HOW THE NEW GEOPOLITICAL REALITY AFFECTS ESG

The war in Ukraine has enormous implications for sustainability goals, writes Marcus Pratsch, head of sustainable bonds and finance, DZ BANK AG.

THE war in Ukraine has a massive impact on all four dimensions of ESG: economic, environmental, social and governance. It has already cost the lives of thousands of civilians and displaced millions of people from their homes. Health, education and housing systems are facing a new test of endurance. Rising commodity prices and trade disruptions are exacerbating inflationary pressures. Higher food prices could push millions of people, especially in the poorest and most vulnerable countries, further into poverty.

Given the ‘weaponisation of gas’, the war is also a wake-up call to expedite the global transition to a more secure and cleaner energy future. It makes clear that a successful development agenda requires inclusive partnerships at global, regional, national and local levels.

The past has taught us that negative external shocks widen the sustainability financing gap, making it even more important to mobilise private capital and allocate it through the capital market to sustainable projects with positive impact. Even before the Russian invasion, the world was not on track to achieve most of the United Nations’ sustainable development goals. Unfortunately, many targets will be set back by the new geopolitical situation, so even more capital will be required in the future.

The war is increasingly becoming a test for the socially responsible investment movement. It will inevitably lead to a reassessment of ESG investment approaches and sustainable portfolios as it not only reveals Europe’s high energy dependence on Russia and how vulnerable the global food system is, but also reveals Europe’s high energy dependence on Russia as concern becomes a source of systemic risk. The last few weeks have shown that more and more SRI investors are now excluding Russian companies as well as issuers with significant ties to Russia.

There is no question that the disruption of global energy markets has caused SRI investors to rethink energy strategies. Does the pace of fossil fuel phase-out need to be adjusted until renewables, hydrogen and storage technologies can fill the gap reliably and affordably? Will nuclear energy and natural gas gain importance as bridging technologies? Without a doubt, this new thinking should focus on renewable energy sources, energy infrastructure and sustainable technologies to support the transition away from traditional energy sources.

Finally, the war in Ukraine has also brought a controversy on ESG discussion back onto the front pages. How should the issue of security and defence be interpreted in a sustainability context? Is defence ESG-compliant? Is ‘Security the mother of all sustainability’ as the Federation of the German Security and Defence Industries argue? How should SDG 16 (peace, justice and strong institutions) be interpreted in this context? A large pension fund has already surprisingly changed its investment policy to include even certain defence companies in selected ESG funds.

Although the conflict has revealed some flaws in ESG investing and shifted priorities, it is too early to say if it will lead to a total rethi

1. MORE CENTRAL BANKS THAN EVER IMPLEMENTING ESG CRITERIA

In which of the following ways do you implement ESG? Select all that apply. Share of respondents, %

1. More central banks are now considering investment in ESG assets, rather than a decline in available data. One respondent noted, ‘We gradually increase investment in green and sustainable bonds (sovereign and corporate), but this market is still immature. Classification criteria are not transparent enough and controversial in some cases.’

Two further trends have emerged on barriers to ESG implementation. First, the share of respondents reporting that ESG does not fit with their fund investment strategy has fallen from 31% in 2018 to 24% in 2020. At the same time, the share of respondents reporting lack of suitable projects as a main barrier to adoption and/or further implementation of ESG has risen steadily over the past few years, increasing to 17% in 2018 and 20% in 2021, suggesting that demand for ESG assets is outpacing supply. Respondents’ comments reflect this, with one stating, ‘Green bonds issued by highly-rated sovereigns are very limited and we cannot invest into corporate bonds or equities in reserve portfolios according to our guidelines.’ This lack of suitable asset class supply suggests significant potential for social bonds as an ESG asset.

Taking together, these figures point towards the growing acceptance and importance of ESG considerations for reserves management, as more institutions develop ESG frameworks and strategies. Despite these challenges, central banks intend to increase allocation to green bonds and 42% intend to increase allocation to other sustainable bonds. In fact, net increases in central banks’ ESG asset allocation are anticipated across all categories over the next two years (Figure 3). As sustainability increases in global urgency, these trends in central banks’ asset allocation are likely to continue over the medium to long term.

Of central banks investing in sustainable assets, 98% invest in green bonds with ‘other’ sustainable bonds the next most popular sustainable asset class at 41% (Figure 4). Sustainable bonds, which include social bonds, were by far the biggest gainer since last year – up a sizeable 33 percentage points – outpacing investment in green equities, sustainable mutual funds and sustainable ETFs. The appetite for social bonds is confirmed by the

“Unfortunately, many targets will be set back by the new geopolitical situation, so even more capital will be required in the future.”

SPONSOR’S COMMENT

THE GROWING IMPORTANCE OF ESG CONSIDERATIONS HAS COINCIDED WITH A PARTICULARLY CHALLENGING MACRO ENVIRONMENT AND A NEW GEOPOLITICAL LANDSCAPE. THIS MEANS THAT ESG OBJECTIVES MAY TAKE A BACKSEAT TO MORE ACUTE PRESSURES OVER THE SHORT TERM.