A LEGAL FRAMEWORK FOR IMPACT

SUMMARY REPORT

LONG TERM VALUE CREATION IN A CHANGING WORLD

CONTENTS

FOREWORDS

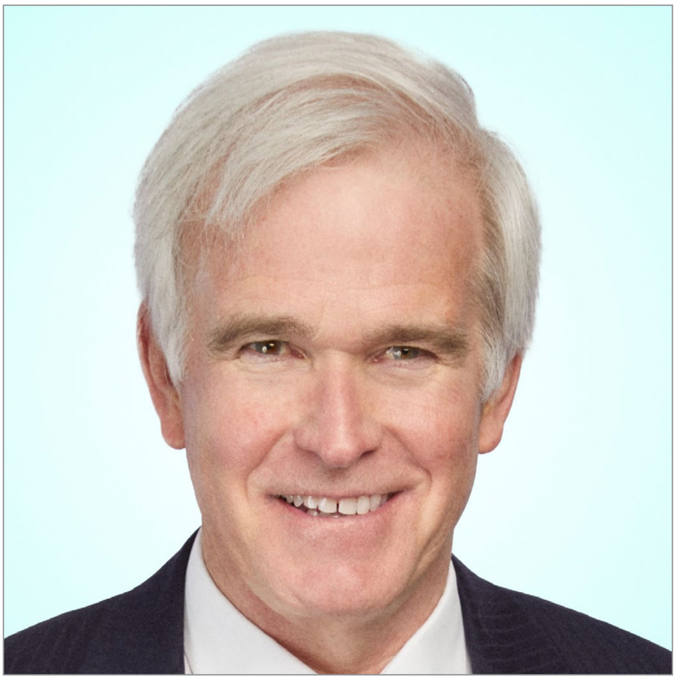
GENERATION

Twenty years ago, Generation began with the dual mission to deliver long-term, attractive, risk-adjusted investment results and to increase the adoption of sustainable investing in the wider market. We wanted to use our investing skills to prove the business case for sustainable investing. And, we aspired to help finance and capital markets tackle global sustainability challenges. We believed and continue to believe finance can be a force for good.

The Legal Framework for Impact project is one of our proudest endeavours. The initial global legal analysis demonstrated that pursuit of impact cannot and should not remain a specialist practice. Instead, mainstream investors should feel empowered to set impact goals and take action to achieve them through their asset allocation, stewardship and policy advocacy. It set out the legal basis for capital markets to respond to, and provide a means for, society's ambitions. It also described what must change to ensure that the rules that govern our financial system foster a truly sustainable economy.

This report details the joint project that followed the legal analysis and sought to embed its findings in investor practice through engagement with industry and policymakers. It highlights the hard-won progress achieved over the last three years – including how investors are increasingly recognising that consideration of impact is not optional, but central to their fiduciary duties.

This paper marks the end of a three-year project, but the work is just beginning. We hope that investors, civil society, regulators and policymakers will continue to urgently drive towards a financial system that can facilitate society's ambitions. We will not attain a sustainable economy unless the stewards of capital consciously allocate the funds to help create it.



David Blood
Senior Partner, Generation Investment Management
Chair, the Generation Foundation

FOREWORDS

UNITED NATIONS ENVIRONMENT PROGRAMME (UNEP FI)

The investment landscape is undergoing a significant transformation as sustainability outcomes gain importance among investors. This shift is driven by the growing recognition of environmental, social, and governance (ESG) factors in shaping financial performance. Many investors now prioritize sustainability, acknowledging its potential to enhance long-term returns and reduce systemic risks.

Regulators and policymakers play a crucial role in supporting this shift by implementing measures to incentivise and enhance investors' ability to assess, monitor and disclose sustainability outcomes. Such regulatory measures, including corporate disclosures, taxonomies, and transition plans, aim to mitigate sustainability risks and contribute to broader goals, ensuring a sustainable and resilient economy. Increased transparency and accountability can foster a more informed investment community, equipped for responsible decision-making. A critical aspect of this is greater clarity and guidance on the interaction between sustainability and financial objectives, highlighting that sustainable practices are strategic financial decisions, not just ethical choices.

This analysis shows that the transition to sustainability-oriented investment isn't without challenges. However, these obstacles should not overshadow the significant momentum and advancements being made by various stakeholders. The focus by regulators and investors on sustainability is reshaping the investment landscape, aligning financial objectives with sustainability goals.

Investors increasingly recognize sustainability as crucial for long-term success and addressing climate change, biodiversity loss, and pollution. However, the global financial landscape requires further transformation to meet the financing needed for a just transition. A conducive policy environment is essential to empower investors to drive positive outcomes for the environment, society, and the economy.

This report summarizes years of collaboration among major investment firms, policymakers, law firms, UN agencies, and key partners. It highlights why sustainability outcomes matter now more than ever, building on key findings from the 2021 Freshfields legal analysis, showcasing progress since 2019, and offering insights from five major jurisdictions, providing a roadmap for investors and policymakers.To make this modern understanding a reality in investment practice and to ensure that sustainability outcomes are not just permissible but necessary, policymakers play a crucial role.

Eric Usher
Director, UNEP FI

FOREWORDS

PRINCIPLES FOR RESPONSIBLE INVESTMENT (PRI)

Since the publication of the Legal Framework for Impact report in 2021, the responsible investment landscape has evolved rapidly. However significant the progress, climate change and the degradation of our natural environment remain large and looming material risks, and increasing inequality of economic outcomes is driving social and political instability worldwide.

Governments have responded with new sustainability commitments and policies to address the degradation of natural and social systems on which investment returns, and our financial system, ultimately rely. While progress is uneven and sometimes contested, the underlying trend is certain. Investors understand that sustainability outcomes are relevant to their financial objectives; not because of fundamental changes in investor's legal duties, but because of changes to the real-world context in which they are interpreted, against the backdrop of sustainability risk, new economic and financial policy trends, and client or beneficiary expectations.

There is a continuous feedback cycle between investment activities, the sustainability outcomes to which those actions contribute (through the behaviour of investee enterprises), whether intended or not, and the ESG risks and sustainability opportunities that affect the financial performance of investments. Investors tasked with securing long term financial returns for clients or beneficiaries may need to consider taking steps to increase the positive impacts of their investment activities and decrease or eliminate the negative impacts, by investing increasingly in enterprises that produce positive sustainability impacts and/or by using stewardship to encourage enterprises in their portfolio to address material issues arising from their operations.

Far from a departure from focusing on financial returns – this evolving practice aims to bridge the gap between risks, opportunities and sustainability outcomes in the face of increasing uncertainty.

The debate has shifted from whether investors should consider sustainability outcomes at all, to now considering how investors can play their full role in addressing evolving sustainability challenges, what is needed to support them, and what are the most effective policy reforms to achieve this. PRI will continue to work with our signatories to encourage and support policy makers in this complex task, to ensure the most appropriate regulatory measures are developed to guide and empower the economic transition.

David Atkins
CEO, PRI

ABOUT THIS REPORT

In October 2019, the Principles for Responsible Investment (PRI), the UNEP Finance Initiative (UNEP FI) and the Generation Foundation appointed leading law firm Freshfields Bruckhaus Derringer to analyse whether and how legal frameworks require or permit investors to consider sustainability impact.[1] It examined the law in Australia, Brazil, Canada, China, the European Union, France, Japan, the Netherlands, South Africa, the United Kingdom and the United States. In 2021, A Legal Framework for Impact, authored by Freshfields, was published.

This work builds on a body of legal analysis that dates back to 2005, and the publication of the highly influential Freshfields report, A legal framework for the integration of ESG issues into institutional investment. It found that investors are permitted to incorporate financially material ESG issues as part of their fiduciary duties. Published at a time of rising investor awareness of the importance of ESG issues, the 2005 Freshfields report was a contributing factor behind the launch of the PRI. Ten years later, in 2015, the PRI, UNEP FI, UNEP Inquiry and the UN Global Compact published their Fiduciary Duty in the 21st Century report. It argued that failing to consider long-term investment value drivers, which include ESG issues, in investment practice is a failure of fiduciary duty, and it provided a set of roadmaps for policy makers. Financial regulators in major financial markets began to accelerate efforts to include ESG requirements in regulations and policies – a trend that has continued.

At a time of growing concern about the risks that negative sustainability impacts pose to the natural and social systems on which investment returns rely, the 2021 Legal Framework for Impact report broke new ground. It directly addressed the question of when and how investors can pursue positive sustainability impact objectives.

Since 2021, the PRI, UNEP FI and the Generation Foundation have published a series of policy roadmaps and undertaken engagement with 34 policy makers in five jurisdictions – the EU, Australia, the UK, Canada and Japan – to encourage reforms that empower and support investors to better integrate the consideration of sustainability impacts into their decision-making and thus contribute to positive sustainability outcomes. We have also undertaken a programme of engagement with over 1000 investors and other stakeholders, hosting more than 20 workshops, webinars and conferences to inform policy engagement and encourage quicker and more comprehensive uptake of investment approaches that address sustainability outcomes.

This final report, authored by the PRI, UNEP FI and the Generation Foundation, summarises the reasons why sustainability outcomes are relevant for investors. It contains excerpts of key findings from the 2021 Freshfields legal report. It assesses the progress that has been made since 2019 to address sustainability outcomes in investment policy and practice, providing examples from the five jurisdictions in focus. And it sets out key learnings and describes how to ensure investors are empowered to contribute to overcoming urgent sustainability challenges in service of, and alongside, the pursuit of financial returns for their clients and beneficiaries.

1 See Key Terms in Appendix

KEY FINDINGS

Sustainability outcomes are highly relevant for most investors.

Negative sustainability outcomes pose significant risks to the natural and social systems on which economic prosperity and investment returns ultimately depend, especially over the long term.

Investors generally have a legal obligation to consider pursuing sustainability impact goals where that can help pursue their financial objectives.

Legal duties generally provide significant discretion for investors to make informed decisions about when to pursue positive sustainability outcomes in ways that support their proper investment purpose and objectives. Long-term investors who fail to consider how to manage sustainability outcomes or systemic risks may find they are failing to address factors that are highly relevant to their ability to protect the value of their beneficiaries' or clients' investments.

Regulators and policy makers are implementing measures to increase the incentives and ability of investors to monitor and disclose sustainability outcomes, mitigate sustainability risks, and contribute to sustainability goals.

Despite the increasing range and depth of enabling policies, established investment practice is not changing fast enough and requires acceleration.

The debate is shifting from whether investors should consider sustainability outcomes at all, to asking how investors can play their full role in addressing sustainability challenges posed by the economic transition.

Modern capital markets are built on the drive to solve difficult problems and grasp previously unrecognised opportunities. The focus is now on measured and effective financial regulation reforms to enable investors to contribute effectively to addressing core sustainability aspects of the economic transition.

Policy makers should continue to clarify legal duties where necessary, while shifting the emphasis decisively to policies that support and incentivise investor action. They should:

- ensure investors can confidently set and pursue commitments to achieve positive sustainability outcomes
- establish compatible national and regional sustainable finance policy regimes with multilateral support
- develop market infrastructure (disclosures, product standards, data and incentives) to enable investors to innovate and scale up investments that contribute to sustainability goals in support of economic transition.

1. THE RELEVANCE OF SUSTAINABILITY OUTCOMES FOR INVESTORS

The ability of investors to generate financial returns ultimately depends on the viability and health of our environmental and social systems. Meanwhile, the actions of investors can impact those systems both positively and negatively. There is growing interest among investors in understanding and tracking those impacts, including at the system level, and in alignment with government policies that seek to address sustainability challenges. Nonetheless, they face a number of barriers to investing to deliver positive sustainability outcomes.

RATIONALE

Recent decades have seen an increase in understanding of the risks posed by declining sustainability outcomes for the natural and social systems on which investment returns rely. Governments have responded with new sustainability commitments and policies, including global goals on climate change and sustainable development as well as widespread reforms to national and regional policies for both the financial sector and the wider economy.

Meanwhile, investors also increasingly recognise that financial returns depend not only on individual decisions about what to invest in, but also on a healthy environment and a stable society, especially in the long term.[2] The stability and viability of these environmental and social systems is threatened by climate change, biodiversity loss and inequitable social structures, among other things.

Many governments are seeking to help investors put capital to work addressing crises like climate change. However, despite increasing commitments from investors, companies and government, the world is not on track to achieve global sustainability goals, including those set out in the Paris Agreement[3] and the Sustainable Development Goals (SDGs)[4]. Consequently, investment portfolios remain exposed to sustainability risks – including system-level risks.

There is a continuous feedback cycle between the decisions taken by investors, the sustainability outcomes to which those decisions contribute (via the behaviour of investee enterprises), whether intended or not, and the ESG risks and sustainability opportunities that affect the financial performance of investments. Negative sustainability outcomes are drivers of both risks for individual companies and sectors, and market-wide or system-level risks that affect whole portfolios. These risks can be relevant over the near, medium and long term. Conversely, investor activity can contribute to positive real-world outcomes on issues such as climate change, biodiversity, sustainable development and human rights.

The growth of investment approaches that seek to contribute to positive sustainability outcomes to manage system-level risks is most advanced where there is a strong scientific consensus on the financial materiality of sustainability issues, clarity on how economic activities contribute to relevant sustainability thresholds and goals, and effective integration of these considerations into data provision and market regulation. This is seen most clearly at present on the issue of climate change. However, improved recognition of sustainability issues and systemic risks, and understanding of investors' capacity to address them in ways that contribute to investment value, means that investor concern and action on other issues, such as biodiversity, human rights and anti-microbial resistance, is growing.

In addition to seeking financial returns, individual clients and beneficiaries increasingly want to know about the real-world impacts of their investments and want those impacts to be positive.[5] Financial markets have responded by identifying ways to allocate capital to enterprises that tackle sustainability problems and by engaging with investee companies to encourage them to deliver greater social and environmental value, alongside financial value.[6]

---

2 Hawley, J. and Lukomnik, J., "Modernising modern portfolio theory", blog post, unpri.org, 27 August 2019.

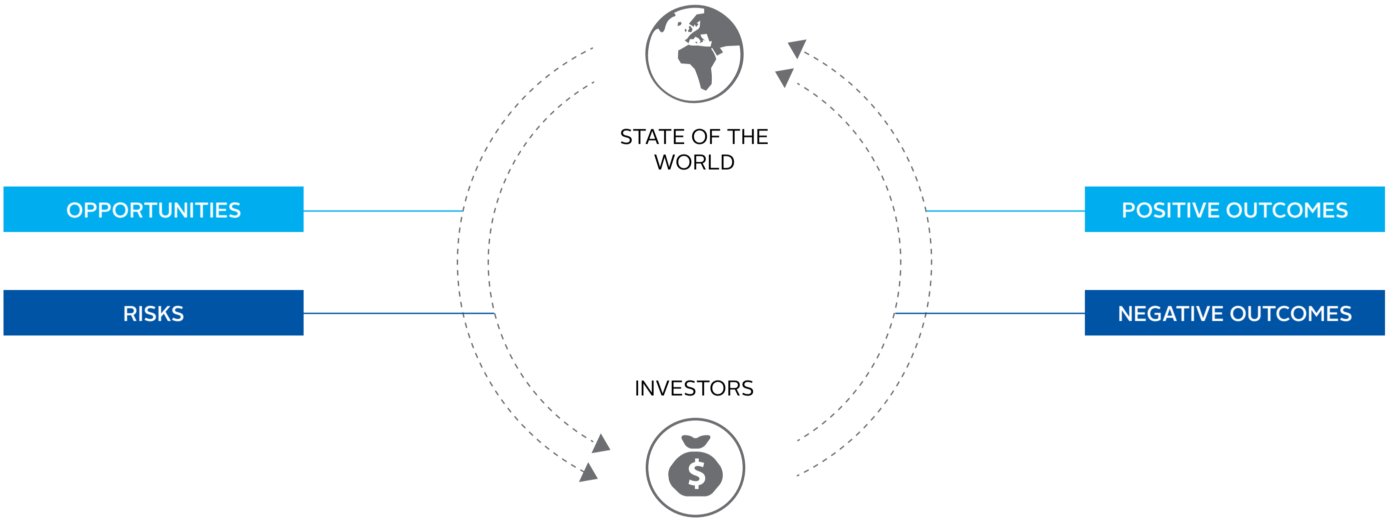
3 https://www.ipcc.ch/report/sixth-assessment-report-cycle/

4 https://unstats.un.org/sdgs/report/2023/

5 2Dii (2023), Assessing Client Sustainability Preferences...lost in the maze?

6 For more information, see Appendix 1, Figure 1, "Investing for sustainability impact" on page 35 of this report.

Figure 1: Feedback cycles on investor activity, sustainability outcomes, and ESG risks and opportunities



Source: PRI (2023)

As part of their responsibilities to clients and beneficiaries, investors may need to assess the real-world sustainability outcomes to which investment decisions and ownership activities can contribute and consider how these outcomes affect the system-level risks to which their portfolio is exposed (alongside their impact on investment risks and opportunities in general).[7] This is especially true for so-called universal owners, who invest across entire economies, although diversification means that most investors are systemically exposed to some degree.[8] Institutional investors are generally tasked with securing financial returns over the long term, which tends to increase exposure to system-level risks.

System-level risks that involve economy-wide effects cannot be mitigated by traditional asset class-based diversification. The role of investors in helping to address these non-diversifiable risks is sometimes overlooked, even where ESG factors are incorporated into investment decisions in other ways. Narrow ESG integration does not aim to resolve non-diversifiable risks that stem from system-wide issues.

To address the drivers of sustainability-related system-level risks, investors may to need take steps to increase the positive impacts of their investment activities and decrease or eliminate the negative impacts. They might do this by investing increasingly in enterprises that produce positive sustainability impacts and/or by using stewardship to encourage enterprises in their portfolio to address material issues arising from their operations.

In such circumstances, long-term investors that fail to consider sustainability outcomes or systemic risks may find they are neglecting to address factors that are highly relevant to their ability to protect their beneficiaries' or clients' investments. The mainstreaming of ESG integration and the rising concern with sustainability outcomes and sustainability goals can best be understood not as departures from a focus on financial returns, but as examples of market practices and norms emerging directly from the need to adapt in order to continue to prioritise beneficiaries' interests and investment value in a changing world.

7 PRI, UNEP FI, Generation Foundation (2021), A legal Framework for Impact

8 Quigley, E. (2020), Universal Ownership in the Age of COVID-19: Social Norms, Feedback Loops, and the Double Hermeneutic; PRI, (2010), Universal Ownership, Why Environmental Externalities matter to Institutional Investors.

A LEGAL FRAMEWORK FOR IMPACT: A SUMMARY OF ITS LEGAL FINDINGS

Financial return as the primary goal of investors

The primary purpose of asset owners' investment activity is generally regarded (by legislators, regulators, courts and the asset owners themselves) as generating a financial return for beneficiaries within acceptable risk parameters. However, that financial return objective does not necessarily mean that impact is outside the purview of an investor.

Pursuing sustainability impact for financial reasons

If an asset owner or investment manager concludes, or on the available evidence ought to conclude, that one or more sustainability factors poses a material risk to its ability to achieve its financial investment objectives, it will generally have a legal obligation to consider what, if anything, it can do to mitigate that risk (using some or all of investment powers, stewardship, policy engagement or otherwise) and to act accordingly. Possible options include seeking to bring about specific sustainability impact goals that can reasonably be expected:

- to help influence the relevant sustainability factor(s) or the exposure of investee enterprises to it/them; and
- to do so in ways that reduce the investment risk.

Investors also talk of addressing sustainability factors that present risks of this sort as being necessary for long-term value enhancement.

Relevant factors for an investor in determining whether it should engage in instrumental investing for sustainability impact include the direct and indirect costs and risks of pursuing this course of action (including as between different generations of beneficiaries, where relevant), and the relative likelihood that doing so will help address the relevant sustainability factor so as to reduce the financial risk posed (or realise financial opportunities).

Pursuing sustainability impact as an end in itself

There will be a legal duty to invest for sustainability impact where an investor is managing the assets of an investment arrangement that has specific sustainability impact objectives: for example, a mutual fund established with the aim of bringing about a particular type of sustainability impact.
In most jurisdictions, certain other investors are also likely to have legal discretion to engage in this sort of investing for sustainability impact, but usually only as a parallel objective alongside financial return objectives. Examples include: where some asset owners have discretion to pursue sustainability objectives provided adequate financial returns are achieved; and where beneficiaries have indicated that they want this.

Collective action

Collaboration with other investors is likely both to reduce the costs and enhance the prospects of a successful sustainability outcome and therefore of achieving the goals of investors when investing for sustainability impact. This may well weigh in favour of a decision to act, whether the investor is discharging a duty to achieve financial returns or pursuing a sustainability impact as an end in itself. Investor cooperation at some level is clearly permitted in all jurisdictions covered by A Legal Framework for Impact (although there are legal rules that need to be complied with). Asset owners delegating to investment managers need to satisfy themselves that the activities of the manager are aligned (or at least not inconsistent) with their own goals and duties to beneficiaries.

It is important to note that the legal rules that apply to different investor types vary considerably between jurisdictions. Their content, application and interpretation reflect the culture of the jurisdiction concerned. Even within a jurisdiction, there can be different rules for different categories of investor. In addition, the circumstances of each investor are unique. Because of these differences, precisely what an investor is legally required or permitted to do will also be specific to that investor: investors need to consider their position on a case-by-case basis. Nonetheless it is still possible to reach a set of broad conclusions about what the law generally requires or permits and the above summarises the conclusions reached in the 2021 report.

BARRIERS TO INVESTORS CONTRIBUTING TO SUSTAINABILITY IMPACT GOALS

The findings of the Legal Framework for Impact report identified a range of factors that may prevent or deter investors from investing for sustainability impact, including:

Legal rules

- limits arising from narrow interpretations of legal rules on investors' powers and duties
- a lack of clarity or understanding about what the law requires or permits

Market structure and practice

- a lack of 'market infrastructure' for impact goal setting and assessment, including investee companies' disclosure obligations
- challenges of navigating the relationship between achieving financial return and sustainability impact
- the potential for confusion over the substance of different forms of sustainable investing to undermine confidence in impact-orientated investment approaches
- uncertainty about what beneficiaries want
- market features (e.g., the dominance of Modern Portfolio Theory, reliance on benchmarks and the prioritisation of short-term performance) that may lead to sustainability factors being underweighted or overlooked
- possible impediments to collective action (perceived and actual)[9]

Engagement with policy makers and investors since 2021 as part of the Legal Framework for Impact project has confirmed that these challenges do continue to inhibit investor action, in varying combinations according to jurisdiction and circumstances.

9 PRI, UNEP FI, Generation Foundation (2021), A legal Framework for Impact, pages 129-133

2. SUSTAINABILITY OUTCOMES IN MODERN INVESTMENT POLICY

The analysis by Freshfields Bruckhaus Deringer in the 2021 Legal Framework for Impact report shows that, in many cases, legal duties permit and could sometimes require investors to consider pursuing positive sustainability outcomes. The need to mitigate system-level risks in order to protect investment value is an important motivation for doing so. However, the number of investors systematically pursuing sustainability impact remains relatively small. This is, in part, due to the barriers described above. Policy makers have an important role to play in supporting investors to serve their clients and beneficiaries' financial goals by overcoming barriers to greater action to pursue impact. These reforms should enable further research, market innovation and investor education, alongside legal and regulatory measures.

SUPPORTING POLICIES

Policy reforms should address both the law and the circumstances in which it is applied, which includes sustainable finance policy frameworks and standards. Since 2021, the Legal Framework for Impact project has published policy roadmaps for the EU, Australia, UK, Canada and Japan. The policy recommendations set out in this work build on the areas for legal and policy reform identified in the Legal Framework for Impact report, supplemented by ongoing engagement with policy makers and investors to understand their priorities and identify the best opportunities for progress.

POLICY RECOMMENDATIONS

The Legal Framework for Impact project has engaged with policy makers to encourage and inform policy reforms addressing both investors' legal duties and the wider framework of sustainable finance policies that shape how rules and duties are interpreted and fulfilled in practice.

Policy makers should consider implementing reforms to address sustainability outcomes coherently across relevant regimes (rather than in isolated interventions), including in the following priority areas. Policy makers should:

Clarify investors' existing legal duties by

1. Updating standards and guidance to clarify when investors' legal duties permit or require them to take into account sustainability outcomes and/or pursue sustainability impact goals;
2. Updating standards and guidance to clarify that purpose-related requirements (sometimes described as a duty to act in the best interests of clients or beneficiaries) may entail consideration of sustainability impact goals; and
3. Exploring ways to enable investors to take client and beneficiary sustainability preferences into account in their asset allocation and stewardship activities.

Ensure sustainable finance policies address sustainability outcomes by

1. Adopting comprehensive corporate sustainability disclosure frameworks which meet the needs of investors seeking to understand material sustainability risks, opportunities and impacts;
2. Supporting efforts to develop international standards and norms for sustainability data and reporting, and aligning national regimes with emerging global standards;
3. Ensuring that sustainability disclosure and labelling regulations for investors address not only integration of ESG risks, but also how investment entities and products assess sustainability outcomes, set sustainability impact goals and take steps to contribute to positive sustainability impacts;
4. Creating and implementing sustainable taxonomies to help investors understand and promote economic activities that are environmentally and socially sustainable;
5. Strengthening regulatory support for effective and accountable stewardship, including for using stewardship powers to address sustainability risks and sustainability impacts;
6. Supporting collaborative action by investors seeking to improve sustainability outcomes, by providing regulatory guidance to ensure that sustainability-related collective action by investors does not fall foul of competition rules; and
7. Establishing proportionate and practicable corporate and investor due diligence requirements to ensure that negative sustainability impacts are identified and addressed, ensuring coherence with international standards including the UN Guiding Principles on Business and Human Rights (UNGPs) and the OECD Guidelines for Multinational Enterprises.

10 The PRI Responsible Investment Regulation Database

Figure 2: Sustainability outcomes in financial regulation are increasingly becoming mainstream

60% of regulations assessed support the economic transition

89% of regulations assessed support the transition, tackle drivers of systemic risk and / or increase protection of human rights

Source: The PRI's Regulation database

Policy makers in most jurisdictions included here are moving beyond the question of 'if' investors should consider addressing sustainability outcomes: they are focusing on 'how' investors can take action that contributes to achieving sustainability goals and mitigating sustainability-related financial risks. This demonstrates growing agreement (although not unanimity) that sustainability outcomes matter for investors. Nevertheless, integrating real-world sustainability outcomes into financial regulations is a complex task. Policy makers (like investors) are now grappling with the challenge of identifying and implementing the most appropriate regulatory measures to guide and support the market response.

The growth and prominence of ESG integration and sustainable investment has brought increased scrutiny and criticism. It is important that investors and policy makers in fast-moving markets are transparent about their objectives and decisions and are able to incorporate feedback and learn from mistakes to maximise effectiveness and accountability. This includes listening to criticisms and addressing mistakes and misunderstandings.

While there is much legitimate and valuable debate about the reasons why investors address sustainability outcomes and the ways in which they do so, some of the more vociferous attacks on ESG integration and sustainable investing owe more to political opinion and affiliation than to reasoned assessment of the practical merits or faults of such investment approaches. Others are rooted in persistent confusion about the relationship between investors' financial objectives and sustainability impact objectives, as well as about what the law does in fact permit investors to do with regard to pursuing sustainability impact goals in parallel to financial return objectives. These challenges are considered further in Part 3 of this report.

RECENT REFORMS IN KEY JURISDICTIONS

Across the five key markets where the Legal Framework for Impact project has tracked policy reforms and engaged with policy makers, the policy interventions are too numerous to place into a simple timeline. The nature of this topic is that success entails integrating concerns around sustainability outcomes systematically across policy and regulatory frameworks, rather than in isolated interventions in one or two regulations. Individual markets have different starting points and do not move at the same speed, but each of the five focus markets covered in detail here has seen a range of reforms to further embed ESG integration as well as to increase the incentives and support for investors to address system-level risks and contribute to sustainability goals. The following examples illustrate the progress that has been made since 2019, with a focus on changes that directly or indirectly increase the extent to which policy frameworks address investors' ability to assess and manage the real-world sustainability outcomes that investments contribute to.

SUSTAINABLE FINANCE STRATEGIES

Overarching national sustainable finance strategies play an important role in ensuring policy reforms are developed in a timely, coherent and effective manner. They also clarify the links between the role of the financial sector and wider public policy priorities, including sustainability goals. All five focus jurisdictions have taken steps to set out sustainable finance strategies that address both the stability and functioning of financial markets and also their effects on real-world sustainability outcomes and, to varying degrees, their role in contributing to sustainability goals.

Examples

- The 2019 EU Sustainable Finance Strategy places strong emphasis on ensuring that the financial system supports EU social and environmental objectives.[11] Its main objectives are to:
  - Reorient capital flows towards sustainable investment, in order to achieve sustainable and inclusive growth;
  - Manage financial risks stemming from climate change, environmental degradation and social issues; and
  - Foster transparency and long-termism in financial and economic activity.

The strategy includes establishing and deploying the 'double materiality' perspective to make it clear how investors should account for both 'outside-in' risks to financial returns from ESG factors, and also the 'inside-out' impacts that investments have on society and the environment. The EU has led global efforts to address the sustainability outcomes that investments contribute to, and is taking steps across its reform agenda to address the way in which sustainability impact is reflected in investors' legal duties, investment practices and disclosures.

- The UK's 2023 Green Finance Strategy sets out plans to ensure that the UK is better equipped to meet its domestic and international climate and environmental targets and to maximise the role of private finance to meet climate and nature commitments.[12]
- The Australian government has proposed a Sustainable Finance Strategy. This will support Australia's pathway to net zero by providing a comprehensive framework for reducing barriers to investment into sustainable activities.[13]
- Canada's government established its Sustainable Finance Action Council (SFAC) in 2021 to help lead the Canadian financial sector towards integrating sustainable finance in standard industry practice, working closely with the national Net-Zero Advisory Body.[14]
- Japan's Financial Services Authority (FSA) set up an Expert Panel on Sustainable Finance in 2020 to understand how financial institutions and capital markets can contribute to creating a virtuous cycle between the economy and the environment and to achieving carbon neutrality by 2050.[15]

---

11 European Commission (2020), Renewed sustainable finance strategy and implementation of the action plan on financing sustainable growth

12 HM Government (2023), Mobilising Green Investment: 2023 Green Finance Strategy

13 Australian Government (2023), Sustainable Finance Strategy

14 Government of Canada (2023), Sustainable Finance Action Council

15 Financial Services Agency (2023), The Expert Panel on Sustainable Finance, FSA The Third Report – Enhancing Sustainable Finance

TAXONOMIES

Taxonomies

Identifying the sustainability performance of sectors, technologies or economic activities provides a set of foundations upon which other sustainable finance regulations and investment practice can build. Sustainable finance taxonomies fulfil this role by:

- defining clear sustainability objectives;
- identifying lists of economic activities that make a positive contribution to those objectives; and
- establishing performance criteria to determine how activities make a contribution to the stated objectives and ensure that they do no significant harm.[16]

Examples

- The EU Taxonomy was introduced in 2020, forming a centrepiece of the framework of policies being implemented as part of the EU Sustainable Finance Strategy.[17]
- The UK government established its Green Technical Advisory Group in 2021 to provide independent advice on developing and implementing a UK Green Taxonomy.[18]
- Canada's Sustainable Finance Action Council proposed in 2022 that a Canadian Transition Finance Taxonomy be developed: the Department of Finance Canada is now leading that process.[19]
- Government funding has been provided to the Australian Sustainable Finance Institute for the development of an Australian Sustainable Finance Taxonomy.[20]

TRANSITION PLANS

Transition pathways and plans

As demonstrated by PRI research, investors need high quality information about how companies will adapt their business operations, products and services to respond and contribute to the transition to a net zero economy.[21] The Glasgow Finance Alliance for Net Zero (GFANZ) defines a transition plan as "a set of goals, actions, and accountability mechanisms to align an organization's business activities with a pathway to net zero greenhouse gas (GHG) emissions that delivers real-world emissions reductions in line with achieving global net zero."[22]

Reliable, comprehensive and comparable transition plan disclosures by companies will make it possible for investors to assess their future prospects and contributions and make better-informed decisions. Transition plans and disclosures by financial institutions will be similarly important for regulators, clients and beneficiaries. One consequence is to improve investors' ability to set and pursue objectives to improve climate change outcomes, with a view to effectively managing climate-related financial risks and opportunities.[23]

GFANZ has developed a set of transition planning tools guidance for financial institutions, to help investors put their net zero commitments into action.[24] The UK government is moving towards making the publication of transition plans mandatory for large companies.[25] It established the Transition Plan Taskforce to lead a collaborative project involving over 100 organisations across finance, business, civil society, government and academia to produce a transition plan framework. The initial framework was published late in 2023 and regulators will draw from it to strengthen requirements.[26]

There is similar momentum in other jurisdictions, with moves to establish expectations and frameworks for transition plans in, for example, the EU, the US, the G7 and the G20 as well as within the new International Sustainability Standards Board (ISSB), as a global baseline for sustainability-related financial disclosures.

16 PRI, "How policy makers can implement reforms for a sustainable finance system taxonomies", online article, 13 June 2022

17 European Commission (2023), EU taxonomy for sustainable activities

18 UK Government (2023), Transforming finance for a greener future: 2019 green finance strategy

19 Government of Canada (2023), Taxonomy Roadmap Report

20 Australian Sustainable Finance Institute (2023), About the Australian Taxonomy

21 PRI (2023), Climate data and net zero: Closing the gap on investors' data needs

22 GFANZ (2022), Final Report: Financial Institution Net-zero Transition Plans

23 The Network for Greening the Financial System (NGFS) surveyed financial institutions in 2023, finding that 57% already use company-level transition plans to assess their ability to meet their own climate objectives. The overwhelming majority plan to use client transition plans in the future to inform their climate action. See NGFS (2024), Connecting Transition Plans: Financial and non-financial firms, Figure 7 (page 14).

24 GFANZ (2022), Towards a Global Baseline for Net-zero Transition Planning

25 Financial Conduct Authority, "FCA welcomes the launch of the Transition Plan Taskforce Disclosure Framework", press release, 9 October 2023

26 Transition Plan Taskforce (2023), Disclosure Framework

FIDUCIARY DUTIES AND INVESTOR REGULATIONS

In some markets, notably the EU and the UK, there have been recent interventions which establish greater clarity about the relevance of sustainability outcomes for the financial performance of investments, the need to understand how investments contribute to sustainability goals, and the importance of taking steps to understand and mitigate long-term and system-level risks. Reforms primarily take the form of refinement of existing rules or additional guidance, given that fundamental reforms of fiduciary duty are generally neither necessary nor widely supported.

Examples

- In 2021, the EU revised its Solvency II rules, requiring insurers to take into account the potential long-term impact of their investment strategies and decisions on sustainability factors. The European Insurance and Occupational Pensions Authority (EIOPA) has consulted and published a technical report for the review of the Institutions for Occupational Retirement Provision (IORP) II Directive. The report states that "IORPs should be required to pursue positive sustainability goals in their investment and engagement activity if it is in line with the members' and beneficiaries' preferences and it is in their long-term best interest."[27,28]
- The UK Department for Work and Pensions has established a Taskforce on Social Factors, which in 2023 published draft guidance on how pension schemes can consider social factors and pursue positive social impacts.

Sustainable finance policy frameworks in other markets are at an earlier stage of development but are nevertheless incorporating increasing attention to ESG integration and taking steps to address the real-world sustainability outcomes that investments contribute to, particularly with regard to climate change.

- In 2021, the Australian Prudential Regulation Authority (APRA) published guidance on climate risk and investment governance.[29] It sets out expectations on addressing system-level risks and confirms that superannuation funds can set environmental and social impact objectives where they are consistent with the investment objectives the funds seek to achieve for their beneficiaries.
- Japan revised its 'Grand Design and Implementation Plan for New Capitalism' in 2024 based on recommendations from the Sustainable Finance Expert Panel. It now states that GPIF and other pension funds can consider non-financial factors, including impact, if considered that there will be medium to long-term improvements in investment returns.

27 EIOPA (2021), Strategy for financing the transition to a sustainable economy - European Commission (europa.eu)

28 EIOPA (2023), Technical advice for the review of the IORP II Directive

29 See APRA, Prudential and Reporting Standards for Superannuation

EXAMPLE

FIDUCIARY DUTIES OF UK PENSION FUND TRUSTEES

In 2024, the UK's Financial Markets Law Committee (FMLC) published a report on Pension Fund Trustees and Fiduciary Duties. The report provides an authoritative explanation of a range of key legal questions. It is directed to pension fund trustees but is also highly relevant for other investors and service providers. Important clarifications contained in the FMLC report strongly reinforce the analysis of the 2021 A Legal Framework for Impact report. Specifically, it found that:

- *"what distinguishes a "financial factor" from a "non-financial factor" is the motive underlying its consideration rather than the nature of the factor."* It also explains that 'non-financial' factors will often be found to be financial when properly considered, and the importance of their review at the level of a specific asset or investment, at a portfolio level and at the level of whole economies material to the pension fund.
- climate change and the response to it have a strong bearing on the consideration of financial risk and return, and pension funds cannot leave the issue of climate change to politicians:
  - *"Can pension fund trustees leave the relevance of the subject of climate change to what is required by current legislation and regulation? The answer is straightforwardly 'no'."*
- investors may need to accept short-term loss for long-term gain:
  - *"It may be necessary to consider whether a strategy should reject shorter-term gains because they create identifiable risks to the longer-term sustainability of investment returns in the fund."*
- pension funds should not fear liability for taking sustainability into account:
  - *"The law requires pension fund trustees to reach a careful decision. It requires that they take into account all relevant matters, and not take into account irrelevant matters. But provided they approach a decision properly, and for a proper purpose, acting within their powers, and give due consideration, and do not neglect to make decisions when they should, pension fund trustees **should not fear liability**."[Emphasis added]*
- pension funds should not leave systemic risks out of their decision-making:
  - *"Given the potential significance to financial risk and return, it would be very difficult to accept that pension fund trustees, advisers or investment managers might responsibly take the position that uncertainty about the subject of climate change and its causes and consequences meant that it could be left out of account."*
- pension funds should not rely solely on numbers for assessing sustainability as the associated risk and returns may be difficult to represent simply as a number:
  - *"Pension fund trustees will need to expect that the reasons for their decision made with regard to financial factors should involve both numbers and words."*

Although it remains quite rare for laws and policies to establish explicit, mandatory obligations for investors to pursue particular sustainability outcome objectives, the UK's Levelling Up white paper set an ambition for local government pension scheme funds to invest 5% of their assets under management in projects that support local areas.[30] Regulations and guidance also too often stop short of clarifying why sustainability outcomes and risks are relevant for investors and fail to make explicit that, in some cases, investors may need to consider intentionally pursuing improved sustainability outcomes in order to address such risks or opportunities.

30 Department for Levelling Up, Housing and Communities (2023), Local Government Pension Scheme (England and Wales): Next steps on investments - government response

DISCLOSURES, LABELS AND PRODUCT STANDARDS

Corporate disclosures

To understand the sustainability outcomes that investments contribute to (individually and across portfolios), assess system-level risks and pursue sustainability objectives, investors need comprehensive, reliable and comparable sustainability data. These need to cover investee companies' sustainability performance (i.e., how an investee's operations and products positively or negatively affect people and the environment), as well as the potential effect of ESG factors and sustainability outcomes on the value of companies or other assets over time.

These two perspectives on decision-useful information are often described as 'impact materiality' and 'financial materiality'. The relationship between the two is dynamic (e.g., sustainability impacts often affect financial performance, and even impacts that do not appear to be financially material today may affect company or investment value in future), and approaches that explicitly address both perspectives can be described as using a 'double materiality' approach.

Examples

- At the supranational level, the International Sustainability Standards Board (ISSB) was formed in 2021 under the IFRS Foundation. The ISSB aims to provide financial markets with information on companies' sustainability risks and opportunities, building on established sustainability reporting initiatives. Its S1 standard requires the reporting entity to assess whether information could "reasonably" be expected to influence decisions by primary users, even if this information is not deemed material on a financial basis, which is interpreted to include systemic risks like climate change. Intuitively, this scope could include some impact-related information. The standard goes as far as recognising the interaction between impacts and dependencies and risks and opportunities, recognising that the former may give rise to risks and opportunities. However, the extent of the implications on entities' disclosure is difficult to assess without forthcoming guidance on how to use the ISSB Standards alongside the impact-focused GRI Standards and European Sustainability Reporting Standards (ESRS).[31]
- EU reporting requirements under the Corporate Sustainability Reporting Directive (CSRD) include a double materiality perspective to address real-world outcomes alongside risks to company value.[32]
- The Australian government has announced that it will introduce mandatory climate-related disclosure standards from 2024 onwards.[33] The standards will be based on those of the ISSB.
- Japan's FSA and the Sustainability Standards Board of Japan (SSBJ) have committed to introduce new sustainability disclosure requirements. In March 2024, the SSBJ released draft standards based on the ISSB Standards and, in April 2024, the FSA convened a Financial System Council Working Group to deliberate the incorporation of the standards into regulatory requirements.
- The Canadian Sustainability Standards Board (CSSB) was established in 2023 to support uptake of the ISSB standards in Canada.

31 PRI (2023), Briefing Note: Summary of Inaugural ISSB Standards

32 European Commission, Corporate sustainability reporting webpage

33 Australian Government Treasury (2024), Mandatory climate-related financial disclosures

Investor disclosure and product standards

Policy makers are continuing efforts to improve levels of transparency and accountability as sustainable investment markets become larger, more diverse and more important. Market rules need to incentivise investment practices and disclosures at entity and product levels that generate high levels of trust and minimise the risk of 'greenwashing'. Policies need to both protect customers and beneficiaries from misleading claims and enable informed decisions about how to achieve financial and sustainability objectives. Regulations and guidance on investment disclosures, standards and labelling are evolving to provide clearer definitions of market terminology. These include steps to distinguish those investment products or strategies that seek to manage the effects of ESG factors on financial risk and returns, from those that go further and make claims about contributing to positive real-world sustainability outcomes.

Examples

- The EU's Sustainable Finance Disclosure Regulation (SFDR) establishes sustainability-related disclosure requirements for the financial sector at entity and product levels, addressing environmental risks and objectives, and principal adverse sustainability impacts.
- The European Securities and Markets Authority (ESMA) is consulting on guidelines to ensure that fund names reflect the characteristics and objectives of their investments.[34] The European Supervisory Authorities (ESAs) are consulting on proposals for policies and standards to more clearly define greenwashing and further promote clarity, transparency and accountability in the EU investment framework.[35]
- In 2023, the UK's Financial Conduct Authority (FCA) published its new Sustainable Finance Disclosure Regulations.[36] These form a comprehensive package of measures to help consumers navigate the market for sustainable investment products. They include new categories and labels to distinguish investment products and entities that intentionally set and pursue sustainability objectives from those that integrate ESG risk management but do not make claims about contributing to positive sustainability outcomes.

International standards and norms

Rapid development of ESG integration and sustainable investment markets and products has resulted in a fragmented and, at times, confusing landscape. This can make it difficult for investors to differentiate their approaches or preserve coherence and continuity across new and existing products and services. It can also make it hard for clients and beneficiaries to choose providers and products that match their needs and preferences. Regulators have stepped up measures to achieve harmonisation and interoperability across markets. These efforts are underpinned by the development of international standards by the ISSB and endorsed by the International Organization of Securities Commissions. Recent developments in sustainability disclosure regimes across key jurisdictions include steps to remove impediments to investing for sustainability impact. These include:

- Cementing ESG integration as a core part of modern investment practice;
- Distinguishing investment approaches that seek to achieve clear sustainability outcome objectives from those that do not;
- Distinguishing the different ways in which investors can contribute to improved sustainability outcomes; and
- Establishing both disclosure regimes and labelling categories that are fit for purpose (both for retail markets and professional investors). This includes disclosures that enable clients and beneficiaries to understand the extent to which the sustainability outcomes that investments contribute to are within global thresholds and align with achieving global goals.

34 ESMA, "ESMA proposes changes and updates timeline for its Guidelines on funds' names", press release, 14 December 2023

35 EMSA, "ESAs put forward common understanding of greenwashing and warn on risks", press release, 1 June 2023

36 Financial Conduct Authority (2023), PS23/16: Sustainability Disclosure Requirements (SDR) and investment labels

STEWARDSHIP AND COLLABORATION

Effective stewardship is one of the most powerful ways for investors to shape sustainability outcomes and improve investment returns in line with beneficiaries' best interests.[37] Addressing sustainability-related system-level risks should be a common goal for institutional investors and requires widespread action by the industry. Success often relies on action taken by many institutional investors rather than a leading few acting alone who, despite best intentions, cannot adequately mitigate market-wide or systemic risks by themselves. This may require enhanced collective action by investors engaging with companies and policy makers, sometimes at sector- or economy-wide levels, which can both increase the chances of success and reduce the associated costs to investors.

Stewardship is too often seen as ancillary to the core process of investment decision making, whereas it should be an integral part of investors' strategy and activities. Policies and regulations should make it clear that appropriate use of stewardship is an essential tool for investors in discharging their fiduciary duties and achieving their investment purpose and objectives – including sustainability outcome objectives. There has been some progress in stewardship rules and guidance across the five focus markets in recent years. But, in many cases, current policies and guidance fall short of what is required to ensure that stewardship activities to improve sustainability outcomes are given the priority and resourcing they deserve, and that investors are able to collaborate effectively in their engagement activities.

Examples

- In 2020, the UK Financial Reporting Council (FRC) published the updated UK Stewardship Code. The UK government's 2023 Green Finance Strategy commits it to review the regulatory framework for stewardship. The FRC's Review of Stewardship Reporting 2022 finds improvements in efforts by investor signatories to address market-wide and systemic risks.[38]
- In May 2024, Japan revised the Financial Instruments and Exchange Act to exclude collaborative engagement and proxy voting from the scope of activities which will trigger additional reporting requirements for large shareholders. This is expected to address barriers to collaboration by Japanese and international investors on ESG engagement initiatives.
- In 2023, the European Commission issued guidelines on "the competitive assessment of agreements between competitors that pursue sustainability objectives", stating that not all sustainability agreements are subject to competition law, and providing safe harbours for sustainability standardisation agreements that comply with certain conditions.[39]
- In October 2023, the UK Competition and Markets Authority set out new Green Agreements Guidance, which includes measures to establish a more permissive approach and provide practical guidance on environmental sustainability agreements.[40]

37 Kolbel, J. et al (2020), Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact

38 FRC, "FRC finds improvements continue in stewardship reporting", press release, 24 November 2022

39 European Commission, "Antitrust: Commission adopts new Horizontal Block Exemption Regulations and Horizontal Guidelines", press release, 1 June 2023

40 Competition and Markets Authority, "CMA launches Green Agreements Guidance to help businesses co-operate on environmental goals", press release, 12 October 2023

THE NEED FOR FURTHER POLICY INTERVENTIONS

While the summary above describes the significant progress already made, there are several areas for reform that require further attention from policy makers. The stated ambition of some of the policy reforms described above is not yet matched by the clarity of the new rules themselves or by the effectiveness of their implementation. Progress needs to be maintained across all the policy reform areas listed at the beginning of this chapter.

The following priorities for future policy interventions stand out. Governments should:

1. **Spell out the need for investors to consider the effects of real-world sustainability outcomes on investment performance, and consider if and how an investor can or should take appropriate action to pursue sustainability outcome objectives.**

   Policy makers in several jurisdictions have taken steps to clarify why many investors are permitted, and in some cases required, to take into consideration the sustainability outcomes that their investments contribute to (as well as the impact of ESG factors on investment value). This clarification process should continue, especially with regard to the need for investors to take into consideration how sustainability outcomes are drivers of non-diversifiable system-level risks.

   However, in many cases, rules and guidance do not explain the implications of this fact. In particular, it is important to clarify that properly taking outcomes into consideration is a process that is not limited to simply understanding sustainability outcomes and their effects on an investor's ability to achieve their objectives. It also includes considering and, when appropriate, taking action to set and pursue sustainability outcome objectives when this can help achieve an investor's investment objectives in the best interests of its clients and beneficiaries.

2. **Ensure that corporate and investor disclosures distinguish between the effects of ESG factors on financial performance and the effects of investment activities on real-word sustainability outcomes.**

   There are signs that both policy makers and investors are coming to terms with the challenges and resolving residual confusions about the need for comprehensive disclosures on both aspects of the double materiality perspective. But progress is uneven across jurisdictions, and critical components of emerging outcomes-focused sustainable finance regulations remain under threat. One example of this is the need for tools like sustainable taxonomies and transition pathways to enable investors to understand outcomes in relation to systemically important goals and thresholds.

3. **Ensure sustainable finance policies are clear, coherent and comprehensive, including in how they define and regulate investments that seek to achieve a sustainability outcome objective.**

   Improving disclosures of ESG factors and sustainability outcomes is a necessary but not a sufficient step. Sustainable finance regimes need to establish a clear and coherent approach across the board. This includes, for example, ensuring that minimum standards and labels for products and entities enable clients and beneficiaries to identify and understand investment products and entities that intentionally seek to improve sustainability outcomes. It further includes ensuring that clients and beneficiaries have accurate information about: how sustainability outcomes are assessed; what specific objectives are being pursued; how the investment strategy and decision making (including asset allocation and stewardship) contribute to those objectives; and how both financial and sustainability performance will be measured and reported.

4. **Increase the focus on stewardship, including stewardship activities for systemic issues and sustainability outcomes.**

   Current policies and guidance fall short of what is required to ensure stewardship activities to improve sustainability outcomes are given the priority and resourcing they deserve, and that investors are able to collaborate effectively in their engagement activities. Policies and regulations should make it clear that appropriate use of stewardship, including collaborative action, is an essential tool for investors in discharging their fiduciary duties and achieving their investment purpose and objectives – including sustainability outcome objectives.

3. INVESTOR ACTION ON SYSTEM-LEVEL RISKS AND SUSTAINABILITY GOALS

Sustainability outcomes have become highly relevant for investors due to the changing real-world context of sustainability risk, economic and financial policies and trends, and client or beneficiary expectations, rather than any fundamental changes in the rules that define investors' legal duties. This section describes how leading investors have already been adapting and innovating in response to this changing context.

PROGRESS IN ESG INTEGRATION IS IMPORTANT, BUT NOT SUFFICIENT

ESG integration alone is not the same as pursuing positive sustainability outcomes, given that it does not necessarily involve intentional steps to improve real-world impacts. But the two approaches are potentially complementary. Investors taking the lead in managing sustainability outcomes often already have advanced ESG integration strategies and capabilities. The increasing extent and quality of ESG integration remains significant (if not sufficient) in the context of tackling real-world sustainability challenges.

Earlier this year, Bloomberg Intelligence (BI) announced that assets managed with regard to ESG factors exceeded US$30trn in 2022 and predicted they will hit US$40trn by 2030.[41] Such broad analysis can obscure the fact that a huge range of investment approaches are included under a single banner, many of which are not concerned with making an intentional contribution to sustainability outcomes or goals. Nevertheless, increased regulatory scrutiny of ESG markets in the BI analysis and other recent surveys and commentaries identify a further shift to shore up credibility.

The shift is also reflected in the findings of the PRI in a Changing World consultation. It demonstrated the need to better target support and incentivise signatory progression on responsible investment.[42] The result of the consultation will be the development of progression pathways, a framework for advancing investment practice, to communicate more clearly to clients, beneficiaries and other stakeholders what PRI signatories' intentions and actions as responsible investors mean in practice for their investments and for a sustainable world.[43]

It is becoming increasingly important for investors to not only integrate ESG factors into financial risk assessment but also to show how they integrate sustainability issues and outcomes systematically into their purpose, strategy and decision making.[44] This includes addressing concerns about greenwashing and increasing the credibility of sustainability claims.[45,46]

INVESTORS ARE ALREADY CONTRIBUTING TO BETTER SUSTAINABILITY OUTCOMES

A Legal framework for Impact provides a foundation for progress as the focus on sustainability goals and outcomes becomes more pressing. It sets out a highly comprehensive and authoritative legal assessment of the question of ***why*** investors may need to take steps to contribute to positive sustainability outcomes: because doing so can help to protect and enhance returns for clients and beneficiaries. This helps clarify the task at hand and enables investors (alongside policy makers) to focus on action: on ***how*** to accelerate their contribution to positive sustainability outcomes and global sustainability goals.

The PRI analysed the responses of 2,796 investment manager and asset owner signatories that reported to the PRI in 2021. It assessed the data to understand what investors are doing to address sustainability outcomes:

- Two-thirds of reporting signatories identified one or more positive or negative sustainability outcomes connected to their investment activities. One-third said they have proactively taken action to increase or decrease these outcomes;
- Half of PRI signatories reported using the SDGs to identify and contextualise the sustainability outcomes of their activities;
- Seventeen per cent referred to specific human rights frameworks, such as the UNGPs or the OECD Guidelines for Multinational Enterprises; and
- Signatories that reported taking action on sustainability outcomes did so primarily in relation to climate change. They also prioritised sustainability issues with relatively standardised and quantifiable metrics, such as energy, gender equality, public health and water and sanitation.

41 Bloomberg, "Global ESG assets predicted to hit US$40 trillion by 2030, despite challenging environment, forecasts Bloomberg Intelligence", press release, 8 February 2024
42 PRI (2023), PRI in a Changing World signatory consultation
43 PRI (2023), Progression Pathways - Advancing responsible investment practices among PRI signatories
44 Michelson, J., "ESG Investing Is 'Soaring.' What Does It Mean?", *Forbes, 18 November, 2022*
45/46 London Stock Exchange Group, "The rise and rise of sustainable investment", *Financial Times, undated*

While the PRI signatory base and the responsible investment world remain a diverse group, a 2022 survey of PRI signatories found 63% of respondents saw responsible investment as including in future a combination of both managing ESG risks and acting on sustainability outcomes. Two-fifths (41%) said they were already taking action on sustainability outcomes. Only 35% identified insufficient client or beneficiary demand and mandate as a significant barrier to action on outcomes. The survey also confirmed that a more expansive dialogue is needed about how the investment community contributes to positive sustainability outcomes in ways that align with fiduciary duties.[46]

One such approach to generating sustainability outcomes is impact investing. The approach was originally considered by its early adopters as a new asset class for investors intentionally seeking to generate positive social and/or environmental outcomes alongside financial returns.[47] This contributed to a false perception that it exists apart from mainstream investing approaches focused on financial risk and return. It is now becoming better understood that impact investing can be integrated across all asset classes. This broader understanding is consistent with the Legal Framework for Impact analysis that shows sustainability outcomes are relevant to many investors and can be addressed across portfolios using a combination of approaches, even when the ultimate motive for doing so is to achieve their financial purpose.

The continued growth of the impact investing market provides, therefore, another yardstick by which to assess the wider increase in investor efforts to manage real-world sustainability outcomes. In 2022, the Global Impact Investing Network (GIIN) published analysis showing that the impact investing market had grown to more than US$1trn for the first time.[48] Other trends identified by the GIIN include:

- The sector is becoming deeper and more sophisticated, as well as larger;
- Most investors report some progress on harmonisation of impact measurement approaches; and
- Investors are increasingly pursuing climate solutions across their entire portfolios, including goals for climate change mitigation and/or adaptation.[49] A range of institutional asset owners are now working to apply an 'impact lens' to portfolio construction.[50]

46 PRI (2023), PRI in a Changing World consultation

47 The Global Impact Investing Network, "Holistic portfolio construction with an impact lens: a vital approach for institutional asset owners in a changing world", online article, 19 December 2023

48 The Global Impact Investing Network (2022), GIINsight: Sizing the Impact Investing Market 2022

49 The Global Impact Investing Network (2023), GIINsight 2023: Emerging Trends in Impact Investing

50 The Global Impact Investing Network, "Holistic portfolio construction with an impact lens: a vital approach for institutional asset owners in a changing world", online article, 19 December 2023

HOW INVESTORS CONTRIBUTE TO POSITIVE SUSTAINABILITY OUTCOMES

The three main ways for investors to influence sustainability outcomes are through asset allocation, engagement with investees and engagement with policy makers. These are best used in combination rather than in isolation. Through these means, investors can help bring about assessable changes in the behaviour and performance of investee enterprises, as well as in the operating environment for companies and investors (e.g., through reforms to government policies and regulatory standards). In general, investors need to be clear about:

- **Intention and rationale** – they must decide what global, national and/or local sustainability outcomes to focus on and why (e.g., reducing carbon emissions is necessary to mitigate systemic climate risks and so is important for preserving long-term investment value);
- **Goals and objectives** – they should set clear goals and objectives for changes in corporate behaviour and in the operating environment for companies, with a credible rationale for how the change contributes to an increase in positive sustainability outcomes and/or a reduction in negative sustainability outcomes; and how it is in line with the interests of clients and beneficiaries.
- **Actions** – they should take steps, using asset allocation, company engagement and policy and wider engagement to contribute to changes in investee behaviour and improved sustainability outcomes, in line with achieving the targeted sustainability outcome objectives.
- **Results** – they should assess and report on progress towards these sustainability outcome objectives against well-defined timelines, including assessment of the investor contribution to change and the investee contribution to change.

For most investors, these sustainability outcome objectives will be targeted because their achievement will be instrumentally important for achieving the primary purpose of delivering financial returns for beneficiaries. Leading investors explain in their investment beliefs and policies why they think sustainability outcomes are relevant factors, how they understand their consequences for protecting portfolios and achieving financial objectives, and how they integrate these factors into their investment strategy and decision making. This may be analysed and communicated in the form of a theory of change.

The advanced level of scientific consensus, economic analysis, political action and available data on the issue of climate change means that investors have more confidence in the tools they need to address these essential elements of the decision-making process. These tools increasingly enable investors to identify how sustainability outcomes are relevant to securing financial returns for beneficiaries, and how they might take active steps to mitigate sustainability risks by improving sustainability outcomes.

Similar foundational resources will need to be in place for investors to accelerate action in relation to other globally important issues like biodiversity, social inequality and human rights. However, it is important to bear in mind that investors do not necessarily need to rely on quantitative evidence alone and are not expected to have perfect foresight. Legal duties require investors to make well-informed and prudent decisions, using good judgement and with credible rationales for the approach they take. They generally do not require an unrealistic level of quantitative certainty about complex chains of cause and effect over time.

Qualitative and narrative analysis also play an important role in demonstrating prudent and well-informed decision-making. It is reasonable, for example, for long-term investors to consider ways to contribute to positive sustainability outcomes like the protection of forests and the reduction of plastic pollution based on existing circumstances and information, as the examples included below illustrate.

SYSTEM STEWARDSHIP AND COLLABORATIVE ACTION

Effective stewardship, with an explicit focus on delivering sustainability outcomes and impacts, can contribute to outcomes with real benefits for investors and for society as a whole. By pursuing sustainability outcomes and impacts through stewardship, investors can foster the kinds of change that are necessary to mitigate system-level risks, thus protecting or even improving the long-term performance of economies and their investment portfolios.[52]

A recent review of stewardship reporting in the UK, published by the FRC in November 2022, finds improvements in many areas of stewardship reporting. It also identified improvements in Stewardship Code signatories' efforts to address market-wide and systemic risks and take steps to hold to account third parties such as asset managers and service providers.[53]

Collaborative engagement can enable investors to enhance their influence and legitimacy while allowing them to pool resources and reduce costs, which in turn facilitates participation by smaller and resource-constrained investors, which is advantageous in markets with highly fragmented ownership. Collaboration is particularly important in the case of stewardship that seeks to address systemic, market-wide risks. Complex market transformation is more likely to be achieved by an alliance of investors rather than a single institution, even a very large one, acting alone.[54]

Across jurisdictions, the Legal Framework for Impact research finds that investor cooperation at some level is clearly permitted, although there are legal constraints that must be respected.[55] These legal constraints do not generally prevent collective stewardship, but may impose rules which should not be ignored.

BOX 2 – STEWARDSHIP AND THE IMPORTANCE OF COLLECTIVE ACTION TO ACHIEVE SUSTAINABILITY IMPACT

The larger the enterprise and the smaller an asset owner's investment in that enterprise, the less likely it is that individual stewardship will influence enterprise behaviour. This perceived limited effect, alongside cost and 'free rider' concerns, can discourage individual investors from engaging in stewardship.

Overcoming the real and perceived barriers to greater collective stewardship becomes even more important when seeking to address systemic risks and opportunities. Systemic risks tend to be the result of what are sometimes called 'collective action problems' which require widespread coordination to resolve and cannot be effectively addressed by individual investors and investee enterprises.

Some large investors may be in a position to catalyse wider collective action because of the way their portfolios are exposed to sustainability risk, their broader influence or their different cost base. Where effective collective action is already underway, smaller investors may conclude that supporting it is a cost-effective way to contribute to positive impact and demonstrate their pursuit of impact in service to their beneficiaries, whose interests may be threatened by declining sustainability.

Any collective stewardship activity must take account of legal regimes that control certain sorts of collective activity in relation to business enterprises. Legal frameworks will generally not prevent collective stewardship but may impose constraints and cannot be ignored.*

* This box is based on Box 2, page 83, of A Legal Framework for Impact.

52 Irwin, R. (2011), Pension Funds as Universal Owners: Opportunity Beckons and Leadership Calls

53 FRC (2022), Review of Stewardship Reporting 2022

54 Thamotheram, R. and Wildsmith, H. (2007), Increasing Long-Term Market Returns: realising the potential of collective pension fund action. Corporate Governance: An International Review, 15(3), pp. 438-454.

55 Freshfields Bruckhaus Deringer (2021), A Legal Framework for Impact: Sustainability impact in investor decision-making, p15

There are numerous examples of collective action by investors seeking to address system-level risks by improving sustainability outcomes. In some cases, collective action involves a formal alliance including, for example:

- Climate Action 100+
- Net-Zero Asset Owners Alliance (NZAOA)
- Net Zero Asset Managers Initiative (NZAM)
- Investor Alliance for Human Rights
- FAIRR (addressing the sustainability of protein supply chains)
- Global Investors for Sustainable Development Alliance
- Dutch Responsible Business Conduct Agreement on responsible investment by pension funds
- Climate Engagement Canada (CEC)

In the US, questions have been raised by some as to whether collective activity by investors and others could breach competition law. Others take the view that this is not the case although, clearly, investors need to ensure that their activities comply with applicable laws and regulation. Nonetheless, the threat of investigations or other actions have had a chilling effect on activity. A recent assessment by Columbia University found that competition rules exist as part of a broad policy framework and need to evolve and operate in a way that is coherent with the integration of sustainability goals across wider economic and financial policy regimes.[57]

57 Hearn, D., Hanawalt, C. and Sachs, L. (2023), Antitrust and Sustainability: A Landscape Analysis

ISSUE-SPECIFIC EXAMPLES

Below, we present examples of leading investment practice in addressing a number of sustainability challenges, namely climate change, nature and biodiversity, and human rights.

CLIMATE CHANGE

Among the sustainability factors that pose market-wide and systemic risks to investments, climate change is the issue on which investors have made by far the greatest progress in assessing the effect of their activities on sustainability outcomes and in taking action to contribute to sustainability goals. It is widely acknowledged that physical climate risks and transition risks are highly significant for future asset values and for the stability of economies and the financial system.[58]

Investment practice example 1: the Brunel Pension Partnership's Climate Change Policy[59]

Assessing the materiality of climate outcomes	"Climate change presents an immediate, systemic and material risk to the ecological, societal, and financial stability of every economy and country on the planet. It has direct implications for our clients and their beneficiaries. It is therefore a strategic investment priority for us."
Setting climate change goals	"…the key objective of our Climate Change Policy is to systematically change the investment industry so that it is fit for purpose for a world where temperature rise needs to be kept to well below 2°C, while pursuing efforts to limit the temperature increase to 1.5°C, compared to pre-industrial levels." "Overall Strategy target: We commit to be Net Zero on financed emissions by 2050, with the goal of limiting global temperature rise to 1.5°C, and Net Zero on our own operations (scope 1 and 2) by 2030. This commitment is made through the Paris Aligned Asset Owners, part of the Paris Aligned Investment Initiative."
Taking action to achieve climate change goals	"In 2020 we designed a five-point plan as part of our Climate Change Policy – to guide our work over the next three years. Our new Policy carries forward that five-point plan to 2030, as we cleave to our aim to change the broader financial system." The five-point plan addresses: ▪ policy engagement ▪ investment products ▪ investment portfolios ▪ positive impact ▪ persuasion (investee engagement)
Governance and reporting	"The Brunel Board approves and is collectively accountable for Brunel's Climate Change Strategy and Policy. Day-to-day operational accountability sits with the Chief Responsible Investment Officer, with oversight from the Brunel Investment Committee and Brunel's Board." "Our regular reporting provides insight in these areas through our annual Responsible Investment & Stewardship Outcomes Report, which considers our performance on meeting our Responsible Investment goals, including on climate change. Further detail is provided in our Climate Action Plan (incorporating TCFD) and our annual Carbon Metrics Report showcases key carbon metrics by portfolio."

58 The Network for Greening the Financial System (2018), First Progress Report.

59 Brunel Pension Partnership (2023), Climate Change Policy 2023-30 Summary

Climate Action 100+ – a collaborative climate action

Objectives

Climate Action 100+ is an investor-led initiative to ensure the world's largest corporate greenhouse gas emitters take necessary action on climate change in order to mitigate financial risk and to maximize the long-term value of assets.

More than 700 investors are engaging companies on improving climate change governance, cutting emissions and strengthening climate-related financial disclosures, in order to mitigate financial risk and to maximise long-term value of assets.

Rationale

CA100+ is underpinned by the principle that climate risk is financial risk. Investors participating in the initiative do so because they acknowledge the need to manage these risks and opportunities to preserve long-term investment value for clients and beneficiaries. It provides an excellent example of investor action that is based on the reasoning outlined by A Legal Framework for Impact. Investors have identified that:

- climate change presents serious risks to long-term investment returns;
- managing those risks requires a reduction in GHG emissions by investee companies, in line with the Paris Agreement goals (i.e., pursuing a sustainability outcome objective); and
- Climate change and the decarbonization of the global economy are systemic and complex challenges that are best addressed through a common response and collaborative action between key stakeholders globally.

Actions

Investors participating in CA100+ engage with investee companies to seek commitments and action from them on three high-level goals:

- implement a strong governance framework which clearly articulates the board's accountability and oversight of climate change risk;
- take action to reduce GHG emissions across the value chain, including engagement with stakeholders such as policy makers and other actors to address sectoral barriers to transition. This should be consistent with the goals of the Paris Agreement, implying the need to move towards net zero emissions by 2050 or sooner; and
- Provide enhanced corporate disclosure and implement transition plans to deliver on robust targets. This should be in line with the final recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) and other relevant sector and regional guidance, to enable investors to assess the robustness of companies' business plans and improve investment decision-making.

NATURE AND BIODIVERSITY

In December 2022, at the 15th Conference of the Parties to the Convention on Biological Diversity (COP 15), 196 countries adopted the Kunming-Montreal Global Biodiversity Framework (GBF). In the face of unprecedented biodiversity loss, the GBF provides a framework to halt and reverse nature loss by 2030. It includes targets that will be translated into national-level biodiversity strategy and action plans, and it emphasises a whole-of-society approach that includes the role of private sector financial institutions.

In the run-up to the conference, over 150 financial institutions, representing over US$25trn of assets under management, signed a statement of ambition, calling for governments to act on biodiversity loss.[60] They recognised the threat posed by biodiversity loss to future prosperity, and committed to contribute to the protection and restoration of biodiversity and ecosystems through their financing activities and investments. UNEP FI, the PRI and the Finance for Biodiversity Foundation have called on investors to act on biodiversity in three ways:

1. integrate biodiversity into decision-making
2. invest in innovative financial solutions to mobilise the US$200bn a year needed to meet the GBF goals
3. disclose nature-related dependencies, impacts, risks and opportunities

They have also provided guidance for investors on how to do so.[61]

Spring – stewardship initiative on nature

Objectives

Spring is a new investor initiative on nature, launched by the PRI in 2023. The initiative is backed by 144 investors with US$9.8trn of assets under management.[62] The initiative's objective is for investors to contribute to the goal of halting and reversing biodiversity loss by 2030. This is aligned with the goals and targets of the GBF.

Rationale

Investors participating in the initiative acknowledge that addressing the systemic, physical and transition risks stemming from biodiversity loss is vitally important to fulfilling their duties, due to the significance of biodiversity loss to long-term financial performance. They recognise that stopping biodiversity loss by delivering on internationally agreed frameworks and goals is necessary and that investors have a role to play in halting and reversing forest loss (a key driver of declining biodiversity). They also believe that collaborative engagement by investors is an effective way to secure better corporate practices and, ultimately, improved biodiversity outcomes.[63]

Universal owners and long-term investors have a limited ability to diversify their portfolios away from the impacts of systemic issues like biodiversity loss. Stewardship activities, particularly when carried out in collaboration with other investors, are an essential tool for managing risk, as well as driving more sustainable real-world outcomes.

Actions

The initial focus will be on forest loss and land degradation, but will likely expand to other drivers of biodiversity loss as the initiative develops further. The initiative will focus on enabling policy alignment and implementation across geographies to help generate positive outcomes for nature and investor portfolios. Focusing investor efforts on policy will make it more likely that systemic risks are addressed across economic sectors and at an appropriate pace. Investors can help foster policy alignment through two broad approaches:

4. directly through their own engagement with policy makers; and
5. indirectly through their engagement with investees, including with regards to how these investees themselves engage with policy makers.[64]

This initiative is another example of emerging practice in investing for sustainability impact that is consistent with the Legal Framework for Impact analysis. Investors have acknowledged that they need to take steps to address the drivers of biodiversity-related risks and that this necessitates improving real-world biodiversity outcomes. They have identified that stewardship is an effective lever for influence over these issues and are collaborating to engage with companies and policy in the most efficient and effective way, and in line with globally endorsed, scientifically credible goals.

60 PRI, "150 financial institutions, managing more than $24 trillion, call on world leaders to adopt ambitious Global Biodiversity Framework at COP15", press release, 15 December 2022

61 UNEP FI (2023), Stepping Up on Biodiversity: What the Kunming-Montreal Global Biodiversity Framework means for responsible investors

62 PRI Spring stewardship initiative website

63 PRI, UNEP FI, UN Global Compact (2024), Investor Statement

64 See the PRI's Responsible political engagement webpage

HUMAN RIGHTS

Investors have a responsibility to respect human rights, as do all businesses. This responsibility is formalised in the UNGPs and in the OECD Guidelines for Multinational Enterprises. In some jurisdictions, regulations on human rights due diligence have already been introduced, based on these standards.

Human rights encompass a range of social issues, some of which are both urgent and systemic in nature. These issues, from inequality and discrimination to inequitable access to healthcare, undermine not just individual rights but also the societal infrastructure on which the global economy relies. Human rights are not limited to social issues alone, but also play a significant role in environmental issues including climate change, biodiversity protection and access to water. Leading investors now realise that preventing and mitigating negative human rights impacts on people can also lead to better financial risk management and better alignment with the interests and expectations of beneficiaries, clients and regulators.[65]

Investors can contribute by making policy commitments, implementing effective due diligence processes, and enabling or providing access to remedy. They can also set expectations and influence service providers and investee companies to identify their most salient human rights impacts, take action to address them, and show how they are managing the risk of harm to people arising from their business activities and relationships.

Advance – an investor initiative on human rights

Objectives

Advance is a collaborative initiative among institutional investors that seek to advance human rights and positive outcomes for people through investor stewardship. Launched by the PRI at the end of 2022, it is endorsed by 265 investors with US$35trn of assets under management. The initiative is engaging with over 35 companies.

Rationale

Negative human rights outcomes undermine not just individual rights and wellbeing but also the societal infrastructure on which the global economy relies. Advancing human rights is both a responsibility under international standards and an important goal that supports long-term prosperity and investment returns.[66] Collaborative engagement in support of progress on human rights can enhance investors' influence by strengthening their common voice and helping overcome collective action problems.

Actions

The initiative will engage with companies in collaboration with other investors, as well as with policy makers. It asks that focus companies:

1. implement the UNGPs;
2. align their political engagement with their responsibility to respect human rights; and
3. deepen progress on the most severe human rights issues in their operations and across their value chains.

Advance has developed an assessment framework that will be used to track progress against the initiative's objectives from 2024. Assessment will use publicly available information on company progress and widely recognised international frameworks and standards. The project will assess investor efforts and activities, company performance and sector-level developments.

65 PRI (2020), Why and how investors should act on human rights

66 PRI, Advance (2022), Advance: a stewardship initiative for human rights and social issues

Investment practice example 2: AP2 – integrating human rights in investment decisions alongside other sustainability outcomes[67,68]

Assessing the relevance of sustainability outcomes	The Fund's Sustainability Policy is part of the Fund's Operating Plan, which is adopted by the Board of Directors. As the Fund's impact on people and the environment changes over time and the Fund's sustainability work develops, the policy will be updated. AP-fonden expects all employees to be aware of this policy and to adhere to it in their work. The Fund's Executive Management has a particular responsibility to ensure that employees have received and are familiar with the information in this policy. Andra AP-fonden also expects its suppliers, business "AP-fonden expects all employees to be aware of this policy and to adhere to it in their work. The Fund's Executive Management has a particular responsibility to ensure that employees have received and are familiar with the information in this policy. Andra AP-fonden also expects its suppliers, business partners and portfolio companies to live up to this policy. The Sustainability Policy sets the overall framework for the Fund's sustainability work. It is operationalised through the Fund's strategies and annual action plans for each focus area, including human rights. AP2 is committed to the promotion of sustainable development through responsible investment and responsible ownership. Protecting human rights is crucial to achieving the UN Global Sustainable Development Goals and is thereby a key aspect of the mission to manage the Fund's assets in an exemplary manner. This work is also in line with AP2's core values, which are based on the Swedish State's core values and among other things entail that the Fund undertakes to comply with international conventions ratified by Sweden.
Setting human rights goals	AP2 has a portfolio level impact goal of net positive development in human rights, achieved through various actions, including specific consideration of human rights in company assessments and engagements. By 2025 at the latest, AP2's activities must be conducted in line with the UN Guiding Principles on Business and Human Rights. Human rights issues must be considered in every aspect of AP2's activities by 2030. A human rights portfolio goal is a key aspect of AP2's responsible investment approach. AP2's approach includes a public human rights policy, due diligence processes to identify and manage actual and potential adverse human rights impacts in the portfolio and a remediation process. By ensuring investments align with human rights principles, AP2 aims to mitigate risks and enhance the protection of human rights.

67 https://ap2.se/wp-content/uploads/2024/04/Sustainability-Policy_240409.pdf

68 https://ap2.se/en/sustainability-and-corporate-governance/focus-areas/human-rights/

Taking action to improve human rights outcomes	AP2 seeks to have a human rights due diligence process in place within all of its asset classes. This process includes risk identification, risk management, follow-up and reporting of the Fund's human rights risks. In accordance with the UN Guiding Principles, the work is primarily conducted from a severity perspective. AP2 identifies countries where there are financial, operational or sustainability reasons not to invest in these countries. The process adheres to an internally developed framework that is based, among other things, on the UN Guiding Principles on Business and Human Rights and the Fund's human rights policy. The risk assessment also evaluates the risks at company level from the perspective of negative impacts on people, rather than the financial risk. One or more relevant sectors are selected for engagement. As an active, long-term owner, advocacy is an important instrument for AP2 to create positive change. Engagement work is thereby a key aspect of managing the Fund's human rights risks and is integrated into the Fund's due diligence process. AP2 can, for example, conduct advocacy work individually, via investor initiatives and other collaboration, or via the AP Funds' Council on Ethics. Human rights issues are often complex and global, and are thus best handled in joint collaboration with other investors and organisations. AP2 supports and collaborates via several initiatives on the human rights risks identified by the Fund. Since 2021, AP2 has been involved in the Platform Living Wage Financials (PLWF) investor partnership, which conducts structured advocacy work with a focus on living wages in the textile industry. AP2 also collaborates with other investors within the framework of the Investor Alliance for Human Rights, which has a special project group focusing on the textile industry. They have also coordinated specific dialogues with companies with potential exposure to negative impacts on the Uighur population in China. Within the PRI Advance initiative, AP2 collaborates with other investors, among other things to increase understanding and the possibility of influencing human rights aspects within companies' supply chains globally.
Reporting	AP2 reports every other year according to the framework of the United Nations Guiding Principles. The UNGP's framework is the world's first comprehensive guide for reporting how companies respect human rights. The Fund also reports annually as part of the Fund's Sustainability Report.

CHALLENGES TO IMPLEMENTATION

Questions have increasingly been asked about why and how investors are increasingly focusing on ESG factors and sustainability outcomes. This scrutiny should not come as a surprise. It is a predictable response to the fact that ESG integration and sustainable investing have developed into significant and growing components of core investment practice and investment markets. Investors employing sustainable investment practices need to provide high levels of transparency and accountability to increase trust and demonstrate effectiveness.

SUSTAINABLE INVESTING UNDER SCRUTINY

There is evidently disagreement among financial market participants and commentators about how and to what extent investors should consider ESG factors and contribute to meeting real-world sustainability goals. Comprehensive regulatory reforms in jurisdictions like the EU have been welcomed by many investors, but the pace and at times uneven implementation of change – which has coincided with wider political and economic shocks – has stretched investor resources and enthusiasm. The emergence of an anti-ESG political agenda (notably in the US) has undoubtedly discouraged some investors.

This political opposition has stalled and, in some cases, reversed recent momentum behind the uptake of ESG integration and sustainable finance. For example, there is evidence of:

- **Falling support for environmental and social shareholder resolutions**

  The latest assessment by ShareAction of the voting behaviour of the world's largest asset managers finds that support for environmental and social resolutions peaked in 2021 and fell in 2022 and 2023. But the picture is not uniformly negative. While there has been a marked decline in support among US asset managers, the assessment found that European managers supported more proposals than ever before.[69]

- **Drop in ESG or sustainable fund launches**

  There was a steep fall in 2023 in the number of funds launched in the UK and the EU categorised as sustainable.[70] Asset managers have also changed the categorisation of some existing funds to avoid perceptions of greenwashing. Yet this is not entirely surprising. Investors are adjusting to new regulations and increased attention to the credibility of claims and adequacy of disclosures. This development can be interpreted as part of a process towards more effective and accountable sustainable investment markets.

  However, the US market has been affected both by the chilling effect of partisan politics and by concerns about the near-term performance of some ESG funds: just six funds claiming ESG attributes were launched in the US in the second half of 2023, compared to 55 in the first half.[71]

- **Pressure on climate change commitments and initiatives**

  Investor initiatives under the umbrella of the Glasgow Finance Alliance for Net Zero have seen the withdrawal of a number of high-profile investor members since 2021. This follows the emergence of the anti-ESG agenda in the US. The impact has spread to some investors in other jurisdictions, particularly those with significant exposure to US markets. In some cases, significant investors have withdrawn from initiatives like the Net Zero Asset Manager initiative NZAM.[72] However, these still account for a relatively small proportion of members. NZAM, for example, still included 315 signatories with US$57trn of AUM as of December 2023.[73]

69 ShareAction (2023), Voting Matters 2023

70 McGachey, K., "European managers stall ESG fund launches as sentiment sours", *Financial News, 2 November 2023*

71 Schmitt, W., "Launches of ESG funds plummet as investors pull back", *Financial Times, 9 January 2024*

72 Masters, B., and Temple-West, P., "Vanguard quits climate alliance in blow to net zero project", *Financial Times, 7 December 2022*

73 The Net Zero Asset Managers website

ADAPTING INVESTMENT PRACTICES TO SOLVE SUSTAINABILITY CHALLENGES

While progress is always uneven and setbacks are to be expected, these reversals should not distract from the underlying trend of steadily increasing investor concern and action on sustainability and a corresponding acceleration of sustainability-related policy and regulation.

Target-setting on sustainability outcomes is still a nascent practice. Investors are beginning to address sustainability outcomes in a more systematic fashion, but it is taking time for new practices to spread from leaders and specialists to the core of mainstream responsible investment practice. There are a range of factors investors need to consider when making decisions and deciding how to achieve their purpose and fulfil their legal duties.[74] In many cases, investors are considering for the first time how these relate to decisions concerning sustainability outcomes.

Implementation challenges include:

- **The size, composition and characteristics of the portfolio.** Different asset classes offer different opportunities and constraints.
- **The ability of the investor (or its investment managers) to influence sustainability outcomes, and the likelihood of success** of different approaches to achieving positive outcomes. The complexity of the intermediation chain can present challenges for some investors.
- **The cost of undertaking the proposed actions**, and the possibilities for an investor (or investors) to enhance the impact achieved relative to the cost of taking action, for example by collaborating with other investors.
- **The nature, extent and timing of any expected direct or indirect impacts on the financial performance** of the portfolio. Investors may be able to accept lower returns for a single company if it benefits the portfolio as whole, and they may accept reduced short-term performance to improve investment performance over the longer term.
- **Benchmarking limitations**, where an investor's asset allocation is constrained and/or performance is assessed in relation to benchmarks.
- **Changing policy frameworks**, where inconsistent policies or uncertainty over longer-term policy priorities or implementation can inhibit investors' ability to plan, discouraging action.
- **The dynamic nature of sustainability-related risks and opportunities** for companies and investors in light of shifting policy, technology and other determinants of sustainable transition pathways.

Investor efforts to address climate change risks and contribute to the goals of the Paris Agreement show how these complex considerations are addressed in practice. Investors with different mandates, portfolios, time horizons and regulatory constraints may legitimately come to different judgements about how to manage climate change risks and opportunities, including how to contribute to net zero goals.

Such diversity of approaches does not necessarily indicate disagreement about the fundamental analysis of the problem, nor about the scope of action permitted or required by fiduciary duties. For instance, different asset owners display a common understanding of why net zero goals are important to mitigate climate-related investment risks, and collaborate with one another in initiatives like NZAOA. At the same time, they are also developing their own specific net zero strategies and tools with different approaches to company engagement, capital allocation to low-carbon solutions, divestment from high emitting sectors, or their combination of these activities.[75]

74 Freshfields Bruckhaus Deringer (2021), A Legal Framework for Impact: Sustainability impact in investor decision-making, pages 80-82

75 Rundell, S. "Investors trying to change the world: Why climate investing is so difficult", Top 1000 Funds, 26 February 2024

4. CONCLUSIONS AND NEXT STEPS

CONCLUSIONS

- **Sustainability outcomes are highly relevant for most investors.**

  Negative sustainability outcomes pose significant risks to the natural and social systems on which economic prosperity and investment returns ultimately rely, especially over the long term. There has also been a rapid acceleration in the policy response from governments, which has led to new global goals on climate change, sustainable development and biodiversity, as well as widespread reforms to national and regional policies for both the financial sector and the wider economy.

- **Investors generally have a legal obligation to consider pursuing sustainability impact goals where that can help pursue their financial objectives.**

  Legal duties generally provide significant discretion for investors to make informed decisions about when to pursue positive sustainability outcomes in ways that support their proper investment purpose and objectives. Long-term investors who fail to consider how to manage sustainability outcomes or systemic risks may find they are failing to address factors that are highly relevant to their ability to protect the value of their beneficiaries' or clients' investments. This does not replace ESG integration. It adds a new perspective to existing market practices, reflecting the fact that current circumstances mean that investors need to consider a variety of steps to manage exposure to sustainability-related risks, tackle the underlying drivers of sustainability risks and pursue positive sustainability outcomes.

- **Regulators and policy makers are already focusing on identifying and implementing measures to increase the incentives and ability of investors to monitor and disclose sustainability outcomes, mitigate sustainability risks and contribute to sustainability goals.**

  Sustainable investment policies in key jurisdictions are being introduced to ensure that investments take account of ESG risks and contribute to the achievement of sustainability goals. They also require investors to be transparent about the way in which they address sustainability risks and opportunities, and be accountable to customers, beneficiaries and wider stakeholders. This report has also described a strong market response to integrate sustainability concerns in investment practices and products. In many markets, there is already a strong consensus about why investors may need to contribute to improved sustainability outcomes, with the focus shifting to how best to do so.

- **For long-term investors, acting in pursuit of climate change goals is already a feature of market practice. The drive to improve sustainability outcomes often stems from increasing understanding of systemic risks and the actions required to reduce them.**

  These efforts are most advanced where there is a strong scientific consensus on the financial materiality of sustainability issues, clear pathways for mitigation and adaptation to outcomes, and effective integration of these considerations into data provision and market regulation. This is seen most clearly on the issue of climate change, but attention is also turning to other issues, including nature, biodiversity, social inequality and human rights.

- **The shift to address sustainability outcomes is raising challenges and generating resistance, but this should not distract from the drivers of change and significant progress.**

  Understanding and managing real-world sustainability outcomes entails a shift in perspective as well as new skills and data. A degree of confusion and misunderstanding persists about how this relates to the core business of investing. There is resistance to the changes that are necessary, as well as legitimate concern and debate about how best to integrate this additional perspective into investment decision making, and into the products and services offered by investment managers and consultants. This is to be expected, and it should not distract from the underlying trend of a significant increase in regulatory and investor focus on sustainability outcomes and an expectation that this trend will continue in future.

- **Despite progress from regulators and leading investors, changes to established investment practice are slow to evolve.**

  The gap is being closed by regulator and policy maker action to embed pursuit of outcomes and systemic risk in legal frameworks and clarify investor duties. Still, many investors remain unaware of the extent of their duties, and educating and engaging investors must be a key priority going forward. As investors begin to unlock the long-term value-creation potential of addressing systemic risks and opportunities, we expect to see investing for sustainability impact become mainstream practice.

NEW PUBLIC POLICY GOALS

The transition to a sustainable and equitable economy that benefits natural and social systems has become an increasingly urgent policy objective in many countries and within international forums. Such a transition aims to shift economic activity from that which exploits and irreversibly degrades the environment to activity which the Earth's natural systems can support sustainably. It also aims to ensure social cohesion by reducing extreme inequality, upholding human rights and protecting vulnerable people and communities from the impacts of transition. Efforts are under way to address decades of market and government failures on environmental and social issues.

WHAT NEXT? SHIFTING FROM 'IF' TO 'HOW'

Modern capital markets are built on the drive to solve difficult problems and grasp previously unrecognised opportunities. Developing new solutions and taking them to scale relies on consistent and coherent efforts from investors and policy makers to provide the market with clarity, incentives, information and accountability. We have shifted from debating whether investors should consider sustainability outcomes at all, to asking ourselves how investors can play their full role in addressing evolving sustainability challenges, what is needed to support them, and how quickly this can be put in place. Reforming financial regulations to enable investors to contribute effectively to the core sustainability aspects of the economic transition is a prerequisite to success.

Policy makers should continue to clarify legal duties where necessary, while shifting the emphasis decisively to policies that support and incentivise action by investors to contribute to sustainability goals. They should:

- ensure investors can confidently set and pursue commitments to achieve positive sustainability outcomes
- establish compatible national and regional sustainable finance policy regimes with multilateral support
- develop market infrastructure (disclosures, product standards, data and incentives) to enable investors to innovate and scale up investments that contribute to sustainability goals

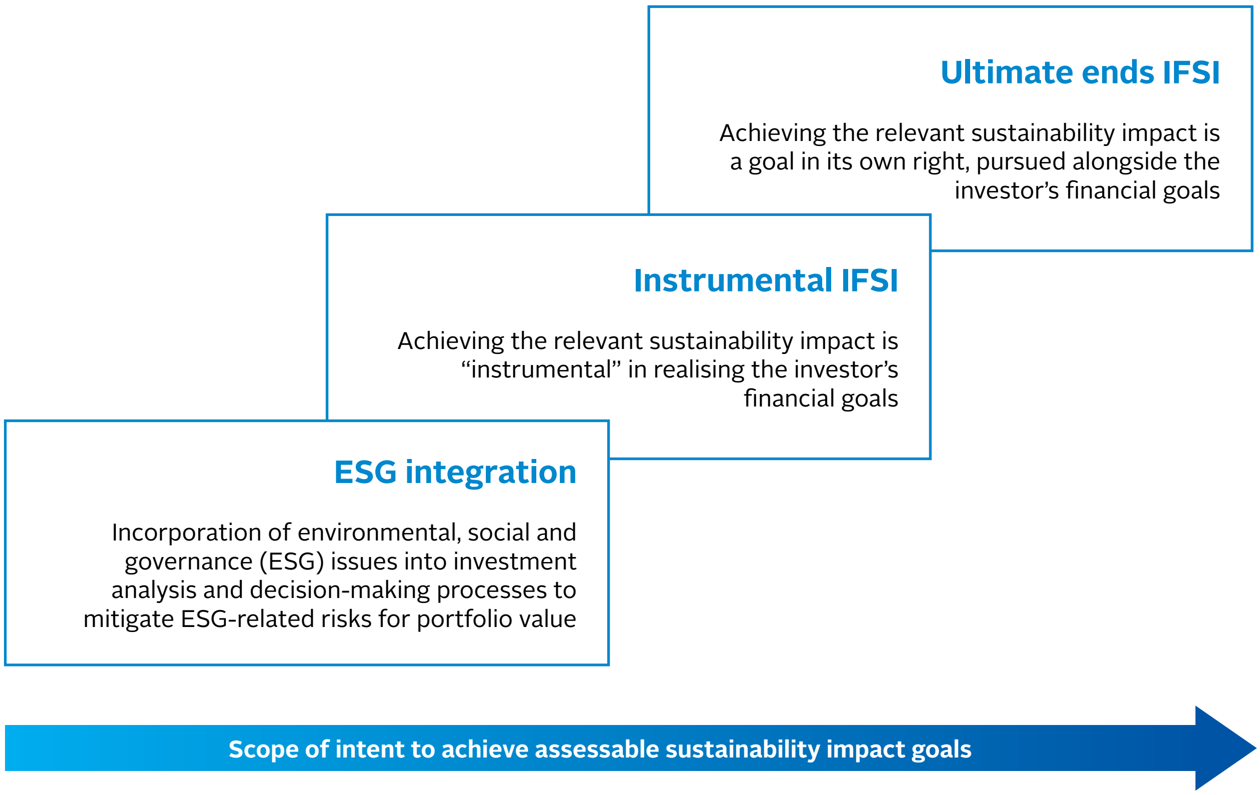
Whole-of-government approaches are needed to accelerate economic transition to sustainable and equitable economies that benefit natural and social systems. Governments must mobilise all sectors of the economy and society at the relevant levels to ensure policy effectiveness. Leading jurisdictions are developing strategic levers to catalyse private investments in credible decarbonisation efforts.[76] There are numerous barriers to such efforts, including vested interests, short-term investment cycles, failures to price environmental and social externalities, perverse subsidies, and tax avoidance and evasion practices. Many, if not all, of these barriers can be removed by effective public policy reform. However, the necessary policy making cannot be undertaken in a piecemeal manner, nor can it be seen simply as a matter for one arm of government or as an issue for the public rather than the private sector. Instead, the economic transition must be placed at the heart of public policy making, to mobilise all sectors of society, including private finance, to ensure the continuation of long-term value creation in a changing world.

76 PRI (2024), Investing for the economic transition: the case for whole-of-government policy reform

APPENDIX 1: WHAT IS INVESTING FOR SUSTAINABILITY IMPACT?

The concept 'Investing for sustainability impact' (IFSI) describes any investment approach where investors intentionally seek (through the activities they finance or otherwise) to influence what investee enterprises and third parties do in assessable ways that address sustainability challenges. An investor might invest for sustainability impact either as a means to achieve financial investment goals (instrumental IFSI), or to achieve sustainability goals as ends in themselves, in parallel with financial goals (ultimate ends IFSI).

Figure 1: Investing for sustainability impact



APPENDIX 2: KEY TERMS

The following key terms are used in this report:

- **Sustainability factors:** a catch-all term for sustainability impacts and sustainability risks.
- **Sustainability impacts:** the impacts of investors' actions on the environment and society. These impacts manifest themselves as the sustainability impacts of investments and can be positive or negative. Positive sustainability impacts are those aligned with global sustainability goals, such as the goals of the Paris Agreement and the UN Sustainable Development Goals (SDGs), as well as with the UN Guiding Principles on Business and Human Rights and the International Bill of Human Rights.
- **Sustainability risks:** sustainability-related threats to investments' financial performance, such as those arising from climate change and social unrest.
- **Sustainability impact goals:** goals set by investors to achieve positive sustainability impacts through their investments.
- **System-level risks:** a catch-all term for systematic risk and systemic risk, both of which have implications for investment performance.
- **Systematic risk:** risk, transmitted through financial markets and economies, that affects aggregate outcomes, such as broad market returns. The term is interchangeable with "market risk" or "marketwide risk". Because systematic risk occurs at a scale greater than a single company, sector or geography, it cannot be hedged or mitigated through diversification. One example of a sustainability-related systematic risk is the risk of reduced global economic growth due to sustained physical impacts of climate disruption; another is the opportunity cost associated with failing to meet the SDGs.
- **Systemic risk:** the risk that an event at a particular point in time or a chronic economic condition destabilises the financial system or leads to its collapse. An example of a systemic risk materialising would be a number of "too-big-to-fail" financial institutions defaulting on obligations to their creditors or investors. An example of a sustainability-related systemic risk would be a sudden repricing of assets across the fossil fuel sector, resulting in cascading defaults that destabilise financial markets – this is sometimes referred to as a potential "climate Minsky moment".

APPENDIX 3: THE STATE OF POLICY REFORM IN FOCUS JURISDICTIONS

THE EUROPEAN UNION

The 2019 EU Sustainable Finance Strategy places strong emphasis on ensuring that the financial system supports EU social and environmental objectives.[77] This includes establishing and deploying the 'double materiality' perspective to make it clear how investors should account for both 'outside-in' risks to financial returns from ESG factors, and also the 'inside-out' impacts that investments have on society and the environment.

New policies brought into place since 2019 include the EU Taxonomy,[78] SFDR,[79] the CSRD[80] (accompanied by Environmental and Social Reporting Standards),[81] and the Corporate Sustainability Due Diligence Directive (CSDDD).[82]

The advanced level of policy implementation reflects the fact that sustainability issues are a priority for many EU governments and citizens, and also that many EU investors are actively seeking to account for the sustainability outcomes of their investments, including by aligning portfolios with pathways to net-zero carbon emissions.

The emphasis of the EU Sustainable Finance Strategy on sustainability outcomes means that the primary focus for policy engagement has been on addressing gaps in the framework and implementation challenges, with a focus on both the technical integrity of the policies and on trust and accountability for financial market participants.

Regulatory developments in the EU since 2019

Policy area	Date	Progress made and next steps
Sustainable finance strategy	**2019**	The EU Sustainable Finance Strategy aims to provide a comprehensive set of policy tools to ensure the financial system supports the transition of businesses towards sustainability.
	2020	The EU Taxonomy is introduced as a foundational element of the EU Sustainable Finance Strategy. It identifies sustainable economic activities to facilitate sustainable investment.
Clarifying legal duties	**2021**	EU Commission Delegated Regulation 2021/1256 revises Solvency II rules to address inside-out factors, requiring insurers to take into account the potential long-term impact of their investment strategy and decisions on sustainability factors.
	2023	EIOPA publishes a technical report for the review of the IORP II directive for occupational pension funds. The report states that, "'IORPs should be required to pursue positive sustainability goals in their investment and engagement activity if it is in line with the members' and beneficiaries' preferences and it is in their long-term best interest."
Disclosures, labels and product standards	**2021**	SFDR comes into force, setting out sustainability-related disclosure requirements for the financial sector at entity and product levels. It addresses environmental risks and objectives and principal adverse sustainability impacts.
	2021	The CSRD mandates the creation of EU sustainability reporting standards. The standards are aimed at increasing the consistency and comparability of reported company information relating to the six environmental objectives of the Taxonomy Regulation, and social and governance factors.
Stewardship and collaboration	**2023**	The European Commission issues guidelines on "the competitive assessment of agreements between competitors that pursue sustainability objectives". This complements the 2013 'white list' of activities investors can cooperate on without assumptions of acting in concert. The guidelines cover issues including climate change, human rights and child labour.[83]
Due diligence	**2024**	The Corporate Sustainability Due Diligence Directive (CSDDD) aims to ensure that companies active in the EU market contribute to the sustainable transition of economies and societies. It introduces obligations for large companies operating in the EU to conduct due diligence on the actual and potential human rights and environmental adverse impacts, with respect to their own operations, the operations of their subsidiaries, and the operations carried out by their business partners in companies' chains of activities.

77 European Commission (2021), Strategy for financing the transition to a sustainable economy
78 PRI, EU Taxonomy webpage
79 PRI (2022), EU Regulation on sustainability-related disclosures in the financial services sector
80 PRI (2022), Scope of the Corporate Sustainability Reporting Directive, PRI, "CSRD and ESRS: how EU corporate sustainability reporting is evolving," online article, 22 September 2022
81 PRI, "PRI reaction statement and quote on adoption of ESRS 1 and ESRS 2", online article, 16 August 2023
82 PRI (2023), How to make the CSDD directive practicable for the investment industry
83 European Commission (2023), Guidelines on the applicability of Article 101 of the Treaty on the Functioning of the European Union to horizontal co-operation agreements

AUSTRALIA

After a number of years of little progress in sustainable finance policy development, Australia has seen a major shift in momentum since the arrival of a new government in May 2022. Publication of a new draft Sustainable Finance Strategy for Australia in 2023 provides a centrepiece for reforms.

The Legal Framework for Impact project found that, up to 2022, Australian investors' confidence to pursue positive sustainability outcomes had been limited by uncertainty over their legal duties, a focus on short-term performance with insufficient attention or guidance on why and how investor should consider system-level risks, limited corporate disclosure requirements, and a lack of regulatory support for active stewardship.[84]

Managing risks and supporting investors with implementing their existing sustainable investment approaches remains the primary focus for Australian regulators, along with ensuring the stability of the financial system and supporting the clean energy transition. There is currently less emphasis on incentivising investors proactively to contribute to positive sustainability outcomes. Nevertheless, the steps described in the table below demonstrate a significant shift in momentum and a clear direction of travel to improve the consideration of sustainability risks and outcomes in Australian investments.

Australia regulatory developments since 2019

Policy area	Date	Progress made and next steps
Sustainable finance strategy	2023	The government proposes a Sustainable Finance Strategy for Australia.[85] This will support Australia's pathway to net zero by providing a comprehensive framework for reducing barriers to investment into sustainable activities. The strategy addresses transparency on climate change and sustainability, financial system capabilities and regulation, and government leadership and engagement.
	2023	The government funds the Australian Sustainable Finance Institute to develop an Australian sustainable finance taxonomy.
	2023	The Your Future, Your Super (YFYS) review explores ways to enhance the ability of superannuation funds to support the transition to net zero, including by reviewing performance tests and encouraging long-term investment approaches.[86]
Clarifying legal duties	2023	The Australian Prudential Regulation Authority (APRA) publishes prudential practice guides on climate change financial risk and on investment governance.[87] The guidance sets out clear expectations that trustees demonstrate how they integrate ESG factors (including market-wide or system-level risks) in their investment analysis, decision-making and governance. Regarding impact and outcomes, the updated guidance also explicitly confirms that superannuation funds can set environmental and social impact objectives where that is consistent with the outcomes the funds seek for their beneficiaries.
Corporate disclosures	2023-24	The Australian Government announces that it will introduce mandatory climate-related disclosure standards from 2024 onwards. The standards will be based on those of the ISSB. Further standards for other sustainability areas beyond climate change will be introduced in due course. The standards include requirements to report on impacts in a number of areas.
Stewardship	2023	APRA's Prudential Practice Guide on Investment Governance (SPG 530) makes explicit reference to the need for superannuation funds to carry out stewardship in relation to ESG issues.

84 PRI, UNEP FI and the Generation Foundation (2022), Australia: Integrating sustainability goals across the investment industry
85 The Treasury (2023), Sustainable Finance Strategy consultation
86 The Treasury (2023), Your Future, Your Super Review
87 See ARPA, Prudential and Reporting Standards for Superannuation

THE UNITED KINGDOM

The UK has been in the vanguard of introducing policies to tackle climate change and encourage responsible investment. The UK government first published its Green Finance Strategy in 2019 and issued an updated one in 2023.[88] While financial policy makers have so far focused on climate-related issues, they are increasingly taking action on other sustainability challenges as well. For instance, in October 2023, a new taskforce to help pension schemes engage with social risks and opportunities published for consultation a guide on Considering Social Factors in Pension Scheme Investments.

The UK has also led on stewardship standards for investors. A voluntary Stewardship Code was revised in 2020 and the 2023 Green Finance Strategy commits to a review of the regulatory framework for stewardship. In June 2022, the Department of Work and Pensions (DWP) also released guidance for pension schemes on stewardship implementation and reporting.

Sustainable finance policy making slowed down in 2022, with delays in the publication of the first consultation on the UK Green Taxonomy and proposals for sustainability disclosure requirements. More recently, there has been fresh momentum in some key policy areas, including sustainability disclosures by investors, the fiduciary duties of UK pension scheme trustees, and new guidance for businesses on how they can lawfully collaborate on environmental sustainability goals (see table below).

Regulatory developments in the UK since 2019

Policy area	Date	Progress made and next steps
Sustainable finance strategy	2019, last updated 2023	The 2023 Green Finance Strategy aims to maximise the role of private finance in meeting climate and nature commitments.
	2021	A Green Technical Advisory Group is established to provide independent advice on developing and implementing the UK Green Taxonomy.
Clarifying legal duties	2019	The FCA sets out a supervisory statement on enhancing banks' and insurers' approaches to managing the financial risk from climate change (SS3/19).
	2021	The Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations, 2021, requires UK pension schemes to take proper account of climate change and address the risks and opportunities identified in investment decisions, and to do so and make disclosures in line with guidance from the Task Force on Climate-Related Financial Disclosures.
	2023	The Financial Markets Law Committee assesses issues around the fiduciary duties of pension funds in relation to ESG and sustainability outcomes considerations.[89]
	2023	DWP establishes a Taskforce on Social Factors, which publishes draft guidance on how pension schemes can consider social factors and pursue positive social impacts.
Disclosures, labels and product standards	2021	TCFD reporting requirements are extended to enhance climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers.
	2023	The FCA publishes its Sustainable Finance Disclosure Regulations.[90] These are a comprehensive package of measures to help consumers navigate the market for sustainable investment products. They include clear distinctions between integrating ESG risks and setting sustainability objectives.
	2023	The Transition Plan Taskforce publishes a new disclosure framework.
Corporate disclosures	2020	The FCA issues a ruling to enhance climate-related disclosures by listed issuers.
	2020	The Companies (Strategic Report) (Climate-related Financial Disclosure) Regulations 2022 are published.

88 UK Department for Energy Security and Net Zero, et al. (2023), Green finance strategy

89 Paper: Pension Fund Trustees and Fiduciary Duties - Decision-making in the context of Sustainability and the subject of Climate Change - FMLC

90 Financial Conduct Authority (2023), PS23/16: Sustainability Disclosure Requirements (SDR) and investment labels

Policy area	Date	Progress made and next steps
Stewardship	2020	An updated UK Stewardship Code Is published. The FRC's Review of Stewardship Reporting 2022 finds improvements in efforts to address market-wide and systemic risks, but notes there still needs to be greater emphasis from signatory investors on their stewardship activities and the outcomes they achieve.
	2023	The UK Competition and Market Authority (CMA) states it wants to ensure competition policy does not create an unnecessary obstacle to sustainable development and that businesses are not mistakenly deterred from collaborating in sustainability initiatives.[91]

CANADA

The 2021 Legal Framework for Impact report found that Canadian law does permit and may even require investors to consider pursuing positive sustainability impacts as a way to achieve financial returns and protect financial value. Nonetheless, many Canadian investors may be interpreting their legal duties and circumstances in ways that discourage them from considering sustainability impact goals, even where pursuing such goals can help them discharge their duties to prioritise financial returns.

Canada is considered a low-regulation jurisdiction by international standards.[92] For example, sustainability-related reporting and disclosure of stewardship activities by Canadian investors remain overwhelmingly voluntary and there has been limited policy support to promote responsible investment.

There is lack of clear guidance for investors about the scope of the legal duties in relation to ESG factors and sustainability outcomes.

However, Canada's prudential regulator, the Office of the Superintendent of Financial Institutions (OSFI), has stressed the need for there to be sound management of climate risks across the financial system. There are several initiatives underway which aim to ensure that Canada's regulatory and policy framework can help achieve national sustainability objectives and bring sustainable finance policy into alignment with leading international standards.

91 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1139266/Consultation_Document_sustainability_guidance_.pdf
92 PRI (2022), Review of trends in ESG reporting requirements for investors

JAPAN

There has been growing support in Japan for sustainable finance from across the private sector and from policy makers and regulators. For example, the Financial Services Agency (FSA) formed its Sustainable Finance Expert Panel in 2020; it published its first report in June 2021, making important headway in terms of progressing the narrative and discussions being held within the FSA on sustainable finance.

Japanese authorities have made clear that investors are permitted to consider ESG factors where relevant to financial returns. But they were not given the same clarity to approaches that align with investing for sustainability impact. The findings of A Legal Framework for Impact indicated that investors' understanding of their legal duties regarding sustainability goals was discouraging them from taking such action.

'The last year, however, has seen a marked shift in Japan where policy makers are placing greater emphasis on investors' role in relation to sustainability impacts. This is strongly supported by Prime Minister Kishida's policy priorities, especially those covered in his Grand Design and New Form of Capitalism policy. This was revised in 2024 to say that Japan's largest pension funds including GPIF can consider non-financial factors, including impact, when making investments.

Regulatory developments in Japan since 2019

Policy area	Date	Progress made and next steps
Sustainable finance strategy	2020	Japan's FSA establishes an Expert Panel on Sustainable Finance to understand how financial institutions and capital markets can contribute to creating a virtuous cycle between the economy and the environment and achieving carbon neutrality by 2050.[93]
	2020	Climate Innovation Finance Strategy published. Japan Green Growth Strategy Through Achieving Climate Neutrality in 2050 published.
	Annually from 2021	The Expert Panel on Sustainable Finance has published a report annually since 2021. The latest report recognises that "[i]t is now essential to promote sustainable finance, which encourages transition to new industrial and social structures and realizes a sustainable society", recognising both the financial materiality of sustainability factors and the need to contribute to social and environmental goals.[94]
	2021	The Positive Impact Taskforce of the Ministry of Environment publishes an Impact Assessment Guide.[95]
	2021	Climate Innovation Finance Strategy is published, as is the Japan Green Growth Strategy Through Achieving Climate Neutrality in 2050.[96]
	2021	The Positive Impact Taskforce of the Ministry of Environment publishes an Impact Assessment Guide.
	2021	The FSA establishes a Working Group on Impact Investment in 2022. Its role includes exploring how impact investment approaches may be relevant across all asset classes. In 2023, it publishes its first report, compiling options for policy measures to promote impact investing; its Basic Guidelines are finalised in 2024 after public consultation.[97]
	2023	The FSA also launches Japan's Impact Consortium as an interactive communication platform, where impact-driven stakeholders can share their expertise and experiences.[98]

93 Financial Services Agency (2020), Establishment of the "Expert Panel on Sustainable Finance
94 Financial Services Agency (2023), The Expert Panel on Sustainable Finance, FSA The Third Report – Enhancing sustainable finance
95 Ministry of Environment (2021), 「グリーンから始めるインパクト評価ガイド」について
96 Cabinet Secretariat (2021), Action Plan of the Growth Strategy
97 Financial Services Agency (2023), インパクト投資等に関する検討会報告書（案）
98 Financial Services Agency (2023), "Launching Japan's Impact Consortium" Announced

Policy area	Date	Progress made and next steps
Clarifying legal duties	2023	The Sustainable Finance Expert Panel plans to establish investor duties as a standing item on the agenda of proceedings from 2023. Its first report in 2021 addressed some aspects of ESG integration and impact investing. It is revisiting this topic because the market has changed and there is now a greater focus on sustainability impacts.[99]
	2024	Prime Minister Kishida's Cabinet Office Policy on the Grand Design and New Form of Capitalism 2024 revision included the provision that GPIF and the Federation of Mutual Aid Associations, etc. can consider non-financial factors, including impact, when making mid to long-term investment decisions.
Sustainability disclosures	2023	The FSA and the SSBJ have committed to introduce new sustainability disclosure requirements.[100] Corporate sustainability reporting becomes mandatory in 2023. There is strong willingness to adopt the ISSB standards in full and there is scope for the inclusion of sustainability impact-oriented indicators in the framework.
Stewardship	2023	The FSA is currently preparing a revision to its rules on acting in concert. This is expected to address, among other things, barriers to collaboration by Japanese investors on sustainability objectives, and may accompany a wider revision of the stewardship code.[101]

99 Financial Services Agency (2023), The Expert Panel on Sustainable Finance, FSA The Third Report – Enhancing sustainable finance

100 Sustainability Standards Board of Japan (2024), The SSBJ issues Exposure Drafts of Sustainability Disclosure Standards to be applied in Japan

101 Financial Services Agency (2023), Regarding the results of public comments on the proposed amendments to the "Cabinet Office Ordinance on Disclosure of Corporate Information etc."

CREDITS

Written by Rob Nash and Kelly Krauter, PRI
Edited by Mark Nicholls
Designed by Will Stewart, PRI

CONTRIBUTORS:

This report was prepared by the PRI, UNEP FI and the Generation Foundation. The project team would like to thank the report contributors and reference group signatories:

- Laura Canas da Costa, UNEP FI
- Grace Eddy, Generation Foundation
- Louisa Guy, PRI
- Nikki King, PRI
- Will Martindale, Canbury Insights
- Emmet McNamee, PRI
- Alina Necula, PRI
- Kazuma Osaki, PRI
- Alison Paton, Generation Foundation
- Margarita Pirovska, PRI
- Hazell Ransome, PRI
- David Rouch, Freshfields Bruckhaus Derringer
- LFI Reference Group

ABOUT THE PROJECT

A Legal Framework for Impact is a flagship project of the Principles for Responsible Investment, the United Nations Environment Programme Finance Initiative and the Generation Foundation. The project is part of the Investment Leadership Programme, a joint initiative between the Principles for Responsible Investment and the United Nations Environment Programme Finance Initiative, created to accelerate collaboration among leading investors and boost action on achieving key global sustainability objectives. The project aims to identify and overcome the barriers to a financial system that is consistent with achieving the Sustainable Development Goals and limiting global warming to 1.5°C. Freshfields Bruckhaus Deringer were commissioned to produce a report on the extent to which legal frameworks in 11 jurisdictions enable investors to consider the sustainability impacts of their activities. The report provided the first comprehensive analysis of how far the law requires or permits investors to tackle sustainability challenges in discharging their duties – a practice called "investing for sustainability impact" or IFSI. The project is a multi-year work programme and is now focused on five key markets: Australia, Canada, Japan, the European Union and the UK.

ABOUT OUR PARTNERS

The Generation Foundation is a philanthropic organisation that was established in 2004 alongside the sustainable investment firm Generation Investment Management. Over the last 20 years, it has used strategic research, grant-making and advocacy to unlock the power of capital markets to drive a more sustainable economic system. Its vision is a sustainable world in which prosperity is shared broadly, in a society that achieves wellbeing for all, protects nature and preserves a habitable climate.

UNEP Finance Initiative brings together a large network of banks, insurers and investors that catalyses action across the financial system to deliver more sustainable global economies. For more than 30 years the initiative has been connecting the UN with financial institutions from around the world to shape the sustainable finance agenda. It has established the world's foremost sustainability frameworks that help the finance industry address global environmental, social and governance (ESG) challenges. Convened by a Geneva, Switzerland-based secretariat, more than 500 banks and insurers with assets exceeding US$100 trillion are independently implementing UNEP FI's Principles for Responsible Banking and Principles for Sustainable Insurance. Financial institutions work with UNEP FI on a voluntary basis and the initiative helps them to apply the industry frameworks and develop practical guidance and tools to position their businesses for the transition to a sustainable and inclusive economy.

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

PRI Principles for Responsible Investment

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP Finance Initiative brings together a large network of banks, insurers and investors that catalyses action across the financial system to deliver more sustainable global economies. For more than 30 years the initiative has been connecting the UN with financial institutions from around the world to shape the sustainable finance agenda. It has established the world's foremost sustainability frameworks that help the finance industry address global environmental, social and governance (ESG) challenges. Convened by a Geneva, Switzerland-based secretariat, more than 500 banks and insurers with assets exceeding US$100 trillion are independently implementing UNEP FI's Principles for Responsible Banking and Principles for Sustainable Insurance. Financial institutions work with UNEP FI on a voluntary basis and the initiative helps them to apply the industry frameworks and develop practical guidance and tools to position their businesses for the transition to a sustainable and inclusive economy.

UN environment programme | finance initiative

United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org