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Sustainability and Financial Markets: Taxonomy, ESG and Climate Disclosures

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Key Takeaways

- Increasing demand for climate finance and green assets has highlighted the need for a standardized taxonomy, sustainable ESG practices and transparent disclosures.
- A globally standard taxonomy should help investors to compare between investments and make informed decisions regarding their sustainability.
- The trend toward integrating ESG in investment practices should be feasible as well, be it in terms of generating returns or in terms of customer demand.
- Lastly, disclosures should be transparent and material and should reflect climate-related risks and transition plans.

Introduction

Post COP26, there is considerable interest and commitment from the part of the private sector and financial institutions toward climate finance. Certainly, these commitments reflect the soaring demand from investors for green assets. But there is also considerable uncertainty regarding the greenness of such assets, especially in light of allegations related to greenwashing. In this context, a standardized taxonomy, a sustainable ESG practice and the availability of transparent, climate-related financial information should go a long way in helping investors to make informed decisions related to sustainable investments.

Taxonomy Helps To Improve Market Efficiency

Taxonomy is a classification tool that is envisioned to help investors to make informed investment decisions on sustainable economic activities. It could also be considered as a disclosure tool that can be used for regulatory as well as policy purposes. As such, a sustainable taxonomical process should help in the creation of a common sustainability metric system that will allow investors to compare between two funds and make an informed choice regarding their suitability.

China pioneered its first Green Bond Endorsed Projects Catalogue in 2015 and the European Union (EU) published a taxonomy in 2020. Many other financial market regulators are in the process of formulating their own taxonomy. However, with a rising number of taxonomies, each with different disclosure requirements and procedures, investors could get confused and may get burdened with untenable administrative and monitoring requirements.

For most investors, taxonomy in the last instance is all about financial market efficiency. This means, when investors talk about the desirability of better data disclosures, they are seeking a more complete set of information about the potential future risks and opportunities for particular investments.

Standardization of Taxonomy

This does not mean that everybody agrees on the final terms and nature of one global, standardized taxonomy. For instance, in the case of pension accounting, reported assets and liabilities can be quite different based on the standardization protocols adopted, which is why voluntary but universal systems such as the International Financial Reporting Standards are important.

One challenge related to regulations in general is that the framing of regulations reflects national, political and even philosophical biases. Regulators could cooperate very effectively at the regional level and sometimes even at a global level. But since their mandate is national, regulatory decisions tend to be political in nature. One example in this regard relates to nuclear energy and gas. In Europe, for instance, different countries take very different approaches vis-à-vis the perceived safety and greenness of nuclear power and the desirability of gas as a transition fuel.

Given this background, the creation of the International Sustainability Standards Board (ISSB) at COP26 and the consolidation of the Value Reporting Foundation (VRF) and the Climate Disclosure Standards Board (CDSB) are significant steps forward. It is notable that the ISSB is a voluntary methodology that could be adopted to have some statutory recognition in the sense of national regulators authorizing or endorsing their eventual standards. As investors, we think the ISSB is an enormous step forward in the journey to provide comparability and an effective global standard of disclosure.

However, it is also important to remember that such standards are not the only solutions. The cooperation between national and regional regulators should still be continuous. State Street is very supportive of efforts invested toward better data disclosure since this will not only enhance market efficiency, leading to greater confidence, but also result in a transparent cost of capital that faithfully reflects all risks.

Toward a Sustainable ESG Practice

There is increasing awareness around the world that Environmental, Social and Governance (ESG) investments help in addressing environmental challenges such as climate change, biodiversity loss and pollution as well as social challenges such as inequality and gender disparity. However, the big question now is whether this big trend toward ESG centricity could be sustained or not.

Three Levers That Make ESG Sustainable

With regard to sustainability, one could start with considering ESG as an investment opportunity in itself. There has been a lot of discussion about moving from active management to passive indexing, and ESG could be one of those potential levers for active management that could be very effective.

ESG data is quite difficult to gather and is inconsistent. But for assessing companies and sovereigns, it is necessary to adopt a forward-looking lens that is qualitative. That is an area of investment process where asset managers could distinguish themselves and generate alpha. If there is a part of finance that has become more standardized based on fact-based quantitative investing, ESG is the opposite of that, in that it could be considered as more qualitative and eclectic. This in turn should provide many opportunities for superior returns.

Another aspect of sustainability of ESG relates to customer demand, which has indeed been robust across the world. Also, if we take the example of Europe, regulatory developments in the region have driven demand, too. The formation of the Glasgow Financial Alliance for Net Zero is an example of how institutions are getting together to take into account various externalities and opportunities and are demonstrating a willingness to change the way money is managed.

In short, the three important levers that are driving the sustainability of ESG in investment practices are: return opportunity, which could be enormous; customer demand, which is shifting quite rapidly; and policy, which is driving some important enablers such as better data disclosure.

Social Dimension of Investing

The huge amount of capital needed for decarbonization, at about US$3 trillion a year, has a social dimension to it. Particularly in Asia where there are needs that are of a social nature, there needs to be clear criteria when considering social bonds, which was something that the green bond initiative took a long time to get right.

Liquidity is necessary, too, and the green bond market now is over US$3 trillion, which has led to stronger liquidity characteristics. Nonetheless, even if issues related to social bonds are quite small, they could still create liquidity issues.

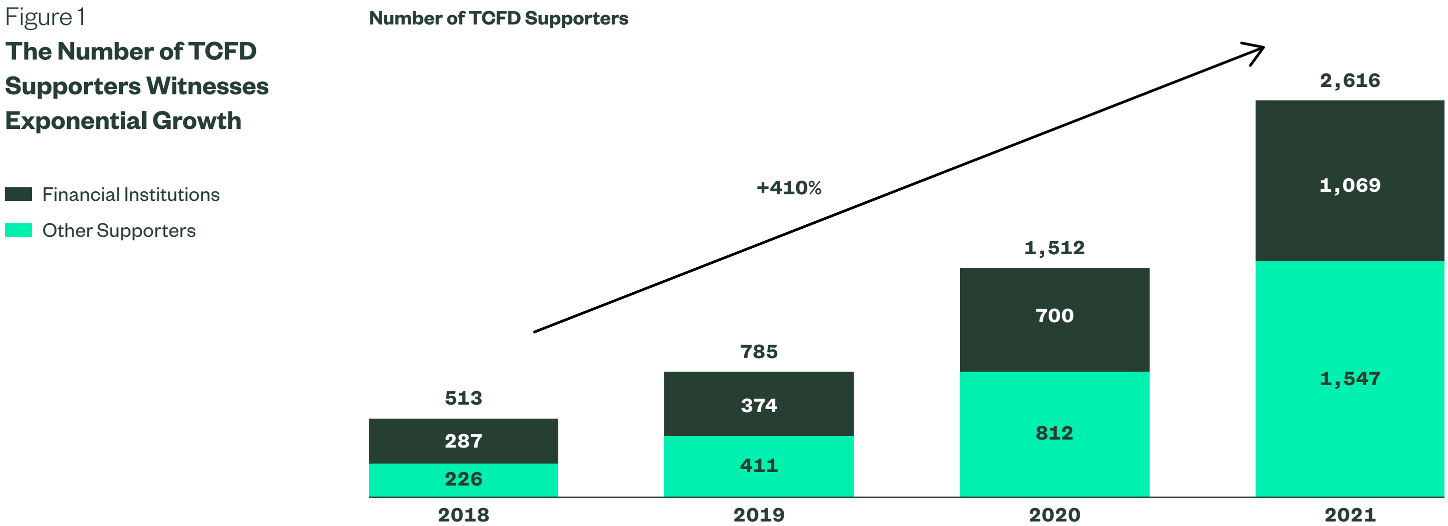
Another point relates to the qualitative nature of certain social metrics. Linked to the United Nations' Sustainable Development Goals (SDG), some qualitative aspects could be improved over time, albeit on an incremental basis. There are many challenges that require financial assistance, but it is important for investors to know that they are creating an impact and there is liquidity and support behind them, especially through supranational institutions such as the Asian Development Bank (ADB). The ADB plays a really important role in translating some of those capital market imperatives into bond issues that eventually find themselves in investor portfolios.

There is a strong appetite, particularly in Europe, for SDG-related investments. To the extent that there is a steady flow of social bonds that are tied to SDGs, there should be a strong appetite for such bonds.

Climate-Related Disclosures Key To Assessing Risks and Opportunities

The Task Force on Climate-Related Financial Disclosures (TCFD) was created by the Financial Stability Board in 2015 to improve and increase reporting of climate-related financial information. Six years later, the investment world has transitioned from considering TCFD as a voluntary disclosure standard to a state where it has become a mandatory and regulatory response to climate risk. The latest EU directives on comprehensive sustainability reporting include climate-related disclosures based on the TCFD. In fact, the number of TCFD supporters has grown exponentially over the last couple of years (Figure 1).

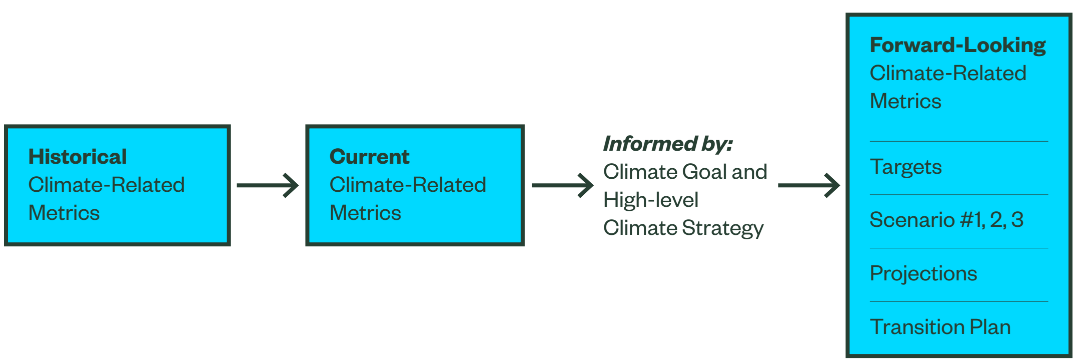
Figure 1
The Number of TCFD Supporters Witnesses Exponential Growth



Source: Task Force on Climate-Related Financial Disclosures, as at October 2021.

At State Street, we recognize the rise of climate-related risks and approach the topic of ESG disclosure with the lens of assessing the risks and opportunities related to various investments. Vis-à-vis the TCFD disclosure, what is pertinent is the focus on material information pertaining to the operations of a company. It is important for corporates to present data that shows they are aware of the risks, can measure it and have a clear risk management process that is carried out throughout the group. It is also important for investors that companies follow the TCFD recommendation on scenario analysis, which should in turn provide important forward-looking information (Figure 2).

Figure 2
TCFD Recommendation on Scenario Analysis



Source: Task Force on Climate-Related Financial Disclosures, as at October 2021.

The Question of Strategy

This leads to the question of strategy, which is important because it gives a sense of where companies are heading toward. Within a strategy, it is vital not just to assess risks but also opportunities. There should be the data and the clarity provided to allow forecasts for what new revenue streams are coming through on the back of climate transition. The strategy should be credible and should involve the most impactful parts of the business. Sometimes this could be captured by Scope 1 and 2 emissions, but in other instances, the supply chain is really the source of emissions and Scope 3 disclosure become necessary.

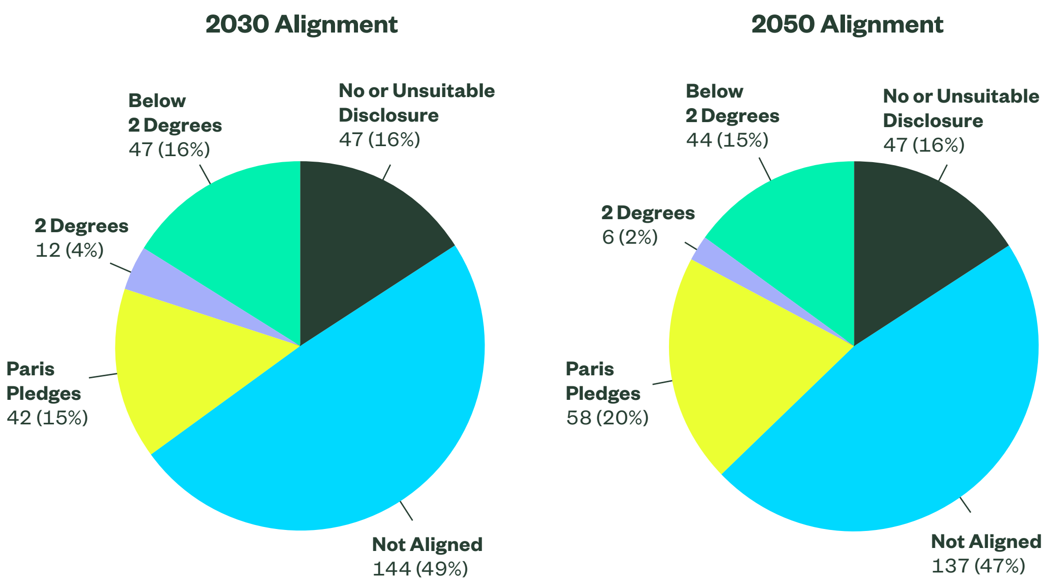
The targets that companies set for themselves should be satisfactorily robust and have short- and long-term perspectives. Clear metrics should be provided, which will enable investors to see how companies are executing against those targets and to assess transition plans. Implementation is very important here and board commitment is necessary, which should be reflected in disclosures. This could be evident in how remuneration is linked to board commitment and also in meaningful key performance indicators that are tied to climate-related risks.

Engagement with corporates on the topic of climate transition should be key to the process. It is necessary to have conversations with management teams on a regular basis where the asset managers' investment process is discussed. State Street's investment process has incorporated very specific climate risks-related factors. State Street's asset stewardship team is also very active with companies in terms of discussing climate disclosures and the endorsement of TCFD disclosures. Since the reporting of climate risk is very uneven, TCFD provides some level of clarity and standardization.

Transparency Generates Greater Investor Interest

According to the Transition Pathway Initiative that publishes the "State of Transition" reports, almost half of the companies surveyed are still not aligned in their carbon emissions pathway with the Paris Agreement Goals, and 16% either do not have disclosures or have unsuitable disclosures (Figure 3).

Figure 3
Number and Percentage of Surveyed Companies Aligned With the Paris Agreement Goals



Note: 401 companies from 16 business sectors are covered by the TPI State of Transition Report 2021. Source: TPI State of Transition Report 2021.

These companies face a headwind with investor engagement where sustainability is considered an important input in the investment process. Inevitably, the companies that disclose comprehensive climate transition information demonstrate that they have identified the risks, have assessed the impacts, have a mitigating strategy in place and are executing on that strategy. It is in such companies that investors and markets are willing to allocate more capital.

Adopting TCFD disclosures could also mean lower cost for capital going forward, which should allow corporates to not only have access to more capital but also have a competitive advantage versus peers who are not transparent enough or have not executed on the implementation of their climate transition strategy.

Conclusion

The demand for climate-related financing and ESG products has exploded significantly over the past year. There has been greater awareness among investors regarding sustainability practices as well, which has accentuated the need for greater standardization of classification systems and an increase in the transparency of disclosures. A sustainable finance taxonomy would not only enhance market efficiency but also allow investors to make informed decisions when faced with a choice of competing financial products.

As far as the financial industry itself is concerned, ESG has become central to addressing some of the most vital environmental and social challenges faced by the world today. This means, it is important for an investment process that adopts ESG to remain sustainable. One way to ensure this is to focus on the qualitative aspects of ESG, which could be an area of investment process where assets managers could distinguish themselves by generating alpha and superior returns.

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 30 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's fourth-largest asset manager* with US $4.14 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of December 31, 2021 and includes approximately $61.43 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.