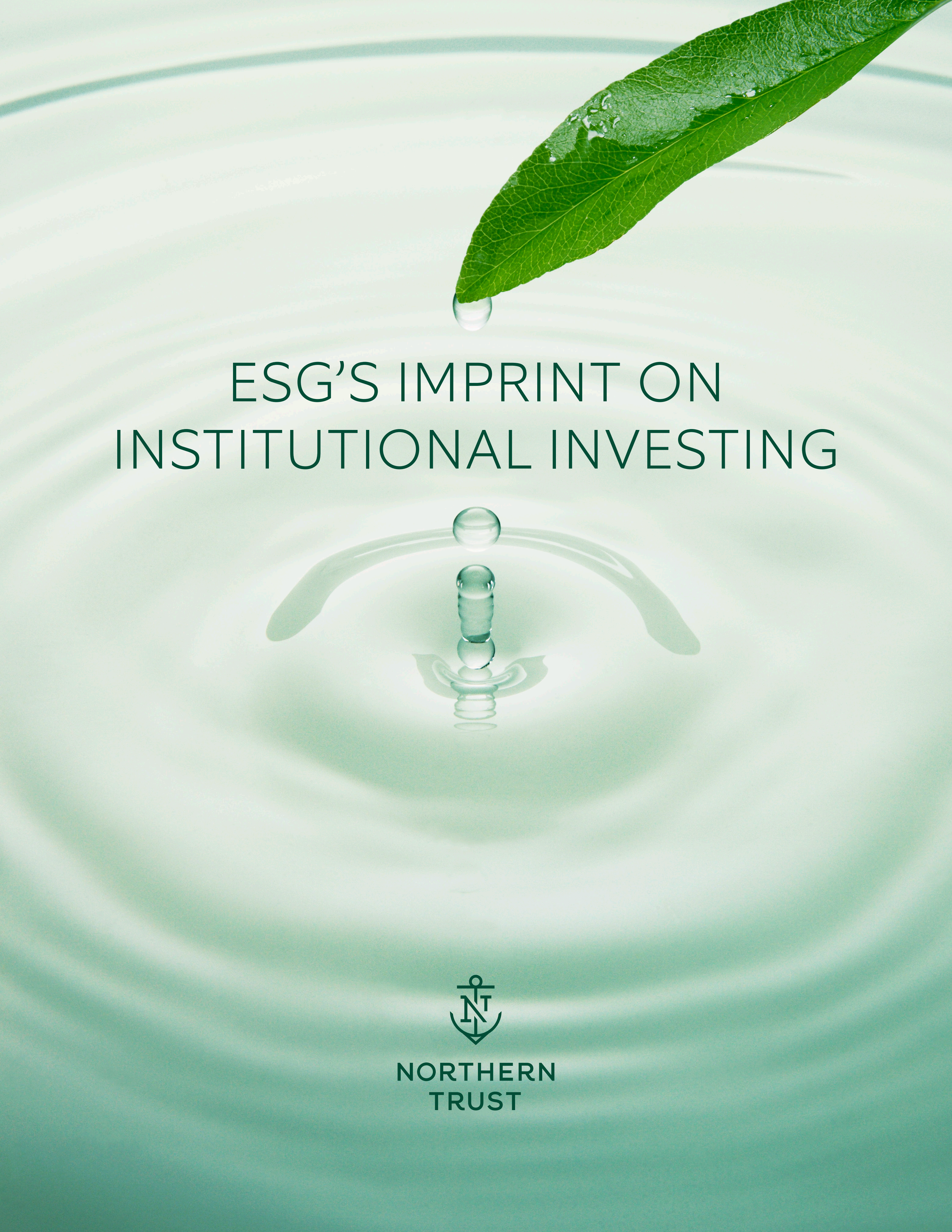


ESG'S IMPRINT ON INSTITUTIONAL INVESTING

NORTHERN TRUST

Managing Environmental, Social, and Governance (ESG) considerations has become a key priority for asset managers and asset owners. There has been a recognisable global shift, as investment businesses position themselves for a future where ESG is embedded in decision-making and investment practices. However, asset managers and asset owners are still determining what the future holds for risk and performance related impacts to their portfolios.

In the second quarter of 2022, Northern Trust and PwC Strategy& conducted a global ESG market study of institutional investor clients to explore attitudes, future needs and preferences, as well as key trends and implications for businesses. The study revealed that while many asset owners and asset managers want to reposition themselves as leaders in ESG investing, they face a plethora of complexities. Several megatrends are shaping the investment landscape and creating new considerations for market practitioners. Evolving regulation, regional differences, the vast proliferation of data and the need to embrace digital innovations in ESG all offer challenges as well as opportunities for the industry.

Executive Summary: A New Landscape

This year, global ESG assets may surpass $41 trillion, one third of projected total assets under management globally (AUM). ESG assets are expected to hit $50 trillion by 2025.[i]

Northern Trust's study of global institutional investors across a range of regions and client types revealed that investment groups are focused on ESG for a variety of reasons. 76% of institutional investors are pursuing ESG investing strategies to meet stakeholder expectations. 53% want to better align with corporate values, and 49% want to focus on ESG to maximise shareholder return. 45% feel they need to adopt ESG to meet regulatory requirements, while 16% want to benefit their local communities.

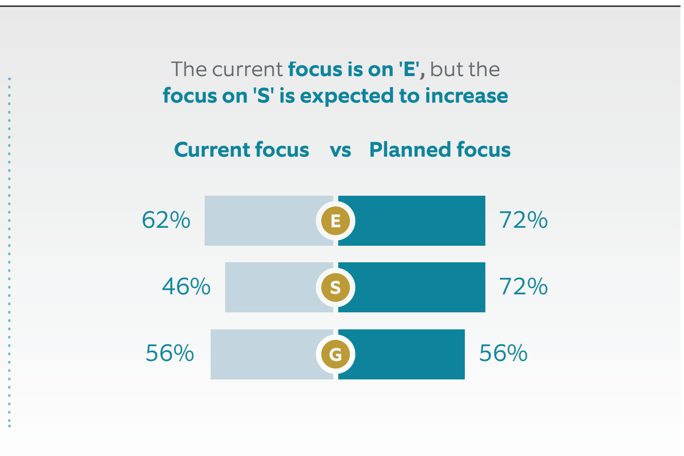
Figure 1 – Why are investors pursuing ESG?

Our survey shows that asset managers are taking more significant action on ESG now compared with asset owners. 53% of managers cite their approach as 'strategic', compared to 21% of asset owners (Figure 2). It is worth noting that much of the push by asset managers is in response to increased focus by their clients and their clients' end investors.[ii] And while 62% of respondents are currently most focused on the 'E' in ESG, the focus on 'S' is expected to increase the most in the near future (Figure 3).

Asset owners, meanwhile, are prioritising climate risk, and adopting net zero initiatives. Asset owners, primarily in Europe (43%) and Asia (44%), but also in the US to a lesser extent (32%) are pledging formal commitments to net zero goals, according to a Cerulli whitepaper. It also found that an additional 49% of European institutional asset owners plan to make a formal commitment within the next two years, compared to 31% in Asia and 29% in the US.[iii]

Figure 2

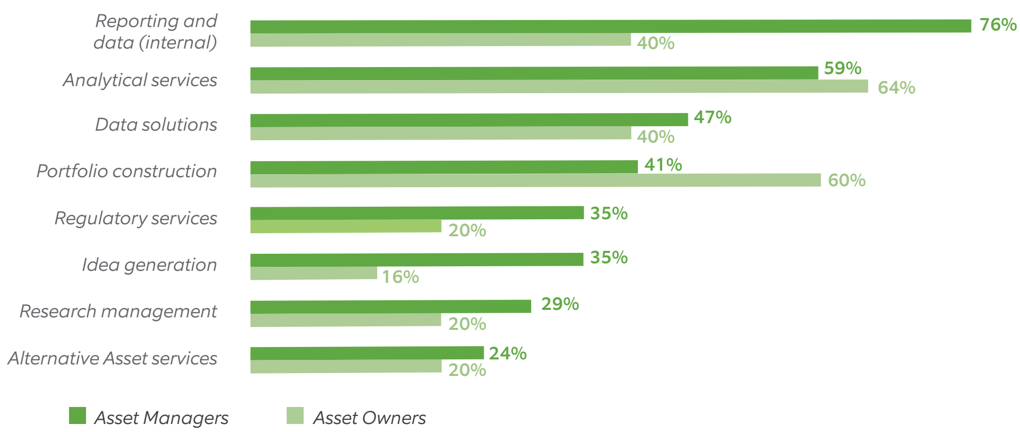
Figure 3



When asked what their greatest ESG needs are for their investing practices, 76% of asset managers cited internal reporting and data, while 40% of asset owners agreed (Figure 4). Also of significance were analytical service needs (59% and 64%), and data solutions (47% and 40%).

Figure 4 – What are their greatest needs?

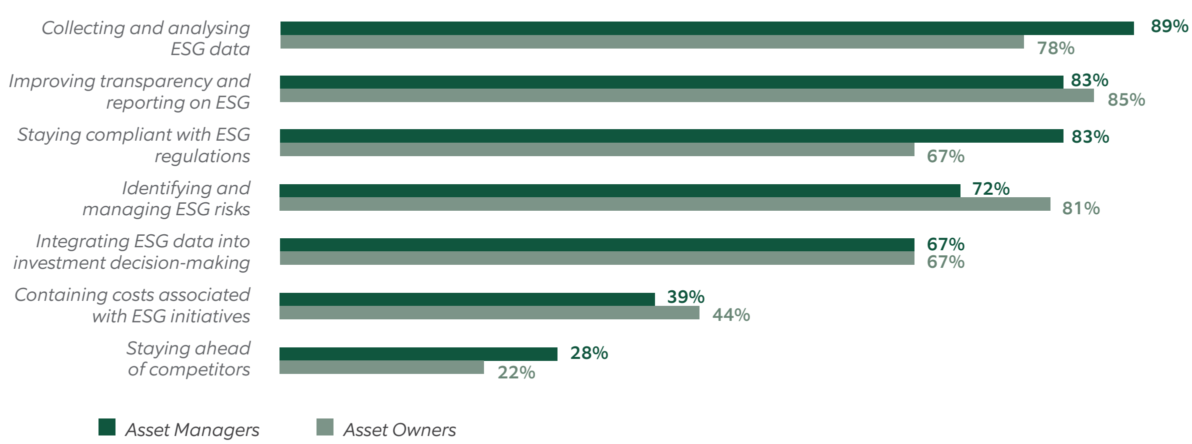
Across asset managers and owners there are prominent needs in data, reporting and regulatory services



Finally, when asked what their greatest challenges are to incorporating ESG practices into their investment process, the top three listed were collecting and analysing data, improving transparency and reporting, and staying compliant with regulations (Figure 5).

Figure 5 – What are their greatest challenges?

Collecting and analysing ESG data is a significant barrier to incorporating ESG into the investment process



THE RISE OF REGULATION

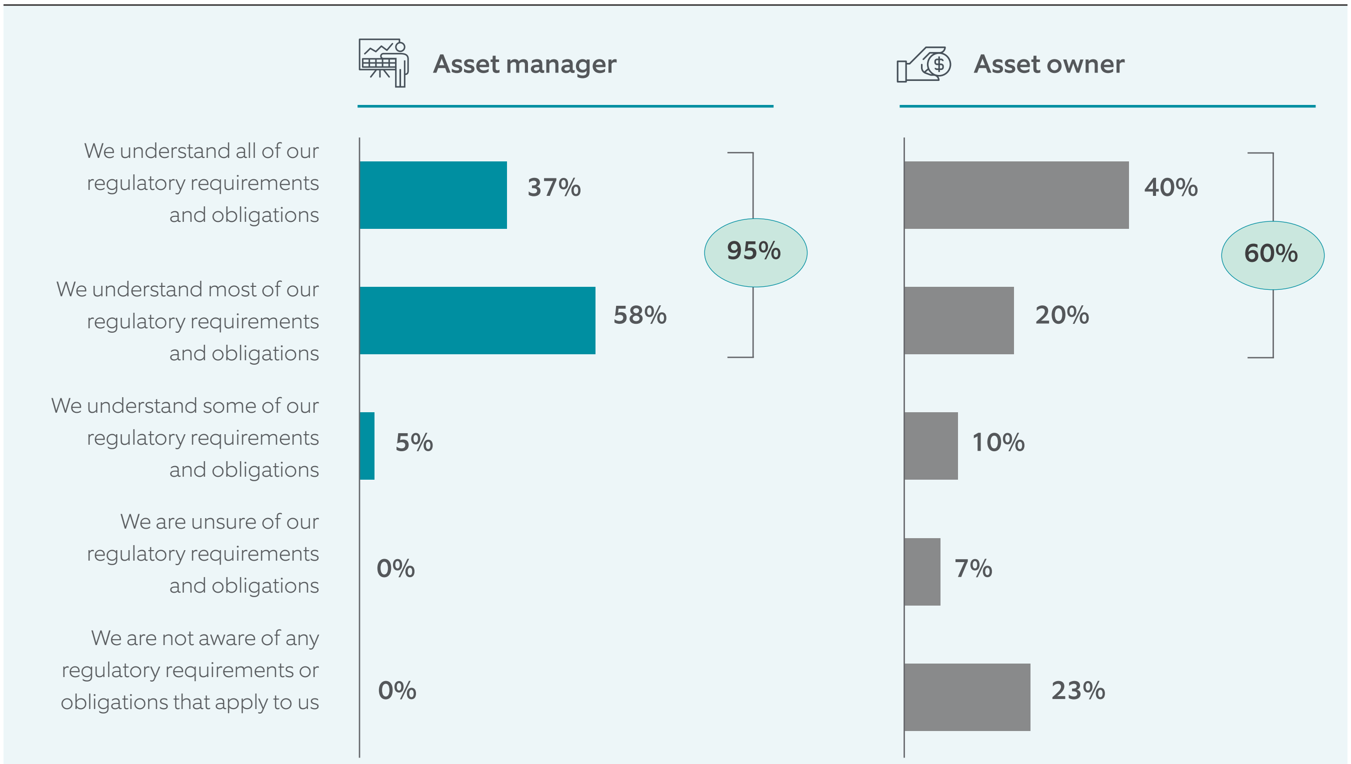
One key catalyst for the growth of ESG assets has been regulation, particularly the need for reporting standards, legal accountability and well-defined taxonomies. Regulatory drivers are considerable, complex, and evolving, and are being driven by investor sentiment as well as by regulatory bodies. Unsurprisingly, Europe has been at the forefront of legislation. Europe is home to 76% of sustainable funds and 81% of assets.[iv] However, regulation is being developed in different ways across the globe.

Global Regulatory Initiatives (partial list)

Region	Legislation	Focus
Europe	EU Taxonomy Regulation	Adopted in 2020 and provides a framework to identify the degree to which asset managers' financial products are living up to environmentally sustainable values.[v]
Europe	Sustainable Finance Disclosure Regulation (SFDR)	Launched March 2021 to address concerns about 'greenwashing' in the industry by putting in place transparency and reporting requirements on asset managers.[vi]
Europe	The Non-Financial Reporting Directive	Launched in 2016, requires companies with more than 500 employees to report on practices, including environmental and social matters, and treatment of employees and human rights, anti-corruption and bribery, and diversity on company boards.[vii]
Europe	The Pensions Directive, (also known as IORP II)	Went into effect in 2019 and regulates how financial institutions manage collective retirement plans.[viii]
Global	Task Force on Climate-Related Financial Disclosures (TCFD)	Global framework, but which eligible UK pension plans were required to adopt by October 2021.[ix]
Canada	Pensions & Benefit Act	Amended by Ontario Parliament in 2016 to disclose ESG factors into investment policy and procedures information.[x]
US	"Fund Names" Proposal	In May 2022, the SEC proposed two amendments to how ESG funds should be marketed and how investment advisors should disclose their reasoning when labelling a fund. The proposals are currently subject to public input.[xi]
US	Climate-Related Disclosure Proposal	Proposed rule changes by the Securities and Exchange Commission that would require certain climate-related disclosures to be included in registration statements and periodic reports.[xii]
APAC	Prudential Practice Guide CPG 229	Designed to assist APRA-regulated entities in Australia in managing climate-related risks and opportunities as part of their existing risk management and governance frameworks.[xiii]
APAC	Stewardship Principles (SSP) for Responsible Investors	Launched in 2016 in Singapore, sets in place a framework for strong governance for investors.[xiv]
APAC	National Pension Service Act of Korea	Requires the National Pension Scheme in South Korea to consider ESG issues and declare how they are taken into account.[xv]

As the alphabet soup of regulation continues to shape ESG development, both asset managers and asset owners will need to keep up. 83% of Northern Trust asset manager survey respondents cited regulatory compliance as one of their top challenges (Figure 5). 95% of asset managers said that they understood all or most of the relevant regulations, compared to 60% of asset owners (Figure 6). Industry conversations are ongoing regarding the need to get the data right, both for the types of information required by regulators as well as clarity of data available to investors and stakeholders who seek to avoid 'greenwashing'.

Figure 6 – Understanding of regulatory requirements and obligations



Key issues include understanding and interpreting regulations and understanding which are relevant to a particular business, with overlapping initiatives and divergent timelines adding to complexities.

Asset managers and asset owners will also have to consider wider ecosystems. The ESG landscape is fast moving and dynamic, and there is a danger that prioritising the need to adopt to regulation will limit wider change. Investor values and belief systems are changing faster than legislation is, for example. Moreover, generational shifts bring substantial changes in perspective. Ultimately, investors are leading on the future of ESG, and any over-focus on regulation risks getting in the way of long-term flexibility and change. ESG investing approaches need to be adaptable and future proofed, looking beyond regulation to broader needs in the coming decade.

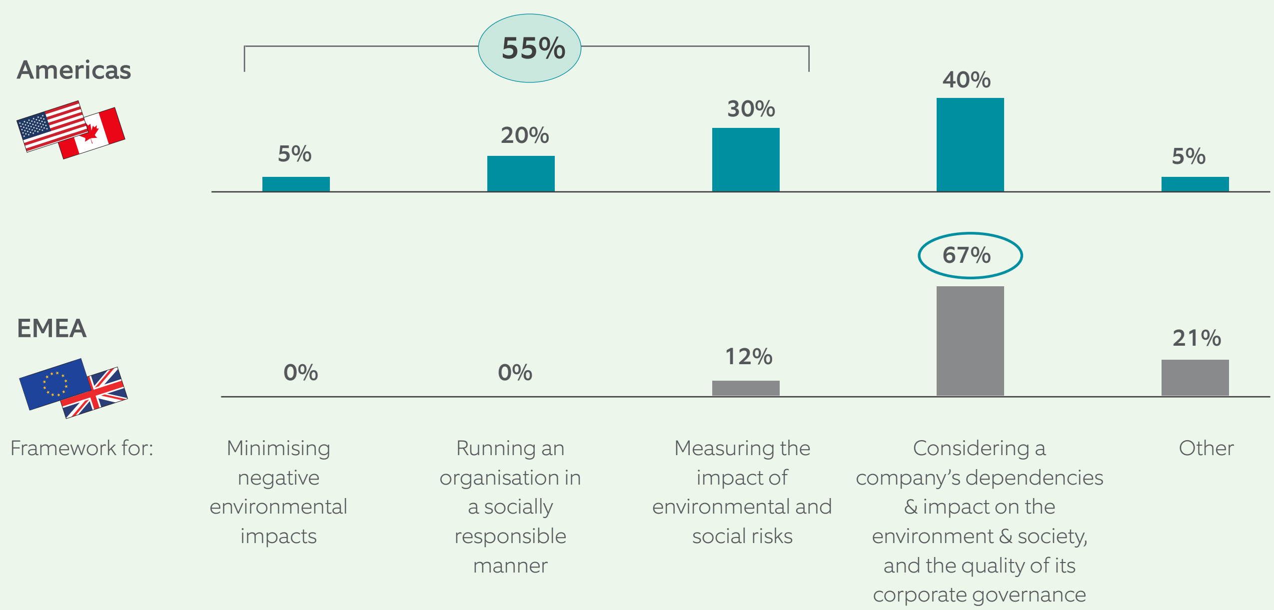
REGIONAL DIFFERENCES

Our survey revealed that, in addition to regulatory burdens, additional challenges remain. One key issue is the difference in regional perspectives. 67% of EMEA survey respondents view ESG holistically, for example, versus 40% of US clients. 55% of US clients focus on only one of the 'E' 'S' or 'G' factors (Figure 7). There is no one size fits all global solution.

Figure 7 – Client ESG focus

67% of EMEA clients view ESG holistically, while 55% of Americas clients focus on only one or two of 'E', 'S' and 'G'

Organisational definitions of ESG



In the US, ESG is at earlier stages, though recent SEC reporting requirements regarding climate risk considerations are acting as a driver for change. And despite limited government commitment pre-2020, the US took a leadership position at the 2021 COP26 conference (UN Climate Change Conference). There has also been an increased focus on the 'S' in ESG as larger organisations make efforts to focus on their diversity and inclusion metrics.

In Canada, pension plans have been leading the charge. For example, a number of large asset owners with approximately US$1.26 trillion in AUM called for companies and investors to provide consistent and complete ESG information to strengthen decision-making and better assess and manage ESG risk exposures.[xvi]

In the Middle East, where Islamic finance has been adopted in many countries, there is a great deal of overlap with ESG approaches already. The topic of ESG as a standalone issue is new to the region, with the focus being primarily on the 'E', and less on the 'S' and 'G', i.e., board transparency and governance. More focused initiatives are being developed, however. Abu Dhabi's Mubadala sovereign wealth fund is looking to build out an ESG unit, while Saudi Arabia's wealth fund has prioritised its own ESG framework.[xvii] Qatar Investment Authority (QIA) co-founded the One Planet Sovereign Wealth Fund Framework to help SWFs factor climate change related risks into investments and announced that it would no longer deploy new investments into hydrocarbon from 2020[xviii] The First Abu Dhabi Bank joined the industry led global Net Zero Banking Alliance, in alignment with UAE's 2050 net zero goal, and issued the first MENA bank green bond.[xix]

APAC represents approximately 20% of global assets,[xx] with Singapore ahead of other countries in the region with the actioning of ESG, for example through sovereign wealth fund Temasek's start up programme supporting climate innovators.[xxi] Temasek reached carbon neutrality in 2020 and aims to reach net zero in their portfolio by 2050.[xxii] Within China, the onshore market is most relevant for ESG, where the focus is on the 'E', driven by net zero commitments. In Australia meanwhile, while the Superannuation industry undergoes consolidation, the regulators are pushing for greater sustainability via the release of a prudential practice guide that is aligned to the TCFD disclosures.

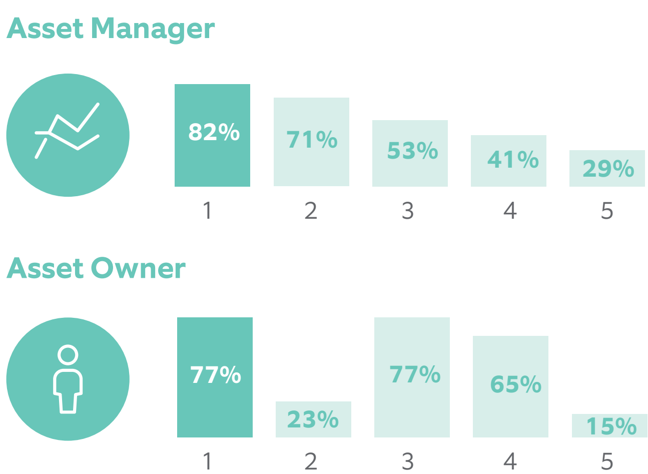
Europe is ahead of the game, with the Nordics and the Netherlands among the leaders. In the 2020 SDG Index, a key global framework for positive impact adopted by all United Nations member states which measures a country's total progress towards achieving 17 Sustainable Development Goals, five Nordic countries – Sweden, Denmark, Norway, Iceland and Finland – and the Netherlands, were all top ranked.[xxiii] 72% of European asset managers and distributors are considering stopping the launch or distribution of non-ESG compliant products, with 60% planning to do so by the end of 2024, according to PWC data.[xxiv] The UK, meanwhile, became the first G20 country to make it mandatory for large businesses to disclose their climate-related risks and opportunities, in line with Taskforce on Climate-related Financial Disclosures (TCFD) recommendations.[xxv]

PROLIFERATION OF DATA

Another challenge revolves around data. As ESG assets grow in the industry, so does the need for high quality data. Currently, there is no standardisation of data or shared industry standards for analysis and reporting, though a number of initiatives are in the pipeline. As a result, it has become a key focus. Spending on ESG data is on the rise, with an annual growth rate of 20%, according to one report.[xxvi]

89% of asset manager and 78% of asset owner survey respondents cited that collecting and analysing data was a top challenge in incorporating ESG into their investment process (Figure 5). There is an increasing need for standardised and comparable metrics, with 82% of asset manager survey respondents and 77% of asset owners citing that securing and normalising sustainable investing data is one of their top five challenges (Figure 8).

Figure 8 – Top challenge in incorporating ESG into investment decision-making process



1 Securing and normalising ESG data to inform decision making

2 Automating and optimising manual processes around ESG

3 Integrating ESG activity with the rest of the investment process

4 Analysing the performance of ESG investments

5 Hiring talent/expertise to perform analysis and research

The complexities around data and reporting will only increase, particularly as allocations to alternative investments continue to grow. The growth in demand for alternative investments is expected to grow by up to 46% over the next 12 months,[xxvii] and according to PwC, ESG is expected to become increasingly mainstream within alternatives, particularly within infrastructure.[xviii]

There is a clear challenge around building stronger reporting solutions and creating innovations that simplify not only the integration of ESG data, but can also help with screening, digitising the investment process, and ensuring ESG is properly aligned across portfolio construction. Any solution must support performance analysis and establish and evolve assessments of ESG impact on both portfolio and business risk.

Another key issue is the ability to interrogate and validate data that is used to comprise ESG scores. Asset managers and asset owners concerned about 'greenwashing' will want to be able to demonstrate that their products and investments are credible.

THE RISE OF DIGITAL INNOVATION

Digital innovation is transforming the investment landscape in every way, and in fact, is offering solutions to many of the challenges previously outlined. Digitalisation presents an opportunity to shape the ESG ecosystem and impact the way data flows. ESG has been a catalyst for innovations in digital growth, as both asset managers and asset owners leverage digital technologies and strategies to address the increasing demands of their sustainable investing portfolios.

Data is one example of how digitalisation has changed the landscape. While the challenge of the proliferation of data remains, data science is becoming second nature to 45% of asset managers.[xxix] Institutional investors are increasingly leveraging cloud computing, predictive analysis, blockchain, and asset tokenisation, all key in the management of vast amounts of data and in the management of complex workflows.

Moreover, distributed ledger technology (DLT) and artificial intelligence (AI) are helping investors shift through vast amounts of structured and unstructured data sets and build actionable insights.

Collaborative digital ecosystems are being created, where custodians become digital conduits for their clients, supporting them in the building of robust portfolio construction. Digitalisation will, in time, address many of the ESG standardisation challenges the industry faces, with the growth of new metrics and monitoring capabilities, and with improved transparency. It will also allow investors to move beyond box ticking regulatory exercises into new and emerging frontiers, driving real change.

As they embark on their ESG digital journeys, asset managers and asset owners should consider what support their providers and partners can offer in building the future.

Key Considerations Check List

Key Considerations for Institutional Investors

- What is your governance mechanism for your ESG process?
- Do you have an accountable individual or team that co-ordinates the internal and external facets of what you are doing related to ESG?
- How are you monitoring your service providers against their goals and outcomes?
- Can your service providers address your data and reporting needs or are they developing capabilities/partnering with other providers to do so?
- Do your providers have global reach to help support ESG mandates in your chosen markets?
- Do your providers have global regulatory expertise to help interpret new ESG requirements?
- Do your providers have policies and processes to gain visibility of supply chain, monitor progress of clients and third parties against ESG metrics and determine processes to update relevant contracts and legal agreements?

Asset owners and asset managers should ensure that their asset servicing partners can answer yes to all or most of the check list questions, that they have the global reach to understand and navigate regulatory complexities and that they have the reporting, risk, and analysis solutions required to build innovative ESG frameworks. Moreover, they should ensure that their asset servicers have credibility in this space themselves, that they are looking at their own carbon footprint, their DEI policies and their governance processes, for example.

LOOKING AHEAD

ESG investing presents both challenges and opportunities for asset owners and asset managers. Industry practitioners will need to navigate the existing and incoming patchwork of regulations and move beyond them to future proof their approaches to further change. They will need to manage the vast proliferation of data, and embrace digital innovations, particularly when it comes to ESG analysis, reporting, and business and portfolio risk. They will need to co-ordinate and co-operate in the interim given that global standardisation will take time to be fully established and adopted. Northern Trust's global ESG market study has revealed just how far the industry has come on ESG. Still, there is clearly a great deal more to be done.

LEARN MORE

To learn more please contact your Northern Trust representative or visit northerntrust.com.

FOOTNOTES

[i] https://www.bloomberg.com/company/press/esg-may-surpass-41-trillion-assets-in-2022-but-not-without-challenges-finds-bloomberg-intelligence/

[ii] Investors push companies for specific ESG actions this proxy season | Pensions & Investments (pionline.com)

[iii] https://www.pionline.com/esg/asset-owners-push-portfolio-level-metrics-net-zero-goals-cerulli

[iv] https://www.morningstar.co.uk/uk/news/202274/investors-back-esg-in-the-crisis.aspx

[v] https://www.northerntrust.com/europe/insights-research/asset-servicing/global-shift-to-esg-mindset

[vi] https://www.northerntrust.com/europe/insights-research/asset-servicing/global-shift-to-esg-mindset

[vii] https://www.northerntrust.com/europe/insights-research/asset-servicing/global-shift-to-esg-mindset

[viii] https://www.northerntrust.com/europe/insights-research/asset-servicing/global-shift-to-esg-mindset

[ix] https://www.gov.uk/government/news/uk-to-enshrine-mandatory-climate-disclosures-for-largest-companies-in-law

[x] https://www.northerntrust.com/europe/insights-research/asset-servicing/global-shift-to-esg-mindset

[xi] https://www.reuters.com/markets/us/us-sec-unveil-rule-crackdown-funds-greenwashing-2022-05-25/

[xii] https://www.sec.gov/news/press-release/2022-46

[xiii] https://www.apra.gov.au/news-and-publications/apra-releases-guidance-on-managing-financial-risks-of-climate-change

[xiv] https://www.northerntrust.com/europe/insights-research/asset-servicing/global-shift-to-esg-mindset

[xv] https://www.northerntrust.com/europe/insights-research/asset-servicing/global-shift-to-esg-mindset

[xvi] https://www.pionline.com/esg/canadian-plans-call-firms-improve-esg-disclosures

[xxvii] https://www.northerntrust.com/europe/insights-research/asset-servicing/global-shift-to-esg-mindset

[xviii] https://www.qia.qa/en/About/Pages/Climate.aspx

[xix] https://www.bankfab.com/en-ae/about-fab/group/in-the-media/20211210-fab-joins-uae-race-or-net-zero-carbon-emissions-by-2050

[xx] https://www.pwc.com/gx/en/industries/financial-services/assets/wealth-management-2-0-data-tool/pwc_awm_revolution_2020.pdf

[xxi] https://uk.finance.yahoo.com/news/singapore-temasek-commits-s-5-billion-to-set-up-climate-focused-investment-platform-072931657.html#:~:text=Yahoo%20Finance%20Singapore-,Singapore's%20Temasek%20commits%20S%245%20billion,up%20climate%2Dfocused%20investment%20platform&text=SINGAPORE%20%E2%80%94%20Temasek%20Holdings%20commits%20an,its%20net%2Dzero%20emissions%20goals.

[xxii] https://www.temasek.com.sg/en/news-and-resources/news-room/news/2020/temasek-review-2020-committed-resilient-together

[xxiii] https://www.esginvesting.co.uk/the-nordics-are-pioneering-the-future-of-esg/#:~:text=The%20Nordic%20countries%20are%20often,Finland%20%E2%80%93%20are%20top%2Dranked.

[xxiv] https://www.reuters.com/markets/europe/european-fund-managers-set-go-all-esg-survey-2022-06-27/#:~:text=The%20PwC%20survey%20of%203%2C354,the%20end%20of%20last%20year.

[xxv] https://www.gov.uk/government/news/uk-to-enshrine-mandatory-climate-disclosures-for-largest-companies-in-law

[xxvi] https://esgclarity.com/esg-data-spending-is-growing-20-per-year/

[xxvii] https://www.nasdaq.com/articles/alternative-asset-demand-expected-to-grow-46

[xxviii] Excluding private equity; Source: PwC Global AWM Research Centre, Preqin, Financial Times, Company websites, Morningstar, PwC Strategy& analysis

[xxix] https://www.swift.com/swift-resource/250581/download