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## The Role of Asset Management in Promoting Sustainable Finance and ESG Standards: Industry Implications and Prospects

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### ABSTRACT

This paper reviews the literature on how asset managers can integrate ESG factors into their decision-making processes, products and services, and how they can influence corporate behavior and public policies on sustainability issues. The paper also discusses the main challenges and opportunities for asset managers in this field, such as data availability and quality, regulatory frameworks and incentives, stakeholder expectations and engagement, and innovation and collaboration. The paper concludes with some recommendations for future research and practice on how asset management can enhance its role in supporting sustainable finance and ESG standards.

## **INTRODUCTION**

In recent years, environmental, social and governance (ESG) factors have become increasingly important for investors and asset managers who seek to align their portfolios with sustainable development goals and principles. Sustainable finance, which refers to the integration of ESG criteria into financial decision-making, has emerged as a key driver of innovation and growth in the asset management industry. However, sustainable finance also poses significant challenges and risks for asset managers, such as the lack of common definitions and standards, the complexity of measuring and reporting ESG performance, and the potential trade-offs between financial returns and ESG objectives. Therefore, it is essential for asset managers to adopt robust and consistent frameworks and practices to ensure that their ESG strategies are credible, transparent and effective. The aim of this paper is to explore the role of asset management in promoting sustainable finance and ESG standards, and to examine the industry implications and prospects of this trend. The paper will provide a literature review of the main concepts, drivers and barriers of sustainable finance and ESG integration in asset management, as well as the regulatory and market developments that shape the current landscape. The paper will also analyze the best practices and challenges of implementing ESG criteria across different asset classes, investment styles and products, and discuss the potential benefits and drawbacks of ESG investing for asset managers and their clients. Finally, the paper will identify the key opportunities and threats for the asset management industry in relation to sustainable finance and ESG standards, and provide some recommendations for future research and action.

## **LITERATURE REVIEW**

In recent years, asset management has taken on a bigger and bigger role in the advancement of sustainable finance and environmental, social, and governance (ESG) standards. Asset managers have a dual duty to support the transition to a low-carbon and more inclusive economy and to align their investment strategies with the long-term interests of their clients and society. The term "sustainable finance" refers to the incorporation of environmental, social, and governance (ESG) considerations into financial decision-making and operations. The Sustainable Development Goals (SDGs) and the Paris Climate Agreement are intended to be achieved through the transition to a low-carbon, resource-efficient, and inclusive economy, respectively. Asset management, a fundamental element of the financial system, is crucial in advancing sustainable finance and ESG norms (Schumacher, Chenet, & Volz, 2020). Applying ESG criteria to their investment processes, products, and services will help asset managers promote sustainable finance and ESG standards. In doing so, they can meet the growing demand from investors and regulators for ESG disclosure and reporting, meet their long-term sustainability objectives, improve risk-adjusted returns, and promote beneficial effects on society and the environment. Asset managers can also engage with investee companies and other stakeholders to encourage them to adopt ESG best practices and improve their sustainability performance (Antoncic et al., 2020). Sustainable finance and ESG integration in asset management are emerging topics in the academic literature that aim to

explore the drivers and barriers of incorporating environmental, social and governance (ESG) factors into investment decisions and processes. ESG integration is defined as "the systematic and explicit inclusion of material ESG factors into investment analysis and investment decisions" (PRI, 2018). Sustainable finance is a broader concept that encompasses not only ESG integration, but also other approaches such as impact investing, green bonds, social bonds and sustainability-linked loans that seek to align financial activities with environmental and social goals (EU, 2019.)

## METHODOLOGY

The main drivers of sustainable finance and ESG integration in asset management can be classified into three categories: demand-side factors, supply-side factors and regulatory factors.

1. Demand-side factors refer to the growing interest and awareness of investors, clients and beneficiaries on the relevance of ESG issues for financial performance and risk management. According to a survey by J.P. Morgan Asset Management (2020), 71% of institutional investors globally consider ESG factors in their investment process, and 74% of them expect to increase their ESG allocation over the next three years. Moreover, evidence from a meta-analysis by NYU Stern Center for Sustainable Business (2021) suggests that ESG integration can lead to improved financial performance over longer time horizons, especially during a social or economic crisis.

2. Supply-side factors refer to the availability and quality of ESG data, tools and products that enable asset managers to implement sustainable finance and ESG integration strategies. The development of ESG ratings, indices, benchmarks and standards has facilitated the assessment and comparison of ESG performance across companies, sectors and regions. For example, J.P. Morgan Asset Management (2020) uses a proprietary ESG scoring framework that covers over 6,000 companies based on multiple data sources and methodologies (Baines & Hager, 2022). Additionally, the proliferation of sustainable finance products such as green bonds, social bonds and sustainability-linked loans has expanded the investment opportunities and choices for asset managers and investors (Brühl, 2021).

3. Regulatory factors refer to the policies and initiatives that aim to promote or mandate sustainable finance and ESG integration in asset management. The most notable instance is the European Union's Action Plan on Financing Sustainable Growth (2018), which introduced a comprehensive set of measures to promote transparency, accountability, and standardization in the sustainable finance market (Redondo Alamillos, & de Mariz, 2022). The Sustainable Finance Disclosure Regulation (SFDR), which obliges asset managers to disclose how they incorporate sustainability risks and opportunities into their investment processes and products, is one of the Action Plan's main tenets. The SFDR went into effect in March 2021 and is anticipated to have a big impact on asset managers doing business in or selling into the EU.

Despite these drivers, there are also several barriers that hinder the adoption and implementation of sustainable finance and ESG integration in asset

management. These include: data gaps and inconsistencies, lack of common definitions and frameworks, limited skills and expertise, misaligned incentives and short-termism, conflicting stakeholder interests and expectations, greenwashing and reputational risks (Friede, Busch, & Bassen, 2015). These barriers pose challenges for asset managers to effectively measure, manage and communicate their ESG performance and impact.

## **RESULT AND DISCUSSION**

It is not simple to implement ESG criteria because there are many obstacles to overcome and best practices to take into account. The definition, measurement, and disclosure of ESG issues are not standardized or consistent, which is one of the major obstacles to ESG investing (D'Orazio & Valente, 2019). When comparing the ESG performance of businesses, funds, or products, different sources may use different terminology, methodologies, and indicators, which can cause confusion, incomparability, and possible greenwashing (CFA Institute, 2021). Investors must adopt ESG disclosure standards that are relevant, adaptable, and complementary to current regulations in order to overcome this challenge. For instance, the CFA Institute's Global ESG Disclosure Standards for Investment Products (2021) are intended to assist distributors, consultants, advisors, and investors in better understanding, comparing, and evaluating investment products that incorporate ESG issues into their goals, investment approach, and stewardship practices. The trade-off between financial returns and social impact presents another obstacle for ESG investing. Even if they carry higher risks or lower returns, some investors might prefer to invest in businesses or products that benefit society or the environment. Others might aim to increase returns while reducing their exposure to ESG risks or unfavorable externalities. These different motivations may require different ESG approaches, such as exclusion, integration, engagement or impact investing (FINRA, 2019). To address this challenge, investors need to align their ESG objectives with their risk-return profile and select the appropriate ESG approach for their investment style and product. For example, passive investors may use exclusion or integration strategies to screen out or weight companies based on their ESG scores or ratings (Driessen, 2021). Active investors may use engagement or impact investing strategies to influence the behavior or outcomes of companies or projects through voting, dialogue or direct financing. Another challenge of ESG investing is the diversification and allocation of ESG assets across different asset classes, investment styles and products. ESG investing is not limited to equities or bonds, but can be applied to other asset classes such as real estate, infrastructure or commodities. Moreover, ESG investing can be implemented through various investment styles such as value, growth or quality (Ndung'u, 2022). Furthermore, ESG investing can be offered through various products such as funds, mandates or structured products. To address this challenge, investors need to consider the availability, suitability and performance of ESG assets for their portfolio construction and asset allocation. For example, investors may diversify within an asset class or investment style by selecting ESG funds or products that do not overlap substantially in their holdings or sectors. Alternatively, investors may diversify across asset classes or investment styles by

selecting a broadly invested ESG fund or product that covers a range of industries and sectors (Popescu, Hitaj, & Benetto, 2021).

ESG investing has gained popularity in recent years, as investors seek to address the challenges and opportunities posed by climate change, social inequality, corporate ethics and other factors that may affect the long-term performance and sustainability of businesses. However, ESG investing also entails some potential benefits and drawbacks for asset managers and their clients, which need to be carefully considered before adopting this approach. One of the potential benefits of ESG investing is that it can help asset managers and their clients achieve better risk-adjusted returns, by incorporating material ESG factors into their investment decisions. According to a meta-analysis by Friede et al. (2015), the majority of empirical studies found a positive or neutral relationship between ESG performance and financial performance, suggesting that ESG investing does not compromise profitability, and may even enhance it. Moreover, ESG investing can help asset managers and their clients diversify their portfolios, by accessing new markets and opportunities that are driven by ESG trends, such as renewable energy, green bonds, social impact bonds and so on. Another potential benefit of ESG investing is that it can help asset managers and their clients improve their reputation and stakeholder relations, by demonstrating their commitment to responsible business practices and positive social impact. ESG investing can also help asset managers and their clients comply with the increasing regulatory and reporting requirements on ESG issues, such as the EU Sustainable Finance Disclosure Regulation (SFDR), the Task Force on Climate-related Financial Disclosures (TCFD) recommendations, and the UN Principles for Responsible Investment (PRI). Furthermore, ESG investing can help asset managers and their clients attract and retain talent, customers and investors who share their ESG values and expectations. However, ESG investing also poses some potential drawbacks for asset managers and their clients, which need to be addressed in order to ensure its effectiveness and credibility. One of the potential drawbacks of ESG investing is that it can increase the complexity and cost of investment analysis and management, by requiring additional data, tools, skills and resources to assess and integrate ESG factors into investment processes (Guo, et al., 2020). Moreover, ESG investing can expose asset managers and their clients to new risks and challenges, such as data quality and availability issues, greenwashing practices, lack of standardization and comparability of ESG metrics and ratings, ethical dilemmas and trade-offs between different ESG objectives, and potential conflicts of interest between different stakeholders. Another potential drawback of ESG investing is that it can limit the investment universe and opportunities for asset managers and their clients, by excluding or underweighting certain sectors, industries or companies that do not meet their ESG criteria or expectations. This may result in lower returns or higher volatility than conventional investing strategies, especially in the short term or during periods of market stress. Furthermore, ESG investing can create some legal and fiduciary challenges for asset managers and their clients, such as ensuring that their ESG policies and practices are consistent with their investment objectives and mandates, disclosing their ESG risks and

performance to their beneficiaries or regulators, and balancing their duty to maximize returns with their duty to act in the best interest of society.

The asset management industry faces both opportunities and threats in relation to sustainable finance and ESG standards. On the one hand, there is a growing demand from investors, regulators and society for more responsible and transparent investment practices that contribute to environmental and social goals. On the other hand, there are also challenges in terms of defining, measuring and reporting on sustainability performance, as well as managing the risks and costs associated with the transition to a low-carbon economy. One of the key opportunities for the asset management industry is to leverage its expertise and influence to support the development and implementation of ESG standards across the financial system (Urban & Wójcik, 2019). By integrating ESG factors into their investment decisions, asset managers can enhance their risk-return profiles, align their portfolios with their clients' values and preferences, and create positive impacts on society and the environment. Moreover, by engaging with issuers, regulators and standard-setters, asset managers can promote greater consistency and comparability of ESG disclosures and methodologies, as well as foster innovation and best practices in sustainable finance (KPMG, 2020). However, the asset management industry also faces significant threats from the increasing complexity and diversity of ESG regulations and expectations. The lack of a common definition and taxonomy of sustainability, as well as the proliferation of different ESG frameworks and labels, can create confusion and uncertainty for asset managers and their clients. Furthermore, asset managers may face legal, reputational and operational risks if they fail to comply with ESG regulations or to meet their fiduciary duties towards their clients. Additionally, asset managers may encounter competitive pressures and higher costs as they seek to adapt their business models and processes to the changing market dynamics and client demands (Kuhn, 2022). Therefore, it is essential for the asset management industry to adopt a proactive and strategic approach to sustainable finance and ESG standards. The ESG practices used by European asset managers can be roughly divided into firm-level frameworks and product-level strategies, according to EFAMA (2022). All or a sizable portion of the portfolios managed by an asset management firm are subject to firm-level frameworks (Hübel & Scholz, 2020). These frameworks include exclusion criteria, ESG integration techniques, and voting and engagement guidelines. Product-level strategies, such as exclusions, sustainability-themed investments, or impact investments, are more specific and only apply to individual funds or discretionary mandates. Asset managers should consider both levels of ESG practices in order to achieve a comprehensive and coherent sustainability strategy that meets their objectives and obligations (Liang & Renneboog, 2020). However, asset managers also face several challenges and barriers in implementing ESG integration and promoting sustainable finance. These include the lack of consistent and comparable ESG data and metrics, the diversity of ESG frameworks and standards, the complexity of measuring and reporting ESG impacts and outcomes, the potential trade-offs

between financial returns and sustainability goals, and the need for adequate skills and capabilities to deal with ESG issues.

To address these challenges and barriers, asset managers can benefit from the guidance and support of industry associations, regulators and standard-setters. For example, in September 2022, AMAS (the Association of Asset Managers) published a self-regulation on setting ESG standards for producers and investment managers of sustainability-related collective investment schemes (the "AMAS ESG Guidelines"). The AMAS ESG Guidelines include mainly governance requirements as well as organizational, process and documentation obligations for asset managers who must ensure that they have the required infrastructure, resources, organization, documentation and processes, including as to ESG compliance and risk management .

## CONCLUSION

In this paper, we have examined the role of asset management in promoting sustainable finance and ESG standards, as well as the industry implications and prospects. We have reviewed the literature on the definitions, drivers, benefits and challenges of sustainable finance and ESG integration in asset management. We have also discussed the regulatory developments and initiatives at the global and regional levels that aim to foster a more sustainable financial system and enhance transparency and accountability for investors and stakeholders.

Our main findings are as follows:

1. Sustainable finance and ESG integration are becoming increasingly important for asset managers, as they respond to the growing demand from investors, regulators and society for more responsible and long-term oriented investment practices that contribute to environmental, social and governance goals (Zumente & Bistrova, 2021).
2. Asset managers can play a key role in promoting sustainable finance and ESG standards by aligning their investment strategies, processes and products with sustainability objectives, applying ESG criteria and methodologies in their portfolio construction and risk management, engaging with investee companies on ESG issues, and reporting on their ESG performance and impact.
3. The asset management industry faces several challenges and opportunities in implementing sustainable finance and ESG integration, such as data availability and quality, standardization and comparability of ESG metrics and disclosures, investor education and awareness, product innovation and differentiation, fiduciary duty and stakeholder expectations, regulatory compliance and harmonization, and collaboration and partnership across the value chain (Zeidan, 2022).
4. The regulatory landscape for sustainable finance and ESG integration is evolving rapidly, with various initiatives at the global (e.g. TCFD), regional (e.g. EU) and national (e.g. UK) levels that aim to provide guidance, principles, frameworks and rules for asset managers and other financial market participants to enhance their ESG practices and disclosures.
5. The prospects for sustainable finance and ESG integration in asset management are promising, as the industry adapts to the changing market

dynamics and embraces the opportunities offered by sustainability. Asset managers can benefit from improved risk-adjusted returns, enhanced reputation and trust, increased client loyalty and retention, new market segments and growth potential, and positive social and environmental impact.

In conclusion, asset management has a significant role to play in promoting sustainable finance and ESG standards. By integrating ESG factors into their investment activities, asset managers can not only enhance their financial performance and reputation, but also contribute to the global efforts to address the pressing social and environmental challenges of our time.

## **RECOMMENDATION**

Based on the literature review conducted on the role of asset management in promoting sustainable finance and ESG standards, this section provides some policy recommendations for the industry and regulators.

1. **Transparency:** Asset managers should disclose their ESG policies, strategies, methodologies, data sources, metrics and targets to their clients and stakeholders, in line with the TCFD recommendations (TCFD, 2017) and the EU Corporate Sustainability Reporting Directive (CSRD) (EU, 2022). This would enable investors to make informed decisions and compare different ESG products and services.
2. **Trust:** Asset managers should adhere to high standards of quality, consistency and reliability in their ESG practices, products and labels. They should follow the AMAS ESG Guidelines (AMAS, 2022), which include governance, organizational, process and documentation requirements for asset managers who offer sustainability-related collective investment schemes. They should also seek external verification or assurance of their ESG disclosures and performance.
3. **Tools:** Asset managers should invest in developing their capabilities and resources to effectively manage climate-related and wider sustainability risks, opportunities and impacts. They should use robust and relevant data, methodologies and models to assess and measure ESG factors and outcomes. They should also collaborate with other industry players, regulators, standard-setters and academia to enhance their ESG knowledge and skills.
4. **Transition:** Asset managers should support the role of finance in delivering a market-led transition to a more sustainable economy. They should align their portfolios with the Paris Agreement goals and the UN Sustainable Development Goals (SDGs). They should also engage with their investee companies and issuers to encourage them to adopt best ESG practices and disclose their climate-related and sustainability information.
5. **Team:** Asset managers should embed ESG into their organizational culture, strategy and operations. They should ensure that their senior management and board are accountable and responsible for ESG integration. They should also provide adequate training, incentives and recognition for their staff to foster ESG awareness.

## SUGGESTIONS

The role of asset management in promoting sustainable finance and ESG standards is a timely and important topic, given the increasing demand from investors and regulators for more transparency and accountability on environmental, social and governance (ESG) issues. However, there is still a lack of consensus and clarity on how to define, measure and report on ESG performance, as well as how to integrate ESG factors into investment decisions and risk management processes. Therefore, this paper suggests some areas for further study that could contribute to the advancement of knowledge and practice in this field.

1. More research is needed to understand the drivers and barriers of ESG adoption among asset managers, as well as the impact of different regulatory frameworks and self-regulatory initiatives on ESG integration and disclosure. For example, a comparative analysis of the AMAS ESG Guidelines introduced by the Association of Asset Managers in Switzerland (AMAS) in 2022 and other similar standards or codes of conduct could provide insights into the benefits and challenges of voluntary self-regulation for asset managers who offer sustainability-related collective investment schemes (Mondaq, 2022).
2. More empirical evidence is needed to assess the financial and non-financial outcomes of ESG investing, both at the portfolio and the societal level. For example, a longitudinal study could examine how ESG factors affect the risk-return profile of different asset classes and investment strategies over time, as well as how ESG investing contributes to the achievement of the Sustainable Development Goals (SDGs) and the Paris Agreement on climate change. Such a study could also explore the potential trade-offs or synergies between different ESG dimensions and objectives.
3. More methodological innovation is needed to address the data gaps and quality issues that hamper ESG analysis and reporting. For example, a collaborative project could develop new indicators, metrics and tools that capture the materiality, relevance and impact of ESG factors across different sectors, regions and asset types, as well as enhance the comparability, consistency and reliability of ESG data sources. Such a project could also leverage new technologies such as artificial intelligence, blockchain and big data analytics to improve ESG data collection, processing and dissemination
4. To conduct empirical analysis on the performance and impact of ESG-oriented funds and portfolios, and to compare them with conventional ones across different markets and sectors.
5. To assess the effectiveness and consistency of the existing and emerging ESG frameworks, standards and labels, and to identify the potential areas for harmonization and convergence at the global level.
6. To examine the role of asset managers in engaging with investee companies and other stakeholders on ESG issues, and to evaluate the outcomes and benefits of such engagement activities.
7. To investigate the drivers and barriers for asset owners and investors to demand and adopt ESG-oriented products and services, and to understand their

preferences and expectations from asset managers regarding ESG integration and communication.

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