ESG derivatives – From equity to fixed income and beyond

Demand for environmental, social and governance (ESG) investments has surged in recent years, creating a growing need for tools to manage ESG risk in portfolios. There are now several ESG versions of mainstream indexes and, more recently, exchanges have launched ESG derivatives, starting with equity markets and moving into fixed income.

However, ESG derivatives are at an early stage of their existence and, while liquidity has grown, the market undoubtedly faces challenges. “Building liquidity on these products is still a work in progress,” said Isabelle Millat, head of sustainable investment solutions, global markets division, at Societe Generale.

Andre Bertolotti, head of sustainable portfolio strategies at BlackRock Multi-Asset Group, called it “early days” for the supply of ESG derivatives. “There are a lot of people looking and talking about it, but when you look at the actual volumes and application of these indexes and futures, it’s not yet developed.”

All panellists stressed that ESG means an array of different things to different people, and this lack of standardisation is challenging and hinders the creation of liquid benchmarks and derivatives. “To build liquidity, there needs to be standardisation and agreement that the underlying index provides a proxy for the risk the market wants to trade,” said Megan Morgan, global head of equity and index sales at Eurex. “This is the challenge that comes with ESG. There are myriad different approaches to what goes into an ESG portfolio, how to construct that portfolio and what data to use.”

Subjectivity
The subjectiveness of ESG affects even the most straightforward exclusions, noted Bertolotti. “There is not full agreement, even between the ESG providers, as to what is, for example, a UN Global Compact violator,” he said. While there are some exclusions that most investors agree on — such as thermal, coal and tar sands — there are opposing views on holding nuclear in a portfolio, for example, he noted.

Positive screening and the opportunities of the green transition bring in further subjectivity, he added. “There is no clear consensus on what a perfect ESG futures index can do to cover all of these different client demands.” As a result, investors have to decide whether the ESG index provides enough alignment with their sustainability goals to warrant a shift away from the core index, he said.

An exchange’s dilemma is that of aligning with each individual sustainable principle, which would allow customised products but would sacrifice liquidity, said Morgan. Therefore, for its first offerings, Eurex looked for common agreement found in basic exclusions, launching its exclusion index, the Stoxx 600 ESG-X, in 2019.

THE PANEL

Moderated by Stella Farrington, Head of Content, Risk.net
Megan Morgan, Global Head of Equity and Index Sales, Eurex
Davide Masi, Fixed Income Derivatives Product Research and Development, Eurex
Andre Bertolotti, Head of Sustainable Portfolio Strategies, BlackRock
Isabelle Millat, Head of Sustainable Investment Solutions, Global Markets Division, Societe Generale

In February 2020, in an effort to reach other regions and have a global ESG offering, Eurex partnered with MSCI to launch screened indexes on MSCI EM, Europe, EAFE, World, Japan and USA. “That was really our effort to start building liquidity from where there was standardisation,” Morgan said.

In November 2020, the exchange moved into phase two of its ESG road map, building indexes that not only screen out companies, but also have positive screening methodologies and a high overall ESG quality. So far, the Euro Stoxx 50 and Dax ESG have been launched using integration and positive screening methodologies.

Millat noted that clients are increasingly looking how to seize the ESG opportunity through positive screening. “The exchange is also exploring breaking down the E, S and G into components where there is standardisation, Morgan said. “One great example of this is climate ... where we’re seeing standardisation around the rules of sustainability.” It is partnering with Qontigo to launch a Paris-aligned benchmark index and derivatives, she said.

Eurex now has around €3 billion of notional open interest in its ESG products, Morgan said, but noted that €2.5 billion of that is in Stoxx ESG-X, and €250 million is in MSCI emerging markets screened indexes.

“So the market is clearly telling us they’re favouring low-cost execution and liquidity,” she said.

As a result, Eurex’s listing strategy for creating benchmarks is “an ever-evolving target”, which identifies where assets are accumulating in the underlying market and lists products accordingly.

Although the Stoxx ESG-X market is liquid, Eurex is not patting itself on the back just yet, Morgan said. “The desire to trade ESG derivatives is not translating into trading ESG derivatives. We have a long way to go, and that is because there are asset managers out there waiting for benchmarks that align with their sustainable goals,” she said.

Bertolotti added that, while asset managers think deeply about which
companies are held in an ESG portfolio, they think less about what sorts of futures to use when equitising the cash. Even though ESG futures are likely to address ESG exposure more efficiently than mainstream futures, investors can be reluctant to switch from them, he said. Concerns include a lack of liquidity, a tracking error between the index and its ESG version, a lack of standardisation around ESG principles, as well as regional differences, and cost.

Bertolotti acknowledged that ESG derivatives volumes are “fairly thin — certainly compared to their core benchmarks”, but stressed that “conceptually, the liquidity behind these particular indexes is quite deep”.

Millat agreed: “When assessing the liquidity on a listed ESG derivative, like a future, we should keep in mind that most traders hedge at the close. Therefore, the so-called liquidity in the future is really that of the index,” she said.

She noted that investors’ reactions to ESG derivatives can vary according to the type of client. “With retail distribution networks or small institutional investors, there tends to be growing consensus around flagship ESG products, but large asset owners usually have their in-house ESG policies and varying views on, for example, exclusions.”

This is why the index team at Societe Generale “creates bespoke indexes that embed the client’s own ESG filters and that can actually vary over time”, she said. However, she added that the bank is also “receiving more and more requests these days to quote on benchmark ESG indexes too”.

**Transparency, data and cost**

Another challenge for ESG products is getting reliable ESG data at a price that won’t hinder the product’s cost-efficiency, Millat noted. “Regulation might help if it fosters robust ESG reporting by companies and greater transparency on ESG ratings.”

Investors are relying more on individual data points of ESG, instead of the aggregate ratings, she added. “A popular [environmental] data point is [still] climate. On that front, things are changing rapidly, though.” While some investors might want to align on the pathways that will reduce global warming, others might be more focused on the circular economy principles or wanting to align with the opportunities brought about by the European Green Deal, she said.

**Fixed income ESG**

Historically, the fixed income space has lagged equities in terms of ESG, largely due to a larger universe of securities, a lack of ESG data on non-listed firms and the inability of bondholders to influence company policy, said Davide Masi, fixed income derivatives product research and development at Eurex.

However, there is now more transparency in the fixed income space when it comes to ESG principles and strategy, he said. Additionally, larger asset managers and owners have strong corporate engagement teams that have a voice with issuers’ management teams, and can help steer ESG policies and strategies.

The European Union’s Next Generation €750 billion bond issuance — of which 30% is allocated to green investments — will also have a huge impact on bond markets, Masi said. “This is going to revolutionise the financial markets in Europe.”

This will create a need for financial tools in the fixed income space that can help with implementation of ESG strategies, he said. He noted cash and bond securities can be illiquid in the secondary market, especially if they are ESG-compliant. “The supply, of course, is limited, which means asset managers and portfolio managers may not be able to implement effectively and efficiently their strategy.”

Therefore, ESG fixed-income derivatives may be a solution, both for equitising a portfolio or for optimising ESG strategies, he said. Millat said that in the fixed income space Societe Generale is “exploring new frontiers” with corporate clients. “For them we structure rates or foreign exchange-hedging derivatives whose conditions depend on the achievement of sustainability targets. The corporates define [these] jointly with the bank’s ESG experts.”

**Greenwashing and sustainability**

Bertolotti said he sees increased regulation, such as the EU Taxonomy, and scrutiny from ratings agencies helping to lower the risk of greenwashing associated with ESG investing. “Also, there’s greater scrutiny [and transparency] of ESG from investors, so they can understand what exactly managers are doing and calling ESG.”

When it comes to sustainability, Masi noted that derivatives can only support in an indirect way. Listed derivatives are tools to help buy-side clients implement their strategies and manage benchmark exposure and cashflows in a portfolio, he said. He points to sustainability improvement derivatives in the over-the-counter market that are able to drive and improve sustainability outcomes.

Millat believes the actions of ESG investors can influence the market and support sustainability outcomes, considering the growing number of ESG investors driven by the financial materiality of ESG and building sustainable, long-term risk return. “Through derivatives, as with other solutions, we are driving liquidity to [those] companies that best suit investors’ ESG strategies,” she said.

Bertolotti called for more measures of outcomes in terms of impact as well as in terms of risk and return. He noted the Global Impact Alliance and other bodies are developing such metrics.

**Future outlook**

Looking to the future, Bertolotti said he expects increasing guidelines from asset owners and investors to asset managers on what their ESG ambitions are, as well as clearer regulatory frameworks. “Index providers will be at the leading edge,” he said. There will be a need for a complete portfolio solution across all asset classes, he added. “This bodes well for the adoption of ESG futures.”

Millat agreed that initiatives such as the European Green Deal and the green agenda in the US will play a huge role in shaping thematic ESG investments, as will China’s plan to become carbon neutral by 2060. “There are real ambitions in the real world. Our job, as financial players, is to innovate, alongside corporations and investors, to make sure we channel capital to these real economy developments,” she said.

Morgan said the strong financial performance of ESG investing is the reason it is moving from niche to mainstream. “It’s up to us as index [and derivatives] providers to provide those liquid pools and price transparency.” Masi agreed that, in creating the price transparency and liquidity that allows ESG strategies to be efficiently implemented, exchanges play a key role. “We have to deliver these values that will help the transition to a more sustainable economy,” he said.

Listen to the full panel discussion, ESG derivatives — From equity to fixed income, what next for this market?, at www.risk.net/7802966

The panelists were speaking in a personal capacity. The views expressed by the panel do not necessarily reflect or represent the views of their respective institutions.