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# A changing landscape

## Rising risk, rising regulation | ESG regulation
UBS Asset Management

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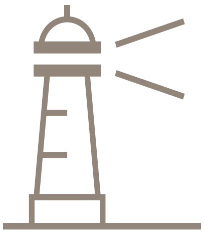
Transitioning to a sustainable economy is fast becoming a priority. And as politicians seek to direct capital towards sustainable investments, environmental, social and governance (ESG) regulations directed at the financial sector – including asset management – are on the rise.

We take a closer look at the changes underway with a focus on the European Union (EU), a leader when it comes to sustainability regulation. In particular, we outline:



- The key drivers behind the need to re-shape our economy to one which is more sustainable
- The main initiatives transforming the regulatory landscape
- Challenges and limitations inherent within those policies and frameworks
- Next steps

If we want a reason for this shift in focus towards greater sustainability, we need look no further than the **WEF Annual Global Risks Report** and the dominance of environmental risks. Given the threat these pose to economic and financial stability, it is hardly surprising that policy makers are responding.

At a global level, international initiatives such as the **UN Paris Agreement** and the **UN Agenda for Sustainable Development** are providing countries with targets around which they can develop regulatory frameworks. Policy bodies, including **The Financial Stability Task-force on Climate Related Financial Disclosures (TCFD)** and the **UN Principles for Responsible Investment**, are providing guidance and recommendations at a global level. Meanwhile, at a local level, regulators such as the **UK Prudential Regulation Authority** and the **UK Financial Conduct Authority** are exploring ways in which finance can address climate issues. **The French Energy Transition for Green Growth law**, is tackling similar considerations.

Perhaps the most ambitious efforts currently are to be found in the **EU action plan on sustainable finance** – a ten point plan aimed at:

- Re-orienting financial flows
- Managing financial risk
- Encouraging transparency and long-termism

Proposed legislation sets out new rules covering:

- A taxonomy – defining what a sustainable activity is
- Sustainability disclosures
- Sustainable benchmarks
- How firms integrate sustainability risks

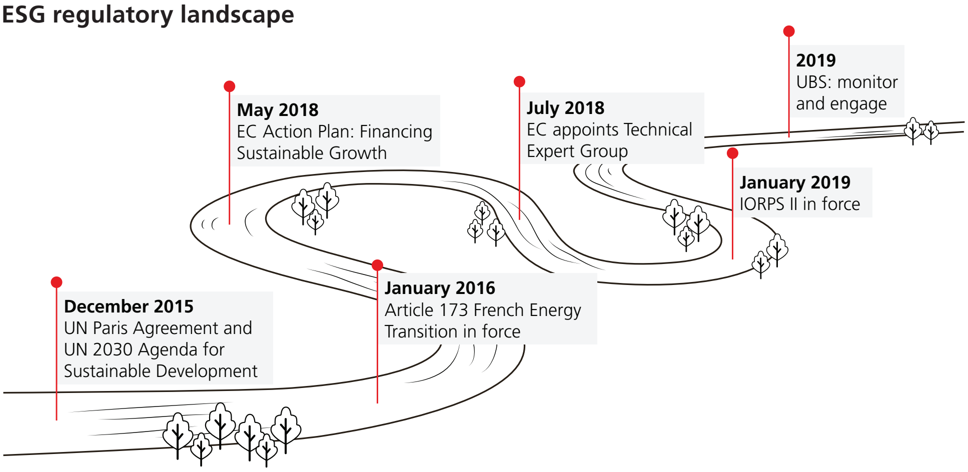
A **technical expert group (TEG)**, comprising industry experts, academics and civil servants is advising the European Commission on some of these topics. While much still needs be to done, progress is meaningful.

These initiatives are well intentioned but not without challenges. This is a transition which must occur over time, balancing ideological and pragmatic considerations.

The question of the taxonomy is a key case in point. The lack of a common framework and terminology for sustainable activities and investments is a longstanding concern. The intention of a **standardized taxonomy** is to achieve consistency and avoid 'greenwashing' – the practice of labelling an activity as sustainable when in fact it isn't. While the concept is welcome, ultimately, the way in which the taxonomy is calibrated will determine its usefulness. Too broad, and its use is limited, too narrow and it could unintentionally exclude companies or sectors which could, in fact, contribute to the transition towards a sustainable economy.

Greater levels of sustainability disclosure, both for financial firms and corporates, are generally seen as positive. Crucially though, **globally accepted disclosure** standards need to be developed, particularly given that asset managers invest globally, across companies of all sizes.

**Navigating the ESG regulatory landscape**




This standardization requirement feeds through to benchmarks. The EU is seeking to develop an EU 'quality assurance mark', initially in the form of an EU 'Climate Transition' benchmark and an EU 'Paris Aligned' benchmark. These will carry greater levels of disclosure, making it easier for consumers to compare products. Again, usability will determine success and at this stage concerns exist around the narrow scope of the Paris aligned methodology.

This brings us to the fourth area of focus, integration of sustainability risks. These fall into two parts: the way in which firms integrate sustainability into their investment and operational processes, and the way in which they integrate clients' sustainability preferences. For some firms, integrating sustainability risks and preferences will be mandatory - a move seen as broadly welcome. Any concerns center more around the need to keep any changes to the sales and distribution process simple and workable, given how soon they come after the MiFID II regime.

Looking ahead, it is clear that asset owners and asset managers will need to work together over time, not only to meet the requirements of the emerging financial frameworks legislation, but also to reap the financial and other benefits of sustainable investing.

As Julie Hudson, Global Head of ESG Research, UBS Investment Bank, recently said, "ESG will become "business as usual" at least partly because of a substantial body of regulation, which will act as an important catalyst, whatever anyone thinks about the detail, and however much doubt people may have about lists and taxonomies."

Source: ESG Keys: ESG Rules & Regs Expansion Global Sustainability: What Does it Mean? Julie Hudson CFA, Victoria Kalb. UBS AG July 2019

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A taxonomy – defining what a sustainable activity is

Sustainability disclosures

Sustainable benchmarks

How firms integrate sustainability risks

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