Sustainable Investment – Guidance on climate-related disclosures for asset managers

"Union standards should take account of any sustainability reporting standards developed under the auspices of International Financial Reporting Standards Foundation. .... Union sustainability reporting standards should contribute to the process of convergence of sustainability reporting standards at global level, by supporting the work of the International Sustainability Standards Board (ISSB). .... integrating the content of global baseline standards to be developed by the ISSB, to the extent that the content of those baseline standards is consistent with the Union's legal framework and the objectives of the Green Deal."

- Recital (43), Directive (EU) 2022/2464

On 26 June 2023, the International Sustainability Standards Board (ISSB) issued two IFRS Sustainability Disclosure Standards which set a benchmark for companies to adhere to when disclosing sustainability-related financial information. IFRS S1 outlines the requirements for an entity to disclose sustainability-related information about its sustainability-related risks and opportunities. IFRS 2 adds to this with specific climate-related risk management disclosures and reporting metrics to enable investors to make informed decisions by presenting the performance and financial position of these sustainable related investments.

IFRS S2 is supplemented by volumes that provide industry-specific guidance on identifying, measuring and disclosing information about climate-related risks and opportunities.

This article looks at the main disclosure requirements of **Volume 15 of IFRS S2**, which offers guidance on implementing climate-related Disclosure Requirements in **Asset Management and Custody Activities.** These activities encompass a range of services such as wealth management, private banking, financial planning, investment advisory, and retail securities brokerage. Entities within this sector oversee investment portfolios for various clientele, including institutional investors, retail customers, and high-net-worth individuals.

With a fiduciary responsibility to their clients, the entities in Asset Management and Custody Activities are obligated to conduct comprehensive analyses of all information relevant to investment decision making. As expressed in Roger's article, given the new consciousness about social and economic impact, this brings to the forefront an examination of Environmental, Social, and Governance (ESG) factors, particularly if they align with the portfolio's objectives. Given that the fundamental goal of asset management is to secure financial returns for investors, this, when coupled with research that indicates an entity's management of certain ESG factors can significantly influence its financial returns, it's evident that integrating ESG factors into investment analysis is increasingly imperative.

IFRS 2 sets out **metrics and targets** aimed at enabling investors to comprehensively assess an entity's performance regarding climate-related risks and opportunities. Under IFRS 2.28, entities are required to disclose:

- information relevant to the cross-industry metric categories;
- industry-based metrics that are associated with particular business models, activities or other common features that characterise participation in an industry; and

- targets set by the entity, and any targets it is required to meet by law or regulation, to mitigate or adapt to climate-related risks or take advantage of climate-related opportunities, including metrics used by the governance body or management to measure progress towards these targets.

In accordance with this, Volume 15 introduces three industry-based metrics tailored to Asset Management and Custody Activities:

- **Metric 1 - Asset Management Disclosure**

Entities are required to provide a detailed breakdown of assets under management across various asset classes, that employ (i) integration of ESG issues, (ii) sustainability-themed strategies, and (iii) screening, regardless of whether these strategies are passive or active. This metric offers a quantitative assessment of an entity's commitment to sustainable investing practices.

As per the *PRI Reporting Framework – Main Definitions 2018*, the integration of ESG issues involves the systematic inclusion of material ESG factors into investment analysis and decision-making processes. Sustainability-themed investing means directing investments towards themes or assets closely associated with sustainability, such as sustainable energy or agriculture. Screening methods encompass various approaches, including negative/exclusionary, positive/best-in-class, and norms-based screening approaches.

- **Metric 2 - Description of ESG Factors Investment Strategies**

This metric requires an entity to disclose its approach to the incorporation of ESG factors in investment or wealth management processes and strategies. This involves disclosing the parties responsible for the incorporation of ESG factors, including their roles and responsibilities, and the approach used to conduct the ESG-related research. The relevant entities are also required to disclose their approach to the oversight and accountability for incorporating the ESG factors.

Entities must address whether they conduct scenario analysis or modelling to evaluate the risk profile of future ESG trends at the portfolio level. ESG trends may include climate change, natural resource constraints, human capital risks and opportunities, and cybersecurity risks. The entity shall describe whether it incorporates ESG factors in strategic asset allocation or allocation of assets between sectors or geographical markets. This entails specifying the types of portfolios or strategies where ESG factors are considered in decision-making. However, disclosing this information at the individual portfolio or strategy level is not mandatory.

Entities are also required to disclose how ESG factors are integrated into investment analysis. This includes assessing the impact of ESG factors on the duration of investment holdings, the risk and return profiles of investments, and how ESG factors interact with traditional fundamental factors such as economic conditions, central bank policy, industry trends, and geopolitical risks.

- **Metric 3 - Disclosing Proxy Voting and Investee Engagement Policies and Procedures**

This metric requires the disclosure of policies and procedures concerning proxy voting and engagement with investee companies. Entities must reveal how they exercise voting rights on behalf of investors.

Disclosure should adhere to the guidelines outlined in the *PRI Reporting Framework 2019 Active - Listed Equity Active Ownership*; as published by the PRI Association This includes detailing the scope and objectives of voting activities, variations in voting approaches among different markets, compliance with local regulatory requirements, and the methods employed for voting (proxy or in-person attendance at AGMs). Entities must also describe how voting decisions are communicated to investee company management. Additionally, entities must disclose how their proxy voting and engagement activities inform their investment decision-making process.

Metric 3 also requires entities to outline their escalation process in cases where dialogue with investee companies is failing. This includes employing tactics such as expressing concerns directly to corporate representatives or non-executive directors, either through direct communication or during shareholder meetings. Other escalation methods may involve collectively expressing concerns with other investors, making public statements, or submitting shareholder resolutions.

The comparability of data and the harmonisation of reporting standards will be critical if society is to succeed in reorientating capital flows towards sustainable investment.

We are just at the start.

On 12 March 2024 the Commission published a Communication on managing climate risks in Europe that sets out how the EU and its countries can implement policies that save lives, cut costs and protect prosperity. It comes as a direct response to the first-ever European Climate Risk Assessment by the European Environment Agency. 2023 was the hottest year on record. Europe is facing the effects of climate change with extreme weather events like floods and wildfires.

In a future article I will cover the EU's four main categories of action.

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