Greenwashing: considerations for New Zealand fund managers

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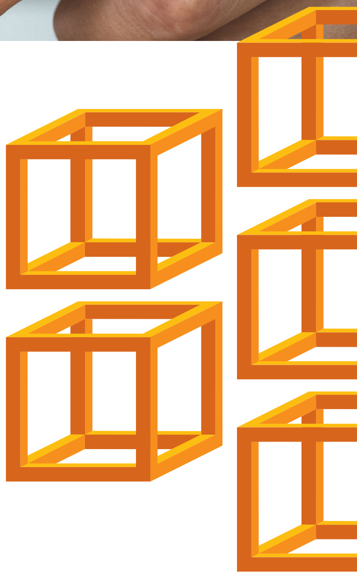


Investors are increasingly focused on Environmental, Social, and Governance (ESG) factors. Capital Group's ESG research shows that nearly one-third of global investors (31%) say meeting client needs and requests is the number one reason their organisation invests in ESG – well ahead of the numbers who say they are doing it for regulatory reasons. At the same time, recent research from the University of Otago has found that many global equity funds sold to New Zealand investors are overstating their ESG credentials.

Understandably, regulators are increasing scrutiny of fund managers in response to this investor demand and government action on sustainable growth.[1] The Financial Markets Authority (FMA) published guidance detailing their expectations for advertising and disclosure relating to financial products that incorporate non-financial factors (e.g. ESG). The FMA stated they want to "*ensure that investors can be confident that these products deliver what they promise and that investors are protected from poor product design and confusing or misleading disclosure and marketing (i.e. greenwashing)*".[2]

This paper is for New Zealand fund managers who have, or are considering offering, funds that apply ESG factors to their investment decisions (sometimes referred to as 'responsible investments'). It details some of the risks and opportunities that considering ESG factors presents. It also poses a number of questions for fund managers to ask to help ensure they are making the most of the opportunities ESG investments offer, and managing the potential risks effectively, and we suggest some actions they can take to help achieve this.

1 The Financial Markets Authority stated a priority activity would be to review whether claims made by providers in their promotions, advertising, social media and related media were true, such as in relation to ESG in their Annual Corporate Plan for 2021/22.
2 FMA's Disclosure framework for integrated financial products.

Risks and opportunities for New Zealand fund managers offering ESG funds

Be clear on ESG promises, and make sure you live up to them

Many fund managers are considering ESG to some extent. ESG phrases and language are starting to feature more prominently in marketing material and where these promises are made, there needs to be clear evidence to support their accuracy in a way that stands up to independent scrutiny. 'Best endeavours' or 'to the best of our knowledge' simply won't be sufficient.

Some fund managers directly market funds as ESG-focused with comprehensive criteria applied to determine whether investments are suitable. Other fund managers may apply a more simple criteria, prohibiting certain types of investments (e.g. tobacco, firearms). In either case, fund managers must be able to back up these statements with clear measurements to prove that these criteria have been met.

Consideration of ESG factors is becoming standard market practice

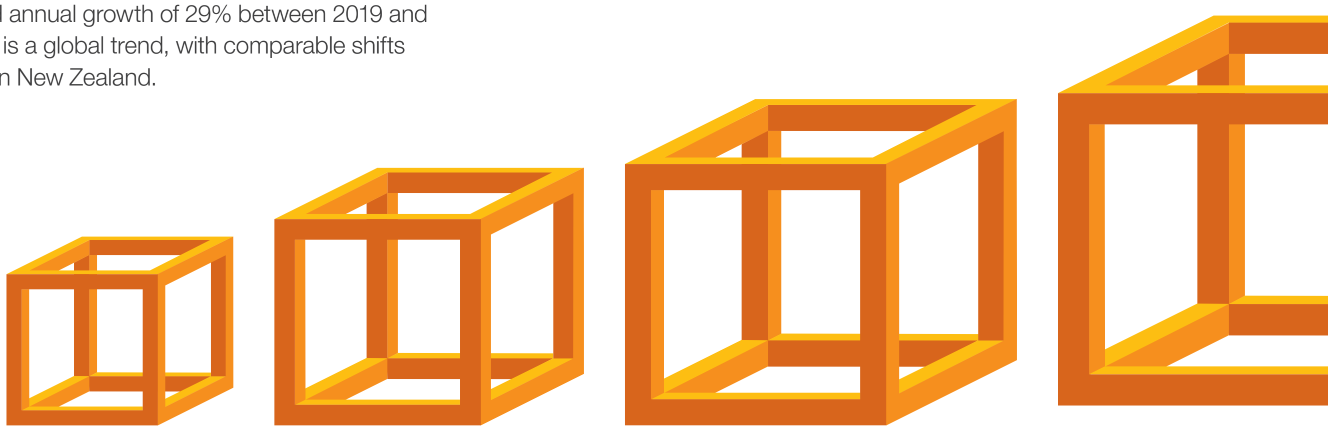
ESG investments are increasingly popular. PwC's research suggests institutional investors in Europe expect ESG and non-ESG products to converge and, from next year, 77% of these institutions expect to stop investing in the latter. ESG fund assets under management in Europe could account for more than 50% of mutual fund assets by 2025, representing compound annual growth of 29% between 2019 and 2025. This is a global trend, with comparable shifts occurring in New Zealand.

Increasing availability of ESG information can be a source of competitive advantage

Some investment managers explicitly and systematically use ESG factors in investment analysis and investment decisions (ESG Integration). This is with the view that ESG factors can affect corporate and investment performance (lower risk and/or higher return investments)[3].

Mitigating the potential to confuse or mislead customers

The multitude of different terms for ESG factors, (including responsible investments, sustainable finance, integrated financial products, green investments), and the different ways they are used and can be interpreted gives rise to the risk of investors being confused or misled. Further, the complexity of ESG factors creates further risk. What may seem a reasonable interpretation to one person may seem unreasonable to another, leading to the potential for confusion. For example, does an ESG policy that prohibits investment in fossil fuels mean it does not invest in companies that transport fossil fuels? Does that answer change depending on the amount/proportion of revenue that company earns from transporting fossil fuels? Are all of your investors likely to share the same view?



3 Investor Group on Climate Change (IGCC) – Full Disclosure: Improving Corporate Reporting on Climate Risk.

Questions to ask

The questions below outline factors to understand if you are considering applying ESG factors to your investment decisions:

What ESG promises or claims do we make (or want to make) in relation to our funds?

You may want to state that you exclude investments in companies that are primarily focused on things you consider are social-ills. Or, you may want to describe a more comprehensive approach, such as you only invest in companies that you have assessed as actively contributing to a social good, paying a living wage, and having zero carbon emissions.

You may want to align the ESG claims you make about your funds with your company's ESG policy, or at least avoid inconsistencies. For example, if your company aims to be carbon neutral by 2025, you may decide to state your ESG fund will only invest in companies that share the same ambition.

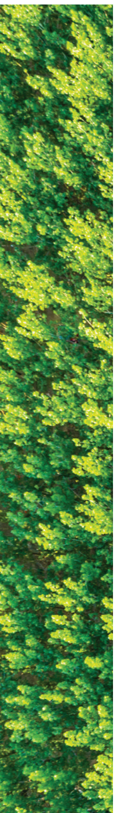
What specific criteria do we apply to determine whether an investment meets our ESG criteria?

For example, you may exclude investments in companies that derive more than 5% of their revenue from tobacco products, based on their most recent financial accounts.

Are there any inconsistencies, or nuances, between the answers to the questions above?

There may be a disconnect between broad claims that are simple and understandable, and actual practices which are more complicated. This gives rise to the potential for investors to be confused or misled. For example, the following may be considered confusing or misleading:

- stating you 'avoid investments related to fossil fuels' while in practice you only prohibit investments in companies that extract fossil fuels, or only restrict companies that earn more than 5% of their revenue from fossil fuel extraction; and
- claims made in relation to the investment fund as a whole, when in practice they only apply to equity investments and not other investments in the fund (e.g. fixed interest).



What reliance do we place on the ESG claims of others, and how do we manage the risks associated with this?

If your fund holds investments in other funds, are their ESG definitions, policies and practices aligned with your claims? What if their ESG policies change over time?

How integrated is the consideration of ESG factors into traditional financial analysis and investment decision making?

ESG factors may contribute to investment value and risk. You may want to integrate ESG factors into all parts of the investment decision making process, rather than being separate. If you do so, you should consider whether you have the right skills and experience.

After the initial investment decision, how do we check our investments meet our ESG criteria on an ongoing basis?

The ESG characteristics of investments may change over time. For example, a company may increase its reliance on fossil fuels, miss a target relating to CO_2 emissions, or increase the proportion of revenue it earns from weapons sales.

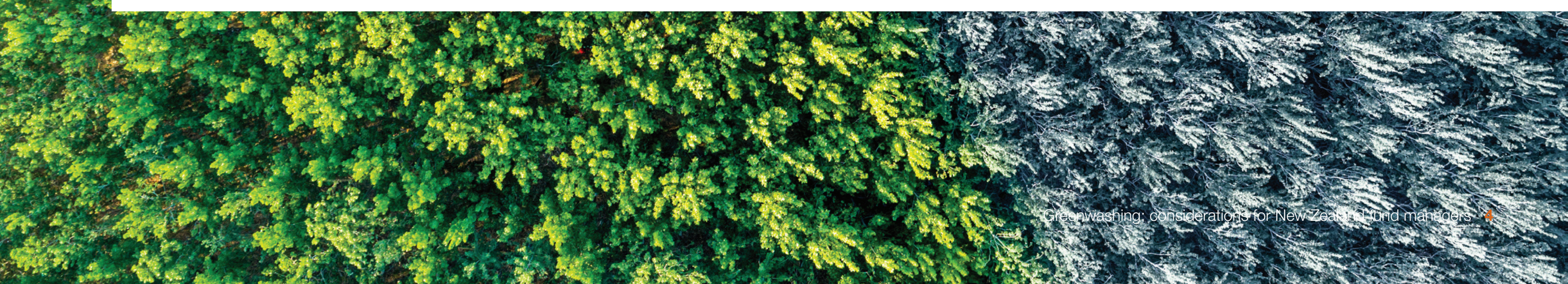
What will we do if we identify an existing investment that no longer meets our ESG criteria?

It is possible the appropriate action will be to divest the holding. If you do so, consider how this can be achieved in a way that is in the interests of investors – particularly if the investment is large and a quick-sale could reduce the price.

How do we ensure all communication with investors in relation to ESG is clear and accurate?

This does not just apply to legally required documents such as the product disclosure statement and financial statement disclosures, but to all your communications with customers – including articles you publish, newsletters you send to customers, and your website.

The overall objective is to be confident that you can substantiate any ESG claims you are making (both at the initial investment stage and on an ongoing basis), and that you consider using information regarding ESG performance to inform investment decisions.



What are the next steps?

To get underway with applying ESG factors to investment decisions we suggest the steps below:

1. Answer the questions above.
2. Identify gaps between your current practices and what you would like your practices to be, and develop a plan with specific actions and timings to address the gap.
3. In the event you identify instances where you may have made ESG-related claims that cannot be substantiated or could be considered confusing or misleading, consider how best to make it right, including remediating affected investors.

How we can help

We have experts in consulting, assurance and risk services who can offer advice and insight. Our Financial Services industry experts work with a wide range of fund and asset managers, from privately owned “boutique” operators to large statutory fund managers. Relevant services include assessing and incorporating climate risks into financial statements, assurance over climate statements and greenhouse gas (GHG) emissions.

We provide assurance over climate-related qualitative and quantitative disclosures. Our role is to provide your stakeholders with trust and confidence over the reliability of the information you are communicating to them.

Who to talk to

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