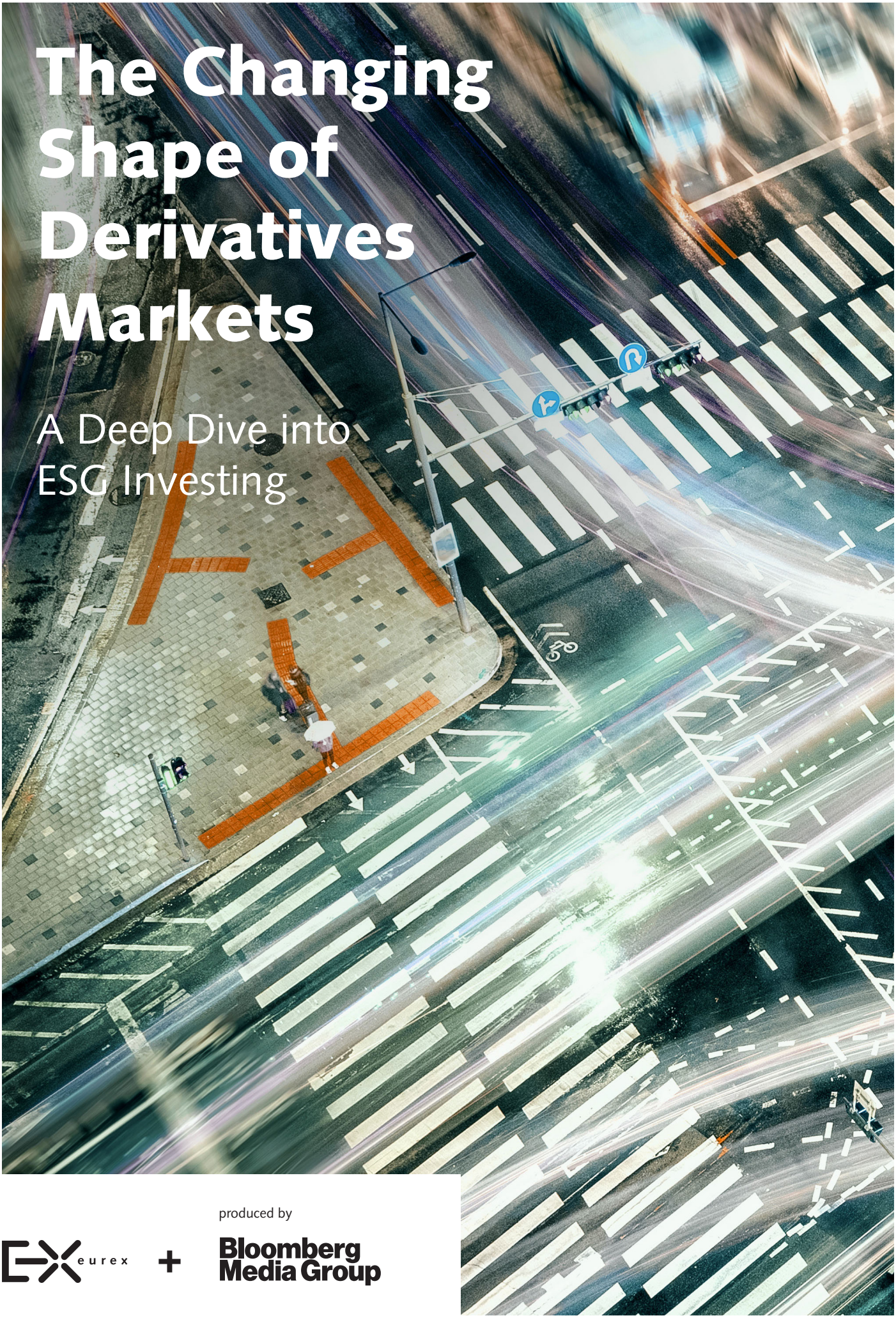
The Changing Shape of Derivatives Markets

A Deep Dive into ESG Investing



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A deep dive into ESG investing

The rising appetite for environmental, social and governance (ESG) and sustainable investment strategies is showing no signs of abating.

Contributing factors include the high social consciousness of the millennial and Gen Z generations (those born in or after 1981)[1], the global financial crisis—which has put governance front and center to forge greater stability of the financial system—and the digital revolution.

As investor demand increases, regulation serves as a moderating force to raise the bar of asset owners, managers and those carrying out due diligence. According to MSCI, roughly 175 pieces of ESG regulation were issued in 2018, compared with just one regulation issued in 2000. However, the index provider estimates that as much as $32.6 trillion in assets under management (AUM) could be subject to pending regulations.

While the equities market in ESG is fairly well established and growing, the fixed income space has been slower to develop. Bondholders not having voting rights negates some degree of vested interest, and many bond issuers are not publicly listed, which makes scoring credit companies from an ESG perspective more complicated.

As companies and countries are being forced to raise their ESG game, the addition of listed ESG derivatives is yet another tool for investors seeking access.

NASDAQ's launch last year of its trio of exchange-listed and ESG-compliant index futures, pegged to the Stockholm, Copenhagen and Helsinki exchanges, was swiftly followed by Eurex's entry to the market this year with its ESG exclusion-based, low-carbon and climate impact-focused futures and exclusion-based options. With CME launching an S&P 500 ESG future in November, the trajectory is clear.

[ESG Derivatives] should enable us to manage the granularity of our client risk exposure more precisely while reducing trading costs."

OLIVIER RUDEZ
HEAD, FLEXIBLE AND ABSOLUTE RETURN PARIS,
BNP PARIBAS ASSET MANAGEMENT

As of September 2019, Eurex had already seen 362,774 contracts exchanged across its three futures, with open interest reaching €590 million.

"Normally, the initial entry into an ESG future happens at the roll period. What we hope is that on each successive roll, as the market gets more comfortable with the product, the open interest grows," says Zubin Ramdarshan, Head of Equity and Index Product Design at Eurex.

He sees demand coming from three main sectors, including portfolio managers looking to improve the efficiencies of managing inflows and outflows in order to remain fully invested without compromising their ESG exposure.

71% The number of institutional investors hoping to manage all their portfolios according to ESG principles by 2030.

Source: Allianz Global Investors, 2019

Olivier Rudez, Head, Flexible and Absolute Return Paris at BNP Paribas Asset Management, Multi-Asset and Quantitative Solutions, says having access to the wider toolkit complements his firm's own ESG, helping to reduce cash securities turnover or, for instance, tactically reducing equity market exposure, with the remaining invested for the long term.

"It should enable us to manage the granularity of our client risk exposure more precisely while reducing trading costs," he says.

The second area of demand for listed futures is expected to be from ETF market makers. Facilitating higher client inflows into related ESG-focused ETFs wil allow for better pricing of block trades and help recycle risk, increasing market activity.

Thirdly, there will be increased interest from the structured products sector. "Issuers are always looking to innovate in terms of index underlying, given the heavy focus on private banks and high-net-worth individuals in the structured products market, and they definitely see a lot of growth for structured products linked to ESG indices," says Ramdarshan.

Ramdarshan explains that for those banks issuing structured products, having listed derivative instruments that enable them to recycle risk is crucial for maintaining capacity to keep issuing new products.

"If they end up stuck in risk, and hitting their risk limits, they can't issue. By having both the futures and also the respective options on the STOXX® Europe 600 ESG-X, we open up the ability for structured product

issuers to hedge their risk books more accurately, therefore growing their assets in ESG strategies," he says.

On the buy side, clients tend to favor ESG for three main reasons: They think meeting such criteria will lead to long-term investment returns; they believe it will have a positive impact on their brand and reputation; or it will mitigate investment risk, according to BNP Paribas.

Lisa Beauvilain, Head of Sustainability and ESG at Impax Asset Management, says ESG analysis is definitely set to move into the mainstream, and suggests that about 85% of the value of S&P 500 companies is intangible and that ESG analysis can help investors better understand that 85%.

"We also see demand for impact measurement increasing; people want to know the impact of their investments and will look to produce net impact analysis for their portfolios.

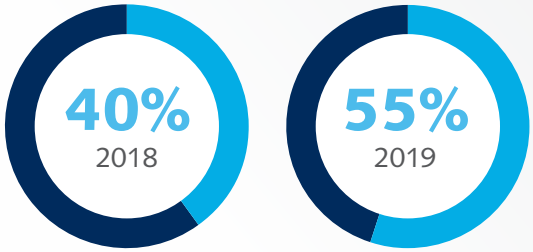
"Finally, climate risk, especially the physical climate risk and resilience of portfolios, is an area where you should expect to see greater focus," she adds.

The ESG theme is here to stay, although the pace of adoption among the broader financial industry is inconsistent. The sticking point seems to be reaching a consensus on standardized methodologies of ESG scoring, according to Eurex's Ramdarshan.

"Do I think all benchmarks will at some point incorporate ESG criteria? I can definitely see that being the future," he says. "But I think the real impact ESG can have is actually in the primary debt and equity markets.

"If you have a situation with [an energy-related company] and it literally costs them more money to raise capital in public markets [if they do not meet the ESG criteria of a benchmark], it might change behavior. And I think that is really where management starts to change strategies, when there is a real cost to the business," he says.

PENSION SCHEMES CONSIDERING ESG RISKS IN THEIR RETURNS



Source: Mercer, 2019

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LISA BEAUVILAIN
HEAD OF SUSTAINABILITY AND ESG, IMPAX ASSET MANAGEMENT

Overcoming ESG challenges

Global sustainable investment strategies have grown 34% since 2016, with total assets under management (AUM) standing at more than $30 trillion at the beginning of 2018, according to the Global Sustainable Investment Alliance.

In Europe, socially responsible investment (SRI) assets grew by 11% over that timeframe, but the segment's overall market shrank from 53% to 49% of total professionally managed money, which the Global Sustainable Investment Alliance (GSIA) says might be due to stricter standards and definitions.

Lack of standardization is often cited as a barrier to companies' engagement with the environmental, social and governance (ESG) segment, and many companies claim to not know where to begin.

In a recent study of nearly 900 boardroom executives, KPMG found that while general sentiment was positive, significant differences existed across countries and industries regarding ESG's strategic importance.

Levels of disclosure may be an issue. Of the 25,000 companies covered by Institutional Shareholder Services (ISS) ESG for their climate performance, only 3,100 submitted reports last year outlining their Scope 1 and 2 greenhouse gas emissions, for example. But indicators suggest levels of transparency are improving. Earlier this year, the International Organization of Securities Commissions (IOSCO) released a statement discussing the importance of including ESG matters when disclosing information that is material to investors' decisions.

Elsewhere, the rise of Big Data and accelerated use of artificial intelligence (AI) indicate that the market will learn to rely less on corporate disclosure and turn to alternative sources of information, which in itself casts a question over the future of the "G" element and how it is comprised.

Lack of common ground between different consensus ratings such as MSCI, ISS and Morningstar seems to result in difficulty gaining a firm grip on intelligence, and while various strategies have been around for years, many across the mainstream investor universe are still waiting on the sidelines.

According to a BNP Paribas survey in 2019, 66% of respondents cite data as the biggest barrier: issues exist around its availability, consistency and quality. Respondents say challenges remain in transforming data into meaningful insights. But as ESG activity matures, solutions to these data challenges will become more prevalent.

In less mature markets, liquidity may present a challenge, but Lisa Beauvilain, Head of Sustainability and ESG at Impax Asset Management, says more concerning is the scale of opportunities.

"Sustainable investment opportunities exist across many different asset classes with different liquidity characteristics. Perhaps a more pertinent question is one of scalability. There is no shortage of capital, but it can be difficult to find the best sustainable investment opportunities and companies."

Here, the role of market maker is essential. "Market makers provide constant liquidity, which is crucial for a robust trading ecosystem," says Rick van Leeuwen, Head of Institutional Trading at IMC Trading. "By providing constant buy and sell quotes, we can ensure that ESG investors will always have a reference market price and can always buy and sell in large or small quantities." This is especially crucial for new products, as there will not be any natural liquidity available," according to Eurex.

Beauvilain believes that while the terminology is still unsettled, the most important thing is to assess and understand the net impact of investments.

She adds: "ESG is an investment process and not an outcome. Clients are interested in ESG because they either think it leads to superior long-term returns or because they approach it from a value standpoint. ESG can be confused with intentionality, which is where greenwashing falls, because ESG does not necessarily result in a green outcome. Labeling is a response to this—for example, the Green Economy Mark launched by the London Stock Exchange in October."