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The EU and China: Leading the World in Sustainable Finance

As the world tried to pull itself up out of the worst financial crisis in nearly a century, the goal was to just survive. Today, investors are taking a long-term holistic view of where they place their bets.

BY JOHN PABON

For decades, the financial sector kept sustainability at arm's length.

If you asked an investor at Blackrock during the Global Financial Crisis whether they considered environmental performance in the make-up of their portfolios, they'd likely answer no. The same would apply across a number of other traditional sustainability factors like workers' rights, community engagement, or ethical operations. At that time, a commonly held thought was that these types of issues had little to do with the overall viability of a company, stock, or investment. But times have changed.

Since the adoption of the United Nations Sustainable Development Goals, and the very public passage of the Paris Agreement on climate change, sustainability is again front-and-center in our global consciousness. Between a near global disgust for plastic, movements like the Extinction Rebellion shutting down global cities, and high-level reports on the impact of man-made climate change, there is no tuning out the fight for a more sustainable future. Many view individuals, companies, and governments who are not part of the movement as pariahs. There is no more sitting on the side lines.

The financial sector has responded to this step change by shifting their view of sustainability. Now one of the hottest topics in the space, sustainable finance was unthinkable only a few short years ago. As the world tried to pull itself up out of the worst financial crisis in nearly a century, the goal was to just survive. Today, investors are taking a long-term holistic view of where they place their bets.

Now, the goal is to thrive.

What is sustainable finance?

Even though it's long overdue, the concept is quite simple.

According to the European Commission, sustainable finance is "… is the provision of finance to investments taking into account environmental, social and governance considerations. [It] includes a strong green finance component that aims to support economic growth while reducing pressures on the environment, addressing green-house gas emissions and tackling pollution, [and] minimising waste and improving efficiency in the use of natural resources."

In short: are your investments having a positive impact on society, the environment, and our shared future, while also showing potential positive financial return?

This is different than in years' past. The old model of financial investment involved portfolio managers considering only financial returns, likely derived from an asset's past financial performance. Corporate revenue, salaries, and overheads – traditional "bottom line" elements – were all that mattered. Today, as before, investors are still looking at these aspects of an asset. In contrast, however, they are also considering the impact environmental, social, and governance performance has on long-term viability.

Sustainable, responsible, or green investment has gone from an unnecessary addition to the decision-making process to a thoughtful consideration for smart investors. According to McKinsey, over a quarter of all assets under management are now "…invested according to the premise that environmental, social, and governance (ESG) factors can materially affect a company's performance and market value." How much is all of that worth? The Forum for Sustainable and Responsible Investment says there are about EUR 10 trillion in assets pegged against sustainable investment practices. Some, like the Global Sustainable Investment Alliance, place this number closer to €20 trillion.

We're not just talking about individual investors, or a couple fund management firms, either. Some of the world's largest funds – including Norway's Government Pension Fund Global, ABP of the Netherlands, and Japan's Government Pension Fund – are all incorporating ESG-related considerations. Broken down, we see asset managers and public stocks accounting for over 50% of impact investing assets, with a further 27% held by development institutions. Business owners are getting in on the action, too. Since 2016, BNP Paribas found a four-fold increase in entrepreneurs who consider positive impact a key metric in business. This means we are seeing both a top-down and bottom-up push to create a more sustainable private sector.

When an investor approaches a number of potential investments, how do they figure out which are more sustainable than others? The typical strategy is to use negative screening. Through this, investors exclude assets which do not adhere to sound ESG principles. They are looking at mitigating risk, so reporting transparency and accuracy is a foundational first step in their judgements. From here, investors screen for ESG performance over time within both the individual company and industry overall. Finally, they look at how stakeholder, community, and beneficiary engagement impact and align with corporate strategies.

Leading the world

Interestingly, the main push for sustainable finance isn't coming from the hallowed grounds of Wall Street or Canary Wharf. No, we're seeing most of the movement in this space happening in places like Paris, Berlin, and Shanghai. That's because these places have decided to emphasize collaboration over competition. China and Western Europe have earned pole position in sustainable finance because they've collaboratively devised mechanisms for information and lesson sharing.

In June, the European Union released its first taxonomy on sustainable investment. This taxonomy is meant to be a guideline to help investors analyze the sustainability of an investment. Investors citing sustainable assets must note how they've used the taxonomy in their analysis. Overall, the goal is to better align major ESG requirements, the SDGs, and the Paris Agreement through a unified framework.

But this wasn't the world's first sustainable investment taxonomy. That honor goes to China with its Green Industry Guidance Catalogue.

Rather than trying to carve out fiefdoms, both parties look to a more collaborative route. The European Investment Bank is working together with China Green Finance Committee to align the EU and Chinese guidelines. This alignment will allow for increased impact, decreased confusion, and easier adoption of green investment principles across two of the globe's largest regions. Capitalizing on being the world's first taxonomies, they want to also influence and act as the standardized foundation for subsequent global guidelines. Analysts believe that, given the credibility of the existing systems, most countries will likely follow the model set by the European Union and China.

This is just one element of a larger EU/China partnership for the environment, which includes the creation of a post-2020 global biodiversity framework, a Blue Partnership for the Oceans, and the Sustainable Blue Economy Finance Principles. Along with green investments in the hundreds of billions of euros, it's clear to see how China and the EU are leading the world towards a more sustainable future.

Barriers remain

Even though the European Union and China are working diligently to create a global impact investment system, there are still barriers which must be overcome for full integration of sustainable finance. A few months ago, the author had the privilege of emceeing the United Nations Environment Programme Finance Initiative (UNEP FI) Regional Roundtable for Asia-Pacific in Shanghai. After an amazing day in discussions with some of the world's leaders in the space, he noticed three major barriers financial professionals, along with sustainability experts, must address.

The first is consistency. There are far too many investment mechanisms, guidelines, and requirements on what constitutes good sustainable investment. While this might seem like a good thing, there is unfortunately little consistency between them. The FTSE might have one set of requirements, while investors in Australia might have to consider another. If you want to invest across borders, which metric do you use? This leaves potential investors in the dark as to what procedure to follow and how to make sound investment decisions.

The second is in how we measure and audit performance. Measuring performance simply by environment, social, and governance aspects, or elements of the sustainable development goals, is not nearly enough anymore. While useful, they only provide a snapshot-in-time of what may be happening at a company. In fact, by the time these are published they are usually already out of date. For true investment analysis, we must be able to provide credible long-term predictions, hopefully incorporating the more human elements of operations.

The final element involves transparency. In order to make a sound investment decision, investors need to have a full understanding of what is going on. They can only do this if the asset they are exploring is being entirely transparent with them. Most, if they are reporting, they should do so as a public relations exercise rather than a way to attract investment. Companies that greenwash, hide performance metrics, or would have readers drown in data should be red flags. These are the types of investments fund managers should immediately consider for negative screening.

One should not underestimate the impact of responsible investing. The practice offers an incentive for many to join the fight for a more sustainable future. Rather than having to volunteer time at a charity or hope to change the internal operations of their businesses, people can now work to financially support companies who are doing good. What's more, these companies tend to have stronger processes in place, meaning their potential return on investment is high.

As humanity continues to find ways to address environmental and social issues, these responsible companies will continue to grow in importance. That makes them a sound investment for your portfolio and a feel-good investment for your peace of mind. In the words of Forbes columnist Lawrence Wintermeyer, in the "...very near future, the only investments that most people will make will be sustainable ones and this is a change whose time has come."

John Pabon

John Pabon has spent the past 15 years championing sustainable development and stakeholder engagement, leading the creation of some of the private sector's most forward-thinking strategic sustainability approaches. Most recently, John founded Fulcrum Strategic Advisors with a mission to get business thinking differently about how they can adapt to a changing world. He spends his days advising multinational firms on Chinese policy, strategic communications, and sustainability, deciphering ways they can take advantage of the shifting geopolitical climate. His previous work includes posts with the United Nations, McKinsey, A.C. Nielsen, and as a consultant with BSR, the world's largest sustainability-focused business network. John has been honoured as one of the world's top 100 voices on modern China, is a regular contributor to China-based business magazines, and speaks to an array of global audiences on issues of sustainability, communications, and societal change. He also serves on the board of advisors to the U.S. Green Chamber of Commerce and the Australian Chamber of Commerce CSR Committee.