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THE CAPCO INSTITUTE
JOURNAL
OF FINANCIAL TRANSFORMATION

ENVIRONMENTAL

Seeing ESG through a U.S. lens
MARINA SEVERINOVSKY

ESG

#56 NOVEMBER 2022

THE CAPCO INSTITUTE

JOURNAL OF FINANCIAL TRANSFORMATION

RECIPIENT OF THE APEX AWARD FOR PUBLICATION EXCELLENCE

CONTENTS

ENVIRONMENTAL

SOCIAL

GOVERNANCE

DEAR READER,

Welcome to edition 56 of the Capco Institute Journal of Financial Transformation, produced in partnership with King's Business School and dedicated to the theme of ESG – environmental, social and governance.

We all recognize that transformation towards a green economic system via sustainable finance is needed, welcome and inevitable. Our clients have a crucial role to play here. Acknowledging the scope and complexity of the evolving ESG landscape, we are perfectly positioned to prepare them for the ESG era.

With climate change accelerating and generating physical events on an unprecedented scale, governments and societies are considering measures to mitigate carbon emissions via net zero initiatives. The focus is firmly on greater sustainability and more equitable policies in response to shifting public attitudes. ESG considerations are reshaping investment risks on the one hand, and opening the way for green financing and sustainable technologies and innovations on the other.

This edition of the Journal examines all three pillars – environmental, social, and governance, highlighting efforts by regulators and practitioners to create a unified approach.

Moving forward, compliance with emerging ESG standards will be a critical differentiator for long-term business success. Data will also play a critical role in delivering the transparency and insights required to validate the ESG credentials of businesses, and investment strategies. Advances in areas such as machine learning, artificial intelligence and cloud technologies will be key to establishing a future model of sustainable finance.

This edition draws upon the knowledge and experience of world-class experts from both industry and academia, covering a host of ESG topics and innovations including the value of tracking Return on Sustainability Investment (ROSI) and the importance of moving away from purely external risks to addressing issues that can have positive commercial and societal impacts.

I hope that that the research and analysis within this edition will prove valuable for you as you shape your own ESG strategies, policies, and innovation.

Thank you to all our contributors and thank you for reading.

Lance Levy, **Capco CEO**

SEEING ESG THROUGH A U.S. LENS

MARINA SEVERINOVSKY | Head of Sustainability – North America, Schroders

ABSTRACT

It is important for asset managers to engage U.S. investors in the sustainable investing conversation in a way that will resonate with them. Across geographies, the political spectrum, and generational cohorts, the asset management industry can seek to meet American investors on their own terms, in relation to their objectives and priorities. From a risk mitigation standpoint and from the perspective of capturing better long-term returns, we believe U.S. clients, no less than those in other regions, can benefit from having ESG considerations integrated into their investments.

1. INTRODUCTION

Schroders is committed to sustainability because we believe that integrating ESG (environmental, social, governance) factors can lead to improved outcomes for all stakeholders. First and foremost, it could be used to mitigate investment risks. The strength and speed of the global shift towards sustainability creates significant risk for the companies that get left behind. As a result, rigorously assessing ESG-related characteristics is crucial to effectively managing portfolio risk.

Second, ESG could create investment opportunities. We believe that a combination of identifying opportunities for growth, and active engagement with companies, can help enhance long-term returns. Finally, we do believe that the impact of their investments is something that clients increasingly care about. In the modern, interconnected world, we are all ever more aware of the impact that our behavior, from our purchasing decisions to our investments, can have on society and the environment. Consequently, it is crucial that investments are aligned with the sustainability objectives of clients.

All of this is as true in the U.S. as anywhere else – yet there is a general perception that the U.S. has lagged when it comes to ESG or sustainable investing.

This has certainly been the case with regards to the regulatory environment, with the Securities and Exchange Commission and Department of Labor in the process of playing catch-up in 2022 with new proposed rules. The U.S., unlike other markets, does not yet have a stewardship code that addresses ESG in any systematic way, disclosure requirements are a work in progress, and fund standards or taxonomies have not yet been established.

It is also true that some elements of ESG are more controversial and divisive in the U.S. than elsewhere. We have already seen rules both proposed and adopted by various states (e.g., most notably Texas and Florida) to prevent their public pension plans from doing business with any entity that "discriminates" against or "boycotts" firearm manufacturers/distributors or energy companies, or to restrict the use of ESG considerations (other than those that are financially material) in investment decisions. There are also other states, especially those with meaningful reliance on fossil fuels, that could enact similar restrictions. Notably, the state of Maine has gone the other way and passed a law that requires the Maine Public Employee Retirement System to divest from fossil fuels, and many other states are contemplating or enacting legislation to promote ESG integration in investments or to mandate divestment of fossil fuels or firearms in their portfolios.

Hence, the U.S. is indeed different. However, our view is that U.S. investors are no less interested in sustainability than others globally – they simply need to see how ESG aligns to their own values. And asset managers must communicate with U.S. investors on their terms, finding areas of commonality. We cannot just take an approach followed in the U.K. or Europe and impose it onto the U.S. market.

Instead, we have to meet the U.S. clients where they are, and show that sustainability is certainly a broad enough discipline to address their interests as well. In short, we need to consider ESG considerations through a U.S. lens, whether that is in our thought leadership, thematic research, company engagement, or product development.

2. OUR OWN SORT OF CLIMATE

What are the top ESG issues in Europe? To say that climate is number one and number two is not much of an exaggeration. European governments, regulators, and investors have placed a strong focus on decarbonization. And the U.S., a vast land rich in natural capital resources and biodiversity, encompassing within it many different terrains and ecosystems, has good reasons to care about climate too.

The elevated physical risks of climate change, such as wildfires, hurricanes, extreme heat, and flooding have increasingly affected many Americans. The preservation and conservation of our nation's abundant natural resources is a core part of the American psyche, associated with great historical figures like Theodore Roosevelt and manifest in the expansive network of our national parks.

U.S. investors, no less than those around the world, want to preserve this natural heritage for their children and grandchildren, and U.S. companies, alongside global peers, have accelerated their net zero and other voluntary climate pledge commitments. After many years of feet dragging, governments, corporates, and investors globally are becoming more aligned on cutting carbon emissions and limiting temperature increases.

However, we must also be conscious that change does not happen in a vacuum. Many regions of the U.S. are reliant on natural resource extraction and production, and many sectors of the U.S. economy are driven by fossil fuels. A transition takes time to effect, and we must support the companies, people, and communities that are required to adapt.

Transition financing, which offers capital to high-emitting companies or industries, in order to support their shift towards a climate-neutral or climate-positive future, is needed. (Rather than excluding such industries or issuers, Schroders is committed to active ownership with companies as they navigate this path.) Moreover, we believe that regulations in the U.S., different to the approach in Europe, will focus on best-in-class instead of exclusions, and allow for transition financing to encourage engagement with problematic industries or issuers and avoid surrendering influence via divestment.

In addition, when investors assess transitioning companies, it is important to consider measures of avoided emissions, which account for the potential decarbonization contributions of companies that are seeking to adjust their businesses and developing products and services that can drive significant reductions in economy-wide emissions in the future. In this way, even companies that currently have higher carbon intensity could evolve and even become enablers of climate positive change over time.

In addition to companies, we must also support workers and communities. In the U.S., the concept of a "just transition" is especially relevant, given how climate change mitigation and decarbonization efforts affect people in various U.S. regions and industries, and the desire on the part of most Americans that these folks not be left behind. Thus, a just transition in our view means combining climate action with fair socio-economic distribution and giving impacted communities a voice. This includes engaging with workers, unions, and communities that will be affected, providing them with a plan for income support during the transition and proper training or retraining of employees to ensure they can transition to valued work in the future.

3. ESG BEGINS WITH E, BUT IT DOES NOT END WITH IT

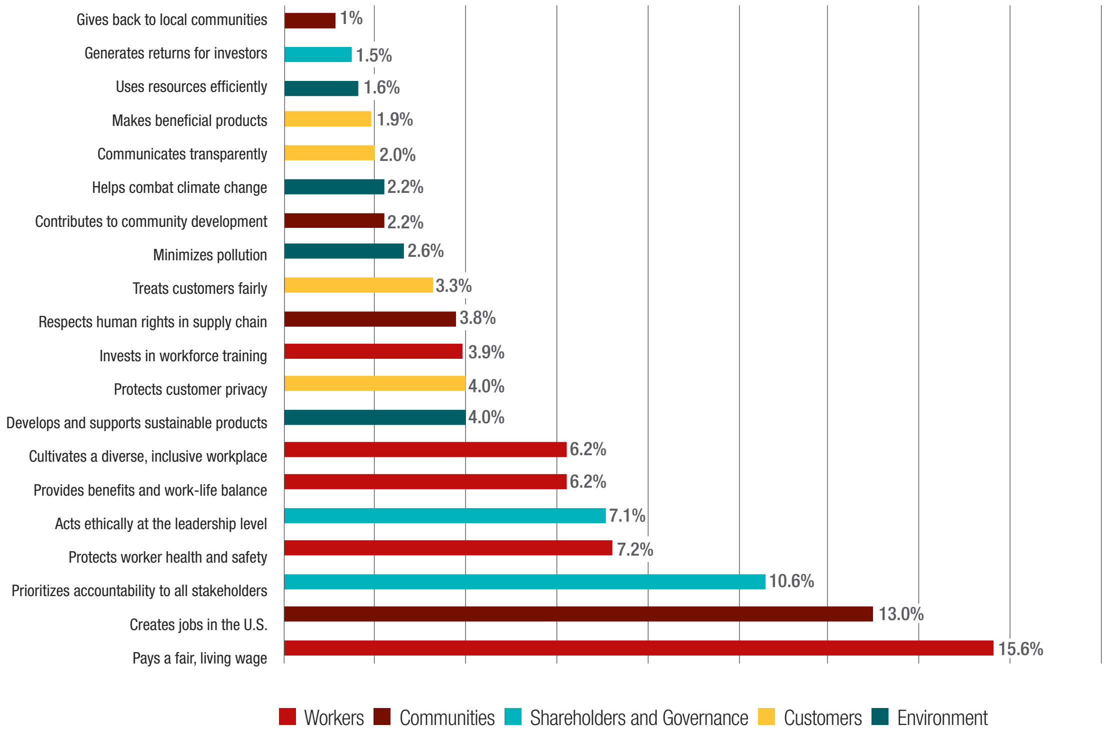
While climate is certainly a critical issue, from both a risk and opportunity standpoint, we observe that among U.S. investors, there is much more of a balance towards social considerations as well.

In the context of the COVID-19 pandemic especially, in the absence of the social safety net that exists in other parts of the world, and in the fraught political climate of recent years, U.S. investors – like all Americans – keenly feel the issues around financial inequalities, social and racial disparities, and the challenges faced by workers (see Figure 1).

Issues like economic inclusion (education and training, quality work, living wages, gender equality, workforce diversity), sustainable infrastructure, and good health and wellbeing (access to healthcare) are meaningful to a majority of U.S, investors, according to recent research from JUST Capital.[1]

[1] https://bit.ly/3dcGjER

Figure 1: What are Americans' top priorities for companies today?



Source: 2022 JUST Capital Foundation.

*Schroders proprietary tools and models are designed to enhance the research and evaluation process but do not guarantee favorable results or any intended outcomes.

It is important that these U.S. investors understand that their priorities also fall squarely within the realm of sustainability.

Social issues are very much a focus of our thematic research and our engagement efforts, and we are currently building a new research framework and testing a variety of human capital metrics to help contextualize the human leverage on capital employed, uncover the human drivers of firm-level productivity, and shed light on the possible human impact on the persistence of returns through the cycle. In addition, our firm-wide roadmap for active ownership in the coming years identifies six key priority areas/themes,[2] three of which are focused on social factors (see Figure 2).

4. FOCUS ON THE UPSIDE

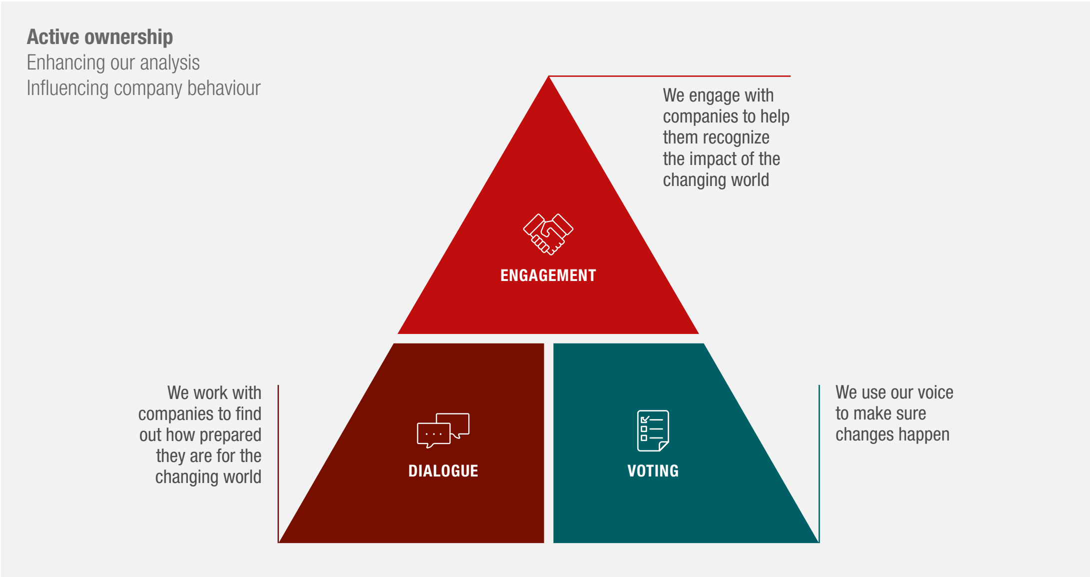
Even if there is less agreement in principle among Americans regarding certain ESG related issues, especially around climate, this need not prevent pragmatic discussion about why ESG integration matters in portfolios, purely from a better long-term risk and return standpoint, as well as from the standpoint of the impacts those investments have. The reality is that conversations do not always need to be about the sacrifices made in trying to reduce emissions in a portfolio. The other side of that same conversation can be about the opportunity to make lucrative investments in new technologies and solutions that can mitigate and even reverse environmental damage.

Also from a purely pragmatic perspective, we believe that we have a responsibility to try to protect our clients' capital from the risks that climate change poses. Given government and corporate decarbonization pledges, regulation, and public awareness of the issue, we expect that huge quantities of capital will be withdrawn from sectors that emit carbon and reinvested in those that aid transition. We, therefore, look for value in the potential opportunities created.

As investors, we believe the way we direct capital not only shapes the financial returns but also the type of impact

[2] https://bit.ly/3BBKtj4

Figure 2: Active ownership and key thematic priorities



SIX KEY THEMATIC PRIORITIES

CLIMATE	BIODIVERSITY AND NATURAL RESOURCE CONSTRAINTS	HUMAN CAPITAL MANAGEMENT
• GHG emissions • Decarbonization • Net zero • Physical risks • Renewable	• Biodiversity • Deforestation • Pollution and chemicals • Waste and circular economy • Water stress • Responsible sourcing • Plastic pollution	• Health and safety • Wellbeing • Compensation and benefits • Employee engagement • Freedom of association • Culture
INCLUSION AND DIVERSITY	**HUMAN RIGHTS**	**GOVERNANCE AND OVERSIGHT**
• Board diversity • Workforce diversity and inclusion • Impact of products and services on diverse communities • Gender and ethnic pay gap	• Child labor • Ethical supply chain • Indigenous rights • Basic access to products and services • Modern slavery	• Shareholders' rights • Executive compensation • Board composition • Governance interlinks with E+S issues

Source: Schroders

we have on the world. The relationship between these two outcomes has rapidly evolved as we see a fundamental shift in how companies are viewed and valued. Understanding the impact that they have on society and the planet could be crucial in determining their true costs and ultimately their impact-adjusted profits. Sustainable investing has become a cornerstone of building robust portfolios that may deliver long-term returns, serving the interests of both investors and society.

5. CONCLUSION

We believe that it is important for asset managers to engage U.S. investors in the sustainable investing conversation in a way that will resonate with them. Across geographies, the political spectrum, and generational cohorts, the asset management industry can seek to meet American investors on their own terms, in relation to their objectives and priorities. From a risk mitigation standpoint and from the perspective of capturing better long-term returns, we believe U.S. investors, no less than those in other regions, can benefit from having ESG considerations integrated into their investments.

ABOUT CAPCO

Capco, a Wipro company, is a global technology and management consultancy specializing in driving digital transformation in the financial services industry. With a growing client portfolio comprising of over 100 global organizations, Capco operates at the intersection of business and technology by combining innovative thinking with unrivalled industry knowledge to deliver end-to-end data-driven solutions and fast-track digital initiatives for banking and payments, capital markets, wealth and asset management, insurance, and the energy sector. Capco's cutting-edge ingenuity is brought to life through its Innovation Labs and award-winning Be Yourself At Work culture and diverse talent.

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ABOUT KING'S BUSINESS SCHOOL

King's Business School, the ninth and newest faculty at King's College London, opened in 2017. It is accredited by AACSB and EQUIS and was rated one of the top 10 business schools for research in the U.K. based on the Research Excellence Framework 2021. It is rated fifth in the U.K. for Business Studies by the Times and Sunday Times Good University Guide. Based in the heart of London, the School is part of an internationally renowned research-intensive university with a track-record of pioneering thinking and the limitless energies of the city's businesses, policy-makers, entrepreneurs and change-makers to draw on. The School's commitment to drive positive change is at the heart of its research and education.

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