The ESG policy tsunami making landfall in 2021

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If sustainable investing reached a high-water mark in 2020, then the level of investor enthusiasm shows no sign of receding in 2021. But a new force is looming on the horizon: EU regulators and the incoming sustainable finance package, writes *IJGlobal* Funds Editor Ott Tammik

Institutional investors – notably publicly-backed pension funds – are more vocal than ever before about their commitment to sustainability. And they are being heard – given the vast amounts of capital they supply to Wall Street and the City. Environmental, social and governance (ESG) issues have become a prerequisite for investing, and in no year has that been clearer than in 2020.

“In our experience, in terms of the intensity of interest from investors and also the requirement of investors to evidence ESG performance, I’d say 2020 bears no real comparison to 2019 or 2018,” says Jonathan Maxwell, chief executive and founder of London-based Sustainable Development Capital LLP (SDCL).

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“There would be plenty of investors with us that could not, and would not, have invested had it not been an ESG-compliant proposition. And that is completely different from the world two years ago.”

While 2020 was also the year of Covid-19 and Black Lives Matter, the flow of sustainability-related business news has been hard to keep up with.

It’s only scratching the surface to note GE’s exit from the new-build coal-fired power plant market, Brookfield’s appointment of former Bank of England governor Mark Carney as head of ESG, China’s commitment to become net zero by 2060, Tesla’s incredible stock price rally, and the record number of sustainability funds that have launched this year.

Looking ahead into the new year, having a Democrat in the White House is likely to bode well for the sustainability cause, perhaps bringing the US back to the Paris Agreement. This would stand in stark contrast with recent US policy positions – not least the Securities and Exchange Commission’s rejection of formal ESG guidelines.

In the meantime, the EU has stepped in to become the global leader on sustainability, with far-reaching implications even for non-EU companies and financial firms doing business in the EU. First outlined in 2018, the EU’s Sustainable Finance Action Plan will require companies and fund managers to begin filing detailed disclosures, starting in 2021, about their business’s impact on the environment.

Five years on from the Paris Agreement and the UN Sustainable Development Goals, it appears social, political and financial interests are broadly in alignment.

Whereas the 2010s were the decade of renewables, the 2020s are poised to see sustainability initiatives extended across a wide range other sectors, such as electric vehicles, energy efficiency and hydrogen. And if one considers that after all the huge amounts of investment in renewables, wind and solar still only make up just 9% of global power generation – and moreover that power generation accounts for just a fraction of carbon emissions – then the incredible scale of this investment universe starts to become clear.

Legislating sustainability

The Sustainable Finance Action Plan, which currently consists of three major regulations, will require financial firms and corporations to submit regular reports about their impact on the environment and climate change.

The new EU rules are part of the union's strategy for achieving the UN Sustainable Development Goals and the Paris Agreement.

"Global emissions must drop by 50% over the next decade for the world to have a chance of staying at 1.5 degrees of global warming and thus avoid the most catastrophic consequences of climate change," EU documents say.

Under the new regulations, fund managers will need to begin making sustainability disclosures, annual reports, and both organizational and portfolio-level evaluations based on new ESG criteria called the EU taxonomy.

The core components of the Sustainable Finance Action Plan include:

- Sustainable Financial Disclosure Regulation (SFDR) – requires investment firms to disclose sustainability and risk aspects of their investments
- Non-Financial Reporting Directive (NFRD) – requires corporations to publish data about their impact on ESG factors
- Taxonomy Regulation – provides a sustainability classification system for investment firms
- additional reforms such as an EU Green Bond Standard and a Financial Services Ecolabel

Several years in the making, this huge regulatory undertaking will be rolled out over the course of 2021.

The disclosure regulation will be the first to be implemented, in March 2021. It will require fund managers to determine the extent to which sustainability objectives fit into their strategy. The more important sustainability is to a fund's strategy, the more thorough the disclosures need to be. Products specifically marketed as sustainable funds will face the strictest requirements.

"Fund and asset managers are busy recategorizing their products to determine which bucket each one falls into under the disclosure regulation," says Vanessa Havard-Williams, global head of environment and climate change at Linklaters.

The taxonomy rules, which are due to be implemented in late 2021, will also include sector-specific thresholds: for instance, sustainably produced power is defined as below 100 grams of emissions per kilowatt-hour, whereas in the transport sector it's 50 grams per passenger kilometer (reducing to zero by 2025). The detailed evaluations will even consider factors such as the rare earth metals that need to be mined for wind turbine manufacturing.

With the initial focus being environmental sustainability, in 2022 the EU will also introduce social and governance standards.

Ultimately, the aim of the regulations is to bring consistency to the ESG space – where hundreds of different methodologies have been developed in recent years – and to cut down on greenwashing.

Although the Sustainable Finance Action Plan will not force companies to become more sustainability-minded, it will introduce a whole new level of transparency, giving investors a much clearer picture of the companies and funds that they invest in.

The EU is not the first to adopt such measures – that honour goes to New Zealand – and others such as the UK and Canada are developing their own sustainable finance regulations. But given the EU's reputation as a regulatory superpower, its rules are bound to have global implications, as they have had for data privacy and telecoms standards.

Asset managers prepare for new era

A few years ago, it was not at all clear that the EU's new sustainability proposals would be successfully implemented. There have been disagreements over the pace of implementation, the complexity of the reporting requirements, and the classification of certain technologies, such as natural gas. Over 100 respondents to a EU policy consultation that is currently under way oppose a proposal to create a separate taxonomy for pollution-linked market activities.

But Europe's private sector appears, on the face of it, to be broadly supportive of the general thrust of the regulations.

This is reflected in the level of voluntary reporting that companies are undertaking and initiatives such as the Sustainable Development Investments Asset Owner Platform, which launched last year with the backing of pension fund managers APG, PGGM, AustralianSuper and BCIMC.

From its origins in morally driven investment strategies that avoided "sin stocks", ESG has filtered into the more opaque private market, where ESG considerations are now seen as critical for mitigating risk and even boosting returns.

"If [private equity firms] haven't built environmental, social and governance standards into their investment strategies already, GPs are fielding uncomfortable calls from their limited partners and employees asking why not," a report by Bain says.

One organization involved in the expert committee helping to develop the new EU regulations is Principles for Responsible Investing, a UN-backed member and grant-funded organisation that represents more than 3,000 investors.

Will Martindale, PRI's director of policy and research, says the investment industry has been receptive to the Sustainable Finance Action Plan.

"There is an acknowledgement within the investment industry that we do need to have a common language in how we understand what's environmentally sustainable and what's not," says Martindale.

"If an investor is very new to the taxonomy process, I think it's understandable that they consider it to be somewhat complex, but a recent exercise by PRI signatories demonstrates that the taxonomy framework can be operationalized, and offer important insights for investors beginning their taxonomy preparation."

For investors, the implications of the regulation will vary greatly depending on a fund's size, portfolio diversity and objectives.

Yet even fund managers with sustainability objectives say they can no longer take investor demands for disclosures on ESG metrics for granted.

Infrastructure – a natural fit

"Infrastructure has probably the most direct impact on the environment, be it energy or highway or an airport," says Gordon Bajnai, the global head of infrastructure of Campbell Lutyens, a placement agent. "By its nature, it also always has some kind of cooperation with the public sector and typically services broad public demand."

Bajnai says that when Covid-19 hit global markets in early 2020, investors feared that ESG's significance could decline as businesses fight for survival and refocus priorities. But in a recent industry survey by Campbell Lutyens, 68% of limited partners said that their sustainable investing allocations would increase in the medium term – supporting the conclusion that the crisis has accelerated capital flows into ESG investments.

In the recent GRESB rankings, which evaluate real asset investors based on their ESG performance, Arcus Infrastructure Partners was the highest ranked fund manager in the infrastructure sector.

"Infrastructure is uniquely placed because it's at the heart of everyone's day-to-day life," says Neil Krawitz, a partner with Arcus Infrastructure Partners. "And because of the significant scale of the business, it's possible to deploy significant amounts of capital as a driver of sustainability. Not all forms of private equity have that ability to influence huge change."

Arcus' current investment portfolio includes fibre, smart meters, cold storage and logistics companies – all of which, the firm argues, have qualities that are essential to sustainability.

While the most straightforward green investment target is renewables – the "low-hanging fruit" of sustainable investing – the insatiable appetite for renewable energy assets will inevitably lead to prices overheating, several investors were quick to point out. But the sustainability mindset, including social and governance factors, needs to move beyond just the power sector, they say.

On the other end of the spectrum, those in the fossil fuel business face mounting pressure. Export finance agencies and commercial lenders are increasingly turning away from the oil and gas sector. New coal-fired power projects are dead in Europe. Some market participants are more keen than others to support natural gas – as a cheap and relatively clean transitional energy source.

"Clearly there are certain assets that could potentially deliver declining returns as we move forward and as trends evolve in the marketplace, you could get yourself invested into a stranded asset," says Ted Frith, COO of GLIL, an infrastructure investment platform created by the Greater Manchester Pension Fund and the London Pensions Fund Authority.

"So on one hand it's about avoiding negative impact on your returns and on the other hand it's also looking at it from a much more positive light and these trends that we're seeing in the world are providing new opportunities to pension funds and other investors. EV charging points or renewable energy – that just wasn't there 20 years ago. We are also concerned about making a positive contribution to the social fabric of the country as a whole."