

July ST 0712022

Shari: [00:00:00] Hi and welcome to Climate Biz.

Denise: The podcast where sustainability meets smart business

Shari: I'm Shari Friedman, Managing Director of Climate and Sustainability at Eurasia Group.

Denise: and I'm Denise Odaro Head of Investor Relations and Sustainable Finance at IFC.

Shari: So, welcome to Sustainability Trends where Denise and I go through the top three picks that we've been reading in the news and been thinking about. So, this month, the top thing, frankly, that's on my mind and that I have gotten just a ton of questions about is ESG, environmental, social, and governance inside of the investment framework.

So, it's just been crazy with some forces saying it's too strict, it's too woke, it's not transparent, it's too transparent, it's not sufficiently strict. It's like, it's all over the place.

Denise: I just want to highlight that Shari used the word 'woke,' which [00:01:00] makes her officially a millennial.

Shari: I was really just quoting Elon Musk. He was the 'woke' user and I think perhaps the Treasurer of West Virginia as well had called ESG funds a little on the woke side. When I look at what everybody's saying, it seems to me that there's a bit of confusion about ESG and it's all been lumped into kind of one big category and it's probably worth pulling it apart and unpacking it.

And I won't bury the lead on this. I mean, I think my major take on this is that ESG right now is going through a lot of growing pains and this is what those growing pains look like.

Denise: And so, I think it makes sense for us to take one step back and say, what does this actually mean 'ESG,' which by the way, just side trivia was coined in a report that was sponsored by IFC and the UN.

Shari: No way really?

Denise: Did you not know that?

Shari: I did not know that I had no [00:02:00] idea.

Denise: So, you know, it's really a means of incorporating elements of sustainability within finance.

Of course, you can do that by selecting your investments that only align with whatever you predetermined to be your environmental criteria or social and governance, or it could be by various ways of assessing investment.

Shari: And as you know, Denise has incredible experience with this evolution inside of this ring fenced ESG set, green bonds and then it was sustainability linked bonds. And there's all this innovation on how you calculate what qualifies for ESG. A long time ago, ESG was all lumped into this kind of value-based judgment on what was good and what was not, what you did not want to include. Like, where you wanted to place capital to grow particular industries. [00:03:00] So, you know, no tobacco, no firearms, et cetera.

And then we have a different piece, which is the part about looking at underlying risk, particularly what's the most advanced is the climate risks and the difference there is that it is not a value based judgment, it is a financial judgment. So you're making a financial decision over whether investing in a carbon intensive asset is a good investment given where global trends are going or investing in something that could have, could be vulnerable.

Denise: The main issue now with ESG is that it is so uber trendy as it were, and for good reason, because we are facing, of course, rather

existential challenges. I think the pandemic for one has brought that to the forefront along with other issues that we've been battling for many years and that have recently started to be taken more seriously, such as of course [00:04:00] climate change.

The main issue I would say is that you very rarely now hear or read about ESG without the buzzword greenwashing, coming alongside ESG. There's a lot of room right now for essentially selling your investments or assets as having embedded ESG when they really haven't and there are various reasons why that is the case.

And maybe we'll actually do a full episode just talking about that.

Shari: I think that's a really good point. So recently there's been a couple of things that have been happening. First thing that's been happening is that ESG funds because of the high, high oil prices, the stocks that contain a lot of the oil companies have been going up. So, ESG funds relative to them have been the returns have been going down.

And so people are wondering, well, is this whole idea that you're going to be [00:05:00] getting a good return on them valid? And to that, I think I would say, yeah, when you have oil prices as they are right now, of course you're getting returns. I think that was never the question. The question is, is a long hold on some of these investments, a risky idea.

Denise: What do you mean? Is a long hold on ESG investments?

Shari: No, it is a long hold on oil investment, right? So the question isn't so much what is going to happen in the moment when oil prices are well above a hundred dollars a barrel, like of course at that moment, you are going to see the traditional funds that are heavily weighted toward fossil fuel companies outperforming ESG. I think the question though, is that this idea of underlying risk is more about looking at this in a longer timeframe.

Denise: Well, the whole thing about including sustainability in one's investment criteria is that you move [00:06:00] the biggest impact here. Quote, unquote, for one of a better word 'impact' is that you move from being a short-term view to a long-term view. And this is where I would say that the difference is made because of course, if you are just investing for tomorrow, then you need not consider some of the things that we now see are systemic risks to people, profit, the planet and climate change being of course, the first of any of these sort of risks that we talk about every day, but then as we just said, there are social and governance risks to go along. And there's a huge transition risk in terms of policy changes that come and literally change things overnight. And we've seen this and we've talked about this a number of times about the EV market and how policies played a huge role in changing business strategies to focus more on non-internal combustion engines, [00:07:00] but the point you make, Shari is an interesting one. We have seen that in the last three years, just given what we were going through globally, the ESG market and the fund market, especially saw tremendous growth. You had constant inflows for three years, and then you had last year now, just looking at the US equity exchange trade in funds where exchange traded funds with ESG standards.

I mean, that saw the largest ever pull outflows from those funds and I, and again, it's because when you look at what the incentive structure is for a fund manager, it is of course seeking returns. And as you said, given the energy by system, we've seen that large, big oil has never had it so good in a long time.

So, they're flush with cash and returning money to shareholders. So of course, when you are thinking again, if you [00:08:00] are not considering long term risks, then you would be, of course you would be moving into wherever it is that you are getting immediate returns.

Shari: Right and I think that's the one point that Stuart Kirk had made from HSBC. He's the fund manager who got a lot of flak for basically

saying that climate risk is overblown, and I will say that I have a lot of issue with what he said. I disagree with a lot of it, but I think the piece that he brought out that's worth a discussion is this issue of short-term versus long-term risk.

And as you said, if, you know, if, if you're in it for the long hold, then. You're certainly going to be looking at risks in the longer term, and holding a carbon intensive investment in, in an atmosphere where policies are moving toward decarbonization is a risk. If you're looking at something, if you know, if you're day trading it's, it's far less of an issue.

Although I would still say that as you're looking at climate impacts, these impacts are [00:09:00] happening today. And some of the policies you get a little more heads up on but if you're looking at climate risks in terms of impacts, you don't know when that's about to happen and you don't exactly know where that's about to happen as we're seeing in India yet again, you know, with the floods that are happening right now, it's something that you have to pay attention in the immediate term, I think.

Denise: Yeah, and I don't want to end with a sour note in that it seems that, you know, ESG is taking a beating because at the same time you continue to see growth on the one hand. You know, again, I used the us, um, statistics earlier, but the share alone, we've seen at least 20 ESG focused funds launched in the US and close to three and a half billion compared to the 2 billion that obviously was outflows that I refer to in May, so it's this balance of a push and pull, I would say here, I don't think it's any, you know, it's not going anywhere anytime soon.

[00:10:00] And the focus we spoke about last episode, as to what the SEC are doing.

I mean, right now you have consultations from, I want to say probably five regulators out there looking ESG in either promoting it or creating some forms of barriers towards greenwashing. So, it's, it's, you know, front and center of the mind of regulators and policy makers. I think so on both sides, you either will have the stakeholder pressure continuing,

or you will have regulators and policies that bring about continued growth and change in this market.

Shari: I do think that, you know, my end piece, as I said at the beginning we're going through some growing pains, but I do not think this is the dissolution of the ESG market, either on disclosure or on ESG funds. We do have to note if we're going to be talking about this, about what's going on in the United States, which is that [00:11:00] you have some of the states that are pushing back against the inclusion or non-inclusion of fossil fuel companies in ESG funds, or even the analysis they're pushing back over the SEC the securities and exchange commission, which is the us regulatory body over traded securities, pushing back on their pending regulations on climate disclosure.

And. So, you know, and this is, I think, where it gets a little bit mushy, like, so for example, in West Virginia, the treasurer of West Virginia was saying that they're not going to use any funds, any West Virginia funds in. Where you are, where companies are basically using where they're either excluding fossil fuel companies, or whether they're using, whether they're evaluating climate risk, just favorably toward them.

And he defined it as, you know, woke. And I feel like. When you're talking about climate risk disclosure, it is [00:12:00] exactly specifically not woke. It is not politically driven. It's judgment driven in terms of a financial judgment, but not in terms of a social or a value based judgment. And I feel like in the US, this conversation around the states is getting all mushy around this and they're conflating these two pieces, which I think is not particularly useful.

Denise: So, there's a lot to say about ESG and, and arguably it will always remain a top sustainability trend for time to come and I think what we wanted to do here was just give you sort of a taster of the various issues that are, I don't know if, celebrated as the right word, but are certainly being discussed and being seen and this cuts across all kinds of investments. So, you know, project infrastructure projects to of

course finance, like we talked about funds, bonds, loans, you know, even derivatives and synthetic financial products. So, there will be a [00:13:00] lot more to come here. I mean, we hope that is the case. In fact, because as I always say that, we hope for a future where ESG and sustainable finance is the.

And so, this brings us to our topic, number two for this month, which is the voluntary carbon market initiative. Now, Shari, as you know, we've talked a lot about the number of companies and hundreds now that have set climate goals to reach net zero emissions. In some cases, it even becomes carbon negative. We had Damir Cement at the end of last season talking about their plans to be carbon negative as an example. And so, we are seeing this growth in the number of net zero commitments. And for some, it's rather difficult to tell what's actually green washing. And you know, now, uh, there is this move [00:14:00] essentially collaboration between the UK government industry and NGOs, and they've pursued a draft code of conduct. Essentially standardizes definitions with the bid to reduce greenwashing in the voluntary carbon offset market. Now voluntary carbon credits. We now allow companies to fund carbon sequestration through nature based solutions, such as forest preservation, renewable energy projects, et cetera, many of which we have talked about on the show and so they use these to offset their carbon emission and Industry reports suggest that the voluntary carbon market reached a high record of over billion dollars in 2021 and this year it's continuing to grow and the projection, in fact, um, is around 50 billion in 2030. Isn't that correct? Is that correct?

Shari: Yeah. So, some estimate [00:15:00] said 30 billion and then Mark Kearney came in and said, it could go up to 50 billion. I mean, it's really hard to tell. And, and I think right now is when a lot of the, a lot of the decisions are being made about how this market is going to go.

Denise: Once you get to 30 X or 50 X only phenomenal growth, it's a lot. And so, while the use of these offsets obviously are certainly a

necessary tool for companies to neutralize their emissions. There have been long standing concerns about transparency in this sector and the code, which was published earlier this month of June aims to address that and the way that it works, it's the, the initiative also the voluntary carbon markets in integrity initiative, as it's called VCMi has established three tiers for corporate offset claims. So, basically the first one is gold, which is, as you would imagine, the most ambitious category. So [00:16:00] companies which are on track to meet their interim decarbonization targets for scope 1, 2, 3, and have offset the entirety of their remaining emissions. So they basically would be gold and then silver have offset at least 20% of their residual emissions and the bottom tier, the bronze are companies which are on track to meet their scope one and two emissions and have offset a maximum 50% of scope three. What do you think about that Shari?

Shari: Yeah, I think that it makes total sense to me in the way that this market has been evolving. So, you know, we just had credit suites come out of the voluntary markets the wild west with just basically no rules. And so you have all these companies saying that they are going to meet their net zero emission ambitions [00:17:00] through offsets, which again makes sense.

And that the offset regulations are really unclear so then that has called a lot of people to say, this is just not fair, not, not going to be robust and so if I had to guess last year, and I think we probably have said this on the podcast before how this will evolve, evolving into tiers of certainty, makes a lot of sense.

It follows this entire concept of transparency so you can understand the risk associated with any particular offset scheme and this follows other efforts that are being made to bring integrity into the voluntary offset market, including the integrity council for voluntary carbon markets which, was launched either at COP 26 or right after COP 26, which is

going to come out with some rules apparently in the third quarter of 2022.

Denise: Yeah, and just bringing that into actual [00:18:00] practice the news today has it that of course, as you would imagine, in terms of the biggest names, you've got Google, you've got Unilever, Hitachi they've signed on to this new code. So I mean, it remains to be seen, but I do think that it's very promising.

Shari: And it's also worth noting, I think that, you know, we launched right into the concept of voluntary markets right away, but you know, there's another carbon market is a very robust carbon market in the regulated carbon market space, which is even bigger than the car, the voluntary carbon markets right now.

And that space is going to be growing quite a bit as you start to see, you know, we've already got the highest prices we've ever seen coming from the EU. Carbon market trading scheme and then an even larger one in China still has low prices, but we would expect those prices to start to come up over time. I mean, if you looked at the EU trajectory, it was very low prices for quite some time, as everybody gets used to it.

And then the prices go up. [00:19:00] So we're going to start to see both the regulatory and the voluntary markets, evolving rules coming in and supposedly, you know, article six was supposed to create this bridge so that you could, you could combine the two. I mean, that's still, that still is to be seen. I'm not sure that that's going to happen, but I think what's, what's clear is that both of these markets are evolving and growing.

Denise: Anything to do with ESG offset the offset market is a huge part of that and there's this, you know, in parallel, I don't know, should I call the, should I call it a caravan of people in institutions looking to dispel greenwash. And so, carbon offsetting has been under criticism for a very, very long time, for various reasons.

And the science-based targets initiative, which most might know, verifies the net zero strategies of corporations and [00:20:00] financial institutions. I mean, they recommended the offset should only account for a small fraction of net zero plans. So, I think this gives some more clarity anyway, to investors, to the market as to what the validity of the claims of some of these net zero ambitions and plants that we see.

Shari: And then we'd be likely to see price differentiation right.

Denise: Mm-hmm

Shari: Among those.

Denise: Did you know, Shari by the way, that the co-chair of the VCMi is our former colleague, Rachel Kite.

Shari: Oh,

Denise: Yes.

Shari: All right. So, moving over to, I think that this is an interesting segue as we start to talk about evolving regulations into some of the big policy and multilateral decisions that have been made over the last, I guess, like month or so. Usually, we stick to what's going on in the private sector, but because all of these rules so affect private sector decisions, we thought it would be good to touch base.

And we're going to do a tour de force of the big ones that have [00:21:00] that have gotten talked about and decided upon in the last.

Denise: So, this brings us to our topic number three, our final topic for today, multilateral and political updates regarding sustainability in the month of June. And first off, the bat is the world trade organization's deal, which they'd met early this month and after 20 years of trying to negotiate, the organization has basically secured a deal to stop subsidies that contribute to overfishing and why is this a big deal? The percentage of fish stocks considered to be within biologically sustainable levels has dropped to 66% in 2017. Pretty, pretty terrible, actually. And that's down

from 90% in 1990. So, you can imagine that sort of trajectory downward, which is not good for very many reasons that I don't think I need to [00:22:00] go into, but so moving this target to essentially stop overfishing and fishing subsidies are considered the biggest factor in depleting global fish populations. And so, without the subsidies, much of the fish in we see the cause as this would not be profitable, essentially and in addition to that, damaging trolling around along seabirds, et cetera.

Shari: Yeah, we didn't add this into our list, but I feel like this decision by the WTO dovetails with the increasing interest in biodiversity and along those lines, the biodiversity COP 15 was supposed to be, it's been postponed several times now and is supposed to take place in China. They made the decision that it will be taking place now in Montreal and so now it has a definite date, and it has a definite place and it'll go forth. So, it feels to me like this sort of converges around the idea of making sure that we are protecting. [00:23:00] biodiversity and our biodiversity resources with, again, this underlying getting back over to the implication for companies.

The idea is that if you over fish, now you will not have those fish later and that affects economies, it affects health, it affects people, it affects businesses and the same thing with biodiversity, the idea is, is not so much biodiversity for biodiversity's sake, but it's really tying it back down into the implications for our economy, for our food systems and for businesses, for companies who rely on those food systems on those on the materials that come out of nature. It's a very interesting switch in the way that we've been looking at things.

Denise: Is 35 billion globally on, that governments put towards fishing subsidies and about 80% of that goes to the industrial sector to basically enhance capacity and this is what brings about overfishing. So, [00:24:00] and, and actually did, you know, a large part of that is, is also

fuel subsidies. And so, yeah, so I, I think it's interesting whether this agreement could become a model for some of the other issues.

Shari: Right, and you moving into that, I think the next, you know, the next piece is the G7 and the G7 met G7 countries are a group of industrialized countries that meet to discuss a myriad of issues. But this time climate was on the agenda and they basically, you know, at a high level they affirmed their intentions toward a one point five degrees. And then they made a couple of additional specific notes, some that were met by the environmental community, very favorably and some that were met, not so favorably. The first one is that they agreed to allow public investment. In fossil fuel projects under specific conditions. And I think that, you know, this was met with a lot of real fear from the environmental community, that this is going to derail decarbonization efforts.

And it was really a nod [00:25:00] over toward the energy security issues that are going on in Europe. And it was a nod over toward the need for LNG, for the ability to have infrastructure that will bring in alternative natural gas sources into the EU. So, I mean, we've been looking at this a lot at Eurasia group.

And when you look at the way that the EU decided that they are going to shift away from Russian gas, LNG capacity is a big piece, and they're going to need more infrastructure in order to have this. But when you look at their plan in net, they still have a very strong decarbonization plan. If you look at all the Russian natural gas that they're trying to displace, some of it will come in from this new LNG infrastructure, but a lot of it comes in from renewable energy and comes in from energy efficiency.

So, in net, it doesn't look like it derails their decarbonization plan. So. EU specifically, I don't know if you can say that for every other, every other economy, if this is going to open up, but I don't know that it's going to be as bad as it [00:26:00] sounds.

Denise: No, I was just going to say it really builds on, um, the 2021 G7 meeting, which was held in the UK and there is this is where they set up the 2030 nature compacts, which was the pledge to have these conservation areas of 30%, but also the G7 ministers responsible for climate and energy and environment who met thereafter.

And then again in Berlin. And really, like you said, I think this geopolitical issue that Russia Ukraine has brought even more so to the fore, this fight against climate change. What I took away from this was recognizing that we cannot fully transition to a green economy with the existing technologies alone, that emphasis of the need to rapidly scale up net zero technologies and that for me was like one of the huge wins of this, this particular meeting.

Shari: Yeah. And there was also [00:27:00] the, there was also the nod toward the death transition where the G7 were talking about increasing those packages, similar to the package that G7 was given to South Africa at COP26 and extending these also over toward Indonesia, India, Vietnam, Senegal. So those were the ones that were noted.

I will say that, I think that you always have to set the intention. So, the attention is excellent. And then the question comes in the operationalization. I mean the money still, and the whole follow through hasn't happened yet in South Africa and the way that people were hoping.

So, I don't think that it's a bad thing to make this intention. I just think that there has to be an acknowledgement that the follow through and a real focus on how the money is going to go and how it's going to be used in the most effective way is what we're going to be watching.

Denise: Accountability really? Yeah. And with the [00:28:00] political angle here, you know, noting the government are often the largest buyers of industrial material. We talked about it, I think it was last month, wasn't it? When we talked about the first movers coalition, this need to

reduce the cost, uh, and the trading of low carbon goods is incredibly important.

And with that, I think in parallel, you cannot have those discussions without, of course, discussing the just transition and the need for skills and labor in this new economy that we're talking about. So, fingers crossed.

Shari: So, this takes us to our final regulation out on our tour de force of policies and regulations, which is the Supreme court handing down a decision that the Environmental Protection Agency does not have authority to set new rules, limiting carbon emissions under the clean air act and kind of what, what they really said was that they are more broadly.

I mean that they are limiting actions by [00:29:00] federal agencies without congressional direction and so what this rule specifically was that without being able to pass legislation through Congress, the EPA was going to regulate emissions coming out of power plants. And so now the Supreme Court is saying that they can't do that unless the law is passed through Congress.

So, I think the question that keeps coming up for this is what's not only in this regulation, but a lot of people are questioning how this is gonna affect other regulations and people are specifically questioning whether it is going to be affecting the SEC regulations that we've been talking about before.

Those are not really those who aren't regulating emissions as much as they are regulating disclosure. So, I think there's a question there. I think there's a difference and there's a question if I don't think it's as clear as, and some people are looking at.

Denise: When people or factions are not happy with sustainability [00:30:00] advances. They often use this mission creep as a basis to oppose sustainability. The sustainability agenda. We've seen that with

the S E C. We've seen that with the central bank screening, the financial system. And that's what this really was, is saying that the EPA does not have the remit to do this not. So, the technicality of it, I think, is where the gap is. So, I don't know if it actually falls short of limiting the EPAs discretion to regulate on all issues, but rather it's how it will be interpreted for others, as you say. And, and so that's guess the big thing.

Shari: Right, and at Eurasia group our us team, particularly clay now has been looking at, has been following this for quite some time. And so, so we'll be looking at this a lot more closely for sure.

Denise: Yeah. There are many, many other steps that the EPA already has to take, uh, to reduce emissions and so [00:31:00] it's I think it really is worth pointing out that reductions are possible without regulations. And so, the targets that were set in the clean air act, as an example, were met a decade ahead of schedule, even though the rule, you know, never went into effect.

So, we shouldn't lose all hope. I mean, it is certainly a setback, but we ought not to lose it all.

Shari: Yeah. I mean, I think you're pointing to the idea that there were different market forces. There were more domestic market forces before, but at this point you've got a lot of international market forces that go beyond any kind of rules that the United States is going to put forth. I mean, it definitely, as you said, puts it at a handicap, but it's not the only thing that is making companies decarbonize for sure. I think with that, we are going to have to wrap up our top picks for this month.

Denise: Thank you for joining us again. If you enjoyed the show, we'd love it if you left us a review on Apple Podcasts.

Shari: And we'd [00:32:00] love it. If you hit follow on your favorite podcast app, you'll be alerted when there's a new episode and it also helps the show grow.

Denise: And so, with that we'll see you on the next episode.