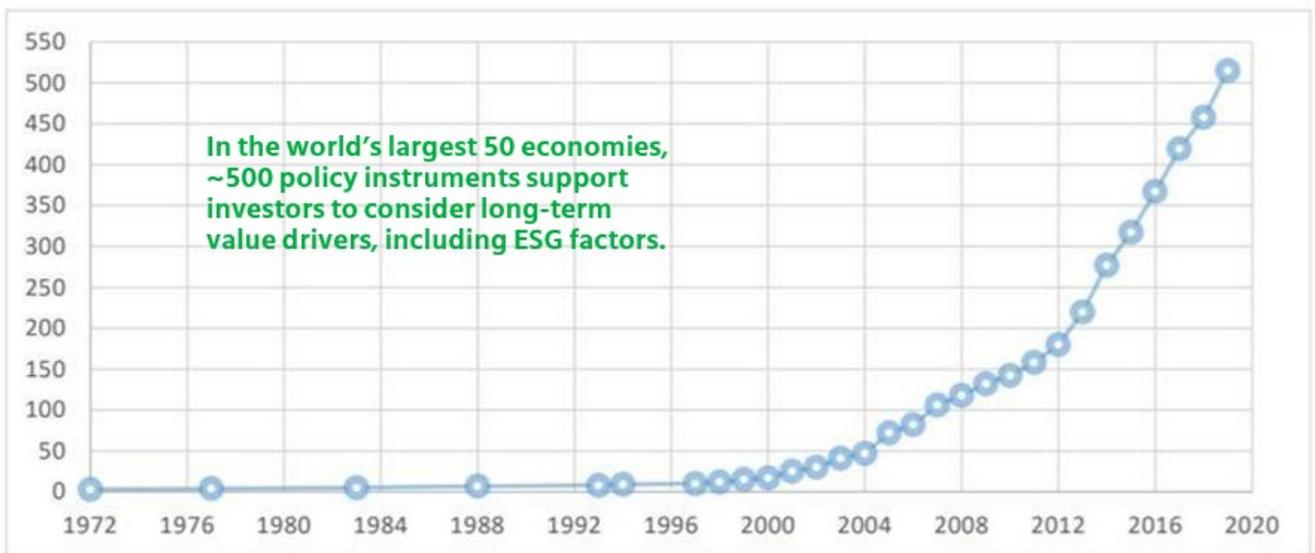
Sustainable Development Goals



Source: United Nations

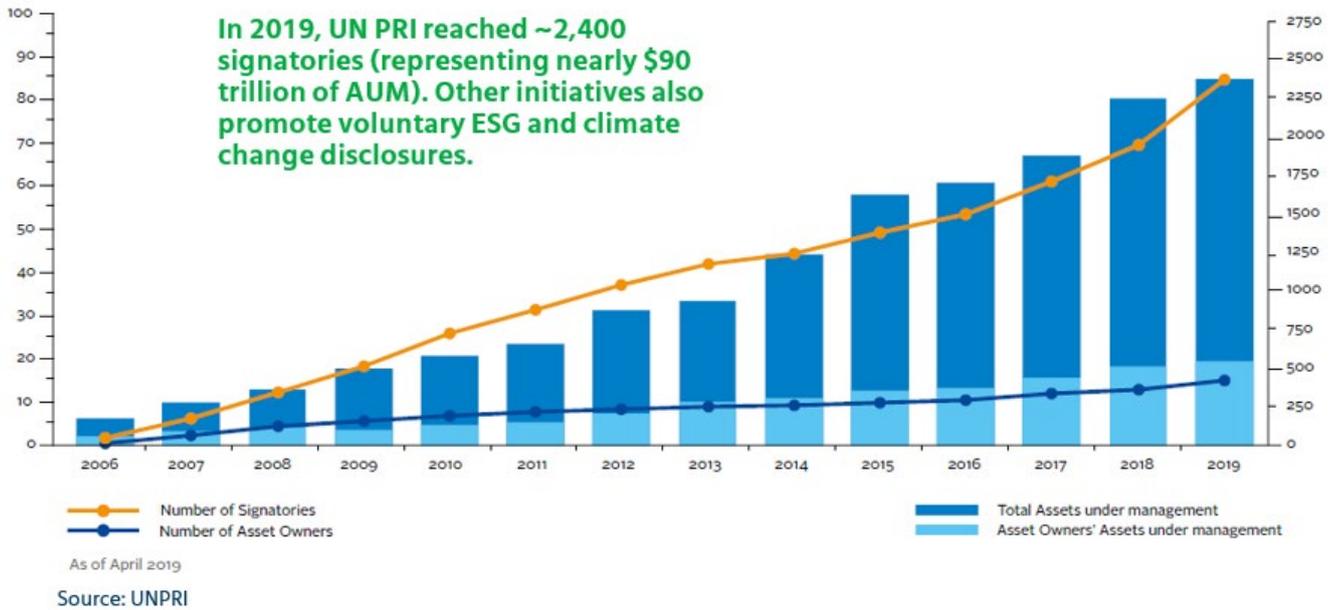
Global ESG policy and regulatory background: UN PRI and TCFD

The ESG policy landscape is rapidly developing with the global cumulative growth in responsible investment regulations captured in the following chart.



Cumulative number of policy interventions per year (source: PRI responsible investment regulation database).

As part of this evolution, increasing numbers of investors are incorporating the integration of ESG issues into their investment practices. This is demonstrated by the year-on-year growth in the number of signatories to the UN-supported Principles for Responsible Investment (“PRI”) shown in the chart below. Signatories are committed to incorporating the initiative’s six principles, which focus on different aspects of ESG integration, into practice.^{viii}



As well as broad ESG integration, investors are increasingly singling out climate change as worthy of specific attention, and in particular are focusing their efforts on climate change risk management. The Task Force on Climate-Related Financial Disclosures (TCFD) framework has been supported by nearly 800 public- and private-sector organisations, including global financial firms responsible for assets in excess of \$118 trillion.^{ix} The aim of this disclosure framework is to support consistent, comparable, reliable and clear climate disclosures at the company level to enable more informed investment decisions by companies, asset managers and asset owners — with the aim to avoid the abrupt re-pricing of risks and the resulting impacts on financial market stability.

Key country-level ESG drivers

The purpose of the remainder of this section is to provide an overview of selective key policies and trends driving ESG developments at the national level in the UK and China. This is intended to provide useful context for the asset owner and asset manager interviews and their findings presented later in the report. We would highlight that government policies and regulation in both countries continue to be behind much of increased adoption of ESG practices in both countries.

UK policy and regulatory background

The UK and Europe are considered global leaders in sustainable investment. In 2019, the UK became the first developed country to set a net zero emissions target by 2050. As a country, it has pioneered new green technology such as offshore wind. Further, London is a leading international hub for green finance, offering deep and liquid capital markets, with a well-educated group of global investors.

We explore below a number of recent European Union (EU) and UK regulations and green finance strategies, as well as a revised Stewardship Code, that are expected to continue to drive innovation and see investors evolve and develop their approach to ESG in the near term.

Green finance initiatives

Recent EU and UK green finance initiatives are expected to create a supportive environment for investors to design and implement leading sustainable investment strategies.

The EU adopted its Sustainable Finance Action Plan in March 2018 which is designed to further connect finance with sustainability and is expected to have far-reaching impacts for asset managers and asset owners alike. It has formed a Technical Expert Group (TEG) to develop elements of the plan across three workstreams which are likely to be highly relevant for investors interested in sustainable investment in the near to medium term:

- Environmentally Sustainable Taxonomy. This is designed to be a classification system to help investors and companies make informed investment decisions on green or low-carbon investment and labelling of products. Of the three work streams, this will likely have the largest impact from an investor perspective, helping to define how asset owners classify sustainable allocations within their portfolios and shaping how investment managers define and develop sustainable or green funds.
- EU Green Bond Standard. This is designed to increase clarity for issuers and increase comparability and transparency of the green bond market.
- Low-carbon Benchmarks. The main objectives of the new climate benchmarks are to increase comparability of climate (or low-carbon) benchmarks, provide investors with an appropriate tool that is aligned with their investment strategy, increase transparency on investors' climate change impact, specifically with regard to climate change and the energy transition and discourage greenwashing.^x

At the national level, the UK government has set the target of becoming carbon neutral by 2050. It was the first developed country to set such a legally binding target. In support of this, the government launched the UK Green Finance Strategy which aims to “align private sector financial flows with clean, environmentally sustainable and resilient growth, supported by Government action” and to “strengthen the competitiveness of the UK financial sector”. In line with this, it has set out an overarching strategy covering three areas captured in the following diagram:

UK Green Finance Strategy

Strategy

Chapter 1 Greening Finance

Ensuring current and future financial risks and opportunities from climate and environmental factors are integrated into mainstream financial decision making, and that markets for green financial products are robust in nature.



Chapter 2 Financing Green

Accelerating finance to support the delivery of the UK's carbon targets and clean growth, resilience and environmental ambitions, as well as international objectives.



Chapter 3 Capturing the Opportunity

Ensuring UK financial services capture the domestic and international commercial opportunities arising from the 'greening of finance', such as climate related data and analytics, and from 'financing green', such as new green financial products and services.



Source: UK Government

Importantly, as part of this strategy, the UK government expects all listed companies and large asset owners to report and disclose in line with the TCFD recommendations by 2022.

Stewardship

The UK introduced the first stewardship code in 2010, and over the last decade similar codes have been introduced by over 20 countries and jurisdictions globally. Leading asset managers and investors have supported the code, and it has played an important role in enhancing voting and engagement activity since it was first introduced.

The UK has recently published its ambitious Stewardship Code 2020, redefining and strengthening its approach for the new decade. The code has been overhauled to ensure it remains fit for purpose in an environment of increased investor expectations on ESG integration, stewardship and climate change. The 2020 Code takes a broader, more comprehensive, approach than previous iterations, which largely focused on voting and engagement activity with respect to equity assets. The latest code defines stewardship as “the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.” Further, the new code requires investors to explain how they are exercising their stewardship duties across asset classes.

UK pension scheme ESG policy disclosure regulations

Regulations on “clarifying and strengthening trustees’ investment duties” introduced in 2018 by the UK government require pension scheme trustees to set out how they take account of financially material considerations, including ESG considerations and explicitly climate change, as well as the approach to stewardship of investments (including engagement with investee firms and the exercise of voting rights) in their investment policy statements (or Statement of Investment Principles). Further legislation introduced in June 2019 requires pension scheme trustees to publicly publish (if not required already) their investment policy statements and develop and publish implementation reports to demonstrate how they have carried out their policy statement in practice. These regulations were

driven by the UK transposing the EU's Shareholder Rights Directive II into law. The Shareholder Rights Directive II is an important piece of legislation that seeks to establish shareholder rights attached to listed companies and encourage long-term, focused shareholder engagement.

These regulations, in conjunction with the government writing to the largest pension schemes asking them to explain their approach to ESG, has seen a significant increase in asset owners looking to better understand the risks and opportunities, develop beliefs and then update their policy positions.

Asset owners and asset managers

This backdrop, which includes a government setting ambitious and legally binding climate goals and set on maintaining London's leadership as a global sustainable finance hub, has created a supportive environment within which a number of asset managers and asset owners have been able to become responsible investment leaders. We have interviewed a number of them as part of this project and, as shown in our interview findings, these investors are keen to support international initiatives such as UN PRI and TCFD, integrate ESG and stewardship considerations into their investment practices and create and/or allocate to sustainable opportunities and strategies across their investment portfolio. Many of these leading investors aren't simply aiming to be ahead of regulations — they are keen to use their influence to shape the policy direction as well as demonstrate leadership by investing to create solutions to the most pressing challenges we face.

Importantly, UK regulators have played an important role by emphasising and clarifying the financial materiality of ESG, including climate change, and stewardship. This has led to an increasing number of mainstream investors adopting meaningful ESG integration and stewardship practices in the expectation that this is part of their fiduciary duty to the ultimate beneficiaries and it will result in better risk-adjusted returns.

China policy and regulatory background

China is the world's largest greenhouse emitter, and it has the world's second largest asset management industry. Therefore, the actions its government, regulators and asset managers/asset owners take will have a lasting impact on global sustainability efforts.

China is the world's largest investor in renewable energy and energy efficiency, accounting for 30% and 27% of the global total, respectively.^{xi} Its green bond issuance demonstrates how rapid progress has been made over a relatively short period. It has grown its green bond issuance from zero before 2015 to second globally in 2017.^{xii} As a result, China is making significant and rapid progress to meet sustainability challenges head-on and scale up green finance efforts. This has been driven by government regulation and growing demand for ESG disclosure as international investors increase their exposure to China A-shares.

Green finance initiatives

As with the UK, Chinese government policies and regulation have driven much of the sustainability developments across the investment industry in recent years. Key to this was President Xi Jinping prioritising the development of a national green finance system as part of China's 13th five-year plan (2016–2020). There have been many developments in China in response to the call for the "scaling up" of green finance, particularly after the People's Bank of China, along with six other government agencies, issued the "Guidelines for Establishing the Green Financial System" in 2016. The guidelines stress that the primary purpose of establishing the green financial system is to mobilise and incentivise more social (or private) capital to invest in green sectors, while restricting investment in polluting sectors.^{xiii}

Over this short period of time, green developments include greening the banking system, the bond market, promoting environmental risk analysis and the availability of environmental data, developing green private equity and green asset-backed securities (“ABS”), among others.

As part of this drive, there has been emphasis on “Beautiful China”. Beautiful China represents a shift in focus from seeking growth in absolute terms to a higher quality of sustainable growth and the associated increased focus on the environmental and social implications of economic growth.

The People’s Bank of China, regulators and related bodies have led efforts to promote green finance and ESG investing through domestic and international initiatives in recent years. These have included “local piloting programmes, education and capacity building, research and policy leadership, and regulatory guidance to set the framework and support the implementation of the policy”.^{xiv}

Arguably, one of the main motivations (and consequences) for the focus on ESG disclosures and aligning domestic guidelines with international best practice more generally is to attract more foreign investors, particularly with the inclusion of China A-Shares in major indices (see below). In terms of regulation, desire from the top to reach international best standards has been instrumental in driving much of the change. China’s focus on aligning green bond guidance with international best practice is one example of this focus. As a centrally planned economy, and with the disclosure policies in place, China has the ability to overtake more mature markets on this front in the near future.

ESG disclosures, reporting and sustainable classifications

The government and regulators have issued a number of regulations and guidance on ESG data disclosure over recent years. Perhaps most importantly, the Environmental Ministry and the Securities Regulator (China Securities Regulatory Commission or “CSRC”) agreed to join forces to establish a mandatory environmental disclosure system for listed companies and bond-issuing enterprises.^{xv} The CSRC is pushing for these environmental disclosures to become a mandatory requirement for 3,000 of China’s listed companies and bond issuers by 2020. This is welcomed as currently there is a lack of high-quality ESG data and therefore no standardised set of ESG disclosure indicators, making it hard for investors to assess how companies are managing their ESG risk exposure, particularly for investors attempting to incorporate the consideration of environmental risks from major polluting companies into their investment process.^{xvi} To date, leading investors have had to develop their own proprietary database and scoring system.

In addition to environmental disclosures, the CSRC issued a revised “Code of Corporate Governance for listed Companies” in September 2018 which established further ESG requirements and a reporting framework. This states listed companies “shall be concerned with the welfare, environmental protection and public interest of the community in which it resides, and shall pay attention to the company’s social responsibilities”.

In November 2018, the Asset Management Association of China released “Guidelines for Green Investment (Trial version)”, which seeks to standardise green investment activities within investment funds. Further, both the Shanghai and Shenzhen Stock Exchanges have joined the Sustainable Stock Exchange Initiative and have provided guidance to companies on how they should report on ESG issues.

While the AMAC has also outlined its ESG-guidelines for private fund managers, there is generally a lack of ESG data relative to the public market, and ESG is still considered a very new concept for Chinese private equity firms, with only a few PRI signatories. However, there is evidence of change, with increased awareness, first led by the larger Pan-Asian private equity funds that leverage their global ESG framework, and now gradually observed in the larger China funds that focus on control

buyout transactions where they have influence over management and strategy. These funds primarily raise capital from global institutional investors that typically cover ESG in their due diligence process.

International investor China A-shares exposure driving ESG best practice

The inclusion of the China A-share market in major emerging market and global indices has brought in new international investors to the market, which has traditionally been dominated by domestic asset owners, including retail investors. Some of these international investors with strong ESG disciplines have applied their ESG policies and practices to their analysis of Chinese companies. This has led to greater demand for ESG information from companies and fostered increased ESG integration by local investors. As a consequence, the inclusion of the China A-share market in the major indices has improved the ESG data coverage and encouraged local investors to develop their approach to ESG. ^{xvii}

Stewardship

Globally, engagement has been a powerful ESG investment approach, but the level of engagement between Chinese companies and investors is low compared to more mature markets.

In China a large proportion of the listed companies are primarily state-owned. Voter turnout at mainland-listed companies is lower than developed markets. While shareholder proposals are not uncommon in China, nearly all are presented by controlling shareholders and typically receive more than 95% support. Retail investors who make up a large proportion of the overall investor base tend not to make the effort to vote at shareholder meetings. Because of the controlling stakes held by the state in many Chinese companies, particularly the large-cap companies, Chinese institutional investors may feel their vote will not affect the outcome.

In an ISS study, governance concerns were cited as the main reason for international investors not investing in China. Transparency and abusive related-party transactions were cited as the top corporate governance concerns by overseas institutional investors. ^{xviii}

Therefore, developing and implementing effective stewardship standards should be an area of focus. Regulator guidance or a code could be an effective way to improve engagement between investors and companies with large investors having a key role to play. We provide more detailed recommendations on this topic later in the report.

Products and opportunities

The evolution of ESG investing in China has arguably been led by the development of ESG products, such as green thematic funds, rather than by, for example, investors first developing their ESG policy approach. China has grown its green bond issuance from zero before 2015 to second globally in 2017 ^{xix} and at the end of Q1 2018 boasted nearly 500 green private equity funds. ^{xx} China has also seen the launch of its first ESG index, the SSE 180 ESG Index, in November 2018. The rapid development of green lending in the banking system has also brought the opportunity for developing green asset securitisation.

China's ambitious Belt and Road Initiative (BRI) offers significant potential green infrastructure investment opportunities. Applying internationally recognised environmental standards to the BRI infrastructure projects that span Asia, Africa and Europe with a planned \$1-\$4 trillion investment will be key to aligning with global climate goals, managing risks and attracting international capital as has been demonstrated by UK-China work on this project to date.

Asset owners and asset managers

Against this backdrop, and thanks to a combination of ambitious government policies and overseas demand for China A-shares, ESG investing is on a positive trajectory that has all major market players across the investment value chain improving their approach and/or setting increasingly stringent standards.

As part of this, China has seen a significant uptake in ESG investing by asset managers and asset owners in the last few years. Although arguably, and as demonstrated by our interview findings, investors' approaches to ESG integration are still in the development phase and have lagged behind the extremely rapid growth in green instruments and green funds.

Currently there are 37 Chinese UN PRI signatories, with the majority being asset managers. More than half of the top 10 Chinese mutual fund managers have become PRI signatories and they have been the driving force in implementing the principles. However, asset managers and asset owner have struggled to adopt the ESG principles at scale and, in turn, it has been hard to develop meaningful engagement with companies.^{xxi} We discuss some of the reasons for these challenges later in the report and provide a number of recommendations to help overcome these.

However, despite China starting from a low base, with ongoing government support and as Chinese markets continue to internationalise, Chinese investors have the potential to rapidly develop their approach to ESG and stewardship. With China's centrally planned economic model, ESG practices which have taken other markets a long time to develop have the potential to be quickly adopted and implemented into investment research, processes and decisions.

Making the case for cooperation and mutual learning

The UK and China are natural partners as the countries accelerate efforts to transition to a low-carbon economy. The UK has been leading efforts to decarbonise its own economy and increase the international flows of green finance. In addition, London is a global hub for green finance and offers deep and liquid capital markets access. China has shown leadership in pursuing sustainable growth, including through renewable energy investment and green bond issuance, as well as regulators pursuing greater ESG disclosure, with rapid strides across multiple fronts in a short period of time.

Both UK and China asset managers and asset owners will play an important role in supporting their countries' green finance strategies. Investors in UK and China have a great deal to learn from one another as ESG practices are being driven in both countries by ambitious and frequent regulatory updates and as international best practice, which is key to staying competitive, permeates more and more areas of the market. In particular, leading UK investors who have been developing their approaches to ESG integration and stewardship for a longer period of time provide a number of practical lessons that Chinese regulators and investors can consider applying as they seek to generate better risk-adjusted returns for the benefit of the ultimate beneficiaries over the long term.



Appendix B

Asset owner ESG best practice

Best practice	
<p>Investment beliefs</p> 	<p>Leading asset owners explore, formulate and articulate their ESG investment beliefs and philosophy, refreshing them periodically. These initiatives are most effective when they are driven by senior management, reflect the overall values of the organisation and take account of key stakeholders, including the ultimate beneficiaries. Given the breadth of ESG, no two investors are likely to have the same beliefs.</p> <p>Ongoing education supports the belief-setting process and helps inform its evolution. Investors are increasingly framing their beliefs to reflect the type of world they want their beneficiaries, clients and society to enjoy in the future. RI leaders are increasingly positioning themselves as “future makers” and asking themselves what their responsibilities are as universal asset owners.</p> <p>Beliefs typically cover the importance of different RI approaches, such as integration, stewardship, thematic investments and sensitive topics, as well as risk management and alpha generation. Being really clear on where ESG considerations are driven by risk and where they are driven by alpha can aid in investment decision-making and deciding where these approaches are deployed.</p> <p>Formulating beliefs in relation to various E, S and G factors and relevance by asset class is important and should be done over the relevant timeframes.</p> <p>Systemic risks and megatrends, such as climate change, should be clearly identified, with beliefs articulated in relation to the most pressing and material ones.</p> <p>In terms of climate change specifically, investors are increasingly articulating their view on the need to limit global warming to 2⁰C or below relative to pre-industrial levels and whether they have adopted any net zero emissions targets for the overall portfolio.</p>
<p>Investment policies</p> 	<p>Leading asset owners benefit by having clearly written ESG policies. These should incorporate investment beliefs and provide a framework for understanding the organisation’s approach to implementing ESG practices.</p> <p>Some investors have a single central policy, while others, as they develop their approach to different areas over time, find it useful to have separate policies for different areas (for example, stewardship and climate change).</p> <p>Leading RI investors often have specific measurable targets against which they can measure progress. This may be metrics and goals in relation to:</p> <ul style="list-style-type: none"> - Portfolio decarbonisation and fossil fuel reserves - Sustainable allocations and green revenues - Stewardship goals <p>Transparency is incredibly important. Making policies publicly available is critical for sharing best practice, maintaining accountability and ensuring beneficiaries understand the asset owner’s approach. For asset managers, we have found it can be a competitive advantage.</p>

Best practice	
<p>Investment processes</p> 	<p>Leading investors adopt firm-wide efforts to embed ESG practices throughout the investment process and across the portfolio. These should be consistent with policy goals and targets, and be underpinned by an appropriate monitoring framework to ensure they are being effectively implemented.</p> <p>To support these processes, appropriate incentive structures should be in place, ESG responsibilities should be written into job descriptions and ongoing education should be provided.</p> <p>Members of the investment team are able to articulate why ESG is financially material to the investment process and how it shapes the investment portfolio.</p> <p>Processes should be supported by sufficient resources and skill. Diversity of skillset, experience and background is a key differentiator.</p> <p>ESG should be embedded across different areas — from idea generation and due diligence to portfolio construction, manager selection and monitoring to stewardship. Ongoing manager monitoring is a particularly important part of the investment process from an asset owner perspective to ensure that investment managers are effectively integrating ESG considerations.</p> <p>Leading investors often commit to quarterly or annual review and reporting cycles as appropriate for the areas under consideration. They then work with their investment managers to improve their approach over time.</p> <p>Stewardship is an important area of focus. Investors should monitor their managers to ensure they are voting where they are able and voting in a thoughtful way and engaging meaningfully to ensure that companies are being held to account and efforts are made to improve the wider market.</p> <p>Effective processes are reinforced by the quality of underlying ESG data. Asset owners are using different metrics (carbon intensity, ESG scores, physical risk assessments for real assets, stewardship assessments, etc.) to challenge their managers’ views and interrogate their own portfolio from different angles.</p> <p>Leading investors are working to ensure they adopt the recommendations of key initiatives and frameworks promoting ESG best practice such as UN PRI, TCFD and local stewardship codes. They are active in joining collaborative, engagement-focused initiatives, such as Climate Action 100+, where these align with their beliefs and policy ambitions and plans.</p>
<p>Strategic and asset class</p> 	<p>Leading asset owners are taking a “whole of portfolio” approach to the greatest extent possible, whether this be in terms of 2°C alignment or ensuring that sustainable allocations are reflected throughout strategies and across portfolios.</p> <p>Asset owners recognise different asset classes such as listed equities and real assets are further progressed in terms of ESG integration and thematic opportunities, and push investment managers for best practice. Likewise, they often partner closely with investment managers where they are investing in asset classes such as fixed income, where ESG integration isn’t as well developed.</p> <p>Asset owners collaborate with investment managers and other investors to create products to meet their needs where suitable products don’t already exist.</p> <p>Some leading investors look to support emerging managers and niche sustainable strategies where they align with their objectives.</p> <p>Consistent with the UN PRI and TCFD framework, leading investors are using climate change scenario analysis to help inform their climate change approach and strategic asset allocation decisions.</p>

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End Notes

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