

Sustainable finance in the COVID-19 era



The current crisis has given a reminder about the need to strengthen our societies. Cosmina Amariei argues that sustainability will remain an enduring policy in the (post) COVID-19 era

Context

The spread of the COVID-19 virus brought the European economy to a standstill and heightened market volatility. This unprecedented shock has been hitting certain sectors hard and exacerbating the vulnerabilities of many governments, businesses and households.

Most exit strategies are gradual and informed by the evolving public health situation in the member states. Fiscal and monetary stimulus packages are being rolled out in an effort to attenuate the negative consequences. Prudential buffers have been lowered in order to allow the financial sector to channel funds to corporates.

Even though markets have witnessed a remarkable rebound, supervisors warn against the potential decoupling from the real economy. There are also concerns that financial insecurity among individuals will become more widespread, with an impact on their saving, consumption and investment decisions.

Market developments

Asset owners and asset managers will continue to face a lower-for-longer yield environment, with positive returns harder to generate especially in the fixed income space.

In the initial phase, repositioning took place through defensive strategies in equities (high quality, low volatility, momentum), with targeted environmental, social and governance (ESG) factors, in addition to investment-grade credit/government bonds and cash/liquid buffers.

The main objective was protecting investment capital from any permanent loss. Many investors also stayed the course and did not make drastic changes.

In the near future it is expected to go beyond traditional asset classes, with an increasing demand for alternatives/ real assets, as well as to rethink the mix of alpha-seeking, index- and factor-based strategies. A total portfolio approach organised around risk and return streams could become the norm, in comparison with the classical segmentation of the investment universe by asset classes, regions or sectors.

The corporate landscape is likely to change. While many companies will remain in survival mode, certain sectors/ companies deemed strategic could benefit from public assistance. For many small and medium-sized enterprises (SMEs), capital markets are still not an actual option and they will rely on other financing mechanisms.

Sustainability will remain an enduring policy and market theme in the (post) COVID-19 era

This crisis will trigger more downgrades, a possible surge in bankruptcies and a wave of industry consolidation. Hence, a common thread among investors will be the focus on strong fundamentals (P/B rather than P/E ratios¹), namely companies with sound balance sheets, resilient business models and sectors with high intangible assets intensity.

But opportunities could emerge for otherwise stressed corporates, with upside potential from a resumption in activity combined with policy/financial support.

Despite a rapidly evolving situation, some investors were still able to separate temporary shifts from structural changes in the markets and maintained (or even accelerated) their ESG commitments, namely 'not only talk the talk but walk the walk'.

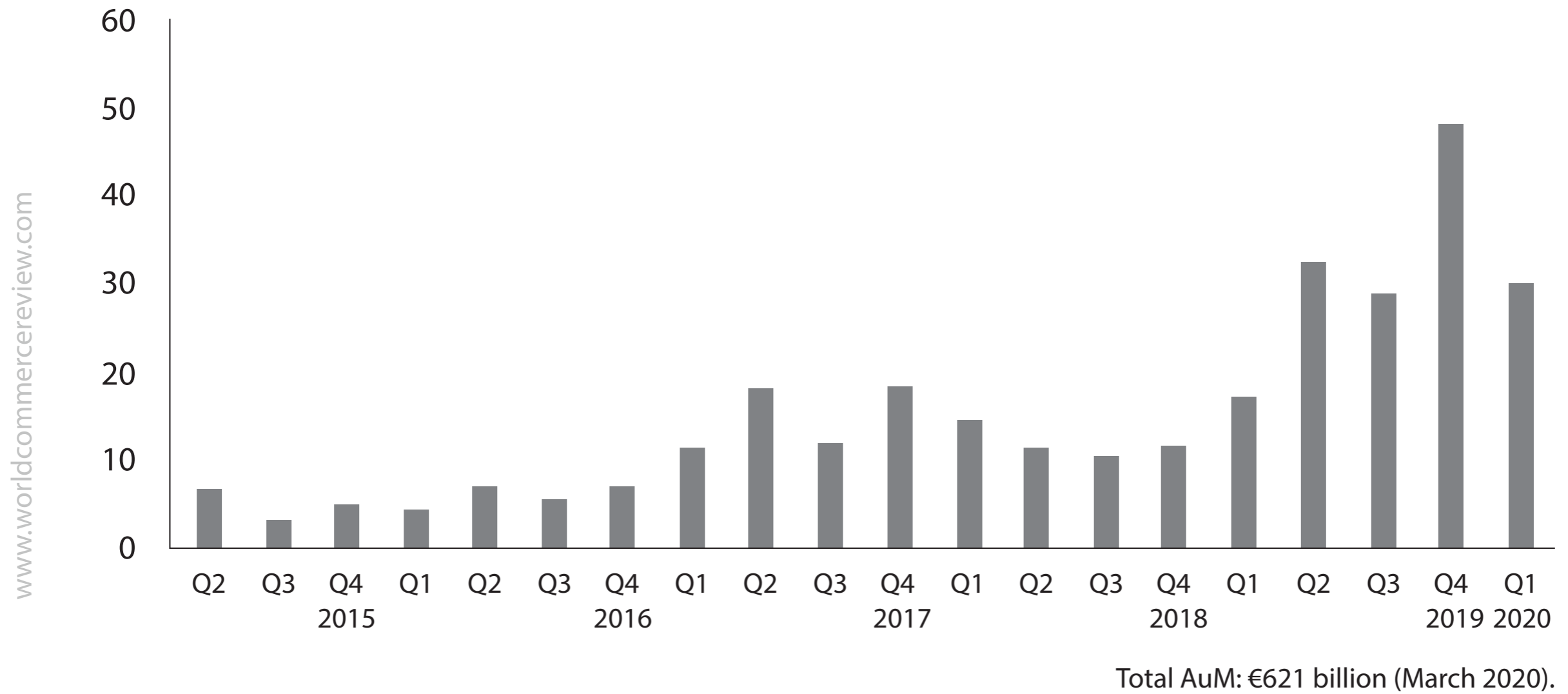
Multiple industry reports highlighted that the majority of sustainable funds and indices outperformed their mainstream counterparts in the first quarter of 2020. The ESG component was the strongest contributor to the performance even after correcting for other variables.

In practice, highly rated ESG companies tend to be less cyclical. In addition, the inflows into sustainable funds remained strong (see Figure 1), compared to outflows from conventional funds. This confirms that certain sustainable strategies could offer better risk-adjusted returns and improve portfolio resilience.

Environmental, Social and Governance

In the midst of the pandemic, an important question emerged: Is there any apparent trade-off between crisis management measures and pursuing the sustainable finance agenda? Many stakeholders argued for the European

Figure 1. Quarterly European sustainable fund flows (€ billion)



Source: Morningstar Direct, Manager Research.

Green Deal to remain central for a robust recovery and growth in the EU, and this was recently reinforced in the Commission's Communication on *Europe's moment: Repair and Prepare for the Next Generation*.

In order to meet the 2030 climate and environmental targets, around €470 billion additional annual investments are needed (see Figure 2). As initially announced, the European Green Deal Investment Plan aims to mobilise at least €1 trillion in public and private funds for achieving climate neutrality by 2050.

At present, many bottlenecks actually lie in the unsatisfactory pipeline of sustainable projects/assets across the EU. Nonetheless, this should actually be seen as an opportunity to build competitive advantage in new industries, taking into account future trajectories and needs.

Figure 2. Overview of investment gaps (€ billion, per year)

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|---|-----|
| Green transition | 470 |
| Climate mitigation and energy 2030 targets | 340 |
| Wider environmental objectives, beyond climate | 130 |
| Digital transformation | 125 |
| Strategic investment (for EU autonomy on critical value chains) | 20 |
| Social infrastructure | 192 |

Source: European Commission, SWD (2020) 98 final, Brussels.

Beyond that, it has to be acknowledged that the larger challenge is the investment case in relevant sectors. Some companies cannot economically justify 'radical' green investments. The financing of the 'pure' green players is imperative but not sufficient.

Inflows into climate-related investment funds could play a greater role in targeting solutions that are not yet competitive. Climate stewardship by asset managers² should be oriented towards clear outcomes, and institutional investors³ with a long-term outlook, for example insurance companies and pension funds, could use their track record when delegating external mandates.

In the longer run, most corporates will have to demonstrate a clear pathway in terms of capital investments, operational expenditures, revenue generation and low-carbon solutions for end-consumers. If the externalities of their economic activities are not adequately priced in, or in the absence of adequate economic incentives, sustainable investments may not reach the desired levels.

A recovery in the green context could lay the groundwork for more issuance of green bonds, supported by an EU standard and an accreditation/supervision regime for external verifiers. Moreover, equity markets could be the 'perfect' candidate for supporting the transition to carbon neutrality, in particular by stimulating innovation and skills upgrades that lead to the adoption of greener technologies, with shorter payback periods.

More broadly, understanding the impact of ESG factors on corporate performance, and consequently portfolio construction, security selection and risk management, is essential. The Social and Governance dimensions will be brought to the forefront, in particular impact on employees, customers, supply chains and local communities but also scrutiny over dividends, share buybacks, executive remuneration and investors' engagement.

To ensure environmental and social interests are fully embedded into business strategies, a new initiative on sustainable corporate governance was announced by the Commission for 2021; this should also account for the diversity in ownership and control structures across the EU.

This crisis could mark a turning point for social bonds. The current outstanding amounts (with proceeds invested in healthcare, housing, education and entrepreneurship) is small but growing. Still, much like greenwashing, the risk of social/governance washing must be avoided by expanding the EU taxonomy, especially if there are 'strings attached' to public support.

When it comes to ESG ratings/scores, investors report divergence across providers and advocate an overhaul of the practices. In addition, trading venues refer to expanding their capacity in tracking ESG metrics.

Corporates, investors & supervisors

Corporate disclosure is a fundamental bedrock for sustainable finance. Establishing standards for non-financial information at the EU level (mandatory or voluntary) is the way forward in order to achieve greater consistency, comparability and reliability.

The scope of companies to be covered is another central aspect. Once a certain level of maturity has been achieved, the Commission should consider creating a public centralised database at the EU level, with both financial and non-financial information, linked to a unique identifier for the reporting entity.

At present, large companies tend to report more comprehensively on ESG factors and dominate investors' portfolios compared with SMEs, for which such a regime should be adequately calibrated. Failure by SMEs to provide non-

financial information may have a negative impact on their business opportunities as suppliers to large companies, or limit their ability to benefit from private capital for certain green or innovative projects.

Nonetheless, raising the bar for disclosure for smaller, non-listed companies – with a focus on double materiality and third-party assurance – may politically be a ‘hard sell’ under the current economic circumstances.

Transparency, proportionality, aligned incentives between corporates and investors, and ultimately performance will contribute to mainstreaming sustainability. Financial advisers, asset managers and institutional investors have a fiduciary duty to act in the best interest of their clients/end-beneficiaries, and therefore should be equipped to seize the investment opportunities and manage the risks arising from ESG factors.

More specifically on retail investors⁴, further analysis on (and detailed guidance on how to cope with) the potential variation in investment preferences will be needed, namely standardisation vs customisation of products/solutions. This comes on top of already well-known problems, such as unbalanced asset allocation, biased advice and closed distribution channels.

The EU ecolabel criteria for financial products should be ambitious enough but at the time not stifle market adoption. For institutional investors, COVID-19 could accelerate interest in mandates aligned with the Sustainable Development Goals (SDGs). And again, robust data on the universe of investments is key for portfolio-level analysis and double-materiality assessments.

ESG risks are characterised by deep uncertainty, non-linearity and endogeneity. Pricing them requires moving from backward- to forward-looking approaches, for example through scenario analysis. Climate-related stress testing is still at a nascent stage (with a few exceptions) for the industry and supervisors, with many identifying challenges

related to firm-specific data availability, methodological difficulties and insufficient mapping of transmission channels.

In addition to adapting/upgrading their sectoral reviews, the European Supervisory Authorities (ESAs) could provide comprehensive technical advice. It is essential to accelerate the efforts on monitoring interconnected exposures to stranded assets and any emerging risk differential.

The use of prudential regulation ('green supporting factor' or 'brown penalising factor') should be exercised with great caution and be evidence-driven. Similarly, other sectoral policies, such as adequate carbon pricing, subsidies and tax incentives linked to taxonomy-eligible activities, should be more carefully re-examined.

Outside of the supervisory dimension, representatives from the ECB alluded to the impact of climate-related risks on monetary policy, and how to potentially integrate these parameters in asset purchase programmes or collateral framework.

Concluding remarks

Sustainability will remain an enduring policy and market theme in the (post) COVID-19 era.

At the EU level, the Action Plan on Sustainable Finance (March 2018) put forward an extensive list of legislative and non-legislative initiatives related to the taxonomy, disclosure, suitability and fiduciary duties, low-carbon benchmarks, non-financial corporate reporting, credit and sustainability ratings, green bond standards and eco-labels for retail financial products.

These will be continued with a Renewed Strategy (December 2020) focusing on the overall ecosystem, implementation of the toolbox and systemic risk implications.

The current crisis has given a brutal reminder about the need to strengthen the preparedness and resilience of our societies as a whole.

The next three to five years will certainly be crucial in terms of the impact on the real economy, ie. translating sustainability in a consistent manner at the operational level, and mobilising significant private capital flows to support recovery and growth in Europe. From a policy perspective, synergies with the capital markets union (CMU) initiative should also be further explored. ■

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Endnotes

- 1. Price-To-Book Ratio (P/B) and Price-to-Earnings Ratio (P/E).*
- 2. At end 2019, the total net assets of UCITS and AIFs amounted to €17 trillion (EU-28).*
- 3. At end-2019, the total assets of insurance companies and pension funds amounted to €14 trillion (EU-28).*
- 4. At end-2019, the total financial assets of households amounted to €37 trillion (EU-28).*

This commentary is part of a dedicated series, as a follow-up to the CEPS–ECMI Task Force Report on “[Asset Allocation in Europe: Reality vs Expectations](#)” released in April 2020.