Key Questions to address – from briefing call with Sirpa Pietikäinen

- ***What is the role of the financial markets and its participants to integrate sustainability considerations in the legislative framework***
- ***[What are the incentives provided to investors in order to integrate sustainability considerations in investment processes]***

1) Where we are

The signature of the Paris agreement on 12 December 2015 marked a milestone for the world and the global economy. One by one, we are taking the necessary steps to put our economy on a more sustainable and resource efficient footing**.** The announcement of the new EU sustainable finance legislation proposal has already had a strong signaling effect: ESG is getting serious attention from across the investment industry, including players hitherto reluctant to embrace sustainable investing.

The EU is leading this shift, but there is a long way to go. Reforms along the entire investment chain will be required, not only to fill the significant gap[1] between the amount of capital required to finance the transition to a low-carbon, climate-resilient economy and the amount being invested, but also to build a sustainable finance strategy for the EU.

Mobilising private capital to fund sustainable investment is essential as the scale of the investment challenge is well beyond the capacity of the public sector alone.

For these reasons we welcome the invitation the European Commission has extended to the financial sector to take active part in the discussions that, we hope, will lead the way to a greener, cleaner and more sustainable economy.

As a firm, AllianzGI is proud to be one of the 30 members of the EU Sustainable Finance Expert Group, and we are profoundly committed to fostering ESG-minded approach to investing across the European Union. We see this as a collaborative process, where we are working with policy-makers, our clients and our investment teams to achieve a shared goal**.**

- As an example, AllianzGI is in the process of integrating ESG across all portfolios, whatever the origins of the strategy. So far, EUR 124 billion of assets qualify as ESG integrated (c. a quarter of total AuM).
- While many firms talk about integrating ESG, we have built evidence that ESG can add value to our investment process through a combination of robust research of "financially material ESG risks and factors" and company engagement, without constraining our investment universe.
- To AllianzGI, our Integrated ESG approach represents a next step in the evolution of our investment offering.
- At the same time, we have a large client base, who would like to invest in a socially responsible way following "best-in-class" SRI methodology; as well as growing interest from institutional and retail investors in so-called Impact strategies, whereby a specific clearly identified environmental or social impact is expected alongside competitive financial returns.

[1] *The Final Report 2018 by the High-Level Expert Group on Sustainable Finance (May 2018) estimated that €180 billion in additional yearly investments in sectors such as renovation and energy efficient buildings, renewable energy generation and transmission, low-carbon transportation etc.*

2) Our role as market participants

As Paul Smith (president and chief executive of CFA Institute) rightly said in a recent publication, "the next generation of investors, and a growing number in this generation, will not accept the absence of precise quantitative frameworks as an excuse for inactivity. They are demanding that the investment industry responds to their desire to proactively address [sic] some of society's most intractable problems".

Achieving this will take vision, ongoing honest engagement with policy-makers and regulators, education of financial market participants, and inevitably, some initial additional costs.

I strongly believe that over time ESG will become a requirement, a 'license to operate' demanded by all stakeholders, but several things will need to come together to make this happen sooner rather than later.

The mindset of the financial industry, the prevailing culture and the incentives will need to align with the longer-term nature of ESG investing. Our greatest challenge today is to be able to operate as a long-term responsible investor within a system that is largely set up to deliver short-term returns. This is where policy-makers and regulators can play a major role in creating an environment where all the links in the investment value chain are able and incentivized to adopt a longer-term perspective.

As an investment industry we have the fiduciary duty to do whatever we can to protect and enhance the value of our clients' assets. This includes carefully selecting investments, engaging with issuers to reduce investment risks and improve corporate practices, but also working with policy makers to address key sustainability challenges within our capital markets and the broader economy.

There is clearly a role for policy and regulation in achieving the necessary focus on long-term sustainability, responsible stewardship of assets and relevant disclosures among investors and issuers alike. However, a truly enabling regulation should be principles-based, creating a clear framework of definitions, expectations and disclosure requirements that would allow innovation, competition and, most critically, an informed choice of investments by institutional and retail investors. A prescriptive approach that restricts investor ability to align their investment objectives with their sustainability goals is unlikely to generate the required flows of capital into ESG strategies and can reverse the current positive momentum.

As market participants we need to stay tuned and engaged to guarantee the future framework allows the necessary flexibility and adaptability to cater for innovation and our clients' needs.

3) At the doors of significant change: As market participants we need to build on current momentum, and start to have a lasting impact.

The old problem is well known: for generations, capital markets have failed to support sustainable development due to persistent misallocation of capital.

Historically, environmental and social costs or benefits of business activities were not incorporated into investment analysis, as they did not affect the company's reported profitability. This means that corporate cost of capital has not been reflective of long-term sustainability of equity and bond issuers, creating a disincentive for investing into sustainable business practices.

However, the world has changed and so called "extra-financial" factors increasingly impact financial value of companies we invest in. End investors are changing as well, with the incoming generation showing more interest in aligning their values with their investment (and indeed consumer) choices. This means that adding an ESG lens to traditional investment analysis can lead to improved investment decisions, as well as contributing towards creating a more stable, sustainable market and society. These are also the main incentives investors have today to integrate sustainability considerations into investment decisions.

The scale of today's social and environmental challenges — with heightened political uncertainty, widespread inequality, and significant pressures on the environment — makes it evident that the responsibility to address them does not fall on policy-makers and regulators alone. Businesses and investors must embrace their responsibility to push for progress.

Asset owners and asset managers alike need to influence capital allocation towards sustainable value creation - we have the power to determine what gets financed and developed and what doesn't. This involves moving towards a longer-term investment perspective and having courage to exert influence, to be good stewards of assets entrusted to us. It requires an ongoing dialogue with companies we invest in to encourage them to adopt more sustainable practices.

Investing in a sustainable way should not be limited to dedicated/labelled ESG investment products, it should become standard investment practice. We are convinced this will result in long-term enhanced returns, financial and societal, for all parties involved. This is the corner stone of our investment philosophy and the reason why at AllianzGI we are integrating ESG and applying stewardship principle across all our strategies and assets, while also offering more tailored investment solutions for clients who have specific sustainability objectives.

There is, of course, a strong and ongoing need to enhance the quality of ESG disclosures and data by issuers. Relevance, materiality and comparability of ESG disclosures, as well as insights into environmental and social impacts arising from their economic activities, will be key to building a common language between investors and issuers. We are confident that under pressure from policy-makers and investors these will improve going forward, but in the meantime we will continue to make informed choices based on our judgement, which is what we do to deliver value to our clients and what defines us as active managers.

4) A partnership to achieve a shared goal. The financial sector has a significant role to play, but this cannot replace the crucial role of policymakers.

While the financial sector has a big role to play, it cannot replace the crucial role that policymakers must carry out in ensuring that negative environmental and social externalities are appropriately priced and translate into operational costs for those directly responsible. For example, the absence of a carbon pricing policy that reflects a real cost of CO_2 emissions to the environment and society, severely limits the ability of the financial sector to allocate capital towards more sustainable businesses.

I see it as a partnership between public and private sectors to achieve a shared goal.

As experts in our field we have the privilege and duty to help policy-makers and regulators to develop vision, rules and guidelines that will shape the future of the industry. We also have the responsibility to speak up if we identify potential unintended consequences of any proposed legislation to ensure these are addressed.

As market demand for sustainable investing continues to evolve, the financial industry needs a regulatory framework that:

- Provides a clear definition of sustainable investing;
- Allows a variety of approaches, but lay out clear and robust expectations and requirements for those offering sustainable investment products;
- Minimizes incentives for greenwashing by requiring transparency and alignment between stated sustainability objectives, investment processes and measurement and reporting of sustainability performance;
- Places value on responsible ownership or active stewardship practices; and
- Addresses conflicts of interests in the investment value chain

To be clear, investors already have incentives to integrate sustainability considerations into their investment processes. Furthermore, I am convinced that – sooner or later - ESG integration will become a must for investors, and that laggards will become unfit for purpose.

However, 'sooner or later' doesn't feel urgent enough, given what is at stake. Developing robust, non-prescriptive, enabling regulation would accelerate this process significantly. This would be an unalloyed good and an endeavor we and other like-minded investors would be happy to work with you on.