

ESG Investing and Climate Transition

Market practices, issues and policy considerations

Workshop on
MACROECONOMIC AND FINANCIAL IMPLICATIONS OF CLIMATE CHANGE

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Markets are increasingly using ESG investing approaches for:

- **Improved risk management and *long-term value***, which includes impact to/from environmental and social factors.
- **The growing consideration of ESG to *help green the financial system***, how it helps lower the carbon footprint of investments

An it help achieve long-term value?

How does it align with sustainability goals?

Fit for purpose for greening of the financial system?

The charts and graphs found in this presentation may be found in the following OECD publications:

OECD(2020), "[Business and Finance Outlook: Sustainable and Resilient Finance.](#)"

Boffo, R., C. Marshall and R. Patalano (2020), "ESG Investing: Environmental Pillar Scoring and Reporting", OECD Paris, www.oecd.org/finance/esg-investing-environmental-pillar-scoring-and-reporting.pdf.

Boffo, R., and R. Patalano (2020), "ESG Investing: Practices, Progress and Challenges", OECD Paris, www.oecd.org/finance/ESG-Investing-Practices-Progress-and-Challenges.pdf

OECD (2021), Financial Markets and Climate Transition: Opportunities, Challenges and Policy Implications, OECD Paris, <https://www.oecd.org/finance/Financial-Markets-and-ClimateTransition-Opportunities-challenges-and-policy-implications.htm>



ESG ratings & investing approaches – growing adoption, emerging challenges

- Progress in widespread adoption of ESG investment approaches to embed sustainability in long-term value.
- *Yet, stark differences in metrics, methodologies, and approaches could undermine market integrity and hinder further alignment with sustainability goals.*

Adoption

- Growing adoption of ESG across G20 countries, esp. **exchange-listed firms**.
- ESG used by **\$40+ trillion AUM**.
- Growing number of exchanges calling for **recommending guidance on ESG disclosure**.

Challenges

- **Wide variance** in use of ESG metrics and weighting to arrive at scores.
- Multiple **materiality** concepts and standards.
- **Low correlation** of ESG scores.
- **Little relationship** between high-ESG tilted portfolios and superior risk-adjusted returns.

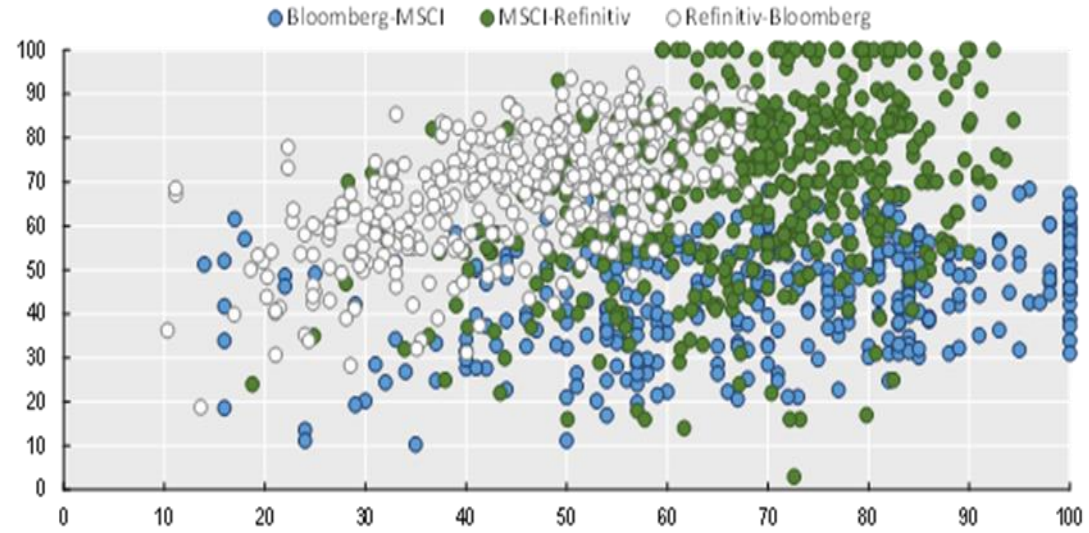


Lack of score correlations and variance in performance calls for strengthening practices

> Lack of correlation and clear meaning of ESG scores could hinder long-term value and alignment with sustainability goals.

There is a lack of correlation among ESG scores across leading rating providers

STOXX 600 ratings correlation for different providers



Note: Providers' names in the legend correspond to the Y axis when at the left and to the X axis when at the right (e.g. Bloomberg (blue), MSCI (green) and Refinitiv (white) on Y axis and MSCI (blue), Refinitiv (green), Bloomberg (white) on X axis). Data from three leading rating providers (Bloomberg, MSCI, Refinitiv) with OECD Staff calculations. For full methodology, refer to source.
 Source: Boffo and Patalano (2020), ESG Investing: Practices, Progress and Challenges, OECD Paris

Different ESG indices have varying risk and performances depending on how they are built.

Comparison of ESG and non-ESG MSCI indices by risk-adjusted performance



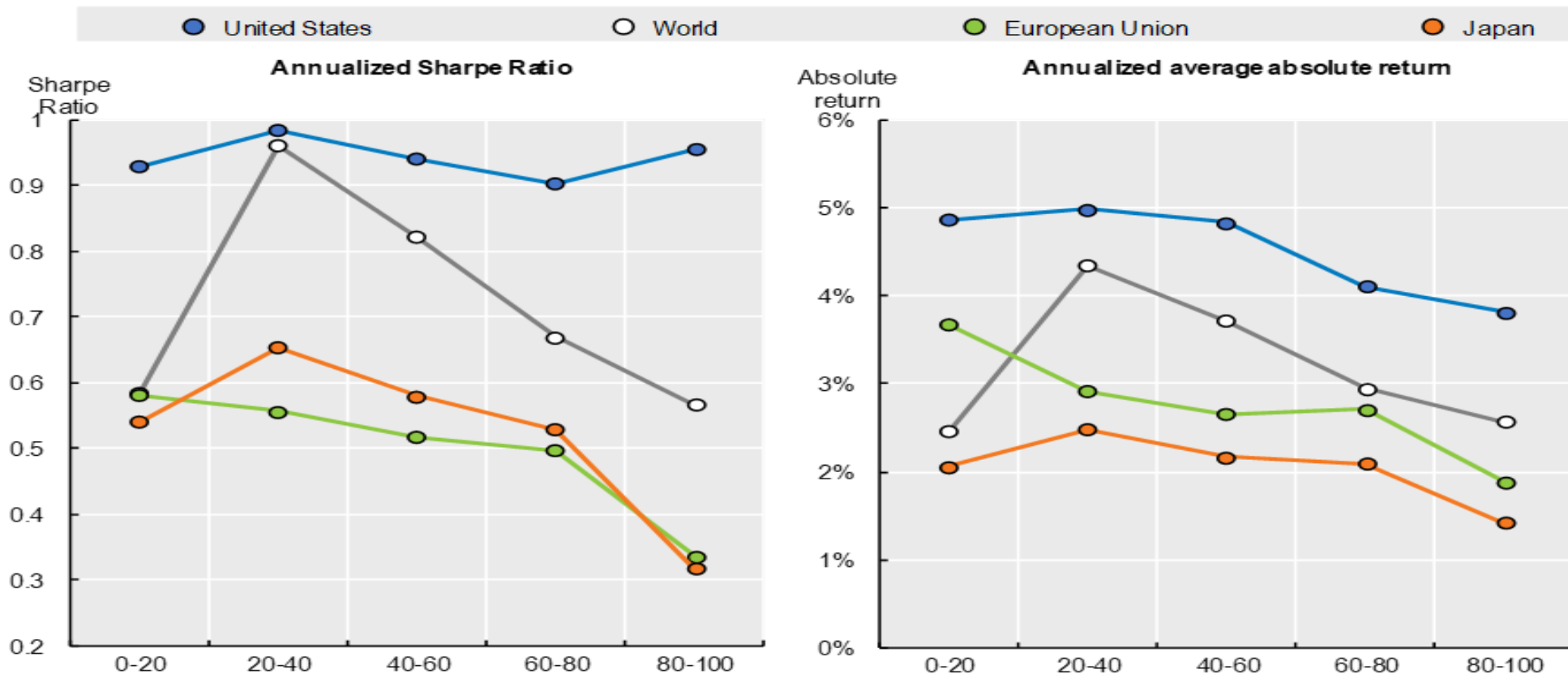
Note: Data from Bloomberg, MSCI, Refinitiv, with OECD Staff calculations. For full methodology, refer to source.
 Source: Boffo and Patalano (2020), ESG Investing: Practices, Progress and Challenges, OECD Paris



Empirical results – Portfolio construction

- Sharpe ratio and absolute return assessments suggest results can vary depending on the region.
- Using a sample of US Small Cap companies, high ESG scoring portfolios do not outperform low scoring firms.

Annualized Sharpe ratio and average absolute return by rating segregation, 2009-2019

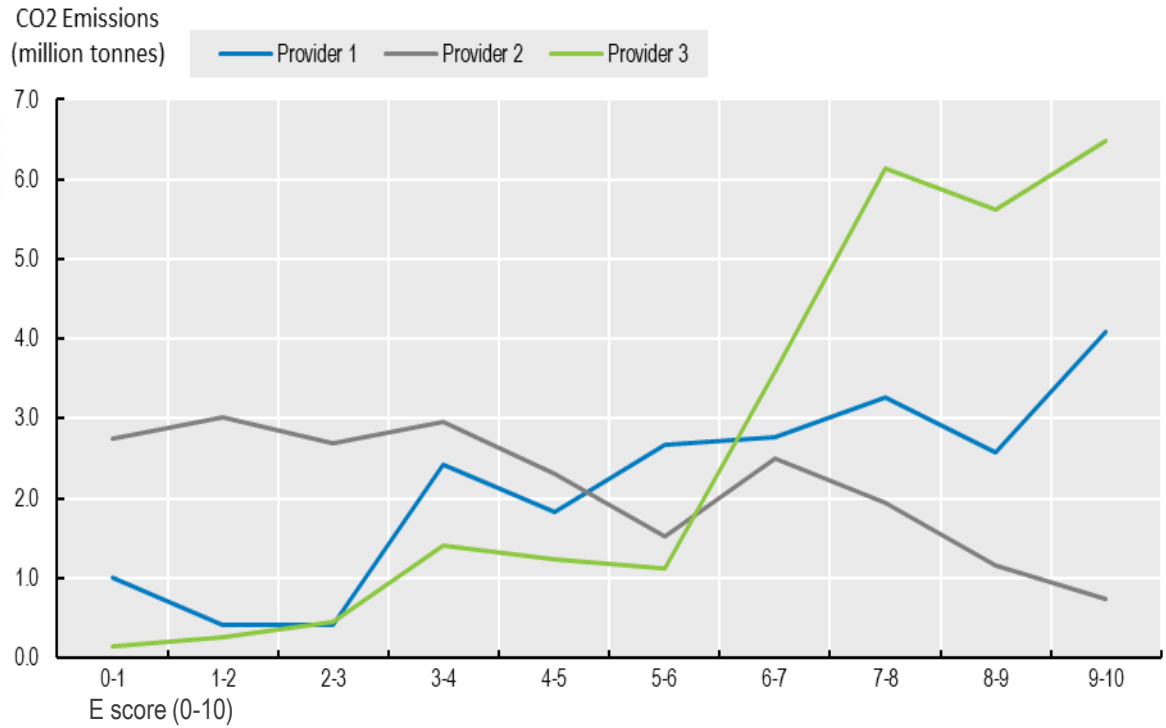




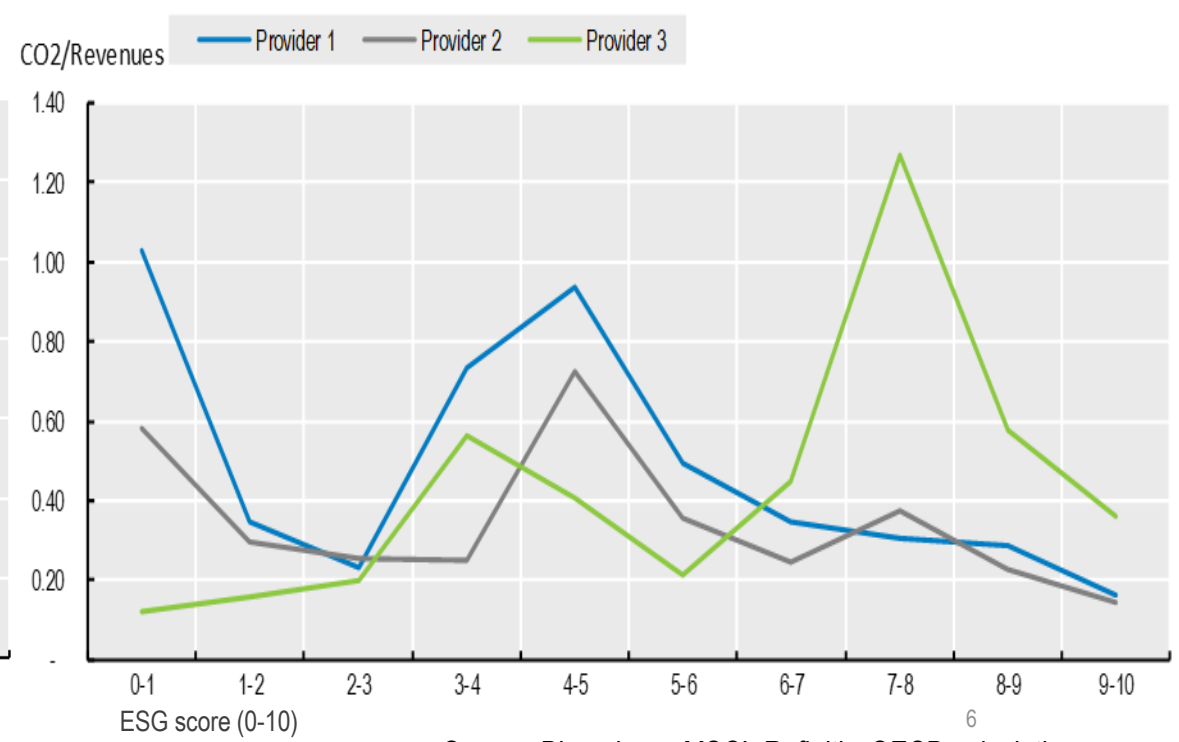
Higher environmental scores in ESG ratings not aligned with low carbon emissions

- Two providers out of the three analysed show positive correlation between CO2 emissions and the Environmental score, meaning that higher “E” scores can be linked to higher CO2 Emissions.

CO2 Emission by E pillar scores



CO2 Emission/Revenue by E pillar scores



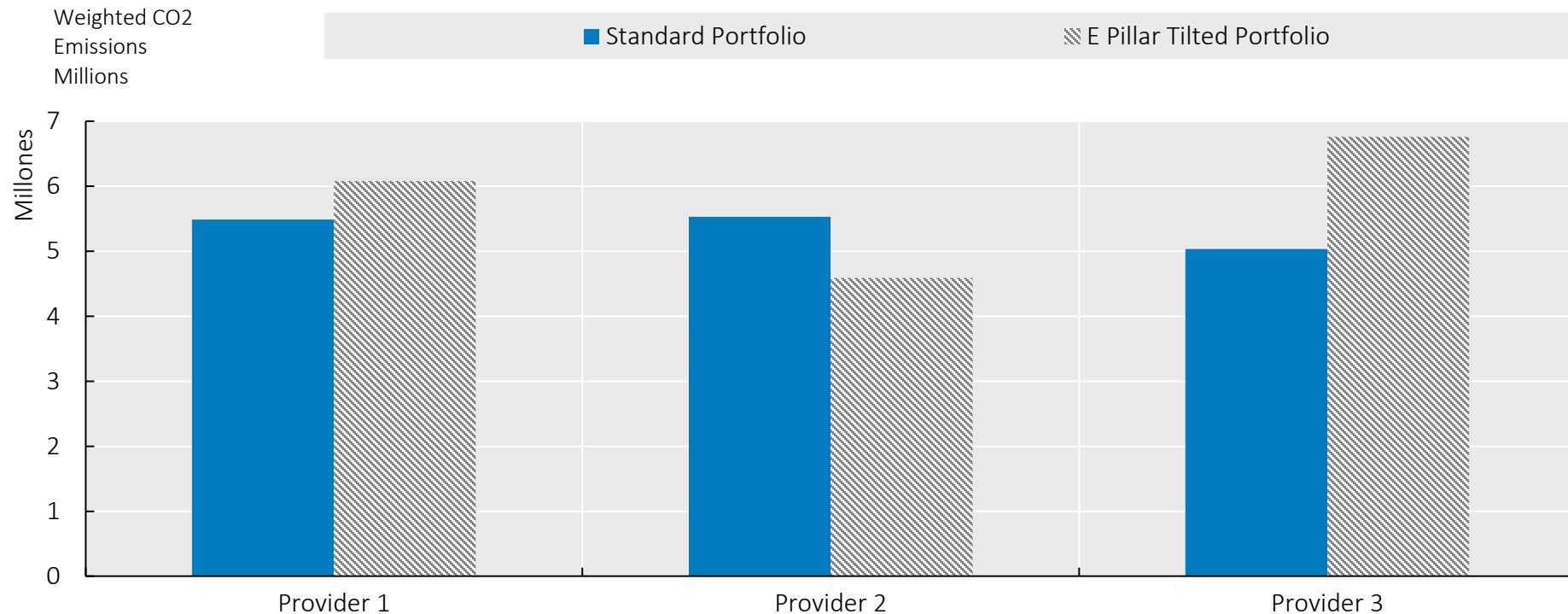
Source: Bloomberg, MSCI, Refinitiv, OECD calculations



“E” tilted portfolios can have higher emissions than market portfolios

- Two providers out of the three ratings providers do not show reduction in carbon emissions when applying the Environmental pillar score to a tilting investment strategy.
- This raises questions over how investors use ESG in combination with other climate tools to align portfolios with net zero.

CO2 Emission by stylized portfolios, tilted by E pillar scores for three providers



Source: Bloomberg, MSCI, Refinitiv, OECD calculations

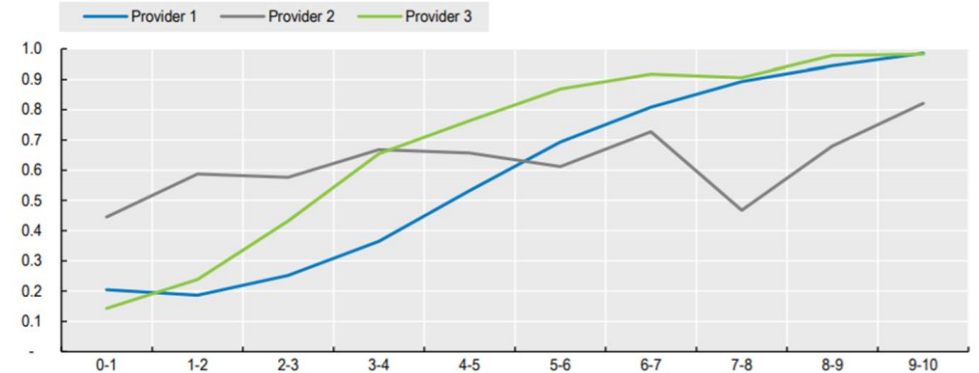


Climate transition metrics and products need greater alignment

Need for greater alignment

- At least some E pillar metrics provide forward-looking perspectives on emissions reduction (top chart) intensity.
- Yet, many drivers of **E metrics relate merely to act of disclosure** (bottom chart) rather than meaningful data.
- **Climate transition plans do not yet contain sufficient and reliable forward-looking metrics** needed to judge progress of transition.
- Lack of near-term commitments and **verifiable interim targets**.

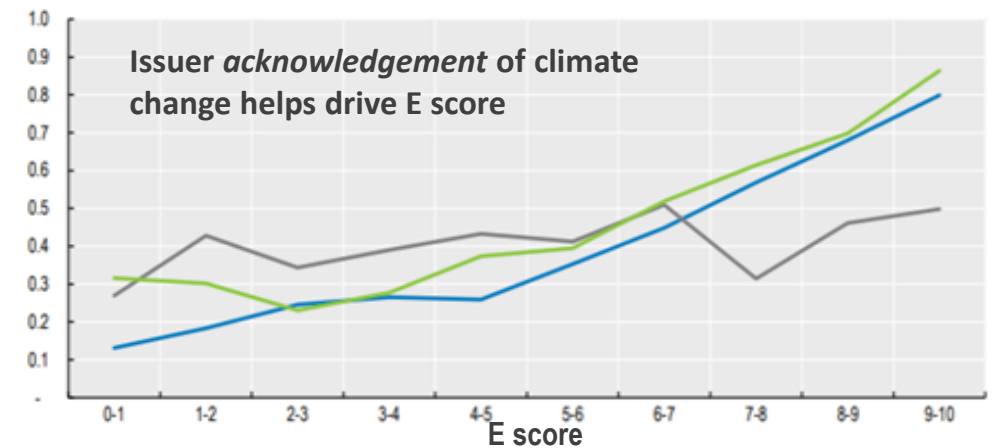
Emissions reduction processes



Source: Bloomberg, MSCI, Refinitiv, OECD calculations

E score

Climate change Risks/Opportunities by E Pillar Score



Note: Data from three leading rating providers (Bloomberg, MSCI, Refinitiv) with OECD Staff calculations. For full methodology, refer to source.

Source: Boffo, Marshall and Patalano (2020), ESG Investing: Environmental Pillar Scoring and Reporting, OECD Paris



Recommendations

> Actions are needed by financial authorities and market participants to ensure that market practices are strengthened to better align with sustainability goals.

ESG & E Pillar

- > Ensure **global consistency, comparability and quality of core ESG metrics** through alignment with long-term enterprise value, including material environmental and social factors.
- > Promote **transparency and comparability of scoring methodologies** for established ESG ratings based on internationally recognised standards.
- > Improve relevance and precision of E score metrics through **stand-alone submetrics for climate transition risk and opportunities**.

Markets & Climate Transition

- > Greater use of granular forward-looking **climate transition disclosure metrics** in ESG approaches to improve consistency, reliability and alignment with low-carbon transitions.
- > Greater commitment to the use of **science-based targets**, annual progress updates, and **third party verification** to ensure integrity.
- > Improve transparency and clarity of institutional investors' **stewardship plans** to incentivise commitment to net-zero pathways.

➤ *OECD seeks to develop high-level **ESG Risk Policy Framework**, which would capture climate transition definitions, principles, and due diligence.*