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EVOLVING FINANCIAL SUSTAINABILITY REGULATION AND THE IMPLICATION FOR INVESTMENT PRODUCTS

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Long-term capital allocation is increasingly focused on achieving risk-adjusted returns, while making a positive impact. This shift is driven by four factors: a growing scientific consensus on long-term biophysical risks, such as climate change and biodiversity; shifting consumer sentiment towards sustainable products and services; the long-term economic competitiveness of businesses and the rapid changes to regulation and policy.

This fast-changing regulatory environment will affect how risks are priced and how products are manufactured, marketed, and distributed. It is also central to financial markets, ensuring they function efficiently whilst protecting participants and the market against systemic risks.

Sustainability touches all these objectives:
1. System stability: Regulators and market participants acknowledge that climate and biodiversity risk present material exogenous risks to long-term market stability.
2. Protection of market participants: As the growth of ESG products has outpaced traditional investment products over recent years, regulators are now acutely aware of the increasing greenwashing risks to investors.
3. Market efficiency: the mispricing of social and biophysical externality costs is considered one of the main market inefficiencies driving the current unsustainable growth.

Regulators are moving to ensure that the level of exogenous biophysical system risk exposure is reduced, that market participants have appropriate visibility on sustainability risks and that effective price signals are in place for environmental externalities to ensure market efficiency.

The pace of change varies across the globe. Whilst Europe has been an early mover, the USA has shown intent to implement legislation, but a growing anti ESG regulatory movement is gaining traction ahead of the 2024 elections. While in Asia, governments are trying to catch up with their western counterparts.

EUROPE LEADING THE WAY

The European Commission aims to transition to low-carbon, resource-efficient and socially-inclusive economic growth. To that end it has developed a green economy taxonomy, setting out a framework for economic activities that are aligned with six environmental and three social target outcomes. The Taxonomy is seen as a powerful tool to boost green economic activity; however it is subject to strong debate in a fast evolving geopolitical environmental. For example, the inclusion of nuclear and gas as transition fuels divided opinion.

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However, the EU continues to make progress on political alignment, reaching agreement earlier this month on European Green Bond Regulations. The European green bond standard (EUGBS) targets companies and public entities that wish to raise funds on capital markets to finance their green investments. At least 85% of the funds raised by the bond must be allocated to economic activities that align with the Taxonomy Regulation. Goldman Sachs and Bloomberg estimate there will be €600 billion of green bond issuance in 2023, potentially taking the market to over €2 trillion by year end.

LONG TERM IMPLICATIONS

The regulatory direction of travel implies a future increasingly shaped by low-carbon, socially inclusive and resource-efficient economic growth. However, the transition to a ‘green economy’ will take time, is likely to be volatile and will impact the historical risk return profiles across sectors, asset classes and regions. For example, we anticipate taxonomy aligned economic activities to enjoy access to capital and growth opportunities; the International Energy Agency anticipates clean energy investments will rise above $2 trillion by 2030, a more than 50% increase from 2022[1].

From a performance perspective we anticipate the growth of sustainability themed benchmarks to guide more productive discussion on risk, return and impact. We also expect an evolution of fee structures tied to the delivery of impact outcomes.

From a product perspective, access to and processing of ESG and impact data will drive innovation in liquid strategies seeking to capture multiple sustainability themes. We anticipate innovation in carbon hedged strategies, and long short approaches targeting the winners and losers in the green economy transition.

Lastly, as a consequence of private markets offering direct exposure to green growth opportunities, we expect an increase in funds offering exposure to these themes. Growth in fund flows to private market impact strategies will be enhanced by platforms offering digital access and lower ticket sizes and further supported by blended finance product innovation that offers de-risking and or liquidity features. As regulatory momentum drives growth in the impact product space, it’s important to recognise that not all green or impactful investments will offer superior returns. Investors will need to take a cautious and balanced approach to shifting their portfolios to navigate the risk and opportunities associated with the green economy transition.

[1] World Energy Outlook – Topics - IEA

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