



# Sustainable Investing and Risk Oversight

Best Practices for  
Asset Managers and Asset Owners

# SUSTAINABLE INVESTING AND RISK OVERSIGHT

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<sup>1</sup>The term **Manager(s)** used throughout this paper refers to the Asset Manager title used mainly by large asset managers. However, many of the practices noted throughout the paper, while intended to apply to large asset managers, would be applicable to smaller asset managers and large institutional investors such as asset owners and insurance companies.

**Assets Managed** on behalf of clients and **Assets Owned** on behalf of beneficiaries are collectively referred to as **AUM** throughout the Best Practices summary.

# CONTEXTUALIZING SUSTAINABLE INVESTMENT PRODUCTS AND RISK

This paper was developed in collaboration with members of [GARP's Buy Side Risk Managers Forums](#) located in the Americas, Europe, and Asia to provide a summary framework of best thinking on the evaluation and oversight of risks associated with sustainability-related investing.

Sustainability-related risks are investment risks to be managed in a manner consistent with managing other risks (e.g., equity, foreign exchange). Risk managers see climate-related issues as presenting risks on multiple levels: direct physical risks, risks associated with counterparties, investments, legal and regulatory matters, disclosure, investment and business models, and transition risks among others. Understanding these risks and addressing them in a studied, structured, and disciplined manner — as credit, market, and operational risks — will allow asset managers to better tailor products to investor requirements and provide objective assurances to stakeholders that their firm is able to understand, measure, assess, adapt to, and plan for climate-related risks.

There is no single definition of a sustainable investment product. Products that incorporate ESG (Environmental, Social, and Governance) objectives alongside financial objectives are generally categorized as sustainable investment products. Examples include products that seek to prioritize holdings/issuers that perform better on certain ESG criteria (e.g., ESG ratings) within an investment universe, products that seek to invest in a specific ESG-oriented theme (e.g., clean energy, water scarcity), or those that seek to have a specific environmental or social impact (e.g., reducing greenhouse gas emissions, outcomes aligned to U.N. sustainable development goals). Many of these products also exclude exposures to certain investments that may be viewed as running counter to sustainable objectives (e.g., tobacco, coal, controversial weapons).

A debate has emerged over the utility and integrity of the term “ESG.” To Managers, the term refers to a set of factors analyzed to make more informed investment decisions incorporating environmental, social, and governance concerns. For many Managers and investors, ESG considerations have become important complements to traditional financial analysis.

Trade-offs between ESG considerations are inevitable and should be resolved by carefully considering which ones are likely to have the biggest impact on investment objectives for sustainable products. To that end, the ESG label is not what matters. What is truly relevant is to assess, understand, and address the wider factors affecting sustainable investing — whether those are societal, environmental, or stewardship related. For that reason, the term “sustainability-related” in this paper is often used to describe the commonly known term “ESG,” i.e., the two terms are interchangeable.

This paper generally notes and recommends, where gaps may currently exist in processes or procedures, suggested best practices which may be adopted by large Managers to assess and manage sustainability-related risks across several dimensions. Some best practices are currently aspirational and longer-term given the evolving nature of issues, data identification and collection, and the status of understandings and developed approaches.

In addition, where representative metrics, targets, and modeling approaches have been detailed, these should be viewed as potential options rather than prescriptive. Managers of varying sizes and investment strategies will likely have differing approaches to risk oversight and will be at varying stages in the integration of sustainability factors into their risk process.



# BEST PRACTICES FOR SUSTAINABLE INVESTING RISK OVERSIGHT

## 1. Governance

Recognizing the unique nature of risk governance within firms, it's impractical to provide one model. Therefore, we suggest the following possible frameworks, anchored by an independent board of directors, senior firm management, and a "Three Lines Model" approach for oversight of sustainability-related risks and opportunities, investing, balance sheet, and operational activities.

Firms, whether financial institutions or general corporates, should utilize a "Three Lines Model" where risk is "owned" by businesses with second line oversight by control functions and third line validation by audit.

As referenced in "Risk Principles for Asset Managers" from the GARP Buy Side Risk Managers Forum in September 2015, first line governance should include senior leadership team members and first line risk management functions (if applicable). Control functions (risk, compliance, legal, and finance) should establish a unified oversight group to optimize second line oversight.

## 2. Risk Oversight

Risk Oversight should specifically define and address such factors as:

- a. Oversight of sustainability-related risks at the enterprise and AUM levels.
- b. Management's oversight through an independent risk committee reporting to the board, with membership including Chief Risk Officer (CRO, [chair]), General Counsel (GC), Head of Compliance, and Chief Financial Officer (CFO). Audit, a third line function, may also attend meetings depending on the Manager.
- c. Dedicated sustainable-investing strategy committee for managers with sustainable, impact-oriented, or client-resilient strategies.
- d. For larger firms, a Chief Sustainability Officer (CSO) should be in place to oversee, manage, and report on sustainability-related issues. Some firms may choose to align CSO responsibilities under an alternative title in conjunction with other duties.
- e. Segregation and clarification of accountabilities on managing sustainability-related issues among CRO, Chief Investment Officer (CIO), CSO, CFO, and other key stakeholders, as well as the governance structure, should be documented in the management authority policy and standards.
- f. Integration of sustainability-related factors in the valuation, new product, model risk, and investment process, including any oversight by relevant sub-committees of the firm's executive committee or risk committee, and should be memorialized and approved by the risk committee.

## 3. Policies and Procedures

- a. A formal sustainable-investing policy and related procedures should be developed and presented for approval by the most senior management committee to the board, including annual updates (or possibly more frequent for material processes or regulatory changes). The policy should clearly; i) convey the firm's commitment to a formalized sustainable investing policy, ii) signal the need for employee adherence to the policy, and iii) express the firm's position on climate risk.
- b. The policy should accurately capture the portfolio manager's sustainable-investing vision, strategy, and obligations relating to his/her fund's AUM, including material sustainability-related topics of focus.
- c. Sustainability-related factors should be captured in standard policies addressing investment and operating activities, including the Manager's risk appetite statement, reputational risk policy, risk policies, valuation policy, client and third-party suitability assessments and investment policy, with materiality and reputational risk as key considerations.
- d. Sustainability-related factors should also be included in Investment Stewardship policies, including proxy voting, engagement, and divestment standards for investee companies (with shares managed on a fiduciary basis).
- e. Corporate level policies should capture:
  - Net-zero objectives and science-based targets, if adopted, with any firm-level commitments consistent with fiduciary obligations to clients. Details on achieving such objectives and/or targets should be clearly communicated.
  - Business and operational resiliency measures related to climate and other environmental risks.
  - Risk targets.



#### 4. Industry Guidelines and Regulations

- a. A firm's governance framework should be designed to align with voluntary industry standards and comply with mandatory regulations, recognizing that the space is rapidly evolving.
- b. Adoption of industry standards must be consistent with a Manager's fiduciary obligation to place client interests ahead of firm interests. In aligning with firms around voluntary standards, firms should consider the potential for collusion or anti-trust issues arising.
- c. Managers should assess the financial and non-financial impact of sustainability-related risks (e.g., as required based on fund classifications) with corresponding key risk indicators (KRIs) and key performance indicators (KPIs).
- d. Fund classification, KRIs, and KPIs should be subject to an independent, holistic review at the time of development and ongoing monitoring by the second line of defense.
- e. Physical and transition risk should be measured over base case and relevant forward time horizons based on varying climate scenarios and transition pathways.
- f. Scenarios should measure the potential impact on AUM (top-down such as potential annualized loss) and financial metrics of the investee companies (bottom-up such as EBIDTA or expected returns), including sensitivity of earnings to varying future carbon price scenarios.
- g. Where feasible, Managers should use relevant quantitative and qualitative metrics to measure sustainability risks. Where standard metrics are not available, ESG ratings or indicators (internal and external) are frequently used to estimate sustainability risks on a stand-alone or combined basis. Managers should conduct thorough due diligence when sourcing external ESG ratings or indicators and, due to differing or not fully transparent underlying methodologies, leverage multiple ratings approaches while maintaining clarity around and documentation of underlying data and methodologies, including limitations and confidence level. If resources permit, managers should monitor granular level ESG indicators or attributes in addition to the aggregated rating.

#### 5. Exposure, Risk Measurement, and Metrics

- a. Exposure and risk should be measured for corporate activities (i.e., balance sheet, seed capital, and operations) and AUM.
- b. Given the nascency of data and models, Managers should understand the limitations of underlying assumptions and introduce risk metrics when there is organizational comfort around usability, applicability, and effectiveness.
- c. Assumptions, metrics, and models used to measure and track sustainability-related risks for investment decisions and risk governance, including performance metrics and ratings, will ideally be subject to approval and validation by an independent model risk team, or alternatively an external model risk expert.
- d. Risk measurement and related metrics for climate risk should capture both quantifiable financial impacts and reputational risk exposures whenever possible due to acute and chronic physical risk and transition risk (e.g., impacted by changes in policy, legal issues, technology, and markets).
- h. Temperature alignment measures may report alignment with recognized industry standards — disclosing which standards are used — and should also cover exposures, emissions, green, or transition taxonomies with more subjective impact metrics such as avoided emissions being clearly defined.
- i. Social, governance, and investment stewardship issues being adopted should also be clearly disclosed.
- j. Risk metrics should be developed to capture both historical events and forward-looking scenarios as available historical data allows.

## 6. Risk Targets, Limits, and Investment Exclusions

- a. Where appropriate, risk targets, limits, and exclusions should be used to align with voluntary industry standards as well as the Manager's risk appetite statement, sustainability-related investment objectives, and reputational risk policy.
- b. Ex-ante or ex-post risk targets, limits, and investment exclusions (e.g., based on controversial behavior, sector, country and/or activity, temperature alignment, science-based renewable energy targets, among others) must be consistent with firm compliance policies, client guidelines and prospectuses, and any Manager's fiduciary obligation to clients.
- c. Corporate level risk and AUM targets should be aligned with the standards suggested by globally recognized "science-based target initiatives."

## 7. Portfolio Management and Construction: First of Line Defense

- a. Managers with a strategy level sustainable investing mandate (versus benchmark returns) should implement investment processes, including portfolio construction techniques, that integrate sustainability-related factors, with primary oversight by the Investment Committee and secondary oversight by the second line risk management team.
- b. The independent risk function should evaluate the level of robustness as well as consistency (and application) of the investment process, including sustainability-related issues and ESG elements.
- c. Sustainability-related risks are investment risks and should be captured robustly and consistently with other investment risks (e.g., credit, currency, leverage, etc.), with reliance on quantitative sustainability-related data and metrics.
- d. Sustainability-related factors should be evaluated "ex-ante" as part of portfolio construction as well as "ex-post" with a review of the impact of sustainable investing positioning on returns.
  - i. For sustainable, impact, and climate-resilient investments and funds, this should include evaluation of principle adverse impacts of holdings in investee companies on environmental, social, and governance factors, depending on a fund's sustainability-related objectives.
- e. Performance attribution should capture financial as well as sustainable investing objectives for sustainable, impact-oriented, or climate-resilient funds.

## 8 Risk Management and Reporting: Second Line of Defense

- a. An independent risk function (risk team) with a reporting line separate from the investment business should oversee risks, including sustainability-related risks at the firm level and across AUM, and help ensure compliance with regulations and internal standards and policies related to sustainability in partnership with compliance.
- b. The risk team should:
  - i. Ensure that sustainability-related issues are captured in the oversight processes for financial and non-financial risks, including investment, model, enterprise, operational, third party (and fourth party), and technology risks.
  - ii. Ensure sustainability-related risks are independently reviewed with respect to risk and returns in a similar (and equally robust) way to all other investment risks.
  - iii. Independently review capture of sustainability-related risks in investment processes for each “unique” investment strategy (e.g., fundamental equity, public credit, emerging markets debt, private investments, real assets, etc.).
  - iv. Use independently validated metrics to measure risk and performance, risk-adjusted performance, and alignment with client guidelines (explicit) and expectations (implicit).
  - v. Ensure risk management reporting incorporates sustainability-related risks, including capture of outliers and exceptions. Reporting should be presented to investment teams and leadership, the risk committee, and the board.
  - vi. In the EU, reporting should also capture principle adverse impacts (PAIs) related to holdings in funds with stated sustainability-related objectives (as required by EU regulation).
  - vii. Administer risk and control self-assessments (RCSAs) of sustainability-related risks which were performed by the business and operating units, escalating “risk and control” issues found to the risk committee and, where necessary, the board.

## 9. Disclosure

- a. The disclosure of sustainability-related issues in regulatory filings, corporate annual reports, corporate sustainability reports, and fund level prospectuses and annual reports should comply with relevant regulations and industry standards (where the latter are consistent with client fiduciary obligations).
- b. Annual sustainability reports should begin with a CEO statement providing top-down direction and support and include asset manager actions to make operations (and AUM) more sustainable, including specific goals and objectives with targets (e.g., for emissions, biodiversity, water, social, and governance) and timelines.
- c. KPIs should be established to track and publicly report progress on achieving goals and objectives.
- d. KPIs ideally should align with the U.N.'s Sustainable Development Goals and the framework set forth by the Global Reporting Initiative (GRI) Standards with a mapping of disclosures against Task Force on Climate-related Financial Disclosure (TCFD) and Sustainable Accounting Standards Board (SASB) standards
- e. Where feasible, disclosure should leverage science-based targets for exposures and metrics.
- f. With the International Sustainability Standards Board (ISSB) and Global Reporting Initiative (GRI) seeking to develop standards to be both interoperable and applicable for meeting the needs of both single and double materiality reporting, it is important to be apprised of developments and the adoption of globally recognized, sustainability-related disclosure standards that are industry-specific and rules-based.
- g. Under the EU's TCFD framework, where investee companies are exposed to “principal adverse impacts” (PAIs), voluntary as well as mandatory PAIs should be evaluated, monitored, and reported.






















































- h. Some of the data and metrics will need to be produced or independently validated by second line risk teams for inclusion in external disclosures, so risk teams will need to understand mandatory disclosure and reporting requirements.
- i. Where applicable, some disclosure metrics (such as certain PAIs) may also be used for risk monitoring, thresholds, and oversight.

## 10. Phased Approach

Given rapidly evolving policies and the nascent state of data, analytics, and tools, Managers should consider a phased but diligent approach for development and implementation of sustainability-related risk oversight best practices.

The following table suggests a potential five-year horizon that Managers may consider for developing and implementing a framework and process for measuring, managing, reporting, and disclosing sustainability-related risks.

	Current	2 to 3 years	4 to 5 years
<b>Measurement &amp; Metrics</b>			
Climate Transition Risk			
Climate Physical Risk			
Emission Metrics			
Climate Exposure Metrics			
Sustainability-related (Non-Climate) Metrics			
ESG Ratings & Controversy Scores			
<b>Targets and Limits</b>			
Financial Emission			
Climate Transition Risk			
Climate Physical Risk			
Sustainability-related (Non-Climate)			
Investment Exclusions			
<b>Portfolio Management and Construction</b>			
Security Selection Integration			
Portfolio Management Integration			
Portfolio Construction Integration			
Performance and Risk Attribution			

	Current	2 to 3 years	4 to 5 years
<b>Risk Management and Reporting</b>			
Risk Monitoring & Oversight			
Model & Metrics Validation			
Risk Reporting			
Risk Management (Non-Climate)			
<b>Disclosure</b>			
Primary TCFD Disclosures in SI Report			
Integrated Annual and ESG/SI Report			
Adoption of TCFD-based ISSB standard			
Quarterly climate metric disclosures			

This phased approach recognizes the nascency of sustainability-related taxonomy, standards, and policies, insufficient ESG disclosure from investees in general, and evolving sustainability-related risk modeling and metrics. For example, at a minimum, Managers should report data they believe is material and explain which metrics are not and why. This will ensure the integration of sustainability-related factors does not become a compliance exercise that undermines the delivery of the benefits sought from the management and reporting of these issues.



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