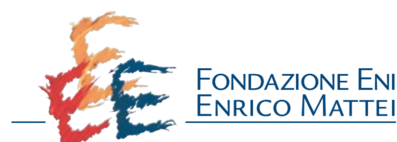
01.2018



Brief

Sustainable Investing and Green Finance: Boosting markets by solving ambiguities

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Abstract

FEEM Policy Brief

The pace at which sustainable investing is leaving its niche to enter ordinary financial markets over the past few years is nothing short of remarkable. Especially after COP21, green finance products have rapidly grown in number, driven by demand from institutional and retail investors – that will increasingly integrate ESG considerations within their fiduciary duty. Nonetheless, it often occurs that market expansions embed ambiguities and risks that foster inadequate or ill-informed investments. To deal with the expansion of sustainable finance, the policy priority is now the elaboration of a uniform framework to clearly define it and to build a common metric to evaluate the impact of the instruments that target climate mitigation, environmental and social goals. These are the core issues in the recent European Commission's Action Plan on sustainable finance.

01 The global uptake of sustainable investing strategies

The recent report by the Dutch Central Bank (De Nederlandsche Bank, DNB) *Waterproof? An exploration of climate-related risks for the Dutch financial sector* analyses the impacts of climate-related risks on the financial sector. It is an example of the concrete concern of prudential supervisory authorities for climate issues, as the establishment of the Task Force on Climate-related Financial Disclosures **(TCFD)** by the Financial Stability Board suggests. However, unlike several works on this matter, which welcome the growth of sustainable investing as an opportunity to enhance stability in the financial sector, the Dutch Central Bank also highlights the downsides of the dramatic expansion of green investment strategies.

The 2016 Review by the Global Sustainable Investment Alliance **(GSIA)**, gives the most updated picture of the status of sustainable investing (also known as Sustainable and Responsible Investment, SRI) in global markets. The concept of sustainable investing has been evolving since the 1960s, and it still does not possess a univocal definition. The GSIA refers to sustainable investing as “an investing approach that takes account of ESG (Environmental Social and Governance) factors in portfolio selection and management”, which makes no clear distinction among the various labels identifying it. Such a broad definition of sustainable investing includes a range of seven different investment strategies:

1. Negative screening: investment criterion that consists of eliminating companies or sectors from the investment universe of the portfolio, according to ESG criteria.

2. Norms-based screening: a form of negative screening that responds exclusively to normative business standards set by national or international norms.

3. ESG integration: the explicit inclusion of ESG factors into financial analyses. Compared to the negative screening, this strategy envisages an active role for asset managers.

4. Corporate engagement: a strategy that exploits the shareholder power to influence corporate behaviour and management directly.

5. Best-in-class screening: an investment criterion that favours financing companies or sectors that exhibit a better ESG performance than their industry peers.

6. Impact investing: a form of finance directed to projects or businesses that aims to solve social and environmental problems while generating returns. It includes community investing, which is specifically directed to

traditionally underserved individuals or communities.

7. Sustainability themed investing: investments in assets specifically related to sustainability, such as clean energy, green technology or sustainable agriculture.

According to the Review, SRIs in 2016 amounted to 22.9 trillion$ assets, 26% of all professionally managed assets worldwide. This represents, in absolute terms, an increase in total value by 25% since 2014. Negative screening is the most diffused strategy worldwide in terms of asset value, accounting for around 15 trillion$. The second most diffused is ESG integration (10 trillion$), followed by corporate engagement strategy (8.4 trillion $) and norms-based screening (6.2 trillion $). It is to be noted that some assets belong to more than one of the investment criteria delineated here, although the overall amount is adjusted to avoid double counting. The value of assets managed according to the remaining three sustainable investing strategies is by far lower than the others. However, impact investing and sustainability themed strategies exhibit the highest growth rates between 2014 and 2016, estimated as +146% and +140% respectively.

02 Retail demand and climate concern boost green finance

Although the market of sustainable investing has been traditionally driven by institutional investors (e.g. mutual and pension funds), there is growing interest in such a market segment of retail investors as well. The Review indicates that in Canada, Europe and the US the share of private owners of SRI assets over the total has almost doubled from 13.1% in 2014 to 25.7% in 2016, suggesting that the recent diffusion of sustainable investing is partly driven by the demand of small savers. Indeed, 85% of US managers interviewed on the reasons for incorporating ESG factors into their investment choices pointed at client demand as the leading factor. Likewise, in Europe, many asset managers declared that taking account of ESG is part of their investment obligations, aligned with their fiduciary duty. On this matter, the Report *Fiduciary Duty in the 21st Century* (UN PRI, UNEP FI, UNEP Inquiry and UN Global Compact, 2015) remarks that there have not been relevant regulatory changes on fiduciary duty in the past ten years and there are no diffused cases of explicit prescription on how to integrate ESG considerations. In most jurisdictions, investors have discretion in determining the approach to fulfil their duty

of loyal and prudent management of clients' funds. Hence, recent changes in the economic and market environment have made ESG investing a good strategy to minimise risks and obtain satisfying financial returns. Indeed, taking account of ESG factors allows investors to have a broader view of the risks and opportunities related to a specific investment, enabling for more accurate valuation of firms' profitability.

A second relevant observation is a spread of green bonds in the last years resulting from rising concern on climate issues. The International Capital Market Association **(ICMA)** defines Green Bonds as "any bond instrument where the proceeds will be exclusively applied to finance or re-finance in part or in full new and/or existing eligible Green Projects and which are aligned with the four core components of the Green Bond Principles: 1. Use of Proceeds; 2. Process for Project Evaluation and Selection; 3. Management of Proceeds; 4. Reporting". As shown in Figure 1, since 2012, the volume of green bonds issuance per year at the global level has grown from approximately zero to almost 160 billion euros in 2017.

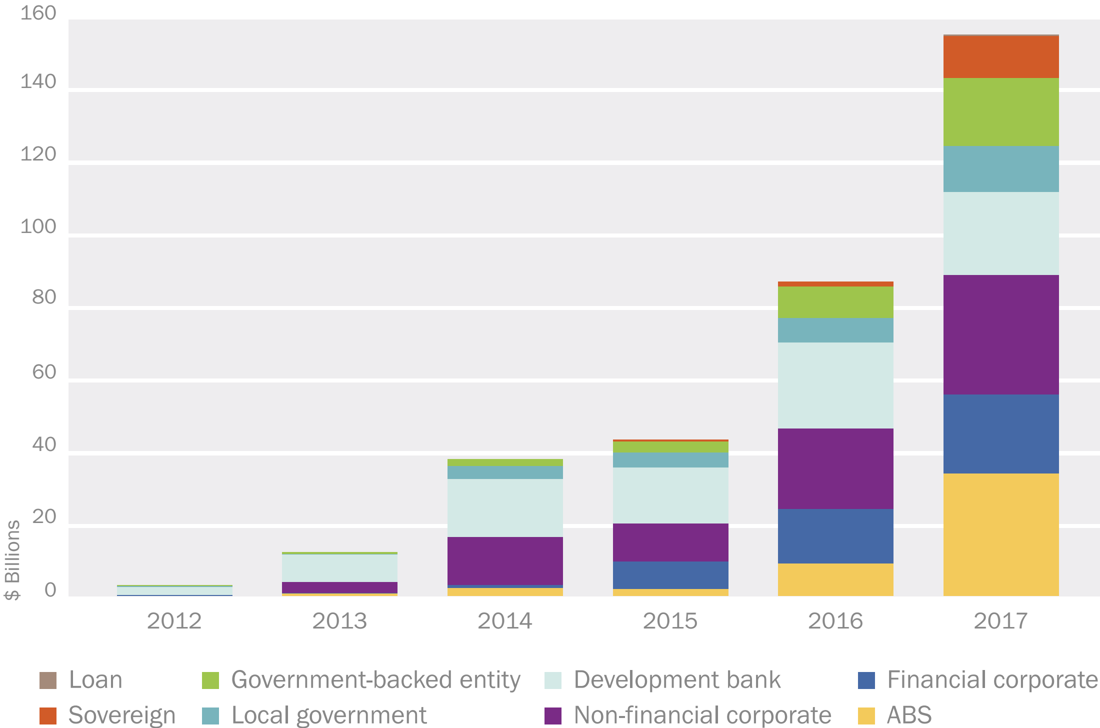

Figure 1. *Green bond issuance at the global level by type (2012 – 2017), Billion euros - Source: Climate Bonds Initiative*

The European SRI Study of 2016, published by **Eurosif**, defines the Paris Climate Agreement as "the tipping point for the investment industry and the reason climate change rightly became a global concern" (European SRI Study 2016, p.15). Indeed, the goals of climate change mitigation set at COP21 play a significant role in affecting the growing interest for green finance in general. Article *2c* of the Paris Agreement signed in December 2015 (FCCC/CP/2015) explicitly involves the financial sector in "making finance flows consistent with a pathway towards low greenhouse gas emissions and climate resilient development". Since then, investors have felt increasing pressure from the media, the public and policy-makers to take account of the carbon intensity of the firms in their portfolios.

According to the survey published in the Report, asset managers acknowledge the materiality of risks related to climate change and the transition towards a sustainable economy. Hence, to uphold their fiduciary duty towards clients, they need to engage in long-term business relationships and minimise exposure to climate risks. Also, DNB highlights that green finance, especially through green bonds, is booming because investors leverage the opportunities arising from a low-carbon transition, such as financing new green technologies.

03 Potential downsides of the rapid expansion of green finance

The report by DNB points out that, beyond its undeniable positive impacts, the sudden expansion of green finance entails potential risks that supervisory authorities cannot neglect. Such risks undermine the expansion of this sector, which is instead an aim to be pursued.

- The current revolution in green technology may generate a financial bubble

There are repeated cases in history that prove how the introduction of new markets and technologies attract massive investments promising considerable profits. Nonetheless, these investments often fail to satisfy such flourishing prospects and become overvalued, as occurred with the Internet Revolution in the early 2000s. A similar circumstance can result from the sharp competition that is leading investors to bet on green technologies, as most innovative producers may turn out to be unable to meet the expectations of clients and investors.

- Greenwashing can entail reputational damage

Issuers of green bonds are expected to undertake projects that have a positive social impact. However, issuers are not always fully transparent on the extent to which such projects contribute to society. DNB reports the case of green bonds issued by oil companies to improve the efficiency of their refineries. By disregarding the purpose of investors hoping for a more environmentally committed use of the proceeds, issuers may incur in reputational damage and threaten the general credibility of green financial products.

- Risks linked to green finance cannot be underestimated

Regardless of the occurrence of greenwashing, green investments aim to finance projects that pursue socially desirable objectives. However, in spite of the growth of green finance in latest years, the Bank still identifies several bottlenecks for its diffusion that overall create an unbalance between risks and rewards, among which policy uncertainty and lack of clear standards (De Nederlandsche Bank, 2017b). Authorities should encourage the diffusion of green finance to ensure the full development of this market segment. In doing so, the Bank warns authorities not to disregard green finance as a bearer of risk just like any other form of credit, suggesting its encouragement backed by ordinary risk-based principles. Specifically, it proposes that policy employs fiscal incentives to reduce the risks or increase the returns linked to green projects or by pricing negative externalities, thus reducing the profitability associated with investing in polluting firms.

04 Further concerns for the expansion of green and sustainable finance

The problems highlighted by DNB do not only apply to green finance but can be extended to the broader universe of SRIs. After all, the expansion of sustainable finance is an opportunity to enhance the stability of the financial system and promote growth. Therefore, it is necessary to individuate the frictions that impede ESG considerations to be fully taken for granted in investing decisions.

With this view, the European Commission is promoting the reform of the European financial system to adapt it to the needs imposed by a transition towards a sustainable economic model. At the end of 2016, the Commission constituted a High-Level Expert Group on Sustainable Finance **(HLEG)**, which published its first Final Report in January 2018, with the aim to build up a strategic framework for the

expansion of sustainable finance in Europe.

The Final Report underlines that, to meet the EU's climate and energy targets alone, there is a need for 170 billion€ per year in sustainability projects more than already invested and individuates the critical aspects behind such an investment gap, among which, that:

- there is lack of a common definition of sustainable investing
- investors underestimate the performance and impacts of sustainability
- there is little transparency, uniformity and reliability of benchmarks and ratings to assess ESG financial performance
- the information on firms' non-financial performance is insufficient for investors to have a complete picture of their sustainability

All these points clearly highlight the need of improving standards, transparency and homogeneity of definitions and of evaluation tools. After all, incomplete and unclear information dampens the growth of a market, stokes uncertainty and increases scepticism. This is why the first point mentioned above is the most urgent challenge to address and serves as a starting point to approach the others. As anticipated, there is no consensus on what "sustainable" means and this creates ambiguity on the nature and social impacts of SRI products. On this regard, the European 2016 SRI Study reports that over 80% of European asset managers have a formal document proving the integration of ESG factors in their asset management policies. Still, the perimeter of ESG integration among different organisations is unclear, making it hard to effectively compare strategies from one society to another and develop standardised viable products. Moreover, sustainable investing, as defined by the GSIA, does not distinguish between adoption of ESG criteria and strictly environment-related investing. However, considering finance aiming at pursuing mere environmental objectives in the broad set of SRIs could be misleading. The adoption of ESG investment criteria aims to build a form of finance that contributes to achieving sustainable development objectives, generally intended as a promotion of stable and inclusive growth. At the same time, as highlighted by DNB, the extent to which green finance contributes to reach such targets seems to be blurred, since instruments such as green bonds alone do not necessarily address further social goals.

Policy conclusions

The survey presented in the European 2016 SRI Study reveals a common perception among asset managers of a slowdown in the pressure on investors coming from external parties (i.e. the media and NGOs), rather than a strong pull by institutional investors. According to the authors, this is proof that the expansion of sustainable investing is now mainly driven by endogenous elements, above all the perception of climate risks and opportunities, a sign that the market is becoming mature. However, there are still frictions that prevent sustainable investing from leaving its niche and entering ordinary finance, allowing it to contribute to the ambitious targets of climate mitigation and sustainable development, such as those set by the United Nations in the Agenda 2030

The policy priority is to set a standard framework to define unambiguously what sustainable investing means and develop metrics to evaluate the financial as well as the social and environmental performance of different SRI strategies. On 8 March 2018, the European Commission published the Action Plan that describes the European strategy for the achievement of climate mitigation and sustainable development, building upon the recommendations furnished by the HLEG. The plan places the establishment of a technical working group for the development of precise sustainability taxonomy, with definitions, screening criteria and metrics as the most important action to undertake. Remarkably, the Plan prioritises climate mitigation targets, as it schedules the delivery of the related taxonomy by Q1 2019, to be extended to climate change adaptation and other environmental and social issues afterwards. Further actions include the definition of a green bond standard, a framework for the harmonisation of sustainability benchmark indexes, to clarify the duties of financial intermediaries as regards sustainability and to improve corporate disclosure of climate-related information. As Michael Bloomberg stated in his speech in Brussels on 22 March for the official presentation of the Action Plan, “Climate Change will not require a miracle, it just requires fixing market failures”.

The Action Plan aims at addressing with urgency the risks that specifically affect green finance, allowing for a further and safe expansion the sector. It could be argued that although efforts to distinguish climate issues from other social goals are certainly helpful to avoid confusion on the impact of different financial tools, they may indeed lead one to forgo the link among different spheres. The accomplishment of climate mitigation ought to go hand in hand with broader sustainable development objectives, and SRIs instruments should be structured in a way that allows investors to acknowledge it clearly. Conversely, investments limited to environmental targets such as energy efficiency or climate resilience that disregard other social objectives should not be considered in the sphere of sustainable investing.

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The Fondazione Eni Enrico Mattei (FEEM), founded in 1989, is a non profit, policy-oriented, international research center and a think-tank producing high-quality, innovative, interdisciplinary and scientifically sound research on sustainable development. It contributes to the quality of decision-making in public and private spheres through analytical studies, policy advice, scientific dissemination and high-level education.
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