

Sustainable investing: A new growth engine for asset management firms



Abstract

The global focus on climate change and sustainability coupled with a growing band of socially conscious investors is driving a shift toward investment options that incorporate environmental, social, and governance (ESG) factors in the asset management industry. Investors are embracing sustainable investing with the twin objectives of improved long-term financial returns and better environment and social outcomes. This investor-driven shift toward sustainable investing offers asset management firms an opportunity to drive AUM growth. In fact, given the growing focus on sustainability, going forward, firms will need to build investment portfolios that balance the traditional goals of financial returns and long-term ESG impact. To achieve this, firms will need to build robust, client-centric sustainable investment offerings by building an ecosystem and leveraging emerging technologies to capitalize on the increased demand for sustainable investment products, enabling them to evolve into future-ready firms. This white paper highlights the challenges firms face in embracing the sustainable investing paradigm as well as regulatory compulsions and implications, and discusses the capabilities they need to develop to offer differentiated value propositions to their clients.

The shifting asset management landscape

The global asset management industry recorded single-digit compounded annual growth rate (CAGR) in AUM from 2015 till the onset of the pandemic¹. Given this backdrop, several firms are offering diverse investment strategies to attract investors and improve AUM. These strategies increasingly include sustainable investment options that encompass ESG investing, socially responsible investing (SRI), and impact investing aimed at positive social and environmental impact. As a result, global sustainable investing assets increased by 34% in two years to touch USD 30.7 trillion in early 2018, with the US and Europe accounting for over 80%². Furthermore, overall value of assets using ESG data exceeded USD 40 trillion in 2020, and this growth is likely to continue.³

The demand for sustainable investing is driven by both retail clients, especially millennials that wish to create positive social impact through their investment choices, and institutional clients focused on mitigating sustainability risks and adding value to their long-term investments. The pandemic has also brought social issues such as employee wellbeing into investor focus. Consequently, the industry is seeing the launch of new sustainable funds as also the conversion of existing funds into sustainable ones to grow AUM. However, the path to sustainable investing is beset with roadblocks and firms will need to overcome several hurdles to achieve sustainable portfolios.

Regulatory action

Regulatory activity, with Europe taking the lead, is driving a shift in the asset management landscape. The European Union (EU) has embarked on an ambitious action plan to become the first carbon-neutral continent by 2050.⁴ To achieve this goal, regulators are promoting transparency by mandating new sustainability disclosures from firms. A few key regulations that will impact firms operating in Europe are:

- **Sustainable Finance Disclosure Regulation (SFDR):** This regulation mandates standardized disclosures at entity and product levels to promote transparency.⁵
- **Taxonomy Regulation:** This regulation aims to establish an EU-wide classification system for environmentally sustainable activities. Firms will need to disclose the percentage of taxonomy-aligned investments in their funds.⁶
- **Amendments to existing regulations:** The European Commission (EC) has amended the Markets in Financial Instruments Directive (MiFID) II, Undertakings for Collective Investment in Transferable Securities (UCITS), and Alternative Investment Fund Managers Directive (AIFMD) regulations to mandate integration of sustainability risks into organizational requirements, operating conditions, and risk management. Similarly, the EC has made additional amendments to MiFID II regulation mandating the integration of investor's sustainability preferences into investment advice and portfolio management.^{7,8,9}

Regulatory changes will significantly impact key functions such as client engagement, portfolio management, reporting, and data management. Upcoming regulations, such as the Benchmarks Regulation related to low carbon benchmarks, EU Ecolabel for retail financial products, and EU Green Bond Standard, too, will impact firms, but to a lesser extent. Climate change can substantially affect asset valuation, which makes managing impact of climate risk in investment portfolios an imperative for firms. The UK government has published a roadmap mandating climate-related disclosures in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).¹⁰ While most of these regulations are expected to be implemented by end 2022, the SFDR and Taxonomy Regulation have extremely stringent timelines. In our view, firms with operations in Europe, must immediately assess the impact of these regulations on their products, processes, and technologies, and initiate remediation programs.

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- [1] CISION PR Newswire, *Worldwide Asset Management Industry to 2030 - Identify Growth Segments for Investment*, July 2020, Accessed December 2020, <https://www.prnewswire.com/news-releases/worldwide-asset-management-industry-to-2030---identify-growth-segments-for-investment-301097895.html>
 - [2] Global Sustainable Investment Alliance, *2018 Global Sustainable Investment Review*, 2018, Accessed January 2021, http://www.gsi-alliance.org/wp-content/uploads/2019/06/GSIR_Review2018F.pdf
 - [3] MARKETSMEDIA, *ESG Assets Have Grown 15% Annually*, July 2020, Accessed December 2020, <https://www.marketsmedia.com/esg-assets-have-grown-15-annually/>
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 - [6] European Commission, *Sustainable finance*, Accessed January 2021, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en
 - [7] Official Journal of the European Union, *Commission Delegated Regulation (EU) 2021/1253*, April 2021, Accessed September 2021, <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R1253&from=EN>
 - [8] European Commission, *Delegated directive - C(2021)2617*, Accessed June 2021, <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/11959-Integration-of-sustainability-risks-and-factors-for-undertakings-for-collective-investment-in-transferable-securities->
 - [9] European Commission, *Delegated regulation - C(2021)2615*, Accessed June 2021, <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/11960-Integration-of-sustainability-risks-and-factors-related-to-alternative-investment-fund-managers->
 - [10] HM Treasury, *A Roadmap towards mandatory climate-related disclosures*, November 2020, Accessed December 2020, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/933783/FINAL_TCFD_ROADMAP.pdf

The new US administration has rejoined the Paris Climate Agreement signaling a return to their climate change priorities.¹¹ The Securities and Exchange Commission (SEC) has begun to take steps toward a comprehensive ESG disclosure framework aimed at producing consistent, comparable, and reliable data that investors need.¹² We expect the US to follow the EU in adopting regulations for mandatory disclosures by asset managers and companies consistent with the current standards of the Sustainability Accounting Standards Board (SASB).

Navigating the rocky path to sustainable investing

While the business case for embracing sustainable investing is clear, asset managers encounter multiple challenges in the adoption of sustainable investing.

Inconsistent ESG disclosures

Companies report ESG data voluntarily; however, absence of quality data characterized by unaudited, inconsistent, and self-reported data may result in biased disclosures and the risk of greenwashing. The inability to benchmark and compare a firm's ESG disclosures with its peers affects investment decision-making and increases risk.

Lack of standardization in ESG scoring

The market is crowded with several ESG data providers for sourcing ESG scores. However, lack of standardized scoring methodologies leads to significantly divergent ESG ratings for the same company. One rating agency can value a firm, such as Tesla, with a heavily weighted score for its environmental impact, while another agency may prioritize Tesla's treatment of employees, resulting in contradictory ratings.¹³

Inability to customize for granular ESG themes

ESG values and goals are client-specific; funds designed for broader appeal may not align with individual clients' ESG values and goals. Without a granular view of the factors driving ESG, firms will be constrained to customize investment strategies for clients. Apart from firm-level challenges, the industry is also witnessing greenwashing at the fund level – some funds are positioned as sustainable funds to clients, but their portfolios often do not align with ESG mandates.

An Approach to Embracing Sustainable Investing

Firms must reimagine customer journeys considering customers' ESG preferences on the one hand and regulatory requirements on the other. In our view, firms will need to enhance inhouse capabilities across five key business areas (see Figure 1) to reimagine customer journeys and address inefficiencies or challenges in their ESG operating models.

[11] *The White House, Press Briefing by Press Secretary Jen Psaki, January 20, 2021, January 2021, Accessed January 2021, <https://www.whitehouse.gov/briefing-room/press-briefings/2021/01/20/press-briefing-by-press-secretary-jen-psaki-january-20-2021/>*

[12] *US Securities and Exchange Commission, A Climate for Change: Meeting Investor Demand for Climate and ESG Information at the SEC, March 2021, Accessed June 2021, <https://www.sec.gov/news/speech/lee-climate-change>*

[13] *Celent, GREENWASHING OF THE ESG INDUSTRY: USING ML TO DEMYSTIFY ESG FUND RATINGS, May 2020, Accessed January 2021, <https://www.celent.com/insights/788398009>*

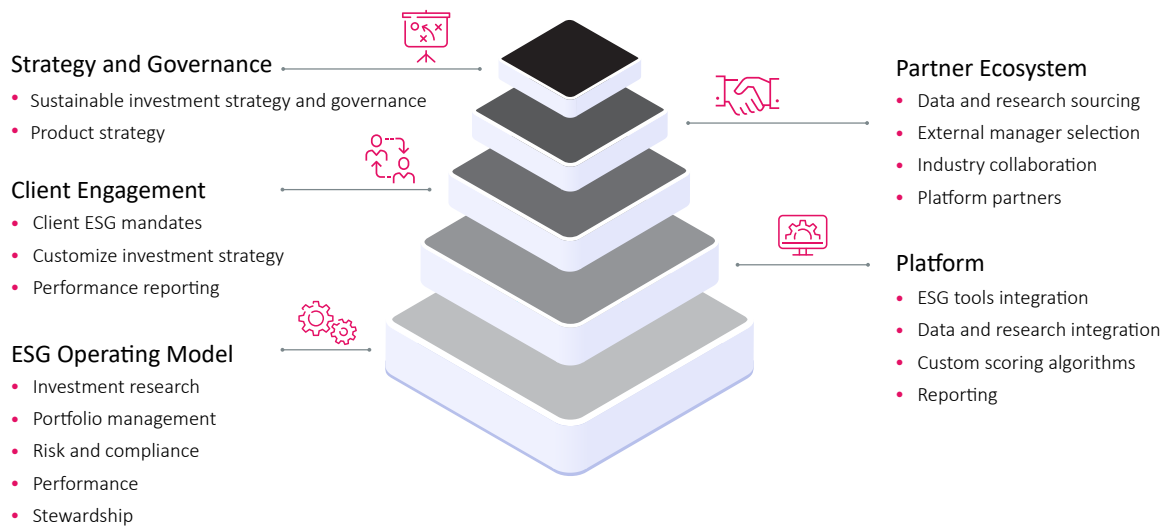


Figure 1 : Key Business Focus areas for Firms to Move to Sustainable Investing

We recommend a step-by-step approach for firms to embrace sustainable investing:

- Formulate a holistic strategy encompassing key business areas (see Figure 1).
- Capture clients' ESG preferences and devise personalized investment strategies.
- Enhance capabilities in investment research, portfolio management, and risk management including climate scenario analysis.
- Leverage ecosystem capabilities for ESG data, engagement platforms, climate scenario analysis tools, and technology solutions.

Embracing sustainable investing will require firms to implement an integrated platform (see Figure 2) with capabilities to provide stakeholders real-time access to ESG research and data, automatically source data from ESG data providers, and maintain and disseminate data to all the stakeholders.

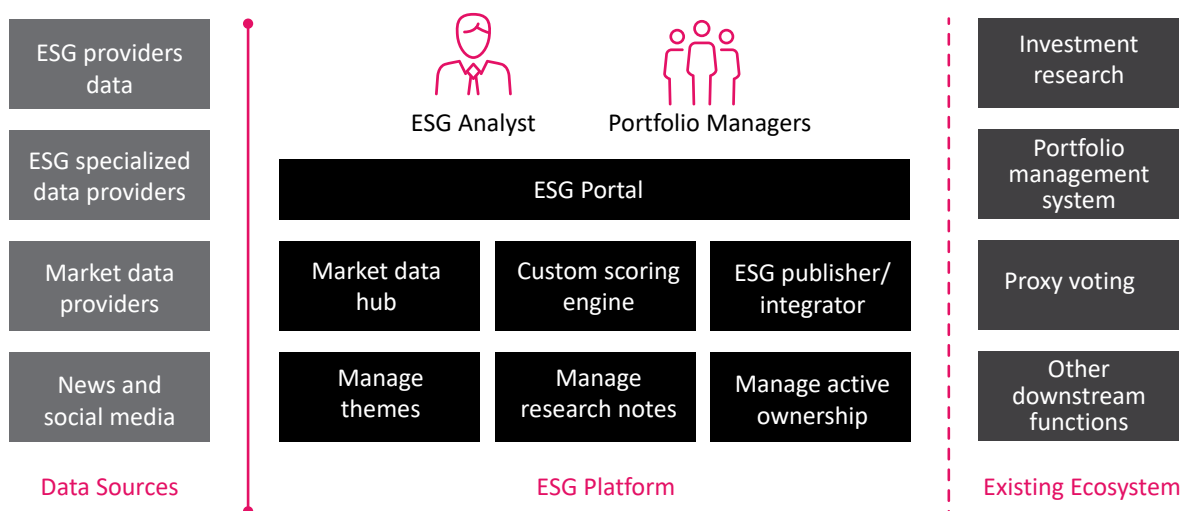


Figure 2 : High-level functional architecture diagram of an integrated ESG platform

The platform must include an application programming interface (API) framework to integrate with data providers' systems and ESG data consuming systems. An artificial intelligence (AI)-backed custom ESG scoring engine with the ability to transparently define ESG indicators and adjust weightages based on clients' preferences must be incorporated into the platform. We recommend using natural language processing (NLP) and machine learning (ML) techniques to uncover material ESG insights in real time from alternative data sources like social media and news aggregators.

Grab the sustainable investing opportunity, drive future growth

With increasing push from investors as well as regulators, a shift to sustainable investing is inevitable, even if challenging. Overcoming the roadblocks to embracing the sustainable investing paradigm requires designing a strategy that focuses on five crucial business areas — operating model, ecosystem, platform, governance, and client engagement. Speed will be crucial; firms that move fast will leave their peers behind in AUM growth.

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