2021: ESG Review

Overview

As we wrap up the year, we thought it would be helpful to write a summary of some of the biggest topics in the ESG space and to provide our commentary on them. As ESG advisors, we have seen tremendous positive momentum and innovations that have helped push sustainable finance further, however significant challenges remain. With our mission to educate financial market participants to be forward-thinking and positively transformative, this piece aims to bring you up to speed with some of the latest developments.

To approach the past year in a easily digestible manner, we have structured this review as mini summaries by topic:

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There seems to be a common trend throughout: We expect a continued push for transparency and genuine action that takes the longer term into account since the quick wins may result in us missing the point of the issues we aim to solve. Regulation plays an important role, but we should all be proactive and sincere in our ESG communications.

Naturally, there are numerous topics we have not mentioned in depth, such as biodiversity and the continued evolution of reporting standards. If there is a particular topic that you would like us to report on, please reach out at info@northpeakadvisory.com.

About NorthPeak Advisory

NorthPeak Advisory ("NPA") is a boutique ESG advisory firm, providing tailored ESG solutions for asset managers and corporates. We create bespoke solutions that address our clients' internal and external needs in the design, implementation, and valuation of ESG processes. A core part of our services involves conducting ESG due diligence assessments and evaluating the ESG practices of both managers and companies.

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Christina works as part of the Advisory team at NPA. She has spent her career at the intersection of finance and sustainability and brings a wealth of experience in Responsible Investment and ESG analysis. At NorthPeak, Christina works across strategies, helping managers advance on their ESG journeys both at the corporate level and in terms of tailored ESG integration frameworks on the investment side.

1. Climate Optimism

The purpose of this first short article is to provide clarity around arguably the biggest risk to our economy and society when it comes to both the impact and its likelihood of materialising.[1] I also want to make sure to highlight some of the work that has been going on for a while when it comes to addressing climate change. It seems to me like many are unaware of the wave that is building up in the financial services space, while also there is a wide misconception of what actually drives change. Governments, regulators, academia, trade associations, individuals etc all have a role to play in solving this issue, and when thinking about the unique role that the financial services industry can play, there are numerous reasons to be optimistic.

What do we need to do?

There is a lot of momentum around climate action in both the private and public sector. Since climate change is a systemic issue that requires action from everyone, we highlight how different actors are addressing the issue in this article.

Before jumping in to the actions, it is important to put things into context: We would need to reduce global GHG emissions by 30% by 2030 from 2010 levels to meet 2°C and 55% to meet 1.5°C by the end of the century (in line with the Paris Agreement), according to UNEP's Emissions Gap Report 2021. Comparatively, the report highlights that global CO_2 emissions were only reduced by 5.4% during 2020, when international travel halted due to the Covid-19 pandemic. The report also flagged that if all the unconditional 2030 national pledges (as of September 2021) would be fully implemented without any further strengthening, we would only reduce 2030 emissions by 7.5%, and thereby the world would be heading towards a 2.7°C temperature increase by the end of the century.[2]

It is therefore clear that action and heavy lifting is needed throughout society and the economy. The asset management industry will not save the world alone, but it has a huge role to play in pushing capital towards transformative companies, climate solutions, and away from those who are denying the problem at hand.

Meaningful **action?**

First of all, I would like to start with my view that 'defunding' fossil fuels is an important campaign, but is often applied in a too simplistic manner for it to be successful. The frustration is understandable – we need to act urgently and the rate of change to date has not been fast enough. In practice however, different types of investors have different tools available for exerting their influence and therefore the 'best' way forward looks very different depending on the strategy. For some strategies, where little or no engagement is possible, it may well be that divesting is the most reasonable course of action in order to not contribute negatively to climate change. However, when engagement is possible, it is significantly more impactful to use levers of responsible ownership to drive change. In fact, there have been numerous cases where investor activism and engagement has lead to impactful corporate action.[3]

I would argue that divestment can be highly counterproductive to the impact it intends to achieve. What happens when those who care about climate change completely divest from high emitting sectors is that (1) someone else needs to buy the share and until then, the price of the share falls, making it a much more attractive investment for those who do not consider climate change issues, (2) as a result, the shareholder base becomes skewed towards investors who do not care about climate impact or do not try to influence the firm to transform. This implies that the other responsible investors are now less able to exert their influence because they collectively own a smaller portion of the firm.

In the same fashion, simply by owning a share investors are not expressing any demand for change, and as such, if any *impact* is aimed for, engagement through voting, dialogue, shareholder proposals etc. is necessary.

[1] World Economic Forum, Global Risk Report 2021
[2] The well below 2-degree scenario is perceived as the limit for avoiding significant and catastrophic changes to the planet's climate.
[3] A famous example we saw in 2021 is the case of Engine No1 against Exxon's board.

But, what if management is unwilling to change though? Ideally, as with the case of Exxon, you will reach the point where the leadership is forced to change because it lacks the skills to drive the company towards a low carbon economy. Climate change is a fact, and those who fail to understand its seriousness may not be fit to lead emissions intensive firms through the transition. Ultimately, these firms are likely to be driven out of business as more efficient solutions emerge and as regulation kicks in. You may argue that we do not have time to wait for these firms to go out of business, but divestment does not drive this change any faster.

"Nothing is more greenwashing than divestiture, because it doesn't change the footprint of the world"
- Larry Fink, CEO BlackRock, 2021

And what about fixed income investors that cannot exert influence through the same active ownership levers? Firstly, you may still be able to vote on proxies in the case of debt to equity swaps, so be prepared to have a stance on climate related matters if this situation arises. Secondly, some fixed income investors may be able to have a look at what the proceeds are being used for – is this loan for developing new GHG-intensive products or plants? Could the proceeds be used for reducing emissions or developing less intense alternatives? In the fixed income space, there are numerous product innovations happening, whereby investment managers can earmark what the proceeds should be used for (read more in *Bonus: Sustainable Debt* on page 8), include climate-related disclosure or performance targets as part of the term sheets, or even link targets to the interest rates.

For sovereign debt, meeting net zero ambitions at the investment level is incredibly challenging without action from policy makers and government. In May 2021, a group of institutional investors and industry initiatives, announced the creation of the Assessing Sovereign Climate-related Opportunities and Risk ("ASCOR") project. Overseen by an Advisory Committee, the project aims to create a tool for investors to understand sovereign climate risk exposure and provide guidance on how to engage with sovereign debt issuers and policymakers. We expect 2022 to bring new innovations and a healthy debate on this topic.

For quant managers, the climate issue may be relatively easier to assess compared to the social side of ESG because there is more data available on firms' and countries' GHG emissions, physical climate risk, regulatory climate risk etc. Some have started tilting portfolios or forecasting whether or not these data points have the potential to impact the financial performance of the investments. Back-testing on climate data is hard and arguably of little use given the time dimension whereby the impacts of climate change worsen over time, regulations are being introduced making poor performance even costlier, and public perceptions are continuously turning against polluters and emitters. The direct engagement element is more problematic here, but data driven approaches can still be taken to shareholder advocacy and engagement on improving disclosures is especially relevant.[4]

What is happening on the ground?

At the country level

Countries are setting their plans for achieving carbon neutrality and carbon negativity. How does this work in practice? It depends on the country, but every five years countries are expected to submit their national climate action plans – Nationally Determined Contributions ("NDCs"). Importantly, actions include carbon taxes or pricing, subsidising and investing in green tech and innovation, country wide policies to accelerate the transition to a low carbon economy.

There is still the urgent need for all countries to pledge net-zero emissions and improving the robustness of the plans for meeting net-zero targets. The new and updated NDCs as of 2021 have been found to be "insufficient to achieve the temperature goal of the Paris Agreement".

Not all countries can set the same targets though and it is important to take into account the local context and development needs. In developing countries, environmental action goes hand in hand with social needs. Especially for countries that are heavily reliant on coal or where populations currently lack access to electricity to begin with, the action plans need to be different compared to those who already have solid infrastructures in place.

[4] See for example Acadian Asset Management's approach to responsible investment here.

At the company level

Ultimately, much of the country-level action will be driven by the companies that operate within them. Here, it all starts with measurement and many companies have measured and reported on GHG emissions data for a long period of time already. For instance, the GHG Protocol released a beta version of reporting tool to help companies calculate their emissions in line with the GHG Protocol standards and estimating scope 3 emissions.[5] Companies are measuring their carbon footprint in order to identify where leaks may arise, how to optimise current operations, diversify and innovate away from areas that are non-transformable, and setting targets for improving.

On targets specifically, there are best practices that should be looked at, such as using science-based targets as recommended by the Science-Based Targets initiative and framework.

At the investor level

At NorthPeak, we see investors increasingly asking about what to do about their climate impact – both at the firm level and for the investment process. For some investment strategies the fund level carbon footprint is easier to calculate (e.g. long-only public equity funds) whereas for others there is virtually no sensible methodology out there (e.g., foreign exchange funds).

It is encouraging to see many committing to action beyond the investment process as well. Numerous funds have taken the responsibility to act on climate change to also include operational aspects such as travelling less, reducing waste and switching to renewable energy use. These are important actions, however, the biggest portion of an asset manager's GHG emissions lie in their investment activities. Here, if possible, it would be important to try to source GHG data or engaging with issuers to understand how they are managing their climate related risks and impact.

We saw an increasing number of examples of net-zero commitments in 2021, among both asset managers and owners. The Net Zero Asset Managers Initiative had 220 signatories with $57 trillion assets under management ("AUM") as of December 2021, whereas the Net Zero Asset Owner Alliance includes 65 institutional investors with over $10 trillion AUM.

At the consumer level

Consumer preference, mainly in the developed world and among the wealthier population, has continued to shift towards buying from ethical and responsible brands (e.g. certified B Corporates), switching to less GHG-intensive methods of travel, trying to buy locally sourced food products.

On a global scale, the majority of people still live in conditions where a "sustainable" lifestyle and reducing personal footprints is not feasible – partly constrained by education about healthy and sustainable alternatives, but also due to the lack of affordable alternatives. Not everyone has the same opportunity to live 'sustainably' and it is unjust to expect all individuals to take the same actions.

Importantly, the interlinked nature of climate, our ecosystems, and social issues means that we will struggle to solve climate change if we do not take a system's view and look at how inequality, biodiversity, water and general pollution etc. all are connected. As with most ESG issues, the systemic nature of the challenge at hand requires a systems solution.

What about methane?

The climate discussion tends to be focused on carbon dioxide emissions and footprint – perhaps because there is more data available and because CO_2 accounts for roughly 66% of global GHG emissions. However, methane, which only accounts for 16% of global GHG emissions has "more than 80 times the warming potential during the first 20 years after it reaches the atmosphere" (EDF). A recent report by the Climate and Clean Air Coalition together with UNEP found that reducing methane emissions is one of the most cost-effective strategies to reduce the rate of warming since concentrations of GHG in the atmosphere will fall faster. The tunnel focus on carbon dioxide can therefore be

[5] Scope 3 emissions are the hardest to measure as they include all indirect emissions occurring in a company's value chain. See standards by the GHG Protocol here.

counterproductive to the ultimate objective of fighting climate change, and actions in 2022 should focus on methane as well.

Read more about actions against methane here:

- The Global Methane Pledge, announced at COP26, commits its signatories to cut their emissions by 30%, compared to 2020 levels, by 2030.
- UNEP: Methane emissions are driving climate change. Here's how to reduce them
- EDF: Pilot project to detect emissions leaks and create methane maps

2. ESG Scepticism

Over the past year there have been numerous critiques of ESG and the Responsible Investment industry. Many of them excellent and highlighting the challenges that the ESG movement faces. The criticism has fuelled a debate and often successfully exposed those who use the ESG trend as a mere misleading marketing exercise.

Do not get me wrong, the industry does require scrutiny, and disagreement is necessary for a healthy debate and driving this space forward. At the same time though, there is also INCREDIBLE misuse of the ESG term by those who claim to expose ESG fakes. As an ESG advisor, my eyes twitch every time I read stories about individuals finding a fossil fuel company in an "ESG fund", or people being shocked when "ESG funds" do not focus on impact. I am writing to all of you, please can we all start using the term "ESG" responsibly?

I am personally very tired of these news articles 'exposing' ESG funds by pointing out that they invest in companies that may be defined by some as "unsustainable". I keep finding myself coming back to the same point: what everyone should know is that there is a difference between "how E, S, and G issues affect an investment" versus "how an investment affects E, S, and G". And it seems to me that many sceptics believe ESG is purely about the latter.

This is the point

ESG is not the same as impact. ESG is not an objective assessment of the sustainability of a firm or country. ESG literally means "Environmental, Social, and Governance" not a specific investment objective or set of values. Responsible investment itself is a spectrum and does not always specifically aim for impact, while E, S, and G information is used by investors in numerous different ways to help build an opinion on an investment or to inform stewardship activities. Most commonly, "ESG funds" use this additional information to help identify investment risks and opportunities (i.e. how ESG issues may impact their investments), or to help drive change in firms who are performing poorly on ESG-related matters, or to build impact investing strategies, or to align their investments with ethical beliefs by ensuring no involvement in particular industries or companies – or a combination of these. Therefore, the one criticising "ESG funds" should first fully understand the nuances of the responsible investment spectrum and then look at how the manager describes the incorporation of ESG information and what this is solving for. If there are inconsistencies between the ESG policy and what is happening on a daily basis or what is reported on – this is cause for concern. But if the way the fund uses ESG information does not align with an outsider's view of 'sustainability' or 'ethics', this is hardly greenwashing and rather comes to the core of subjectivity in ESG, sustainability, and investing itself.

On the topic of what ESG is and is not, there was an article recently about "The ESG Mirage" in Bloomberg stating that "MSCI, the largest ESG rating company, doesn't even try to measure the impact of a corporation on the world". In MSCI's methodology, they do not claim to measure impact and their website states that the ESG Rating is "designed to measure a company's resilience to long-term, industry material ESG risks". This is not the same as the impact of the firm on the external environment – rather it measures how the external environment impacts the firm. MSCI's ESG ratings have always been about the ESG risk exposure and how well companies are managing this – not about quantifying the impact of the company on society or the environment. MSCI does have impact metrics and this is a different product offering from the ESG Ratings. Similarly, there are data providers out there who

specifically focus on impact (see for example Clarity AI and Richmond Global Sciences), while others focus on material risks and opportunities, sentiment, or specific ESG themes.

ESG data providers should be held accountable for misleading marketing practices and should provide transparency around what their products do and do not measure. But similarly, those using the products should understand the spectrum of responsible investing and the numerous use cases for ESG information.

Let me give you a simplified example for thought

Consider an investment manager looking at investing in companies located in a water scarce region.

The manager can look at how the water scarcity in the region and water management practices may impact the future value of each firm, investigate the exposure to water-related regulation and controversies, and assess how the water scarcity might change over the lifetime of the investment *(impact on the investment)*. She might want to focus on evaluating how and by how much the firms' practices impact the water scarcity in the region and the communities in which each of them operates *(impact of the investment)*.

If the investment manager has the opportunity to take ownership stakes in the firms, among other things, she might want to look at those who are water intensive to help them improve efficiencies, thereby reducing risks and drive long-term value. She might also decide that she does not want to be involved in companies that may contribute negatively to water scarcity, and thereby exclude poor performers completely. If she has the ability to short firms, she might want to consider shorting poor performers based on the conviction that they will be driven out of the market. Or, she might decide that she doesn't want to profit from those firms at all, and also excludes them from the shorting universe. What happens if she cannot take an ownership stake, and instead provides credit to these firms? She might decide that the water management aspect is not a significant enough downside risk that influences the ability of the borrower to repay its debt, and therefore goes ahead with the debt position despite the water issue. Or she might include water-related improvement targets in the loan terms or even link the interest rate to water-related KPIs. What happens if she is trading the price difference between the equity and debt of the firm? She would want to understand how water related risks and opportunities impact the movements between these two, if at all. What if she is trading the sovereign debt of the country that this region is in? Or the currency? Does water scarcity in a region have the potential to impact the exchange rate? If so, how, and by how much?

As you can see, the information about the water related aspects of the region and the firms can be used in numerous different ways depending on the investment thesis. And we haven't even discussed what KPIs to use, mentioned any other traditional financial factors, or even other E, S, and G issues that may be relevant for the investment in question.

Clearly, ESG cannot be applied in the same way across all funds, and it would be ridiculous to expect that ESG is a one-size-fits-all whereby you can criticize a fund as "ESG or not" purely based on the holdings of the portfolio.

To limit the uncalled-for scrutiny, it is of incredible importance that asset managers clearly explain **why** they believe ESG is important for their investment and ownership activity, **how** ESG information is used on a daily basis as well as evidencing **what** the outcome of this process has been through reporting. Similarly, ESG information is not as easily applicable across all asset classes and investment strategies, and therefore it is necessary to describe where on the journey the asset manager is as well as discussing future ambitions and timebound targets.

In response to the confusion and to provide more transparency, regulators have also started stepping in. A welcome development is the Sustainable Finance Disclosure Regulation in the EU, whereby fund managers are required to explain how ESG information is used in the investment process. There are still inconsistencies and confusion around how the disclosure and reporting requirements will evolve

and apply across different investment strategies. But we believe that this has the potential to be a step in the right direction.

Similarly, the Financial Conduct Authority in the UK shared a letter with guiding principles for fund ESG disclosures, after being concerned about the quality of fund applications. The FCA's guidelines were based on three principles:

i. The design of the fund and disclosure of its ESG investment strategy should be fairly reflected in the fund's documentation;
ii. The implementation of the fund's ESG investment strategy should be appropriately resourced and consistent with its disclosed objectives; and
iii. ESG-related information disclosed by the fund should be easily available and comprehensible for investors to enable them to make investment decisions.

Outside of the regulatory developments, we should all do our homework and call out those who are actually greenwashing and claiming to do something that they are not instead of policing funds against our own subjective beliefs on what should exist in an "ESG fund". In fact, there is no such thing as an "ESG fund" – at minimum, this is just prudent investing.

I have tried to explain this as clearly and concisely as possible, which is hard given how multi-faceted ESG actually is. I would love to hear your take on the matter and if you disagree. Hopefully we can drive the financial system towards solving the biggest issues that humanity faces together – ESG plays a role here, but impact investing more so.

3. Executive Pay

Corporates and investors are increasingly linking compensation, and specifically executive pay, to long-term performance indicators or sustainability targets. In the UK, almost 50% of the 100 largest firms have used ESG related targets for executive pay. The trend is unsurprising, given the urgency to take action on material sustainability issues and externalities, and therefore it is deemed important that incentives are aligned from above in order to drive change.

This is not a new phenomenon by any means. Alcoa was one of the first companies to link executive pay to sustainability performance in 2013. Other notable firms include BP, Chipotle, Danone, Siemens, Starbucks etc. Depending on the firm, the pay may be linked to specific ESG issues such as climate related performance, or diversity, equity and inclusion, or general ESG performance.

In January 2021, Apple announced that it would amend executive cash bonuses to align with its social and environmental values. The tweak implies 10% increases or decreases in bonus payouts after reviews of executive performance in line with the values. Its CEO, Tim Cook, was still one of the highest paid US CEOs, with a compensation 256 times higher than the median Apple worker. Pay ratios have been increasingly apparent in shareholder proposals in the past year, and we would expect this to continue given the increased focus on addressing inequality.

There has been a healthy debate around this topic and the efficacy of these measures driving the performance initially intended. Alex Edmans, professor at London Business School, suggests that it would be important to consider executive compensation in terms of shares that would need to be held after the executive leaves – thereby incentivising the executives to drive lasting change, and not simply meeting targets as quickly as possible without considering the longer term. Firms are at risk of "hitting the target, but missing the point", says Edmans, which arguably extends to many ESG issues on the whole as well.

Overall, investors are helping to drive transparency around pay, with for example Blackrock's US investment stewardship guidelines for 2022 including specific mentions of executive pay related to

sustainable long-term value. We do believe that investors and other stakeholders will continue to push for more transparency in 2022, and expect to see that firms proactively develop sustainability strategies with clear ambitions and link compensation to these accordingly, while shareholders will continue submitting proposals for voting on the lack of these.

4. Inclusion Awareness

We have been delighted to see the increased focus on meaningful strategies around diversity, equity and inclusion. In October, we published our whitepaper on the topic, aiming to provide useful action points for firms to consider.

Taking action on DEI was pushed higher on the agendas of business leaders after the murder of George Floyd and the Black Lives Matter movement. Nevertheless, corporate focus has tended to be on the "diversity" aspect, and trying to address the quick and visible wins through hiring talent that comes from underrepresented backgrounds and signing up to initiatives. These actions are important, but a blind focus on diversity without the aspects of equity and inclusion is short-sighted and will unlikely lead to lasting and significant improvement for society as a whole.

In 2021, we saw more firms recognising the need for identifying hidden barriers that may hinder individuals to succeed, taking action on mental health, and accepting that the cultural and local context has an important role to play in the success of DEI actions. We expect firms, and especially the financial services industry, to continue innovating on the equity and inclusion area of DEI, and are hopeful that 2022 will bring more transparency around the issue at hand.

For more insight on DEI, you can download our full paper here: Diversity, Equity, and Inclusion in the Financial Services Industry

Finally, I want to leave you with a couple of data providers focused on DEI.[6] As we all know, the 'S' in ESG is still lagging behind when it comes to meaningful KPIs and coverage, but data providers, regulators, and standard setters are working to overcome this issue. Generalist ESG data providers tend to have 'S' related data points that can be purchased as part of the ESG products, but also specialist providers exist. See a few examples here:

- Diversio: Provides data and tools for companies and investors to measure and improve performance on diversity and inclusion. The company has created an "Inclusion Score" that specifically aims to measure inclusion – which tends to be overlooked by traditional metrics focused on representation.
- Equileap: Provides data on gender equality, with metrics including female representation, gender pay gap, parental leave, and anti-sexual harassment policies.

Bonus: Sustainable Debt

Let me end with an exciting trend that is here to last: Sustainable debt instruments are booming.

A report by the Climate Bonds Initiative found that the global issuance of green bonds is on track to reach $400-500bn in 2021 – almost double of that in 2020. And indeed, as of early December, the 2021 issuance of green bonds had already reached $435bn. Beyond green bonds, sustainability-linked bonds

[6] NorthPeak Advisory has no commercial relationship with either data provider.

have seen an uptake since the first target-linked bond was launched by Enel in 2020. In July 2021, Enel launched a $4bn multi-tranche sustainability-linked bond for institutional investors, linking Scope 1 GHG emissions reductions targets to the interest rate. We would expect this trend to continue as standards for classifying bonds and loans as green, sustainable, social, or transition instruments continues to evolve.

The challenge that this development sees is mainly the different ‘shades of green’ and the definitions of ‘sustainable’, whereby the risk of greenwashing is prevalent. It is therefore important for anyone creating or assessing these instruments to ensure that the process and monitoring is transparent and that global standards are adhered to.

Outside of specific sustainable debt instruments, we also saw ESG criteria being increasingly used in loan terms, with the ELFA and LPA updating their best practice guidance on how ESG related matters could be included in term sheets.

Read more about best practice and guidance here:

- Best Practice Guide to Sustainability Linked Leveraged Loans (LMA)
- Green Bond Principles (ICMA)
- Green Loan Principles (LMA)
- Social Bond Principles (ICMA)
- Sustainability Bond Guidelines (ICMA)
- Sustainability Linked Bond Principles (ICMA)
- Sustainability Linked Loan Principles (LMA)

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