OCTOBER 2023

EUROPEAN CORPORATE & INVESTMENT BANKING

OUTLOOK

EURO GROUP CONSULTING

EXECUTIVE SUMMARY

This article aims to delve into the ever-evolving realm of the European Corporate and Investment Banking (CIB) industry. In the first section, the report analyses the performance of Corporate and Investment Banks in Europe and interrogate the various factors that form the foundation for financial performance. In the second section, ESG's role and application within financial frameworks are explored.

From volatile market trends to industry innovations, the macro-environment for CIBs is subject to profound changes and disruptions. Against this backdrop, we examine the trends underpinning these shifts across three segments: Primary Markets, Equities and Fixed Income, Currencies and Commodities. Despite the significant impact of the Ukraine War on the European economy, there has been a continuous improvement in asset quality throughout the year. The resulting heightened uncertainty, risks, and surging prices for energy, food, and commodities have increased inflationary pressures, prompting central banks to raise interest rates. These interests ultimately have an adverse effect on the financials of CIBs. Nevertheless, their financial performance remains consistent and is coupled with robust financial reserves and liquidity standings.

ESG criteria are central to the financial sector's efforts to align with the objectives of the Paris Agreement and the EU Sustainable Finance Action Plan. European regulations, including the EU Taxonomy Regulation, Corporate Sustainability Reporting Directive (CSRD), and Sustainable Finance Disclosure Regulation (SFDR), aim to enhance transparency and promote the allocation of capital toward a sustainable and climate-neutral economy. Nevertheless, as the industry navigates issues such as data collection, biases, the delicate balance between short-term and long-term investment horizons, and the design of effective employee incentive structures, it opens a vital reflection on strategies to bridge these gaps. Perhaps, one pivotal stride toward advancing the climate transition and maximising the impact of sustainable investments entails fully embracing an outcome-based approach to evaluate performance.

01

LATEST PERFORMANCE OF EUROPEAN CORPORATE AND INVESTMENT BANKS

Since our last Corporate and Investment Banking Outlook publication last year, market conditions have continued to be relatively volatile. In response to inflationary pressures, central banks have begun to hike interest rates, introducing unique financial prospects and challenging market conditions to CIBs. This has resulted in significant impacts on macroeconomies overall, with the US outlook bringing questions and concerns across Europe.

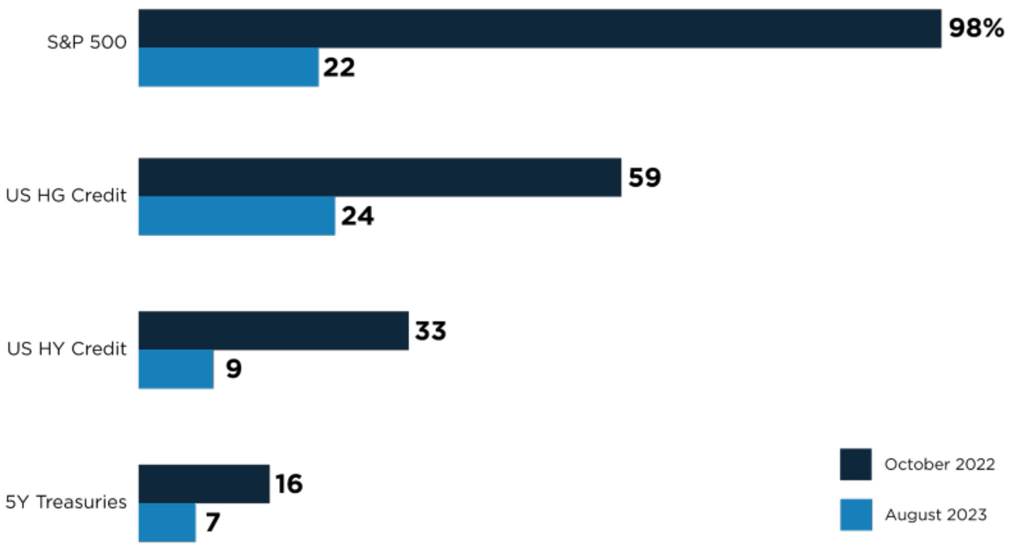
1. HOW CAN THE CURRENT MACROECONOMIC CONDITIONS BE QUALIFIED AND THEIR IMPACT ON THE CORPORATE AND INVESTMENT BANKING SECTOR?

As the prospect of a recession wanes in US and broadly across Europe, financial markets become susceptible to claims that the US economy may be overheating. According to financial analysis by JPMorgan Chase & Co[1], the probability of an economic downturn, already priced into various financial assets, has reached its lowest point since April 2022. This marks a significant shift from the prevailing pessimism of the past year when a recession seemed almost inevitable. Consequently, the fate of these markets increasingly hinges on economic reports that suggest a resurgence of rampant inflation, which poses challenges for strategies sensitive to interest rate changes. For numerous investors, favourable economic data, and the potential for more stringent policy measures, present significant obstacles.

Even the Federal Reserve has removed a recession from its forecasts for this year[2]. This has prompted investors across various asset classes to reconsider their recessionary predictions. The S&P 500, for example, is now attributing a 22% likelihood to a recession, a stark decrease from a figure of 98% in October last year, while the high-yield bond market assigns a 9% chance[3]. These metrics are calculated by comparing the peak values of various asset classes before prior recessions to their lowest points during those economic contractions. Some express concerns that this reversal may have gone too far, with a robust economy potentially driving consumer price pressures to levels that make the Fed uncomfortable. Achieving a soft landing, where interest rate increases curtail inflation and stabilise the economy without causing a crash, has historically been proven challenging for policymakers over the past decades.

Exhibit 1

Recession probabilities have tumbled across asset classes



JPMorgan
The bank calculates the metrics by comparing the pre-recession peaks of various classes and their troughs during the economic contraction.

[1] Bloomberg Sept. 2023: Wall Street Fears a Too-Hot Economy as Recession Bets Plunge.

[2] Reuters (2023) Fed staff drop US recession forecast, Powell says. Reuters.

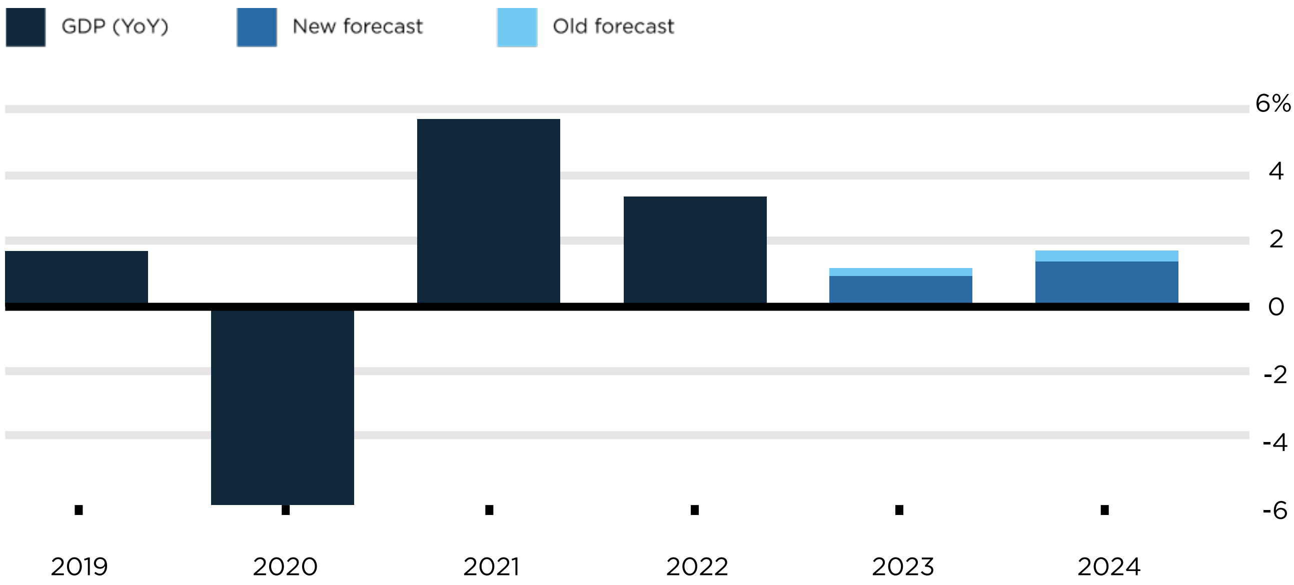
[3] Tsekova, D. (2023) Wall Street Fears A Too-Hot Economy As Recession Bets Plunge.

The European Central Bank (ECB) warns of heightened financial stability risks in the eurozone due to surging energy prices, high inflation, and slow economic growth. They've taken actions to combat inflation, tightening financial conditions with potential implications for borrowing costs and economic activity. Rising inflation and a sluggish economy are impacting individuals and businesses, and potentially leading to financial stress for households and firms. Increasing risks make debt-laden entities vulnerable. Financial market stress is growing, and investment funds face resilience tests. Higher energy costs pressure corporations, potentially leading to increased default risks, especially for energy-intensive firms. Inflation and energy bills reduce household purchasing power, affecting loan repayment, especially for lower-income households. Banks may face higher credit losses. Governments provide fiscal support, but high debt limits expansion. Inflation and interest rate uncertainty increase the risk of disorderly asset price adjustments. Non-bank financial sector vulnerabilities need regulatory attention. Germany faces a 0.4% economic decline in 2023, the Netherlands at 0.5% (down from 1.8%), while Spain and France are set for expansion. Inflation remains high at 5.6% in 2023, predicted at 2.9% in 2024[4]. These numbers raise concerns about prolonged subdued growth and above-target inflation in the eurozone, influencing the ECB's future decisions on interest rates.

Exhibit 2

Euro area set to grow weaker than predicted

European Commissions lowers GDP estimate for this year and next



Source : European Commission

The International Monetary Fund (IMF) has announced in its latest update to the World Economic Outlook, that global gross domestic product (GDP) is expected to expand by 3% in 2023. This represents a deceleration from the 3.5% growth observed in the previous year but is an improvement from the IMF's April projection of 2.8%[5]. Despite this somewhat more positive global economic outlook, the IMF has cautioned that growth prospects still appear lacklustre when compared to the pre-Covid-19 pandemic two-decade average of 3.8%[6]. Furthermore,

[4] Fitchratings.com. (2023). Fitch Affirms Germany at 'AAA'; Outlook Stable.

[5] International Monetary Fund (2023). World Economic Outlook Update, July 2023: Near-Term Resilience, Persistent Challenges.

[6] Ibid.

the IMF has noted that the risks to global growth continue to pursue a negative trajectory, with higher interest rates aimed at curbing inflation expected to exert downward pressure on economic activity. The possibility of additional disruptions, such as an escalation of the conflict in Ukraine or climate-related disasters, could prompt central banks to implement further tightening measures.

One thing remains certain in Europe : uncertainty is substantial and about to remain for the long term. Stock markets have lighted investors' resilience whereas advisory volumes proved to deteriorate amidst local yield curves inversion in the US and more broadly across Europe.

2. ARE WE SEEING A PARADIGM SHIFT ACROSS A SELECTION OF ASSET CLASSES?

After a decade of flat returns, 2022 was the start of a new era in banking launched by the interest rate straightening series. In 2022, the sector revenue grew by USD 345bn as net margins increase accounted for 60% of the banking overall revenue gains. Since mid-2022, capital markets and investment banking segments revenues have decreased as a result of central banking policies.

Consumer expectations for euro-area inflation fell in June but remained above the European Central Bank's 2% target[7] as officials ponder whether to continue their unprecedented interest-rate hikes. German industrial production fell for a second month in June, further holding back Europe's biggest economy after it barely exited a recession earlier this year. The drop in Germany was mirrored by lower industrial output in France and Spain during the month. The UK economy delivered its strongest quarterly growth in more than a year. Even with the modest 0.2% advance, the UK remains the only G7 country that has yet to fully recover from the pandemic.

Exhibit 3

Euro-area inflation outlook

European Commission forecasts see consumer prices rising 5.6% in 2023, 2.9% in 2024

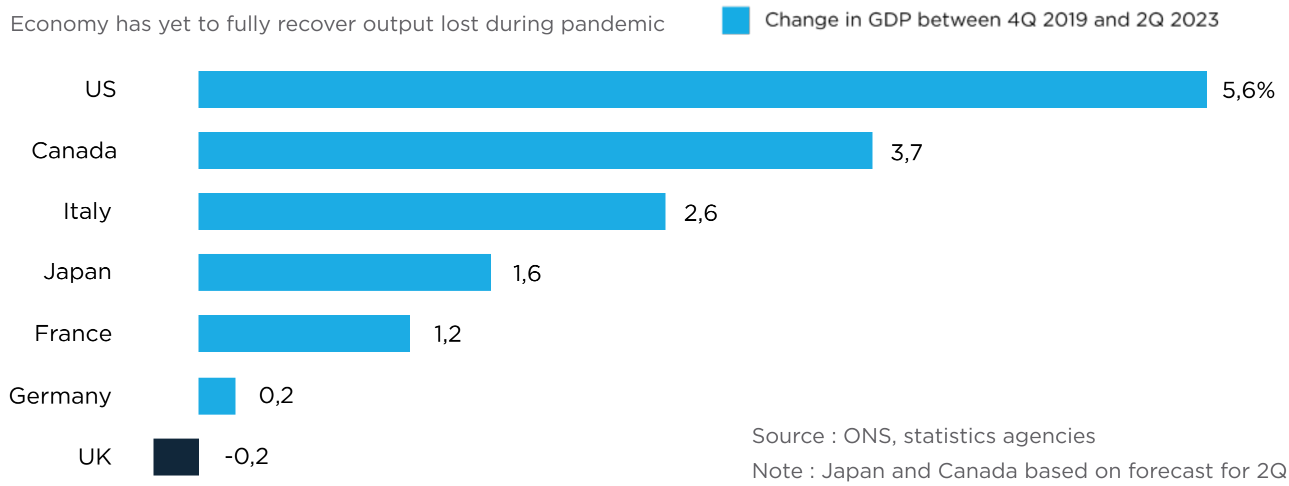
Source : European Commission

[7] Langley, A. (2023). EU Cuts Euro-Zone Outlook as German Economic Woes Deepen. Bloomberg.com. [online] 11 Sep. Available at: https://www.bloomberg.com/news/articles/2023-09-11/euro-zone-outlook-cut-by-eu-shows-germany-sinking-deeper-in-mire [Accessed 27 Sep. 2023].

Exhibit 4

Britain is still lagging behind its major peers

Economy has yet to fully recover output lost during pandemic



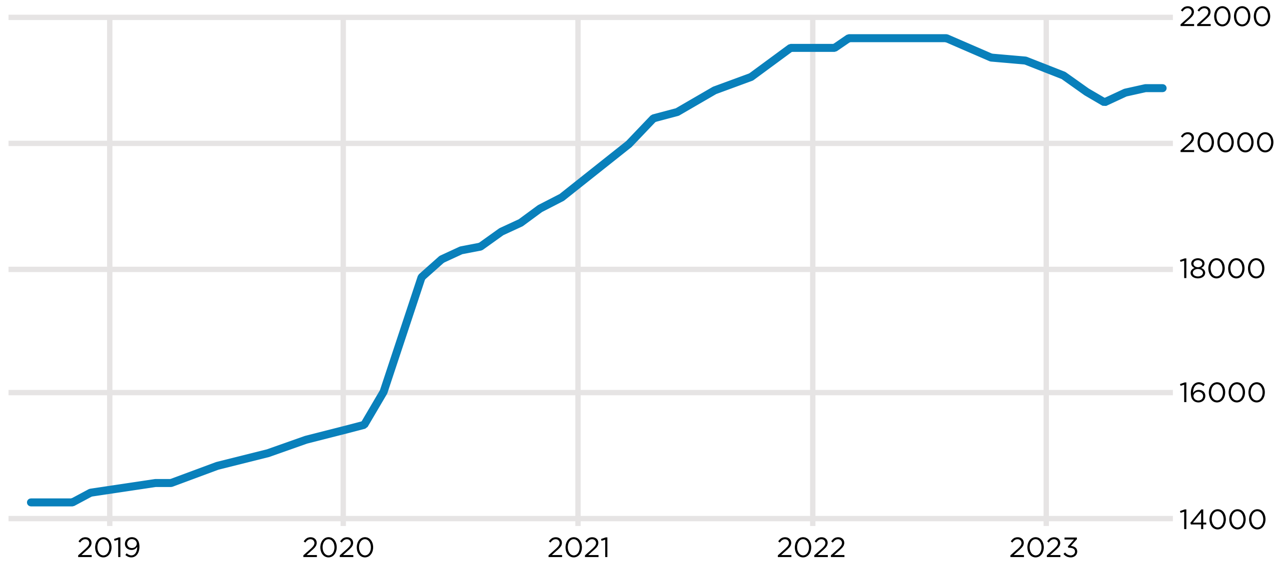
Source : ONS, statistics agencies

Note : Japan and Canada based on forecast for 2Q

2022 resulted in robust primary market volumes: over USD 250bn was raised in the US and over 1,500 deals were completed with significant amounts of capital deployed[8]. That dynamic was also spread out across Europe with an all-time low short-term rate that led to post-Covid excess money savings. Consequently, global liquidity went up during the period with an all-time high of USD 21.3tn in the US in March 2022. Major Central Banks hiked their short-term interests throughout the year and kept tightening financing facilities. The European Central Bank (ECB) has increased its policy rates by a cumulative total of 425 basis points over the last 12 months – following the Federal Reserve's path – and is aiming to achieve a timely return of inflation to their 2% medium-term target. Global liquidity has been decreasing since summer 2022 and investors are now selective in their Capital Markets investments.

Exhibit 5

Money supply M2 in the US increased to 20902,70 USD Billion in July from 20890 USD Billion in June 2023



Source : Federal Reserve

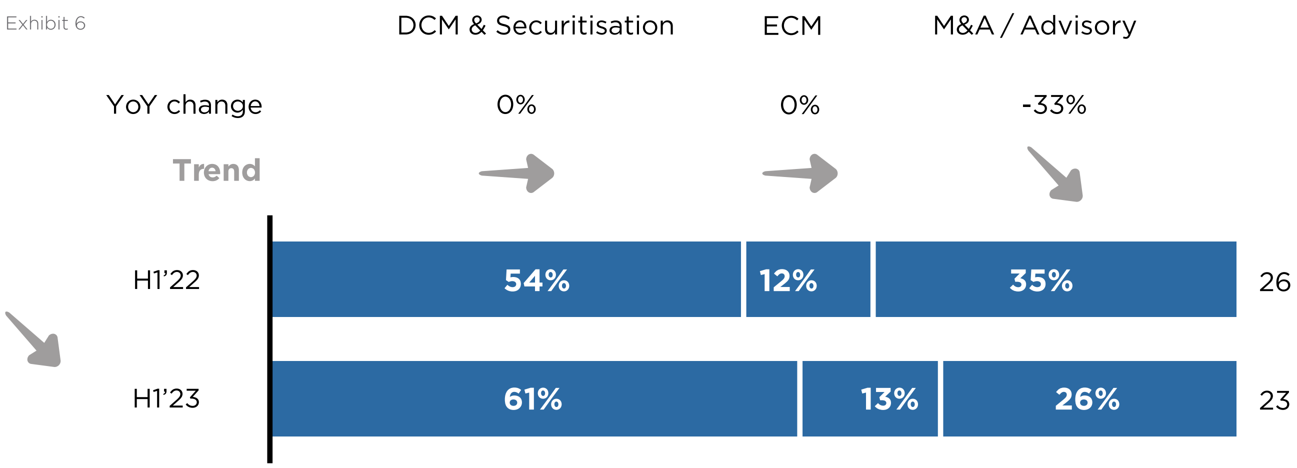
[8] JP Morgan (2023). Private Markets Outlook. [online] www.jpmorgan.com. Available at: https://www.jpmorgan.com/insights/banking/private-capital-markets/private-markets-outlook [Accessed 27 Sep. 2023].

3. IN THAT CONTEXT, HOW HAVE CORPORATE AND INVESTMENT BANKING ACTIVITIES BEEN IMPACTED?

M&A and Advisory

M&A and Advisory segment revenues have been decreasing all over the last 4 quarters, with a productivity deterioration from USD 0.6m to 0.4m[9]. The leveraged loan market is going through a difficult period as the underlying turned hardly into a security nowadays, with banks being required to disclose material risks when releasing their securities. However, the outlook might not be that negative. During down markets, there are usually more assets available to choose from during downturns, and valuations tend to be lower, giving more headroom for positive returns. Furthermore, in times of uncertainty and the absence of regulatory interventions that can 'save' an institution, nearly all potential deals face a significantly higher level of internal scrutiny, so those that get approved and executed often boast an extra robust business rationale.

Exhibit 6



Source : Eurogroup consulting and Tricumen 2023

DCM & Securitisation

Nonetheless, high-yield issuance has increased by 30% YoY in revenues, strengthening the DCM & securitisation volumes to a steady trend. Indeed, US corporate fears of a potential credit rating deterioration have stifled amidst the US debt ceiling uncertainty. Moreover, US fees have doubled in IPOs YoY increasing ECM productivity from USD 1.6m to 1.9m per FTE.

Over the past year, underwriting of leveraged loans globally has dried up in the second half amidst increasing interest rates while Fixed Income markets have been propelled by two contrasting crosscurrents. On the one hand, the surge in demand for Fixed Income assets was driven by the rise in bond market yields. This was particularly appealing to clients seeking to diversify their portfolios and mitigate risks associated with equity holdings. On the other hand, the uncertain macroeconomic environment had a dampening effect on primary activities and dealmaking, as investors grew increasingly risk-averse.

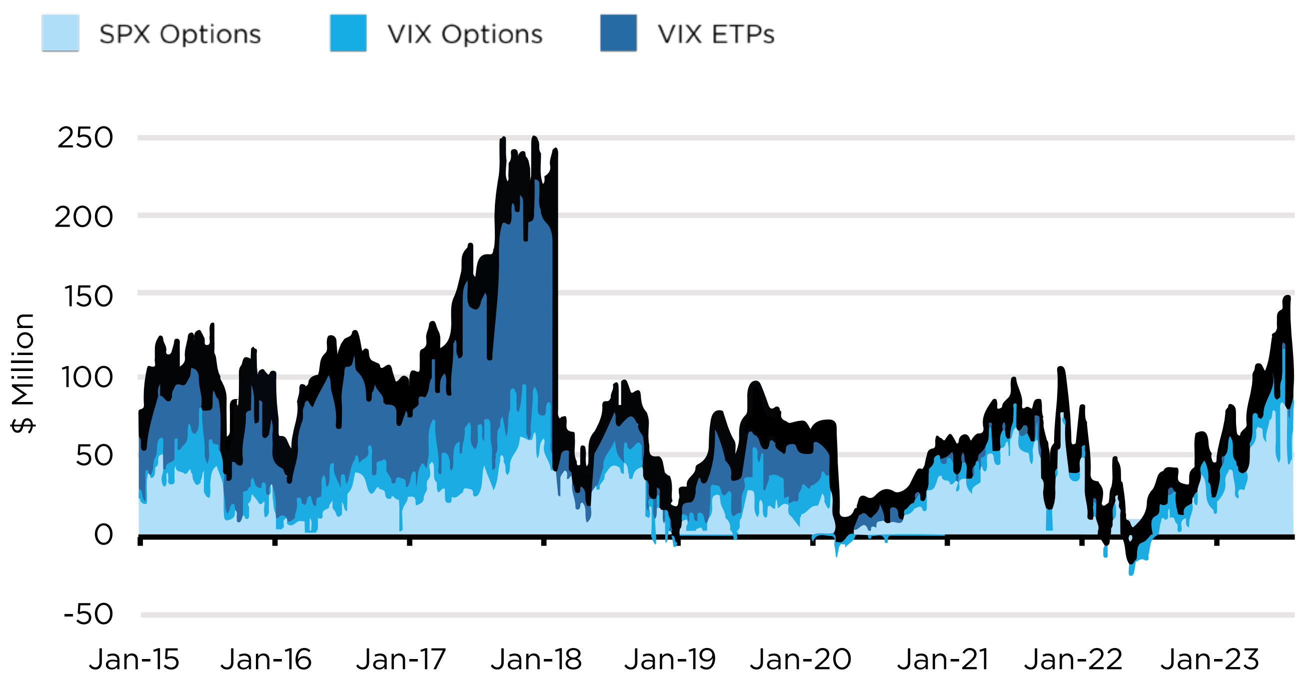
[9] Tricumen. (2023). CIB Review 2Q23/6m23 – Tricumen. [online] Available at: https://www.tricumen.com/cib-review-2q23-6m23/ [Accessed 25 Sep. 2023].

Equities

Lower long-volatility and muted client flows made both Equity Derivatives and Cash Equity segments decline over the year first half. In parallel, the short-volatility trade is back as billions of dollars pour into options-selling ETFs. The vol selling has left options dealers — who are on the other side of the transactions — in a "long gamma" position where they need to go against the prevailing trend. That means they buy when stocks go down, and sell when they go up, to maintain a market-neutral stance. Therefore, an equity selloff could shock options dealers out of these positions entirely forcing them to add fuel to the turmoil given their elevated sensitivity right now to implied volatility.

Exhibit 7

Net vega to trade across S&P 500 options, VIX options, and VIX ETP rebalancing (-5% Move in SPX and +5pt move in 1m vix future)



Source : Morgan Stanley QDS

Fixed income, Currencies and Commodities

Revenues from FICC operations relying on interest rates remained steady YoY. However, as interest rates volatility persists, fixed-income managers are benefitting from the outlook and can offer now attractive yields through fixed-income products while hedging their portfolios with a reliance on heavy floating rates. Hedge funds, however, are reporting a negative outlook on the euro since the start of the year ahead of a watershed European Central Bank decision that could see policymakers break their cycle of interest-rate hikes.

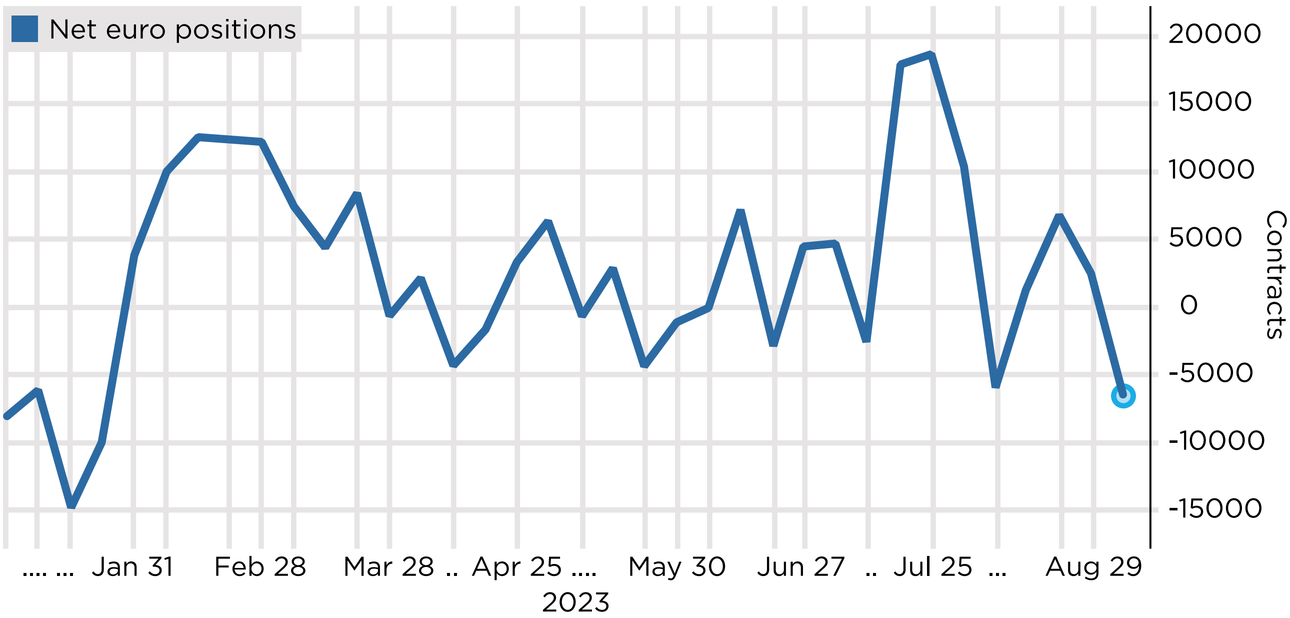
FX market volatility dropped down consequently YoY ahead of the US Congress decision on raising the debt ceiling. The segment revenue is expected to decrease for as long as the uncertainty in that decision remains.

The same trend can be observed in commodity markets because of the downturn in the sector financing behaviour. The energy transition induced significant turbulence within the commodities sector, with annual investments in traditional hydrocarbons falling by 50% since 2013. Consequently, changing market conditions made commodity traders' performances depend on the volatility in absolute price stead.

Exhibit 8

Hedge funds are most bearish euro since january

Leveraged investors shifted to net short positions



Source : CFTC / Bloomberg

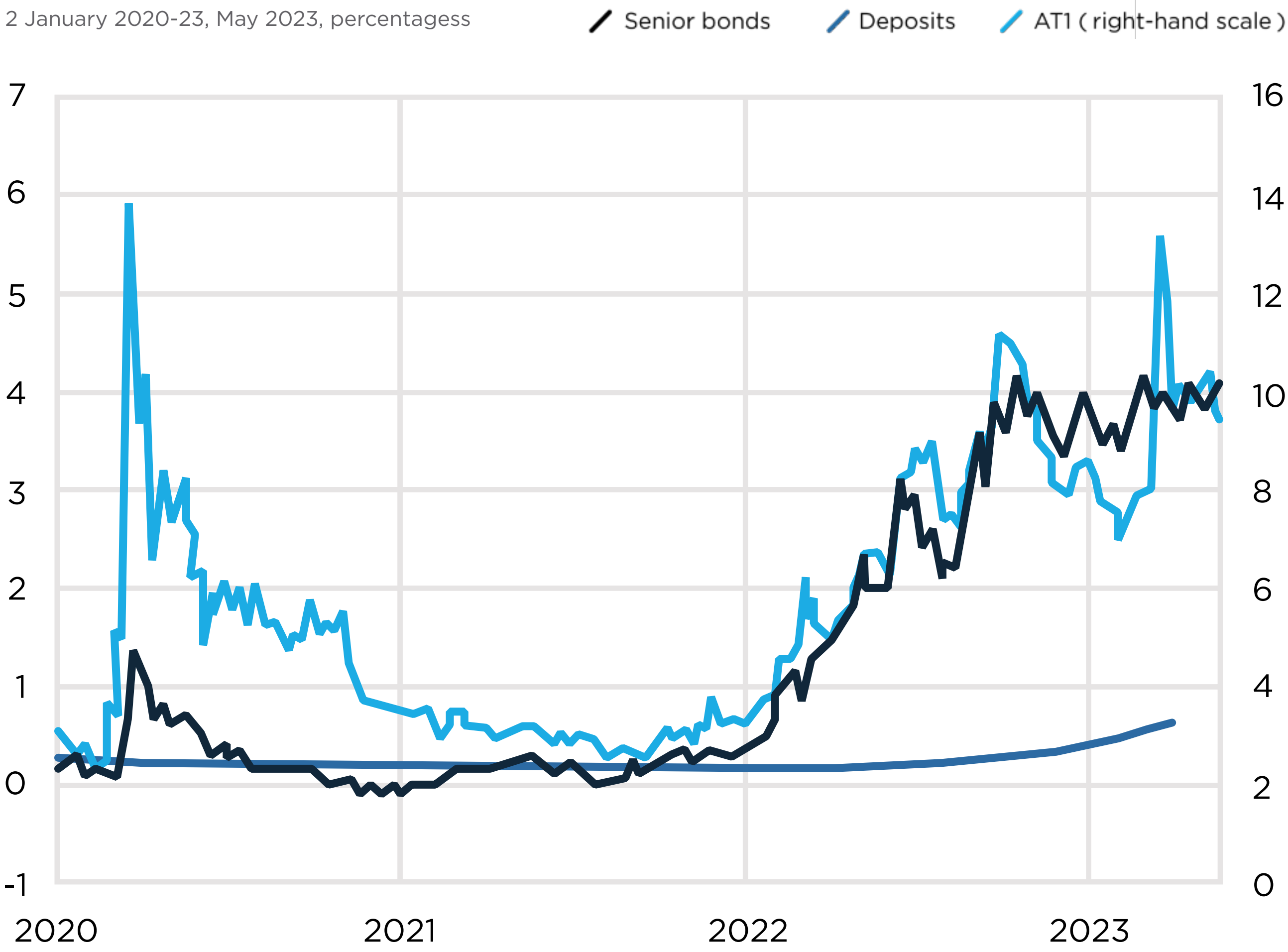
With strong inflows into HY credit benchmark funds, revenue in this sector has risen YoY. Companies raised capital from mid-2020 to early 2022, staying insulated from credit stress due to low rates. However, as refinancing needs to grow and debt costs remain high, this situation won't last unless corporate earnings improve significantly, which is unlikely. Companies' ability to pay interest on leveraged loans is deteriorating as rising rates make loans the most vulnerable part of corporate credit. Interest expenses outpaced EBITDA for the median loan borrower in Q4 2022, and this trend continues, causing interest coverage ratios (ICRs) to decline. By the end of 2023, assuming flat earnings growth, ICRs on loans will likely drop to 4.5 from 5.5 in Q4 2021[10]. If earnings decline, ICRs could approach recessionary lows, increasing the number of companies with stressed ICRs. This analysis only considers existing debt, but including upcoming maturities will only further pressure ICRs. Loan-only structures are expected to underperform mixed-capital structures in this environment. Larger, higher-quality borrowers should weather challenges through gradual ICR declines and balance sheet adjustments. For investment-grade companies, positive excess returns (0.5%) and more robust total returns (7% to 8%) are forecasted by Morgan Stanley Research[11]. High-yield bonds and loans are expected to yield negative excess returns and total returns in the 4% to 5% range, potentially less in volatile and risky scenarios.

[10] Morgan Stanley Research (2023). What higher rates may mean for corporate credit.
[11] Ibid

Exhibit 9

Banking funding costs, by type of instrument

2 January 2020-23, May 2023, percentagess



Source : Refinitiv and ECB calculations.

Note : The latest observation for data on deposits is the 31st of March 2023

4. ANALYSING THE LATEST PERFORMANCE OF EUROPEAN CORPORATE AND INVESTMENT BANKS

Whilst overall Corporate and Investment Banking revenues seem to benefit from the outlook, cost-to-income ratio performances have shown disruptions in our panel of CIBs with European institutions outperforming American-based banks. The shift in the industry made the overall productivity decrease and that effect seems to be strengthened in the US with a larger headcount and larger volumes. Across the last 2 years, revenue for CIBs from our panel increased by 8.6%[12].

+8.6%

revenue increase across the last 2 years

Since Q2'21 US CIB revenues increased by 6.4% while EU CIB revenues increased by 8.6%. After a substantial increase in revenue for CIBs in Q1'23, Q2'23 shows a general decrease in revenues and a resurgence of difficulties. Since Q2'22, US CIBs increased revenues by 5%, similarly their EU counterparts increased their revenue by 6% on average. Santander and BBVA have shown outstanding growth since Q2'22 with a 53% and 55% increase respectively.

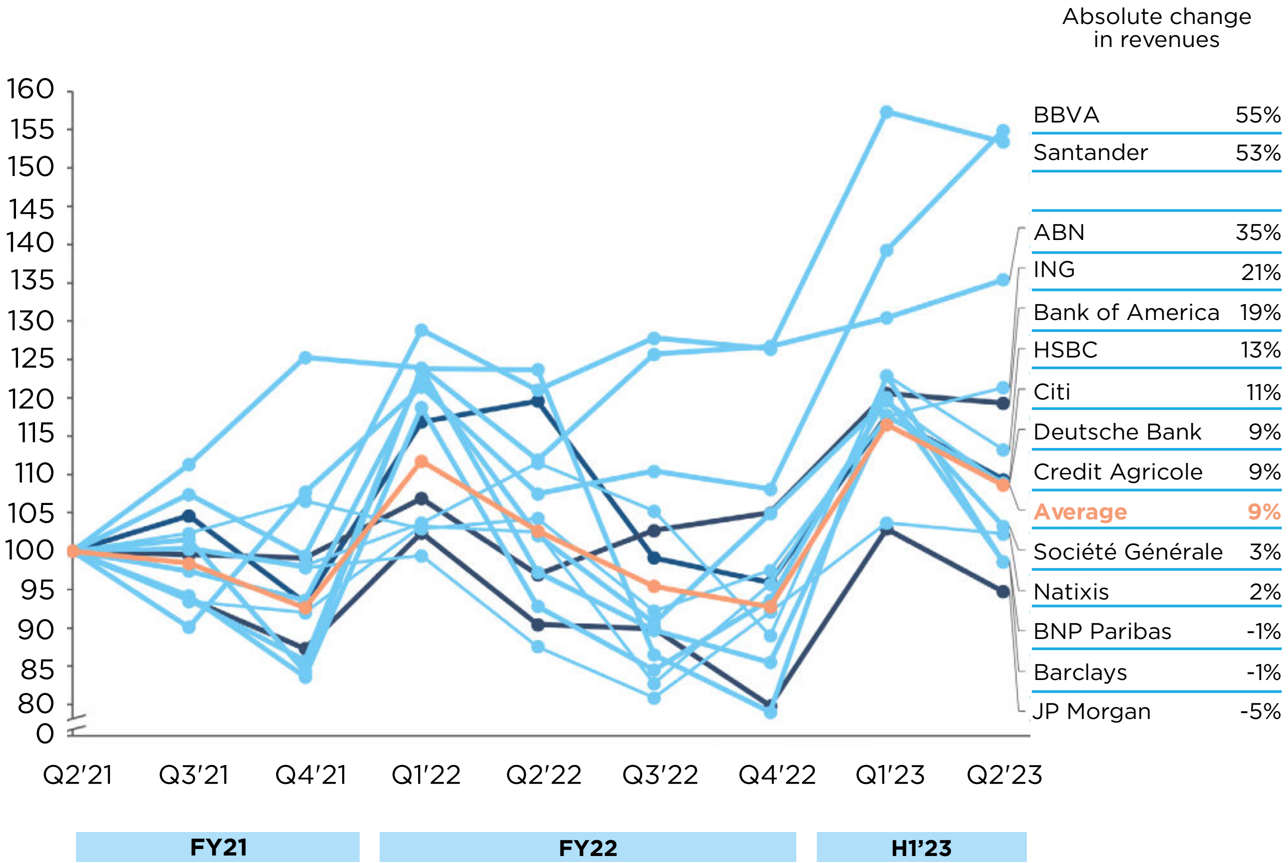
[12] Eurogroup Consulting (2023). CIB Economics – 2023 first half. Paris: Eurogroup Consulting

The average Cost-to-Income ratio of CIBs from our panel stayed relatively stable during the 2-year period, from Q2'21 to Q2'23 (1% deterioration). However, C/I ratios significantly improved from Q4'22 deterioration: HSBC, Bank of America and Santander improved their C/I ratio by 14%, 7% and 15% respectively. Since Q2'21, US CIBs C/I ratio have deteriorated by 7% on average while EU CIBs improved their C/I ratio by 5%. ABN has the steepest improvement in its C/I ratio over the period, from 69% to 37% respectively. Barclays C/I ratio remains on the higher end of the panel, although the CIB had reached its medium-term target of reducing its C/I ratio below 60% in FY'23(in Q1'23), whilst its C/I ratio fell below target (63%) in Q2'23.

Exhibit 10

Evolution of revenue for major CIBs

(analysis base 100)



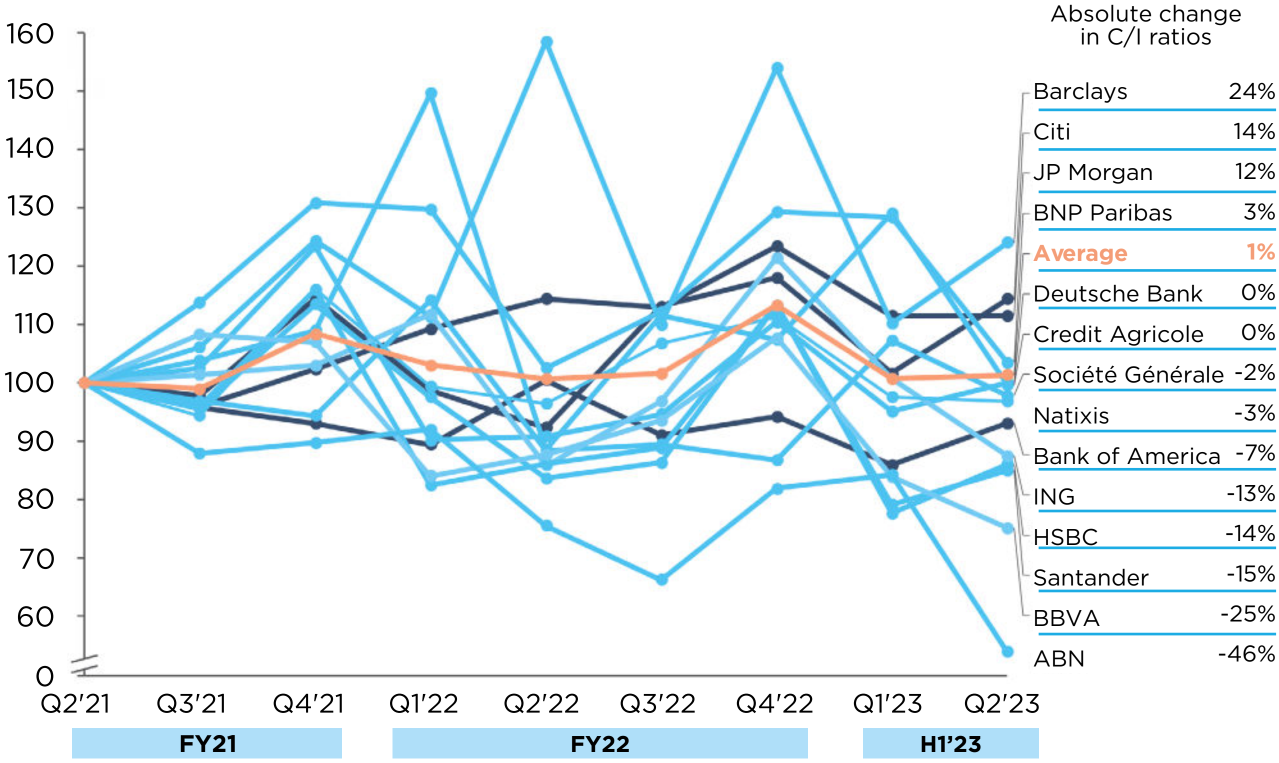
Source : Eurogroup Consulting (2023)

European CIBs have seen their Jaws ratio deteriorating over the last 4 quarters, with the global universal ones flattening their revenues and costs. With the exception of Bank of America, American CIBs have seen their C/I ratios deteriorate. JPMorgan has improved its Jaws whereas Citi is on a downward trend.

Exhibit 11

CIB C/I Ratio analysis base 100

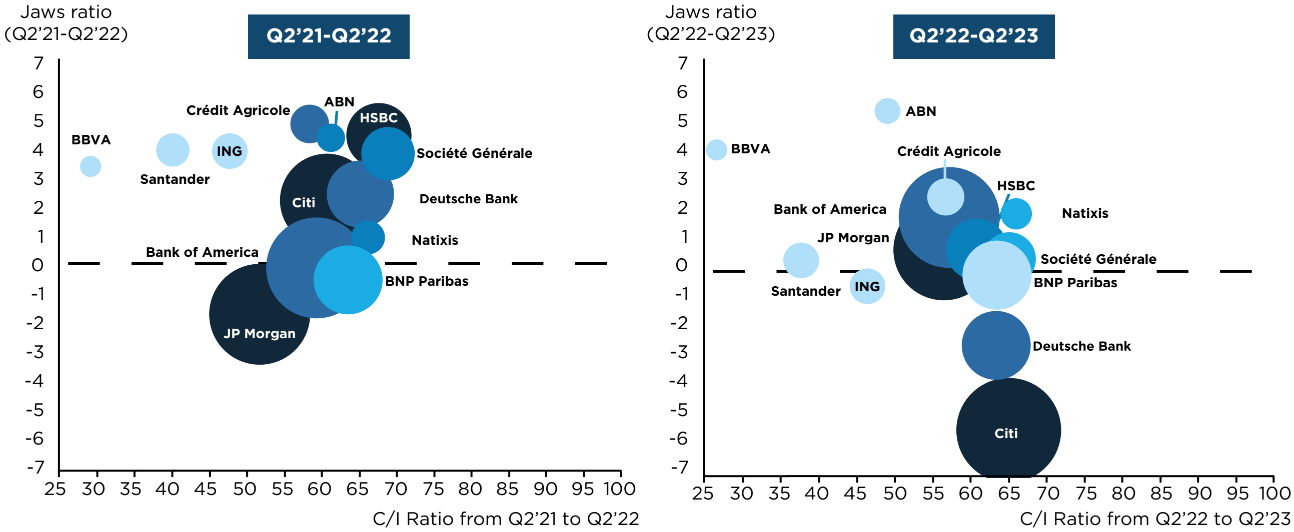
(Q2'21 to Q2'23)



Source : Eurogroup Consulting (2023)

Exhibit 12

CIBs Jaws analysis



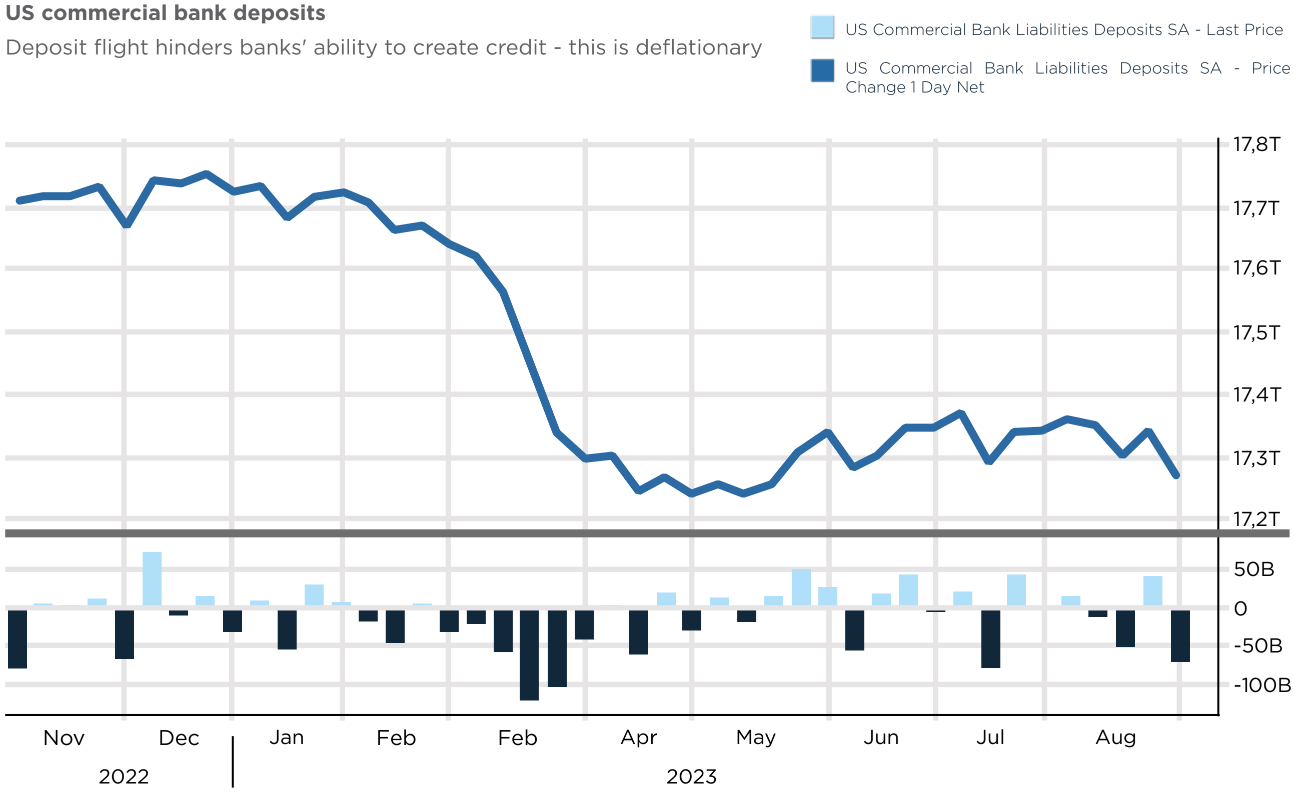
Source : Eurogroup Consulting (2023)

The market and macroeconomic contexts discussed so far are rather extraordinary and several detrimental consequences are now emerging. Banks in the US just saw their biggest weekly deposit outflows since the collapse of SVB. Total bank deposits (on a seasonally adjusted basis) plunged by USD 70bn in a week alone. This puts bank deposits at their lowest levels since May. Money Market Funds saw USD 41.8bn of inflows last week. At the same time, usage of the Fed's emergency bank funding facility just hit a record high of USD 108bn.

Exhibit 13

US commercial bank deposits

Deposit flight hinders banks' ability to create credit - this is deflationary



Source : Joe Consorti (ALCLSPST + ALCLLPST)
ALCLDEPO Index (US COmmercial Bank Liabilities Deposits SA) Bank Deposits

Corporate defaults are at their highest level since the global financial crisis. Credit rating agency S&P Global has released new data that shows that corporate defaults in August were the worst since 2009. The global corporate default tally jumped to 107 as of the end of August 2023, with 16 defaults in August. They now expect the US and European 12-month trailing speculative-grade default rates to continue to rise from current levels to 4.5% and 3.75% respectively, by June 2024. USD 800bn of investment-grade, high-yield and leveraged loans are maturing in 2024 which will need to be refinanced at higher interest rates according to Goldman Sachs[13].

Since Lehman Brothers' bankruptcy, US Money Supply M2 remained growing continuously overall. However, there is now an existing shift in that trend since interest rates have begun to change the broad way of consuming and saving. What does that represent from a CIB perspective?

[13] S&P Global (2023). Default, Transition, and Recovery: The U.S. Speculative-Grade Corporate Default Rate Could Rise To 4.5% By June 2024.

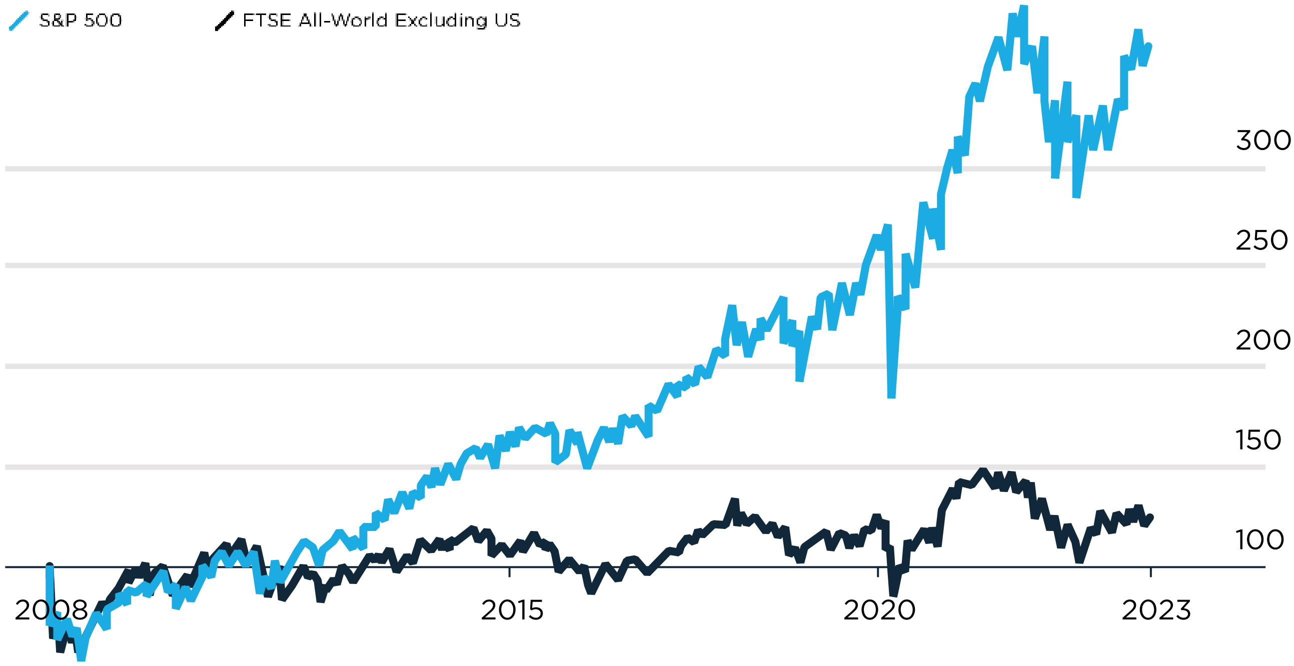
5. THE WORLD POST-LEHMAN AND THE PERFORMANCE OF CORPORATE AND INVESTMENT BANKS?

15 years ago, on the 15th of September 2008, Lehman Brothers filed for bankruptcy, sending the financial markets into a freefall that sparked unprecedented volatility, triggering the worst recession since the Second World War in the United States (-4.3%)[14] and an unprecedented contraction of interbank liquidity. Among the factors considered, this last one had the most adverse effect on the global banking system. Without the exceptional measures voted by the US Congress, a total economic collapse would have followed. At the start of this century-long crisis, central banks and governments were not equipped to deal with such a shock. In the space of a few weeks, most countries had to take two types of measures. First, exceptional measures to support the financial sector through recapitalisations and asset purchases. Secondly, significant support to the economy was given through colossal stimulus plans financed by quantitative easing of the money supply. The significant support given to the banking system and banks in crisis, despite the obvious moral hazard following the subprime excesses, was then counterbalanced by significant regulatory frameworks designed to solidify the global banking system: new regulations, notably governing the liquidity and solvency of banks, but also orderly winding-up mechanisms and reinforced regulatory supervision, for example by the ECB in Europe.

Exhibit 14

The world post-Lehman

Outside the US, markets went sideways; but not in the US itself



Source : Bloomberg

In the context of the prominent role of risk in European banking, it's important to emphasize the significance of a metric that has been relatively overlooked until now: the rate of Return On Risk-Weighted Assets (RoRWA). This benchmark seamlessly combines balance-sheet management with revenue and cost considerations. RoRWA can emerge as a practical measure to assess and manage performance and make informed risk-reward decisions.

[14] Weinberg, J. (2013). The Great Recession and its Aftermath | Federal Reserve History.

The banking sector has been undergoing a significant transformation, and only the most adaptable will survive. Traditional tools for charting competitive courses fall short in navigating this evolving landscape. Capital adequacy, asset quality, and macroeconomic trends now play prominent roles in a bank's financial performance. The balance sheet, rather than the profit and loss statement, provides a more comprehensive view of a bank's health and areas needing improvement in this era of disruptive change.

RoRWA and its component analysis can be used to assess the bank's performance along four dimensions[15] :

1. RoRWA tracks a bank's balance sheet management and risk appetite

2. RoRWA indicates how a bank incorporates risk into cross-selling opportunities that generate fees and commissions

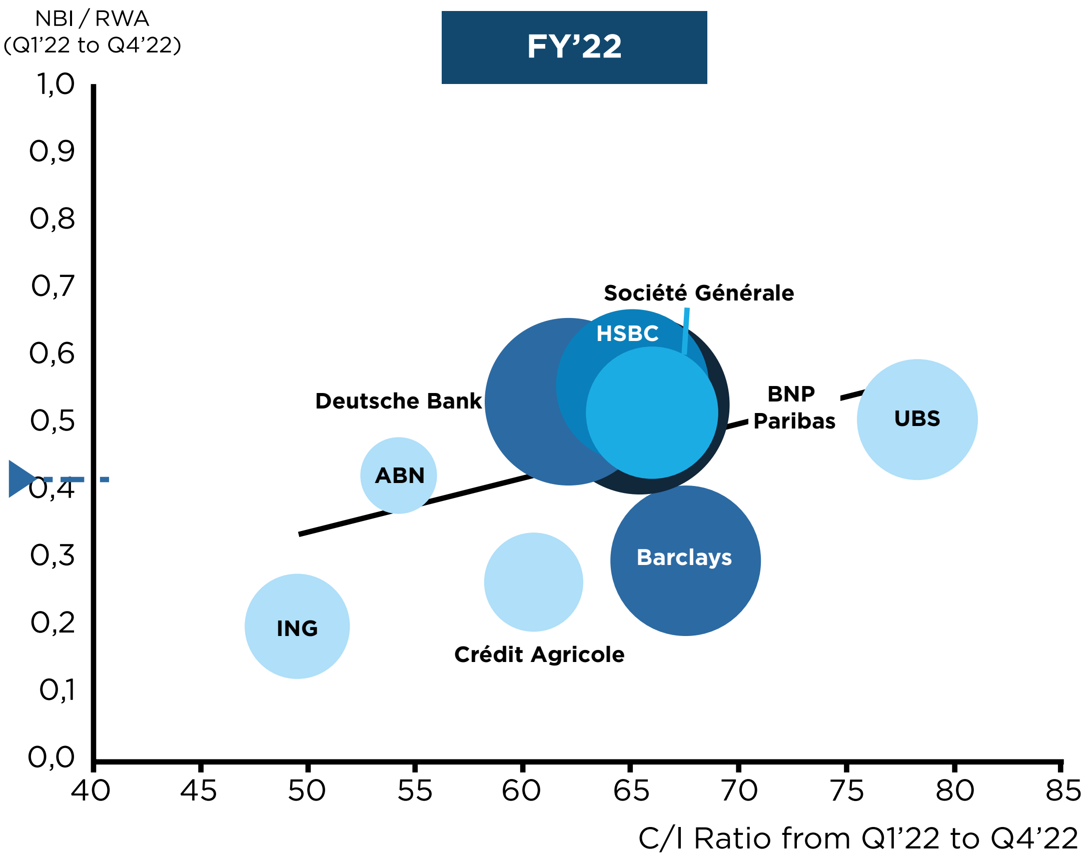
3. On the cost side, RoRWA reveals cost efficiency per unit of risk for a bank's business volume

4. RoRWA assesses the cost of risk by disclosing a bank's ability to minimize loan-loss provisions on a risk-adjusted basis

Despite better handling of their costs, EU CIBs suffer from low RoRWA in FY22[16]. The largest EU CIBs (HSBC, Deutsche Bank and BNP Paribas) seem to have higher asset profitability compared to their smaller counterparts. A volatile and uncertain macro-financial environment marked by rising interest rates poses several challenges threatening outstanding revenue growth in a post-Covid era. European CIBs can investigate diversification strategies of their current portfolios. This can include the evaluation of their best products to increase asset profitability.

Exhibit 15

CIBs assest profitability analysis



Source : Eurogroup Consulting (2023)

[15] Sinn, W., Acunto, R. and Oldrini, A. (2013). Bain & Company EUROPEAN BANKING: Striking the right balance between risk and return.

[16] Eurogroup Consulting (2023). CIB Economics – 2023 first half. Paris : Eurogroup Consulting

CIBs Assest Profitability Analysis

The trend in our dataset shows a slight increase YoY of asset profitability for CIBs in H1'23. Reflecting on the performance of European Corporate and Investment Banks in H1 2023, one can highlight their continued performance. In a challenging environment, EU CIBs have demonstrated resilient performances that notably improved top-line growth.

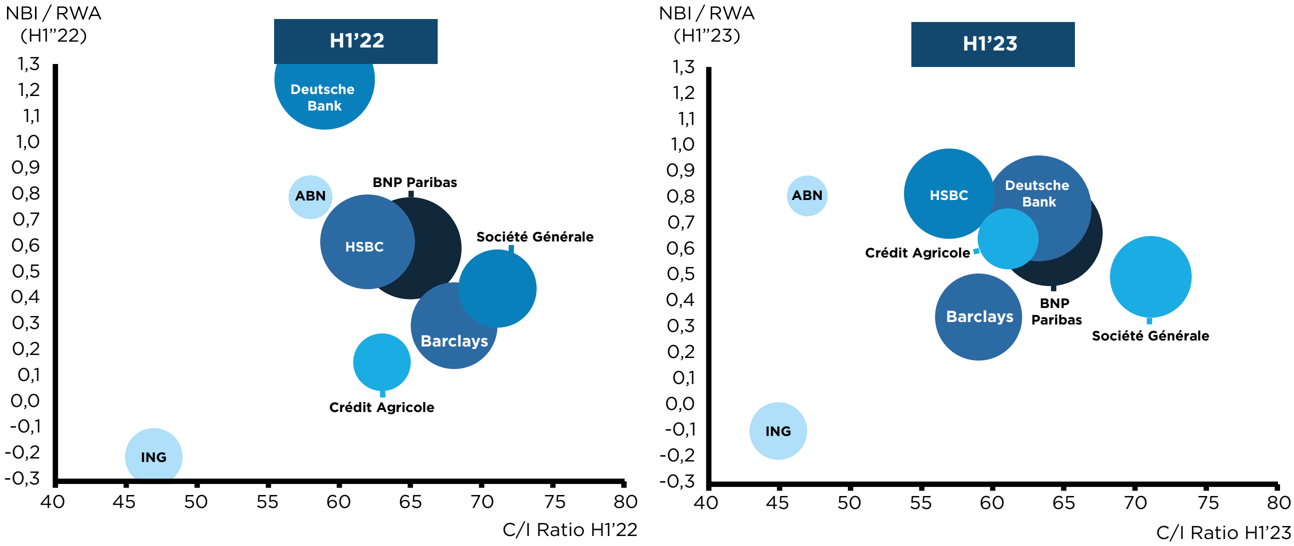
+6bp

increase in asset profitability

EU CIBs continued to outperform their US counterparts during the period: +5.8% and +4.8% respectively for EU and US CIBs compared to H1'22. However, C/I ratios have deteriorated during the period and RoRWA still require improvement. Both must be addressed in the next cycle.

Exhibit 14

CIBs assest profitability analysis



Source : Eurogroup Consulting (2023)

6. IN CONCLUSION, A CONTINUED PERFORMANCE BEFORE THE NEXT CYCLE

Against a volatile and challenging environment, European Corporate and Investment Banks continue to perform, delivering continuous improvement in asset quality throughout the year. Heightened uncertainty, risks, and surging prices for energy, food, and commodities have increased inflationary pressures, prompting central banks to raise interest rates. Against a stormy macro-financial environment, European CIBs have notably maintained their performance level together with solid capital and liquidity positions, albeit benefiting from lowered jaws ratios in the period. In that context and in anticipation of the next cycle, Corporate and Investment Banks must focus on their bottom-line and asset profitability, together with wider considerations in terms of risk assessment. As highlighted by the European Central Bank Supervisory (SREP 2022) beyond building resilience to immediate shocks, banks must address digitalisation challenges, strengthen their governance, and bolster their risk data aggregation and reporting. Additionally, it remains crucial to step up efforts in addressing climate-related and environmental risks (e.g. material exposures to physical and transition risks drivers) as scrutiny is increasing[17].

[17] European Central Bank (2022). Walking the talk.

02

TO ESG AND BEYOND: ALIGNING OUTCOMES WITH INVESTMENT STRATEGIES

Commercial and investment banks play a crucial role in expediting the global shift towards a net-zero future. According to certain projections, achieving net-zero emissions by 2050 necessitates an annual investment of more than US$9 trillion, significantly larger than the current figure set at US$5.7 trillion[18]. To bridge this substantial gap, unprecedented amounts of funding must be secured to implement innovative financing solutions and foster extensive collaboration across the ecosystem.

However, the existing climate financing landscape, although valuable in certain aspects, suffers from inherent flaws and falls short of addressing the magnitude of the climate crisis. Insufficient funding, bureaucratic complexities, and the prevalence of short-term interests frequently impede substantial progress.

Since 1880, the concentration of carbon dioxide in the atmosphere has continually and significantly increased, most notably in the past 60 years. Today, levels near 400 parts per million (ppm); the highest level in at least 800 000 years.

Temperatures are now approximately 1.2°C higher than pre-industrial levels. According to Climate Action Tracker (CAT), without major efforts to reach carbon neutrality and limit global warming, temperatures will increase up to +2.9°C.

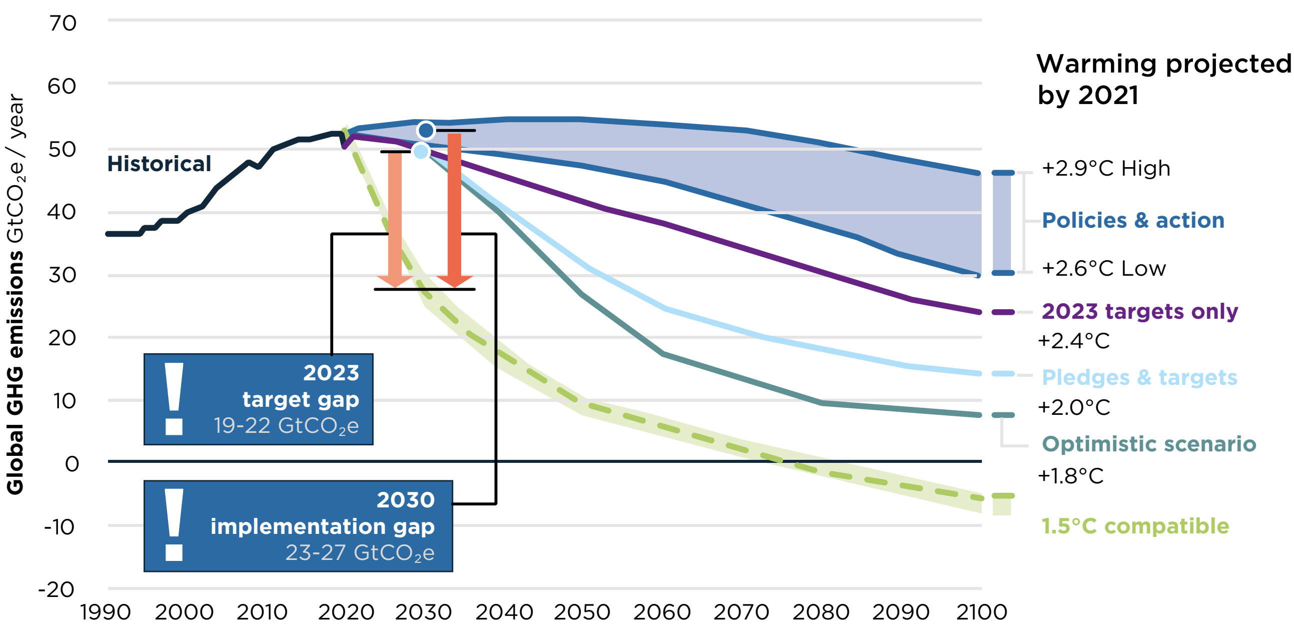
To achieve the target of the Paris Agreement, a scenario represented by the dotted green line of the CAT, disruptive actions must be taken rapidly to bring down GHG emissions to zero between 2070 and 2080.

With an optimistic outlook, GHG emissions could stay well above 0 after 2100, whereas in the worst-case scenario temperatures rise between +1.8C to +2.9C.

Exhibit 1

2100 Warming Projections

Emissions and expected warming based on pledges and current policies



Source : Climate Action Tracker. Nov. 2022 Update.

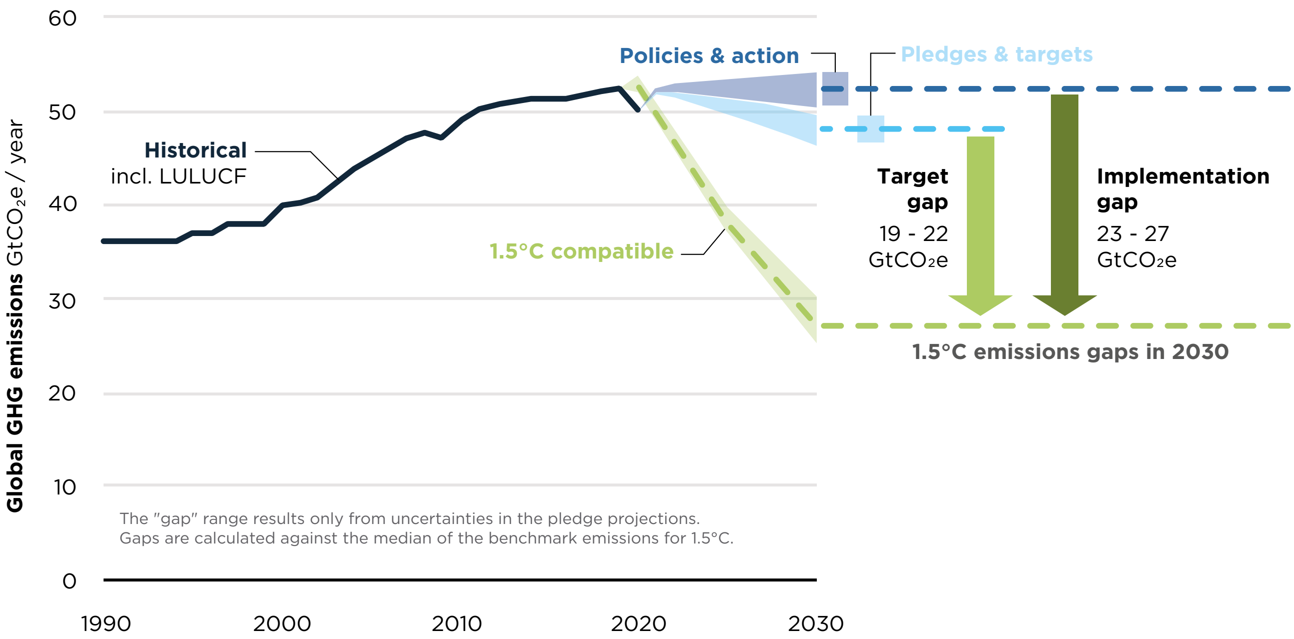
In combination to rising temperatures the CAT has mapped out the outlook concerning global greenhouse gas emissions. They argue the recent energy crisis has been a setback for climate action as governments are doubling down on fossil fuels to increase energy security even though 'renewables, efficiency and electrification are by far the cheapest, fastest, and most secure options'[19].

[18] Rolan Berger (2023).
[19] Climate Action Tracker (2022).

Exhibit 2

2300 Emissions Gaps

CAT projections and resulting emissions gaps in meeting the 1.5°C Paris Agreement goal



Source : Climate Action Tracker. Nov. 2022 Update.

The CAT estimates that projects in the liquefied natural gas (LNG) sector pose a severe threat to achieving the 1.5°C temperature limit. The current construction of LNG facilities, in conjunction with their expansion initiatives, could lead to a staggering increase in emissions, surpassing 1.9 GtCO2e annually by 2030 when compared to emission levels consistent with the International Energy Agency's (IEA) Net Zero by 2050 scenario. This surge in the number of new LNG plants exacerbates the already critical issue of overcapacity, with the existing capacity as of 2021 expected to exceed the requirements outlined in the IEA's Net Zero by 2030 framework.

Fossil fuels are not the solution to the energy crisis nor to climate change, but unless global efforts are made to curb drastically fossil fuel consumption, it will continue to top the energy mix in 2050.

The present levels of public contributions to climate finance fall short of providing the necessary support for facilitating the transitions and enforcing regulations aimed at reducing emissions. As of the end of 2022, the CAT observes that government allocations towards climate finance funding have only experienced a 4% increase. According to their evaluation and panel, no developed nation has achieved a rating higher than 'Insufficient,' with many being ranking as 'Critically Insufficient' or 'Highly Insufficient.'

In this report we will discuss this landscape interrogating two key facets of ESG in Finance:

1. To what extent ESG advances the objectives of the EU Sustainable Plan and Paris Agreement?

2. How can we foster systemic change and greater engagement of the financial sector in Sustainable Finance?

THE OBJECTIVES OF THE EU SUSTAINABLE PLAN AND PARIS AGREEMENT

Environmental, Social and Governance (ESG) refers to a set of criteria investors use to evaluate the sustainability and societal impact of a company or an investment. ESG has gained considerable traction as regulators are pushing for the financial sector to align with the objectives of the Paris Agreement and the EU Sustainable Finance Action Plan and support the transition to a greener economy.

Several shocks such as the energy crisis, hikes in inflation, and banks failures have recently turned the market away from ESG to focus on short-term risks linked to the macro-financial environment. However, ESG has never gone out of fashion. Article 9 funds have shown significant stronger flows per fund versus Article 8 and 6 funds and have exhibited strong resilience despite market turbulence[20]. Climate change and social movements are increasingly influencing the way value is perceived and evaluated. As performance evaluation evolves, the investment industry must adapt to retain credibility, define success beyond financial metrics, and move towards outcome-based approach and ensure its relevance.

European governmental bodies are actively establishing criteria and measurement prerequisites for the financial sector. They have taken the lead to implement regulations setting standards and reporting mandates that specifically address the financial industry's fulfilment of non-financial key performance indicators.

WHAT IS THE EU SUSTAINABLE FINANCE ACTION PLAN?

The action plan set out a comprehensive strategy to connect finance with sustainability.

The EU action plan is divided into three main objectives :

1. Increase and reorient the allocation of capital flows towards sustainable investments.

- Establishing a clear and detailed EU Taxonomy
- Creating an EU Green Bond Standard and labels for green financial products
- Fostering investment in sustainable projects
- Incorporating sustainability in financial advice
- Develop sustainability benchmarks

2. Manage the financial risks stemming from climate-related risks.

- Better integrating sustainability in ratings and market research
- Clarifying asset managers' and institutional investors' duties regarding sustainability
- Introducing a 'green supporting factor' in the EU prudential rules for banks and insurance companies

3. Foster greater transparency and long-termism in financial and economic activity to achieve sustainable and inclusive growth.

- Strengthening sustainability disclosure and accounting rulemaking
- Fostering sustainable corporate governance and attenuating short-termism in captial markets

[20] Goldman Sachs. (2023). SFDR, two years on - trends and anatomy of Article 8 & 9 funds in 2023.

The objectives of current regulation developments are two folds: the regulation seeks to bring greater transparency across the investment chain and enable a shift in the allocation of capital towards a sustainable and climate-neutral economy while lowering overall financial risks stemming from climate change and environmental degradation.

Beyond the goals of increased transparency and, consequently, the clear protection of clients through the fight against greenwashing, there are also underlying objectives of mobilising capital for the purpose of financing these transitions.

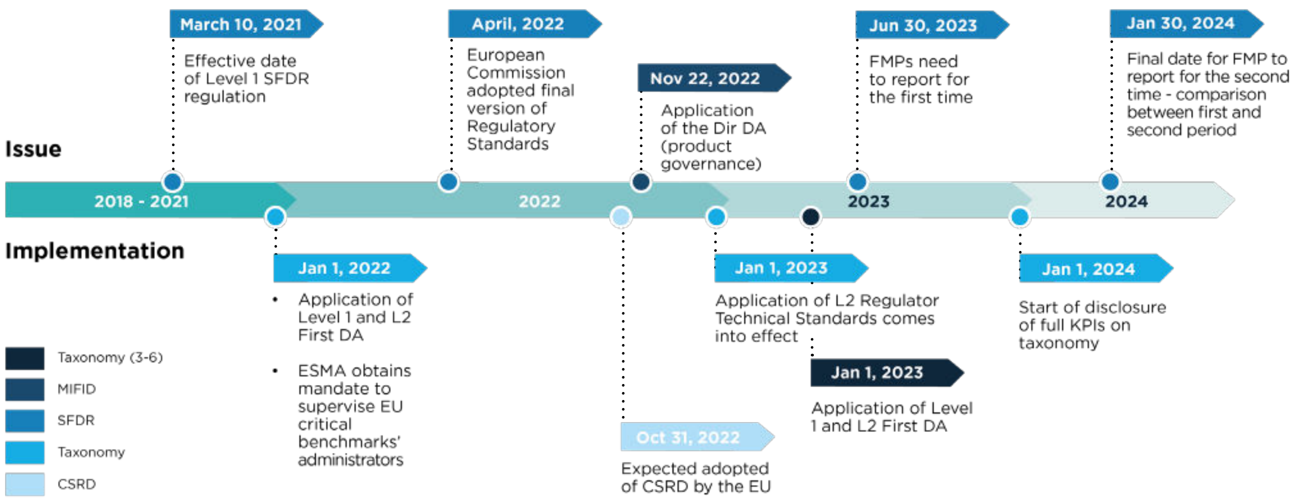
Timothée Jaulin, Head of ESG Development & Advocacy, Special Operations at AMUNDI

The European regulatory landscape is currently composed of three main regulatory pillars :

- Firstly, the **EU Taxonomy Regulation** determines whether an activity is environmentally sustainable.
- Secondly, the **Corporate Sustainability Reporting Directive (CSRD)** requires companies to disclose environmental, social and governance factors and how these affect its value, the environment, social matters, or human rights.
- Finally, the **Sustainable Finance Disclosure Regulation (SFDR)** supplements current rules governing the public disclosures of financial products; in other words, how investment decisions achieve these objectives while accounting for the principal negative effects on sustainability factors.

Exhibit 3

Sustainable Finance Action Plan Timeline



Source : Amundi (2022). ESG Thema #11 - EU Sustainable Finance Action Plan: State of play.

These regulations have begun constructing the framework within which ultimately all organisations must operate – a well-needed scaffolding. Let's take a closer look at the progress they're making progress toward their intended objectives.

In the realm of transparency, it is safe to say that the regulation has exceeded its initial objectives. The EU Taxonomy has sparked a surge in demand for companies to report not just financial metrics but also a range of non-financial criteria. Corporations now find themselves obliged to demonstrate their commitment to 'doing no significant harm' by thoroughly evaluating their Scope 3 emissions. Consequently, investment firms are compelled to provide detailed reports on their products and services, substantiating their eligibility for classification as Article 9 funds. According to a Goldman Sachs report on SFDR, 'Article 8 and 9 Equity funds have received 3.4 times the cumulative inflows vs. non-ESG counterparts (Article 6) since 2019'[21]. This newfound transparency permeating the investment ecosystem not only facilitates more refined classification but also acts as a safeguard against unfounded claims of greenwashing, ultimately benefiting clients.

THE REAL CHALLENGES: DATA AND BIASES

Currently, the main challenge is data collection, specifically in constructing accurate assessments of 'doing no significant harm', Principal Adverse Impact (PAI), and subsequent classification by investment firms. The efficacy of this process hinges on the availability of data that adheres to the rigorous regulatory standards. For many investors, the quest for high-quality ESG data to evaluate investments is already a challenge. The complexity intensifies when one extends this scenario beyond the borders of the European Union. In such instances, ESG data collected by companies and the benchmarks they adhere to can frequently diverge significantly from the EU's established norms. This divergence can, in turn, trigger a reclassification of the product in question. As noted by Goldman Sachs, ''Downgrades' of Article 9 funds are slowing meaningfully and now more than 60% of equity AUM is now categorised under Articles 8 and 9, the commercial dynamics of SFDR are leading to a trend of 'light upgrading' of Article 8 funds towards Article 8+.'[22]

This issue is not solely geographically confined. Variations in practices and ESG literacy span across different market sizes and industries. Generally, larger corporations typically have a more robust capacity to adapt to shifts in the regulatory landscape, placing them at a more advantageous position versus smaller firms. Regardless of size, implementing up-to-date regulations stretches over a longer period for companies, and 'without this is being a call for complacency, we need to give actors time to implement the regulations and take a step back to really gauge areas of improvement' says Timothée Jaulin.

However, it is crucial to acknowledge that a regulatory framework overly focusing on implementing a transparency regime can overlook potential biases that lead to disparities in capital allocation. To illustrate this; take a product underpinning an ambitious sustainable project from an emerging market. This product might seem less competitive on global markets compared to a green bond issued by a European counterpart. Similarly, a relatively young company in the energy sector reliant on hydrocarbon-intensive manufacturing could receive deteriorated ESG ratings. Regrettably, this undermines the secondary goal of the regulation: to fund entities that drive the climate transition - those who genuinely offer groundbreaking solutions.

Regulatory solutions are underway, discussions between on-field actors and regulatory institutions and/or market supervisors as well as initiatives in collaboration with South Africa or the Chinese Central Bank are encouraging steps towards alignment. It is still fair to wonder whether these two combined objectives are compatible in the long run.

As of now, it is difficult to assess how well ESG regulation serves the goal of advancing the climate transition and operating a significant and enduring shift in the allocation of capital. ESG remains a term for measuring the outcomes of sustainability efforts made by a company or an investment. These metrics are output-centric

[20] Goldman Sachs. (2023). SFDR, two years on - trends and anatomy of Article 8 & 9 funds in 2023.
[22] Ibid.
[23] Ibid.

based on the results of processes but do not track impact. Consider this: a global equity ESG portfolio consists of a range of companies from tech sector giants such as Amazon, Google to Oil and Gas behemoths like ExxonMobil. The €573m SPDR Bloomberg SASB 0-3 Year Euro Corporate ESG UCITS ETF (SPPS) holds a stake in French petroleum company Total Energies[23]. While these companies might rank high in ESG performance metrics, their contribution to facilitating the climate transition may not necessarily match their ESG accolades. Investing solely based on an acronym makes little sense, it becomes evident that it is not an enduring way to reallocate capital to support the climate transition agenda.

Obviously, we should avoid the oversimplification of ESG discourse as a binary distinction of 'good' and 'bad' assets. ESG is often misinterpreted as a direct synonym for 'virtue.' A widespread illusive belief is that a company with a high ESG score is inherently a champion of climate transition. Perhaps, it's time to reconsider the concept of dedicated 'ESG assets' or 'ESG funds' and instead, make ESG metrics an integral part of all investment strategies across the board. Regardless of the investment strategy, there should be a systematic commitment to transparency for sustainability and financial reporting.

There are different ways to incorporate these criteria, and depending on the approach, there will be an expected impact on performance based on market cycles and specific challenges related to certain sectors. In this perspective, you can favour companies that are on trajectories of improvement in terms of ESG but have a very low starting point. Equally, an investment strategy can rely on the exclusion of certain companies or sectors, on setting alignment targets.

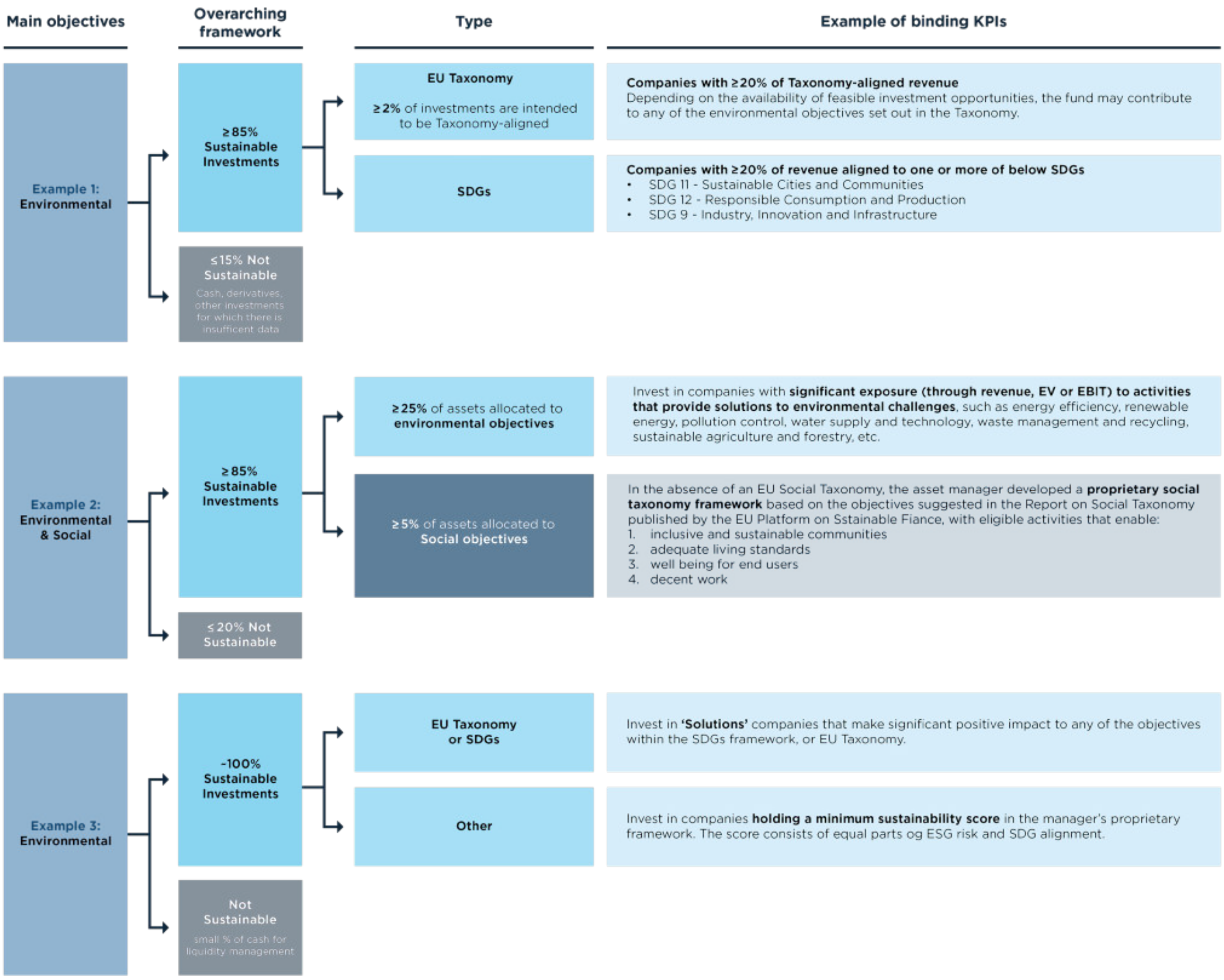
Timothée Jaulin

IMMEDIATE CHALLENGES ASSOCIATED WITH REGULATION DEVELOPMENTS - A RECAP:

- **Structural challenges** : These regulations are complex and composed of many building blocks which actors across the investment chain need to understand and take on the topics. To this end major institutions face a monumental challenge to train and align all stakeholders to steer into this direction.
- **Implementation challenge** : Not all regulations are implemented at the same time and applicability of regulations vary by sector and industry.
- **Data availability and data fluency** : Investors often find it challenging to find high-quality ESG data when evaluating investments. And even with the data at hand, remains the challenge of precessing, interpreting, and analysing it.

Exhibit 4

Examples of live sustainable investment frameworks adopted by large Article 9 funds



Source: Company data, Data compiled by Goldman Sachs Global Investment Research

Defining a sustainable investment and a strategy to align with a standardised definition remains a challenge, especially for Article 8 funds where consensus is notoriously hard to reach. Article 8 funds have a low entry threshold which might not reflect and promote best-in class ESG considerations. To better reflect ESG risks and opportunities into the investment process which cannot be limited to exclusion-only strategies, asset managers are incorporating additional exclusions or engagement strategies to promote credibility and adjust to the new market-defined label of Article 8+ funds (which adds a sustainable investment dimension to ESG considerations). On the contrary, interpretations of Article 9 funds are perceived as more homogenous across the board with building thematic/impact investment strategies (Paris Agreement, SDG alignment, etc.). Asset managers work on comprehensive strategies as they both show how selected key performance indicators (KPIs) and qualitative frameworks are used to assess how a company meets previously set objectives, while incorporating PAIs and assessing the governance strategy compliant with SFDR.

Advancing the climate transition objectives requires investors and institutions to perhaps move beyond ESG to foster more system-thinking strategies. As previously mentioned, ESG is primarily a measure of the outcomes of sustainability efforts. In that sense, ESG is not a silver bullet for global climate change but remains an extremely important factor to consider when valuing a company. This is not a niche investing project and should not be associated with a particular job title. ESG is one of many metrics useful to evaluate a company's long-term value. Additionally, as noted by Ulrik Fugmann, ESG Champion at BNP Paribas Asset Management, ESG metrics, for example, do not provide direct information on whether a company is an enabler of the climate transition, this remains an area investors have agency over when defining their investment strategy.

THE REAL OPPORTUNITY: OUTCOME AND IMPACT-BASED APPROACH

There is a major imperative to infuse an outcome/impact-based approach to investment strategies intending to support the climate transition. While regulatory definitions of 'impact' are yet to emerge, it stands as a powerful lever for channelling capital towards companies that drive transformative change. 'Impact' can prove to be incredibly hard to define and measure, its contours will necessarily shift across sectors, private/public equity, and more. Nevertheless, it is a concept that holds the potential to be universally applicable and incorporated into all investment strategies. According to Goldman Sachs, 'transition' and 'improvers' funds are becoming a fast-growing impact category, as asset managers seek differentiation in ESG fund strategies. Investors are gradually recognising the potential to design investment strategies to align with transition goals as these are 'measurable, additional, and connected with tangible outcomes in the real economy'. These strategies are gaining ground, with Goldman Sachs estimating that they had reached $50 bn in AUM in July'[24]

The industry broadly still struggles with data availability and assumptions behind traditional climate modelling which makes it very difficult to measure a specific environmental outcome like Net Zero, for example, and even more so when it comes to natural capital and biodiversity impacts. That said, the urgency behind climate change is very real and present, and while outcomes are difficult to measure, one should not use this as an excuse or argument for companies that provide solutions or services to address climate change as an example.

The funds we have launched within the Environmental Strategies Group are uniquely environmental solutions focussed on, in other words, the solutions we need for the broader economy to approach net zero. Without these innovative solutions across solar, wind, hydrogen, alternative protein, and plastic recycling, net zero is simply unachievable. Since founding the group in 2019, we have given investors globally the ability to actively invest in the solutions we need to have a fighting chance to achieve anything close to net zero and alongside this, to provide these investors with the data and reports needed that enable them to measure and understand the environmental outcome. In fact, with our investors, we want to be part of the solution and are today one of the largest investors globally in public companies involved with the hydrogen economy, residential solar, and energy storage.

Ulrik Fugmann - Head of the Environmental Strategies Group within Fundamental Active Equities at BNP Paribas Asset Management

[24] Ibid.

THE DIFFERENTIATING FEATURE: TOWARDS A SYSTEM-THINKING APPROACH

Sustainable goals are impacting the entire investment chain, prompting the inclusion of all entities such as CIBs in a comprehensive group strategy. The drive to meet well-defined sustainability goals and comply with EU regulations has become a shared pursuit. This ongoing process demands adaptable action, encompassing the implementation of ESG metric assessment tools, the formulation of novel decision-making protocols, and widespread training across all entities. Achieving a deep-seated grasp of regulations and their underpinning goals is crucial before implementation in daily operations.

The core issue resides in a holistic comprehension and alignment across the investment value chain. Any disruption within this intricate network carries the potential of undermining the entire structure, potentially diminishing positive outcomes.

There is a danger of oversimplification when broaching these topics with clients. The allocation of capital might not reflect individual perspectives and outcomes desired beyond financial return targets. For instance, in the matching process of preferences to products, clients 'inclined to invest in impact products will express strong preferences for high-level rated products in the taxonomy or in sustainable investment, but because of this, will be less likely to be offered products invested in emerging economies' according to Timothée Jaulin.

To bridge these gaps, establishing effective communication channels with clients to understand the true drivers of demand and transparently map their preferences to desired financial and non-financial outcomes of their portfolios is a sum-positive solution. Transparency remains a cornerstone to match client preferences to the right fund and manage expectations.

There is an urgent need in asset management to align what you say you do with what you do. Whilst investing in mega-themes like the Energy Transition means that the odds of long-term market outperformance are tipped in your favour, it does not mean that is without risk or immune to macro events like the ones experienced since early 2021 including rampant inflation, aggressive central bank tightening with higher interest rates, supply chains challenged and bank failures in the US and Europe. However, in the longer term, investing in mega-themes 'through the cycle' should produce superior results and an alignment with an exponential market penetration of new technologies, a positive regulatory landscape, and total addressable markets that have grown despite macro uncertainty. The BNP Paribas Energy Transition Fund holds significant stakes in some of the most important and innovative environmental solutions companies globally and our investors that look through our portfolio of holdings understand the role we play in financing and benefitting from the energy transition.

Ulrick Fugmann

To ignite a broader transformation and resonate with a wider audience, asset managers and institutional players must craft end-to-end strategies that maximise alignment and impact across the investment value chain. It's easy to overlook the fact that consumer demand is a driving force shaping tomorrow's investment, but the participant pool is expanding to asset managers who share a core belief in delivering a positive impact. It is about offering a range of products with socially and environmentally driven themes to shape opportunities for clients to transition to impact-based investments. This isn't merely a footnote, it's constitutive of the EU Action Plan's vision for sustainable and inclusive growth.

Inclusivity isn't just an aspiration; it's a goal that demands proactive pursuit at every echelon within financial institutions. There is substantial leeway for financial actors to take the lead and find strategies from a bottom-up perspective to engage with a larger audience and new clients. ESG reports, though undoubtedly comprehensive and informative, sometimes lack that certain 'currency' of engagement. The true challenge lies in personifying the climate transition, in forging a tangible connection between clients and the companies' funds invested on their behalf. Shifting away from discussions purely centred on risk and returns to include broader elements such as engagement, impact, and scalability builds the client's tolerance and understanding of the specific dynamics of these investments.

Great examples of initiatives are taking shape– the Transition Energy Fund at BNP is working on finding solutions to foster inclusion and breathe life into the climate transition narrative. In a bid to make the topic more approachable for a broader audience, they have launched a podcast – The Uncapped Impact Series - along with articles and short videos on social media platforms. CEOs of medium to large-sized companies in the hydrogen, aggrotech, and solar residential space are invited to share insights on their sectors, expectations for the future, and the impact they deliver within their field in non-technical terms. This series opens avenues for people who want to support and align with a climate-conscious lens but may have previously been in the dark about available options.

The significance of this outreach effort cannot be overstated, as it spans from engaging with investors to a wider demographic, offering an alternative narrative to the common belief that true investment impact is necessarily achieved through venture capital, private equity, or direct project finance. Achieving resonance with both smaller clients and a broader audience is an indispensable endeavour to catalyse more substantial strides in support of the climate transition.

To that end, projects to fortify connections within various segments of the investment chain are great steps towards inclusion. These initiatives at BNP's Energy Transition Fund extend to local advisors, who play a pivotal role in providing information and guiding investment decisions of local clients. To nurture this relationship, BNP Paribas fosters a dialogue and strengthens peer relationships across the investment chain from clients to local advisors.

While we celebrate these young initiatives, we believe in bolder, large-scale disruptive initiatives involving all levels of the organisation to co-create strategies that govern a faster transition. Co-creation fosters inclusivity, value, and alignment among employees, who then internalise the leadership objectives as their own mission. This shared ownership translates into heightened commitment and engagement, two key drivers of successful and innovative transformation initiatives. Additionally, strategies revolving around co-learning by co-investing could be a great tool to drive engagement and peer relationships, improving the environmental alignment of an organisation. Recent studies show that such incentives lead financial actors to internalise shared sector-level understandings of the importance of the importance of sustainability[25].

HOW TO SHIFT THE TIME HORIZON PARADIGM?

Despite a strong recognition for the need to increase the flow of capital to investments in sustainable projects and production methods (and away from environmentally or socially destructive practices) to meet the ambitious climate goals of the Paris Agreement and EU Action plan, the financial sector remains resistant to large-scale change[26]. Fundamentally, the sector still undoubtedly operates on short-term time horizons, with quarterly reporting and risk-adjusted rewards reigning supreme and taking prevalence over ESG considerations.

ESG metrics and more generally climate transition financing requires much longer time horizons. For the sector to become a driver of sustainability, it requires incremental regime change and near-terms actions with a paradigm shift to reconsider investment horizons, risk, and reward. Worryingly, the economy is not transitioning fast enough to be on track to meet global sustainability and climate targets despite ESG factors gradually becoming mainstream[27]. So, is it perhaps overly optimistic to believe the sector can lead this transformation on its own?

Despite ESG regulation becoming more ambitious, small and medium capitalisation companies investing early on to meet ESG goals might experience negative short-term financial[28]. Relying solely on short-term considerations, small and medium capitalisation

[25] DiMaggio and Powell (1983).
[26] Geddes and Schmidt (2020).
[27] Ibid.
[28] Assael and Challet (2021).

companies inherently carry a greater risk profile compared to their larger counterparts, which can disincentive commitment to bold ESG investments that might deter potential investors due to relatively worse off financial prospects.

This assessment, though worthy of consideration, should be taken with a degree of caution. The study of ESG metrics and their precise impact on financial outcomes remains a relatively recent endeavour, and the current body of literature in this domain remains somewhat limited.

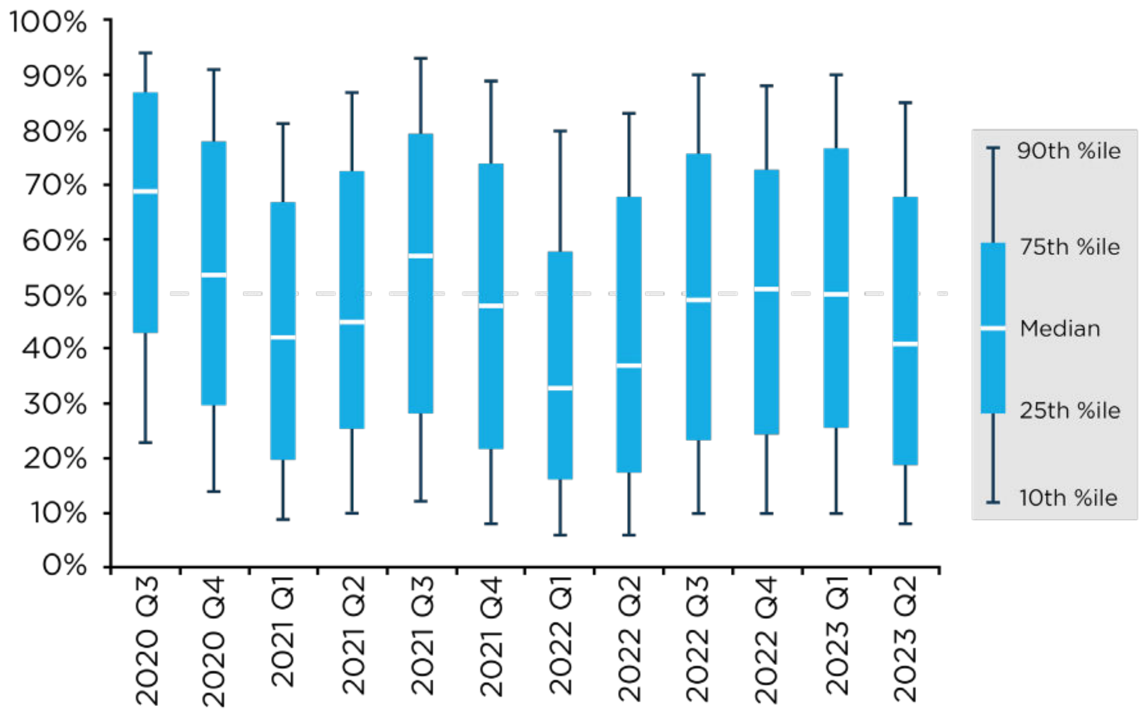
Nevertheless, by proactively addressing environmental and social concerns early on, we can assume that companies can position themselves to adapt and thrive in an ever-changing business landscape and contribute to future resilient investment. By mitigating potential long-term risks, investors can hope to secure long-term growth and profitability while aligning to defined climate or social based outcomes. As ESG is increasingly perceived by investors as a risk management tool, there is potential to balance time horizons if short-term setbacks are overshadowed for higher potential returns in the future. This is particularly true for long-term oriented shareholders such as pension funds who tend to hold shares for longer periods of time and can 'influence the actions of management by pushing them to address their concerns[29]'

Similarly, investments enabling climate solutions display unique characteristics within the financial markets. They often exhibit heightened volatility and necessitate a longer-term commitment. These distinguishing features place them at odd with prevailing market dynamics. Consequently, such climate-focused funds may encounter hurdles in gaining broader acceptance, particularly among major institutional investors.

Exhibit 5

Article 9 funds' performance have been historically more volatile

CAT projections and resulting emissions gaps in meeting the 1.5°C Paris Agreement goal



Morningstar return percentile ranks are assigned within Morningstar fund categories, which group funds based on their investment styles

Source: Morningstar, Goldman Sachs Global Investment Research

[29] Keddie and Magnan (2023).

Essentially, effectively financing the transition towards a more sustainable future requires a significant scaling-up of investments across diverse sectors and a commitment to investing in innovative and disruptive solutions. However, embracing this path entails embracing the inherent risks associated with being an early investor. Here, these risks often hinge not on whether the supported companies will ultimately succeed but on when that success will happen. Given the conservative risk appetite of larger investors, the short-term risks of engaging with volatile funds should be offset by the asset's environmental and social values.

This is not to say that environmentally friendly products cannot deliver robust financial returns while advancing the climate agenda. It could be that green products only become the preferred choice and mainstream when they consistently offer risk-adjusted returns that meet investor expectations. However, a challenge emerges in this regard as well: highly green products, due to their frequent period of elevated volatility, may attract investors during periods of rapid growth, but these investors could be exiting when short-term market fluctuations impact their returns.

In essence, the financial sector grapples with inherent contradictions owing to its fundamental nature tightly linked to risk-adjusted rewards. Naturally, not every investor should be an early investor, and capital allocation must encompass various developmental stages. Nevertheless, it is pertinent to question whether conventional risk assessment models, tailored for short-term horizons, are suited for steering the transition toward sustainable finance on a large scale. Traditional financial evaluation models may struggle to fully capture the long-term benefits and risk mitigation potential of ESG investments, contributing to the perceived riskiness. As highlighted by Timothée Jaulin 'while there is an increase in data quality, understanding and getting a good grasp of the data remains an issue we must address' in the upcoming months.

NEW INNOVATIONS IN CLIMATE RISK

A first step towards better understanding and evaluating climate-related risks:

Climate-Risk Assessments are increasingly becoming mandatory as regulations tighten, although supervisory climate tests are not likely to be set in Pillar 1 minimum capital requirements. One reason is that it remains a difficult endeavour due to varied data and methodological limitations. Businesses, communities, and investors across all sectors face climate-related risks either as a direct consequence of climate change or indirectly through the economic transformations required to transition. Additionally, the ECB climate stress test in 2022 showed that participating banks received more than 60% of their interest income from corporate customers operating in 22 high GHG-emitting sectors (previously identified by the ECB). This raises concerns on banks' ability to assess climate-related risks and the breadth of difficulties they might face in decarbonising their balance sheets.

Climate-Risk Assessment is becoming a crucial characteristic that investors need to grapple with. According to the ECB, 'less than 10% of institutions use sufficiently forward-looking and granular C&E risk information in their governance and risk management practices'[30]. Yet, all institutions are expected to fully align with the ECB's expectations by the end of 2024 before supplementary supervisory instruments are instigated. [31]Climate-Risk Assessment requires knowledge of climate change hazards in precise geographies and timescales, understanding of the exposure of assets and value chains to these changes, and their potential vulnerabilities[32]. This entails compiling information from heterogeneous sources and effectively understanding and processing the data so it can be used in investment strategies.

Main constraints are hindering the integration of Climate-Risk Assessment[33]:

- **Scope:** When evaluating climate risk there

[30] European Central Bank (2022).
[31] Ibid.
[32] Arribas et al. (2022).
[33] Arribas et al. (2022).

is an imperative to consider compounding or systemic risks, meaning that specific climate-related risks cannot be isolated.
- **Data:** The data tend to lack user-relevance as it is either from global datasets which do not provide local coverage or local data which cannot be scaled according to needs.

Finres is an innovative solution that compiles local climate data in a global context to help investors understand the full breadth and depth of climate-related risks in the agricultural sector. Their tailored and standardised scientific solutions combined with AI tools and new computing models help investors understand, assess climate risks, and prioritise their investment decisions.

Although Finres mainly assists both public and private financial institutions in granting agricultural loans, they are paving the way for solutions to adopt more resilience in investment decisions beyond the agricultural sector.

HOW CAN WE PRACTICALLY INTEGRATE OUTCOME-BASED TARGETS IN DAY-TO-DAY OPERATIONS?

A case for employee incentive structures

A growing number of companies have included ESG factors in the compensation of top executives. According to the Financial Times, three-quarters of S&P 500 companies have disclosed that ESG metrics were considered in executives' pay, up from two-thirds of companies in 2021. This shift reflects an understanding that financial metrics alone cannot encapsulate a company's true value. This evolution in compensation underscores the commitment to holistic investment strategies that consider the broader impact of their decisions.

This has not come without a wave of scepticism on the impact, objectives, and usefulness of such policies, particularly from the financial sector. Asset managers are questioning whether ESG pay metrics are worthwhile as they are perceived to be somewhat blurry, subjective, and easily rigged. Based on research on the moral hazard present in the financial sector, ESG-tied financial bonuses must be set up 'to ensure that they are designed to provide effective incentives rather than serve the interests of executives, pay arrangements need to be subject to effective scrutiny by outsiders'[34]. They show that in almost all cases which S&P 100 companies use ESG metrics, 'it is difficult if not impossible for outside observers to assess whether this use provides valuable incentives or rather merely lines CEO's pockets with performance-insensitive pay.'

On the other hand, one might question whether linking outcomes to financial returns for private markets would foster a more inclusive and responsible investment landscape. This is a complex and ambiguous as the financial sector has long struggled to include non-financial considerations but worthy of exploration.

The lifecycle of investment products demands ongoing evaluation and commitment to purpose. The right incentives depend on the internal motivations of managers to review the delivery of a strategy in line with its commitments, objectives, and intended purpose. The success of an investment can no longer be limited to financial returns alone; it must encompass the broader impact a product has on society and the environment. Could linking part of long-term compensation to outcome-based metrics be a relevant incentive to catalyse change

[34] Bebchuk and Tallarita (2022).

without it being a smokescreen for additional compensation?

This goes without saying - investors should not solely rely on an acronym for decision making. On the other hand, and as previously argued, ESG should be considered as a long-term value factor in all investment strategies in combination with intangible assets. Indeed, ESG does not define long-term returns and/or positive externalities. However, ESG does allow investors who may fail to uphold their commitment to be held accountable no matter the branding of the fund.

In the same manner, compensation linked to non-financial metrics should not take precedence over sustainable, resilient, and profitable investment strategies. But perhaps they could help investors reassess how the market overlooks important value drivers, which will become increasingly important with the onset of climate change, that constitute resilient and profitable investments. Perhaps as a mere reminder that financial market actors should pay greater attention to the long-term value drivers specifically those mispriced by the market.

Long-term compensation incentives could rely on commitments to achieve net-zero carbon emissions or other basic common measurements as foundations for outcomes-based products such as the top-to-bottom pay ratio or gender pay gap. These commitments should not be abandoned due to their complexity or superficially attained by relying on a virtue-signalling firm-level objective that is left unaccomplished if not held accountable through progress monitoring and reporting. Such commitments can become powerful tools.

Beyond that, it becomes worthwhile to include an assessment of the long-term value generated from an investment strategy. It prompts us to consider how an investment strategy or an organisation actively 'does good' and how value is created through a chosen strategy. This entails tailoring measurements to the specific objectives of a financial institution or a specific team.

In essence, it is less about linking ESG metrics to compensation per se but finding relevant measures to encompass positive value created. Merely applying ESG metrics carries the potential to backfire as actors might prioritise them over other crucial metrics. Ultimately, it constrains strategies to fit within the predefined boxes of ESG criteria and neglects opportunities for qualitative assessment. Instead, the aim should be to strike a balance that rationalises and aligns with the chosen investment strategy. It is not about creating overnight radical change; but about catalysing existing change and transition to quantifiable metrics that incentivise positive outcomes.

Non-financial incentives are also gaining traction such as offering additional holiday allowances to employees who opt for more sustainable travel options. These measures align individual behaviours with broader societal and environmental goals[35]. In this sense, it could be relevant to measure what costs have been avoided through a chosen strategy. Negated emissions could help identify areas that might have been underappreciated but impact positively sustainability efforts.

Designing and aligning the incentive framework with sustainable targets

Another concern arising is to whom these incentives should apply. While we have primarily discussed tying executive compensation to ESG metrics, should this not trickle down and extend more broadly? CEOs as well as top executives in companies are steering the wheel of the ship, guiding its course. However, in the financial sector, investment and asset managers for example hold some agency in decision-making processes. Nonetheless, when defining the scope, it is essential to avoid creating competition for resources to achieve the same objectives. Hence, it is imperative to assess specifically how employees can impact pre-

[35] Acre, Outcomes-aligned incentive structures for investment managers and their employees.

defined outcome-based objectives and foster cooperation across units.

Introducing a new performance evaluation framework to adjust compensation can catch employees off guard, especially when this framework has the potential to reduce their compensation based on metrics, they are unfamiliar with. Such a scenario can lead to disengagement and growing discontent, ultimately resulting in resistance to adopting this new framework. To ensure the effectiveness of these metrics, it is crucial to check that employees understand the objective, its relevance, and their unique role through transparent and clear communication channels. Most importantly, Stéphane Rambosson CEO of VICI Advisory, an executive search boutique in Financial Services, insists that any initiatives looking to include extra financial criteria should be ‘clear, simple and transparent’, to collect precise data point according to needs and prevent overwhelming teams in yet another layer of bureaucracy.

The industry continues to adhere to a conventional framework, and due to the implementation of bonus limits, base salaries have seen a substantial rise. Bonuses are one of many decisive factors that individuals consider when evaluating a job opportunity. Stéphane Rambosson underscores the pivotal role played by a company's culture, team cohesion, and its overall positioning in influencing talent decisions when selecting a firm. Among younger individuals, two additional factors carry considerable weight: the availability of flexible work arrangements and the potential for career advancement in terms of roles and responsibilities. On the other hand, within a more experienced audience, the focus shifts to the significance of business opportunities and the strength of the business case during the decision-making process. He observes that while junior professionals may occasionally touch upon ESG as a facet of a company's value proposition, its prominence in their discussions remains relatively constrained.

> *Sometimes, among young people questions are asked about ESG as part of a company's value proposition, but much less so among seniors, except for those who are directly involved in ESG.*
>
> ***Stéphane Rambosson - CEO of VICI Advisory***

In conclusion, banks and CIBs can leverage outcome-based criteria to walk the talk and enable ESG to become a mainstream parameter considered across the board. Strategies should be tailored to their unique context both at a smaller scale to fit specific entities’ situations, objectives, and needs while also firmly embedded within a larger global framework. Particular attention should be put on controls to ensure independent oversight and an impartial assessment of performance against these criteria to prevent greenwashing and executives from using it to obtain extra compensation.

The essence of incorporating an ESG approach is about catalysing change and transition while employing quantifiable metrics to guide the journey and maintain momentum. It's not just about the financial bottom line but also about how each employee's incentives align with their behaviours and the outcomes they generate through their roles.

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EXHIBITS

PART 1

- Exhibit 1 – Tsekova, D. and Worrachate, A. (2023). Wall Street Fears a Too-Hot Economy as Recession Bets Plunge. Bloomberg.com. [online] 9 Sep. Available at: https://www.bloomberg.com/news/articles/2023-09-09/wall-street-fears-a-too-hot-economy-as-recession-bets-plunge?leadSource=uverify%20wall [Accessed 27 Sep. 2023].
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- Exhibit 9 – Refinitiv and ECB calculations.
- Exhibit 10 - Eurogroup Consulting (2023). CIB Economics – 2023 first half. Paris : Eurogroup Consulting.
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EXHIBITS

PART 2

- Exhibit 1 – Climate Action Tracker (2022). 2100 Warming Projections: Emissions and expected warming based on pledges and current policies. November 2022. Available at: https://climateactiontracker.org/global/temperatures/. Copyright ©2022 by Climate Analytics and NewClimate Institute. All rights reserved.
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