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# Eurosif Report 2021

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# Foreword

## From Eurosif President and Executive Director

We are only weeks away from the 26<sup>th</sup> UN Climate Change Conference of Parties (COP) and just finishing the 15<sup>th</sup> meeting of the Conference of the Parties to the Convention on Biological Diversity. Sustainability it seems has never been higher on the global agenda of decision makers.

Yet, in August 2021, the Intergovernmental Panel on Climate Change (IPCC) report resonated as a “Code Red for Humanity”. Scientists stated that even in the best scenarios the objectives of the Paris Agreement may very soon be out of reach. The human-induced increase in the global temperature is likely to reach 1.5°C by 2040, well before 2050. In the current market conditions, we are still on a +3°C trajectory that will result in severe threats to biodiversity and human communities all over the world.

In May, the International Energy Agency (IEA) released its Net-Zero 2050 Roadmap, detailing the enormity of the challenge in meeting the climate objectives, the investments required and more importantly the policy and regulatory changes and behavioral changes required.

However, despite Sustainable and Responsible Investments (SRI) having expanded significantly in the last few years, **the State of our Planet is still deteriorating**. Scientific research repeatedly shows that we are nowhere near reversing negative sustainability impacts, be it on the climate and biodiversity front. Therefore, **more than ever, investors need to refocus their efforts on where they can generate positive environmental and social outcomes**. As recent academic research is showing, investors have valuable tools to generate ‘investor impact’ by influencing corporate behaviour through engagement and stewardship and redirecting capital towards sustainable businesses and projects. It is now time to refocus those tools on their primary purpose to achieve positive outcomes in the businesses and real-world.

Since the Paris Agreement in 2015, the financial industry has gradually embraced sustainable finance. Private finance needs to be leveraged and complement public finance to meet investment needs. Financial markets will not be shielded from the physical and transition risks linked to climate change. And investors have a key role to play in transitioning the real economy towards a climate-neutral and more inclusive model of growth, consistent with the Paris Agreement and the UN SDGs. Therefore, investors have increasingly integrated sustainability as part of their investment processes and in line with their fiduciary duty. By integrating environmental, social, and governance (ESG) considerations in their investment decisions, they aim at both mitigating risks and enhancing long-term return.

In recent years, **the European Union has positioned itself as the world leader in promoting a vision of sustainable finance**, pushing for concrete policy actions and regulatory frameworks through its Action Plan on Financing Sustainable Growth, and more recently with the Strategy for Financing the Transition to a Sustainable Economy. The EU institutions and the EU Sustainable Finance Platform have made relentless efforts to conceive and implement a set of regulations that promote transparency and common definitions on sustainability, within the European single market and beyond. The EU sustainable finance agenda,

with the EU Taxonomy, the SFDR and the Paris-Aligned Benchmarks, represents the world's leading standard for financial market participants to address the challenges of climate change and social inequalities.

**Eurosif believe we must increasingly look at the EU sustainable finance agenda through the prism of investor impact.** We now need to fully unlock the potential and the transformative power of capital markets and close the investment gap to achieve net-zero and the SDGs.

This **2021 Eurosif Report** seeks to shift the narrative of the EU sustainable finance agenda by focusing on how investors can achieve positive outcomes in the real world. The analysis of the existing tools and regulatory initiatives has the objective to verify whether they are adequate to enable and enhance investor impact.

**The policy recommendations resulting from this analysis are intended as food for thought for policymakers, practitioners and all other stakeholders.** Eurosif will continue to engage with European policymakers, stakeholders and civil society to ensure that the EU sustainable finance agenda and the various pieces of legislations work and deliver on the policy objectives of reorienting capital flows towards sustainable investments while tackling risks of greenwashing.

**While investors have their role to play, they cannot walk all alone on the road to net-zero.** A strong collaboration between investors and policymakers is essential to tackle the sustainability challenges. Currently, the European Union is expected to require €28 trillion of structural investments between now and 2050 to achieve carbon neutrality. Yet half of these investments currently do not have a business case, with the consequence that they cannot be purely financed with private capital. It is time to move beyond transparency and disclosure, and to recognise that, to be a success, sustainable finance needs to be complemented with policies to incorporate and price negative externalities and unlock appropriate incentives for both companies and investors. Furthermore, effective public-private-partnerships frameworks will also be important to reduce the risk associated with sustainable projects and attract long-term investors.

As the President of the European Commission Ursula von der Leyen recently said: "Europe has become the home of sustainable investment". Both companies and investors have a strong will and an extraordinary potential to build a new, carbon neutral and more inclusive model of growth. To be up to this challenge, they need to work side by side. Innovative sustainability solutions need financial resources to be implemented and scaled-up. Investors are seeking long-term and reliable projects to finance, with the ambition to generate value for the environment and their social communities, alongside financial returns.

The decisive challenge in the coming years will be to find ways to link these ambitions. Eurosif, in collaboration with the national Sustainable Investment Fora (SIFs), is ready to take its part and to welcome and collaborate with all the stakeholders that are willing to work towards achieving this objective.



**Will Oulton**  
President of Eurosif



**Victor van Hoorn**  
Executive Director  
of Eurosif

# Foreword

From Stefan Kreuzkamp,  
Member of the Executive Board at DWS Group,  
Head of Investment Division & Global CIO

The ninth Eurosif SRI report provides highly useful insights into the role investors can play on the path to sustainability, which is especially relevant considering current regulatory and market developments.

Since March 2021, Level 1 of Sustainable Finance Disclosure Regulation (SFDR)<sup>1</sup> has already been binding for financial market participants. But the wider economy and society will continue to evolve as sustainability remains one of the most pivotal topics of this decade.

Within this context, we must reflect on the role that finance can play in shifting towards a more sustainable economic model.

Already in 2015, EU policymakers clearly articulated that the required shift towards sustainability could not be financed by public means alone. SFDR has taken a broad perspective on sustainability, evoking a change within financial market participants regarding product classification, disclosure, ESG data usage, double materiality and engagement. Below are elements that might further shape such development.

## 1) Market for SRI

The past years have commercially been favorable for ESG, both in terms of performance and growth in assets. Various reports have emphasized in 2021 the growing number of investment products<sup>2</sup> classified under Article 8 "light green" or Article 9 "dark green" of SFDR.

The interpretation of SFDR as a new classification system has attracted some controversies<sup>3</sup>, which is to be expected when such a new and important standard is introduced. While the trend towards classifying products as sustainable is likely to continue, investors will need to credibly demonstrate through action that they are delivering towards the new classification system showcasing that an effective ESG integration is in place and the relevant information on how promoted ESG characteristics are met in the Level 2 implementation of SFDR is disclosed.

## 2) SRI strategies and the role of engagement

Exclusionary screening was, in the past, the most dominant mechanism of SRI strategies in Europe. While exclusion of investees must remain an important option, investors need to step-up engagement with investees to achieve positive change.

This has also been addressed, as SFDR calls for a disclosure of policies on the integration of sustainability risks - including engagement policies<sup>4</sup>. While SFDR has never been intended to be a labelling scheme for products, it provides useful tools for investors, among others

1 Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability related disclosures in the financial services sector

2 See Morningstar research report (2021) "SFDR: Four Months After Its Introduction" at <https://bit.ly/3aoT6z7>

3 <https://www.reuters.com/business/sustainable-business/fifty-shades-green-eu-sustainable-fund-rules-muddy-waters-2021-08-19/>

4 With reference to Shareholder Rights Directive

the definition and quantification of principal adverse sustainability impacts<sup>5</sup>. As a result, investors should use these tools and evaluate each company individually and have a direct dialogue with the aim to evoke ESG change. Still the debate has evolved and it recognizes that a transition to a more sustainable model goes through working with most sectors within the real economy. Each sector will certainly have leaders and laggards. Engaging with these laggards could possibly result in an otherwise unobtainable sustainable impact by enabling a de-risking of these ESG laggards.

### 3) Disclosure and data on sustainability

Irrespective which SRI strategy investors use, data is needed to formalize binding ESG elements into an investment strategy. Recent academic debate has centred around "aggregate confusion"<sup>6</sup> regarding ESG ratings, but assessments of non-financial information are not as clear-cut as assessments of financial data. Simply put, sustainability is very complex. To start with, one could look just at the risks that the sustainability debate is having on its own expected return, which is very different from looking at it both from a society and financial return perspective. How well investors can choose the share of SRI<sup>7</sup> depends on the quality of corporate disclosure. The problem is that there is no such standard yet. Sustainability disclosure still lags behind financial data quality. While EU Ecolabels, Corporate Sustainability Reporting Directive (CSRD) or SFDR clearly go into the right direction, they could turn out too restrictive and improving disclosure takes time. Therefore, the current transparency and disclosure regimes, such as SFDR, should be assessed, and adjusted accordingly to market trends, as outlined in this report.

In conclusion, capital can play a role in ensuring that we move towards a more sustainable path. Regulation is and will continue to change, disclosure will change. We collectively need to deliver on what is required to ensure that more capital is allocated towards a more sustainable economic model. It was warned that "the ecological footprint of humanity far exceeds the capacity of the earth's biosphere to sustain it"<sup>8</sup>, hereby clearly underlining that the economy must change, and that investors can act as *one* driver of that change. We are still at the beginning of our path to a more sustainable future. So, what can investors do to achieve a tectonic shift towards that future?



**Stefan Kreuzkamp**

Member of the Executive Board at DWS Group,  
Head of Investment Division & Global CIO

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- 5 These are negative, material or likely to be material effects on sustainability factors that are caused, compounded by or directly linked to investment decisions and advice performed by the legal entity
- 6 Florian Berg, Julian F Köbel and Roberto Rigobon, Aggregate Confusion: The Divergence of ESG Ratings, Massachusetts Institute of Technology (MIT) - Sloan School of Management, 18 May 2020: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3438533](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533)
- 7 Defined by e.g. Taxonomy Regulation or Article 2 (17) of SFDR
- 8 See pp. 138 in "The Economics of Biodiversity: The Dasgupta Review" (2021) at <https://bit.ly/3v3DkDm>



# Executive summary

## Eurosif recommendations to policymakers and practitioners to enhance investor impact

Despite a stellar growth of sustainable and responsible investments (SRI) and sustainability-related initiatives in the last few years, science is telling us that the State of the Earth is deteriorating (Chapter 1).

Hence, investors and policymakers must ensure the effectiveness of current and future SRI strategies and regulations to achieve positive outcomes in the real world.

Investors can address the sustainability challenges of the biosphere only through the companies they invest in, by using three levers: i) shareholder engagement; ii) focussing on how to fund ventures, companies and underfunded projects that are key for the transition; iii) and sending market signals to companies.

After having analysed strengths and limitations of each mechanism (Chapter 2), and having conducted a thorough analysis of the current EU sustainable finance agenda (Chapter 3), Eurosif put forward the following recommendations which are spelled out in more details in Chapter 4.

### **To policymakers**

**Strengthening the stewardship and engagement framework to focus on outcomes by revising the Shareholder Rights Directive II** – The revision envisaged in the Renewed Sustainable Finance Strategy should move beyond the ‘comply-or-explain approach’ and mandate disclosure of engagement policies and activities, including a clear description of: i) the targets pursued; ii) the tools to monitor and evaluate the outcomes; iii) the actions to tackle the unsatisfactory initiatives.

**Ensure the market gets clarity on SRI products by re-examining the SFDR** – The current transparency-oriented formulation of the regulation has opened the door to dissonating interpretations among financial market participants. As such, far clearer guidance on the characteristics of the different categories of sustainable products (Article 8 and Article 9) is required to convey straightforward market signals, and we would support the EU considering a formal review of SFDR in the next several years. This function could be taken up by the still-negotiated EU Ecolabel, if the ambition of environmental requirements is tempered by the need to allow a sufficient uptake of the label.

**Streamline the EU Taxonomy so as it becomes a tool to reorient capital** – Policy and regulatory measures should render the Taxonomy the tool that was initially conceived by policymakers: a factor for capital allocation decisions. This function can only be carried out if the criteria remain science-based, and clear distinction is maintained between: i) economic activities fully compatible with environmental objectives; ii) activities that are transitioning; and iii) activities that are necessary for the transition in other sectors.

**Create a CSRD enhancing net-zero pledges and triggering corporate transition plans** – In the framework currently being negotiated by policymakers, companies that commit to climate neutrality should be required to disclose: i) the base-year scenario and its assumptions; ii) explanations for why publicly available scenarios are not adequate, if not used; iii) interim targets and objectives before 2050; iv) sectoral decarbonisation pathways used; and v) explanation of why and how carbon offsetting is justified to decarbonise certain activities. This could complement and build on the reporting under Article 8 of the Taxonomy on capital expenditures.

**Expand the collaboration with private actors on strategic projects** – Considering the need to internalise 90% of unaccounted carbon costs by 2050, governments and their public banks are expected to design and foster Public-Private Partnerships (PPPs) and blended finance schemes. Those frameworks are necessary to de-risk and lower the upfront costs of the gigantic projects that are required to transition the real economy away from fossil fuels.

**Price negative climate, environmental and social externalities** – While politically and diplomatically sensitive, this step is a real game-changer to send decisive signals to companies and financial markets by making harmful investments more expensive and sustainable investments more competitive (for example through a carbon pricing mechanism).

#### **To financial market participants**

**Send clear, directional market signals through capital allocation** – Financial market participants should refocus their investment strategies and tools to achieve positive outcomes in the real world: that repurposing exercise would allow them to improve their efficacy to convey strong market signals. For instance, an assumption for efficient SRI strategies is that overweighting low-impact sectors is not conducive to concrete impact. On the contrary, capital needs to continue to be allocated to certain high-emitting sectors whose transition is vital to meet the objective of the Paris Climate Agreement.

**Use the EU Climate Benchmarks and the EU Taxonomy to engage with companies** – Investors embracing decarbonisation objectives should use the EU Climate Benchmarks and the technical screening criteria of the EU Taxonomy to engage with the investee companies. Those tools could serve as a shared vocabulary for the targets that companies must meet to remain compatible with the portfolio decarbonisation pathways.

**Improve the engagement and stewardship activities by applying an outcome-oriented approach** – To improve their capacity to achieve impacts in the investee companies, investors should i) set clear, science-based targets; ii) monitor and evaluate the outcomes; and iii) plan specific actions to address insufficient or disappointing responses.

**Engage with European policymakers on the EU Green Deal and the Fit-for-55 Package** – As we expand in the report, engagement with companies has limits and it needs to be complemented and extended with engagement by investors with policymakers on public policy impacting the industries in which these companies operate. By establishing strong and efficient relations with policymakers, financial market participants should ensure that the direction of such policies end up creating the right incentives in the sectors where decarbonisation is most urgently needed. Within those discussions, investors should also explain concretely how they can contribute to financing these decarbonisation efforts.

• **Enhance the collaboration with public actors on strategic projects** – SRI investors should play a pivotal role in upgrading and scaling-up critical technologies by bringing capitals and technical expertise in PPPs and blended finance projects. The main objective will be to de-risk investments necessary to the decarbonisation of certain economic sectors to ensure these investments have attractive risk-return profiles for private investors.

## Introduction

Sustainable finance is increasing its share of the market, but is it increasing its impact? The need for a new mindset

**Sustainable & Responsible Investment (SRI) has undergone a dramatic evolution in Europe since the EU's Action Plan on Financing Sustainable Growth was published in 2018. The EU's mammoth regulatory initiative represented the first concerted effort to bring a degree of standardisation and transparency to the market for sustainable investments.**

**T**he EU's regulatory intervention was partly triggered by a recognition that investments promoted as sustainable were increasingly popular among investors. While highly positive, the increasing interest in sustainable investments, and the simultaneous growth in sustainable investment offerings heightened the risk of greenwashing considerably. Accordingly, clear **legal definitions** and greater **transparency** were needed to ensure that sustainability-related claims could be substantiated. Through instruments such as the **EU Taxonomy** and the **Sustainable Finance Disclosure Regulation (SFDR)** the EU has started to clearly define what qualifies as sustainable and to introduce elaborate **disclosure requirements for financial institutions and the products they offer**. The implementation of the new requirements is now underway and will be a catalyst for further evolution as the market gradually adapts to the new regulatory regime.

### What do we mean by Sustainable & Responsible Investment (SRI) in this report?

Eurosif defines Sustainable & Responsible Investment as: "a **long-term** oriented investment approach that integrates **Environmental, Social & Governance (ESG)** factors in the research, analysis and selection process of securities within an investment portfolio. It **combines fundamental analysis and engagement** with an evaluation of ESG factors in order to better capture long term returns for investors, and **to benefit society by influencing the behaviour of companies**".

For its part, the financial sector in Europe, and globally, has assumed a more prominent role in addressing environmental and social challenges in response to growing societal expectations. In recent years, the expectation that financial institutions generally, and **sustainable investors in particular, should be part of the solution to sustainability challenges** has become deeply embedded. Accordingly, financial institutions have gradually integrated consideration of sustainability into the investment process. Sustainability risks have increasingly been recognised as material to long-term portfolio returns and to financial stability at a systemic level. Asset managers in particular have steadily embraced sustainability so as to assure better risk management and reflect the ESG preferences of their clients in investment portfolios.

The potential of investors to have a positive impact through investing in economic activities beneficial to the environment and society has long been assumed. By reorienting capital towards sustainable activities, the conventional wisdom has it, a broader transition towards sustainability will be precipitated in the real-economy. However, while appealing, this notion belies the fact that significant **shareholder engagement** on the part of investors is required to **encourage and assist investee companies to improve their environmental and social performance**. Accordingly, a broader perspective is needed to account for the importance of direct shareholder engagement and both regulation and industry practice should be optimised for the purposes of engagement.

As we will outline in **Chapter 1**, environmental and social challenges are growing more severe. Climate change is accelerating, driven by a continually rising global temperature; biodiversity loss is occurring at an unprecedented rate, and socio-economic disparities have increased. In the words of the UN Secretary-General António Guterres in December 2020, **“the state of the planet is broken”**<sup>1</sup>. Moreover, while environmental challenges are more easily quantifiable, social challenges across the globe will likely become more apparent as the physical implications of climate change start to manifest. Accordingly, despite investors' continuous efforts to integrate sustainability considerations into their investment process the deterioration of the planet's ecological systems has continued unabated. This reality

confronts the sustainable investment industry with an awkward question: **Why has the surge in sustainable investments not translated into positive environmental and social outcomes?**

If an SRI investor's primary objective is to be effective in addressing sustainability challenges, as opposed to simply aligning their portfolio with favourable ESG criteria, then a course correction in terms of our thinking and practice is urgently needed<sup>2</sup>. As a result, a growing number of SRI investors are **starting to consider how their investment practices could achieve real-world impact**.

At this juncture the question that presents itself is: **How can investors have an impact through the companies in which they invest?** Upon an analysis of the current state of the market it quickly emerges that, in addition to efforts by investors, **public policies are also necessary** to alter current market dynamics in favour of sustainable investments. We will explore this further in **Chapter 2**.

In the aftermath of the Paris Agreement, Europe took the lead in efforts to mobilise the financial sector to address environmental and social challenges. The 2018 Action Plan, as well as the regulations that followed, are steadily defining what sustainable investment means in Europe. However, practitioners have begun to realise that **transparency is not sufficient to reorient large-scale capital flows towards transition nor to instigate the changes in corporate practice necessary to the transition**. More will be required in terms of public policy to influence the capital allocation of investors. In **Chapter 3** we will analyse current sustainable finance regulations from the perspective of investor impact and try to grasp whether they are fit for purpose.

Finally, this report puts forward a **set of recommendations for policymakers and practitioners**. The aim is to shift the trajectory of sustainable finance by re-defining the role investors can play in achieving positive environmental and social outcomes. **Sustainable investments can be a driver of transformative change in the real economy**. From this perspective on sustainable investments, Eurosif and national Sustainable Investment Fora (SIFs), together with European policymakers and other stakeholders, want to set the direction for the SRI industry for the next decade.

1 Address by UN Secretary-General at the Columbia University on 2 December 2020, entitled “The State of the Planet”, available at <https://bit.ly/3AxAEyT>

2 For more insights on the debate on sustainable investing and different investor objectives and practices, see also Heeb and Kölbel's (2021) Responsible Investor article at <https://bit.ly/2YIzKTg>



## Chapter 1

# Sustainable investors in the real world: what are the sustainability challenges?

**T**he current SRI narrative focuses primarily on the need to mitigate financial risks associated with climate change and the optimization of financial returns, thus overlooking the tension between economic growth and ecological boundaries observable in the real world. As warned in the 2021 Dasgupta Review, the ecological footprint of humanity far exceeds the capacity of the earth's biosphere to sustain it<sup>3</sup>. **Despite the significant acceleration of sustainable investments in recent years, the state of the Earth** – of which climate, biodiversity and social wellbeing are part – **continues to deteriorate**. This casts doubt as to the real-economy impact of the SRI industry.

To reverse this trend and remain within the limits of the Earth system, human activities must undergo a radical transformation. As sustainable investments are meant to achieve sustainability objectives in the real world, investors should concentrate their efforts on **supporting the transformation of the real economy**, and measure their success in terms of positive environmental and social outcomes in addition to financial returns.

By briefly examining the current situation of the Earth system, this Chapter is meant to demonstrate why the real economy has to change, and how the SRI investors can act as a herald of that change.

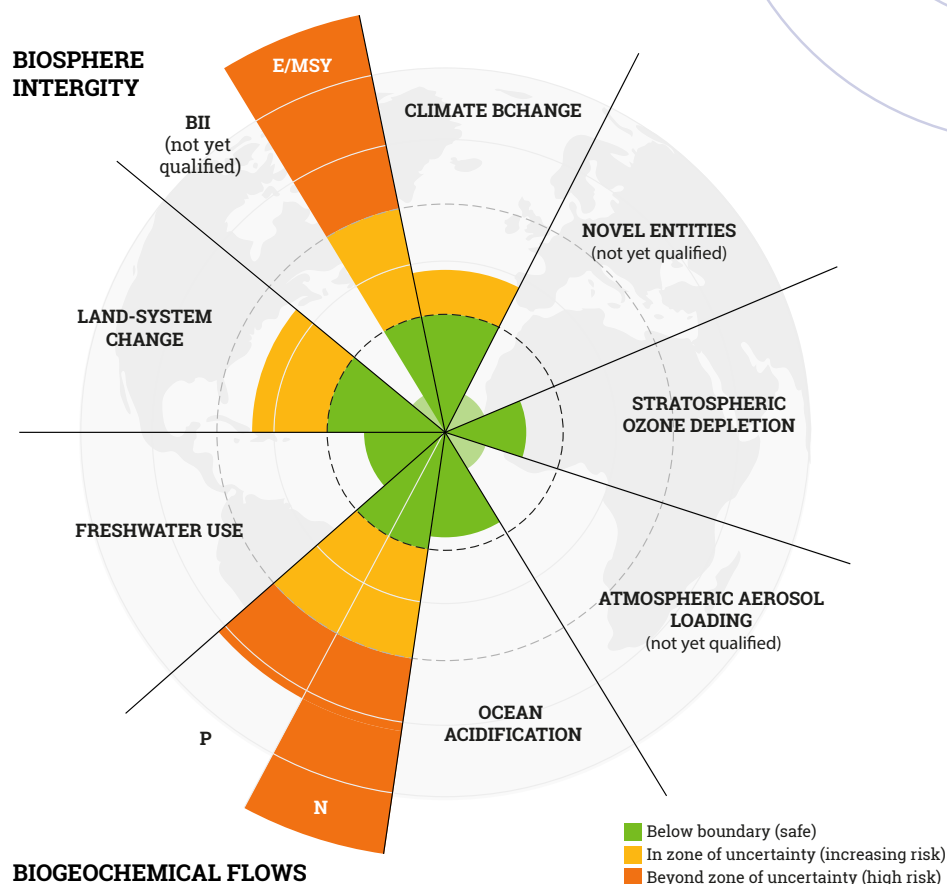
### Planetary boundaries and a warming planet

The **planetary boundaries**, a concept developed at the Stockholm Resilience Centre (SRC), offers a science-based analytical framework to illustrate why and how humanity should stay within the natural limits imposed by the planet. The scientists at the SRC identified nine processes that regulate the stability and resilience of the Earth system<sup>4</sup>. For each of these processes, the scientists set quantitative boundaries that human activities should not exceed so as to prosper sustainably and avert irreparable damage to the planet's ecology. According to the SRC's analysis, four out of nine processes – climate change, biosphere integrity, land system change and biogeochemical flows – are at an increasing or high risk of exceeding those planetary boundaries, which would cause abrupt, irreversible, and devastating changes in the Earth system (Figure 1)<sup>5</sup>.

<sup>3</sup> See p. 138 in "The Economics of Biodiversity: The Dasgupta Review" (2021) at <https://bit.ly/3v3DkDm>

<sup>4</sup> The nine boundaries are: (1) climate change; (2) change in biosphere integrity (driven by biodiversity loss); (3) stratospheric ozone depletion; (4) ocean acidification; (5) biogeochemical flows; (6) land system change; (7) freshwater use; (8) atmospheric aerosol loading; and (9) introduction of novel entities. For further information see <https://bit.ly/3Aw6Kec>

<sup>5</sup> See also Joint EEA/FOEN Report (2020) "Is Europe living within the limits of our planet? An assessment of Europe's environmental footprints in relation to planetary boundaries" at <https://bit.ly/3aufUxc>



**Figure 1 - Planetary boundaries**

Source: J. Lokrantz/Azote based on Steffen et al. 2015

Moreover, these nine processes are interrelated to varying degrees with climate change, biosphere integrity, land system changes and biogeochemical flows all being interdependent. For instance, biodiversity increases the adaptability and the resilience of ecosystems to temperature rise and natural hazards, but it is declining at an unprecedented rate due to deforestation and overgrazing<sup>6</sup>. Scientists warn that there are one million threatened or endangered species out of an estimated total of eight million<sup>7</sup>. Overgrazing and intensive agriculture that rely on agricultural fertilisers release high levels of phosphorus and nitrogen into the biosphere, resulting in acid rain, the greenhouse effect, and degradation of aquatic ecosystems when those chemical elements leak into the oceans<sup>8</sup>. Still further, water scarcity, droughts and extreme weather events accelerate the disappearance of crop varieties<sup>9</sup>.

Inevitably, pre-existing social and regional inequalities mean the social costs of the **Earth system's deterioration will be unevenly distributed**. Climate change will affect less developed regions of the world more severely, as well as the most vulnerable social groups. By way of example, if the sea level rises by 0.5 meter by 2050 alone, the houses of 800 million people living in 570 coastal cities will be threatened<sup>10</sup>. Climate-induced extreme weather events, water scarcity and crop failure will drive further displacement of people, particularly in Sub-Saharan Africa, South Asia and Latin America<sup>11</sup>.

6 Humans have already caused the loss of 83% of wild plant and animal species, despite its marginal representation of 0.01% of all living things by weight. For further information see article by Quinney (2020) at <https://bit.ly/3iR2TCm>

7 See IPBES (2019) "The global assessment report on biodiversity and ecosystem services - Summary for Policymakers" at <https://bit.ly/3lvArIq>

8 Human activity converts about 120 million tons of nitrogen from the atmosphere into reactive form and mines 20 million tons of phosphorus, most of which is used to produce agricultural fertilizers. See also Rockström et al. (2009) "A safe operating space for humanity" at <https://www.nature.com/articles/461472a>

9 See Food and Agriculture Organization of the United Nations (FAO) at <http://www.fao.org/3/y5609e/y5609e02.htm>

10 See also Muggah (2019) at <https://bit.ly/3DpR5yW>

11 The World Meteorological Organization estimates that 23.1 million people have already been displaced on average every year during the period of 2010-2019. See "State of the Global Climate 2020" at <https://bit.ly/3mH4uvY>

In August 2021 the 6th Assessment Report of the Intergovernmental Panel on Climate Change (IPCC)<sup>12</sup> confirmed that it is scientifically unequivocal that global warming and associated natural phenomena are predominantly human-induced. The report further highlighted that the effects of the changing climate are increasingly visible and affecting every region across the globe<sup>13</sup>. Still further, it is highly probable that the Paris Agreement targets (limiting the increase in global temperature to 1.5 degrees Celsius by 2040) will be beyond reach even if the most optimistic emission scenarios are achieved (Figure 2)<sup>14</sup>.

In view of the growing demand for coal and natural gas – which together account for two-thirds of total global GHG emissions – and continuing financial support in G7 countries for the fossil fuel sector<sup>15</sup>, the world is **heading for a temperature rise of more than 3 degrees Celsius of pre-industrial levels by 2050 at the current rate**<sup>16</sup>.

However, a concerted effort could still redeem the situation and reverse some of the damage: significant and sustained reductions in emissions of carbon dioxide (CO<sub>2</sub>) and other greenhouse (GHG) gases would limit global warming and its concomitant negative environmental effects.

## Call for far-reaching actions: changes to our consumption and production patterns

Scientific evidence underlines **that transitioning the real economy towards a more sustainable model of growth is an absolute necessity**. Transition is needed to bring human activity back within the limits of the planetary boundaries – into what the SRC refers to as the **“safe operating space”**.

At a global level, the human activities that generate the majority of GHG emissions are: cement, steel and plastic production (31%), producing and using electricity (27%), agriculture and farming (19%), transportation via planes, trucks and cargo ships (16%) and heating, cooling and refrigerating (7%)<sup>17</sup>.

Transitioning the real economy will require implementing radical solutions within these sectors; to reduce, offset and negate the GHG emissions that they produce, in addition to other negative environmental and social externalities. Most of the changes require a **complete rethinking of existing production processes**, and consideration of how to make them circular, resource-efficient, and both economically and environmentally viable in the long-term. In some cases, entirely new solutions or alternatives will have to be found. For example, the production of three essential and ubiquitous materials – concrete, steel, and plastic – produce one third of GHG emissions. In many cases, notably concrete, there is as of yet no clear climate-friendly solution with no alternative means of producing concrete without considerable CO<sub>2</sub> emissions that is both practicable and scalable.

**Massive investment, both public and private, will be needed** to orchestrate such a fundamental and ambitious transformation of the real-economy. This process will witness entire sectors undergo radical change, others may disappear entirely as new sectors emerge. Accordingly, strong political leadership and careful strategic planning will be required to ensure a just and orderly transition.

12 IPCC (2021) Sixth Assessment Report: The Physical Science Basis at <https://www.ipcc.ch/report/ar6/wg1>

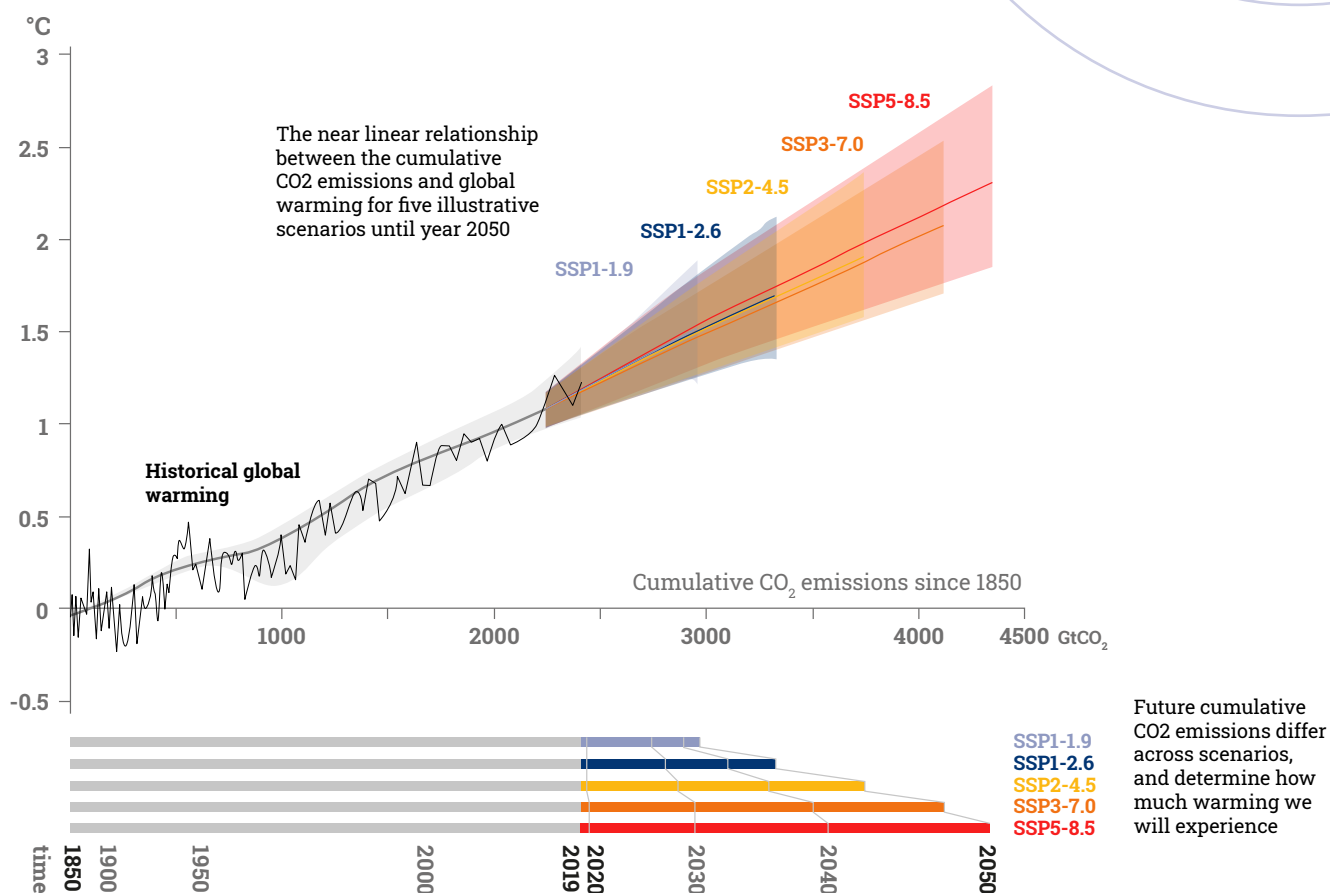
13 Such as an intensified water cycle, changes in rainfall patterns, more frequent extreme sea level events, loss of seasonal snow covers and melting of ice, alterations in the equilibrium of the oceans, damages in the urban areas.

14 Even under the very low GHG emissions scenario global surface temperature averaged over 2081–2100 is very likely to be higher by 1.0°C to 1.8°C. Under the very high GHG emissions scenario it is likely to be by 3.3°C to 5.7°C higher.

15 According to Oil Change International (2021), the G7 nations provided an average of \$86 billion in international public finance for fossil fuels compared to \$21 billion for clean energy between 2017 and 2019; see <https://bit.ly/3Fyq6Df>. The UK has a new policy since March 2021 to halt immediately new finance for fossil fuel projects overseas.

16 See UN Environment Programme Emissions Gap Report 2020 at <https://www.unep.org/emissions-gap-report-2020>. Additionally, major G7 index benchmarks such as FTSE 100, S&P 500, SPTSX 60 and NIKKEI 225 are all on the course of 3.0°C+ pathways, overshooting the 2015 Paris Agreement; see Responsible Investor article at <https://bit.ly/3lvLy3H>

17 Gates (2021) “How to avoid a climate disaster. The solutions we have. The breakthrough we need”, Penguin Books Ltd.



**Figure 2 - Due to the linear relationship between cumulative CO<sub>2</sub> emissions and global temperature, all scenarios suggest a 1.5°C increase by 2040**

Source: IPCC (2021) Sixth Assessment Report

Note: SSP1-1.9 (very low GHG emission scenario); SSP1-2.6 (low scenario); SSP2-4.5 (intermediate scenario); SSP3-7.0 (high scenario); SSP5-8.5 (very high scenario)

Strong political leadership is all the more essential as the **transition will be expensive and politically challenging**. That said, the cost of inaction would be even higher. According to the results of climate stress testing concluded by the European Central Bank (ECB) in September 2021, by the end of the century more frequent and severe natural disasters could result in the EU economy contracting by as much as 10% if no new policies are introduced to mitigate climate change. By comparison, the costs of transition would not exceed 2% of GDP<sup>18</sup>.

SRI investors can be part of the solution and share the burden of orchestrating the transition with public authorities. To do so, SRI investors can harness their influence over investee companies to improve their environmental and social performance. In addition, SRI investors can directly finance projects or companies that will create a more sustainable economic model. As we will discuss in the next chapter, SRI investors can achieve real impact through shareholder engagement with investee companies and through the funding of capital-constrained companies and underfunded projects. Collectively, SRI investors may also be able to influence capital allocation by sending market signals that favour sustainable investments.

18 See ECB's (2021) Economy-wide climate stress test at <https://bit.ly/2YJPjN>



## How to ensure regulatory compliance for the integration of sustainability risks and detecting new opportunities

*A contribution by our Sponsor Universal Investment*

**ESG regulation is growing in complexity. For investors, identifying potential ESG issues related to their investments and classifying them in a comparable manner across asset classes and investment vehicles is becoming crucial. Moving on from current approaches to ESG reporting, real-time analysis is one way to integrate sustainability risks and identify opportunities in order to make impactful investments.**

According to ECB data, private and institutional investors across the European Union and England have invested a total of 13.6 trillion euros in investment funds. Germany is the largest market for UCITS and AIFs, with assets of 3.2 trillion euros. This corresponds to a share of 23 percent of the European market.

Against the backdrop of increasing regulation in the ESG sector, it is becoming more and more important for institutional investors to maintain a precise overview of their investments. However, conflicting ESG ratings and a host of different approaches to scoring a company or an investment on environmental, social and governance criteria make it difficult for investors to compare results. On top of this, institutional investors, such as pension funds, also need to be able to provide documentary evidence that their investment approach and implementation are in accordance with their statutes and their stakeholder's wishes.

This is where Universal-Investment steps in as a fund service platform and Super Management Company. Universal-Investment's ESG reporting allows for comparisons to be made, for example across different fund vehicles. As a full-service partner, Universal-Investment offers institutional investors and asset managers efficient administration as well as solutions for structuring their funds, securities and alternative investments, complemented by state-of-the-art risk management. A capital management company that purely specialises in the administration of special assets, the so-called Master-KVG is independent and can connect specialised asset managers and advisors. The Master-KVG is able to implement sustainability criteria in all asset classes, from securities to alternatives to real estate. Universal-Investment acts as a responsible trustee and since innovation has always been part of the company's DNA, Universal-Investment takes the lead on issues that affect its clients, such as the integration of sustainability risks.

### **Sustainability risks – the framework**

"Sustainability risk" is defined as an environmental, social or governance event or condition that if it occurs could have a negative material impact on the value of an investment. Sustainability risks are not defined as a new risk category, rather as a factor of existing risk types, like credit risk, market (price) risk, operational risk, strategic risk or reputational risk. This is due to the nature of sustainability which impacts have already been taken into account in the past by implicitly considering material risk factors when assessing a potential investment. Sustainability risks can be divided into physical risks and transition risks. Physical risks arise, for instance, as a result of climate change and environmental conditions like heatwaves, storms or other extreme weather events that may directly affect companies' operations. Transition risks may arise as a result of the transition to a low-carbon economy when, for example, emission certificates that may be crucial for a company's operations become more expensive due to scarcity. If these sustainability risks materialise, they have a significant effect on existing risk types. For example, if a pension fund is invested in companies whose operations might be affected by regulatory changes, these investments might become so-called stranded assets that suffer unexpected declines in value.

### Accounting for sustainability risks in investment decisions

Integrating sustainability risks into investment decisions is of growing importance to investors as the European Union's Sustainable Finance Disclosure Regulation (SFDR) obliges all European funds to disclose whether and how sustainability risks are taken into account in investment decision-making processes. For Germany, the Federal Financial Supervisory Authority (German: Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)) has published the "Guidance Notice on Dealing with Sustainability Risks", underlining that consideration of sustainability risks should be integral to previously mentioned risk types.

Revisions to other European regulations, such as UCITS and AIFMD, make it necessary to integrate sustainability risks into governance structures of financial market participants. However, so far, no reliable standards for this integration have been established, leaving market participants facing severe problems putting this regulation into action.

### News-based ESG Scores as one way to tackle sustainability risks but also identify potential opportunities

As European and national regulators push for greater transparency and accountability in the integration of sustainability risks, market participants are looking for possible ways to integrate sustainability risks into already existing risk models, stress tests and scenario analysis. To be able to react fast when sustainability risks materialise, an in-depth analysis and assessment of environmental, social or governance factors needs to be accessible.

With this in mind, the Innovation Management and ESG-Office of Universal-Investment, together with Berlin-based start-up YUKKA Lab, have developed an approach that makes sustainability risks more measurable and comparable. Events in the news around a company are being scanned using a cutting-edge natural language processing technology that tracks public mood about that company or a particular topic. This analysis is then used to calculate an overall news-based ESG Score. This Score gives a real-time indication of the company's media presence related to relevant positive or negative ESG events, which can be translated into potential risks as well as opportunities. The ability to drill down on specific news articles, makes the score easy to understand and shows the news behind it.

The tool detects expected and unexpected events, and their participants, in the news in real time, starting from an event cluster which is being used to identify areas of potential risk and opportunities in the three sustainability fields: Environment, Social and Governance. The analysis of the semantic structure of a sentence, identifies participants in the event, learns new linguistic expressions and is paired with ontology in order to understand related entities. The engine uses Natural Language Processing (NLP), a subfield of artificial intelligence which aims to understand human language and extract and interpret information. The sentiment analysis identifies emotional statements and classifies terms on a semantic approach as positive, negative or neutral.

### Transforming unstructured data into actionable scores

Once the individual events are identified and classified, they can be fed into an ESG risk-scoring model that converts unstructured real-time news data into actionable scores by applying weighting and persistence for each event. Such scoring models can be iteratively evaluated and gradually improved to fine-tune its calibration and increase its accuracy, either based on statistical approaches or, if suitable, on neural networks.

This approach can be used as a building block for assessing sustainability risks. It offers the advantage that it is faster than the services of established ESG data providers because the sentiment analysis is based on real-time data, while traditional ESG reporting tends to use past data and only takes current developments into account with a delay. From an investor's point of view, time is essential to ensure that their investments are compliant with their own statutes as well as with an increasingly complex regulatory landscape.

Next to the risk perspective the tool can potentially outline the sustainable footprint of a company. Not only in ways of static ESG ratings but rather in detecting companies endeavours towards a more sustainable economy and society. Especially companies with a current more negative ESG reputation can be assessed in their potential transition towards more responsible and impactful business activities. This can help to identify potential investment opportunities early on by analysing which companies are ready to change or even already moving to become more sustainable in the future.

Whilst not neglecting analysis and reporting of traditional data, for Universal-Investment, News-based ESG Scoring is an important step towards the integration of sustainability risks and the recognition of potential investment opportunities. The cooperation with YUKKA LAB is a great example of how to facilitate networking between players, create transparency and establish reliable standards for an industry that evolves at a fast pace – contributing to shaping the future of the investment management industry.

## Chapter 2

# How can SRI investors achieve positive impact in the real world?

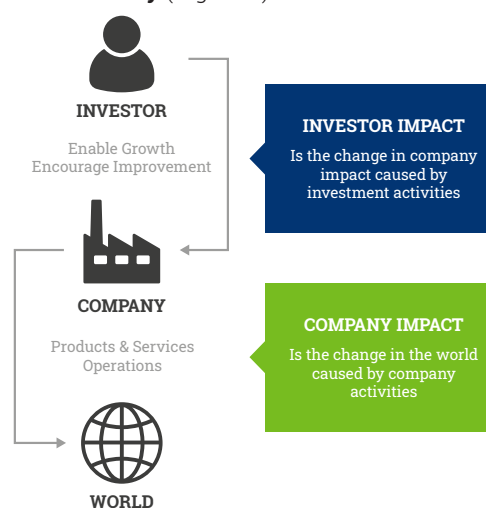
**Using the concept of investor impact we aim to shed light on the strategies that enable investors to support the transition of the real economy towards an environmentally and socially sustainable model of growth. As such, “investor impact” is the means by which the financial sector can contribute to ensuring that human activity becomes more sustainable and thereby remains within the natural limits imposed by our planetary boundaries, as described in the previous Chapter.**

**T**he concept of “investor impact” is not new to SRI investors<sup>19</sup>. However, it is important to avoid confusion with the concept of “impact investing” which refers to “investments made into companies, organisations, and funds with the intention to generate social and environmental impact alongside a financial return”<sup>20</sup>. For example, investors could have a positive impact by supporting the transformation of production patterns in such a way as to reduce GHG emissions – thereby limiting global warming. This Chapter examines how and to what extent SRI investors can play such a role.

### Investor impact: what it means and how it can be achieved

**Investors can have positive real-world impacts only through the companies they invest in.** Julian Kölbl, Florian Heeb and researchers at the University of Zürich offer a theoretical basis to understand investor impact, as distinct from the impact of companies. Based on a literature review of impact in an investment context and corroborated with the International Finance Corporation (IFC)'s 2019 Operating

Principles for Impact Management<sup>21</sup>, the researchers define investor impact as “the change that investor activity achieves in company impact”. In other words, it is **the investor’s ability to change the impact that companies have on the real economy** (Figure 3)<sup>22</sup>.



**Figure 3 - What is investor impact?**

Source: Kölbl and Heeb (2020) “The Investor’s Guide to Impact”

19 The Impact Management Project (IMP), for example, funded by foundations and financial groups globally, groups 16 standard-setting organisations including OECD, PRI, UNEP, CDP, GIIN, CDSB, GRI over 2000 practitioners to work together to build global consensus on measuring, assessing, and reporting impacts; see <https://impactmanagementproject.com/>. The Eurosif SRI Study 2018 also looks at “impact investing” as a growing strategy, albeit small (€108.6 billion in 2017), to channel finance to the social economy and social enterprises which seek to improve civic interests and local development; see <https://www.eurosif.org/sri-study-2018/>

20 Definition from the Global Impact Investing Network (GIIN), see <https://thegiin.org/impact-investing/>

21 Investors should not only define the intention of impacts (Principle 1), but also establish and document a credible narrative on its contribution to the achievement of impact (Principle 3); see <https://www.impactprinciples.org/9-principles>

22 See Kölbl, Heeb, Paetzold, and Busch (2020) “Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact” at <https://bit.ly/3BACwly>

As the researchers point out, there are two ways to change the impact of a company operations: either improve the company's ESG practices or enable sustainable companies to grow. The former entails providing sufficient incentives for companies to improve their ESG performance, and the latter is about funding and/or improving access to finance of established or prospective sustainable companies. After a systematic analysis of the academic literature and interviews with industry practitioners and regulators, three mechanisms for investor impact can be identified:

i) shareholder engagement; ii) funding of capital-constrained companies and underfunded projects that are key for the transition; and, finally, iii) sending market signals.

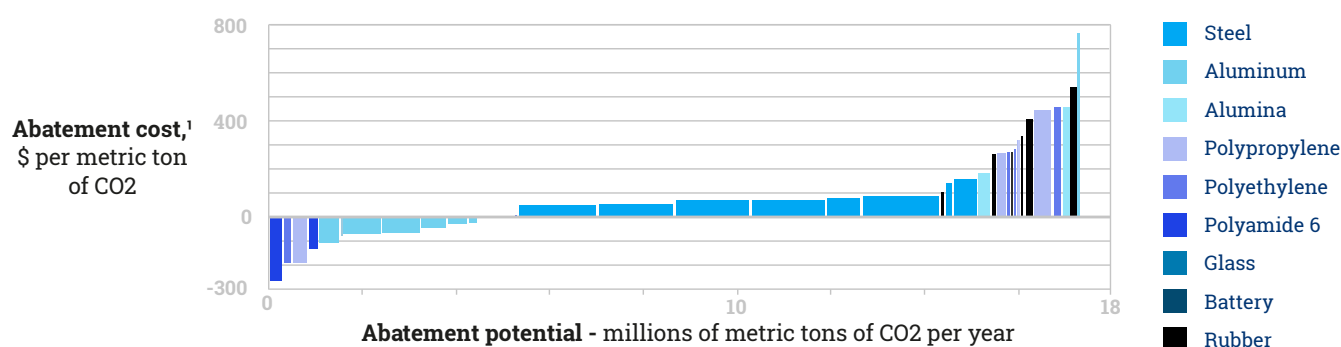
### Shareholder engagement

Shareholder engagement is **the most reliable, empirically proven mechanism by which to realise improvements in corporate ESG practices**, such as reductions in GHG emission in the value chain, decommissioning or decarbonising the activities that cause significant harm to climate mitigation, or improving the energy efficiency and circularity of production processes. The impact potential of an engagement strategy is higher when the investor holds a significant amount of shares and builds strong relationships with the management of the target company. Moreover, the engagement strategy tends to be more effective when the investor is a large, internationally well-known, and motivated active shareowner with cultural affinity with the investee company<sup>23</sup>. Further research confirms that the success rate increases when collaborative engagements are led by a domestic investor and supported by international investors<sup>24</sup>. Moreover, engagement is fundamental for big investors that commit to net-zero, in order to retain a proper level of portfolio diversification.

### The limits of shareholders engagement

Through shareholder engagement investors can request and obtain meaningful changes in investee companies that improve the ESG performance of the latter. However, the effectiveness of shareholder engagement requires certain market conditions according to which **both the investor and the company have appropriate incentives to request and implement the necessary changes**, respectively. Companies will not commit to changes that would significantly reduce their profits, expose them to excessive risks, or negatively affect their competitiveness. Likewise, it is not always in the interest of investors to request changes that, if implemented, might undermine the profitability of the investee companies and with it the value of their investment<sup>25</sup>. **Therefore, despite the best intentions of the companies and/or their investors, the necessary changes may not occur.**

This dynamic is particularly relevant with respect to achieving progress on decarbonisation which is highly demanding. For instance, the cost of the carbon abatement curve is so high that companies are often discouraged from adopting emission reduction plans to achieve net-zero. A recent analysis by McKinsey<sup>26</sup> on **the carbon abatement cost curve for the full value chain of a European automotive player shows that less than 25% of the path to net-zero is positive net present value** (Figure 4): for the companies in the sample eliminating the upstream emissions would reduce profits by around €1 billion. This condition undermines the willingness of investors to engage on climate mitigation<sup>27</sup>.



<sup>1</sup>Internal-combustion-engine vehicle, all carbon-reduction levers, 2030 estimate. Source: McKinsey analysis

**Figure 4 - The cost of decarbonisation for a European automotive player**

Source: McKinsey (2021)

<sup>23</sup> See Heeb and Kölbel (2020) "The Investor's Guide to Impact" at <https://bit.ly/3lCpLYt>

<sup>24</sup> See Dimson, Karakaş and Li. (2018) "Coordinated Engagements" at <https://bit.ly/2X22XHT>

<sup>25</sup> Literature informs that a reform request involving costly reorganisation and environmental compliance is less likely than manageable governance improvement. See Barko, Cremers and Renneboog (2017) "Shareholder engagement on environmental, social, governance performance" at <https://bit.ly/3DwdfzD>

<sup>26</sup> See McKinsey article (2021) "Net zero or bust: Beating the abatement cost curve for growth" at <https://mck.co/3lxyrPg>

<sup>27</sup> See Azizuddin's Responsible Investor article (2021) "US execs not convinced Net Zero is commercially viable, finds Standard Chartered" at <https://bit.ly/3mKy0Rn>

Therefore – as further explored in this Chapter – investors should also start to engage with policymakers on the need for effective public policies that price negative externalities (e.g. a carbon price) thereby creating appropriate incentives for companies and investors to adopt decarbonisation pathways. Public policy measures – such as an effective carbon price – will **ensure a level playing field** for all the companies in the market. With the appropriate market conditions in place, shareholder engagement could be rendered more impactful and could trigger further improvements in the practices of individual target companies.

Finally, difficulty in holding the Board accountable for the long-term commitments, such as net-zero pledges, is another limitation of the transformative potential of shareholder engagement (see also Chapter 3).

### Funding of capital-constrained companies and underfunded projects

Many enterprises are motivated by a desire to have a positive impact on the environment and society. For example, companies operating in the renewable and clean energy sector emerged with the express goal to contribute to climate change mitigation.

Many such enterprises are prospective sustainable companies. However, when first established or at an early stage they often lack the necessary financial resources to realise their ambitions. This is particularly the case where such companies wish to develop, deploy and/or scale innovative new technologies. Such companies could be described as capital-constrained as their potential is limited by a lack of financing. **SRI investors can achieve impact in the real world in relation to these companies by providing much needed funding**<sup>28</sup>. According to Bloomberg NEF, in 2020 investors allocated more than \$500 billion into energy-transition-related companies, twice as much as in 2010<sup>29</sup>.

This often occurs through capital allocation in primary markets, where securities are issued. Capital allocation of this sort is typically observed in the **private market**, as private equity investors and venture capitalists have the required risk-tolerance to fund Research & Development projects, start-ups in breakthrough low-carbon technologies and infrastructure projects<sup>30</sup>.

This **practice can be particularly relevant in emerging markets**, where growing populations and expanding economies require a massive deployment of clean energy and new infrastructures, but in which local companies are often underfunded.

*Limits to the opportunity of funding capital-constrained companies and underfunded projects*

**However, a strong performance in terms of sustainability is not sufficient in and of itself to result in a positive investment decision. Merely qualifying as green or socially sustainable does not automatically make an investment a sound one.** Accordingly, companies may be capital constrained for good reason and investors may have legitimate concerns regarding the level of debt, the business plan or commercial management of the company.

Market conditions also play a significant role in the evaluation of investment opportunities. Interestingly, McKinsey estimates that nearly half of the **€28 trillion investments necessary to transition key sectors to net-zero by 2050 – power, transportation, buildings, industry, agriculture, and infrastructure – are not profitable** in the current market and policy context<sup>31</sup>.

28 See Cravo and Piza (2016) "The impact of business support services for small and medium enterprises on firm performance in low- and middle-income countries: A meta-analysis" at <https://bit.ly/3ly2CX3>. Brest and Born (2013) argue that private investors with distinctive knowledge about the risk and potential social and financial returns of a particular opportunity of nascent companies can have investor impact without having concessions on return, while being concessionary by providing non-monetary impacts such as dispatching human resources and providing training and expertise; see "Unpacking the impact in impact investing" at <https://bit.ly/3Au5GHF>. In the view of Brest, Gilson, and Wolfson (2018) additional due diligence and monitoring costs for private investors investing in these smaller companies entail concessions; see <https://bit.ly/3oRLvkX>

29 For further data and single experiences see article by The Economist (2021) at <https://econ.st/3lvlcYP>

30 See Ameli, Dessens, Winning et al. (2021) "Higher cost of finance exacerbates a climate investment trap in developing economies" at <https://www.nature.com/articles/s41467-021-24305-3>

31 According to a McKinsey report (2020), there is a fundamental deficiency of positive business cases to invest in key transition sectors. In industry sector, 95% of potential investment capitals lack positive business cases, 85% in buildings, 85%; 46% in power, 36% in transportation and 11% in agriculture; see <https://mck.co/3v35ZbF>

## Sending market signals

Investors in secondary markets can send signals as to their investment preferences by stipulating ESG criteria that determine or influence their capital allocation decisions. In turn, assuming there is a degree of consensus among market participants as to what ESG criteria are most highly valued, market signals could be generated collectively through differentiated capital allocation.

These market signals could then incentivise companies to improve their ESG performance accordingly so as to remain eligible for investment.

This lever works as an **improvement in the financing conditions of companies**: investors' choices about buying and selling securities influence the prices of assets. These changes in the prices of assets raise or lower the cost of capital of the issuers<sup>32</sup>. According to this view, the decisions made by ESG funds when buying and selling securities in secondary market will render it easier or more difficult for companies to attract funding in the primary market. In theory, this mechanism has the potential to trigger collective changes in the ESG practices of companies.

### Limits to the effectiveness of market signals

The growth of ESG funds, accompanied by a proliferation of ESG ratings, benchmarks, and other tools, already reflects the interest that investors have in the ESG performance of companies. Many investors also clearly convey their ESG preferences to the market. In a sense, this already provides a signal to the market that a high value is placed on strong ESG performance at company level. However, whether such signals are clear enough and whether they result in improved financing conditions for more sustainability is still not validated by compelling empirical evidence<sup>33</sup>.

Indeed, the findings by Kölbel et al. (2020) suggest buying and selling by investors in the secondary markets has a marginal effect on improving corporate practices<sup>34</sup>. Other recent studies, although producing results that cannot be generalised, show that the effect of sustainability-related funds is limited to share and bond price movements<sup>35</sup>.

In order for clear market signals to materialise and influence the reallocation of capital, **investors should act**

**in unison, using the same ESG criteria**. EDHEC Business School-Scientific Beta research on funds tracking climate benchmarks revealed that climate indicators were decisive only in 12% of the differences in stock weighting, as opposed to market capitalisation, which drove 88% of the differences in weights. As researchers pointed out, "climate strategies, just like business-as-usual strategies, are mostly influenced by the market capitalisation of stocks. The climate score plays second fiddle at best". The researchers also found that on average around 35% of the stocks with deteriorating climate scores were subsequently overweighted in the analysed portfolios. Those evidences suggest that the ESG strategies available on the market currently convey discrepant and blurred market signals<sup>36</sup>.

In addition to this, ESG benchmarks should have effective **allocation constraints requiring SRI investors to continue investing in high-emitting sectors** but favouring emitters that achieve better progress in the decarbonisation process. Otherwise, investors would simply underweight high-intensive sectors and prefer low-impact sectors, as indicated by recent research. Excluding high-emitting sectors entirely would weaken the potential of market signals, as big emitters would not be incentivised to decarbonise.

As in the case of the previous two investor impact levers, these conditions would arise provided the **appropriate market incentives** were in place to support low-carbon activities and penalise harmful activities.

Finally, while the pressure on companies to measure and report their ESG performances increasing, **ESG ratings** often fail to provide companies with guidance as to how they should alter their practices so as to improve their ESG performance<sup>37</sup>. This is due to several reasons, including the wide **variety of methodologies employed by ESG ratings providers**, which often result in the same companies receiving divergent evaluations depending on the provider. Moreover, as will be discussed further in Chapter 3, the methodologies used by ESG ratings providers are not sufficiently transparent and they mainly focus on ESG risks as opposed to ESG performance. As a result, a high ESG evaluation can mean that the company is well hedged against ESG risks, but it reveals little about the company's environmental or societal impact.

32 Studies evidence that underweighting non-sustainable companies leads to higher cost of capital for these companies, resulting in less investment activities and a market share decline. As shown by a MSCI study (2020), lowest-ESG-scored companies faced significantly higher cost of capital than the highest-ESG-scored companies, with a minor regional difference; see <https://bit.ly/3Fvz18B> as well as Beltratti (2005) "Capital market equilibrium with externalities, production and heterogeneous agents" at <https://bit.ly/3mZP32b>

33 The same MSCI study (see above) is inconclusive on the point that the highest ESG score companies enjoy the lowest cost of capital. The European and Japanese data show that the highest-ESG-scored companies are not associated with the lowest cost of capital.

34 See Kölbel, Heeb, Paetzold, and Busch (2020) "Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact" at <https://bit.ly/3BACwly>

35 A Greenpeace study on ESG funds in Switzerland and Luxembourg, conducted by Inrate (2021), reveals that sustainability funds when compared to conventional funds hardly improved carbon intensity and exposure to harmful activities. Moreover, after controlling the benchmark types (sustainability vs. conventional), exclusions and best-in-class approaches had no significant effect on carbon intensity and ESG impact scores; see <https://bit.ly/3tLtNT>. A study by 2°Investing Initiative (2021) on French sustainability-related retail funds also found that 69% of environmental claims are unclear as to the aspect of the financial product that is supposed to generate the environmental impact; see <https://bit.ly/30goBcN>

36 See EDHEC-Scientific Beta Research website and research at <https://bit.ly/3mJM900>

37 Chatterji et al conclude that the effect of ESG ratings on changing behaviours of rated companies is limited; see Chatterji, Durand, Levine, and Touboul (2016) "Do ratings of firms converge? Implications for managers, investors and strategy researchers" at <https://onlinelibrary.wiley.com/doi/10.1002/smj.2407>

## The importance of public policies and public-private partnerships to create appropriate market incentives

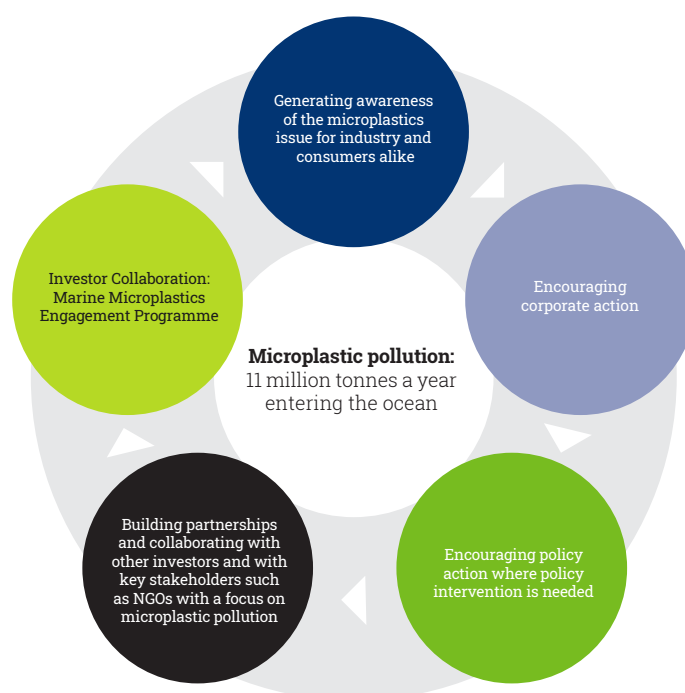
In the previous section we demonstrated that the three investor impact levers are, individually, insufficient to ensure a reorientation of capital towards sustainable activities and companies. As illustrated, there are significant barriers to sustainable investments that limit the potential of investors to achieve real impact. Accordingly, investors are increasingly conscious that public policies and public financing tools will be required to render sustainable investments more viable by altering market conditions in such a way as to penalise investments or activities associated with negative externalities and de-risk certain sustainable investments.

In this section, we will analyse how investors can engage with governments and policymakers to bring about the market conditions necessary to unlock capital for sustainable investments. According to our analysis, there are two principal ways in which investors can contribute to altering market dynamics in favour of sustainable investments: i) advocating for public policies that render

climate neutrality and decarbonisation economically viable; ii) partnering with public financial actors, via Public Private Partnerships (PPPs) and blended finance projects to ensure adequate financing to sustainable projects.

### Public policy advocacy

SRI investors should advocate for the introduction of public policies that alter the business environment to incentivise transition and mitigate the competitive dynamics of the market that often put sustainable investments at a disadvantage. The **pricing of negative externalities** whereby companies would incur higher costs for a poor ESG performance is the most obvious means of triggering transition at company level<sup>38</sup>. Through **combined engagement with both corporates and policymakers**, investors gain an additional lever to minimize the negative impacts and/or improve the positive impacts of companies on the environment and society<sup>39</sup>. For instance, the First Sentier MUFG Sustainable Investment Institute has identified a sequence of actions to enable investors to tackle the issue of microplastic pollution. This process involves engaging directly with the companies producing and consuming microplastics on one hand, as well as with policymakers on the other (Figure 5)<sup>40</sup>.



**Figure 5 - Engagement actions for investors: microplastics**

Source: Eurosif based on First Sentier MUFG Sustainable Investment Institute's report on microplastic pollution

38 For example, Ian Simm, CEO of Impax Asset Management shares his view in LinkedIn (9 July 2021), "engaging with policymakers and regulators (...) is at the heart of the essential, rapid transition to an economy with a stable climate. (...) Governments can accelerate the development of such (low carbon) markets through policy interventions, particularly carbon pricing, product standards and support for market development. Academic literature also supports this. Quigley (2020) argues that pension funds, insurance companies, university endowments and sovereign wealth funds, who cannot diversify away from systemic risks like climate change, inequality, pandemics, should focus on strategic engagement with public policy and standard-setting regimes to alter companies' fundamental strategies. "Universal Ownership in Practice: A Practical Investment Framework for Asset Owners" at <https://ssrn.com/abstract=3638217>

39 The recent Freshfields Bruckhaus Deringer report "A Legal Framework for Impact" also recognises an essential role for collective policy engagement, next to stewardship, in the public market; see <https://bit.ly/3Fzkc1f>

40 In a recent report (2021), the First Sentier MUFG Investment Institute addresses the issue of microplastic pollution, considering specific contributions that can be made by investors to mitigate microplastic pollution; see <https://bit.ly/3oVIIqT>

Public policy advocacy will play a particularly fundamental role in reaching net-zero by 2050<sup>41</sup>. Currently half of the investments in Europe necessary to achieve net-zero in key sectors are unprofitable<sup>42</sup>. For those investments, it would defy economic logic and financial sense to insist the company achieve net-zero given the implied costs.

To improve this situation, investors should advocate for public policy interventions, such as: **carbon pricing** (e.g. by putting a price on the GHG emissions incorporated in goods; or creating and tightening cap-and-trade systems across all industries or in specific sectors); **setting GHG emission targets** for high-emitting sectors within pre-determined timeframes; **introducing sales and tax incentives** to stimulate sustainable market segments. These public policy measures should aim to make environmentally unsustainable practices at company level economically and commercially unsustainable also while reducing the costs and risks associated with sustainable investments.

As discussed further in this section, **direct public financing** will also be key to financing the development of new technologies, and to scaling-up new business models. Direct public financing reassures private investors by lowering the financial risks associated with large-scale or innovative investment projects (e.g., infrastructure). Such public interventions would **introduce the appropriate market incentives** essential to redirect the flow of capital towards transitioning companies and sustainable projects.

The package of legislative proposals adopted by the EU Commission in July 2021, the **"Fit-for-55 Package"** moves in the right direction. Among other measures, the Package has proposed intermediary GHG emission reduction targets for high-emitting industries, including specific targets for the use of renewable energy; a proposal for tightening the 2030 emission reduction target of the EU Emission Trading Scheme (ETS); a proposal for establishing a carbon border adjustment mechanism (CBAM) for cement, iron, steel, aluminium, fertilisers, and electricity, that will price importers' direct emissions from the production process and discourage carbon leakage<sup>43</sup>.

The "Fit-for-55 Package" is thus a positive step – envisaging many of the public interventions necessary to alter market dynamics in favour of sustainable investments and demonstrating that public authorities are increasingly cognisant of the need to price negative externalities. Accordingly, it is an opportune time to initiate public policy engagement to ensure these regulations give the right incentives and signals to these sectors to decarbonise. Several market-led initiatives already involving public policy engagement in some form.

- For instance, the **Net-Zero Asset Owners Alliance (NZAOA)** embeds three priority policy engagement targets in its 2025 Target Setting Protocol: 1) embedding net-zero by 2050 in the post-COVID economic recovery, National Determined Contributions (NDCs) and national emission reduction plans, with a clear commitment to a just transition; 2) sector policies (real economy and financial sector) to promote transition; and 3) promotion of mandatory climate reporting and transition plans<sup>44</sup>.
- Ahead of the 2021 G7 meeting, the **Alliance of CEO Climate Leaders'** open letter<sup>45</sup> demanded mandatory decarbonisation targets for all businesses, the elimination of fossil fuel subsidies, tariff reduction for climate-friendly goods and increased support for R&D funding in green technologies<sup>46</sup>.
- Finally, the **Investor Agenda** includes "Public policy advocacy" as part of its four-focus-area strategy<sup>47</sup>. In a statement intended for the world leaders gathered at the COP26, the founding partners list essential public policy actions, including the support for private investments in zero-emissions solutions and ambitious pre-2030 action through: "robust carbon pricing, the removal of fossil fuel subsidies, the phase out of thermal coal-based electricity generation in line with credible 1.5 degrees Celsius temperature pathways, the avoidance of new carbon-intensive infrastructure (e.g. no new coal power plants) and the development of just transition plans for affected workers and communities"<sup>48</sup>.

41 Jane Ambachtsheer, Global Head of Sustainability at BNP Paribas Asset Management, for example, recently stated that "policy advocacy by the investment community is a critical success factor for achieving a net-zero future", see Institutional Investors Group on Climate Change (IIGCC) at <https://bit.ly/3DwmH6g>

42 See McKinsey (2020) report "How the European Union could achieve net-zero emissions at net-zero cost" at <https://mck.co/3uZUyBq>

43 Further, a proposal for a Regulation amending CO<sub>2</sub> emission standards for new passenger cars (Regulation (EU) 2019/631) will practically ban combustion engines in new cars from 2035, and a proposal for a Directive on Renewable Energy Directive, amending Directive (EU) 2018/2001, Regulation (EU) 2018/1999, will require at least 40% of share of energy from renewable energy sources by 2030 (49% for buildings). For further information on the Fit-for-55 Package see <https://bit.ly/3AyZZIF>

44 See Inaugural 2025 Target Setting Protocol (2021) at <https://bit.ly/3ltlJRO>

45 The Alliance of CEO Climate Leaders groups 79 company heads and investors managing \$41 trillion; see also <https://reut.rs/3iSYBux>

46 More recently, Dutch investors, including banks, pension funds and insurers, requested their government to do more on carbon reduction in response to emerging research showing a financing gap of €170 billion to achieve carbon neutrality by 2050 and forecasting actual CO<sub>2</sub> reductions in 2030 of 34% instead of the planned 49%. See Kraneveld's (2021) Responsible Investor article at <https://bit.ly/3FvBoZ3>

47 For further information on the Investor Agenda see <https://theinvestoragenda.org/focus-areas/>

48 The 2021 Global Investor Statement to Governments on the Climate Crisis is accessible at <https://bit.ly/3mOwk9I>



## Blended finance and Public Private Partnerships (PPPs)

Partnerships between investors and public institutions are necessary to channel private capital towards the sectors where transition finance is most needed to rapidly decarbonise the economy. As clarified by the International Energy Agency (IEA) in its 2021 roadmap to net-zero, the mobilisation of capital needed to ensure a successful and affordable transition towards clean energy will require close co-operation between governments, public finance institutions, investors and developers<sup>49</sup>.

In light of this, **Public Private Partnerships (PPPs) and blended finance**<sup>50</sup> are attracting the interest of investors as mechanisms to **de-risk and drive down the costs of large-scale projects**, such as those needed to support the low-carbon transition in the energy sector, the electrification of transport, and the renovation of buildings to improve energy efficiency.

Blended finance and PPPs differ in terms of their use of market mechanisms. PPPs are contracts between public entities and private investors to deliver public services. They involve a call for tender by a public institution to build and/or manage public infrastructure; the successful bidder can absorb the initial investment and make returns by applying charges for the delivery of the public service.

Blended finance projects on the other hand involve the commitment of public funds at below-market rates, e.g. by a public institution or third party donors. With governments, local entities, or development banks co-investing, or acting as guarantors, the **cost of the project decreases, and the risk-return profile improves, thus drawing in private investors** that would otherwise be unwilling to invest, as they would consider project as either too risky, or unprofitable. If projects are cheaper and less risky, they are also more bankable, meaning that private investors can access bank loans more easily, or issue sustainable bonds to cover their costs. Figure 6 shows the four-stage life cycle of typical blended finance projects.

By lowering the risks and the costs associated with an investment, PPPs and blended finance have enormous potential in terms of unlocking sustainable investment opportunities and attracting long-term SRI investors in

sectors and/or regions where transition finance is needed most. By way of example, clean and affordable energy in emerging markets. Put simply, **once the viability of an investment or project in a specific sector or region are demonstrated through a public-private partnership the private sector will be willing to fund similar projects of its own accord.**

Leveraging private finance is **essential for governments** for two reasons. First, the amount of capital needed to transform the economy exceeds the capacity of public authorities<sup>51</sup>: financing those systemic changes entirely through the public purse would dramatically increase national debt levels, which would be both politically and economically inexpedient. Moreover, funding the transition and sustainable projects entirely through public resources might be perceived by the markets as a signal that the deals are not investable or commercially viable, thus failing to crowd in private investors.

The European Investment Bank (EIB) Group plays a pivotal role in financing the transition as the EU's main lending arm: in 2020, the Group signed a total of €76.8 billion of financing; €270 billion of investment was supported, while 40% of total EIB financing was dedicated to green financing<sup>52</sup>. The Group's activities are carried out through lending, investments in equity and funds, guarantees to de-risk critical projects, as well as mandates and partnerships, including blended finance initiatives (see examples in Chapter 2). In 2019 the EIB Board of Directors approved a set of targets to support the EU to deliver on the long-term goals of the EU Green Deal and the UN Sustainable Development Goals (SDGs). As a matter of fact, that decision transformed the bank into the so-called "EU climate bank". Firstly, the EIB committed to increase its support to climate action and environmental sustainability to exceed 50% of its overall lending activity by 2025 and beyond: according to the EIB estimates, this should leverage €1 trillion of investment by the Group over 2020-2030. The second dimension of the commitment postulates all financing activities would have to be aligned to the goals and principles of the Paris Agreement by the end of 2020. The 2020 Roadmap is comprised of 4 workstreams, including the support for Paris-aligned operations, especially in high emitting sectors<sup>53</sup>.

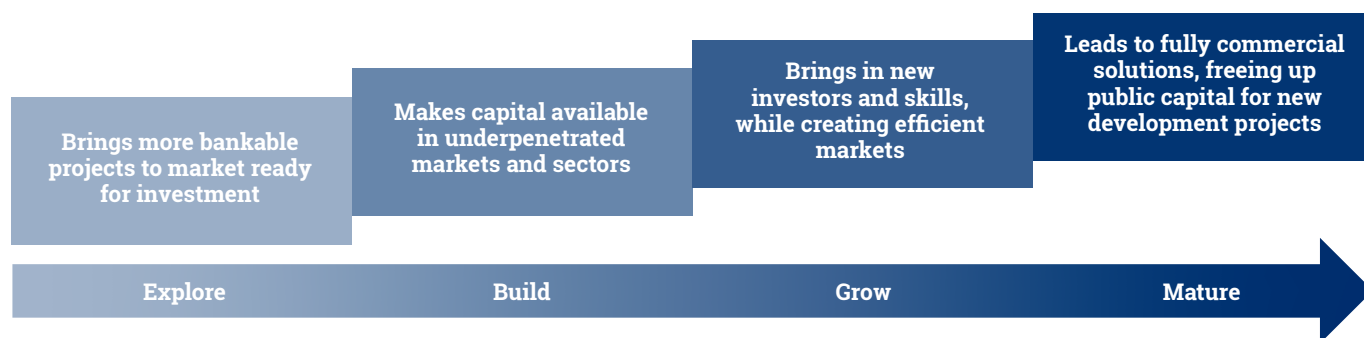
49 International Energy Agency (2021) "Net Zero by 2050: A Roadmap for the Global Energy Sector" at <https://bit.ly/3mD0blc>

50 Coined by the World Economic Forum and the OECD, blended finance "attempts to achieve similar goals to Impact Investing by using a structuring approach to 'blend' the different intents of a range of investor motivations to achieve these development objectives at scale"; see also <https://bit.ly/3mHxXG7>

51 Europe will need an estimated €350 billion in additional investment per year over this decade to meet its 2030 emissions-reduction target in energy systems alone, alongside the €130 billion it will need for other environmental goals; see EU Commission's Strategy for Financing the Transition to a Sustainable Economy at <https://bit.ly/3iQivX8>

52 For further numbers see EIB's website at <https://bit.ly/2Z59icC>

53 More precisely, the 4 workstreams are: 1) accelerating the transition through green finance; 2) ensuring a just transition; 3) building strategic coherence and accountability - e.g. with the EU Sustainable Finance Action Plan, and 4) supporting Paris-aligned operations, especially in high emitting sectors. See EIB (2020), "EIB Group Climate Bank Roadmap 2021-2025" at <https://bit.ly/2Z2BlmE>

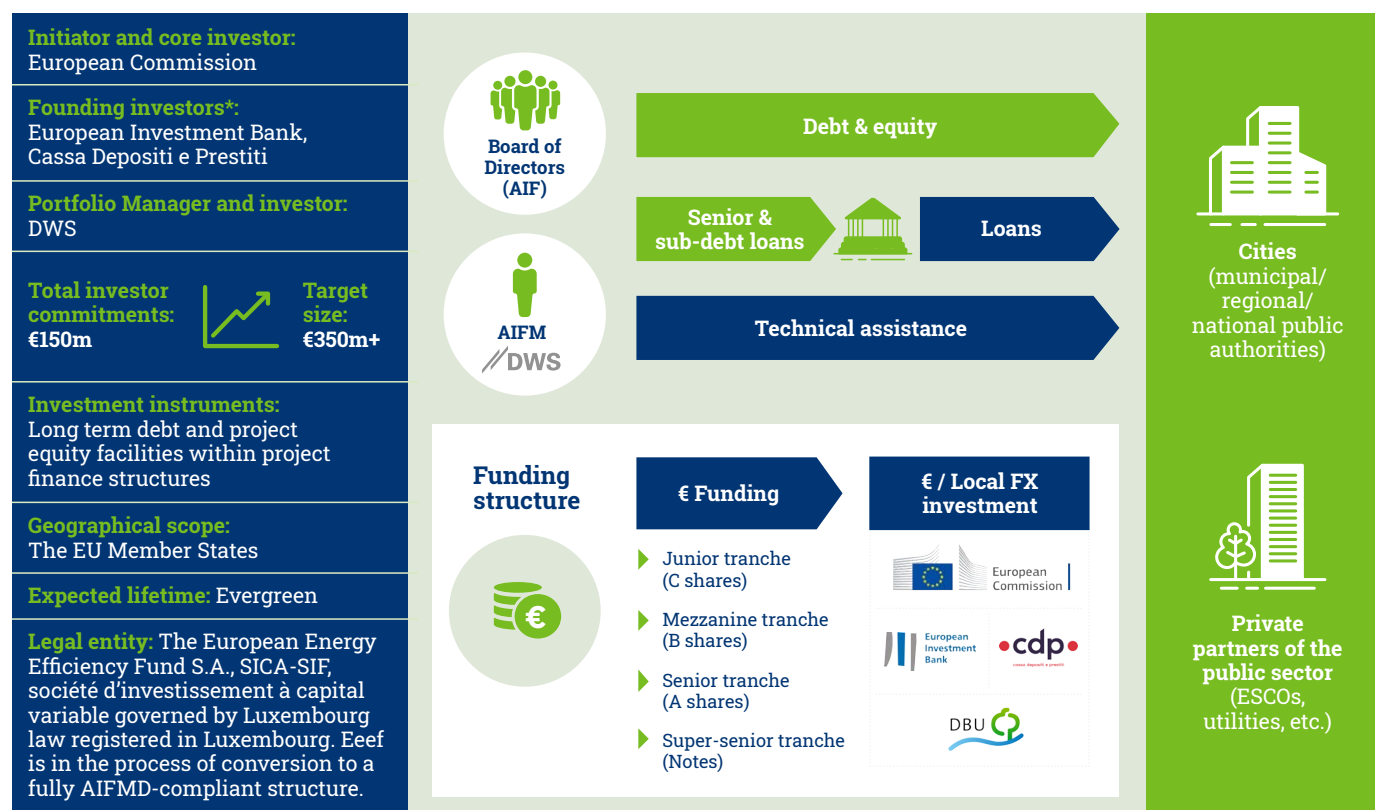


**Figure 6 - Life cycle of blended finance projects**

Source: World Economic Forum and OECD (2015)

In the European market there are several projects already exploiting the potential of PPPs and blended finance. The European Commission, together with the European Investment Bank (EIB) has been promoting the use of PPPs for over a decade<sup>54</sup>. For example, the European Energy Efficiency Fund (eeef), set up in 2011 as a joint initiative between the European Commission, the EIB, the Italian public financial institution Cassa Depositi e Prestiti (CDP) and DWS Group, the Asset Manager which is majority owned by Deutsche Bank Group, provides a market-based PPP for commercially

viable projects in the energy efficiency and renewables space<sup>55</sup>. The eeef benefits European municipal, local and regional authorities as well as private and public investors by financing utilities, public transport providers, social housing associations and energy service companies (ESCOs). The fund offers flexibility in terms of financing instruments (debt, mezzanine, equity, leasing) and maturities (up to 15-18 years for debt) (Figure 7). By 2020 the fund mobilised €150 million of committed capital<sup>56</sup>.



**Figure 7 - The eeef investment structure**

Source: eeef presentation<sup>55</sup>

54 According to a report by the European Court of Auditors (2018), one third of 1749 PPPs worth a total of €336 billion that have been concluded since 1990 in the EU, was in the transport sector, followed by healthcare and education; see <https://bit.ly/3AvwS9g>

55 eeef was originally established in 2011 to meet the commitment of the EU Member States to achieve the 20/20/20 goals: 20% increase in Energy Efficiency, 20% reduction of CO<sup>2</sup> emissions, and 20% Renewable Energy in EU's energy mix by 2020. It is organised by a dedicated alternative investment company in Luxembourg. For more information see <https://www.eeef.lu/home.html>

56 See <https://bit.ly/3oR9NeJ>

57 See LUXFLAG Label and eeef introduction presentation (2021) at <https://bit.ly/3DuQSKR>

The European Commission and the EIB have recently started intensifying the use of blended finance to accelerate the energy transition and scale up renewable energy technologies. In May 2019, both institutions together with Breakthrough Energy Ventures<sup>58</sup> set up a €100 million investment fund named “**Breakthrough Energy Ventures Europe (BEV-E)**” to help companies using new clean energy technologies to enter the market. Half of the funding for BEV-E is guaranteed by InnovFin, a financial instrument funded through the EU’s research and innovation programme, with another half funded by the Breakthrough Energy Ventures<sup>59</sup>.

In June 2021 the European Commission entered another partnership with Breakthrough Energy Ventures to mobilise €820 million between 2022 and 2026 for technologies that are currently too expensive to compete with fossil-fuel-based technologies. The partnership was established to invest in EU-based projects within four sectors that are instrumental to the EU Green Deal, such as: green hydrogen, sustainable aviation fuels, direct air capture, and long-duration energy storage<sup>60</sup>.

Notwithstanding the opportunities, **blended finance still possesses unrealised potential**. Some of the obstacles hampering more widespread use of blended finance are: the lack of familiarity investors have with the mechanism; scaling-up the dimensions of the investments; building trust and a common vocabulary between private and public actors; attracting highly-skilled finance practitioners; increasing the number of investable projects; and, finally, providing more transparency<sup>61</sup>.

To conclude, in this chapter we have described the three impact levers through which investors can make an impact in the real economy – shareholder engagement, funding capital-constrained companies and capital allocation in secondary markets. However, the potential of these impact levers should be integrated with public policies that alter the economics of sustainable investment. Accordingly, public policy engagement and use of public-private partnerships are essential to improving the efficacy of these levers. In parallel, EU policy and regulatory developments in the area of sustainable finance increasingly aim to foster and enhance such investor impact. Chapter 3 critically assesses these developments and tries to determine whether they are fit-for-purpose in terms of enabling investor impact levers.

58 The Breakthrough Energy Initiative was established in 2015 by Bill Gates and a coalition of private investors concerned about the impacts of accelerating climate change. For further information see <https://www.breakthroughenergy.org>

59 See EU Commission press release (May 2021) “The European Commission, European Investment Bank and Breakthrough Energy Ventures establish a new €100 million fund to support clean energy investments” at <https://bit.ly/3apTkpp>

60 See EU Commission press release (June 2021) “Commission and Breakthrough Energy Catalyst announce new partnership to support investments in clean technologies for low-carbon industries” at <https://bit.ly/3AusgQI>

61 See The Economist article “Blended finance is struggling to take off” (2020) at <https://econ.st/2YFXvuD>

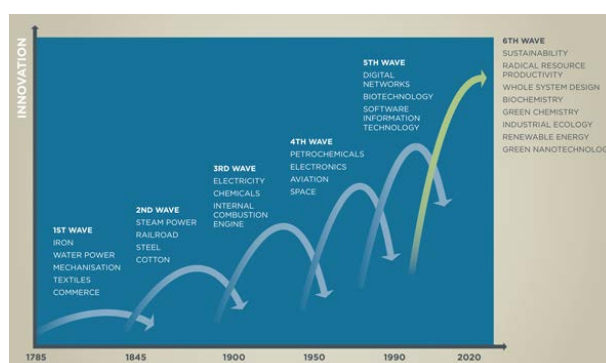
# The role of engagement in driving green industrialization and sustainability outcomes

## A contribution by our Sponsor DWS Group

**The science is unequivocal, human activity is and will continue to warm our planet. We have reached a tipping point where the level of carbon dioxide in the Earth's atmosphere has increased by 48% since the pre-industrial age<sup>1</sup>.**

If human activity remains unchecked, current projections estimate a world-wide temperature increase of 2.9 degrees Celsius by the end of this century<sup>2</sup> almost double the Paris climate target. This could lead to detrimental, irreversible, and widespread changes in the atmosphere, ocean, cryosphere and biosphere, causing extreme climatic events. The shift to a net-zero society will lead to an economic transformation comparable to previous waves of industrialisation. The so-called Green Industrialisation will likely accelerate, driven by digitalisation, artificial intelligence, automation, biotechnology, fintech and clean technologies. Working towards net-zero carbon emissions will probably render many old business models obsolete as the global economy moves away from a linear growth model – dominated by carbon-intensive companies – towards a more circular economic model, which takes into account all the costs of the production circle.

As fiduciary investors for clients, who are increasingly demanding sustainable actions in their investments, asset managers are in a good position to accompany the economy in this green industrialisation. Academic literature underlines that asset managers can have substantial sustainable impact in our economy by evoking positive environmental, social and governance (ESG) change in investee firms via shareholder engagements<sup>3</sup>. Overall, we see four key areas by which asset managers can actively support the shift to a low carbon economy with the goal to ultimately achieve net-zero within sustainable capital markets: portfolio company engagement, client engagement, interaction with accounting standard boards and public advocacy programme with governments. Within here we want to elaborate on the first two areas.



### The waves of innovation from the 18th to the 21st century

Source: Adapted from Karison Hargroves and Michael Smith (2005)

## Our portfolio company engagement

DWS's engagement activities particularly in Europe are based on our objective to induce improvement in our investees' behaviour on ESG aspects with the aim of improving long-term performance. With the integration of climate-related goals in our engagement approach we want our investees commit to robust net-zero goals based on science. We expect company Boards and Management to manage risks associated with climate change and will hold them accountable in case they fail to respond adequately to such risks or fail to provide the necessary disclosure. We exercise our ownership rights and vote accordingly.

Within the last two years DWS Group has taken steps to create further awareness on the integration of sustainability risks in the investment process. In 2020 and 2021, DWS Investment GmbH's Committee for Responsible Investments has analysed various cases of very severe climate and transition risks or violation of international norms and permitted ongoing investments only under the condition of company engagement.

As a next step our new engagement framework will be geared towards defining and tracking sustainability outcomes at our investees. Three clusters of engagement will be defined along the degree of interaction with the investee as well as target setting towards sustainability outcomes which are mapped to the Sustainable Development Goals (SDGs).

- **Strategic Cluster:** It is our objective to work with companies that are very important for DWS and our clients on a number of clear ESG and non-ESG targets, with a potential to "de-risk," them

1 For more information see NASA (2021) information on carbon dioxide at <https://climate.nasa.gov/vital-signs/carbon-dioxide/>

2 see UNEP summary on Emissions Gap report at <https://bit.ly/3FDz424>

3 See among others Barko, Cremers, and Renneboog (2021) "Shareholder engagement on environmental, social, and governance performance" at <https://bit.ly/3iVlhrw>; Dimson, Karakas, and Li, (2015) "Active ownership" at <https://bit.ly/3iWzdUK>; Semenova and Hassel (2019) "Private engagement by Nordic institutional investors on environmental, social, and governance risks in global companies" at <https://bit.ly/3FETgVX>



- Focus Cluster: Different approaches will be defined on an ad-hoc basis. For certain investees, the focus lies on climate and norm violations as well as governance related issues, for others it could be on specific sustainability themes
- Core Cluster: Focus on core corporate governance values and broader environmental and social issues

### Our Client Engagement

We see a growing trend among our clients who want to know what impact their capital is having on the world underlined by both market developments and academic research<sup>4</sup>. These ambitions are increasingly aligned with our fiduciary responsibilities. Throughout 2020, discussions with institutional clients have had a deliberate focus on decarbonisation. In our home market Germany, we have conducted numerous workshops, surveys, or introduction of ESG capabilities with corporate, insurance and pension clients or Non-Profit-Organisations. These activities will need to intensify in the context of our goal to support the mobilisation of private and institutional capital for climate solutions.

Next to investee and client engagement, we will further focus on our interaction with accounting standard boards as well as our public advocacy programme with governments.

### Case Study

To illustrate challenges that asset managers face during engagement with investees, the following case study highlights the long-term nature and importance of setting ambitious but realistic engagement targets including meaningful escalation steps.

Italian Utilities – Climate Action 100+

**Case:** We joined the Climate Action 100+ initiative which was launched in 2018. It is a five-year investor-led initiative to engage the world's largest corporate greenhouse gas emitters to curb emissions, strengthen climate-related financial disclosures and improve governance on climate change risks. Each investor focuses its discussions with one of the companies in scope. Our focus company is part of the utilities sector.

#### Targets:

- Board: Nomination of an independent director candidate that will enhance the board's expertise on climate related issues.
- Long-term goals: Emissions reductions and net-zero, while ensuring a just transition for workers in sectors vulnerable to climate disruption.

**Progress:** The company has already made significant improvements to the governance of ESG aspects. They also enhanced their transparency in terms of reporting on non-financial aspects, following also the recommendations of the Task Force on Climate-related Financial Disclosures ("TCFD"). The oversight is made at a board level via the dedicated Corporate Governance and Sustainability Committee. We continued our one-on-one engagements and sent our questions to the board before the AGM of the company in 2020 and 2021. The company nominated a climate expert to the board based on a shareholder proposal by a group of investors. In November 2019, the company presented the 2020–2022 Strategic Plan, which, while confirming the strategic direction already set, explicitly integrates the SDG objectives into the financial strategy. New targets (certified by Science-Based-Targets initiative, SBTi) have been disclosed: reducing direct CO<sub>2</sub> emissions per kWh by 70% by 2030, compared with 2017 levels to reduce indirect emissions associated with the consumption of gas by end-users by 16% by 2030. We emphasized that annual disclosure on reaching those targets is required. The company also disclosed Scope 3 figures and link to the SDGs as well as its emission intensity. Long-term goals for emissions reductions and net-zero: the company made a 2050 commitment. We further asked for expanding current TCFD scenario analyses to other countries as well as increasing disclosure on lobbying plus further formalization through a climate lobbying policy. Lastly, we felt that regarding remuneration, the current key performance indicators (KPIs) are not fully aligned with net-zero targets, which is why we asked that Scope 3 target achievement becomes part of remuneration in the medium and long-term.

**Status:** Ongoing

#### IMPORTANT INFORMATION

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4 ee among others Bauer, Ruof, and Smeets (2021) "Get real! Individuals prefer more sustainable investments" at <https://bit.ly/3oUZIXI>; Heeb, Kölbel, and Zeisberger (2021) "Do investors care about impact?" at <https://bit.ly/3iWUWM7>

## Chapter 3

# EU policies and regulations on sustainable finance: do they enable investors to achieve positive outcomes in the real world?

**I**n the previous chapters we clarified how SRI investors can play a significant role in reversing the deterioration of the Earth system. To do this, they should focus on achieving positive outcomes in the real world by encouraging changes in the companies in which they invest. In other words, they should seek to achieve investor impact. We then described three mechanisms through which SRI investors can influence companies: i) shareholder engagement; ii) funding capital-constrained companies and underfunded projects; iii) sending market signals via capital allocation in the secondary market. The analysis of these three mechanisms reveals that public policy measures are also necessary to create appropriate market incentives in favour of sustainability. With those incentives in place, it would make greater financial sense for investors to encourage investee companies to address sustainability challenges as well as commercial sense for the investee companies to improve their ESG performance. Moreover, we examined the potential of PPPs and blended finance to channel private funds towards underfunded regions, sectors, and companies that are key to achieve positive environmental and social outcomes.

Even though pricing mechanisms are pivotal to trigger the large-scale reallocation of capital needed to transition the real-economy, **the financial industry can and must improve its SRI strategies and tools** to ensure that the investment decisions result in real-world outcomes. This chapter critically assesses **whether the current EU sustainable finance policy and regulatory agenda enables investors to achieve real-world impacts**.

With flagship economic policies like the EU Green Deal and Next Generation EU, the European Union is leading global efforts to decouple economic growth from Earth system exploitation. To achieve all of this, the financial sector plays a crucial role. The EU sustainable finance agenda was launched in 2018 through the **EU Action Plan on Financing Sustainable Growth**, with the aim of: i) reorienting capital flows towards a more sustainable economy; ii) mainstreaming sustainability considerations in risk management processes; iii) and fostering transparency and long-termism across investment processes<sup>62</sup>. Subsequently, in July 2021 the EU Commission issued a **Renewed Sustainable Finance Strategy** to further enable the financial industry to contribute to achieving the goals of the EU Green Deal. The Strategy is focused on six actions, which include: financing the transition of the real economy towards sustainability (Action 1) and improving the contribution of the financial sector to sustainability goals (Action 4)<sup>63</sup>.

Bearing these policy objectives in mind, for each of the three investor impact levers, we will examine **whether individual policies and/or regulatory initiatives are conducive to enabling investor impact**. We will develop our analysis by responding to three questions:

- i) Does the sustainable finance agenda enable effective shareholder engagement?
- ii) Does the sustainable finance agenda contain measures to channel capital towards impactful capital-constrained companies and projects?
- iii) Are current regulations helping investors to convey market signals?

<sup>62</sup> See EU Commission's Renewed Sustainable Finance Strategy at <https://bit.ly/3iQMqhK>

<sup>63</sup> The other actions include 2) improve the inclusiveness of small and medium-sized enterprises (SMEs), and consumers, by giving them the right tools and incentives to access transition finance; 3) enhance the resilience of the economic and financial system to sustainability risks; 5) ensure the integrity of the EU financial system and monitor its orderly transition to sustainability; and 6) develop international sustainable finance initiatives and standards, and support EU partner countries; see <https://bit.ly/3AZhWjO>

## Does the sustainable finance agenda enable effective shareholder engagement?

Shareholder engagement allows investors to achieve positive impacts in the real world through the companies in which they invest. By creating a dialogue with the companies and/or exercising their voting rights during Annual General Meetings (AGMs), investors can push for changes in the conduct and practice of investee companies. The sustainable finance agenda envisaged legislation to enhance the potential for and efficacy of shareholder engagement. The main items are analysed here below.

### Concerning the Shareholder Rights Directive (SRD) II

The **Shareholder Rights Directive – SRD II** (2017/828/EU), effective as of 10 June 2019, establishes an overarching shareholder engagement framework in Europe. Its aim is to enable institutional investors and asset managers to carry out longer-term shareholder engagement, it improves the transparency of the voting process, and enhances investor-company dialogue. In its current form, the SRD II applies on a **“comply or explain”** basis, whereby investors and asset managers are not required to have any engagement policy, provided they can offer an explanation as to the absence of one. In addition to this, **investors are required to describe their processes** for monitoring companies and voting, as well as collective and individual engagement actions, but **not to report on the outcomes achieved**. The legal provisions, as they currently stand, hence fall short of ensuring substantive engagement that may lead to positive investor impact.

Accordingly, some national stewardship codes have introduced higher standards than those legally mandated by the SRD II. A good example is the **UK Stewardship Code 2020**. The Code demands more than a mere description of engagement policy by also requiring **outcome-based reporting** of the voting and engagement actions. Moreover, it replaced the previous comply or explain approach with an **“apply and explain” approach**<sup>64</sup>. Moreover, stewardship is defined for the first time as an outcome-oriented strategy that involves: “the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society”<sup>65</sup>.

In recognition of the need for enhancements to the SRD II framework the EU Commission recently announced its intention to enhance shareholder engagement in two regards. First, through requiring **impact considerations in the SRD II**. Second, by providing **guidance on collaborative engagement**<sup>66</sup>. According to the Strategy, the Commission will, in view of the 2023 review: “explore how the SRD II may better reflect impact considerations and global best practices in stewardship guidelines”, and “will ask the ESAs and national regulators to develop further guidance to ensure acting in concert does not impede collaborative engagement by investors around common sustainability goals”<sup>67</sup>.

However, the question remains as to **whether disclosure on engagement outcomes alone results in better ESG performance at company level**. The year 2021 witnessed a record number of approved shareholder proposals at Annual General Meetings (AGMs), with a robust increase in investor support for environmental and social issues<sup>68</sup>. Yet, there is little evidence to demonstrate that the increased support for the shareholder resolutions has translated into meaningful changes of company practice. For instance, the oil majors’ emissions increased over a 2016-2019 period despite the successes of shareholder resolutions<sup>69</sup>.

In this regard, one of the issues that prevent investors from obtaining concrete results in terms of decarbonization is the **difficulty in holding the Board accountable** for long-term commitments (e.g. 2025, 2030, 2040, 2050 etc.). The insufficient expertise of investors in assessing the sustainability plans of the investee companies vis à vis the climate and environmental objectives stipulated by the science is often another factor that undermines the effectiveness of engagement initiatives<sup>70</sup>. Accordingly, during the reform of SRD II it is essential that the Commission recognises the need to **set intermediate short-term targets** for companies and sectors which investors could use to hold companies accountable and improve the expertise of investors on ESG issues so as to ensure more effective shareholder engagement.

64 Signatories must provide examples of how they have applied the stewardship principles and how these activities have contributed to effective conclusions. See also p. 5 in Reddy (2021) “The Emperor’s New Code? Time to Re-Evaluate the Nature of Stewardship Engagement Under the UK’s Stewardship Code” at <https://bit.ly/3mKSCZl>

65 The Financial Reporting Council (UK) recognises signatories to the voluntary Code only if they submitted the first Stewardship report by 31 March 2021; see <https://bit.ly/3iR8Cbx>

66 ESMA reiterated its opinion in January 2019 that the rule on collaborative engagement needs clarification in relation to the EU Takeover Bid Directive that governs shareholder cooperation and acting in concert in the context of takeover bids; see <https://bit.ly/2YGLjd2>

67 See p. 9 of Annex to the Communication- Strategy for Financing the Transition to a Sustainable the Economy COM (2021) 390 final

68 For further information see <https://www.georgeson.com/us/proxy-governance-insights>

69 See Bindman’s (2021) CapitalMonitor article “Shareholder resolutions surge, but impact in doubt” at <https://bit.ly/2YBxsW9>

70 See Meager’s (2021) CapitalMonitor article “No bite: Lack of net-zero accountability puts onus on investors” at <https://bit.ly/2YBkc3L>

### Concerning the Sustainable Finance Disclosure Regulation (SFDR)

As of March 2021, the **Sustainable Finance Disclosure Regulation – SFDR** (2019/2088/EU) requires financial market participants (FMPs) to **disclose their engagement policies as part of a negative impact statement** (Article 4, 2(c))<sup>71</sup>. This provision is on a comply or explain basis. In the draft of the Regulatory Technical Standards (RTS) detailing the disclosures, the European Supervisory Authorities (ESAs) clarified that: “The brief summaries [...] shall include a description of the indicators for adverse impacts considered in those policies and how those policies adapt where there is no reduction of the principal adverse impacts over more than one reference period” (Article 8, 2). Thus, FMPs are required to explain how they follow-up when investee companies fail to take action to minimize the negative impacts on which their engagement policies are focused.

While the SFDR was conceived of as a transparency tool, in practical terms, the SFDR has become a quality standard for SRI policies and products across the market. Therefore – once finally implemented – the **Principal Adverse Impact Indicators (PAIIs) could be used as a basis for engagement** to monitor, assess and measure if and how the investee companies improve their ESG performance.

That said, the potential of the SFDR to be used as an effective engagement tool to trigger change in investee companies is currently hampered by a combination of factors, such as: i) the noncommittal tone of the requirements in the text of the SFDR; ii) the delayed adoption of the RTS; iii) the lack of clarity on the definitions and metrics for the PAIIs, and; iv) the absence of thresholds to quantify the negative impacts. Quantitative values could be used as a reference point when setting targets for engagement policies. Accordingly, in order for the SFDR to become an effective engagement tool, greater clarity is needed in terms of its definitions and performance metrics for the PAIIs.

### Concerning the EU Climate Benchmarks

The EU Climate Transition Benchmarks (CTBs) and the EU Paris-aligned Benchmarks (PABs) were introduced in November 2019 via EU regulation (2019/2089/EU). Benchmarks labelled as CTBs, or PABs are meant to allow investors to create portfolios that are either; on a decarbonization trajectory (in the case of the CTBs) or have a level of carbon emissions consistent with the objectives of the Paris Agreement (in the case of the PABs).

Two requirements are particularly relevant. First, the CTBs demand that the carbon intensity of the portfolio is at least 30% lower than the wider investable universe, whereas the PABs demand a 50% reduction. Second, both benchmarks require that a portfolio reduces its carbon emissions by 7% year-on-year.

CTBs and PABs can be used as tools for shareholder engagement, as **investors may wish to encourage investee companies to improve their ESG performance in order to remain eligible as a constituent of the benchmark**, or to become eligible for inclusion in the first instance. That said, the structure of these benchmarks is not entirely fit for achieving real world impacts. For instance, investors appear to pursue a “risk-sensitive” approach when making use of the benchmarks. Their emphasis is on reducing the carbon emission intensity of their portfolios by limiting their exposure to high-emitting sectors. This contrasts with a more “outcome oriented” approach whereby investors would have large exposures to high-emitting sectors accompanied by engagement with investee companies to trigger decarbonisation. By avoiding high-emitting sectors these investors are limiting the potential of their engagement to have a meaningful impact. Sector allocation constraints were introduced to address this tendency but they appear too loose to tackle the issue in practice. Finally, both CTBs and PABs have **exclusion criteria**, thus depriving investors the opportunity to use the lever of engagement in certain sectors.

### Concerning the EU Taxonomy

The EU Taxonomy was introduced in June 2020 via EU regulation (2020/852/EU). In essence it provides a list of economic activities that qualify as environmentally sustainable provided they satisfy certain conditions. In order to qualify as environmentally sustainable, economic activities must make a **substantial contribution** to one of the six environmental objectives stipulated by the EU Taxonomy while avoiding **significant harm** to the others in the process.

The Taxonomy sets out so-called Technical Screening Criteria (TSC) that specify how economic activities can make such a significant contribution and avoid harm to the climate and the environment. In terms of climate change mitigation, the **Taxonomy can instruct companies in high-emitting sectors how to decarbonise**. As such, the Taxonomy could also provide a tool to investors undertaking shareholder engagement by establishing performance levels for companies to qualify as environmentally sustainable that investors could reference in engagement policies.

71 The article references the SRDII as to how the engagement policies should be disclosed.



In addition, data disclosed as per Article 8 of the Taxonomy Regulation could further enable investors to monitor and **evaluate the actual performance of the investee companies** (through the percentage of Taxonomy-aligned turnover) and their **decarbonisation plans** (through the percentage of the Taxonomy-aligned Capital Expenditure). However, it should be noted that until 2023 and 2024, non-financial companies and financial institutions respectively will only be required to disclose information about their taxonomy-eligibility, rather than their level of Taxonomy-alignment. That is to say, they will merely be required to indicate whether the activities they carry out/invest in are currently covered by technical screening criteria. Hence, Taxonomy-related disclosures are unlikely to provide meaningful information for the purposes of shareholder engagement.

Moreover, for Taxonomy-based shareholder engagement to be effective, both investors and companies should have appropriate incentives to pursue Taxonomy-alignment. Hence, pricing mechanisms should be introduced to ensure that Taxonomy-aligned activities are more economically viable than harmful activities thus significantly improving the prospects for successful engagement and investor impact.

### **Does the sustainable finance agenda contain measures to channel capital towards impactful capital-constrained companies and projects?**

Investors can have a meaningful impact by investing in capital-constrained companies and projects expected to play a significant role in the transition. For instance, by providing financing to start-ups with innovative hi-tech solutions in the renewable energy sector, or big infrastructure projects in emerging markets to provide clean and affordable energy. We have previously highlighted the importance of PPPs and blended finance in bringing down the risks and costs associated with big projects in view of attracting private investors.

Transition projects in the European Union will receive public funding through programs such as InvestEU, and the Next Generation EU (NGEU), the post COVID-19 recovery package, thus creating opportunities for PPPs and blended finance.

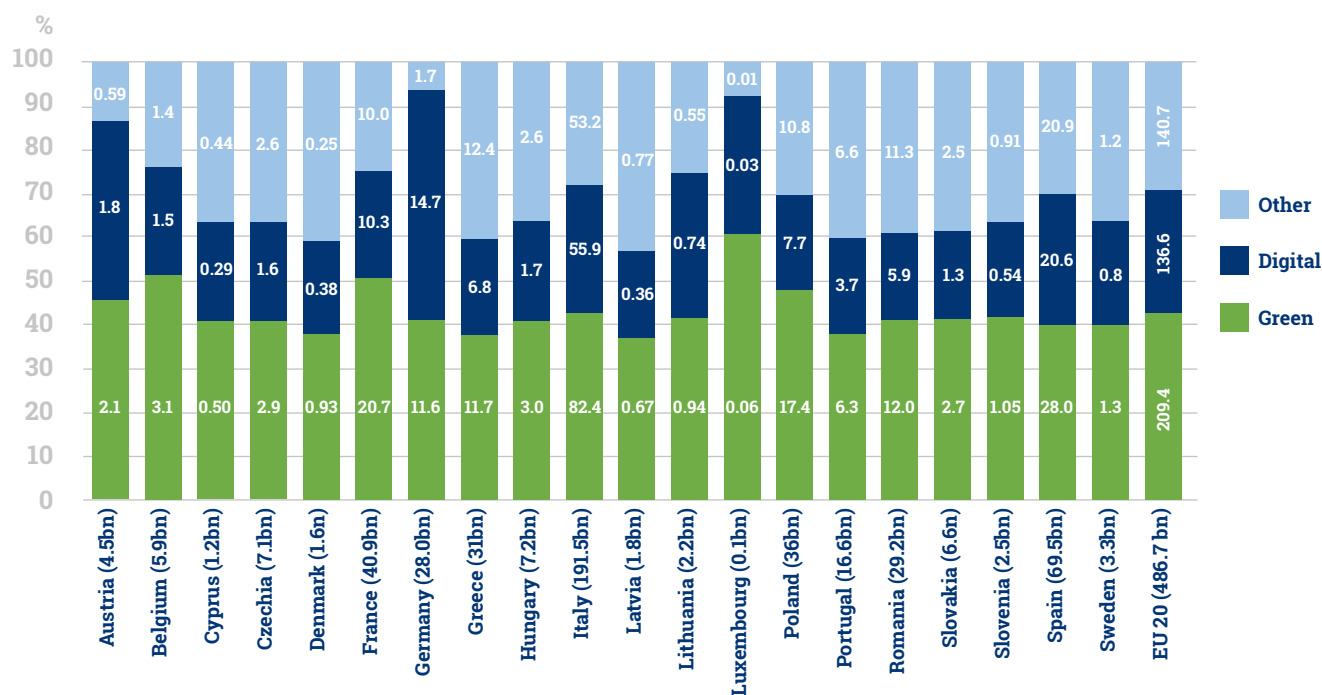
The **InvestEU Programme** seeks to boost sustainable investments, innovation, and job creation across all sectors in Europe. The financial arm of the program is the InvestEU Fund, which aims at mobilising more than €372 billion of public and private investments over the period 2021-2027. The Fund leverages an EU budget guarantee of €26.2 billion that backs investments from implementing partners, such as the European Investment Bank (EIB) Group and other financial institutions. Importantly, at least 30% of the InvestEU Programme shall support investments that contribute to the EU's climate objectives. Moreover, one of the four policy windows that are supported by the Fund focuses on sustainable infrastructure<sup>72</sup>. 60% of the investments within this window shall contribute to the EU climate and environmental objectives.

- The NGEU represents the largest stimulus package ever financed in Europe, worth around €2 trillion when combined with budget allocations under the Multiannual Financial Framework (MFF) 2021-2027. Under the current MFF, 30% of the EU budget will be allocated to climate action, amounting to approximately €350 billion. The NGEU's centrepiece, the Recovery and Resilience Facility (RRF) seeks to enhance the resilience and sustainability of European economies and societies with a total of €723.8 billion in grants and loans. To access finance, Member States need to prepare recovery plans including a minimum of 37% for climate investments and reforms, as well as a minimum of 20% to foster the digital transition<sup>73</sup>. According to data from the think-tank Bruegel, almost 45% of the overall resource allocation in national recovery and resilience plans will concentrate on green spending (Figure 8)<sup>74</sup>.

72 In particular, the sustainable infrastructures should be developed in the following sectors: sustainable energy, digital connectivity, transport, the circular economy, water, waste, other environment infrastructure and more. For further information see [https://europa.eu/investeu/about-investeu\\_en](https://europa.eu/investeu/about-investeu_en)

73 For further information see <https://bit.ly/3DtBvlZ>

74 The Bruegel (2021) data-set can be accessed via <https://bit.ly/3BAuZsY>



**Figure 8 - Overall resource allocation in national recovery and resilience plans**

Source: Bruegel (2021) % of total and € billions<sup>75</sup>

The unprecedented levels of post-pandemic public financing being made available for green investment presents an opportunity to crowd-in private investors and channel capital towards projects and companies with a role to play in the transition.

#### Are current regulations helping investors to convey market signals?

Investors can send signals through capital allocation in secondary markets. Through buying and selling securities, investors affect the price and the risk profile of assets. As a consequence, they affect the cost of capital for companies, thus improving or worsening their access to funding. If investors act in accordance with clear ESG preferences when allocating capital on secondary markets they could, theoretically, convey market signals. However, this requires a critical mass of ESG-oriented investors with homogeneous preferences, all using the same criteria.

#### Concerning the SFDR

In effect, while conceived of as a transparency regime, the SFDR has partially established product standards for SRI funds. The regulation has created a common language among financial market participants, whereby "Article 8" or "light green" funds are products that promote environmental and/or social characteristics, and "Article 9" or "dark green" funds are products that pursue a sustainable investment objective.

The SFDR also provides a definition of "sustainable investment", as an investment in an economic activity that contributes to an environmental or social objective, where the company does not harm other objectives, besides having good governance practices (Article 2 (17)). According to a Morningstar analysis conducted four months after the SFDR became effective, Article 8 and Article 9 funds already represent 34% of the overall EU fund universe in terms of assets<sup>76</sup>.

Hence, from a theoretical standpoint the SFDR has the **potential to convey powerful market signals through the proliferation of Article 8 and Article 9 products**. The assumption is that since FMPs are strongly interested in including SFDR-compliant funds in their offers, they will increasingly allocate capital towards issuers that allow them to qualify their products as Article 8 or Article 9.

<sup>75</sup> See <https://bit.ly/3BAuZsY>

<sup>76</sup> See Morningstar research report (2021) "SFDR: Four Months After Its Introduction" at <https://bit.ly/3aoT6z7>

However, preliminary market research reveals that this is not yet the case due to **insufficient clarity regarding the definition** of “sustainable investment” and poor delineation of product categories. There is also a **lack of minimum standards and thresholds with respect to** portfolio composition with the legal text leaving the door wide open to different interpretations. As one would expect, FMPs have started adopting **widely divergent approaches to the classification of Article 8 and Article 9 funds**<sup>77</sup>.

As for the lack of thresholds, Article 5 and Article 6 of the Taxonomy Regulation prescribe the disclosure of Taxonomy-alignment of Article 8 and Article 9 products pursuing environmental objectives. However, no threshold has been specified, meaning that products with 1% as well as 99% of Taxonomy-alignment can potentially be marketed under the same label. The **delayed finalisation of the RTS** with technical guidance on the product disclosure requirements further compounds the fragmentation of the market.

The result is that market signals are weak and fall short of precipitating the massive reallocation of capital that is needed to transition the real economy. A significant contribution to solve this problem may arrive from an SFDR review aimed at **introducing minimum sustainability criteria for Article 8 products**, as envisaged in the Renewed Sustainable Finance Strategy.

#### Concerning the EU Ecolabel for financial products

The EU Ecolabel is a product standard that defines the criteria to identify and award the best performing retail financial products<sup>78</sup>. Once the standard is adopted by the EU legislators, **it could act as the product quality label lacking in the SFDR**.

However, **the latest proposed qualification criteria are so strict that it is unlikely the Ecolabel will be widely used**. According to the March 2021 report, one of the requirements for the equity funds is that at least 50% of the total portfolio value of the assets under management shall be invested in environmentally sustainable economic activities<sup>79</sup>. This target is out of reach, as the green share of the broad market indices is below 2%. According to practitioners' estimates, at present there are no diversified equity funds in Europe that would qualify for the Ecolabel<sup>80</sup>.

As things now stand, the EU Ecolabel for financial products has **limited potential to mobilise the critical mass of investors needed to** send powerful market signals.

#### Concerning the Taxonomy

The EU Taxonomy was introduced to provide FMPs and companies with a **common standard** by which sustainable economic activities could be identified, with the ambition being to create **“the gold standard for green finance”**<sup>81</sup>.

**Theoretically the Taxonomy represents a valuable tool through which SRI investors can send signals to the market** as to where their investment preferences lie. The architects of the Taxonomy expect investor preferences will increasingly favour sustainable economic activities as defined by the Taxonomy and allocate capital accordingly. However, in actuality it is far less certain that the Taxonomy will serve as a tool for capital allocation in the near future.

Two conditions would first have to be in place for the Taxonomy to become a widely used capital allocation tool. First, the green criteria would have to include **an investment universe sufficiently broad** to allow financial institutions to preserve an acceptable level of portfolio diversification. Second, investors representing a meaningful share of the market would have to **use the Taxonomy as a reference point while making investment decisions**. Neither of these conditions are present. Recent research estimates that broad market indices have a **very low level of alignment (1-2%) with the Taxonomy**: this is not necessarily bad for the Taxonomy itself, it merely reflects the reality that the current EU economy is unsustainable<sup>82</sup>. According to other estimates, between 1% and 5% of all companies and investment portfolios would qualify as environmentally sustainable in accordance with the Taxonomy<sup>83</sup>. This estimate was validated by ESMA, which calculated that fewer than 3% of EU fund portfolios with estimated Taxonomy-alignment of 5% or higher (see Figure 9)<sup>84</sup>.

77 See Morningstar research report referred to in footnote 74

78 Based on the requirements of the EU Ecolabel Regulation (66/2010/EU); see <https://bit.ly/3Bs1GZH>

79 See EU Commission Joint Research Centre Technical Report 4.0 (2021) “Development of EU Ecolabel criteria for Retail Financial Products” at <https://bit.ly/3ByWqU2>

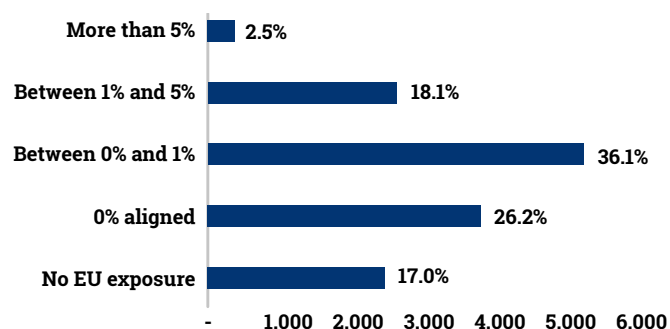
80 See Zaouati (2021) “Is the Ecolabel heading for ‘large-scale failure?’” at <https://bit.ly/3at8Dha>

81 See EU Platform on Sustainable Finance (2021) “Public Consultation Report on Taxonomy extension options linked to environmental objectives” at <https://bit.ly/3FzuUZ9>

82 See Adelphi and ISS ESG (2020) “European Sustainable Finance Survey 2020”, commissioned by the German Federal Ministry for the Environment at <https://bit.ly/3ByWYJA>

83 See EU Commission (2021) “FAQ: What is the EU Taxonomy and how will it work in practice?” at <https://bit.ly/3FA3imG>

84 ESMA (2021) “Final Report: Advice on Article 8 of the Taxonomy Regulation” at <https://bit.ly/3oRcYmF>



Note: Number of EU funds by estimated Taxonomy alignment of equity and corporate bond holdings. Sources: Morningstar, Refinitiv EIKON, ESMA.

**Figure 9 - Number of EU funds estimated by Taxonomy**

Source: ESMA (2021)

### Concerning the EU Climate Benchmarks

Potentially, the CTBs and the PABs can channel capital into companies on a decarbonisation trajectory, or that demonstrate compliance with a Paris-aligned scenario. **If tracked by a significant amount of assets**, those benchmarks might be capable of sending broad market signals.

For example, in May 2021 the German Bundesbank announced its plan to manage four public pension equity funds, amounting to €9 billion, in accordance with the CTB. The bank is currently replacing the Euro Stoxx 50 with the CTB developed by Euronext and S&P<sup>85</sup>. Consequently, €3.15 billion will flow into 75 companies across six countries outside the Eurozone through the Euronext VE ESG World 75 index by the end 2022, while €5.85 billion to an unknown number of Eurozone companies constituting the S&P Eurozone Bund/SV Climate Transition ESG Select Index by the end of 2021<sup>86</sup>. However, it is uncertain if the German example will be replicated elsewhere in the Euro area pension market (€3 trillion)<sup>87</sup>. Moreover, research by the EDHEC Business School-Scientific Beta revealed that the current criteria of the EU Climate Benchmarks imply portfolio reshuffles that are **not conducive to meaningful decarbonisation in the real world**. The research reveals that the sector-related constraints applied to climate alignment products are too loose. The sector constraints refer to macro-sectors, like "high climate impact": the researchers found that while the benchmark exposure to "high climate impact sectors" is 64%, in unadjusted strategies the average weight of those group of sectors is 60%. That is to say, benchmark

alignment does not require a significant effort. Moreover, the category is so broad, that it is not difficult to obtain portfolio decarbonisation by simply choosing companies that have lower impact – for example, the researchers mention the example of electricity, which is included in the broad sector of utilities, together with companies that have a much lower CO<sub>2</sub> intensity<sup>88</sup>.

### Concerning the ESG ratings

Most SRI investors rely on ESG ratings to varying degrees throughout the investment process. In principle, ESG ratings represent valuable instruments to convey market signals, and their use provides **meaningful information about the way SRI investors evaluate the ESG credentials of the investee companies**.

That said, the ESG ratings that are currently available on the market employ wildly differing methodologies and neither the companies subject to the rating, nor the investors using it in their investment process understand how ESG ratings are determined by the provider<sup>89</sup>. These issues will be tackled in the next few years by the EU Commission, which has planned to launch a public consultation and to conduct an impact assessment with the aim to **improve the transparency, the comparability, and the reliability** of ESG ratings<sup>90</sup>.

Transparency and comparability are not the only issues with ESG ratings. As recently argued by Hans Taparia from New York University's Stern School of Business, most ESG rating methodologies **measure the exposure of the company's financial value to ESG risks, rather than focusing on their ESG impact**. Therefore, a company with a high ESG score is well hedged against sustainability risks (e.g. regulatory and reputational risks), but does not necessarily have positive impacts in the real economy (e.g. can be highly polluting, or harmful for the health)<sup>91</sup>. Taparia further notes that ESG ratings aggregate scores in different areas of sustainability, meaning that a good overall performance might hide serious negative impacts in one or more areas.

A new rating system "that measures the economic, human, and environmental costs of market failures caused by corporations", is thus required to drive investments towards achieving positive ESG outcomes and send strong market signals.

85 The four pension funds are two civil service pensions (Versorgungsfonds des Bundes and Versorgungsrücklage des Bundes), the Federal Employment Agency fund (Versorgungsfonds der Bundesagentur für Arbeit), and the provident fund for long-term care insurance (Vorsorgefonds der sozialen Pflegeversicherung).

86 See Webb's (2021) Responsible Investor article "Bundesbank moves forward on €9bn climate benchmark shift for public pension schemes" at <https://bit.ly/3AvAMPs>

87 See ECB Economic Bulletin, Issue 7/2020 at <https://www.ecb.europa.eu/pub/pdf/ecbu/eb202007.en.pdf>

88 See Amenc, Goltz, Liu (2021) "Doing Good or Feeling Good? Detecting Greenwashing in Climate Investing" at <https://bit.ly/3AtEfoh>

89 For example, see European Commission and Environmental Resources Management (ERM) (2021) "Study on sustainability-related ratings, data and research" at <https://bit.ly/3AqZOPH>

90 See Action 4 in the EU Commission's Communication (2021) on the Strategy for Financing the Transition to a Sustainable Economy at <https://bit.ly/3Dv3sd1>

91 See Taparia (2021) "The World May Be Better Off Without ESG Investing" at <https://bit.ly/3ax1RXC>

## Fit for purpose? Real world outcomes are a good start, but investors will still need to look further for value

*A contribution by our Sponsor ISS ESG*

### **Key Takeaways:**

- Analysis shows the EU Taxonomy and Sustainable Finance Disclosure Regulation (SFDR) have the potential to drive investment in activities with positive real-world outcomes. While initially focused on climate-related topics, a future expansion of the Taxonomy will help to broaden this benefit to other areas of the environmental, social and governance (ESG) spectrum.
- Positive EU Taxonomy and SFDR Principal Adverse Impact (PAI) performance does not necessarily correlate with the overall financial quality of an investment, however. Prudent investors will continue to consider more than just the current set of impact metrics provided for in the regulation, as sustainability-related public policy and industry initiatives continue to drive changes in market dynamics across the board.
- Regulation is moving beyond a focus on transparency in the investment process, with increasing calls for more sustainable outcomes in the real world, with a potentially logical next step being a move towards introducing appropriate market incentives such as carbon pricing. ISS ESG's research illustrates the potential for this evolution to support the EU's transition to a greener economy and reduced principal adverse impacts.

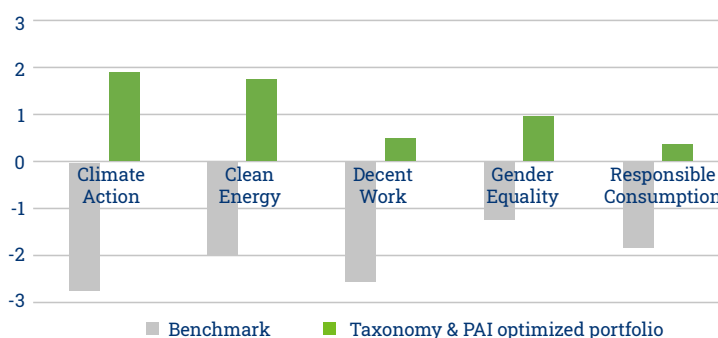
A key goal of the European Union's Action Plan for Financing Sustainable Growth is to shift capital flows towards investments with positive real-world impacts. Several regulatory initiatives have been introduced to support asset owners and managers in the management of their investments' impacts on people and the environment.

One of the key initiatives is the EU Taxonomy, which provides a framework to identify economic activities that substantially contribute to the Union's environmental objectives. It is supported by the Sustainable Finance Disclosure Regulation (SFDR), which encompasses a list of "Principal Adverse Impact" (PAI) indicators that are relevant to a broad set of financial market participants. While these metrics are only at the early stages of being adopted in the decision making of investors, the question arises: what kind of impact will the Taxonomy and PAI optimized portfolios have?

## The real-world impact of a Taxonomy and PAI optimized portfolio: beneficial for the climate

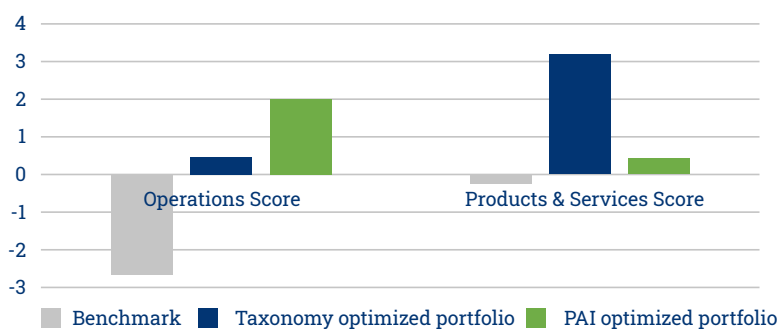
An analysis of ISS ESG data shows that the adoption of the regulator-defined Taxonomy and PAI metrics has the potential to redirect capital towards companies with positive environmental and social impacts, both at a portfolio and market level. We compiled a sample global portfolio of listed companies optimized for Taxonomy-alignment and minimal Principal Adverse Impacts<sup>92</sup>. Using ISS ESG's SDG Impact Rating<sup>93</sup> we were able to demonstrate a higher concentration of companies positively aligned with the United Nations Sustainable Development Goals (SDGs) compared to the benchmark.

This outperformance is by no means equally distributed across all SDGs, however. The selected portfolio shows significantly more positive results in some SDGs, most notably SDG 13 (Climate Action) and 7 (Clean Energy), but little meaningful difference can be observed for many others.



### Selecting a portfolio based on Taxonomy-alignment and PAIs leads to significantly more positive outcomes related to some SDGs only

This bias towards climate action and clean energy of course reflects the Taxonomy's current focus on climate. The outcomes may become more uniform as the Taxonomy is extended to incorporate the remaining four environmental objectives and potentially also social objectives<sup>94</sup>.



### SDG 13: Taxonomy-alignment comes with positive products & services while lower PAIs come with better management of operational climate impacts

A closer look at the climate outcomes also reveals a crucial difference between Taxonomy and PAI metrics. Both can help identify companies with positive climate outcomes – but in very different ways. Companies with higher levels of Taxonomy-alignment tend to generate positive impact through their products and services, e.g. by producing renewable energy. Companies that do better under the PAIs tend to manage the climate impacts from their operations more effectively. To measure both dimensions of corporate impact, investors will thus have to rely on a combination of metrics.

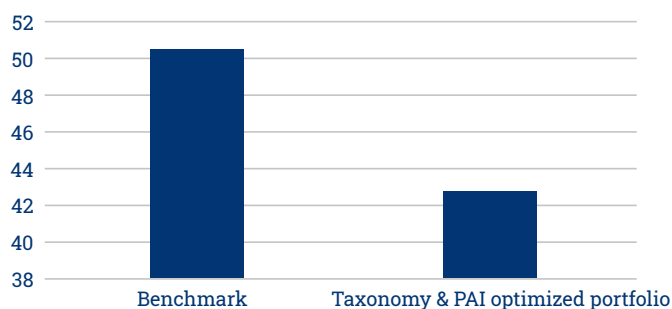
92 The benchmark used in the analysis consists of companies listed in major global indices (MSCI World, Russel 3000, Solactive Global Markets Large & Mid-Caps, S&P 500). From this benchmark, a portfolio of 100 companies was selected using data on Taxonomy-alignment and Principal Adverse Impacts (taking into consideration only those PAIs which are mandatory and relevant across all sectors, except for gender pay gap for which data was not yet available) from ISS ESG's EU Taxonomy Alignment Solution as well as ISS ESG's SFDR PAI data set.

93 ISS ESG's SDG Impact Rating provides a holistic measurement of a company's positive or negative impact on the 17 SDGs, using a scale from +10 (significant positive impact) to -10 (significant negative impact). See also <https://www.issgovernance.com/esg/impact-un-sdg/>

94 See European Commission's call for feedback on the draft reports by the Platform on Sustainable Finance on a social taxonomy and an extended taxonomy at <https://bit.ly/3Bv001z>

## The other side of the double materiality coin: financial materiality

The European Union has engrained double materiality into its regulatory initiatives. This concept sees ESG metrics as relevant not only for measuring sustainability risks which may have an impact on the value of the investment, but also for the consideration of impacts on people and the planet. While other ESG metrics have been shown to help investors manage risk and achieve sustainable value creation<sup>95</sup>, an analysis of ISS ESG Economic Value Added (EVA) data<sup>96</sup> for our sample portfolio reveals a lower financial quality on average compared to the benchmark. Previously observed correlations between ESG and financial performance<sup>97</sup> are therefore likely associated with additional metrics not covered in this exercise. Such metrics could include climate-related performance not otherwise covered by the Taxonomy or the PAIs and are likely to extend to broader ESG initiatives.



**The portfolio selected based on regulatory metrics has a lower average financial quality**

## Taxonomy, SFDR & real-world outcomes – seismic shift or much ado about nothing?

The EU's Action Plan aims to change the real world through the transformative power of capital markets. The good news is that the regulatory metrics appear to be fit for purpose – a Taxonomy- and PAI-optimized portfolio results in comparatively more positive outcomes for the planet and society. Given the Taxonomy's current laser focus on climate related objectives, it is unsurprising that SDG 13 (Climate Action) is where most of the impact outperformance can be observed.

However, the analysis also suggests that selecting portfolios in accordance with the regulator-prescribed metrics does not necessarily come with increased financial quality. Again, this isn't surprising given that the purpose of these regulations is not to provide a holistic insight into financial or even ESG related performance. Prudent investors will continue to consider a wider range of factors than just the current set of impact metrics set out in the regulations. Regulatory initiatives are moving past a focus on transparency and beginning to introduce specific goals and thresholds. It is likely that this shift, teamed with increased market interest in impact investing, will strengthen the contribution of sustainable finance regulation towards achieving the intended real-world outcomes.

The EU Action Plan is on the right track. Our research shows that public policy that supports market-based initiatives can deliver the intended outcomes. There is room for more work, however. To ensure that investment products are delivering positive sustainability and financial quality outcomes, as well as driving change within investee companies, the scope of regulatory intervention could be broadened.

There are many levers for impact beyond capital allocations in the equity market: corporates are preparing to report on performance vis-à-vis regulatory metrics; we are likely to see engagement and stewardship action around taxonomy-alignment and PAIs; and the requirements will sooner or later find their way into public funding. As these regulations come fully into force and are embedded into financial markets, it is plausible that we will see if not a seismic, at least a notable shift towards more sustainable outcomes in the real world. What is more, though, as investor priorities shift towards impact investing and with a possible introduction of specific goals and thresholds rather than disclosure requirements alone, the contribution of sustainable finance regulation towards achieving the intended real-world outcomes will increase dramatically.

95 See Responsible Investor article "What The ESG...F" at <https://bit.ly/3BGPdla>

96 ISS ESG's EVA Financial Quality Score provides a measurement of a company's financial quality on a scale from 0 (worst) to 100 (best); see also <https://www.issgovernance.com/eva>

97 See ISS Insights (2021) ESG Matters II at <https://bit.ly/3mO9VsS>

## Chapter 4

# Embedding investor impact in the EU sustainable finance agenda – Eurosif's recommendations

**As we have seen in previous chapters, the scale of the sustainability challenges is systemic in nature and therefore the financial sector and investors need to adopt this systemic approach in their thinking about impact. The EU sustainable finance agenda has been a catalyst in triggering financial institutions to elaborate more sophisticated approaches to this impact challenge. Yet it does not fully exploit the potential for investor impact. In this Chapter we will formulate some policy recommendations that will strengthen the tools available to investor to have impact.**

### Key principles for effective policy elaboration

As the EU sustainable finance agenda enters its second iteration with the Renewed Sustainable Finance Strategy<sup>98</sup>, its effectiveness in achieving the policy goals of reorienting capital, increasing transparency and combatting greenwashing will depend on several key principles.

First, we should always bear in mind how investors and financial markets operate. Asset managers are bound by their fiduciary duty to achieve investment returns for their clients while incurring appropriate levels of risk, in line with their clients' objectives. Asset owners are bound to adequate returns to meet their obligations towards beneficiaries whether they are pensioners or insurance clients. This means that to influence capital allocation decisions by investors, policies and regulations will need to directly impact the expected returns of the underlying investments. Some investors may accept sub-market returns out of purpose, but they are likely to remain a small subset of the market and not nearly enough to fund the scale of the systemic changes we need.

Second, the availability of sustainability data by investee companies is critical to make the EU sustainable finance agenda and its underlying pieces of legislation operational. But in that quest for ever better sustainability data to meet regulatory obligations of the SFDR and the EU Taxonomy, it is critical to keep sight of the fact that **the key added value of data will be to allow an increasingly larger group of investors to make better, more informed investment decisions** taking into account critical sustainability dimensions. This is arguably far more important than the availability of data to meet regulatory obligations if we wish to see changes in capital allocation away from excessively harmful and towards more sustainable companies.

Thirdly, it will be necessary to maintain a holistic view of the EU sustainable finance agenda and particularly in how far the proposed pieces of legislation serve the policy objectives stated. Many of the policies up to now have been focussed on transparency and reporting. With more transparency, market participants would be better positioned to pick up signals and adjust their decision-making accordingly. However, **the question is whether transparency is enough to trigger change** on the scale required without strong signals pricing adequately unsustainable economic activities and making sustainable activities more economically attractive<sup>99</sup>.

<sup>98</sup> See EU Commission's Renewed Sustainable Finance Strategy at <https://bit.ly/3iQMqhK>

<sup>99</sup> On 20 September, the European Court of Auditors released a special report on the EU's sustainable finance activities, concluding that more consistent action is needed to redirect finance towards sustainable investment. For more information see <https://bit.ly/3vm3nWr>



## 1 A regulatory framework that fosters investor engagement with companies and policymakers

As we outlined earlier, individual and collective engagement is one of the most powerful tools for investors to have some impact and trigger some change. We have formulated below some recommendations.

- Revise the Shareholder Rights Directive II (SRD II)** – The SRD II<sup>100</sup>, adopted in 2017, lays down the requirement for institutional investors and asset managers to publicly disclose an engagement policy that describes how they integrate shareholder engagement in their investment strategy or to publicly explain why they do not. As a result, one of the most impactful tools remains optional for institutional investors and asset managers and not subject to much specificity. In its latest Sustainable Finance Strategy<sup>101</sup>, the European Commission confirmed its intention to review the SRD II by 2023, to ensure it better reflects impact considerations and global best practices in stewardship guidelines. **The revision should ensure that institutional investors and asset managers are obliged to disclose their engagement policy, their engagement activities, what objectives they set, what actions they take and how they evaluate the outcomes of their engagement actions**, including escalation procedures, in case engagement actions do not yield the sought-after outcome.
- Revise the Sustainable Finance Disclosure Regulation (SFDR)** – The SFDR lays out the transparency framework for financial products having as objective sustainable investments (Article 9 SFDR) and products promoting environmental and/or social characteristics (Article 8 SFDR). It also requires certain financial firms to report on how they consider and take into account Principal Adverse Impact (PAI) indicators (Article 4 SFDR). At this stage though, firms are only required to report voluntary on any actions planned to mitigate PAI and refer to their SRD II engagement policies. Bearing in mind that engagement by investors can be one of the most impactful tools, it seems clear that **the requirements and provisions on shareholder engagement and stewardship in the SFDR will need to be strengthened** considerably in the future as part of a review of the SFDR.
- The EU Taxonomy and Paris-Aligned and Climate-Transition Benchmarks as engagement tools** – The EU Taxonomy, the classification system of sustainable economic activities, has up to now mostly been discussed as a reporting tool for companies and investors to report on how sustainable their revenues, investment plans and investment portfolios are. It could however also be used by investors as a powerful engagement tool, which sets the long-term objectives per economic sectors of what is deemed sustainable or compatible with a net-zero 2050 world. Investors could ask from investee companies to **formulate plans on how they intend to meet the significant contribution thresholds** as laid down in the Taxonomy. A similar reasoning could be applied to Paris-Aligned and Climate-Transition Benchmarks (PABs & CTBs). Investors should have an incentive to **engage with companies to achieve the decarbonisation objectives** so that these companies can remain constituents of these indices.
- Investor engagement on the EU Green Deal and the Fit-for-55 Package** – As mentioned earlier in the report, the decarbonisation pathway for certain sectors to meet the objective of the Paris Agreement requires significant structural investments that are in the current technological, political and fiscal environment not rational for either the companies in these sectors or their investors. That is where shareholder engagement knows its limits, and where investors need to take a more proactive stance in public policy discussions. In July 2021, the European Commission launched a very ambitious package of climate policies and regulations with the aim of translating the objectives of the European Climate Law (-55% of GHG emissions by 2030 and neutrality by 2050) into sectoral regulation. It is **vital that investors engage with policymakers to ensure these regulations give the right incentives and signals** to these sectors to decarbonise. It is also vital in these discussions that **investors concretely explain how they can contribute** to financing these decarbonisation efforts.

100 See Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement at <https://bit.ly/3iddnfw>

101 See EU Commission's Renewed Sustainable Finance Strategy at <https://bit.ly/3iQMqhK>

## 2 Improving market signals generated through the EU sustainable finance agenda

Another possible avenue for investors to exercise some indirect impact, is to collectively send strong and clear market signals, which in turn may create a stronger focus on sustainability.

- Strengthening the SFDR's classification** - One of the strongest signals emanating from the EU sustainable finance agenda has been the wide uptake of the SFDR by the asset manager and institutional investors community. The classification of financial products into different groups of Article 9 (sustainable investment objective), Article 8 (promoting environmental and/or social characteristics) and Article 6 (focusing on ESG risks) has seen a very wide uptake in all the European markets as well as beyond the EU's border in global markets. However, evidence available<sup>102</sup> shows that **financial market participants have been giving widely different interpretations to the different categories**, leading to situations where products in the same SFDR category are hard to compare. As a result, a growing number of national regulators are adopting local guidance and rules to protect investors, further increasing the risk of fragmentation of the European market. Therefore, we believe a review of the SFDR will be urgently necessary to clarify and specify further the different categories of funds.
- Ensure the criteria of the EU Ecolabel are calibrated to see some uptake in the market** – The aim of the EU Ecolabel for retail investment funds is to make available a voluntary label that applies throughout the EU. As we know from existing labels on the market, a label's success and ability to exert impact depends on its ability to achieve an equilibrium state between two goals. On the one side, being a label with sufficiently ambitious and stringent requirements, while on the other side allowing for a large enough scope to cover sufficient products and assets under management, in turn sending a signal to other investors. Reaching this equilibrium requires constant balancing. Unfortunately, the draft EU Ecolabel standard as currently designed, linking to the EU Taxonomy, is very stringent but may prove impossible to comply with for a very large number of existing investment funds. Therefore, it is not expected to form a powerful signal to investors. It is vital that the final criteria of the Ecolabel are calibrated so that enough products can apply for the label.
- Ensuring the EU Taxonomy sends the right signals** – As a classification tool identifying economic activities compatible with the climate objectives, the Taxonomy has the potential to send strong signals to both companies and investors about the future direction of travel. If the Taxonomy is to act as a source of these signals, it needs to be **usable** by investors in their capital allocation processes, **based on scientific evidence** and **clearly differentiating between economic activities already deemed sustainable** and fully compatible with environmental objectives, and those that are in transition or necessary for the transition. A Taxonomy not deviating from these principles is likely to send diluted and possibly conflicting messages to investors and is therefore likely to have a reduced impact on the flow of capital.
- Make companies accountable for net-zero commitments under CSRD** – Ahead of COP 26, many companies and financial institutions are making net-zero or Paris-aligned commitments. While the overall signal to markets is strong, it is already clear that these commitments are uncertain, not always verifiable and not comparable between companies in the same sector. Therefore, there is a need for policy and regulation to formulate a **robust definition of net-zero** and Paris-aligned, based on **solid and robust sector and regional transition pathways** that underpin climate scenarios. The current review of the CSRD<sup>103</sup> offers the opportunity to ensure that companies publicly committing to net-zero are required to disclose: (1) the base-year scenario and its assumptions used, particularly when they do not use a publicly available scenario, (2) explanations for why publicly available scenarios are not adequate, (3) setting of interim targets and objectives before 2050, (4) a description of sectoral decarbonisation pathways used, particularly if and how they are materially different from publicly available sectoral decarbonisation pathways, and, (5) explanation of why and how carbon offsetting is justified to decarbonise certain activities.

102 See, amongst others, Morningstar research report (2021) "SFDR: Four Months After Its Introduction" at <https://bit.ly/3aoT6z7> and Autoriteit Financiële Markten (AFM) report (2021) "Implementation of the SFDR" at <https://bit.ly/3BUGPyi>

103 See COM(2021) 189 final Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting at <https://bit.ly/3AUJyXj>

### 3 Increasing investor impact by de-risking investments necessary for net-zero

Finally, investors can have a significant impact by considering tilting their asset allocation towards companies and projects necessary to reach environmental objectives but currently lacking access to the necessary funding.

- **Increase public spending in the form of PPPs or blended finance** - In the EU, around half of the €28 trillion investment required to reach carbon neutrality by 2050 are deemed not financially feasible by companies and investors in the current environment of policies, regulations, taxes and technological development<sup>104</sup>. As a result, these necessary investments will not, at this stage, find the necessary funding from private capital alone. Considering the need to internalise 90% of unaccounted carbon cost by 2050, there is an enormous expectation for governments and their public banks to offer climate-related blended finance schemes to mobilise private capital at scale. The intentions of the European Investment Bank (EIB) to be Europe's climate bank is a very welcome development, but more will need to be done at a larger scale by European Member States.
- **Asset allocation towards emerging markets** – A key determinant of whether we manage to achieve the objectives of the Paris Climate Agreement by 2050, rests according to the IEA<sup>105</sup> on how Asian economies and emerging markets will address their increase in energy demand in the future: will this demand be met by renewable energies or traditional fossil fuels? The sheer scale of investments required there show that the choices made will impact the ability of the world to reach the climate objectives. Therefore, investors could have a very positive impact by expanding their exposure to investment strategies focused on clean energy investments in emerging markets<sup>106</sup>. Policymakers should **facilitate and encourage investors to complement public-finance focused initiatives for emerging markets with private capital allocation** to expand the financial flows to emerging markets.

### 4 Go beyond transparency to focus on reorienting capitals

Much of the EU sustainable finance agenda has focussed on bringing more transparency through increased disclosures. While more transparency is critical as a precondition to orchestrate change, it is not sufficient to orchestrate the scale of investments and associated transition efforts needed fast enough.

In this situation the current sustainable finance agenda needs to be complemented with policies seeking to **price negative climate, environmental and social externalities**, sending very strong signals to companies and financial markets by making harmful investments more expensive and sustainable investments more competitive. The European Commission proposed in July 2021 as part of the EU Green Deal its Fit-For-55 Package to ensure the European economy aligns with the climate target set in the European Climate Law of -55% of GHG by 2030 and the alignment with the objectives of the Paris Agreement in 2050.

The review of the EU Emissions Trading System (ETS) that sets a target for emission reductions to price carbon and increase renewable energy by 2030 is a step in the right direction to shift investment from brown to green technologies. But we must be mindful that the EU ETS is a means to an end. While it covers 41% of the EU's total emissions, it only gives a price signal to polluters to accelerate GHG emission reductions. Such price signal, even if gradual, will allow companies to internalise the carbon costs into long-term investing strategies.

We encourage the EU to be more ambitious and raise in a gradual and transparent way the **minimum explicit carbon price (ETS) or implicit carbon price (through sectoral regulation)**. The ETS price has increased since 2017 and hit €64 towards the end of September 2021. According to the Potsdam Institute of Climate Impact Research (PIK), however, the effective cost of carbon should be between €80 and €140 per ton of CO<sub>2</sub> in a structural way, as 90% of emissions are currently priced below external costs due to inter alia fossil fuel subsidies<sup>107</sup>. Others argue that a minimum price of €100 per ton of CO<sub>2</sub> is needed to reorient capital<sup>108</sup>. In view of setting the intermediate targets for 2040, it is paramount that the EU halts providing diverging incentives to decarbonise sectors and opts for harmonising a minimum carbon price across industries.

104 See McKinsey (2020) report "How the European Union could achieve net-zero emissions at net-zero cost" at <https://mck.co/3AUMTFP> as well as McKinsey (2021) report "Net zero or bust: Beating the abatement cost curve for growth" at <https://mck.co/3lSf0kJ>

105 See for instance the International Energy Agency's (2021) report "World Energy Investment" at <https://bit.ly/3jdFXxw> as well as report by the Global Financial Markets Association and Boston Consulting Group (2020) "Climate Finance Markets and the Real Economy" at <https://bit.ly/2Z2Ysha>

106 See for example Larry Fink's (2021) guest essay in the New York Times "Rich Countries Must Bear the Cost if We Can Ever Hope to Achieve a Net-Zero World" at <https://nyti.ms/3voZWhz>

107 See Edenhofer, Franks and Kalkuhl (2021) "Pigou in the 21st Century: a tribute on the occasion of the 100th anniversary of the publication of The Economics of Welfare" at <https://bit.ly/3FVnMXd>

108 See McKinsey (2020) report "How the European Union could achieve net-zero emissions at net-zero cost" at <https://mck.co/3AUMTFP>

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