

ESG strategies

Special report 2021

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ESG strategies signal progress for people and the planet

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Continued interest in environmental, social, and governance (ESG) issues is driving up global sustainable fund assets. According to data from Morningstar, inflows reached the highest-ever levels in the first quarter of 2021 for the fourth quarter in a row, with European sustainable funds dominating at around 80% of net inflows. While ESG investments still represent only a small portion of overall fund assets, by 2025, ESG funds are expected to outstrip traditional funds.

An ESG boom can partly be explained by ‘inelasticity’ in the market. This unresponsiveness to price changes is artificially pushing up returns (see page 13).

Evaluating ESG investments is fraught with difficulty, from defining ESG criteria to understanding the true impact of individual assets. For example, in the 2021 *Risk.net* buy-side risk management survey, it was revealed that – at the cutting edge of ESG efforts – portfolio and risk managers struggle to measure and set limits on climate risk because of the lack or poor quality of the underlying data (see page 4).

The dearth of depth and transparency in corporate disclosures is a serious impediment to the field. In particular, the lack of supply chain data makes it very difficult to measure the true sustainability of companies. Efforts by regulators to force disclosure of material exposures to climate risk, for example, have been delayed by opponents (see page 26), but experts believe reporting initiatives, such as the International Sustainability Standards Board (ISSB), will lead to a global framework of consistent standardised corporate ESG disclosure.

Although there are some ESG criteria that are commonly agreed on in the industry – particularly for environmental aspects – not all ESG metrics are standardised. So how these criteria are weighted by ratings providers or asset managers will vary. The standardised metrics can sometimes be unhelpful in measuring sustainability, even at focal points such as carbon metrics (see page 10). An analysis of the challenges in measuring ESG and climate transition risk also features in this report (see page 8).

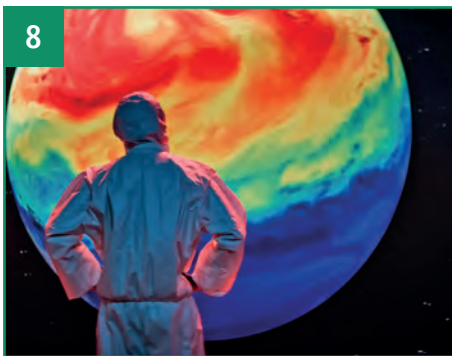
Some qualitative ESG criteria around corporate culture, for example, are not easily quantifiable. But experts are encouraged by the progress made towards materiality. For example, the Sustainability Accounting Standards Board has defined a core set of indicators using a materiality framework that carries over to the ISSB initiative.

One way asset managers can approach the challenge of meeting investor expectations is to ensure a fund complies with an independent ESG label such as the European Union’s Sustainable Financial Disclosure Regulation. There is no approval process for this, but the UK Financial Conduct Authority, for one, is exploring how to do this (see pages 23 and 29).

Methodologies that screen certain stocks are the easiest to communicate, but are not necessarily the most effective in making ESG progress. Investors have long been shifting away from negative screening and divestment to ESG integration. And industry experts see impact investing as a decisive approach towards measurable progress for people and the planet. At the heart of this report, these experts explore these and other developments in a roundtable Q&A (see page 14).

Finally, this report explores the challenges for issuers around liquidity and hedging of ESG structured products and derivatives (see pages 20, 28 and 32).

Zoi Fletcher
Contributing editor, *Risk.net*



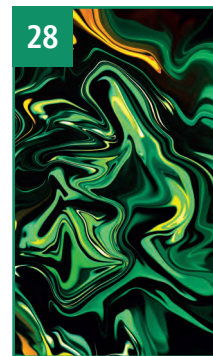
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Copping out on climate change

Buy-side risk management survey

Only 9% of respondents to this year's buy-side risk management survey say front-line staff have a climate role today, while specialists call for better metrics and link to pay. By Kris Devasabai

Every large asset manager these days claims to be a responsible investor. But whose responsibility is it? Ask portfolio or risk managers – as *Risk.net* did for this year's buy-side risk survey – and the answer will generally be, "someone else's".

That doesn't surprise executives leading the industry's sustainability efforts.

"We are in a transition," says Rick Lacaille, global head of ESG at State Street. "People still regard climate risk as a peculiarity or anomaly that needs to be placed in a separate structure for which another person or team is accountable."

The problem, according to execs in those separate structures, is that the industry has not yet given front-line risk-takers and risk managers the right incentives or tools to tackle climate risk. Most portfolio managers are driven by short-term return and compensation goals that give them little reason to look beyond the next few quarters.

"You will struggle to find any fund manager that has a remuneration policy that goes beyond a five-year horizon," says Brunno Maradei, global head of responsible investment at Aegon Asset Management.

The head of sustainability at a US hedge fund agrees "incentives are a huge part of it".

Risk managers, meanwhile, have another reason to duck responsibility for climate risk. For a group of professionals whose job is to fence exposures in – by measuring them and setting limits – climate change is unpleasantly slippery.

"The challenge for them is that they're normally used to dealing with either vast amounts of data or fundamental structural models that will help them forecast risk into the future," says State Street's Lacaille. When it comes to climate risk, data is patchy and models are still evolving. "That creates quite a bit of stress for risk professionals, because they're used to being able to have pretty good coverage and a confident answer as to what the risks look like. And where they don't have confidence, at least in my experience, it makes them uneasy."

Lacking the incentives and tools to fix the problem, many are currently sidelined.

This is borne out by the *Risk.net* survey. While 64% of respondents said their firms had a corporate level strategy for managing climate-change related risks (see figure 1), only 9% said risk and portfolio managers were responsible for implementing and executing that strategy. The vast

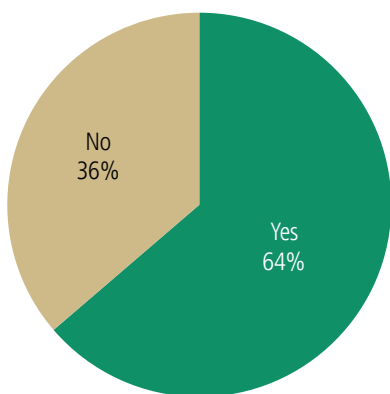
majority of respondents said responsibility for climate risk lay elsewhere – with senior management (32%), the board of directors (22%), or corporate and social responsibility officers (22%) (see figure 2).

But portfolio and risk managers are likely to have accountability forced upon them. As climate risk moves up the policy agenda, finance firms are being pushed by regulators and stakeholders to disclose and actively lower the carbon intensity of their portfolios – creating work for the front and middle office, and potentially bringing forward the moment when climate risk starts to manifest as market, credit and liquidity risk, and the securities of the largest polluters collapse in value.

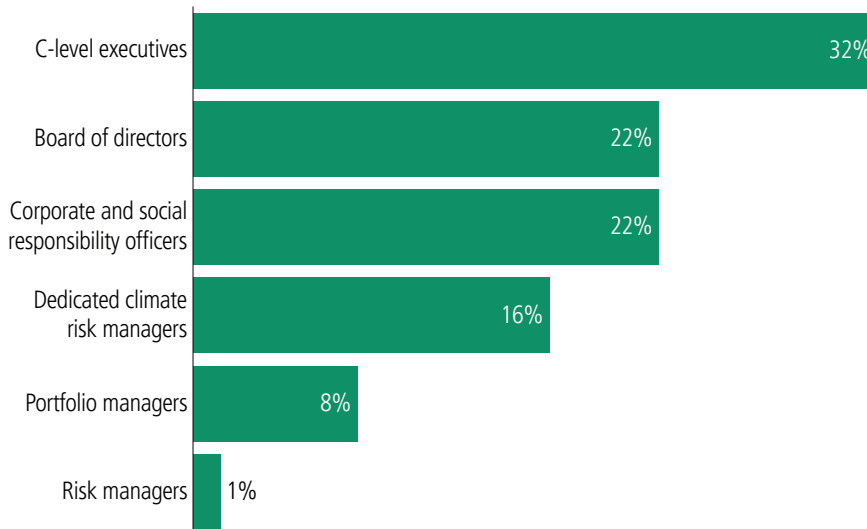
This year, the Bank of England and the European Central Bank launched new stress tests to gauge how large finance firms – including insurers – are dealing with climate risks.

Meanwhile, pension rules introduced in the UK on October 1 require retirement schemes with over £5 billion (\$6.77 billion) in assets to assess and disclose their climate-related financial risks in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD). Similar rules for UK insurers will come into force in April next year.

1 Does your firm have a corporate-level strategy for managing climate-change related risks?



2 If so, who is responsible for implementing and executing this strategy?



“We’re getting this deluge of incoming demand,” says Craig Mackenzie, head of strategic asset allocation research at Aberdeen Standard Investments.

“If you’re a chief risk officer [at a large UK financial company], you are now having to deal with the fact that the Bank of England is requiring you to run various climate scenarios – and you have to do it,” he adds. “If you manage money for a UK pension fund over a certain size, you’re being asked, ‘can you provide climate scenario analysis for these three scenarios’ and we need it by November 30. And if you manage money for insurance companies in the UK, you would have been asked to do this nine months ago.”

Meeting those demands is an all-hands-on-deck undertaking.

“It’s not just the ESG teams that are doing it,” Mackenzie says. “It’s the risk teams, the governance teams, the portfolio management teams.”

Risk.net’s survey suggests many firms may struggle to respond to the growing requests for climate risk data and analytics. Only half of respondents said their firms calculate the carbon intensity of their portfolios and just 54% run climate stress tests (see figures 3, 4 and 5).

Better stress tests

For risk managers tasked with steering the climate transition at their firms, the problem starts with shoddy data and gets worse from there.

According to Ceres, a sustainability group, climate risk data is currently available for a set of around 3,000 large companies globally.¹ Much of this is self-declared and does not always include the indirect scope 3 emissions from a company’s supply chain.

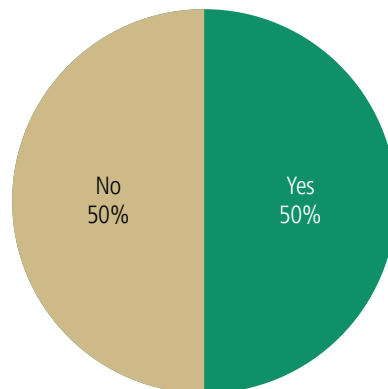
Asset managers rely on databases to plug the gaps, though this information is of varying quality. “We have broad coverage,” says Mackenzie. “We just don’t think the data is any good.”

In *Risk.net’s* survey, 55% of respondents said their firms calculated the scope 3 emissions of investments – but almost none could do it for more than 60% of their total assets (see figures 6 and 7).

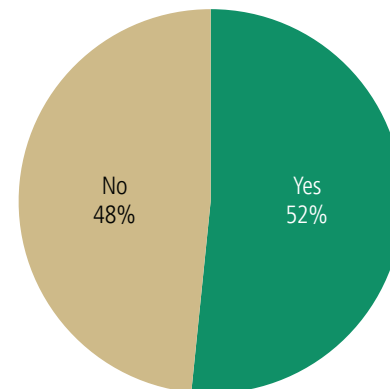
Even if an investor is able to collect enough data of reasonable quality, there is little consensus on what to do with it. “Most firms are in the early stages of trying to figure out what metrics to use to aggregate climate risk across the portfolio,” says Robert Litterman, a founding partner and chairman of the risk committee at Kepos Capital, a systematic global macro investment firm.

Most start with the carbon footprint of their portfolios, expressed as emissions per \$1 million of revenues, market capitalisation, portfolio value, or some similar denominator. This is the approach recommended by the TCFD.²

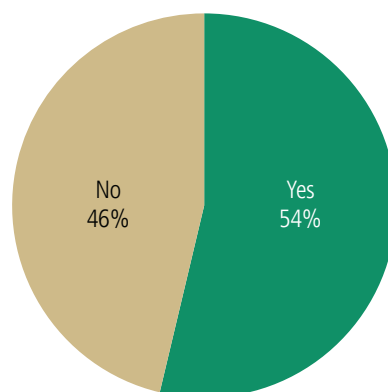
3 Does your firm calculate a carbon intensity number for the scope 3 carbon emissions of its investments?



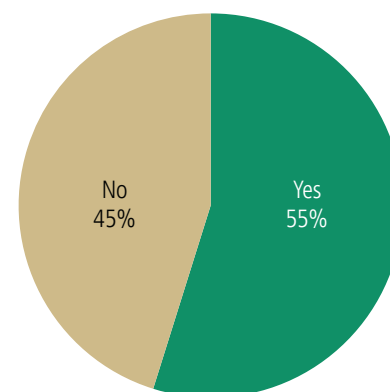
4 Does your firm calculate a temperature rating for its portfolios?



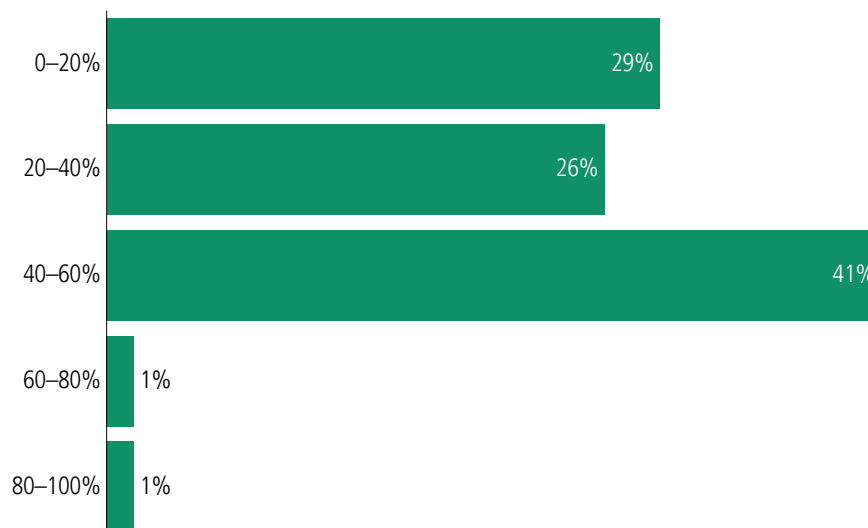
5 Does your firm run climate stress tests on its portfolios?



6 Does your firm calculate the scope 3 carbon emissions of its investments?



7 For what percentage of AUM has your firm calculated the scope 3 carbon emissions of its investments?



Several large investors, including BlackRock, have also committed to calculating so-called temperature alignment metrics, which estimate how much global warming a portfolio will cause over a period of time.

But these metrics only work for relatively simple long-only portfolios. “You ask, ‘how do you calculate this metric for a short position?’ and there’s no agreement,” says Litterman.

For quants like Litterman, who previously led the risk management department at Goldman Sachs, this is infuriating. Asked if long climate risk exposure should be offset against shorts, he says: “Of course, to me it’s obvious.”

Most firms also conduct some form of climate stress-testing. This can be a useful exercise, if done correctly. Often, it is not. Most stress tests, including those devised by supervisors, take some end-point, say a 2° Celsius increase in 2050, and make simplified assumptions about how the world manages to get there – for instance, uniform carbon prices or widespread adoption of renewable energy.

“What tends to happen is people take a 1.5°C scenario and a 3°C scenario and they stress-test – which is good, but it only shows you the tails. We want the full distribution,” says Aberdeen’s Mackenzie.

Two years ago, Aberdeen Standard set out to build a more robust climate scenario analysis tool for its portfolio and risk managers.³ The firm mapped out various plausible pathways to lower global temperatures, incorporating different assumptions about policy and technology developments. For instance, one scenario assumes wide adoption of carbon capture and storage technology to lower natural gas emissions, while another envisages greater reliance on renewables. It then worked with Planetrics – a climate risk-modelling specialist that was acquired by McKinsey in March – to translate these scenarios into economic shocks and estimate the impact on asset prices.

The resulting system spits out fair value impairment estimates for around 20,000 securities across a range of plausible future scenarios. “Our equity, credit and risk teams can see how climate transition impacts valuations across 16 different scenarios, and the probability-weighted mean average,” says Mackenzie, who was involved in developing the scenario analysis tool.

But after doing all that, Aberdeen Standard ran into the incentive problem – many of its investment teams didn’t bother to run the scenarios on their portfolios.

“There are quite a few managers who don’t use our tools very much,” Mackenzie admits. “They’re not that interested if they don’t have clients asking them to do it. They might be interested in the oil price risk for their holdings, but they don’t necessarily think about it in carbon terms.”

The firm has a plan to change that – it will soon announce a target to reduce carbon intensity that will apply to all assets under management, though

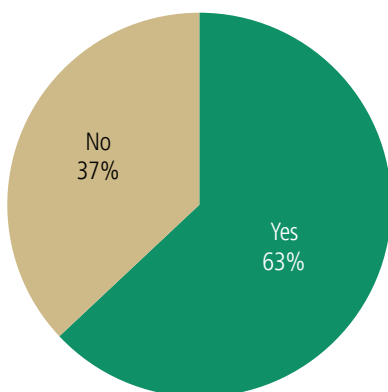
perhaps not in uniform ways. Mackenzie declines to say what the target will be, as it is still being discussed internally. Eventually, bonuses for fund managers may be tied to hitting those targets, although that isn’t currently part of the plan.

“That forces the portfolio managers to start using the tools – to look at the climate scenarios and understand the carbon trajectories of individual companies – in a way they currently don’t have to,” says Mackenzie.

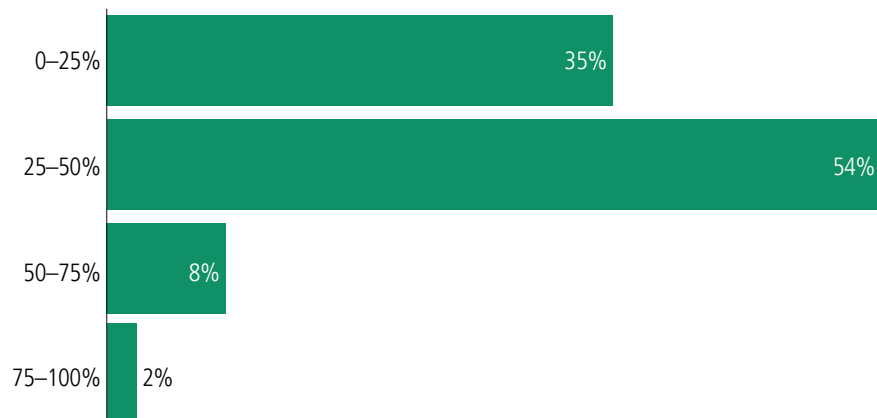
The move to set a target is already changing the way rank-and-file staff think about climate risk. The investment risk governance team is having meetings with portfolio managers about how carbon intensity targets should be managed, if they were to be implemented. The clear message was that it shouldn’t be hived off to another team.

“Our portfolio managers said, ‘we don’t want you to create a whole new infrastructure with the ESG team – can we use the existing investment risk governance framework?’,” Mackenzie says. “We

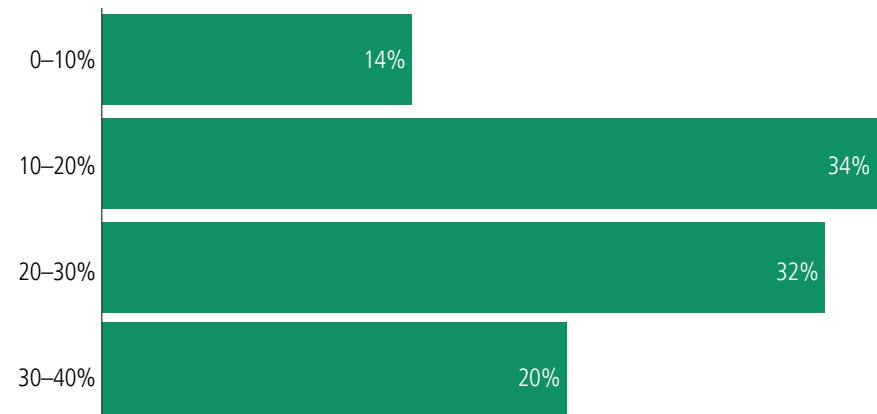
8 Has your firm set targets to reduce the carbon intensity of its investment portfolios?



9 What percentage of your firm’s total AUM is covered by this targeted reduction in portfolio carbon intensity?



10 What percentage reduction in investment portfolio carbon intensity is your firm targeting in 2030?



have a framework, we have the investment control tools, and we'll be able to include carbon data as part of that. This will all get integrated so you'll get a red flag if you try to buy a carbon intensive company and you're already close to the limit."

State Street's Lacaille agrees with the approach: "I really don't think ESG should be any different than the other risks we look at that are very important in the business," he says.

Missing the target

Nearly two-thirds of respondents to the *Risk.net* survey said their firms had set targets to reduce the carbon intensity of their investment portfolios – a surprisingly high number, given the scarcity of reliable data and metrics to use as benchmarks.

But the targets themselves are hardly encouraging – at 90% of firms, the targets apply to less than half of total assets under management, and only a fifth of firms expect to cut the carbon intensity of their portfolios by more than 30% by 2030 (see figures 8, 9 and 10).

Most studies suggest investors will need to cut carbon intensity by at least 50% by 2030 in order to meet net-zero goals by 2050.

By that measure, very few investors have net-zero targets currently. Aberdeen Standard's Mackenzie is not surprised. "I wouldn't really expect most asset managers to have net-zero targets," he says. "The world is not currently on a 1.5°C trajectory, and if you set targets that act like it is, you are taking some investment risks. Asset managers generally are managing money for external clients, and historically at least, the industry has felt it is for the asset owners to make that decision."

State Street Global Advisors (SSGA), the world's fourth largest asset manager with nearly \$4 trillion in AUM, joined the Net Zero Asset Managers initiative in April.⁴ By signing up, the firm has committed to reach net-zero greenhouse emissions in its portfolios by 2050 and to set interim targets for 2030.

That may not translate into hard targets for portfolios – at least not immediately.

The big challenge is setting a target that makes sense across the firm's diverse investment products, which include index trackers, separate accounts and active funds subject to varying constraints. "Because of that mix, it's very hard to say, 'we're going to reduce the carbon intensity of our portfolios by 10% in the next five years'. How do you do that with an index fund?"

SSGA has already factored ESG and climate risk into its active portfolios. But for passive portfolios, its only real option is to engage with the companies in the indexes they track. Many of those companies have committed to reducing emissions, but the outcomes are outside an investor's control, and the timeframes may not align with near-term net-zero goals.

Lacaille says SSGA can make good on its net-zero commitments by offering clients better choices. "Many of our clients have signed up to the Net Zero Asset-Managers initiative or made similar commitments. And what we say to them is, 'we've got some techniques, new indexes or tilted portfolios that will accomplish that goal'. That's what we're doing," he says. "Our goal is not to reduce carbon intensity whether clients like it or not, irrespective of the sort of value creation or destruction that might bring, but rather to address material ESG issues to better serve our clients' needs and portfolios."

For actively managed funds, those that have done the analysis say aggressive reductions in carbon intensity are possible. "At the moment, I think a 50% intensity reduction target by 2030 is pretty unproblematic from a risk point of view," says Mackenzie at Aberdeen Standard. "We analysed various portfolios, and we estimate the tracking error for regional equity indexes would be in the region of 20 basis points."

Mackenzie says this can be achieved mostly by tilting exposures in a handful of sectors – utilities, energy and basic materials – away from the most carbon intensive companies. "You tilt away from oil to gas companies, you tilt from coal to renewables in utilities, and you tilt your miners away from coal and iron ore to copper and lithium, and you don't need to have that much tracking error," he says.

Mike Chen, head of sustainable investments at quant investment firm PanAgora, agrees. The sustainable equity portfolio he runs has around 50% lower emissions than its benchmark, the MSCI World Index, with a tracking error of around 2–3%, which is about average for long only quant funds.

"If you want to cut portfolio carbon by a reasonable amount, it's really not that difficult," says Chen. "The fact is the emissions profile of your portfolio is very concentrated – a few names are responsible for the vast majority of the emissions. If you cut those names, that will get you a fair way."

Research has shown 20 companies in the MSCI World Index are responsible for around a third of emissions, with 100 companies accounting for 70% of emissions.

For active managers, a 50% carbon reduction target versus a benchmark "is a good place to start," Chen says. "If you want a reduction of 50% by 2030, then that's achievable."

Aberdeen's Mackenzie also expects to see more and more asset managers adopting aggressive targets to accelerate action on climate change. "I think one of the things we're going to see, and we're already starting to see, is asset managers setting targets for reducing carbon emissions across all of their portfolios, even though in the past they've said they could never do that because this is all the asset owners' money," he says. "We are crossing the Rubicon at the moment as an industry. I don't think many asset managers are going to set net-zero targets – 60% targets – but I think we're going to get relatively close to that." ■

Previously published on Risk.net

ABOUT THE SURVEY

This is *Risk.net's* second annual survey of buy-side risk management practices – the inaugural edition focused on lessons learned from the volatility that followed the first Covid-19 lockdowns.

As with that first survey, this year's results will be followed by a series of other articles in the coming weeks, including profiles with senior risk managers.

There were 124 respondents to the survey. Of those, 39% worked at hedge funds, with a further 22% at other asset managers and the balance working

at insurers, pension funds, endowments or other investors. By job role, just over half of the respondents were risk managers, while a fifth were portfolio managers – the balance were in operations, trading, or corporate and social responsibility functions.

By AUM, 29% of respondents had assets of less than \$100 billion; 47% of respondents controlled between \$100 billion and \$499 billion; 12% had AUM of between \$500 billion and \$999 billion; a further 12% had AUM of \$1 trillion or more.

¹ M Lubber (June 2021), *Public input on climate change disclosures*, Email to Vanessa Countryman, <https://bit.ly/3rEM3vP>

² TCFD (October 2021), 2021 status report, <https://bit.ly/31CXLvS>

³ J Lawson, E Cairns, C Mackenzie and A Moss, *abrdn* (February 2021), *Climate scenarios: a rigorous framework for managing climate financial risks and opportunities*, <https://bit.ly/3Ep9VXU>

⁴ *Net Zero Asset Managers (2021)*, The Net Zero Asset Managers initiative grows to 87 investors managing \$37 trillion, with the world's three largest asset managers now committing to net zero goal, <https://bit.ly/31wppDl>

⁵ I Ghosh (October 2019), Which companies are responsible for the most carbon emissions?, <https://bit.ly/31GqdUS>

To learn more

Download the full survey results at www.risk.net/media/download/1072466



Climate risk takes scenario analysis and stress-testing to the next level

Financial institutions are facing several challenges as they prepare for the transition risk journey that will see them evaluating their existing risk and finance solutions. Ludwig Dickens, client advisor, risk business consulting, at SAS discusses what this means for scenario analysis and stress-testing in steering towards the net-zero emissions ambition

The focus of this article is the ‘environmental’ pillar of ESG and climate transition risk. We consider the challenges financial institutions are facing, how past Basel Committee on Banking Supervision and International Financial Reporting Standards (IFRS) global and local experiences can provide valuable lessons, and what this means for scenario analysis and stress-testing in steering towards the ambition of net-zero emissions.

In doing so, this analysis foregoes but recognises the dependencies between physical and transition risk, as well as the impact that actions on the environment have on the other ESG pillars, and vice versa.

Challenges

In determining the transition risk of a bank’s portfolio (assets and liabilities) there are many aspects to consider. For example:

- **Regulatory framework** – currently it is unclear how far regulators will become prescriptive, rather than giving financial institutions the freedom to show when and how to get to a net-zero portfolio that matches their situation from geographic and business perspectives.
- **Geographic differences** – the various regions worldwide have either different carbon reduction ambitions, different focus areas or different timelines. This makes developing a coherent strategy a challenge for organisations with a global presence.

- **Taxonomy** – there is no single truth on green versus brown, nor on how green a funding is. Partly because of a lack of reference data on carbon dioxide (CO₂) emissions, but also because of differences in how to classify assets and investments.
- **Granularity of geospatial data** – assessing the carbon footprint of both scope 2 and 3 emissions requires detailed knowledge about suppliers and customers, processes and assets or, alternatively, the availability of industry emissions statistics with sufficient relevance.
- **Multilayered assets** – the repackaging nature of complex financial instruments requires a multilayered analysis to get to the carbon emissions of the underlying assets, but there is not an obvious choice as to what to consider and what not to.

History has shown that the solution to complex problems requires several iterations

Climate risk has many unknowns and approximations for carbon emission calculations and translating them into financial impact, so it will likely take several iterations before getting to a desired agreed maturity.

Assessment should be made to evaluate candidate solutions on their ability to:

- Integrate various calculation methods (internal or publicly available, such as the Paris Agreement Capital Transition Assessment).
- Integrate additional data sources (climate, taxonomies, emissions, and so on).

- Handle models for various combinations of industry segments and geographies.¹
- Increasingly disclose details to address the requirement for transparency.
- Compare period-to-period evolutions, and identify and interpret outliers, which may lead to complementary steering actions.

With this comes the need for strong version management and process governance.

Do not simply reuse and extend what is already there

Many financial institutions have already started on their journeys by:

- **Controlling the influx of new carbon-intensive investments** – additional data about the underlying assets themselves will need to be gathered to assess the financial impact of physical and transition risk.²
- **Assessing the carbon footprint of the current portfolio** – this is new ground and will be especially challenging for calculating scope 3 emissions for upstream and downstream processes. Small and medium-sized enterprises typically do not know the CO₂ footprint on the services they offer so one can, at best, rely on published averages.

¹ Already today this can be seen with, for example, syndicated loans or large corporations as counterparties for which a lot of information is available compared with retail counterparties.

² As insurers traditionally do for assessing the insurance risk.



Ludwig Dickens

- Exploring how the carbon footprint will evolve towards an intended target – banks participating in early regulatory climate stress-testing exercises experienced difficulties due to:
 - Long time horizons
 - Poor data quality

- High data volumes
- Granular geospatial forecasting data
- Mature scenario analysis capability
- **Implementing strategy and governance** – a net-zero ambition needs to set the objectives at the level of individual portfolios and the asset manager. The next step is to regularly measure decarbonisation progress and integrate metrics into a management dashboard to be able to actively monitor, steer and adjust.

There is more to scenario analysis than just scenario analysis

While scenario analysis is exploratory by nature compared with stress-testing, both can easily be achieved within a single solution. Nowadays regulators worldwide are requesting that financial institutions conduct stress tests for various scenarios. Climate risk will add to the complexity, warranting a sophisticated and industrialised approach that goes beyond manual processes and spreadsheets.

Tight deadlines, multiple and complex scenarios, increasing frequency of requests, traceability, explainability and governance throughout the steps of the process will all require banks to further improve or replace their solutions for stress-testing and scenario analysis.

Conclusion

Basel and IFRS regulations were fine-tuned through several iterations, pushing many financial institutions to rebuild their risk and compliance solutions. Transition risk is a less well-defined journey, so a solution for scenario analysis (and stress-testing) will require adaptability.

The initial steps on the transition risk journey will see firms evaluating their existing risk and finance solutions – recently put to the test by Covid-19 stress-testing. This will be important and timely, as banks prepare for what lies ahead, considering the speed at which regulators are gearing up for mandatory disclosures, and stakeholders look to understand how the bank will support a transition to net-zero carbon emissions. ■

EU's new carbon-scoring metric bedevils investors

Buy-side risk survey 2021: Evic could have harmful consequences for green investing. By Rob Mannix

The devil – in carbon-scoring, as in so much else – is in the detail. What might look like an arcane, even insignificant tweak to the evaluation of carbon scores by European Union policy-makers could have an outsized effect on carbon metrics, influencing billions of dollars of future investments.

Investors, however, aren't buying it. Experts say the EU's policy switch to using enterprise value as the denominator in calculating carbon emissions scores will favour fast-growing firms over the rest – distorting green credentials and bringing undesirable consequences to both portfolio construction and to efforts towards greening the economy.

"The debate here may seem academic. But the choice can influence significantly how capital is allocated, as well as a fund's factor exposures and transaction costs associated with turnover," says Vitali Kalesnik, director of research at Research Affiliates.

Need to know

- Revisions to the EU Benchmarks Regulation in 2020 introduced carbon emission metrics scaled by enterprise value including cash (Evic), versus the prior norm of scaling by revenues.
- Investors complain Evic jumps around too much, and for the wrong reasons – causing fast-growing companies to look greener, regardless of behaviour.
- It's a metric "driven by market performance ... as opposed to climate performance", says a critic.
- Portfolio managers claim Evic will skew portfolio construction, hurting value funds and ramping up turnover so as to bite into margins.
- A global consensus on how to formulate carbon scores may yet diverge from the EU line. But, for now, practitioners see the new metric exerting a strong influence in portfolio construction.

Before the shift, carbon intensity was most often calculated by dividing a company's emissions by its revenue. The new way – written into EU law by a revision of the Benchmarks Regulation that took effect in December 2020 – is to scale emissions by enterprise value including cash, or Evic.

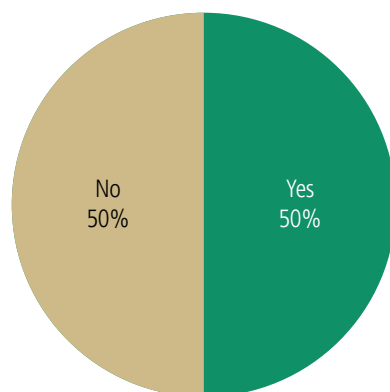
But green investors say the Evic measure jumps around too much – and for the wrong reasons – impeding efforts to gauge a company's actual progress in reducing emissions. Businesses with an accelerating market value will see their carbon intensity fall quickly, regardless of their true credentials in the field.

"What you get is a metric driven by the market performance of companies, as opposed to their climate performance," says Frederic Ducoulombier, ESG director at Scientific Beta, a provider of quantitative indexes.

Portfolio managers complain the approach will skew portfolio construction. It will arguably force investors to load up on growth stocks – to satisfy what ought to be emissions-driven targets – and will likely increase turnover, thereby adding to costs.

"It changes the relative attractiveness of a company, based on market sentiment or the market environment," says Kalesnik. "If the price goes up, the company becomes more expensive and [therefore] becomes more attractive. That's an undesirable feature."

1 Does your firm calculate a carbon intensity number for the scope 3 carbon emissions of its investments?



Research Affiliates] is researching how the EU's choice of metric will affect portfolio construction, including any unintended consequences.

The industry verdict on Evic already seems to be in though. Andrew Laphorne, head of quantitative research at Societe Generale, sums up the view of many market participants who spoke with *Risk.net*: "If the best way to cure a carbon problem is for the share price to go up, clearly that's not solving anything."

The scores on the doors

The purpose of carbon-intensity or footprint scores is to allow investors or regulators to compare emitters of different sizes. They normalise emissions relative to a company's size and output – so a large firm with a high total volume of emissions might still score better than a smaller firm with less total output, thanks to the relative scale of its emissions.

Of the 124 investors quizzed for *Risk.net*'s buy-side risk survey, 50% said they calculated a carbon intensity score for their portfolios, expressed in terms of tons of CO₂ emitted per \$1 million invested (see figure 1).

And until last year, the standard methodology for calculating a stock's carbon intensity was to divide its emissions by its revenues – but that's when the EU changed tack.

The EU Low Carbon Benchmark Regulation, an amendment to the existing Benchmarks Regulation, created two new index classifications: EU Climate Transition Benchmarks and EU Paris-Aligned Benchmarks.

For both new benchmarks, the regulation mandates a minimum 7% per year decarbonisation standard – far more than most firms are currently targeting (see figure 2).

Critically, it measures progress to this end by using emissions divided by Evic rather than revenues.

Firms are under no obligation to use the Evic version of intensity in selecting individual investments, says Ducoulombier, but in practice they will do so because of the regulatory metric. "If you have a regulatory restriction couched in Evic-based intensity, it makes sense to use it in all steps of portfolio construction."

Critics say inserting Evic into carbon-intensity scores will accomplish a sort of accidental greenwashing.

Certainly, some of the numbers created by the new approach seem topsy-turvy.

E.on is a prime example. Its Evic-scaled carbon score went down by a fifth for the year to October 2021, indicating a lower carbon intensity, according to data from Research Affiliates. Yet the company's Scope 1 and 2 emissions increased by more than a quarter during that time.

Nestlé sits in the 76th percentile of consumer-staple stocks by emissions-to-revenues, UBS researchers calculated, but only in the 42nd percentile by emissions-to-Evic.

There are also some distorted effects at the sector level. Energy companies, which this year have seen valuations soar by more than 40% amid the Covid recovery, suddenly look much improved under the newer measure.

Beneficiaries of the EU's decision are companies with high valuations relative to sales, which include online retailing and real estate development, both of which are contributors to higher emissions.

Cynics also say companies will be able to arbitrage their way into indexes by issuing bonds to increase enterprise value and pushing down their carbon scores in the process.

"Increasing revenues is difficult," says Carmine De Franco, head of research at asset manager Ossiam. "Increasing debt is easier."

The problems don't end there.

Judging whether companies are cleaning up over time becomes problematic because Evic-scaled numbers are likely to be volatile.

Between 2013 and 2020, more than 6% of Evic figures from companies in developed markets showed a year-on-year increase of half or more, according to data from Scientific Beta.

"An increasing number of institutional investors wish to see the Evic-type metric reported"

Frederic Ducoulombier, Scientific Beta

"You can go from a good carbon intensity to a very bad carbon intensity in the space of a month, simply because stock prices have moved a lot," says Georgios Oikonomou, a quant analyst at Societe Generale.

From October 2020 to 2021, BP's Evic-scaled carbon score improved by 18%, for example, despite the firm's scope 1 and 2 carbon footprint's remaining level, according to data compiled by Research Affiliates' Kalesnik.

The EU added a mechanism in the Benchmarks Regulation to adjust scores for big market moves. But critics say the 'detrending' mechanism has little effect on individual security selection.

Ducoulombier found that nearly a third of companies that improved Evic-based scores by 7% or more after applying the adjustment had nonetheless increased emissions. For revenue-scaling, the cadre of firms that improved by this degree was 18%.

Currency and inflation effects muddy the picture too. If the currency of a company's stock gains versus the currency of its carbon reporting, its Evic increases – again making the company appear to get greener.

Evic-scaled carbon intensity scores calculated by the Dutch central bank show Dutch pension funds and insurers cutting emissions by 34% and 31%, respectively, from 2012 to 2019. When the bank adjusted for inflation and currency fluctuations, the figures fell to 24% and 23%.

Practically speaking

In building portfolios, meanwhile, Evic-scaling will magnify factor bias, says SG's Laphorne.

"The change pushes portfolios towards more expensive companies because they have higher valuations. It pushes them into lower-risk companies because, typically, more expensive companies are lower risk, with higher market cap," he says. "You bring out a much stronger large-cap bias and a negative-value bias."

Laphorne and Oikonomou have constructed factor-neutral Paris-aligned portfolios. But they see the task getting harder as the requirement to cut emissions by 7% a year squeezes investors' choices in stock selection. "The need to reduce carbon every year is going to be a big challenge for investors," says Laphorne.

Value funds are likely to suffer especially badly from the EU switch. European value funds invest heavily in energy and utilities, De Franco points out. "In value, you are buying a lot of the real economy. And the real economy does pollute. Your carbon scores compared to the cap-weighted benchmark will look horrible."

The growth bias in an Evic-scaled measure will only hurt more. "Lowering carbon scores for value will tilt the portfolio towards a point where you are no longer a value fund, but neither are you a growth fund," he says. "You're in the middle of the distribution, where typically there's no signal."

Evic volatility will also lead to higher turnover in portfolios. "Turnover is often under-appreciated," says Kalesnik. "Investors could be losing millions of dollars cumulatively."

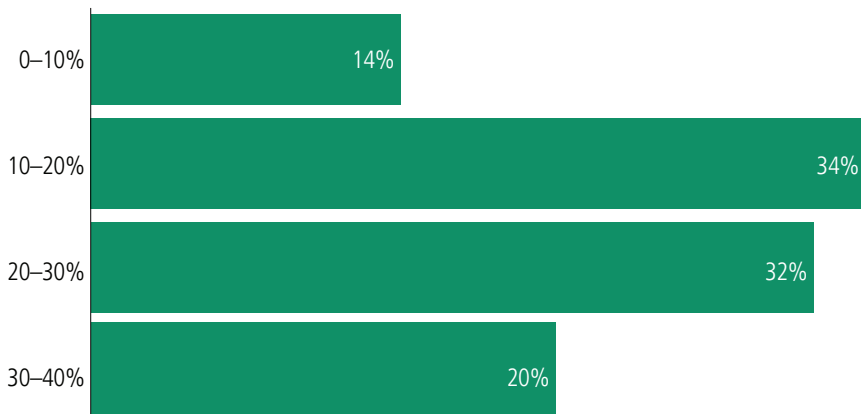
Studies by Research Affiliates show smart-beta indexes that over-trade can incur tens of basis points in unnecessary costs, he points out.

Evic-based measures could even dilute the alpha in certain investing strategies.

Research conducted by Gerald Garvey, Mohanaraman Iyer and Joanna Nash in 2018 found that companies producing less greenhouse gas by sales use their resources more efficiently and should be a better bet for investors.

Indeed, analysts at UBS found that a simple strategy of buying stocks with stronger emissions-to-revenue scores beat its benchmark by about 60bp a

2 What percentage reduction in investment portfolio carbon intensity is your firm targeting in 2030?



year. The same strategy using Evic in the signal beat the index by a more modest 40bp a year.

But could the problems with using Evic be resolved? Scientific Beta advocates a return to revenue-scaling for metrics used in portfolio construction. “It’s not perfect, but it’s better,” says Ducoulombier.

Kalesnik suggests normalising emissions scores with a five-year-average Evic number would smooth some of the volatility and prevent needless turnover.

“Fixing the problem further down the line may add complexity that reduces transparency and increases costs,” he says. “If you could do something simpler, it would be cheaper and would benefit investors.”

But Evic’s advocates say the criticisms might be balanced out by other advantages.

Revenues can also be volatile. In industries such as copper mining, for example, where prices change quickly, volatility can lead to choppy intensity scores – much as with Evic.

Companies that spend on developing cleaner technology might suffer under the old measure because their revenues drop in the short term.

Also, policy-makers have made no secret of wishing to penalise energy firms, which can earn high revenues in the near term, while economies slowly transition to cleaner fuels.

Even Evic’s critics acknowledge the effects of the switch may remain narrow to begin with.

In the EU, the metric will be a binding constraint only for portfolios that specifically seek Climate Transition or Paris-aligned status. Investors might use both calculation methods depending on the task in hand.

Sweden’s AP2 pension fund, for example, tracks emissions-to-sales for the purposes of stock selection in some funds and engagement with companies. But it uses emissions-to-Evic in its reporting and as a constraint in the optimisation of certain factor funds.



“The need to reduce carbon every year is going to be a big challenge for investors”

Andrew Laphorne, Societe Generale

How differently stocks will rank under each measure can perhaps be overstated. UBS found that nearly half of stocks fell within the same quintile by sector and region. Equally, the metrics are likely to be reviewed and amended in coming years.

And, in time, other more forward-looking measures will become more important.

Practitioners describe carbon-intensity scoring as a stepping-stone between counting scope 1 and 2 emissions and calculating implied temperature rise scores.

But the industry may be moving to implied temperature scores faster than expected – 52% of respondents in *Risk.net*’s latest buy-side survey said they already calculate temperature ratings for at least a portion of their portfolios (see figure 3).

BlackRock, the world’s largest asset manager, with around \$9 trillion in assets, has committed to publishing implied temperature scores for its public funds that invest in markets with reliable data by the end of the year. The firm, which struck a deal to acquire consulting firm Baringa’s climate-modelling software in June, will enable rival fund managers to calculate temperature scores for their funds through its Aladdin risk management platform.

Third way

A global consensus on how to formulate carbon intensity scores may yet diverge from the EU line.

The Task Force on Climate-related Financial Disclosures (TCFD), which issues guidance aimed at forming an international industry standard, recommends asset managers calculate a portfolio-level score built up from measures for individual stocks – a so-called weighted average carbon intensity, or Waci – which uses revenue as a scalar. The organisation published updated recommendations in October that left the door open to alternative approaches that use market capitalisation – but not Evic – to normalise emissions across companies.

That said, emissions-intensity scores using Evic are locked into the EU’s hard rules already, and practitioners see the new standards driving further adoption of the EU approach in time.

“These kinds of metrics will not only drive the construction of low-carbon portfolios. They will also drive the construction of a much larger slice of investment portfolios,” says Ossiam’s De Franco.

Sarita Gosrani, director of ESG at investing consultancy bfinance, says the “vast majority” of passive investment managers she has spoken to have either launched an EU benchmark-aligned product, are developing one, or are applying the EU criteria internally as part of monitoring carbon intensity.

Ducoulombier fears the chance of an alternative course has passed. Even in the TCFD guidance, he notes, an Evic-based measure was introduced alongside Waci for the first time.

“The EU has ruled,” he says. “An increasing number of institutional investors wish to see the Evic-type metric reported. Some people that thought something else was better will just go with it and won’t be so vocal anymore. I hope I’m proven wrong and we don’t incentivise a metric that has some unfortunate unintended consequences.”

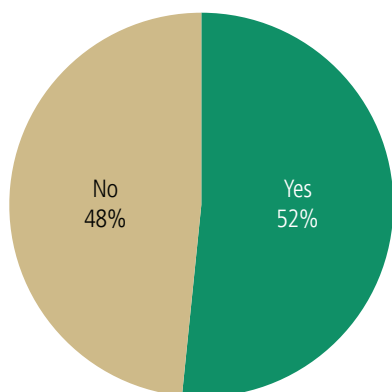
The asset managers interviewed by *Risk.net* acknowledged the risk of policy-makers suffocating under the detail of setting metrics. Any single measure is “bound to be imperfect”, says Lucian Peppelenbos, climate strategist at Robeco. “Action matters more than measurement when it comes to climate change.”

Yet concerns aren’t going away about unwanted side-effects to a complex policy that’s changing fast.

“We might find we tried to push capital toward companies that provide solutions to fight global warming and mitigate climate change,” says De Franco. “And we ended up simply piling up on artificially low-carbon companies, such as tech and healthcare.” ■

Previously published on Risk.net

3 Does your firm calculate a temperature rating for its portfolios?



Stock-level ‘inelasticity’ explains ESG boom

ESG investors’ reluctance to sell holdings is pushing prices even higher. By Rob Mannix

The prices of ESG stocks are being driven up largely because many of the investors that hold them simply refuse to sell, new research finds.

Stocks that meet ESG criteria have beaten the wider market by around 1.5% per annum over the past five years. But in the absence of surging demand, these stocks would have underperformed the market by 2.1% a year, according to Philippe van der Beck, a researcher at École Polytechnique Fédérale de Lausanne and the Swiss Finance Institute, who carried out the study.¹

While ESG investments still represent only a small portion of overall fund assets, they have grown exponentially in popularity. The first quarter of 2021 saw over \$180 billion in inflows to sustainable funds globally, according to data from Morningstar. But even with valuations rising rapidly in response to increasing demand, existing holders of ESG stocks are unwilling to sell their positions.

This unresponsiveness to price changes – known as inelasticity in academic parlance – means “flows are artificially pushing up realised returns”, says Van der Beck. He estimates that every dollar invested in ESG stocks over the past five years pushed up prices by \$2–2.50 on average.

Van der Beck’s findings also suggest that some specialist ESG funds – because of the inelasticity of the stocks they invest in – have a greater impact on the cost of capital for green firms than other such funds.

Using data from quarterly US mutual fund filings, Van der Beck examined how investors adjusted their portfolios in response to buying pressure in ESG stocks. He estimated a “price elasticity matrix” for every investor to gauge how quickly they would sell different stocks when prices rose. He then calculated a ‘multiplier’ for individual stocks – a measure of how far demand can move the price – based on the ownership-weighted sum of elasticities.

By simulating different levels of flows into ESG funds and then applying the multiplier, Van der Beck was able to estimate the returns attributable to the growth in investor demand. “These are returns not because of any fundamentals, but due just to flow-driven price pressure,” he explains. After deducting

“The realised return on green firms will be even stronger in future if flows continue to rise, and that may be for years to come”

Philippe van der Beck,
École Polytechnique Fédérale de Lausanne

the flow-driven returns, he found the performance of ESG stocks to be “strongly negative”.

The latest research builds on recent high-profile work by Xavier Gabaix at Harvard and Ralph Koijen at Chicago Booth on how flows affect prices.

Economists and quants have long argued over whether flows influence prices, or vice versa. Conventional theory says flows have little price impact because investors will quickly sell out of stocks in response to growing demand.

By examining fund holdings data, Gabaix and Koijen showed that many investors are in fact price insensitive. This inelasticity in supply means demand spikes can cause outsized and permanent changes to stock prices.

“Classical financial market theory tells you investors are very elastic,” Van der Beck says. “The multiplier matrix would have all zeros. But everybody in the industry knows that large flows create price pressure. And that’s what we’re estimating.”

The research suggests ESG stocks will outperform as long as flows into the sector remain elevated.

“The realised return on green firms will be even stronger in future if flows continue to rise, and that may be for years to come,” Van der Beck says.

Spillovers

Van der Beck also tracked the spillover effects that occur when ESG sellers reallocate capital to other investments. “If you buy Apple, not only will you have an impact on the price of Apple but you will also have an impact on the price of Amazon and Microsoft and Google and all other stocks,” he says. “People will rebalance their portfolios in order to sell Apple to you.”

These spillover effects can be surprising and can even extend to unrelated stocks. For example, if BlackRock had sold its entire 6.8% stake in ExxonMobil during the third quarter of 2020, the resulting flows would have caused its stock price to fall by 62%, Van der Beck says. At the same time, shares of renewable natural gas company Clean Energy Fuels and retailer Walmart would rise by 9% and 2% respectively, the model says.

Van der Beck’s research suggests that some specialist funds can drive up the price of ESG stocks sharply, lowering the cost of capital for the companies they invest in. But ESG funds that hug the market benchmark too closely and invest in highly elastic stocks can have little effect on prices.

“An extremely green investor might invest only in the greenest firms but if those green firms are held by elastic investors they’ll just sell to you and the price remains unchanged,” Van der Beck says.

He claims the research can help investors cut through “flowery fund prospectuses” and identify ESG funds that have a “true” impact on the cost of capital for green firms. Every dollar invested in the iShares MSCI USA SRI fund pushes up the price of ESG stocks by \$5 and lowers the valuation of mining stocks by five cents, Van der Beck estimates. By contrast, a dollar invested in the DFA US Sustainability Core Equity Portfolio would cause the value of ESG stocks to increase by just 28 cents.

Successful impact investing, Van der Beck argues, relies on investing in green firms held by inelastic, often passive, investors. “Then you really drive up the price of those stocks and you can have a large permanent impact on valuation, resulting in a lower cost of capital [for the company].”

Valentin Haddad, associate professor of finance at the University of California, Los Angeles, says the research could help explain how flows can inflate ESG stock prices, despite what conventional theory says. Haddad’s own research shows that even if some hedge funds bet against heavily bought ESG stocks, they are unlikely to reverse the effect. ■

Previously published on Risk.net

¹ P van der Beck (September 2021), Flow-driven ESG returns, www.bit.ly/3AYPj6D

ESG strategy, investment and risk

Appetite for ESG funds has never been higher. Inflows exceeded \$180 billion in the first quarter of 2021 – equal to the whole of 2019 – and, according to some estimates, ESG funds are set to outnumber conventional ones by 2025. A forum of industry leaders looks at how the market for ESG investing is evolving, discusses the current challenges and evaluates the latest tools and methodologies for managing ESG risk



Peter Plochan, Principal Business Solutions Manager, Risk Presales
www.sas.com

Does there need to be more corporate disclosure on firms' ESG goals and criteria and, if so, what form should this take?

Peter Plochan, SAS: Over the past couple of years, we have seen some positive development in the uptake of disclosures by companies globally – the Task Force on Climate-related Financial Disclosures (TCFD) being one of the emerging standards within an accelerating trend. This is supported by some jurisdictions that are making this mandatory. So, first, I would like to see everyone joining a standard. At this time, it is difficult to obtain even such relatively simple information as the carbon footprint of a company. For example, in SAS's recent climate risk webinar, a chief risk officer (CRO) from a global systemically important bank said they were able to collect carbon footprint data for only 17% of their corporate portfolio. For the rest, they had to use proxies. The second question this CRO raised was, even if we can collect the data, can we trust and understand what is behind it? The TCFD has also done a good job of providing the first hints on standardisation of the measures that companies put into their reports. I am confident that, in the next year or two, we will see more initiatives like this that will improve transparency and comparability.

Jaspreet Duhra, S&P Dow Jones Indices (S&P DJI): In the 20 years we have been using ESG data in our indices, we have seen a notable uptick in disclosure from companies. In part, it's due to regulation; for instance, the European Union's Non-Financial Reporting Directive requires companies to disclose on a number of ESG topics. This is just one of many global initiatives that recommend disclosure of non-financial metrics from companies. In part, it is due to investors and data providers such as S&P Global asking companies questions pertaining to ESG metrics.

Despite this, there are still notable data gaps and, yes, we would like to see more corporate disclosure. The more data we have, the better the ESG analysis we can use in our indices. However, ideally, this data should be consistent, comparable, verified, and so on.

S&P Global ESG Scores form the foundation for the ESG scores we use in our indices. As part of the data collection process, S&P Global is looking at

information in the public domain, but also considers information submitted from companies in response to questionnaires, enabling S&P Global to form a richer understanding of the companies' ESG profiles. In turn, this can potentially lead to better public disclosures as companies may begin to report on ESG issues if they see these issues attracting investor interest.

We also have ways to tackle data gap challenges. For instance, we use S&P Global Trucost data for climate metrics. Trucost has developed modelling techniques to fill in the gaps where data from companies may be lacking in metrics such as carbon footprints.

Mike Chen, PanAgora Asset Management: ESG disclosure and ESG data are huge challenges. They have improved over the years, but there is still so much confusion right now. The lack of common standards is a serious impediment to the development of the field.

PanAgora and Google Research recently completed a study that found that the more ESG data a firm discloses, the better ESG commercial rating they tend to get, even if the underlying data does not state the case. A lot of ESG ratings are tick-box exercises on whether a firm has a given policy – and these are categorical rather than numerical. So there is a cognitive bias here. But it is to a firm's advantage to publish as much ESG data as it can. Hopefully there will be a centralised data repository or standardisation in the future, where ESG data could be disclosed in the same way as accounting standard data.

Steffen Hörter, Munich Re Investment Partners: Despite numerous voluntary and regulatory ESG efforts, corporate ESG disclosure still needs to be advanced globally. As an investor, what I need are the right ESG key performance indicators (KPIs), not more quantity. But materiality of ESG KPIs is industry-contingent. So qualitative context is required to understand quantitative ESG KPIs. For example, I am keen to understand the forward development of a corporate's ESG programme and how it has integrated sustainability into its business growth strategy. I'd also like to understand which ESG KPIs are considered relevant and what capital expenditure and research and development they invest into those. I also want to know what ESG risk management practices they apply and how they mitigate adverse sustainability footprints, as well as other business controversies.

Preferably, quantitative ESG KPIs would be standardised, electronically accessible, machine-readable and clearly mapped to a corporate issuer identifier. They would be structured to reflect business activities, using internationally accepted industry classification codes. I would expect them to be linked to financial metrics and integrated into International Financial Reporting Standards (IFRS). And, ideally, ESG KPIs would be submitted directly from the corporate source.

Bruno Bertocci, UBS Asset Management: Everybody is calling for more disclosure. As asset managers we need consistent, standardised disclosure. There is currently a huge amount of less structured disclosure, with information we cannot use. But I think the formation of a new value reporting initiative from IFRS, the International Sustainability Standards Board (ISSB), will lead to a global framework of standardised ESG disclosure. This is something regulators are looking for as well. The Norwalk agreement between the Financial Accounting Standards Board and the London-based International Accounting Standards Board in 2002 eventually led to a standardised global framework for accounting data, which is a good model for the effort to standardise sustainability data.



Jaspreet Duhra, Managing Director
Global Head of ESG Indices
S&P Dow Jones Indices
www.spglobal.com/spdji

How can the industry move towards greater standardisation of ESG criteria when it is such a subjective topic?

Jaspreet Duhra: There are plenty of grey areas when it comes to ESG and sustainability. There are some topics that are less subjective – such as governance, and health and safety. Counting women on the board or the number of accidents should be straightforward but, even in these areas, there is subjectivity. For example, what percentage of the board should be women? Should this percentage be reflective of the workforce or the broader population? What is a poor accident rate? Are sick days due to work-related stress accounted for? Once you start looking at the details, it is easy to understand why ESG scoring providers end up with different assessments. However, there may be some straightforward metrics that all companies should be able to disclose, and there are initiatives in progress to encourage consistent disclosure. For instance, the IFRS Foundation is working to develop a unified framework of consistent comparable company sustainability disclosure requirements.

More broadly, users of ESG data may want to consider what their goal is when it comes to ESG assessments. Is it to understand how companies will be impacted by ESG issues? Or how a company is impacting the world and society? Are users satisfied with a rating that assesses a company's direct operations only or do they also want to understand the impacts of the products produced? There are numerous angles to think about, which can make it a challenge to create a standardised approach.

In addition, there is the simple fact that people have different opinions when it comes to ESG values. For instance, is involvement in military contracting a controversial business activity that needs to be screened out of an ESG fund or are these companies providing an essential service to allow national defences to function?

Ultimately, ESG is difficult to outsource and standardise. Engaged, responsible investors will need to take time to understand methodologies and philosophies when deciding how to incorporate ESG.

Peter Plochan: Taking the carbon footprint calculation example, there is a lot of latitude for subjective and expert-based assumptions, particularly in scope 3 emissions, which capture indirect emissions within a company's value chain. This is very industry- and company-product-specific, and requires a very granular

approach and methodology. And, as we see more and more jurisdictions and investors requiring companies to produce mandatory ESG disclosures, the need for standardisation and comparability increases. The TCFD has worked well in starting this but, as it is industry-generic, it has limitations. Therefore, each industry has an important role to play in this.

For example, a year ago, we saw the Partnership for Carbon Accounting Financials publish the Global Greenhouse Gas Protocol Corporate Accounting and Reporting Standard for the financial industry, which provides a standardised methodology for carbon footprint calculation focusing on scope 3 financial portfolios. What started as the initiative of a small number of Dutch financial institutions has now turned into a standard that has been adopted by more than 250 institutions worldwide. The point is that key industry players should not be waiting until somebody defines this for them; they should be actively involved and driving this standardisation.

Mike Chen: Studies have shown vast disparities among ESG ratings because people have different approaches to what constitutes ESG, what data you can use to verify it and how you should measure it.

ESG is values-based investing, and different companies care about different things. Some companies care about the same things, such as climate change, where there are some commonly agreed-upon main ESG criteria. And the main quantitative data can be standardised for cut-and-dried elements, such as carbon and water. Things like gender, ethnic/racial and age composition of companies, independent boards and incentive alignment can also be standardised.

But, some companies want to disclose relatively esoteric items. These might be relevant to their own operations or things their investor-base cares about. And there are many questions around corporate culture, for example, that are more qualitative and not easily quantifiable. For that kind of information, utilising our natural language processing capabilities we seek to assess these aspects so they may be disclosed in both tabular and textual formats.

Steffen Hörter: When it comes to corporate disclosure, the recent creation of the ISSB by the IFRS is a promising step. This consolidates important groundwork from such organisations as the Sustainability Accounting Standards Board (SASB) and will focus on financially material ESG KPIs. Moreover, from an EU perspective, the new Corporate Sustainable Reporting Directive will help to shape sustainability reporting standards.

In tandem with financially relevant ESG KPIs, the EU's dual sustainability risk approach requires metrics on the adverse environmental and social footprint. This new requirement aims for corporate transparency in this area. And then there is the holy grail of ESG standardisation, the EU Sustainability Taxonomy – a powerful, impact-driven approach to sustainability that evaluates business activities and investment funds. This is relatively complex and rigid, but corporates should expect it to gain traction.

I don't think harmonisation of corporate issuer ESG ratings is necessary. As much as sell-side stock recommendations vary, there is value in having different ESG rating approaches. However, we do need qualitatively reliable ESG ratings and transparent methodologies for investment decision-making. To this end, granular ESG KPIs are more relevant than aggregated ESG ratings.

Dimitri Senik, PwC Switzerland Pension Fund: There is a perception that ESG is something very customised and unique for every investor. But the topic is not subjective per se. It's just that some investors have preferences for some specific ESG factors or elements. And it is a very broad topic because you need to look at the E, the S and the G. And, within each of those, you have a variety of criteria that need to be established.

When investors select specific stocks or issuers for their ESG portfolios, they will probably be applying the same criteria, such as exposure to controversial industry sectors, norm violations and climate impact, on the environmental side. But it's like any investment strategy: you might have some common definitions, but the implementation will be different. So, the set of criteria can be standardised, but the way individual managers or ratings providers will be weighting those criteria will probably be different.

Bruno Bertocci: The focus on materiality is key. There is a core set of indicators initially identified and delineated by the SASB. These use a materiality framework that carries over to the current ISSB effort. The TCFD provides a very good global approach that is being taken up by regulators. The ESG Technical Committee for the Chartered Financial Analyst (CFA) Institute has created an ESG product disclosure framework, which is a very good start for a global standard.

If a standard is focused on material indicators, I think disclosure will be highly encouraged, if not mandated, by regulators. And, with a framework that is aligned with what we're used to seeing in the field of financial disclosure, investors will be well on their way towards standardisation.



Mike Chen
Head of Sustainable Investments
PanAgora Asset Management
www.panagora.com

How can asset managers know that a particular ESG portfolio meets the variety of expectations ESG investors may have?

Mike Chen: First, investment managers must be transparent with asset owners about how they derive the ESG portfolio. And they must disclose how the portfolio measures the ESG metrics that their portfolios target.

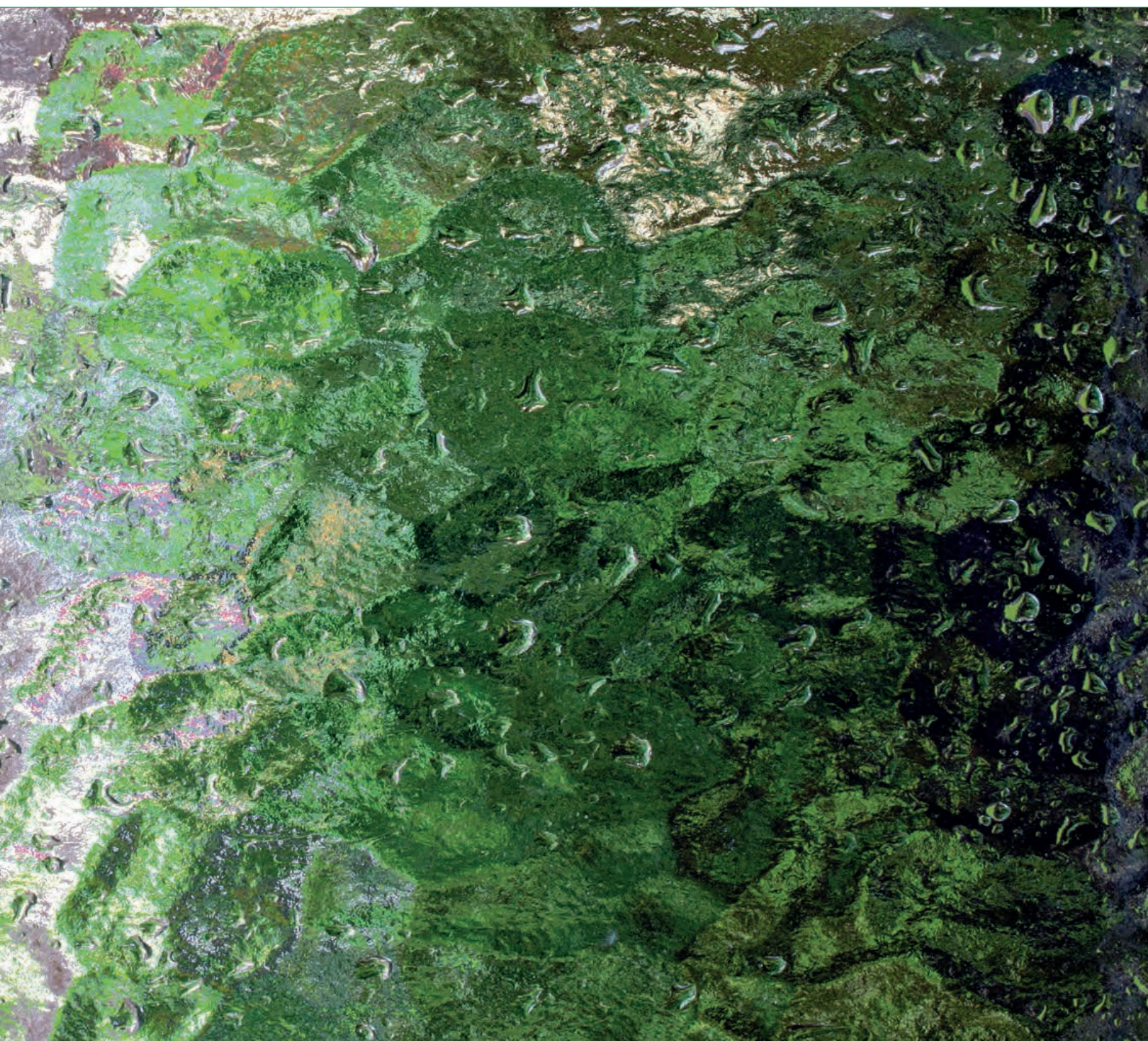
But every manager builds their portfolio to different benchmarks and ESG criteria, and each of them discloses different types of ESG reports. So, in addition to our report showing the portfolio versus our own 'secret sauce', we produce another report to demonstrate how the portfolio measures against a standard commercial ratings benchmark, such as MSCI. And we suggest asset owners ask each of their managers to generate this type of report so they can compare them.

Steffen Hörter: Getting a full understanding of the institutional investor's ESG and financial investment objectives, policies, constraints and portfolio legacy is paramount. To align the portfolio to these, investment managers should seek to identify the investor's exclusion criteria and whether they aspire to specific sustainability outcomes or favour optimising specific portfolio ESG KPIs. ESG goals need to be clearly documented and regularly reviewed in meetings with investors and supported by focused ESG fund reports.

For ESG mutual funds, it's a bit trickier. Investor preferences differ and these funds cannot be customised to meet all of these. So these funds aim to meet the 'average' ESG preferences of investors. One way to approach this challenge is to make a fund comply with a specific, independent ESG label or provide better ESG transparency. The EU Sustainable Finance Disclosure Regulation (SFDR) sets minimum product disclosure for ESG characteristics and impact funds.



Dimitri Senik: Asset managers need to talk to prospective investors before launching an ESG product, such as a pooled mutual fund. Otherwise, it won't necessarily be aligned with the expectations of the potential target group. For example, Switzerland has regulatory fiduciary duties that pension funds must comply with. Often when asset managers offer an ESG investment product, they only highlight the ESG parameters and features. But they fail to demonstrate that this product does not impair our fiduciary duties, for example, in terms of the expected impact of the ESG investment decisions on returns, risk, liquidity, and so forth. They need to understand the regulatory environment, and the duties and requirements investors need to fulfil in their target markets. And then they need to align their message with those local requirements.



Bruno Bertocci: There will not be consistent agreement across the entire market about the sustainability of portfolios. For example, some investors will consider a portfolio green enough if it includes the traditional energy companies that are transitioning to a clean profile. Some will not. The marketplace accepts a certain amount of cognitive dissonance in other areas, and there will always be some here too. However, transparency and a common understanding of the criteria that drive the portfolio construction decision-making are key. Right now, that's very challenging because we don't have the uniform, comparative set of disclosures we have in other areas. The CFA product-labelling standards encourage this, and I think other efforts such as SFDR will similarly help investors enable better comparability.

Peter Plochan: ESG investors are much more sensitive to qualitative information than traditional performance-driven investors. The standardisation previously discussed, in combination with transparency, will be the key here. Simply put, the more ESG information disclosed, the better picture investors can get. For example, once the EU's Green Taxonomy and Green Asset Ratio reporting frameworks go live next year, it will be easier to compare different financial portfolios and assess how green they are. In the current setup, where one way of doing this has not yet been established, it might be worthwhile for asset managers to disclose information according to the variety of ESG reporting frameworks. Disclosing a little too much will definitely be better than disclosing too little.

Jaspreet Duhra: It is important to note that S&P DJI is not an asset manager or investment adviser. In general, the asset manager will need to take the time to understand the ESG expectations of the investor. It would also be best practice for regular reporting to be provided to clients on how the portfolio is performing against ESG metrics alongside any stewardship activities that may be undertaken by the asset manager. We understand investors have different appetites and objectives when it comes to ESG. Some are looking for core benchmarks with an ESG overlay that seek to maintain a low tracking error versus the parent index. Other investors may be willing to accept potentially higher tracking errors, but want to see heightened attention to ESG considerations.

As a benchmark provider, we are transparent about the way we construct indices; all methodologies are published on our website and a range of supporting content is produced discussing the methodologies of key ESG data inputs.



Dimitri Senik
Investment Committee Member
PwC Switzerland Pension Fund
www.pwc.ch

When allocating assets to an ESG portfolio, how can a portfolio manager measure the full environmental and societal impact of those assets given that they are part of a complex supply chain?

Jaspreet Duhra: Constructing an ESG rating for a company is an incredibly complex process. In some cases, up to 1,000 data points may be collected per company and then analysed by industry ESG experts. This detailed research and analysis needs to be replicated for thousands of companies globally – an arduous and time-consuming task.

Although some pragmatism is necessary when it comes to how deep a rating can go into second- or third-tier supply chains, ESG ratings can look beyond the direct operations of companies. They can take into account supply chain policies and, increasingly, the impacts of the end-use of the company's products.

Mike Chen: When it comes to supply chains, investors are really constrained by data. For example, we know there are a lot of human rights violations by cotton suppliers in certain parts of the world, but there is no real data to substantiate this. Although it is inadequate as a solution, it is now best practice to monitor news sources and flag companies that source from unethical suppliers. The onus should be on companies to do more and be more aware, but we are doing what we can.

From an environmental perspective, scope 1 and 2 emissions are relatively easy to measure but, when it comes to supply chain – in effect, scope 3 emissions – people are forced to make hundreds of assumptions and get wildly different figures, so we don't include those.

There are very significant data gaps for investment managers and anyone in the industry in terms of disclosure involving supply chains. And this is something governments should probably provide guidelines on.

Peter Plochan: Looking back at the recent 2021 UN Climate Change Conference (COP26) held in Glasgow and the recently formed Glasgow Financial Alliance for Net Zero, more than 450 financial institutions committed to full decarbonisation of their portfolios (net zero) by 2050. With aggressive targets for 2030, and with new institutions joining almost every day, there is going to be a tremendous push on assets in their portfolios to become greener. There are

many roads that lead to 'net-zero Rome', and each will have a different risk/return profile. The challenge lies in finding the optimal one that will enable you to achieve net zero by 2050, with the lowest risks and highest returns along the way.

To identify this optimal pathway, portfolio managers will need to collect more data and do more forward-looking portfolio analytics – get smarter and better at simulating the impact of their portfolio choices on portfolio KPIs and key risk indicators that, from now on, need to also include carbon footprint indicators. This includes running more simulations with multiple alternative asset allocation mixes over longer time periods (until 2050), under multiple scenarios and with alternative business and modelling assumptions. Having done their maths, portfolio managers can then make smarter portfolio allocation decisions backed by analytical evidence, and maximise their returns while meeting their carbon reduction targets and minimising the risks.

Dimitri Senik: Right now, it is not possible to measure the full environmental and societal impact. A lot of progress has been made measuring impact in the climate area. However, although we can reliably measure scope 1 and 2 carbon dioxide emissions, scope 3 is a model-based calculation for emissions from the whole supply chain, and you can't reliably measure that, let alone other environmental and societal impacts. We don't really have reliable measurement processes for such metrics because of the lack of or poor reliability of the underlying data. When the depth and transparency of corporate disclosures improves, and issuers start publishing detailed statistics about how their businesses impact climate, pollution, water, diversity and other societal matters, then that information can be transferred into the investment management process.

Bruno Bertocci: Impact investing has come through to equities and fixed income from the private equity side, where it is much easier to measure. This is a very complicated area that is under development, with no standards really set yet for measurement. But, according to the CFA Institute product labelling framework, managers must disclose how they will achieve their stated objectives, as well as measure and evaluate them. For example, it is incumbent on the manager to do this for funds designated as article 9 under SFDR, where objectives have been set. According to the Global Impact Investing Network, an impact strategy must have the key attributes of intentionality, measurability, verifiability and additionality. Additionality comes primarily through engagement with the issuer, as it does in the private equity space. This is certainly the bleeding, cutting edge of the field but, with so much focus on it, I do think this will come together.



Dr Steffen Hörter
Head of ESG
Munich Re Investment Partners
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The simplest methodologies – for example, those that screen out certain stocks – are the easiest to communicate and understand, but not necessarily the most effective in making true ESG progress. However, the more complex methodologies risk curbing liquidity. How can asset allocators navigate this dilemma and which direction do you see things moving in?

Steffen Hörter: Sustainable investing is moving from negative screening to ESG integration and, ultimately, to delivering positive environmental and social

impact outcomes. I see impact investing as the final and decisive approach aiming to shift the ESG needle towards measurable progress for people and the planet.

Often, impact investments are project-driven. And, while these investments focus on better, measurable sustainability outcomes, they usually come with a period of financial lock-in and illiquidity. The upside of such impact investments is that – depending on risk profile – they can provide stable cashflows and serve as liability matching assets. So, they can be a substitute for low- and negative-yield bonds.

The challenge is in scaling impact investments, especially in emerging markets. Green bonds offer a middle ground, where corporates commit to allocating bond proceeds for a ring-fenced project to achieve positive improvement of defined environmental KPIs.

Dimitri Senik: Divesting decreases the demand for the specific security. So, in the long run, there will be less capital allocation, which leads to increased cost of capital for issuers. However, the real impact of this strategy is very limited.

Impact investments are an example of more complex ESG investment methodologies that risk curbing liquidity. They are less liquid because they tend to be in the private markets. But there are also liquid products that have much better impact than simple exclusions. For example, there are ESG integration or best-in-class ESG strategies that involve overweighting good-performing ESG stocks and underweighting lower-performing ones. And investors can achieve much more through engagement with issuers than through exclusions.

Peter Plochan: At the time of writing, the leading financial institutions are setting up products and frameworks that will help their counterparties transition towards net zero. Green loans and green bonds are just examples of where 'exclusion' can be turned into new products and opportunities. In the end, it will be up to each institution's net-zero strategy as to how they want to get there with how much exclusion and how much assistance with transition they want to do.

Bruno Bertocci: Exclusion criteria are usually something that clients mandate. Or managers might adopt them as part of client requirements for a pooled vehicle. It is often up to the asset owner to specify any exclusions. At this point, people are much more concerned about what investors own rather than what they exclude. For example, nowadays, who wants to invest in controversial weapons?

And there are many regional and individual differences. For example, French portfolios often include nuclear utilities and German ones exclude them. And faith-based investors have their own set of exclusions. If clients expand the list of exclusions significantly, they can eventually make the portfolio difficult to construct. But, in general, the exclusions that investors want are quite limited and can easily be built into diversified portfolios.

Mike Chen: Exclusions make sense for certain investors. For example, there are certain things that an Islamic or Catholic investor just cannot have in their portfolio. However, from an alpha perspective, exclusion is a very crude approach. It focuses on risk management, whereas so much of ESG is really a glimpse into how well a company is run. The world of ESG investing has become more sophisticated, and I think inclusion or integration approaches will be the predominant approaches going forward.

In an integration approach, the aim is to invest in companies that are responsible and can also add alpha. Here, investors consider ESG another criteria by which to judge how well a company is run. And liquidity is one of those criteria that we consider, along with other risks, when building an ESG portfolio.



Bruno Bertocci
Managing Director
UBS Asset Management
www.ubs.com

How do you see the use of ESG derivatives for managing ESG risk growing?

Bruno Bertocci: If you include ESG exchange-traded funds in the discussion, I think they serve a real purpose in terms of getting exposure to factors or themes such as diversity or clean energy.

There are a variety of methodologies to offset carbon exposures and portfolios, and some debate as to whether all of those achieve real-world objectives. That said, there are various offsets within carbon-related structures that will prove useful to portfolio constructors in managing the carbon footprint. If they have a bona fide engagement strategy with the issuers, then they can credibly talk about the carbon footprint of the total portfolio from a holistic viewpoint.

Mike Chen: We're not in the best position to opine on that as we don't use derivatives in our ESG portfolios.

Steffen Hörter: At Munich Re Investment Partners, we think ESG derivatives offer various opportunities for ESG investing, which has been defined thus far by long, cash equity and fixed income strategies. For example, ESG derivatives can be used for price discovery. More specifically, ESG index derivatives can provide efficient access and exposure to ESG-related asset classes for investors. Furthermore, asset owners and investment managers can use ESG derivatives as ESG policy-consistent hedging instruments. Overall, ESG derivatives can contribute to flexible, cost-efficient portfolios and ESG-compliant investment management.

Dimitri Senik: My understanding is that there are essentially two types of ESG derivatives. The first kind are just pure ESG-related structured products, with a basket of exposures to issuers or stocks based on specific ESG criteria. These are easier to bring to market than pooled funds, which often have specific regulatory or diversification requirements. Instead, investors can design the product's structure, investing in a few specific stocks that give them the desired ESG performance.

The second kind of ESG derivatives are linked to the credit risk of specific issuers. These are typically linked to fixed income instruments with specific ESG parameters, where, for instance, the interest rate is variable depending on the issuer fulfilling some ESG KPIs. The issuer can hedge that ESG-related interest rate risk by issuing a derivative, such as a credit default swap. Essentially, this is transferring the ESG-related risk to other investors. Issuers that hedge ESG risks must evaluate this area very carefully, and there needs to be a lot of transparency to understand the impact. Otherwise, investors in their bonds could potentially be contributing much less in terms of ESG than they think. Also, the reported volume of ESG investments may become inflated. ■

>>> The panellists' responses to our questionnaire are made in a personal capacity, and the views expressed herein do not necessarily reflect or represent the views of their employing institutions

Demand for ESG structured notes spells hedging pain for banks

As products linked to niche equity indexes grow in popularity, banks grapple with the volatility risk they pose. By Natasha Rega-Jones

ESG principles have taken the investment world by storm in recent years. But now there is a storm brewing over the hedging of certain ethical investment products – a sizeable and growing subset of the \$7 trillion structured product market.

As ESG equity indexes proliferate and investors become increasingly discerning, demand for structured notes linked to niche and bespoke sustainable indexes is rising. Hedging such products, though, is challenging as options on the indexes are either too illiquid or don't exist at all.

"You tend to accumulate risks that aren't liquid in the market when you undertake ESG indexes, as you don't have any listed options or the like," says the global head of exotic equity derivatives structuring at a European bank. "So you need to be able to recycle that risk away with your key partners and clients like hedge funds or pension funds."

Finding investors willing to take on chunks of the risk is one possibility for banks. Another is to hedge the awkward products with options on the closest proxy index, though that often comes with its own headaches. Alternatively, issuers can simply run more risk. Structured products typically combine a bond with options that provide a payoff if the underlying asset appreciates, and full or partial capital protection if it loses value. Many popular products are based on equity indexes.

As the spot level of the underlying index moves around throughout the life of the product, issuers need to continuously manage the volatility, or vega, risk of the structure, which is usually done by buying and selling options on the index.

Issuers say demand for structured products linked to sustainable assets is growing.

"The ESG structured products market is becoming an increasingly large market," says Patrick Kondarjian, global co-head of ESG sales, markets and securities services at HSBC. "Thematic investing is growing and the number of clients we transact with and how much volume we do today have grown by a significant multiple compared to a few years ago."

Likewise, Isabelle Millat, head of sustainable investment solutions at Societe Generale, says the bank's issuance of structured products with ESG equity indexes as the underlying doubled in the first quarter compared with the same period last year.

Need to know

- Investors are showing an increasing appetite for structured products based on ESG equity indexes. They are also becoming pickier, looking for products that reflect their particular idea of ethical investing.
- Issuers often struggle to hedge structured products linked to niche and bespoke indexes. Options on many such indexes – typically used to manage the products' volatility risk – are either illiquid or don't exist.
- One workaround is to use options on a proxy index, but that can create hefty basis risk and requires constant monitoring as correlations between indexes fluctuate.
- Alternatively, banks can approach investors willing to take some volatility risk off their hands. Or they can simply live with the risk.

She adds that, in 2020, 67% of issuance in the French retail market was linked to ESG equity indexes – a proportion she predicts will hit 80% this year.

An equity structurer at one European bank says that, at first, ESG structured products were fairly simple – for instance, including a single long-only option. But over time they have become more complex, designed to maximise the payoff in any given market.

Millat says there are now "long-dated autocallable ESG structured products in the UK and France, shorter-dated ESG autocallables in most other European countries and capital-protected ESG products in Belgium, as well as central and eastern Europe".

In fact, the most popular structured products among retail investors are autocallable. These include two barriers, one on the upside and one on the downside. If the upside barrier is breached, the structure knocks out and investors get their principal back plus a coupon. If the downside barrier is breached, investors' principal can be at risk. If spot remains between the barriers, investors receive an above-market coupon.

Autocallables are difficult to hedge, as losses on the products sustained by Societe Generale and other banks showed last year.

The problem with proxies

But even taking the autocallable feature out of the equation, many ethical structured products are tricky to hedge because of the indexes they are linked to.

In an ideal world, the vega risk would always be hedged with options on the underlying index. There are already listed options on a range of ESG indexes – for example, the S&P500 ESG Index and the Stoxx Europe 600 ESG-X index.

Some ESG indexes are attracting a lot of investors and becoming more liquid, says HSBC's Kondarjian, which means options on the indexes are growing more liquid too. "Today you can trade quite significant sizes [issue products] on ESG indexes like the euro Stoxx without facing any hedging issues," he adds, referring to the Stoxx Europe 600 ESG-X index.

Indeed, open interest in options on the index hit almost €2 billion (\$2.3 billion) in June – a level of liquidity that makes it much easier to hedge structured products linked to the index. But when a structured product is based on a less widely used index, dealers often have to look for proxy hedges.

For ESG indexes that derive from larger indexes, banks use options on the parent index where liquidity is far deeper. That works because the child indexes are designed to mimic the performance of their parent indexes. For example, the correlation between the S&P500 ESG index and its parent index is 0.99 (see figure 1), and the correlation between the Stoxx Europe 600 ESG-X index and its parent index is about 0.97. The closer that figure is to 1, the more correlated a pair of indexes are.

For structured products linked to such ethical indexes, the basis risk is fairly negligible. However, when niche or bespoke indexes are involved, the basis risk is much larger. Take MSCI's World ESG Yield Select Variance Index and the iStoxx Global Low Carbon Ex-Controversial Activities Select 30 Index, both of which have been used in ESG structured products.

There are no listed options on either, so the products linked to them have to be proxy-hedged with options on a major equity index. The major index most correlated with the MSCI index – which brings together good ESG performers relative to their peers – is the Nikkei. According to Bloomberg, the correlation between the two indexes is at 0.64 but it has varied in recent months, going as far down as -0.10.

The major index most correlated with the iStoxx ESG index is the Euro Stoxx 50 at 0.61. Here, too, the correlation has moved around in recent months, reaching as low as 0.35.

Barclays is one issuer that uses proxy hedges for ethical structured products.

Asked how the bank deals with proxy indexes that are only loosely correlated with the indexes underlying its products, structurer Arnaud Heckenroth says: "The key element is to make sure that the proxy is both liquid enough and close enough. There is naturally ongoing work to monitor and optimise the hedging instruments used."

Heckenroth, who is head of equities structuring for Europe, the Middle East and Africa at Barclays, adds: "Alternative hedging methods such as recycling risks with some institutional investors are possible."

Reduce, reuse, recycle

Recycling the vega risk is what issuers often do with autocallables. This is usually achieved by selling the risk to hedge funds at a discount, via variance swaps or other complicated derivative structures.

Heckenroth stresses the importance of offloading the risk in sustainable structured products, especially once there is significant exposure.

"Once banks start upscaling their ESG exposure, they'll need to ensure that they have a framework in place where they can successfully recycle the risk that they're loading onto their primary business away to other market participants," he says.

As more ESG structured products are issued, the opportunities for recycling the risk in them are also multiplying, observes Millat at Societe Generale, although for the French bank, that is far from the whole story.

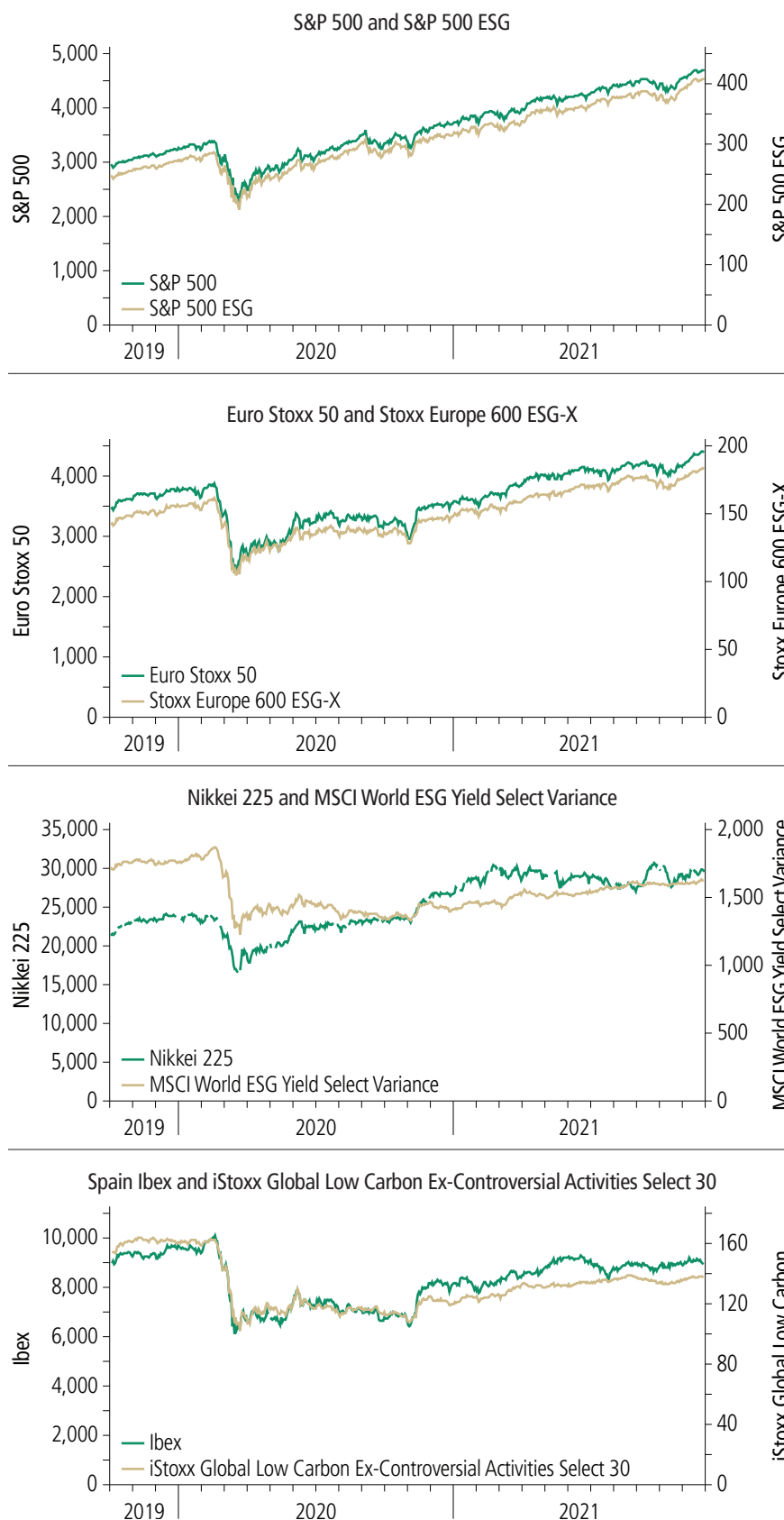
"We do recycle our risks with hedge funds to a certain extent," she says. "Still, we should bear in mind that it is only a limited part of our hedging capacities."

While hedging is something that happens after a product is issued, many banks start tackling the hedging challenge at an earlier stage: when they are designing an ESG structured product.

Typically, issuers add features to some ethical structured products that make them easier to hedge, says a source at a sixth dealer. These could be fixed dividends and high yields.

"Bespoke ESG indexes are more difficult to hedge because there is no market in volatility or dividend for those indexes, as opposed to the liquid volatility market that exists for ESG versions of traditional benchmarks like the Euro Stoxx 50 Index. Hence banks add features such as fixed dividends to make hedging easier and reduce hedging costs for end-investors," the source says, declining to elaborate on how such features help.

1 Correlation between ESG and mainstream indexes



Source: Bloomberg



The relatively new FTSE Custom 100 Synthetic 3.5% Fixed Dividend Index (CSDI), created for structured products, supplies one possible answer.

The CSDI tracks the same 100 shares as the FTSE 100, but the equivalent of a fixed 3.5% dividend per year is deducted daily from the level of the index. The 100 companies have historically produced about 3.5% on average in annual dividends.

“Investors utilising the CSDI as an underlying take on the risk of variability of dividends, so the bank doesn’t have to – which should translate to higher potential coupons on offer than with equivalent FTSE 100 contract,” Ian Lowes of Lowes Financial Management, a financial advice firm, wrote in September.¹

Lastly, some suggest it may be necessary to make a product more generic to be able to hedge it.

“Adding more complexity into the design of a product by following a specific ESG theme typically has a negative impact on hedging, so we try to find the right balance between how strict a product’s ESG credentials are and how attractive the hedging conditions look,” says the global head of exotic equity derivatives structuring at the first European bank.

Presumably, many ESG investors strive to strike a similar balance between reaping healthy returns and saving the world. ■

Previously published on Risk.net

ALL-GREEN, ALL-TRICKY

A rare ESG structured product launched by Barclays in September provides an example of how ethical structures can be hedged.

The bank’s first Green Structured Notes Programme offers institutional and retail investors an opportunity to invest in green equity indexes, while Barclays will use the investor cash to finance green activities such as renewable energy, energy efficiency and sustainable transportation.

“The feedback we’re increasingly hearing from clients is that having a structured product invested in a green underlying only isn’t ideal,” says Arnaud Heckenroth at Barclays. “They wanted to have an all-green solution, whereby the use of proceeds and the underlying index that the structured product is exposed to are both green.”

He adds that Barclays is not the first dealer to offer such all-green structured notes “but there are very few banks that have that capability today”.

The first index to be used in the dealer’s programme is its own Solactive Climate Change Europe BTI index. The index comprises European companies aligned with the scenario of no more than 2° Celsius global

warming by 2050, as determined by a so-called X-Degree Compatibility model. As an extra filter, only stocks with lower volatility and a track record of growing dividends are included.

To hedge structured notes based on the index, Barclays has to use proxy indexes, but none are sufficiently closely correlated. As a result, the bank is running basis risk, Heckenroth notes.

This is forcing the trading desk to constantly keep an eye on other potential proxy indexes in case some become more closely correlated with the Solactive Climate Change Europe BTI index.

As Barclays foresees strong demand for its new structured notes, it is already talking to institutional clients that could take the associated risk off its hands – if the bank’s exposure from the programme grows too big to just sit on.

“This is one of the discussions that we’re having on a regular basis with various institutional clients, such as hedge funds, asset managers and pension funds,” Heckenroth says. “When we build an exposure of significant size into a specific risk and we believe it’s worth sharing, we would reach out to some of them.”

¹ I Lowes, *Lowes Financial Management (September 2021), New underlying helps raise structured product yields*, Professional Paraplanner, <https://bit.ly/335POLN>

In over their heads?

How greenwashing overwhelms regulators

Difficult to identify and difficult to prove: asset managers doubt regulators' ability to crack down on cases of greenwashing.

By Samuel Wilkes

As the focus on climate change intensifies, and demands for sustainable investing develop, fund managers have found their green credentials also inviting greater scrutiny. This in turn puts pressure on regulators to crack down on cases of greenwashing, where funds overstate their commitment to financing the transition away from fossil fuels.

But asset managers doubt regulators are fully ready for that challenge just yet.

"What will take time is for the European supervisory authorities to develop the knowledge, capabilities and resources to stop any greenwashing or exaggerated claims," says Will Oulton, global head of responsible investment at First Sentier Investors. "If the supervisory authorities are not doing that role of checking, challenging and rejecting materials they see regarding funds, then they won't be able to effectively fight or challenge greenwashing – it will still be a feature of the industry, and nobody wants that."

Need to know

- Legislators are creating rules to encourage flows to sustainable investments, but there are growing claims of greenwashing – funds and managers misleading investors about their sustainability credentials.
- There are doubts regulators will be able to effectively crack down on greenwashing, with techniques to identify it systematically still at an early stage.
- Some believe the easiest way for regulators to tackle the problem is via investor complaints, which provide proof that someone has been misled.
- Others tout quantitative measures for identifying greenwashing as a more comprehensive method of detection.
- However, some of the accusations may stem from philosophical differences about what should count as a sustainable investment.

The debate about funds claiming to invest based on ESG criteria intensified earlier this year, when a whistleblower from DWS claimed the German asset manager overstated how far ESG criteria were truly factored into investment decisions.

Risk.net reporting has shown a quasi-label for funds that promote environmental or social characteristics – known as 'light green' – allows some funds to qualify with as much as 91% of their investments in oil and gas producers. And a letter sent to UK-authorized fund managers by the UK Financial Conduct Authority in July 2021 warned that the regulator has noted "poor-quality" ESG fund applications.¹

Regulators and legislators are now looking to take action to identify and tackle greenwashing. In the European Commission's renewed sustainable finance strategy, released on July 6, the EC said it is assessing whether the current supervisory and enforcement toolkit available to European authorities is suitable.

The European Securities and Markets Authority hopes to build convergence between national European authorities in addressing greenwashing. But regulators are hampered by the need to build from scratch a methodology for identifying a problem no-one has yet begun to track in a systematic way. That will be even more difficult, because the method will need to be robust enough to prove an asset manager is actually misleading investors.

"No research team is already at a place where they can really grab an algorithm and identify greenwashing, but it is a very interesting research area at the moment," says Markus Leippold, chair in financial engineering at the University of Zurich, who is looking into how natural language processing can be used to detect greenwashing in various industries.

Asset managers and industry onlookers have various ideas as to how regulators could effectively identify greenwashing, but each method comes with its own limitations and drawbacks.

Art versus science

For a start, regulators will most likely need to agree a definition of greenwashing. That's not easy, says Brunno Maradei, global head of responsible investment at Aegon Asset Management: "One person's greenwashing is another person's dark-green fund."

But without such a definition, regulators will have to make judgement calls on opposing views of sustainability.

For example, Leippold argues that exclusion-only funds (which exclude companies such as heavy polluters) are potentially a form of greenwashing, because they have been proven to have no impact on the characteristic they are trying to promote. Hence regulators would have to decide whether the effectiveness of particular strategies merits claims that the funds will help the environment or society.

"With exclusion-only strategies, there is a big question whether they should claim that they will save the world at all, because there are academic papers that show just by excluding a company you have absolutely no effect on the company's strategy," says Leippold.

Another criticism is levelled at funds that call themselves 'climate solutions' and 'green transition' but invest in companies that aren't actively contributing to lowering greenhouse gas emissions. These funds will hold technology, financial service and healthcare stocks that don't produce much emissions by virtue of their business models.

Seb Beloe, head of research at impact investor Whed asset management, says it would be more appropriate for companies that, for example, create wind turbines to appear in such climate solution funds, as they offer a low-carbon alternative to burning fossil fuels.

"If you are claiming to be a climate solutions strategy, then every holding in that portfolio should be offering a climate solution," says Beloe. "That is a very high standard to set. Amazon, Alphabet, Visa, these aren't offering a solution to climate change."



“We have so many claims made by the asset management industry, and in a first round you need a tool to identify these claims”

Markus Leippold, University of Zurich

Theodor Christensen, head of sustainable finance at Danish regulator Finanstilsynet, points to a similar case he’s identified of funds called green transition funds that make similar investments.

“There are multiple ways to be a sustainable fund, but being mainly invested in low-carbon companies because of a specific sector exposure such as tech can be quite different from investing in the green transition,” says Christensen. “It’s important that you have an honest communication and dialogue with your investors so they understand what they are buying; we believe this is an important part of investor protection.”

Where are the green cops?

Although EU legislation lacks a definition of greenwashing, regulators are able to use existing EU laws set out in the second Markets in Financial Instruments Directive (Mifid II), which specify that marketing material must not mislead investors.

Regulators can require the asset manager to change their marketing material or issue administrative fines if information sent to investors is found to be misleading.

The Sustainable Finance Disclosure Regulation (SFDR) now requires asset managers state which of their funds are sustainable and be clearer on how exactly they justify the sustainability of those funds. But that doesn’t make it any easier to police a large and ever-growing part of the market, and then prove whether greenwashing has occurred.

SFDR introduces three categories of disclosures for fund products, with providers self-certifying their funds under one of the categories. Article 8 applies to financial products that “promote environmental or social characteristics”, provided the investee companies follow good governance practices. Article 8 funds are widely referred to as ‘light green’.

Article 8 has been contentious, amid suspicions that some funds are inappropriately assigned the label to ensure they attract interest from sustainable investors.

Article 9 applies to products that have sustainable investment as their objective. Sustainable investment is defined as an investment in an economic activity that contributes to an environmental or a social objective, and in companies with good governance practices. Article 9 funds are dubbed ‘dark green’.

“The scale and breadth of this regulation means that there are a lot of products out there,” says Finanstilsynet’s Christensen. “In the Danish market, we’ve calculated that around 40% of the UCITS fund universe has labelled itself as Article 8 in SFDR, and around 5% is labelled Article 9, so obviously it’s a huge number of products.”

One problem with the EU’s SFDR is that regulators are not able to check and approve which funds bestow on themselves the Article 8 or 9 status.

“It’s not an approval process for the SFDR,” says Christensen, who leads a dedicated team tackling greenwashing. “A stronger set of rules would [require] us to approve before they could label themselves, but that’s not how it works. So they label themselves, and then that’s a disclosure, and then they need to live up to the disclosure requirements.”

The UK’s FCA unveiled proposals for its own labelling and disclosure regime on November 3.² The potential labelling regime would place sustainable funds into three categories: transitioning, aligned and impact.

The FCA’s regime might possibly include a pre-approval process. Within the authority’s consultation, the UK regulator also asks whether there should be third-party verification in the labelling of products.

Make a complaint

That kind of individual assessment of each fund is just one way to identify greenwashing. Industry participants suggest others, including relying on client complaints or using quantitative benchmarks to compare funds.

Michael Maldener, chief executive of ESG consultancy Sustaide, says using client complaints has the advantage of regulators being able to prove easily that an investor has been misled by an asset manager’s marketing information.

“Probably the easiest way for regulators to tackle the risks of greenwashing, and to prove it, is being pointed at it by someone – be it clients, be it the press,” says Maldener. “Using quantitative measures or benchmarks could be one way in the future, but that . . . means there needs to be much more clarity and aligned understanding in terms of what is a ‘sustainable product’, beyond [the] SFDR classification.”

Market participants suggest that for this approach to work, the avenues for clients to report their concerns would need to be improved.

“If I’m a sustainable investor today and I think someone is greenwashing, I don’t really know the best place to complain,” says Aegon’s Maradei. “You could probably go to the FCA in the UK or a European regulator and say . . . company X is greenwashing, and that might prompt an investigation, but it is not super clear what would happen at the moment.”

Christensen of Finanstilsynet says investor complaints are one way he will identify greenwashing. But he thinks that, more often, the regulator will use its own judgement to begin investigations. That hasn’t happened so far, however.

“Admittedly this is early days, we still need to build up capacity,” say Christensen. “So far we’ve spent a lot of time on dialogue and communication with the sector, building understanding of the rules, so that has been our main focus, rather than taking supervisory action.”

Bring in the quants

Pre-approving green funds or investigating them individually both have the same drawback: these methods can’t systematically examine the claims made by every fund manager, nor do they provide an objective threshold to define greenwashing.

Quantitative measures would be better, to allow regulators to check large numbers of fund prospectuses at the same time, and analyse what they say about their green or ESG commitments.

“We have so many claims made by the asset management industry, and in a first round you need a tool to identify these claims,” says Leippold of

the University of Zurich. “There are obvious claims which do not need further attention and then you have less obvious claims that need some kind of qualitative assessment.”

Quantitative measures would include using a benchmark as a base to find out the difference in the sustainability touted by the fund versus a traditional fund. For example, regulators could calculate the difference in ESG scores between a fund claiming to be ESG and traditional market indexes.

“The more quantitative criteria you have the better,” says a head of ESG at a large exchange-traded fund provider.

Some jurisdictions have already incorporated quantitative thresholds in their local rules. For example, products marketed in France with a non-financial consideration must have a “significantly engaging approach” towards the non-financial consideration.³ In practice, a 20% threshold is set on whatever non-financial consideration a manager is looking to promote – for example, ESG. These funds can also obtain a socially responsible investment label.

Meanwhile in Spain, Article 8 funds calling themselves ESG funds must have 50% of their fund invested in securities that achieve their environmental or social characteristic.⁴ In Germany, the local regulator Bafin held a consultation in August and September of this year on their proposals for a similar threshold, set at 75%.⁵

The FCA consultation says it will welcome views on quantifiable criteria for its categories of funds.

The introduction of green taxonomies in the UK and EU identifying low-carbon companies is also expected to provide a means to benchmark and quantify the sustainability of funds. But no benchmark can be used to justify all possible ESG or sustainability claims made by a fund.

Sustaide’s Maldener says it could be difficult to prove or disprove fund managers who justify their ESG credentials by saying they engage with companies in their portfolio to make positive ESG-related changes, for example lowering carbon emissions or improving working conditions. A quantitative approach could be developed for asset managers’ shareholder voting records at their investee companies, but it wouldn’t cover all of their supposed work.

“Even if you look at say ESG benchmarks for ESG funds, what if someone says I’m doing active ownership and engagement on ESG issues?” asks Maldener. “That in itself is actually already good enough to be Article 8 today, and requires different metrics and analysis such as voted portfolio ratios or detailed engagement reports, which you don’t find in a benchmark.”

“In the Danish market, we’ve calculated that around 40% of the UCITS fund universe has labelled itself as Article 8 in SFDR, and around 5% is labelled Article 9”

Theodor Christensen, Finanstilsynet

Wheb’s Beloe points out that some fund managers withhold information about their engagement approaches, which often means they can’t be tested.

“Some asset managers do say they are engaging with a company and that they don’t want to publish the details of their engagement because that might have an effect on quality of conversations they can have with companies,” says Beloe.

Lies, damned lies and statistics

A further downside to identifying greenwashing based on benchmarks is that there can be variations of the same benchmark, which regulators would have to navigate, particularly for ESG-related benchmarks.

ESG rating providers can have widely different scores for the same company, which can make it difficult to say what exactly a positive ESG investment is. Research recently shared by Nomura with financial media suggests the use of ESG ratings based on consensus between different rating providers as a way around the subjectivity of individual providers.

This problem can also limit the usefulness of regulator-set thresholds if a single benchmark is not set under the rules. The French, German and Spanish fund laws don’t prescribe one benchmark that funds must use to meet their quantitative thresholds. Nor do their rules stipulate the use of aggregated or consensus ratings as a way to cope with rating dispersion.

In fact, one trend among some asset managers which could easily turn into a form of threshold arbitrage is the use of a proprietary ESG rating rather than one from a third-party provider. In that case, the fund manager would effectively be marking its own homework.

A consensus-based benchmark could check whether a fund manager’s proprietary benchmark is meaningful, or too lax. The problem for a regulator is that if asset managers only make specific reference to their own internal ratings in their marketing material, it would be difficult to prove that investors had been misled.

“If I go out and say: ‘Well, my portfolio is based on the best ESG names according to my own proprietary rating,’ how do you test if that is ESG or not?” says Maradei of Aegon. “A regulator can test it against a few external providers but it was never

promised to investors that [the fund] would be good according to an external ESG rating provider’s perspective; you are not breaking any rules there.”

That’s one reason why external providers find it difficult to begin systematically identifying greenwashing, says Zurich University’s Leippold. He has helped create an algorithm – known as ClimateBert – with other researchers that detects companies’ climate commitments. One of the next steps planned is to train the algorithm to identify obviously misleading claims that can’t possibly be true. But that’s a much simpler exercise than checking the holdings of funds and the methodologies to assess ESG.

“For the fund industry, you would need to look at the underlying fund holdings. You would then need to analyse each company, and then you need to analyse what the ratings of these companies are,” says Leippold. “But then you are opening Pandora’s box: what is the rating of these companies? Do you trust the ratings at all?”

Even using the EU’s green taxonomy – touted as a common language for sustainable investments – as a benchmark also faces its own challenges, as some disagree with its definitions of sustainability.

For example, electric cars can be considered taxonomy-aligned, but not manufacturers of the chips that are built into cars. Unless that disconnection is resolved, it means some funds’ taxonomy scores will be lower than they feel they deserve to properly reflect the sustainability of their investments.

“We invest in companies such as Infineon and Aptiv. A big part of their business is in power semi-conductors, sensors and connectors that go into electric cars,” says Wheb’s Beloe. “As far as the Commission is concerned, those aren’t explicitly included in the taxonomy.” ■

Previously published on Risk.net

¹ N Miller, FCA (July 2021), *Authorised ESG and sustainable investment funds: improving quality and clarity*, Letter to AFM chair, www.bit.ly/3EzoBDQ

² FCA (November 2021), *Sustainability Disclosure Requirements and investment labels*, www.bit.ly/3IsCg28

³ *Autorité des Marchés Financiers (March 2020)*, *Sustainable finance and collective management: the AMF publishes a first policy on investor information*, www.bit.ly/31DB0s9

⁴ *Comisión Nacional del Mercado de Valores (June 2021)*, *Questions and answers on sustainability regulations applicable to financial products*, www.bit.ly/3pRUG3V

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Litigation threats seen delaying SEC climate disclosure rules

Efforts to demonstrate materiality of exposures to investment decision-making is taking longer than expected, say lawyers.

By James Ryder and Sharon Thiruchelvam

Efforts by the US Securities and Exchange Commission (SEC) to ensure the drafting of its landmark climate risk disclosures rulemaking is legally watertight are taking longer than expected, securities lawyers say, risking delays to the publication.

The watchdog's anticipated rules on climate disclosures – which could force companies to reveal their exposure to greenhouse gas emissions, financial impacts of climate change and their progress towards mitigating them – has proved to be one of its most contentious of recent years, with an army of corporate lobby groups, Republican lawmakers and state attorney generals queuing up to oppose them since the proposals were first mooted.

In a speech last summer, SEC chair Gary Gensler ordered the agency's rule-writing staff to draft a proposal for commissioners to review by the end of 2021. But while work on the rulemaking is due to be completed this year, one person familiar with the matter says they do not expect its publication before February 2022.

Neither staff for SEC commissioner Allison Herren Lee – who led the agency's climate push while serving as acting chair – nor the SEC press office responded to requests for comment in advance of publication.

Much hinges on the agency's ability to demonstrate that climate exposure data is material to the price of a security, and an investor's decision on whether to buy it or not, says Todd Phillips, director of financial regulation at the Center for American Progress.

"The SEC is trying to collect data showing that investors need this information, and whether a business's cost of furnishing the information is less than the benefits that investors will receive. [SEC staff] need data about how investors would use the disclosed information, or whether they want the information disclosed in order to protect it from litigation."

It is this key aspect that is said to be causing delays, suggest senior legal sources, speaking to *Risk.net* for this article.

"Being sued for noncompliance creates defence costs, and if such suits become commonplace, it can have an impact on the cost of directors' and officers' insurance coverage"

Doug Henkin, Dentons

Susan Schroeder, a partner at US law firm WilmerHale, and a former head of enforcement at the Financial Industry Regulatory Authority (Finra), says the SEC will anticipate complaints that it has failed to prove that markets need ESG data.

The watchdog is therefore amassing a "corpus of evidence" that supports its case as thoroughly as possible, she says.

"They will be doing data collection, and will want to be able to show they found a number of investor protection problems [and] enforcement actions that the SEC has needed to bring, which will underscore the need for enhanced obligations," Schroeder tells *Risk.net*.

Lawyers experienced in cases involving the SEC say they expect a number of legal challenges on several fronts, depending on what information the SEC requires firms to disclose. The current ESG reporting benchmark, developed by the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) has three key areas.

Scopes 1, 2 and 3, respectively, cover direct greenhouse gas (GHG) emissions; indirect GHG emissions produced on its behalf; and indirect GHG emissions produced through its value chain.

The big question is whether scope 3 of the TCFD disclosures will be mandated, says Phillips: "I don't think anyone knows where the SEC is going to come down on that question."

A former senior SEC staffer, who recently departed the agency, is uncertain the SEC will be able to make full TCFD disclosures mandatory: "[To] make it mandatory will be difficult to do – that might actually require some additional factfinding. I'm sceptical they'll make progress."

Burden of proof

The SEC will have to determine and prove with the information it receives from investors whether or not these disclosures are material to investment decisions or not.

As well as disputing the materiality aspect, opponents of the rulemaking argue it would place an additional compliance burden on firms, particularly the data-gathering and reporting obligations, which they claim would cause unnecessary costs.

Regulated firms could also complain that their liabilities will unnecessarily increase, as the disclosures provide a new angle of attack for private litigants who could bring suits alleging that companies are failing to comply.

"Being sued for noncompliance creates defence costs, and if such suits become commonplace, it can have an impact on the cost of directors' and officers' insurance coverage," says Doug Henkin, a partner and co-US financial institutions lead at law firm Dentons.

The simplest challenge would involve a litigant demonstrating the SEC has taken actions that aren't authorised by its governing statutes, says Henkin. Such challenges have precedent, notably in exchange operators' fight against the SEC's market data fees rules.

But the legal challenges the agency might fear most, according to Phillips, relate to the Administrative Procedure Act (APA), which governs the rulemaking process of federal bodies.

"The way the SEC would lose this lawsuit is [through failing to meet a] standard [that rules be neither] arbitrary nor capricious," he says.

Plaintiffs could accuse the SEC of making procedural mistakes in its rule drafting that contravene APA terms, or of failing to undertake a proper cost/benefit analysis, says Dentons' Henkin.

Consequently, the SEC will need to justify all facets of its ESG disclosure rules and prove that they are neither arbitrary nor capricious. For this reason, the SEC is compiling evidence to demonstrate that ESG disclosures are necessary, material to investors, and that the benefits exceed the costs.

Promise to sue

The SEC's highest-profile critics on this issue include Republican SEC commissioner Hester Peirce and a coalition of state attorney generals, some of whom have promised to sue the agency if it proceeds with the planned rulemaking.

The US Chamber of Commerce's Center for Capital Markets Competitiveness – the largest lobbying group in the US – has indicated its intention to sue if the SEC appears to have stepped beyond its established legal boundaries.

"We have a history of the SEC operating outside the bounds of the law, and we've not been afraid to go in and sue," Tom Quaadman, executive vice-president of the CCMC, tells *Risk.net*.

"We've been supportive of climate disclosures within the legal bounds of materiality: beyond [those boundaries] is where the SEC has traditionally got in trouble."

In 2015, the CCMC successfully brought a suit against the SEC that found that it had violated the First Amendment and its rulemaking was unconstitutional. Parts of an SEC rule to compel companies to disclose their use of 'conflict minerals' were quashed by the US Court of Appeals for the District of Columbia Circuit.

First Amendment violations are also the basis of the 15 Republican state attorney generals' threat to sue. Such challenges appeal to the "compelled speech" concept, which says the government should not force people to express things they don't want to.

In a letter to the SEC in March 2021, West Virginia attorney general Patrick Morrisey told the agency that climate risk is not "information that is material to future financial performance". He also said mandatory disclosures would "help some customers and investors advance prejudice and animus towards groups and activities they disfavour".

However, Amy Greer, a partner at law firm Baker McKenzie, and a former chief litigation counsel at the SEC's Philadelphia office, says such suits are typically brought by plaintiffs, such as public companies, that can "demonstrate significant cost and harm caused by new rulemaking".

"The state attorney generals could participate in that challenge, but they would not lead it," says Greer. None of the 15 attorney generals opposed to the rulemaking could be reached for comment.

The former senior SEC staffer agrees with Greer: "I'd be more nervous about corporate companies suing the SEC, honestly, than the state agencies." ■

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Many ESG products face liquidity struggle, say exchanges

Fragmentation, design and definition challenges mean many exchange-traded products will remain illiquid. By Rebekah Tunstead

While there has been a proliferation of ESG exchange-traded products launched in recent years, exchanges say fragmentation, as well as difficulties around design and definitions, means many of these contracts will struggle to build enough liquidity to challenge the incumbents.

Speaking on a panel at the Futures Industry Association's IDX conference in London on September 28, Owain Johnson, global head of research and product development at CME Group, said the flurry of new launches results in fragmented liquidity, which means some instruments will struggle to get off the ground.

"It's probably a mistake to think that all products are on a journey to deep liquidity, and I think we accept that some ESG products will always remain niche," said Johnson. This is the case even though some of these lower-liquidity ESG products are suited to managing specific risks, he said.

"We're really happy to see trades that use cooking oil, but we don't think that's going to replace WTI [West Texas Intermediate] anytime soon," said Johnson. "Some of our products will, and already are, becoming really liquid ... but some of them won't, and I think we're OK with that. So, I'm not sure it will always be this constant upward curve."

Richard Heath, head of business development for global commodities at the European Energy Exchange, said part of the problem for power products is that the hurdle to reach ESG certification is too high for some instruments, meaning supply is constricted.

"If we design a product with a very narrow specification, such as it has to be 100% green production, yet there isn't any of that, or there's very little of it actually traded around the world, it makes it impossible for that product to be liquid," said Heath, speaking on the same panel.

To help build liquidity in these products, he believes it might be better to gradually ratchet up the ESG hurdles over time.

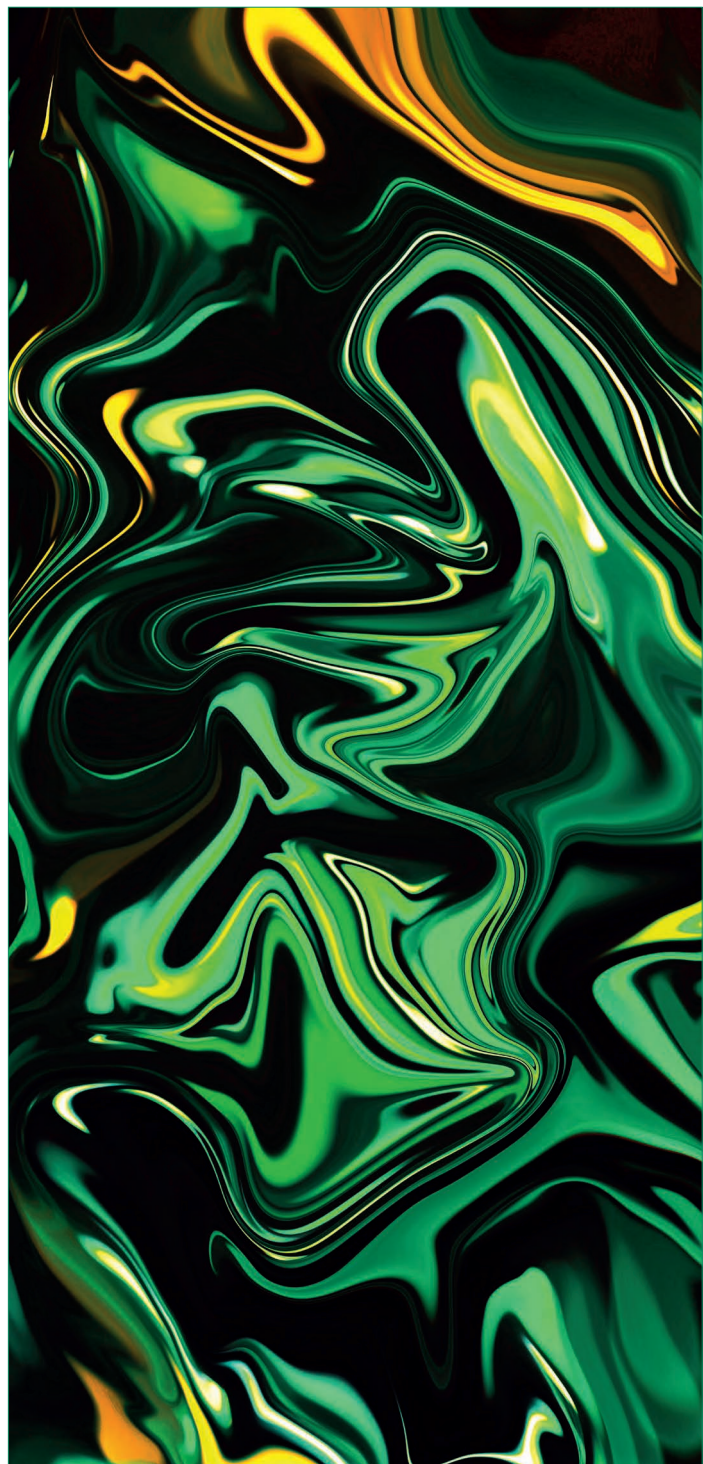
"If we create a product which by design is going to be completely illiquid, we have to ask ourselves: Are we actually serving that market? Are we helping with that transition? Are we giving people what they need today?" he said. "Wouldn't it be better to give them an imperfect product, and iterate it and make it better as the market that it supports changes and transitions to more sustainable production?"

Another barrier to building liquidity in ESG products is the lack of consistency around definitions. Hugo Brodie, vice-president of sustainability at the London Metal Exchange, said the exchange had looked at launching a cash-settled, low-carbon version of its existing aluminium contract earlier this year. But without international consensus around what terms such as 'low carbon' and 'sustainable' mean, it believed the product would struggle to gain traction.

"It's very difficult to launch a contract and get a lot of liquidity globally when there's big disagreement on what one company says is sustainable and low carbon and what another company in another area of the world says is nowhere near what they can ever be capable of," said Brodie, who was also speaking on the panel.

However, recent industry initiatives such as the International Aluminium Institute's guidance on emissions calculations for building standards in the industry mean the market is moving towards being ready for low-carbon products, he added. ■

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Why new EU rules are fuelling greenwashing and how to stop it

Reporting requirements for ESG funds may not solve the problem of greenwashing, but a list of harmful investments might.

By Samuel Wilkes

Europe's new rules on sustainable finance were meant to help investors hunt out truly ethical funds. Instead, they have gifted sheep's clothing to the wolves: asset managers say many undeserving funds now declare themselves green.

Admittedly, the granular reporting requirements that come with an ethical label are not yet in force. But even when they do kick in, there is scepticism the fully-fledged Sustainable Finance Disclosure Regulation (SFDR) will combat greenwashing. Another fix may be necessary – such as a tool to identify environmentally harmful investments. The gloom over the regulation is palpable. “The SFDR is creating the greenwashing it was trying to avoid,” says a regulatory expert at a large asset manager.

Need to know

- Asset managers say the Sustainable Finance Disclosure Regulation has been widely used to stick a green label on funds with questionable environmental credentials.
- The mass of self-proclaimed sustainable products is likely to grow as more funds adopt the dominant interpretation of the vague Article 8. So spotting truly responsible funds will become even harder.
- Some hope disclosure requirements for ESG products will expose undeserving funds once they come into effect. Others are sceptical, pointing to quirks in investor behaviour and the design of the rules.
- Managers suggest tweaking the rules to make firms report negative sustainability impacts for each fund.
- Two other potential solutions are in the works: minimum sustainability criteria for Article 8 funds, dubbed ‘light-green’, and an ‘eco-label’ for the most environmentally friendly retail products.
- The simplest way to stop greenwashing may be to set out criteria for identifying companies that cause particular harm to the environment – a so-called ‘red taxonomy’.

Another source – Eoin Fahy, head of responsible investing at KBI Global Investors – makes an equally downbeat prediction: “The disclosure requirements are so detailed and cover so many factors that I suspect not many investors will actually pay a great deal of attention to them, unfortunately.”

The current mislabelling of funds is attributed to the vague wording of the SFDR's Article 8. A fund can be classed as an Article 8 financial product if it promotes “environmental or social characteristics”, provided the fund justifies this claim and the companies it invests in follow good governance practices.

Julia Linares, a senior sustainable finance policy officer at conservation charity WWF, considers the Article 8 definition “extremely wide”, saying: “The slightest thing that is more sustainable than average actually qualifies and can be called Article 8.”

Article 8 funds have become known as ‘light-green’, reflecting the industry's present focus on environmental rather than social credentials and contrasting with Article 9 funds, dubbed ‘dark-green’. A stricter and less controversial definition of sustainability applies to these funds: they must have sustainable investment as their objective.

Funds that do not fall under either article are known as Article 6 products. Article 6 requires all funds to disclose how they take account of sustainability risks and how these are likely to impact their returns.

In theory, more detailed information about self-proclaimed Article 8 funds should help retail investors decide for themselves whether the funds are green in practice. But there are doubts such disclosures will actually weed out products with dubious environmental credentials – for reasons that have to do both with investor behaviour and the specific disclosure requirements.

Asset managers say there are several possible ways to stop the greenwashing inadvertently made easier by the SFDR. Potentially the simplest one is to create a taxonomy for companies that damage the environment. If funds disclosed what share of their investments is in such companies, investors should find it easier to separate the wheat from the chaff.

Good marketing

Without regulatory changes, identifying green funds that deserve the label will become even harder as the universe of Article 8 funds is likely to expand. And not because more truly sustainable funds will spring up, but because more plain vanilla funds will start describing themselves as ‘light green’ to fall in line with the dominant interpretation of Article 8.

The regulatory expert at the large asset manager explains why his firm currently has fewer Article 8 funds compared with competitors: “We thought we were being honest but in hindsight we wonder if we were foolish. If the whole market shifts like this [to Article 8], then we may get forced to do so too. But we don't think that really helps anyone.”

Another asset manager says it is considering reclassifying more of its Article 6 funds as Article 8, for the same reason.

But there is a more questionable motive for shoehorning funds into Article 8: the label provides good marketing.

For example, some fund distributors and asset managers allow users to filter through products based on which SFDR article they fall under. And some distributors have told asset managers that only their Article 8 and 9 products will be made available to clients.

So, many asset managers have a clear motive for greenwashing. Unwittingly, with the murky Article 8, lawmakers have also given them the means to declare funds green, whether or not that is strictly true.

“The policy-makers have done this to try and make it easier for retail investors to invest sustainably,” says Fahy of KBI Global Investors. “In fact – on the current wording and the way it's being implemented – it appears to me that there is a risk that it may have made the situation worse.”

Linares of WWF is more emphatic: “SFDR was supposed to be kind of an anti-greenwashing tool but now, unfortunately, Article 8 is becoming a greenwashing label.”

Risk.net has identified a group of funds labelled Article 8 that are heavily invested in oil and gas producers, with one holding as much as 91% of its portfolio in such companies.

Managers of some of the funds have defended their light-green status by saying the investee companies do not engage in the most environmentally damaging extraction practices, such as fracking. That is the case with two funds run by BNP Paribas Asset Management, for example.

NN Investment Partners has also been able to justify the Article 8 classification for one of its funds that invests in oil and gas producers because it is underweight fossil fuels versus its benchmark. The fund also excludes companies involved in oil sands and thermal coal – particularly harmful activities – as do all Article 8 funds managed by the firm, according to its website.

“Crazy” flexibility

According to three sources, the Article 8 definition has been made even more flexible by a Q&A on the SFDR published by the European Commission (EC) in July as it lists a wide range of activities that can mean “promotion” of ESG principles.¹

The Q&A states: “The term ‘promotion’ within the meaning of Article 8 ... encompasses, by way of example, direct or indirect claims, information, reporting, disclosures as well as an impression that investments pursued by the given financial product also consider environmental or social characteristics in terms of investment policies, goals, targets or objectives or a general ambition.”

Brunno Maradei, global head of responsible investment at Aegon Asset Management, comments: “The commission has made the situation even worse by saying promotion can mean anything, including just issuing a report. To me that is crazy.

“You could have a fund that invests in tobacco and oil stocks and you produce an ESG report for this fund – which says the fund is terrible on ESG – and by doing that you have promoted an ESG characteristic, so therefore you might classify it as Article 8.”

Kristian Håkansson, head of product and marketing at SPP, a Swedish subsidiary of Norwegian fund manager Storebrand, believes most funds will be categorised as Article 8 in the future.

“So we are basically back to where we began,” he says. “You still have thousands of Ucits [retail] funds to choose from and they will all be Article 8 and you will be none the wiser.”

The proliferation of funds labelled as Article 8 since the SFDR came into force in March goes against the EC’s expectations for the regulation, according to Fahy of KBI Global Investors.

“They’re thinking about it as being a set of regulations that force extra disclosures. Their thinking certainly was – and maybe still is – that funds won’t want to offer Article 8 funds because if they do, they’ll have all those extra sets of disclosures,” he says.

Indeed, there were protestations from fund managers when detailed disclosure requirements were put out for consultation last year. These regulatory technical standards (RTS) were then published on February 2 this year, reflecting responses to the consultation.² The latest requirements, still to be adopted by the EC, have been relaxed compared with the 2020 version.



Disclosures to the rescue?

Regulators will still be hoping that the disclosure rules are comprehensive enough to help investors filter out pseudo-Article 8 funds.

“The proposal of SFDR regulatory technical standards requires Article 8 and Article 9 SFDR financial products to disclose on an annual basis its largest investee companies and sectors, as well as the proportion they represent out of the total investment,” says a spokesperson for Luxembourg regulator CSSF.

“Once the RTS will be adopted and mandatory, such type of disclosures will speak for themselves in the context of the fund examples presented,” the spokesperson adds, referring to Article 8 funds that invest heavily in fossil fuel producers.

The EC plans to implement the disclosure rules on July 1, 2022, according to a letter it wrote to the European Parliament last July.³ Not everyone is as certain as the CSSF that they will have the intended effect.

The main problem is investors may not look at the reported data – something asset managers say is common with financial and legal information they already publish. “A lot of retail investors are not very up to date on this at all, but if they are using anything, they will be using filters provided by distributors and execution-only platforms that filter through SFDR Article 8 funds and Article 9 funds,” says Håkansson of SPP. “I don’t think they will ever look into the annual reports and the pre-contractual information in a way that is meaningful for them.”

But look they should, even for the simple reason that eco-conscious investors can’t otherwise be sure that the Article 8 fund they have their eye on carries the label on environmental rather than social grounds. Particularly diligent investors will also want to know whether the fund is aligned with their specific concerns – say, promoting biodiversity as opposed to reducing carbon emissions.

Investors using the services of an investment firm or a financial adviser will, in a way, be forced to consider the SFDR disclosures as the service provider will be obliged to ask about their sustainability preferences. Sustainability preferences cover the investor’s view on a product’s “principle adverse impacts”, among other considerations.⁴

However, information on these negative sustainability impacts will not be readily available for each fund. The incoming SFDR disclosure rules will force asset management firms to report the indicators for all of their products in aggregate, meaning investors won’t be able to compare individual Article 8 funds. What would help, according to three sources, is to impose this requirement on individual products.

Gavin Haran, head of policy for asset management at law firm Macfarlanes, is one of the people in favour of the change.

“If you look at the product level, then you can really measure if this is actually something that’s good or bad for the environment? Is this mandate or this product doing good ESG things or bad ESG things?” he says. “I think that’s a lot more useful often than looking across a company’s entire portfolio.”

Maradei of Aegon Asset Management makes a similar point, pointing to an SFDR requirement that he thinks should go further. Managers of Article 8 funds will have to disclose whether the fund takes into account principal adverse impacts, but it is a yes/no question that doesn’t require any evidence to back up a ‘yes’ answer.

“What is missing is this next level down: at the fund level, [what are your] adverse impact indicators and what is the fund doing about them? The supervisors ... need to connect the dots a bit more before the legislation can have the right bite that they want it to have.”

Naughty or nice

There is another possible fix to the greenwashing conundrum – the EU’s Taxonomy Regulation – but the success of this solution depends on a number of factors. From next year, the regulation will introduce a requirement to disclose what proportion of investments are sustainable according to a set of environmental criteria – that is, the taxonomy.

The first problem is that – based on EU regulators’ latest interpretation of the Taxonomy Regulation – only a subset of environmental Article 8 funds will be subject to the requirement, in addition to all Article 9 products that pursue an environmental objective.⁵

Even for those Article 8 funds that will publish their so-called taxonomy alignment score, the score will rarely be an accurate reflection of reality because so far, the Taxonomy Regulation requires only some EU investee companies to disclose their share of sustainable activities.⁶ On top of that, non-EU corporations release little sustainability information. So companies not subject to the EU Taxonomy Regulation will mostly receive a 0% score.

Until more companies are brought into scope or start publishing sustainability information voluntarily, enabling fund managers to estimate their scores, truly green funds will struggle to stand out from the crowd.

“If a very dark-green fund only has 5% or 10% of its investments complying with the taxonomy, then a fund with no green investments at all having 0% doesn’t really mark it out as very different,” says Fahy of KBI Global Investors. “When that extra information is published by companies, the percentages might well go up to 15%, 20%, 25%, or 30%. So that could be quite a game-changer if that happens.”

Lastly, as with all disclosures, there is no guarantee retail investors will pay attention to the taxonomy alignment scores of Article 8 funds.

But that could change. Some fund managers have held up a new taxonomy, dubbed ‘red’, as the best remedy against greenwashing. Such a taxonomy would set out standards for identifying companies that are causing significant harm to the environment.

“That could have quite an impact on the Article 8 funds that are invested in oil. It would then become a stretch to characterise oil funds as Article 8,” Fahy says.

An expert advisory body set up by the EC has recently consulted on developing such a taxonomy.⁷

Two further potential solutions don’t rely on investors’ working their way through fund disclosures.

One is establishing minimum sustainability criteria for Article 8 funds. This is something the EC said in July that it would consider, without elaborating.⁸ The commission did not respond to a *Risk.net* request for more details. Choosing the criteria is unlikely to be a speedy process.

“It is a fraught discussion that is going to take a lot of consensus-building because then you get into a debate about what is a useful ESG characteristic,” says Maradei of Aegon Asset Management.

The other fix is creating an entirely new ‘EU ecolabel’ for the most environmentally friendly retail financial products, as proposed by an EC research centre.⁹ However, asset managers have criticised the latest iteration of the proposal for setting excessively high thresholds for qualifying for the label. For example, retail equity funds must invest at least 50% of their portfolio in environmentally sustainable economic activities.

“Most likely there will [even] be Article 9 funds that won’t make the eco-label because you need a concentrated portfolio to obtain 50%,” says Håkansson of SPP.

What should responsible investors do in the meantime? Linares of the WWF offers a simple answer: “I would just try to find Article 9 funds that, although not perfect, shouldn’t allow unsustainable exposures to be included.” ■

Previously published on *Risk.net*

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² *The Joint Committee of the European Supervisory Authorities (February 2021)*, Final report on draft regulatory technical standards, www.bit.ly/3GbbOBM

³ *EC (July 2021)*, Information regarding regulatory technical standards under the Sustainable Finance Disclosure Regulation 2019/2088, www.bit.ly/3aVduw31

⁴ *EC (April 2021)*, Amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms, www.bit.ly/3E2k2l2

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⁶ *EC (April 2021)*, FAQ: What is the EU Taxonomy and how will it work in practice?, www.bit.ly/3aYGbE8

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⁸ *EC (July 2021)*, Strategy for financing the transition to a sustainable economy, www.bit.ly/3G52k1X

⁹ *EC (March 2021)*, Development of EU ecolabel criteria for retail financial products, www.bit.ly/30R8rad

Ethical derivatives strive to win over sceptics

The new International Swaps and Derivatives Association standards are the latest move to overcome client hesitancy to use contracts linked to ESG targets. By Rebekah Tunstead

Corporate clients are shying away from sustainability-linked derivatives over concerns that the performance targets embedded in the contracts are inconsistent and hard to verify. An influential industry body released standards for these derivatives earlier this month in a bid to assuage client fears, but some say the standards don't go far enough.

Derivatives linked to ESG metrics are bespoke contracts between counterparties, and can vary widely deal-by-deal. This lack of consistency has made some clients worry that the ESG targets may be too weak or below industry expectation. Counterparties are also keen to avoid accusations of greenwashing, where the environmental credentials of a deal don't stand up to outside scrutiny. "If clients are not comfortable that [an ESG instrument] is going to be considered at par with standards, they might be reluctant to do it, and to communicate it for fear of backlash and accusations that it's not respecting a recognised framework," says Isabelle Millat, head of sustainable investment solutions for global markets at Societe Generale.

Dealers are scrambling to devise and sell derivatives with an ESG overlay in response to wider demand for sustainable financial instruments. Clients themselves are under pressure from shareholders and governments to meet ethical targets, such as the UN's Sustainable Development Goals.

ESG versions of other instruments, such as bonds and loans, are now common. The capital raised from green bonds or loans is often committed to a sustainable project, for example a wind farm or an anti-pollution initiative. Alternatively, the coupon or interest rate on the deal may be linked to ESG performance targets.

Sustainability-linked derivatives are a newer arrival, first seen in 2019 with an interest rate swap between ING and Dutch oil and gas company SBM Offshore. When used as a hedge, the derivative does not have to be connected to an ESG-related underlying instrument. Instead, the ESG component of the deal can require one or both counterparties to meet sustainability goals. Failure to meet these goals can result in a penalty rate. Or the deal can be structured to incentivise the client to meet its goals with the carrot of an improved rate.

So far, the deals have been highly customised. As bilateral trades, much of the detail of the contracts is not publicly available, which can act as a drag on efforts to compare trades or build consensus. The wide variation between deals also does not lend itself to standardisation. The International Swaps and Derivatives Association (Isda) is concerned that this variability – particularly in how so-called key performance indicators, or KPIs, are created – will deter clients from entering the market.

"The contracts are so bespoke, the KPIs are drafted on an ad hoc basis, and the next firm doesn't know what the other firm is doing. So, there's a little bit of reluctance to enter into this contract, because they don't know how you can verify and validate the achievement of the goals or the validity of KPIs," said Bella Rozenberg, head of the regulatory and legal practice at Isda, during a recent press briefing on the topic.

In an attempt to tackle these shortcomings, Isda has released a set of guidelines for companies in setting performance targets for green derivatives.¹ The standards are not prescriptive. They do not offer specific targets for companies to meet. Rather, they provide general guidance in how a company can create its KPIs.

The standards are organised under five headings: specific, measurable, verifiable, transparent, and suitable. The guidance covers benchmarks for performance, processes for verifying KPIs, and fallback procedures, among other elements.

Isda hopes the guidelines will help give counterparties more confidence in setting and evaluating KPIs, and bring more consistency to the market.

"The goal of [the framework] is to create a contract for two specific counterparties to achieve a certain ESG goal, but at the same time, the more commonality we can apply to the KPIs will improve transparency and it will lead to improved liquidity and ultimately improve trading in this contract," said Rozenberg.

The standards have received a qualified welcome. A senior structurer at a global bank says the framework could alleviate some of the work that corporates face when building KPIs. "It's a bit of an undertaking by firms to execute sustainability-linked derivatives. For users, it's probably going to be even more helpful to have a framework like this," says the structurer.

Millat at SG also describes the framework as "helpful". However, she adds that the framework may in future need to go into further detail on what is an acceptable period of time to monitor KPIs.

The Isda guidance states that "counterparties should identify the period of time the target will cover, including a baseline year against which progress is measured".

But Millat says: "I would suspect there will be an elaboration on what timing is relevant for sustainability-linked derivatives. The whole point of these trades is to have a period of time over which you can very feasibly demonstrate that the client has improved on a meaningful KPI which was defined, and their improvement is audited."

Others feel the guidance is helpfully broad, as too much detail could be offputting for clients.

"Had it gone much further it would maybe put the bar significantly high for people even to consider the framework," the senior structurer says. "It gives you scope and flexibility for firms to define things and set it up with some amount of freedom that I think is useful at this stage."

The senior structurer adds that the framework may also be useful for companies that want to create a single KPI framework across multiple asset classes, from cash products to derivatives.

Industry bodies representing other assets have already published guidance around sustainability-linked products. The International Capital Markets Association set out standards for sustainability-linked bond principles in 2020, and the Loan Markets Association published its standards for sustainability-linked loans in May of this year. ■

Previously published on Risk.net

¹ Isda (September 2021). Sustainability-linked derivatives: KPI guidelines, www.bit.ly/31H6L36