

Embracing ESG transformation

How asset managers are leveraging regulation to drive value creation

ESG

July 2021



Foreword

Environmental, Social and Governance (ESG) issues are now front of mind for the asset management industry. The trend has been driven by changing public attitudes, increased investor demand for ESG-focused funds, and a realisation of the commercial growth opportunities.

Regulators and policymakers are further accelerators, as they seek to embed sustainability considerations into financial services to help mobilise finance for sustainable growth. This has resulted in numerous regulatory initiatives impacting the asset management sector, forcing it to integrate ESG risks, make new disclosures, and play a more active role in driving sustainable outcomes.

There is clearly a significant volume of ESG-focused regulation stemming from the EU's Sustainable Finance Action Plan that remains relevant to UK-based asset managers. This includes the Sustainable Finance Disclosure Regulation, which requires firms to be more transparent over their consideration of ESG factors across their investments and funds. There is now also a significant agenda emerging in the UK, as the Government seeks to demonstrate global thought leadership in the area ahead of the crucial COP26 summit in November 2021. As part of its efforts, the Government has published a roadmap to make TCFD disclosure mandatory in the UK by 2025, which will introduce some important climate-related disclosure obligations for asset managers.

We surveyed 16 UK-based asset managers of varying sizes to understand the relative importance of regulation compared with other drivers that sit behind the sector's current focus on ESG. This involved a quantitative survey that was then supplemented by a series of qualitative interviews. We also gathered further insight on how firms are setting themselves up to respond to ESG regulation and wider drivers, as well as the challenges and opportunities they are navigating on their journey.

From our survey, it is clear that ESG is viewed as a central priority across the UK asset management sector, driven by a challenging regulatory environment, increased investor demand for ESG investing, and a general desire to establish a more purposeful culture. The majority of firms are looking to respond to these drivers strategically, using them to accelerate transformation across their organisation. Firms see their work on ESG as far more than a compliance exercise – it is being viewed as a value creation exercise and a commercial necessity in the market.

But for some, there is a disconnect between ambition and action. Many firms are still busy reacting to incoming regulatory initiatives and to new investor demand in a tactical, bottom-up sense, and have not yet formulated the comprehensive strategic response they aspire to. However, if firms want to stay ahead of competition, they should begin their transformation journeys now, embedding ESG considerations across the full spectrum of their

business and operating models – from their risk management frameworks and investment approach to corporate issues such as diversity and inclusion and managing their climate footprint. This will help them meet their desire to establish a more purposeful culture, to play a more active role in addressing important societal challenges, and drive sustainable value creation across their business.

Elizabeth Stone
UK AWM Leader



David Croker
Partner



Executive summary

ESG moves into the mainstream

The term ESG has come of age. It is 16 years since the United Nations published its landmark study into how to integrate environmental, social, and governance concerns into capital markets. Now, as the world contemplates how to 'build back better' from the COVID-19 pandemic, we are embarking on another step-change.

ESG is no longer a niche pursuit. PwC's [research](#) suggests institutional investors in Europe expect ESG and non-ESG products to converge and, from next year, 77% of these institutions expect to stop buying the latter. We believe that in Europe alone, ESG fund assets under management could account for more than 50% of mutual fund assets by 2025, representing compound annual growth of 28.8% between 2019 and 2025.

Against this backdrop, it is crucial to understand how asset managers in the UK are integrating ESG into their investment processes. This research seeks to explore this through both quantitative surveys of asset managers with £15.5trn of assets under management, and a series of follow-up qualitative interviews.

Above all, it is clear that asset managers have never been more conscious of the need to engage with ESG – and to develop new approaches to integration with greater sophistication and maturity. Some 81% of firms now have an ESG programme in place.

Regulation and investor pressure is behind the increased focus on ESG

The wave of ESG regulation worldwide is one of the leading drivers of this integration, with global initiatives progressing in different ways regionally and nationally, including both the European Union and the UK itself. Asset managers are acutely aware of the need to comply with a host of new regimes. Some 76% cite regulation as a significant, or very significant, driver of their focus on ESG, and of ensuring their approach to ESG goes well beyond the greenwashing concerns that regulators – such as the [Financial Conduct Authority](#) and the [Securities and Exchange Commission](#) – have highlighted recently.

More broadly, this research identifies several other key drivers for asset managers' increasing focus on ESG. Firms recognise the huge growth in investor demand for ESG – 31% point to changing consumer preferences over the past 12 months – and many regard ESG issues as front and central as they work harder to define corporate purpose. The pandemic has accelerated the ESG focus, highlighting fundamental societal shifts in the context of environmental, social and healthcare crises.



75%

of respondents said that specific investor demand played a 'significant' or 'very significant' role in promoting the firm's focus on ESG.



76%

cited regulation as a significant or very significant driver of their focus on ESG.



82%

of respondents said that they have an ESG programme in place, with most respondents viewing their ESG programmes as a transformational exercise.



63%

of respondents said that a lack of international consistency in ESG regulation is creating either a 'very significant' or a 'significant' challenge. However, 44% of firms said they see a very significant opportunity to develop new product ranges in response to changing consumer preferences on ESG.

Executive summary (cont'd)

Firms eye ESG-focused transformational change

The direction of travel is clear. Many firms regard the ESG debate as part of a broader imperative to transform every aspect of their organisations rather than purely an exercise in regulatory compliance and responding to specific drivers. This research suggests many asset managers now see huge opportunities in ESG if they are able to look beyond regulatory necessity and embrace transformation. Some 63% hope to develop new product ranges, for example. Indeed, the imperative today is to look at ESG through a strategic lens, rather than acting tactically.

In this report, we begin to consider how to achieve a transformative approach to ESG in practice. Now is the moment for asset managers to define ESG transformation for their own organisations, and to begin plotting a roadmap towards achieving their vision.

But firms will need to overcome a number of hurdles along the way...

Although most asset managers have a clear ambition, our research highlights some worrying disconnects, particularly in relation to approaches to ESG investment where some firms lack a coherent investment approach on ESG issues at an entity level. Firms are also having to overcome a range of hurdles as they progress their ESG journeys, such as data quality, skills shortages, and navigating the waterfront of regulatory initiatives.

Now is the time to act

Dramatic transformation does not happen overnight, of course. Some asset managers are realistic that fundamental and comprehensive change will take time and sustained commitment. They reject the idea of a big bang moment for ESG; even if pressing regulatory deadlines must be met, for many holistic transformation appears to be a medium-term objective.

However, if firms want to stay ahead of competition, they should act now, embedding ESG considerations across the full spectrum of their business and operating models – from their risk management frameworks and investment approach to corporate issues such as diversity and inclusion and managing their climate footprint. This will help them meet their desire to establish a more purposeful culture, to play a more active role in addressing important societal challenges, and drive sustainable value creation across their business.

Part 1: The imperative for ESG

43%

said that formal regulation played a 'very significant' role in prompting the firms focus on ESG.

75%

said that specific investor demand played a 'significant' or 'very significant' role in promoting the firm's focus on ESG.

31%

said that developments in consumer preferences have 'very significantly' influenced their stance on perception of ESG integration.

25%

described COP 26 as a 'significant' driver of their increased focus on ESG.

This research suggests that multiple drivers underpin an increased focus on ESG among asset managers (Figure 1).

Regulation and investor pressure is central to increased ESG focus

It is clear that both push and pull factors are significant: regulation is a very significant driver for many asset managers, but so too is investor demand. While regulation is front of mind given the weight and diversity of the regulatory agenda, qualitative interviews with asset managers suggest they would feel compelled to respond to investors' desire for more ESG products even without new rules and regimes. And, of course, the two go hand in hand: regulation is in part a function of increased demand for ESG-focused investments and the need to ensure investors get what they have been promised.

Desire for a purpose-driven culture – with ESG considerations at the heart

Equally, it is important to recognise that asset managers themselves have been playing their part in the ESG debate, with corporate purpose also cited as a key driver. Many firms claim to be increasingly focused on how they can establish a purpose-driven culture that is focused on long-term value creation for investors, the firm itself and society as a whole. ESG considerations have become a critical part of this conversation, from the way in which asset managers vote at portfolio holdings to their own firm-wide practices.

COVID-19 intensifies the ESG agenda

The COVID-19 pandemic has had a significant impact on many asset managers' stance on ESG issues (Figure 2). The pandemic has raised the profile of ESG directly, shining a light on issues ranging from employee wellbeing to social inequality. More broadly, it has fuelled a growing awareness and concern around the interconnectedness of society, and the extent to which responsible corporates can help to address important societal challenges.

In this sense, COVID-19 is the crisis that, for many, has fully revealed the potential impacts of global systemic risk. The legacy of the pandemic will be multi-faceted and far-reaching, but one enduring impact in an ESG context will be of a much wider understanding of why global issues are also local in nature.



Part 1: The imperative for ESG (cont'd)

Is COP26 a significant driver?

In a year when the UK is due to host the United Nations Climate Change Conference (COP 26), 25% of asset managers describe this milestone as a significant driver of their increased focus on ESG in recent months, but other firms appear to be less convinced. While climate change is at the centre of many firms' ESG activities, the survey findings suggest that the extent to which COP 26 and the race to Net Zero specifically is driving increased ESG focus may be more limited.

With many national governments pushing for a 'Green recovery', COVID-19 and climate change have become inextricably linked. Private finance will be an important facilitator of this, and many asset managers see these drivers as part of a broader imperative to act, including as part of a response to regulation. For example, a key part of the UK Government's push on COP 26 from a financial services industry perspective is its roadmap to make climate-related disclosure mandatory across all sectors of the UK economy by 2025.

Role of social movements and activist pressure

Similarly, asset managers largely regard prominent climate change campaigns over the past year – such as the Extinction Rebellion protests – as having had only a moderate impact on their ESG focus (Figure 2). Still, that may change over time, particularly if campaigners begin to target asset managers directly – and if public support is galvanised.

In the meantime, significant numbers of asset managers ascribe their ESG focus to 'societal movements'. These broader, catch-all descriptions take in a multitude of ideas, underlining the extent to which a broad range of issues are coalescing to drive ESG into the mainstream.



Figure 1: Drivers of ESG focus

How would you rate the following factors in terms of their significance in prompting your firm's current focus on ESG?

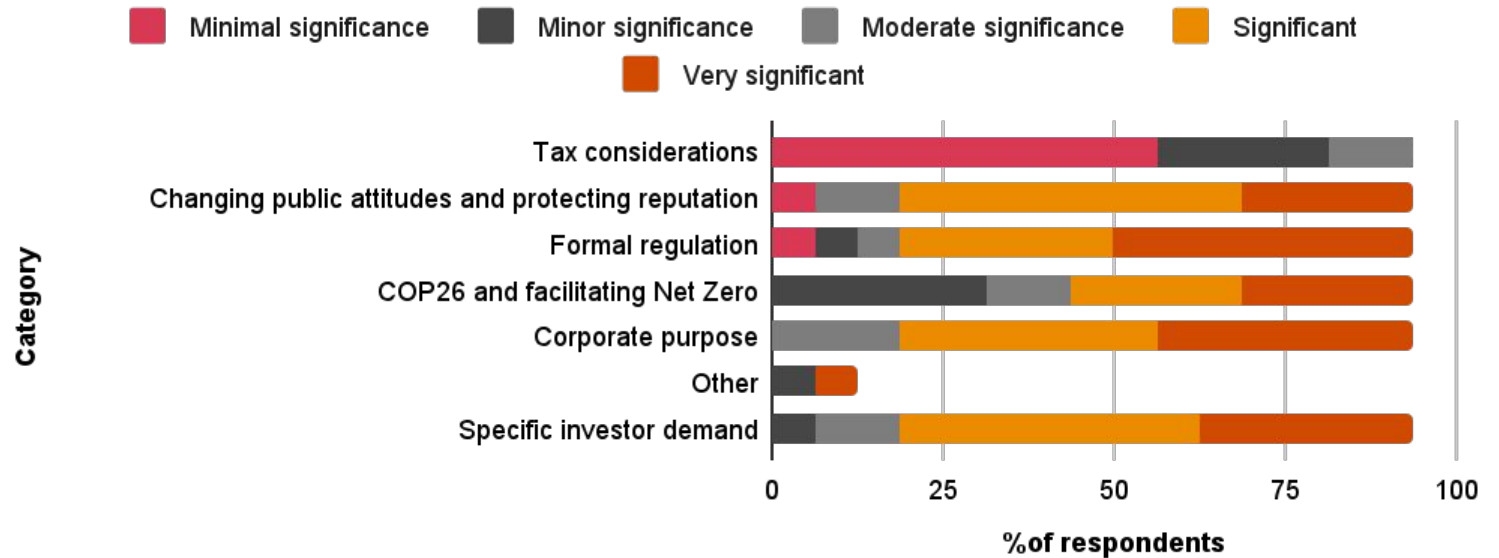
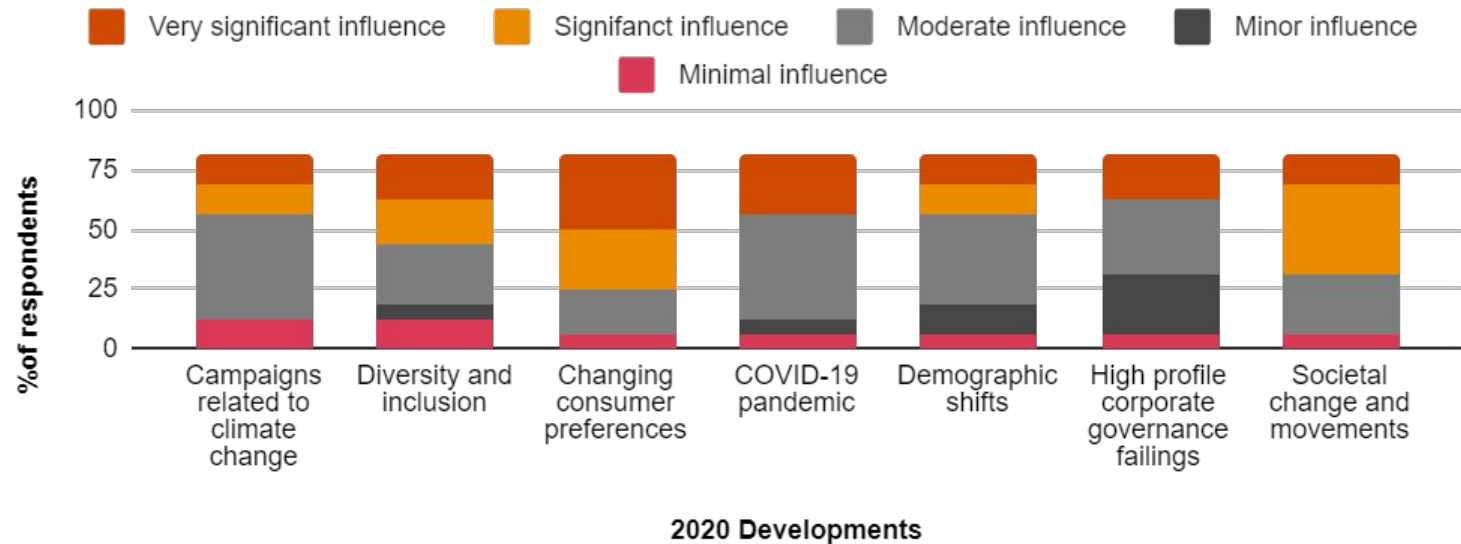


Figure 2: The impact of the past 12 months

To what extent have the following developments in 2020 influenced your stance on/perception of ESG integration?



Asset managers face pressure from all directions to act on ESG

Taken in the round, the data is compelling. The increased focus by asset managers on considering ESG factors across their organisations is gathering pace. This is being driven by a mix of investor demand and regulatory imperative, with the COVID-19 crisis acting as a further accelerant – and likely to remain so as governments invest in a green recovery.

More broadly, many firms insist their focus on ESG reflects their corporate purpose as they focus on sustainable value creation for their clients and society as a whole. This will become increasingly important as more asset managers build and implement firm-wide ESG frameworks. Indeed, to refute potential accusations of greenwashing, asset managers will need to be able to demonstrate how a holistic approach to ESG has become an important element of their value strategy – and not simply another compliance challenge or, worse, a marketing tool.

On specific issues, climate change will naturally remain a key ESG consideration – the relatively low numbers of survey respondents calling COP 26 out as a very significant driver in 2020 likely reflects the difficulty of isolating the environmental agenda as a single factor. Rather, the Net Zero debate is part of a much broader conversation about systemic risk – amplified by the pandemic – and is also reflected in the regulatory imperatives that firms face.

Elsewhere, other drivers currently seen as less significant are expected to come to the fore over time. Tax is one good example. Some survey respondents say the fact that tax is not currently cited as a major ESG focus reflects the lack of tax incentives to encourage ESG investment in the UK. Equally, respondents also stated that corporate tax, as an issue of investor concern, has been less prominent over the past year.

However, tax and ESG interact in other ways. The World Economic Forum (WEF) includes the total tax contribution of a business as part of the overall ESG analysis. Plus, the recent G7 agreement, in which leading economies agreed to a minimum global tax rate of 15%, may be another sign that change is on the way. The agreement includes new rules on taxing companies where they generate revenues, rather than where they declare profits. Effective tax governance is a key area of focus for business, and should be an integral part of any overall business control framework.

The US's plan for minimum global tax rates under the Biden administration may also, in time, shift the dial here.



Our ESG drivers are a combination top-down regulation and bottom-up client demand. The SFDR is a game changer, but our clients are increasingly asking us questions about the ESG features of our products.

**Head of Sustainability
Regulation and Policy at a
global asset manager**



The purpose of our focus on ESG is to deliver sustainable long-term returns for investors.

**Head of Responsibility at a
global asset manager**



The trade-off between ESG approaches and investment returns is likely to be modest in the short term and to disappear in the long term, given the transition to a low carbon economy and issues such as stranded assets.

**Chief Investment Officer at a
large global asset manager**



Part 2: The regulatory agenda

69%

said they are implementing the Sustainable Finance Disclosure Regulation (SFDR) in their UK entity, while 63% said they are implementing the EU's Taxonomy Regulation.

Respondents are heavily considering existing regulatory obligations and principles in the context of ESG. Some 69% said they are 'very significantly' or 'significantly' considering product governance

obligations. **74%** of respondents are giving this level of consideration to the 'clear client communications' obligation.

44%

believe they have integrated disclosures into their public reporting in line with TCFD.

23%

said they have 'minimal' or 'some' engagement with the Financial Conduct Authority's Diversity & Inclusion agenda.

Significant regulatory pressure from the EU

The prominence of regulation among the drivers for asset managers' increasing focus on ESG reflects the sheer weight of ESG-linked reforms that the sector currently faces, and on multiple fronts.

One source of compliance pressure is the European Union. And while certain important EU-led initiatives such as the Sustainable Finance Disclosure Regulation (SFDR) are not directly applicable to UK asset managers post-Brexit, it is clear these changes are on the agenda. Firms may have products in scope, including EU-domiciled funds or funds they market to EU-based investors, or they may be the delegated investment manager of their EU entity. In any case in the current absence of a concrete UK approach to SFDR, many asset managers are talking to their UK investors in the language of the EU's regime.

In this context, some 69% of survey respondents said they are implementing the SFDR in their UK entity. And 63% said they are implementing the EU's Taxonomy Regulation - a figure that may rise given that its scope mirrors that of the SFDR. Indeed, across a whole range of EU ESG reforms, firms point to the significant impact on their UK business (Figure 3).

Clarity emerging on UK regulatory approach

Meanwhile, UK-specific regulatory imperatives add to the burden of work (Figure 4). Above all, many survey respondents point to the various UK-based obligations following the work done by the Taskforce on Climate-Related Financial Disclosures (TCFD). This will need to be an ongoing focus as the UK moves towards mandatory disclosures by 2025 and given the Financial Conduct Authority's (FCA's) significant agenda on climate-related disclosure. Only 44% of respondents believed they have fully integrated disclosures into their public reporting in line with TCFD (Figure 5). Even this number may overestimate asset managers' readiness; the Financial Stability Board's work suggests aggregate compliance levels are much lower.

Other work is also ongoing. The FCA's Sustainable Investment Principles are an important focus. The UK's Green Taxonomy framework, by contrast, are less of a priority for most firms currently, though this may reflect the current lack of clarity on the UK's technical screening criteria.

Nor should it be overlooked that firms' existing regulatory obligations bring ESG issues into play. In areas such as product governance, client communications and the best interests of clients, more than half the asset managers surveyed said that ESG issues have become a significant or very significant consideration. These broader areas of work have the potential to become even more important as asset managers seek to prove their deep-seated commitment to ESG – and to counter suggestions of greenwashing.

Inevitably, given this huge workload, asset managers are taking a view on the significance and prioritisation of different pieces of ESG regulation - according to the relative impact of each set of changes and the timeline towards completion. Where there is less clarity on the roadmap for change the wait-and-see approach is a more likely one.

In other areas, asset managers appear to be thinking hard about the direction of travel. For example, the importance of the FCA's Sustainable Investment Principles may reflect the way in which they represent the building blocks of a broader UK agenda, including a UK version of the SFDR. Similarly, the fact that large numbers of asset managers see the imperative to apply an ESG lens to their existing regulatory activities may also reflect perceptions that the FCA is doing the same.

Overall, asset managers are taking the regulatory aspects of ESG very seriously. But they must be careful to ensure work does not fall through the gaps. The limited implementation work done on EU Taxonomy Regulation versus SFDR, for example, is a concern given the close links between the two.

There is also a need to keep a finger on the pulse of regulatory travel. The FCA's renewed push on diversity and inclusion under Nikhil Rathi's leadership appears to have stirred some firms into action, but not others. Almost one in four firms concede their engagement with the FCA's diversity and inclusion agenda is minimal (Figure 7). The FCA's [discussion paper](#) on this agenda, published in July 2021, may force a reassessment of priorities here.

Patchy adoption of voluntary standards

The patchy adoption rates for various voluntary ESG standards and initiatives paint a similar picture (Figure 8). While these standards are not yet on the same footing as formal regulation, in many cases they are similar in nature. These statistics therefore imply that significant numbers of asset managers may have much work to complete in order to reach compliance with those formal regulations.

Part 2: The regulatory agenda (cont'd)

Spotlight on regulation



Asset managers have faced a flurry of ESG-related regulatory initiatives in recent years, and this shows no sign of easing.

In the European Union, the EU Sustainable Finance Action Plan, originally launched in May 2018, has resulted in numerous new legislative proposals to introduce significant new frameworks for sustainable finance (for example, the EU Taxonomy Regulation and the Sustainable Finance Disclosure Regulation (SFDR) as well as amendments to existing regulations to incorporate sustainability concepts. In the UK, the Government launched its Green Finance Strategy in 2019, signalling a focus on the integration of climate-related risks and reporting, and addressing greenwashing risk. Further clarity is now emerging on what this means for asset managers, with various proposals having been put forward by the FCA.

Key regulatory themes for asset managers to navigate include:

Assessing and managing ESG risk

A range of regulatory initiatives require asset managers to assess and manage ESG risks across their business and operating models. The current focus is on how ESG risks can be integrated into investment-decision making processes and due diligence through initiatives such as SFDR, amendments to the UCITS Directive and AIFMD, and the revised UK Stewardship Code.

There is also a broader focus from regulators on greenwashing risk, and ensuring that firms are properly categorising their funds. The FCA is looking at this through its sustainable investment principles, and it is also a core objective behind EU regulations such as SFDR and the Taxonomy Regulation.

Increased disclosure and reporting

The majority of new ESG regulations impacting asset managers have some form of disclosure or reporting element. For example, under SFDR, firms must be transparent about how they integrate ESG risks into the investment process in an ESG policy, and about the ESG characteristics and objectives of certain funds in pre-contractual product disclosures and annual reporting, while also having to report on the sustainability impacts of their investments. Similar disclosures are expected under the FCA's sustainable investment principles. The FCA's agenda to embed TCFD reporting into various aspects of its regulatory framework means that climate-related disclosures are also an important focus for asset managers.

Greater standardisation

Regulators are trying to drive more standardisation in how ESG is considered across the financial services sector. This standardisation is supported through the EU Taxonomy Regulation, which establishes a classification framework to determine whether companies that financial services firms are exposed are environmentally sustainable. The UK Government has established a UK Green Technical Advisory Group to develop a UK Green Taxonomy, which is expected to tailor the EU's technical screening criteria to the UK market. The Government has said this UK framework will be in place by end-2022.

These taxonomy frameworks, together with wider initiatives including the amendments to the EU Benchmarks Regulation so that investors can measure and compare ESG performance more readily, are likely to promote better management of ESG risks and improve access to sustainable investment products.

Stewardship

A number of regulatory initiatives require asset managers to facilitate more effective stewardship on ESG issues by enhancing the transparency of their engagement policies and investment strategies. Under the revised EU Shareholder Rights Directive (SRD II), asset managers have to publish their engagement policies on a 'comply or explain' basis, and be more transparent on how their investments support long-term value creation. The revised UK Stewardship Code requires asset managers to disclose how they integrate stewardship considerations into their investment processes.

Figure 3: The impact of EU regulation

How would you rate the following EU initiatives in terms of the impact they are having/is likely to have on your UK business?

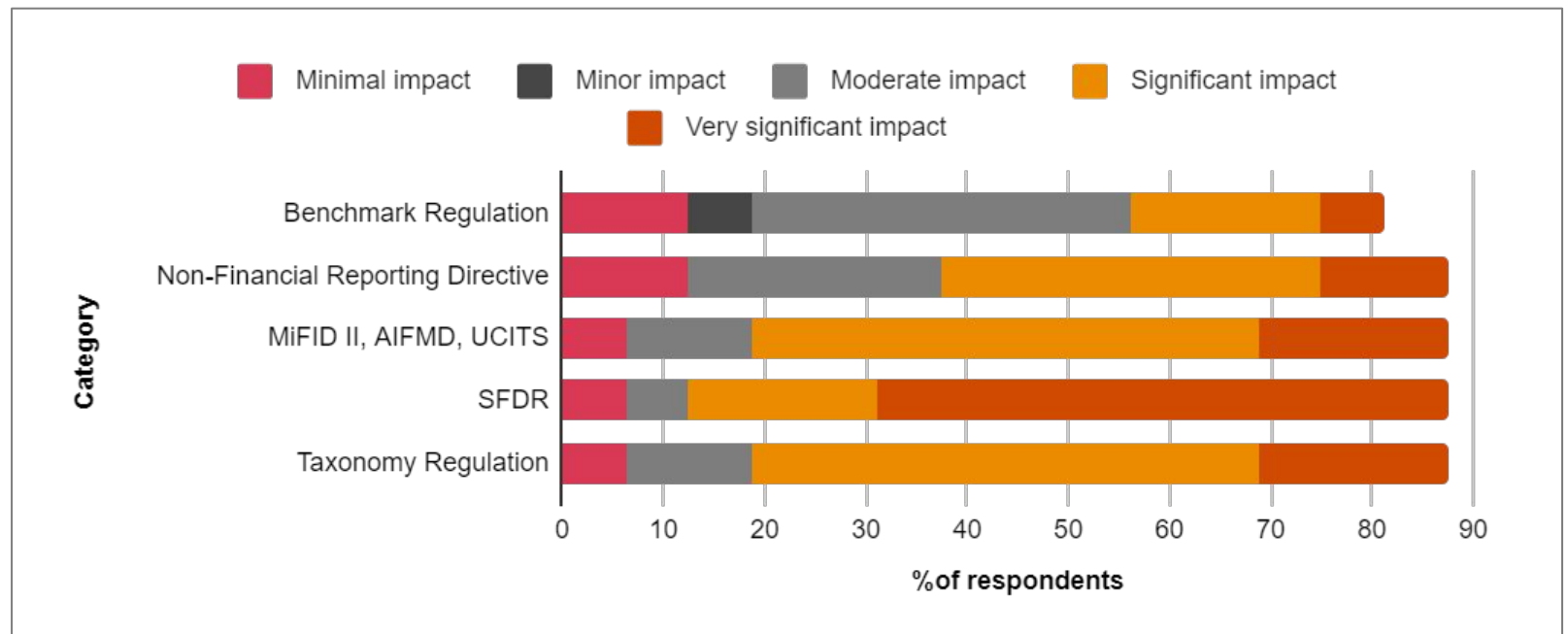


Figure 4: The impact of UK regulation

How would you rate the following UK initiatives in terms of the impact they are having/are likely to have on your UK business?

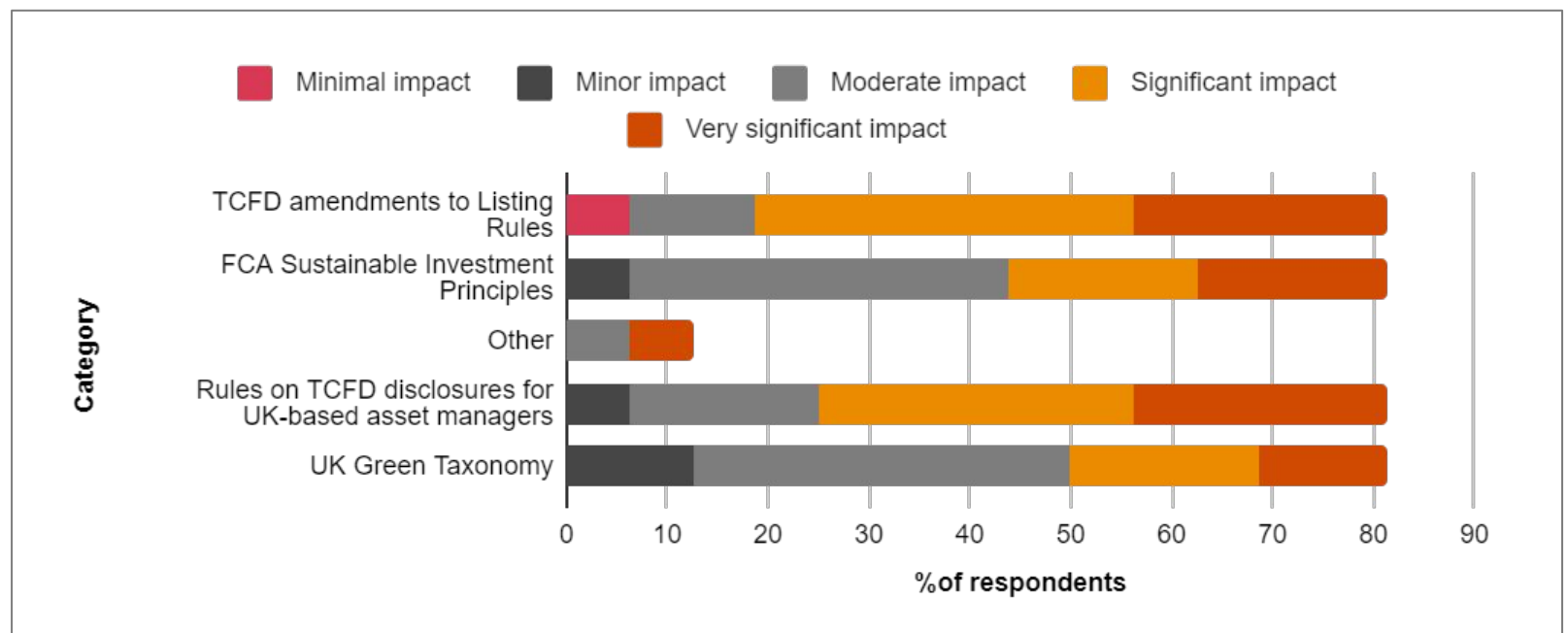


Figure 5: Plans for TCFD disclosures

Ahead of the UK initiatives to mandate TCFD disclosures across the economy by 2025, have you integrated TCFD-aligned disclosures into your public reporting?

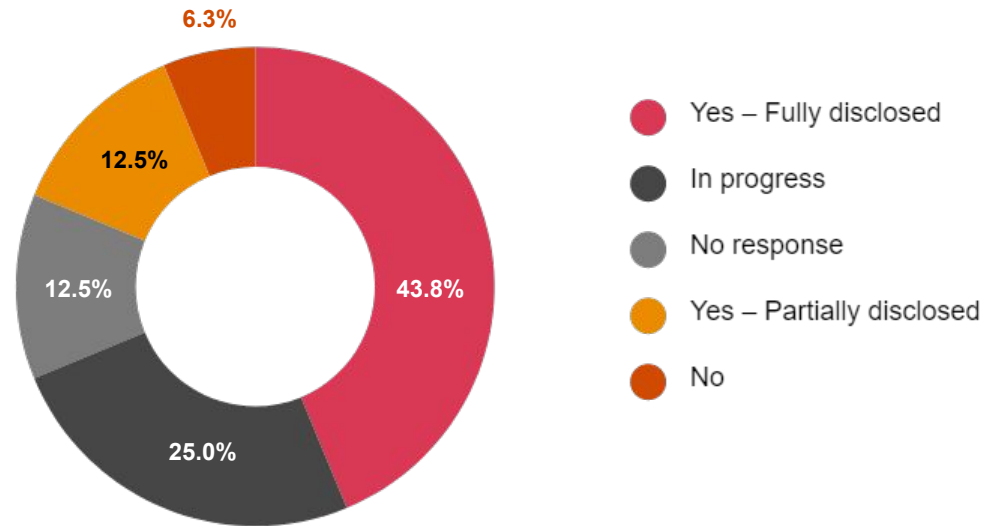


Figure 6: ESG and the broader regulatory context

To what extent are you considering ESG issues in the context of meeting the following existing regulatory obligations?

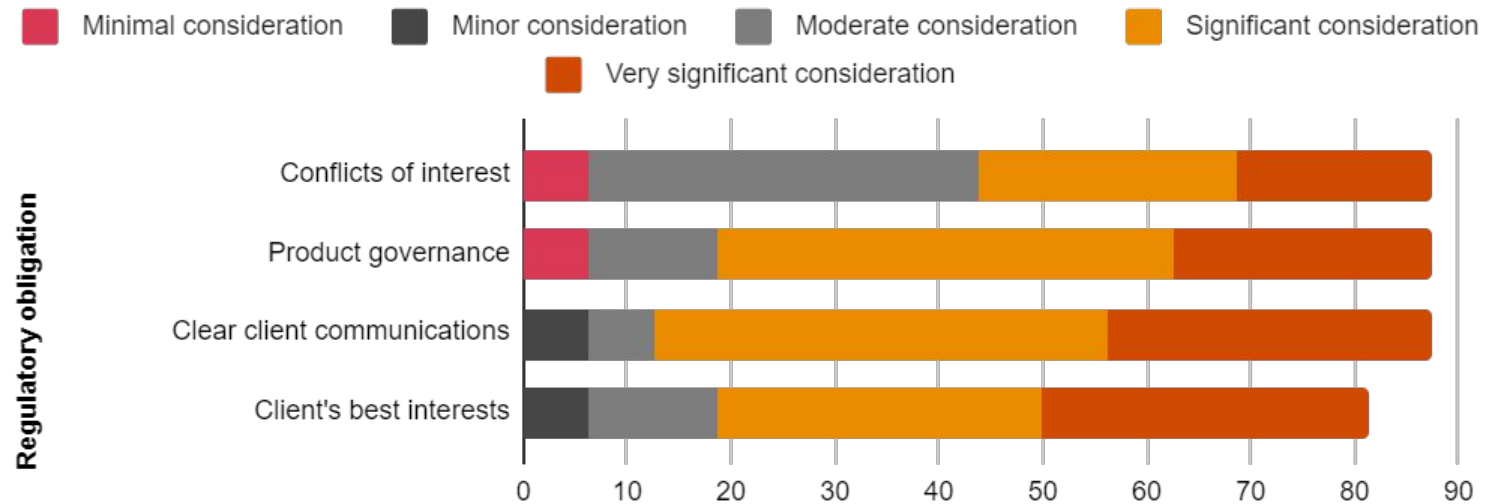
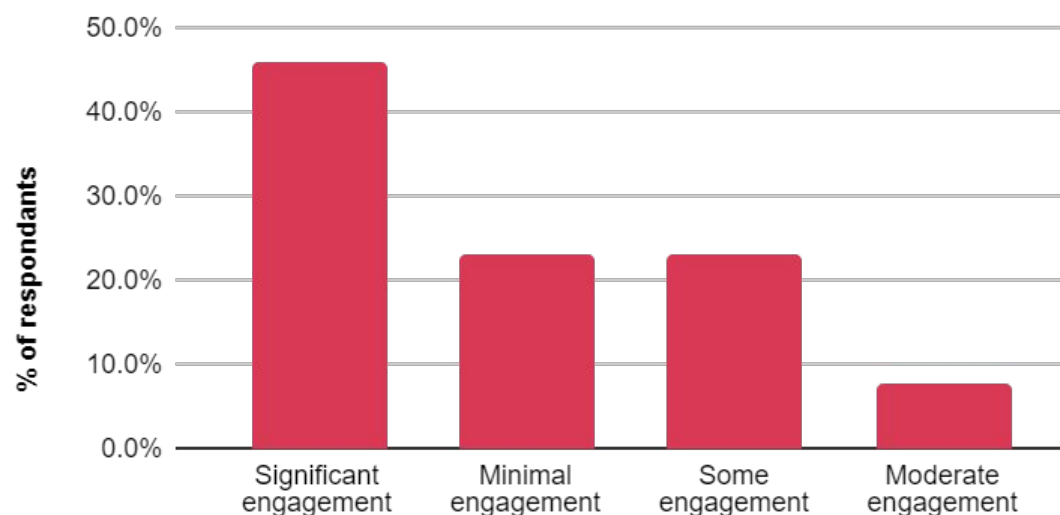


Figure 7: Engagement on diversity and inclusion

To what extent are you aware of/engaging with the FCA's wider supervisory agenda around diversity and inclusion?



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Regulation means ESG has become mainstream. We do not regard that as simply a compliance exercise, but as a means to drive accountability and support our clients.

Head of Governance and Sustainability at a mid-tier UK asset manager

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Regulation is playing a key role in accelerating our focus on ESG, but commercial opportunity is the central driver, from the opportunities for product development to brand and reputation.

Head of Responsible Investment and Impact at a mid-tier European asset management group

Figure 8: Voluntary initiatives

Is your firm a signatory/member of the following voluntary initiatives?

Is your firm a signatory member of the following voluntary initiatives?

Initiative	Yes
Taskforce on Climate-related Financial Disclosures	75.00%
UN PRI	75.00%
Carbon Disclosure Project	56.20%
D&I Initiatives	56.20%
FRC Revised Stewardship Code	56.20%
Net Zero	56.20%
Sustainability Accounting Standards Board	50.00%
Climate Action 100	6.20%
UN Global Compact	6.20%



The EU Sustainable Finance Disclosure Regulation (SFDR) introduces a range of new obligations for asset managers to be more transparent over their consideration of ESG factors across their investments and funds. The regulation took effect for in-scope firms from 10 March 2021, though a long list of obligations will be phased in over time until 2023.

Broadly, this flagship regulation under the EU Sustainable Finance Action Plan requires asset managers to be more open about how they integrate ESG risk factors into the investment process, the impacts of their investments on certain sustainability metrics, and the sustainability characteristics and objectives of certain so-called 'Article 8' and 'Article 9' funds. These disclosures will need to be made in ESG policies, websites, pre-contractual product documentation and periodic reports.

Despite being an EU regulation, SFDR remains relevant for many UK asset managers. Many UK entities are in scope because they have EU-domiciled funds, are marketing funds to EU-based investors, or are the delegated investment manager of their EU entity.

Figure 9: SFDR product classifications

	Article 8 funds	Article 9 funds	Article 6 funds
	Funds that promote environmental or social characteristics	Funds that have a sustainable investment objective	Non-ESG funds
Pre-contractual disclosures	<ul style="list-style-type: none"> Information on the environmental or social characteristics Information on whether any index used as a reference benchmark is consistent with characteristics Taxonomy alignment or disclaimer 	<ul style="list-style-type: none"> Information on how the sustainable investment objective is met Information on whether any index used as a reference benchmark is consistent with objective Taxonomy alignment or disclaimer 	<ul style="list-style-type: none"> How ESG risks are integrated into the investment process Assessment of the impact of ESG risks on investment returns Whether principal adverse impacts are considered
Periodic reporting	<ul style="list-style-type: none"> Extent to which the environmental or social characteristics have been met Taxonomy alignment or disclaimer 	<ul style="list-style-type: none"> Overall sustainability performance of product against relevant metrics Comparison of the sustainability performance of the product against the reference benchmark Taxonomy alignment or disclaimer 	<ul style="list-style-type: none"> Taxonomy alignment or disclaimer
Website disclosures	<ul style="list-style-type: none"> Description of the environmental or social characteristics Information on methodologies to assess, measure and monitor characteristics 	<ul style="list-style-type: none"> Description of the sustainable investment objective Information on methodologies to assess, measure and monitor the objective 	<ul style="list-style-type: none"> No obligations

Part 3: How asset managers are responding to key drivers

82%

said that they have an ESG programme in place and

81%

of respondents said their goal is to use these programmes to drive transformational change in their firm-wide approach to ESG.

50%

said that their Head of ESG is responsible for their

ESG programme, while 19% said that the programme is run by the CEO.

Only 46%

said they are conducting any form of quality assurance work on their ESG data, putting a question mark over its accuracy.

13%

said that they are fully prepared for the EU Taxonomy

Regulation, while 25% said that they are fully prepared for SFDR.

ESG investment approaches

ESG is now a key discipline for all asset managers, but their approaches vary significantly. Every asset manager in our survey now integrates ESG risks into the investment process, with a majority of firms also adopting a 'thematic' ESG approach to some of their investment strategies, such as an exclusions or best in class approach.

However, while this is a firm-wide activity spanning the entire product range for some managers, for others it is confined to certain funds. For example, while every firm in this survey applies an exclusions approach in some capacity, only 56% do this at both fund and firm level (Figure 9).

Some firms' ESG investment approaches include much darker green practices than others, including impact investment. In fact, this has already been more widely adopted than might be expected, with additional managers in the qualitative phase of this research signalling their intention to pursue impact. For some this may fall short of a full-scale impact investment strategy (for example some suggested that they consider impact in the round across their investment portfolio rather than having funds with an explicit impact strategy), but this survey suggests traction is growing.



We have clear guidelines for portfolio managers when integrating ESG risks; the key is to establish consistency, with a view to embedding an ESG lens into the culture of our investing.

Head of Governance and Sustainability at a mid tier UK asset manager

Our research shows the extent to which asset managers perform stewardship activities to drive better ESG outcomes across investee companies as they seek to deliver long-term sustainable investment returns also varies at fund and firm level, though to a lesser extent. More than two-thirds of respondents perform stewardship activities at firm and fund level. So while these firms are now undertaking a wide range of stewardship activities (Figure 10), their approach may not always be consistent.

The evidence here points to a disconnect. As some managers have launched ESG product offers in recent times, their approach to ESG has often been fund-led, rather than firm-wide; each new ESG fund has added to this piecemeal approach, with managers lacking a coherent investment approach on ESG issues at an entity level. A similar disconnect applies to stewardship at some responding firms, but more managers are taking a holistic approach, with engagement across the firm underlining the contradictions and inconsistencies elsewhere in their ESG work.

Part 3: How asset managers are responding to key drivers (cont'd)

Asset managers should aim for firm-wide consistency when assessing ESG investment risk

Closing the disconnect is crucial. This is especially true for the way in which firms integrate ESG risks into the investment process. It offers managers the opportunity to drive long-term sustainable investment returns across their firm-wide portfolios, regardless of which funds those investments sit in.

The progression for many managers will be to think firm-wide. For example, is a firm-wide ESG investment policy being consistently translated into fund-level integration by fund managers? Is there sufficient guidance in place for fund managers? Does the firm-wide policy set out factors to take into account when applying the policy to different funds/asset classes?

Asset managers that lack a firm-wide vision or narrative on their approach to ESG investing face increasingly significant levels of risk. Inconsistency and the lack of a holistic view may lead to, for example, regulatory failures, loss of trust with customers - particularly amid increasing concern about greenwashing - and disconnects in engagement with portfolio companies. Greater sophistication is needed: ESG risks need to be managed more consistently and holistically across the entire investment portfolio, with a fully-integrated and standardised ESG approach that is firm-wide.

Responding to ESG regulation

Our research suggests that respondents are not yet fully prepared for the incoming UK and EU regulations. Only 25% and 13% of respondents said that they are fully prepared for EU SFDR and EU Taxonomy Regulation respectively. Follow-up interviews with respondents found that 'fully prepared' indicated they have a plan to implement these regulations, rather than that they have already fully implemented, suggesting that most firms still have a considerable amount of work to do fully align with these critical initiatives.

Most respondents admitted to only partially preparing for key UK regulatory initiatives, including the FCA's sustainable investment principles and the FCA's rules on TCFD for regulated asset managers (Figure 16). We were told that this reflects the lack of details the industry currently has on these initiatives, although the FCA has since published proposals on climate-related disclosures for asset managers, which is likely to trigger much greater focus on this area.



Figure 10: Key ESG approaches

Which responsible investment components are you following across your investment strategies?

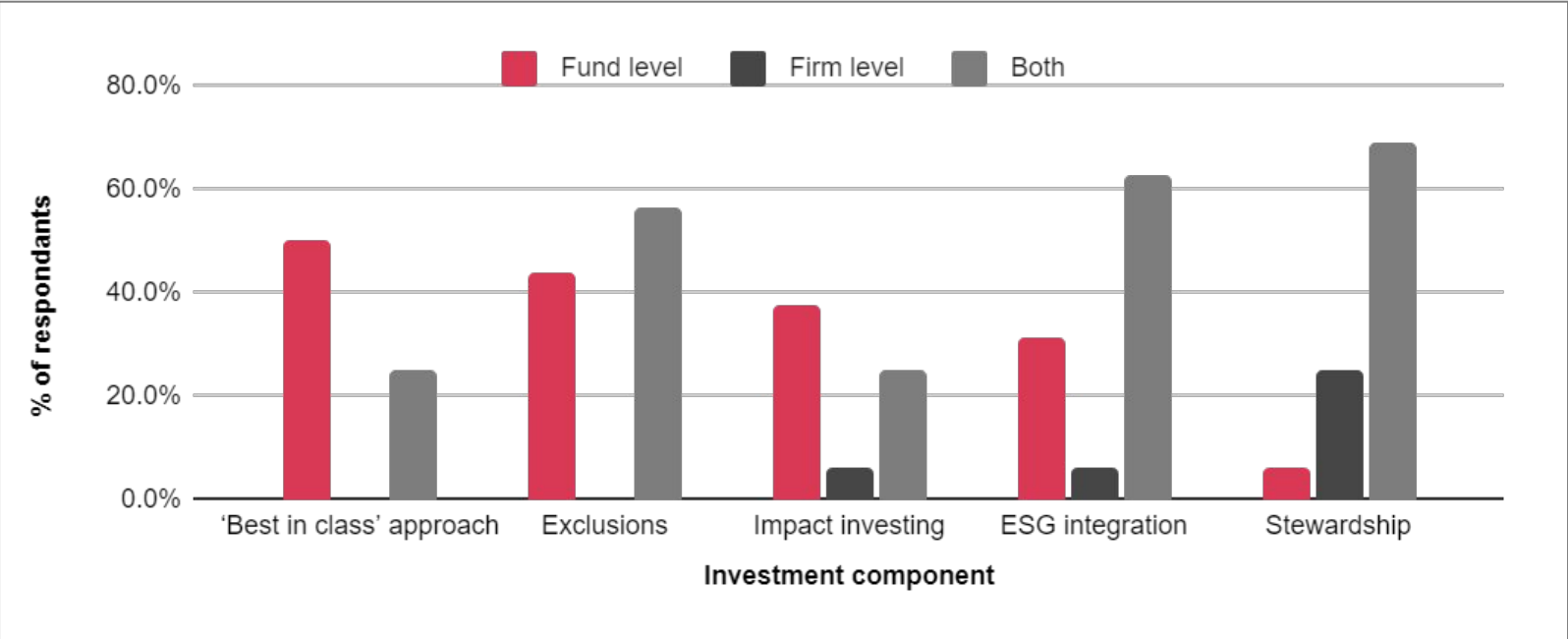
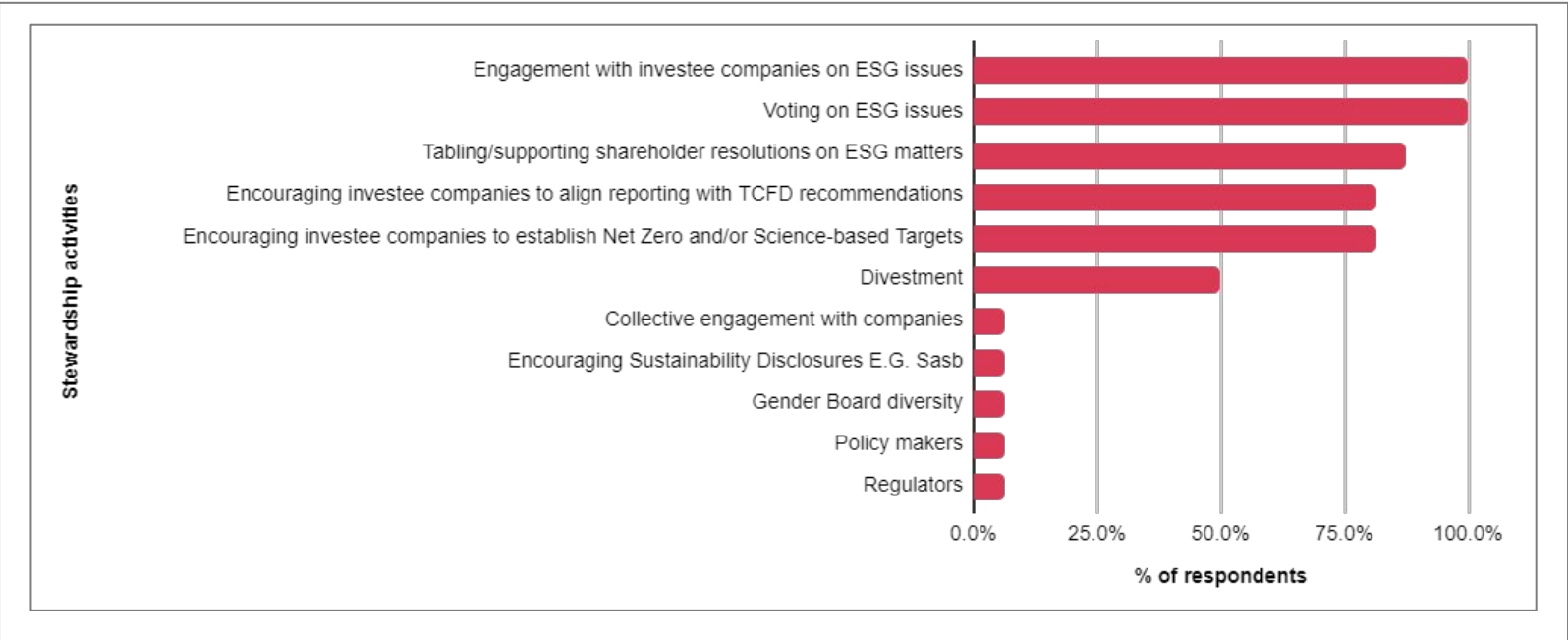


Figure 11: Stewardship in practice

As part of your fiduciary duty to deliver long-term sustainable returns, which stewardship activities do you undertake to drive better ESG outcomes among investee companies?



Approach to ESG data



We are very conscious of issues around the consistent use of data. One reason we are reluctant to label our funds under SFDR is that data issues leave us vulnerable to accusations of greenwashing.

**Head of Investor Relations
at a UK asset manager**

The difficulty of securing high-quality and consistent data on a broad range of ESG issues has been a persistent concern – this survey shows such anxieties remain front of mind for many asset managers. Their data collection is fragmented and hard work, requiring them to scan multiple potential sources of information; much of that work is currently being done internally, with asset managers also paying for third-party input from providers Sustainalytics, MSCI, though Reprisk, ISS, iBOXX, and VigeoEiris (Figure 15).

Even where asset managers are securing plenty of data, there are question marks over its accuracy, with only 56% of survey respondents conducting any form of quality assurance work on this information, whether internal (31%), external (19%), or both (6%). This may not be tenable for long given the focus of regulators on the importance of data and the increasing requirements around reporting, one reason why some firms are now considering assurance for the first time. The picture on the use of targets and metrics is similarly patchy (Figures 16 and 17). Although ESG metrics and targets are common, a sizable

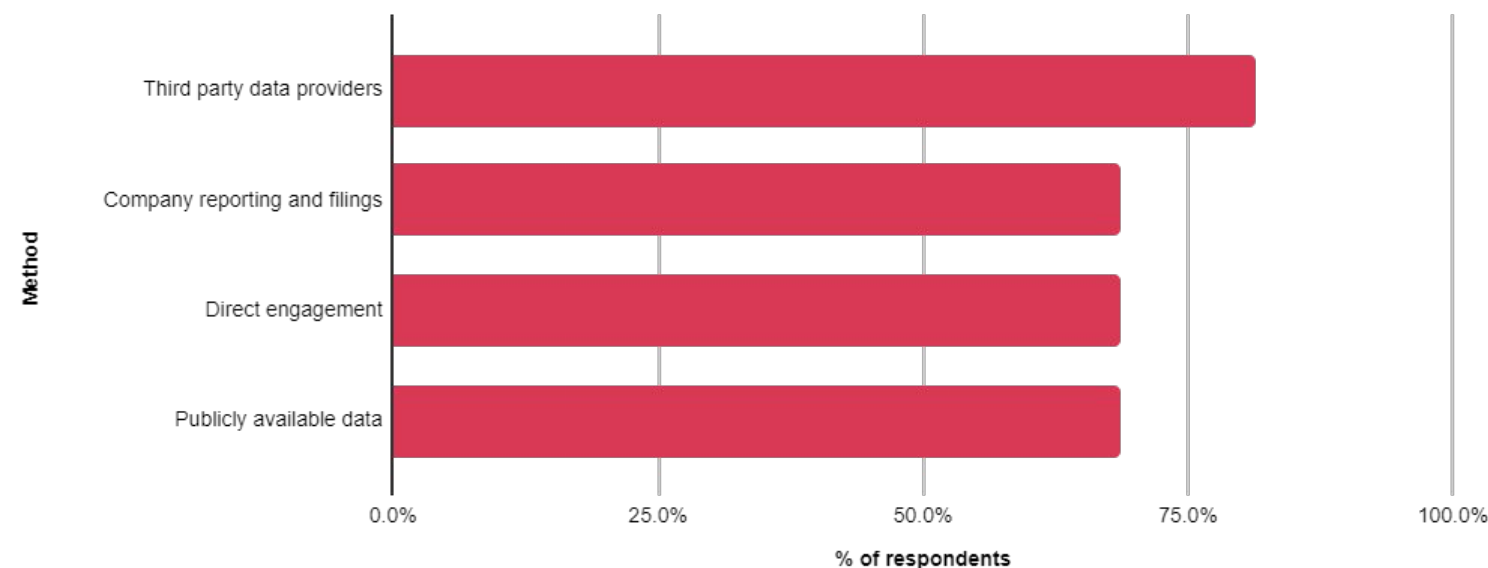
portion of firms do not currently have these in place. Again, regulators may force managers' hands; for example, the low number of firms currently using principal adverse impact (PAI) metrics as set out in the SFDR is surprising in this regard. But one in four asset managers are now considering adopting ESG metrics – the regulatory imperative will be part of that narrative.

More broadly, data promises to become a battleground issue as firms increase their focus on ESG and begin to think in terms of holistic firm-wide ESG approaches. The fragmentation of data collection today looks inefficient and expensive, while regulatory attention in areas such as assurance and targets and metrics should be considered imminent.

A more coherent and structured approach to ESG data should be seen not purely as a response to regulatory and compliance pressures; rather, it can be a key enabler of the transformation that many asset managers have ambitions to achieve through their ESG work.

Figure 12: Where asset managers source ESG data

How do you source ESG data?



Can ESG programmes drive sophistication?

Majority of asset managers target ESG transformational change – but progress is mixed across the industry...

Formal ESG programmes may provide a means for asset managers to move towards the more holistic approach that is now required, while also providing the framework to robustly embed ESG considerations across the entire organisation. In this survey, 81% of firms said they already have such a programme; and of these, more than half said their programme is now operational, with the rest at different stages of implementation (Figure 11).

Some 81% of survey respondents with ESG programmes said their goal is to drive transformational change – rather than simply to respond to specific imperatives such as new regulation. Assuming this aspiration can be translated into action, this potentially represents a way to solve some of the disconnects between fund and firm level approaches to ESG, both from an investment perspective, and across the organisation as a whole.

However, this is a challenging aspiration. Some qualitative discussions with asset managers suggest that firms have felt under pressure to get ESG programmes up and running before they have had an opportunity to think more deeply about strategic goals.

Many firms are still defining what they mean by transformation. They recognise the way in which COVID-19 is driving a focus on purpose – but are still reflecting on what that might imply for their organisations; ESG is just one part of this debate. PwC's view is that embedding ESG considerations into corporate purpose can help asset managers realise significant value, but this is a work in progress for many firms.

In practice, the success or otherwise of transformation efforts will depend on the support they win across the business, including at executive level. At first sight, the fact that heads of ESG are most likely to be responsible for these programmes – rather than the CIO or CEO – is a concern, particularly as at the vast majority of asset

managers in the research, the Head of ESG is not a member of the firm's executive committee (Figure 12). Still, 19% of firms do said their CEO takes the lead, underlining the importance of this agenda.

Is ESG transformation a medium-term project?

Resourcing is also an issue. There is some evidence that ESG programmes are not well-staffed, with relatively few people involved, often on a part-time basis (Figure 13). Nor is quantum the only issue: one challenge (Figure 18) highlighted by many asset managers is a skills shortage as the need for an ESG skillset to transition from specialist to mainstream becomes increasingly important.

These difficulties may help explain why asset managers from this survey paint a mixed picture on how much progress their ESG programmes are making in dealing with impending regulatory requirements (Figure 14). Most have made only partial preparations for key regulation. And the qualitative element of this research suggests that among those firms that say they have fully prepared, the reality is often that they simply have a plan for implementation; this plan has yet to be executed.

In this context, while it is encouraging that so many asset managers have ESG programmes in place – and that so many see these as driving ESG transformation across the business – there are question marks over whether reality yet lives up to ambition. Some programmes are not yet up and running and anecdotal evidence suggests the transformation appetite may be difficult to deliver. On resourcing and accountability, there are question marks over whether these programmes have sufficient numbers of staff, and whether they have enough executive sponsorship, given their lofty aspirations.

The progress made on regulation tells its own story. Going beyond tactical regulatory implementation work will take even longer – transformation may be viewed as a medium-term project for most firms.



ESG is a specialism that has to become mainstream, but this will be a journey.

Chief Investment Officer at a large global asset manager



Skills and knowledge are a significant challenge: as ESG becomes mainstream, we need to build our level of expertise through upskilling and recruitment.

Head of Responsible Investment and Impact at a European asset management group



Training our staff is a major focus: we will have ESG experts, but everyone needs to have knowledge.

Head of Sustainability Regulation and Policy at a global asset manager



We do have transformational ambitions for our ESG programme, but we also recognise there will inevitably be tactical work to ensure compliance.

Chief Investment Officer at a large global asset manager



We are taking a bottom-up approach, joining up our story on ESG and communicating it to clients.

Head of Investor Relations at UK asset manager



ESG is central to our business – this is why ESG considerations are embedded in the performance management of all our staff, not just our investment teams.

Head of Responsibility at a global asset manager



Our ESG programme is intended to bring together all our internal stakeholders to establish a consistent house view on ESG; we don't want ESG to sit within our investment teams and we want to be able to discuss product development and other implications across the business.

Investor Relations professional at UK emerging markets asset manager



Figure 13: The progress of ESG programmes

At what stage is your ESG programme?



Figure 14: Who is responsible for your firm's ESG programme?

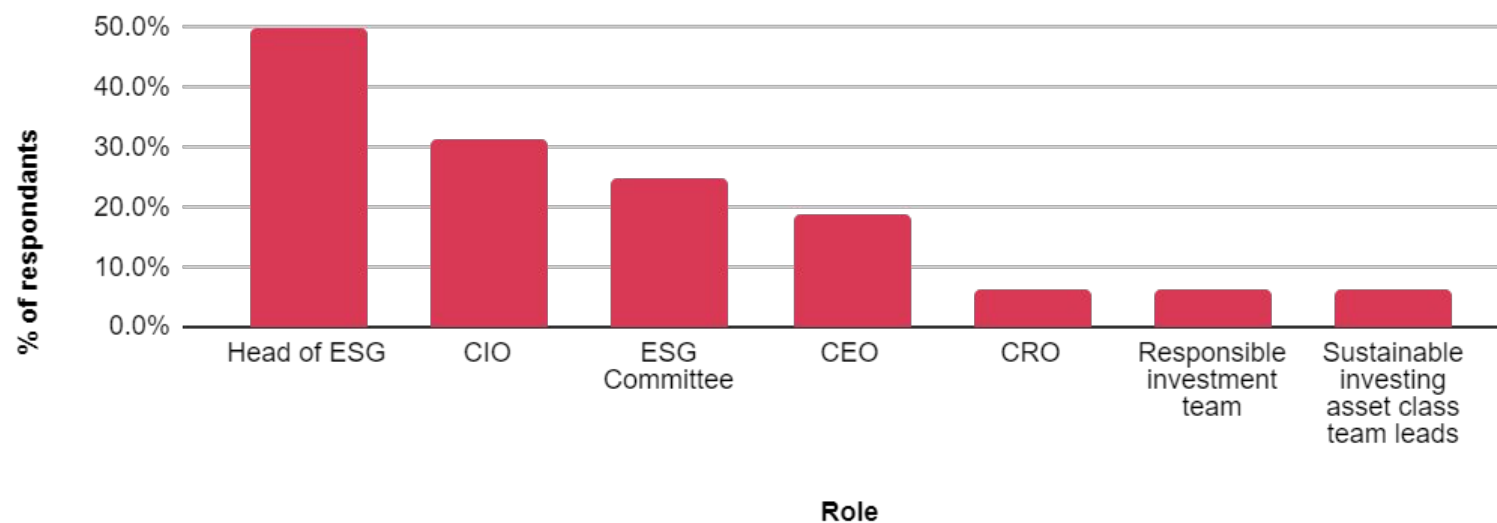


Figure 15: How ESG programmes are staffed

How many staff are involved in your firm's ESG programme?

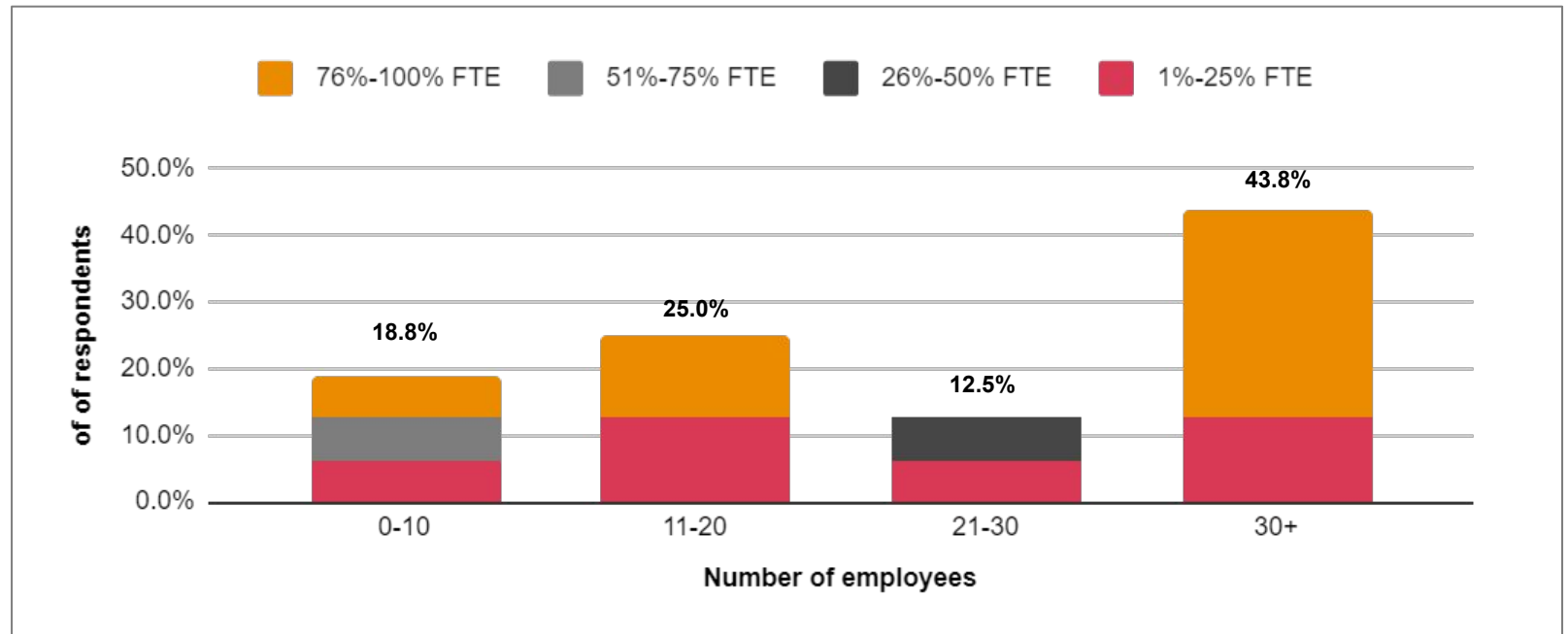


Figure 16: Progress on regulation

How would you rate your firm's readiness for specific incoming ESG-related initiatives?

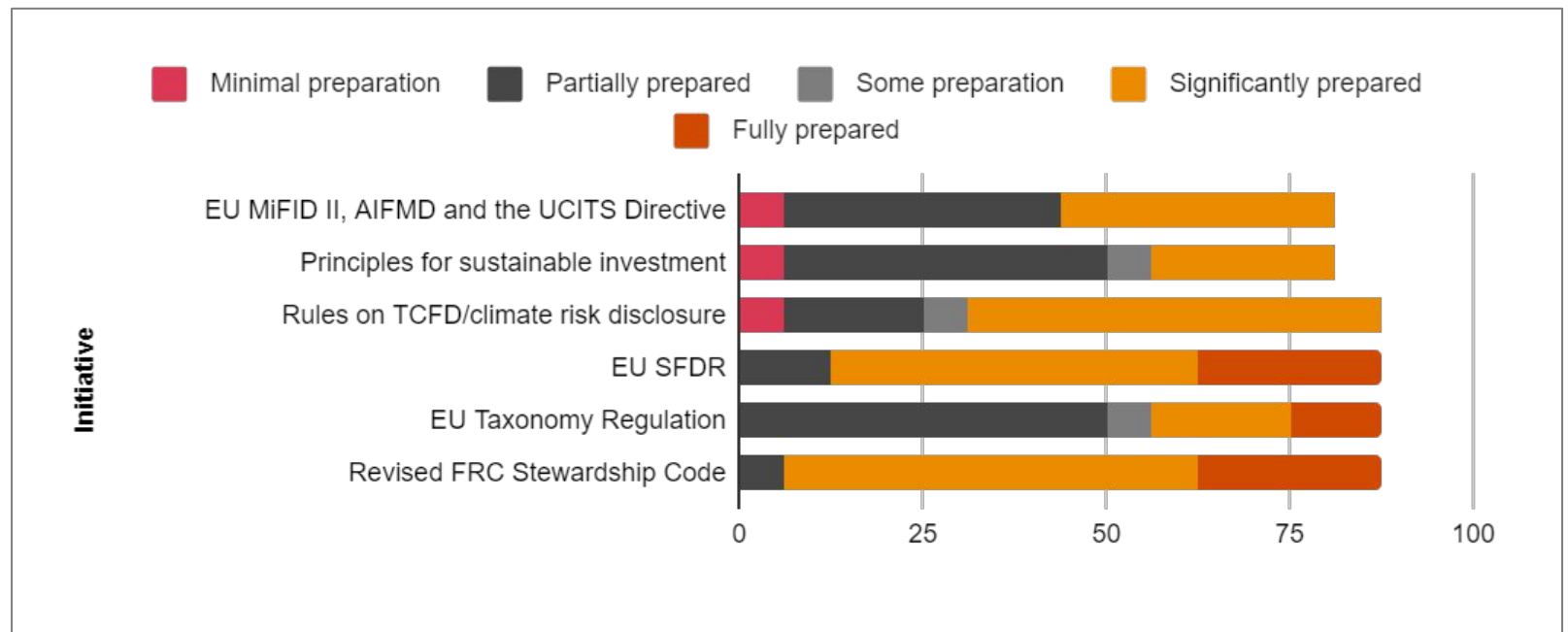


Figure 17: Use of ESG targets

Are you considering, or have you established, targets to inform your understanding of ESG-related risks and opportunities?

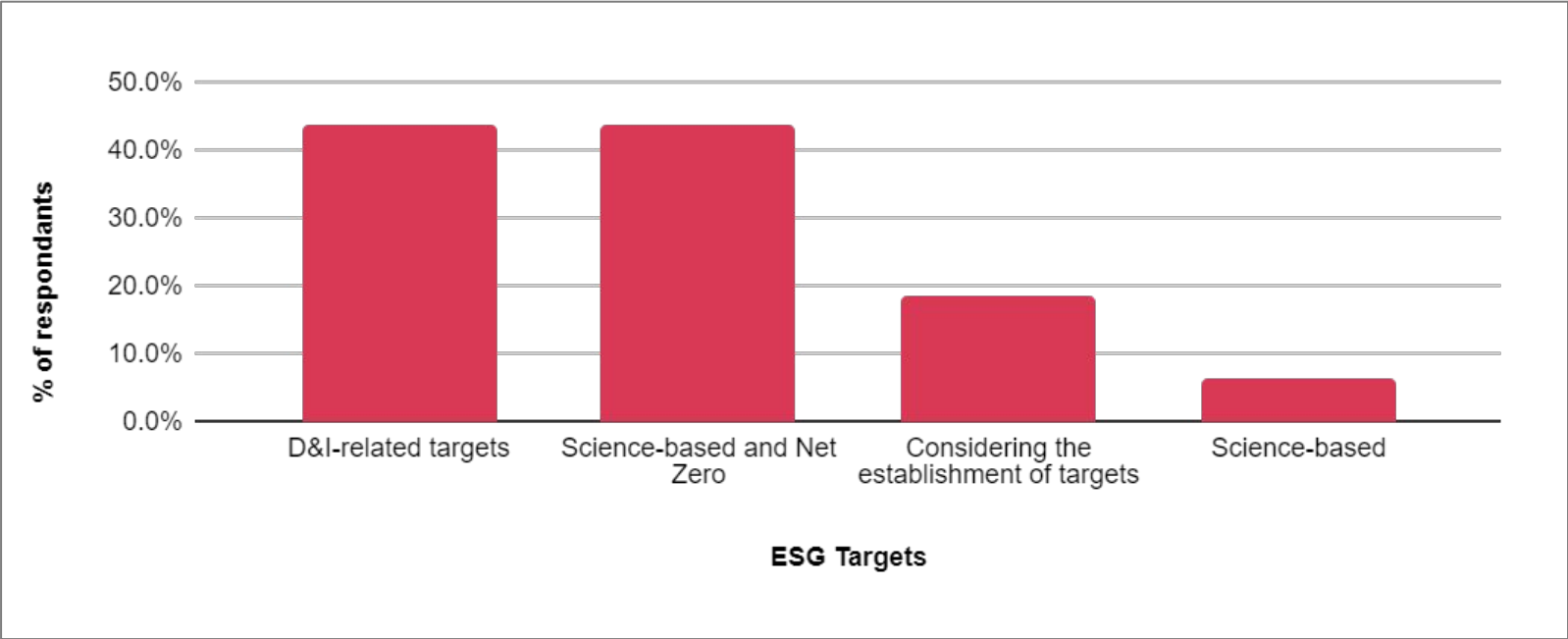
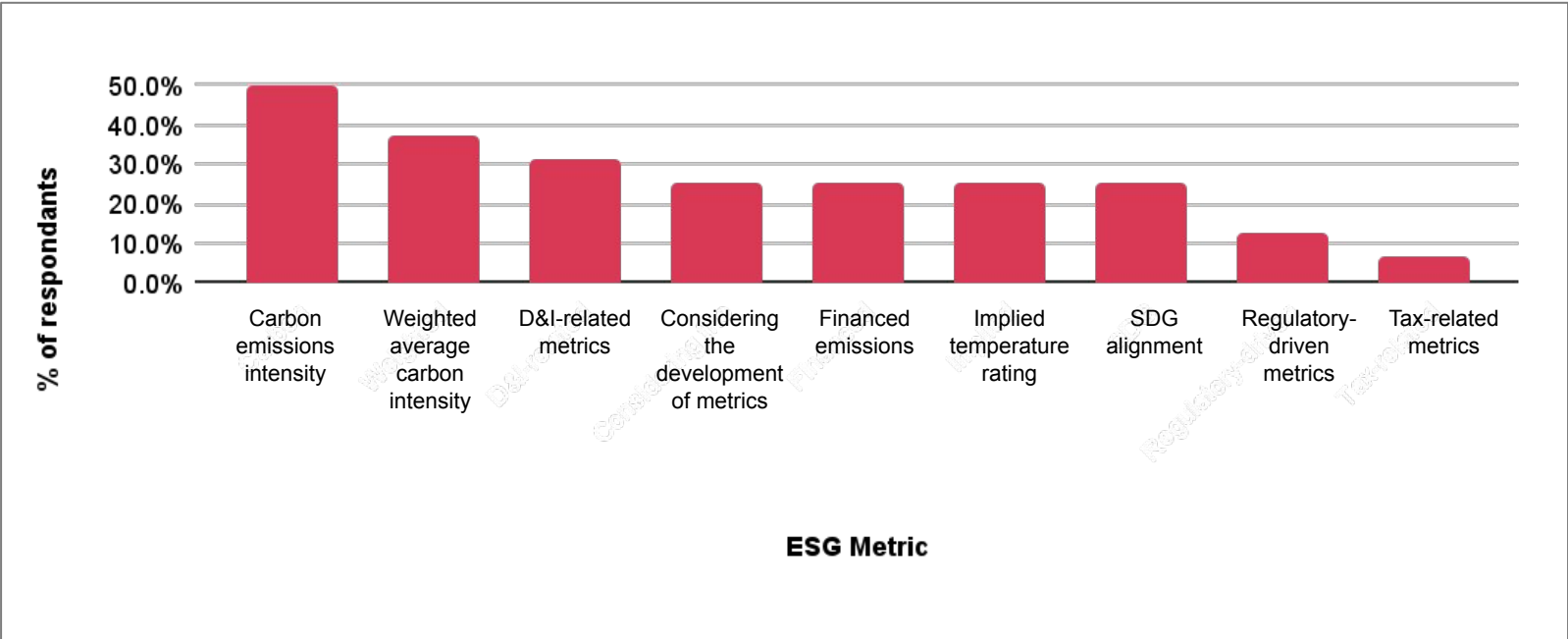


Figure 18: Use of ESG metrics

Are you considering, or have you established, metrics to inform your understanding of ESG-related risks and opportunities?



Part 4: Challenges and opportunities

63%

said that a lack of international consistency in ESG regulation is creating either a 'very significant' or a 'significant' challenge. Some 43% said that the volume and complexity of regulation is either a 'very significant' or 'significant' challenge.

92%

said that the cost of accessing data and the lack of consistency is problematic.

44%

said they see a 'very significant opportunity' to develop new product ranges in response to changing consumer preferences on ESG.

31%

said the ESG agenda presents a 'very significant opportunity' to attract top talent.

What stands in the way of asset managers as they strive for a more holistic and transformational approach to ESG? In this survey, firms identified a series of key challenges (Figure 18).

Volume and complexity of regulation is a major challenge

Regulation is one stand-out issue. First, 44% of survey respondents pointed to the volume and complexity of the regulation as a very significant or significant challenge. In addition, 63% worry about the lack of international consistency, despite initiatives such as the World Economic Forum's [focus](#) on universal reporting. This requires many asset managers to address the same problems in different ways in different areas of their organisation.

The danger here is that the focus on regulation forces asset managers into a compliance mentality, preventing them from striving for the transformational benefits to which many aspire. The resources required to deal with the regulatory burden may leave little room for more ambitious work.

Data quality is a concern

The other major concern is the issues around data, cited by 56% of responding asset managers as a very significant or significant challenge. Every firm in this survey cited challenges around data quality, while 92% complained that the cost of accessing data and the lack of consistency is problematic (Figure 19).

Regulators/policymakers are alert to the need to improve corporate data, but any regulatory or policy solution will take time. In the meantime, firms will need to find innovative ways to access the data they need and focus on driving better data quality through engagement with investee companies.



There is a cultural challenge to shift the whole staff's mindset on the importance of ESG integration.

Investor Relations professional at UK emerging markets asset manager

Firms struggle with greenwashing risk

Greenwashing is another area where there is now clear anxiety. The growing attention to ESG paid by investors and regulators alike finds firms under intense scrutiny; the reputational risk of being perceived as marketing products under false pretences is high; there may also be regulatory peril if funds are inappropriately classified or positioned. Equally, some firms warn SFDR will amplify greenwashing risk, enabling them to hide behind regulatory definitions rather than focusing on ESG principles.

Nor are these easy challenges to confront. While taxonomy and disclosure regulation could also help bring clarity, the reality is that ESG is a term that means different things to different people, with many taking a different view on what represents good practice.



Figure 19: Key ESG challenges for asset managers

How much of a challenge do the following issues present when responding to the regulatory environment and wider drivers to integrate ESG into the investment process?

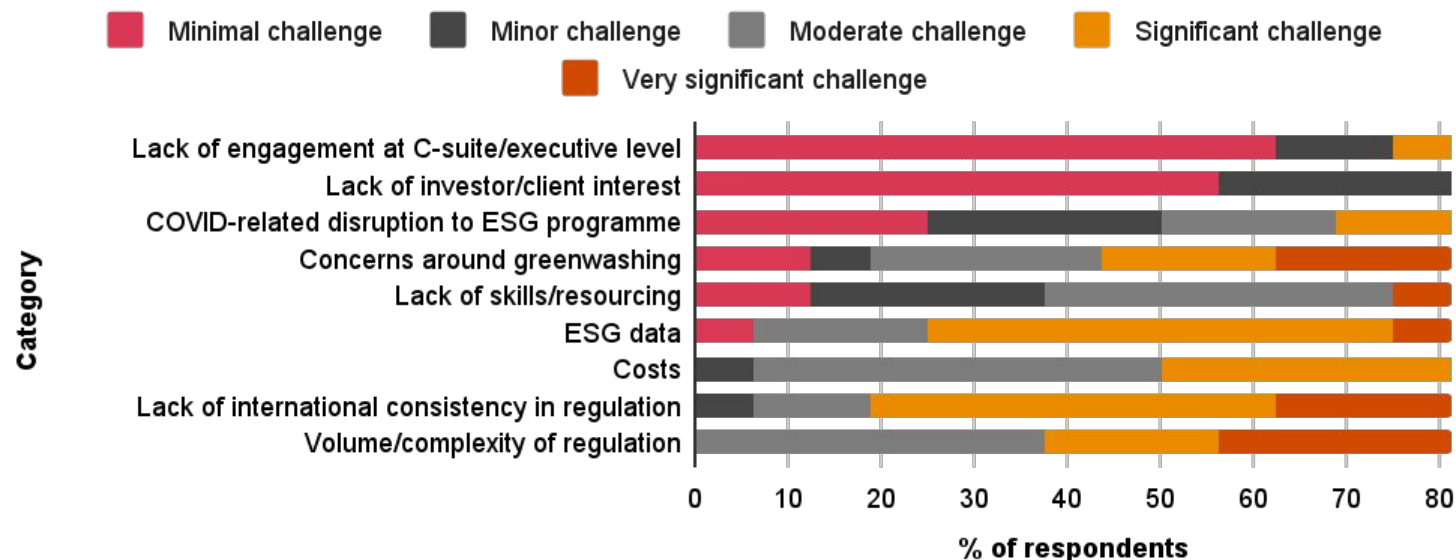
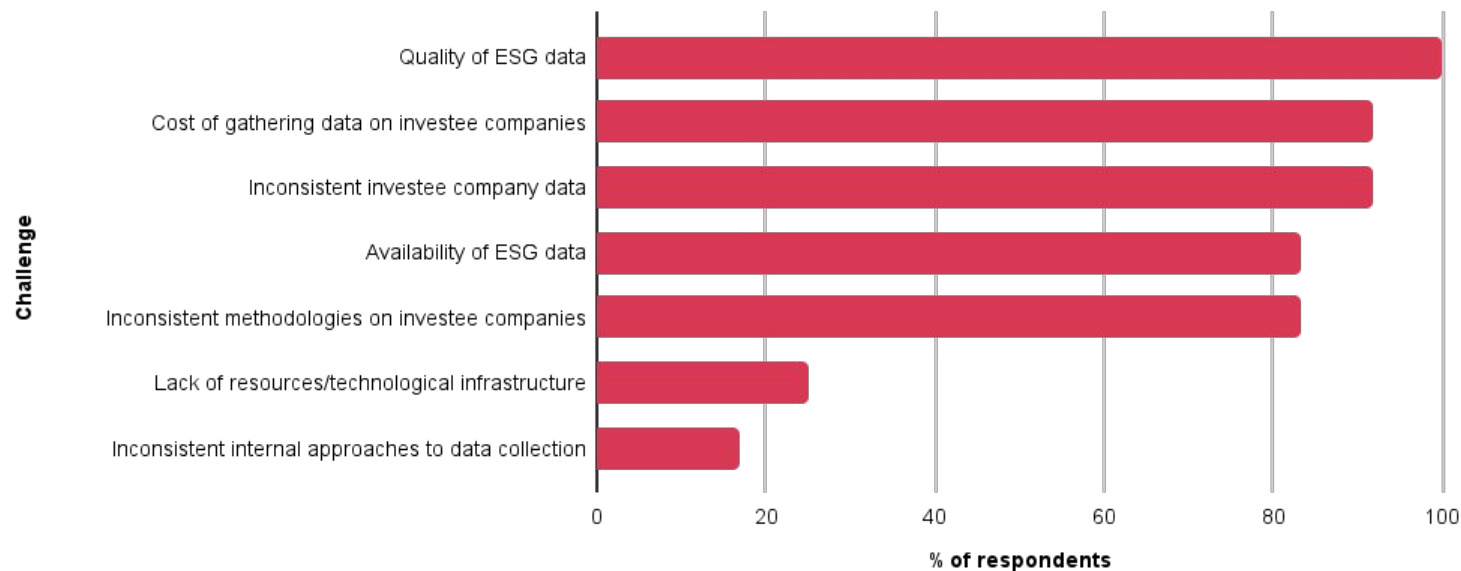


Figure 20: Key data challenges

What are the key challenges you are facing in relation to ESG data?



Focusing on opportunity

The prize for managers that are brave and ambitious enough to confront the undoubted challenges posed by the need to focus on ESG is a valuable one. Firms see a number of compelling reasons to focus on ESG for competitive advantage.

The customer opportunity, for example, is enormous, with ESG offering a way of reaching out to both existing and new clients with new products. In this survey, 44% of asset managers said they see a very significant opportunity to develop new product ranges in response to changing consumer preferences on ESG; a further 19% highlight significant opportunities.

In addition, 38% of respondents think that a stronger focus on ESG factors in their investment approaches will improve investment returns. There is a growing body of research suggesting that investors do not have to sacrifice performance in order to secure sustainability in their portfolios.

Quite the opposite, with increasing evidence of a link between performance and stability. ESG-aligned assets outperformed the market in the wake of the 2020 COVID-19 sell-off; Bloomberg analysis suggested the average ESG fund fell 12.2% in 2020, less than half the decline of the S&P 500¹. There is good reason to expect the gap between ESG and non-ESG products to widen as ESG investment processes become more sophisticated and sustainability risk moves up the agenda.

Asset managers with strong ESG credentials also stand to benefit at a corporate level from these trends. More than two-thirds of firms believe that successful ESG integration across their entire organisation will improve their brand and reputation. This should help with recruitment and retention of staff – particularly among younger generations more focused on purpose in the workplace. Almost a third of firms believe the ESG agenda is a very significant opportunity to attract top talent.

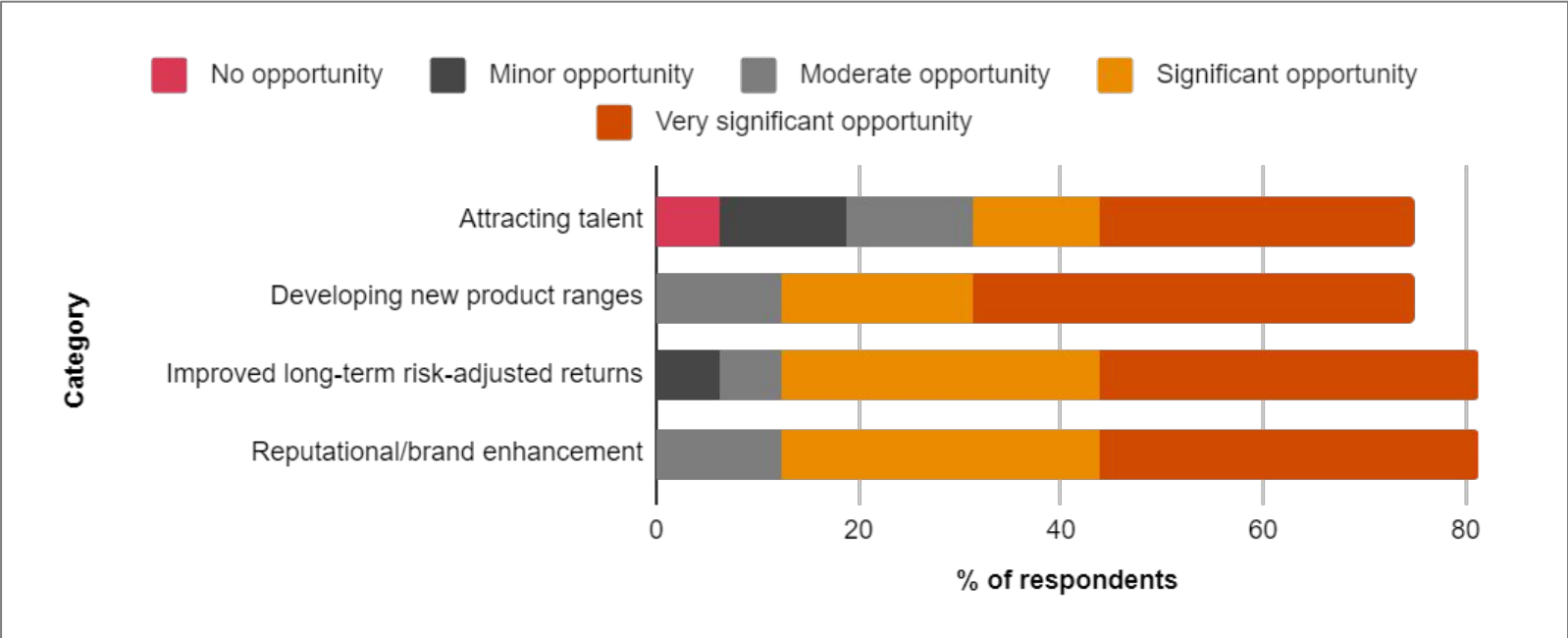
The business case for an increasing ESG focus is clear. No wonder so many asset managers now believe they must approach their ESG programmes as an exercise in transformation. Indeed, the greatest gains will accrue to those firms that are able to see past the regulatory and compliance agenda to pursue holistic strategies across their businesses.

¹ Bloomberg, Older ESG Funds Outperform Their Newer Rivals In Market Tumult, 2020



Figure 21: Opportunity knocks

How would you rate the following opportunities associated with ESG integration?



Conclusion: How to realise the ESG opportunity

The asset management sector's focus on ESG is here to stay: this is a structural change in the competitive environment within the market. Regulation, investor pressure and wider societal attitudes has prompted a sea change in practices, bringing ESG into the mainstream. Firms that do not engage at a commercial level risk falling behind competition.

In this context, the key considerations for asset managers inform the actions they should take. These range from fundamental strategic issues through to more granular operational considerations, such as how to navigate specific challenges highlighted in survey responses.

From tactical to transformational

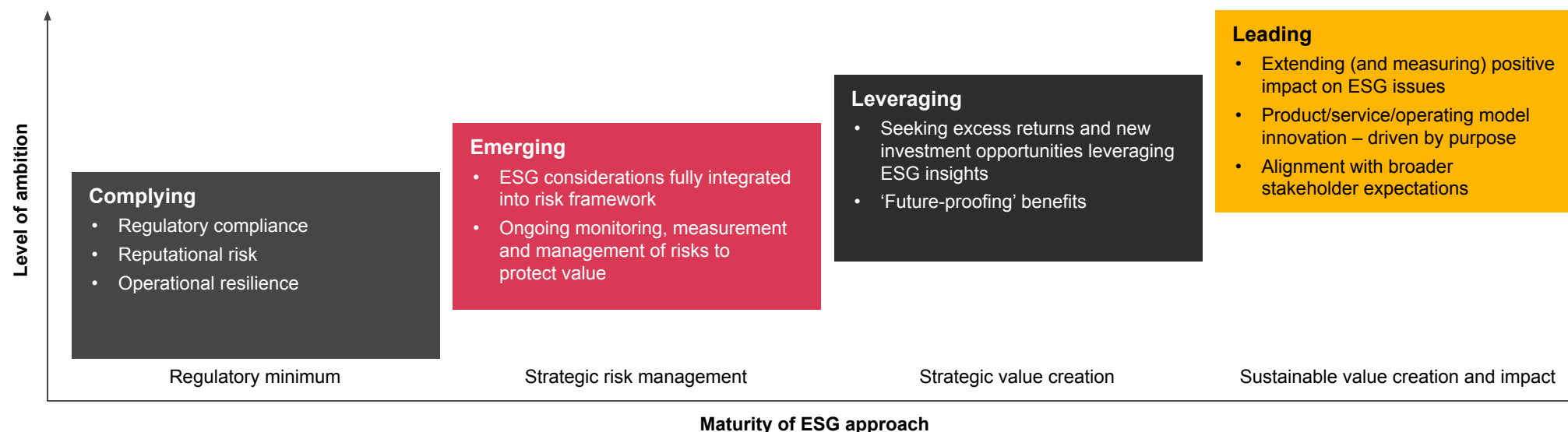
Our survey reveals the majority of participants are taking – or have ambitions to take – a transformational approach to ESG, with all the benefits that brings (Figure 21). If firms want to keep up with competitors, those not currently doing so should focus on front-to-back ESG transformation. This means not only focusing on compliance with individual ESG-related regulations or an increased focus on ESG investing, but also reflecting on how firms can bring ESG principles to their own corporate approaches.



Figure 22: Spectrum of ESG responses

There are significant benefits to be gained from adopting a holistic approach to ESG – not seeing it purely as regulatory compliance

We are seeing a spectrum of approaches to ESG across the asset management sector, ranging from tactical compliance with regulation through to end-to-end ESG transformation. Embedding ESG into strategies and business models provides an opportunity to create value, improve resilience and drive a competitive advantage.



Asset managers must define what ESG transformation looks like in the context of their own organisations, and establish a clear strategy for achieving their vision. This could range from systematically integrating ESG considerations into their risk management frameworks across all aspects of their business activities, through to a more advanced approach involving innovative ESG product offerings and ensuring alignment with the expectations of all stakeholders.

Once asset managers have defined their level of ambition for ESG transformation, they will need to establish a roadmap for putting in place the capabilities, skills and processes to translate their ESG transformation strategy into execution.

This should consider the governance structure for an ESG programme with clearly defined roles and responsibilities for each workstream, as well as wider considerations once the programme transitions to 'business as usual', such as whether to centralise ESG expertise in a single team or to integrate it across the firm.

Discussions with firms during our research suggest an ambition to move towards a decentralised approach where ESG becomes a 'generalist' skill set across the organisation. However, even where firms take such an approach, they will need to decide whether to appoint a Chief Sustainability Officer or a board member with responsibility for ESG at the corporate level to coordinate activity across the organisation.



The roadmap will also need to set out specific actions for executing organisational change. Key focus areas include:

- **Organisational purpose and culture:** Consider how to incorporate ESG into corporate purpose to drive long-term value creation for investors, the firm itself, and society more broadly, and how to translate that purpose into cultural change.
- **People:** Identify changes to the firm-wide approach to inclusion and diversity, and pay transparency, and consider how to incorporate management of ESG risk into remuneration approaches. This should also include a plan for upskilling staff across the organisation on ESG concepts.
- **Data:** Establishing a plan to obtain ESG data on investee companies and generate data on the firm's own ESG credentials, with a view to satisfying regulatory obligations and robustly integrating ESG considerations across the organisation.
- **Risk management:** Plan how to adapt the enterprise risk management framework to identify and manage ESG risks at both the investment and corporate level.
- **Investment due diligence:** Consider how to adapt investment due diligence policies and processes to assess the impacts of ESG risk factors on investment returns across the investment portfolio and at a fund level.
- **Stewardship:** Ensure that stewardship activity is taking place holistically on a firm-wide basis across all investments. Firms should look to align themselves with the UK Stewardship Code, with clearly defined engagement strategies on ESG issues. Focus on driving long-term investment returns for clients, and on pushing for improved ESG reporting to help address the data gap.
- **Product development/governance:** Identifying opportunities for the development of innovative new ESG products that future-proof the firm against constantly evolving investor demand. This should at least be partially informed by the new fund classifications introduced under SFDR. While some firms might not have looked to re-classify their existing products as Article 8 or 9 in time for 'day one', they should carefully consider whether there is a business case for doing this ahead of the Level 2 provisions taking effect in 2022. Some asset managers have been facing demand from investors to re-classify certain funds as Article 8, and there may also be a strong case to proactively do this (or to launch new products with this classification) to satisfy the likely growing demand for ESG-focused products.



Such a roadmap would then form the basis of a comprehensive work programme to embed ESG considerations across the organisation.



In addition, asset managers must also place heightened emphasis on their ESG reporting. This involves adapting their ESG reporting frameworks with clearly defined key performance indicators across funds and on the asset manager's own operations. Central to this will be new regulatory-driven reporting metrics, stemming from initiatives such as SFDR, the revised NFRD, and TCFD.



This provides opportunities for firms to showcase their ESG credentials to stakeholders, and to build their brand reputations as leaders on ESG. Asset managers will also need to consider levels of external assurance they seek on their reporting, which is becoming increasingly important given levels of scrutiny on ESG by regulators, policymakers, and wider stakeholders.

Tackling the ESG data challenge

This survey highlights some significant challenges associated with ESG data, notably a lack of widely available and standardised information on the ESG credentials of investee companies. This makes it difficult for asset managers to monitor, assess and disclose ESG-related risks and the sustainability impacts of their investments, for purposes such as satisfying various regulatory obligations.

Asset managers need ESG data on corporates to become more widely available and in a consistent format that allows comparability. Regulators and policymakers are alert to this data challenge, and are exploring a range of solutions. Comprehensive globally standardised reporting by corporates, providing information that is consistent with the regulatory obligations and wider pressures faced by asset managers, will be crucial.

This is likely to take time for regulators to resolve. In the meantime, asset managers must be proactive in finding solutions if they are to progress their efforts to drive ESG-focused transformation across the businesses. They need to develop their data strategy now, since it may involve finding innovative ways of obtaining the necessary information. Core areas to think about to enhance access to ESG data on investee companies include:



How to maximise stewardship efforts:

As part of their stewardship engagement with investee companies, asset managers should push for those companies to publicly report on ESG issues in a way that is helpful for their own approach to ESG integration.

1

How to make data requests:

Firms should consider compiling information requests to investee companies, tailored to their own data needs. Doing so should allow firms to obtain standardised information from the various corporates they are exposed to, rather than relying on a patchwork of public information provided in company filings and other sources.

2

How to engage with ESG data providers:

Asset managers should actively engage with third party ESG data providers, encouraging them to find industry-wide solutions to address the current shortcomings with data. Start by communicating existing data gaps to those providers so that the precise nature of the challenge is fully understood, which should help drive greater standardisation across the entire market.

3

How to leverage technology:

Smart technologies such as natural language processing and machine learning techniques can extract unstructured ESG data on corporates. Our research suggests these more advanced techniques are not yet commonly used in this context, but this is set to increase in the future as ESG programmes become fully operational and more established.

4

Solving the data problem is of paramount importance. These solutions, especially those utilising smart technologies, could redefine the industry, supporting asset managers as they integrate ESG considerations into the investment process. Ultimately, this will enable firms to establish a differentiated sustainable value creation offering.

Navigating the regulatory puzzle

A central theme in the survey responses was how asset managers are struggling to determine which ESG-related regulations they are in-scope of and are relevant to their business. This is hardly surprising given the volume of initiatives that are being driven by regulators on a global basis.

The scale of this challenge means many asset managers are finding themselves allocating a significant amount of time and effort to answering a fundamental question that will shape their overall approach to ESG. Failure to get these scoping questions right will not only bring explicit regulatory risks arising from non-compliance, but also potential lost opportunities associated with using regulation to accelerate broader organisational change. For example, incorrectly determining that a firm falls out of scope of SFDR could mean their reporting against ESG metrics is not as useful for investors and other stakeholders as it otherwise might have been had they aligned with the principal adverse impact indicators.

Asset managers should approach this strategically and holistically, rather than perform assessments tactically on a case-by-case basis. They should consider establishing a scoping assessment framework for all notable ESG regulatory initiatives across financial services, linked to any existing horizon scanning capabilities. Firms should focus on identifying the common themes across these regulations, either in terms of the nature of the requirements or the impacts on their business - for example on ESG policies, investment due diligence, product, data and so on. The most advanced firms are using this thematic lens to drive their approach to complying with regulation, achieving operational efficiencies along the way.

Towards transformation

The opportunity for asset managers now is to drive transformation by making ESG considerations a central feature of firms' corporate strategy. As asset managers strive to establish purpose-driven culture focused on long-term value creation for investors, the firm itself and society as a whole, the focus on ESG will be a natural driver of change.

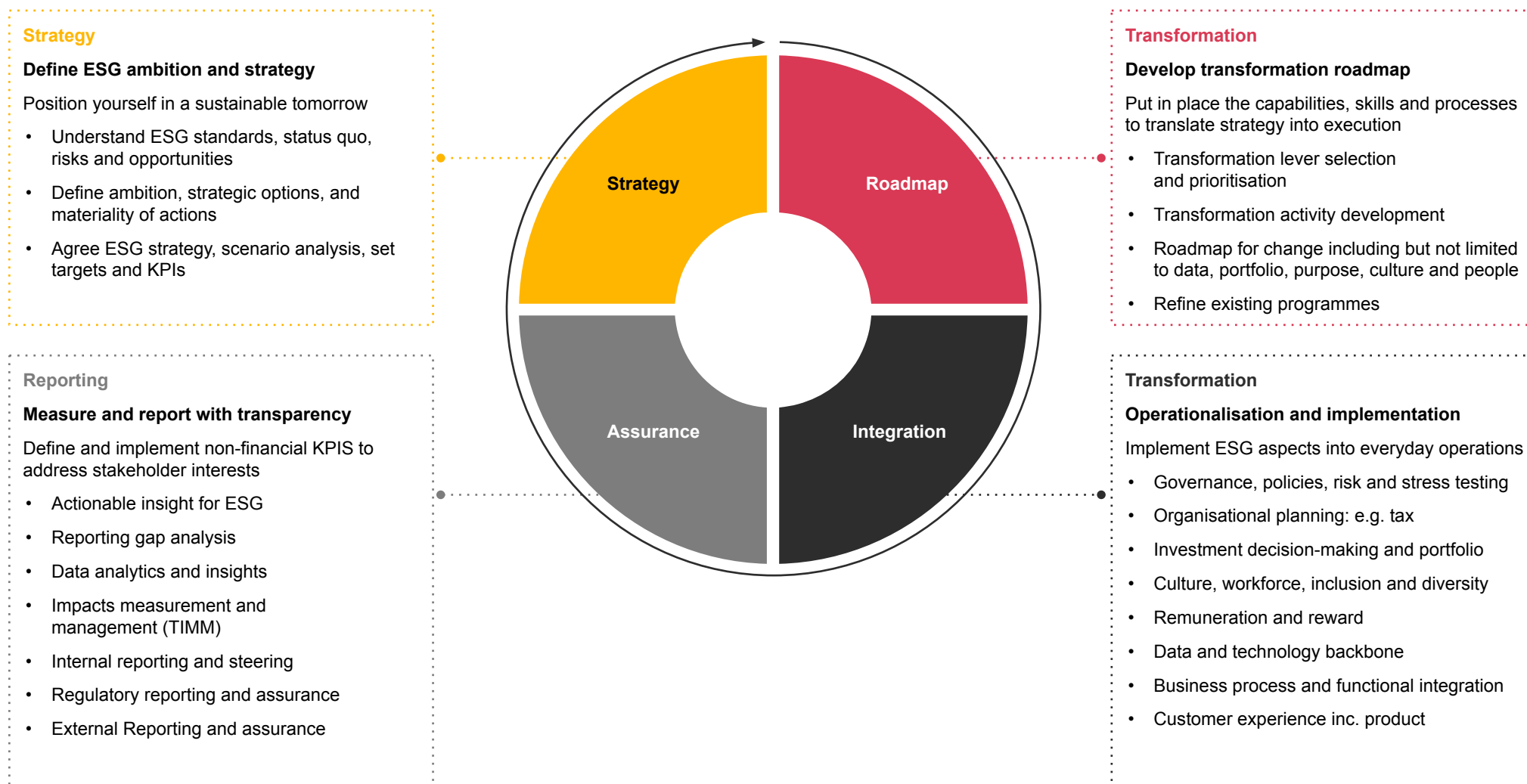
This is imperative. Asset managers have an active role to play in addressing societal and environmental challenges and in helping to 'build back better'. But to fulfil this role, firms will need to be clear on their ambition across the full range of ESG factors.



Figure 23: Achieving ESG transformation

How can PwC help?

PwC well positioned to support asset managers at every stage of their ESG journey, as appropriate for their level of ambition – whether that's meeting minimum requirements or being a market leader.



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