Redefining Value in ESG

The Myriad of Paths to the Summit

Rebecca Healey

Redlap consulting

Redefining Value in ESG: The Myriad of Paths to the Summit

Capital markets are undergoing rapid change in terms of what investments are sought and how investments are made. In the first two reports[1] in this series of three we looked at the role of market makers in supporting European capital markets and buy-side investors through the provision of liquidity.

This third report focuses on:

- The impact Environmental, Social, and Governance (ESG) investing is having on the existing market structure landscape
- How buy-side firms are looking to make the necessary shift in assets under management
- The support asset managers will need to access accurate and relevant data, as well as liquidity, to make better informed decisions about ESG investments, whether direct in an underlying company or via indexes and alternatives

To understand the situation today, and to assess the possible future of sustainable investing, we spoke to 35 industry participants including ESG specialists, portfolio managers and heads of trading at asset managers along with liquidity providers, exchanges and ESG data providers regarding the changes they are making to meet the new ESG demand and the opportunities that are being created as a result.

1 https://wearemarketmakers.com/turning-the-tables-on-liquidity-provision-download-the-report/
https://wearemarketmakers.com/liquidity-in-the-time-of-covid-download-the-report/

Executive Summary

Investor Demand Continues to Rise

65% of surveyed asset managers now embed ESG factors as part of their investment process across all funds; with just 35% of respondents only offering separated ESG funds (see Exhibit 1).

Increasing global regulation will require asset managers to reassess how investee companies, including the products and services they produce, are valued. It will also force buy side firms to review how they engage with their clients. An example is the recently announced extension of the European Sustainable Finance Disclosure Regulation (SFDR)[2] to the Alternative Investment Fund Managers Directive (AIFMD), the Undertakings for Collective Investment in Transferable Securities Directive (UCITS) and Markets in Financial Instruments Directive II (MiFID) as well as incorporating the Circular Economy[3].

Reassessing Risk to Meet Demand

For asset managers, understanding exactly what investment you are making and with whom has never been more critical. In spite of regulatory efforts to provide objective clarity, sustainable investing – and the interpretation of what is "green" and therefore, by extension, what constitutes "greenwashing" – remains highly subjective.

Traditional risk management has focused on thematic fundamental bottom-up analysis. This, however, is labour and resource intensive and often backward looking – thus restricting the speed at which the industry can keep up with investor demand.

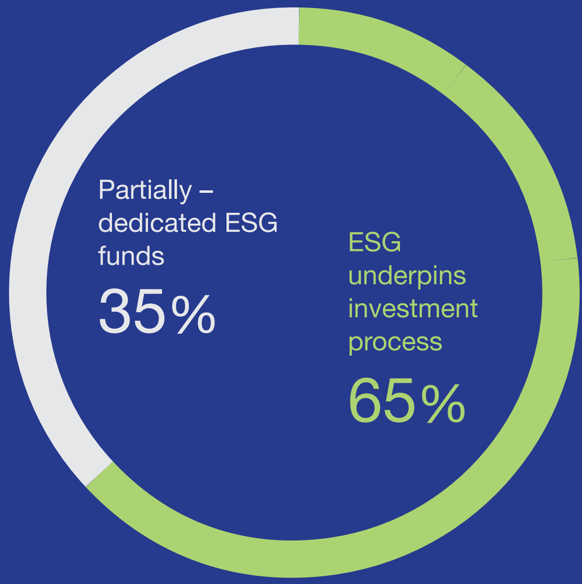
Historically, ore mainstream ESG policies have focused on green energy (such as Task Force on Climate-related Financial Disclosures[4]) but as this moves into a greater focus on bio-diversity (Taskforce on Nature-related Financial Disclosures[5]) it is clear that current exclusion policies need to be rewritten.

Subsidiary and supply chain risks are creating a web of complexity as investment strategies pivot away from commercial concerns to a greater focus on ethical and moral grounds.

2 Appendix 1
3 https://www.wired-gov.net/wg/news.nsf/articles/Circular+Economy+ Commission+proposes+new+consumer+rights+and+a+band+on+greenwashing+04042022132500
4 https://www.fsb-tcfd.org/
5 https://tnfd.global/

Exhibit 1

What proportion of your AUM is now subject to ESG investment criteria?



For example, the Russian invasion of Ukraine has led many global companies to close commercially successful operations in Russia.

This complexity is increasing further as more ESG strategies become aligned with Sustainable Development Goals (SDGs) such as "zero hunger" (SDG #2), "quality education" (SDG #4), as well as "responsible consumption and production" (SDG #12).[6] These are harder concepts to measure and more subjective.

As an ever-increasing number of economic sectors and geographical assets become caught up in a less favourable perception, liquidity risk and portfolio concentration may create unnecessary volatility, which can even lead to further de-investment in stressed market conditions.

Consequentially, ESG as an investment strategy is becoming unwieldy to manage, particularly for global diverse portfolios with hundreds of names.

6 https://sdgs.un.org/goals

The Data Required to Reassess Risk

Ultimately for investors, what matters most is the sustainability impact and outcome of the investment. Yet the ability to make properly informed decisions as to the suitability of an investment depends on access to information. Our report demonstrates that both the provision of data as well as the means in which to extract relevant information need to improve if investors, and regulators, are to have greater confidence – not just in the underlying company but also in relation to any subsidiaries or supply chain risks.

Currently ESG data is often provided by third-party data providers, which given the subjective nature of sustainable investing, may be misaligned with the investment strategy of a particular fund. Furthermore, the data is often incomplete, possibly inaccurate and largely backward looking. Where current ESG data is licensed to asset managers, it typically will not be company-level data. Most market data contracts only allow for summary portfolio level or sector/country breakdowns to be shared.

If the full data picture of the investee company's activity is not available, accurate analysis cannot be conducted on the investment in question - let alone any subsidiary or supply chain activity. In addition, different data vendors make different assumptions which lead to different conclusions, making peer to peer company comparisons meaningless.

The Path Ahead

The cost of obtaining relevant data and the difficulty in managing data will only continue to accelerate for firms as ESG investing becomes mainstream. Investing will move away from the concept of “value” being based on profit and loss to how a company’s product or service positively or negatively impacts society and therefore whether it is “sustainable” as an investment.

Access to relevant, more accurate and granular data regarding the underlying investee companies (including subsidiaries and supply chains) will be at the core of improving the efficiency and effectiveness of sustainable investing. Buy-side firms are already using data from multiple providers. Filtering it to the appropriate level – and adding their own understanding of a company’s sustainability credentials relative to the investment strategy in question – will only enrich their decision-making process.

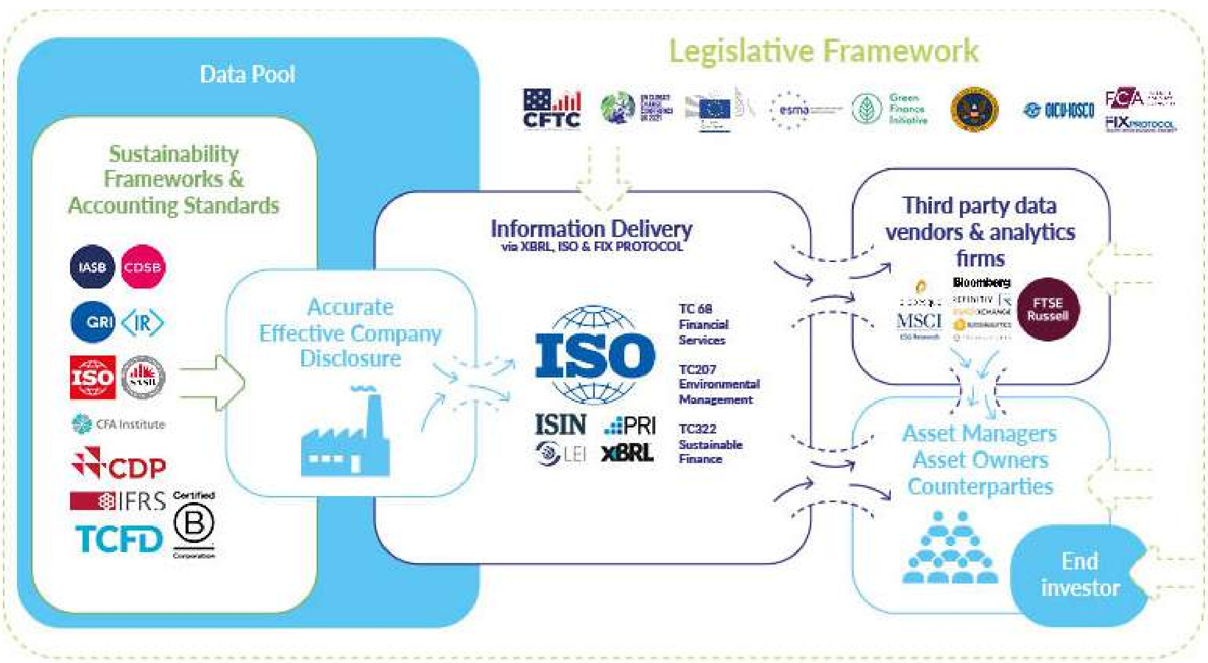
Rather than benchmarking, a taxonomy (with a small “t”) that recognises multiple routes to reach the outcomes, together with a central depository of direct company disclosure reporting, according to existing industry frameworks such as ISO and TCFD/TNFD, could provide a more effective approach in furnishing asset managers with the information they need (see Exhibit 2).

Through systems of systems to manage the extraction of relevant data for the investment strategy in question, including the possible adoption of blockchain and DLT in smart contracts, investors could access data in a more timely manner, not just relating to the company but their activity globally including subsidiaries an supply chains. For example, an investor can take a view that an electric car maker is a “good” sustainable investment but understanding more about the source of the necessary lithium or the longevity of the battery, can influence whether the relevant investment criteria are still being met.

Once the investment decision is made and executed whether that is to buy a new issuance, secondary market shares, bonds or specific ESG related products — the ecological impact can then be tracked over the lifetime of the investment. While data is needed at the point of trade, either to inform selection of products or a broker to complete at transaction - ongoing data is required whilst the investment is held to allow for a constant reassessment of risk.

The concept of “value” is slowly being radically redefined for a sustainable world. This will have a profound impact on capital markets, the investments made, by whom and in what manner. As an industry we are just at the start of a long and arduous – if worthwhile – route to a sustainable summit.

Exhibit 2



Contents

Redefining Value in ESG: The Myriad of Paths to the Summit 2

Executive Summary 3

Investor Demand Continues to Rise 3

Reassuring Risk to Meet Demand 3

The Data Required to Reassess Risk 4

The Path Ahead 5

Managing ESG Today for the Risks of Tomorrow 10

From Xinjiang to Ukraine – Rethinking Exclusion 10

Exclusion Plus 12

ESG is Dead, Long Live Sustainability 13

Understanding the Hidden Costs of Greening Portfolios 14

Alternative ESG Products 16

The Positives 17

The Challengers 18

ETF to ETD 20

Big Short Mark II 21

The Data Path Ahead 24

Looking Forward 26

Appendices 27

Appendix 1 – Articles 8 and 9 of SFDR 27

Appendix 2 – SFDR extended to MiFID II 28

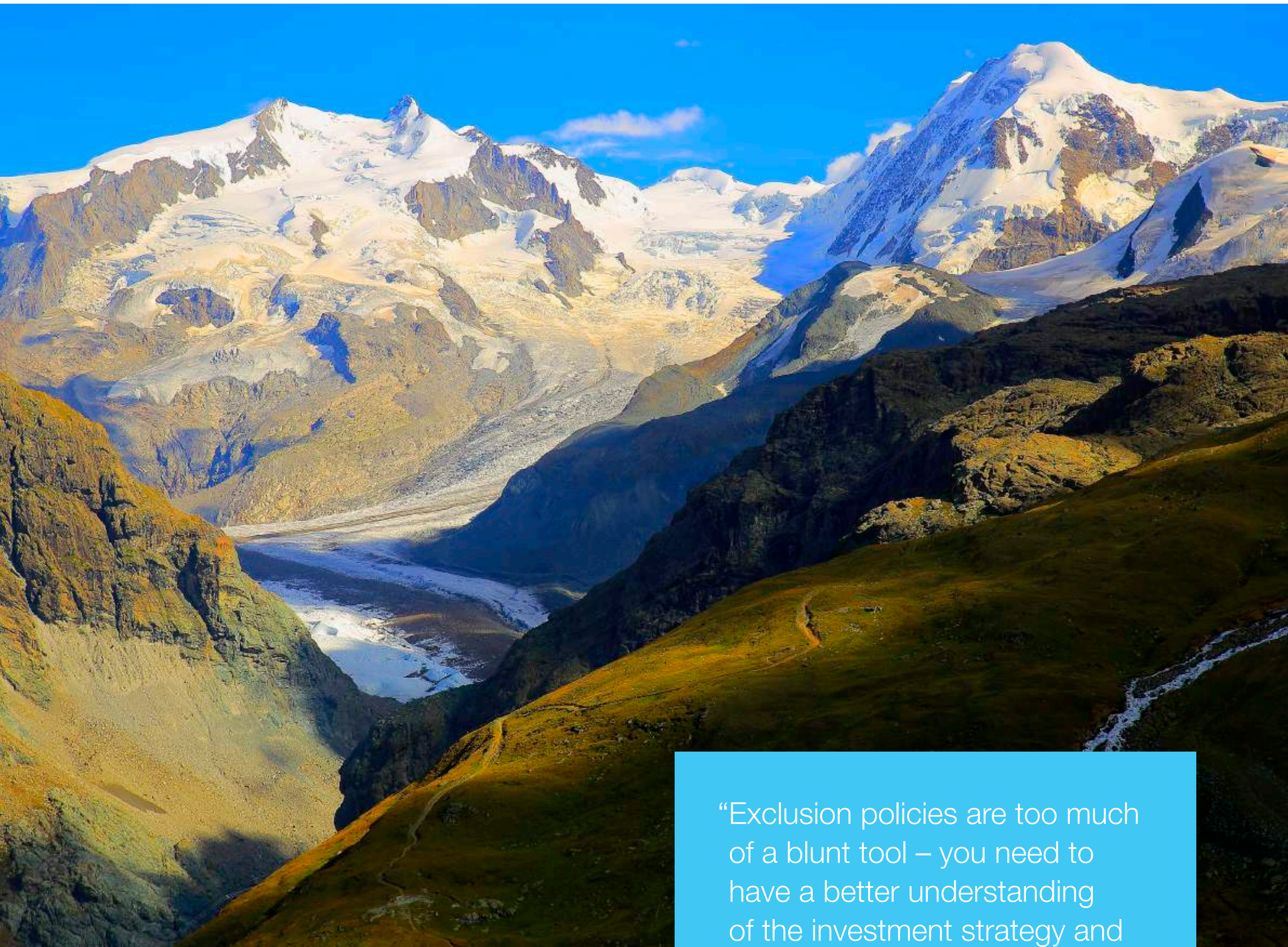
Appendix 3 – United Nations Sustainable Development Goals (SDGs) 29

Appendix 4 – US Regulation 30

Appendix 5 – Rise in Exchange Based ESG Products 30

Appendix 6 – Current ISO Standards being used in Financial Services /Sustainability 31

Managing ESG Today for the Risks of Tomorrow



The ESG debate is no longer whether sustainable investments are needed but rather how best to manage the shift in investor appetite in the most effective and least volatile manner. Any change in investment effects the entire capital markets chain from listings to execution to clearing, and the industry itself is already taking direct action – from the creation of new specific products such as Natural Asset Companies[7] to the post-trade space, where clearing firms are opting to no longer accept Palm Oil Futures[8].

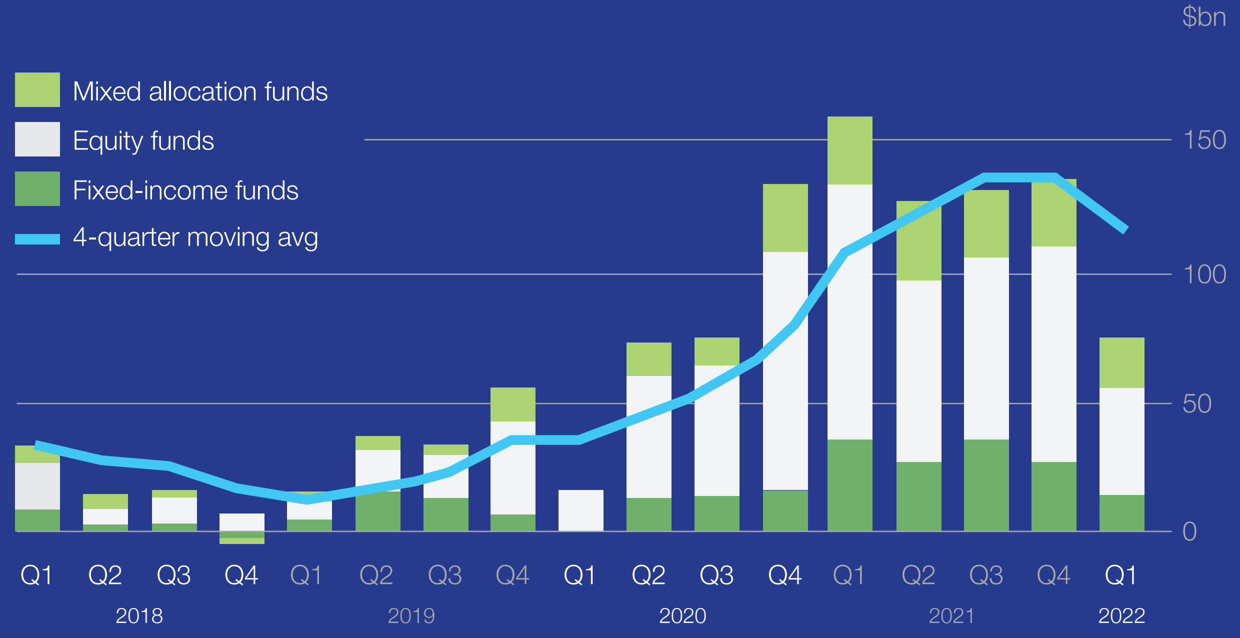
> "Exclusion policies are too much of a blunt tool – you need to have a better understanding of the investment strategy and the company in question …. A better outcome would be for me to invest in a company with a low ESG score today but with the objective of becoming a good ESG performer in the future – what happens to those that are excluded from indices?"
>
> Head of Sustainability,
> Large Global Asset Manager

7 https://www.nyse.com/introducing-natural-asset-companies
8 https://www.abnamro.com/clearing/en/product/sustainabilit

Managing ESG Today for the Risks of Tomorrow

Exhibit 3

ESG Fund Flows 2018 - Q1 2022



Source: Financial Times / Institute of International Finance

The increasing perceived complexity of ESG is leading some asset managers to call for a more sustainable investment approach which would support companies looking to transition from “brown” to “green”.

Companies that may not meet the criteria for green bonds can still issue sustainability-linked bonds where the interest rate on the bonds decline the closer the companies get to reaching their target reduction in carbon emissions.

And there is growing appetite for a more pragmatic approach, with the EU Council agreeing to include nuclear energy and natural gas as “green” investments[9]. While the EU Commission initially proposed 100% alignment with the EU Taxonomy, this has been watered down to include a 20% “flexibility pocket”.

> “We are fossil free, so we don’t trade anything in that space. The non ESG sectors, we’re more or less out of them, unless you can call it a ‘brown’ company that’s on its way to be green.”
>
> Mid-sized EEA Asset Manager

9 https://www.consilium.europa.eu/en/press/press-releases/2022/04/13/sustainable-finance-council-agrees-its-position-on-european-green-bonds/

Managing ESG Today for the Risks of Tomorrow

As ESG as an investment process moves away from an overly simplistic focus on “environmental issues” to includer broader factors relating to the future sustainability of the global economy, there are three challenges emerging:

- Firstly, a greater number of factors will need to be considerered in relation to the future sustainability of the investment. These include wider environmental issues, such as nature and biodiversity, as well as social and governance issues, diversity and inclusion, the living wage and fair taxation. The investment decision will not only be about a company’s carbon footprint but increasingly about the company’s positive impact on future society.
- Secondly, the more sustainability factors involved in a decision, the more comprehensive is the required understanding of the interdependencies of all the elements of the investee company, its subsidiary and supply chains.
- Thirdly, the concept of “value” will need to change from a sole focus on the bottom line or a company’s ability to manage future environment risks, to a broader consideration of companies who have a positive impact on the UN Sustainability Goals (see appendix 3).

From Xinjiang to Ukraine – Rethinking Exclusion

According to the CEO of Norges, one of Europe's largest institutional investors, firms that fail to acknowledge the level of change required in how they operate will "face a world in which financing will dry up, insurance companies will walk away, employees will defect, social media shaming will intensify, and customers will disappear"[10].

Meeting the speed of adoption as individuals look for investments which benefit people and the planet as well as, and sometimes ahead of profit, is only matched by the rising level of regulatory scrutiny.

> "Barely a year after Sweden's SEB bank adopted a new sustainability policy that excluded defence stocks from its funds, the group has made a U-turn. SEB says it began to review its position in January as a result of 'the serious security situation and growing geopolitical tensions in recent months' which culminated with Russia's invasion of Ukraine."
>
> Financial Times, March 9 2022

But the definition of a "green" or "brown" investment varies from one fund to another, one manager to another, and one end investor to another. Understanding what exactly an investee company does, who it employs and how it treats them and in what way it conducts business with its entire supply chain will continue to redefine investment evaluations as the concept of "value" is redefined.

Historically, ESG investing was, in the main, based on the exclusion of potential areas of economic concern like cluster munitions and tobacco, followed by supporting companies which were making the transition to a sustainable economic model such as energy companies investing in renewables. However, both the scope and the speed at which the investment industry needs to adapt to a changing context is escalating.

The industry has been adjusting to rising public concern regarding climate change after the recent record-breaking floods[11] and wildfires[12] across Europe in 2021. At the same time, the public mood for stricter regulation over the use of forced labour in China's Xinjiang region has shifted. Now, with the atrocities in Ukraine following the Russian invasion, assumptions about what should or should not be excluded from ESG are being called into question further still. "Good" defence companies which abide by international treaties on the development and sale of weapons including stepping up end-use monitoring of equipment[13] are now being discussed as eligible ESG investments.

On the other hand, there is increasing recognition of the environmental cost of making batteries for electric cars, including the use of raw materials mined in potentially dubious circumstances. Moral questions can also arise as to an investor's view of alcohol or adult entertainment. This creates further subjectivity over investment decisions.

Ultimately what matters most is how investors are defining their ESG investment strategy criteria and whether those investment objectives are being met.

10 https://www.bloomberg.com/news/articles/2021-12-06/esg-duds-have-nowhere-to-hide-world-s-biggest-stock-owner-says?sref=12wgA5jj
11 https://www.worldweatherattribution.org/wp-content/uploads/Scientific-report-Western-Europe-floods-2021-attribution.pdf
12 https://ec.europa.eu/commission/presscorner/detail/en/ip_21_5627
13 https://www.ft.com/content/c4dafe6a-2c95-4352-ab88-c4e3cdb60bba?desktop=true&segmentId=7c8f09b9-9b61-4fbb-9430-9208a9e233c8#myft:notification:daily-email:content

Managing ESG Today for the Risks of Tomorrow

Exclusion Plus

For over half of the respondents, exclusion policies are often the default way to minimise the risks of greenwashing, However, this approach is fast becoming seen as just the first step in assessing the level of ESG risk (see Exhibit 4). With ESG negative screening representing over 60% of all existing fund strategies in Europe (Exhibit 5), the challenge of accurately assessing the level of ESG risk using exclusion is only likely to increase. This is especially the case because risks are no longer limited to just the company itself.

In addition to the scope extention of European regulation, we see even stronger requirements emerging. For example, Germany approved a law on due diligence to enforce the protection of human and environmental standards in supply chains globally. Fines for non-compliance could rise to 2% of average annual sales for companies with €400m in sales[14] making the issue not just a moral concern but also a financial one.

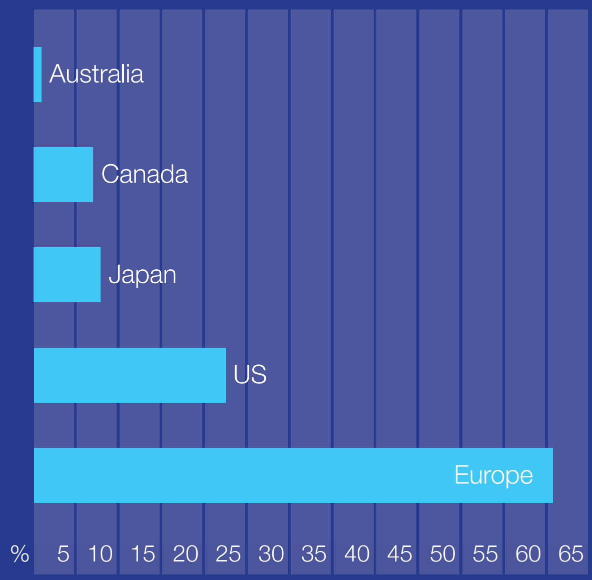
> "You have a base list of exclusions that clients will have zero tolerance to - cluster munitions, weaponry, tobacco. That could morph into alcohol, nuclear power, fossil fules, cannabis. It's making sure we are aware of exactly what is in the product, but also what liquidity risk there is, given the increasing risk of portfolio concentration from the investments you have excluded."
>
> Mid-sized EU Asset Manager

Exhibit 4

How are you managing new "hidden" risks within portfolios?

Exhibit 5

Geographic share of negative screening strategies



Source: Redlap Consulting / Financial Times

14 https://erma.cc/8JUX-ET2Q

Managing ESG Today for the Risks of Tomorrow

ESG is Dead, Long Live Sustainability

The reality is that ESG investment strategies come in many guises (see Exhibit 6). The way investors define their investment strategy to reach their sustainable investing goals needs to change to focus on the overall sustainable investment outcome rather than the name of the investment strategy.

As investing moves across the "green" spectrum, complexity increases and expectations grow. Some funds exclude fossil fuels, some don't.

There is an argument that excluding investable assets to only a handful of names will neither assist the transition to a sustainable economy, nor support investor needs. To encourage more companies to invest sustainably, there are portfolio managers who deliberately select a fossil fuel company that is performing poorly on ESG ratings today, because they are confident their engagement with the company will lead to a higher ESG rating in the future, making it a good investment.

Exhibit 6

The Difference in Sustainable Finance Investment Strategies

ESG includes the consideration of environmental, social and governance factors alongside financial factors in the investment decision-making process

SI refers to investment in themes or assets specifically related to the sustainability of individual companies in a carbon neutral world

SRI actively excludes investment involved in harming our planet based on specific ethical guidelines

RI involves including ESG information in investment decision-making, to ensure that all relevant factors are accounted for when assessing risk and return

II solves global challenges by investing in companies developing solutions to those challenges

"For us it is all about: does the investment do good? For some asset managers, unless the company already has a high ESG score, they are unable to make the investment which makes it harder for us to raise funds to do good. ESG is becoming a victim of its success."

Small EEA Asset Manager

"There is not one single version of ESG; some want to exclude bad sectors, some are selecting ESG companies as they believe they are better run and will deliver better returns – one person's green fund is another's greenwashing."

Mid-sized UK Asset Manager

Managing ESG Today for the Risks of Tomorrow

Understanding the Hidden Costs of Greening Portfolios

Using exclusion policies to meet compliance concerns regarding greenwashing also increases the risk of a liquidity squeeze resulting from a reduced investable universe. A gargantuan task is awaiting asset managers who must review every name they hold to make their portfolios ESG-friendly.

Forthcoming amendments to MiFID II legislation will include suitability requirements and changes to integrate sustainability factors, risk and preferences into organisational requirements and operating conditions for investment firms[15] (see Appendix 2). There is concern that firms will group Article 8[16] funds together with impact and other sustainability funds, increasing the risk of greenwashing given the difficulty in accurately assessing future sustainability risk.

Some jurisdictions such as Finland, UK, France and Singapore are beginning to pass regulations to specifically address greenwashing in this area. Crucially for capital markets sustainable evaluations have in the main been focused on the effects that the environment was having on the portfolio, but NOT what the investment/organization was doing that impacted the environment – and this is about to change.

New regulatory requirements under Scope 1, 2 and 3 emissions increases the complexity of managing multiple fund structures across numerous portfolios; with Scope 3 emissions relating to a company's supply chain, which can represent anything from 65 to 90% of all emissions (see Exhibit 7)[17]. Rather than just looking at shareholder profit, companies now need to demonstrate their planetary and social footprint.

While there is a need to calculate greenhouse gas emissions (GHG) from the entire value chain, the presence of standardized verifiable method for determining Scope 3 emissions remains elusive. Yet as more companies opt to promote their Scope 3 credentials, boards are recognising their need to address Scope 3 to survive. Most notably impacting finance, with the Gfanz agreement[18] including making financial services firms accountable for the Scope 3 emissions of their clients.

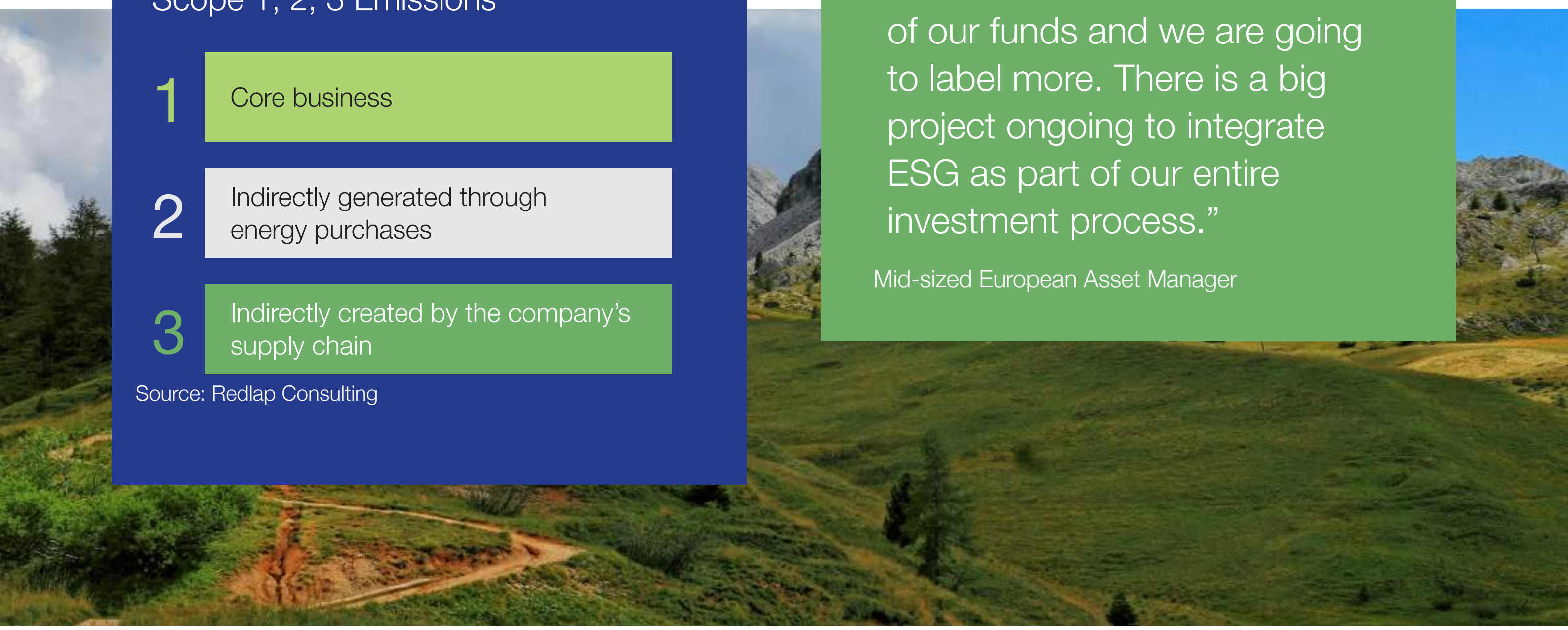


Exhibit 7

Scope 1, 2, 3 Emissions

1 Core business

2 Indirectly generated through energy purchases

3 Indirectly created by the company's supply chain

Source: Redlap Consulting

> "We have re-labelled a lot of our funds and we are going to label more. There is a big project ongoing to integrate ESG as part of our entire investment process."
>
> Mid-sized European Asset Manager

15 https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/sustainability-related-disclosure-financial-services-sector_en
16 https://www.carbontrust.com/
17 https://www.gfanzero.com/
18 https://www.gfanzero.com/

Managing ESG Today for the Risks of Tomorrow

Without accurate information on the underlying company and a standardised means by which to make a valued assessment, compliance departments may err on the side of caution. This could result in the exclusion of potentially risky assets to avoid inadvertent greenwashing.[19]

As more assets become perceived as "unsustainable" in the long-term, entering or exiting an investment strategy will become increasingly challenging and market timing will be critical.

By relying on traditional sell-side relationships to access liquidity for their ESG investing, asset managers may not be accessing the best liquidity available. This could impact their best execution obligations (see Exhibit 8).

Using third-party data providers for investment strategy purposes frees up execution strategies to select the most appropriate liquidity available. This is only likely to increase in significance as sustainable investing becomes more crowded.

Exhibit 8

How are you sourcing liquidity for ESG funds?

No change – rely on traditional sell-side relationships
83%

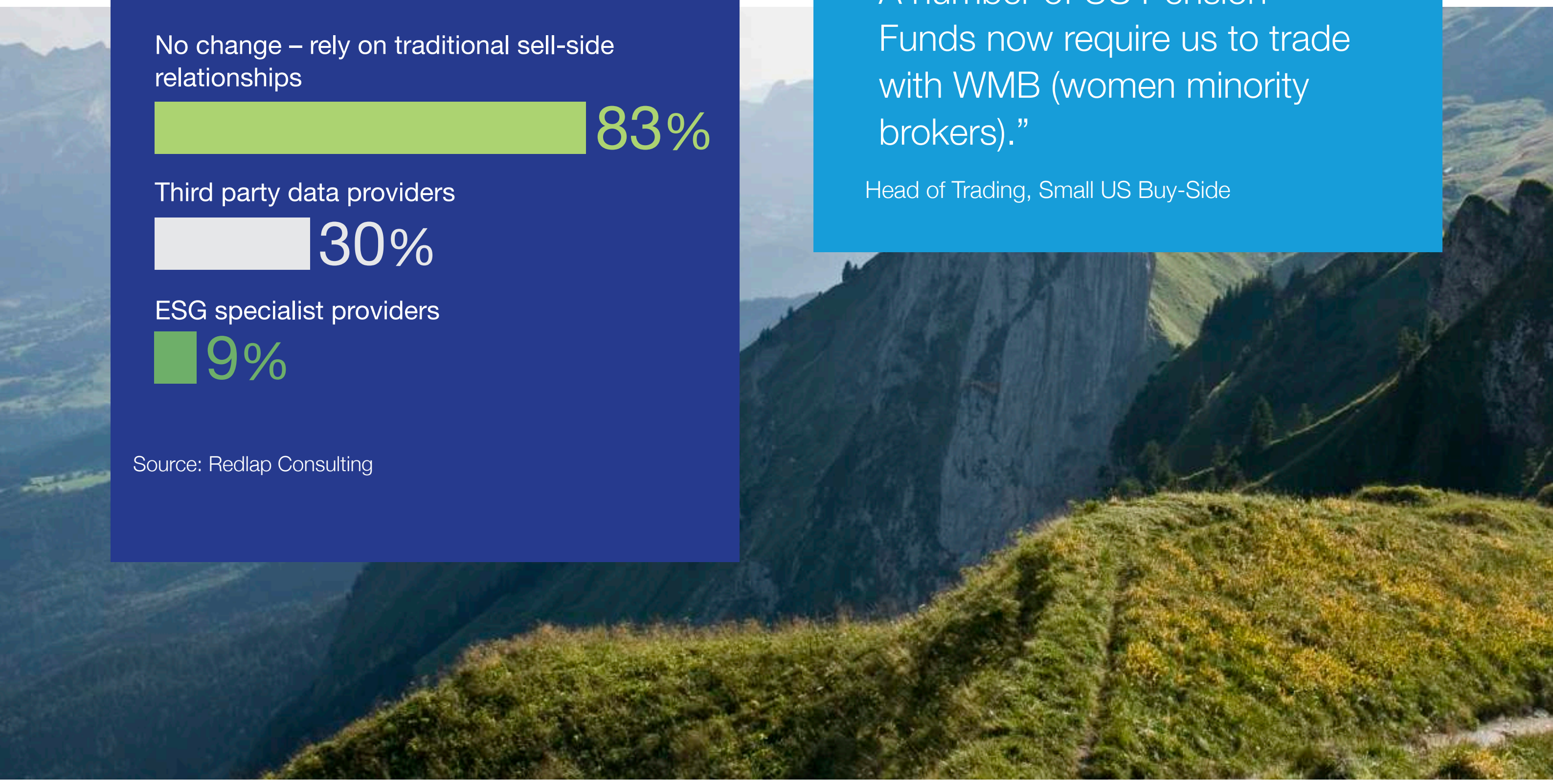
Third party data providers
30%

ESG specialist providers
9%

Source: Redlap Consulting

"ESG is now creeping into the broker selection process. A number of US Pension Funds now require us to trade with WMB (women minority brokers)."

Head of Trading, Small US Buy-Side



19 The definition of greenwashing under ISO Standard 14100 equates to false or misleading information, either intentionally or inadvertently, regarding the environmental or sustainability attributes of a product, asset, and activity, which can have consequences on the assessment of financial and non-financial materiality.

Alternative ESG Products

With more evidence now required from the buy-side to demonstrate how they are integrating sustainability factors in their investments, understanding how to green portfolios in the future will be critical. The challenge for asset managers is multi-faceted.

ESG was traditionally seen as the bedrock of successful active fund management. By conducting bottom-up research and engaging directly with companies, active managers have a better understanding of a company's future risks and opportunities.

However, the level of understanding that is now required of a company, subsidiaries and supply chains, means that in-depth analysis and monitoring only works well for asset managers with a limited number of holdings. The situations becomes much more complex for a portfolio manager with hundreds of names to manage.

Specific sustainable (index) products are increasingly being seen as a means of offering liquid and cost-efficient alternatives to asset managers. These can help mitigate sustainability risk while providing investors with exposure to "green" products. Sell-side liquidity providers who service both retail and institutional investor flows, with highly automated risk books and sophisticated modelling, can help reduce unnecessary risk by providing liquidity in specific sustainable products.

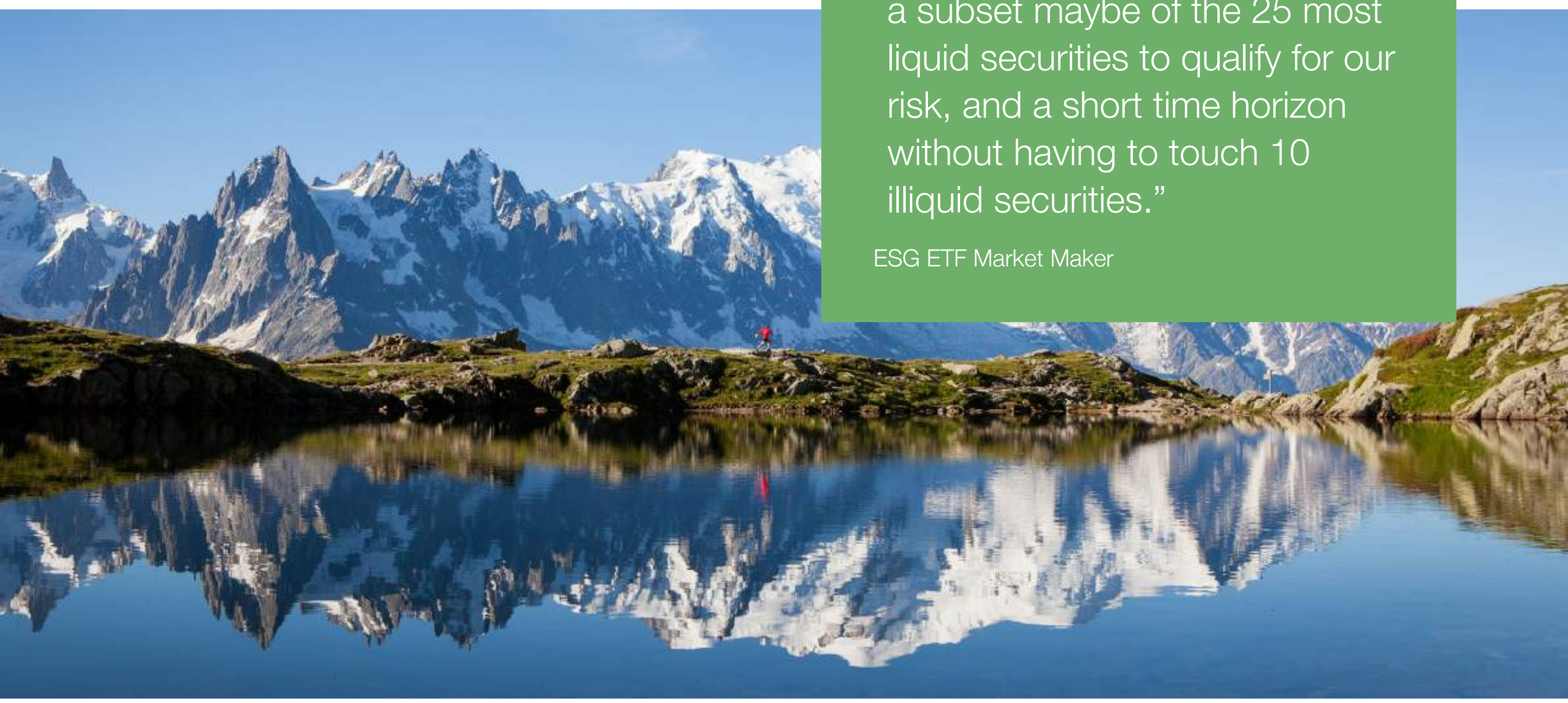
Yet ESG Exchange Traded Funds (ETFs) continue to be seen by many asset managers as securities predominantly used by passive managers to lower the cost of ESG investing. As investors' demand continues to increase for more sustainable investments, ETFs combined with active management could be used as a first line of defence against greenwashing by weeding out initial controversies.

However, exclusion alone in an index raises questions as to:

a. How firms are able to invest successfully in the firms of the future, and
b. Whether the rating agencies that provide the benchmarks are sufficiently robust. Although these are set to change given the intended regulatory focus on sustainability benchmarks.

"With automated pricing of risk, you can much more effectively price that risk, which increases your access to liquidity. With a basket of 100 securities, 10 are extremely illiquid. We can use a subset maybe of the 25 most liquid securities to qualify for our risk, and a short time horizon without having to touch 10 illiquid securities."

ESG ETF Market Maker



Alternative ESG Products

The Positives

- With massive discounts and premiums to NAV, Exchange Traded Funds (ETFs) are viewed as a fast practical solution to the vast sums of passive money looking to switch to green investments.

- ETFs can provide diversified and cost-effective exposure to a broad basket of securities via a single transaction.

- The underlying securities can be traded on a very specific time horizon to limit the impact of pricing individual instruments, such as the close, where liquidity formation is at the highest.

- ETFs can offer a more accurate indicator of fair pricing as well as create liquidity in ETF names.

- ETFs can also reduce the overall ESG inventory requirement by netting buys and sells in an end of day transaction.

> "The policy starts off with what the client objectives are, then what the voting engagement should be, including the active PM - they have the in-depth knowledge of the company to justify the voting position. You can't justify a voting position just on the benchmark. Step two is looking at the underlying benchmark. Exclude the worst offenders - weapons, thermal coal, oil, tobacco - and you tilt the index to those companies who are doing most to improve their ESG momentum."
>
> Head of Trading, Large Global Asset Manager

Alternative ESG Products

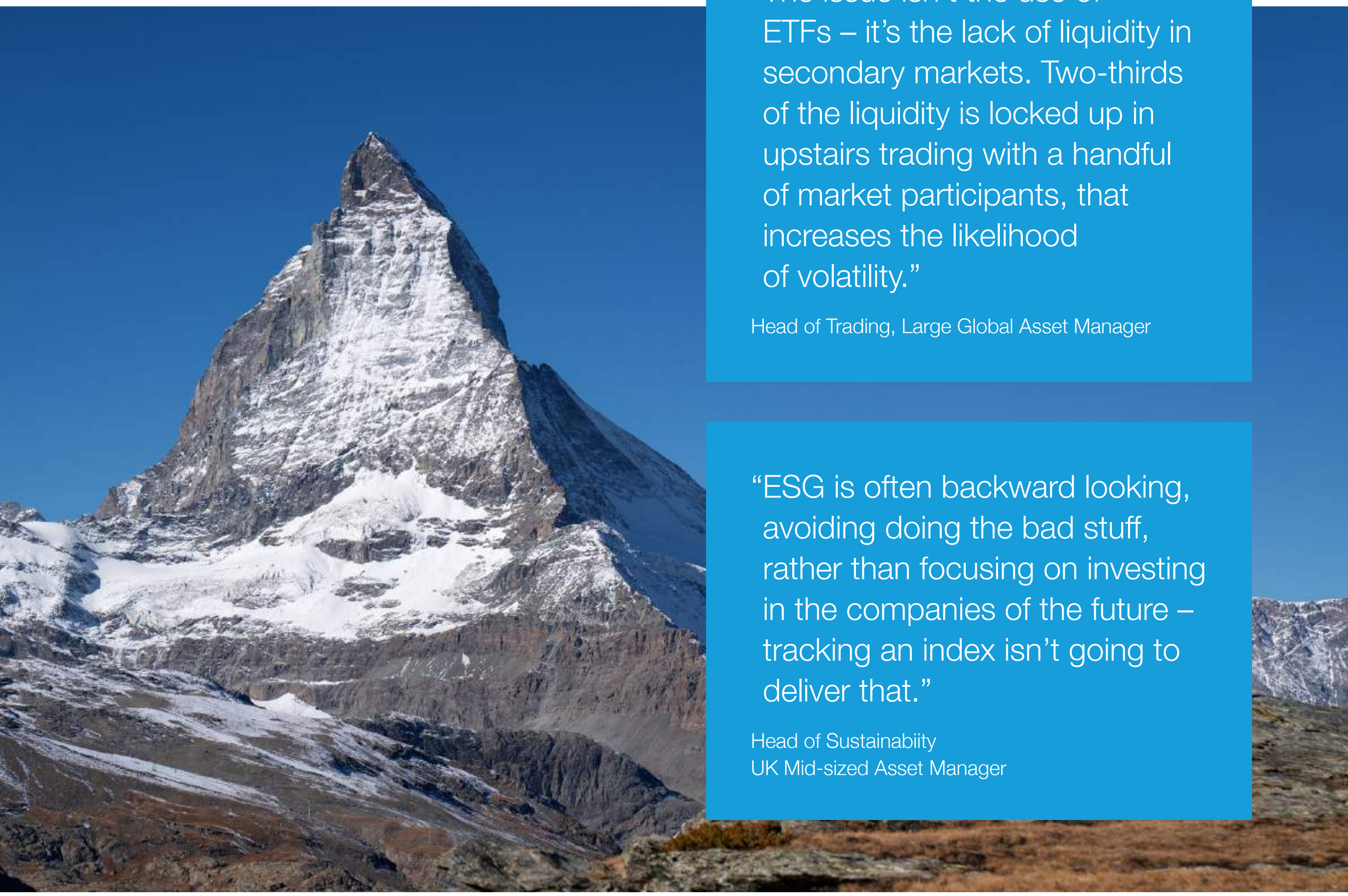
The Challenges

- Investors are asking questions about the content of some ETF indices given recent exposes on perceived questionable ratings. There are inherent risks with tracking an index based on exclusions. For example, it may become too complex to manage by incentivising a minority universe of investible companies which creates liquidity risk.

- Some ETFs have become a victim of their own success. Vast unmanageable inflows with over-inflated valuations and high portfolio concentration force re-benchmarking the index construction, unwinding positions and reinvestment regardless of market conditions[20].

- Different interpretations as to what ESG means lead to diverging views as to which assets should or should not be included in a fund or benchmark.

- For example, a widely marketed Clean Energy ETF was found to include fossil fuel companies such as Gazprom, Lukoil, or MOL Group[21]. For asset managers with fossil fuels on their exclusion list, the presence of such companies in the ETF may be contrary to their sustainable investment policy. This situation could also be viewed as greenwashing and presents a risk fewer and fewer firms are willing to take today.



> "The issue isn't the use of ETFs – it's the lack of liquidity in secondary markets. Two-thirds of the liquidity is locked up in upstairs trading with a handful of market participants, that increases the likelihood of volatility."
>
> Head of Trading, Large Global Asset Manager

> "ESG is often backward looking, avoiding doing the bad stuff, rather than focusing on investing in the companies of the future – tracking an index isn't going to deliver that."
>
> Head of Sustainabiity
> UK Mid-sized Asset Manager

20 https://www.nyse.com/introducing-natural-asset-companies
21 https://www.ishares.com/us/products/312222/ishares-esg-msci-em-leaders-etf-fund

Alternative ESG Products

A lack of understanding of the difference between environmental impacts and the effects that organisations are experiencing could undermine trust in the market, with grave consequences.

To address these concerns, ESG ETFs will need to re-assess risk exposure by including underlying investor objectives in order to assess the benchmark.

Once the worst offenders are excluded, companies doing the most to improve can be overlaid. This would overweight the leaders and underweight the laggards. After that, depending on investor appetite, other factors, such as SRI, can be taken into consideration.

This more in-depth approach may be the best way to address recent research findings which suggest many ESG ETFs actually have a higher carbon footprint than the S&P500 when using emissions data disclosed by companies[22]. For example, with soybeans now recognised as the second-largest driver of deforestation in tropical countries after cattle, ETF indices also hold 380 publicly-listed companies linked to deforestation[23].

So, whether such companies should be included in an ESG ETF or not depends on if the investment strategy focuses on how, if at all, the underlying companies are taking action to address negative sustainable behaviour.

"The future will be tailored ETFs. The product is already available in the US, where instead of tracking an index you can create a bespoke portfolio designed to meet your individual ESG criteria. That can be sector or individual company based – incorporated into the ETF is directly tradable underlying assets – you avoid the locked up liquidity and you have deep secondary market trading."

Head of Trading, Large Global Asset Manager

22 https://qz.com/2105647/the-problem-with-esg-investing-in-one-chart/
23 https://planet-tracker.org/planet-tracker-names-the-seven-companies-critical-to-tackling-etf-deforestation-risk/

Alternative ESG Products

ETF to ETD

Despite the recent growth of ESG linked products, ESG ETFs or ESG Exchange Traded Derivatives (ETDs), only 42% of respondents so far are changing their asset mix to gain greater sustainable exposure (see Exhibit 9). However, that may be about to change.

Many exchanges are now offering green products in a bid to facilitate the green transition (see Appendix 4). Eurex has established ESG versions of main European benchmarks including STOXX, MSCI, DAX 50 ESG, Euro STOXX 50 ESG[24]. Nasdaq is also looking at expanding its ESG derivatives offering by launching option contracts on the OMX Stockholm 30 ESG index[25].

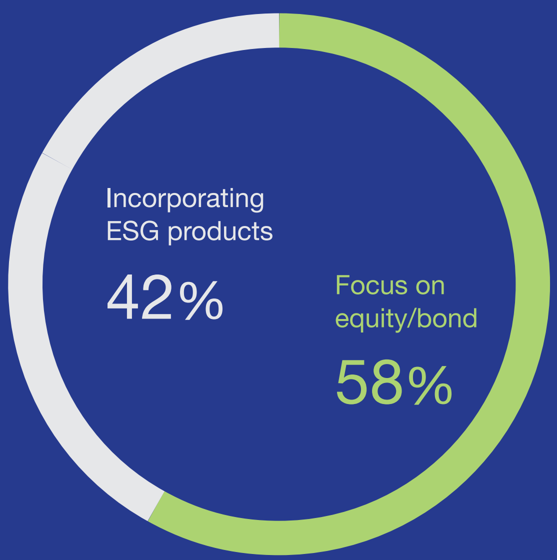
Moving investments to ESG derivatives remains hampered by fund restrictions which prevent the use of derivatives. Yet, derivatives could play a critical role in supporting the transition. They not only provide the means to hedge against the impact of climate-related events on investments, but also help the buy-side manage risks related to inflows and outflows. This is because they enable going long or shorting ESG futures within the necessary level of ESG exposure.

Even if asset managers can use derivatives to manage their exposure and hedge their risks as part of their fund mandate, the general lack of awareness around existing ESG derivatives means that asset managers may tend to revert to more traditional benchmarks for the time being.

This could change with the arrival of new smart contracts which could authenticate where metal is sourced as well as track the shipment. Smart contracts can also monitor customers' market positions in real time to ensure there is sufficient collateral to cover trades. This would also avoid unnecessary market volatility as electronic trading algorithms can automatically reduce and rebalance customer positions, making situations such as the recent intervention by the London Metal Exchange (LME) unnecessary[26].

Exhibit 9

How has your asset mix changed?



Source: Redlap Consulting

> "It is changing our mix of the assets we trade because our strategy direction will evolve to become more ESG friendly. That impacts our risk management framework, hedging positions and our portfolio management services. We are not really moving into the ETF space because we also have the internal team to assess each instrument so this doesn't mean we have to buy ETF, we can buy the underlying asset of the component of ETF."
>
> Mid-sized EEA Asset Manager

24 https://www.eurex.com/ex-en/markets/idx/Equity-and-Index-ESG-Derivatives
25 https://www.eurex.com/ex-en/markets/idx/Equity-and-Index-ESG-Derivatives
25 https://www.ft.com/content/3a4748f7-f47e-4891-95be-377561666b48

Big Short Mark II

To meet the speed of investor interest, regulators are increasing their scrutiny to ensure end investors are aware of what they are investing in. However, in a similar manner to the mortgage backed securities issue that preceeded the global financial crisis of 2008, when rating agencies were enmeshed with the American Mortgage Loan Market and Credit Default Swaps market, ESG investments are often inherently tied to ESG ratings. Yet it is becoming increasingly clear that current labels are not always able to guarantee ESG claims. This may not always be deliberate but many global conglomerates have multiple operations in multiple jurisdictions and information on company activies is not always easy to obtain. Bloomberg Intelligence estimates that 60% of all the money retail investors have ploughed into sustainable or ESG funds globally has gone into those reliant on just one rating agency - MSCI[27].

This is leading to concerns from some regulators such as the AMF[28] and other authorities such as the Bank of International Settlements[29]. The reliance on ESG ratings providers to highlight investment risk and the extension of the regulatory risk to subsidiary and supply chains raises the stakes further still. As a result, rating agencies are coming under increasing scrutiny concerning how individual investee companies are scored. For example, a “water stress” score for a chemical company does not include the impact it has on the local community but whether there is sufficient water access to produce the chemicals.

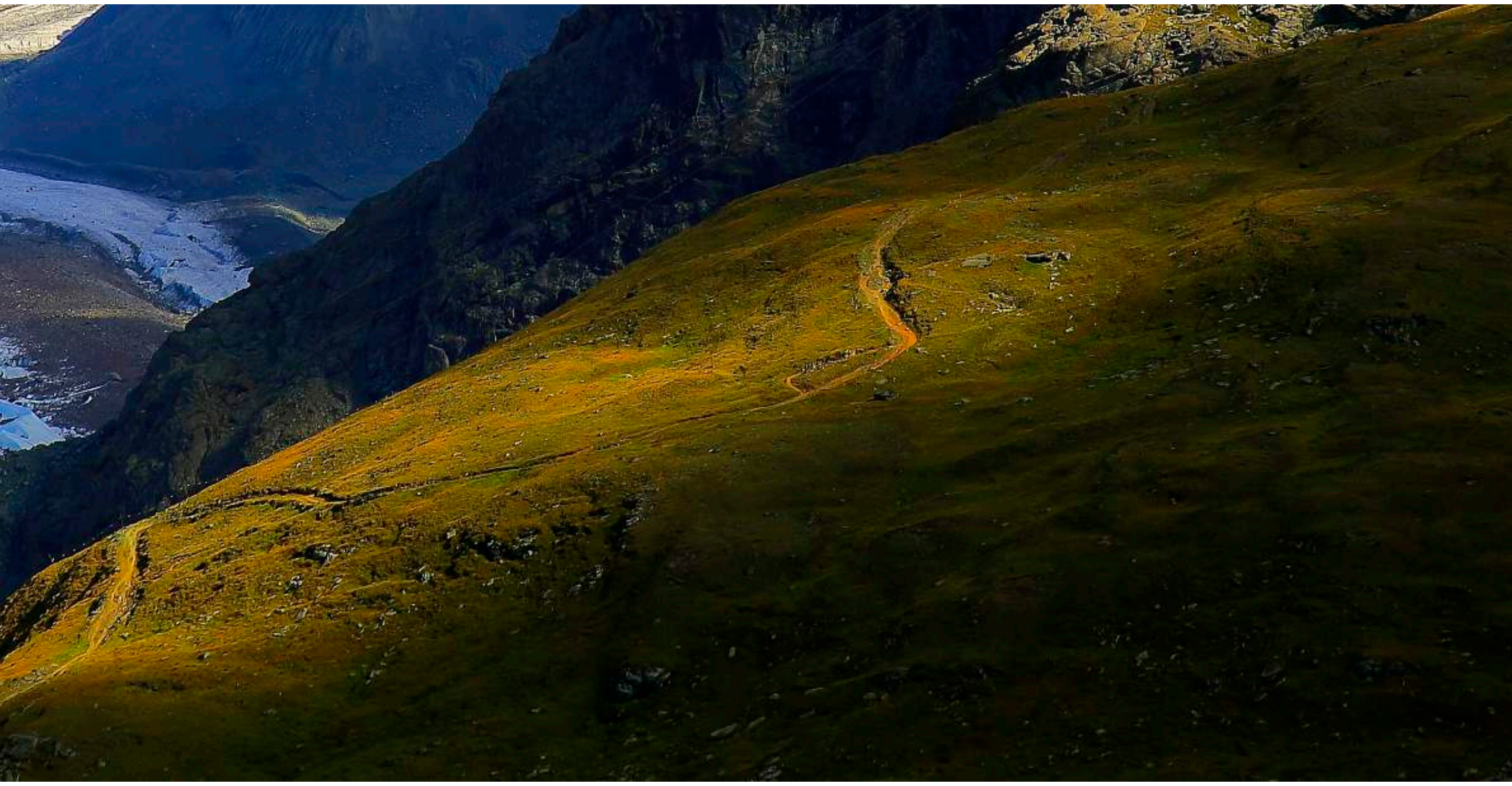
“This is inflating bubble territory - I cannot believe our industry has not learnt anything from the dot com bubble. We are about to create another bubble all over again.”

“90% of the stocks in the S&P 500 have wound up in ESG funds built on MSCI’s ratings. What does sustainable mean if it applies to almost every company in a representative sample of the U.S. economy?”

Bloomberg Intelligence

27 https://www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line/
28 https://www.amf-france.org/en/news-publications/publications/reports-research-and-analysis/market-impact-rating-agencies-decisions
29 https://www.bis.org/publ/qtrpdf/r_qt2109.pd

Big Short Mark II



Europe is ramping up its regulatory arsenal to tackle supposed ESG "greenwashing" with the introduction of the EU Taxonomy[30]. This aims to establish a classification system of environmentally sustainable activities and includes a recent call for evidence by ESMA on the use of ESG Ratings[31].

The EU has also implemented SFDR[32] which requires asset managers to evidence how they are integrating ESG factors. The EU also extended this into MiFID II organisational requirements including suitability and risk management assessments, conflicts and product governance arrangements (see Appendix 1 and 2). The Corporate Sustainability Reporting Directive (CSRD)[33] will increase the number and scope of companies subject to non-financial disclosures. The extension to the circular economy will encapsulate cybersecurity policies and governance structures as well as the right to repair. Consumer electronics and IT will be the sectors most impacted by policy initiatives to reduce waste and pollution through adoption of more circular economy initiatives[34].

Similarly, the UK is looking to expand company sustainability disclosures. The FCA has released its proposals for additional disclosures for asset managers[35] consistent with the Task Force on Climate-related Financial Disclosures (TCFD) in terms of how climate-related risks are taken into consideration both at an entity level and a product and portfolio level. These disclosures are soon to be followed by the Task Force on Nature-related Financial Disclosures (TNFD)[36] designed to increase transparency on how firms are managing biodiversity-related risks alongside climate risk.

30 https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en
31 https://www.esma.europa.eu/press-news/esma-news/esma-launches-call-evidence-esg-ratings
32 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32019R2088
33 https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en
34 https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12511-Environmental-performance-of-products-&-businesses-substantiating-claims_en
35 https://www.fca.org.uk/publication/policy/ps21-24.pdf
36 https://tnfd.global/

Big Short Mark II

The US is also developing its own frameworks for climate-related disclosures with proposals to amend the Securities Acts of 1933 and 1934 requiring companies to provide climate-related information in their registration statements and annual reports[37]. Assessing climate-related factors not only helps individual companies better understand the risks they face, but also allows greater assessment of systemic risk across the market globally and informs the compound effect of irreversible climate change. All of which will directly impact how assets are invested, as well as marketed and sold to investors (see Appendix 3).

In an effort to address the financial risks from climate and sustainability globally, the International Sustainability Standards Board (ISSB) is also proposing new rules which would require companies to disclose the risk they are exposed to[38]. The proposals are currently under public consultation but intend to require companies to disclose information on sustainability risks and the impact on the value of their business. In addition, companies will be required to disclose information regarding the metrics and targets on how they measure, monitor and manage climate-related risks in particular.

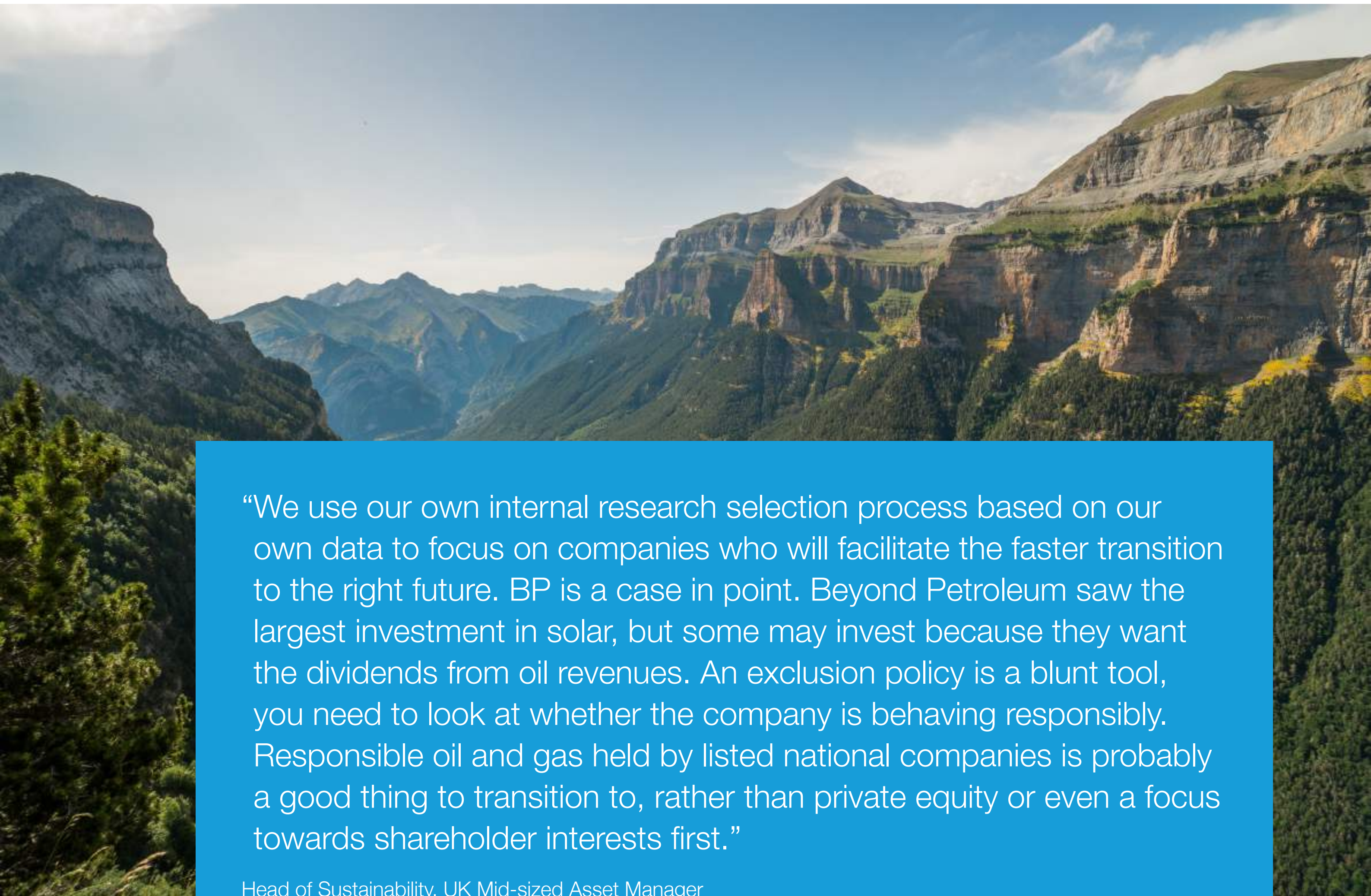
37 https://www.sec.gov/news/press-release/2022-46
38 https://www.ifrs.org/news-and-events/news/2022/03/issb-delivers-proposals-that-create-comprehensive-global-baseline-of-sustainability-

The Data Path Ahead

With the current sustainability shift, the concept of value is being radically redefined. Ultimately, the answer to the sustainable investment challenge relies on the need to rethink the information required ahead of making an investment – in terms of the new risks attached to that investment decision and timing of execution. While a portfolio manager can have a great investment idea, any inability to enter or exit a strategy in a timely manner can have negative consequences on returns. Recent markdowns on fund exposure to Russian assets after its invasion of Ukraine are a case in point.

The sustainability outcome of the investment is what matters most, rather than highly codified attempts to define the investment strategies.

To achieve this requires information relating to the activity of the underlying company, subsidiary or supply chain, as well as the products and services they supply and the employees who work within their organisations. Using existing global frameworks and industry standards such as ISO, iXBRL and FIX Protocol to replicate the transition of ESG data alongside financial data will be the most effective way to deliver this (see Appendix 5). For example, a useful indicator of better management is the presence of a robust, credible, and reliable Environmental Management System that is built upon ISO 14001. Direct company data can then be imported using FIX Protocol and distributed into order and execution asset management systems (OMS and EMS) – not just to establish investment criteria but to incorporate liquidity risk as well.



"We use our own internal research selection process based on our own data to focus on companies who will facilitate the faster transition to the right future. BP is a case in point. Beyond Petroleum saw the largest investment in solar, but some may invest because they want the dividends from oil revenues. An exclusion policy is a blunt tool, you need to look at whether the company is behaving responsibly. Responsible oil and gas held by listed national companies is probably a good thing to transition to, rather than private equity or even a focus towards shareholder interests first."

Head of Sustainability, UK Mid-sized Asset Manager

The Data Path Ahead

Moving available information away from rating agencies' corporate sustainability reports is essential in this regard. Often information is manually keyed in which can be subject to errors, inconsistencies or gaps, with an inability to verify accuracy or agreement. Ratings may conflict with each other or the asset management firm's view of sustainable investing. A firm's internal view of their appetite for exposure may also differ from issue-based analysis (primary) to secondary market investment exposure. Data is required at the product level (fixed income and for more complex equity products) when looking at subsidiary and supply chain risk.

Mandatory disclosures reporting is already reflected in financial accounts including International Accounting Standards IASB, FASB or reporting on sub-set of sustainability topics considered material for enterprise value creation – Sustainability Accounting Standards Board (SASB), Climate Disclosure Standards Board (CDSB) and International Integrated Reporting Council (IIRC).

The issue here is that current regulatory-mandated reporting looks at ESG data through a local lens whereas asset management is global.

Using international standards such as reporting that reflects an organisation's significant impact on economy, environment and people – Global Reporting Initiative (GRI) and Carbon Disclosure Project (CDP) or Corporate Sustainability Reporting (CSRD) – would enable this information to be reported into a centralised data repository. This would be similar to how US Edgar produces machine readable reporting standards via iXBRL, which has also now been mandated in the EU as well.

Looking Forward

Sustainable investing covers a myriad of investment strategies; but as the concept moves from a bottom up risk assessment of how a company is run, to the impact the investment will have on the future of society – the concept of "value" itself will change.

Different firms currently have different investment strategies and are on varying stages of the journey to the sustainable summit. The relevant investment strategy in question will determine how any data obtained will affect the investment decision. Investing in fossil fuels may be appropriate if the company is facilitating a faster transition to renewables and as such may be considered a "good" investment by that fund. Once the data question has been solved, the issue over how to successfully "green" a portfolio will become easier and capital markets can quickly support the transition to a sustainable future.

While sustainability as an investment strategy is seen as a mountain worth climbing, there are multiple routes to the summit with regard to how investment decisions are made. Right now, the industry is still at base camp. The rising investor appetite for sustainable investing is not yet matched by global companies' ability to pivot fast enough towards sustainable business models. The risk is that investor demand will be met by over-promised performance and the risk of greenwashing.

Specific ESG products may be easier to benchmark today when focusing on being aligned to net-zero or decarbonising by 30 or 50%, but as these products move across the spectrum there is far greater risk of greenwashing inadvertantly rather than deliberately.

At that point, the importance of matching the right product to the clients investment objectives becomes critical.

ETFs can support asset manager use of passive investing to lower costs, but the level of success still depends on meeting a client's underlying investment objectives. Investors may want to do good, but the jury is still out on the extent to which they are prepared to sacrifice performance of the investment. In addition to an investment risk, the increasing risk of portfolio concentration creates higher liquidity risk, which necessitates re-benchmarking, unwinding and reinvesting.

Regardless of the investment style – active or passive – the critical question is what level of sustainability is an investor is comfortable with. This will dictate the information to be sourced and the extent to which it will necessitate any changes to the investment – whether that is in equities, bonds, ETFs, derivatives or even now ecological assets. It all comes back to the investment outcome and, for that assessment, investors need data and analysis to provide relevant context. The consistent introduction of more granular and prescriptive regulation will help provide consistency in how companies and benchmarks are classified.

However, the first step for the industry is to move towards greater principles-based regulation around sustainability remains access to accurate and consistent data. That is the most effective base camp solution for the sustainable investment mountain that lies ahead.

Appendices

Appendix 1 –
SFDR extended to MiFID II

EU Commission Delegated Regulation (EU) 2021/1253 of April 21, 2021 has introduced revisions to MiFID II, integrating sustainability factors, risks and preferences into reputational, procedural and organizational requirements and operating conditions for MiFID II investment firms. There are similar requirements for UCITS and AIFMD regulations.

MiFID II investment firms who distribute product will need to ask investors whether they would like to take sustainability into account when making investments. If investors express interest in making sustainable investments, MiFID II investment firms must then provide them only with products that either;

a) are aligned with the EU sustainable taxonomy or

b) possess a minimum level of sustainable investments as defined by SFDR.

There are also rules on the concept of "sustainability factors" and "sustainability risks" disclosures of sustainability-related information for firms offering investment advice and portfolio management services.

a) If the financial product does not promote environmental and/or social characteristics (Article 6), it cannot be sold to clients or potential clients with sustainability preferences;

b) If the financial product is aimed at sustainable investment (Article 9), it can be sold to clients or potential clients with sustainability preferences.

However the categorisation of sustainability preferences in MiFID II is not fully aligned with that of financial products identified in the SFDR. There are question marks over whether financial products in Article 8 of the SFDR, while not being considered suitable for clients who have sustainability preferences, could still be marketed as promoting environmental and/or social characteristics.

In terms of organisational procedures, MiFID II Investment Firms providing services should;

a) ensure sustainability risks are considered in decision-making procedures, organisational structure, compliance controls, internal reporting, record keeping, and risk management policies and procedures.

b) include clients sustainability preferences in the identification of conflicts of interest

c) provide a description of the sustainability factors considered in the selection process of financial instruments within the investment advice to clients

d) where firms provide financial advice or portfolio management, they must

- a. conduct an assessment of suitability to include how it meets their clients sustainability preferences.
- b. have policies to show they – the firm – understand the sustainability factors of products
- c. include sustainability preferences in reports on suitability of product provided to clients.

In terms of organisational procedures, MiFID II investment firms manufacturing financial products should;

a) identify sustainability-related objectives in its identification of a target market;

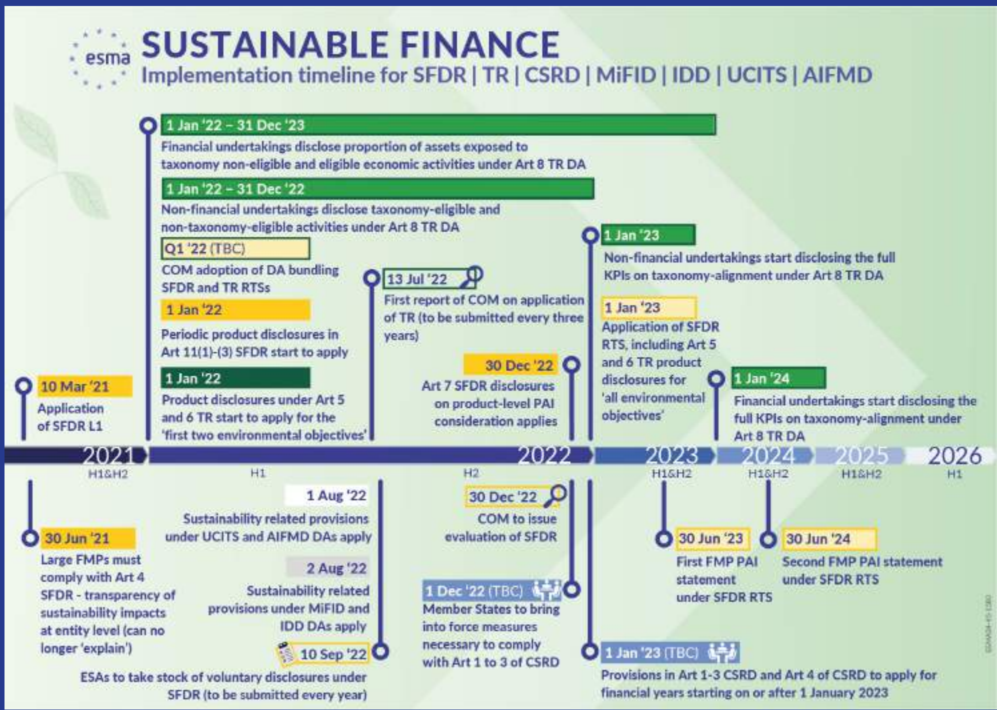
b) ensure the sustainability factors of the product are consistent with target market;

c) display the sustainability factors; and

d) ensure that information on the sustainability factors of investment are transparent and relevant for distributors.

Appendices

ESMA Sustainable Finance Implementation Timeline



Source: ESMA

Appendices

Appendix 2 –
Articles 8 and 9 of SFDR

Articles 8 and 9[39] of the SFDR require more information on how the promotion of environmental and social characteristics are met.

Article 8 products only commit to integrating ESG criteria into the investment process. They promote environmental and/or social characteristics but do not have sustainable investment as their primary objective.

Article 9 products do have sustainable investment as their primary objective and are required by the SFDR to make a positive contribution to at least one sustainability goal and to demonstrate the impact achieved transparently.

Article 9, in particular, requires that where an index has been designated as a reference benchmark, information is provided on how this index is aligned with the sustainable investment objective as well as an explanation as to why and how it differs from a broad market index.

Under Article 8 currently around 20% of all mutual funds are classified as "light green" sustainable investments, while about 5% are classified as "dark green" under Article 9.

However, even this is undergoing a state of flux given the recent energy crisis with Brussels now looking to recognize nuclear power and natural gas as "green" activity despite considerable opposition from many quarters[40].

39 https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en
40 https://static1.squarespace.com/static/5f7709cd633d6220bbee2709/t/61e1939054123e426d5d391a/1642173330735/Taxonomy+CDA+-+ISFC+Reaction.pdf

Appendices

Appendix 3 – United Nations Sustainable Development Goals (SDGs)

Sustainable Development Goals

Source: United Nations

Appendices

Appendix 4 – US Regulation

After the Federal Reserve Bank of Chicago recently released a framework[41] merging climate change risk categories of physical, transition and liability risk with the more traditional means of assessing risk in financial markets — market, credit, liquidity and operational risk — the SEC have also released proposals on climate related disclosures. The proposals require registrants to disclose information regarding governance of climate-related risks and management of those risks; how any climate-related risks could have a material impact on its business in the short, medium or long-term; how these risks may impact business strategy and outlook; and the financial impact of any climate related events. The proposals also include requirements to disclose information relating to greenhouse gas emissions – from direct emissions (Scope 1) to activities within the value chain (Scope 3) if these are material, similar to the Task Force on Climate-Related Financial Disclosures and the Greenhouse Gas Protocol.

Appendix 5 – Rise in Exchange-Based ESG Products

Despite timid debuts, ESG ETFs have grown exponentially over the last few years with, for example at Deutsche Börse Xetra 436 ESG ETFs in October 2021 up from 33 in 2016. Volumes in these securities are also picking up, standing at 16.1% of order book turnover up from 0.3% in 2016 as a growing numbers of liquidity providers commit to supporting the transition by making a market in these new ESG products (see Exhibit 6).

Exhibit 10

ESG ETFs listed on Deutsche Börse Xetra

ESG ETFs listed on Deutsche Börse Xetra	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021 YTD (Oct 2021)**
Number of ESG EFTs	18	33	42	84	149	252	436
% of all Xetra-listed EFTs	1.6%	2.9%	3.5%	6.1%	9.9%	15.6%	25.3%
Assets under management (€ million)	1,300	2,505	4,926	7,390	25,465	80,862	174,586
% of all Xetra-listed EFTs	0.4%	0.6%	0.9%	1.4%	3.6%	10.3%	16.8%
Order book turnover (avg/mth) (€ million)	26	35	69	110	261	1,017	2,656
% of all Xetra-listed EFTs	0.2%	0.3%	0.6%	0.9%	2.5%	6.2%	16.1%

Notes:

ESG ETF classification before 2021 based on individual issuer assessment and own analysis.
ESG EFT classification as of 2021 based on SFDR (Art. 8 and Art. 9).

Data reflects new ESG ETF listings as well as EFT reclassifications due to benchmark changes from non-ESG to ESG indices.

Source: Deutsche Börse

41 https://www.chicagofed.org/publications/chicago-fed-letter/2020/448

Appendices

Appendix 6 –
Current ISO Standards Being Used in Financial Services/Sustainability

ISO 20022 provides a methodology for the creation of financial messages and maintains the ISO 20022 Financial Repository, a publicly available catalogue of messages and central dictionary of business items. ISO 20022 enjoys wide adoption by financial market infrastructures and their communities for the processing of transactions in the areas of payments, securities, credit/debit cards, foreign exchange and trade finance. ISO 20022 is already leveraged in several contexts for the construction and exchange of standardised regulatory reports in the financial industry.

ISO 32220 – Sustainable finance – Basic concepts and key initiatives provides an internationally agreed glossary of terms and definitions to enhance global understanding and coherence. The technical report features a non-exhaustive list of those commonly used in financial markets, intended to guide financial regulators, banks, asset managers, investors, researchers and more.

ISO 17442 – Legal Entity Identifier (LEI). The LEI provides a unique identifier for legal entities, which can be leveraged for identifying parties for ESG activities and reporting.

ISO 20275 – Entity Legal Forms (ELF). The ELF works alongside ISO 17442 for the identification of entity legal forms in a structured way, enabling entities to be classified according to the nature of their legal constitution. Again, this is helpful in the area of ESG-related reporting.

ISO 6166 – International Securities Identification Number (ISIN). The ISIN identifies financial instruments and can be used in connection with the reporting and identification of financial instruments linked to sustainable activities, such as green bonds. The ISIN can be used in conjunction with two further standards; ISO 18774 (FISN) which provides financial instrument short name, and ISO 10962 (CFI code) for classification of financial instruments.

ISO 4914 – The Unique Product Identifier (UPI) is a new standard being published in autumn 2021, for the identification of certain types of derivatives products. This can be relevant with the upcoming move to offer financial derivatives products related to environmental risks and green investing.

About this report

This study has been produced by independent financial services research group Redlap Consulting. It was commissioned by the FIA European Principal Traders Association (FIA EPTA), which represents Europe's leading Principal Trading Firms. Its 24 members are independent market makers and providers of liquidity and risk transfer for end-investors across Europe. FIA EPTA works constructively with policymakers, regulators and other market stakeholders to ensure efficient, resilient and trusted financial markets. To find out more visit www.fia.org/epta

About Redlap Consulting

Redlap consists of a group of experienced industry professionals who have a deep knowledge of capital markets. Using this as the basis of research this enables us to provide detailed and thought-provoking research on the impact of evolving market structure globally.

About the Author

Rebecca Healey
Rebecca is a leading industry voice on market structure, regulatory reform, and financial services technology. Writing research since 2011, Rebecca has authored a plethora of qualitative reports and commentaries covering the impact of market regulation on all asset classes, the impact of the rise of fintech in capital markets, as well as the impact of the move to esg and sustainability in asset management; focusing on how technology can help address current challenges, improving capital markets both for participants and investors.

Rebecca is co-chair for FIX EMEA and a member of the Consultative Working Group (CWG) of ESMA's Secondary Markets Standing Committee. In relation to ESG, Rebecca is co-chair of the FIX Working Group on ESG; Convenor for the ISO/TC 68 Sustainable Finance Advisory Group; a member of ISO TC 68 Strategic Leadership Group and serves on the ISO Technical Management Board committees of Climate Change Coordination Committee (CCCC) and ISO Positioning and Consultation Responses (CCCC-TG 4).

Disclaimer

This document is not investment advice or intended as a recommendation to buy or sell any instrument covered within it.

Although the statements within this document are believed to be correct, they have not been verified by the author and should not be relied upon when considering the merits of any particular investment.

All presented data may be subject to slight variations.

All data and figures are Redlap Consulting internal data unless stated otherwise.

Redlap
consulting