CACEIS ROUNDTABLE SERIES

caceis
INVESTOR SERVICES

Staying in front of sustainability regulation

CACEIS held its roundtable this December with representatives across the asset management community, including host authorised corporate directors. Clarity AI, CACEIS' partner on ESG, climate and regulatory sustainability, also provided technical perspective on data and regulatory reporting.

The discussion's overarching theme was the data challenge. This included the availability of good data, and managing the inconsistencies across different data providers. There was also agreement that governance processes around data collection, and the interpretation of it, was an important step to get right. Indeed, education and insight was a thread that ran across the discussion – from UK asset managers learning about Europe's SFDR regulation ahead of similar rules that are expected in the UK in 2024, through to equipping fund boards with the right information. Also the panel raised the importance of other functional areas like legal and compliance in building their knowledge of ESG and climate risks. This too cannot be ignored.

Regulatory requirements on sustainability reporting are growing and the FCA recently proposed new rules to tackle greenwashing to help consumers build trust in investment products that have a sustainable focus. During the discussion, it was generally observed that over time most investment products will have a sustainable tilt to them as investor expectations in this area are growing, alongside an expanding awareness of the concept of ESG and climate risk. Such risks can include stranded assets – companies suffering from devaluations because they can't economically transition to a low-carbon world.

Tackling the sustainability regulation was a key theme across the roundtable. A starting point in the discussion was learning from the recent Sustainable Finance Disclosure Regulation (SFDR), where the industry experienced a number of funds moving from Article 9 to Article 8 classification. Companies may have been a bit too ambitious at a time when the SFDR regulation was still evolving and this is a useful learning point as the FCA looks to implement Sustainability Disclosure Requirements (SDR) in 2024. Alignment between SFDR and SDR was also a topic of discussion, especially in how funds already classified under SDFR can map themselves against the new UK framework. It was commented that classification could be a challenge where SFDR compliant Article 8 and Article 9 funds might not be able to align themselves into one of the three classification buckets proposed under SDR. This could have consequences for distribution.

> "Indeed, asset managers with UK-based funds that have not been subject to SFDR should begin to develop a broad understanding of SFDR in preparation for the UK's SDR regulation".

SDR took shape because the FCA's consumer behavioural research found that consumers are increasingly demanding financial products that take sustainability into account. In order to use ESG in the marketing of funds under existing SDR proposals, investment products must meet one of the three clearly defined criteria:

- That the investment product or fund is investing in companies that are clearly transitioning to better outcomes.
- The fund has a sustainable focus (70% of assets must be applied here).
- Impact, which means a fund has an objective of delivering a positive environmental or social impact.

The objective of the regulation is to ensure consumers clearly understand the sustainability features of the funds in which they invest. This is against a backdrop of increasing scrutiny around greenwashing and misleading claims in the ESG space (similar to the themes affecting article 9 funds). In this light it was commented that 'labelling needs to be very clear for consumers, just like labelling in supermarkets".

THE DATA CHALLENGE

The regulatory burden was highlighted as a challenge, especially in the development of new 'sustainable' funds leading up to the SDR regulations. It's here that data became a point of discussion and what information is required.

For those asset managers that work with asset owners, a good starting point on data is to look at what UK pension schemes are required to report on today. Here, the Task Force for Climate Related Financial Disclosures (TCFD) is a key starting point.

> "For pension schemes, it's important to have portfolio-level data and look-through, which means information on ESG and climate risks at a security level".

Comparability was another theme explored by the roundtable when getting their hands on data. It was commented that "We still have to leverage estimations for Scope 3 carbon emissions – while we can get good estimations on Scope 1 and Scope 2 carbon emissions data". And in a recognition that all funds will eventually have to report on climate risk information, it was commented that "even if your fund does not currently have an ESG or climate-related objective, at some point all funds will need to report carbon and other climate-based metrics". The lack of comparability between data providers was also raised, with each one having different methodologies as to how they go about assessing ESG and climate risks – "this makes the data inconsistent and difficult to work with".

A general consensus at the roundtable was the lack of comparability, and the expense of accessing data providers made it less practical for smaller asset managers to properly get their hands on good information. This is further amplified by the resource intensive nature of sifting through the data to make sense of it.

Despite the lack of comparability, the roundtable agreed that asset managers need to start somewhere. Aligned to this, their own governance and decision-making processes will become key. There might be a lot of interpretation of data and having an audit trail on the decision-making around the robustness of information that's going to be used to reinforce a fund's ESG or climate approach will be critical – as one individual commented, "root and branch governance around reporting on ESG and climate risk is going to be crucial".

Finally, it was mentioned that there is a lot more data now on scenario analysis but interpreting this information for good decision-making remains a challenge. It was agreed that unpredictability remains in data collection and the construction of climate modelling, together with asset managers, should be more strategic about the process – seeing it more as a framework. Education featured briefly in that it could learn from insurers, who are leading the way in climate modelling.

OTHER CHALLENGES

Aligned to data, getting information to properly address scenario analysis is another challenge and this is one area where the roundtable participants felt there might be more regulation coming. The focus right now for regulatory frameworks is understanding and reporting on emissions, but going forward should the emphasis shift to greater expectations on reduction targets for emissions?

Integrating information on ESG and climate risks into assessment of value (AOV) reporting was also a consideration raised by the roundtable, especially for those funds that had a sustainability mandate.

In terms of value of service, if a fund has a focus on ESG or climate, then information around this should be part of the AOV process'. Generally, it was expected that ESG and climate considerations will begin to appear more on AOV reports.

Fund boards were also a topic of discussion. At this point, governance is becoming a key point, especially around managing reputation risk when it comes to ESG and climate risk. For example, the fund boards of host authorised corporate directors face a challenge when they are reviewing a range of different asset managers that are doing things differently – and they are having to review data from each asset manager that has been provided and interpreted in a different way. It was recognised that the lack of consistency in reporting back up into fund boards can be a governance headache. More generally for fund boards, the roundtable agreed that board members don't need to be climate experts – they need to be able to trust the data and have enough knowledge to interrogate it and then ask the right questions of the portfolio managers – In short, the "fund boards need to ask the right questions, and this is where education is key".

EDUCATION

"There was a huge emphasis on educating the investment teams in what ESG and climate risk means, in developing a consistent approach to questioning companies and what it means to company analysis – this now needs to extend across different functional areas".

Extending education more broadly was also a key point of discussion. For example, it was highlighted that there are regulatory and compliance pitfalls, which means that legal and compliance teams need to have more knowledge on ESG and Climate risk. The culture needs to change as well, which cuts across all employees – "every employee should have ESG education as part of their annual objectives".

> "Asset managers also need to carefully convey what they are doing for end consumers, so crafting messaging that's authentic and measured requires education. As one participant summed up 'we have an opportunity to help our clients become more knowledgeable on climate risk through good communication".

In summary, a lot more still needs to be progressed. Education, in particular, was viewed as an increasingly important area to get right.