The risk to investment flows will not be from the tighter sustainable finance

Europe's new, and very dry-sounding, Sustainable Finance Disclosure Regulation (SFDR), will have a far deeper impact than is immediately obvious.

It establishes common rules on how companies that manage money for others should disclose the impact of their investments on the environment and society. Employers of any size, be it government agencies, local councils, big or small companies, tend to outsource the managing of their employees' pensions. Up until now, there has been little oversight of how sustainable or responsible the pensions investments are. Instead, money managers have been selling what they label as "green" funds without widely established or recognised criteria on what that means.

The new SFDR, phased in from March, replaces a patchwork of different rules across the EU. It requires money managers to report to their clients how "sustainable" investments fulfil certain criteria. As well as pensions funds, those clients may be insurance firms, individuals making private investments or brokerages trading on their own account.

In five years' time, ESG will be the new normal

Dr Antonios Koumbarakis, PwC

The regulation has been introduced to promote a behavioural shift among money managers towards genuinely sustainable investments. Since it has an extraterritorial reach (all funds must be labelled, wherever they are invested) this could influence the behaviour of companies around the world seeking capital from the markets. About 60% of European fund assets are invested outside the EU. In China, foreign equity holdings are increasing dramatically.

"There's a huge demand for green assets and not enough supply. Everything will eventually have to go green," said Dr Paul Fisher, fellow of the Cambridge Institute for Sustainability Leadership and member of the European Commission's High-Level Expert Group on the regulation.

He described the new rules as a "pretty blunt instrument and not a silver bullet" when it comes to promoting a shift to greener investments, as asset managers don't usually get that close to the companies in which they invest. But the rules are, he said, necessary given the level of greenwashing. "It's a very crude mechanism for making adjustments; all asset managers can do is make divestments or vote for climate-friendly resolutions at AGMs. But it will force them to tighten up on what they invest in."

Is it having an effect?

With the regulation in the works since 2018, many of the world's largest investment firms such as Blackrock and Pimco have already adopted sustainability criteria. However, there are still many unknowns. Accompanying regulations, the regulatory technical standards and the EU taxonomy which essentially defines what is “green”, are being scrutinised by the European Parliament and won’t enter into force until January 2022.

HSBC Bank headquarters building on stormy day in Canary Wharf

RECOMMENDED

The foreign money in China’s booming coal industry

Draft documents were published on 21 April, including a list of “green” sectors; the so-called EU taxonomy. The Commission has underscored that this is an evolving list that will be continuously updated. For now, gas and nuclear have been left off it as the Commission has not yet reached a decision as to whether they may serve as a transition fuel – which companies in the sector insist they would – as the world attempts to leave behind coal.

Invest Europe, which represents private capital providers, said it had received many questions from its members who were having difficulties interpreting the rules. “Green and deep green – what do these specifically mean? We are waiting for the RTS [regulatory technical standards] and the taxonomy but since the rules apply already, some of our companies are struggling,” said Martin Bresson, Invest Europe’s public affairs director, adding that these teething troubles would be resolved when the accompanying regulations are finalised.

Deceptive green claims

In January, the European Commission, the EU’s executive arm, published a study into greenwashing claims by a range of companies. It concluded that in 42% of cases green claims were “exaggerated, false or deceptive”.

The regulation will be effective in discouraging such greenwashing, experts said. It fills the gap that makes greenwashing so possible and provides greater transparency, said Dr Antonios Koumbarakis, Sustainability & Strategic Regulatory Leader at PwC Switzerland.

In France, which had already introduced national rules on disclosure, there has been a discernible positive impact, said Byford Tsang from climate think-tank E3G. “The (introduction of the) SFDR has generated quite a lot of change in the French asset management community with a higher level of disclosure. The quality of ESG reports has become higher,” said Tsang.

There is already evidence that companies seeking investment have responded to the regulation, according to Victor van Hoorn, director at Eurosif, the European Sustainable Investment Forum. “Even companies outside Europe are starting to get questions from their own investors as well as the financial benchmark providers and data providers and so this system is putting gentle pressure on companies to start reporting this information.”

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Study by the European Commission

In China, companies are already getting ahead on sustainable investment planning with national initiatives. The government is developing a slew of economic and social governance disclosure rules, including the UK–China Climate and Environmental Information Disclosure Pilot, the Shenzhen SEZ Green Finance Regulations, and the Pilot on Environmental Information Disclosure of Financial Institutions in the Guangdong–Hong Kong–Macao Greater Bay Area. These are preparing companies for increased demand from asset managers selling into the EU.

Blackrock, for example, invests in Shanghai A-listed shares of China Merchants Bank Co Ltd, Kweichow Moutai Co Ltd, Ping An Insurance Group and China Petroleum & Chemical Corp. These companies may well end up being included in the taxonomy depending on their role in the green transition and their investments in greener technologies such as renewables.

An even greater effect is coming from the increased demand from investors for sustainable financial products and the outperformance of sustainable finance instruments compared to traditional investments such as coal and mining, previous favourites of funds invested in China. BlackRock said a year ago that it would exit coal as part of its new climate-focused strategy while Pimco said it has also refocused on decarbonising its portfolios.

According to the European Central Bank, assets of funds with an environmental, social and governance (ESG) mandate have grown by 170% since 2015 and take-up by euro area investors since the start of the Covid-19 pandemic has risen by 20%. In terms of performance, ESG and non-ESG funds in Europe had posted similar gains until the start of the pandemic when ESG began outperforming.

Brown investments are no longer attractive

Koumbarakis at PwC said: “In five years’ time, ESG will be the new normal,” adding that “some brown investments such as coal are even no longer attractive” because of the comparatively lower returns.

China is well placed with its growing green businesses to take advantage of this surge in green investing and the tougher EU criteria for fund managers.

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deforestation in indonesia
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Reducing the forest footprint of Chinese soft-commodity financing
CDP, a non-profit organisation which runs a global disclosure system for companies, told China Dialogue: “Companies with high sustainability performance and which are climate and environment friendly will have the opportunity to obtain more overseas investment.” This would be in line with government guidance issued last year to promote investment and financing to address climate change by attracting international funds and foreign investors.
While investments in brown sectors look set to dwindle further, overall, regulations like the SFDR will likely boost investment flows. “For China, this is a big opportunity,” said Koumbarakis.
Political risks
The risk to investment flows will not be from the tighter sustainable finance regulation but from

growing protectionism globally and uncertainties over the relationship between China and the EU, analysts told China Dialogue.

“The question for me is how open is China to receiving a lot of those foreign capital financing for these types of companies. Geopolitically we see a trend where different economic blocs are starting to be more protective about companies in those technology sectors and therefore are quite happy to fund them themselves and maybe less keen for foreign capital to fund those operations,” said van Hoorn from Eurosif.

“The very real risk that investors have to deal with right now is the political volatility. All these uncertainties would have an impact on investment flows into China generally but it would also have an impact on the investment flow into China’s green sector,” said Tsang of E3G.