# Sustainability Guide:
# ON THE RIGHT PATH


SFDR REGULATIONS

**Duncan Ferris examines the new SFDR requirements that pension schemes are getting their heads around, looking into how the industry has reacted to the regulations, how much demand schemes have felt from their members and how challenging adhering to the new rules might be**

**WRITTEN BY** DUNCAN FERRIS

# SFDR: A closer look

Level one of the European Union's new Sustainable Finance Disclosure Regulation (SFDR) took effect in March, increasing the environmental, social and governance (ESG) responsibilities for financial market participants such as pension schemes. In essence, these mean that schemes are now required to disclose information about their policies regarding the identification and prioritisation of things that will impact sustainability. These disclosures will need to be present on the market participants' websites, prospectuses and periodic reports. Level two disclosures, which are set to be even more comprehensive, will come into force from 1 January 2022.

### Objections?

It is no secret that pension schemes are becoming more aware of the importance of ESG and they are seemingly becoming more active in ensuring that they do not shy away from the issue. Mercer's *European Asset Allocation Insights 2020*, published last August, showed that 54 per cent of European schemes were now actively considering the impact of climate risks, compared to just 14 per cent in 2019. The same research found that 89 per cent of schemes considered wider ESG risks as part of their investment decisions, up from 55 per cent in 2019.

However, this increased attention to the issue of ESG does not mean that all aspects of SFDR in its current form have been welcomed with open arms by the European pensions industry.

Ravien Sewtahal, responsible for ESG at Stichting Pensioenfonds Medisch Specialisten (SPMS), says: "SPMS welcomes further harmonisation of ESG reporting and sees the SFDR regulation as paramount to achieving that objective. As such there is no objection to the SFDR requirements as a general concept.

"We do acknowledge that the SFDR regulation is not complete yet, and may incur costs from a data perspective at some point. We are actively seeking collaboration with our stakeholders and peers to balance potential extra costs with complying with SFDR."

PensionDanmark head of ESG, Jan Kæraa Rasmussen, goes further, stating: "Overall, we are strong supporters of the broad sustainability purpose of the SFDR but there are many details that we need to work with during implementation before we can make the final judgement."

However, AMF sustainability manager, Anna Viefhues, is more positive, commenting: "We share the ambition of the European Commission to increase transparency on sustainability. This is something that we have focused on for many years in the Swedish finance sector, for example, developing a national market standard for sustainability information. This standard will now be replaced by the new SFDR requirements."

Eversheds Sutherland pensions partner, Eric Bergamin, points out that the different forms that pension schemes take in different countries can cause friction. He explains: "Pension funds in the Netherlands are mainly seen as social institutions, not as financial institutions like banks and insurance companies. The SFDR regulation focuses on rules for financial institutions Pension funds, at least in the Netherlands, have a different way of disclosing information and communication to members."

He adds that funds are generally not subject to competition as approximately four-fifths of the nation's pension fund members are in mandatory sectoral funds, further entrenching the funds' distinction from financial institutions.

Bergamin then states that "current figures show that a large number of pension funds have chosen to opt-out of the SFDR rules", noting that SFDR was "not well received in the Dutch market".

He concludes: "My personal view is that the hesitation or even resistance against SFDR is not based on resistance against ESG investments, but against the rules not being adequate and tailormade for pension products, as offered in the Dutch market."

## Demand

ESG has been a hot topic in the industry for several years at this point, but how much demand is there from actual savers and professionals for information about how their savings are being invested, or how their workplace is using its money?

A spokesperson for Aviva Life & Pensions Ireland DAC makes it sound fairly straightforward, stating: "We are seeing an increase in interest by pension fund trustees, brokers and customers in how their funds are invested and an associated demand for ESG funds, which we expect will increase in the years to come."

Sewtahal is on a similar wavelength, explaining: "SPMS is increasingly experiencing a demand for transparency and ESG-awareness at our pension fund by our scheme participants. We welcome this development and take into account input from our participants as well in further developing our ESG policy."

In February, Morningstar highlighted the increased interest in ESG as it stated that sustainable open-end and exchange-traded funds available to European investors had attracted net inflows of €233 billion in 2020, noting that this was almost double the amount from the previous year.

However, this response appears not to be as universal as one might expect when it comes to pensions, with the demand clearly falling short of being a near-rabid hunger for pension schemes to formulate refined ESG strategies.

Rasmussen comments: "We feel that the demand is not yet huge for all of our members, but the demand is certainly in good growth, and our stakeholders among the social partners are very focused on sustainability."

Viefhues adds: "We see an increased interest, but it cannot be compared with, for example, consumer products. Our own surveys show that many savers expect pension companies to act and invest responsibly, and that climate is one important issue that they expect pension companies to work with."

## Challenge

It is also worth examining how challenging pension schemes will find it to adhere to SFDR requirements. Rasmussen acknowledges that, for some of the required indicators, the availability of meaningful data presents a "challenge", though he argues that he believes this difficulty "will be mitigated in the next few years".

Sewtahal appears to agree regarding these difficulties, stating: "SPMS has already started collecting ESG data on its portfolio with the objective to further tailor our ESG policy. We acknowledge that ESG data is still in its early stages, for example there is no international accounting standard on how to define ESG metrics.

"As such we welcome the SFDR regulation and will use that as our starting point. The biggest challenge right now is waiting for more clarity on the SFDR level two data reporting requirements, and the associated costs of accessing that data."

However, accessing meaningful data is not the only challenge, as making reporting accessible for customers is also a concern for some schemes. Speaking about AMF's experiences to date, Viefhues comments: "In March, we reported on the level one requirements for the first time, and for example labelled our traditional insurance product 'light-green'/Article 8.

"Implementing the reporting criteria in the regulatory technical standards will of course be a much larger project, and we, and I guess all our peers in the sectors, are struggling with interpreting the different requirements right now.

"One of the largest challenges, besides challenges with collecting data on the different indicators we should report on, will be to make the information easy accessible and understandable for the end-customer, and thus achieving the main purpose of the regulation."

Ultimately, it seems that the challenges schemes will face when it comes to SFDR implementation may lessen as the industry adapts to new responsibilities.

The level one requirements will allow schemes to dip their toes in the water before the next round of regulations come into force next year. ■

ESG INVESTMENT

# How to give all investors voting power within pooled funds

**As an open architecture platform, at AMX, we aim to instil an ethos of sustainability and help improve environmental, social and governance (ESG) practices among investors, managers and other service providers in the asset management ecosystem**

**WRITTEN BY** RYAN TULLY, BUSINESS DEVELOPMENT AMX

Whilst our industry, as a whole, has responded well to the call for choice in investment strategies in line with a growing focus on environmantal, social and governance (ESG), there exists a significant governance challenge for schemes, which has largely been unresolved, namely operational governance around stewardship.

A platform's focus on operational excellence offers a better way to address this notable 'governance gap' that currently exists in pooled funds. Importantly, the unique position of a platform allows for connection across a number of vendors, allowing the investor choice based on their specific needs.

## Stewardship - the governance challenge faced by trustees

Pension schemes are under increasing pressure from regulators and members to integrate sustainable investment practices. Where trustees have not developed their own policies, they should be familiar with their asset manager's polices and where appropriate, seek to influence them.

The Department for Work and Pensions issued specific guidance in February 2021[1] which stated:

*"Trustees should be clear on how stewardship fits within the scheme's investment strategy and how it helps them meet their climate-related objectives.*

*"Where they delegate to asset managers, trustees should carry out due diligence, ensure their approaches are in line with the trustees', set expectations, and hold managers to account."*

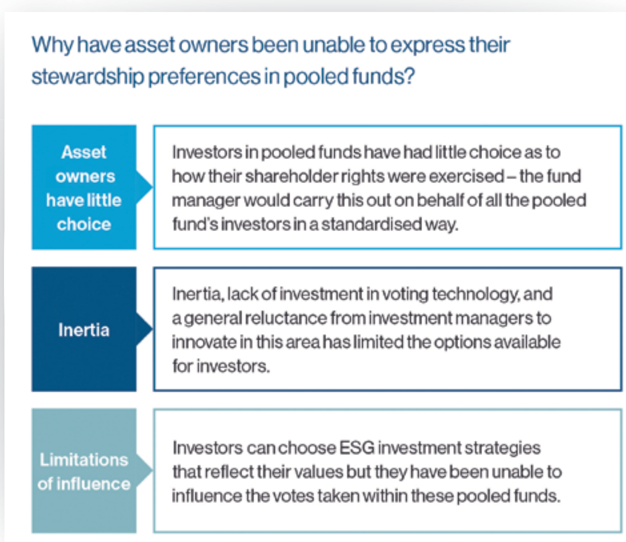
Furthermore, the guidance also stated: *"Trustees should document and disclose their own stewardship policies, report on how they have followed them."*

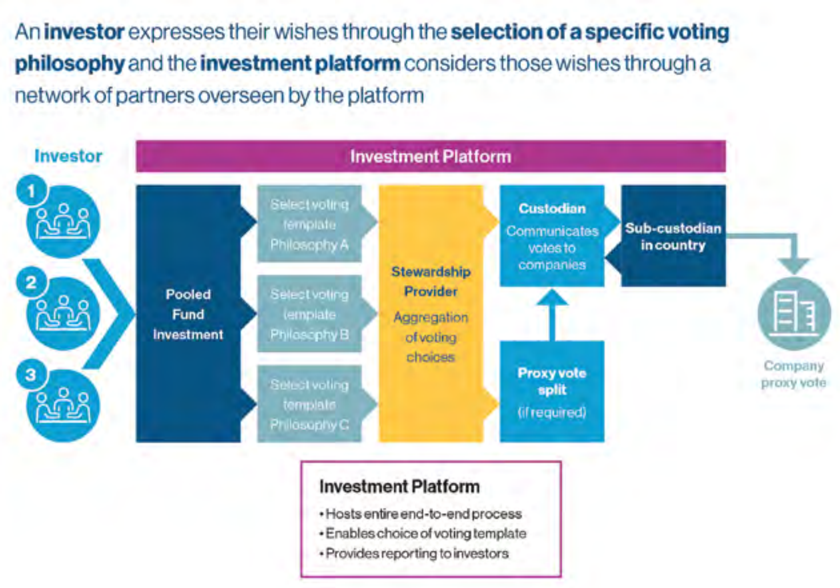
And yet, with $50 trillion AUM globally held in pooled funds[2], the challenge remains: how to exercise this stewardship responsibility within these funds?

Historically, investors in pooled fund structures have had little choice in how their voting rights were exercised. Fund managers would have voted on behalf of their investors but, where investor preferences diverged from the manager's own policy, it's the investor who has been forced to accept the votes placed by the manager, often with very little power to voice their views on issues such as on diversity of workforce.

That being said, the industry has responded by producing guidance on how to exercise stewardship through the use of voting templates, which is a way for investors to communicate their voting preferences to their investment managers.

However, many managers are still not geared to aggregate the voting preferences of multiple clients within pooled vehicles, nor have they demonstrated the flexibility to offer independent stewardship overlays for their pooled funds. Schemes which invest in pooled funds are reliant on the underlying manager's voting policies and initiatives such as the Association of Member Nominated Trustees' (AMNT) Red Line Voting and calls to managers for 'comply or explain' have been frustrated by limited action and innovation in these important areas.






## How institutional platforms provide stewardship solutions

A platform, with expertise in managing operational governance, allows the unbundling of stewardship activities from the manager implementing the investment strategy within a pooled fund. For some time, pooled funds have been available in the market which utilise a separate stewardship provider from the underlying manager. Investors can be confident that a general, proactive stewardship policy is in place for their investment and they have no need to lobby the asset manager to adopt their views.

A solution now also exists to address the challenges for investors in exercising their stewardship responsibilities across multiple pooled equity funds. Using a network of partners, a new service allows the aggregation of investor stewardship preferences for each voting philosophy, using templates such as the Pensions and Lifetime Savings Association's voting guidelines or AMNT'S Red Line voting principles. The votes will then be executed in alignment with these individual templates. Where voting philosophies may conflict on a specific vote, it is the intention to split the vote according to the proportional share of the underlying voting philosophies. This innovation offers the ability for investors to vote in line with their values whilst enjoying the benefits of a pooled fund.

## How it works in practice:

• Each investor makes an investment into the same pooled fund on the platform. The investment manager can manage equity strategies within the pooled fund. At onboarding the investor selects their preferred voting philosophy from a standardised template or by the creation of a bespoke template.

• The stewardship provider develops the rules for each philosophy to create a voting template which guides how votes are expressed. They aggregate the unit holder positions in the fund to determine the total assets guided by each voting template. And finally, they communicate the vote decision to the custodian for the fund. In some cases, this may be a split vote within the fund.

• The custodian and their proxy implementation vendor allow the stewardship provider to cast the vote(s). After recording the vote(s), the confirmation process returns through the same chain.

• Reporting is provided by the platform to each investor on how the votes were cast. Reporting helps the trustees prepare their Implementation Statements, but with an important twist. The 'material votes' included in the Implementation Statement will have been selected by the investor, not by the manager.

An investment platform is in the unique position to work with multiple stakeholders and partners, through the ecosystem it has built up, to solve operational governance gaps, paving the way for more industry participants to respond in kind. Now that the 'impossible' is indeed possible, all trustees are in a position to demand independent stewardship services for new equity pooled fund tenders by institutional investors.

This paradigm shift will begin the transition of voting power from investment managers to the rightful institutional investors owners and will increase the speed by which important climate change and governance issues are addressed by corporate stewards across the globe. ■

[1] *www.gov.uk/government/publications/aligning-your-pension-scheme-with-the-taskforce-on-climate-related-financial-disclosures-recommendations/part-2-quick-start-guide-trustee-governance-strategy-and-risk-management-how-to-integrate-and-disclose-climate-related-risks*

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

ESG INVESTMENT

# Why less carbon means stronger growth for the global economy

WRITTEN BY AXA IM CIO, CORE INVESTMENTS, CHRIS IGGO

As long-term investors, we always need to have an eye on sustainability – sustainability of business models, of earnings growth and the ability to manage risk.

Sustainability, however, has taken on a new meaning in recent years. It is widely agreed that climate change poses a huge threat to the world – to our societies and economies. Quite simply, without the transition to a low carbon economy, we won't have sustainable economic growth, and that means we can't have sustainable investment returns.

The economic hit from COVID-19 has seen unemployment rates go up and businesses go under. A recent report from the Organisation for Economic Co-operation and Development highlighted that government borrowing in the world's richest economies surged by a record 60 per cent in 2020, double that of the 2008 financial crisis. The world needs greater GDP expansion and less toxic emissions.

Fundamentally, I believe lower carbon will mean more growth. But achieving the Paris Agreement goal of limiting warming to well below 2°C, preferably to 1.5°C, compared to pre-industrial levels will require substantial investment. If we do nothing, scientists believe that global temperatures will rise by more than 3°C.

We know that would be very damaging to the environment. It will result in rising sea levels, extreme weather, societal disruption, the loss of economic activity and more.

The energy transition will take us beyond the fuels that have driven the global economy for the past 200 years. Instead we need to rely on renewable energy and achieve greater energy efficiency. This will impact not just power generation but transport, industrial processing, agriculture and the buildings in which we live and work.

## Government backing

Governments are thankfully pledging to invest billions into the energy transition – and setting some very ambitious targets. In 2020, the European Union unveiled a recovery deal which included some €550bn earmarked for green initiatives – the biggest single climate pledge ever made. China, the world's biggest emitter of carbon dioxide, has committed to carbon neutrality by 2060.

France has set itself the goal of becoming the first major low-carbon economy in Europe, after announcing a €100bn post-COVID-19 rescue package, of which a third is dedicated to climate-related projects. Australia, home to some of the world's largest coal mines, is aiming to have 94% of its electricity generated via renewables by 2040.

US President Joe Biden has yet to set out his stall in full, but climate is high on his agenda – and he has already said he wants to convert around 645,000 federal vehicles to electric power. In November this year, we have the delayed United Nations climate change conference COP26 in Scotland. As it approaches, we will likely hear more governments refresh their energy plans and carbon reduction targets.

## Growth opportunities

Policy and technology are driving the economics of the transition. In our view, the energy transition will be as transformative for the world economy as the digital revolution has been since the 1980s. Over recent years there has been a huge amount of investment into renewable energy, with generation soaring by 57% between 2010 and 2018. The share of renewables in global electricity generation had risen to nearly 28% by the first quarter (Q1) of 2020.

This increase has come mainly at the expense of coal and gas, though these still represent close to 60% of global electricity supply. In Q1 2020 variable renewables – solar and wind power – reached 9% of generation, up from 8% a year earlier.

The potential is huge. There are going to be significant growth opportunities as a result of this shift towards renewables. Research shows that clean technology has the potential to drive $1trn to $2trn a year of green infrastructure investments while creating some 15 to 20 million jobs globally. Renewable energy could be the largest area of spending in the energy industry in 2021, surpassing oil and gas.

For investors, I believe, there is a need to start adjusting portfolios now. We all need to reset what we think will be the drivers of economic growth over the next decade and beyond.

### Cutting carbon

The reliance on oil and other fossil fuels has led to enormous political problems – even war – over the years. Moving to renewable energy brings immediate benefits. It lowers the external costs – things that can affect everybody, such as healthcare costs from heat waves and droughts, and loss of property from flooding.

It is widely recognised that we need to internalise those costs by putting a price on pollution. Meanwhile, the costs of renewable energy sources have fallen dramatically; the levelized cost of electricity from renewable energy – the cost of electricity over the entire life of a power project – is now lower for renewable than for coal-fired electricity generation.

At the same time the price of carbon is rising. There are various frameworks, or emission trading systems, which aim to put a price on carbon. Companies in certain industries need to pay for the right to generate carbon emissions and the price is going up. More of these trading systems are being established and they are going to help internalise the costs of carbon emissions – if you generate $CO_2$, you will pay for it, and pay more in the future. This dramatically changes the economics of some business models and should lead to greater efficiency because of lower, more stable energy costs.

### The transition

It is not easy to replace fossil fuels. Goldman Sachs created a so-called 'carbon curve' that estimates the cost of moving from 'business as usual' to replacing primary energy sources with renewable energy. That cost curve eventually gets very steep. For some activities – power generation, agriculture and other land use – this is less problematic and more straightforward. We are witnessing big growth in electric vehicle usage – global sales of electric cars accelerated by 43% in 2020 despite an overall slump in car sales. Electric vehicle numbers remain relatively small, but their uptake is expected to grow.

However, for other sectors – industrial processing or air transport and shipping – moving to renewable energy is very expensive. New technology may help. Hydrogen has barely scratched the surface of its potential as a fuel source for industry and transport, while carbon abatement technology is improving, and providing lots of growth and investment opportunities. The fact that renewable energy still accounts for only 28% of global electricity generation means we still have plenty of room to grow.

The cost curve of the transition is ultimately flattening because of the investment we are seeing in new technology, government policy support and allocation of capital to low carbon technologies. Saudi Arabia's planned zero emissions city in the desert is going to rely completely on renewable energy and new technologies –a real-life experiment to show how we might make our lives more sustainable.

### The long-term benefits of the transition

As investors, we need to think about the structural trends that will generate economic growth in the future. We believe that means decarbonising portfolios and investing in climate solutions. It means thinking about how to generate earnings growth as business models change and we all benefit from more economic growth and less carbon. Traditional oil and gas producers are adapting business models – they know that if they do not, they will be left with stranded assets. We are not going to move to zero oil and gas; companies will still do what they are doing today but they are moving very quickly into the renewables space.

The lower carbon economy doesn't mean less economic growth – it means more – and the risks of doing nothing are much too high. This journey will involve billions, if not trillions, of dollars of investment over the next few years, bringing very exciting technological opportunities. The energy transition will not just create jobs for displaced oil and gas workers, but new positions in new locations, as new energy sources become more spread out around the globe.

We need economic growth to return but we also need to reduce carbon emissions. I believe the energy transition can deliver both short-and-long-term benefits – there are huge investment possibilities and massive opportunities in terms of how it affects business models going forward. Investors need to be ready to play their role. ■

*In association with*

AXA Investment Managers

[i] *Government Borrowing Jumps by Most on Record in Covid Pandemic - Bloomberg*
[ii] *https://www.gouvernement.fr/en/european-aspects-of-france-s-recovery-plan*
[iii] *Climate Change Response (Zero Carbon) Amendment Act | Ministry for the Environment (mfe.govt.nz)*
[iv] *AEMO | Australian Energy Market Operator*
[v] *International Renewable Energy Agency; Renewable Power Generation Costs in 2019.*
[vi] *Renewables – Global Energy Review 2020 – Analysis - IEA*
[vii] *Goldman Sachs | Insights - Carbonomics: The Green Engine of Economic Recovery*
[viii] *Carbonomics The green engine of economic recovery (goldmansachs.com)*
[ix] *EV-Volumes - The Electric Vehicle World Sales Database (ev-volumes.com)*
[x] *Saudi Arabia to build a zero emissions city | News | DW | 11.01.2021*

## AMX

AMX (The Asset Management Exchange) is an institutional platform that gives investors and asset managers a way to do business with each other and is built with fund infrastructure that's designed specifically for the needs of institutional investors.

AMX provides centralised back office and standardised fund infrastructure, reducing cost and resource duplication, delivering scale benefits to both sides of the market while increasing transparency and improving operational governance.

Managed by a 100-strong team who negotiate with managers, transition assets, monitor strategies and add an extra layer of risk oversight, AMX is accessed by an online portal, AMXConnect, that allows investors and managers to interact seamlessly with each other.

AMX aims to support the emerging taxonomies in sustainable finance to provide transparent reporting and insights to end investors and engage with relevant industry movements that champion responsible investing.

**AMX standardises, centralises and streamlines the entire process so it works better for everyone.**

To find out more visit **theAMX.com.**

## AXA

AXA Investment Managers (AXA IM) is a responsible asset manager, actively investing for the long-term to help its clients, its people and the world to prosper. Our high conviction approach enables us to uncover what we believe to be the best global investment opportunities across alternative and traditional asset classes, managing approximately €858 billion in assets as at the end of December 2020.

AXA IM is a leading investor in green, social and sustainable markets, managing €555 billion of ESG-integrated, sustainable and impact assets. We are committed to reaching net zero greenhouse gas emissions by 2050 across all our assets, and integrating ESG principles into our business, from stock selection to our corporate actions and culture. Our goal is to provide clients with a true value responsible investment solution, while driving meaningful change for society and the environment.