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Whether it is a reckoning, reevaluation, or reassessment, the past month has seen a number of regulatory and market developments that will have a significant impact on the future of sustainable finance and *ESG*. In the past few weeks, the following has occurred:

1. Advancement on *Greenwashing* by regulators.
2. Increased skepticism that existing net-zero and deforestation pledges are sufficient.
3. Consolidation of organizations that provide sustainable guidance.
4. New research from the Fed detailing green bond funding and the impact of recent anti-ESG legislation enacted by states regarding the pricing of their municipal debt.

**What does all of this mean and why is it important?**

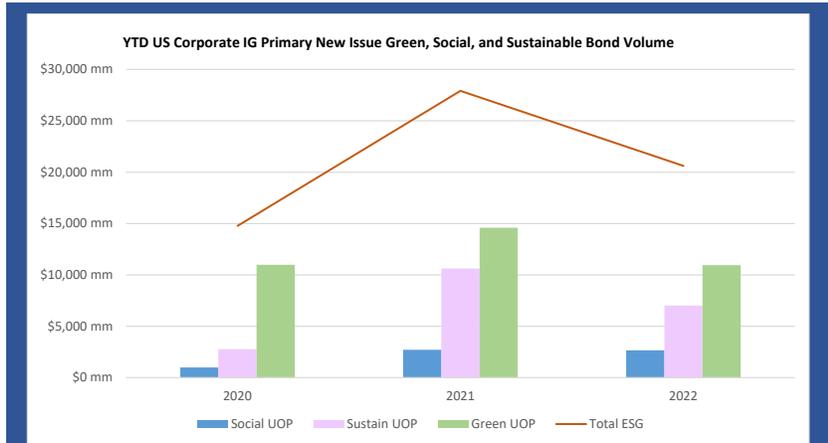
First, these developments show that many investors and market participants find this type of information important, but at the same time, there is still “wood left to chop” as to what details are the most critical to financial decision making and how it is disclosed. It should also be an indicator that the current model being used is in need of improvement. Which leads one to ask, what exactly is the current model?

**Current Model & Response**

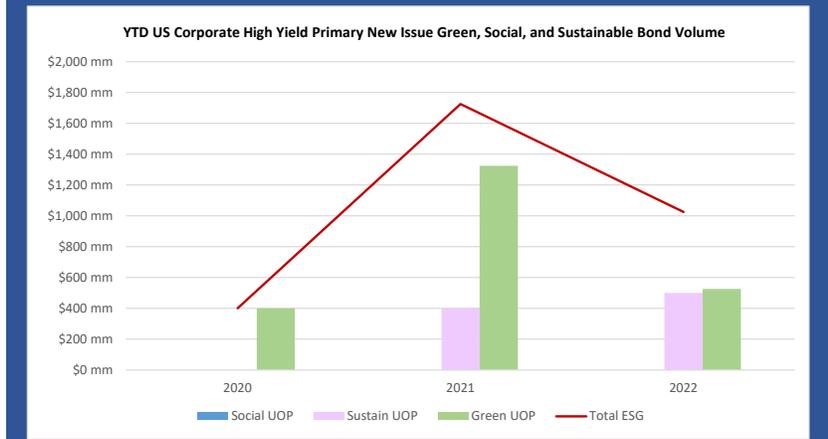
The answer is that there is no real current model (at least here in the US). The SEC addressed this in its April 2021 Risk Alert letter on ESG funds when they wrote, “The Division has observed that firms approach ESG investing in various ways.”

If there is anything like a current standard model to ESG investment here in the US, it is primarily a combination of prescriptive investment screens based off of morals (bad vs. good) and the use of ESG ratings issued by either existing ratings entities or newer entrants focused on sustainability assessment. The challenge is that unlike many credit ratings, which are within a similar range of each other, ESG ratings often do not show the same level of consistency. In a response to a consultation on ESG integration, the UK Financial Conduct Authority found that some of its respondents suspect that the reason behind these discrepancies include the depth of knowledge of ratings analysts as well as cost constraints.

The use of ESG ratings and decisions by some banks with ESG mandates hasn't been without consequences. States including Utah and West Virginia have responded by looking to avoid asset managers and underwriters with ESG mandates. In the case of Texas, it enacted SB 13 & 19 which specifically prohibits investments with financial companies



*Investment Grade: 2022 US IG ESG themed debt issuance has now dipped to volumes not seen since 2020. Despite the volatility MetLife, Goldman Sachs, and NiSource have all come to market in June with use of green themed proceeds offerings.*



*High Yield: No new issuance for the month of June as ESG themed high yield debt issuance remains muted.*

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that discriminate against certain energy companies and firearms manufacturers. According to a recent report, this could cost Texas entities an additional \$303mm - \$532mm in interest on the \$32bn borrowed in the first 8 months of the law being enacted.

In Europe, the tone is slightly different, but still highly prescriptive. The European Commission issued its green instrument taxonomy which establishes a list of environmentally sustainable economic activities over a year ago. It also has its Article 6, 8, and 9 funds. Yet despite all of this, headwinds remain in light of geopolitical uncertainty as BaFin recently postponed plans for classifying funds as sustainable due to the impact that the conflict in Ukraine has had on global energy markets. There have also been revisions to natural gas and nuclear investments.

The problem with this is that given the “expansive” nature and varying definitions of ESG (or lack thereof), there is the potential opportunity to game the system or obfuscate risk. This has grabbed the attention of regulators both here in the US and in Europe. The SEC more recently (in addition to its climate and cyber disclosures) has announced the proposal of disclosures for RIAs, BDCs, and funds that integrate and/or focus on ESG factors or have a stated impact mission. In some respects, it mirrors what has been done in Europe with article 6, 8, & 9 funds, but with some differences.

While still just a proposal, the attention being paid by the SEC to greenwashing (in addition to broader market gyrations) has throttled back sustainable and green themed UOP bond offerings. These bonds are also experiencing some changes in guidance, more specifically for sustainability linked bonds. One area of critique of the structure was the callable component of linked bonds, wherein an entity could call their bonds prior to review of SPTs and KPIs. This could potentially allow an issuer to avoid paying the step up even though their SPTs might not have been met. The new guidance by the ICMA aims to fix this flaw by recommending at least one SPT be evaluated prior to the bond becoming callable. However, unlike the SEC, the ICMA has no authority to prescribe or legislate mandates—making their guidance for all intents and purposes, voluntary. Even the EU's Green Bond Standard is voluntary, again, adding another layer of difficulty when looking to make comparisons. In another critique, the Fed in its research of corporate green bonds found that there was little pricing advantage for those with “greener” uses of proceeds and instead beneficial pricing tends to be shown to higher grade index eligible issuers.

The other uphill battle for investors is gauging the impact of their investments and then disclosing that impact. How exactly does an investor track the impact of their green bond or ESG fund investments on their balance sheet? PCAF in cooperation with JPMAM and others are currently looking at developing standards and guidance for calculating this impact. This is one area where more clarity and agreement could be helpful in avoiding “greenwashing” (an aim of the SEC's greenwashing proposal), which will require the disclosure of Weighted Average Carbon Intensity (WACI).

### [Transforming vs. Transition](#)

This is a topic our team has touched on in the past and an important issue to consider given the recent challenges we are seeing as the world grapples with rapidly changing ecosystems, a return from over 2 years of pandemic restrictions, and a volatile geopolitical climate—Russia, Ukraine, and a rising China. In light of this, we need to strategically think about sustainability, its value, and its incorporation into financial decision making and capital allocation.

One area where there is room for improvement is in the use of prescriptive screens which are often applied to sectors

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like energy & defense. For example, many manufacturers of firearms or providers of products/services within the defense industry (as well as oil & gas companies) are excluded from “ESG” funds. Yet, many of these companies are in fact looking to become more sustainable by reducing their environmental impact, enhancing the safety of their products and/or process, and improving cybersecurity and corporate governance.

Several major US and international energy companies have invested in entities pioneering hydrogen technology, efficient engines, battery technology, micro-mobility, and ion-exchange membranes. One company, which is involved in land drilling for the oil & gas and geothermal sector, has made significant investments into a Slovakian and US based geothermal drilling company. Another example is a major contractor to the DoD has made investments in a hybrid electric plane start-up that requires less room for take-off.

As we look to decarbonize and increase our use of the grid for vehicle transport and other uses, having a diverse energy supply will be critical to avoiding the similar supply/price shocks we have seen in the past (and are seeing more recently). So instead of transitioning away from these companies, investors should heavily consider those who are looking to transform (and so should regulators). Energy companies especially will be key players in the hydrogen fuel space. The defense industry (within its value chain) has lots of room to enhance the technology used—whether that is making existing technology more efficient, green, or developing new technologies for the DOD (which also has sustainability mandates).

#### Bottom Line

1. Changing landscape, one that will become more refined/value proposition driven, especially if disclosure is standardized in machine readable formats using structured data language.
2. More support for companies looking to transform and shift away from prescriptive moral exclusions.
3. Greater scrutiny from regulators on issues of *greenwashing*.

#### Further Resources

Net Zero Tracker: <https://zerotracker.net/analysis/net-zero-stocktake-2022/>

Fed Reserve System, Green Bond Issuance: <https://www.federalreserve.gov/econres/ifdp/files/ifdp1346.pdf>

Anti-ESG Legislation Impact: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4123366](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4123366)

SEC Proposed ESG Fund Rules: <https://www.sec.gov/rules/proposed/2022/ia-6034.pdf>

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