



# Barriers to Impact

Exploring barriers to the implementation of impactful climate actions by Asian Financial Institutions

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ASFI ASIA SUSTAINABLE  
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# About

**WWF** is one of the world's largest and most experienced conservation organizations, with over 5 million supporters and a global network active in more than 100 countries. WWF's mission is to stop the degradation of the planet's natural environment and to build a future in which people live in harmony with nature. WWF has worked with the finance sector for more than a decade via innovative collaborations that seek to integrate Environmental, Social and Governance (ESG) risks and opportunities into mainstream finance so as to redirect financial flows to support the global sustainable development agenda. Our approach to sustainable finance leverages WWF's conservation expertise as well as our partnerships with companies on key issues such as water, energy, climate and food to drive sustainability. We strive to strengthen lending and investment criteria for key industry sectors, provide insights and data on environmental and social risks, fulfil critical research gaps and help unlock innovations in sustainable finance products.

**2° Investing Initiative** (2DII) is an independent, non-profit think tank working to align financial markets and regulations with the Paris Agreement goals. Working globally with offices in Paris, New York, Berlin, London, and Brussels, 2DII coordinates some of the world's largest research projects on sustainable finance. In order to ensure our independence and the intellectual integrity of our work, we have a multi-stakeholder governance and funding structure, with representatives from a diverse array of financial institutions, regulators, policymakers, universities and NGOs.

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# Executive Summary

Based on the latest IPCC<sup>1</sup> report, the current changes in the climate, in all regions of the globe, have not been observed for at least thousands of years. Most parts of Asia are highly exposed to climate change while being a significant contributor as the largest CO<sub>2</sub> emitter by region, responsible for 53% of the global emissions. There is an urgency to decarbonize Asian economies in-line with the Paris Agreement goals, and this will require all businesses to contribute to these goals, including the financial sector.

According to WWF-Singapore's 2021 annual RESPOND report on responsible investment in the region<sup>13</sup>, Asian asset managers are taking important steps to build their responsible investment (RI) capabilities. However, they need to step up their ambitions and practices to match current best practices in RI and contribute to *driving real world tangible change*.

In this joint report, WWF-Singapore and 2° Investing Initiative (2I<sup>2</sup>) explore what *driving real world tangible change* entails for Asian financial institutions (FIs), using dedicated surveys that are based on the authors' experiences on effective climate actions.

The responses reveal that most of the surveyed FIs have started their responsible investment journey, albeit quite recently. Yet, most of their impact strategies are hampered by limitations, some of which have been identified by respondents, others inferred by the authors from the survey responses.

The FIs acknowledge that accelerating their actions remains necessary for them to have any significant impact on reducing climate emissions in their portfolios, but barriers frustrate the success of these ambitions.

The limitations expressed by the respondents are summarized below, along with some identified internal and external barriers to climate action.

## Limitations of the current actions

- Climate actions are perceived as a niche in the global strategy
- Low ambition of the demands made
- Need for improved escalation strategies

## Barriers to climate action implementation

### Internal

- Finding the motivation: The need to understand the case for action
- A limiting business organization: Aligning the organizational structure with impact goals
- Small organization size

### External

- Extrinsic liquidity
- Profitability objectives and fiduciary duty
- Reputational concerns
- Lack of supporting policy environment, in particular marketing regulations
- Lack of climate performance tracking systems and transition plans at company level
- Specific barriers to the deployment of conditional investments

While the barriers expressed by the FIs can be current impediments to meaningful climate action, solutions exist to guide these and others forward, including:

- Setting up mandatory climate change training so that all employees involved in the impact strategy understand the issue at stake
- Aligning the organizational structure with impact goals through, for example, the setting up of an Impact Management System
- Learning from good practices when it comes to maximizing climate actions' effectiveness (for e.g., Pushing for the set-up of a science-based transition plan as a preliminary step, implementing a proper escalation strategy when the goals are not reached, etc.)
- Regulatory support on the cost of action

The solutions are recommended actions for policy makers, financial supervisors and financial institutions, on the most effective ways to break through the barriers and accelerate the Asian finance sector's contribution to collective sustainability objectives and the low-carbon transition thereby mitigating some of the worst of the climate impacts outlined by the IPCC reports.

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## Chapter 1

# State of Sustainable Finance in Asian Markets

With ambitions on climate action no longer languishing behind Europe and North America, Asian financial institutions are firmly embracing sustainable finance. A key factor is the new sense of urgency both on climate and nature issues. The latest findings from the United Nations Intergovernmental Panel on Climate Change (IPCC) 6th report<sup>1</sup> ring the alarm bells more soundly than ever, showing that changes to the climate have occurred at an unprecedented rate in every region across the world. Particularly in Asia, sea level rise has increased faster than global average, with resulting coastal area loss and shoreline retreat. The report shows that increase in greenhouse gas (GHG) concentrations inducing a rise in human-caused surface temperature of 0.8°C to 1.3°C. Recently, the United Nations Environmental Programme Emissions Gap 2021 report<sup>2</sup> reveals that we are on track for a global temperature rise of 2.7°C by the end of the century.

Regulation also drives change. Several Asian countries now have sustainable finance regulations or voluntary guidelines on responsible finance. Notably, Malaysia's work on a green taxonomy is a first for the region and Singapore's Environmental Risk Management guidelines aim to enhance financial institutions' resilience to and management of environmental risks.

Alongside governments, corporations and individual actions, the financial sector shares a responsibility to accelerate sustainable outcomes. Concerted action is required from all market participants, from reallocation of capital by asset owners to effective channelling of financial flows by asset managers and banks to more sustainable companies and innovation. Central banks, financial regulators and supervisors' leadership will be paramount, providing guidance, setting the rules and maintaining the stability of a financial system that will be increasingly stressed by climate risk.

The finance sector is responding to these needs. With increasing attention across global markets, there is a proliferation of climate-related initiatives in Asia, ranging from climate risk disclosure to net-zero pledges. There is also a growing number of Asian signatories signing to the Principles of Responsible Investment, as evidenced by a 31% uptick from 2020. This is in contrast to the EU and US regions which dipped in new PRI signatories' year on year<sup>3</sup>.



**Proportion of Asian FIs in Net-Zero Alliances under the Glasgow Financial Alliance for Net Zero**

This is influencing investment decisions, with Morningstar reporting that ESG assets in the Asia ex-Japan region amounted to US\$25.4 billion at the end of 2020, a 131 per cent increase over the past 12 months<sup>4</sup>.

However, out of the nearly 2,000 global commitments pledged with the Science Based Targets initiative, Asian financial institutions represent only 20%<sup>5</sup>. Additionally, the largest investor-led initiative

on climate change, Climate Action 100+ recorded Asian investors representing only 6% of its total members as of October 2021<sup>6</sup>.

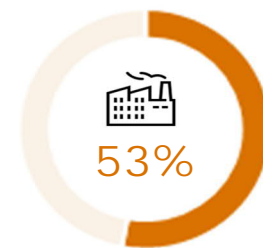
While the growth in Asian ESG assets is likely to continue, the lack of standardization amongst disclosure frameworks makes it difficult for financial institutions to navigate this complex landscape. The convergence to common frameworks is much needed but it is crucial to build in flexibility to account for differences between Asian countries' economic growth and climate ambitions. A global baseline of sustainability disclosure standards will be developed by the recently created International Sustainability Standards Board (ISSB).

## Decarbonization: A transformational opportunity for Asia

In a joint WWF-PwC report<sup>7</sup>, loss of nature and climate change are identified as the twin emergencies facing humanity. That nature underpins our economy is highlighted in World Economic Forum's (WEF) research<sup>8</sup> with \$44 trillion of economic value generation, more than half of the world's total GDP, is moderately or highly dependent on nature and its services, and hence exposed to risks from nature loss.

Most regions in Asia are highly exposed to the dual effects of climate change and nature loss. Acute physical risk, like extreme weather, is exacerbated by climate change, and already poses material risks to business operations and supply chains in Asia. Chronic physical climate risks also abound, for example with nineteen of the twenty-five cities most exposed to a one-meter sea-level rise situated in Asia.

Burning of forests for agriculture in Asia is also adding to the rise in greenhouse gases, causing air pollution and impacting both human health and the economy. The World Health Organization found that more than 90% of the 7 million air-pollution-related premature deaths occur in Asia and Africa<sup>9</sup>. The region needs to undertake clear actions to bolster its resilience, engage and educate stakeholders to manage deforestation challenges. Each Asian country has a different risk profile, so solutions need to be tailored to the specific environmental and social context.



Percentage of global CO2 emissions from Asia, the world's largest emitter by region<sup>10</sup>

There is an urgency to decarbonize Asian economies in-line with the Paris Agreement goals. With the rapid decline in energy generation costs, Asia is in a unique position to drive renewable energy deployment. The total global investment in renewables is expected to reach \$131trillion by 2050<sup>11</sup>. With large installed renewable energy capacities, Asia will account for around 40% of global energy demand by 2040<sup>12</sup>.

There are huge opportunities in Asia to achieve impactful change and where real impact actions are needed. Financial institutions have the opportunity to be a force for good and play a central role in the low-carbon transition.

## Confusion between alignment and impact

WWF-Singapore's 2021 annual RESPOND report<sup>13</sup>, an assessment of European and Asian asset managers' approaches to ESG adoption, shows that many Asian asset managers' climate strategies are not yet anchored in setting science-based targets nor translated into robust expectations toward investee companies to contribute to driving real world tangible change.

Even where investors are claiming to have impact, the reality of this impact can often be questioned. Based on 2DII's recent report<sup>14</sup>, the funds that market themselves as "impactful" are not always what they seem, with 12% of these claims being considered by 2DII as "deceptive", and 73% as "too vague to be substantiated". The analysis was conducted on French fund, yet similar results were found throughout Europe<sup>15</sup>, and one can expect to find similar results in all markets. One of the top marketing tricks used to convey the idea that the fund has an impact when it is not the case is to conflate alignment with impact. For example: *"Our sustainable funds have allowed us to realize this year: 430,000 tons of saved carbon emissions, which equates to 4 million trips from Berlin to Paris."* Here, the reallocation of the portfolio from high-carbon to low-carbon companies on secondary markets (portfolio alignment) is presented as leading to emissions reductions (impact) when this cannot be substantiated. The confusion is frequently presented in FI's communications and also in the Sustainable Finance ecosystem as explained [here](#).

If this widespread confusion between alignment and real-world impact is not clarified, impact washing will likely continue to proliferate. Regulators and clients will be inclined to call upon financial institutions to validate their impact claims and demonstrate how the funds' benefits are measured. As seen in the recent [DekaBank case, the company was sued](#) for its misleading marketing claims over the social and environmental impacts of its funds.

Sustainable investing in Asia is full of promising opportunities for financial institutions and governments in the region to scale up finance solutions, mobilizing capital towards sustainable solutions in the pursuit of building a greener and nature positive future. Clearing up the too frequent conflation between alignment and impact is key to unfolding this great potential.

As a science-based conservation organization, WWF is engaging with financial sector stakeholders globally to ensure the financial system integrates climate and nature-related risks and accelerates investments in low-carbon and nature positive activities. By driving sustainable practices throughout the economy, we help to create a sustainable global economy poised to flourish and serve people and the planet.

In this joint report, WWF-Singapore and 2° Investing Initiative (2DII), explore what *driving real world tangible change* entails for Asian financial institutions. The report will guide Asian policy makers, financial supervisors and financial institutions on the most effective ways to reach sustainability objectives and enable the low-carbon transition.

**Chapter 2** of the report discusses how FIs can impact real world emissions, and introduces the two mechanisms analysed in the surveys, **Chapter 3** describes the surveys which this study is based on and the characteristics of the surveyed FIs, **Chapter 4** discusses the results of the surveys and based on that highlights the limitations of the current climate actions (CAs) and the barriers to more ambitious CAs, and **Chapter 5** outlines various recommendations for policy makers, financial supervisors and financial institutions on the most effective ways to lift those barriers and to foster further contribution from the Asian finance sector to sustainability objectives and the low-carbon transition.



## Chapter 2

# How Can Financial Institutions Achieve Impact?

Article 2.1c of the Paris Agreement calls upon the world to “*make financial flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development.*” In a context where the real economy is not aligned with transition pathways, Article 2.1c in practice is a mandate for the finance sector to spur the alignment of the real economy – by funding necessary innovations and by pushing investors towards more sustainable business practices.

The Asian market is currently one of the most exposed to climate change and at the same time is at the source of most carbon emissions. As a result, this is where climate actions are most needed, and where the biggest opportunities for making impactful changes exist.

The below section discusses how FIs can impact real world emissions, the main lessons to be drawn from literature, and introduces the two mechanisms analyzed in the surveys.

## Defining Impact

Behind FIs’ impact is the idea that “*it is within the capacity of financial institutions to influence the real economy*” (Rocky Mountain Institute, 2020).

The impact of the FI on climate change can thus be defined, in line with academic literature, as **the change that the FI causes in the activities of real-economy actors** (most often companies) **that directly or indirectly reduces GHG emissions**. This change caused in companies’ activities can be direct and/or intermediated by the intervention of a third party. E.g. where a financial institution pressures policy makers to adopt a carbon tax, that will in turn affect companies’ activities.

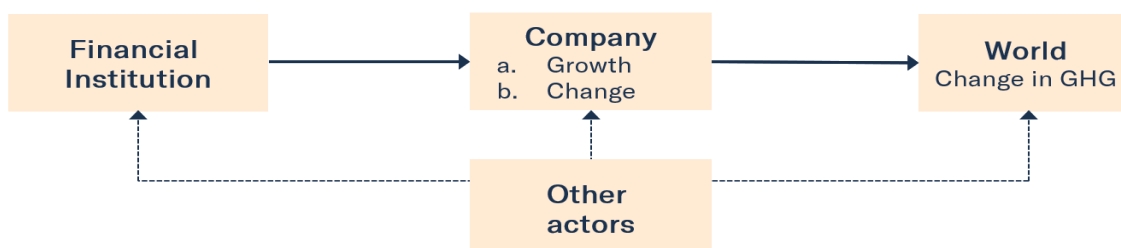


Figure 2 A synthetic definition of FI impact (2DII, based on Kölbel et al., 2018; Caldecott, 2020)

If we apply this definition to the climate issue, this change can either take the form of **growth** in a company's activities (e.g. growth in its green power production) or of a change in the **quality** of a company's activities (e.g. an increase in the energy efficiency of a plant). This definition can be applied not only to positive impacts of the FI on climate change, but also to negative impacts. An example of the latter could be growth in the activities of a coal extractor enabled by a bank's loan.

**“Impact” thus designates a causal, demonstrable relationship between a financial institution's action and a real-world change** – aligned with the Paris Agreement goals. Many other factors, beyond the FI's actions, can affect the activities of companies (e.g., consumer pressure, regulations, etc.). The FI's impact is the share of the observed change that was caused by the FI's actions.

## Impact Mechanisms and Climate Actions

FIs can impact the behaviours of companies in two main ways (Kolbel et al., 2020; Caldecott, 2020):

- by offering **financial support for the transitioning or growing company**, or
- by **pushing/supporting the companies to transition or grow through non-financial levers**.

More granular classifications of climate actions exist, such as the one of the Impact Management Project, yet, overall, they all fall under these two categories. Figure 2 below provides a few examples.



The actions classified under these two categories do not have the same chances of succeeding. Preliminary research concludes that direct engagement with companies, the provision of concessional capital, and the provision of capital at concessional rates are associated with the most evidence of effectiveness when it comes to impacting the behaviour of companies. On the other hand, actions such as divestment, exclusion or screening on secondary markets are not associated with any evidence of effectiveness (Kolbel et al, 2020). See 2DII's [Climate Impact Management System](#) for further discussion of existing evidence.

Having said that, actions that are associated with high levels of evidence are often harder to implement than divestment or screening – this can be because of regulatory constraints, market conditions, human resources constraints, etc. It is these internal and external constraints that we hope to better understand through this study.

To explore these constraints in detail while avoiding too much complexity, we decided to focus on two actions only, both associated with evidence of effectiveness, and representative of the two impact categories mentioned at the beginning of the section. Figure 3 introduces these actions.

### **Conditional Investment**

**Definition.** Conditional investments are made by financial institutions with specific conditions attached, relating to the sustainability performance of the investee/borrower.

**Example.** Sustainability-Linked Loans. The interest rate is partially adjusted (a premium or discount is usually applied to the margin) depending on the evolution of the borrower's sustainability performance.

### **Investee Engagement**

**Definition.** Engagement actions are all financial institutions' actions undertaken to influence the behaviour of a company they own.

**Example.** An investor does bilateral engagement with the investee company to persuade it to increase the scale of its investment plans in renewable technologies.

Chapter 3

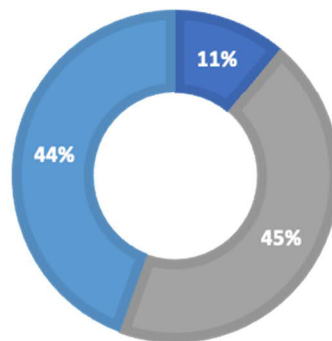
# About The Surveys

## About the Surveyed FIs

Nine Asian financial institutions participated in the survey, including assets managers, asset owners and banks. The respondents were engaged by WWF-Singapore, and the surveys conducted jointly with 2DII.

### TYPE OF SURVEYED FINANCIAL INSTITUTIONS

■ Asset Owners ■ Asset Managers ■ Banks



### SIZE OF SURVEYED FINANCIAL INSTITUTIONS

Banks	Assets	Asset Managers	AUM	Asset Owners	AUM
B1	> \$400 Billion	AM1	> \$100 Billion	AO1	> \$100 Billion
B2	> \$100 Billion	AM2	< \$50 Billion		
B3	> \$100 Billion	AM3	< \$1 Billion		
B4	< \$100 Billion	AM4	< \$1 Billion		

## CHARACTERISTICS OF SURVEYED FINANCIAL INSTITUTIONS

Respondents	Member of / Commitment	Sustainability Team
AO1	NZ commitment	Investment team + Support of ESG team
AM1	PRI ACGA AIGCC CA100+ CDP	3 ESG specialists
AM2	PRI AIGCC CA100+	Investment team + Support of ESG team
AM3	PRI AIGCC CA100+ IPDD The Investor Agenda NZAMi	2 ESG analysts + 1 rolling intern
AM4	NA	15 analysts with complementary skillsets + 6 analysts dedicated to impact
B1	NA	7 ESG specialists + 4 sustainable finance analysts
B2	NA	Team of diverse background
B3	NA	NA
B4	NA	Sustainable finance team

## About the Surveys

The purpose of the surveys is to explore the constraints that limit the ability of the financial institutions to implement impactful actions.

To avoid any confusion on the actions to be explored, a background section is provided in each survey in which the climate action is presented with examples on how it could be implemented.

The rest of each survey consists of eight questions that ask the respondent to explain the following:

- The current experience the FI has with the action targeted in the survey, if any.
- The constraints faced or that may be faced while implementing the action.
- What would help to lift the barriers to implementation of the action?
- What current internal capacity the FI has to implement such action?

The focus of each survey is on the external and the internal constraints the financial institutions may face that limit their ability to take impact-focused action. The figure below illustrates these constraints.

External	Internal
Regulations Fiduciary duty Liquidity requirements ...	HR resources Internal capabilities (skills) Financial resources Short term incentive scheme ...
Market conditions Clients' appetite for risk Limited offer of sustainable products ...	

Several examples of these constraints are provided in the surveys to help the respondents, but the space remains available should any FIs wish to build on any constraint that is not listed in the examples.

Surveys are collated and analysed by 2DII and summary results are presented anonymously in the next chapter.

## Chapter 4

# Barriers to Impactful Climate Actions

While the Asian financial institutions represent only a small percentage in the global investor-led initiatives on climate change, the survey responses reveal a strong concern for climate preservation in the FIs interviewed.

Most of the surveyed FIs started their responsible investment journey quite recently by first building internal responsible investment (RI) capabilities and developing initial dialogues with their investee companies. However, their impact strategies face several limitations - some of these limitations having been flagged by respondents, others inferred by the authors from the survey responses.

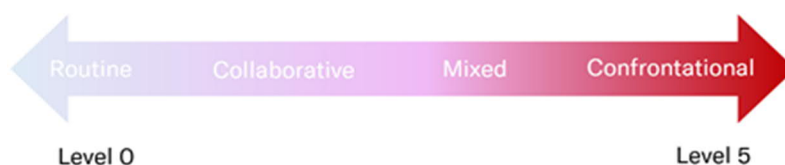
## Actions Taken and Limitations

The main barrier is that **climate actions remain marginal in the overall strategies of most surveyed FIs**. Based on the surveys' results, none of the surveyed FIs seem to yet have an overall impact strategy outlining how impact on the GHG emissions is accounted for in all the FIs' activities.

We have identified two key limitations to the effectiveness of the actions that are taken.

First, the results revealed the relatively **low ambition of the demands made by some FIs to the companies through their engagement process or loan covenant design**. Too often, and based on the results, the demands are centred around increasing disclosure and improving risk management. Although these are important topics, impactful climate actions should aim for concrete and sizable reductions in the companies' emissions. Disclosure and risk management may be stepping stones to such a goal - as flagged by some of the FIs, but they are not sufficiently impactful. The recommendation section discusses what ambitious demands could look like.

Another key limitation of the current climate actions is the **lack of tracking of climate performance and escalation strategies**. In the case of engagement, all FIs surveyed tend to keep their engagement process 'collaborative' (see Figure 4 below) and avoid moving on to 'confrontational' strategies, even when the engagement is unsuccessful. Although actions such as threat of divestment or publicization of the issue at stake should be kept exceptional, they are sometimes necessary to achieve impact from the action. For further details on this escalation scale, please refer to Annex 1.



**Figure 4 Engagement escalation scale**

Regarding the conditional investments, respondents flagged that too much conditional capital investment is not yet equipped with effective punitive covenants for non-delivery, while it is key to the impact of these investment structures. In fact, this form of action is effective but in terms of impact, only if the investee company is aware of the fact that the financing will be revised (eg. rate adjustment or loss of continued finance) if the required sustainability performance is unmet.

## Barriers to More Ambitious Actions

As discussed in the previous section, all FIs interviewed have started to take action on climate change, in one way or another. Yet – and most FIs acknowledge this in their responses – they will need to step up their actions to significantly impact climate change through GHG emissions reduction. With this section, we aim to discuss the main barriers that prevent FIs from doing so, based on the survey responses. The diversity of the sample of FIs interviewed (in terms of size, geography, FI type, etc) allows us to get a comprehensive view of these various constraints.

### Internal barriers

**Finding the motivation: The need to understand the case for action.** A barrier mentioned by several FIs is the **lack of evidence that climate actions are a source of financial performance** or, as it was sometimes put, the belief that the cost of ambitious action is too high compared to the benefits.

First, we believe that this argument relates to another barrier that has been widely mentioned in the surveys: the **lack of climate change knowledge among finance professionals**. Given the dramatic consequences of an unmitigated climate change outlined by the latest report of the IPCC<sup>1</sup>, **the key question should not be “are climate actions a source of financial performance?”, but “is climate inaction detrimental to financial performance?”. The answer is undoubtedly “yes”**. If all actors that have high ability to influence the trajectory of the economy (as FIs do) do not take action now, the risk of financial underperformance will certainly increase.

Taking action on climate change should thus not be subject to a short-term profitability requirement, but be considered a prerequisite to the continuation of the business.

Now remains the important question: are impactful climate actions and profit maximisation compatible? Since the emergence of green finance, the infamous “doing well by doing good” has been at the core of many “green” products’ marketing. How feasible is that? “Doing good”, for a financial institution, implies causing a positive change in the real world - most often, in the behaviour of its investees. This is something that an FI can do in two main ways: by supporting part of the “greenium” associated with the green / transition activities of the companies (e.g. offering a discount on the interest rate of a loan if transition KPIs are met), or by engaging the companies to transition through non-financial levers (e.g. engaging with companies to have them change their business model). In the first case, this implies lowering the profitability of the investment, given that this profitability for the FI corresponds to the cost of capital for the company (unless the “greenium” is taken over by another actor - as in the case of a Green Supporting Factor, but the FI is unable to claim “impact”). In the second case, this means spending significant resources to engage in an efficient way - which very often lowers the profitability of the investment as well. Apart from that, the cases when pushing for a meaningful transition of the investees’ business model might be detrimental to short-term shareholder value.

Hence, if an FI’s mission is to “do good”, in the sense of “having an impact” on climate change, the possibility to reach the same **short-term profitability** as mainstream competitors should not be considered a given.



If an FI wants to truly contribute to the fight against climate change, it needs to broaden its definition of profit maximisation to include impact on the biosphere in the equation. This is something that cannot be done in isolation and requires strong support from regulators and policymakers. The ideas regarding how this shift could be operated are discussed in the last section of this paper.

**Rethinking the business model.** In relation to the above discussion regarding impact and profitability, is where lies the need to **rethink the FIs' whole culture and business model**. Respondents mentioned several interconnected constraints:

- The impact strategy is not integrated in the global strategy of the institution. The ESG team works only as a support for the investment team who is responsible for the final decision.
- The lack of support of the board and / or general management for the impact strategy, leading to a lack of human and financial resources allocated to climate action.
- The lack of impact incentives in remuneration schemes.

The three barriers all reflect the paradox that, while contribution to climate change mitigation for an FI implies a shift in the institutional priorities (see above), the issue most often is not seen as systemic by the leadership. Ideas for how an organisation-wide impact plan could be designed are discussed in the “Recommendations” section.

Finally, another major internal constraint that has been flagged by some FIs in relation to engagement – but could also apply to conditional capital – is the **lack of individual leverage of small FIs**, which can be mitigated by the contribution to collective actions (see Box 2 for a case study from Maitri Asset Management, a boutique player in the Asian market) - refer to the recommendation section.

## External barriers

In addition to internal barriers, FIs also face external barriers to create change which hamper their ability to take an impactful climate action. The first of these constraints is **reputational risk**.

Two types of opposing reputational risks can be identified. Firstly, as written by one FI, in the current state of the market, it is “*easier to avoid than withstand scrutiny*”. In particular, some FIs are concerned that if they decide to focus on long term impact objectives to be met through engagement or offering of conditional capital, at the detriment of the popular portfolio alignment objectives supported by most NGOs, critics will flag their lack of short-term action. Secondly, industry associations and collaborative initiatives may highlight financial institutions who are passive in their climate actions.

One possible answer to this concern, as set out in the “Recommendations” section, is the design and communication to all stakeholders of a clear and reasoned impact plan. See 2DII's [blog](#) on aligning vs. contributing to climate goals for more details on why portfolio alignment objectives can disincentivize impact.

The second, and maybe most important of the external barriers that have been mentioned by respondents is **extrinsic profitability and liquidity objectives**.

**Liquidity.** One respondent wrote “*long-term value is what ESG and sustainability commitments deliver and the desire for highly liquid, tradeable strategies can hamper the underlying/investee's ability to demonstrate meaningful progress.*” A key challenge to scaling up impactful investments (either through engagement or conditionality, which both require long positions) is thus to convince clients of the necessity of a reduced liquidity when it comes to impacting the behaviour of investors.

**Profitability and fiduciary duty.** Some survey answers also raise the question of fiduciary duty. How legally feasible is it, for an asset manager, to include GHG emissions reduction in its definition of ‘profit maximization’? Existing work on the topic is scarce. The report “*Investors’ obligations and duties in 6 Asian markets*”<sup>16</sup> tackles part of the question, but from the perspective of “standard” ESG strategies, that do not necessarily contradict with profit maximization. Their conclusions are summarized in the box below.

### Box 1: “Investors’ obligations and duties in 6 Asian markets”<sup>16</sup>

Across all six markets, this report finds that investors have the same broad obligations and duties, including:

#### Loyalty

- Acting honestly and in good faith
- Avoiding conflicts of interest
- Ensuring that assets are kept safe, including avoiding embezzlement and theft
- Delivering on the goals of the pension fund
- Treating beneficiaries fairly

#### Prudence

- Investing in a prudent manner – taking due account of the risks associated with particular investments and the portfolio as a whole.

The report concludes that these obligations should be interpreted by FIs as inclusive of ESG factors (i.e. “Prudence” also covers ESG risks, “keeping assets safe” covers ESG risks, “delivering on the goals” covers ESG in cases when the client expressed interest in sustainability.). Hence, Asian FIs should consider ESG integration as a part of their fiduciary duty as long as it is material to financial value and/or as long as sustainability objectives have been expressed by the client.

An important consideration that remains unanswered by this report is “in cases when impactful action leads to short-term drop-in profit compared to competitors, to what extent is that legally acceptable?”. The report “*A legal framework for Impact*”<sup>17</sup> provides part of the response by explaining that, if the willingness to compromise financial return for impact is voiced by the asset owner (called in the report “ultimate-end IFSI”), it is legal for the asset manager in most jurisdictions to follow this desire. As specified in the last section of this report, we thus recommend that asset managers who truly desire to integrate climate impact in their objectives openly discuss the profit / impact balance that this implies with their clients.

The **lack of clear marketing rules to differentiate impact products from others** has also been mentioned as a barrier to ambitious action. Hence, to date, no stringent regulation exists that was specifically designed to address the issue of environmental impact claims related to financial products - in Asia but also on other continents. This situation undermines the possibility for rigorous impact investing practices to ever emerge: Why would FIs bother to prove something that can be claimed without evidence? The absence of marketing claim regulations also leads to a situation where FIs that offer products that are truly compliant with state-of-the-art guidelines that are applicable to impact are subject to an unfair competition from “green washers”. In such a permissive situation and while reputational risk is not too high, it is perfectly rational that a financial institution may not take action on climate change while claiming they do.

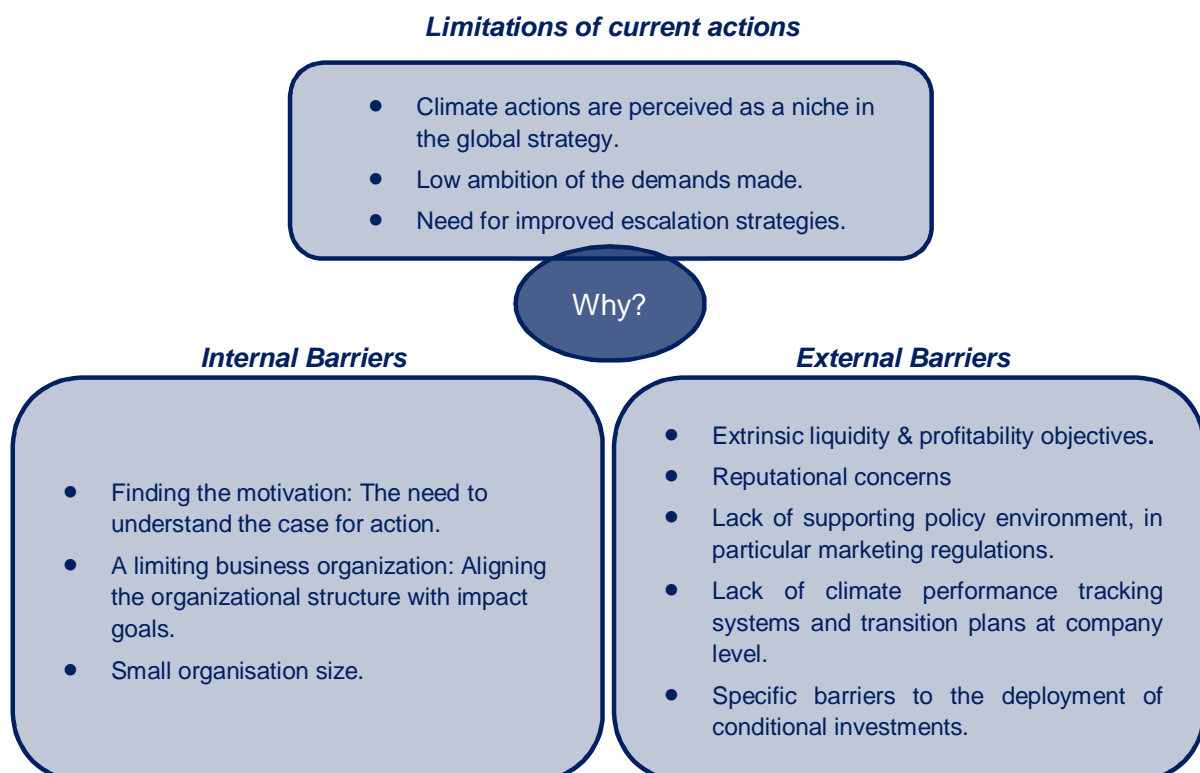
Another external constraint is the **lack of climate performance tracking systems and transition plans at company level**. Hence, engagement or covenants that aim at triggering real-world changes require that the companies have robust systems in place to measure and track their sustainability performance. This condition is often not met at all by smaller companies, and not satisfactorily by listed ones (e.g. lack of comprehensive carbon accounting). Furthermore, on top of a clear “picture”

of where the companies stand carbon-wise, impact-based climate actions require a granular transition plan to be established, outlining the necessary changes in the business model of the companies across the coming decades. Only if such a plan exists can the FI design meaningful engagement strategies or loan covenants.

Finally, there are two other limitations specific to conditional capital offering that are discussed.

First, some respondents have flagged the **need for technical assistance at the early stages of the design of the loan / bond**, until internal capacity at the FI and investee company is achieved. Advisers could include climate risk assessors, GHG inventory consultants, biodiversity experts, indigenous peoples or social justice, human rights specialists, etc. Depending on the sector, geography, project type, etc. various consultants may be needed upfront and on an on-going basis. Such assistance is in their view currently lacking in the market.

Second, some flagged the **lack of attractiveness of conditional capital**, both for the client (why accept a risk that faces a penalty?) and for the FI (why accept a risk to lose money in case of a lowering of the interest rate? What is the value in setting up such a complicated investment?). Suggestions are made in the following section to tackle this lack of attractiveness, with the caveat that some corporates are asking banks for sustainability loans.



## Box 2. Case Study: The Power of Collective Engagement – Maitri AM

*“Since 2020, Maitri Asset Management has been part of a consortium of more than 20 investors, representing more than US\$5.5 trillion in assets under management (“AUM”), urging contractors and financiers involved in the Vung Ang 2 (“VA2”) coal-fired power plant project in Vietnam to withdraw their participation, due to severe climate-related risks.*

*Over the past year, key project parties announced a variety of measures ranging from ending their participation in VA2, to limiting future involvement in coal power projects. These include Mitsubishi Corp’s withdrawal from a coal project linked to VA2; Samsung C&T exiting the coal sector upon completion of VA2; KEPCO ceasing to fund overseas coal plants; MUFJ deciding to stop financing upgrades for existing coal fired power plants; and Mizuho Financial Group announcing that it will not finance any new coal projects.*

*Progress in ESG investing observed in the past 12 months has been greater than the impact made in the last decade combined, and this is in large part driven by climate activism. We believe that every investor, regardless of size, has an important role to play. Participating in a collective investor initiative, such as our collective engagement around VA2, not only serves as a learning and collaborative opportunity - it demonstrates the strength in numbers. The initiative, led by Nordea Asset Management, was shortlisted at the 2021 PRI Awards for Stewardship Initiative of the Year.*

*As an early signatory to and target setter within the Net Zero Asset Managers initiative, Maitri has committed to halve the emissions intensity of 50% of our AUM by 2030, as well as engage at least 70% of financed emissions in the material sectors either directly or through collective investor initiatives. With that, we seek to step up in engagement, especially with non-responders of the initiative, not just on coal projects, but also in the setting of net zero targets.”, Maitri AM.*

## Chapter 5

# Recommendations

We outline below various ideas for how the above-listed constraints and limitations to climate action could be addressed, in chronological order (i.e. from designing the impact strategy to tracking actions).

## 1. A key preliminary action: Understanding the issue at stake

The desire to take ambitious action can only emerge if the issue at stake is well understood. As explained above, the lack of education of finance professionals is one of the reasons that limits the sectors' actions. Hence, **implementing a mandatory climate change training - designed for industry use and presenting a financial view of climate action** - for all ESG analysts, sectoral analysts working with climate-relevant companies, as well as for the management and board members, is needed.

The above training allows all critical decision points to familiarize with the concepts of planetary boundaries, double materiality, decarbonization scenarios, as well as the implications of all these notions for economic systems.

Regulators could help the spreading of this measure by partnering with academics and NGOs to develop easily understandable yet comprehensive training material, and make it freely available to FIs. [ASFI academy](#) could be an option for topics related to sustainable finance, but also initiatives such as [Climate Fresk](#) could be an inspiration for non-finance/climate-related topics.

## 2. Aligning the organizational structure with impact goals and getting stakeholders on board

Respondents, as explained above, often mentioned the lack of support of stakeholders (internal, like management and board; or external, like NGOs or clients) as a limitation to their ambition. From this lack of support stemmed insufficient inclusion of the impact strategy in the overall strategy of the organization.

We thus recommend that any ESG department willing to scale up the impact ambition of their institution to negotiate with their hierarchy to set up a centralized Impact Management System. One possible example of such a system can be found [here](#).

In the process of designing such a plan, emphasis is put on identifying the constraints faced by each department of the FI when it comes to implementing impactful actions, such that the resulting action plan is tailored to the FI's own situation. The setting up of this plan requires the involvement of employees from various departments, thus offering an opportunity for discussion and building of consensus.

The plan resulting from the collaborative work of employees then needs to be presented to the management and board - assuming point 1 (climate change training) has occurred beforehand. We finally recommend that a communication campaign is launched to introduce the plan to external stakeholders, clearly explaining the rationale behind controversial decisions (compromises on the financial performance of some products, choice to favour engagement over divestment in some cases, etc.).

### 3. Designing actions to maximize effectiveness

As explained in the previous section, most of the actions currently implemented by the surveyed FIs clash against the lack of climate performance tracking systems and transition plan at the company level. Hence, we recommend that in the design of a climate action, be it an engagement process or the offering of conditional capital, the first request of the FI to the company is to set up (i) A carbon accounting system<sup>18</sup> and (ii) A detailed transition plan outlining how the company can decarbonize its activities. A strict escalation process should then be put in place to incentivize action - refer to Annex 1 for inspiration.

As noted by some of the respondents, a mandatory extra-financial reporting requirement for companies could be implemented by regulators to facilitate the design of impactful climate actions by FIs. Companies could be asked to report on how their activities depend upon the use of natural capitals (e.g. the atmosphere, water reserves, soil, etc.), and what costs are associated with these uses (how would it cost to preserve / regenerate the natural capital that is used by the company?). Academics such as the “Ecological Accounting Chair”<sup>19</sup> are currently developing such reporting frameworks and could support regulators in implementing them.

### 4. Who bears the cost of action? Towards shared responsibilities.

It now remains the trickiest constraint to address: who will bear the cost of action when clients do not want to? As reminded in the previous section, having an impact for an FI often creates a need for additional short-term investment, which can lower short-term profitability. Yet, the need for asset managers to not compromise the financial gains of their clients is often brought forward as a reason not to take impactful action. For the cases when fiduciary duty indeed is an obstacle to impact (when having an impact compromises profit and the clients are not willing to accept that), asset managers can educate clients on the legislative definition of fiduciary duty. They could take over part of the cost of action to “normalize” impact products - yet, in this case, it should be noted that the responsibility for the “impact” of the actions taken shifts from the FI to the government. The public de-risking of impactful assets – provided that the overall financial stability is maintained, represents an interesting option. If we take the example of conditional capital, such interventions could consist in:

- Amending existing prudential regulations: an interesting idea could for example be to implement a “Supporting Factor” (i.e. lower capital requirements) for conditional loans<sup>20</sup>. Such a supporting factor would, as opposed to the “Green Supporting Factor” recently debated, satisfy both the objective of using capital requirements for risk reduction and the objective of shifting capital towards improving the sustainability outcomes.
- Directly “de-risking” conditional investments, for example through guarantee schemes. One could imagine the design of “impact guarantee schemes”, similar to the loan guarantee schemes being put in place by governments all over Europe to help companies recover from the COVID-19 crisis<sup>21</sup>.

Yet, the most systemic solution to this “fiduciary duty” constraint would be to subordinate the very notion of “profit” to the viability of the biosphere. It could be argued that “prudence” - one of the pillars of fiduciary duty - applies not only to the preservation of the client’s financial capital, but also to the preservation of the other capitals (natural and social capitals) that enable the very existence of this financial capital. Regulators could support such a shift in various ways - ranging from a modification of the national regulations to encourage FIs to broaden their understanding of fiduciary duty, to a modification of value-defining conventions. The box below explores the latter idea in more detail.

### Box 3. “What gets measured gets managed”

At the heart of financial analysis lies accounting. It is through this language (ROA, EVA, PER, etc.) that financial analysts orient their investments. It is through this language that they gauge the solvability, and thus investment potential, of companies or projects. In a context where FIs, if they are to truly contribute to real world evolutions, need to invest more in alternative – and thus “riskier” / less profitable assets, evolutions are needed in the regulations that bound FIs to sticking to a given solvability/rentability profile. They need to be mandated to not only preserve (and make fructify) financial value, but all that has value. For that, the notions of **rentability** and **solvability** themselves need evolving. Nowadays, only financial criteria are considered to assess the solvability of an investment and, more often than not, the same goes for rentability. Voices emerged in 1997 to argue that extra financial criteria too need to be considered when assessing the rentability of an investment decision and, more recently, to argue that solvability too needs to be assessed for both financial and extra-financial capitals (Rambaud & Richard, 2015). Such evolutions could be initiated by a remodeling of our accounting frameworks.

With an enlarged definition of “solvability”, **fiduciary duty could be extended to the preservation of all capitals, and not only financial capital** – thus automatically mandating FIs to take action. Considering natural and social capitals as entities that need to be preserved to the same extent as financial capital also **“frees” these companies’ investments decisions from the uptake of the Shareholder Value Maximization paradigm**. In such a model, dividends can only be paid once all capitals have been maintained, thus ensuring that nature and people come first.

Various approaches already exist to integrate ecological issues into traditional accounting, ranging from conservative to deeply transformative. One specifically catches our interest: The Comprehensive Accounting in Respect of Ecology (CARE) Model. This model consists in the *“exten[sion] of the principle of protection of produced/financial capital to natural and human capitals. This is implemented through inclusion of social and environmental issues in the balance sheet and income statement, and extension of financial solvency to environmental, human and social solvency.”* (Capitals coalition, 2020). Specifically, CARE allows for the accounting of preservation/restoration expenses and of provisions (e.g. investments for an ecological transition). In this logic, the income is the surplus of revenues after all the capitals have been preserved.

First steps towards the integration of an accounting logic similar to that of CARE in accounting standards are already being taken. See (Capitals coalition, 2020) and (Rambaud & Richard, 2015) for more details on the model and the options for integration in accounting standards.

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- <sup>17</sup> <https://www.unpri.org/download?ac=13902>
- <sup>18</sup> Ranging from standard carbon footprinting to integrated accounting systems (<https://www.chaire-comptabilite-ecologique.fr/la-chaire?lang=en>)



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<sup>19</sup> <https://www.chaire-comptabilite-ecologique.fr/la-chaire?lang=en>

<sup>20</sup> <https://www.responsible-investor.com/articles/there-are-more-effective-alternatives-to-the-green-supporting-factor>

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# Annex 1

## Engagement Mechanisms and Escalation Strategy

The below mechanisms are derived from various sources, either sustainability-specific examples [1] or more standard, i.e. shareholder value-motivated examples [2]. The mechanisms cover:

- “Routine” engagement activities (level 0), best suited to monitor well-performing companies.
- “Activist” activities, best suited to engage the worst performers.

The 5-level scale is meant to reflect the aggressiveness of the engagement mechanisms, and is based on the above-mentioned sources, as well as on various case studies (mentioned in the Table below). The below figure illustrates the scale. Levels 2-5 should remain exceptional activities.



	Engagement lever	Description
<b>Routine engagement</b>		
<b>0</b>	Monitoring of performance and routine meetings with investor relation office	Regular (at least yearly) one-to-one meetings with the investor relation office and/or management have become a routine element of investor strategy since the 90s and are often considered as the prime source of information about the company for the investor (Barker et al., 2004). Although usually conducted to monitor the financial health of the company, climate considerations could be included in the agendas of these meetings. A key to the meeting being useful to both parties is the preparation of a clear agenda ahead of the meeting. (Martin R. et al., 2007)
<b>0b</b>	Voting at AGMs	Voting at AGMs can also be considered a “routine” engagement practice. However, meaningful climate engagement might sometimes require diverging from proxy advisors’ recommendations and thus make the voting process more demanding than for standard products. A best practice when it comes to voting is notifying the company when voting against a resolution. (Martin R. et al., 2007)

<b>Activist engagement strategy</b>		
<b>1</b>	Raising concerns via company advisors	When specific concerns are identified that cannot be fixed by the “Level 0” engagement, more tailored engagement activities will be necessary. These activities mainly include meetings with the directors and/or sustainability department (not general “monitoring” meetings as in level 0, but goal-oriented meetings), and letters written to the management.
<b>1b</b>	Meetings with the Chairman/separate directors, or at first head of sustainability	<p>These engagement activities should target precise objectives that the investor expects the company to meet, and these objectives need to be articulated clearly to the company. See interesting example of such a “level 1” engagement process <a href="#">here</a>. As evidenced <a href="#">here</a>, these steps can also take place before the inclusion of the company in the fund.</p> <p>Level 1 engagement activities, combined if necessary with threats of publicizing the dispute, are expected to be most often sufficient. More aggressive strategies that involve publicization of the disagreement (2 to 5) should remain rare.</p>
<b>1c</b>	Letters written to the board of directors	
<b>2a</b>	Public statements in advance of AGM/BHM	Level 2 engagement activities correspond to AGM-related activities that go beyond voting and involve publicization. Engagement with investee companies should take place in private, and it is only when the situation is not resolved after a defined timeframe that the concerns of investor should become public. A first step of such publicization can be a public statement in advance of AGM/BHM.

<b>2b</b>	Joint submissions of resolutions to AGMs (if binding)	<p>Another Level 2 activity is to propose resolutions in order to put pressure on management, and withdraw the proposals if management agrees to the resolutions.</p> <p>Proposals are more likely to be withdrawn following management acceptance if they are sponsored by coordinated groups (Martin R. et al., 2007). A key element to be investigated if SURA considers submitting resolutions is the local legislation: minimum holdings required and other potential conditions need to be identified.</p>
<b>3</b>	Letters written to the press/published in the public domain	<p>This activity, which can potentially lead to important reputational damages for the company – and to some extent the investor, is likely to be most effective when coupled with other investors. It should be undertaken as the last engagement step before requesting management change.</p>
<b>4a</b>	Requisitioning of EGMs	<p>Shareholders can requisition an EGM to consider a resolution, often for the removal of directors and the appointment of new ones. Requisitioning an EGM is a rare occurrence as it can damage company's shareholder value, but the threat of requisitioning an EGM is frequently used to coerce company management to change in the direction recommended by shareholders. (Martin R. et al., 2007).</p>

<p><b>4b</b></p>	<p>Joint actions to change the composition of the management / board</p>	<p>However, if the threat is activated, the investor needs to bear in mind that the outcome of the process will be the change of management, not directly the desired climate outcome. Further engagement will thus be needed with the new management to bring about the requested climate-related changes.</p> <p>An example of successful climate-motivated management change is provided by the recent Exxon case. Lessons that can be learn from this use case are that engagement is most likely to succeed if a balance is found between climate-related concerns and the overall economic strategy of the group: managers put forward by the investor(s) should be relevant from both climate and economic perspectives. Another key to success, when the initiator of the process is a small investor, is to mobilize the bigger shareholders of the company through well-documented meetings.</p> <p>A key element to be investigated if SURA considers such aggressive activities is the local legislation: minimum holdings required and other potential conditions for requesting management change need to be identified.</p>
<p><b>5</b></p>	<p>Divesting shareholdings or bond holdings, or boycotting future bond issuances</p>	<p>Divestment from the company, or threat of divestment, is the last lever to use once all others have been exploited.</p>

[1] In particular the Hermes SDG Engagement Fund reporting material

[2] In particular: *The Responsibilities of Institutional Shareholders and Agents: Statement of Principles*, ISC, 2002; and *Investor engagement – Investors and management practice under shareholder value*, Martin,R, Casson,P.D, Nisar,T.M, 2007; *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, Klein & Zur, 2007