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ESG in 2020: European Themes to Watch

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Climate change definitively entered mainstream public and political debate in 2019.

New EU regulations and green commitments promise progress in boosting investor capital to tackle climate change but a united global commitment to cut carbon emissions remains out of reach.

Alongside regulations, improvements in ESG and climate data and reporting should drive further adoption of ESG and particularly climate change-aware investment approaches across Europe.

Read on for our five ESG themes in 2020.

1. Climate Change Will Drive Asset Allocation

"If we want things to stay as they are, things will have to change"

The quote from Giuseppe Tomasi di Lampedusa's *The Leopard eloquently* describes where the world stands on climate change at the dawn of a new decade.

UN Secretary General António Guterres put it more bluntly at COP25 in Madrid: The "point of no return is no longer over the horizon". The UN climate talks finished with a small measure of success in countries' pledges to cut carbon emissions, but regrettably agreement on carbon emissions trading systems will have to wait until COP26 in Glasgow in November.

Progress has been slow against a backdrop of more extreme and frequent weather events globally. Last year is set to be the hottest on record. Four years on from the Paris Agreement, the concentration of greenhouse gases (GHG) has reached record highs and without action, global temperatures will rise by 3–4°C by 2100, double the threshold set in the Paris Agreement.

In response to the climate change threat, governments globally are committing to net zero carbon emissions. The EU, France and UK parliaments have gone further and declared a "climate emergency".

Incoming president of the European Commission Ursula von der Leyen has announced her arrival with a €100 billion 'Green New Deal' setting out a commitment to carbon-neutrality by 2050, requiring at least a halving of carbon emissions by 2030. In addition to the existing EU emissions trading system, the Green New Deal proposes the introduction of a "carbon border adjustment mechanism" that would penalise imports from countries with less stringent rules in tackling climate change.

In 2020, we will also start to see implementation of the EU's wide-ranging reforms to boost investor capital towards tackling climate change (see theme 2). While the world won't go green overnight, the wheels of change are certainly in motion.

What happens in China (highest total greenhouse gas emissions) and the US (highest per capita emissions) will be critical. China has a mixed record on sustainability with the greatest solar and wind power in the world but also the largest builder of coal plants. As the Chinese economy slows and the trade war with the US drags on, the danger is that China regresses to fossil-fuelled growth. Promisingly, China plans to introduce a carbon emissions trading system in 2020 starting in the power sector.

In the US, the November presidential election will be a critical juncture. President Trump has publicly dismissed man-made climate change as a hoax and will, if successful, pull the US out of the Paris Agreement in November, while several Democratic nominees have proposed green schemes. Rarely has so much been at stake.

The implications for investors are far-reaching. The transition from fossil fuels to renewable energy and the global trend towards decarbonisation is happening at pace and will impact on countries, industries and sectors beyond fossil fuel exporters and the energy sector.

In recognition of the centrality of climate and other ESG risks, credit rating agencies have started to explicitly cite ESG in their assessment of company credit ratings. Entire industries and sectors that are not transitioning to the low-carbon future face possible downgrades.

Carbon Tracker estimates that a quarter of the value of global equity and fixed markets are tied to the fossil fuel value chain. And the UN-backed PRI (Principles for Responsible Investment) warns that up to $2.3 trillion of company valuation could be lost by 2025 because of government policies to tackle climate change, including support for renewable energy, bans on coal and carbon prices.

Our research shows that investors can use techniques to embed climate mitigation and adaptation approaches to their portfolios to achieve climate goals in a risk-efficient manner, and without harming returns. With so much at stake — and so much in the balance — long-term investors will need to keep climate change risk front and centre when formulating investment strategies.

2. Regulation Will Make Sustainable Investing the Norm in Europe

We hear from clients that regulation is a key factor pushing them towards ESG adoption. We predict that incoming EU regulation will be a driving factor shaping investor decision-making around ESG and climate risks in Europe.

To meet the Paris Agreement goals and the UN Sustainable Development Goals, the EU released an 'Action Plan for Financing Sustainable Growth' in 2018. The aim of the new legislation is to incentivise and channel private sector investment into green and sustainable development.

Two new categories of climate benchmarks will be introduced: the EU Climate Transition Benchmark and the Paris-Aligned Benchmark. Benchmark administrators must comply with the new requirements by 30 April 2020.

The EU will also introduce a taxonomy to determine which activities are environmentally sustainable, expected to be implemented in phases over the next two years. An activity must be seen to substantially contribute to one or more environmental objectives, including climate change mitigation and adaptation, transition to a circular economy and pollution prevention and control.

Investment managers will have to disclose information on how they have applied the taxonomy to determine the environmental sustainability of their products. As a result, asset owners will be able to better determine which investment products are truly environmentally sustainable.

The taxonomy is expected to be used for the proposed EU "Green Bond Standard" which the EU hopes will increase issuance and investment in green bonds. It will also be used for the new EU-wide investment fund label, or Ecolabel, expected in November 2020. Funds eligible for the Ecolabel certification must have 70% of overall assets invested in accordance with the EU Taxonomy. Time will tell whether we see existing products being accredited or standards being raised, and whether incentives will be offered for investors that buy in.

Finally, the Disclosure Regulation planned for introduction in 2020 will impose new disclosure requirements concerning how institutional investors and asset managers take sustainability into account in investment processes.

The Action Plan has been supported by the European Insurance and Occupational Pensions Authority which has advised on how sustainability considerations can be integrated into the prudential and conduct framework for insurers, reinsurers and insurance distributors.

The European Securities and Markets Authority has provided similar advice to the European Commission on MiFID II. Under MiFID II, investment firms, institutional investors and assets managers will have to disclose how they integrate sustainability risks in the investment decision-making or advisory process. This should further fuel demand for more comprehensive and transparent ESG reporting (see theme 4).

3. Greenwashing Will be Detected and Penalised

One of the aims of the new European regulations is to disincentivise greenwashing, whereby (predominantly investment) firms give false claims about their, or their product's, ESG credentials. Not only does greenwashing misdirect capital towards activities that are less sustainable than they appear, it also misleads investors, encouraging them to buy products that don't meet their goals and preferences.

As a result, we predict investors will increasingly look beyond simplistic 'ESG' labelling on a fund name and dive deeper into the investment process, the way that ESG data are integrated across asset classes, how screening is implemented, and investment managers' stewardship approach. We predict that an increasing number of market participants will orient themselves towards frameworks such as the PRI.

SCM Direct recently examined Morningstar's classification of 'ethical' funds and holdings on fund platforms and found several ethical funds with exposure to 'sin' stocks, which led to the removal of these products.

At a company level, growing awareness of climate-related risks will also increase the reputational cost of greenwashing. The focus on greenwashing is a consequence of a broader trend towards stakeholder capitalism where companies are deemed responsible not just to shareholders but also to a wider set of stakeholders and the environment.

We expect companies and financial institutions to continue to come under the spotlight with respect to their claims to be 'green' and sustainable. This will likely drive further demand for high-quality and transparent ESG and climate reporting.

To avoid greenwashing, companies will be urged to report on and explain financially material issues, using frameworks such as the Sustainability Accounting Standards Board (SASB).

4. Reporting Needs Will Push Further ESG Adoption

The last two years have seen investors starting to demand evidence of the effectiveness of their ESG investment strategies. Over the coming year, we expect to see increased pressure on companies, their investors and investment management firms to adopt transparent and consistent ESG reporting measures.

Specifically, new EU regulation will stipulate that investors show how climate-related measures are incorporated into their strategy and risk management processes. This will include information on portfolio holdings, investment process, level of ESG adoption and corporate engagement. The work done by the Task Force on Climate-Related Financial Disclosures (TCFD) will also hasten the development and adoption of voluntary and consistent climate-related disclosures and reporting.

These efforts around disclosures will be supported by the work of bodies like the SASB and the GRI (Global Reporting Initiative) that have developed comprehensive reporting standards.

The SASB has identified 26 sustainability-related business issues that are material — that is, likely to significantly affect the financial condition or operating performance of companies within different industries. SASB has been referenced by the TCFD as an appropriate framework by which to fulfil the TCFD recommendations and we believe more and more investors will follow that recommendation.

Companies using such frameworks can better identify, manage and report on material sustainability issues. Investors can make better long-term capital allocation and financial decisions and have a more targeted stewardship approach.

In just the first twelve months since the SASB standards were launched, there has been a significant uptake in the number of investors and companies that publicly support SASB as a framework that can improve the quality of companies' ESG reporting.

5. The ESG Data Conundrum Will Start to Unravel

In a recent survey we conducted of 300 institutional investors globally ('Into the Mainstream'), problems with ESG data and ratings were cited as the main hindering factor in assessing companies and their portfolio-level impact.

This highlights a sea change in how investors view ESG data. A few years ago, investors would generally treat ESG data and ratings as a given, without questioning respective approaches and treating them with the same rigour and objectiveness as credit ratings.

There is now an increasing appreciation that ESG data can lack the transparency and comparability of accounting data and frameworks. To illustrate, the correlation between ESG ratings of different providers has been shown to be far lower than correlation between credit ratings determined by credit rating agencies*.

The lack of standardisation of ESG data poses a challenge because when a certain ESG provider is chosen, investors are effectively buying into the provider's investment philosophy.

The issues surrounding ESG data can also inadvertently encourage greenwashing. Given the vast amount of ESG data from different providers, companies can easily find a good rating and report it.

The challenge is therefore one of consistency — how can investors objectively evaluate ESG ratings amid a multitude of data providers and reporting frameworks, each with their own data sourcing, methodologies, materiality frameworks and objectives?

Looking ahead, we believe investors will increasingly appreciate the challenges with ESG data and will have to evaluate the approaches of different providers. The coalescing of investors around widely accepted frameworks like the previously mentioned SASB will also play a key role in harmonising definitions and standards. This is one of the reasons we created R-Factor™.

We expect the demand for improved reporting to strengthen industry-wide understanding of ESG data and set off a positive feedback loop where reporting and data quality improve in tandem. This will be critical for further ESG adoption.

* Berg, Florian and Kölbel, 'Aggregate Confusion: The Divergence of ESG Ratings', August 2019. MIT Sloan Research Paper No. 5822–19.

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