ARTICLE

ESG: Defining a brave new world

As institutions increasingly look to obtain new sources of long-term investment returns and strengthen their brand credentials, many are now boosting their exposure to ESG linked assets.

ESG REPORTING EMBEDS ITSELF INTO ASSET MANAGEMENT

According to a study by BNP Paribas Securities Services, 22% of investors said ESG (environmental, social, governance) assets comprise at least 75% of their portfolios and this is projected to grow in the next two years.[1] The scale of the progress being made is remarkable – asset managers may need to plan for ESG funds to grow by three to four times by 2030 and for sustainability factors to play a more decisive role in sourcing new business. Dedicated responsible investments through funds and mandates has reached US$8 trillion out of the US$100 trillion of professionally managed assets tracked in the Broadridge Global Market Intelligence platform.[2]

This amount could more than double to US$19 trillion by 2025 and over three times to US$30 trillion by the end of this decade.

However, with this impressive growth spurt comes challenges. The complexity and costs of ESG implementation have risen, and fund selectors have begun to ask more challenging questions. As ESG investing becomes ubiquitous, regulators globally are being forced to introduce new provisions to ensure the safeguarding of clients and prevention of green-washing. New regulations in Europe have created a maze of requirements but have already improved the quality of disclosure, doubled the size of the market, and sped up the pace of change.

RETAIL AND INSTITUTIONAL AUM FORECAST SCENARIOS	Forecast Scenario		
	Low ($tn)	Mid ($tn)	High ($tn)
AUM 2025	14	16	19
AUM 2030	20	25	30
Net Inflows 2021 - 2025	3	3	3
Net Inflows 2026 - 2030	3	5	6
Realignments / Conversions	2	5	7
ESG share of flows by 2030*	30%	45%	60%
ESG share of AUM in 2030*	18%	23%	28%

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ESG RULES TAKE EFFECT IN THE EU

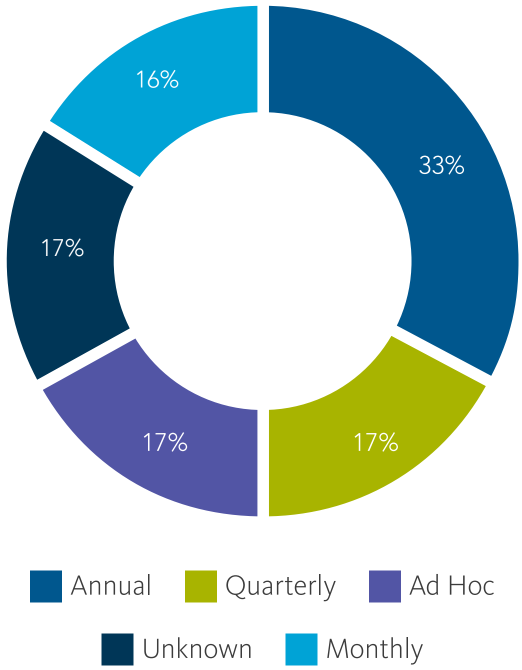
As one of the first markets to announce the introduction of ESG investment rules, the EU's requirements are starting to take shape. Having implemented the first phase of the Sustainable Finance Disclosure Regulation (SFDR), the second phase is now expected to be adopted from January 2023 after a second six month delay. While Phase 1 of SFDR subjected asset managers including those regulated under AIFMD (Alternative Investment Fund Managers Directive), UCITS and MiFID (Markets in Financial Instruments Directive) to a number of ESG disclosure requirements, the second phase imposes even more detailed reporting rules on firms, including an obligation to report on the 18 mandatory principle adverse impact statements (PAIS). Similarly, the EU's Taxonomy Regulation introduces a set of criteria outlining those economic activities which it believes are sustainable. If successful the taxonomy should help firms benchmark their ESG investment activities more easily. Some believe the taxonomy could do for ESG investing what UCITS did for mutual funds.

In order to simplify and standardise all of the data exchanges now taking place between managers and distributors under the EU's ESG rules, a new data template known as the European ESG Template (EET) is being implemented and asset managers will be expected to be able to produce one from June 2022. The EET, developed by FinDatEx, shares a number of commonalities with other templates such as the EPT (European PRIIPs [Packaged Retail Investment and Insurance-based Products] Template) and the EMT (European MiFID Template). Despite the parallels between the EET and the EPT/EMT, there are some notable differences between them. For instance, the EET contains many more data fields for population - 580, has limited data at the portfolio level and adopts different timelines for having it all in place.

So what does this mean? Under the EU's ESG rules, those providing investment advice must identify clients' ESG preferences and manage their portfolios accordingly. In addition to these suitability assessment changes, firms must make adjustments to their product governance and risk management activities. If asset managers cannot prepare an EET by the deadline the implications could be severe. For example client transparency concerns may have an impact on sales and marketing, with certain products not being considered for distributor selection because of a lack of ESG data. It is therefore vital that asset managers ensure they have the correct processes in place to compile the EET.

Once an EET has been produced it will also require continuous maintenance to ensure that the data being published within it remains up to date. There is no industry consensus on the frequency of these updates with expectations ranging from an annual basis to a more frequent monthly or quarterly refresh similar to existing templates such as the European MiFID Template (EMT).

HOW REGULARLY DO ASSET MANAGERS PLAN TO PROVIDE UPDATED EET DATA?



Based on an email survey conducted by Broadridge Fund Communication Solutions, March 2022

THE UK JOINS THE ESG REGULATORY CLUB

Following the EU, the UK is also pushing ahead with its own ESG reform package for asset managers. Despite not transposing the EU's SFDR into UK law post-Brexit, the Financial Conduct Authority (FCA) announced last year that asset managers running £50 billion+ will be subject to a new climate related disclosure regime - modeled on the Financial Stability Board's (FSB) Task Force on Climate Related Financial Disclosures (TCFD).

The FCA said the first set of reports will be due in June 2023.[3] The provisions will also impact investment firms below the FCA exemption threshold (£5 billion and under AUM), although their reports do not need to be submitted until June 2024.[4] While the proposals apply to UK investment firms, they will not (for now) impact foreign managers marketing funds into the UK under the UK's AIFMD rules.

Building on the TCFD-based reporting framework, the UK is also adopting its own Sustainability Disclosure Requirements (SDR), which it plans to phase in over the next few years. In its 2021 paper – "Greening Finance – A Roadmap to Sustainable Investing" the UK government proposed new sustainability disclosure rules for asset managers and asset owners. The UK SDR requires manufacturers to report on their products' sustainability impact together with any relevant financial risks and opportunities. "This information will form the basis of a new sustainable investment labeling regime that will make it easier for consumers to navigate the range of investment products available to them," it reads.

Conscious of the ambiguity about what constitutes 'green', the UK government said it would establish a taxonomy too, drawing extensively on the EU's existing taxonomy. The UK government said the disclosure rules and green taxonomy provisions will apply to asset managers running £5 billion+ in the next two to three years, before being imposed on firms with £1 billion+ in the next three years or more.

THE REST OF THE WORLD TAKES AN ESG PLUNGE

Regulators globally are starting to follow the example set by the EU and UK by strengthening their relative protections for investors in ESG funds. Having previously taken a largely agnostic approach on ESG, the US authorities are now changing course. In addition to potentially requiring corporates to disclose more ESG information to shareholders, the Securities and Exchange Commission (SEC) is examining allegations of green-washing and ESG mislabeling by asset managers, raising the prospect of potential enforcement action later this year.[5] A handful of major markets in Asia are also introducing ESG reporting obligations.

The Monetary Authority of Singapore (MAS) confirmed it would impose added disclosure requirements on ESG funds being sold to the country's domestic retail allocators.[6]

Similarly the Hong Kong regulator, the Securities and Futures Commission (SFC) is also demanding ESG or climate focused funds publish how they incorporate ESG into their investment processes. These changes will help ensure investors are properly protected when buying ESG products.

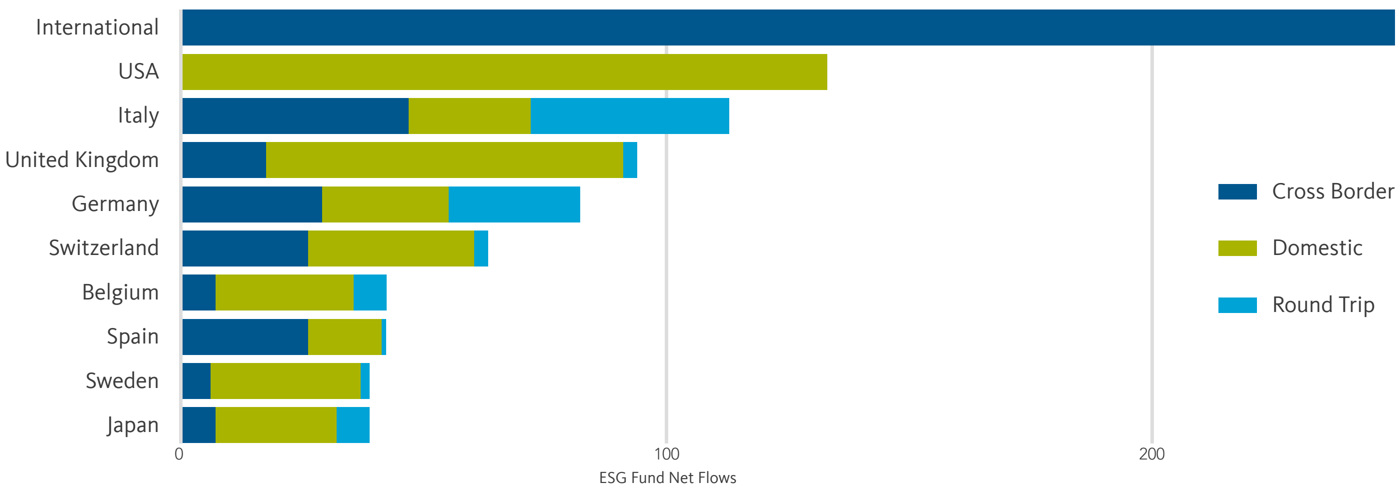
Fund selectors in Japan did not cite sustainability as one of their main needs, yet the largest launches in each of the past two years integrated ESG. The offerings also reveal the unique potential for international sub-advisors in the market. Notably, AM One's introduction from 2020 is managed by Morgan Stanley and has surpassed US$10 billion, and Nikko AM's launch of a positive change innovation fund, advised by affiliated thematic leader ARK Investment Management, has raised US$4 billion.

ESG REPORTING – A COMPLEX UNDERTAKING

With so many regulators globally cobbling together their own ESG reporting frameworks, the scope for complications is high. Asset managers operating in multiple jurisdictions are now likely to face a plethora of ESG reporting requirements, very few of which will be properly synchronised. If managers are to get to grips with the sheer volume of ESG reports, they need to engage with service providers who have a strong track record of helping firms deal with various regulatory reporting requirements.

Broadridge Fund Communications has over twenty years of regulatory reporting expertise, and is here to help you with your upcoming ESG reporting responsibilities, from the monitoring of incoming regulations to the production and distribution of your EET. We deliver technology-driven solutions that drive business transformation for our clients and help them get ahead of today's challenges to capitalise on what's next. Our representatives and specialists are ready with the solutions you need to advance your business.

ESG FUND NET FLOWS, 2019 - SEPTEMBER 2021 BY COUNTRY, $BN



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FOOTNOTES

1. BNP Paribas Securities Services – The ESG Global Survey 2021
2. Includes money market funds. GMI tracked $89 trillion in assets excluding money markets as of June 2021. Our forecasts reflect various scenarios of probable growth that asset managers may consider in their strategic planning.
3. Sidley (January 5, 2022) New UK FCA rules on Climate-related disclosures-ten key points for asset managers
4. Sidley (January 5, 2022) New UK FCA rules on Climate-related disclosures-ten key points for asset managers
5. Bloomberg (September 3, 2021) Fund managers feel heat in SEC crackdown on overblown ESG labels
6. Asia Asset Management (September 10, 2021) Singapore regulator to bolster disclosure standards for retail ESG funds

* Source: Broadridge proprietary date. Share of flows and AUM excludes mandates and private funds. Excludes money market funds and fund of funds.

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