The ESG potential – how mutual fund boards can manage risks and seize opportunities

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Environmental, social and governance (ESG) investing — and the broader area of sustainable finance — has become a much-talked-about issue for financial services. Though aspects of ESG issues have been around for several decades, the level of interest has ebbed and flowed. Major events have often proved to be trigger points for accelerating and broadening the focus on ESG. For example, following severe wildfires in California, Australia and Brazil within a 12-month time frame, climate change issues became a dominant topic at the World Economic Forum's (WEF) annual meeting in Davos, Switzerland. Then came COVID-19, which put a spotlight on employee well-being, community engagement and operational continuity, followed by diversity and a public focus on social imbalances.

An offshoot of ESG investing has been the growth in sustainable finance. Initially, the focus was on incorporating ESG factors into investment decisions; currently, between a quarter and a third of global assets under management are, in some way, influenced by ESG. But over the past five years, many more innovative ESG-related products and services, such as green bonds or sustainability-linked loans, have hit the market. That innovation continues, largely in response to rising investor and public demand for more "ethical" products and services. But it also shows financial services will be the engine for industry- and government-led transition to a low- or zero-carbon economy. After all, the transition has to be financed.

Sustainable finance and ESG are critical for the asset management industry. As investors, mutual funds play a central role in pushing companies in which they invest to manage ESG risks and seize related opportunities. As intermediaries, they have to offer ESG products and services to meet evolving customer and investor needs. As fiduciaries, they have to manage risks related to ESG.

In a recent webinar, hosted by the Mutual Fund Directors Forum (MFDF), Ernst & Young LLP (EY) explored these trends in detail with more than 70 fund directors.
The discussion covered:

- **The evolution of ESG — fresh thinking and broad definitions:** ESG has evolved significantly from the early years of corporate social responsibility and philanthropy to incorporate a wide and complex set of issues. At the same time, the breadth of sustainability-related financial products has grown. Climate change risk has also become more prominent.
- **A major growth platform, going forward:** The sustainable finance market has grown significantly, and the innovation in products and services continues apace. It presents real commercial opportunities for those funds that have the strategy, brand, management commitment and discipline.
- **Intensifying regulatory focus and the emergence of disclosure standards:** The growing prominence of ESG issues and the role of sustainable finance in the broader capital markets have not escaped the eye of regulators globally. They continue to push for better nonfinancial disclosures and are becoming much more focused on the efficacy and marketing of ESG-related products and services.
- **Ten major ESG issues for mutual fund directors:** Fund boards have a set of risks that they need to oversee, relating to their own corporate strategy alignment, product development, data sourcing, distribution, and disclosures and reporting to asset owners and advisors, as well evolving industry and regulatory standards.
- **Moving forward to success in the age of ESG:** The industry is maturing its approach to ESG investing and sustainable finance, but many funds have a long way to go to manage the risks and seize the opportunities in an integrated manner.

This article provides a summary of the discussion with MFDF members and includes results from the real-time polling conducted during the MFDF webinar.

The evolution of ESG investing: fresh thinking and broad definitions

Conventional wisdom surrounding corporate social responsibility (CSR) held that companies "gave back" to society only after achieving success. CSR was viewed as means for companies to self-regulate their activities in a way that showed they were, in some way, accountable to a broader set of stakeholders in their community beyond shareholders. During the past decade, though, that notion has been flipped so that success itself is defined as contributing to society. The shift from CSR and philanthropy to governance, sustainability and fiduciary duties has been driven to a large extent by increasing consumer and shareholder preference for more engaged and purposeful corporations that recognize their responsibilities to a broader range of stakeholders.

In the meantime, the meaning of ESG has evolved, and many board directors find it useful to clarify the meaning. The following are some of the issues that now come up the ESG agenda.

E	Environmental	Climate change and carbon emissions Energy efficiency Pollution Use of natural resources	Waste management Clean energy and technologies Biodiversity
S	Social	Labor relations Diversity agenda Employee safety/working conditions Human rights/child labor	Product safety Community engagement Supply chain management
G	Governance	Board independence and diversity Compensation policies Business ethics Risk management/oversight	Cybersecurity Compliance and legal Corruption and bribery/anti-money laundering

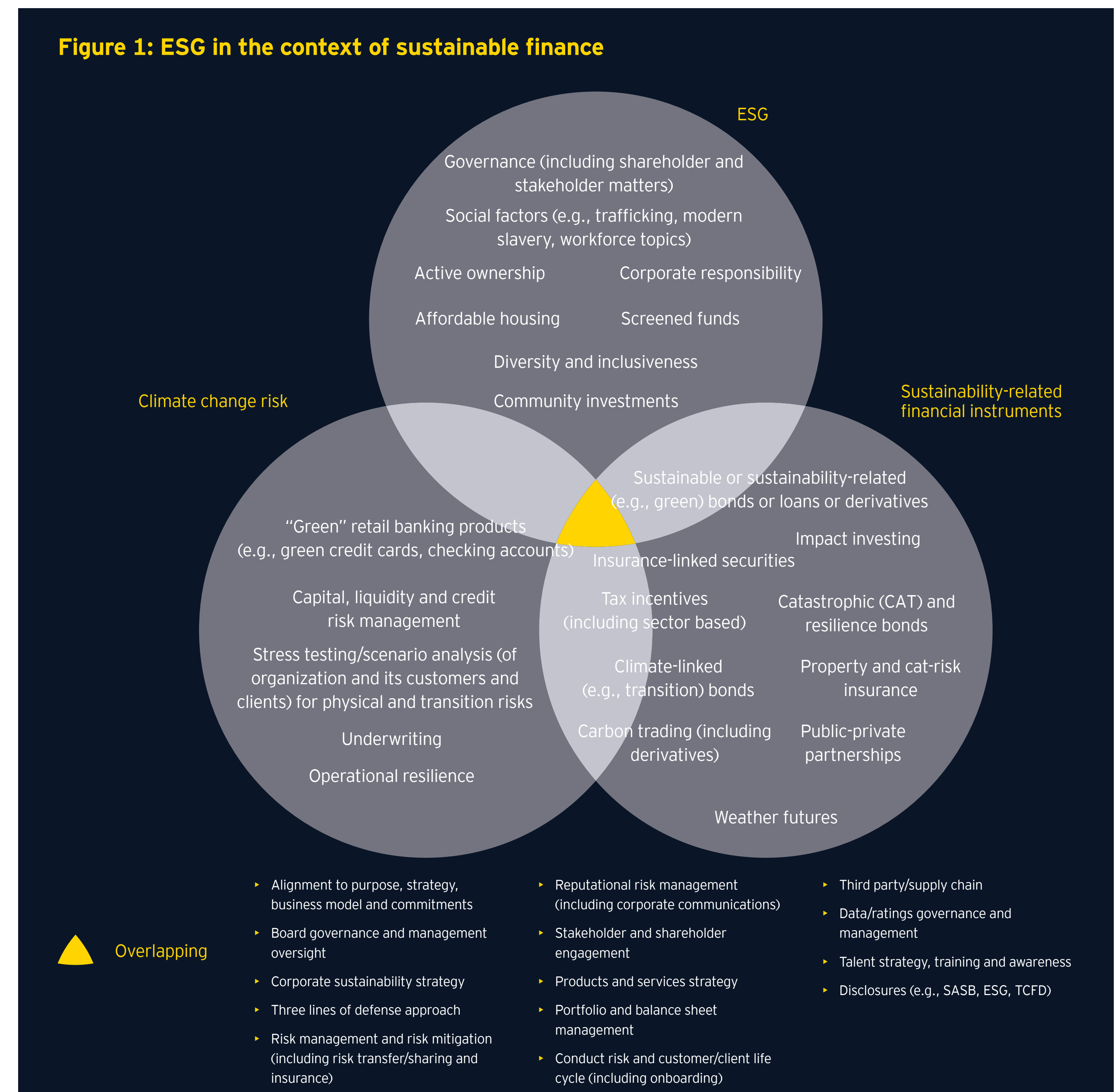
How ESG links to sustainable finance

It is useful to view ESG investing in the context of sustainable finance, a much broader area. Sustainability-related financial instruments are debt or equity instruments aligned to ESG factors and designed to promote specific behaviors or insurance that allows for risk transference and sharing. The following page provides an overview of types of sustainability-related lending.

The other pillar of sustainable finance is climate change risk. Those risks include both physical damage as a result of weather events (e.g., floods, wildfires) and the impacts and risks that result from the longer-term shift toward a low-carbon economy (e.g., policy, technology, customer sentiment). This emphasis is not new; in fact, the WEF's top five risks for 2020 were all related to the environment before the pandemic.

Figure 1 highlights the links between ESG, sustainability-related financial instruments and climate change risk.

Figure 1: ESG in the context of sustainable finance



Types of sustainability-related lending

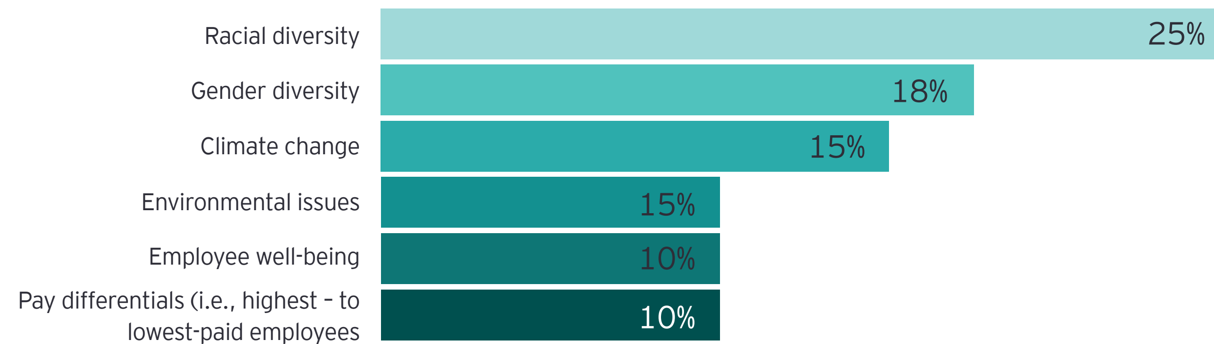
- **Sustainability-linked corporate loans:** To encourage clients to meet their sustainability goals, banks are offering incentive-based loans, whereby the lender either receives differing levels of rates depending on their achievement of certain sustainability objectives or pays a "step-up" rate if it falls short.
- **Transition bonds:** These are bonds that provide funds to finance transition technologies, such as less-carbon-intensive alternatives, or for the development of more sustainable business models.
- **Social bonds:** Similar to environmental bonds, these provide funds for areas such as education, health care, housing and employment.
- **Resilience bonds:** These are akin to catastrophe bonds that link insurance premiums to resilience projects, so the issuer garners a financial benefit in premiums linked to the loss they avoid by completing the project. In effect, the reduction or "rebate" relates to measurable risk reduction.
- **Insurance-linked securities (ILS):** Typically, these are one-year securities designed between the entity that needs specific insurance and an investor (as distinct from three- to five-year catastrophic bonds, whereby the issuer discloses its model assumptions and a set of investors invests). These highly tailored ILS may evolve into more standardized short-term securities but already are a large part of this insurance segment.
- **Energy-efficient mortgages:** In effect, these provide additional funds in a consolidated mortgage to pay for home-efficiency improvements.

Proxy voting creates reputational risk

Shareholder voting patterns provide visibility into emerging issues. Take environmental and social matters. Not so long ago, shareholder proposals on such issues attracted only a minority support; in 2016, only 29% of proposals gained the support of more than 30% of shareholders. Today, support for such proposals has increased materially; in 2019, 48% of proposals had more than 30% support.

Fund directors are well aware of the challenges in proxy voting. They have witnessed the increase in shareholder activism during the past decade and know that as their funds vote their shares as fiduciaries on a growing set of issues, there is an increase in reputational risk if the proxy issues are not underpinned by a deliberate and transparent voting policy that aligns with the firm's broader ESG policies. Figure 2 shows the views of mutual fund directors on which ESG issues present reputational risk to funds, if they are not well managed. Not surprisingly in the current global context, diversity issues rank highest.

Figure 2: Voting issues with highest reputational risk



Clearly, the central challenge for boards is validating that ESG issues are understood in context of the proxy-voting process and managed in a consistent and informed manner by their advisor.

Types of sustainable investment

- **Negative/exclusionary screening:** The exclusion from a fund or portfolio of certain sectors, companies or practices based on specific ESG criteria.
- **Positive/best-in-class screening.** Investment in sectors, companies or projects selected for positive ESG performance relative to industry peers.
- **Norms-based screening.** Screening of investments against minimum standards of best practice based on international norms, such as those issued by the OECD, ILO, UN and UNICEF.
- **ESG integration.** The systematic and explicit inclusion by investment managers of environmental, social and governance factors into financial analysis.
- **Sustainability themed investing.** Investment in themes or assets specifically related to sustainability (for example clean energy, green technology or sustainable agriculture)
- **Impact/community investing.** Targeted investments aimed at solving social or environmental problems, and including community investing, where capital is specifically directed to traditionally underserved individuals or communities, as well as financing that is provided to businesses with a clear social or environmental purpose
- **Corporate engagement and shareholder action.** The use of shareholder power to influence corporate behavior, including through direct corporate engagement (i.e., communicating with senior management and/or boards of companies), filing or co-filing shareholder proposals, and proxy voting that is guided by comprehensive ESG guidelines.

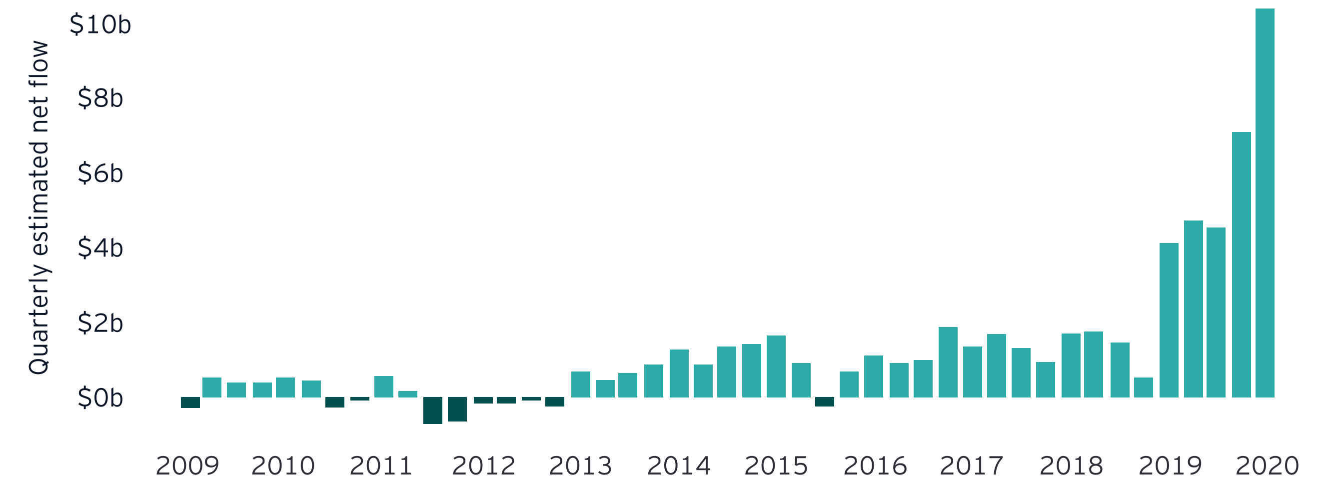
Source: Global Sustainable Investment Alliance

A major growth platform, going forward

The growth of sustainable finance appears inexorable. Take three examples:

- **Investment funds:** Even two years ago, assets under management (AUM) linked to ESG-related factors had already reached almost $30 trillion, up 34% from two years prior.[1] Since then, the growth has accelerated, as show in Figure 3.
- **Bond market:** The ESG-related bond market is showing growth. Last year was a record year for issuance, at almost $260m.[2]
- **ESG data market:** The market for ESG data is growing apace, with estimates suggesting it may reach $1 billion globally by next year.[3]

Figure 3: Sustainable fund inflows, 2009-Q1 2020



Source: CNBC

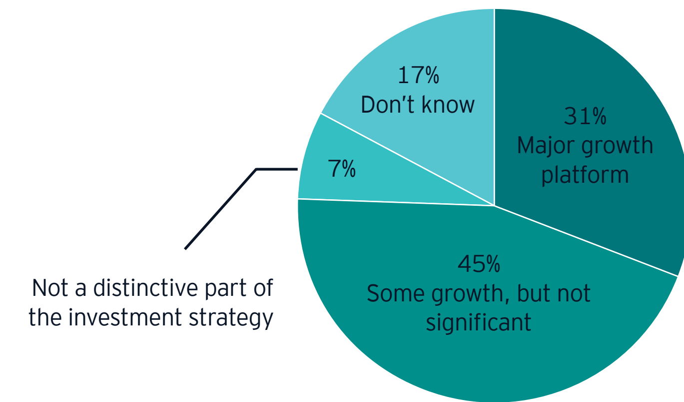
[1] 2018 Global Sustainable Investment Review
[2] Climate Bonds, February 2020
[3] Opalesque, March 11, 2020

ESG investing continues to evolve. The original — and still the most dominant — approach to investing involved using ESG criteria to screen out specific companies or sectors. More recently, more sophisticated approaches to integrating ESG factors into the investment process has fostered growth.

The debate on the performance of ESG investing continues. Advocates of ESG investing point to a growing body of research concluding that ESG-related funds outperform funds that do not incorporate ESG factors. Recent fund performance during the COVID-19 arguably supports this case. However, there are concerns about the sustainability of the performance and whether screening out investments may reduce the benefits of diversification. Though the debate will be enduring, it hasn't stalled asset growth.

Though COVID-19 has greatly altered the focus of many stakeholders, few expect it will derail the sustainable agenda (see sidebar below). The bottom line is mutual fund boards should expect the considerable momentum behind ESG and sustainability-linked financial instruments to gather pace in coming years. Thus, they need to challenge their fund advisors' strategies to harness this growth to include the different types of sustainability-related lending, as discussed earlier. Indeed, as shown in Figure 4, fund directors already expect ESG to be a very real growth engine, with more than 75% saying it will play a part in their fund's growth strategy.

Figure 4: Role of ESG-related investments in fund growth over the next five years



If anything, COVID-19 has placed more emphasis on ESG

Prior to COVID-19, environmental factors, notably climate change, had shot up the agenda, alongside strengthening governance of sustainability. This trend was reaching a crescendo following the Davos agenda, just prior to onset of the COVID-19 pandemic. That said, diversity and inclusiveness, notably gender equality, became a key focus over the past couple of years.

Social issues during COVID-19 stole the limelight, with a focus on employee well-being and broader human capital matters, as well as on companies' broader societal role. The more recent focus on racial discrimination greatly elevated the breadth of the discussion on diversity. The governance focus shifted to operational resilience, cybersecurity threats brought on by remote working and risk management.

Figure 5: What has changed in light of COVID-19

- The immediate increase of air quality and reduction of pollution show that ecological measures to combat climate change can be effective when applied consistently.
- The global and rapid spread of COVID-19 shows that beside climate change further sustainable development goals (SDGs) like health and well-being need to be taken into focus.
- Politicians are now stressing the importance of listening to scientists and experts, and wider society is looking to them for guidance and solutions.
- The rapid shutdowns all over the world reveal the magnitude of consequences when being hit unprepared by a global crisis and show that early mitigation and preparation measures are key to circumnavigate future disasters.
- Digitization emerges as a key factor for companies to survive during the COVID-19 crisis, with digital infrastructure being a basic necessity.
- The changes made post the -financial crisis have put the financial system in good stead to weather the shocks and tail effects of the COVID-19 pandemic.

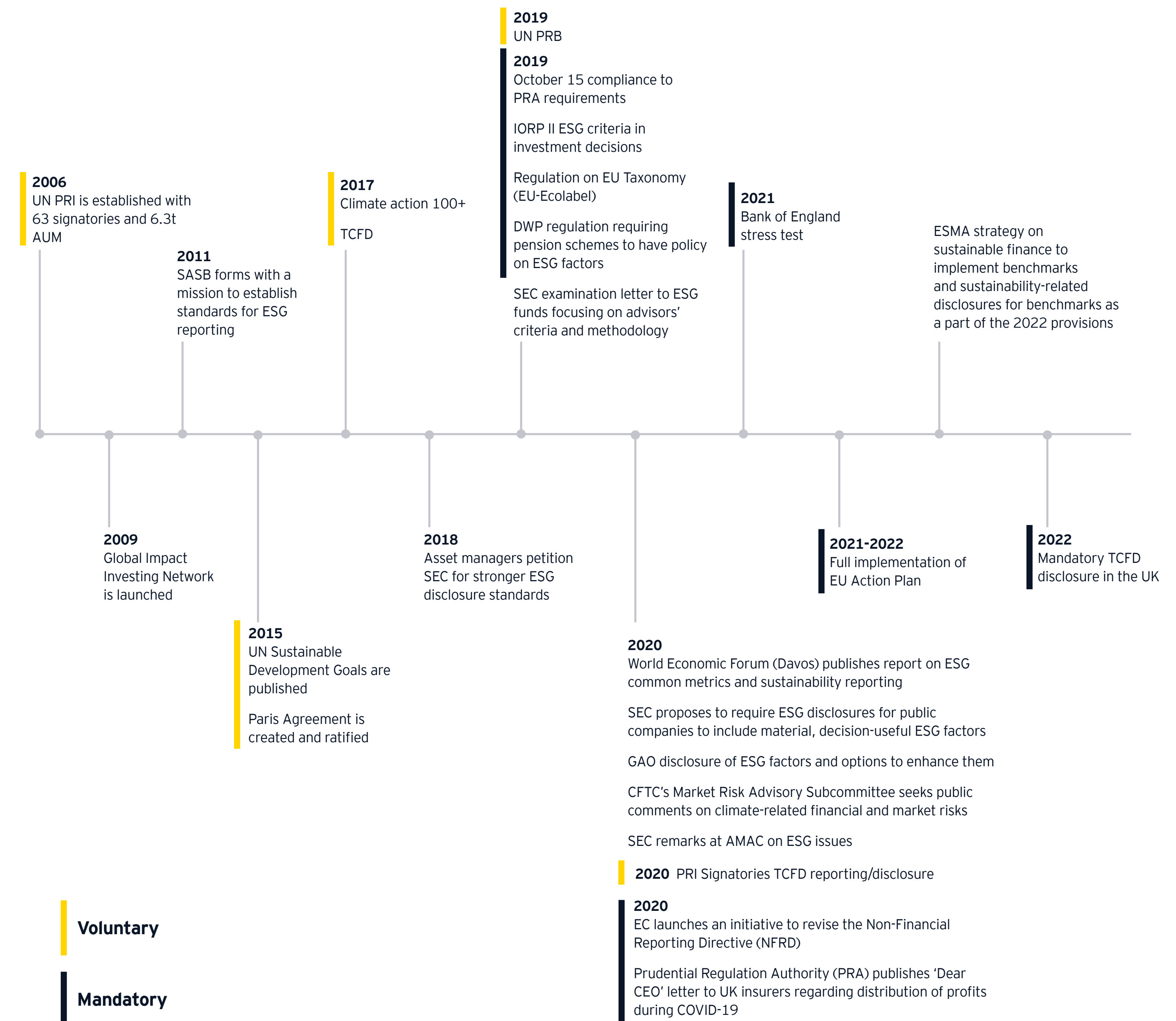
This will likely shape how sustainable finance and ESG issues are managed. For example:

- Creating a more sustainable financial system involves developing a deeper understanding of the broader societal context in which businesses and financial services itself operate.
- For the financial system to better understand climate risk, physical risk or transition risk, there is a need for more consistent data, standards and methodologies.
- Stress testing and scenario modeling will help equip financial services firms for future sustainability shocks, such as climate change catastrophes and social disruptions.
- Reporting on sustainability factors has become increasingly important, and organizations are working hard to encourage greater disclosure and consistency.

Intensifying regulatory focus and the emergence of disclosure standards

Regulators are aware of the increase in activity in sustainable finance and ESG and, as such, are increasingly focused in this area, alongside the activities of investors and industry, which are highlighted in Figure 6. The most enduring regulatory focus has been on nonfinancial disclosures, including the use and quality of private sector-led standards (see next page).

Figure 6: A brief history of significant ESG activity



A complex and evolving set of nonfinancial disclosure requirements

In terms of global reporting, numerous ESG industry groups and international agencies have published voluntary ESG-related disclosure guidelines, as seen in Figure 7. The Global Reporting Initiative has become the de facto standard for sustainability reporting for a broad group of stakeholders. Launched in 1987, its guidelines are now followed by a significant portion of the Fortune 250.

The global reporting standard developed by the Sustainability Accounting Standards Board (SASB) focuses on the metrics of most interest to investors and was developed through a stakeholder-inclusive process. The Task Force on Climate-related Financial Disclosures (TCFD) is important, given how it has expanded the thinking of many stakeholders. For instance, TCFD encourages boards to ask not just "What is our organization's impact on climate change?" but also "How could climate change impact our organization?"

If and when reporting standards are imposed, boards should not lose sight of the upside. For instance, clearer and more consistent disclosures can help fund companies tell a better story to the market, gain credibility and provide valuable investor-ready data about their funds and the companies in which they invest.

However, in recent years, the regulatory focus has shifted markedly to ESG-related products and services. There are growing concerns about the considerable challenges investors face in evaluating what constitutes a green or ESG-related product. The absence of global — or even regional — standards for "green" products or an agreed taxonomy of product terms exacerbates the difficulty.

Some regulators are questioning the quality of data and the processes used to build ESG considerations into products and services. Indeed, Securities and Exchange Commission (SEC) Chairman, Jay Clayton, recently said, "I have not seen circumstances where combining an analysis of E, S and G together, across a broad range of companies, for example with a 'rating' or 'score', particularly a single rating or score, would facilitate meaningful investment analysis that was not significantly over-inclusive and imprecise."[4]

Some regulators have raised questions about the fiduciary responsibilities of mutual funds to deliver positive, or least not suboptimal, financial returns — even if investors are willing to take the risk of having a less diversified portfolio (for example, due to screening out certain sectors or types of firms). Regulators worry investors are not sufficiently aware of this associated investment risk.

[4] SEC, May 27, 2020

Figure 7: Major nonfinancial disclosure initiatives

Name	Guidance (disclosures, performance indicators, etc.)	Mandatory
UN six Principles for Responsible Investment (PRI): signatories include 7,000 institutions in 135 countries	Climate-related financial disclosures	N
UN Sustainable Development Goals (SDGs)	17 SDGs adopted by all UN Member States (e.g., ending poverty, clean water and sanitation, ending hunger)	N
Sustainability Standards Accounting Board (SASB)	Accounting standards across environment, social capital, human capital, leadership and governance, and business model and innovation topics	N
Sustainable Insurance Forum (SIF)	Climate-related financial disclosures	N
World Economic Form	Sustainable development	N
Task Force on Climate-related Financial Disclosures	Climate-related financial disclosures	N
European Commission/ESMA	Non-Financial Reporting Directive (NFRD)	Pending
Organisation for Economic Co-operation and Development (OECD)	Sustainability impact assessment	N
Global Reporting Initiative (GRI)	Sustainability reporting	N

Ten major ESG issues for mutual fund directors

Despite the huge market momentum toward ESG, integrating it into the business will not be easy for mutual funds or other large players in financial services. The lack of generally accepted reporting standards is one challenge. It's difficult for peers to compare their ESG efforts or progress toward ESG goals without common metrics, which are still a few years away from widespread implementation. For ratings and data, multiple agencies use different scoring methodologies, causing further confusion.

Scaling ESG presents unique challenges for large fund companies and banks. They may struggle to attract investors away from specialized and niche firms that have made their name through their "impact" investment strategies. The bottom line is that expanding to a full suite of ESG offerings may be more costly and time intensive than some firms expect, given the need to access specialized skills and data, build robust technology solutions to leverage ESG data, and the costs of marketing such funds on an ever-crowded market.

In seeking the solutions to these challenges, fund directors might consider adopting the point of view of their financial advisors, whose concerns frequently include:

- "My client only wants to invest in companies with a low carbon footprint, but I can't find that information in company reports."
- "Is an AAA ESG rating better or worse than a 90 ESG rating?"
- "My client keeps asking about ESG. I'm afraid that they will move to a competitor if I can't provide ESG offerings."

Based on its engagement with the industry, EY has identified 10 major challenges for mutual fund directors related to ESG to work through:

1. **Reputational risk associated with proxy voting:** As directors are well aware, proxy voting may be a fiduciary responsibility, but it carries significant reputational risk if it is not informed by a deliberate voting policy. Beyond policy, funds — especially smaller funds — face challenges in managing voting policies and processes, especially when they rely on third-party proxy-voting firms. Of course, reputational threats can stem from risks not associated with proxy voting, especially in social media within which potentially negative issues can arise and be amplified quickly.
2. **Lack of rigor in incorporating ESG factors into the investment process:** Building ESG into the investment process is not easy; the topics are complex and inevitably more qualitative than financial matters. Directors have to be confident the fund's investment procedures perform as disclosed to investors (for example, that the proportion of investments that should be influenced by ESG factors are, in fact, determined that way). They have to validate that the fund uses ESG data consistently by portfolio managers in the investment decision-making process and that the fund builds ESG into the due diligence for major investments, as necessary. The fund's governance of ESG investing needs to be well defined and rigorously managed

3. **Lack of quality ESG data to use in developing products and services, and distribution needs and requirements:** Notwithstanding the growth in available ESG data, there are concerns about how useful or insightful that data is. Fund directors should seek assurances from their fund advisors that investment professionals are using an appropriate level of judgement and healthy skepticism when using ESG in their decision-making or in the development of ESG-related services (e.g., data or portfolio management) for clients. Using a single provider often leaves data gaps to a firm which has led many firms to consolidate multiple sources and, in some cases, build their own scoring methodologies and algorithms. However, multiple providers imply higher costs and coordination efforts, and any home-grown scores represent a risk - both of which have to be carefully assessed.

4. **Mis-marketing of ESG products:** Regulators are increasingly focused on so-called "greenwashing," whereby financial services firms knowingly or accidentally mis-market products and services as ESG friendly in nature. A portion of the growth in number of ESG funds during COVID-19 appears to have come from funds simply rebranding themselves. The lack of industry standards makes such concerns real, as investors and customers do not have a means to assess the quality of the products and services relative to such standards. Directors should gain assurance the fund is appropriately marketing its products, services and credentials. Increasingly, issuers are seeking assurances from third parties that ESG-related products and services are constituted and operate in line with public disclosures and other communications, with the goal of boosting investor confidence and mitigating reputational and compliance risks. The options include agreed-upon procedures, other kinds of attestations, more detailed assurance statements and certifications. Already, in some markets (e.g., green bonds) such assurance is almost a prerequisite for issuance.

5. **Lack of compliance with evolving ESG-related laws and regulations:** Mutual funds directors take their compliance responsibilities very seriously and rely heavily on their fund's chief compliance officer (CCO) to assess whether and how processes, procedures and disclosures meet legal and regulatory requirements. Fund directors are aware the regulatory picture for ESG products and services is evolving. Not surprisingly, when polled, over 4 (42%) in 10 fund directors identified compliance as their largest concern in terms of ESG. It is important that fund boards get routine updates on regulatory trends and changes and seek assurance from the CCO that the fund's practices are keeping pace.

6. **Third-party ESG-related risk:** Mutual funds rely on a host of third parties, affiliated subadvisers and service providers and increasingly expect more of them to meet their ESG standards and requirements. Fund boards have to discuss ESG with relevant advisors and seek assurance that the fund's standards and requirements are being met fully and can accommodate future changes. Almost a fifth (19%) of fund directors view this as one of their main concerns about ESG.

7. **Inability to capitalize on ESG growth:** Directors may feel bullish about the growth opportunities presented by ESG, but without a clear strategy as to how to attract and retain ESG-seeking investors, and a plan to distinguish the ESG funds in an increasingly crowded marketplace, those opportunities might not be realized. A trusted brand and differentiation are key success factors. Directors have to gain confidence the fund has an effective strategy to launch and grow products and to remain competitive and visible in the market.

8. **Lack of board reporting and oversight:** The fact is fund boards have to be engaged on ESG matters. Not only is it part of their fiduciary responsibilities, it is a critical competitive issue for funds, going forward. Yet, almost a fifth (19%) of fund directors view this as one of their main concerns about ESG. They worry they do not receive sufficient information on their fund's ESG strategy, performance and proxy-voting record, and that they do not apportion sufficient time to ESG issues when evaluating investment managers and other service providers. Fund boards will need to rectify these governance shortfalls.

9. **Misalignment between sponsors and funds:** Even though fund boards operate independently of their fund manager, it would be naive to believe fund directors are not aware of the risks associated when ESG strategies, the fund sponsor's public statements, and the ESG policies and proxy-voting practices of the fund manager are misaligned. In a world where social media can quickly amplify perceived discrepancies between statements and practice, it is important that fund directors are sufficiently attuned to where those misalignments could create reputational risks.

10. **Substandard ESG disclosures:** Fund managers are increasingly committed to new voluntary standards and more demanding mandatory disclosures. Directors should understand what disclosure frameworks or requirements the fund advisor has committed to or might be subject to and validate the fund has processes to assess the accuracy and consistency of these disclosures on an ongoing basis. It is especially important that the fund has accurate and timely disclosures about ESG fund strategies and performance.

Moving forward to success in the age of ESG

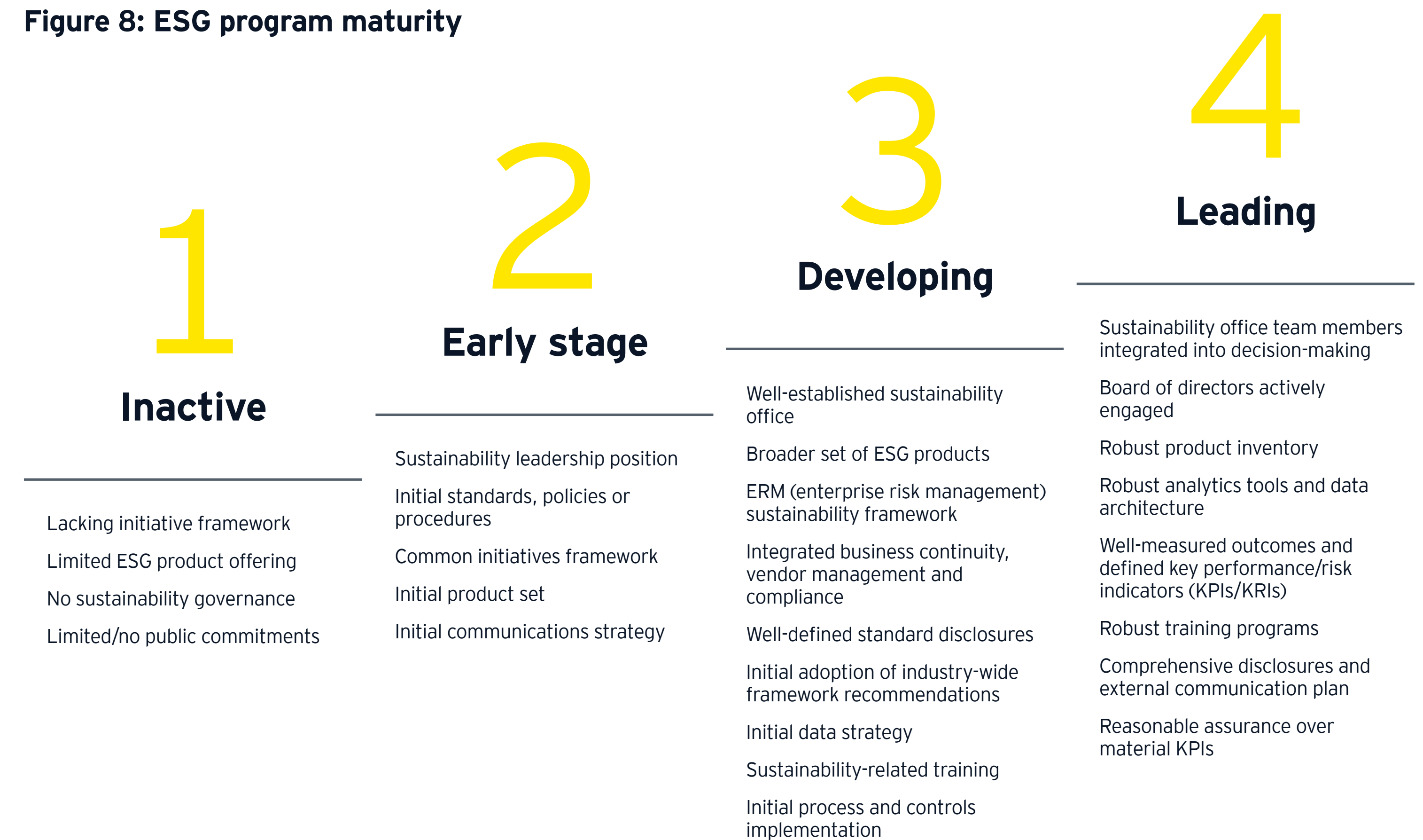
Financial institutions of all types face increasing pressures from stakeholders — including investors and customers, employees and the communities in which they operate — to enhance how they manage ESG issues and engage in the fast-growing sustainable finance market.

Directors have to engage their fund advisors to determine if they are:

- Integrating sustainability into business strategy and aligning to purpose
- Defining their corporate ESG and sustainability frameworks
- Establishing cross-functional teams and accountabilities to drive performance across investment centers

They need to assess the fund's maturity and in so doing recognize the industry is itself still maturing. As investors, asset managers may have been at the forefront of promoting ESG standards for many years, but increasingly they are having to live up to the very same standards. Few in the industry can truly say they are leaders in terms of maturity, in part because expectations and practices continue to evolve quickly. Many firms are still in the early stages or developing their approach, and some are, in effect, doing very little.

Figure 8: ESG program maturity



Fundamentally, fund boards should recognize how ESG and sustainability programs intersect with issues and opportunities ranging from branding and competitive differentiation, to social purpose and the organizational mission statement, to core business strategy and performance metrics. Thriving in the age of ESG starts with understanding ESG's direct impact across all of these strategic dimensions, as well as how it plays out on multiple tactical fronts. In practical terms, that means directors should expect to see ESG not as a single line item on future board agendas but rather a topic that will incorporate many areas of critical discussion.

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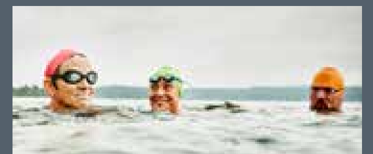

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