Sustainable Finance as a Fuel to Action

November 2022

WOMEN ACTiON SUSTAiNABiLiTY

Life Is On | Schneider Electric

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Foreword

The purpose of this report is to demonstrate the key drivers and challenges that financial institutions are facing when incorporating ESG criteria into their investment decisions, define expectations for businesses regarding disclosures and performance evaluation, and to examine opportunities available through various sustainable financing tools and frameworks.

The report is informed by an online survey that was launched in July 2022 to key stakeholders from the selected financial institutions as well as a series of interviews with both investors and corporates. The responses received were used to formulate best practices and provide recommendations on maximizing the impact of sustainable finance as a fuel for action.

IPCC reports showcase the indisputable urgency of climate change mitigation needed to remain within 1.5°C planetary warming threshold, as outlined by the Paris Agreement as the way to avoid the worst effects of climate change. This requires major investment in clean technologies, low-carbon infrastructure, and sustainable business models and services.

From **Women Action Sustainability (WAS)**, we want to thank to **Schneider Electric** for supporting us on this report: Sustainable Finance as a Fuel to Action.

We are in an unprecedented period that demands urgent collaborative action by all stakeholders to make 1.5°C a reality. The world needs to move faster on the low-carbon transition not only within developed economies but also in emerging markets. It is time to scale up financial solutions for large corporates and small business alike.

An immediate shift in capital allocation is a critical lever to usher in a better, more sustainable world and to imagine a resilient and prosperous future for the generations to come.

Mónica Chao, President, WAS

Foreword

Among all the uncertainties we are facing: the consequences of the Russian conflict with Ukraine, higher levels of inflation, rising interest rates…the fight against climate change should still be a top priority, as it still is. The development of a new productive model that allows the European Union to reach zero emissions by 2050 is one of the main policy objectives and cannot be understood without the role of the financial sector, since it requires the channelling of extensive resources.

Sustainable finance is the fundamental framework for this task as it allows us to analyse the ways in which the financial sector can contribute to achieving the climate objectives that we have set for ourselves.

To promote a financial sector that supports our sustainable objectives, we, as a public sector, must incentivize it with a clear legal framework that guarantees investor confidence in environmental, social, and corporate governance (ESG) aspects. Spain has actively participated in defining the European framework for sustainable finance and its three pillars: taxonomy to identify sustainable economic activities, disclosure obligations to cover data gaps, and tools to adequately channel resources, such as the European Green Bonds Standard.

In parallel, the public administration has actively contributed to the development of sustainable finances with the implementation of the sovereign green bond program, which is already a structural element of the financing policy of the Public Treasury. Many Autonomous Communities also issue in a green or sustainable format, to which should be added entities such as the Official Credit Institute or ADIF Alta Velocidad.

Likewise, the public bodies work toward the alignment of funding to developing countries with the Paris Agreement objectives, through multilateral development banks or through other international funding activities.

In this way, the Spanish public administrations are committed to sustainable finance and the transformation of the country's productive model, which is finding a response in the private sector. **All efforts will be necessary to achieve the goals we have set for ourselves.**

Ana Puente, Head of Securities Markets and Financial Instruments Legislation in the Ministry of Economic Affairs and Digital Transformation of Spain

Foreword

Though in recent years we have seen many more companies setting climate goals and disclosing environmental performance information, there is still a long journey ahead. Transparency and disclosure of climate risks and opportunities is key, as is the resilience of an organization's sustainability strategy under different climate scenarios. Companies not only need to communicate ambition but also to show progress on their implementation plans for decarbonization.

Listening to several financial stakeholders, one of the main pieces of advice given for companies was simple: get started. Do not let perfection on methodologies or data be the enemy of progress.

Corporate climate disclosure efforts will help investors to deploy their fiduciary duty to drive fair and fast transition and enable them to be a catalyst for change.

The time for excuses is behind us; the time for action is now.

Raquel Espada, Vice President Strategy,
EMEA Sustainability Consultancy, Schneider Electric

Women Action Sustainability is a nonprofit association whose main purpose is to raise sustainability to the first strategic priority of companies, entities, institutions, and society.

In pursuit of this goal, we launched an online survey with Schneider Electric to explore the importance of:

- Various ESG topics and targets explored by investors.
- Existing commitments of financial institutions.
- Policies and tools implemented on sustainable finance.
- Key challenges in disclosure and delivering impact.
- Best practices and opportunities for sustainable portfolio transition.

At WAS, we aim to collaborate with enthusiasm to:

- Reinvent governance.
- Reinvent the economy, promoting sustainable finance, supported by sustainable taxonomy from the EU.
- Reinvent employment and prioritize R+D and innovation.
- Reinvent our territory.
- Build confidence and optimism.

Ana Belen Peña, President Climate Change Group, WAS

Executive Summary

Executive summary

The importance of corporate environmental, social, and governance (ESG) performance is rapidly growing due to the urgent need to address issues of climate change, energy security, social diversity, human health and safety, and ethical conduct. Various emerging regulations and initiatives, such as the EU Sustainable Finance Disclosure Regulation (SFDR), the forthcoming U.S. SEC Climate-Related Disclosures rule, and the Task Force for Climate-related Financial Disclosures (TCFD) framework, set the common ESG language and strengthen requirements for **transparency and quality of corporate ESG disclosures.** These developments are driving investors and financial intuitions across the world to evaluate and support the transformation of their assets and portfolio companies toward stronger ESG performance and disclosure. **The finance sector is key in driving system-wide change** across various sectors to support sustainable transformation. Financial institutions can deliver significant impact by unlocking capital, providing guidance and tools, and offering ESG-linked products like loans and bonds to support transition activities. Climate negotiations at COP26 in Glasgow brought sustainable finance into the spotlight with a coalition of finance firms worth $130 trillion pledging to accelerate climate change mitigation under the Glasgow Financial Alliance for Net Zero (GFANZ). One of the key themes of COP27 was to mobilize the finance sector and **focus on implementation**, including the development of the new collective quantified goal on climate finance with technical expert dialogues on the post-2025 goal (where private sector actors will be increasingly called to action).

Summary of findings

Sustainability is a company's passport to the future, a way to drive innovation, and a lever to create a competitive advantage and demonstrate resilient business models to investors. It comes with the transition costs, but inevitably delivers value in the long-term both in financial and societal terms. The survey results show that:

- ESG performance across various types of assets and investments **gained significant traction** among both institutional and private investors in recent years. This trend has been reinforced by geopolitical and economic crisis.
- The majority of participants responded that **environmental impact is one of the key drivers for introducing ESG criteria into investment decisions,** while financial and reputational risks were highlighted as another important drivers. Regulatory changes in the sustainable finance landscape were found to be ambiguous. On one hand, a universal common framework with a definitive set of targets and requirements is seen as essential for alignment on measuring ESG performance. On the other hand, concerns around clarity of requirements and the timeline of implementation impose additional challenges for investors and corporates.
- **Climate change, diversity and inclusion, and gender equality were among key topics** of sustainable investment programs, while biodiversity and use and protection of natural resources (including circularity) were found to be the most difficult issues to address.
- The main challenges in addressing ESG topics were associated with **measuring the impact and incorporating ESG performance into ROI.**
- The most significant gaps investors find in driving ESG performance among corporates are **lack of transparency (communication) and lack of top-management commitment.**
- Most investors **(75%) practice inclusionary investing:** actively investing in companies leading on ESG performance. The vast majority of respondents referred to active engagement with investees as a vital way to drive efficiencies in their ESG transformation.

Sustainability is a company's passport to the future

Key recommendations for financial institutions from the sustainable leaders in the sector and from the investees:

Set your organization's vision and deploy fiduciary duty to drive fair and fast transition.

Establish your ESG strategy with the focus on material impacts and set ambitious targets, both short-term and long-term.

Streamline disclosure requirement for your investees.

Include ESG assessment in processes for portfolio evaluation throughout the investment lifecycle including in the due diligence stage.

Keep going and go fast: continue to engage with your investees to drive meaningful impact.

Introduction

Importance of the finance sector in driving ESG transformation

In 2015, The Paris agreement established ambitious goals aimed at fostering the decarbonization of the global economy and halting the increase in global surface temperatures. The finance sector was recognized as a key enabler to align the finance flows with decarbonization pathways. Today, there is no doubt that ESG has become a central aspect of the finance sector, with $2.47 trillion in global sustainable fund assets and an expected amount of $41 trillion total ESG assets by the end of 2022.

To understand the importance of the finance sector in driving environmental, social, and governance (ESG) transformation, **two factors should be considered:**

1. **Financial institutions (FI) have a unique power in unlocking capital and providing resources to companies.** Thus, they can create effective frameworks for ESG transformation by imposing conditions and requirements on their current and future investments and implementing ESG criteria in their investment strategy. From divesting from controversial companies or sectors, to actively investing in companies to drive the ESG performance, or even to prioritizing ESG impact over financial returns, FIs can have decisive influence over companies that are looking for new investors and/or need capital. As an example, the results of the 2021 CDP Non-Disclosure campaign showed that "companies were 3.1 times more likely to disclose on forests when targeted by financial institutions" because they are aware that providing robust and reliable data is crucial for decision-making.

2. **Investors are becoming more aware of the impact of ESG risks on their own futures.** This awareness is, in part, driven by growing regulatory and societal pressure on investors and corporates to address various sustainability topics, such as climate change and social impacts. An increasing number of European and American companies consider that their business is, or could be, affected by the physical risks of climate change (58% and 63% respectively). It is also undeniable that increased investor action on climate issues is driven by the desire to secure better return on investment and ensure resilience of the business via sustainable investments. Many studies demonstrate that businesses with good ESG performance and those that embrace sustainability within their own business strategy have better economic performance than the ones that don't integrate sustainability issues.

The research speaks: Climate preparedness pays

The European Securities and Markets Authority (ESMA) published a report in May 2022 showing that **ESG funds are cheaper and better performers than their non-ESG peers.** Companies that do not endorse a climate change strategy could represent an investment risk in the future, as Larry Fink said in 2020 in his annual letter to CEOs, "climate risk is investment risk". CDP has also indicated that "financial institutions are more engaged than ever on requesting environmental disclosure" to assess the climate risks of their investments, which echoes the ambition for deeper action in sustainable finance. In the same vein, the Investor Agenda, an initiative of seven major groups working with investors (PRI, CDP, UNEP FI, etc.), has launched the "2022 Global Investor Statement to Governments on the Climate Crisis" urging investors to advocate for greater policy action on climate change from governments around the world. The main reason behind this statement is that "Investors are urgently seeking to manage their exposure to climate risks and increase the contribution that their investments make to the Paris Agreement goals."

> At Schneider Electric, we are an Impact Company. The foundation of this is the belief that investing in energy efficiency, gender equity, or low-carbon solutions, for example, makes good long-term business sense. We play a major role in accelerating the energy transition and fighting the climate crisis, while making a long-term positive impact on the planet and society. Sustainable investments create a virtuous circle for our entire value chain of stakeholders. It drives real value for employees, customers, partners, and investors.
>
> **Gwenaelle Avice-Huet**
> Chief Strategy & Sustainability Officer
> Schneider Electric

Key sustainability initiatives and regulations for financial institutions

The past decade marked the rise of various global initiatives and regulations aiming to establish a more standardized framework for sustainable finance.

2006 April — PRI Principles for Responsible Investment

Principles of Responsible Investment

UN-supported network of investors working to promote sustainable investment by incorporating ESG issues into investment practice.

2015 April — TCFD

Task Force on Climate-Related Financial Disclosures (TCFD)

Framework for financial institutions and other organizations to disclose climate-related risks and opportunities.

2020 October — SCIENCE BASED TARGETS

Science Based Targets Initiative (SBTi) Framework for Financial Institutions

Guidance and process for setting climate targets for financial institutions' investment and lending portfolios.

2020 December — The Net-Zero Asset Managers initiative

The Net-Zero Asset Managers initiative

Framework for moving the asset management industry towards the goal of net-zero emissions.

2021 April — UN environment programme | finance initiative

Net-Zero Banking Alliance

Framework to align lending and investment portfolios in the banking sector with net-zero emissions by 2050.

2022 April — SCIENCE BASED TARGETS

SBTi Net-Zero Guidance for financial institutions

Actionable criteria and guidance to support financial institutions in implementation of their science-based net-zero targets.

Regulations in Europe

2018

European Commission (EC) Action plan on Financing Sustainable Growth: aiming to further connect finance and sustainability.

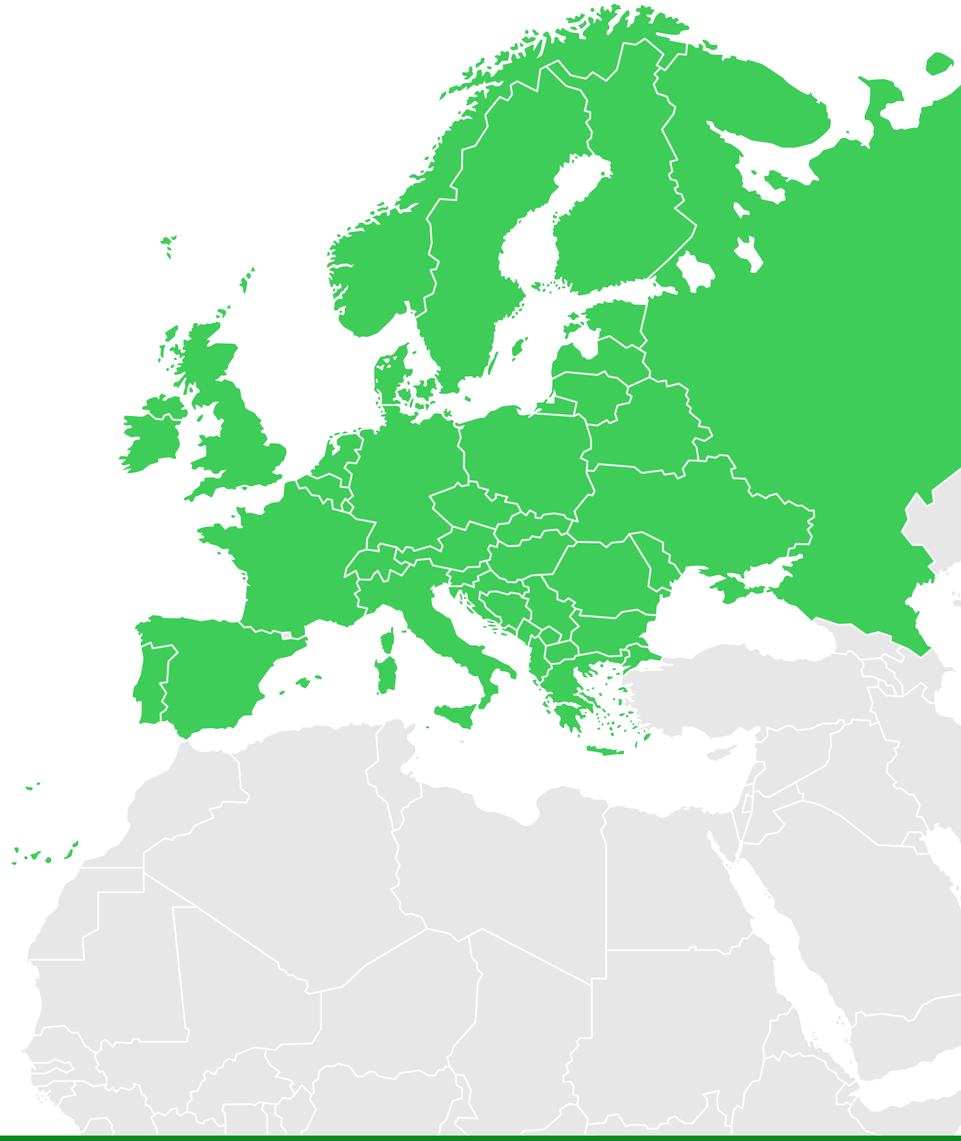
2020

EU Green Deal: Set of initiatives with the aim of making the European Union (EU) climate neutral by 2050

2021

Strategy for financing the transition to a sustainable economy: Package of measures designed to direct investments towards more sustainable initiatives and business, including:

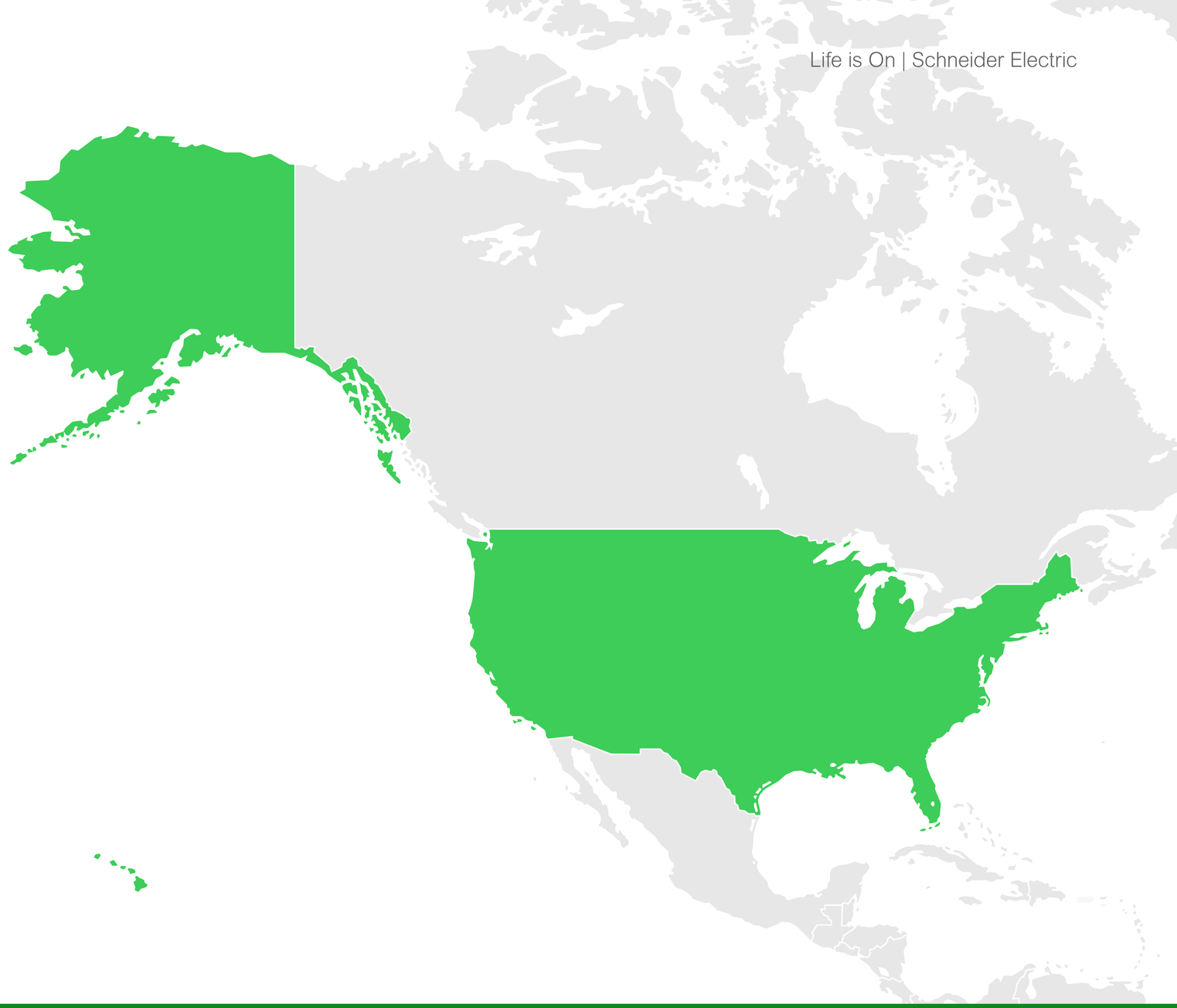
- The Taxonomy Regulation: A classification system for environmentally sustainable economic activities.
- The European Green Bond Standard: A “gold standard” to guide companies and public authorities in using green bonds to raise funds in capital markets and finance large-scale environmental investments that will foster the transition to a low-carbon economy.
- Sustainable Finance Disclosures Regulation (SFDR): Rules for classification and reporting on ESG matters in investments and mandatory disclosures for market participants.
- Corporate Sustainability Reporting Directive (CSRD): In replacement of the Non-financial Reporting Directive (NFRD), the CSRD stipulates mandatory disclosure requirements on sustainability issues affecting more than 50,000 companies.
- European Sustainability Reporting Standards (ESRS): Framework for investors to access more reliable and comparable information about companies’ sustainability information.



Regulations in the USA

March 2022

The Enhancement and Standardization of Climate-Related Disclosures rule: the U.S. Securities and Exchange Commission (SEC) proposed requirements for companies to disclose their climate risks and greenhouse gas emissions in line with TCFD framework and GHG protocol requirements.



Regulations in APAC

Hong Kong | November 2021

Hong Kong Exchanges and Clearing Limited (HKEX) launched guidance to listed issuers on climate disclosures in line with TCFD requirements.

Singapore | December 2021

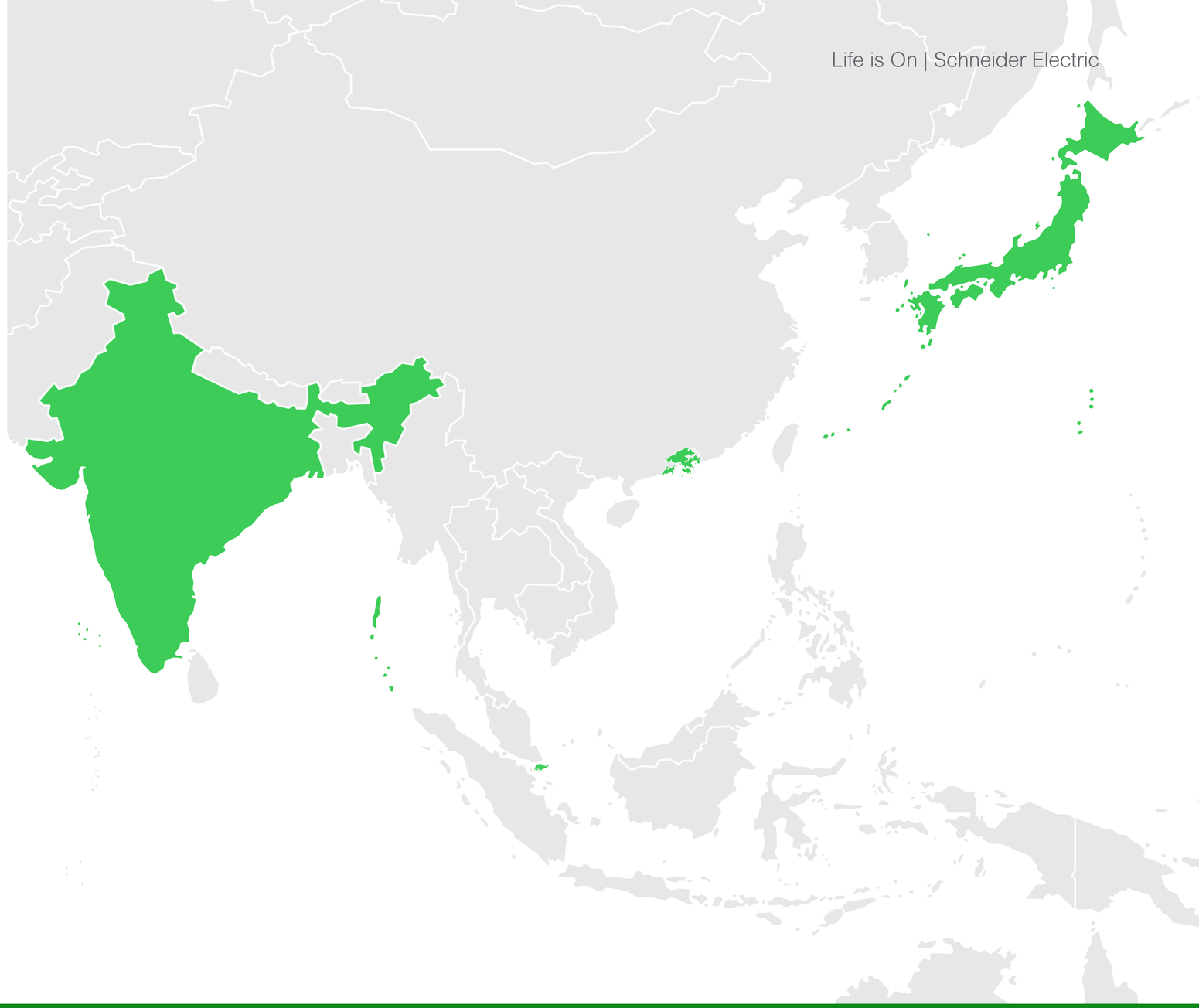
The Singapore Exchange (SGX) established climate disclosure rules mandating issuers to prepare an annual sustainability report and disclosure in line with TCFD.

Japan | April 2022

Japan's Corporate Governance Code added requirement for listed companies to disclose climate-related opportunities and risks in line with TCFD requirements.

India | 2021

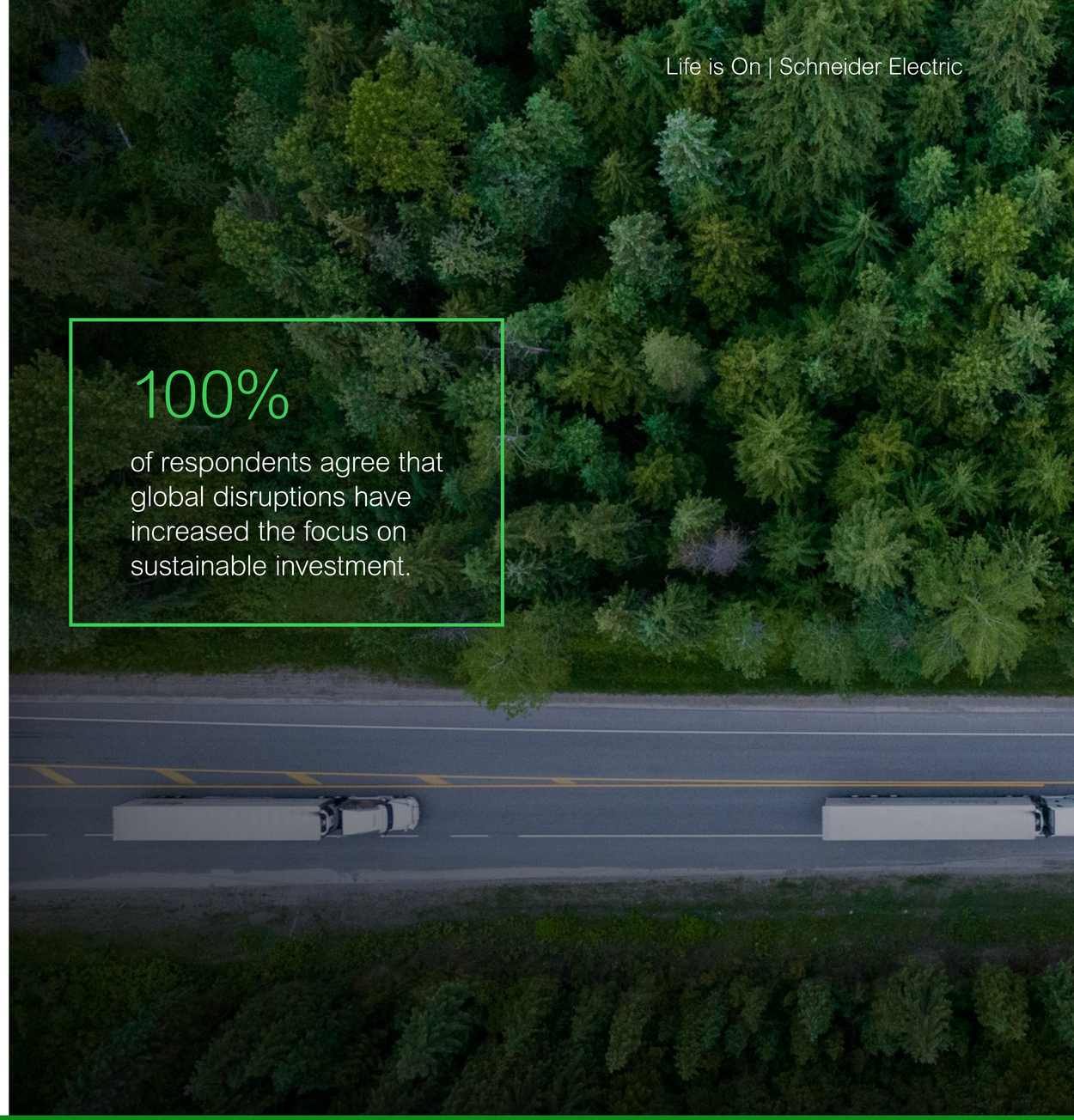
The Securities and Exchange Board of India set requirements for the top 1,000 listed companies in India to prepare Business Responsibility and Sustainability Reports (BRSR).



Key pillars of sustainable investment

Key pillars of a sustainable investment strategy

Overall, the survey and interview results demonstrated the definite increase in the attention investors pay to ESG topics when making investment decisions. The majority of participants gave ESG a rank of **9 out of 10** in terms of importance to investment decisions. Within the scope of ESG issues, **climate change, diversity and inclusion, and corporate governance** rose to the top of the list of key topics that they are addressing. All respondents agreed that the focus on sustainable investment has in fact increased due to recent global events, such as COVID-19, conflict in Europe, and supply chain crisis.



100%

of respondents agree that global disruptions have increased the focus on sustainable investment.

ESG rank importance: 9 out of 10

The majority of participants gave ESG a rank of 9 out of 10 in terms of importance to investment decisions.

Risk management - the bridge between sustainability and finance

One of the main roles of financial institutions is to build more **resilient portfolios**, and that means better risk management and better long-term risk adjustment returns. This approach entails integrating climate change risks in investment decision strategy.

The concept of long-term resilience is also being integrated by banks and investors that were traditionally only considering financial criteria.

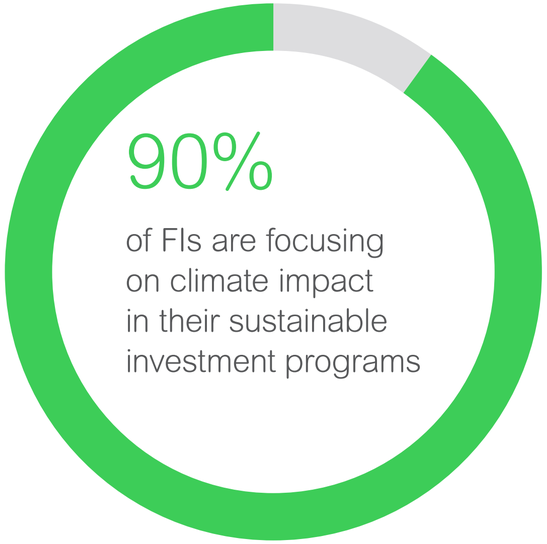
> We have seen a **tectonic shift of capital**. A lot of clients are asking us about the role that sustainability and sustainable strategies can play in their portfolio. We strongly believe that the integration of climate and sustainable considerations into investment processes can help investors to build more resilient portfolios and achieve **better long-term risk adjusted returns**. However, this is not only about climate risks; we saw a very good example of sustainability driving resilience during the pandemic. During the first quarter of 2020, while in five weeks the equity markets went down 34%, simultaneously, 94% of a globally representative selection of widely analyzed sustainable indices outperformed parent benchmarks.
>
> **Aitor Jauregui**
> Country Head for Iberia
> BlackRock

The “E” is still the focus ESG investments

Traditionally, ESG topics have been dominated by climate change and climate transition, and the results from the interviews clearly reinforce this notion.

Not only did 63% of the participants say that environmental impact is one of the key drivers for introducing ESG criteria in investment decisions but also, among the key topics, **climate change was the most cited**, with 90% of FIs reporting that they are focusing on climate impact in their sustainable investment programs.

> Most of the existing investment regulation and collective global initiatives are focused on climate. No surprise here: in addition to having more scientific data, climate change poses an existential threat, and we just have a narrow time window to address it. **Transition planning** is therefore critical for the financing of big companies, especially for the high emitting ones.
>
> **Marisa Aguilar Villa**
> Country Head for Iberia
> Allianz Global Investors



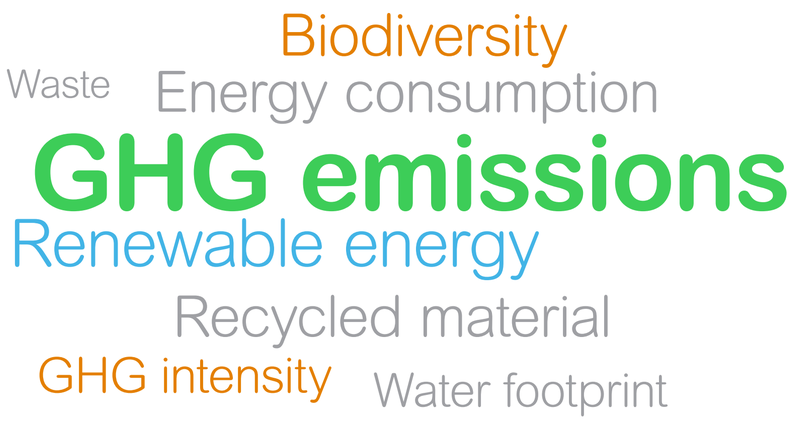
Many of the interviewees agreed that climate change is the one of the most - if not the most - important pillars of their sustainable strategy. Beyond the relevance of the topic itself, FIs point out the fact that it is the ESG area for which there are abundant metrics to measure impact and on which the most regulations are focused.

The “E” is still the focus ESG investments

This perception is also shared by corporates. An interview with the investor relations lead from a company that has traditionally been at the forefront of sustainability action and disclosure confirmed that climate change topic is among the most common requests from the investors, customers, and regulators. **Decarbonization goals are also one of the most common criteria** when it comes to sustainability-linked bonds and loans, which are the most frequently used instruments for implementing sustainable investment initiatives.

The preponderance of the environmental pillar and climate change is closely linked to the energy transition challenge gaining even more importance in recent years, exacerbated by the ongoing global energy crisis. The transition to cleaner energy sources is considered one of the largest investment opportunities by some of the most prominent asset managers. According to the IEA, reaching net-zero emissions by 2050 will require a complete transformation of the energy system, with energy investment above USD 4 trillion by 2030, highlighting the need to attract new investors to the energy sector.

The most prominent topics cited by investors in the environmental category were:



75% of FIs have climate targets in place

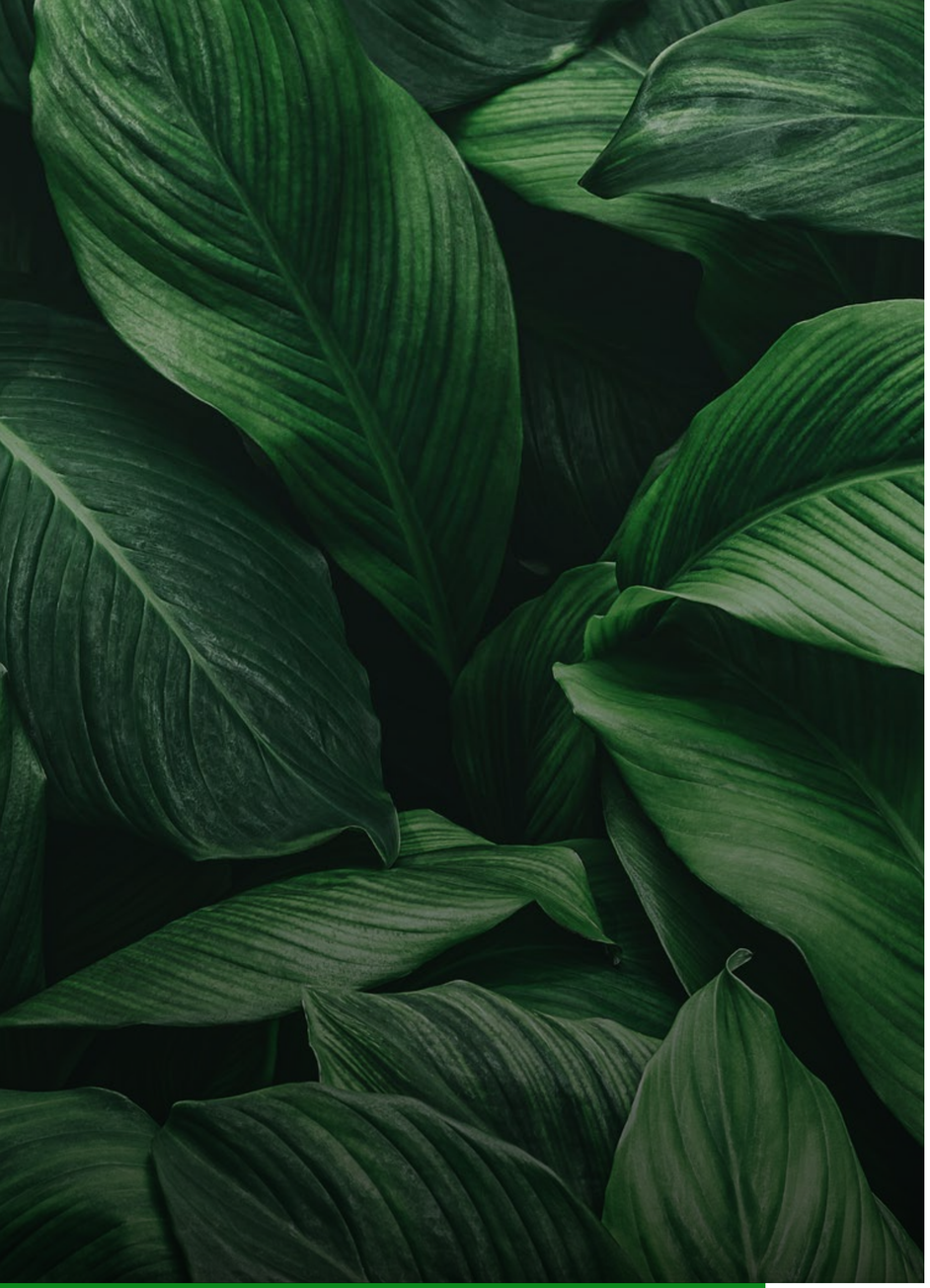
Climate change topic is among the most cited in the responses to address. **75% of FIs in the survey disclosed that they have climate targets in place covering all or certain assets** and none of the respondents do not consider setting targets.

The call for engagement

Most common ESG investment strategies

- **Exclusionary investing:** investors that follow this strategy screen out controversial companies or sectors (e.g. whose revenues come from tobacco, gambling, weapons, fossil fuels, etc.) and avoid making investments in companies that don't meet their sustainability criteria (or divesting from them).
- **Inclusionary investing:** FIs actively invest in companies leading on ESG performance, looking for companies that are ranked highly in their sector in terms of sustainability.
- **Impact investing:** Investors specifically seek to invest in companies that have an intrinsic environmental and/or social goal to generate a positive ESG impact alongside financial returns.

While some investors are strong supporters of the divestment strategy (or exclusionary investing), the survey results demonstrated that vast majority of investors prefer inclusionary and impact investment in their strategy.



The call for engagement

> The ambition is to have a **real impact on the economy**. The real impact does not come in excluding certain sectors and high emitters. Our work is to push the companies to promote a real change where it is needed most and invest in the transition.
>
> **Lara Marín Fernández**
> Head of Global Product
> BBVA Asset Management

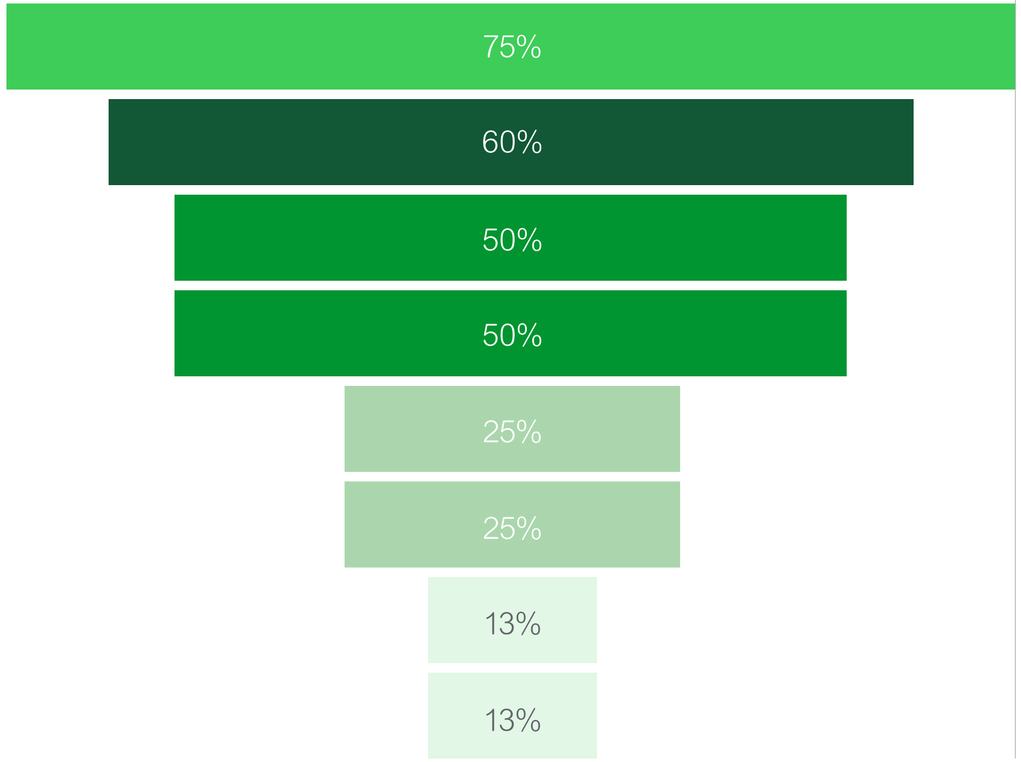
According to some of the interviewees, investors should not totally exclude high emitters from their portfolios, mainly because it would mean losing any kind of influence over the emissions-intensive sectors. Emissions-intensive sectors require more support – and thus funding – to transition towards low-carbon economy. A number of the biggest investors believe that, through impact investing, they can deliver sustainable impact by engaging with these companies on a regular basis, monitoring progress, and supporting activities that help them perform better. Moreover, divesting from such companies and sectors removes the pressure from sustainability-committed shareholders, opening the door to other investors who may be less concerned about ESG issues and will not prioritize sustainable resolutions. Real transformation requires all sectors and investors to be moving in the same direction, with no one left behind.

ESG Investment challenges

ESG Investment challenges

Although the increasing number of commitments from the financial sector in terms of sustainability is encouraging, the path from ambitious commitments to real actions is not always straightforward. Finding solutions to the following challenges uncovered during the survey is critical to bridging the ambition to action gap in the financial sector.

% of FIs that identified each of the following challenges



Key challenges when addressing ESG issues in your portfolio

- Measuring impact
- Lack of baseline data
- Large heterogeneity of ESG reporting standards
- Incorporation of ESG performance in ROI
- No universal targets
- Reporting burden for investees
- Short investment lifecycle
- Low maturity of the portfolio

Measuring the financial impacts of ESG integration

Three quarters of survey respondents reported that the main challenge that they are facing when addressing ESG issues in their portfolio is linked to the measurement of the real impact of those investments. This means that FIs still struggle to quantify a meaningful correlation between the integration of ESG factors into their investment strategy and the return on investment.

Another important barrier to measurement is that the real impact of sustainable investment often occurs over the course of many years, while investors tend to be more focused on short-term results. Business plans are usually designed to cover 3-5 years, while the impacts and benefits from ESG transformation unfold over the 10-15-year horizons.

3/4 respondents' main challenge is in measuring the real impact of investments

> Investing sustainably involves some clear trade-offs, particularly over the short term. Companies might have to assume extra costs for transitioning towards a low carbon economy and therefore see their P&Ls suffer. However, t**hose that transition in a sound and thoughtful way are expected to be tomorrow's winners.** That is why transition planning is key for building a successful corporate strategy and a critical disclosure for long-term investors.
>
> **Marisa Aguilar Villa**
> Country Head for Iberia
> Allianz Global Investors

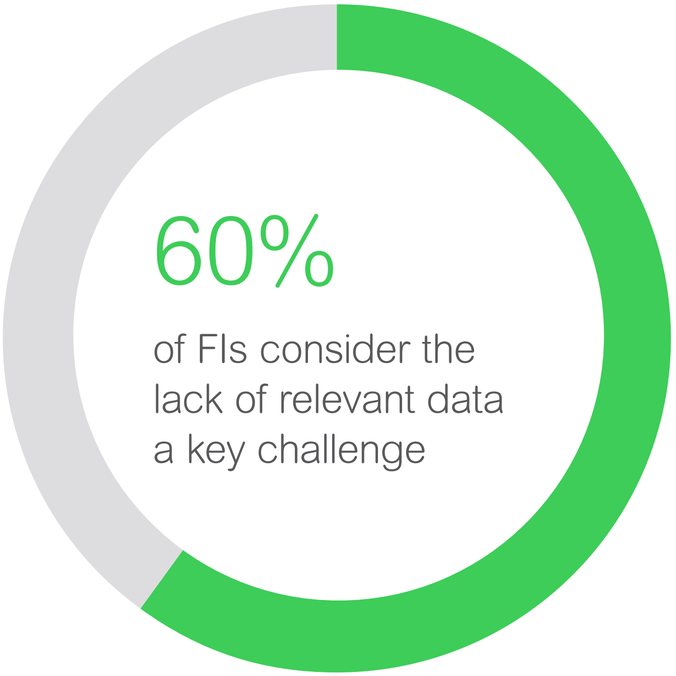
Insufficient reliable and comparable data

Lack of reliable and comparable data is one of the most frequently mentioned challenges by market participants. 60% of FIs consider it to be one of the main challenges they're facing when addressing ESG issues in their portfolio and is a fundamental issue that regulators are seeking to tackle.

Many FIs interviewed stressed the fact that they often face the need to assess the decarbonization strategy of a company from a sector that they do not have deep knowledge of. Consequently, **insufficient access to comparable data** between companies hinders their ability to confidently evaluate the performance of one against another and make informed investment decisions.

Along these lines, the Net-Zero Asset Owner Alliance recently called on companies and data providers to provide critical sector data, arguing on behalf of the difficulty for investors to analyze and assess companies' decarbonization pathways and climate targets.

"With a view to staying invested in and providing capital to transform even the hard-to-abate sectors, the Alliance urgently calls on all real economy companies… to prepare and transparently disclose forward-looking decarbonization transition" - Net-Zero Asset Owner Alliance, September 2022.



Insufficient reliable and comparable data

Banks, too, are facing difficulty in accessing robust ESG data and are challenged by the lack of common definitions and official frameworks when ensuring group-wide ESG integration. According to a report published by the European Commission in 2021, data-related issues (data availability, reliability, accuracy, comparability, etc.), the absence of common standards, and limited internal resources are the main obstacles to the integration of ESG issues into banks' strategies and, more broadly, to the development of a well-functioning sustainable finance market.

The development of **homogenous disclosure criteria structured by a common regulation is crucial** to ensure investors' capacity to make investment decisions based on comparable ESG indicators and figures.

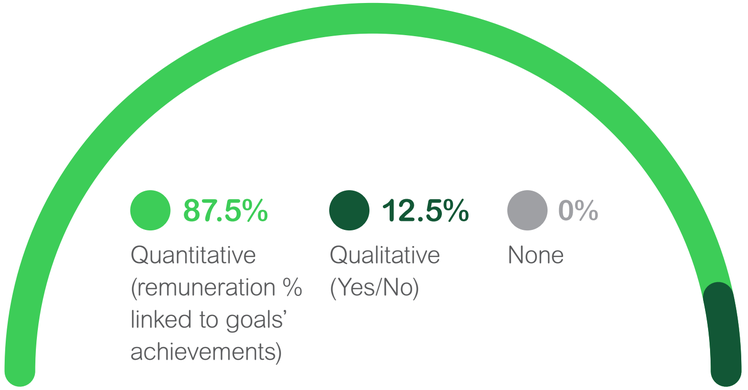
This lack of a clear disclosure and measurement framework is also raising a challenge at the corporate level. Several interviewed corporates mentioned that investors and funds, with the aim of differentiating themselves from the others, are asking for information and data in a very specific way, with their own KPIs that differ from one investor to another, resulting in even more confusion for companies.

Lack of ESG commitment at the corporate board level

50% of the survey respondents consider the **lack of top-management commitment** to addressing sustainability issues the main gap at the company-level that is hindering sustainable investment. A recent study from think tank, Planet Tracker, shows that there is a clear scarcity of environmental and social proposals submitted for annual shareholder meetings. Despite a considerable increase in ESG proposals, this challenge is driven by governance proposals that account for 93% of submissions, with most linked to regulatory requirements such as approving agenda minutes, auditors, adjourning/closing a meeting, etc. Consequently, social and environmental factors comprised only 5% and 2% of the proposals respectively and many important issues are never included in the vote.

The **lack of ESG integration in corporate strategies** is one of the main challenges mentioned by the interviewees. Some pointed out that sustainability must be part of a company's business strategy; it must be at its heart for the commitment to be real. Good governance is a key pillar, and full integration of ESG is difficult to achieve if a company's board is not fully involved in sustainability-related decisions. Backing this trend, 100% of the survey respondents believe that ESG issues should be integrated within management performance review and almost 90% of them, think executive pay should be linked to the achievement of ESG goals.

How do you think ESG issues should be integrated within management perfromance review?



Addressing the most challenging ESG topics

At the beginning of an FI's sustainability journey, adopting a sustainable investment strategy typically means addressing environmental, and more specifically, climate change-related issues. Indeed, many frameworks, tools, and standards have been developed to help companies track and monitor their GHG emissions. However, when looking at other environmental issues like **circular economy or biodiversity**, understanding and assessing a company's impacts becomes more complex.

> Even though there are requirements within the SFDR linked to biodiversity and circular economy, it is currently a challenging task for any larger FI to fully understand its investment portfolio's impacts in these areas. We want to support business models that ensure biodiversity protection and develop more circular business models. Addressing these topics more structurally will require FIs to better understand the whole value chain impact of any given investment. This necessitates a level of focus and resources that many organizations do not have today.
>
> **Gustav Magnusson**
> Project Manager of Group Sustainability
> EQT Group

Difficulty to address ESG topics

average ranking from 1 to 5

Addressing the most challenging ESG topics

Consideration of **diversity and inclusion is also gaining much more relevance** within the FIs sustainable investment programs. 75% of the organizations prioritize these issues in their investments, demonstrating that interviewees agree that there is still a lot to do on the topic of diversity in the finance sector.

Quite often, investors' action focuses on setting targets within the portfolio companies' board members, but for some industries, it is still a challenge to find female candidates at the board level. For instance, while the healthcare and services sectors may perform quite well on gender diversity of the board with a good balance between men and women in top-management positions, the cultural context in the infrastructure sector remains a significant barrier. Moreover, using gender metrics to assess a company's ESG performance based on the percentage of women in the board, could seem quite unfair and lead, in some cases, to positive discrimination.

Indeed, within the financial institutions, the challenge is more about retention of diverse employees than attraction. There is a persistent problem in retaining females in professional services companies.

> We are consistently working with our diversity agenda, both in terms of delivering on our existing targets and broadening the scope of our diversity ambitions. There is a persistent challenge of retaining women in more senior roles within FIs, but we are mindful of the fact this is an industry-wide issue. We are glad to have seen good outcomes from diversity targets in portfolio company boards, on 3rd party suppliers, our own intake and mentorship programs. EQT, and our industry, must focus on creating equal opportunities for the underrepresented gender at our firms.
>
> **Gustav Magnusson**
> Project Manager of Group Sustainability
> EQT Group

Solutions to foster the ESG transformation

A universal and standardized framework for sustainable investments is necessary but will take time

The need for a common reporting framework seems undeniable. Today, in many regions and countries, the governments and institutions come up with the relevant regulations. This plan is structuring the way FIs are developing sustainable investment and the kind of information investors are requiring from companies; it's becoming the framework of the industry and FIs see regulations as a true catalyst as they are helping to clarify a standardized definition of sustainable investments.

The fact that the new ESG regulations are overwhelming and complex is shared by both FIs and Corporates.

For example, from the corporate perspective, Taxonomy alignment is complicated, both from a financial point of view and because of technical complexity of the requirements. Companies require a longer timeframe to report the information aligned with the new standards. The timeframe is indeed one of the main challenges mentioned by corporates during the interviews.

On the other side, from the FI's perspective, there is a huge challenge in disclosing information about their investments without having access to this kind of information. For example, banks need to offer sustainable products but very often, they do not know how to assess Taxonomy alignment or detect real sustainable products.

Indeed, today, only 38% of listed NFRD companies are reporting figures in alignment with Taxonomy and only 10% of them are reporting a real alignment (above 0%).

Considering the existing challenges on both sides, **flexibility and collaboration** will be key in the adoption and alignment to this new framework.

> A broad number of new regulations around sustainability have entered into force or will soon. The need is to clarify the criteria for applying them along with the timing of entry into force of all of these new regulations
>
> **Lara Marín Fernández**
> Head of Global Product
> BBVA Asset Management

The long-term: the essential condition of sustainable finance

Consideration of the **long-term impacts and resilience** of companies is key to successful sustainable financing. This is particularly relevant on climate change, as climate risks impacts will become more visible as time progresses. The necessary changes to promote a sustainable transition will not happen in the short-term. One of the most illustrative examples is the energy transition. It is not a short-term transition because the technology is not yet ready to replace many of the traditional uses of fossil fuels. The energy transition might take decades, but this should not be a deterrent. Investments are needed today, but to see the impact of those investments might take longer.

Integrating ESG considerations will help to ensure resilience and returns in the long-term and this is the change of mindset that needs to be encouraged.

> We are confident that sustainable business models are more successful in the long term, and as such, ESG considerations are an essential component in our investment process.
> **EDM Global Equity Impact Fund**

Make use of the best practices in sustainable investment

Different types of financial institutions referred to various instruments they found successful in driving the sustainable transition across their portfolio. **ESG-linked loans** were referenced as a good example of an efficient tool in impact investing, not only to deliver lower interest rates, but also as a tool to get more attention and ensure action within the organization.

Identifying use cases of such programs, evaluating the impact on certain sectors and activities, and exchanging on best practices on various instruments used by FIs, such as green bonds and sustainable financial products, may help to accelerate the implementation of sustainable investment strategy.

Sustainable Financing at EQT

EQT has signed fund bridge facilities with pricing linked to private equity portfolio company ESG performance. These two fund-level subscription credit facilities have an upper limit of €10bn combined. The EQT IX fund bridge was the first ESG-linked fund bridge facility of this size in the global fund financing markets, and has really helped accelerate the sustainability performance of the EQT Funds' investments since the launch in 2020. EQT AB has also issued two sustainability-linked bonds on a corporate level during 2021-2022 to support harmonization of sustainability outcomes.

Financial incentives for ESG transformation

Some of the interviewees believe that further evolution of regulatory legislation and instruments, such as the deployment of a **global carbon tax,** would help to further integrate carbon valuation into financial planning. Currently, the financial impact assessment of climate risks - mainly transition risks - is based on a shadow carbon price that would entail an important flow of funds leaving the company. However, the value of this risk is still uncertain. Putting a real price on carbon would help both investors and companies to reduce arbitrary decision-making. Having **clearer knowledge of the financial impacts of climate risks** would enable investors to build a strong business case for ESG integration.

Within the context of the COP27 in Egypt, the call for a well-designed carbon price has been one of the key recommendations of PRI, which cites carbon pricing as being “part of a comprehensive policy mix” and “can provide broad-based incentive for decarbonization”. More precisely, a fixed carbon price will help to provide price predictability, minimizing uncertainty for companies and investors and reducing competitive distortions that differences in carbon prices between regions can sometimes generate.

Collaboration, fair transition, and public action

Collaboration between public and private entities is another important step to mobilize the financial streams across sectors and governments.

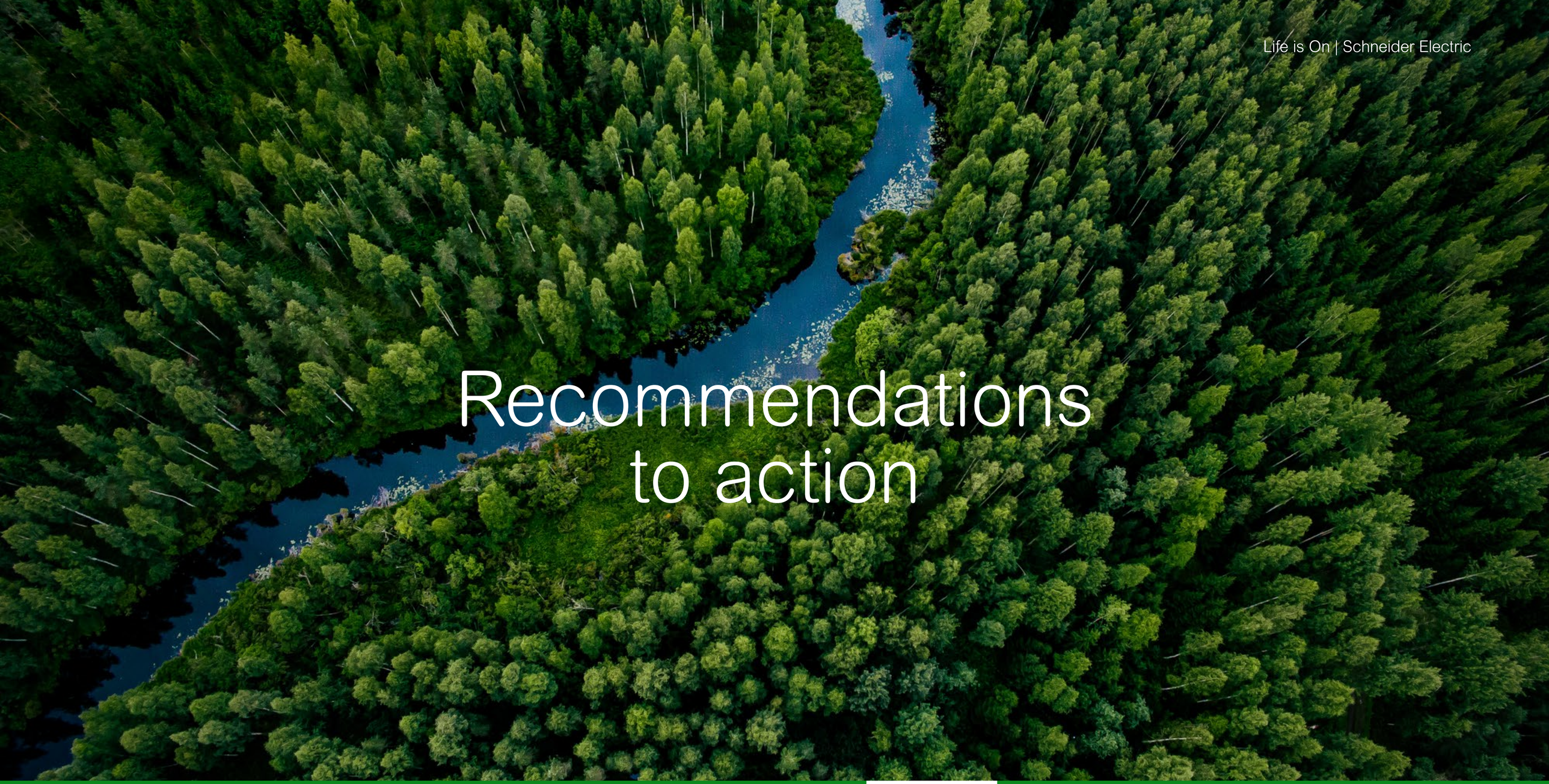
The power of public-private partnerships

The Climate Finance Partnership, a collaboration between BlackRock and the governments of France (AfD), Germany (KFW), and Japan (JBIC) as well as several leading U.S. impact organizations, was first conceived at the One Planet Summit in New York. The partnership seeks to accelerate the flow of capital into climate-related investments in emerging markets. Developing nations are among the most vulnerable to climate change impacts, but also show ample opportunity for investment and infrastructure growth, with nearly half of global energy capacity expected to come from non-OECD renewables by 2050.

The relevance of a "fair transition" and of "inclusive capitalism" are components of interviewees' ESG investment strategies. This includes topics such as gender, inclusion, and poverty, which are also essential parts of the UN Sustainable Development Goals (SDGs) and targets that FIs are trying to tackle.

According to the World Economic Forum (WEF), the drive for sustainability has magnified global inequalities in access to finance. Sustainable finance is rising quickly in high-income countries, which account for 97% of newly established sustainable investment funds, but developing countries are still lagging.

> "Banks have a critical role to play in supporting inclusive and sustainable growth around the world. We are part of the solution, supporting our employees and customers while delivering sustainable returns to our shareholders.
>
> **Ana Botín**
> Executive Chairman
> Santander Group
> Santander Group ESG report



Recommendations to action

Recommendations to investors

Embrace your fiduciary duty to drive fair and fast transition.

Deploy resources and expertise to cope with the urgency of the ESG transformation.

Establish your ESG strategy.

Focus on assets where the organization can deliver the greatest impact. e.g. majority owned assets in private equity or carbon-intensive sectors when it comes to lending and investment activities of banks, etc.

Set ambitious targets.

Use both short-term and long-term goals, in line with best practice. For example, align climate ambition with the Science-based Target framework to deliver net-zero ambition no later than 2050.

Streamline disclosure requirement for your investees.

Make use of existing reporting frameworks and regulatory requirements to reduce complexity of reporting and measurement for investees.

Integrate ESG into due diligence processes.

This helps to understand ESG risks early on, prioritize topics to address under active ownership, and define a transformation pathway.

Adopt “test and learn” mindset.

Include ESG assessment in your assets’ evaluation throughout the investment lifecycle and analyze what works and what does not work with investees. Support partnership and best practice exchange within the portfolio leveraging, lessons learned and case studies from the sector.

Keep going to go faster.

Despite the complexity of ESG frameworks, continue to engage with your investees to drive meaningful impact. Sustainability is never “done.” It is a virtuous cycle that requires continuous monitoring and iteration.

Recommendations to investees

Remember that sustainability is an opportunity not a burden.

Evaluate the upsides of ESG integration into business strategy to go beyond the view of sustainability being purely a risk management maneuver. Look for business opportunities such as new products and markets, innovation strategy, etc.

Define and communicate a clear sustainability strategy.

Demonstrate that your business has a structured ESG approach, where sustainability is engrained into the overall business strategy at the top-level, and also at the granular level from a product and service development perspective.

Maintain a long-term vision.

Keep your gaze set on the ultimate purpose of your ESG commitments while addressing short-term actions. Understand that ESG success in the future demands investment and resources to be dedicated to the cause today.

Proactively collect and report on the most material ESG topics.

Be transparent in ESG disclosures about both successes and shortcomings. Do not sweep gaps in performance or missed milestones under the rug. Embrace them openly and explain plans to compensate for them. In this sense, digital technologies and connected platforms are a key asset to reduce data gaps and foster information collection.

Create agile governance structures.

Intentional and well-planned governance can drive your sustainability agenda across the organization and ensure both top management involvement and integration of cross-functional business stakeholders, including finance, accounting, strategy, and sustainability. This will be essential as reporting requirements become increasingly complex and comprehensive.

Assign responsibility to the board.

Align incentives for board members and leaders in top management positions with ESG impact by connecting remuneration with target achievement.

Addendum

Glossary and definitions

Finance sector terms and asset types

- **Asset manager (mutual funds)**: firm that invests a pooled fund of capital on behalf of its clients. The capital is used to fund different investments in various asset classes. Returns are then delivered for the clients in exchange for a fee that the asset manager keeps.
- **Private equity firms:** Firms that use their own capital or capital raised from investors to take companies private with the aim of running them better and later taking them public or selling them at a profit. (source)
- **Venture Capital:** A type of private equity investing that focuses on startups and early-stage companies with long-term, high-growth potential. (source)
- **Universal Banks:** can be both a commercial bank and an investment bank; they provide a wide variety of comprehensive financial services, including checking and savings accounts, business, and personal loans but also investment services for companies like merger and acquisition services, financial analysis, etc.
- **Asset owners (pension funds, closed-end funds, insurance firms etc.):** organizations that represent the holders of long-term retirement savings, insurance and other asset. (source)
- **Mortgage real estate investment trust (mREITs):** mREITs help provide essential liquidity for the real estate market. They invest in invest in residential and commercial mortgages, as well as residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS).
- **Sustainability-linked loans (SLL):** differ from ordinary green loans in the sense that they can be used for general corporate purposes rather than for a specific purpose. Sustainability linked loans are linked to the borrower's sustainability performance measured against Environmental and/or Social and Governance criteria.

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