HOW POLICY MAKERS CAN IMPLEMENT REFORMS FOR A SUSTAINABLE FINANCIAL SYSTEM

PART I

A TOOLKIT FOR SUSTAINABLE INVESTMENT POLICY AND REGULATION

PRI Principles for Responsible Investment

WORLD BANK GROUP

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EXECUTIVE SUMMARY

Government and policy maker interest in sustainable finance and investment has grown dramatically over the past decade. Sustainable finance and investment can:

- support national policy goals on climate change and the SDGs;
- enhance the resilience and stability of the financial system and the economy;
- improve market efficiency by clarifying and aligning investor and company expectations; and
- increase the attractiveness of countries as investment destinations.

As sustainable finance and investment policies develop, driving investments towards sustainable, inclusive and zero-carbon economies will require aligning regulatory frameworks globally.

CORPORATE ESG DISCLOSURES

Corporate ESG disclosure policies refer to the regulatory measures defining issuers' obligations for recurrent publication of current and forward-looking data and analysis on key ESG issues.

They aim to provide investors with information on corporate performance on ESG issues that will be used when making investment decisions and leading engagement with investee companies – activities regarded by investors and policy makers as part of their fiduciary duty.

But without mandatory and standardised corporate ESG disclosure regulations, the resulting information is incomplete and not readily comparable, creating a major barrier for sustainable investment.

STEWARDSHIP

Stewardship is the use of influence by institutional investors to maximise the overall long-term value on which returns, and clients' and beneficiaries' interests, depend.

Stewardship codes aim to formalise these expectations on investors in regulation or guidance and are key tools for sustainable finance policy, as effective stewardship produces real-world outcomes at scale.

Achieving such outcomes matters: systemic risks, such as climate change and inequitable social structures, seriously threaten the long-term performance of economies and asset owners' portfolios, as well as the world in which their beneficiaries live.

INVESTOR ESG REGULATIONS

Investor ESG regulations refer to measures that encourage investors, particularly asset owners, to incorporate ESG issues in their investment decisions and disclosures to beneficiaries and other stakeholders.

The manner in which investor duties are defined has profound implications. Decisions made by fiduciaries cascade down the investment chain, affecting decision-making processes, ownership practices and, ultimately, the way in which companies are managed.

These regulations play an important role in removing the barriers to action by creating positive duties for investors to integrate ESG issues into their investment practices and processes and to report how they do so.

TAXONOMIES

A sustainable taxonomy is a classification system to help investors understand whether an economic activity is environmentally and socially sustainable, and to navigate the transition to a low-carbon, inclusive economy.

It aims to set a common language between investors, issuers, project promoters and policy makers, and to help investors assess whether investments meet robust sustainability standards and are aligned with high-level policy commitments.

A taxonomy can to help to increase investments that are consistent with sustainability goals, such as creating a net-zero, resilient and sustainable economy.

NATIONAL SUSTAINABLE FINANCE STRATEGIES

National sustainable finance strategies refer to the broader national policy frameworks that aim to ensure that the finance sector supports the goals of sustainable and inclusive growth.

Decisions on the allocation of capital – whether investment capital or capital that supports and enables the functioning of a country's economic and financial system – are ultimately driven by the views of companies and the finance sector on the risks and opportunities presented by different investments.

The other measures described in this report will only drive capital flows to the extent that these investments are incentivised or rewarded. National sustainable finance strategies bridge this gap between the finance sector and the wider economy.

ABOUT THIS REPORT

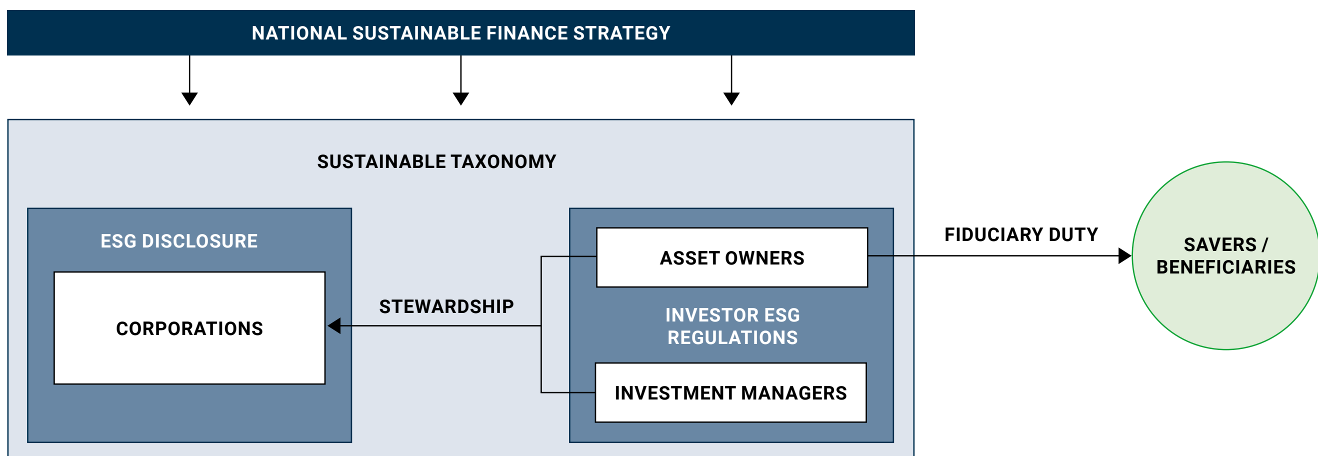
The PRI and the World Bank's Financial Stability and Integrity Team are working to support government policy makers and regulators in implementing reforms to build a sustainable financial system. Such reforms must align capital markets with the goals of the Paris Agreement on climate change and the Sustainable Development Goals (SDGs).

This toolkit provides a high-level overview of five foundational sustainable investment policies, listed in Box 1, explaining why each is important, setting out their key features and presenting some examples of such policies in action.

BOX 1: PRIORITY ELEMENTS OF SUSTAINABLE INVESTMENT POLICY AND REGULATION

Sustainable investment policy and regulation need to cover the following five areas:

- Corporate ESG disclosures, including alignment with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD)
- Stewardship (engagement and voting)
- Investors' duties to incorporate ESG-related considerations in their investment decision making, to provide sustainability-related disclosures and to report on their ESG incorporation policies and performance targets
- Taxonomies of sustainable economic activities, defining common and clear criteria to classify projects or investments as green or sustainable
- National/regional sustainable finance strategies, that encourage and enable the low-carbon transition and the delivery of the SDGs



The toolkit builds on the World Bank's Global Program on Sustainability, the PRI's policy programme, particularly the recommendations of the Fiduciary duty in the 21st century country roadmaps, and both organisations' experience of national policy reform. It will:

- provide the basis for a regulatory dialogue, involving the World Bank, the PRI and regulators and policy makers from emerging markets, on the best path forward in aligning finance with sustainability;
- contribute to the creation of a common language on sustainable finance and investment policy design, implementation and monitoring;
- facilitate the uptake and promotion of such policy standards by multilateral organisations such as the OECD, IOSCO and IOPS.

Further publications are planned for 2021:

- Part 2 – a second toolkit for policy makers, focused on the banking and insurance sectors;
- Part 3 – detailed implementation guides, which will help governments to put these toolkits into practice.

WHY SUSTAINABLE INVESTMENT POLICY AND REGULATION IS ON THE RISE

Government and policy maker interest in sustainable finance and investment has grown dramatically over the past decade. Across the world's 50 largest economies, there have been over 730 hard and soft law revisions to some 500 policy instruments, which support, encourage or require investors to consider long-term value drivers, including environmental, social and governance (ESG) factors.[1] Of these 50 economies, 48 have some form of policy designed to help investors consider sustainability risks, opportunities or outcomes.

Sustainable finance and investment can:

- support national policy goals on climate change and the SDGs;
- enhance the resilience and stability of the financial system and the economy;
- improve market efficiency by clarifying and aligning investor and company expectations; and
- increase the attractiveness of countries as investment destinations.

As sustainable finance and investment policies develop, driving investments towards sustainable, inclusive and zero-carbon economies will require aligning regulatory frameworks globally.

SUSTAINABLE FINANCE AND COVID-19

Sustainable finance is receiving additional attention as governments and policy makers discuss how to rebuild their economies in the wake of the COVID-19 pandemic. It has put many aspects of our economy and lives on hold, highlighting the social and economic consequences of inequality.

The pandemic has not, however, stopped the climate emergency and will not prevent the risks from extreme weather events and other climate-related shocks that threaten us now and in the future.

There is a growing consensus that economic recovery strategies must be sustainable and inclusive and deliver reforms that enable a more just and fair society.

Specifically, policy makers need to seize the opportunities created by shifts in markets and behaviour to accelerate change, focusing on areas in which the COVID-19 recovery and decarbonisation priorities are best aligned and can support immediate needs such as job creation.

To create a decisive, sustainable and inclusive transition, targeted government stimulus spending must be backed up by accelerated measures to build financial markets that can deliver for people and the planet.

1 https://www.unpri.org/sustainable-markets/regulation-map, data as at 9 September 2020

THE BENEFITS OF A SUSTAINABLE INVESTMENT POLICY FRAMEWORK

BENEFITS FOR THE REAL ECONOMY / COMPANIES	BENEFITS FOR INVESTORS	BENEFITS FOR POLICY MAKERS
▪ Improved management and board oversight of performance on key ESG issues ▪ Improved ability to identify and access social and environmental opportunities, such as through changes to business models, across supply chains and through new and expanded products and services ▪ Enhanced social licence to operate through better and more proactive communication of social and environmental performance ▪ Increased clarity around the social and environmental expectations of investors and other stakeholders ▪ Enhanced domestic and international investor confidence through improvements in corporate governance and in the management of social and environmental performance	▪ Improved information on corporate ESG performance, providing insights into how companies contribute to social development and affect environmental quality ▪ Improved investment decision making through the provision of data and analysis on ESG-related risks and opportunities, including those that may not be in conventional financial reports and analysis ▪ Flexibility to consider ESG issues over longer timeframes, allowing investors to take fuller account of transition, tail and financial system risks ▪ Improved protection against long-term and systemic downside risks, resulting from increased corporate focus on climate change and the SDGs ▪ Reduced risk of negative impacts on financial performance or reputation due to better management of social and environmental issues ▪ Increased investment universe of high-quality companies because of improvements in ESG performance ▪ Improved quality of dialogue with companies due to better information on ESG practices and performance ▪ Closer alignment between financial markets and desirable societal outcomes ▪ Market players incentivised to invest in sectors and activities that support or align with a country's sustainable development and climate change goals	▪ Greater alignment of the private sector with the SDGs and with national economic development goals ▪ Increased investment in greener and more sustainable assets, and in areas that align with national economic development priorities and goals ▪ Allocation of more capital to sustainable economic development ▪ Closer alignment between financial markets and desirable outcomes for society, the environment and the real economy ▪ Improved market attractiveness for international investors ▪ Enhanced financial sector resilience

CORPORATE ESG DISCLOSURES

DEFINITION AND PURPOSE

Corporate ESG disclosure policies refer to the regulatory measures defining issuers' obligations for recurrent publication of current and forward-looking data and analysis, relevant to their corporate strategy, operations and performance on key ESG issues.

The goal of such policies is to provide investors with information on corporate performance on ESG issues that will be used when making investment decisions and leading engagement with investee companies.

WHY CORPORATE ESG DISCLOSURES ARE IMPORTANT

ESG data and analysis have many uses in the investment process:

- Integration in valuation models, alternative beta, quant, factor and index investing
- Integration in credit research and assessments
- Screening (positive, negative and exclusions based)
- Producing best-in-class ESG approaches (ESG ratings)
- Thematic investment (allocating capital to environmental or social outcomes)
- Creating and monitoring funds with specific environmental and/or social characteristics
- Measuring the impact of companies and/or funds (portfolio monitoring, carbon foot-printing)
- Active ownership, including engagement
- Communicating with clients and beneficiaries

Corporate ESG disclosure is a prerequisite for responsible investment – incorporating such information in investment strategy, policy decisions and active ownership is regarded by investors and policy makers as part of their fiduciary duty.
Across markets, regardless of local policy requirements, companies tend to report on similar ESG topics through their voluntary disclosures. But without mandatory and standardised ESG disclosure regulations, the resulting information is incomplete and not readily comparable across markets, industries and portfolios, creating a major barrier for investing sustainably.

National and international ESG disclosures should build on existing and widely used standards, including the TCFD guidelines and consistent with disclosure requirements introduced by relevant sustainable or green taxonomies.

KEY FEATURES

Corporate ESG disclosures include quantitative and qualitative ESG data and analysis on companies' sustainability performance. They should be integrated with financial and corporate performance disclosures.

There are four common components – governance, strategy, risk, and metrics – which can be found in most of the existing independent disclosure frameworks, as well as in national or stock-exchange-led disclosure regulations.

DISCLOSURE REQUIREMENTS

For ESG disclosures to be meaningful – and to avoid companies treating ESG disclosure reporting as a box-ticking exercise – ESG data and analysis should be:

- integrated within corporate processes and performance assessments, and ESG performance analysed and explained against corporate strategy and targets;
- published in corporate annual reports, under the supervision of the board and linked to companies' business models, their corporate strategy (including financial and sustainability objectives and thresholds) and risk factors;
- published alongside financial indicators, based on the same reporting scope; and
- made accessible to all investors (available in a timely manner, free of charge and online).

ESG data should also be verified and assured by independent third-party auditors in the same way as financial data.

GOVERNANCE

Disclosures should include information on:

- who is responsible for collecting, analysing, preparing and publishing corporate ESG disclosures;
- who monitors corporate ESG performance.

STRATEGY

Disclosures should include:

- an analysis of how ESG issues affect corporate strategy and expected performance;
- target setting on improving ESG performance and how it affects overall corporate performance.

METRICS AND TARGETS

Disclosures should include how material ESG risks are integrated in corporate risk management processes

RISK MANAGEMENT

Disclosures should focus on quantified and qualitative metrics and information on key ESG topics, associated with dated targets to track performance over time. This includes:

- a set of standardised indicators that allow for comparability across industry sectors, portfolios and time-series;
- a reporting methodology that specifies the scope, methods of calculation, minimum reporting thresholds, board oversight, monitoring and enforcement mechanisms, as well as guidance on how to assure the quality of reporting by third-party auditors; and
- quantified and dated targets and thresholds, aligned with national / global sustainability goals, allowing performance assessment over time and comparison to industrial averages.

POLICY DESIGN CONSIDERATIONS

WHO ESTABLISHES CORPORATE ESG DISCLOSURE POLICIES?

At a national level, ESG disclosure is under the supervision of securities regulators; it can also be included in corporate law. At a market level, it can be included in stock-exchange listing rules.

ARE CORPORATE ESG DISCLOSURE POLICIES MANDATORY OR VOLUNTARY?

Evidence demonstrates that mandatory disclosure regulations are more impactful than voluntary guidelines and can also create market efficiencies, as companies currently respond to multiple voluntary frameworks.[2] Mandatory regulation will not only help to codify terminology (for greater consistency), it will also level the playing field on existing best disclosure practices by rewarding first movers and the best social and environmental performers. Voluntary disclosures do not provide sufficient data to investors in terms of scope, comparability and quality.

SHOULD ESG DISCLOSURE POLICIES BE STANDARDISED ON A NATIONAL AND INTERNATIONAL LEVEL?

National regulators are encouraged to adopt international frameworks which are becoming increasingly recognised (such as TCFD), whilst providing guidance on how these should be adopted locally (particularly in countries with less developed capital markets). At an indicator/data feed level, ESG data comparability is hindered when companies choose to report on different indicators for the same ESG topic. Comprehensive investment analysis is enabled by consistent data and disclosures from companies to investors, based on existing frameworks and standards. The standardised disclosure of ESG data and analysis will support more sustainable investment decisions, improved corporate performance on ESG issues, and the transition towards more sustainable economies.

DO ALL ELEMENTS OF ESG DISCLOSURE POLICIES NEED TO BE REPORTED?

Disclosure requirements can combine mandatory and comply-or-explain parts and be updated with further mandatory elements as international alignment and market practice develop.

2 For more detail, see https://www.unpri.org/sustainable-markets/regulation-map.

EXAMPLES

HONG KONG

Stock Exchange ESG disclosure rules, published in 2012, updated in 2015 and 2020

ESG disclosure is a listing requirement for companies on the Hong Kong Stock Exchange.

According to the latest update, companies are required to report on corporate policies, metrics and targets on a select number of ESG issues, applicable on a mandatory or comply-or-explain basis.

INDIA

National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business, published in 2011, updated in 2015, 2018 and 2020

The Securities and Exchange Board of India (SEBI) issued a consultation in September 2020 to update the existing voluntary guidelines and make them mandatory for all businesses investing or operating in India. The proposed update includes an extensive list of required ESG indicators to be included in corporate disclosures.

CHILE

Proposed update of General Rule 386, 2020

The Financial Market Commission is developing a framework for sustainability disclosures, to be made in companies' annual reports.

The proposed regulatory update introduces mandatory disclosures on key environmental and social issues.

MALAYSIA

Sustainable Reporting Guide, published in 2015, updated in 2018

Prepared by the Malaysia stock exchange, the guide helps companies identify, evaluate and manage material economic, environmental and social risks and opportunities.

PRI RESOURCES:

Driving meaningful data: financial materiality, sustainability performance and sustainability outcomes

EXTERNAL RESOURCES:

IOSCO: Statement on disclosure of ESG matters by issuers

IOSCO: Sustainable Finance and the Role of Securities Regulators and IOSCO

Task Force on Climate-related Financial Disclosures: TCFD Knowledge Hub

European Commission: Guidelines on non-financial reporting: Supplement on reporting climate-related information

International Financial Reporting Standards Foundation: IFRS Standards and climate-related disclosures

STEWARDSHIP

DEFINITION AND PURPOSE

Stewardship, also referred to as active ownership, is the use of influence by institutional investors to maximise overall long-term value, including the value of common economic, social and environmental assets, on which returns, and clients' and beneficiaries' interests, depend.

A stewardship code aims to formalise these expectations on investors in regulation or guidance, including adoption and reporting requirements.

WHY STEWARDSHIP CODES ARE IMPORTANT

Effective stewardship produces real-world outcomes at scale. Achieving such outcomes matters: systemic risks, such as climate change and inequitable social structures, seriously threaten the long-term performance of economies and asset owners' portfolios, as well as the world in which their beneficiaries live.

While the first stewardship codes focused on listed equities, more recent codes recognise that investors should encourage high standards across all the assets in which they are invested – such as equity (including private equity), directly held assets such as property, and fixed income (including sovereign bonds).

Most codes now emphasise the importance of investor collaboration to encourage positive changes in company practice and performance. There has also been growing recognition that service providers such as investment consultants, engagement overlay service providers and proxy advisors can support and encourage stewardship by institutional investors.

Stewardship codes are therefore key tools for sustainable finance policy. They:

- explicitly identify environmental and social issues as being proper matters for investor attention;
- place growing emphasis on public policy engagement – by investors and by the companies and other entities in which they invest – to encourage policy makers to:
  - adopt measures that strengthen ESG disclosure across the investment system;
  - strengthen the resilience of the financial system; and
  - improve the sustainability of the real economy.
- explicitly highlight that investors contribute to the achievement of sustainability outcomes through stewardship;
- encourage greater transparency and allow stakeholders (such as beneficiaries) to scrutinise investors' stewardship activities and compliance with local codes; and
- set out clear expectations for investors.

KEY FEATURES

The areas over which institutional investors might wish to exert influence are technically unlimited, but their stewardship activities tend to focus on issues such as company strategy, financial performance, capital allocation, leadership and remuneration, and environmental and social performance.

DEFINITION OF INVESTOR STEWARDSHIP DUTIES AND OBLIGATIONS

Investors should set out how they implement their stewardship obligations as part of the value-creation process over the short, medium and long term; including how they use stewardship to protect common assets on which individual investee performance depends. Individually or collaboratively, investors can exercise their stewardship obligations by:

- engaging with issuers (in all asset classes, whether current or potential investees);
- voting at shareholder meetings;
- filing shareholder resolutions/proposals;
- holding direct roles on investee boards and board committees;
- negotiating with and monitoring the stewardship actions of suppliers in the investment chain (e.g. asset owners engaging with investment managers);
- engaging with policy makers;
- engaging with standard setters;
- contributing to public goods (such as research) and public discourse (such as media) that support stewardship goals; and,
- litigating or seeking legal recourse, where necessary.

Stewardship activities also include the informal influence that investors have, either through their investment or potential investment in a company or another entity, or their exposure to and reliance on public goods (or common assets), such as a stable environment, fair system of commerce or functioning judiciary.

GOVERNANCE AND INCENTIVES

Investors should ensure their own organisational structure and incentive plans encourage a long-term investment approach.

INCLUSION OF ESG ISSUES AND SUSTAINABILITY IMPACTS

Investors should consider and act on environmental, social and corporate governance risks and opportunities, and sustainability impacts of investment decisions.

CONFLICTS OF INTEREST

Investors should establish and implement a policy to identify and manage conflicts of interest in their approach to stewardship.

BENEFICIARY PREFERENCES

Investors should understand the sustainability preferences of the ultimate beneficiaries and should align their investment approach with these preferences.

REPORTING

Investors should report on how they have implemented their approach to stewardship. This should include information on:

- their stewardship and related policies (e.g. managing conflicts of interest);
- their stewardship priorities and objectives and targets;
- their monitoring processes;
- the actions they have taken to implement the policy;
- the companies or entities they have engaged with, and the topics on which they have engaged; and
- the outcomes, in terms of changes in corporate practice and performance, that have resulted from their engagement and other stewardship-related activities.

POLICY DESIGN CONSIDERATIONS

WHO ESTABLISHES STEWARDSHIP CODES?

To date, most stewardship codes have been established by national financial regulators. Examples include the Financial Reporting Council in the UK and SEBI in India. In some cases, stewardship codes have been developed by other institutions, as with the Australian Asset Owner Stewardship Code.

DO ALL ELEMENTS OF STEWARDSHIP CODES NEED TO BE COMPLIED WITH?

Most stewardship codes have a comply-or-explain approach where signatories can diverge from the requirements if they explain the reasons for doing so. Best practice entails an apply-and-explain approach.

WHAT ARE THE IMPLEMENTATION MECHANISMS?

To date, most stewardship codes have been established as voluntary instruments, although they are increasingly referred to in legislation: the recently introduced Indian Stewardship Code is mandatory for all asset managers in India. Voluntary stewardship codes have tended to include some or all of the following:

- Institutional investors are encouraged to sign up to the codes (creating a market norm where large investors support it).
- A public register is maintained of code signatories, and signatory investors are also expected to publicise the code on their websites.
- Signatory investors are expected to report on how they have implemented the codes, providing data (e.g. on the number of companies or entities engaged with, on the topics engaged on and the outcomes achieved) as well as case studies to illustrate the organisation's approach. This requirement is given greater emphasis in some codes, where the signatory investor's chair person, CEO or CIO is required to sign off on the accuracy of this report.
- Code signatories are ranked or tiered based on the quality of their stewardship activities or disclosure, to encourage a race-to-the-top dynamic.
- A formal review of how the codes have been implemented.

EXAMPLES

UK

Stewardship Code (adopted in 2010, revised in 2012 and 2019)

The UK defines stewardship as "the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society."

Key features of the UK Stewardship Code include a requirement for signatories to report on stewardship activities and their outcomes in relation to ESG factors and systemic risks. This is applicable beyond UK listed equities.

INDIA

Stewardship Code (2020)

India has introduced a mandatory stewardship code, which requires investors to set out clear policies on engaging with companies directly and collaboratively, including on material ESG opportunities and risks.

Applicable to all investors in listed Indian companies, the code requires them to formulate a policy and publicly disclose how they discharge their obligations set by the code.

JAPAN

Principles for Responsible Institutional Investors (updated 2020)

The Japanese stewardship code defines the responsibilities of institutional investors as enhancing the medium- to long-term investment return for their clients and beneficiaries by improving and fostering the investee companies' corporate value and sustainable growth. This includes engagement and dialogue on corporate performance and business environment, including consideration of sustainability / ESG factors.

Signatories are expected to report on how they implement the code.

KENYA

Stewardship Code for Institutional Investors (2017)

The Kenyan stewardship code encourages the investment community to serve as responsible stewards for their beneficiaries and promote good corporate governance and sustainable success of listed companies in the capital market. One of its principles states that investors shall act responsibly and incorporate environmental, social and ethical issues in investment decision making.

The code is applicable to Kenyan listed equity investors. Signatories are expected to report on how they implement the code.

RUSSIA

Responsible Investment (Stewardship) Code (2020)

The first Russian stewardship code, published by the Central Bank, introduces the notion of responsible investment from a risk management angle but is also expected to have a positive impact on society.

The code introduces the concept of engagement (including collaborative engagement and the need to develop/apply escalation strategies at times) and of selecting managers based on their responsible investment practices and monitoring their performance, including in mutual funds (which are common in the market).

PRI RESOURCES:

Active Ownership 2.0

Introductory guide to collaborative engagement

A practical guide to active ownership in listed equity

ESG engagement for fixed income investors

EXTERNAL RESOURCES:

International Corporate Governance Network: Global Stewardship Codes

INVESTOR ESG REGULATIONS

DEFINITION AND PURPOSE

Investor ESG regulations refer to measures that require investors, particularly asset owners, to incorporate ESG issues in their investment decisions and in their disclosures to beneficiaries and other stakeholders.

By imposing measures such as ESG incorporation and disclosure requirements on asset owners, the intention is to drive sustainable investment practices through the entire investment chain.

WHY INVESTOR ESG REGULATIONS ARE IMPORTANT

The manner in which investor duties are defined has profound implications. Decisions made by fiduciaries cascade down the investment chain, affecting decision-making processes, ownership practices and, ultimately, the way in which companies are managed. Investor ESG regulations can remove the barriers to action, creating positive duties for investors to integrate ESG issues into their investment practices and processes.

Such regulations can:

- provide clear signals through the investment chain – from asset owners to investment managers to companies and other entities – about the importance of effectively managing ESG issues;
- provide clarity on the duties and obligations of asset owners and investment managers to take account of ESG issues in their investment research and decision making, and in their engagement with companies and policy makers;
- create demand for better ESG disclosures from companies;
- improve the quality of the dialogue between investors and their beneficiaries and clients through better disclosures and more structured engagement processes; and
- increase the attention paid by investors to long-term drivers of investment value.

KEY FEATURES

Investor ESG regulations are generally non-prescriptive in terms of the investment strategies adopted – investors can choose how they integrate ESG issues into their investment processes (through screening, fundamental, thematic or scenario analysis, using best-in-class strategies, or through a combination of these or other approaches).

Similarly, ESG issues – except for corporate governance, which has been a long-standing concern for investors and policy makers – tend not to be specified in detail, with investors free to decide which issues they focus on. The notable exception is systemic risks such as climate change.

INVESTOR DUTIES AND OBLIGATIONS, INCLUDING FIDUCIARY DUTIES

Institutional investors should:

- incorporate ESG issues into their investment analysis and decision-making processes, consistent with their investment time horizons;
- engage with companies and other entities to encourage high standards of corporate governance and corporate sustainability performance (*for more detail, see the Stewardship section*);
- understand and incorporate beneficiaries' and savers' sustainability-related preferences, regardless of whether these are financially material;
- support the stability and resilience of the financial system; and
- report on how they have implemented these commitments.

DISCLOSURE OF POLICIES ON ESG INCORPORATION IN INVESTMENT DECISION MAKING

Investors should disclose:

- the coverage of the policy, and any exceptions to it;
- the importance assigned to ESG issues in their investment practices and processes;
- how they take account of financially material considerations, including those arising from ESG considerations such as climate change;
- how they act as the stewards of their investments, including their engagement with investees and exercising their voting rights;
- how they manage conflicts of interest, including those that relate to the delivery of their commitments to sustainable investment; and
- how they account for the interests and preferences of their clients and/or beneficiaries.

RELATED ESG DISCLOSURES

Investors should disclose:

- major holdings by asset class;
- the most significant (material) ESG issues for their investments;
- the ESG-related objectives and targets they have set for themselves;
- the actions they have taken to deliver on their policy, objectives and targets;
- their performance against their objectives;
- the ESG characteristics of their investment portfolios (e.g. carbon footprint);
- the risks and opportunities presented by climate change to their portfolios; and
- their engagement with clients and beneficiaries.

POLICY DESIGN CONSIDERATIONS

WHY FOCUS ON ASSET OWNERS?

Asset owners are at the top of the investment chain. Often, they set the tone and agenda for the market as a whole: the issues they are concerned about are the issues concerning the wider market. By imposing disclosure requirements on them, the intention is to drive disclosure and action through the entire investment chain. When investment managers see asset owners making commitments and taking action, they tend to respond quickly – by building their own systems and processes, developing ESG products and reporting on their practices, processes and performance.

WHY FOCUS ON DISCLOSURE?

Disclosure is a starting point for implementation. The requirement to adopt and publish a policy creates an expectation that investors will report on how that policy has been implemented. Similarly, a requirement to disclose how a policy has been implemented creates pressure for an investor to strengthen its internal systems and processes.

EXAMPLES

BRAZIL

Resolution 4661 on pension funds (2018)

Resolution n.4661/2018 by the Brazilian National Monetary Council states that, in their risk analysis processes, pension funds shall consider environmental, social and corporate governance aspects, whenever possible, in addition to economic sustainability analysis.

This recommendation was enhanced by Instrução Previc n. 6/2018, which states that pension funds' investment policies shall include guidelines for complying with ESG issues, preferably by economic sector.

EU

Investor Disclosure Regulation (2020)

Article 3 of the Investor Disclosure Regulation requires all financial market participants (including investment managers) to disclose their policies on the integration of sustainability risks in their decision making, investment or insurance advice and to provide a statement on how they consider principal adverse impacts of investment decisions on sustainability factors. Financial products promoting environmental and/or social objectives or with a sustainable investment objective are required to provide further description of their objectives and details of how they are met.

MEXICO

Retirement Saving Systems Provisions (2019)

The 2019 regulation on pension funds requires the incorporation of ESG factors in investment analysis, to promote in-depth understanding of global trends such as population growth, scarcity of raw materials and globalisation; and to assess the extent to which these factors impact on the risks and opportunities of their strategies. Pension funds should explain how they incorporate ESG factors in investments and risk management and what the objective is of applying these principles.

UK

Occupational Pension Schemes Regulations update (2018)

The Occupational Pension Schemes (Investment) Regulations were updated in 2018 to clarify that pension funds must consider material ESG factors as well as other financially material issues in their Statement of Investment Principles. The fund's stewardship policy and the extent to which it considers the views of beneficiaries should also be included.

PRI RESOURCES:

Fiduciary duty in the 21st century final report

Asset owner technical guides – Asset manager selection, appointment and monitoring

WORLD BANK RESOURCES:

Sustainable Investment: Best Practice Disclosure Checklist for Pension Funds

TAXONOMIES

DEFINITION AND PURPOSE

A sustainable taxonomy is a classification system to help investors understand whether an economic activity is environmentally ad socially sustainable, and to navigate the transition to a low-carbon, inclusive economy.

The purpose of a sustainable taxonomy is to set a common language between investors, issuers, project promoters and policy makers, and to help investors assess whether investments meet robust sustainability standards and are aligned with high-level policy commitments.

WHY TAXONOMIES ARE IMPORTANT

A taxonomy can:

- provide clarity on what is a green – or sustainable – activity, and under which conditions;
- help to measure the degree of sustainability of an investment and of companies' activities, for example, through identifying the proportion of revenues or expenditures which are green, and which are not;
- help investors and companies to plan and report on the transition to a low-carbon, inclusive economy, by setting the objectives and the direction of travel for different economic activities, including when engaging with investees;
- help policy makers to make informed decisions, developing more effective policies consistent with relevant long-term objectives such as the Paris Agreement; and
- provide a shared reference point and encourage collaboration between policy makers, investors and companies.

A taxonomy can to help to increase investments that are consistent with sustainability goals, such as creating a net-zero, resilient and sustainable economy.

KEY FEATURES

Investors can screen their equity and fixed income investments against a taxonomy, while listed companies can also report their compliance, by assessing the percentage of their revenues or expenditures which are aligned to it.

OBJECTIVES / ENVIRONMENTAL OR SUSTAINABILITY GOALS

A taxonomy is pegged to a long-term goal that sets the direction of the economic transition. For example, a green taxonomy is linked to environmental objectives such as the Paris Agreement or national climate goals. An SDG taxonomy would be pegged to the SDGs, and a social taxonomy, with long-term social goals. A taxonomy needs to be updated and revised periodically to reflect developments in science, technology, market dynamics and policy needs which would impact the transition to its long-term goal.

CLASSIFICATION SYSTEM / LIST OF ECONOMIC ACTIVITIES

A taxonomy should be based on a market or national classification system of economic activities. For example, the EU Taxonomy is based on the EU's statistical classification system for economic activities, NACE. Using a classification system means a taxonomy can be comprehensive in its coverage. It can also support comparability with other taxonomies, as major statistical classification systems like the EU's and the US's are based on the same international system and have corresponding tables.

TECHNICAL CRITERIA / PERFORMANCE METRICS AND THRESHOLDS FOR EACH ACTIVITY

For each sector and type of activity considered by a taxonomy, specific technical criteria are necessary to define whether an activity is compliant or not. For example, the EU Taxonomy suggests that power generation would be considered to substantially contribute to climate change mitigation if it emits less than 100g of CO2e per kWh.

MINIMUM SAFEGUARDS

For policy consistency, a taxonomy should not promote activities that are contrary to other government policies and international agreements. In the case of the EU Taxonomy, this guarantee is embedded under two provisions:

1. a 'do no significant harm' clause, whereby an economic activity that contributes to one environmental objective (e.g. reduce CO2 emissions) does not go against any other of the five environmental objectives (e.g. threaten biodiversity); and
2. minimum safeguards including the OECD Guidelines on Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, with specific reference to the ILO Core Labour Conventions.

POLICY DESIGN CONSIDERATIONS

WHO DEVELOPS A SUSTAINABLE TAXONOMY?

Usually developed under the guidance of a financial policy maker, sustainable taxonomies are built with the contribution of economic and industry experts, or a technical expert group as in the case of the EU Taxonomy. It is important to allocate overall responsibility for taxonomy development to a steering committee, led by a relevant authority or government department. It is furthermore essential to engage with:

- technical experts on the specific sectors to be covered to ensure the right components and activities are included in the taxonomy, and
- financial market participants to guarantee that a taxonomy can be used in practice.

A wider stakeholder consultation is advised, which should include environmental and other regulators, key economic sectors most likely to be materially affected and/or benefitted by the green taxonomy and (representatives of) financial market participants (e.g. banking, asset/investment manager and insurance industry associations).

HOW ARE SUSTAINABLE ECONOMIC ACTIVITIES DEFINED?

Instead of developing a new taxonomy, governments are advised to engage with existing taxonomies which can serve as a helpful starting point or even be used with modifications dependent on the national context. Industrial expertise is necessary if a taxonomy contains technical screening criteria for assessing whether an activity is sustainable or not.

HOW IS A TAXONOMY APPLIED BY INVESTORS?

In the case of the EU Taxonomy, investors use it to assess the extent their portfolios are aligned with the Paris Agreement, by analysing each issuer's relevant activities. Investors use the taxonomy mostly on equity and fixed income investments and calculate financial metrics such as turnover of activities aligned with the taxonomy.

SHOULD SUSTAINABLE TAXONOMIES BE STANDARDISED ON NATIONAL AND INTERNATIONAL LEVELS?

Given that markets are global, the standardisation of taxonomies on national and international levels is encouraged to maximise the impact of these tools. However, it is recognised that local and regional differences may exist as countries and regions have different challenges and transition pathways. In this context, it is essential that any taxonomy clearly defines its sustainability goals and level of ambition.

EXAMPLES

EU

Green Taxonomy (2020)

The EU Taxonomy is a tool to help investors understand whether an economic activity is environmentally sustainable. It sets performance thresholds, or technical screening criteria, for activities which:

- substantially contribute to at least one environmental objective – starting with climate change mitigation or adaptation;
- avoid significant harm to the other environmental objectives – pollution prevention and control, transition to the circular economy, protection of water resources and protection and restoration of biodiversity.

The activities must also meet minimum social safeguards, currently defined as ILO 8 Core Labour Conventions, the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights.

The technical screening criteria were developed by a Technical Expert Group and released in March 2020. They will be used to develop implementing regulations that establish the taxonomy in law.

CHINA

Green Bond Projects Catalogue (2020)

The proposed 2020 update of the Green Bond-Endorsed Projects Catalogue is expected to become China's unified policy framework, aiming to channel investments into clean, low-carbon assets. It has been developed under the guidance of the People's Bank of China, the National Development and Reform Commission and the China Securities Regulatory Commission.

The 2020 version was updated to:

1. unify pre-existing domestic standards for green projects and green bonds;
2. address emerging issues including improving the quality of the environment, climate change, and resource efficiency;
3. align with global standards, by removing clean coal projects and other clean fossil fuel projects, to address climate change in addition to domestic pollution.

MALAYSIA

Climate Change and Principle-based Taxonomy (2020)

Bank Negara Malaysia (BNM) has proposed a framework on a Malaysian taxonomy. It is aimed at institutions supervised by BNM, but can also be used as guidance for others, such as investment management companies, rating agencies and research houses.

The taxonomy provides five Guiding Principles (GP) to help institutions assess the environmental impact of an economic activity. Verifications that an institution has followed these GPs can be done by a third party; by using recognised certifications from local agencies or national authorities; or by using globally accepted standards.

Unlike the EU Taxonomy, where an economic activity can only be aligned if it does no significant harm to any of the other environmental issues, the Malaysian taxonomy places an economic activity into one of five different categories, depending on how each GP is followed.

MONGOLIA

Green Taxonomy (2019)

The Mongolian Sustainable Finance Association has adopted the Green Taxonomy, which sets up a nationally agreed classification framework of activities that contribute to climate change mitigation, adaptation, pollution prevention, resource conservation, and livelihood improvement in the context of green finance.

The taxonomy defines a list of industrial activities with quantitative and qualitative reference policy targets. It also includes a list of technologies associated to economic activities, with the potential to implement Mongolia's commitments under the Paris Agreement and the National Green Development Policy (2014).

PRI RESOURCES:

EU Taxonomy alignment case studies: https://www.unpri.org/policy/eu-sustainable-finance-taxonomy/eu-taxonomy-alignment-case-studies

WORLD BANK RESOURCES:

The World Bank: Developing a National Green Taxonomy: A World Bank Guide

EXTERNAL RESOURCES:

European Commission: Sustainable finance: TEG final report on the EU taxonomy

International Platform on Sustainable Finance: IPSF Green Taxonomy working group

NATIONAL SUSTAINABLE FINANCE STRATEGIES

DEFINITION AND PURPOSE

National sustainable finance strategies refer to the broader national policy frameworks that aim to ensure that the finance sector as a whole supports the goals of sustainable and inclusive growth, by aligning economic and financial goals with the Paris Agreement and the SDGs.

WHY NATIONAL SUSTAINABLE FINANCE STRATEGIES ARE IMPORTANT

Decisions on the allocation of capital – whether investment capital or capital that supports and enables the functioning of a country's economic and financial system – are ultimately driven by the views of companies and the finance sector on the risks and opportunities presented by different investments.

The other measures described in this report – corporate ESG disclosures, stewardship, investor regulations, taxonomies – will only drive capital flows to the extent that these investments are incentivised or rewarded.

National sustainable finance strategies bridge this gap between the finance sector and the wider economy:

- Well-designed and well-implemented finance policy strategies can promote economic development, foster social inclusion and protect the environment.
- They can support and enable investment in areas that require capital, particularly where governments are unwilling or unable to do so.
- They can enable or accelerate a country's ability to deliver on its climate or sustainable development goals – for example, whether energy subsidies and taxes support fossil fuels or renewable energy can be a critical determinant of whether a country achieves its national greenhouse gas targets.

3 The finance sector includes banks, investment companies and insurers, but this section focuses on the investment sector.

KEY FEATURES

A comprehensive and effective national sustainable finance strategy – that directs capital towards actors and activities that support the SDGs and the goals of the Paris Agreement, and away from those that do not – requires action across three levels:

MEASURES THAT SUPPORT RESPONSIBLE INVESTMENT AND ESG.

These include those discussed elsewhere in this report – corporate ESG disclosures, stewardship codes, investors' duties and taxonomies of sustainable economic activities.

MEASURES THAT SUPPORT OR ENABLE INVESTORS TO ALLOCATE CAPITAL TO FOCUS AREAS

These include first-loss insurance schemes, green and social bonds. They may also include wider capacity-building and education programmes, and product labelling and certification standards (which may reduce research and transaction costs for investors).

MEASURES THAT DRIVE ACTIVITY AND INVESTMENT IN THE REAL ECONOMY

These include mandatory regulations (e.g. product standards, planning legislation) and economic incentives (which can be designed to encourage investments in particular areas, and to reduce the incentives to invest in others). They also include wider macroeconomic policies that influence a country's ability to deliver on its climate or sustainable development goals – for example, energy subsidies and whether these support fossil fuels or renewable energy, and tax and other incentives for green investment.

Policy makers also need to consider the context within which they are developing these policies, such as:

- the shape and structure of their economy;
- the energy and industrial mix;
- the pressing needs of their populations (e.g. water, energy, housing, education, employment);
- their economic and development priorities; and
- the shape and structure of their domestic capital markets, and the potential for these to provide the capital and financing needed to deliver on their sustainability-related goals

Critically, policy makers need to understand how the prevailing incentives and behaviours within their capital markets influence the decisions taken by the financial institutions within them.

Different countries will inevitably make different decisions about their priorities and the actions they will take.

Ultimately, national sustainable finance strategies should influence capital flows at scale, directing capital towards sustainable investment and managing the financial risks stemming from climate change, resource depletion, environmental degradation and social issues.

POLICY DESIGN CONSIDERATIONS

WHO DESIGNS A NATIONAL SUSTAINABLE FINANCE STRATEGY?

The development of a national sustainable finance strategy will require the involvement of many different parties. Clear engagement mechanisms and effective stakeholder management will therefore be imperative. To ensure adequate implementation of the strategy, authorities should set out specific objectives for different actors in the system, which can be translated into practical actions.

HOW ARE COMPONENTS OF THE STRATEGY DEFINED?

The exact components of the strategy can differ per country and should be tailored to local conditions. However, there are several key components which should be considered for its design:

- The strategy should give due consideration to the supply and demand of sustainable finance and aim to be aligned with a country's nationally determined contributions to the Paris Agreement.
- The strategy should recognise the interconnectedness of the system and aim to cover all different areas of the financial system – such as banking, insurance, institutional investors and capital markets.

HOW WILL PROGRESS AND SUCCESS BE MONITORED?

A good strategy sets out how it will monitor progress and determine what works, and how it will be deployed in the financial policy framework as sustainable finance and investment practice become mainstream through policy updates and new regulations.

EXAMPLES

EUROPE

The European Commission Sustainable Finance Action Plan

The European Commission Sustainable Finance Action Plan proposes ten reforms across three areas:

- Reorient capital flows towards sustainable investment, in order to achieve sustainable and inclusive growth:
  - Establishing an EU classification system for sustainability activities
  - Creating standards and labels for green financial products
  - Fostering investment in sustainable projects
  - Incorporating sustainability when providing investment advice
  - Developing sustainability benchmarks
- Mainstream sustainability in risk management:
  - Better integrating sustainability in ratings and research
  - Clarifying institutional investors' and asset managers' duties
  - Incorporating sustainability in prudential requirements
- Foster transparency and a long-term focus in financial and economic activity:
  - Strengthen sustainability disclosure and accounting rule making
  - Foster sustainable corporate governance and reduce the short-term focus of capital markets

AUSTRALIA

The Australian Sustainable Finance Initiative (ASFI)

The objectives of ASFI's roadmap include:

- mobilising capital to deliver on Australia's national and global sustainable development goals, commensurable with science-based targets and informed by international conventions, treaties and norms;
- enhancing the sustainability, resilience and stability of the financial system by embedding sustainability and human rights considerations into financial markets, products and services to better account for and manage risk and impact;
- ensuring better-informed financial decision making by enhancing disclosures and transparency in financial markets for enhanced valuation of environmental and social risks and opportunities; and
- delivering a financial system that meets community and consumer expectations around sustainability and norms, including informed engagement, improved and informed choice, effective disclosures and client interests while enhancing financial inclusion and financial well-being.

CANADA

Expert panel on sustainable finance

The panel's 15 recommendations for embedding climate change opportunity and risk management in everyday business decisions, products and services are grouped into three mutually reinforcing pillars:

Pillar I: The opportunity

- Recommendation 1: Map Canada's long-term path to a low-emissions, climate-smart economy, sector by sector, with an associated capital plan.
- Recommendation 2: Provide Canadians the opportunity and incentive to connect their savings to climate objectives.
- Recommendation 3: Establish a standing Canadian Sustainable Finance Action Council, with a cross-departmental secretariat, to advise and assist the federal government in implementing the panel's recommendations.

Pillar II: Foundations for market scale

- Recommendation 4: Establish the Canadian Centre for Climate Information and Analytics as an authoritative source of climate information and decision analysis.
- Recommendation 5: Define and pursue a Canadian approach to implementing the recommendations of the TCFD.
- Recommendation 6: Clarify the scope of fiduciary duty in the context of climate change.
- Recommendation 7: Promote a knowledgeable financial support ecosystem.
- Recommendation 8: Embed climate-related risk into monitoring, regulation and supervision of Canada's financial system.

Pillar III: Financial products and markets for sustainable growth

- Recommendation 9: Expand Canada's green fixed income market and set a global standard for transition-oriented financing.
- Recommendation 10: Promote sustainable investment as business-as-usual within Canada's asset management community.
- Recommendation 11: Define Canada's clean technology market advantage and financing strategy.
- Recommendation 12: Support Canada's oil and natural gas industry in building a low-emissions, globally competitive future.
- Recommendation 13: Accelerate the development of a vibrant private building retrofit market.
- Recommendation 14: Align Canada's infrastructure strategy with its long-term sustainable growth objectives and leverage private capital in its delivery.
- Recommendation 15: Engage institutional investors in the financing of Canada's electricity grid of the future.

CHINA

Guidelines on establishing a green financial system

In August 2016, China launched the Guidelines on Establishing a Green Financial System, with the Governor of the People's Bank of China clearly articulating the link between finance and ESG and commenting that "establishing a green financial system has become a national strategy." The key elements include:

- Develop green lending
    - Establish a policy framework, support financial institutions to establish a credit management system
- Enhance the role of the securities market
    - Improve rules and regulations for green bonds, guide international investors to invest in green assets
- Launch green development funds and public private partnerships (PPP)
    - Improve relevant rules and regulations on green PPPs
- Develop green insurance
    - Establish a compulsory environmental pollution liability insurance system in areas of high environmental risks
- Improve the environmental rights trading market
    - Develop variety of carbon finance products, promote the establishment of markets for pollutant emission and energy use rights
- Support local government initiatives
    - Explore supportive measures such as bank re-lending, macro-prudential measures and capital market instruments
- Promote international cooperation
    - Promote cooperation through the Belt and Road Initiative, South-South cooperation and the Asian Infrastructure Investment Bank (AIIB)
- Prevent financial risks
    - Improve supervision mechanisms, rules and standards

SOUTH AFRICA

Financing a sustainable economy

In 2020, South Africa's National Treasury published a report setting out several recommendations for the financial sector:

- Regulators and industry to co-develop or adopt technical guidance and standards for identifying, monitoring, reporting and mitigating environmental and social (E&S) risks, including climate-related risks, at portfolio and transaction level. These should include E&S risk management frameworks, the use of science-based methodologies and the incorporation of the TCFD recommendations.
- Develop a benchmark climate risk scenario for use in stress tests by the sector.
- Develop or adopt a taxonomy for green, social and sustainable finance initiatives, consistent with international developments, to build credibility, foster investment and enable effective monitoring and disclosure of performance.
- Incorporate disclosure of progress in E&S risk management, including climate risks, in supervision activities carried out by the Prudential Authority and Financial Services Conduct Authority. Incorporate voluntary codes of principles, or acknowledged benchmarks for good practice, into regulatory regimes.
- Work with trustees, professional and industry associations and academic institutes to build governance capacity and the skills necessary for the identification and management of long-term risks and sustainability challenges.
- Build capacity across the sector and in the implementing arms of government – particularly local government – to ensure E&S risks are addressed within local infrastructure and development planning, capital raising and insurance planning.
- Finalise an action plan to implement the recommendations, using a technical working group to be comprised of regulators and industry representatives.

WORLD BANK RESOURCES:

The World Bank: Roadmap for a Sustainable Financial System

EXTERNAL RESOURCES:

The UNEP Inquiry: Nudging the Financial System: A Network Analysis Approach

CREDITS

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The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

The World Bank

The World Bank Group is and international organization designed to finance projects that enhance the economic development of member states.With 189 member countries, staff from more than 170 countries, and offices in over 130 locations, the World Bank Group is a unique global partnership: five institutions working for sustainable solutions that reduce poverty and build shared prosperity in developing countries. The organization provides a wide array of financial products and technical assistance, helping countries share and apply innovative knowledge and solutions to the challenges they face.

More information: www.worldbank.org