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TRANSCRIPT

Climate Regs Seek Progress, Not Perfection

Adam Bass (00:03):

This is MSCI Perspectives. Your source for insights for global investors and access to research and expertise from across the investment industry. I'm your host, Adam Bass, and today is June 9th, 2023. Regular listeners to this program know that the combination of investing, climate and regulation, well that adds up to a topic that takes up a lot of mind space, both at companies and within the investment industry. And you will also know that this combination leads to a veritable cacophony of acronyms. But as I spoke with our guests earlier this week, what became clear was that getting distracted by the alphabet soup was to miss the point. The need to measure, report and act has only grown stronger and frankly, time is not on our side. I explored this topic with Nakul Jadhav and Simone Ruiz-Vergote of MSCI ESG Research, as well as Brenda Kramer. She's Senior Advisor Responsible Investment at PGGM. Yes, another acronym. Here's that conversation.

(01:17):

First off, of course. Thank you all for joining us. We've really been looking forward to having this conversation, as you all know for quite a while. So let's dive in and perhaps Nakul you can start us off. Let's just define terms for folks. We're here today to talk about the EU sustainable finance package. So what is that? What are the key regulations around it?

Nakul Jadhav (01:42):

Yeah, so the EU sustainable finance package mostly has key regulations as the EU taxonomy, the SFDR. So EU taxonomy has been the most prominent regulation of the sustainable finance package, which has been in the news and in the works for the last couple of years and companies have really started reporting on this and SFDR also has now come into prominence as more often importance than the EU taxonomy. And those two are kind of like the building blocks or the major components of the EU sustainable finance package. So last year for EU taxonomy, it was more about eligibility, but from this year they have to also report an alignment and more and more companies have now realize the challenges coming from these two regulations. The reporting challenges, data challenges.

Simone Ruiz-Vergote (02:34):

And maybe just to add, there is also the EU green bond initiative or legislation that is voluntary, but if you want to have the EU green bond standard in the future, you will have to implement and follow the EU taxonomy.

Adam Bass (02:49):

That voice you just heard was Simone.

Simone Ruiz-Vergote (02:52):

And it was really the first use case, mandated use case, even though it's voluntary. But if you want the EU green bond bond label, you'll have to take this into account. So it empowers the taxonomy and gives it a direct use case linking it to bonds. But the taxonomy could also be used for broader reporting under the SFDR, the Sustainable Finance Disclosure Regulation. And it becomes mandatory and requires an assessment by an audit firm in the future. Under CSRD, which is the last piece maybe on this used sustainable finance package, the Corporate Sustainable Disclosure Regulation, and that one will enter into force next year only. So it's the last missing piece, but one that feeds all the rest in terms of data and reported information that everyone needs to disclose and measure alignment or adverse impact under the SFDR.

Brenda Kramer (03:45):

I agree. I think SFDR is very useful. It's basically about say what you do and do as you say.

Adam Bass (03:51):

And that's our third guest, Brenda.

Brenda Kramer (03:54):

So it increases transparency, and it really forces you to build on the claims that you do. So you can't just say, Hey, I'm doing this very nice pairs aligned benchmark, or things like you really need to substantiate that with data, and I think that's a major step forward. CSRD obviously is a key piece of fulfilling the architecture of companies reporting on what they do in taxonomy, what they do on critical ESG factors so that financial institutions can start allocate their capital in a different way. So we're eagerly waiting for CSRD to come in place and I really hope it's going to still be as substantial as we hoped it would be after the negotiations are finished.

Adam Bass (04:42):

So the negotiations are still going on. What is the timing that we're looking at?

Simone Ruiz-Vergote (04:48):

So there was a report from an external advisory group, EFRAG, and that was the foundation. And now, they come with their own proposals and they will run a very, very short consultation because in this before the summer, they want to have finalized these standards. So companies have sufficient time to look at them and implement them. And you need to remember that for a couple of the metrics that need to be reported, materiality assessment is required and that needs to be run now. So companies know actually what to capture as of next year. So that's why there's a high time pressure.

(05:19):

Brenda, what you refer to our concern right now is that the metrics that are required by financial investors, the principle adverse impact indicators for the SFDR reporting that they don't become mandatory as we had expected, but there is talk about making those as well subject to materiality assessment. However, they were always thought as a double materiality screen, which means it is relevant for each industry. Even if advertising business has nothing to do with emissions to water, it's still relevant metrics according to the SFDR. And so investors have to report it for all sectors. And now some sectors might not report it. That's difficult.

Brenda Kramer (05:59):

That will be problematic, right?

Simone Ruiz-Vergote (06:01):

Definitely, yes.

Adam Bass (06:03):

Brenda, problematic how? Can you expand on that?

Brenda Kramer (06:06):

Yeah, so if we are really dependent on the data that we get from the companies that we invest in, so we are obliged to do this set of, it's a set of 16 ESG indicators that are prescribed basically by the Sustainable Finance directive or sorry, Disclosure Regulation. And so if we don't get that data, it's going to be really hard to get credible and accountable data for that. There is a part in SFDR or actually also in CSRD that does refer to that investor should at least get the data that they need to fulfill their obligation. So there's some kind of legal hook, but still we see negotiations going a bit in a different direction. So it will be exciting to see what comes out of it and how this develops further in an international space as well. Because if you look at the IFRS and the International Sustainability Standards Board that is working on standards that should become a global benchmark or global baseline basically.

Simone Ruiz-Vergote (07:07):

Because in the end you need that data for your entire portfolio and not just for the European companies that report, right?

Brenda Kramer (07:07):

Exactly.

Simone Ruiz-Vergote (07:13):

And then the question becomes is these European regulations are applicable to the rest of the world. Some say yes because any company that is listed on the European Exchange might have to report this data. That becomes a very extensive reporting obligation for the same reason there is a push to reduce this burden so that actually companies across different sizes and different reporting infrastructures can actually do the work and report on that data. And there's also a different phase approach depending on the size of the company, depending on whether it's European or international with European business. So there are different timelines and that makes sense, but at least we need to know that at one point the data will be there, will be comparable and that there is a certain interoperability between these two standards, the international one and the European one.

(08:02):

Also the international one only covers climate for the start, but they are already planning on building on that with biodiversity and human capital subsequently and maybe others. There is a consultation running right now on the ISSB standard, but we will see before the summer, the climate one, and so we'll have the climate one at the international level and the climate one in the EU plus further topics in the EU because that also covers other environmental objectives, governance and then also social indicators.

Brenda Kramer (08:32):

This point that Simone makes is absolutely important. Global data would really help us as international investors. I think working towards a global baseline is really important. And for me, I do this work because I want capital to move in a sustainable direction. I just want us to invest differently and invest us in a better world. And we can only do that if the data on sustainability gets equality and a comparability that is equal to financial information as we processes now.

Nakul Jadhav (09:04):

Yeah, I think the keyword here was the commonality between the data, the baseline, because as we move from NFRD to CSRD, then scope of the companies will increase, the coverage will increase. And if you want companies who are going to invest into EU also from a EU taxonomy of view, it's very important to have a common baseline across the globe for all these regulation. We cannot just focus on EU laws even though these are EU regulations. It's also important to establish this common baseline as Simone was saying. And we cannot just focus on regional levels of laws or transpositions. It needs to be on a global level.

Brenda Kramer (09:45):

I think we can still be more ambitious in Europe. I really hope we keep that ambition because we've been really on the front of what's happening when it comes to sustainability regulation and the EU green deal, and it can be a good economic model. I believe that especially the green deal just covers the whole economy.

Simone Ruiz-Vergote (10:03):

And I think one concern I have in that I totally agree, Brenda, that this is some leadership role here that is also seen in how other countries pick up the taxonomy. We are just doing a mapping-

Brenda Kramer (10:03):

Absolutely.

Simone Ruiz-Vergote (10:14):

... between these global taxonomies and the European one, and there are so many similarities. You can really see that this has become a blueprint that is copied in variations, and that's of course making sense. Other countries have different priorities, might want to include agriculture for instance, or might have a greater focus on natural resources, especially from an emerging country perspective, a very relevant point. But I think the EU has also started on a train that's very difficult to slow down and revert, and that's called complexity. I think Nakul, you have a lot of experience in collecting this data now, and companies struggle with reporting the right data.

(10:53):

Even though when you think about how you look at the data landscape, you always think reported data. So company reported data is the most reliable one, but that is something we can't always confirm because companies also need to understand the regulation. When the data is highly regulated, that means there are metrics and templates that are just very predefined with a lot of granularity. Then you can lose, it's easy to get it wrong, let's put it this way. And then the data reliability suffers. I don't know if you have maybe some example to give here.

Nakul Jadhav (11:24):

Yeah, you're correct about the EU taxonomy being too complex that that's also in line with the ambition of the EU. Just like Brenda mentioned that we are becoming too ambitious. Maybe it's just become too big to handle maybe from a complexity perspective. So companies are facing really big challenges in reporting as per the regulation, especially some of the technical screening criteria, for example, are so stringent that it is very difficult for companies for pollution, for emissions, where the units of measurements are so complex that companies would rather just say, not disclose or say we are not aligned rather than going into so much efforts in reporting as per such complexity. So adding a very high level of complexity is proving to be a major roadblock in reported data. As we are seeing more and more reported data for 2022, for example, for eligibility and alignment coming in, we see a lot of mismatch or gaps. This is because there is still a gap between what the regulations says and what the companies are interpreting it.

Brenda Kramer (12:31):

I agree, especially I think the concept of do no harm has proven to be very difficult and we see that in our own implementation now as well. So at PGM, we've for a long time, I think almost 15 years done investments that align revenues with certain impact indicators and our own taxonomy, but applying the do no significant harm screen has proven to be very difficult even though we have so much experience with doing this kind of measurements already. The complexity of either EU taxonomy where you have this prescriptive harm criteria that you have to look at or in SFDR where they say you can define it yourself, but you have to look at these 16 adverse indicators. So basically 16 prescribed ESG indicators. And there the question of materiality really comes into play again, because if you're not allowed to apply materiality there and you have to apply all 16, you can never ever say you do a sustainable investment because the data coverage that you rightly say Nakul, is not that good that you know that for every company.

(13:39):

It's proven to be a major challenge with a lot of differences, at least from our opinion in depending on what asset class you are. In general, we see public markets are okay, especially large corporates. Then we thought all private markets would be difficult, but we've seen in practice that our direct private investments, we've done quite well on the data coverage. Whereas if we do private equity fund to fund management and the small caps under that or even mid-caps, that is very difficult.

Simone Ruiz-Vergote (14:12):

Yeah, I guess what I hear is a bit from the taxonomy side that there was an expectation on the infrastructure side, which is often structured through special purpose vehicles that they could use the taxonomy to leverage finance for especially those very green, very renewable, top of the, top-notch activities where you would think this is a perfect use case, but in the early days they don't generate a lot of revenue. The CapEx data is also not necessarily available at the right amount, and also it's not necessarily always collected. That's also a topic, so you might not get that data through our data up. So there is this limitation and that's something we are working on as well at MSCI just extending the private asset database here. So this is a little bit of the question of there is a market use case for all of what you're seeing here in that regulatory space, but that's not necessarily the day-to-day job of the regulators.

(15:21):

So now we have the SFDR consultation, which really is around where are we going with this regulatory instrument as a real opportunity to provide feedback, not on just what is being proposed as a change, but also more broadly, is this the right instrument? Do we need to change the way we assess harm? Do we need to change the way we assess sustainable investments? What are the indicators apart from the 16 that you mentioned that really matter for us? So I think that's not necessarily the end of the discussion here. It'll take some time, but it's the moment to make your voice heard if you listen to this podcast.

Adam Bass (16:01):

And Brenda, that would be, I mean, I'm sorry to interrupt, but I want to make sure we use that as an excellent segue, Simone, to talk about the fact that as you say, this is not the regulator's day-to-day job, but Brenda, it is yours. So I would really love for you to talk a bit about how this has impacted you and your teams as you go about your day-to-day business.

Brenda Kramer (16:25):

We've talked a lot about the data and there are definitely complexities, but I think a good thing about what SFDR did is that first of all, it made us reflect on are we really doing what we're saying that we're doing? Do we do everything that's on our websites and how do we do it and in which asset classes do we do it in which way? So it has increased our own reflection. And also what I like most about my day-to-day job at the moment, and I love that when developing taxonomy as well, is that you need different disciplines. There's no one discipline in any company that can do this. Your responsible investment team is not able to do SFDR on its own. You need your legal people, you need your data people, you need model builders. You need the investment teams to tell you what they're actually doing and how they were assessing it.

(17:10):

And so it's been a major integration exercise. Actually my team is 10 people. 10 people from different divisions of the company and we're working very intensely with our client, which has proven very useful as well and very enriching. So it's brought us also very good internal discussions and internal reflections. Due to the timelines and the pressure we haven't, weren't able to look at it from a strategic point of view where you would say, how can we optimize these processes? So can we align it with our responsible investment strategy that has been there for years now and we are updating that once every couple of years. I hope we will have the time and space to do that next year. And to actually see, hey, can we go from what we know from the regulator now, can we find a way that we can do this more efficiently and more coherently? Instead of just publishing the data because we need to do it. Because that can't be the purpose of all of this.

(18:18):

So what I've really realized is that the entity level statement that we need to do on adverse impacts, it's a roll up statement on NC level. It's not very useful if you look at the data, but the underlying data, if you want to steer and want to get more feeling for your portfolios are very useful. So I'm really hoping we can dive a bit more into that and see what we can do for clients there. It's brought good discussions and less good discussions because there are also some, especially international parties that say we're not obliged to do anything on EU. So you would, you have this best effort obligation, which means even if you're not going to get anything back, you need to mail all of your external managements to see what they can give you and data. But we've had so many answers like, Hey, we're a US company, we can do this or we're this and we can't do it. We're not obliged to do it. And yeah, that was interesting because we are so who's right in that has a very, very nice discussion.

Simone Ruiz-Vergote (19:18):

That was really interesting what you said because it's also a bit the experience we have when we talk to clients. And I'm a bit concerned the more we have legal teams on the call, the more I know this is the tick the box exercise that the regulator didn't want.

Brenda Kramer (19:30):

No, exactly.

Simone Ruiz-Vergote (19:32):

So we are asked to come up with all sorts of statements to help you communicate with the regulator and I always feel like you take out the excitement that is sustainable investment, that is impacted.

Brenda Kramer (19:45):

Is so true.

Simone Ruiz-Vergote (19:46):

Searching to leverage the green credentials of your assets and that I'm not, I'm sure it's the unintended effect. And I think once you have done the first alignment and you're sort of getting more comfortable also with what data you can report on and that you are aligned with the regulatory expectations which actually are just forming themselves, they are not yet set in stone.

Brenda Kramer (19:46):

Exactly.

Simone Ruiz-Vergote (20:07):

There is also this practice emerging. So I think then you can start and building on that, you can focus on these indicators and I think you once said it is a good focusing of your reporting energy and then also of your building and manufacturing energy hopefully coming up with new products that really leverage the indicators and not a hundred or thousand, but just these ones that are really considered relevant.

Nakul Jadhav (20:32):

Right now from a data collection perspective or what we are seeing in the market, the company are still seeing it as an obligation rather than a motivation. So the moment they start seeing it as business as usual, as part of their life or a part of a company's motivation to contribute to sustainable finance and then I think we will see better data quality, better exposure, better disclosures.

Brenda Kramer (21:00):

I think so. I hope so. And I find we have a role in that to play as well. So as investors, if we ask for these data, we should be generally interested in what we get and talk to companies. We have 6,000, so we are never able to talk to any company, but at least the direct investments in the companies that you have larger stakes in, you can have a conversation on, Hey, what are you doing here? Or for private equity, we work together with other private equity parties to get better data and to prevent companies to get 20 or 30 different questionnaires from all of their investors. So I think it can definitely align and consolidate these reporting efforts. I keep telling my team, this is no work for perfectionists. I can't have perfectionists in the team because we're never going to be perfect. This is not going to be like there's no golden standard yet.

(21:49):

So we're developing this and we need to deal with that uncertainty throughout the project and throughout the implementation. And I've told my organization, the clients that it is likely that we'll get a letter from the regulator because the regulator is going to look at all of these statements and take the best parts of everyone and then tell the others that they should do it that way. So even though I worked super hard, my team did everything they can, I can't prevent that from happening. And so I think it helps to be clear up front. It's never nice to get these letters, but we need to keep telling them this is a development for doing what we can do. We answer on these consultations where we can to have influence on what is helping us. And eventually I do believe that this consolidation of reporting efforts can free up energy and space to think about, okay, and what are we going to do with it now that we have that information?

Nakul Jadhav (22:50):

If we right now strive for companies to be a absolutely perfect in the reporting, it's just going to scare the people away and also scare investor away. So it's not for perfectionist, but more for the optimist about, who are people who are more optimist or who are persevering to do the common vision of the green deal. So yeah, I think we should be supportive of the company that they're trying their best to match this requirements to navigate through this complexity. And I think in the coming years we will be reaching close to the perfection.

Brenda Kramer (23:23):

I hope so. Let's see.

Adam Bass (23:27):

And Nakul, I liked the way that you put that earlier about moving from an obligation to a motivation. I'm curious for any of you when it comes to different types of companies, are those who see it as an obligation versus a motivation in one sector versus another, one area of the world?

Nakul Jadhav (23:46):

There are different regions with different preferences based on politics, based on company distribution. But also if you go to financial institutions like banks, they see more as an obligation because they have so many undertakings. They have to report so much data. So they see it more as an obligation. But you have other companies which have exposure to natural products or they have investments in, for example, which are affecting actual people, so sustainable products. So they see it more as a motivational thing or they see it more as their job rather than just as a requirement. But right now, like I said, it is seen almost by everyone as an obligation because it's been forced upon so much and have the deadlines are so close by.

Brenda Kramer (24:38):

I've seen some really interesting examples from Dutch banks that are creating taxonomy aligned loans and they do have ESG incentives. So for example, the company might not yet be taxonomy aligned, but if they get this loan and they get taxonomy aligned, there is a lower interest rate in the future. So the demand for that is increasing, which is a good thing. So there is some space I think in banks to think about their reporting application is obviously enormous. But I think we haven't talked about it yet. But you mentioned the green bond standards amount, there was also the benchmarks regulation, and that is also something where at least commercial asset managers have an ability or a possibility to get this label where you can actually say, Hey, I am aligned with these European ambitions and you can buy these benchmarks. So there's some opportunities in there, but it's completely right that the timelines were so tight this year that the head space was really clouded with deadlines and getting things done instead of thinking more about this as a business opportunity. But-

Adam Bass (25:53):

You mentioned the green bonds designation. My mind immediately goes to greenwashing and the potential for that is how would this work?

Brenda Kramer (26:03):

So the green bond standard is the European, should be the European gold standard for a green bond. So that means if you get this standard, it is actually, it proves you not to greenwash. So there are strict reporting obligations that needs to align with EU taxonomy for a certain percentage, very high percentage. And you have to report on whether you make that alignment and you have to have that verified. So if you see a bond that has an EU green bond label on it, once it's there, the idea is that you can definitely trust that it's not greenwashing.

Simone Ruiz-Vergote (26:41):

Yeah, I think the challenge really is this high alignment requirement. 80% I think usually when you look at the green bond markets, at least a million I think is actually a small bond. So you'll see the bond size being in the millions and then finding the investment activities to finance that sort of align in their structure so that the bond can be easily put together. All these things and elements that play a role is not going to be easy to find. And that's also to do with the fact that the reporting has just started, so you don't know.

(27:21):

But at the same time, of course you can then connect the project reporting to the bond and that makes it easier. So you have direct access to the data and that's a different approach than when you say finance a company and you need to make sure that the company is actually reporting on this alignment and you might not have a direct access to that company. So there is the beauty of it that you probably see a pull from this financial instrument into data provisions through the project or the vehicle financing the project.

Adam Bass (27:54):

Can you talk a little bit more about the effect on those existing regulations as we look for that commonality, that global standard, what are some of the lessons that other jurisdictions can take from what's happening in the EU?

Simone Ruiz-Vergote (28:09):

Yeah, I can start. I would think that what the International Sustainability Standards Board, the ISSB is working on is a common baseline. It's also called a minimum baseline. And I think the fact that the EU strives for maybe almost a maximum baseline if you like, because it's essentially going for impact double materiality. It's going for an extensive set of indicators and areas there, the ISSB chooses a different approach whereby they build start with climate and they build up on it over time. The disadvantage such an approach is that it will take years until you cover all relevant sustainability areas or ESG areas, but it allows countries to start maybe with the most burning topic, which is currently perceived to be climate change. It's also a topic that it can't be solved alone in one region like the EU with 10% of global greenhouse gas emissions has to involve countries like China, India, the US.

(29:12):

And so I think starting there is a good idea, but then the interoperability really means that if you report under the EU standard, that it's accepted as equivalent to the international standard. And I think that's really important as especially if companies go all the length to report under the EU, they want to make sure they actually also in line with the international standards. And then maybe if a company reports under the ISSB in a developing country that maybe has business in EU, that this could also be counted towards any reporting obligation that arises from this business in EU. So this sort of allows for capital to flow, it allows for goods to flow, it allows for setting up and collecting a dataset on maybe the most burning societal environmental topics that then investors can use to build products, but also can be used for its broader society to understand how a company fares on sustainability.

Brenda Kramer (30:09):

You asked for lessons and I was like, I would have three. First of all, I think what Simone says, phase in and keep it proportional. Second of all, draw on different skills, not only economists, not only ecologists, like combine those skills. And a third one would be keep asking why are we asking this data and are they still the right data to fulfill our policy ambitions? So those three lessons for me would be key in further developing this package.

Simone Ruiz-Vergote (30:37):

I love it.

Adam Bass (30:40):

That's all for this week. A big thank you from Joe, Yair and me. To Nakul, Simone and Brenda, and to all of you for listening, you can find more information on the EU taxonomy, including a recent blog post from the ESG research team at msci.com. Until next time, I'm your host Adam Bass, and this is MSCI Perspectives. Stay safe, everyone.

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