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Global Asset Manager Chief Executive Says Facts “Left Aside” in ESG Funds Pushback

February 14, 2023

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Just days after the Texas Senate questioned a global asset manager—among other major financial investment firms—about its ESG-related investing policies, its chief executive said in an interview for the Financial Times that Republican politicians “have left facts aside” when opposing ESG-focused investments. As one of the major targets of the anti-ESG agenda, State Street has received backlash from politicians who argue that asset managers should not consider ESG factors in making investment decisions. While some politicians call for an end to ESG-driven investment practices, on the other side of the spectrum, climate activists have also applied pressure to asset managers like State Street and BlackRock to do more to address climate change risks and to stop investing in fossil fuels.

In his interview, chief executive Ron O’Hanley focused on overall investment risk:“[f]or us it is a matter of value, not values. . . . No one seems to question us when we say interest rates going up or down or GDP going up is an investment risk.” He also expressed confidence that people across the political spectrum would “welcome the associated jobs and economic impact” that ESG-related investing will have on the economy. In addition to the January 2023 hearings in Texas, certain Congressional Republicans are zeroing in on the investment industry’s climate practices. According to O’Hanley, ESG “is not a political issue. It is nothing more than a proposition that climate needs to be incorporated into our investment risk framework.”

Taking the Temperature: O’Hanley’s sentiments echo those across the financial sector: considering ESG factors when making investment decisions is consistent with an asset managers’ fiduciary duties to investors, just as they should asses any other material impact. Backlash and “political wrangling,” as O’Hanley called it, only inhibit the development of a potential source of positive economic impact and weakens the United States’ foothold as a leader in the area of climate change. Nonetheless, as we have covered, pressure continues to be exerted on financial institutions from various corners of government, including Republican state attorneys general, who wrote to two proxy advisory firms claiming that their "climate and diversity, equity, and inclusion priorities" may conflict with the contractual agreements they have with states' investment vehicles; various Republican state finance officials, who have sought to penalize banks deemed insufficiently supportive of the fossil fuel industry by precluding participation in underwriting syndicates or withdrawing pension funds under management; and

Republican members of Congress or their staff, who have inquired into various ESG-related issues on the part of financial-industry climate collaborations and ESG ratings providers. However, this is almost exclusively a U.S. phenomenon. Other jurisdictions by and large are free of this type of politically-driven debate. Even here, while “anti-ESG” political moves generate headlines, it is questionable whether these actions are having a major impact. For example, BlackRock’s CEO Laurence Fink said that the firm actually took in $230 billion in 2022 from clients, while losing approximately $4 billion AUM as a result of state government reaction to ESG issues. Those results could be read as evidence that the market agrees with BlackRock and others on the need to responsibly consider climate risks when making investment decisions.

NZAOA Issues Target Setting Protocol Third Edition

February 14, 2023

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Last month, the Net-Zero Asset Owner Alliance (NZAOA), an alliance of asset managers committed to transitioning their investment portfolios to net-zero greenhouse gas emissions by 2050, released the third edition of its **Target Setting Protocol**, which identifies and describes NZAOA's approach to target setting and reporting. The first two editions focused on the years 2020-2025, and 2030, respectively. The recently published third edition **updates** the prior protocols to account for "the latest science, expands methodological coverage across asset classes, provides further details for some of the Alliance's four target types, and adds chapters on carbon removals and just transition."

The NZAOA utilizes a four-part target setting approach:

- Engagement targets, which "help track member engagement activities with companies and asset managers, while also guiding member efforts to engage with the broader investment and real economy sectors through position papers."
- Sector targets, which "help link portfolio-level reductions to the carbon efficiency requirements of a given sector and therefore, real world outcomes."
- Sub-portfolio emission targets, which "cover the asset classes where credible methodologies and sufficient data coverage exist as of the date of the target's publication."
- Financing transition targets, which encompass efforts to support "financing the transition and the increase of climate solution investments, for example, in emerging economies but also by promoting net-zero aligned benchmarks."

The protocol recommends that members set targets on all four parts, but requires members to set targets for at least three (and engagement targets are mandatory). The protocol further provides that:

> "Targets shall be set on the members' own Scope 3 emissions related to investments (sometimes referred to as 'portfolio emissions' or 'financed emissions'). In addition to setting Scope 3 emissions targets, Alliance members should set net-zero targets on their own Scope 1 and 2 emissions. Members shall set targets on Scope 1 and 2 emissions for their underlying holdings and should do so on Scope 3 of underlying holdings for 'priority sectors' as soon as possible, as detailed in the chapter on sector level targets. At the portfolio level, Alliance members should track portfolio company Scope 3 emissions, but are not yet expected to set targets until interpretation of these emissions in a portfolio context becomes clearer and data becomes more reliable."

The third edition protocol "introduces overarching principles for target setting in private assets, a reporting framework for sovereign debt accounting in line with the latest guidance by the Partnership for Carbon Accounting and Financials (PCAF); and carbon accounting and target setting for direct commercial real estate mortgage loans." Updates include:

- A recommendation that members set targets to reduce emissions between 22-32% by 2025 and between 40-60% by 2030 based on the latest assessment report of the Intergovernmental Panel for Climate Change (IPCC).
- With respect to sovereign debt, a recommendation that members track and report carbon data to the NZAOA by 2024.
- A requirement that members not use carbon removals for their sub-portfolio or sector targets at any time before 2030 to promote accountability toward decarbonization efforts on a wider scale.
- Develop tools via **ASCOR** (the UN-led Assessing Sovereign Climate-related Opportunities and Risks project) to assess sovereign exposure to climate risk and transition with the goal of having members include sovereign debt in sub-portfolio target setting.

Taking the Temperature: The protocol provides helpful guidance to asset managers who are either voluntarily reporting emissions information or are mandated to do so. Either way, the protocol addresses target-setting and reporting at management, portfolio, and financing levels. Importantly, the NZAOA relies on scientific data to support the requirements and recommendations contained in the protocol.

The protocol also contains two noteworthy "disclaimers." The protocol observes that asset managers must be cognizant of their fiduciary duties to investors in dealing with climate-related concerns: "Asset owners have fiduciary duties that require them to act in the interests of beneficiaries, clients, and members, to act prudently, and to exercise care, skill, and caution in pursuing an overall investment strategy," and therefore, NAZOA recommends that its members "use science-based ranges, targets, and methodologies in their strategic planning to meet their net-zero commitments," which the protocol provides, to the extent available.

The protocol also includes an "Antitrust and regulatory disclaimer," stating:

> **"The Alliance and its members are committed to comply with all laws and regulations that apply to them. This includes, amongst others, antitrust and other regulatory laws and regulations and the restrictions on information exchange and other collaborative engagement they impose. Further, each member is responsible for setting their own individual targets. Progress reports shared with the Alliance Secretariat are not shared between members. Any information shared with members is done so on an anonymized basis, and no transaction level information is shared."**

The protocol's reference to applicable anti-trust laws was perhaps prompted by recent criticisms regarding climate organizations and their members. It remains to be seen how far such challenges go, and whether regulatory antitrust relief for such climate-focused collaborations will gain steam, as was recently suggested by the head of the UK's Competition Markets Authority.

The SustainAbility Institute Releases 2023 Trends Report: The Ongoing Evolution of Sustainable Business

February 14, 2023

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The SustainAbility Institute at global consultancy group Environmental Resources Management (ERM) recently **released** its 2023 Trends Report: The Ongoing Evolution of Sustainable Business. The report identifies ten key trends shaping sustainable business: (1) integrating ESG; (2) valuing human capital; (3) responding to climate change; (4) safeguarding natural systems; (5) building sustainable consumption and production; (6) enabling sustainable consumption and production; (7) applying technology to sustainability; (8) respecting fundamental rights; (9) shaping policy, regulations, and norms; and (10) moving toward stakeholder capitalism.

ERM predicts that the growing trend of companies integrating ESG considerations into their business decisions will continue through 2023, particularly in the Asia-Pacific region, as "more and more financial institutions in the region [are] becoming signatories to ESG-related frameworks and peer groups such as PRI and PRB, or developing their own ESG frameworks, establishing net zero goals, and overall taking a more comprehensive approach to ESG investing." Like ERM, we have previously discussed certain 2023 anticipated trends, including the **developing consensus** around certain climate-related reporting and measurement standards (although overall global regulatory or industry consensus on a particular framework remains elusive), the increasing recognition of the importance of **biodiversity impacts** on companies' operations and reputation, and related reporting obligations, and the **challenges** associated with divergence among scores from ESG ratings providers.

ERM also highlighted various studies suggesting a gap between issuers' statements on climate change and their actual transition policies. According to one study, for instance, although 93% of companies in the S&P 100 acknowledge the material risks posed by climate change, only 50% have lobbied for Paris-aligned policies and only 8% have completed a trade association climate policy alignment report. Likewise, according to a 2022 Oxford University study, 65 percent "of net zero targets among global publicly traded companies do not meet minimum procedural standards of robustness (e.g., include a plan to achieve the target, publish progress on target achievement, etc.)." Nonetheless, the Report expects "more climate action by governments, businesses, and NGOs," and we believe that part of the gap identified in the Report between goals and progress is attributable to challenges associated with accurate data collection and assessment and the nascent frameworks for reporting such information.

Taking The Temperature: ERM's 2023 Trends Report highlights several topics we have discussed in the past and will continue to monitor through 2023. Governance continues as an issue of paramount importance, as companies increasingly recognize. For instance, the Report cites, among other things, that "executive compensation at S&P 500 companies increasingly includes performance metrics tied to ESG considerations, rising from 66 percent in 2020 to 73 percent in 2022." Additionally, the divergence of ESG ratings continues to cause problems for companies looking to comply with disclosure requirements and for investors looking to make informed decisions. Climate-related shareholder activity is off to a strong start in 2023, with stakeholders like the NYC Comptroller and advocacy group As You Sow submitting proposals to some of the largest global banks. At the same time, pushback against climate-related private activity continues, especially in the U.S. with Republican federal and state lawmakers increasingly scrutinizing banks and asset managers for their ESG policies. Further, 2023 promises increased supervision and investigation into greenwashing. Companies and their stakeholders should be cognizant of these trends as they look to fulfill their net zero and other ESG-related commitments.

ECB Board Member Proposes Intensification of Climate-Related Action

February 14, 2023

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On January 10, Isabel Schnabel, a member of the Executive Board of the European Central Bank (ECB), gave a **speech** at an international symposium on central bank independence on monetary policy tightening and the green transition. The event was hosted in Stockholm by the central bank of Sweden. Schnabel made the case that current climate-related actions being taken by the ECB will be insufficient for the central bank to meet its objectives of carbon neutrality by 2050. The ECB's roadmap **detailing** its climate change-related plans up to 2024 was **published** in July 2021 as part of the ECB's action plan to include climate change considerations in its monetary policy strategy.

To improve the ECB's corporate bond portfolio, Schnabel proposed a move from a flow-based tilting approach, which adjusts "reinvestments of corporate bonds based on a climate score that reflects issuers' carbon intensity, their decarbonisation plans and the quality of their climate-related disclosures." She instead recommends the use of a stock-based tilting approach that would "actively reshuffl[e] the portfolio towards greener issuers." Schnabel explained that the ECB's process is primarily guided by the tilting parameter, which is the "weight [the ECB] put[s] on the climate score in [its] benchmark allocation for new purchases."

Schnabel also suggested exploring additional options to ensure that the ECB's policies align with the objectives of the Paris Agreement. One such option is to apply the stock-based tilting approach proposed for the corporate bond portfolio to public sector bond holdings, which currently account for approximately half of the ECB's balance sheet. She further proposed "greening" the ECB's lending operations by "limit[ing] the share of assets issued by entities with a high carbon footprint that can be pledged as collateral by individual counterparties when they borrow from the Eurosystem."

Schnabel concluded her speech by stating: "In line with our mandate, we stand ready to further intensify our efforts to support the fight against climate change, building on the achievements of our climate change action plan. Our long-term goal is to make sure that all our monetary policy actions are aligned with the objectives of the Paris Agreement. This means greening our stock of bond holdings, including public sector bonds, as well as our lending operations and collateral framework. Greening monetary policy requires structural changes to our monetary policy framework rather than adjustments to our reaction function. Restoring price stability through an appropriate monetary policy today will benefit society over the longer run and will facilitate the transition to a greener economy."

As we recently discussed, Schnabel's speech was followed by the ECB's January 24 **announcement** of "new experimental and analytical indicators" that are intended to help analyze climate-related risks in the finance sector and monitor a green transition. And, within a few weeks of Schnabel's talk, on February 2, the ECB **announced** its decision to adopt "a stronger tilting of its corporate bond purchases towards issuers with a better climate performance during the period of partial reinvestment." In its press release, the ECB explained that this was consistent with "the Governing Council's climate action plan" and that the approach would support "the gradual decarbonisation of the Eurosystem's corporate bond holdings, in line with the goals of the Paris Agreement."

Taking the Temperature: Inflationary pressure and wider market instability are affecting lending across the global economy and will also impact the ECB's activity, including its stated goal to align its lending approach with the Paris Agreement. Currently, the ECB is heavily reliant on the transition reforms of entities held within its portfolio in order to meet its climate-related commitments. It is clear from her speech that Schnabel would like the ECB to take a more dynamic approach by further "greening" the ECB's lending criteria, and the ECB recently adopted at least part of her approach. We expect central banks globally to wrestle with climate change management on the part of regulated entities, at least as a matter of promoting financial sector stability, but how they do so and how aggressively will vary among different jurisdictions (with the U.S. Federal Reserve, for instance, limiting its involvement to its role as a prudential regulator).