Semi-Annual ESG Sentiment Study of Canadian Institutional Investors

February 14th, 2022

In December 2021, Millani conducted its Semi-Annual ESG Sentiment Study of Canadian Institutional Investors, with asset owners and managers responsible for managing over CA $4.0 trillion.[1] This study is conducted to highlight and understand key trends related to environmental, social and governance (ESG) integration and to capture a uniquely Canadian perspective.

Everyone can agree that 2021 was the year we saw unprecedented changes across various industries. The financial industry was no exception. The level of ESG integration in the financial sector and significant growth in sustainable fund assets have surprised many, including investors.

In our interviews, investors shared that ESG integration became a firm-wide initiative in 2021. This came with its challenges, including investors feeling overwhelmed and the unavailability of ESG data. ESG adoption comes with the risk of greenwashing, which continues to be top of mind for investors. Looking forward, investors continue to focus on engagements and transition financing, rather than pure divestment.

This report provides a deep dive of the key changes and trends observed by some of Canada's largest asset owners and managers.

1. Approximate amount calculated from public sources.

Sustainable finance and ESG trends

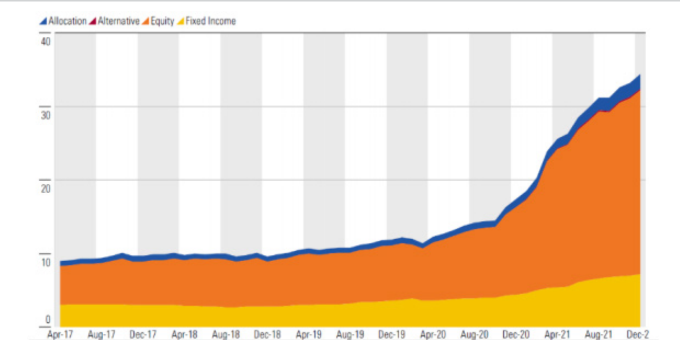
ESG integration is a firm-wide initiative

Globally, a lot happened in 2021. The ESG field was no exception. In December 2021, Millani conducted a sentiment study with Canada's largest institutional investors to gather their insights on key ESG trends. More than 85% of the respondents affirmed that they were planning to emphasize or improve their offering on responsible investment in the coming year.

"We didn't expect investors to focus on ESG considerations, but the pandemic has only enhanced ESG investing appeal." Asset Owner

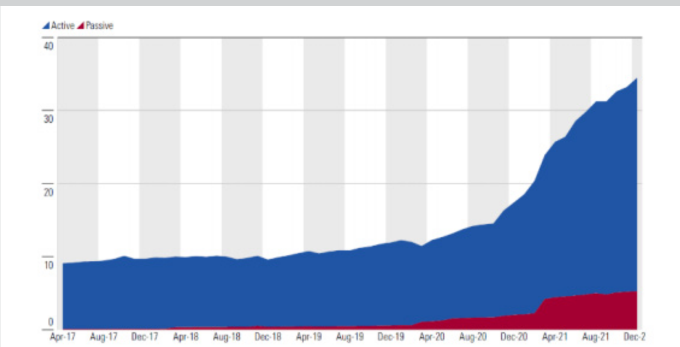
As highlighted by Figures 1 and 2 below, sustainable fund assets keep increasing, with a high growth rate amongst passively managed funds.

Figure 1
Canadian Sustainable Fund Assets by Asset Class



Note: Excludes Funds of Funds, CAD, Billions.
Source: Morningstar, 2021.

Figure 2
Canadian Sustainable Fund Assets, Active vs. Passive



Note: Excludes Funds of Funds, CAD, Billions.
Source: Morningstar, 2021.

One of the biggest surprises for investors in 2021 was the pace of change over the year, with many noting that ESG integration became a firm-wide initiative. A recent global survey shows that in 2021, 45% of institutional investors say their ESG capabilities are embedded throughout the organisation, compared to 23% in 2019.[2]

"If you would have asked me five years ago if I would ask myself all these ESG questions I would have said no. Today, we are hiring employees and ESG is a priority topic in our firm-wide discussions." Asset Manager

These systemic changes involve a significant amount of ESG-related information (news, announcements, initiatives, regulations in different jurisdictions, etc.). There is pressure to move quickly on integrating ESG factors into investment process, and some professionals expressed feeling overwhelmed and burned out.

"Firms want to integrate ESG fast and external pressures are causing this integration to be rushed. A challenge for financial professionals will be to manage the overwhelming feeling that comes with the fast integration." Asset Manager

"We have to consider the big H [for Human] behind ESG. People are burned out." Asset Manager

The ESG burnout has not gone unnoticed. In December 2021, Responsible Investor published an article regarding burnout in the ESG space,[3] and it was the most read article of the year.

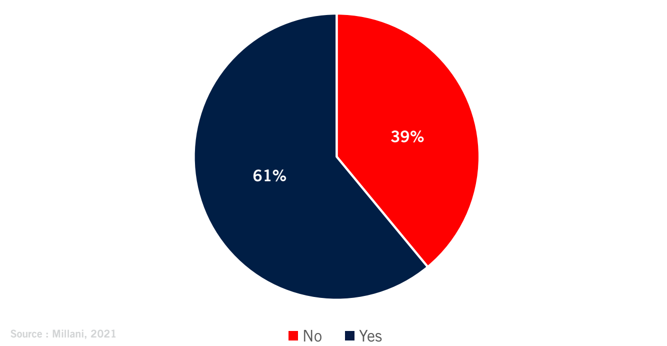
Investors are facing data challenges

One of the biggest challenges investors face when integrating ESG and assessing sustainable finance offerings is the availability of data, which impacts their ability to track and report standardized ESG metrics. In fact, 61% of investors shared that tracking information and the availability of data was one of their top three challenges when it comes to ESG integration.

2. BNP Paribas, "The ESG Global Survey 2021 – The Path to ESG: No Turning Back for Asset Owners and Managers", September 2021.
3. Responsible Investor, "A letter to sustainable finance professionals: ESG burnout is real. I know because I have it.", December 2021.

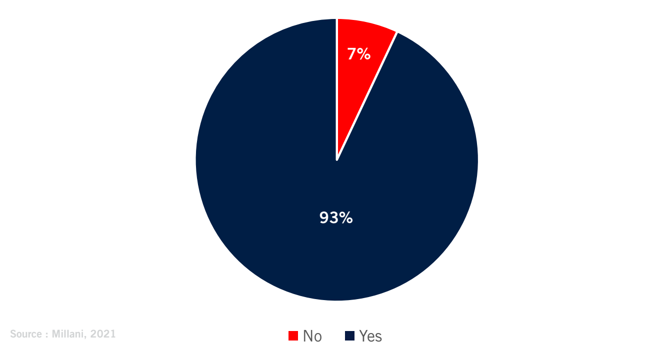
"Data availability remains a challenge, which makes the reporting aspect complicated [for investors]." Asset Manager

Figure 3
Tracking information and the availability of data is one of investors' top 3 challenges



Investors acknowledge corporate issuers' progress on ESG disclosures, with 93% of investors highlighting that issuers are being increasingly proactive in their ESG communications.

Figure 4
Have corporations' disclosures improved in 2021?



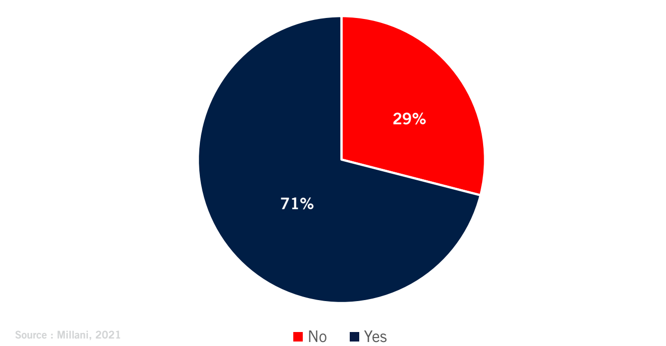
"ESG is being talked about with a value-added aspect instead of checking some boxes and it has translated into increased disclosures." Asset Manager

"Some companies were reluctant to disclose at the beginning and now, it's not about 'if' they will disclose but rather 'how'." Asset Owner

Investors also noted that they are feeling pressure to report on their own ESG topics to their clients, particularly climate-related reporting. This trend has been highlighted in the Taskforce on Climate-related Financial Disclosures' (TCFD) latest Status Report published in October 2021, where it noted that in 2021, 1,069 financial institutions supported the TCFD, compared to 700 in 2020. These financial institutions were responsible for USD $194 trillion in 2021 compared to USD $150 trillion in 2020.[4] 83% of investors interviewed noted they are either producing, or intend to produce, a TCFD report in 2022.

71% of investors interviewed noted they are trying to calculate the carbon footprint of their portfolios. The biggest challenge remains the availability and reliability of climate data as it is not homogenous across all asset classes.

Figure 5
Do you calculate the carbon footprint of your portfolio?



"One of the biggest challenges has been to reach Scope 1 and 2 emissions reporting consistency. In fact, the reliability of emissions accounting and the inconsistency of carbon intensity metrics used by issuers have represented challenges." Asset Manager

4. Task Force on Climate-related Financial Disclosures, 2021 Status Report, October 2021.

"The fixed income emissions data is very sparse, which makes it challenging to conduct meaningful analysis from that data." Asset Manager

Regulators are stepping up to help. In October 2021, the Canadian Securities Administrators (CSA) opened a public consultation on potentially mandating certain climate-related disclosures for Canadian issuers. The overwhelming sentiments from our interviews were concern that the CSA might not go far enough, that it may only meet minimum global standards and that it would be important for Canada's competitiveness to demonstrate leadership.

"Investors are looking for relevant decision-useful information and when it comes to climate change, we do not have that yet. […] We are seeing other countries and regions of the world that have made climate disclosures mandatory and we want Canada to be a competitive market." Asset Manager

"As asset owners, we need to report our own climate-related activities and we need to understand the exposures of the companies we invest in. To do so, we need Scope 1 and 2 emissions and Scope 3 emissions data, if they are material, to understand how these entities are governing climate-related risks and opportunities." Asset Owner

Investors expressed that they want standardized metrics in disclosures, with a focus on material ESG topics. They conveyed that their focus was moving from just environmental topics towards social and governance topics in 2022, and are looking for mandatory disclosures to move beyond climate as well.

"We want to draw the spotlight on social and governance issues. On the social side, we want to look at workers' conditions, compensation parity, internal advancement opportunities and training. On the governance side, we want to look at information on pay equity, pay package alignment, compensation, diversity, and decision rights in line with diversity." Asset Manager

Supporting this desire was the announcement in November 2021 of the International Sustainable Standards Board (ISSB), which has been embraced by investors.

"The creation of ISSB is a natural way to consolidate ESG data and reporting standards." Asset Manager

"It will add a level of comfort and will be complementary to other frameworks that are less accounting oriented." Asset Manager

Engagement is growing as an active ownership tool

Investors recognize that stewardship remains an important part of their responsibility. As they look to 2022, most believe that climate change will continue to be a priority, however, many expect their engagements this year to also focus on human capital and governance.

"Every industry is facing human capital shortages. Companies must now go the extra mile to attract, retain, and train their employees or have a different approach to attract employees and keep them. A change of mindset is required." Asset Manager

Investors see collaborative engagement initiatives, such as the newly launched initiative of Canadian Institutional Investment Network (CIIN) to engage on climate action, Climate Engagement Canada (CEC), and the Canadian Coalition for Good Governance (CCGG) as powerful mechanisms, and time-efficient ways to engage. Issuers should brace for increased demands for engagements with their investors, and on topics beyond climate change.

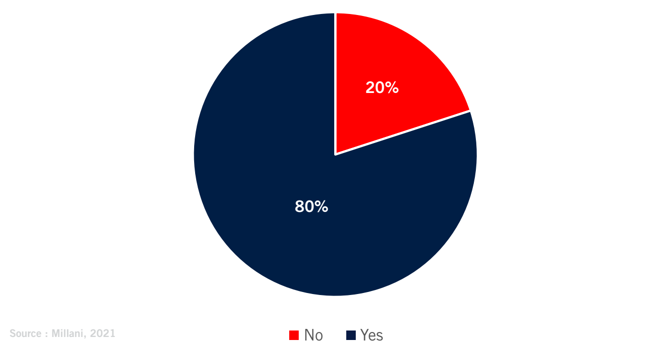
"The return on the time spent, and the impact achieved, is much higher with collaborative engagements [than with one-on-one engagements], so we will continue to focus on collaborative engagements." Asset Manager

"We expect new initiatives that gather investors to engage with issuers on different ESG topics." Asset Manager

A move from divestment to transition?

Throughout 2021, there was another significant shift. We witnessed an increased focus towards transition financing, with high levels of engagement, rather than divestment. 80% of the interviewed investors, representing more than CAD $3.5 trillion, said they were shifting their approach and were acknowledging the holistic nature of markets. If the goal of a company is to get to net-zero, they need to financially support the organizations that are going to put commitment into action.

Figure 6
Are you observing a shift in the market towards transition financing and away from pure divestment?



"We see engagement as being the right approach. For businesses to achieve sustainability goals, they need capital, so divestment is counter-productive." Asset Manager

"The increase in engagement activities is driven by the realization [by investors] that just because a publicly listed company sets decarbonization goals and sells off carbon intensive assets, it does not mean that these assets go away. We need a holistic approach to think about net zero." Asset Manager

They indicated however, that there remains a high level of confusion on this topic and that there remains a need to educate clients on the importance of engagement and supporting the transition to a lower carbon economy.

"There are a lot of clients that are not yet positioned [for the transition], and it is up to investors to educate those clients and explain the implications of transition financing." Asset Manager

"There is an educational component to it. As an investor, you need to educate clients that ESG does not necessarily mean divesting or excluding investments, ESG is more sophisticated than this." Asset Manager

Greenwashing will continue to be top of mind for investors

One of the challenges that comes with sustainable finance's rapid evolution is the risk of greenwashing. Given the pressures investors feel from their clients and the financial market to remain competitive, interviewees acknowledged the need for clarity around ESG-related products.

"Many asset managers are launching products to meet their clients' heightened expectations and want to do so as fast as possible. The risk that comes with this is greenwashing: asset managers are launching new products, but the credibility of these [ESG] products can be questionable." Asset Manager

"We expect to see more regulatory scrutiny on responsible investment products' claims and marketing claims related to ESG products." Asset Manager

Shortly after our study, the CSA published a Staff Notice on January 19, 2022, providing guidance on ESG-related investment funds' disclosure practices. The CSA's Staff Notice has also set expectations relating to engagements and proxy voting, highlighting that "more than half of the funds reviewed use proxy voting as a strategy to achieve their ESG-related investment objectives [but] more than half of those funds did not disclose this in their investment strategies disclosure."[5] We believe that this will lead to a continued focus on engagements, voting, tracking and formalized processes, all leading to more structure and demands, and higher expectations for both investors and issuers.

5. Canadian Securities Administrators (CSA), CSA Staff Notice 81-334: ESG-Related Investment Fund Disclosure, January 2022.

Conclusion

Investors are moving quickly to formalize the integration of ESG into their investment processes. At the same time, regulators are also advancing and focusing their oversight on potential greenwashing. This scrutiny will only continue as the level of competitiveness grows and assets continue to flow.

For investors, the need to demonstrate how you integrate ESG has never been higher. With this comes the need to understand, manage and disclose on your own ESG topics.

For issuers, brace yourselves. Your efforts are being acknowledged. However, for investors to meet their own objectives and to report publicly on their own performance, they need standardized disclosure of data. This push will continue at a feverish pace, so ensure that you have appropriate resources allocated to meet this growing demand. Strategically marketing and communicating on your ESG efforts has never been more important and more difficult.

At Millani, given our capital markets' experience, we are well positioned to support issuers and investors identify their material ESG risks and opportunities and effectively communicate their management approach and performance of these topics to different stakeholders. Find out more about Millani's services here: www.millani.ca.

Contributors

Thank you to our contributors who took the time to provide their insights on key ESG trends. Our contributors represent 19 of Canada's largest institutional investors, some of which are listed below.

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About Millani

Millani provides advisory services on ESG integration to both investors and companies. For the past 14 years, Millani has become the partner of choice for institutional investors. By providing advisory services on developing ESG communications, engagement and disclosure strategies and integrating material ESG issues into their investment strategies and decision-making processes, we help our clients reduce risks, increase returns, and create value. Millani is also leveraging this expertise and its experience in ESG consulting to help reporting issuers improve their ESG disclosure to financial stakeholders and optimize their market value.

For more information, contact us at info@millani.ca or visit our website: www.millani.ca.