Semi-Annual ESG Sentiment Study of Canadian Institutional Investors

August 23, 2023

Key observations

In June 2023, Millani conducted its Semi-Annual ESG Sentiment Study of Canadian Institutional Investors, with 40 asset owners and managers representing over CA $5.8 trillion in assets under management.

Key observations include:

- **The pushback on ESG is having the reverse effect.**
  As a result of the politicization and pushback on ESG in the United States, investors are reviewing Responsible Investment processes and further integrating the consideration of environmental, social, and governance factors into their fundamental approaches, making it more mainstream.
- **Human capital and human rights have become increasingly important to investors.**
  Human capital and human rights (including Indigenous reconciliation) now ranks with equity, diversity and inclusion (EDI) as the second most important ESG topic for Canadian institutional investors.
- **Canadian investors are ready to provide capital to transition projects.**
  Canadian institutional investors shared their need and interest in a national transition taxonomy to help them better identify and finance transition and green projects.
- **Investors are rethinking their approach to engagement.**
  With scarce resources and an evolving regulatory environment, collaborative engagements can help investors convey a strong message while managing time and resource constraints.
- **The concept of 'sustainability outcomes' continues to be of interest.**
  In their stewardship activities with investee companies, investors are beginning to integrate a three-dimensional model (risk, return and sustainability outcomes).

Interest rates, inflation and market regulations preoccupy investors

Unsurprisingly, broad market themes like interest rates, inflation and market volatility have been preoccupying Canadian institutional investors throughout the first half of 2023.

As Millani undertook its seventh edition of this Study, with 40 asset owners and asset managers (representing CA $5.8 trillion in assets under management), it was apparent that investors are feeling the pressure from many angles: regulatory changes in responsible investing (RI), geopolitical risks, climate change, and the quality and availability of ESG data.

"It's a tough environment as an investor right now." (Asset Manager) Business risks driven by an economic slowdown and potential recession have investors questioning overall market valuations. It was noted, however, that **"most of our businesses are not levered and Canadian banks are capitalized."** (Asset Manager)

Given this macro environment, investors have been shifting asset allocations, anticipating change in the next 12 months. In particular for RI and ESG mandates, some are asking: **"How do we maintain the relevance of our ESG mandate given the current environment of a potential recession while regulators continue to evolve how we address and define terms [in the industry]?"** (Asset Manager). Many investors acknowledged that their **"largest time allocation has been assessing and responding to regulators signalling their intent to be more active on ESG."** (Asset Manager) Evolving regulation and labelling for investment products, largely driven by the EU Sustainable Finance Disclosure Regulation (SFDR), saw many firms focusing on assuring that their ESG products and related communications were aligned.

"There has been a lot of scrutiny around the language we use. It echoes the regulatory scrutiny we have been subject to."
– Asset Manager

Is the "ESG pushback" having the reverse effect?

As investors encountered growing tension in the USA regarding the term "ESG", and its use by political figures at the federal and state levels, we were intrigued to see how Canadian investors were experiencing what has been referred to as the "ESG pushback".

"Backlash on ESG shows the healthy maturity of the industry. Some issues need to be dealt with and it brings us back to fundamentals, which is fiduciary duty. As ESG becomes mainstream, and because of the backlash, we are being more traditional in terms of our approach and language."
– Asset Manager

In alignment with the regulatory changes relating to fund labelling and classifications, **"We are being mindful about our headline, client facing and public facing communication, not to "greenhush", but not getting involved in big labels. We are investing the way it's best to invest, to meet our fiduciary duty."** (Asset Manager)

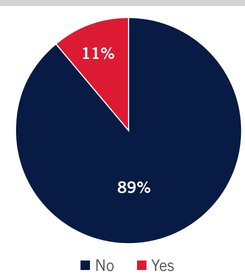
Some communicated that the pushback has been good for business as it has brought opportunities to gather more assets for those who can demonstrate they already have a track record in integrating ESG. **"We associate [the pushback] with misunderstanding. It awakens the need for better classification. It has had a good impact for us, because we were doing it [ESG integration] in a proper inclusion approach."** (Asset Manager)

Others went as far as to say, **"The backlash we see is very specific to the US. I don't think it will contaminate Europe or Canada. It goes back to a lack of understanding of what ESG integration truly is. It is not impact investing. There are different types of strategies [in a market] and a lot of misuse of the word "ESG". It creates a lot of confusion and misunderstanding of the responsible investing ecosystem."** (Asset Manager)

The ESG headwinds may be having the opposite effect to what was originally intended. It appears to have caused many investors to review and ensure that their ESG practices are mainstreamed within their firms, rather than be a sidelined approach. **"The pushback is not changing responsible investment approaches, but deepening the quality of those approaches within organizations."** (Asset Manager) As an outcome, investors are ensuring their communications are aligned with the regulatory principles being set as a global baseline.

It may well be that the term "ESG" has passed its expiry date, but the ESG integration investment approach seems well entrenched. Of the investors who commented on the pushback, 89% of them said it had no impact on their business (as shown in Figure 1). Most see this pushback, together with global regulatory efforts, as healthy for the industry in the medium to long term.

Figure 1
Has the ESG pushback in the USA impacted your investment approach?[1]



1. Note : Not all respondents answered this question; results are based on a sample of the total population.

How much regulation is enough?

As much as investors communicated a strong desire for regulations and standards, in order to have access to decision-useful disclosures, some mentioned that **"regulations are becoming the enemy of themselves. Issuers, asset owners and asset managers are taking more time to file the required reports than focusing on the real purpose of the regulations – to influence the market."** (Asset Owner) Others suggested that **"we are in the adult phase of ESG, leading to a more regulated approach."** (Asset Manager)

Resource requirements needed to ensure alignment to new regulation were frequently noted as a major challenge. There is an upscaling of internal investment teams across the board, as well as a growing need for quality data. The hope is that the newly announced disclosure requirements by the ISSB (International Sustainability Standards Board) will help alleviate some of these resource costs.

The global investors interviewed highlighted some additional challenges. **"We have seen different metrics based on the regulatory framework used. Some quirky parts of the regulations cause us to calculate data and metrics differently than before. The UK Financial Conduct Authority (FCA) and TCFD reporting is more streamlined with our approach. The biggest difference is that one metric might look different in one report versus another, because of different regulatory requirements [for disclosures], so it makes it difficult to compare our data. It has been the most challenging regulatory aspect for us."** (Asset Manager)

Due to these challenges, it was suggested that **"disclosure requirements will be challenging. We would like to report metrics and report to the same extent as we do financial reporting at the firm level, but it's hard to implement now."** (Asset Manager)

Others suggested that the EU SFDR, noted by 25% of interviewees as the most impactful regulation in the past year, is now their "best in class" baseline. **"[We are] looking to the EU SFDR as we are a global asset manager and we sell our funds everywhere. Our mindset is, if you are compliant to Article 8 or 9 of SFDR, you are probably the best in Canada, and we want to be compliant everywhere."** (Asset Manager)

The most commonly anticipated change is the ISSB S1 and S2 standards, released on June 26, 2023. **"We can't wait to see the impact it [ISSB] is going to have on companies and on us, in terms of responsible investment. It's going to bring a certain minimum to companies [...] It will make it simpler, more top of mind for the average CFO. If it is well delivered, and the world adopts it, it's going to have an impact on the [investment] industry and companies."** (Asset Manager)

"These [ISSB] standards will clean things up and then we can concentrate on concrete actions." *– Asset Manager*

Is there a need for a Canadian transition taxonomy?

The Canadian transition taxonomy has been in the works for a number of years. It was highlighted by the Sustainable Finance Action Council (SFAC) in its Sustainable Finance roadmap, published in March 2023.[2]

Many investors are in support: **"We need a taxonomy."**

"We hope that Canada gets that taxonomy. It is moving too slowly, there's got to be a better momentum. We need more sustainable finance stimulus programs, it [a taxonomy] will be impactful. The taxonomy will be helpful in defining these investments." *– Asset Manager*

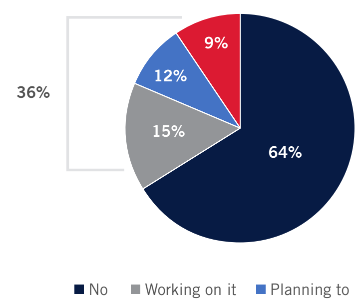
The Canadian taxonomy is a foundational tool to help mobilize and accelerate the deployment of capital to combat climate change. To meet its 2050 net-zero economy objective, Canada will require climate investments of approximately CA $125 billion to $140 billion annually.[3] Canada's current level of climate investments is about CA $15 to $25 billion annually. The taxonomy will help unlock a new market for transition financing that is urgently needed to reduce emissions while scaling up technologies and infrastructure. Moreover, the taxonomy will provide a common language to identify what does count as green and what does not, mitigating "greenwashing" risk from issuers.

Some firms are waiting for the release of a public taxonomy. **"We are going to wait and see. We want to use public information. Internally when doing [ESG] integration, we leverage the SASB (Sustainability Accounting Standards Board) framework heavily, so we prefer a public framework that everyone can adopt and see."** (Asset Owner)

However, due to the lack of progress, some firms have started to create their own investment guidelines for products that would typically be covered by such a taxonomy, so they can start classifying investments and avoid greenwashing accusations. Of the firms surveyed, 36% are currently working on, or planning to create, their own guidelines in the absence of a public taxonomy.

2. Canadian Climate Institute, Canada's new climate investment taxonomy framework critical to securing competitiveness, achieving targets, experts say, March 2023.
3. (Adjusted from) Sustainable Finance Action Council, Taxonomy Roadmap Report, September 2022.

Figure 2
Does your organization have its own "taxonomy" for classifying investments?[4]



In the absence of a taxonomy and given the heavy weighting of the Canadian economy to resources, and therefore, the need for businesses to decarbonize, the question of where Canadian businesses will get access to capital to compete with countries like the USA, with its Inflation Reduction Act (IRA), are front and center.

"From a market point of view, we see interest rates rising and investors shortening their horizons. There are changing dynamics in the market and investors are not rewarding companies making the significant long-term investments. Hopefully regulations in the US and Europe will incentivize investors to recognize the value in these investments."
– Asset Manager

Transition products – is there a market?

Issuers are questioning if there is sufficient appetite from investors for transition-oriented investments. Some investors suggested there that the demand is there, but there is not yet ample supply. **"Issuers need to issue the transition products. Even if we have our [Canadian] taxonomy, if we have no products on the market because they [issuers] are too scared, for whatever reason, then it is useless. We will buy. We have been trying to push companies to issue transition products, but issuers need to be at the right place in terms of their ESG strategy, and their climate transition."** (Asset Manager)

There also appears to be growing frustration with issuers noting that **"there is impatience from stakeholders because we are way behind. We want to be realistic in terms of timelines [we would invest with issuers] but we are still seeing pushback. It is really, really hard to sympathize with companies as some of them are not doing the baseline yet, such as reporting their emissions."** (Asset Owner)

There is an anticipated need for as much as CA $115 billion per year in new investments to transition Canada to a lower-carbon economy.[5] Participants were asked what their anticipated investment timelines for a transition-oriented investment would be. Some investors were very clear, citing five years. However, there were inconsistencies. Investors suggested that private markets might consider longer timelines.

"We look at companies as a whole. To us, it is not at the project level that we look and should look. Looking at the project means verifying the use of proceeds and determining if it falls into either a green or transition taxonomy [or product]. Timelines for us can be five, ten, twenty or thirty years for corporate issuers, with usual investment in the three to eight years. [As an investor], you need to build a curve with different terms and it needs to be diversified in many different ways and aspects." (Asset Manager)

Others have suggested that they have **"no clear timeline, as long as the traditional business is doing well, while the new one is growing. It is just sound management, a matter of total cashflow of the firm and how well it is managed. They [issuers] can make the calculations, somehow you know what a viable project is or isn't, there are different ways to evaluate a project and methods. It is not a delay or time question. There are companies that will take five or ten years to develop new products, but their stock price will do well and be promising. But another can be cash flow negative for ten years for that project, but if it is well done and you report on your progress, you will be rewarded, and your stock price will still go up."** (Asset Manager)

The general sentiment of these investors is that there is great interest and hunger for these transition-oriented products, however, many expressed the need to consider returns. **"Transition, yes - if it doesn't hurt the returns too aggressively."** (Asset Manager) The secret for issuers will be to have a transition plan, a demonstration on how capital expenditures and operating expenditures align to that plan, and regular disclosures.

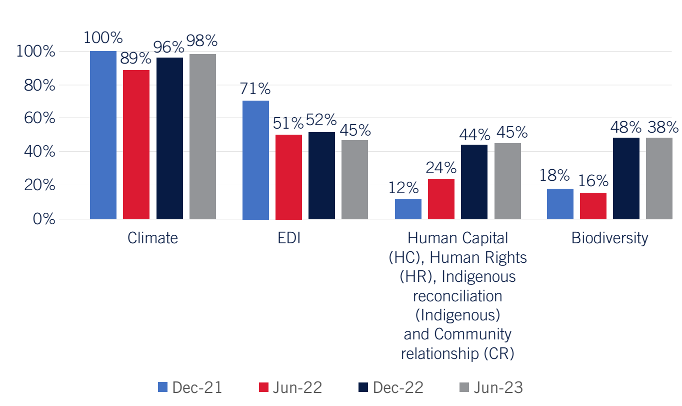
Climate is still top of mind for investors. Focus is dropping on EDI but rising for human capital

To gauge how the market interest in ESG topics is shifting, participants are asked what their top three ESG focus topics are in each iteration of this Study. In June 2023, the four most frequently mentioned ESG topics remained very similar to the results from December 2022 (Figure 3), with 98% of investors identifying climate change as a top ESG focus area.

4. Note: Not all respondents answered this question; results are based on a sample of the total population.
5. (Adjusted from) Sustainable Finance Action Council, Taxonomy Roadmap Report, September 2022.

Figure 3

Most frequently mentioned ESG focus areas[6]



Equity, diversity and inclusion (EDI) remains second to climate overall. However, when assessing the hierarchy of topics for investors, biodiversity was cited as the second most important issue 24% of the time, and EDI 19% of the time (see Figure 4). Human capital & human rights (including Indigenous reconciliation) was cited as the third most important topic 22% of the time and EDI 17% of the time (see Figure 5).

At the same time, investors are recognising the interconnectivity between climate change, biodiversity loss, Indigenous rights and reconciliation, human capital and human rights. Inequality as another facet of climate change was also discussed, again demonstrating the acknowledgement of the interconnectivity of these issues.

Although EDI remains an important focus area, momentum and recognition around human capital & human rights and biodiversity is increasing, with investors placing an increased focus on these topics.

Figure 4

Frequency of the ESG topic identified as being the second most important

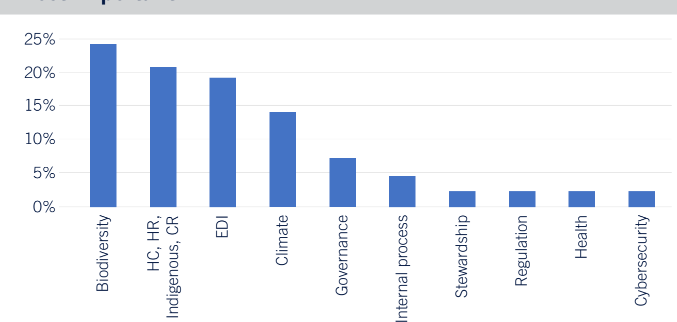
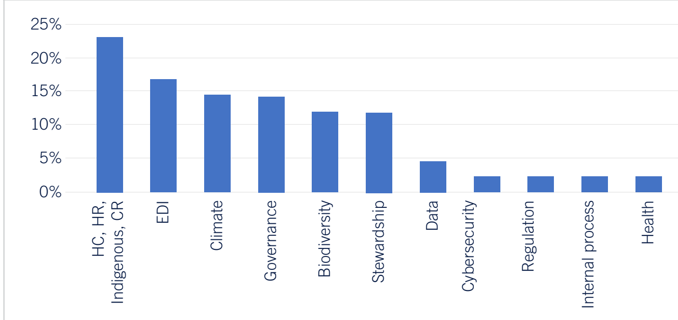


Figure 5

Frequency of the ESG topic identified as being the third most important



Consultation fatigue?

At the time of this Study, the Canadian Securities Administrators (CSA) was seeking public comments on its Corporate Governance Guidelines pertaining to the director nomination process, board renewal and diversity.[7] Approximately 50% of participants had not heard of the consultation, likely due to it taking place during a heavy proxy season. The CSA has since extended the comment period to September 29, 2023.[8]

Investors appeared overwhelmed by the number of market-related consultations and engagements they are expected to participate in, or lacked the internal resources and time needed to respond. As such, collaborative engagement will become an important tool to manage investor resource and time constraints. For issuers, collaborative engagements are expected to take more market presence, so preparing strong engagement strategies will be critical.

ISSB has released a consultation to understand where market participants believe it should focus next.[9] Of investors interviewed, 37% said that biodiversity, ecosystems and ecosystems services should be ISSB's top priority. This was followed by human capital at 24%, the integration with the International Accounting Standards Board (IASB) at 21%, and human rights at 18%.

6. Some organizations had more than one participant. This may be reflected in the data.
7. Canadian Securities Administrators, Canadian securities regulators propose changes to corporate governance disclosure practices and guidelines, April 2023.
8. Canadian Securities Administrators, Canadian securities regulators extend comment period on proposed changes to corporate governance disclosure practices and guidelines, June 2023.
9. IFRS, Consultation now open: The ISSB seeks feedback on its priorities for the next two years, May 2023.

Figure 6
What should ISSB focus on next?

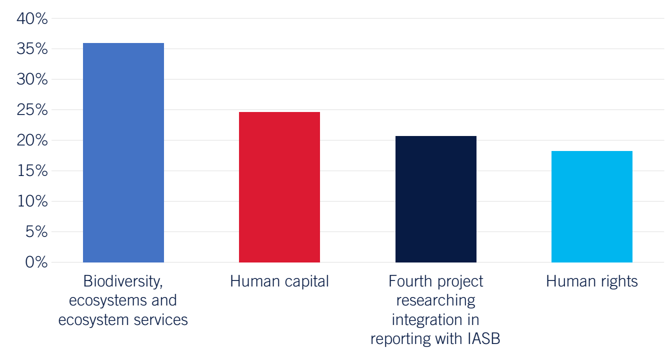
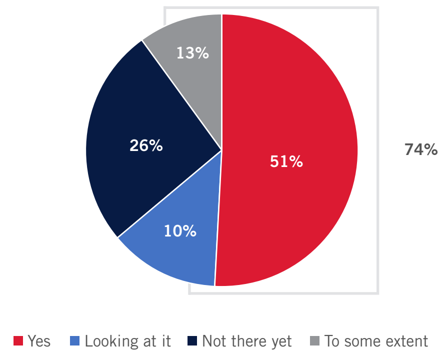


Figure 7
Has your organisation started to embrace 'sustainability outcomes'?



What's the outcome?

In Millani's February 2023 study, a growing market acceptance of the tri-dimensional investment model of risk, return and 'sustainability outcomes' was identified. For this Study, participants were asked if their organizations had started to consider sustainability outcomes as part of their investment process. The Study found that 50% of participants indicated that they have begun to consider it to some extent (see Figure 7) – albeit with some reservations.

Many investors are concerned about how to define sustainability outcomes. With growing scrutiny and accusations of greenwashing, there is a healthy level of questioning of how one's organization can claim that their efforts caused a specific outcome. **"Outcome oriented-investing can be better measured in the private market asset classes, but in the secondary market it is very difficult. There is a risk of double counting."** (Asset Manager)

The main mechanism that investors are using to avoid greenwashing claims is to adjust their level of individual engagements. Various firms are adapting their approaches to ask for and track specific outcomes. **"Analysts are asked to add for tracking purposes: Did you ask them to do something, to complete something? If so, what's the timeline? Then we match that outcome to our engagement."** (Asset Manager)

The overall challenge that investors face is the impacts derived from one-on-one engagements versus collaborative engagements, which are both time and resource efficient. **"[It is] difficult to determine who is responsible for the positive impact when there are a lot of people engaged."** (Asset Manager)

Although still voluntary, it is obvious that there is a growing seriousness by investors to understand how they can embrace this market evolution, especially considering it is asked as part of the UN's Principles for Responsible Investment (PRI) reporting. Issuers would do well to understand the implications and shifting expectations around sustainability outcomes. Access to capital may depend upon it.

The approach issuers could consider to meet this changing market dynamic is through the lens of double materiality. Although relatively new in North America, it is an approach that considers both how an ESG issue may be material from a financial perspective and how a company may itself have an impact on the issue. A small percentage of interviewees are currently embracing it.

"We definitely see the growth in that [double materiality] and we expect to see more. Investors need to demonstrably want it and encourage companies to use this approach. We are seeing it both from the demand and supply side." *– Asset Manager*

"We don't feel that issuers are quite there yet to report in a consistent comparable way. We will continue to support and encourage this. We are not seeing it come through in the way we would like, but we are waiting for ISSB to help with this."
– Asset Manager

A shifting market

In recent months, a change in discussion has been noted - from the need to transition to a lower-carbon economy, to a transformation of the entire financial system. Such system change appears to be broadening its lens, from responsible investors to all stakeholders.

"There is a recognition now that in order to be a successful market participant, you need to be a good citizen overall."
– Asset Owner

This 7th edition of Millani's Semi-Annual ESG Sentiment Study of Canadian Institutional Investors demonstrates an evolving market with a shifting focus towards sustainability outcomes, and strong engagement from investors recognising the interconnectivity of climate change, biodiversity and its impacts on human capital and human rights.

There is a shift afoot in capital markets. The development of new international standards, the desire for a transition taxonomy, and a sense of maturity around ESG seem to indicate the early stages of this transformation.

Contributors

Thank you to our contributors who took the time to provide their insights on key ESG trends. Our contributors represent 40 of Canada's largest institutional investors, some of which are listed below.

About Millani

Millani provides advisory services on ESG integration to both investors and companies. For the past 15 years, Millani has become the partner of choice for institutional investors. By providing advisory services on developing strategic 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 and engagement strategies to optimize their market value.

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