Semi-Annual ESG Sentiment Study of Canadian Institutional Investors

September 9, 2024

Key observations

In June 2024, Millani conducted its Semi-Annual ESG Sentiment Study of Canadian Institutional Investors, with 37 asset owners and managers representing approximately CA $5.4 trillion of assets under management.

Key observations include:

- **Is ESG dead?**
  No, it has gone mainstream. However, there is growing recognition that **it may not be sufficient anymore**, as markets evolve from assessing the impacts on financial returns to also considering the impacts of businesses on environment and society.

- **Connected to this move to impacts, we are seeing a significant increase in investor focus on social issues.**
  Given the uptake in adoption of a double materiality, which considers financial and impact materiality, there has also been an increase in related sub-topics disclosed by companies and assessed by investors.

- **Equity, Diversity and Inclusion (EDI) is decreasing as a priority engagement topic for investors.**
  However, it is still considered a priority topic which investors expect to be managed as part of good governance and disclosed on.

- **The Minister of Environment and Climate Change Canada indicated earlier this year that Canada will have a transition taxonomy by December 31, 2024.**
  The inclusion of the exploration and development of new natural gas seems to be the stumbling block causing delays. Currently, 21% percent of respondents support its immediate inclusion, 58% support further studies and potential inclusion in the future, and 21% are opposed.

Setting the context

As we see an ever-increasing focus on populism and the resulting societal polarization, the question frequently asked is: Is ESG dead?

Rather than answering this ourselves, we decided to take this to investors and let them answer this question, as we conducted our ninth Semi-Annual ESG Sentiment Study of Canadian Institutional Investors, with 37 assets owners and asset managers (representing CA $5.4 trillion in assets under management).

In this edition, we will discuss responses to this question, reactions from investors to decreasing focus on equity, diversity and inclusion (EDI), views on details of a pending Canadian transition taxonomy as well as reactions to the most recent changes to Canada's Competition Act, Bill C-59, related to greenwashing.

Although there has been a healthy response from regulators and investors in the markets related to any potential claims of greenwashing, the global sustainability fund market saw net inflows of nearly US$900 million in Q1/24, recovering from a small outflow in Q4/23. In Canada, Q1/24 saw a rebound in flows into Canadian-domiciled funds of US$188 million, with passive strategies representing the majority of inflows in the quarter. One noted surprise was that sustainability funds had better performance and lower fees.

Macroeconomic focus is shifting

As we began 2024, inflation and rising interest rates were top of mind for investors. Many assumed that several interest rate declines would have occurred by mid-year. In Canada, that did not happen until June when the Bank of Canada decreased rates by 25 bps, followed by another 25 bps in July. The resiliency of consumers, the economy and the markets has been one of the biggest surprises cited by participants. The strength of the U.S. economy and its divergence from Canada's economy was also noted, suggesting that the variance between mortgage lending structures is a key driver of such divergence.

While most investors expressed increasing confidence that inflation is being managed, we also heard a view that ongoing inflationary impacts may not be as controllable by central banks as society and the market expect, with one investor noting: **"There's structural inflation. Everything related to protectionism and decarbonization is very much driving inflation. You need to build and double your infrastructure […] a lot of money is being thrown around for green initiatives. It will keep inflation above the 2% target rate and this inflation was not driven by demand, but by disruption."** (Asset Manager)

In this latest study, there seems to be a shift in focus to geopolitical risks. Since the beginning of the conflicts in Ukraine and the Middle East, and elections in France and the UK demonstrating society's desire for change, investors are concerned about the implications of elections in the U.S. and the growing strife between the U.S. and China. There is increased scrutiny on portfolio position and exposures to both sector and geographic impacts. Many expressed concerns related to policy uncertainty, especially in the U.S., related to the role of agencies like the Securities and Exchange Commission (SEC) or the Federal Reserve, given the Chevron Deference[1] legal strategy and the country's recent decision on to the power of federal government agencies to drive policy versus the courts[2]. A clear message is that geopolitical risks are growing, and investors are very concerned, one investor citing that these shifts will be **"critical for ESG and other aspects of our economy."** (Asset Manager)

> Chevron Deference is a legal strategy rooted in the 1984 U.S. Supreme Court case, Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc. This doctrine mandates that courts defer to a federal agency's interpretation of ambiguous laws if the interpretation is reasonable.
>
> Chevron Deference grants agencies significant discretion in interpreting laws, influencing regulatory practices in various sectors. It has sparked debate over the balance of power between agencies and the judiciary, with critics arguing it gives too much authority to unelected officials.

Top ESG-related topics

As mentioned, participants recognize the impacts of rising interest rates and inflation on society. As we asked which E, S or G topics were the focus for their portfolios, voting or engagements, we witnessed a notable shift in this edition of our study. Typically, we have had very clear responses by investors on these topics. However, in this study, "S" issues were raised almost 29% of the time, outpacing governance by close to 10%.

With little surprise that the "E" (which now includes the interconnectivity of climate and biodivewrsity) remains in top spot, investors are now clearly connecting geopolitical shifts, inflation, and rising interest rates to issues like affordability and potential social unrest. With elections in France and the UK confirming this thesis, it seems that society is indicating that it simply wants change. As such, we have noticed that participants are acknowledging that getting the "social" right has becomes a management issue. Social unrest causes geopolitical unrest, which can have significant impacts on global systems and economies and therefore, portfolios. The "S" in ESG is becoming recognized as one of the biggest growing risks in the markets. From a domestic perspective, a particular focus continues to be understanding Indigenous rights, reconciliation and economic development within the Canadian business context.

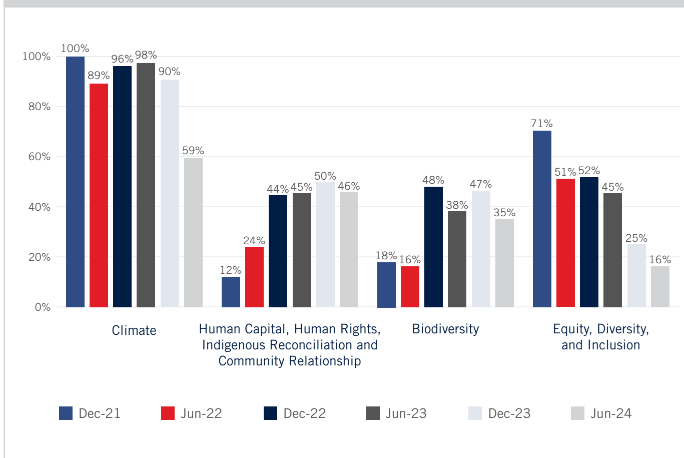
1. Stevens, John Paul, and Supreme Court Of The United States, *U.S. Reports: Chevron U.S.A. v. Natural Res. Def. Council, 467 U.S. 837*, 1983.
2. The Globe and Mail, *What is Chevron deference and why did the U.S. Supreme Court overturn it?*, June 28, 2024.

Figure 1
Distribution of ESG focus areas across Environmental, Social, and Governance, as identified by investors among their top three priorities

Topic category	Number of related sub-topics mentioned	Number of times sub-topics were mentioned	% of time the sub-topics were mentioned
E	7	51	54.26%
S	9	27	28.72%
G	8	16	17.02%
Total	**26**	**94**	**100.00%**

As the Canadian Securities Administrators (CSA) began, and continues, with its consultation related to equity, diversity and inclusion, we continue to observe a decreasing focus on this topic by our participants from December 2021 to today (See Figure 2).

Figure 2
Most frequently mentioned ESG focus areas



The most frequently noted comment explaining this shift was that progress has been made, with some thresholds having been achieved. Some investors are also starting to pay attention to specific themes.

"I think we have made a lot of progress regarding internal processes for EDI, looking at shareholder proposals three or four years back, a lot were pushing for board diversity and a lot of proposals have been successful. A lot of entities are putting genuine efforts for higher diversity and hence the push has been successful. Any further shareholder proposals we are seeing now are declined because they are going beyond what is reasonable. No one is declaring a success, but we are on the right path." *– Asset Manager*

Most participants suggested that similar to other topics that have come and gone from this list, such as cybersecurity, **"nothing has changed on our front when it comes to EDI, expectations are higher. There are now other areas to spend our time on."** (Asset Manager) Other investors noted that **"it is still front and center, it is just not a headliner"** (Asset Manager), and that **"the conversation is now going to the next step, talking about the nuances, such as culture. It is the next genesis of this topic, what is to come next."** (Asset Manager)

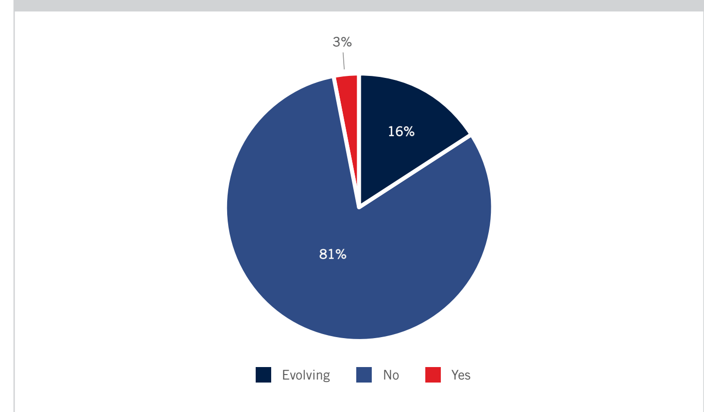
Others mentioned that **"so much still needs to be done from a corporate standpoint"** (Asset Manager), and that **"there are a number of different developments in the legal space that have impacted legal decisions of the supreme courts [...] that have an impact on EDI programs. EDI is a priority for larger organizations, but they may not talk about them as much, similar to some ESG topics, due to the political debate and therefore may not disclose as much on these topics."** (Asset Manager)

Moving beyond ESG

Given the politicization of the term ESG in the U.S. and the subsequent pushback that capital market participants have encountered either directly or indirectly, much of which we have written about in earlier editions, we sought to understand whether ESG integration as an investment approach is finished or evolving.

When participants were asked the question: "Is ESG dead?", 81% gave an emphatic "no", with 16% commenting that it is evolving towards something new and only 3% suggesting that it is dead. We heard that the key driver is that asset owners have set targets, either relating to climate, biodiversity, diversity or otherwise, and that they are now focused on achieving them. This has meant facing the realities of those commitments themselves, and, as such, so have their external managers.

Figure 3
Is ESG dead?



The general sentiment is that the investment industry has matured, as it has developed better regulations, definitions and tools, and that there has been significant progress towards sophistication in ESG practices today. One asset owner who uses a multitude of asset managers noted: **"It [ESG] is now part of the mainstream. The problem is, there has not been a lot of definition of what ESG is, [...] today, if you are not looking at ESG risks, you are not looking at the entire equation of your investments."** One investor added: **"This is a normal rite of passage for any theory of change, it needs pushback and to be pressure tested, to make itself more applicable."** (Asset Manager) When asked about whether ESG was dead, another investor responded: **"Never. Never in a million years. I just think that in the U.S., they think it [ESG] is exclusions. It's not exclusions, it's the integration of ESG factors, and new regulation is going to clean things up."** (Asset Manager)

Has then the polarization in the U.S. around the use of the term ESG affected their investment strategy? A clear 94% responded that it has not. In fact, we heard comments like: **"No, we continue to be consistent in our approach, we are going slow and steady."** (Asset Owner), and: **"No, because we've always been pragmatic and not ideological. What we do, we do because we think it's important."** (Asset Manager), and: **"Not in the sense that we are going to scale back, we are looking to increase ESG integration even more."** (Asset Manager)

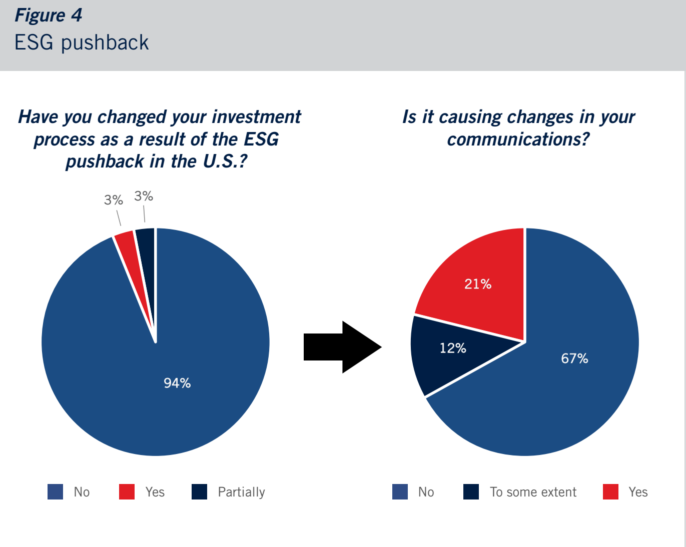
However, 46% of participants did suggest that **"the term is losing weight in how it is used"** (Asset Manager) and that **"there is a lot of opposition and therefore you could say resistance – which can mean dead. But we're seeing more of an evolution [...] it is becoming more tangible than being just the qualitative side. It's reaching a mature stage, but there remains a lot of misunderstandings."** (Asset Manager)

If not "ESG", then what term are investors using? Responses suggest that, formally, organizations are using terms like "sustainability", "sustainable investing", "responsible investing" or "responsible growth", given the perception that responsible or sustainable investing is wider in scope than integration of ESG factors into investment analysis. Yet, 71% of respondents use the term ESG internally **"because it is easier."** (Asset Manager)

So, what have the impacts of this polarization been? When asked, 21% of participants confirmed that it has led to a thorough review of communications, some have decided to publish less thought leadership, while 67% suggested that it has not changed their communications at all. Where it does seem to have had some impact is in how some asset owners **"approach conversations with our [external] managers"**, noting that **"you need to have productive conversations and relationships with managers to have good engagement. We went from talking a lot about 'net zero commitments' to now reducing this emphasis and now talking about 'decarbonization' strategies."** (Asset Owner)

Lastly, some investors mentioned that the polarization has made their jobs slightly more challenging, as they face more scrutiny.

Figure 4
ESG pushback



Words matter

As we were conducting our interviews for this study, Canada's federal government passed amendments to its Competition Act (Bill C-59), allowing for action by the general public relating to information or communications by issuers that might be considered greenwashing. We wrote a briefing note in July which outlines in fuller detail the reactions of investors.

A key element of this amendment is that corporations need to test their claims according to "internationally recognized methodology" which still needs to be clearly determined. The legal community has been actively doing audits of communications and in some cases, guiding organizations to remove information from websites and other forms of communications. This has led to a variety of reactions by the investor community: 1) those who agree that organizations should take down their information until they are certain about which methodologies are to be considered for testing, given the potential litigation risk if they do not; 2) those who have expectations that issuers have been testing the materiality of their disclosures along the path to their disclosures and therefore, look to those who have removed information as having a significant risk of potential greenwashing; 3) those who believe that this will ultimately lead to shorter, more focused reporting, removing the extraneous content they have had to parse through in the past; and 4) those who believe that this action will drive Canadian regulators to move more quickly towards a mandatory disclosure regime in Canada, aligned with the International Sustainability Standards Board (ISSB).

In Canada, the Canadian Sustainability Standards Board (CSSB), which has been tasked with determining if or how the ISSB standards should be implemented in Canada, recently had an open consultation for responses from investors and the broader public. Although there was a desire to hear the investor voices in this consultation, we learned that it was only about 47% of those we interviewed who had submitted a commentary, either directly or through industry alliances or collaborative initiatives.

The key message from participants was that Canada should align with the ISSB standards, emphasizing that there is no reason for Canada to deviate from the global baseline. However, there were concerns expressed to us regarding the **"excessive focus on climate and CSDS 2 (Climate-related disclosures)"** (Asset Manager), while CSDS 1, General Requirements for Disclosure of Sustainability-related Financial Information, is foundational and should not be overlooked. Participants noted that it is important to have access to reporting on all sustainability topics, not just climate. This is an interesting development as Canada's security regulator, the CSA, has indicated that it will prioritize climate, while we heard clearly that investors want a comprehensive approach covering all areas of sustainability.

Where there did seem to be debate was with regards to the necessity of transition periods for organizations to disclose. Some advocating for no delays while others suggesting a two-year grace period, especially for smaller companies, with some mentioning that simplified reporting should be allowed for smaller companies.

There was a general emphasis on the importance of including Scope 3 emissions in the standards, despite concerns about data quality and potential delays. Additionally, the suggestion of safe harbour provisions to protect companies throughout the transition was highly supported by investors. Finally, it was noted that regulatory timelines and processes could cause delays in implementation. Given the passing of Bill C-59, we now seem to have the very opposite occurring as some issuers choosing to remove sustainability-related disclosures altogether. Was this amendment meant to serve as a mechanism to move the market faster than the CSA can? Though it may be too soon to tell, it has created havoc and uncertainty in the markets in the meantime and ultimately, disrupting communications and disclosures in the short term. What's more, this seems to all be happening at a point where companies are desperate for capital to begin to execute on their decarbonization plans - likely causing delays to and interference with such plans and flows of capital.

Will Canada have a transition taxonomy in 2024?

Another aspect affecting the flow of capital has been the call for Canada to create its own "transition taxonomy" rather than the green taxonomy adopted by Europe, which is an instrument that would allow investors to invest in businesses that are moving towards decarbonizing their businesses to meet net-zero targets.

What is a taxonomy?

A taxonomy is a system that categorizes financial instruments, activities, and entities based on specific criteria, facilitating better understanding, comparison, and analysis for investors, regulators, and stakeholders. The Canadian federal government's creation of a transition taxonomy will boost confidence and transparency, helping investors make decisions that align with Canada's climate goals, transition pathways, and specific climate action plans or net-zero commitments.

There have been great efforts made over the past five years to develop a transition taxonomy in Canada. However, one of the key stumbling blocks slowing its publication relates to whether the exploration and development of new natural gas should be allowed in a transition-oriented portfolio. With the Canadian economy rich in natural resources, the debate continues.

At a conference earlier this year, Canada's Environment Minister Stephen Guilbault confirmed the intention to have a Canadian transition taxonomy by the end of 2024. As such, we took the opportunity to gather insights on the following question: "In a scenario where new natural gas exploration and development does not get included in the first phase of a transition taxonomy, but efforts continue to discuss if/how it might be incorporated later, how would you respond?" Our study found that 21% of respondents would like natural gas to be included in a transition taxonomy, while 58% suggested that they would be open to having natural gas left aside for now for assessment and continued study, although not a first choice. One investor shared: **"I don't see why we shouldn't include natural gas in a transition [taxonomy]. It does have a role to play. If we want to get there faster with the taxonomy, if this is the way to resolve the issue, then let's exclude it. But on the flip side, people run the risk of not understanding why it is not included."** (Asset Manager)

A larger concern was expressed however: the urgency to move soon. It was expressed that if our organizations do not align, then Canadian companies and investors will be assessed by other standards, particularly European ones, and not our own.

"I don't see why it would be excluded first and that then we will open it, it is usually the contrary. However if that means that we will not have a taxonomy for the upcoming two years, I say we exclude it for now. The choice is coming out with a Canadian taxonomy that is more or less stringent now, or it will be a European taxonomy assessing our assets."
– Asset Manager

Re-assessing impact

These structural changes are being paired with the suggestion that we are moving from a basic integration of E, S and G topics into investment decision making, to an evolving and maturing market. This then begs the question – evolving to what?

In our last study published in February 2024, 43% of participants had planned to launch an impact-oriented fund this year. There seems to have been a reassessment of this enthusiasm since, as market participants are concerned about definitions and, in particular, given the market's focus on greenwashing, being called out for anything that might be misconstrued as impact washing.

We have seen increased interest in understanding the nuances of what is considered "impact" and how to measure impact within a fund alongside financial returns, rather than a focus on "impact investing". While we heard that many asset managers are considering this measurement of impact as a differentiator in the market, many questions remain relating to whether impact can be found in public and private markets, the source of demand, whether focusing on impact will negatively affect returns, and whether it is part of investors' fiduciary duty. The clarity that will come with a transition taxonomy in Canada may help develop this market. In the meantime, one investor noted: **"I worry about impact branded funds that are not actual impact products – that may destroy the market. What would be damaging, would be impact-washing, taking advantage of a part of the market that is not focused on impact. That is really concerning."** (Asset Manager)

There is an ongoing healthy dialogue on how to develop the impact market, with communications, returns and intentionality of impact at the center of discussion. While there are additional regulatory developments in progress, there are also still debates to be had and clarity to be gained. Overall, some of the exuberance we witnessed seemed to be increasingly grounded in recognizing that impact funds are easier to market compared to ESG funds due to a more straightforward narrative. However, the criteria for qualifying as an impact fund are more stringent than those for ESG funds. Our view is that we remain in the early stages of this market evolution from ESG towards sustainability outcomes that can be measured as impacts. The market is in development and the key will be to remain cautious and ensure alignment of the various related aspects, to avoid any kind of impact fund washing.

Conclusion

As usual, the ESG / sustainability arena is exciting and dynamic. Yet again, within six months of our last study, we have witnessed mainstream markets shift and more "S" oriented topics surfacing for investors as risks to their portfolios. The regulatory landscape related to disclosures by issuers for investor use has shifted and remains in turmoil until further clarity is provided, suggesting investors may have more difficulty gaining access to ESG-related information in the near term. Investor reactions to these changes are highlighting that the integration of E, S, and G topics for risk management is far from dead.

Investors want clear and transparent communications to make appropriate investment decisions, and it appears that a variety of elements are being put into place in the medium- to longer-term to allow that to happen. In the coming months, we should have guidance from the CSSB on their recommendations regarding the ISSB standards; we may see a new Canadian transition taxonomy, with or without natural gas exploration and development as part of it; and guidance and clarity regarding the vague areas of Canada's Competition Act.

It seems that we are in the midst of the inevitable growing pains associated with the formalization of new systems and structures. However, it is clear that the materiality of E, S and G issues is now well understood by investors and is not going away.

Contributors

Thank you to our contributors who took the time to provide their insights on key ESG trends. Our contributors represent 37 of Canada's largest institutional investors, some of which are listed below.

About Millani

Millani provides responsible investing and corporate sustainability advisory services, including ESG integration and impact, to both investors and companies.

For the past 15 years, Millani has become the partner of choice for institutional investors and corporations alike. By providing advisory services on integrating material ESG issues into investment strategies and decision-making processes, Millani helps reduce risks, increase returns and create value. Millani also regularly develops leading thought leadership on investor and disclosure trends. The firm leverages this expertise and experience to help corporations, both public and private, create strategies, engage with stakeholders and strengthen their disclosures, supporting the organizations in their access to capital and optimization of market value.

Millani's success is founded on a bespoke, client-centric approach that focuses on material issues, practical implementation, and independent advice. Our extensive capital market experience and unparalleled expertise in ESG, and its connection to value creation, position Millani at the nexus between investors and companies—making us unique in the Canadian market.

For more information, contact us at info@millani.ca or visit our website www.millani.ca.

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