Principles for Responsible Investment

POLICY BRIEFING

PRI SUSTAINABLE FINANCE POLICY CONFERENCE, BARCELONA, 29TH NOVEMBER 2022

January 2023

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United Nations Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

INTRODUCTION

On 29th November 2022, the PRI hosted its annual sustainable finance policy conference in Barcelona, the day before PRI in Person & Online 2022. The conference was held under Chatham House rule and contained breakout table discussions, which enabled connections and collaboration between regulators and investors. Each year, the conference explores the latest developments in sustainable finance policy reform, and new areas of focus for responsible investors in a changing world.

This briefing summarises key topics discussed during the day.

SETTING THE SCENE

Policy matters. It defines the rules of the game, including responsibilities for market participants, and builds the foundation to enable the pursuit of shared sustainability goals. Sustainable finance has been an increased focus for policy makers, investors and the broader international community in 2022. As responsible investment is becoming mainstream, policy makers need to accelerate reforms to shift the baseline and clarify investor duties and responsibilities.

PRI's Sustainable Finance Policy Engagement handbook describes why and how responsible investors should engage with policymakers on these topics.

Legal analysis shows that investors can pursue sustainability impact goals while seeking financial returns. To enable investors to navigate a changing, goal-oriented world, policy makers need to further clarify and adapt financial regulations. This will ensure market efficiency, as well as prevent greenwashing and freeriding.

TOWARDS THE FIRST GLOBAL STANDARDS ON SUSTAINABILITY REPORTING

In 2022, greenwashing has been a major focus of regulators, brought forth by the lack of clarity on climate pledges by corporates and financial sector firms. As a result, policy makers have focused on corporate and financial industry disclosures, as well as taxonomies. This has led many to recognize the importance of ISSB standards and their key role in ensuring global alignment of these efforts.

There are three challenges that need to be overcome to ensure that the ISSB standards can create a global baseline for financial sustainability disclosures by public and private companies.

- Interoperability: this concept is critical to the success of the ISSB standards. Definitions and key concepts need to be aligned when the standards are integrated into domestic laws and regulations.
- Implementation: the ISSB standards need to work for developing and developed markets alike. They need to work for different sizes of reporting entities and work across different sectors.
- Independent Assurance: independent assurance is necessary to afford credibility to mandatory reporting. Another key issue that needs to be addressed is how sustainability information impacts traditional financial information on the balance sheet.

IOSCO will work to mobilize its members to ensure that the ISSB standards are incorporated in domestic law and regulation, as a measure to combat greenwashing.

SHIFTING THE BASELINE: A REVIEW OF RECENT DEVELOPMENTS IN FINANCIAL REGULATIONS

In this first session we heard regulators from across the globe discuss the evolution of sustainable finance policy. With heightened scrutiny on the investment industry from financial regulators, as well as a substantial increase in regulatory reform, the discussion touched upon the need for coherence, effectiveness and timeliness. This means policies that are coherent at regional and international levels; fit for purpose, enforced and meet their goals; and well balanced between ambition and the ability of the market. Panellists opened the discussion noting the trend from voluntary to mandatory policies and the awakening of the corporate and financial community that ESG issues are important – that there are sustainability risks and opportunities that need to be considered seriously.

The session took a deep dive into the key sustainable finance topics such as taxonomies, disclosures, stewardship, incentives and ratings and how China, Japan, the EU and the US are approaching them.

We heard about the value of taxonomies in all jurisdictions, providing the language and the aim, to enable transparency, predictability and robust disclosures. However, we also noted the limitations of defining activities in a binary way. Panellists said the discussion was moving forward as policymakers want to better account for, and advance, the climate transition. In the EU, the possibility of mandatory climate transition plan adoption under the proposed Corporate Sustainability Due Diligence Directive was seen as a lever to raise awareness in companies, while in the US it was noted that the Inflation Reduction Act has a very specific focus on the just transition. China also intends to develop a set of rules on transition finance, building on the G20's 2022 Transition Finance Framework which it lead as the co-chair of the sustainable finance working group. The trend towards transition-supportive policy is evident and will be supported by increasingly robust corporate and investor disclosure.

Regarding disclosure, of course the EU Sustainable Finance Disclosure Regulation (SFDR) took centre stage as panellists discussed whether it was being used in the correct way and lessons other jurisdictions could learn. This led to the hot-topic of greenwashing – do we all have the same definition? How can we ensure consistency (in approach and disclosure) between product name, investment strategy, and governing structure? Panellists made reference to IOSCO's work on this topic as well as upcoming ESMA consultations on fund names and greenwashing. The importance of the work of the ISSB to achieve coherency and interoperability in corporate disclosure was also touched upon.

The third most discussed topic was ESG ratings. All panellists noted the need for more work in this area and called for a coherent approach, emphasising that the role ESG ratings and data providers have in guiding investment decisions should not be overlooked. The importance of stewardship as a key concept in the sustainable finance toolkit was also raised, in the context of the recent DOL rule on ESG and proxy voting and Japan's stewardship code. Attendees also requested an update on the revision of the EU Shareholder Rights Directive. Finally, panellists touched upon the finance gap and the need for capacity building – despite all the advancement in sustainable finance policy, we are not meeting financing targets. China has a decarbonisation support tool and local government subsidies for local sustainability projects to try to bridge this gap. The role of regulators to support and empower investors was repeated across jurisdictions, as well as the importance of bringing in complementary real economy policies.

Panellists noted, throughout the discussion, the need for interoperability and alignment, and the important role played by international fora such as the G20, IOSCO, ISSB, NGFS and IPSF to support regional regulators in achieving this. Interoperability is a priority of the G20 and the IPSF is helping to make progress with regards to taxonomies through its "Common Ground Taxonomy", which is influencing taxonomy development in Sri Lanka, Pakistan and Hong Kong, to name a few. Coherency across the approach to greenwashing and ESG ratings was also repeatedly emphasised. Panellists called for global coordination of capital markets and support from IOSCO and others to bring together different regulators to make it happen on the ground.

A FOCUS ON THE LEGAL FRAMEWORK FOR IMPACT

The second session started with a presentation of the Legal Framework for Impact report. The report covers 11 jurisdictions and answers the question, ''Are institutional investors legally required or permitted to tackle key sustainability challenges?''. The report also contains some key policy suggestions on how to facilitate this.

Investing for sustainability impact is where an investor uses any means available such as stewardship, policy engagement, investment powers or any other levers to have an assessable positive impact on the sustainability footprint of investees or other third parties. Investing for sustainability impact is wider than what has historically been referred to as 'impact investment' as it covers any form of investment activity that is intended to achieve positive sustainability outcomes, whatever the asset class or investor type.

Investors increasingly recognise that sustainability outcome-focused activities may help them in discharging their duties. Also, they are under increasing social pressure to engage in such activities. However, the lack of clarity about what the law requires or permits has been hampering progress.

The report distinguishes between two types of investing for sustainability impact: 'instrumental' and 'ultimate ends'. Instrumental investing for sustainability impact is where achieving the sustainability goal will also help the investor achieve its financial goal. For ultimate ends investing, the sustainability goal is pursued alongside the financial goal.

Where declining sustainability poses a threat to achieving their financial goals, investors are under a duty to consider what, if anything, they can do about it. Where a sustainability impact approach could reasonably be expected to help in mitigating that threat, they should also consider using it and act accordingly.

Modern portfolio theory has increasingly led investors to diversify their portfolios to minimise the financial risks of the idiosyncratic investee specific performance. However, the modern portfolio theory does not address the risk to portfolio performance posed by failure of whole economic systems - in other words, precisely the type of risks that are created by declining sustainability. As most portfolio performance comes from systemic economic growth, there is a compelling case for investors to consider how they can protect those systems.

The role of collective action is crucial because it transforms goals that might be impossible or too expensive to address by individual investors into something that is achievable collectively. Key policy suggestions from the report include:

- The need for legal regimes to have a clear concept of sustainability impact.
- The need for regulation to distinguish clearly between pursuing impact to achieve financial goals and pursuing it because it's the right thing to do (alongside the financial goal).
- Where sustainability impact is desirable for financial reasons, investors need clarity on how that accords with existing legal duties, especially in the case of collective action.
- Where sustainability impact is socially desirable, the rules may need to change to facilitate it.
- Steps to encourage high quality stewardship and removing remaining barriers to collective stewardship. An important area of focus is flexing competition regimes, especially at the level of sustainability orientated cooperation by investees.
- Given the importance of the investors' circumstances in how they decide to act, steps are needed to strengthen the enabling environment for sustainability impact activities, especially providing investors with the information they need.

THE NEXT PHASE FOR FINANCIAL REGULATIONS: BRIDGING THE GAP TO SUSTAINABILITY OUTCOMES

The second session panel discussion explored with regulators from 4 regions (Canada, EU, Japan and the UK) the following key questions: why sustainability impact and sustainability goals are important for investors; what are investors' responsibilities and roles in managing sustainability impacts; what are the key sustainability reforms that will enable investors to address sustainability impact.

In the EU, from August 2022, (re)insurance companies are required to consider the long-term impact of their investment decisions on sustainability factors, as part of the prudent person principle. This means that being prudent and sustainable are no longer separate. Further reforms and guidance are expected including on the concepts of long-term best interest and the prudent person rule.

In other markets, policy makers noted the significant gap in terms of sustainable investments, which is also an opportunity for financial institutions to participate in the transition to a sustainable economy. To enable such a transition, international cooperation is essential, for example on issues such as carbon pricing. Speakers also noted the need to develop better comparability of stewardship disclosures across markets in order to tackle ''stewardship washing'' (e.g., overstating engagement activities) and identify good practice for different types of investors.

Participants in the session raised several suggestions related to outcomes-focused policy reforms:

- Key concepts need to be further clarified, including better definitions of outcomes/impact and investor contribution to impact. Investing for sustainability impact/outcomes encompasses a greater range of approaches than established understandings of impact investing.
- Investors need better quality data to compare different products and strategies. Better data can also help investors substantiate the benefits of investing for sustainability impact and build confidence in the market.
- Policymakers and regulators should clarify that, under their legal duties, investors are permitted to consider pursuing positive sustainability outcomes and, in many cases, are required to do so when this can contribute to financial returns for client/beneficiaries.
- Stewardship: regulatory expectations on stewardship responsibilities for sustainability outcomes need to be clear. Investors need to know how they can use stewardship powers (including collective action) alongside asset allocation decisions, and also have confidence that other competition and securities rules do not unduly restrict their ability to engage with investees. Policy reforms need to address such barriers to collective action by investors.
- Regulatory coherence: sustainable finance policies need to be coherent in their focus on sustainability outcomes – both within jurisdictions and globally, where interoperability is vital to the market. One example is the emerging EU, UK and US regimes on sustainability disclosures, as well as the role of ISSB globally.
- Phased implementation of major reforms (e.g., reporting, transition plans) is important. It can enable ambition to be high, while providing investors and companies the time to adapt to the changes.
- Investors are concerned that increasing regulation is leading to ''green hushing'' – e.g., where companies or investors do not want to disclose sustainability information as they are concerned about compliance burden or fear litigation.
- Further work is still needed to establish clear links between sustainability outcomes and financial system stability and integrity, and system-level risks. Regulators should focus more on system-level risks rather than narrow in on portfolio risk, because dominant portfolio approaches like diversification do not address system-level risks.

PILOTING AN ECONOMY-WIDE TRANSITION: CONNECTING FINANCE AND INDUSTRIAL / REAL ECONOMY POLICY

The last session of the day focused on the links between transition policy, financial policy, and real economy policy. Real economy policy alone isn't enough to keep the hopes of a 1.5C world alive. There is a clear mandate to increase and align financial flows as well.

The discussion started with the need for good data to navigate the transition. Current developments need to be viewed in light of longer-term trends—for example, coal had a small and temporary boom in 2022, but wind and solar saw a larger and more permanent expansion.

Security and affordability are vital to energy transitions and are critical components of future energy blends. Emerging risks are complex and global. Clean energy supply chains can be very geographically concentrated and all of them will need to expand rapidly. Current conversations might be focused on gas, but we must avoid swapping one vulnerability for another. For example, where are rare earth minerals mined? Where are clean energy technologies produced?

To invest effectively in the transition, the financial sector needs whole-of-government policy approaches that are backed by legislation. The UK's 2008 Climate Change Act, for example, created a system laying out mandatory emissions reductions, carbon budgets, etc. Such policies need to be ambitious but also accountable and have long-term time horizons to produce consistent signals for investors. This facilitates realistic and achievable transition plans (including short-, medium-, and long-term objectives) for businesses. Another policy example is the US Inflation Reduction Act (IRA) which was the focus of a dedicated discussion. The IRA is a large-scale industrial policy effort to address climate change and restructure the US economy towards a net zero economy.

Supervisors are taking climate change seriously and the pace of regulatory change is rapid. For example, ECB published climate-related risk guidance close to a year ago. One of the biggest current questions is the investment gap—there's a big need for investment reorientation (reallocation of investments/capital). This comes via stress-testing, supervisory rules and expectations, deliberate decision-making, but also financial stability. The fight against greenwashing also contributes to the transition, as it ensures that the supply of capital will continue.

The conference participants pointed that international interoperability, and policy coherence and consistency are critical:

- Within sustainable finance frameworks. E.g.: The "do no significant harm" in the EU's sustainable finance framework is not always consistently applied across the various regulations – notably Taxonomy Regulation (TR), SFDR and Benchmarks Regulation.
- Within broader financial regulations. E.g.: what are the types of policies that should be put into place to support SMEs calculating their carbon footprints?
- Regulatory competition across markets—there are many different taxonomies that can overlap with one another. E.g.: Energy Performance Certificates in the building sector vary widely across many countries. How can financial institutions access and compare this information?

An effective economic and sustainable finance transition must account for special cases such as SMEs or developing countries, thinking outside pure financial regulation. Some developing countries cannot meet taxonomy criteria just because enabling pre-requisites do not exist.

The conference participants indicated broad support for a whole-of-government economic transition approach. Common themes around the key elements of such an approach included:

- Investors need confidence that a government will pursue a coherent approach to the transition, and that this strategy will not be jeopardised by changes in government (e.g. 'hard coding of obligations').
- The development of industry roadmaps/pathways/scenarios, and broad support for transition plan requirements, real economy policy, as well as incentivising investments through industrial and fiscal policy.
- Investors have a role to play in clarifying what they need from policy makers beyond pure financial policy to conduct more effective policy engagement.