The Key Role of Stewardship to Advance Sustainable Finance

Summary Report from the Masterclass on the Key Role of Stewardship to Advance Sustainable Finance, delivered at the 2024 LSFI Summit.

This report is the outcome of the Masterclass on the Key Role of Stewardship to Advance Sustainable Finance, delivered on September 19, 2024, at the LSFI Summit.

This Masterclass was designed to help financial professionals integrate sustainability into their investment strategies through stewardship. It provided an overview of stewardship, its definition, and its role in achieving sustainability goals. The session covered the Swiss Stewardship Code and key principles for effective stewardship. Additionally, practical case studies were presented, highlighting perspectives, best practices, and challenges faced by asset managers, asset owners, and service providers in implementing stewardship best practices.

Disclaimer

The practical insights of this summary report aim to provide an initial roadmap for financial professionals to navigate the complex landscape of stewardship. However, this report is not intended to be comprehensive or be used as financial or business advice by the reader.

The report has been produced by the LSFI for information purposes only.

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1. Stewardship

What Stewardship Is

Stewardship is defined as a responsible investment approach whereby investors actively collaborate and engage with the companies they invest in.[1] The goal is to create long-term financial, environmental, and societal value, leading to measurable, positive, and sustainable outcomes. It can also be defined as using investor rights and influence to protect and enhance overall long-term value for clients and beneficiaries. This long-term value refers to any long-term value that accrues to the ultimate beneficiaries of an investment.

Activities for stewardship can differ by asset class, but stewardship is primarily conducted through two activities:

1. **Active voting**: Exercising voting rights during general assemblies, allowing investors to influence governance, strategy, and accountability directly.
2. **Engagement**: Engaging in a continuous and constructive dialogue with investee entities to influence their approach to environmental, social, and governance (ESG) issues.

Stewardship focuses on outcome-driven investments, aiming to generate financial returns and positive societal impacts and it is applied on a voluntary basis. This dual focus means that investment decisions should benefit the investor’s bottom line and the long-term sustainable development of the invested entities.

The success of effective stewardship implementation relies on three main aspects. First, a clear understanding of the different roles of asset owners, asset managers and service providers. Second, a transparent and ongoing dialogue. And finally, joint efforts in addressing sustainability related risks and contributing to positive outcomes.

Why Stewardship

Stewardship plays a key role in risk mitigation and long-term value creation for both companies and investors:

- From the company perspective: Stewardship supports sustainable value creation and can boost risk-adjusted returns over the long term, benefiting all investors equally.
- From the investor perspective: It is a core element of fiduciary duty, allowing investors to protect and enhance value over time.

Levers of the Financial Industry

Financial institutions can use different tools, mechanisms, and influences to drive change. Some of these are:

1. Asset management:

- Capital Mobilisation – Allocating new capital to companies focused on sustainable solutions and green assets.
- Voting and Engagement – Exercising voting rights and engagement with companies to encourage the development of credible climate and sustainable strategies (Stewardship).

[1] https://www.sustainablefinance.ch/api/rm/5A7ME29CD6M925N/2023-10-04-swiss-stewardship-code-final.pdf

2. **Financing business:**
    - Risk Pricing – Pricing in risks associated with unsustainable activities.
    - Promoting Net-Zero – Engaging with companies to promote sustainable business models (particularly net-zero strategies).

3. **Mortgage business:**
    - Mortgages – Offering mortgages with incentives for sustainable construction.
    - Client Education – Providing information to clients on sustainable buildings.

4. **Wealth management and advisory:**
    - Sustainable Investment Solutions – Offering a wide range of sustainable investment solutions.
    - Client Guidance – Advising clients on sustainable investments.

5. **Asset owners:**
    - Long-Term Commitments – Setting long-term commitments and long investment horizon.

2. Effective Stewardship: the example of the Swiss Stewardship Code

The Swiss Stewardship Code, published by the Asset Management Association Switzerland (AMAS) and Swiss Sustainable Finance (SSF) for the first time on October 4, 2023,[2] provides a framework for achieving impactful stewardship through nine guiding principles. This Code aims to guide for more stewardship and to offer a framework that leads to better comparability. Its principles highlight a structured approach to stewarding, emphasising transparency, accountability, and collaborative effort.

The 9 Principles of the Swiss Stewardship Code

1. **Governance:** Investors and service providers incorporate stewardship into their investment processes, with appropriate board leadership and oversight in line with their fiduciary duties.
2. **Stewardship policies:** Organisations establish stewardship policies that align with their long-term goals and values, ensuring their investment decisions foster sustainability.
3. **Voting:** Commitments to active and informed voting ensure that investors contribute to long-term sustainable value. This includes integrating voting mechanisms within their investment strategy to drive governance and accountability.
4. **Engagement:** Active dialogue with investee entities is encouraged to generate long-term societal and financial value. Collaborative efforts with other stakeholders can amplify engagement outcomes.
5. **Escalation:** When necessary, investors escalate stewardship activities, pushing companies to commit to sustainable practices and positive outcomes.
6. **Monitoring of investee entities:** Continuous monitoring allows investors to assess the impact and effectiveness of their stewardship activities, adapting strategies as necessary.
7. **Delegation of Stewardship activities:** If stewardship responsibilities are delegated, investors ensure consistency between the delegated actions and their stewardship goals and policies.
8. **Conflicts of interest:** Investors and service providers actively manage conflicts of interest to protect client interests and maintain transparency.
9. **Transparency and reporting:** Investors and service providers disclose their stewardship activities to clients, demonstrating accountability and commitment to their fiduciary duties.

[2] https://www.sustainablefinance.ch/api/rm/5A7ME29CD6M925N/2023-10-04-swiss-stewardship-code-final.pdf

3. Case study: Pension fund

Drivers of Stewardship in a Pension Fund

Stewardship is essential in pension fund management, ensuring investment strategies align with beneficiaries' long-term interests, and pension funds increasingly recognise stewardship as a critical component of sustainable investment. Some of the drivers for this are:

1. **Fiduciary duty:** Pension funds have a legal responsibility to act in the best interest of beneficiaries, and stewardship supports this duty by enhancing long-term value.
2. **Rise of passive investing:** The growth of passive investment funds, which lack easy exit strategies, makes engagement essential for influencing corporate behaviour.
3. **Regulation:** Legislation like the EU Shareholder Rights Directive mandates active ownership,[3] which can be understood as shareholders engaging in a company they have invested in to influence the company's strategy and action, pushing pension funds to engage responsibly.
4. **Self-Regulation:** Stewardship codes provide a framework and best practices for pension funds to follow a responsible management of their assets.

Exercising Stewardship in Practice

In practice, stewardship or active ownership involves strategies such as proxy voting or engagement, among others.[4]

1. **Proxy voting:**
   - Pension funds participate in general meetings or assemblies where they exercise voting rights on critical issues, such as board elections, climate strategies, and sustainability reports.
   - Voting decisions are guided by principles that prioritize the long-term interests of beneficial owners, ESG criteria, and corporate governance best practices.
   - Pension funds can evaluate board independence by considering key factors such as previous employment with the company, potential conflicts of interest, and board members' compensation.

[3] https://engage-int.com/eu-encourages-active-and-responsible-ownership/
[4] https://www.unpri.org/download?ac=4151

2. **Engagement:**
   Engagement is a practice which allows to:
   - Change the behaviour of companies from the “inside”.
   - Have an impact on the real economy.
   - Maintain a broader exposure to the market.

3. **Intensification:**
   - Escalating efforts, such as filing shareholder resolutions, is a last-resort tool when companies fail to address sustainability concerns.
   - Rules for filing resolutions vary by country; for instance, a 5% capital requirement applies in the UK, while in Switzerland, it can be 0.5%.

A successful case of engagement

A Swiss foundation, part of Climate Action 100+, engaged with the world’s largest cement producerto enhance its climate strategy.

Through continuous discussions, the swiss foundation influenced the cement producer’s commitment to more ambitious climate targets and secured shareholder approval for the climate report at the 2023 AGM.

4. Case study: Stewardship for Climate Change

Climate change represents a critical and systemic challenge requiring long-term, proactive stewardship. Investors are increasingly adopting systemic stewardship approaches that address broad environmental and social risks to the global economy - and, by extension, their portfolios. Through stewardship, investors can influence corporate policies on emissions reduction, lobbying alignment, and capital expenditure, helping companies align with climate objectives. By addressing these systemic risks, stewardship-related activities aim to reduce portfolio-wide risk and enhance long-term, sustainable returns.

Engagement Cycle for Stewardship Tackling Climate Change

Financial institutions can follow an engagement cycle. This is a structured and iterative process designed to drive meaningful change in companies through active stewardship. The cycle typically includes the following key steps:

1. **Establish clear, measurable, and timebound expectations**: define specific objectives for the company that align with long-term value creation and sustainability goals. Expectations should be measurable, actionable, and time-constrained, ensuring clarity and accountability. For example, setting targets for emissions reductions, governance reforms, or diversity improvements.
2. **Engage with the company individually and, or collaboratively**: Conduct direct dialogues with company leadership to advocate for the desired changes. Collaborate with other investors or stakeholders to amplify influence and demonstrate broad alignment on key issues where appropriate.
3. **Assess engagement success using standards and benchmarks**: Regularly evaluate the company’s progress against predefined goals using established standards and industry benchmarks. Use tools like sustainability metrics, third-party assessments, or performance reports to track outcomes and adjust engagement strategies as needed.
4. **Align voting with engagement outcomes**: Cast votes on company resolutions and ballot items in line with the company’s progress toward meeting key engagement milestones and voting policies: Support or oppose proposals, such as director re-elections or policy adoptions, based on alignment with stewardship objectives.

5. **Consider escalation for persistent misalignment**: Implement escalation strategies if a company fails to meet expectations or demonstrates continued misalignment after sustained engagement.These may include filing shareholder resolutions, engaging with regulatory bodies, increasing public pressure, or, in extreme cases, divesting from the company.

By following this systematic engagement cycle, investors can foster accountability, encourage sustainable practices, and drive long-term value creation, ensuring that companies remain aligned with the broader goals of the so called "ESG Stewardship".[5]

Focus on the Oil and Gas (O&G) sector

A pension fund first engaged with their investee companies within the O&G sector to urge them to focus on 1.5C alignment of targets and investments and escalated where companies were misaligned. Afterwards, they excluded all O&G companies across equity and debt holdings, which were focused on exploration, production, refining or pipelines, as none were aligned with a 1.5C pathway. Finally, they decided not to invest without alignment with the 1.5°C target. Instead, the focus going forward will be placed on reducing demand for oil and gas by engaging with major users.

5. Conclusion

This masterclass highlighted the central role of stewardship in sustainable finance, which aims to incorporate and foster sustainability-related considerations in investment processes. Stewardship is primarily conducted through active voting and engagement. Investors can drive corporate accountability and sustainability by exercising voting rights, engaging constructively, and employing escalation measures. For companies, stewardship supports sustainable value creation and improves risk-adjusted returns, while for investors it helps fulfil fiduciary duties by protecting and enhancing long-term value. Stewardship enables the financial sector to address systemic risks like climate change and biodiversity loss, thereby supporting a just and resilient economy.

To provide guidance to financial institutions on how to implement stewardship, the Swiss Stewardship Code was launched to promote responsible investment by encouraging investors to engage actively with companies to drive long-term financial, environmental, and societal value. The Swiss Stewardship Code serves as an international reference, and robust framework, fostering transparency, consistency, and alignment of investment with long-term sustainability goals.

[5] https://securities.cib.bnpparibas/unleashing-the-power-of-esg-stewardship-for-a-sustainable-tomorrow/

6. Annexe

Speakers

We would like to express our gratitude to the masterclass speakers for their insights and for sharing their in-depth expertise in this matter with the masterclass audience and the LSFI:

Katja Brunner, Director Legal & Regulatory, Swiss Sustainable Finance

Katja Brunner is the Director of Legal & Regulatory at Swiss Sustainable Finance (SSF), where she oversees legal matters and regulatory initiatives related to sustainable finance. With nearly 20 years of experience in the financial sector, Katja has held various management and expert roles, leading numerous projects in financial market regulation across institutions such as the State Secretariat for Economic Affairs (SECO), the Federal Department of Finance (FDF), and FINMA, as well as in the banking, funds, and asset management industries, including Big Four consulting.

Katja holds a law degree from the Universities of Lausanne and Geneva and is a qualified attorney admitted to the Geneva State Bar. She also earned an LL.M. in International Business Law from the University of Zurich.

Laura Hillis, Director, Climate & Environment, Church of England Pensions Board

Laura Hillis is a seasoned sustainable finance expert with more than 15 years of experience addressing climate change, nature, and social issues within the financial sector. As the Director of Climate & Environment for the Church of England Pensions Board, which manages a £3.2 billion pension fund, Laura leads initiatives that position the organization as a pioneer in ethical and responsible investment. Previously, she played a key role in leading Climate Action 100+ in Australia and was a member of its Global Steering Committee.
Currently, Laura co-chairs the corporate programme for the Institutional Investor Group on Climate Change (IGCC) and recently completed a Master of Sustainability Leadership at the University of Cambridge.

Vincent Kaufmann, CEO, Ethos Foundation

Vincent Kaufmann has served as the CEO of Ethos Foundation and Ethos Services since June 2015. He joined Ethos in 2004 as a Corporate Governance Analyst, progressing to Senior and Deputy Head of Corporate Governance. As a member of Ethos Services' management in charge of investment since 2011 and deputy CEO since 2013, Vincent has been instrumental in advancing responsible investment practices.
In addition to his role at Ethos, Vincent has been a board member of Swiss Sustainable Finance since June 2019. He is a Swiss certified Expert for Accounting and Controlling (2009) and holds a Master's degree in Business Economics from the University of Geneva (2004).

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ABOUT THE LUXEMBOURG SUSTAINABLE FINANCE INITIATIVE (LSFI)

The LSFI is Luxembourg's coordinating entity on sustainable finance, driving change across the whole ecosystem as a Centre of Excellence and Knowledge Hub, supporting the financial sector to accelerate the financing of the transition, and measuring progress.

The LSFI was founded in January 2020 by the Luxembourg Ministry of Finance, Ministry of the Environment, Climate and Biodiversity, Luxembourg for Finance and the High Council for Sustainable Development (Conseil Supérieur pour un Développement Durable).

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