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ESG INVESTING, FINANCIAL MARKETS AND CLIMATE TRANSITION

The accelerating threat of climate change raises the urgency of commitment to climate transition, including the important role of global financial markets to align investment with net zero targets. On 4 October 2021, the Organisation for Economic Co-operation and Development (OECD) published two reports which discuss policy considerations in the areas of ESG investing, financial markets and climate transition.

The first report 'ESG Investing and Climate Transition — Market Practices, Issues and Policy Considerations'[1] is intended to serve as an input report to the G20 Sustainable Finance Working Group. This report highlights the main findings from recent OECD research on ESG rating and investing. It offers policy considerations to strengthen ESG practices to foster global interoperability and comparability, as well as encourage greater alignment of environmental metrics with a low-carbon transition.

The second report on 'Financial Markets and Climate Transition'[2] focuses on the critical contribution financial markets must play towards achieving an orderly transition to low-carbon economies, and the policies needed to support this. It explores the key elements that could factor into market pricing of climate transition risks and opportunities, offers frameworks and case studies, reviews the growing range of market products and practices and puts forward policy options that can support this transition.

This e-briefing provides a high-level overview of the first of these reports.

The OECD report focuses on the critical contribution financial markets must play towards achieving an orderly transition to low-carbon economies, and the policies needed to support this. The report also:

Explores the key elements that could factor into market pricing of climate transition risks and opportunities, from stranded assets and production processes to renewables transition strategies.

Offers frameworks and case studies to understand how facets of the transition can affect market pricing.

Reviews the growing range of market products and practices that have emerged to more efficiently channel capital to price and manage opportunities and risks from climate transition.

The OECD report puts forward policy options than can support this transition by helping markets incorporate price changes and by incentivising companies to take measures that address climate-related risks and opportunities over time.

The OECD report says that, notwithstanding noteworthy progress, there remains considerable challenges that hinder the efficacy of these approaches, and notably ESG investing, to support long-term value and climate related international objectives.

This report highlights the main findings from recent OECD research on ESG rating and investing challenges, including the promulgation of different approaches, data inconsistencies, and lack of comparability of ESG criteria and rating methodologies, as well as inadequate clarity over how ESG integration affects asset allocation.

This report will be of interest to asset managers, investors, institutional investors, ESG rating providers, market participants and government policy makers.

What does this OECD report hope to achieve?

1 *Strengthening the comparability of ESG rating and investing approaches, and improving the quality of data used for investment decisions.*

The OECD report explains that ESG ratings often lack transparency in their calculation and differ substantially in the metrics on which they draw, raising questions as to the extent to which their aggregation contributes to long-term value. It also notes that methodologies tend to differ substantially across rating providers, and result in a lack of correlation between ESG ratings supplied by different providers.

The OECD concludes that policies are needed to ensure global transparency, comparability and quality of core ESG metrics in reporting frameworks, ratings, and definitions of ESG investment approaches.

2 *Improving the alignment of the environmental pillar of ESG ratings with a low-carbon transition.*

Here the OECD report notes inconsistencies in the construction of ESG ratings across providers, the multitude of different metrics measured in one Environmental (E) pillar score,[3] and insufficient quality of forward looking metrics preventing them from supplying consistent and comparable information on transition risks and opportunities across firms and jurisdictions.

Notably, the OECD find that rating providers appear to place less weight on negative environmental impacts while placing greater weight on the disclosure of climate-related corporate policies and targets, with limited assessment as to the quality or impact of such strategies.

The OECD say that such limitations could hinder the use of E pillar scores by investors with an aim to align portfolios with the low-carbon transition. Greater transparency and precision of the meaning of sub-category scores and metrics could contribute to better alignment of E pillar scores with a specific purpose, such as to assess climate transition risks and opportunities, or broader environmental impacts.

Such clarity would allow investors with specific sustainability goals to use ESG approaches as a more effective tool for portfolio rebalancing and risk management.

3 *Strengthen the integration of climate transition risks and opportunities into market frameworks and products in a manner that enhances market efficiencies to support an orderly low-carbon transition.*

The OECD report notes that while markets are beginning to price transition risks and opportunities due to progress on climate-related financial disclosures, they remain constrained by a number of impediments, from uncertainties that undermine pricing of externalities to inadequate disclosures of forward looking metrics on net-zero pathways.

In particular, the OECD says that effective market pricing of the positive and negative valuation impacts of a transition is hampered by insufficient data, including financially material metrics and analytical tools to measure and manage transition risks, and lack of policy clarity regarding carbon pricing and support for renewables.

Moreover, market products and measurement instruments will need to further evolve to allow investors to better align portfolios with specific climate-objectives and strategies, from divestment to active engagement and assessment of ways to strengthen the veracity of transition plans.

The recommendation from the OECD is that policies should be considered to foster transparency and comparability of ESG approaches, as well as to strengthen the tools and methodologies that underpin disclosure, valuations, and scenario analysis in financial markets associated with a low-carbon transition.

ESG disclosure frameworks and approaches

As part of the OECD report, in terms of ESG disclosure frameworks and approaches it looks to:

- Ensure global interoperability and comparability and quality of core ESG metrics in reporting frameworks, ratings, and investment practices to address global fragmentation. Frameworks should utilise standardised core metrics to form baseline reporting for the E, S and G pillars for use by market participants.
- Strengthen relevance of ESG metrics through alignment with long-term enterprise value, including environmental and social factors that become material over time. Currently, ESG rating and reporting approaches do not sufficiently clarify the materiality of either financial or non-financial factors. Therefore, a comparison should be provided for investors to assess the relative weighting of metrics and financial considerations across markets and industries.
- Promote transparent and comparable scoring and weighting methodologies for established ESG ratings and indices. This will ensure that market participants can understand how ratings are devised, and can support the potential tailoring of ratings by market participants with differing motivations with respect to long-term value or environmental, social and governance topics.

Then in relation to the environmental pillar of ESG rating and investing the OECD would like to see:

- Facilitation and greater transparency on the high-level purpose of the E pillar so that market participants understand the extent to which the methodology they choose aligns with transition risks and opportunities, and environmental impact.
- Improvement in the transparency of methodological practices, including metric calculation and weighting of categories in the generation of E pillar scores and indices.
- Encouragement for greater transparency and precision of environmental pillar sub-categories, such as with respect to metrics that could be used to develop climate transition or environmental impact sub-scores, in order to improve the informational value of the E pillar score.

Considerations to strengthen the tools, methodologies, and products to support an orderly transition

Here the OECD report recommends actions to:

- Further strengthen the Task Force on Climate-related Financial Disclosures (TCFD) practices to improve granularity, reliability and interoperability of metrics with respect to climate metrics, targets, and climate transition plans.
- It also encourages the use of science-based interim targets and disclosure of annual progress in a quantitative and comparable format within climate transition plans.
- Consider the overall verification processes for low-carbon and renewable strategies and plans, so that market participants are better able to make sound investment decisions based on commitments and implementation of emissions reduction over time.
- Improve the transparency and clarification of stewardship plans of major asset managers and institutional investors in their engagement with Boards and executive management on reduction of climate intensity and commitment to emissions targets.

  Asset managers could be expected to disclose principles and information on the implementation of climate transition plans, and remedial actions when issuers do not adhere to their stated plans.
- Ensure pilot scenario analysis for financial institutions to assess potential losses from carbon exposures against anticipated valuation increases from renewable energy and new green technologies.
- Achieve greater assessment by the appropriate government policy makers on how a range of climate-related policies could better support and incentivise the transition.

Overall, greater international co-operation is needed to ensure that ESG and climate transition-related practices progress in a manner that improves to a degree, the current market fragmentation, and strengthens investor confidence and market integrity.

Addressing challenges related to information on sustainability-related risks and opportunities will help ensure that capital can be effectively allocated to investments that support the low-carbon transition and sustainable growth, and merits the attention of the Sustainable Finance Working Group under the Italian G20 Presidency.

[1] See https://www.oecd.org/finance/ESG-investing-and-climate-transition-market-practices-issues-and-policy-considerations.pdf.

[2] See https://www.oecd.org/finance/Financial-Markets-and-Climate-Transition-Opportunities-Challenges-and-Policy-Implications.pdf.

[3] The E Pillar score within ESG ratings is increasingly being considered to assess and rebalance investor portfolios to better align them with climate-related risks and opportunities.

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