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THE PATHS OF RESPONSIBLE INVESTING IN CHINA AND EUROPE

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The paths of responsible investing in China and Europe

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Summary

In this joint white paper, Harvest and DWS compare and contrast the drivers of responsible investing in China and Europe. We explore the pros and cons of the approaches adopted and provide our recommendations to support the market's growth.

One could call Europe's historical approach to responsible investing as decentralised or laissez-faire. This market-led approach has had many benefits since it has created a fertile industry focusing on the many aspects of ESG. However, it has also led to confusion and slowed what might have occurred in an environment of more central planning. But, when compared to China, the obligations on asset owners and asset managers have diverged.

China's legislative agenda of green financing has been mainly targeting the banking sector. This has meant the progress of raising responsible investing awareness and stewardship in the country has been relatively slow with only 16% of Chinese asset managers having ESG investment policies, processes of initiatives in place[1]. In Europe, the decentralised approach has placed more onus on asset owners and asset managers, which has meant a more mature industry has developed.

Each system has its strengths. Implementation in China has been fast, but not all investors agree with the taxonomy. For example, the categorisation of clean coal as green in China has been one of the major hurdles for global investors to allocate into Chinese green bonds. The pluralism is Europe's strength, but action has been slow. Pluralism has delayed the path to a common standard, which has created confusion amongst consumers, policymakers and asset owners and managers. This has meant high entry costs, a barrier to small and medium assets owners and managers. The ambiguity of meanings may also lead to greenwashing, a detriment to sustainability.

Current frameworks have also placed a heavy burden on investors, who have significant expertise on financial markets, but little awareness of science and sustainability. The lack of a science-based sustainable accounting standard, for example, means that investors need to rely on unregulated ESG datasets for their decision-making. Such information may help them understand their risks, but, there is no standard on how providers interpret risks. Still, the centralised approach in China to forcing disclosure has also met with concerns and pushbacks. This is important for investors looking for data consistency and comparability.

Our analysis shows that each model has in the end its strengths and a unique best approach will not be easy, but a healthy comparative analysis is useful in understanding the way to take it forward. Both regions also need to do more to enhance disclosure to encompass the concept of double materiality. Better classifications for ESG investment products and more forceful engagement are also required to satisfy a community of more impact-focused investors.

The first section of this white paper examines the benefits and shortcomings of the EU and Chinese responsible investment markets. The second examines the steps being taken to remedy obstacles which are restraining the market's growth and the third how these new emerging frameworks have, at their heart, a focus to help drive both regions to a net zero carbon future.

[1] Asset Management Association of China (March 2020). China asset management industry ESG investing survey report (2019)

Section I: The shortcomings of a market-led approach in Europe

Europe is at the forefront of responsible investing globally. The region captures the lion's share[2] of global ESG assets under management. Europe is also home to just over 50% of PRI signatories[3] and 40% of corporate signatories to the RE100 initiative are European, followed by US corporates who constitute just under 30% of signatories[4]. In addition, European institutional investors constitute the majority of the PRI's 2020 RI Leaders Club[5] as well as Morningstar's[6] leading responsible investors by region.

These successes have been achieved not by a centralised approach akin to how the green finance market has developed in China, but, rather via market forces, and specifically a multitude of different stakeholders and investor coalitions leading the charge, with governments, until recently, taking a back seat. This has had its benefits as development has been more organic, encompassing multiple views that capture not just environmental issues but also the materiality of social and governance issues. It has encouraged numerous investor coalitions to emerge, such as the Net Zero Asset Owner Alliance. This has facilitated investors to share best practice when it comes to targeting carbon-neutral investment portfolios by 2050. Other investor alliances have been established, such as Climate Action 100+, offering the potential for more forceful corporate engagement.

However, what might be viewed as a democratic approach has its drawbacks. Take fiduciary duty for example. One of the early and authoritative opinions outlining ESG from a fiduciary duty perspective was expressed by the law firm Freshfields Bruckhaus Deringer. In its 2005 report[7], commissioned by UNEP FI, it stated that, among other things, "integrating ESG considerations into investment analysis is clearly permissible and arguably required". However, despite this clarification, and more than a decade later, an updated report[8], this time by UNEP FI, UN Global Compact and the PRI found that "despite significant progress, too many investors are not yet considering ESG issues in their investment research and decision-making. Even with investors that do accept the argument that they should consider ESG issues in their investment processes, implementation remains variable".
The adoption of responsible investing techniques has required a significant amount of work in the area of understanding the financial materiality of ESG factors, not least since ESG investing has, at its core, the concepts around risk, return and fiduciary duty. In China, as well as many other emerging markets, the motivations have, at least initially, been centred on improving the quality of growth and particular environmental protection.

Another part of the problem in mainstreaming responsible investing, not just in Europe but globally, has been the heavy burden placed on investors since investors are being asked to:

(i) Become experts in understanding a myriad of ESG risks
(ii) Measure these risks across different asset classes without any assurance about the quality of the underlying data
(iii) Search for and validate data from third-party data providers, who take no risks for quality and instead transfer all the risks of data usage onto investors
(iv) Create a portfolio of investments where the concept of ESG 'risk' is inconsistent with traditionally accepted 'risk' concepts, such as factor analysis
(v) Deal with regulators and fund management boards who want to ensure that this new concept of risk is not detrimental to the risk-reward framework that the final consumer of investment products normally enjoys
(vi) Engage with the management of the company that he or she is investing in to drive change. This is supposed to take place while the portfolio manager remains an expert on other issues that companies face, such as politics, business dynamics, valuation, and so on.
(vii) Report and possibly educate institutional and retail clients, regulators, their own shareholders and a wide range of voluntary initiatives on their portfolios and firm-wide approach to ESG.

These burdens naturally place significant costs on asset owners and asset managers. They also threaten to hold back the mainstreaming of ESG investing and, if left unchecked, could potentially condemn responsible investing to becoming an elite sport only fit for the premier league of large institutional investors with deep financial pockets. Institutional investors in the Netherlands, for example, are widely recognised as being at the cutting-edge responsible investment. Yet according to a recent VBDO survey[9] there is a disparity of performance across the local pension fund community.

Of the top 50 pension funds in the country, which represent 92% of their pension fund market, only two funds score in excess of four (out of five) and only seven score in excess

[2] GSIA (2018). Global sustainable investment review. The 2020 review will be published in early 2021
[3] PRI asset owner and investment manager signatory database (February 2021)
[4] RE100 members database (February 2021). Europe is defined as EU, EFTA plus UK
[5] PRI Leaders Group 2020(October 2020) https://www.unpri.org/showcasing-leadership/leaders-group-2020/6524.article
[6] Morningstar (November 2020). The Morningstar ESG commitment level https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/ESG_Commitment_Level_White_Paper_2020.pdf
[7] UNEP FI (October 2005). A legal framework of the integration of ESG issues into institutional investment
[8] UNEP FI (September 2015). Fiduciary duty in the 21st Century
[9] VBDO (October 2020). Benchmark on responsible investment by pension funds in The Netherlands 2020

of three. This may reflect a tough benchmarking approach adopted by VBDO. However, also revealing is comparing the scores according to the size of pension fund as measured by assets under management. Here we find that scores of the top performing small- and medium-sized pension funds (below 3) still fall short of the leaders' universe (above 4).

It is difficult to identify all the causes of such a divergence in performance, but we can see the benefits of removing the burden of 'finding, assessing and measuring' of ESG risks from investors' shoulders. This would have, for example, the advantage of creating a more level playing field. There would also be clarity on the roles and responsibilities along the value chain.

Europe's decentralised approach has also allowed a multitude of definitions and standards to develop. This has spread confusion and the spectre of greenwashing. What classifies as sustainable or green often seems to be in the eye of the beholder, just look at the debate surrounding nuclear power in Germany, where nuclear facilities are being decommissioned, compared to France where nuclear represents 71% of the country's power generation[10]. This divergent approach to nuclear has proved problematic in defining what constitutes an environmentally sustainable activity as defined by the EU taxonomy, so much so that nuclear is neither in nor out of the taxonomy classification[11].

Beyond the single debate, greenwashing comes in many different forms and activities, including: (i) corporate advertising, (ii) corporate lobbying, (iii) proxy voting and engagement, (iv) where the fund is managing risk or is having an impact and (v) fund mis-selling. A more consistent approach to definitions, fund classifications and impact measurement has been slow to emerge.

Public reporting is therefore long overdue for an update. The original framework of corporate reporting with the focus on profit maximisation neglected environmental damage and human rights abuses resulting directly or indirectly from the activities performed by companies. The prevailing framework is largely framed with the famous quote of Milton Friedman in mind, namely 'the social responsibility of business is to increase its profits"[12]. However, investors are now demanding an increasing level of disclosure about how their capital is being used as well as the impact that capital is having on the world. In specialist language, the focus is shifting from 'single' to 'double' materiality.

There is still much work to be done, but as we wait for a global ESG Accounting Standard, investors have taken on this role with the support of third party data providers. The emergence and spreading of data providers that support investors on sustainability has to be framed in the historical context of the role played by accountants as an independent and accountable profession bringing together the users and providers of capital. Through their work, they play an important role in capital markets.

However, throughout the rise of sustainability, accountants have effectively relinquished their role and other providers have filled the gap. The challenge is that these new providers are (i) unregulated, and where the responsibility for errors sits with the user, (ii) conflicted (they define, measure and sell risk), (iii) they have different interpretations of 'risks', something that was picked up by ESMA, the European regulator[13], that highlights the need for closer definition of sustainability and risks.

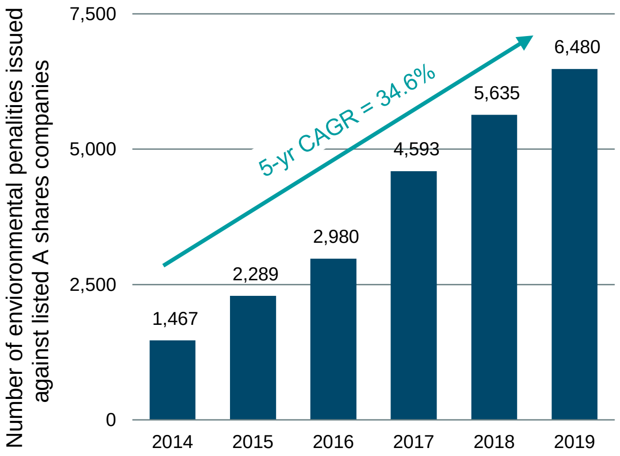
The net results are higher finding costs for both asset managers, owners and consumers, as well as confusion and conflicts of interest along the investment chain. Recently, there has been a consultation by IFRS[14] about whether (i) a Sustainability Standard Board is desirable, (ii) what should be the focus of a potential new standard, and (iii) whether the focus should be on single or double materiality. Yet, the debate still appears to be limited as the focus is on climate change and possibly on single materiality and it will take time for it to come into force. Adding to the complexity is the array of reporting frameworks including SASB, IIRC, GRI, CDP and CDSB.

China: A centralised green finance approach with unbalanced participation from financial market participants

China has taken a more centralized approach for establishing a top-down green finance policy and system. Before the creation of an overarching green financial system starting from 2016, green finance had already taken root through the green credit policy in China's banking sector.

[10] World Nuclear Association (January 2021). Nuclear power in France
[11] In June 2020, the European Commission requested the its Joint Research Centre to draft a technical report draft a technical report on the 'do no significant harm' aspects of nuclear energy
[12] The New York Times (September 1970). A Friedman doctrine
[13] ESMA (June 2019). ESMA''s technical advice to the European Commission on integrating sustainability risks and factors in MiFIDII
[14] IFRS Foundation (September 2020). Consultation paper on sustainability reporting

FIGURE 1. NUMBER OF ENVIRONMENTAL PENALTIES ON THE RISE IN CHINA



Source: Harvest, data from the Ministry of Ecology and Environment (2014-2019)

The 2016 issuance of the Guidelines for Establishing the Green Financial System by the People's Bank of China (PBoC), along with six other government agencies symbolized that the greening of the entire financial system had become a national strategy. Its objectives were not just to curb financing for polluting sectors and businesses, but, also to encourage green investments, especially by non-banking financial institutions.

The fast-paced escalation of pollution control measures and green finance policies have created material headwinds and tailwinds across different sectors and businesses in China, which has in turn significantly changed the investment landscape in the country over the past few years.

A tough regulatory stance on curbing pollution

Environmental degradation has been a key concern and has mobilised the Chinese government to take a forceful transformation from a high-speed economic growth path to a high quality one. The 2015 revision of the Environmental Protection Law marks the beginning of forceful environmental violation crackdown and clean-up efforts evident in rounds of countrywide investigations and penalties led by regulators at both central and local levels.

Violators have experienced increased penalties and sometimes regulatory orders to suspend or even terminate their key production facilities resulting in significant operational disruptions and risks, and even putting the sustainability of some business models into question. Our data show that environmental penalty cases where production permits or operating licenses were provoked increased at a CAGR of 73% during 2017-2019[15]. Highly polluting industries, such as steel and cement, have been subject to regular production curtailment during the winter season. Production in some industries with excess capacity has also been curtailed.

As environmental enforcement shifts from an industry-based approach to an individualized and differentiated approach within industries based on relative environmental performance, it has become essential for highly polluting industries and companies to adapt to the new normal and retrofit their operations and facilities to improve their environmental performance.

The centralized approach to enforcing environmental policy has also been accompanied by a push for increased reporting of environmental information in the form of pollution violation data, high frequency pollutant emissions data and pollution permits. The focus has primarily been on corporates and government agencies. These alternative datasets provide a good basis for investors to investigate company ESG risk exposure and performance. This has given rise to the increasing use of fintech and alternative ESG data sources in China for more timely and comprehensive assessment of corporate ESG practices and performance.

However, corporate disclosure of environmental issues has fallen short of investor expectation in terms of availability and quality. It possibly also suffers the same problems as we see in Europe namely conflicts of interest and the lack of single standard. The mandatory environmental disclosure requirement for listed companies was scheduled to come into force by the end of 2020, but has been delayed. The only requirement for listed companies now is to disclose involvement in "significantly material environmental violations" which are defined by companies themselves and cannot be enough for a 'fiduciary business' to take a decision without significant additional due diligence. This disclosure discrepancy potentially undermines the perception of materiality of environmental issues among corporates and the investment community.

Greening the financial system

Besides China's persistent focus on greening the real economy by enforcing sectoral and regional environmental protection policies and measures, the government has also targeted the financial system to pivot financing and capital from highly polluting sectors to greener ones, also under a centralized approach. This took place through its world leading green finance framework and policies.

As debt financing accounts for the majority of the total social financing to the real economy, China's banking sector has been at the forefront of the green financial system. The

[15] Data from the Ministry of Ecology and Environment, Harvest reconciled

green credit policy was launched as early as 2012, and has since given rise to the world's largest green credit market, with nearly RMB 12 trillion (approximately US$1.86 trillion) in outstanding green loans as of the end of 2020[16].

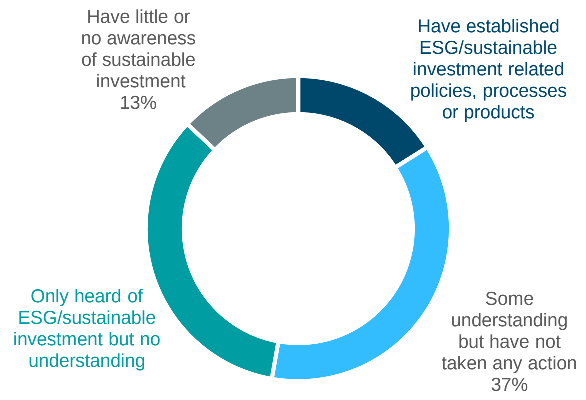
Since the launch of the green financial system guidelines, the development of other green financing and investment tools has also accelerated. Today, China is one of the world's largest green bond issuers, with US$30 billion issuance in 2019, ranking only second to the US. Although the issuance has slowed in 2020 due to the Covid-19 pandemic (ranking 4th with US$18bn issuance), China has delivered a strong comeback in 2021 with US$ 3.5bn issuance just in the first month alone[17].

The fast growth in the green bond issuance volume is largely attributable to top-down policy incentives. China's green bond market has developed with accompanying scrutiny, particularly around the definition of green. The discrepancy between Chinese green bond standards and global standards, in particular its categorization of "clean coal" as green, has been one of the major hurdles for global investors to invest in Chinese green bonds. In May 2020, the PBoC, the National Development and Reform Commission (NDRC) and the China Securities Regulatory Commission (CSRC) jointly issued the draft for Public Consultation of the "Green Bond Endorsed Project Catalogue (2020 edition)". This new Green Bond catalogue for the first time removed "clean coal" from its eligible projects, a major breakthrough effort to align Chinese with international standards.

So far, China's green finance policies and implementation have been mainly targeting the banking sector, with other capital market participants, such as asset owners and asset managers in China cut loose from regulatory requirements or meaningful incentives to participate in green investment. However, local asset managers are increasingly integrating ESG considerations and formulating responsible investment frameworks, mainly driven by the need to:

(i) Reduce ESG-related risk and enhance risk-adjusted returns due to the increasing financial materiality of ESG issues.
(ii) Respond to government policy priorities with a focus on corporate governance and environmental issues.
(iii) Respond to increasing institutional client demand for ESG and green investment, originally from overseas investors, but, increasingly from local investors.

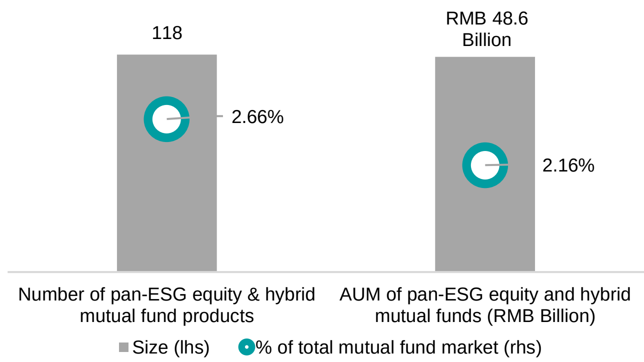
FIGURE 2. CHINESE ASSET MANAGERS' SUSTAINABLE INVESTMENT PRACTICES (2019 SURVEY)



Source: Harvest, Asset Management Association of China (2020)

In contrast with the banking sector, China's asset management industry is taking a more bottom-up and market-led approach. Yet, despite increasing ESG awareness among local asset management firms, thanks to the multi-year capacity building by investor alliances and associations, adoption of ESG and responsible investment policies and processes remains low. According to a survey[18] of 324 Chinese asset managers conducted by the Asset Management Association of China (AMAC) in 2019, only 16% have ESG investment policies, processes or initiatives in place. This is reflected in the still small share of ESG/ sustainability related thematic funds, despite the spike in new launches in 2020[19].

FIGURE 3. SIZE AND SHARE OF ESG THEMATIC FUNDS IN CHINA'S MUTUAL FUND MARKET



Source: Harvest, Asset Management Association of China (2020)

The participation in China's green financial system of different financial segments and market participants has been unbalanced. Equity and bond investors play an important role in pivoting capital into greener or more sustainable areas,

[16] State Council Information Office (Febuary 2021)
[17] BNEF data as of 5 Febuary 2021; Harvest reconciled
[18] Asset Management Association of China (March 2020). China asset management industry ESG investing survey report (2019)
[19] China SIF (December 2020) Sustainable Investment Review 2020

but their role is still weak and we are missing a key link in the closed-loop responsible investment cycle, where the government, creditors, investors, and the public have their interest and goals aligned to promote sustainable practices in the corporate world.

Asset owners controlling a large stake of the local capital market are now being called on to take a leadership role in promoting responsible investment. So one should expect more to come. An overarching government-led ESG framework is anticipated by many market participants to take responsible investment in China to the next level. The "E" and "G" aspects within the ESG framework have long been the focal points in various government policies, regulations and guidelines at both national and sectoral levels. It is only recently that government guidelines feature and promote ESG as a whole, although, one could argue that the "S" focus has been there throughout as policymakers have been promoting the common-good and advancing progress for the entire society.

Section II: Taking action

The lack of a common understanding as to what constitutes green, poor disclosure and the risk of greenwashing have contributed to a more forceful regulatory approach to emerge in Europe. The Green Finance Task Force established in 2014 and its subsequent report and recommendations a year later helped shape the Chinese government's 13th Five Year Plan (2016-2020). This and COP 21 in Paris leading to 196 countries signing an accord to regulate climate change inspired the European Union to follow suit. For it was in December 2016 that the European Commission established its own high-level expert group (HLEG) on sustainable finance.

In 2018, the European Commission established a technical expert group of sustainable finance to assist in the development of:

_ A unified classification system for sustainable eco-nomic activity,
_ An EU green bond standard, and
_ Methodologies for low-carbon indices and metrics for climate-related disclosure

Together these formed the foundations of the EU's Sustainable Finance Action Plan, which support the European Union's efforts to meets its climate and energy commitments under the Paris climate agreement including its ambition for the continent to be a net zero carbon emitter by 2050.

Regulation was clearly required to provide clarity relating to investors' fiduciary duties. In March 2019, new regulation implementing aspects of the EU's SFAP stated that financial market participants and financial advisors must integrate ESG in their processes as part of their duty to act in the best interest of clients. In May 2020, the next step of the fiduciary duty journey was revealed under the EU Commission's consultation on a renewed sustainable finance strategy. This relates to examining the merits in adopting rules on fiduciary duty that directly require investors to consider and integrate adverse aspects of investment decisions on sustainability, Figure 4.

FIGURE 4. THE EVOLUTION OF FIDUCIARY DUTY IN EUROPE

2005 **ESG integration allowed**	**"Integrating ESG considerations into investment analysis is clearly permissible and arguably required"** *Freshfields Bruckhaus Deringer law firm commissioned by UNEP FI*
2016 **ESG integration is variably implemented**	**"Despite significant progress, too many investors are not yet considering ESG issues in their investment research and decision-making.** Even with investors that do accept the argument that they should consider ESG issues in their investment processes, implementation remains variable." *UNEP FI, PRI, UN Global Compact Fiduciary Duty in the 21st Century*
2019 **ESG integration is required**	**"Financial market participants and financial advisors must integrate ESG risks and opportunities in their processes, as part of their duty to act in the best interest of clients.** Financial market participants should inform investors about their compliance with the integration of ESG risks and opportunities and requires the disclosure of adverse impact on ESG matters, such as in assets that pollute water or devastate biodiversity" *EU regulation implementing aspects of the EU Sustainable Finance Action Plan*
2020 **ESG impact/outcome is being considered**	**"Do you see merits in adapting rules on fiduciary duties,** best interests of investors/the prudent person rule, risk management and internal structures and processes in sectorial rules **to directly require them to consider and integrate adverse impacts of investment decisions on sustainability?"** *EU Commission consultation on a renewed sustainable finance strategy*

Source: UNEP FI (2005); European Commission (2015, 2019, 2020)

Another issue that needed to be addressed was the array of definitions surrounding ESG. This is where the development of an EU taxonomy has been critical to deliver a common framework just as the metric system two centuries earlier had unified measurement across the continent.

A taxonomy should also help in the area of greenwashing. European Union regulatory guidance states that "based on the general clauses of the Unfair Commercial Practices Directive ...traders must present their green claims in a clear, specific, accurate and unambiguous manner, to ensure that consumers are not misled". "Traders must have the evidence to support their claims and be ready to provide it to competent enforcement authorities in an understandable way if the claim is challenged".

With this in mind, the Sustainable Finance Disclosure Regulation, which comes into force in March 2021, will mean financial products will have to be classified into one of the three categories:
(i) Financial products with environmental or social characteristics (Article 8 – Light Green)
(ii) Sustainable financial products with an intended sustainability impact (Article 9 – Dark Green)
(iii) Other products which are not classified as Light Green or Dark Green

China's adaptation and lessons learned

While one may think that there is just an accounting methodology challenge with regard to ESG, we must also be clear that perceptions about ESG materiality, i.e. what issues matter and what needs to be done, are also a function of the peculiarities of various nations/regions.

_ Chinese investors tend to look at ESG from a cost-benefit perspective, where financial materiality or relevance of ESG would be the key consideration for ESG integration. This also tends to form the baseline for fiduciary duty, which is to improve the risk-adjusted return for investors by incorporating only material ESG factors.

_ When it comes to financial materiality or relevance of ESG, the impact of specific ESG factors are viewed differently in China than in developed markets, given differences in policy priorities, social needs, and customer preferences among others. Governance in China, for example, is primarily interpreted as quality and credibility of financial reporting, leadership and management capabilities, interests encroaching by controlling owners given the dominance of controlling shareholding structures and the like. Whereas in the EU and the U.S., investors are more concerned about issues related to board independence, board gender diversity and executive pay. As for the social aspect, recent social disputes and unrest in developed markets have put human rights, social inequality and employee diversity issues at the core of investors' social considerations, while in China the focus has largely centred around product quality and safety, poverty alleviation and local community development.

_ In weighting the different factors, governance is often considered as the most material in China, followed by environmental, which has already had significant impact on some sectors. In contrast, the governance factor has already been relatively well-priced in Europe and U.S. markets, while environmental and more recently social factors have become more dominant, spurred by the rapidly escalating global climate and biodiversity crisis, as well as the COVID pandemic

To gain wider ESG adoption by local investors, it is critical for asset managers to align investors' needs for returns with their pursuit of sustainability, and focus on both delivering ESG alpha and positive environmental and social impact. Addressing whether ESG makes business sense for corporates and investors is critical to ensure ESG and responsible investment are a sustainable concept in their own right. The call for a localized ESG rating framework is thus strong, as global ESG rating frameworks tend to lack geographic granularity and market specific considerations.

From a local asset manager perspective, the key to improving the relevance of ESG factors to Chinese investment is to combine local fundamental investment insights with ESG philosophy. The good news is that more and more empirical and academic research has indicated a strong correlation between ESG factors and financial returns, and that ESG factors have greater alpha generation potential in the China market than in the developed markets[20]. This provides a good starting point for winning more local investors over.

While China desires to develop a localized approach and framework for ESG and responsible investment, it is also making significant efforts to converge to global framework to address universal priorities of global importance such as climate change and biodiversity loss. For example, aside from the revision of Chinese green bond standards to exclude clean coal to address investor doubts, another example is on "Corporate Governance", where the CSRC referred to the Principle of Corporate Governance published by OECD in 2015 for its 2018 version of Corporate Governance Code. The revised Code includes new sections on ESG disclosure and stewardship, encouraging investors of all kinds to exercise good stewardship and highlighting the importance of protecting the rights of non-controlling shareholders.

[20] DWS Research Institute (December 2015). ESG and corporate financial performance

Section III: The road ahead

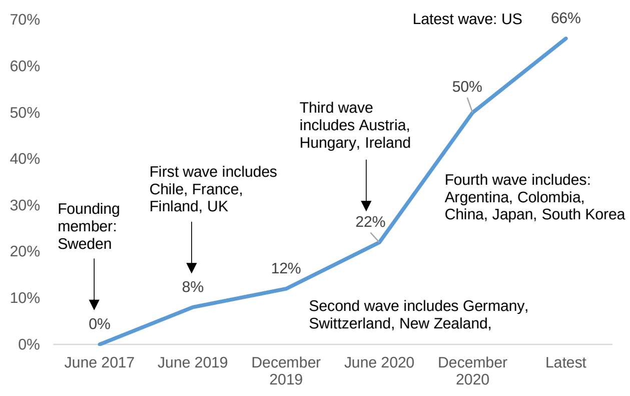
Most of the focus of the investment community towards responsible investing not just in Europe, but, also in China has been in the area of financial risk management, and understanding specifically how environmental, social and corporate governance (ESG) factors affect a company, or what is referred to as "outside-in". This explicitly tries to understand and manage how the outside world affects the risk adjusted return of existing investments. However, this approach does not ensure that capital is deployed sustainably with an eye to how this actually affects real world outcomes, such as levels of pollution or inequality, or what is termed "inside-out".

The next phase of the responsible investing journey is therefore set to focus on outcome- or impact-focused investing. This provides the opportunity for the investment community to become more directly linked to addressing major societal issues such as biodiversity loss or climate change, which damage growth and undermine investment returns.

One example of this more outcome or impact-based approach can be illustrated by government commitments to reach net-zero greenhouse gas emissions over the coming decades. This club has humble origins, dating back to June 2017, when Sweden was the first country to declare its pledge to reach carbon neutrality by 2045. Two years later, G7 members France and the UK joined the club, representing two of the world's largest carbon emitting countries.

Since then wave upon wave of new countries have joined the net-zero club, increasing the share of global GDP covered by net-zero carbon commitments, with a noticeable acceleration since the onset of the coronavirus pandemic, Figure 5. While China's net-zero ambition stretches out to 2060, there is hope that this target might be reached earlier as plans and roadmaps to peak carbon emissions before 2030 have been set out in various provinces including Shanghai, Jiangsu, Guangdong, Sichuan among others. Taking Shanghai as an example. At this year's Shanghai Municipal People's Congress, the mayor declared the city is aiming to reach a peak in CO_2 emissions by 2025, five years ahead of national targets. With China continuing to top the league table when it comes to annual clean energy investment, the country has become an attractive destination for impact-based investing. Indeed we are witnessing a few global companies considering and implementing steps to green their Chinese supply chains[21].

FIGURE 5. SHARE OF GLOBAL GDP COVERED BY GOVERNMENTS' NET-ZERO COMMITMENTS



Source: DWS Investments UK Ltd analysis (January 2021); IMF World Economic Outlook database (October 2020)

At the same time, there is a growing engagement and commitment from institutional investors towards ensuring that capital is deployed in a more sustainable manner. An example of growing institutional investor demand for positive impact and outcomes can be found in the Asset Owner Net Zero Alliance established in September 2019[22]. This commits signatories to carbon-neutral investment portfolios by 2050. Similarly, at the end of last year, the Institutional Investors Group on Climate Change (IIGCC) launched the Net Zero Asset Managers Initiative which commits signatories including DWS to investing to achieve net zero emissions by 2050 or sooner[23]. Part of the recommendations of these initiatives point to more forceful corporate engagement.

One of the challenges when it comes to successful corporate engagement relates to the different economic models and capital financing routes adopted in Anglo-Saxon versus continental European countries. Rather than tapping capital markets, in continental Europe the banking sector plays a significantly more important role when it comes to meeting company capital requirements. This reflects the greater predominance of private unlisted companies, most notably in Germany and Italy. Such entities are largely shielded from growing investor demands towards sustainability. To drive change in this important segment of the economy, will require greater banking sector oversight, but also for listed companies in these markets to play their role in driving sustainability along their entire supply chains.

Regulation will therefore play an important role as we move away from the laissez-fair attitude based on the sole pursuit of profit maximisation. The sustainable investor, the investor looking for a fair return on nature and the capital it provides, requires support. Hence, growing ambition among investors

[21] Apple (September 2019). Apple-launched China Clean Energy Fund invests in three wind farms
[22] UNEP FI (September 2019). Net-zero asset owner alliance launches at Climate Action Summit in New York
[23] IIGCC (December 2020). Leading asset managers commit to net zero emissions goal with launch of global initiative

around impact has also been accompanied by strengthening initiatives around reporting and regulatory oversight. With more than 3,600 signatories with in excess of US$90 trillion assets under management, the PRI is spearheading a number of initiatives with impact at their core. This includes the PRI's "Active Ownership 2.0" plan, the PRI's 2021-2025 strategic plan and the addition of an 'outcome' focus to the annual PRI assessment for signatories. In the UK, the Stewardship Code 2020 also has a greater focus on real world outcomes, which may become a template for other stewardship codes around the world.

The EU's consultation on future sustainable finance policies initiated last year[24] is moving fiduciary duty beyond the concept of "outside-in", to consider adapting rules, which consider "inside-out". This double materiality concept makes it clear that investors must also consider their adverse impacts on sustainability, so-called negative externalities. This means we have a better understanding about how capital is used by companies, and their track-record on human rights, gender equality, climate change and biodiversity for example.

China: An embryonic form of stewardship emerging with a focus on improving corporate quality and governance

In China, investment stewardship is a relatively nascent concept. The highly concentrated shareholding structure, the retail-dominated market and the lack of regulatory guidance on shareholder rights have traditionally been the main roadblocks for minority shareholders to express their opinions and has led to a culture of "vote by foot" by market participants. This has been gradually changing in the past five years against the backdrop of China's accelerated efforts to boosts foreign investors' access to the onshore capital market and the institutionalization of its investment landscape.

Active ownership and company engagement has gained some traction in China in 2020. According to the ESG investing survey[25] conducted by AMAC in 2019, 25 out of the 42 (or 60%) asset managers that have ESG or green investment policies or strategies in place, claim that they engage with invested companies on material ESG issues to raise the companies' awareness of ESG issues and to promote better ESG disclosure. The regulatory push for better corporate quality alongside asset owners' demands has, in recent years, helped to drive a mindset change among investors and supported stewardship development in China.

China's policymakers and securities regulators have expedited efforts to improve corporate governance standards to boost investor confidence. In 2018, CSRC revised the Code of Corporate Governance for listed companies, embarking on the journey to systematically enhance listed companies' governance and management quality. This was followed and supported by the latest State Council guideline to further improve the quality of listed companies in October 2020. While an explicit stewardship code remains absent in China, these high-level policies and guidelines are encouraging investor participation in investee companies' corporate governance and enabling a smoother communication between companies and investors.

Growing stewardship policies globally and stewardship activities led by foreign investors in China have also helped to build awareness and spurred local asset owners' attention on the matter. ESG is also gaining traction among Chinese asset owners. Some of the major players have started to research into ESG investment and look into stewardship activities. As it relates to stewardship, this involves taking a more active role in ESG engagement and voting, in light of rising interest from asset owners and recent regulatory focus on improving corporate governance among listed companies in China.

Leading Chinese asset managers have already started to put in place voting policies, guidelines, systems and procedures to address material corporate governance issues. However, current practices are on a case-by-case basis and they rely heavily on investment team's discretionary efforts. The establishment and development of local proxy voting advisory industry in recent years is helping to bridge the gap between local and global proxy voting practices and standards.

For company engagement, many Chinese asset managers already have regular engagement activities on key governance issues given high financial relevance. For the next step, these activities need to broadened into a more systematic approach that incorporates key environmental and social topics. Local investors can leverage their on-the-ground investment insights and ESG understanding to increase awareness of ESG issues among companies and provide then with guidance to achieve sustainability goals to enhance long-term enterprise value.

Chinese investors could also play a more active role in engaging companies on climate change issues in particular. Since the launch of China's 2060 carbon neutrality pledge, we have started to see meaningful changes in the corporate world for carbon neutrality. China's key energy and power groups are moving quickly to launch carbon neutral plans and strategies, and seeking for guidance and advices from

[24] European Commission (April 2020).Consultation on the renewed sustainable finance strategy

[25] Asset Management Association of China (March 2020). China asset management industry ESG investing survey report (2019)

all stakeholders including investors. We have seen significant progress achieved in engaging with Chinese emitters in the Climate Action 100+ initiatives, facilitated by Chinese asset managers. Chinese asset managers will become an increasingly important force in driving global and regional collaborative engagement initiatives.

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Harvest Fund Management
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