ESG & Climate Transition – progress and challenges

Regulation and Supervision of Climate-related Financial Risks
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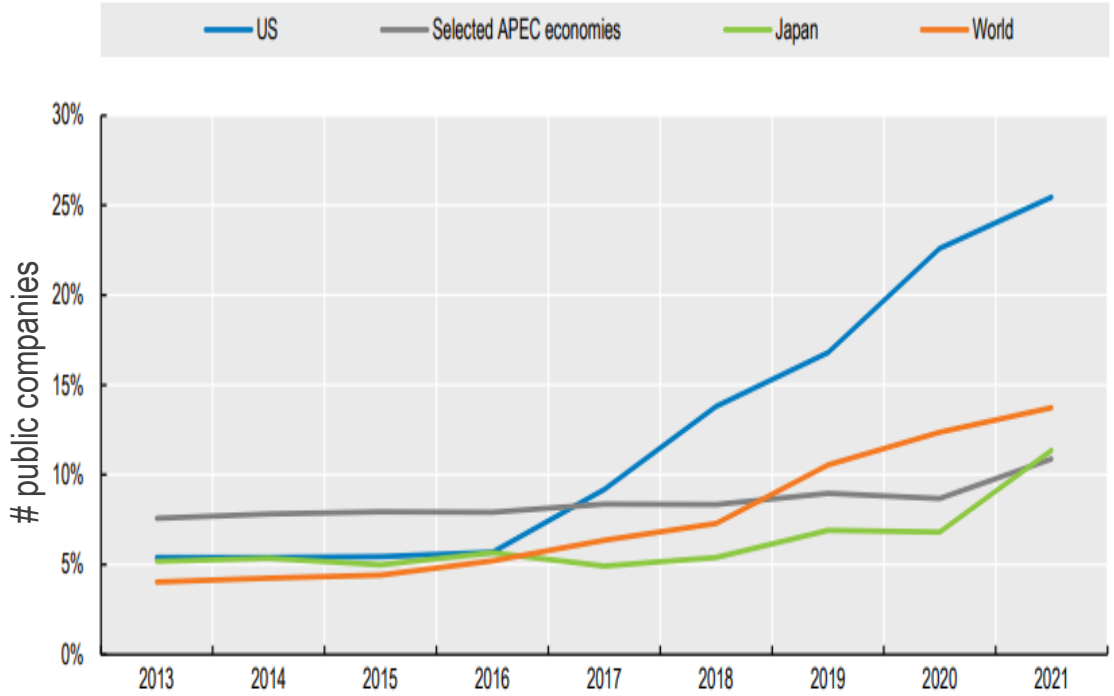
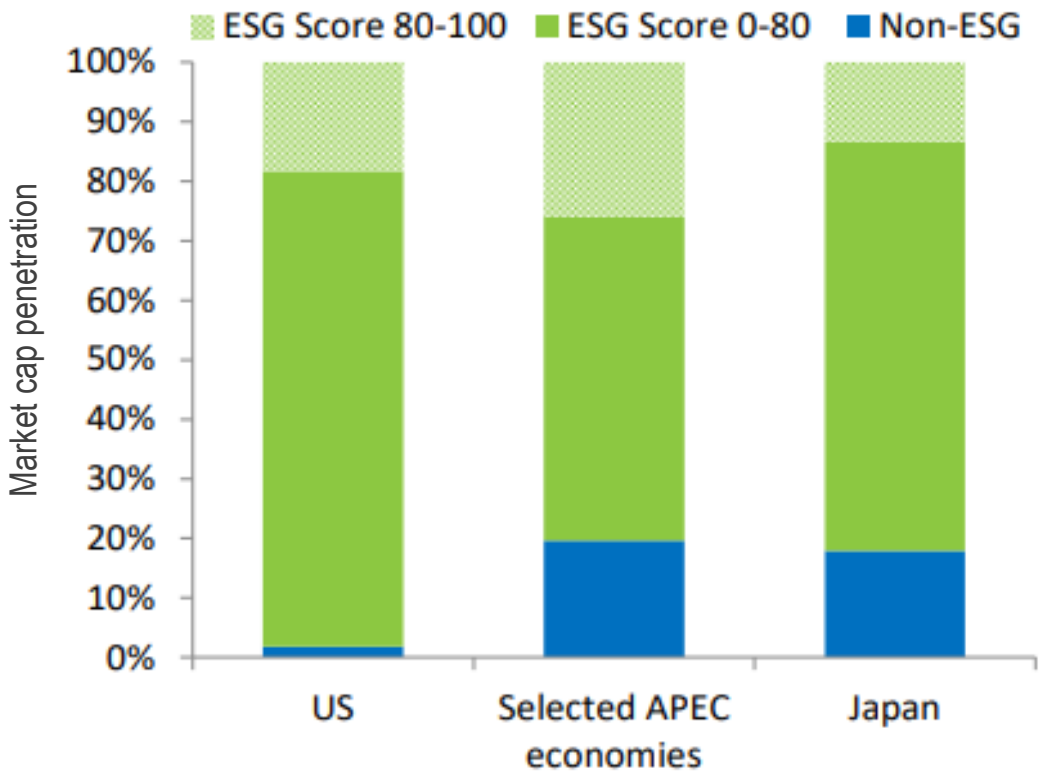
The rise of ESG forms of sustainable finance

- ESG ratings and investing are being mainstreamed across major markets, by number of companies and even more by market capitalisation. ESG used by asset managers with $**40+ trillion AUM**.
- Companies with large market capitalisation are much more likely to have ESG scores by a major rater.

Growth of ESG ratings coverage (entity count)



Growth of ESG ratings coverage, (by market cap)

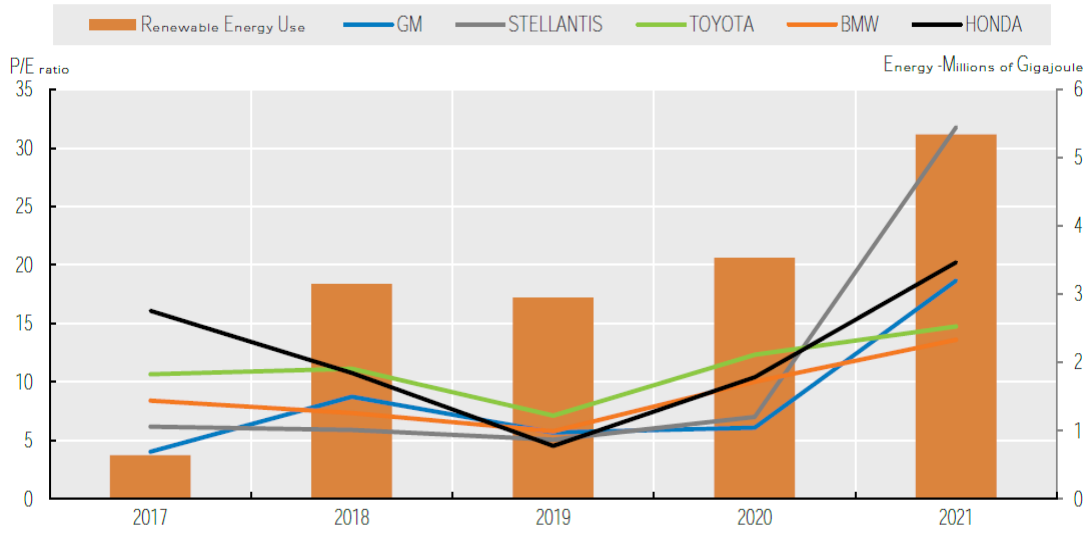


Source: Refinitiv, OECD calculations. (LHS) Calculated as the number of public companies with an ESG score over the total number of public companies, in each year. (RHS) Market capitalisation calculated as of 01/01/2021. The Selected APEC economies include: Australia, Indonesia, Malaysia, New Zealand, Singapore, Republic of Korea and Thailand.

Signs that markets are starting to consider the transition, among other factors

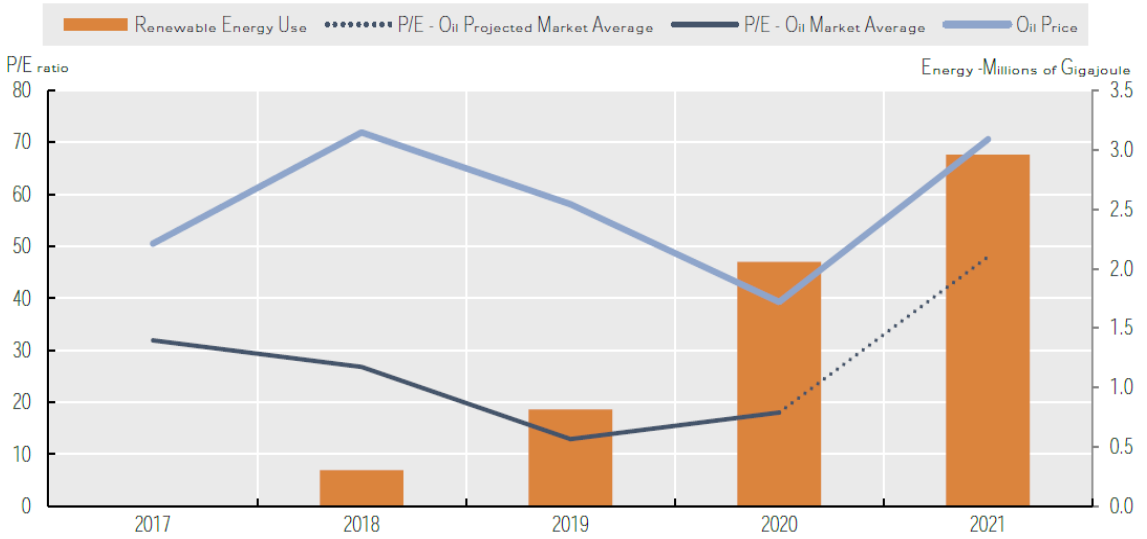
- Academic and industry analysis offers signs that aspects of climate transition – both stranded assets and climate opportunities – are being priced into the markets, and affect credit fundamentals.
- OECD trend assessment found lower WACC as firms make progress with climate transition.
- As per charts below, P/Es and renewables use increased sharply in 2021, yet is there causation?

Auto companies' P/E, and renewables use



Note: Trailing P/E ratio against Renewable Energy Use Average for selected companies in the Auto industry. The Renewable Energy Use Average is calculated on a sample of ten companies based on market capitalization: AUDI, DAIMLER, GM, STELLANTIS, TOYOTA, BMW, VOLKSWAGEN, TESLA, FORD, HONDA.
Source: Refinitiv, OECD calculations

Oil companies' P/E, renewables use, and oil price

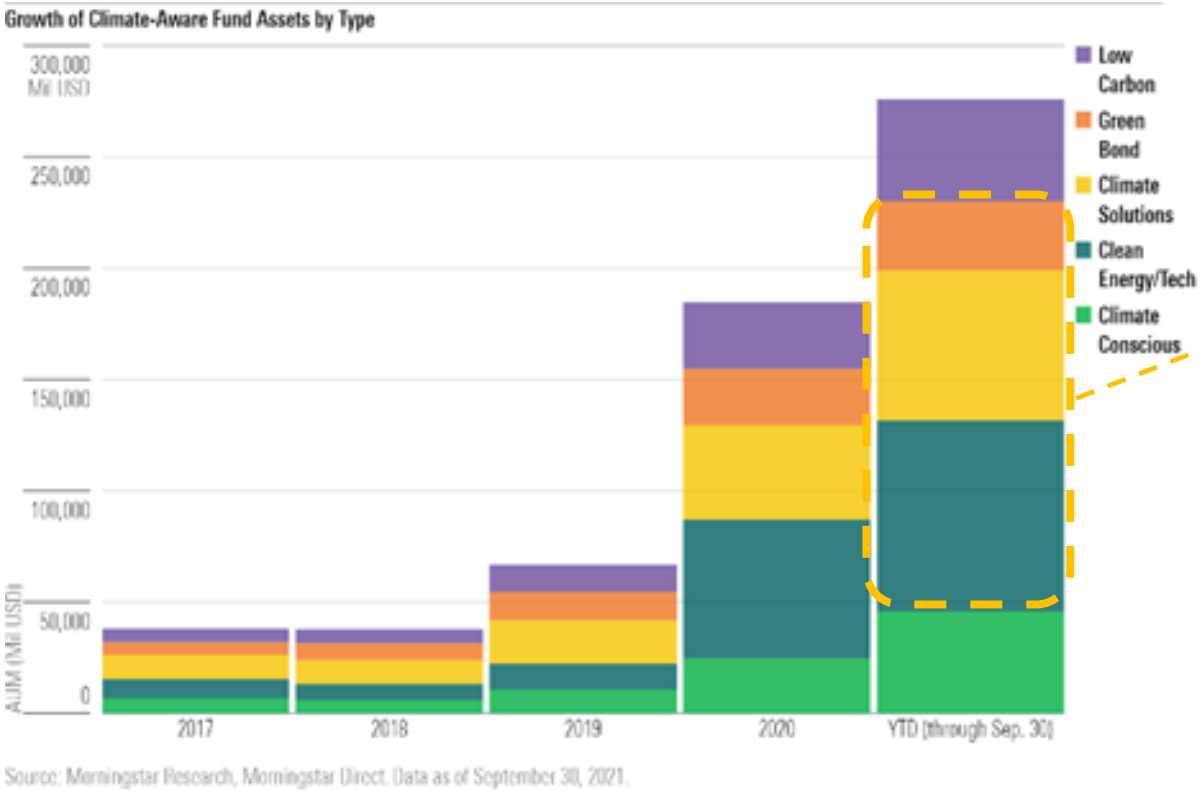


Note: P/E ratio Average against Renewable Energy Use Average of a sample based on market capitalisation of ten selected companies in the Oil and Gas industry: TOTAL, SHELL, ENI, EQUINOR, BP, MARATHON PETROLEUM, PHILIPPS 66, EXXON MOBIL, NESTE, CHEVRON. The P/E Projected Market Average is calculated for the firms in the sample for which data are available in 2021. Oil price: Crude Oil-WTI Spot Cushing USD/BBL
Source: Refinitiv, OECD calculations

Carbon intensity of “climate aware” funds vary greatly

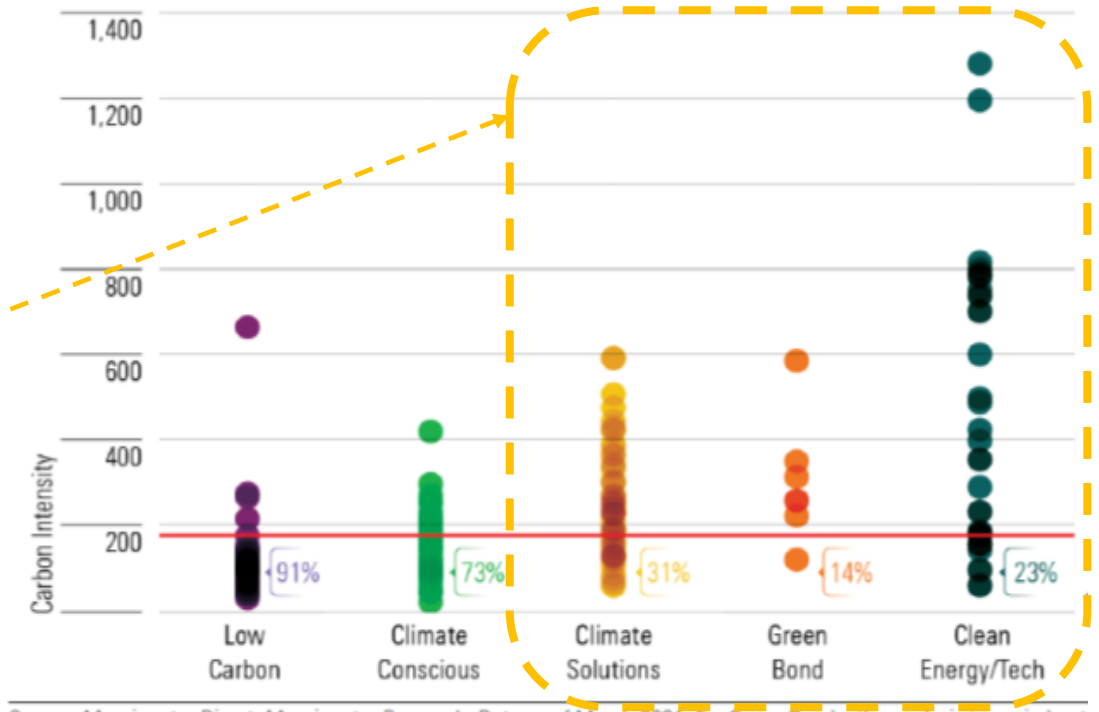
- Sharp growth of “climate aware” funds, which have risen x5 since 2018.
- Yet, some investment styles – climate solutions, green bonds, and clean energy, have *much more carbon intensity* than typical funds. Are investors aware, and monitoring?

Growth of “Climate Aware” Funds (assets by type)



Source: Morningstar Research, Morningstar Direct. Data as of September 30, 2021.

Carbon Intensity by Type of Climate Aware Funds



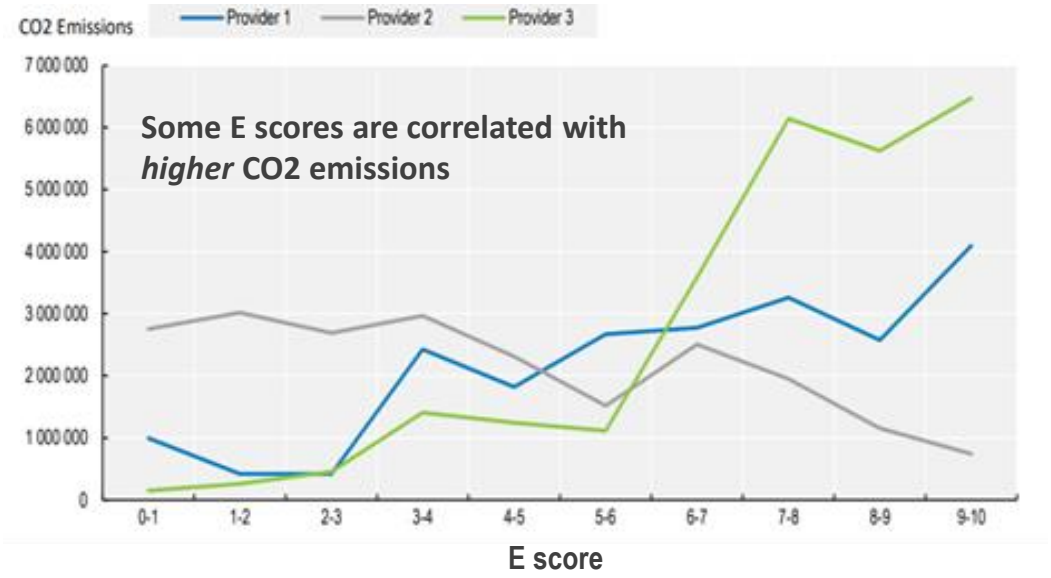
Source: Morningstar Direct. Morningstar Research. Data as of March 2021. For Green Bonds, the analysis is carried out

% = percentage of funds by AUM that are below the Morningstar Global Target Market Exposure

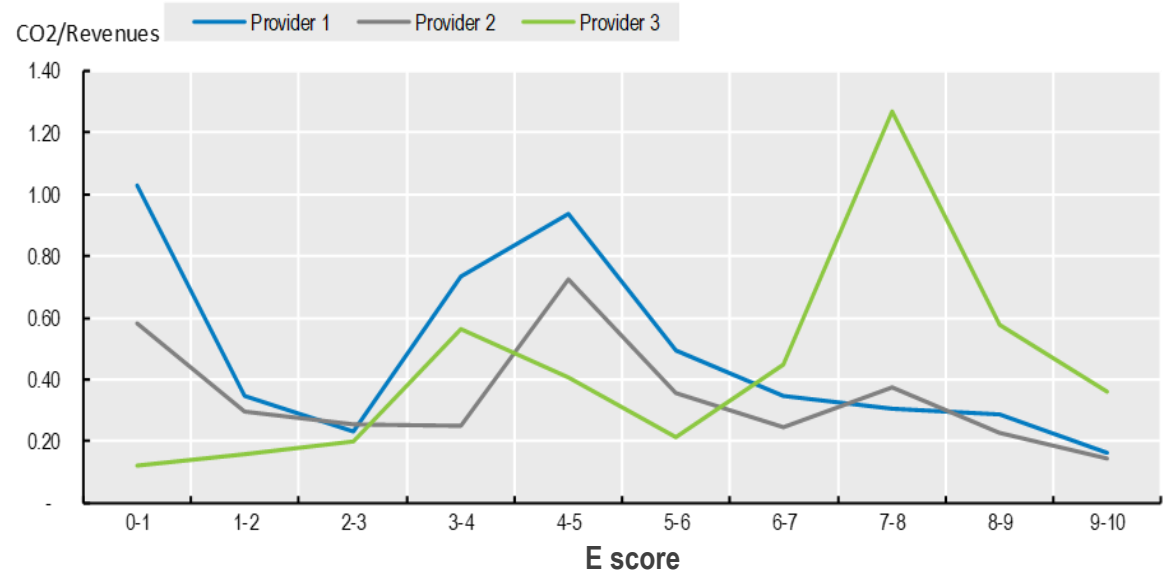
Climate transition metrics and products need greater alignment

- E pillar metrics *do not consistently align* with carbon emissions or carbon intensity, and some ESG ratings providers give relatively high scores to companies with high emissions and/or high carbon intensity
  - Evidence suggests some ESG providers reward large companies that are high emitters, simply for act of disclosure rather than meaningful data.
  - Evidence suggests that companies can be rewarded for future plans.

CO2 Emissions by E pillar score



Carbon Intensity (CO2/Revenues) by E pillar score

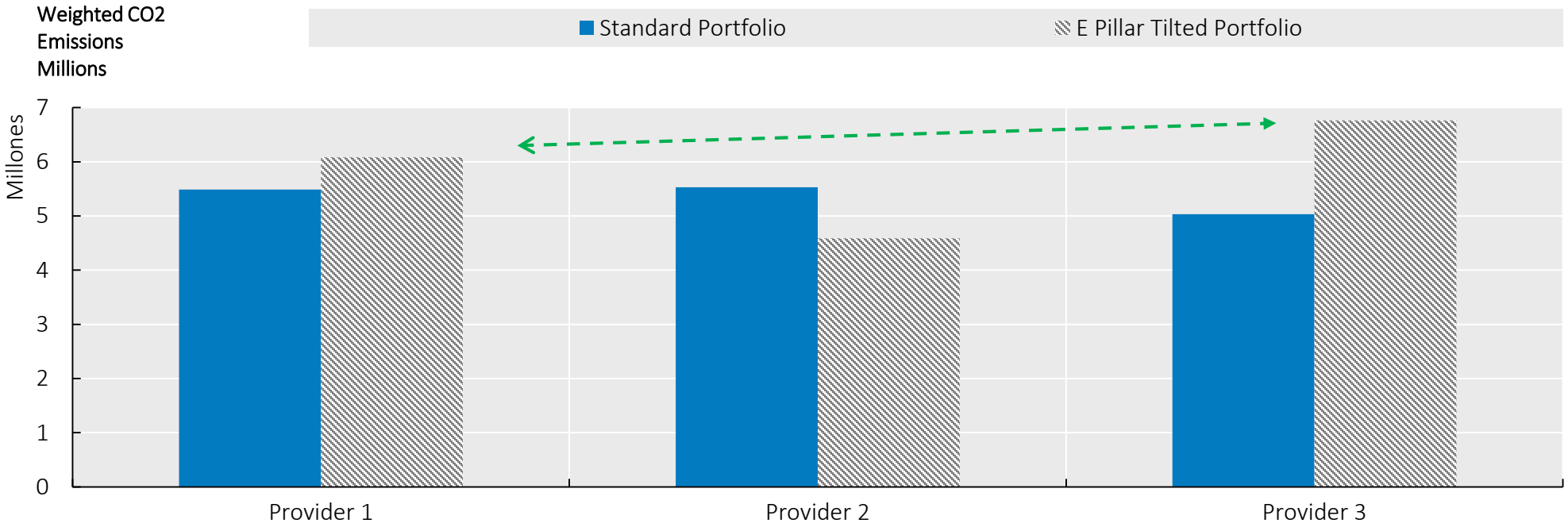


Note: Data from three leading rating providers (Bloomberg, MSCI, Refinitiv) with OECD Staff calculations. For full methodology, refer to source.
Source: Boffo, Marshall and Patalano (2020), ESG Investing: Environmental Pillar Scoring and Reporting, OECD Paris

“E” tilted portfolios can have higher emissions than market portfolios

- By using the scores of prominent ratings providers, development of Environmental score-tilted portfolios *do not show reduction in portfolio’s carbon emissions; two of the three portfolios shows an increase.*
- This raises questions over use of ESG to align portfolios with low-carbon investments.

CO2 Emission by stylized portfolios, tilted by E pillar scores for three providers

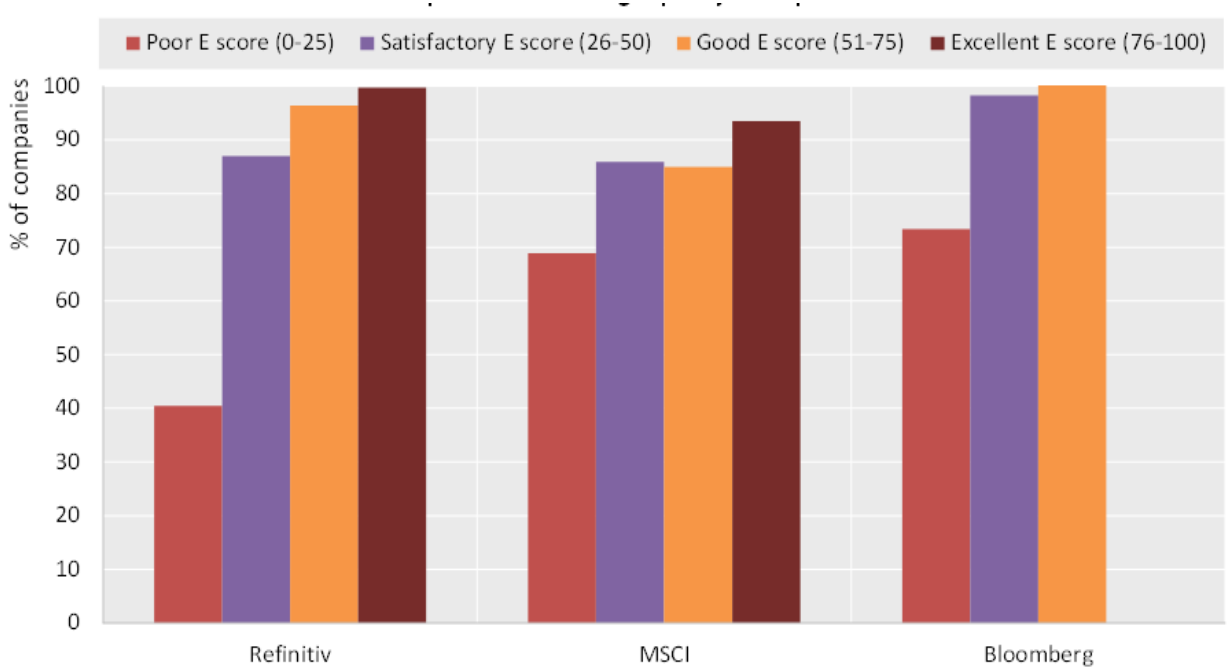


Source: Bloomberg, MSCI, Refinitiv, OECD calculations

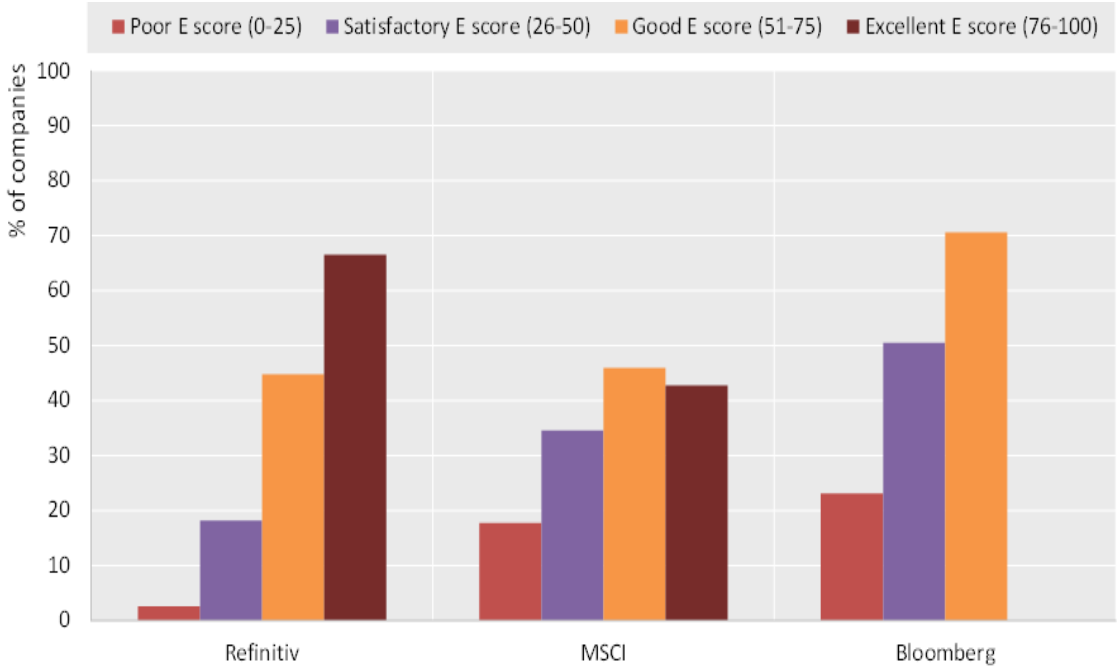
Climate transition – growing use and relevance of reporting

- Rising use of climate transition reporting across industries to communicate awareness, strategy and targets.
  - Charts below show disclosure of *policies to improve emissions reduction*, *and objectives to improve energy efficiency* are more likely to be associated with higher Environmental pillar scores of ESG.
  - Disclosure of transition strategy and climate risk management, are associated with higher E scores.

Shares of companies disclosing policy to improve *emissions reduction*



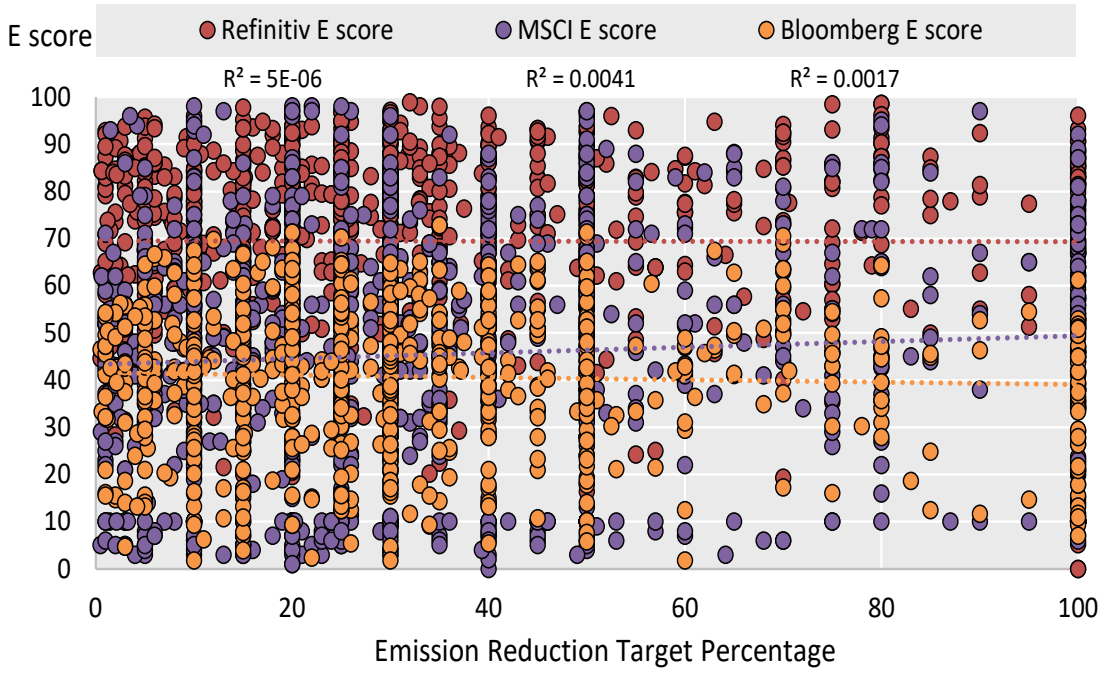
Share of companies disclosing objectives on *energy efficiency*



Amid increasingly reporting emissions reduction targets, is reduction of carbon intensity rewarded?

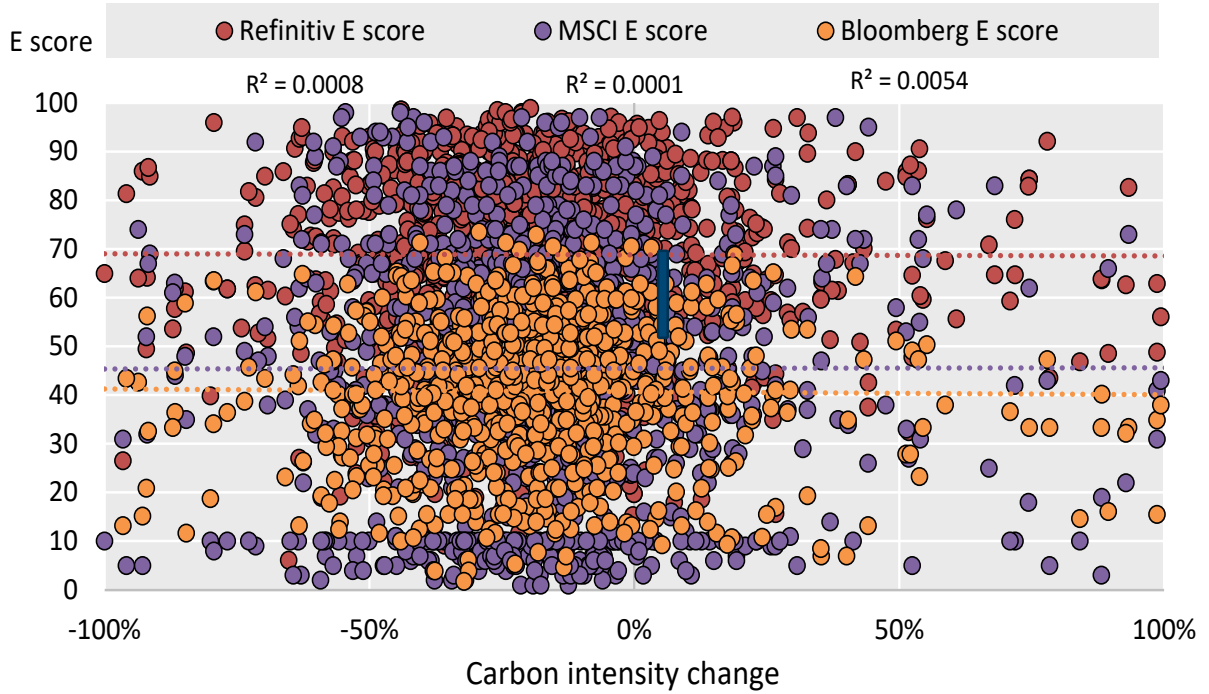
- The growing disclosure of ***emissions reduction targets***, and the actual ***reduction of carbon intensity*** over the past 3 years, does not appear to affect the E pillar score of ESG.
- This raises questions as to the extent to which investors are willing to reward firms that are advancing against their targets.

Companies setting emission reduction targets do not consistently receive higher "E" pillar scores



Note: Percentage of emission reduction target set by the company as reported by Refinitiv.

The reduction of carbon intensity does not align with high "E" pillar scores

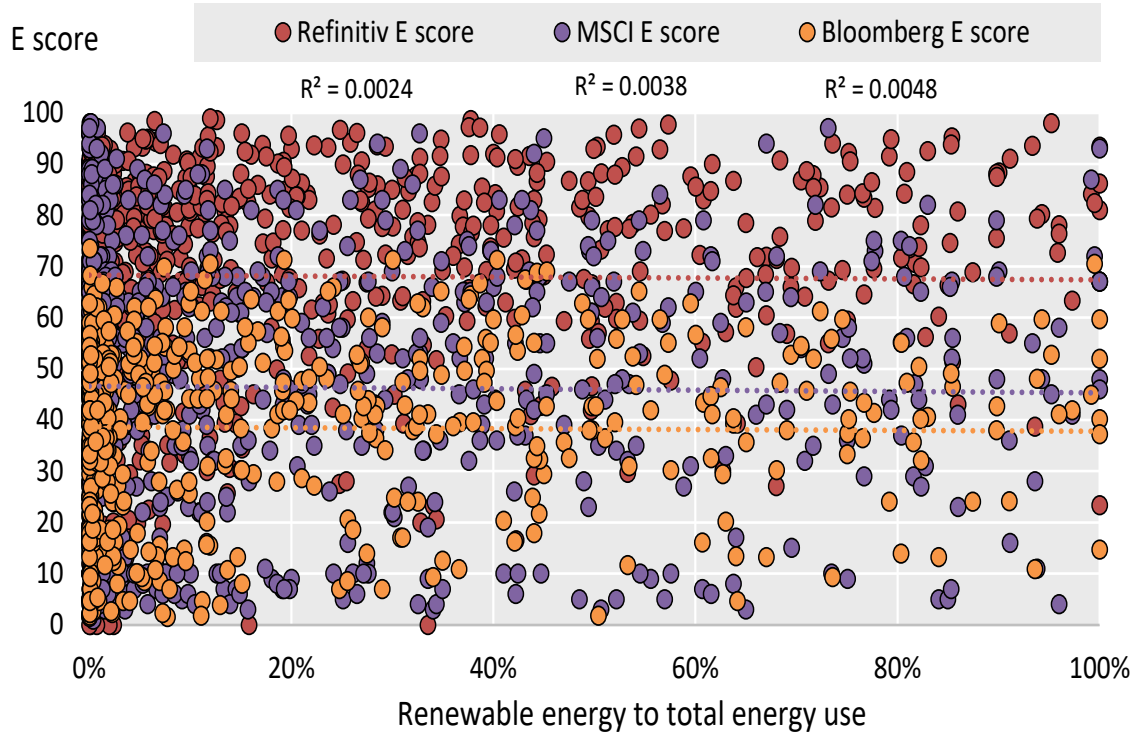


Note: Carbon intensity measured as total CO2 and CO2 equivalents emission in tonnes divided by net sales or revenue in US dollars in million.

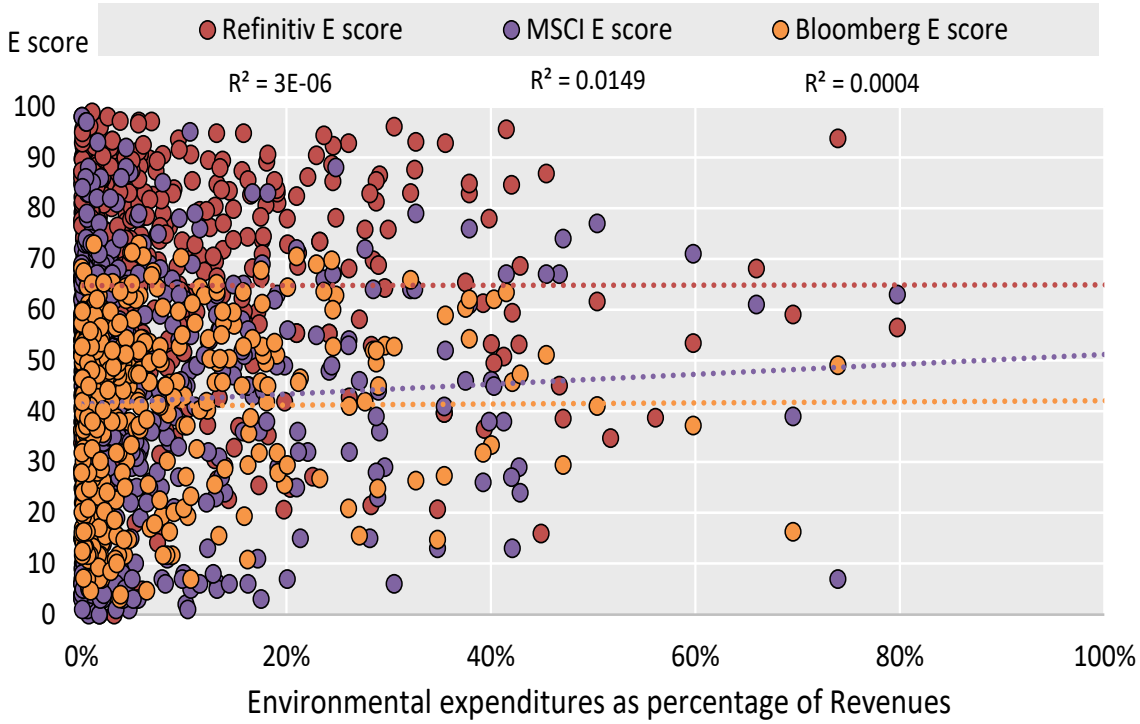
Should investors reward higher use of renewables or environmental expenditures?

- Companies' climate transition strategies include environmental expenditures, environmental R&D, and renewable energy use as % of total energy, which signals the strategy to transition.
- Yet, there is currently no material relationship between the E pillar score and either higher use of renewable energy or environmental expenditures (See low correlation on charts below).

Higher use of *renewable energy* (% of total energy used) does not imply higher "E" pillar scores



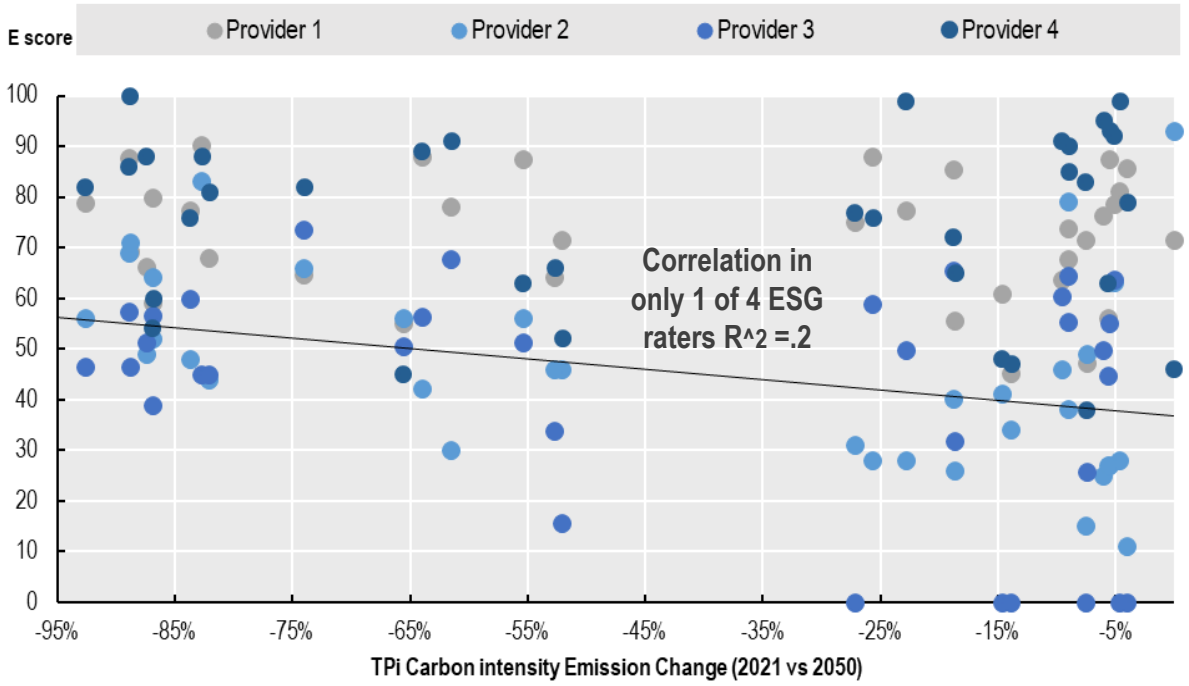
Higher *environmental expenditures* (% of revenues) do not align with higher "E" pillar scores



Climate Frameworks and alignment with Climate Transition

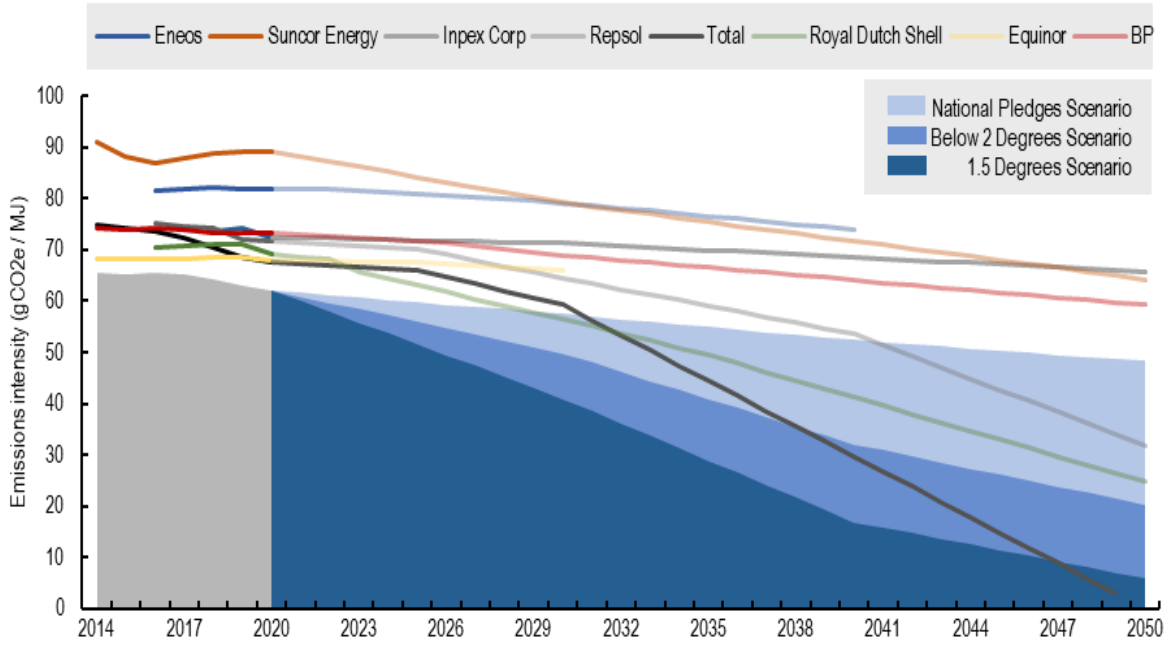
- Environmental Pillar scores of major ESG raters (left chart) are generally *not even correlated with forward looking ambitious declines in carbon intensity* of companies with transition plans as per Transition Pathway Initiative (TPI).
- A number of Energy firms that receive the highest E scores and TPI management scores (right chart) have yet to target significant carbon intensity reductions.

E-score vs TPI carbon intensity emissions change 2021 to 2050



Source: TPi, Refinitiv, Bloomberg, OECD calculations

TPI carbon performances forecasts for firms with an Excellent E score and a TPI Level 4 Management Score



Source: TPi, Refinitiv, Bloomberg, OECD calculations

Recommendations

- Actions are needed by financial authorities and market participants to ensure that market practices are strengthened to better align with sustainability goals.

ESG & E Pillar

- Ensure **global consistency, comparability and quality of core ESG metrics** through alignment with long-term enterprise value, including material environmental and social factors.
- Promote **transparency and comparability of scoring methodologies** for established ESG ratings based on internationally recognised standards.
- Improve relevance and precision of E score metrics through **stand-alone submetrics for climate transition risk and opportunities**.

Markets & Climate Transition

- Greater use of granular forward-looking **climate transition disclosure metrics** in ESG approaches to improve consistency, reliability and alignment with low-carbon transitions.
- Greater commitment to the use of **science-based targets,** annual progress updates, and **third party verification** to ensure integrity.
- Improve transparency and clarity of institutional investors' **stewardship plans** to incentivise commitment to net-zero pathways.

Policy considerations – central banks and financial market participants

Central Banks

- **Vital to understand** the different tools and their strengths and weaknesses.
- Using tools in isolation/combination **to determine climate transition risks and opportunities**.
- Use **tools to assess market surveillance and financial stability** in terms of transition risks.
- **Caution on use of E of ESG for reserves management** unless goal is risk adjusted returns without "climate transition" goals.

Financial Markets

- **Mandatory climate reporting** in alignment with TCFD and IFRS ISSB global baseline standards.
- **Net zero science based targets, interim (eg 2030) targets, and short-term (e.g. annual) progress against pathway** to achieve targets.
- Better clarify a **subcategory of E of ESG that clearly defines a climate transition score**.
- **Third party verification** of net-zero target and performance.
- Active and transparent **engagement plans** and consequences.