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# Executive summary

EY research into ESG investing provides rich insights into investment managers' activities to date, current areas of focus and plans for the future.







### The shift to a commercial mindset

Growth in ESG investing is being powered by a mix of demand, supply and regulation. Investment managers overwhelmingly view ESG as a commercial opportunity, with investor needs shaping innovation and development. However, enthusiasm and approaches vary hugely between firms and markets. Many organisations still need to sharpen their vision and strategy for ESG investing.

### Growing risk expertise – and challenges

Climate change is absorbing the bulk of resources. More firms are using climate risk scenarios and science-based targets. Most are only just beginning to measure current emissions, let alone map decarbonisation plans. Strong support for the revised Supervisory Code reflects the growing preference for engagement over divestment.

### Disclosure: the struggle continues

Investment managers face a range of overlapping reporting frameworks. This poses major challenges to investor understanding, client education and cost control. Clarity remains a long way off, and confusion can be made worse by fragmented internal approaches.

### Regulation remains influential

Regulation continues to actively shape the evolution of ESG investing. The need to apply Sustainable Finance and Disclosure Regime (SFDR) to new and existing funds – without a technical standard or taxonomy – is leading to concern over potential greenwashing risks. It also underlines the importance of robust, focused ESG strategies. Specialised talent and skills are at a premium.

### Elusive data and technology solutions

Many investment managers are unhappy with the quality, cost and consistency of ESG data. Firms are exploring a range of vendor partnerships, but there is concern about the industry's reliance on a handful of data providers. Growing data footprints are layering internal and external costs, but without addressing firms' underlying needs.

ESG investing is rapidly gaining influence and momentum. Opportunities are growing, but complexity and costs are mounting too. Investment managers can no longer succeed with unfocused or unoriginal strategies. A clear vision for ESG – backed by the required talent, data and technology – is key to attracting capital and achieving success.

Over the coming year, key actions to prioritise include filling gaps in emissions data; developing practical decarbonisation plans for key sectors; and enhancing the management of other environmental

and social risks. Prioritisation, focus and clear oversight are key to making the best out of regulatory, reporting and ESG data challenges.

Looking further ahead, ESG will continue to evolve in response to global events. Investor scrutiny will increase too, making it vital for firms to deliver real-world improvements. It is a huge task, but the industry is committed to building the skills and capabilities that will make ESG work for investors and the wider economy.

# Introduction

## ESG investing is being transformed



The global adoption of ESG investing has continued since the last survey in 2020, with Europe in the lead, comprising of global sustainable fund assets as of June 2022 (Morningstar Manager Research – 28 July 2022). Fresh regulation, increasing investor demand and changing public attitudes have driven powerful growth in sustainable finance. Climate change remains the dominant concern from a risk management perspective, but there is also a growing focus on social justice and other environmental challenges, such as biodiversity impact. Wealth and asset managers are also increasingly focused on investing in environmental opportunities, such as renewable energy, efficient buildings, sustainable water, and green mobility. Managers are facing a difficult balancing act between seizing the growth opportunity and managing implementation challenges and potential greenwashing risks. The last two years have also seen a transformation in industry thinking. Investment managers are positioning themselves

at the forefront of the fight to secure a more sustainable future. Most leading firms now place ESG at the heart of their strategic thinking.

This is illustrated by the growth of the Net Zero Asset Managers (NZAM) initiative, which expanded from 30 signatories at its December 2020 launch to 273 signatories with more than \$61tn in AuM by May 2022 – including 53 new joiners since COP 26 in November 2021. The Glasgow summit also saw a commitment by NZAM's partner body GFANZ to align \$130tn of finance with Paris Agreement goals. Interest in Stewardship, a key enabler of the 'G' in ESG, is growing rapidly too – 95% of firms we have spoken to are now signatories to the Stewardship Code.

In short, now is the ideal time to take a fresh look ESG investing in Europe. EY teams have therefore repeated their in-depth survey of leading investment managers, which was first conducted in 2020. This involved interviewing ESG leaders across the industry, seeking their quantitative and qualitative insights into:

- ▶ ESG drivers, strategies and products
- ▶ Risk management of ESG factors
- ▶ ESG reporting and disclosure
- ▶ Corporate activity and ESG implementation
- ▶ ESG data and technology

EY sample of 19 participants comprise of many of the world's largest firms, with a collective AUM of \$23.4tn. Some are relatively new to ESG, but others have been investing sustainably for decades. We are very grateful to each for their time and support.

This report sets out our key findings. It examines how ESG investing is changing, and why; identifies the obstacles to growth and their potential solutions; and aims to provide a sense of what may lie ahead. We hope it will help investment managers to benchmark themselves against their peers, and to critically challenge their thinking about the future of ESG investing – and their own position in this vital global market.

# Key findings

1

## Drivers and direction: moving to a commercial mindset

- ▶ Growth is being driven by a combination of demand, supply and regulation.
- ▶ Firms now overwhelmingly view ESG investing as a commercial opportunity.
- ▶ However, this opportunity needs to be balanced with increasing reputational and regulatory risks, and escalating costs from embedding ESG activity into operating models.
- ▶ Clear, focused strategies are vital to seizing opportunities for firms and their clients.

Investor demand for both financial and non-financial returns is now the most important driver of investment managers' ESG activities [see Figure 1]. This is supported by the desire to align investment activities with firms' broader purpose and strategies, and to seize the commercial opportunities of ESG. Regulation too remains impossible to ignore, with the

need for compliance ranking as the number four driver of ESG investing. The belief that ESG criteria can enhance investment returns is also an important factor.

It is clear that investors themselves are now the leading drivers of growth. As a result, investment managers increasingly see ESG investing as a commercial imperative. It is this sense of opportunity and anticipation above all that is now shaping and pushing forward the ESG agenda.

Needless to say, attitudes and approaches to ESG investing vary significantly between different investment managers. Firms range from enthusiastic believers to reluctant followers and demonstrate an equally wide variety of positioning, mindsets, skills and understanding. Some houses focus on narrow issues – such as specific climate solutions – while some choose individual social groups or causes to champion.

These differences often reflect firms' size and ability to invest in ESG capabilities. The geographic location or cultural features of firms' home markets can also have an effect, with European-based firms tending to be further advanced than their North American counterparts. The views and enthusiasm of individual senior executives can have a surprisingly big impact too.

**Figure 1: Please rank the top five ESG drivers in terms of their influence on ESG activity at your firm**



In contrast, some firms – including many that see an increasingly compelling business case for developing their ESG capabilities – have yet to identify a distinctive strategic focus.

If there is a common theme here, it is that many investment managers still need to sharpen their focus on strategy and implementation. As they do so, firms should ask themselves searching questions about their ESG philosophy. The days when managers could be all things to all investors in this space are over. Generic commitments are no longer enough to attract capital, let alone to demonstrate success. In an increasingly crowded marketplace, clear positioning backed up by authentic commitment is vital. Investment managers need a focused approach that they believe in, aligned to their wider strategy and attributes, if they are to seize the opportunities of ESG investing in the years ahead.

## 2

### Risk management: growing understanding, growing complexity

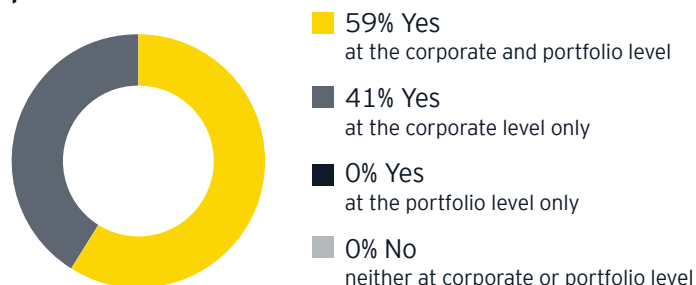
- ▶ Climate change tops the risk agenda and absorbs the bulk of resources.
- ▶ Despite great effort, firms are only beginning to set science-based targets, identify emissions, baselines and map decarbonisation pathways.
- ▶ Nature-related risk is gaining attention, but risk management is in its early days.
- ▶ Attention to social risks is patchier but looks set to grow rapidly during 2022.

Public awareness, investor interest, regulation and the net-zero commitments of COP26 are working together to keep climate change at the top of the ESG investing agenda. NZAM's latest report shows that 84 institutions have now set net-zero targets covering \$16tn in assets – 38% of their

total AuM. Many firms have also identified interim emissions reduction targets for the current decade. The use of detailed science-based targets is also growing, with the majority of NZAM's disclosing signatories using one or more of three endorsed target-setting methodologies, most frequently either the Net Zero Investment Framework (NZIF) or the Science Based Targets initiative (SBTi).

The TCFD<sup>1</sup> framework is pushing firms to measure their current greenhouse gas (GHG) emissions, but this is proving to be a major task. Nearly half of the respondents (41%) have identified their corporate emissions, but only 18% have also completed the much harder challenge of measuring their Scope 3 "financed emissions" (see Figure 2). Firms are therefore focusing their Scope 3 efforts on selected portfolios or key client mandates. Despite considerable cost and effort, very few have yet established their GHG baselines across the whole portfolio, let alone at the fund or investor level.

**Figure 2: Have you measured your firm's current GHG position**

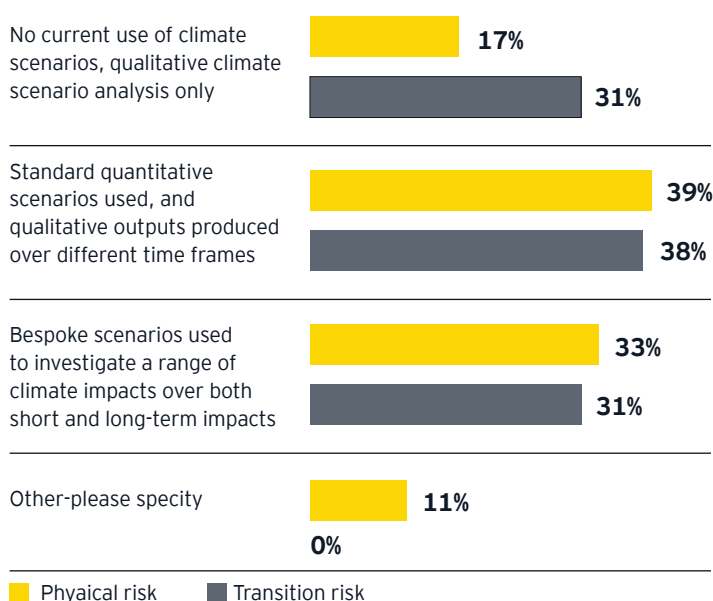


Filling out these gaps will be a major priority for firms over the next twelve months, encouraged by the prospect of the TCFD framework becoming mandatory in the UK and elsewhere. On average, smaller investment managers and those based in the US have further to go than larger or Europe-based firms. Even so, the use of climate risk scenarios is now embedded in many firms, with more than two-thirds of the respondents using either standardised or bespoke scenario analysis [see Figure 3].

<sup>1</sup> Task force on Climate-related Financial Disclosures



**Figure 3: Climate risk scenario analysis: which of the following best describes your activity on measurement and reporting on climate related physical/transition risks across your portfolios?**



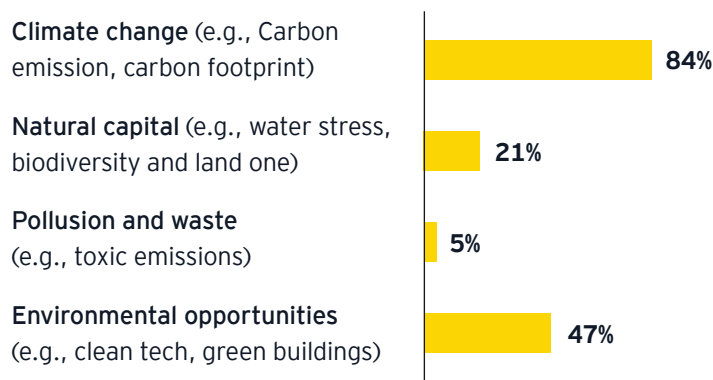
When it comes to systematically reducing financed emissions, investment managers have even further to travel. Most firms are just at the start of mapping credible decarbonisation pathways that meet their stated targets and investors' goals. Focused strategies concentrating on key industries or technologies will be crucial to accelerating the transition, financing climate mitigation and seizing the opportunities of climate solutions.

The need to achieve better climate outcomes is driving the industry's accelerating shift away from divestment towards investee engagement. This trend is creating more opportunities for passive managers to advance decarbonisation through stewardship, with growing numbers of firms willing to publicly 'name and shame' emissions laggards. Even so, managers must be alert to the risks of perceived greenwashing.

Beyond climate change, nature is rapidly climbing up the ESG agenda. Earlier this year, the Taskforce on Nature-related Financial Disclosure (TNFD) released its beta framework v0.1, helping financial institutions to act and report on nature-related

risks and opportunities. The regulatory response to biodiversity in the UK and EU also continues to grow (see Figure 4). Whilst the integration of nature as a material ESG risk into portfolio management remains nascent in the market, data and tools are increasingly available to support this and the framework provided by the TNFD will provide investors with greater certainty and specificity when undertaking analysis.

**Figure 4: In terms of your firm's activity in relation to the E in ESG are you primarily focused on activity around (please select all that are relevant)**



Looking beyond the environment, investment managers are relatively confident in their ability to address governance risks. Almost all the firms we surveyed have either signed up to the revised Stewardship Code or plan to do so, with 95% of respondents being signatories to the code. In contrast, attitudes towards social risks are highly varied. Criminal issues such as modern slavery are well understood, but many other social factors are less well-defined and rarely prioritised. Even so, investor focus on social risks is growing fast, aided by interest in investment themes such as food security or access to healthcare.

We expect social factors to receive additional attention during 2022 as COP27 – expected to emphasise a 'just transition' – approaches. Overall though, it seems certain that the urgency, complexity and regulatory impetus of climate change will see this issue continuing to absorb the bulk of investment managers' ESG resources for the foreseeable future. As already highlighted, the enormity of the task firms face in meeting ambitious net-zero targets make this statement understandable.

### 3

## Reporting and disclosure: rapid progress, but a long journey ahead

- ▶ Investment managers are struggling with overlapping reporting and disclosure frameworks.
- ▶ Some initiatives are gaining influence, but other schemes continue to appear.
- ▶ C-level oversight is improving, but with little consensus around best practice.
- ▶ Despite these challenges, firms can take steps to aid understanding and simplicity.

The need to understand and use multiple ESG reporting frameworks is the latest of many disclosure requirements investment managers have faced in recent years. But while other major initiatives such as MiFID 2 have drawn on existing industry practices, ESG reporting and disclosure is a far less familiar – and more fragmented – prospect.

The harsh reality is that investment managers now face the challenge of overlapping frameworks and initiatives, some compulsory and some voluntary. Client and regulatory requirements also vary hugely between markets, activities and investors. The situation poses huge challenges to investor understanding, client education and operating efficiency, especially for small and medium-sized firms.

It's no surprise that every firm we surveyed is asking – how do we move forwards from here? On the upside, firms do expect the consistency of reporting and disclosure to improve in the long term. While no single initiative has universal support, some of the best-established are accumulating increasing influence and impact [see Figure 5]. TCFD and Climate Action 100+ are examples of two very different schemes that enjoy strong support – from 89% of our respondents in the case of TCFD. Many surveyed firms are also leveraging the SASB framework and the UN Global Compact.

**Figure 5: Which of these 3rd party initiatives is your firm leveraging in relation to ESG disclosure and reporting?**

Rank	Initiatives	Percentage of respondents using the initiative
1	TCFD	89%
2	Net Zero AM initiative	67%
3	SASB	61%
4	IIGCC	56%
4	Climate Action 100+	56%
6	PCAF	50%
7	CDP	44%
8	GRI	22%
9	WEF IBC	17%
10	TNFD	11%
10	ClimateWise Principles	11%
12	UN Global Compact	6%
13	Business ambition for 1.5 degrees C	0%

Set against that, the prospect of uniformity remains remote for now. The fragmentation of reporting and disclosure is dividing firms' energies, and new non-financial frameworks such as the SEC's proposed rule on GHG emissions continue to appear. Ultimately, true harmonization will depend on far greater global alignment, backed up by consistent independent assurance over the quality of non-financial data.

The complexities of ESG reporting and disclosure can also be amplified by a lack of unified ownership. Without strong leadership and clear top-down messaging, ESG reporting and disclosure runs the risk of being siloed/ marginalised and largely tactical in nature. The survey shows that responsibility for the issue often depends on personal enthusiasm and organizational quirks. All firms now report some C-level ownership of ESG reporting and disclosure, but oversight is often fragmented into historic silos, reducing business buy-in.

In short, the challenges of ESG reporting and disclosure look set to get worse before they get better. The good news is that firms can act now to focus their energies as effectively as possible. Not every initiative is suited to every institution, and many investment managers could benefit from concentrating on a handful of key schemes – giving them greater influence over their development. Aligning internal oversight and responsibility can also help firms to enhance the integration of ESG into their investment reporting processes.



# 4

## Corporate activity: regulation sharpens focus on the future

- ▶ SFDR and other regulations are putting investment managers under huge pressure.
- ▶ Classifying existing funds is a challenge, and product development is affected too.
- ▶ Firms are trying many approaches to implementation, and to addressing talent shortages.
- ▶ Despite these difficulties, regulation can help firms to focus their ESG strategies and thinking.

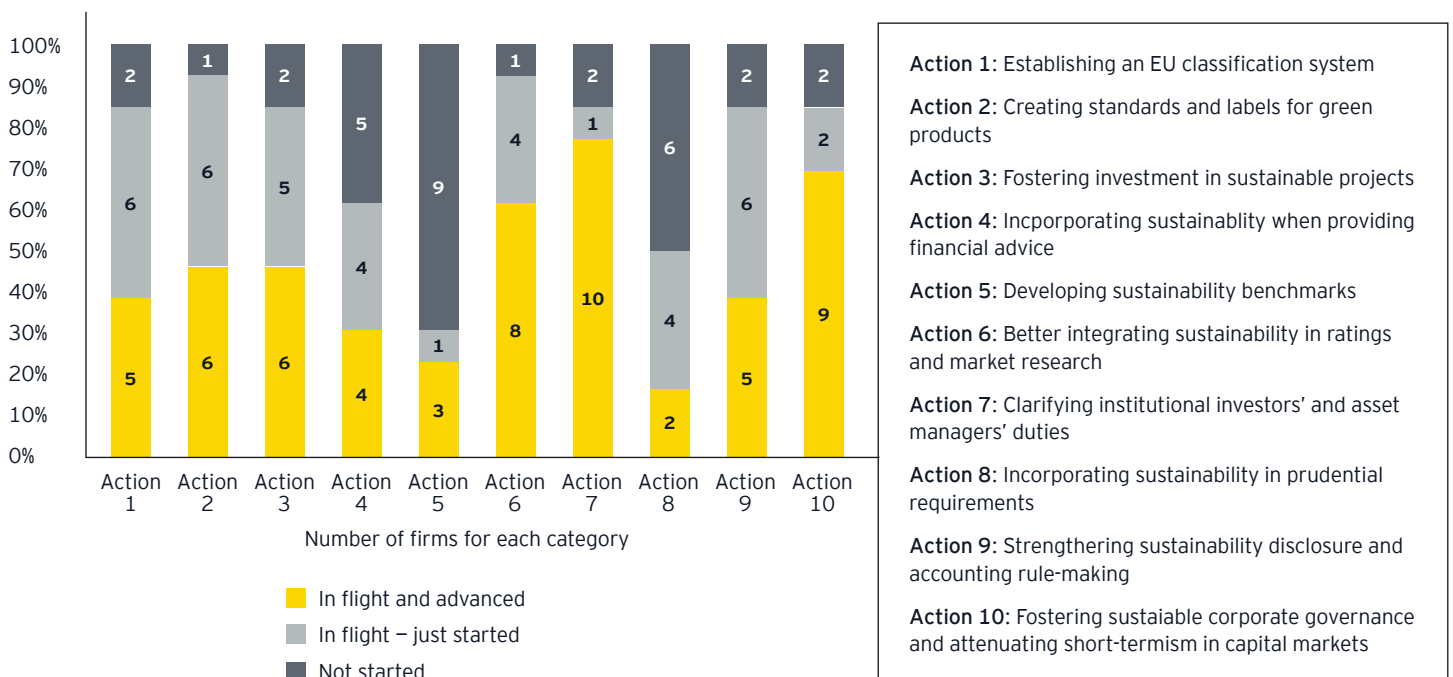
The EU's Sustainable Finance Action Plan continues to shape the evolution of ESG investing [see Figure 6]. The survey shows that investment managers are relatively well-advanced in clarifying their duties (Action 7) and establishing sustainable corporate governance (Action 10). Passive specialists are also prioritising the development of tilted indices (Action 5). Overall though, there is no doubt that the Sustainable Finance

Disclosure Regulation (SFDR) stands out as the industry's greatest and most pressing compliance challenge

It's not hard to see why. Investment managers face significant stakeholder pressure – especially from institutional investors – to apply SFDR categories to existing funds, even though the technical standard and EU taxonomy are not yet final. Firms are trying to square this circle in different ways. Some are confidently using Article 8 (light green) and Article 9 (dark green) classifications; some are applying those classifications provisionally; some are opting for safety by temporarily classifying all funds as Article 6 (non-sustainable); and some are struggling to pick an approach.

As they step up their SFDR efforts over the next 12 months, firms will need to strike a difficult balance between growth opportunities, implementation challenges and potential greenwashing risks. That's not only true for existing funds. SFDR is also making product development much harder, given the need for firms to educate clients, develop measurement capabilities for sustainability impact across investments, understand investment preferences, and meet heightened expectations for performance and reporting.

**Figure 6: Please advise on the status of activity across each of the EU Action Plan "Actions" across your firm**



When asked about their overall progress in integrating ESG into products and services, firms range from making statements of good intention to running well-advanced implementation programmes backed up by investments in data, technology and talent. Most respondents (83%) have focused cross-functional working groups and dedicated ESG committees. Meanwhile, 78% say that the front office integrates ESG into investment processes and 72% report having a dedicated group-wide ESG function. Larger firms are more likely to have dedicated ESG sub-committees too.

The need for specialised resources, and the limited availability of experienced staff, means that talent is at a premium. So it's no surprise that most firms we surveyed (77%) favour a combination of partnering, recruitment and training to develop the skills they need. Many organizations have also integrated ESG into staff performance metrics and introduced ESG-linked remuneration. It's hard to judge the impact of these changes on organisational behaviour, but positive effects should multiply as incentives grow more aligned.

In short, despite its obvious flaws, SFDR is clearly acting as a major driver of change and innovation in investment practice. Instead of viewing regulation through a narrow compliance lens, firms should see the new rules as an opportunity to take stock of their current products and refocus their investment strategies. Choosing a distinctive direction will force investment managers to identify the data, skills, processes and technology they need – helping to develop a targeted, impactful approach to ESG investing.



## 5

### Data and technology: still defying easy solutions

- ▶ Investment managers are unhappy with the quality, cost and consistency of ESG data.
- ▶ The industry's growing data footprint is creating additional knock-on problems.
- ▶ The influence of a handful of data providers is a source of concern for some.
- ▶ Firms are looking to FinTechs and specialist partners to overcome their ESG data challenges.

The difficulties of capturing, interpreting and harnessing ESG data are well-known, but the survey clarifies exactly which problems firms see as being the most acute [see Figure 7]. Respondents view poor quality, contradictory data as the biggest challenge, followed by escalating cost. Other leading concerns include conflicting vendor ratings and the lack of comparable data across regions.

**Figure 7: What are the biggest challenges in relation to ESG data?**

Rank	Initiatives	Percentage of respondents using the initiative
1	Quality of data-contradictions	22%
2	Escalating cost	17%
3	Conflicting vendor ratings and scores	15%
4	Lack of comparable data across regions	12%
5	Lack of coverage across E, S and G	10%
5	Lack of consistent data across sectors	10%
6	Lack of data within sectors	7%
6	Lack of transparency	7%

These results highlight a vicious circle for investment managers. Firms have little choice but to pay external providers for ESG data, adding to the cost burden of traditional data feeds and ongoing investments in 'golden sources' of data. Expanding their data footprint inevitably drives up other costs too, with additional systems and processes needed to manage increasing complexity. And yet this data is frequently seen as insufficiently reliable in terms of its quality, availability and usability.

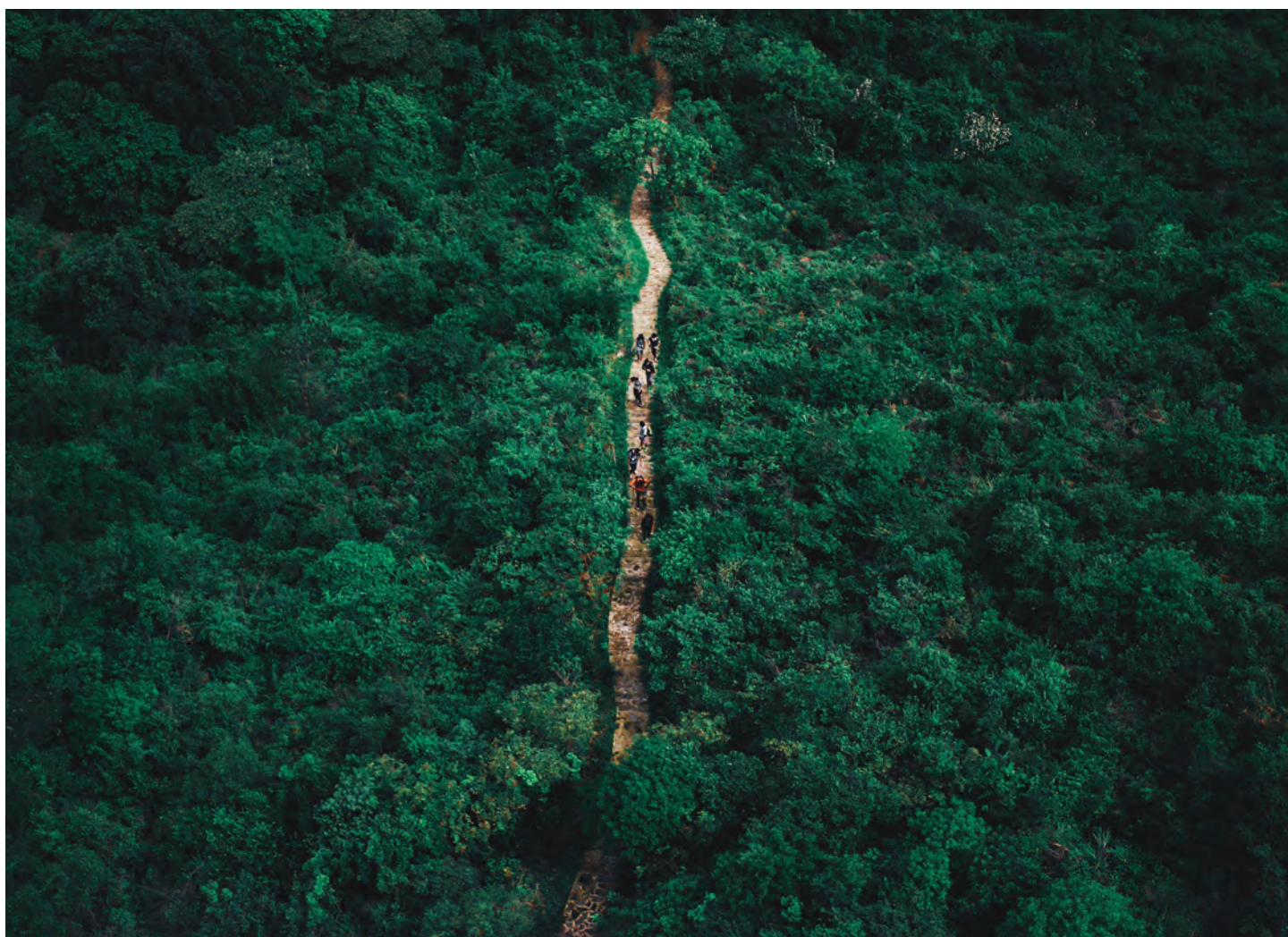


Widespread concern with the inaccuracy, expense and contradictions of ESG data puts the role of third-party data providers in the spotlight. Many respondents (68%) use internal data models for ESG ratings and research, and 63% are building ESG platforms in-house. Unsurprisingly though, 92% of asset managers and 50% of wealth managers also work with external data providers.

In theory, data providers allow managers to focus on their core competencies. In practice, they often leave firms unsure about the quality of underlying disclosures, standards of regulation and assurance, and the treatment of information. A few respondents also expressed concerns about possible concentrations of risk arising from excessive reliance on a handful of data providers, or about the influence they exert

over regulatory standards. Some firms seek to overcome these challenges by using multiple data providers, maximising the information they receive. In contrast, others try to control costs by limiting their use of third-party data to targeted areas.

In reality, there is no simple way to cut through the bewildering ESG data jungle. Investment managers are being as innovative as possible in their responses to the challenge. Many are using external technology partnerships to address the limitations of ESG data and in-house systems. Collaboration with software vendors, FinTechs and other specialists such as expert climate modelers (47%) and alternative data providers 32% is increasingly common. In our view, the use of ecosystem models is only likely to grow as the industry struggles to make sense of the imperfect world of ESG data.





# Conclusion

## Taking ESG investing to the next level

There is still a huge amount for wealth and asset managers to do to fully integrate ESG into their targets, strategies, products, operations, remuneration and culture. Climate change especially will continue to be the major focus over the coming year as firms set ambitions, measure baselines and develop decarbonisation plans.

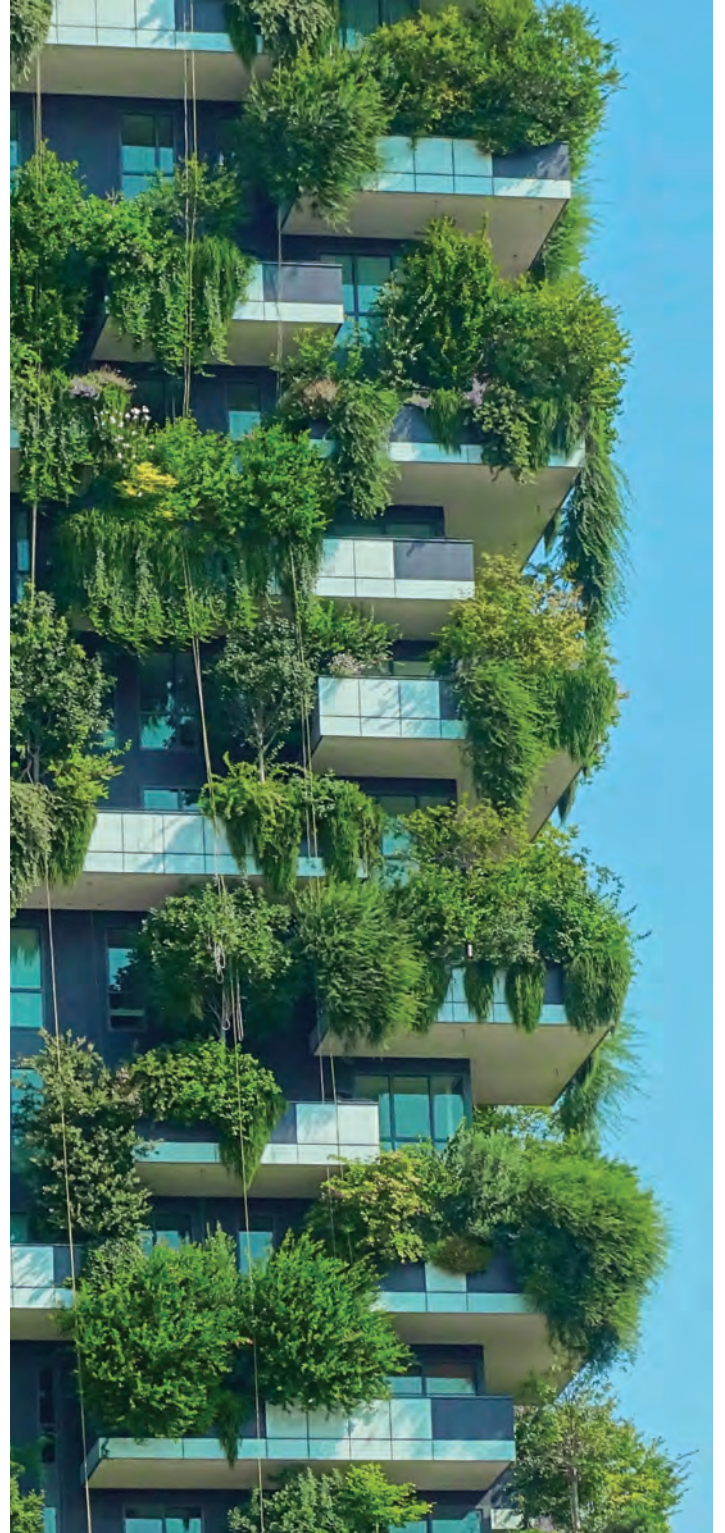
Closer acquaintance with the reality of ESG implementation is increasing the industry's knowledge base. Set against that, it is also underlining the scale of the task and laying bare the scarcity of talent – a recurring theme that affects every organisation.

It is good to see that, while regulation remains a key driver, ESG investing is increasingly shaped by commercial imperatives. However, that comes with potential risks too. It is vital for firms to keep their eyes on achieving real-world outcomes, not just on achieving internal targets or the appearance of progress. That calls for a stronger commitment to investment governance – something illustrated by firms' strong interest in the revised stewardship code.

Looking further ahead, each cycle of commitments and target-setting will only heighten the stakeholder expectations that investment managers need to satisfy. At the same time, it's becoming clear that ESG will never be a "settled issue". The global shocks of recent years are a reminder that sustainability will continually evolve, shaped by shifts in economics, geopolitics and public consciousness.

These dynamics suggest that ESG investing will only continue to gain importance and momentum, exerting greater influence over investment strategies and industry structures in the process. They also mean that firms can no longer pursue unfocused ESG strategies or me-too approaches that mimic industry leaders. Each institution needs to nail its colours to the mast, ensuring that its approach to ESG is well-aligned with its wider strategy, goals and competencies.

But while our conversations with clients show that many questions around ESG investing remain to be answered, they also paint a picture of an industry that's stepping up to meet the challenge. Developing a dynamic mindset based on purpose, understanding, focus, skills and flexibility will be critical to achieving lasting ESG success for investors and firms alike.





# Key contacts



**Gillian Lofts**

Global Head of Sustainable Finance,  
Ernst & Young LLP

T: +44 20 7951 5131

E: glofts@uk.ey.com



**Naheed Tapya**

Consulting Partner,  
Wealth and Asset Management,  
Ernst & Young LLP

T: +44 20 7951 3094

E: naheed.s.tapya@ey.com



**Scott Mc Evatt**

Director,  
Wealth and Asset Management,  
Ernst & Young LLP

T: +44 20 7197 7171

E: scott.mc.evatt@uk.ey.com

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