'Doing Well by Doing Good'? Examining the rise of Environmental, Social, Governance (ESG) Investing

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Executive Summary

Since the Financial Crisis, the asset management industry and exchange-traded funds (ETFs) have surged with respect to the value of assets they represent globally. By extension, so has their direction-setting influence over the real economy through capital allocation and shareholder power. A significant part of this growth is attributable to passive investing, which is dominated by the ‘Big Three’ passive asset managers (BlackRock, Vanguard and State Street). Their growth has driven significant consolidation of ownership and power within the asset management industry, with the Big Three controlling a staggering 20% of the average S&P 500 company.¹

Alongside these trends, ‘ethical’ or ‘sustainable’ investment strategies, called ‘Environmental, Social, Governance’ (ESG) investing have enjoyed increasing popularity, with record inflows during the pandemic. Governments around the world are increasingly looking to ‘ESG’ strategies and leveraging ‘sustainable’ private finance to drive the transition to a decarbonised economy. However, there are several reasons to be sceptical of the ability of ‘sustainable finance’ to deliver.

This report interrogates ESG, particularly the ‘E’ and ‘sustainable’ investing, asking two key questions: 1) Does ‘sustainable investing’ deliver on its promise, namely shifting finance from unsustainable to green investments and driving commensurate change in the activities of the real economy?; and 2) Is relying on private finance to confront the climate crisis an appropriate path if it risks exacerbating key dynamics underlying climate crisis and injustice to begin with, namely vast inequalities of wealth and economic power?

The research analysed a cohort of over 10,000 mutual funds and ETFs registered for sale in the UK, finding 809 ‘ethical’ funds, 150 funds marketed under an ESG theme, and 33 funds marketed according to a specific climate or low-carbon theme. Within the climate-themed funds, 12 funds (one third of the cohort) held oil & gas producing companies as of their recent filings (Q1/Q2 2020), of which three had stakes in ExxonMobil. The report found the most common holdings of the climate funds were Tech companies (15%) and Financial Companies & Real Estate Investment Trusts (15%). While these findings don’t necessarily suggest any misconduct or false advertising on the part of the providers, they do indicate the need for greater transparency and regulation, and beg the question: how much do ‘sustainable’ funds really have to do with the climate crisis and rapid transition to a sustainable economy?

American passive investment titan BlackRock surged in market share over the past year to control nearly a quarter of all assets in UK-sold ‘ethical’ funds (total sector-wide AUM £94Bn). The three largest providers in the sector together represent over 60% of the market by assets, with a further 150 firms controlling just a third of assets. This consolidation of ownership and questionable portfolio climate impact, in combination with enormous inequalities in financial asset ownership and poor or non-existent mechanisms for public input into asset allocation, stewardship actions and shareholder voting raises...
questions about the utility of ESG in its current form for driving rapid decarbonisation, let alone a transition to a sustainable economy that allows a just distribution of benefits and costs, is democratic, and resolves the underlying dynamics of inequality driving crisis in the first place.

To address these challenges, the report proposes three sets of recommendations. The first suite of recommendations seeks to ensure ESG actually drives a shift in investment from unsustainable to green assets, and critically, to ensure this is reflected in shifts in the real economy. The second suggests necessary changes to the currently inadequate stewardship approach to ESG investing.

The final suite of recommendations more fundamentally questions the usefulness of the idea of ‘sustainable finance’ for the urgent task of driving a rapid and just transition to a sustainable economy, and proposes three key principles for securing this future: scaling up democratic economic mechanisms within asset management; resisting the extension of financial logic into new domains like the protection of nature which are incompatible with demands for financial return; and consequently an embrace of public investment - rather than public de-risking of private investment - in delivering the transition.
Glossary of terms

— **Greenwashing:**
  The use of misleading claims or falsehoods pertaining to a company or product’s ‘green’ credentials for marketing or branding.

— **Securities:**
  A tradable financial instrument, such as a stock or bond.

— **Securitisation:**
  The conversion of an asset, such as a loan, into a tradable security. Often, this involves packaging several such assets into a single security e.g. the ‘Mortgage-Backed Securities’ made notorious by the 2008 Financial Crisis, which packaged multiple mortgages into a single security for trading.

— **Fixed income:**
  A type of investment that generates income for their holders over fixed periods of time, such as periodic interest on a bond. Bonds are the most common form of fixed income investment.

— **Bond:**
  A type of fixed income investment that effectively represents a loan from the investor (lender) to the entity that issued the bond (borrower), such as a corporation or government. Like loans, bonds have a principal that must be repaid by a certain date (the bond’s ‘maturity’) as well as interest; however, unlike bank loans bonds can be traded on exchanges, and don’t generally carry the same restrictions for the issuer as a bank loan might, such as collateral or restrictions on further borrowing.

— **Equity:**
  A type of investment that involves purchasing shares in an entity such as a company. Equity investments may be publicly listed securities, such as stocks on stock exchanges, or ‘private’, where purchases are made between parties and not via a public exchange. Unlike bonds, equity gives investors ownership and an interest stake in a company, entitling them to influence how it operates e.g. through shareholder voting rights. It may also entitle shareholders to benefits like dividends.

— **Mutual funds:**
  Funds are pooled investment vehicles, which purchase securities on behalf of the investors who buy into the fund. Mutual funds are typically purchased from the fund management company itself.

— **Exchange Traded Funds (ETFs):**
  In contrast to mutual funds, ETFs are traded on exchanges rather than purchased directly from the company providing the fund (the asset manager). This means shares in the fund are traded directly between investors, rather than via the fund manager. ETFs tend to be passively managed.

— **Passive management:**
An investment strategy whereby funds ‘track’ indexes that represent a specific market, industry, and/or purpose such as the S&P 500 or the S&P Global Clean Energy Index (which tracks companies engaged in clean energy production) with the aim of replicating the level of return of the index as a whole. Considered ‘passive’ because asset allocation is determined by the index rather than the stock selection done by active fund managers.

— **Beneficiaries:**

The party to which the assets being invested belong, and on whose behalf financial intermediaries carry out investment activities. E.g. pension holders.

— **ESG (Environmental, Social, Governance):**

An increasingly popular investment strategy where asset allocation takes into account ESG factors such as companies’ carbon intensity, labour practices, corporate governance etc., typically based on ratings in various categories. Ratings/scores may come from in-house research, index providers, or specialist consultancies.

— **Shadow-banking:**

A form of market-based finance, this involves financing (lending) activity that occurs outside of traditionally regulated banks. These transactions involve collateral-based financing of purchases in other markets (capital & derivative). The ‘lenders’ are generally institutional investors and their respective asset managers, and transactions include short-term arrangements like securities lending or ‘repo’ agreements.

— **Repo agreements:**

Used for short-term borrowing, these agreements involve the exchange of liquid government securities, in which a dealer sells these securities to investors for a brief agreed period, e.g. overnight, agreeing to repurchase the securities at a slightly higher price at the end of the period. The difference between the sale and repurchase price is called a ‘haircut’.
Introduction

1.1 The Rise of Asset Management

Systemic crises generate complex and unpredictable vulnerabilities, as the Covid-19 pandemic has underscored. Studies suggest thousands of strains of coronavirus could exist in the bat populations of Southeast Asia, and with deforestation and climate change expected to force the migration of 99% of these bat species by 2050, the risk of zoonotic crossover and further global pandemics could soar. As we look to a post-pandemic future, the urgency of addressing the climate and nature emergencies has never been more salient, and governments around the world are beginning to promise ‘green recoveries’ from the virus’ economic impacts. However, to wean the world off fossil fuel energy and protect and restore biodiversity and ecosystems will require not just green stimulus, but the fundamental reorganisation of the economies of the world’s wealthy nations.

The Green New Deal explicitly addresses this need, providing a plan that extends beyond eliminating carbon from the economy as it currently exists and operates. Though centred on rapid decarbonisation through an ambitious programme of public investment, Common Wealth understands the Green New Deal also as a project of institutional transformation, which – like the New Deal of the 1930s, despite its flaws – seeks to dismantle the systems and logics generating crisis in the first instance, replacing them with an institutional architecture that supports collective thriving.

The institutions of the private financial system - banks, asset managers, insurers and others - urgently need transformation to address their contributions to widening economic inequality and climate and environmental degradation. Just 35 global banks have extended over $2.7 trillion in financing for fossil fuel projects worldwide since 2016, while the world’s three largest asset managers own hundreds of billions in fossil fuel assets. Critically, as a major locus of financial power and activity, drastically reforming how the UK financial sector operates with respect to the climate emergency would have significant knock-on effects for the global financial system, and could significantly reduce the UK’s contribution to the climate crisis through the financing of fossil fuels and other carbon intensive or environmentally destructive activities around the world. As the Brexit transition deadline advances with considerable uncertainty and the UK government looks toward its own ‘green recovery’ from the Covid-19 crisis with a ‘Ten Point Plan’ and COP26 presidency, there is a brief but significant window of opportunity for meaningful progressive shifts in the operation of the UK’s financial system.

Since the 2008 financial crisis, the asset management industry and, in particular, a pooled investment product called the ‘exchange-traded fund’ (ETF), has surged with respect to both market share and, by extension, influence over the direction of the financial system and the wider economy. As Financial Times columnist Gillian Tett recently wrote: “while the banks played a starring role in the last big financial crisis, non-bank financial structures, such as ETFs, matter much more now.” As of 2019, non-bank financial institutions controlled 51% of assets to traditional banks’ 49% – marking a paradigmatic shift in the locus of control in the global financial system, and a significant change from even 2007, when banks controlled 58% of assets, and non-bank institutions just 42% (see Figure 1). In large part, this reflects the comparatively loose regulation enjoyed by the ‘shadow banking’ sector, which provides
‘market-based finance’, and which has successfully resisted further regulation in recent years. And although they are not often considered or, most importantly, regulated in the same way as traditional banks, asset managers effectively lend to corporations through the corporate bond market, which has exploded in recent decades, and particularly since the 2008 financial crisis.

However, despite the rising importance of asset management and pooled investment vehicles (hereafter: funds) relative to traditional targets such as banks, until recently this industry has been comparatively ignored by regulators, and often by progressives focused on issues like inequality and climate justice. These blind spots have implications not just for financial stability, but also with respect to the increasing concentration of wealth and power in the economy – a concentration that has been furthered by the economic fallout of the Covid-19 public health crisis.

A small number of powerful asset management firms now wield tremendous capital allocating power, with BlackRock alone controlling US $7.8Tn in assets as of September this year. By comparison, Norway’s Government Pension Fund Global, the world’s largest sovereign wealth fund, has just over US $1.2Tn in assets. The concentration of assets has been propelled by the growth of ETFs and other index funds: just three leading fund providers – BlackRock, Vanguard and State Street Global Advisors, frequently deemed ‘The Big Three’ - have a combined ETF market share of 80%. Across the asset management industry more broadly, a staggering 61% of all assets are held by the largest 1% of managers alone. In short, both assets and, by extension, power, are becoming highly concentrated.

The implications for the direction of the economy are significant. The Big Three dominate US equities, collectively controlling 20% of the average S&P 500 company; projections suggest this could reach 40% within two decades. It’s worth noting that despite the staggering scale of this share ownership, equities make up just half of BlackRock’s global portfolio; a full 31% of its $7.8Tn in assets under management (AUM) is in fixed income. The market shaping capacity of these actors is thus enormous, and the actions of just a handful of companies could increasingly influence the market as a whole. A recent paper deemed these large firms “Permanent Universal Owners”, reflecting their long-term positions in companies across the entirety of the economy, with implications for the logic of corporate governance, particularly when it comes to shareholder voting and ‘stewardship’ (detailed in Chapter 2.3).

There is also an important dynamic established by the rise of asset manager power and concentration, namely that - although securities are purchased with beneficiaries’ money – beneficiaries have little to no say in how their assets are used, whether in allocation or voting at the companies they effectively own through their shares, which is conducted by asset managers as ‘proxies’. Moreover, beneficiaries of institutional investors like pensions often have little if any ability to convey their preferences concerning issues like climate change and sustainability to Trustees.

Leading academic Benjamin Braun argues that the once dominant ideology of shareholder value maximisation, according to which firms’ primary motivation was to maximise returns for shareholders, has been supplanted by a new economic paradigm he calls ‘asset manager capitalism.’ This new logic is defined by vast ‘universal owner’ firms which are motivated not by maximising the profitability of and returns from individual portfolio companies, but rather by the drive to accumulate additional assets. Shareholder value maximisation has been rightly criticised by many leading thinkers such as Mariana Mazzucato for its tendency to incentivise financialisation, environmental unsustainability, poor working conditions and other critical issues. But as Braun contends, it may be that this logic is now being supplanted by an equally problematic but distinct paradigm.
Both logics, however, have similarly problematic consequences for the climate crisis, albeit for different reasons. Under the doctrine of shareholder value maximisation, particularly over the short-term horizons demanded by annual reporting and business cycles, cutting emissions or improving environmental outcomes may often appear to be in conflict with maximising investor returns due to increased costs. By contrast, for universal (market-spanning) asset managers, the sustainability of portfolio companies ceases to be of importance, meaning there is little incentive - beyond marketing to new clients - for managers to act as stewards, for instance demanding companies set decarbonisation targets or shift to alternative green business models. This is reflected in the woefully undersized stewardship teams of major firms: BlackRock, for example, which employs over 11,200 globally, has a dedicated stewardship team of just 45.

Moreover, this lack of incentive is compounded by the concentration of undemocratic power in the hands of a few players, restricting who has a say in the financial system’s actions on climate. As governments continue to champion the private financial system for driving ‘green finance’ and a rapid reallocation of capital toward more sustainable activities, it will be vital to contest the ongoing consolidation of both wealth and economic direction-setting power (with respect to both shareholder votes and capital allocation) within a small number of vast asset management firms, as well as to interrogate what potential – if any – private finance has to not only ‘green’ the economy at the pace needed, but also to deliver just outcomes in doing so.

## 1.2 ‘Ethical’ investing in a time of crisis

Within the steady growth of asset management and ETFs, ethical investment strategies – so-called ‘ESG’ (Environmental, Social, Governance) – have recently spiked in prominence. Though touching on all three of these issues, this report focuses specifically on the ‘Environmental’. The ESG approach to climate and environmental stewardship operates according to a handful of primary strategies.

- The first is the marketing of products that are tilted toward ESG criteria, often involving weightings or exclusionary screens based on certain company traits and activities. This may involve ‘tilting’ a mainstream index such as the S&P 500 toward products that score more highly on ESG ratings (often provided by external companies such as MSCI or specialist consultants) and/or exclusionary screens which eliminate investments in ‘sin stocks’ such as fossil fuels or arms manufacturing. (though notably this does not necessarily mean the funds are in line with science-based targets such as those of the Paris Agreement, as acknowledged by recent EU legislation discussed in Chapter 4.1).

- The second approach sees investors retaining stakes in problematic companies in order to use this position to demand changes that address these negative impacts, such as carbon emissions, through engagement between stewardship teams and corporate management. For instance, the Climate Action 100+ coalition of investors collectively target the highest emitting companies globally in an effort to push for decarbonisation or transparency over lobbying activities. Such engagement can take the effect of meetings and direct negotiating, or the filing of shareholder resolutions and use of voting power at corporate annual general meetings.

- The third, often called ‘impact investing’, involves investors seeking companies – often smaller than those included in mainstream indices – which operate according to a particular mission deemed compatible with the investor’s ethics, and which seek
to demonstrate a material positive impact. However, because of its slightly different focus and scale, impact investing is not examined in this report.

Though the stewardship approach has been dominant since the beginnings of ‘ethical investing’, relying on active management and teams of researchers, the substantially lower costs and more consistent returns offered by their passive counterparts have, as with the wider asset management industry, driven comparatively faster growth in the passive ESG fund industry, which relies on the weighting and screening strategy.25

After years of growth, with projections from 2018 showing nearly two-thirds of assets could be ‘ESG’ by 2021,26 the combined financial tremors of Covid-19 and the oil price shock prompted a surge in ESG investing over the course of 2020. The sector saw record inflows even at the height of the pandemic, bringing the total assets invested in ESG-specific products to over $1Tn;27 ESG ETFs alone measured over US $100Bn as of July this year.28 Index-tracking (passive) ESG funds have consistently performed well, regularly exceeding the returns of the mainstream indices from which they are derived.29

It could be argued this marks a turning point in asset management, as investors – alarmed by the impact of a global pandemic – are awakening to the significant financial risks posed by systemic crises like climate change; indeed, according to analysis from Deloitte, the proportion of investors globally applying ESG criteria to at least a quarter of their assets soared to 75% in 2019.30 Others suggest that consistent returns are no longer enough for younger investors, who also expect investments to be consistent with their ethics and politics, for instance by excluding investments in arms or fossil fuels.

The likely reasons behind the sector’s tremendous recent success (in terms of popularity and high returns) are complex. Record inflows to ESG during the pandemic may reflect a growing awareness on the part of investors that ‘ethical’ investment strategies may be a sound financial choice because they should minimise exposure to systemic risks like climate change. Whatever the reasons, in theory, this growth could be good news for the ‘greenness’ of the finance industry, as cleaner investment strategies grow and gain longevity, not only due to beneficiary preference but also market out-performance.

However, critics have attributed the sector’s popularity to a fallacious ‘win-win’ logic, with investors piling into the sector based on its outperformance, without recognising that largely, funds have outperformed the wider market simply because they underweight energy companies, which have fared poorly in the pandemic, and are overweight in tech and pharma, which have fared well.31 For instance, the top five holdings of Vanguard’s US ESG fund – which has returned an impressive 28% to the 17% of its mainstream equivalent – are Apple, Microsoft, Amazon, Facebook, and Google; Tesla is the first non-tech-giant in the fund, at number six.32

There is therefore considerable reason to question the Panglossian optimism surrounding the relentless growth of ESG investing. For the ambitions of the Green New Deal in particular, the redirection of funds that could be investing in decarbonisation or companies committed to improving social outcomes should be of concern. Indeed, what does the dominance of Big Tech in Vanguard’s flagship ESG fund suggest about the practices underlying the wider ESG sector, as well as its prospects as a vehicle for driving decarbonisation and the transition to a sustainable economy?

These questions are important given ESG is increasingly entering the mainstream, far beyond the asset management industry itself. Creating a regulatory framework for sustainable investment has formed a key priority for the EU over the past few years, which saw its design of a comprehensive ‘taxonomy’ for green assets fraught with disagreement from governments
reliant on fossil fuel industries, such as Poland, as well as from financial trade associations resistant to regulation.\textsuperscript{33} The EU’s pandemic recovery plan has designated 30% of its €750bn fund to ‘green bonds’, which are notionally tied to decarbonisation or other projects on the part of the entities that issue them.\textsuperscript{34}

Major financial institutions and governance and regulatory bodies including the UK’s Financial Conduct Authority (FCA)\textsuperscript{35} and the Bank of England\textsuperscript{36} have also taken steps toward prioritising ESG factors – particularly climate risk – in financial regulation. However, it’s important to note that this approach is fundamentally risk-based, rather than impact-based, meaning these regulators are primarily concerned with the financial materiality of environmental and climate risks (that is, the impact of these risks on finance), rather than with regulating finance according to its material environmental and climate impact. Internationally, the ‘Task Force on Climate-Related Financial Disclosures’ (TCFD), a voluntary programme founded by Michael Bloomberg, also advances this approach, creating a system for financial institutions to disclose their climate risk exposure. The TCFD now has the participation of 480 financial institutions with $138Tn in assets and is advocated by the United Nations Principles for Responsible Investing programme.\textsuperscript{37}

The advance of ESG and sustainable investment thinking among regulators is increasingly evident in the pensions sector. For instance, as of October 2019, pension funds in the UK were required to show how they take ESG criteria into consideration in their investment decisions and how they conduct stewardship responsibilities, under the EU’s Shareholder Rights Directive II. However, with Brexit, additional and alternative regulations are now being pursued. In August of this year, the UK Government released proposals for the 100 largest occupational pension funds to be required to disclose climate risks by 2020.\textsuperscript{38}

However, numerous concerns have been raised about the actual, material impact of ESG investing; how this could be appropriately measured (if at all)\textsuperscript{39} and whether ESG investments contribute to achieving any positive outcomes in the areas of concern that they purport to address, for example by lowering carbon emissions, reducing deforestation, or ensuring the protection of human rights in supply chains. Further, leading academics such as Daniela Gabor have argued that the pivot by governments and international institutions like the World Bank toward leveraging private finance for traditionally undesirable investment areas such as international ‘development’ and biodiversity constitutes a problematic and indeed counterproductive approaching to meeting the urgent tasks of improving standards of living and preserving ecosystems around the world (discussed in depth in Chapter 2.4).\textsuperscript{40} The approach, she argues, provides ample opportunity for private finance to ‘greenwash’ its image, while the public sector takes on financial risks.
Moreover, it seems likely that a sharp pivot toward relying on private investment to meet the urgent and complex challenges of the climate crisis, biodiversity collapse, and economic ‘development’ cannot be met - and indeed will be directly undermined - by a profit-motivated approach that contributes to inequalities in wealth and economic power (explored further in Chapter 2.4). It is worth noting that inequalities in financial wealth have been exacerbated by policies such as quantitative easing, which has kept the value of financial assets high over the past decade (with asset purchase programmes under the Covid-19 crisis response continuing this tradition), disproportionately benefiting those who already hold these assets. Given the strong empirical evidence for a relationship between inequality and escalating emissions, resource use, and social injustice, to build an economy that is sustainable and just, our approach to the climate crisis must necessarily combat inequality in its many forms, including financially.

In light of these issues, as well as the urgent need to decarbonise the asset management industry, which currently allocates enormous sums to carbon intensive industry while largely failing to demonstrate the capacity for stewardship approaches to drive rapid decarbonisation or improve other environmental outcomes, a review of the sector from a critical, progressive economic perspective is overdue. To that end, this report interrogates the ESG or ‘sustainable finance’ industry (focusing specifically on climate and environmental issues), asking whether it fulfils its purported role in allowing for ‘ethical’ investment and, more critically, driving material benefit with respect to climate and environmental justice. Chapter 2 traces the rise of asset management power and consolidation over the past decade, and introduces critical issues related to a private finance-led approach to sustainability. Chapter 3 examines key critiques of the ESG approach, while Chapter 4 introduces new analysis to evaluate these critiques for the UK ESG sector.

Finally, Chapter 5 proposes policy and regulatory mechanisms for resolving some of the issues identified and makes the case for mainstreaming a radically improved suite of regulation pertaining to ‘ethical investment’ strategies and throughout asset management, to make the system more just and sustainable by design. Lastly, it argues against the Panglossian optimism with which ‘ethical investing’ is often approached, proposing measures to combat risks of inefficacy, rising inequality and the concentration of economic power that accompany it. The report concludes with proposals for countering these risks, and advocates the scaling up of democratic mechanisms in asset management and the wider economy for a commitment to public-led investment in many areas that are the most critical to securing a just and sustainable future, and which are incompatible with a profit and returns-led approach. These latter themes will be explored in further detail in an upcoming programme of work focused on the rise of asset management over the course of 2021.
2.1 Asset management and the ‘shareholder democracy’

Asset managers are a form of non-bank financial institution operating according to a fee-based model, investing on behalf of other parties with whose assets they are entrusted, from individual savers up to multi-billion-pound pension funds. The consequence is that while the assets themselves do not belong to the asset management firms, they are the legal effective holders of the securities in which they invest, such as shares and bonds.

Figure 1: The chain of investment

This chain of investment linking individual beneficiary to institutional asset owner to asset manager and, finally, to the ‘real economy’ via stock and bond holdings produces a structure in which the individual whose money is invested, such as a pension holder, may have very little or no say over how that money is invested, or used to shape the behaviour of companies. Though the ultimate owners of these assets (e.g. pension holders) willingly give over their assets to intermediaries to invest on their behalf using their expertise, the notion that this implies full consent on the part of beneficiaries in the use of their assets is complicated by prevailing interpretations of ‘fiduciary duty’, the legally binding duty of intermediaries to act in
Namely, fiduciary duty is generally interpreted to mean prioritising financial returns, often precluding the consideration of other factors such as sustainability in investment decisions, as exemplified by a recent mandate under the Trump administration inhibiting pension funds from considering ESG strategies.\textsuperscript{44} In the UK, regulators have acknowledged that ESG considerations are financially material over different time horizons and may therefore be considered; furthermore, asset managers and institutional investors such as a pension fund may agree a ‘Statement of Investment Principles’ in which the investor can affirm their wish for ESG factors to be considered in the investment strategy.\textsuperscript{45} However, input from beneficiaries in establishing this agreement is not required. It is also important to note that ESG considerations are increasingly encouraged only insofar as ESG factors pose a financial risk to the investors’ returns, rather than a consideration of the impact of investments on environmental or social concerns in the real economy.\textsuperscript{46} This is complicated by the fact that the degree to which ESG factors pose a financially material risk to returns varies over different time horizons, creating different concerns for beneficiaries of a single pension fund of different ages.

As a consequence, asset managers wield considerable power over the allocation and use of investors’ assets, notably in shareholder votes at corporate annual general meetings (AGMs). This concentration of power is compounded by the fact other stakeholders beyond investors, such as the labour force of a company or its suppliers and customers, have no say in its governance despite having unique and valuable knowledge or concerns about how it operates.

There are also steep inequalities in the ownership of financial assets in the UK, excluding many individuals from the structure just described. As highlighted in Figure 2, a small fraction of the UK population controls a large majority of private pension and ISA assets. This distribution is also marked by clear inequalities along the lines of factors like gender,\textsuperscript{47} race,\textsuperscript{48} and age. Unions, university endowments and other institutions are also major investors representing large pools of individuals. However, even those individuals owning financial assets, or indirect beneficiaries such as students, faculty and union members have limited or no ability to influence the use of these assets. When privatising public assets en masse in the 1980s, Margaret Thatcher promised a ‘shareholder democracy’, in which everyone in society would have some small stake in the management of these assets. In light of the above, it seems more fitting to describe the UK economy as the reverse: a system in which a small minority of the population is entitled to a majority of the stake and say over the economy that this form of wealth provides.

Despite these current structural flaws, however, these institutions represent a potential route for increasing democratic participation and accountability by embedding mechanisms for participation and, crucially, building a drastically more equal distribution of wealth in the UK economy. For instance, the extension of pensions coverage and other forms of saving through pension auto-enrolment programmes such as NEST,\textsuperscript{49} will see millions of working people increasingly linked to ownership of public companies through their pensions, and this figure is likely to grow.
2.2 The Passive Revolution

Funds are a common route to investment for both retail and institutional investors, and are a form of pooled investment vehicle, in which multiple individual sources of investment (e.g. multiple individuals’ assets) are pooled into one fund that is able invest in a variety of financial instruments. Though there are several types, the Exchange Traded Fund (ETF) has surged in importance and market share over the past decade, first in the United States and increasingly in the UK and Europe. A significant portion of this booming ETF market is made up of index-tracking or ‘passive’ funds, which invest in all or a representative sample of the securities included in an index to track its performance. For example, the S&P500 is an index representing the 500 largest US companies by market capitalisation.

The share of assets held in passive funds has soared since the 2008 financial crisis. In the US, passive funds now represent more than half of all mutual fund assets and 60% of trading activity, and worldwide assets in passive funds (either mutual or ETFs) surpassed US$12Tn this year. Institutional asset owners are increasingly allocating funds in passive strategies, with pensions expected to shift assets to passive strategies at a rate of 6% per year over the coming decade. As of 2019, some 34% of global pension assets were invested passively. In the UK, the passive market has been slower to take off than in the US, but it is rapidly growing, with inflows in 2019 double those of 2018. The increased prominence of globalised US-based fund managers like BlackRock in the UK market at the expense of the UK’s traditionally active focused companies, many of which have suffered significant outflows in recent years, represents a major driver of this growth.

Importantly, passive investment strategies raise questions concerning the ‘democratic’ potential of the shareholder model of the corporation, as the passive strategy effectively
abdicates fund managers’ control over asset allocation (though some deviation from the index is generally permissible, if not acted upon),\(^5\) as well as reducing or eliminating altogether an active engagement and shareholder voting role on the part of managers.\(^6\)

Research has found that - as might be expected of a ‘passive’ investment approach - the large index fund providers tend to vote strongly in line with management at corporate AGMs (effectively the default option), where shareholder resolutions are brought on critical issues like governance, labour rights, supply chains and climate change, with voting power that increasingly dwarfs that of asset owners who may have more direct incentive to vote on such issues.\(^7\) As argued by Oxford academic Caleb Griffin, the rise of share ownership within non-voting index-tracking funds has created a paradox, whereby “individual index fund investors have essentially no power to shape corporate governance, while index funds themselves arguably have too much power over corporate governance,” through their ever-expanding ownership.\(^8\)

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### 2.3 Asset manager capitalism: consolidation and control

The rise of the asset management industry over the past several decades challenges conventional understandings of who wields power in the economy, and chiefly over its core unit: the corporation. Under ‘asset manager capitalism’, ideas surrounding corporate governance dynamics such as shareholder value maximisation may no longer be sufficient to describe how decisions are made.\(^9\) Rather, the proliferation of large, universal owners (i.e. asset management firms whose assets are distributed across the whole of the economy) has been advanced by the rise of index-tracking funds, whose objective is to minimise ‘tracking error’ (the amount by which the fund’s performance deviates from an index) rather than the ‘alpha seeking’ (market beating) purpose of traditional active management.\(^10\) Moreover, the ownership structure of asset management - in which beneficiaries are entitled to returns from investments and managers operate typically according to a fixed rate fee means the incentive for managers is not maximising returns for investors, but first and foremost growing the assets they manage (though it should be noted these two priorities are not necessarily independent). The result of these related trends has been the shift in the operating logic of investment away from maximising the performance (returns) of individual companies and toward the accumulating of assets as a whole,\(^11\) while also increasingly removing the option of divesting from companies in an index. The combination of these two dynamics calls into question the potential for passive funds to meaningfully pursue an ESG strategy: first, it’s unclear how passive funds would be able to generate impact either via engagement and/or shifting capital, and second the incentive to maximise accumulation of assets rather than company performance makes attendance to the impact of ESG factors on returns less salient.

Importantly, this logic – of accumulation rather than value maximisation – is compounded by the degree of consolidation of assets within the asset management sector itself. Prior to the onset of the Covid-19 crisis, the so-called ‘Big Three’ asset managers (BlackRock, Vanguard and State Street, all of whom are leading passive fund providers) collectively controlled in excess of 20 percent of shares in the average S&P 500 company; studies suggest that if current trends continue, they could together control as much as 40% of all shares by 2040. Importantly, the Covid-19 crisis has accelerated the consolidation of the ETF market worldwide, meaning other countries may follow the trend set by the US.\(^12\) According to recent Common Wealth analysis, prior to the Covid-19 crisis, just two of the largest asset managers operating in the UK – BlackRock and Legal & General – together owned 5% or more of all shares in 70 of the 100 largest non-financial companies in the UK, and 10% or more of over 30.\(^13\)
The leading asset managers are also increasingly exercising influence beyond the management of assets itself. For instance, BlackRock’s ‘Aladdin’ platform, which sells a risk assessment service to other financial entities, informs the investment decisions of thousands of fund providers. As of 2017, $20tn in assets were on the system worldwide; BlackRock has not disclosed a more up-to-date figure since, but the Financial Times estimates that the assets on the platform from just a third of its clients cover a staggering 10% of global stocks and bonds.\(^5\) Serving as the primary source of risk modelling and analysis for the world’s largest fund managers, insurers, and even corporations such as Apple and Google, its prevalence in global financial decision making has raised concerns regarding conflicts of interest.\(^6\)

Finally, the asset management industry exerts growing influence directly through political, regulatory, and institutional channels. A number of financial trade associations, for instance, were found to have lobbied to weaken aspects of the EU Sustainable Finance Action plan, namely the ‘taxonomy’ designating which assets are considered sustainable,\(^6\) while BlackRock was courted to advise on the drafting of environmental regulations for European banks\(^7\) - a decision now criticised by the EU ombudsman for the Commission’s failure to reflect clear conflicts of interest.\(^7\) BlackRock was also designated the role of leading the Federal Reserve’s Covid-19 asset purchase programme,\(^7\) which involved their purchasing of stakes in a suite of the firm’s own ETFs.\(^7\)

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### 2.4 Asset Manager Capitalism and the ‘Wall Street Climate Consensus’

The consequence of these ownership trends is the concentration of significant direction setting power over the real economy within a shrinking number of increasingly vast management firms. The growing proportion of investment falling under ‘passive’ strategies is accelerating this process, with the Big Three passive asset managers holding hundreds of billions worth of fossil fuel equities through their funds alone.\(^7\)

At the same time - despite government responses to the Covid-19 pandemic undermining the old adage that ‘there is no magic money tree’ - the neoliberal bias against public investment, intervention and leadership, and toward private capital, remains strong within the policy approaches of most governments – including the UK’s - to the climate crisis. The European Union’s much lauded €1tn ‘Green Deal’, for instance, created just €7.5bn of new budget commitments, instead generating much of the headline figure from projected government guarantees for private investment.\(^7\)

International financial institutions like the World Bank are increasingly championing an approach to complex challenges like sustainable ‘development’ and biodiversity coined by leading economist and academic Daniela Gabor as the ‘Wall Street Climate Consensus’.\(^7\)
Rather than advocating public investment, the approach relies on shepherding private finance into these areas by ‘de-risking’ investments, shifting the burden of loss onto the public. Though presented as novel, the Consensus thus constitutes a business-as-usual approach, founded on the belief that sufficient incentives will unleash financial capitalism to decarbonise the economy without a leading role for the state or significant changes to the prevailing economic system. The approach forms the core of the World Bank's "Maximising Finance for Development" programme (MfD), which seeks to leverage private finance to reach the Sustainable Development Goals (SDGs). As IMF and World Bank watchdog Bretton Woods Project has noted, the World Bank continues to push its MfD programme amidst the Covid-19 crisis, despite its potentially destabilising effects, as well as a lack of evidence for its efficacy in delivering SDG outcomes. Similarly, in a recent landmark report entitled "Financing Nature: Closing the Biodiversity Financing Gap" - endorsed by prominent figures including former Governor of the Bank of England Mark Carney and IMF Managing Director Kristalina Georgieva - authors explore how public support, "financial innovation" and securitisation could be used to encourage private capital to invest in biodiversity and ecosystem restoration.

Against this backdrop, asset management is claiming to offer an increasingly popular solution to the ‘financing gap’ that the World Bank claims as an obstacle to efforts to decarbonise and restore nature: ‘ethical’ investment according to environmental, social and (corporate) governance criteria (ESG). According to its proponents, ESG strategies offer a ‘best of both worlds’ solution to the challenges of sustainability and social outcomes, enabling investors to allocate capital to green or socially valuable assets while also protecting returns by reducing exposure to the risks associated with a changing climate and environmental degradation. In other words ‘doing well by doing good’.

However, there are many reasons to be sceptical of these claims, detailed in subsequent sections. Despite this, there is increasing evidence that governments and international financial institutions view ‘sustainable finance’ as a preferred route to mobilising finance for addressing the climate crisis and pursuing sustainable development goals. The result is support for continuation of an economic consensus that unreasonably lionises the private sector with respect delivering the solutions for challenges as immense, complex, and global as the climate crisis, and sees economic inequalities as distinct from – rather than a central underlying cause of – climate and environmental breakdown.

With respect to the success of a Green New Deal – namely, delivering a just and sufficiently rapid response to the climate crisis – the continuation of these trends raises several concerns. As outlined in the Introduction, the Green New Deal, demands rapid decarbonisation, but it also demands radical reductions in inequality, economic and social justice, and the transformation of institutions and architectures that facilitate economic and other forms of inequality, unsustainable extraction and resource use, and the production and burning of fossil fuels.

Outlined in the following chapters, there are several reasons to think that ‘ESG’ fails to meet these demands, begging the question: is ESG simply a way for investors to adapt to climate change and protect their returns, or can it really be a route by which finance can influence corporations and drive material change by mitigating emissions and environmental damage? Further, to drive decarbonisation that attends to concerns of social and economic justice, it seems likely the current approach will require more fundamental change than currently offered by ‘sustainable finance’.
ESG: Green Finance or Greenwash?

Despite its success and integration into mainstream investment requirements, the proliferation of ESG should not be taken as an uncritical good. The explosion of ESG products and seemingly relentless flow of assets into the sector, coupled with the increasing enthusiasm for the strategy from regulators and governing bodies has led some to speculate that ESG and ‘green’ investments more broadly are a growing bubble. There are also serious questions about the basis of and consistency between ratings, the scale of ‘greenwashing’, and dubious material impacts. In a more extreme example, Credit Suisse - one of the asset management firms with the poorest record on shareholder voting on ESG issues at corporate AGMs according to recent analysis - just launched the ‘LGBT 350’ index of “LGBT inclusive companies”, drawing immediate ire from the investment world who pointed out its top contents mirror the S&P 500, and casting a spotlight on the doubt surrounding the impacts such strategies have on real world outcomes. From the perspective of the goals of the Green New Deal, the ESG trend raises additional concerns, particularly with a view toward the consolidation of economic power within a small fleet of vast, private financial institutions, relatively insulated from democratic demands and accountability.

— 3.1 Ratings, Consistency, and ‘Greenwash’

The scores and analysis on which ESG indices and products are based, whether rating environmental, social or governance criteria, may be constructed by leading index providers such as MSCI or S&P, by bespoke consultancies and NGOs, or produced by in-house analysts at asset management firms. Notably, the index providing business is dominated by a small host of providers including MSCI, S&P, Dow Jones and FTSE Russell, who exert increasing private authority through their opaque construction of mainstream indices which effectively determine a significant amount of capital allocation in the global economy, serving as “gate-keepers that exert de facto regulatory power,” and should be regulated in a way that reflects this power.

Owing to the continued absence of a stringent regulatory framework for ratings, criteria and conclusions may vary widely between sources; moreover, methodologies are often questionable. For instance, MSCI’s prevailing methods for evaluating climate impact are carbon emissions per dollar of sales and ‘potential’ emissions per dollar market capitalization, meaning high emitting companies may readily pass the thresholds set, provided they are highly profitable or valuable. More recently, the scandal of severe Covid-19 outbreaks in clothing retailer Boohoo’s facilities in Leicester – casting a harsh light on a lengthy history of poor working conditions in the company’s supply chains – called into question Boohoo’s stellar ESG rating. In another example, a 2019 InfluenceMap analysis found that several funds marketed as ‘fossil fuel reserves free’ held shares in major fossil fuel extracting companies, including thermal coal.

Concerns about ‘greenwashing’ are prevalent in the absence of regulatory consistency, and there is a booming market for specialist consultancies and civil society groups to provide analysis to investors. The Carbon Disclosure Project (CDP), for instance, is a non-profit organisation which publishes over 8,000 companies’ disclosures of their carbon emissions, as
well as impacts on forests and water security. CDP’s scores are widely adopted by companies who perform well and used by investors to inform their engagement and product construction. However, in the CDP system, companies that are major contributors to global emissions and carbon intensive manufacturing such as Ford Motors score an A so long as they provide strong disclosure of these emissions according to the CDP criteria.\textsuperscript{92} Though CDP scores are designed to evaluate the quality of disclosures, it’s worth noting the website states “CDP’s annual A list names the world’s most pioneering companies leading on environmental transparency and performance” (emphasis added). In general, the abundance of ratings like these could allow companies (and investors) to ‘shop around’, selectable more favourable indicators to improve their environmental credentials without having to adjust their business models or, for example, their lobbying against environmental and climate legislation.\textsuperscript{93}

ESG ratings may also be limited by relying on publicly disclosed accounts from the companies being rated, which may not contain all key information. Reflecting this incomplete information, ESG ratings often reflect companies’ processes and protocols pertaining to ESG issues, rather than actual impacts or outcomes.\textsuperscript{94} Transparency among the host of private index rating consultancies is often poor, with research and grading processes not publicly disclosed.\textsuperscript{95} Finally, the emphasis on disclosure of risks - rather than their management - is based on a ‘market fixing’ logic according to which full information is sufficient to create optimal management of risk, when in fact there is little evidence to support this link.\textsuperscript{96}

There are thus considerable risks associated with a booming ESG industry that lacks regulatory consistency and methodological stringency, including, principally, that very little material impact is generated, or capital shifted. The EU (and, more recently, UK) taxonomy (discussed in Chapter 5) aims to address this; however, when it comes to a sound method for measuring impact, let alone determining which impacts should be considered sufficiently ‘green’ or positive, there is no panacea.

\subsection*{3.2 The Real World: In Search of Impact}

Perhaps the most significant criticism of the ESG industry is whether it produces any ‘real world’ impact that its marketing and proponents suggest such as lowering carbon emissions or ensuring the protection of human rights in supply chains. Indeed, as detailed above, in applying exclusionary screens or ‘weighting’ to mainstream indices, ESG funds – rather than filled with socially impactful or clean energy companies – often end up overweight in Big Tech, financials, and major pharmaceutical companies. Importantly, though they may pass through a restricted set of criteria used in ESG rating, many of these companies may have questionable ‘real-world’ ESG impacts in less obvious ways: for instance, the prominence of Facebook in socially-themed funds has raised concerns about their role in misinformation and privacy breaches.\textsuperscript{97} Moreover, several key companies that feature in ‘green’ and ESG products - like Apple, Google, and Tesla - are currently being sued for knowingly benefiting from child labour in cobalt mining in the Democratic Republic of Congo.\textsuperscript{98}

Research has also found that the traits underlying companies that perform well in ESG scores are often wholly unrelated to the virtues these scores imply, such as few buildings (low emissions), and few or no employees (no unions or other labour issues).\textsuperscript{99} A publication from the Harvard Law School Corporate Governance Forum found inherent geographical bias toward Europe in positive ESG ratings, as well as a bias in favour of larger companies.\textsuperscript{100} Both biases are of concern with respect to driving a just and rapid transition to a decarbonised economy, as new green companies may be crowded out by larger incumbents, and areas of the world most in need of investment comparatively precluded from receiving it.
A recent major study found the single most important determinant of ESG indices’ outperformance of the Russell 3000 (a general index of the 3,000 largest US equity stocks) – 100-fold more relevant than any other input - was companies with fewer employees. The result is an ESG industry that has very little relation to the impacts it espouses. In the words of the study’s author:

“ESG’s bias against humans is probably unconscious, but it is a feature, rather than a bug. Companies with no employees do not have strikes or problems with their unions. There is no gender pay gap when production is completed by robots and algorithms. Biotech labs where a handful of PhDs strive to find the next blockbuster molecule have no carbon footprint. Financial networks which enjoy a natural monopoly in processing payments can have the luxury of ticking all the boxes of the corporate governance checklist.”

These findings are echoed in the arguments advanced by non-profit investment consultancy 2 Degrees Investing Initiatives in their report ‘Impact Washing Gets a Free Ride.’ Namely, the authors argue that there is a misunderstanding of the difference between what is considered a ‘green’ investment, such as purchasing stock in an energy company or a fund that eliminates fossil fuel holdings, and ‘green’ impact – that is, materially changing a company’s business model or capital expenditure, and thereby their emissions and/or environmental impact. Climate-themed funds, it argues, overwhelmingly make misleading or unsubstantiated claims in their marketing by suggesting that the investment strategy – effectively, betting on the future financial success of low-carbon activities by investing in the securities of companies exposed to these activities – directly generates material positive impact from a climate and/or environmental perspective. In reality, purchasing the shares of a company such as a diversified energy company that already has access to financial markets has no direct effect on whether that company shifts toward more electricity generation from renewable energy.

Conversely, the definition of impact advanced by Eurosif (the European Responsible and Sustainable Investment association) requires that investments meet three strict criteria: intentionality on the part of the investor to create a measurable, positive impact; additionality, insofar as the investment creates a positive impact in addition to the provision of capital; and finally the ability to measure and demonstrate the impact claimed. Funds constructed based on exclusionary screens, by reweighting mainstream indices, or applying green themes would find it challenging to meet these stricter criteria of demonstrating impact, underscoring the criticisms many have of the sector’s primary approach. However, some argue these standards might be met by the ‘Impact Investing’ and stewardship approaches outlined in Chapter 2.2; this argument will be evaluated in the following section.

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3.3 Stewardship, Engagement & the Proxy Democracy

Many prominent asset managers, owners and investor coalitions now champion the stewardship and engagement approach to ESG investing. One such coalition is the Climate Action 100+ (CA100+), which uses shareholder power to engage with the companies it deems “systemically important emitters” from around the world in order to bring their business plans in line with the targets set out in the Paris Agreement. That the CA100+ now represents over 500 asset owners and managers with a collective $47Tn in assets, and recently welcomed BlackRock to its ranks underscores the success of the engagement narrative and strategy with the investment community itself. The approach has had some wins: in 2018, for instance, Shell bowed to CA100+ pressure and set short-term carbon emission reduction targets, tying these to executive pay. The oil major also conducted a review of its trade associations in 2019, agreements to exit the American Fuel and Petrochemical Manufacturers group over disagreement
with its lobbying positions on climate change.\textsuperscript{110}

However, while positive, these successes are highly modest advances. In light of the immense urgency of the climate crisis, the commitment from Shell to reduce its emissions by just 20\% by 2035,\textsuperscript{111} for instance, falls woefully short of the rapid winding down of fossil fuel production and transition to renewable energy required. Nor does it address the need for a just transition for workers, which ensures they don’t pay the price of the transition to a decarbonised economy. As suggested by the widespread shedding of oil & gas industry jobs over the course of the Covid-19 pandemic to date,\textsuperscript{112} securing a just deal for workers will be a challenging undertaking, and unlikely to be willingly delivered by the companies without substantial pressure and/or government intervention.

This slow and minor success is mirrored in the progress that has been made through shareholder resolutions and proxy voting at corporate annual general meetings. Recent research from shareholder advocacy group ShareAction found that many investors – including a number of CA100+ signatories – are still failing to use their shareholder votes to drive progress on climate change or voting to retain corporate management despite lack of progress on key issues; a December 2020 report from ShareAction found that just 15 out of 102 resolutions related to social and environmental issues received majority support in the 2019 AGM season, but had the ‘Big 3’ passive providers lent their support to, a further 17 would have passed.\textsuperscript{113} Similarly, InfluenceMap research found that BlackRock and Vanguard supported just 9\% and 16\% of climate-related shareholder resolutions in 2018, respectively.\textsuperscript{114}

This latter finding is particularly concerning in light of analysis conducted as part of this report, which assessed the ownership data of roughly 2400 companies engaged in sectors worldwide spanning fossil fuel production, transport (aviation, automotive manufacturing, shipping), energy utilities, and cement and steel production, and found that BlackRock alone controls more than 5\% of all shares in 326 of these (more than 1 in 10).\textsuperscript{115} This represents substantial influence over key sectors of the economy with respect to decisive action on decarbonisation and a just transition.

Critics of the CA100+ process, for example, have emphasised its lack of transparency in terms of not only the content of engagement meetings, but also how the organisation establishes target outcomes and measures its success.\textsuperscript{116} In place of a clear set of democratically determined principles and goals that reflects the urgency of the climate crisis and could be contested by beneficiaries, the coalition often wields its immense investor power as a black box, reflecting an industry adheres to technocratic ideals and remains extremely opaque to the general public – including those whose money it manages.

Importantly, both the engagement process and the decision-making behind shareholder votes are conducted using not the asset manager’s money, but that of its beneficiaries, without direct input from these beneficiaries. Rather, in entrusting their assets to intermediaries, under the current system beneficiaries voluntarily yield their ability to do so under mutual agreement that the intermediary will act in line with their fiduciary duty. However, the prevailing interpretation of fiduciary duty as restricted to financial return is increasingly open to debate with respect to ESG considerations,\textsuperscript{117} and organisations such as the UN Principles for Responsible Investment have suggested that a failure to consider ESG factors in investing is a failure of fiduciary duty.\textsuperscript{118}

Voting in AGMs is conducted by asset managers serving as ‘proxies’ for those whose assets they have invested with, with the result that investment firms dominate the allocation
of the votes that determine company behaviour and planning, rather than those whose assets generate the voting right, or workers employed by the firm in question, who could be given a stake and a say in its future. As previously noted, the combination of this deficit and the enormous growth of index-tracking fund assets has created a ‘paradox’ whereby the rapid expansion of shareholder voting power now controlled by index funds coincides with the shrinking power of individual investors in those index funds, who have “essentially no power to shape corporate governance.” Given that, as Benjamin Braun argues, the concern of large and particularly passive asset managers is the accumulation of further assets rather than the performance of individual portfolio companies, this structure produces little to no incentive for the kind of “forceful” stewardship that might have a chance of generating material change at a given company, such as emissions cuts or improved labour conditions, whether or not this stewardship is motivated by interest in ESG outcomes or financial concerns.

### 3.4 Sustainable Finance and Green Neo-Colonialism

When it comes to securing justice beyond our own borders in the way to respond to the climate crisis, the pursuit of rapid decarbonisation absent significant reductions in inequality will not only fail to cut emissions and resource use at the pace and scale needed, but will also drive highly destructive processes of neo-colonial extraction to meet the resource demands of the Global North, particularly for commodities like lithium for batteries and other components of the ‘clean energy’ transition. Thus, without a strategy for financing the transition to a decarbonised economy that simultaneously delivers drastic reductions in inequality both within and between countries, ‘sustainable finance’ is likely to be anything but.

Further, a reliance on private investment to drive decarbonisation and climate adaptation in the global South creates considerable vulnerabilities for recipient countries, as demonstrated by the record outflows from so-called ‘Emerging Markets’ investments early in the Covid-19 pandemic. Given the regular shocks and adverse events sure to affect these nations as the climate crisis advances, such vulnerability could have devastating consequences for the public finances and - by extension - the people of many countries. It could also exacerbate the problematic patterns of neo-colonial ‘dependence’, as outlined by Anuoluwapo Abosede Durokifa and Edwin Chikata Ijeoma, that has been generated by mainstream development strategies, such as those advanced by the World Bank and United Nations through initiatives such as the Millenium Development Goals.

From the perspective of the Green New Deal - particularly one that prioritises climate justice beyond one’s own borders - this advancing consensus reflects the most problematic aspect of the ESG industry’s recent ‘success’ (or, perhaps more appropriately, its popularity). Namely, the Green New Deal as understood by Common Wealth is premised on the recognition that securing a genuinely sustainable future requires more than simply decarbonising the economy as it currently operates – replacing fossil fuel energy with renewables one for one. Rather, it demands a deep reordering of our current economic model. To that end, an adequate response to the climate and environmental crises, particularly one that is just and rectifies the vast economic inequalities driving unsustainable emissions and resource use to begin with, will require us to move beyond incentivising and de-risking private returns, and toward a reparations-based framework. In particular, an approach that is premised on maximising financial returns for investors, primarily located in affluent countries - even if investing in ‘green energy’ and other forms of mitigation - is likely to be highly extractive and exploitative of global South nations, while also increasing inequalities in wealth and, by extension, consumption, resource use and emissions.
Spotlight: Green Neo-Colonialism and Nature-Based Solutions

Compared to climate mitigation, the destruction of biodiversity and ecosystems has not been as high a mainstream priority for finance despite its immense importance. In part, this reflects the fact that ‘sustainable finance’ and associated initiatives have largely focused on supporting energy and mitigation projects which are profitable and “germane to the activities of developed societies.” In this respect, it’s notable that this study found 33 funds marketed in the UK under a climate or low carbon theme (Chapter 5), but none marketed according to criteria on deforestation, biodiversity or environmental protection.

Earlier this year, a Financial Times editorial argued that investors appeared to be finally “wak[ing] up to biodiversity risk.” But progress is slow: a recent report from Friends of the Earth, for example, found that in the 16 shareholder resolutions pertaining to the management of deforestation in supply chains at familiar corporations like Kroger, Kraft Heinz and Domino’s pizza since 2012, the ‘Big Three’ asset management firms voted against or abstained on every single resolution.

Moreover, the emerging approach to protecting and restoring nature appears to be following the ‘Wall Street Consensus’, relying on public sector de-risking of private investment and the use of ‘financial innovations’ to drive investment into the area. As the Green Finance Observatory has argued, there are several serious problems with this approach, including the challenges of measuring the monetary value of ‘ecosystem services’ and biodiversity, moral hazard, and the pro-cyclical risks associated with securitisation. Further, the concept of ‘nature-based solutions’ involves extensive offsetting, financing re/afforestation or ‘like-for-like biodiversity offsetting’ (meaning the replacement of destroyed biodiversity with biodiversity of equivalent type and/or ‘value’. Beyond the challenges inherent to measuring this value and dubious ecological implications, carbon offsetting and other ‘nature-based solutions’ have been widely criticised for facilitating land grabs in the global South to the detriment of local communities, in order to sustain consumption and carbon emissions elsewhere. This neo-colonial premise - consuming resources in the name of ‘sustainability’ to maintain status quo behaviour in wealthy nations - is unacceptable as a ‘solution’. This neo-colonial premise - consuming resources in the name of ‘sustainability’ to maintain status quo behaviour in wealthy nations - is unacceptable as a ‘solution’.

The Institute for Innovation and Public Purpose at University College London has also strongly called into question the adherence to the ‘efficient markets hypothesis’ that underlies many attempts to price and securitise nature, which implies that with fully correct information related to the value of nature and costs of its destruction, markets will deliver a sustainable outcome. However, as the IIPP notes, among other reasons, the “radical uncertainty” associated
with the complexity of ecosystems makes this a problematic assumption.

Crucially, if the driving force of the Green New Deal is to deliver not just rapid decarbonisation and the preservation of nature, but also an economy that is fundamentally more equitable and therefore sustainable, the commodification and privatisation of what should be considered a public good is counterproductive and unnecessary. Mandating financial returns to justify investment in a sustainable environment risks undermining the project of protecting nature altogether risks undermining the project of protecting nature altogether.

## 4 Analysis of ESG Fund Portfolios in the UK

### 4.1 Industry Trends: Passive Investing and the ESG Explosion

To evaluate developments in the ESG sector in the UK, as well as broader trends in the asset management industry, analysis was conducted on the 10,046 listed funds (both mutual and ETFs, spanning equity, bond and mixed asset classes) classified as registered for sale in the Lipper database, of which 10,003 reported data at both the 2019 and 2020 disclosure dates. Table 1 provides a breakdown of the number of funds assessed in different categories. The subsequent discussion highlights key findings.
As discussed previously, a significant factor underlying the trend toward consolidation in the asset management industry is the growth of passive funds, whose provision is dominated by a small number of large players, with BlackRock and Vanguard outstripping the next largest competitor by trillions of dollars in assets under management. This analysis – specific to funds registered for sale in the UK – echoed findings from other markets, finding that the roughly 2000 index tracking funds covered by the analysis performed considerably better than the fund sector as a whole, growing by nearly 11% from an aggregate value of £1.23Tn to £1.36Tn, and attracting net inflows of £85Bn, or 7% of their aggregate 2019 value.

While the active fund sector remains dominant in the UK for the time being, it saw net outflows of over £105Bn over the course of the year – in stark contrast to the success enjoyed by the passive segment of the industry. Perhaps most compelling was the success of the ‘ethical’ investing industry. The 550 UK-registered funds flagged as ‘ethical’ by the Lipper database grew in aggregate value by 39% to a total of nearly £370Bn; however, net inflows were lower, at 4% compared to the 2019 aggregate value, suggesting a disconnect between moderate but steady growth in new money and the rapid inflation of value in the segment. Within the ‘ethical’ cohort, the 150 funds marketed explicitly with ‘ESG’ in their name told an even more impressive story, growing in aggregate value by a remarkable 62% over the course of the year to total over £60Bn, and attracting net inflows of 22% of their September 2019 aggregate fund value.

Importantly, there are clear overlapping trends between the rise of ESG and passive investing. Specifically, index-tracking (passive) funds accounted for a majority of the inflows in the ESG fund sector: though index-tracking ESG funds represented roughly 3 times the aggregate value of active ESG funds as of September 2020, the indexed funds attracted net inflows nearly 14 times greater than those of active ESG funds over the past year, reflecting the significant shift toward interest in these products over the past decade, and particularly over the course of the Covid-19 crisis.\(^{127}\)

### 4.2 Cornering the Market: UK ESG and Ethical Funds

<table>
<thead>
<tr>
<th>Fund Type</th>
<th>All</th>
<th>Active</th>
<th>Index</th>
<th>Ethical</th>
<th>ESG in Fund Name</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Funds</td>
<td>10,046</td>
<td>7,960</td>
<td>2,088</td>
<td>809</td>
<td>150</td>
</tr>
<tr>
<td>Aggregate AUM 09/2019 (£Bn)</td>
<td>5,360</td>
<td>4,130</td>
<td>1,230</td>
<td>266</td>
<td>37.6</td>
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<tr>
<td>Aggregate AUM 09/2020 (£Bn)</td>
<td>5,540</td>
<td>4,180</td>
<td>1,360</td>
<td>369</td>
<td>60.9</td>
</tr>
<tr>
<td>Aggregate Net Flows 09/2019 – 09/2020 (£Bn)</td>
<td>-20.7</td>
<td>-106</td>
<td>85.9</td>
<td>11.0</td>
<td>8.4</td>
</tr>
</tbody>
</table>

Note: All monetary values in £Bn. Due to rounding, figures may not sum exactly. Categories are not mutually exclusive, so ‘Ethical’ funds may be active or index-tracking. ESG funds are a subset of ‘Ethical’ funds. The ‘Ethical’ flag is provided by the database. Source: Thomson Reuters Lipper Database
Though, as discussed in preceding sections, consolidation within asset management is less pronounced in the UK than in the US, the growing success of US-based asset management giants like BlackRock in the UK and beyond means the UK may follow suit. In particular, the significant interest and growth in ESG and ‘ethical’ investment strategies provides opportunity for managers to swiftly corner market-share, particularly if they offer increasingly popular passive ESG products. To evaluate this possibility, this research examined consolidation among asset management groups in the ESG and ethical sectors of UK-registered ETFs and mutual funds. Figure 3 shows changes in the AUM controlled by various managers in active ethical funds in Q3 2019 and Q3 2020.

Note that all data is derived from the most recent available findings. Q3 2020 represents the most recent possible filing date in the cohort; not all funds will have disclosed data to this date, and figures cited may reflect a prior disclosure. Within Figure 3 and 4, below, it should be noted that the five largest asset management firms within each category (e.g. Active-Ethical) are shown, while the ‘Other’ category represents the collective AUM of all other funds and firms in the category. Additionally, the relative size of each chart reflects the total AUM within each category at the given point in time (also indicated in absolute terms below each chart).

Figure 3: Aggregate AUM in Active 'Ethical Funds' - Q3 2019 (left) vs. Q3 2020 (right)

AUM in Actively Managed 'Ethical' Funds

<table>
<thead>
<tr>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Agricole (Amundi) 2.27%</td>
<td>Credit Agricole (Amundi) 1.55%</td>
</tr>
<tr>
<td>Deutsche Bank 1.67%</td>
<td>Deutsche Bank 1.84%</td>
</tr>
<tr>
<td>AXA 4.63%</td>
<td>AXA 4.38%</td>
</tr>
<tr>
<td>BNP Paribas 4.33%</td>
<td>BNP Paribas 4.95%</td>
</tr>
<tr>
<td>Schroders 8.99%</td>
<td>Schroders 5.41%</td>
</tr>
<tr>
<td>Other 77.09% (154 firms)</td>
<td>Other 81.87% (154 firms)</td>
</tr>
<tr>
<td>Total £196 Billion</td>
<td>Total £261 Billion</td>
</tr>
</tbody>
</table>

Common Wealth analysis of public disclosures and data from Thomson Reuters Lipper and Eikon databases.

As Figure 3 shows, within the actively managed ethical fund cohort, although there was a growth in total assets of roughly 33%, the market-share occupied by the top five providers shrank by 5% over the year; further, consolidation within the top five appears to have slightly reduced, with a marginally more equal distribution owing to the reduced market share of Schroders, the largest provider as of Q3 2019. This may reflect that there is little advantage for active investors in accumulating maximum market share and assets, in contrast with their
passive counterparts. Indeed, it’s notable that BlackRock does not even feature within the top five in this category.

By contrast, the rapid growth and increasing dominance of BlackRock in passive ethical funds, as shown in Figure 4 below, is evident. While Northern Trust remained dominant in this category as recently as Q3 2019, representing nearly a third of the UK-registered passive ethical fund market at this time point, BlackRock had surged to control 23% of AUM in the sector by September 2020. Importantly, there is also evidence of consolidation even over this brief timeframe: while the nearly 160 firms within ‘Other’ controlled 39% of passive ethical assets in Q3 2019, this share had dropped to 34% by the same time this year, with the share controlled by just the three leading firms at nearly 60%. It is also notable that while active ethical funds – for the time being – currently have more than double the AUM of the passive ethical fund segment, passive ethical funds saw their aggregate value increase by a stunning 60% over the past year, nearly doubling the rate of growth of their active counterparts.

Figure 4: Aggregate AUM in Passive 'Ethical Funds - Q3 2019 (left) vs. Q3 2020 (right)

AUM in Passive 'Ethical' Funds

<table>
<thead>
<tr>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total £59 Billion</td>
</tr>
<tr>
<td>Credit Agricole (Amundi) 3.25%</td>
</tr>
<tr>
<td>Legal &amp; General 2.68%</td>
</tr>
<tr>
<td>UBS 10.99%</td>
</tr>
<tr>
<td>Northern Trust 31.21%</td>
</tr>
<tr>
<td>BlackRock 12.96%</td>
</tr>
<tr>
<td>Other 38.99% (No firms: 154)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total £94 Billion</td>
</tr>
<tr>
<td>Credit Agricole (Amundi) 3.98%</td>
</tr>
<tr>
<td>Legal &amp; General 4.03%</td>
</tr>
<tr>
<td>UBS 13.37%</td>
</tr>
<tr>
<td>Northern Trust 21.66%</td>
</tr>
<tr>
<td>BlackRock 23.40%</td>
</tr>
<tr>
<td>Other 32.55% (No firms: 154)</td>
</tr>
</tbody>
</table>

Common Wealth analysis of public disclosures and data from Thomson Reuters Lipper and Eikon databases.

These findings reflect previously established trends in the wider asset management industry, whereby passive products are both growing considerably faster than their active counterparts, and the passive segment of the market is marked by a considerably higher degree of consolidation than the active. Should the rapid growth of both passive investing and, more recently, ESG investing continue, these trends could be mutually reinforcing, such that the already-dominating passive providers come to dominate a growing ESG investing industry as well.
With respect to the ostensible goals of ‘ethical’ or sustainable investing – that is “doing well by doing good”\textsuperscript{129} – these trends raise concerns, at least for the ‘doing good’ half of the epithet. As summarised in preceding chapters, prior research has suggested that ESG investing – particularly when based on reweighting indices and relying on passive strategies – often has little to do with the themes under which the products are marketed, and evidence of strongly positive material environmental or social outcomes is limited. The following section explores this issue by examining the portfolios of funds registered for sale in the UK and marketed specifically under a climate-related or low carbon theme.

### 4.3 Just Hot Air? Examining Climate-Themed Funds

Within the original cohort of 10,003 UK-registered listed funds, 33 were identified as being marketed with a specific climate theme by name, based on the inclusion of one or more of the following key terms: climate, low carbon, lower carbon. The full list of funds and key details are provided in the appendix. Full portfolio data was not available for all funds, depending on disclosures; only findings for those with full data are presented.

The cohort, though small, does offer evidence of inconsistency among funds explicitly marketed according to their climate credentials. For example, as Table 2 shows, ExxonMobil shares were held by three funds as of their most recent filings – two of which are actively managed. The actively managed Ossiam fund’s prospectus describes the fund objective as “to deliver the net total returns of a selection of US equities...while taking into account ESG (Environment, Social, Governance) criteria and improving carbon performance.”\textsuperscript{130} Similarly, the HSBC GIF Global Lower Carbon Equity funds states the fund: “aims to provide long-term total return... seeking a lower carbon footprint than its reference benchmark (the MSCI World Net Index).” Even for an actively managed fund, however, which might argue it aims to change the behaviour of carbon-intensive companies that it owns, Exxon Mobil – as a leading lobbyist against climate legislation\textsuperscript{131} and the least advanced programme of development for low carbon alternatives among the oil majors\textsuperscript{132} – seems an unlikely candidate for effective engagement. Further, given the oil major’s consistent under-performance relative to mainstream indices,\textsuperscript{133} justifying its inclusion based on high return is also questionable.\textsuperscript{134}

<table>
<thead>
<tr>
<th>Fund Name</th>
<th>Fund Management Firm</th>
<th>Date of Most Recent Disclosure</th>
<th>Shares Held in Exxon Mobil</th>
<th>% of Total Fund Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lyxor MSCI World Climate Change UCITS ETF</td>
<td>Societe Generale</td>
<td>June 2020</td>
<td>233</td>
<td>0.06</td>
</tr>
<tr>
<td>Ossiam ESG Low Carbon Shiller UCITS ETF</td>
<td>Ossiam Ireland</td>
<td>Dec 2019</td>
<td>25,500</td>
<td>4.47</td>
</tr>
<tr>
<td>HSBC GIF Global Lower Carbon Equity AC</td>
<td>HSBC</td>
<td>July 2020</td>
<td>7,900</td>
<td>0.41</td>
</tr>
</tbody>
</table>

In general, oil & gas companies are heavily represented in the cohort, with 12 climate-themed funds (one third of the cohort) containing one or more companies in the Oil, Gas and Consumable Fuels sub-sector as of the funds’ most recent available filings, four of which are passive (index-tracking).\textsuperscript{135} As of the most recent filings available for each fund, companies in
this category comprised nearly 3% of all holdings in the fund cohort assessed; importantly, this represents nearly all of the average value in the entire wider ‘Energy’ sector held by these funds.

Figure 5 shows the distribution of each GICS industry as a percentage of total fund value for the cohort of funds assessed as of Q2 this year, when complete filings were widely available across the cohort. Notably, information technology dominates, at an average of 14.9% of fund value. Tech is followed by industrials, financial companies, and health care & pharmaceuticals, which together comprise an average of 50% of the total value of a climate-themed or low carbon fund registered for sale in the UK. When real estate investment trusts (grouped by GICS under ‘Real Estate’ alongside management/development companies) are instead considered within the ‘financials’ category (see highlighted bar in Figure 5), the finance industry’s average share of a climate fund climbs to just over 11% to 15%, supplanting Tech as the largest industry by value; together, Tech and finance therefore comprise nearly a third of the average value of these funds. The entire Utilities sector, in which some companies engaged in renewable energy production may be found, makes up just a third of the average value allocated to each of Finance/real estate trusts and Information Technology.
While not explicitly contrary to any of the funds’ labelling or marketing, the preponderance of technology and financial companies begs the question: what do these ostensibly climate-focused funds really contribute to combatting the climate crisis, reducing emissions or driving a rapid transition to low carbon economic activities? There is nothing in the specific labelling or remit of these funds that would require them to invest in the green economy, in financial instruments design to drive the transition of business models to lower carbon activities, or other similar investments; however, there are a number of problems that arise from the current makeup of low carbon funds, even if they technically meet the ‘lower carbon’ criteria, as defined by a relatively narrow measure such as carbon footprinting or exclusionary screens. These are, in order of increasing importance:

1. While there is no mandate for climate-themed or low carbon funds to invest in the green economy, the average individual investor making the effort to select a climate-focused fund option could reasonably expect their assets to be used to invest in decarbonisation, clean energy, and other related areas. However, given the present cohort of listed funds in this category, the opportunity to do so may not be available to them.

2. Many of the top sectors found in climate-focused funds, though they may be ‘low carbon’ in the narrow sense of direct emissions, such as a bank, may have an outsized indirect role in the climate crisis through lending, underwriting and investment activities. Similarly, many leading tech companies support the perpetuation of the
fossil fuel industry through tech service contracts\textsuperscript{136} (in addition to having questionable ‘Social’ credentials such as treatment of employees and labourers in the supply chain).\textsuperscript{137} While they may therefore escape the definitions used by weighted or screened climate-themed funds, companies in these sectors may nonetheless be highly problematic from a climate and emissions perspective.

3. ESG and climate-focused investment products are increasingly lionised by governments and international regulatory and financial bodies as a vital source of finance going forward for accelerating the transition to a zero-carbon economy and delivering much-needed investment in everything from green industry to nature restoration. However, without drastic changes to the offerings in this industry and firm regulations defining what can be considered an environmentally or climate-friendly investment, the industry seems doomed to fail with respect to meeting this ambition. Rather, if it continues along its current track, the booming industry may simply drive more investment into Big Tech, finance and pharmaceutical giants.

Crucially, should the third issue noted above continue unabated and governments increasingly leverage private finance to deliver on climate targets, there is serious risk of failing to deliver critical investment not just in decarbonisation, but also of leaving the substantially less ‘investable’ areas such as adaptation and nature restoration woefully under-resourced. It’s important to note that, in part, the findings above may reflect a lack of investable climate-supporting opportunities in the publicly listed equity and corporate bond universe, but this should call into question the potential of ‘sustainable finance’ as a strategy.

Further, the valorisation of ESG investing on the part of the private sector by governments risks omitting a core tenet of the principles of a Green New Deal programme: climate justice. While investment in the transition to a zero-carbon economy from the private sector should be encouraged and welcomed, this should not be seen as an adequate replacement for a bold programme of public investment focused not only on the conventional areas such as energy and transport, but also on affordable zero-carbon housing, social justice, reductions in inequality, a just transition for workers, and reparations-based justice for global South nations on the frontlines of the impacts of climate breakdown.

Rather than a panacea, ESG investing should thus be at best understood as one tool in a large toolkit to be used by governments in the urgent task of building a just, equitable and decarbonised society. To that end, the final chapter outlines a number of policy recommendations and directions for, first, ‘greening’ asset management, and second, building a financial system that is more just and sustainable by design, and from which everyone can benefit, rather than a select few.
5 Policy Recommendations

In light of the findings of the preceding chapters, two distinct policy programmes are necessary in order to:

1. Green asset management, ensuring shifts in investment products from ‘harmful’ carbon-intensive and/or environmentally destructive securities to ‘green’ securities are reflected in rapid, decisive shifts in capital expenditure in the real economy;

2. Reverse the monopolisation of wealth and decision-making power in the economy by democratising asset management in terms of both assets and mechanisms for representation.

The success of item 1) is urgent, insofar as meeting the target of remaining within a maximum of 1.5°C of global warming by the end of this century demands immediate shifts in capital. Crucially, mechanisms for encouraging investment in ‘green’ must be concurrent with the elimination of financing for and investment in ‘harmful’ activities. The success of 2) is similarly urgent not only to ensure that the rapid transition to a decarbonised economy is democratically representative, but also to begin to address underlying roots of climate and environmental degradation in vast inequalities of wealth and economic power.

Current green financial regulation and guidance in the UK is far from adequate for achieving either of these ambitions in the timeframe demanded. The UK government’s 2019 Green Finance Strategy prioritises disclosures of climate and environmental risk over regulation to decisively reduce that risk, with “ambitious actions” that include “exploring the appropriateness of mandatory reporting” of climate risk and “working with international partners to catalyse market-led action on enhancing nature-related financial disclosures.”

The Chancellor’s November 2020 Financial Services Statement similarly emphasised the importance of disclosures, announcing mandatory TCFD disclosures “across the economy” by 2025, alongside the creation of a UK green taxonomy to regulate which assets are considered green. Absent from the announcement was the suggestion of penalties for or disincentives to invest in ‘harmful’ – or even to determine what constitutes a harmful asset. This all carrot no stick approach is mirrored in the Bank of England’s announcement of climate stress testing for banks, without reflecting the outcomes of these tests in differential capital requirements or ‘penalising factors’ based on ownership of green and harmful assets, as many have previously advocated.

Finally, current financial regulation and strategies do not address the concentration of economic decision-making power within the asset management industry, nor the implications of this consolidation for a programme of rapid and just decarbonisation. From the perspective of the Green New Deal, this is a mandatory part of a strategy for ‘greening finance’, owing to the direct relationships between climate and environmental degradation and inequalities in wealth and power.

Using the current landscape of UK financial policy - in particular the November 2020 Financial Services Statement from the Chancellor of the Exchequer – as a guide, the final
sections of this report interrogate which changes in policy are urgently needed to deliver on these two interrelated ambitions.

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### 5.1 Greening Asset Management

While the preceding chapters discussed ESG as a whole (albeit with a clear focus on climate and environmental issues, in which ESG is arguably most advanced), the following recommendations focus specifically on the ‘E’ of ESG, namely the construction of a financial system that is sustainable and compliant with a 1.5°C world.

Regulation to green the private financial system should meet the criteria of consistency, rigour, and, crucially, impact generation in the real economy. That is, ‘green’ investing shouldn’t be limited to include only those portfolios that don’t invest in (or, more often, investing less) in fossil fuels. While an end to investment in fossil fuels is urgent, shifting some assets out of Big Oil and into Big Tech and other financial companies will not drive the transition in the real economy needed, even if these investments are considered ‘green’ under certain criteria. Thus, a rigorous regulatory approach to green finance should also encourage investment in actively ‘greening’ activities such as low-carbon energy and transport, and/or investment that commits companies to transitioning business models to be compliant with a 1.5°C world and scaling up zero-carbon alternatives. To that end, we recommend the following near-term changes, as well as principles for long-term policy. It should be emphasised that the following recommendations are intended to serve as a starting point for addressing core issues in a relatively nascent and rapidly evolving area; over the course of 2021 Common Wealth will be pursuing a programme of work on the asset management industry allowing a more in depth exploration of this and related policy questions.

1. **Define a comprehensive taxonomy that categorises economic activities along a clear spectrum including: Zero-Carbon Accelerating (Green), Non-Compliant (harmful) and Transition/Enabling.**

   The prevailing approach to a ‘taxonomy’ for investments, namely that advanced by the European Union, classifies some activities as ‘green’ according to whether they meet at least one out of six objectives (climate change mitigation; climate change adaptation; the transition to a circular economy, sustainable use/protection of water and marine sources; pollution prevention/control; protection of healthy ecosystems) and don’t “do significant harm” to the other five. Other categories include ‘enabling’ and ‘transition’. However, as Daniela Gabor has argued, in their current form and in the absence of a ‘harmful’ category, these latter two labels facilitate greenwashing and business as usual, using highly vague phrasing that opens broad categories for inclusion in the taxonomy of activities that should not be considered compliant under the guise of supporting the transition to a decarbonised economy.

   Moreover, significantly lobbying from private finance, industry and certain member-states has created difficulty in agreeing a taxonomy that is stringent and fit for purpose, and much of the deliberation has suffered from a lack of transparency. To correct this, the UK’s Green Technical Advisory Group should incorporate the views and expertise of a wide range of stakeholders and civil society groups with a fully transparent process including public consultation, as advocated in a recent letter to the Chancellor from leading civil society groups.

   Instead, a full and rigorous spectrum of economic activities must be defined from ‘green’ to ‘harmful’ with shades of harmful activities in between to enable a clear reallocation of capital away from carbon-intensive activities and provide much-needed clarity and consistency on
the products being marketed. Defining this full spectrum is far beyond the scope of this paper; rather, the suggested categories are intended to offer a conceptual starting point with which to expand the prevailing idea of a ‘green taxonomy’ championed by the European Union and, now separately, the UK. ‘Green’ investments should be solely those that are already low or zero-carbon or support these activities, rather than “those that contribute to the transition to a net zero economy, but do not currently operate at this level.”\footnote{146} Additionally, activities should consider key biodiversity targets, whether domestically determined or agreed internationally in future negotiations at the UN Biodiversity Conference (CBD COP).

Areas like retail which might be considered neutral and therefore external to the economy should be required to prove via disclosure that their activities do not directly contravene the goals of remaining within the 1.5°C target and are compliant with or on a 1.5C-compliant pathway to a sustainable, decarbonised economy. This should include a review of business activities, supply chains etc., similar to the nature of evaluation currently conducted for ESG ratings, but with strict, science-based and clearly defined criteria. Importantly, the definition of ‘harmful’ activities will correct the current situation whereby ‘harmful’ activities with no place in a decarbonised economy and ‘neutral’ companies which neither drive the green transition nor directly impede it are both excluded from the taxonomy, and thus lumped together. However, companies whose primary activities might be considered neutral but which violate certain criteria, such as financial companies whose investment, insurance or lending portfolios surpass a clearly defined threshold for “harmful” investment should not be eligible for ‘neutral’ status i.e. exclusion from the taxonomy.

Importantly, properly classifying certain financial products as ‘Transition/Enabling’ - recognised as “shades” of harmful\footnote{147} - could help direct much-needed finance to investment in industries and activities that have a necessary place in building a sustainable economy or are necessary to a functioning economy but must be decarbonised, such as materials production (cement, steel etc.), or transport. Limiting a taxonomy solely to already ‘green’ assets such as renewable energy companies risks reducing investment in these areas. However, rather than the vague definition advanced by the EU, which defines ‘Transition’ as “activities for which there are no technologically and economically feasible low-carbon alternatives, but that support the transition to a climate-neutral economy”,\footnote{148} and ‘Enabling’ investments as “activities that enable other activities to make a substantial contribution to at least one of the environmental objectives”, clear and stringent boundaries should be defined to determine that an activity is required for the transition to a decarbonised, sustainable economy and/or the investment is used expressly to decarbonise a necessary industry such as steel.

This is a break with the EU approach which currently permits ‘transition’ activities to simply include an activity that isn’t yet low-carbon enough to be considered ‘green’, such as electricity generation <100g/CO2 per kWh, without mandating that reductions to zero carbon are facilitated by the investment. Further, there should be clear mechanisms to ensure ‘Transition’ investments are directed toward emissions-reducing and sustainability-increasing activities through tools such as corporate ‘Transition bond’ instruments with funds earmarked the above. Use of funds from these investments should be transparently disclosed and meet clearly defined, stringent criteria to prevent greenwashing, which is a significant issue in the ‘green bond’ market as currently regulated.\footnote{149}

2. **Introduce green supporting and harmful penalising factors for market-based finance based on the taxonomy**
A taxonomy should not simply serve as a method of categorisation and disclosure; rather, it should be seen as a powerful tool for changing the allocation of capital in the economy. A range of proposals have been advanced for greening banks’ capital requirements through ‘green supporting’ and, less frequently, ‘unsustainable penalising’ factors which decrease or increase, respectively, the capital which banks must hold against lending to different entities/activities through adjusting risk weights for assets. For instance, a 2019 independent expert report to the Labour Party argued current requirements under the UK’s Capital Requirements Directive IV contain an implicit bias against low-carbon activities – which tend to be less liquid than conventional investments – by requiring a certain amount of liquid assets to be held. These biases should be eliminated and, indeed, actively reversed, not only for banks but by extending the same logic to non-bank financial institutions, including asset management firms engaged in ‘shadow banking’ or market-based finance activities.

Specifically, investors engage in ‘market-based finance’ (lending) in high daily volumes through securities lending (loaning a stock, derivative or other security to another investor) and repo agreements (short-term, collateral-backed, market-based borrowing). In these exchanges, the borrower is required to take a ‘haircut’ on the security used as collateral, defined as the difference between the market value of the security, such as a UK Treasury, and the price agreed to be paid for it by the lender. As the report to the Labour Party notes, the size of the haircut “determines the amount of financing that (shadow) banks have available to finance new assets or lend against those assets. The higher the haircut, the higher the implicit cost of financing securities positions and the lower the build-up of leverage.” The same is true of margin requirements for derivatives, introduced after the 2008 financial crisis.

As an extension of the logic for ‘greening’ banks’ capital requirements advocated elsewhere, the haircuts and margins associated with market-based finance should be similarly required to take into account climate and environmental considerations, requiring larger haircuts to be taken on unsustainable collateral, defined according to the taxonomy, while smaller haircuts should be required of ‘green’ securities such as regulated green bonds linked to the taxonomy activities. This would discourage the extension of credit to high emitting or environmentally destructive activities while encouraging financing for activities that are compatible with a decarbonised economy.

As non-bank financial institutions continue to grow in scale and influence, regulating their activities with a level of stringency that is equal to those of banks is increasingly vital, both from the perspective of systemic risk and, most pressingly, the mobilisation of capital for rapid decarbonisation, adaptation and environmental restoration.

3. **Create an exclusionary list, based on the taxonomy, of the most carbon-intensive and environmentally destructive assets, to restrict investment in these assets as well as their use as collateral in market-based finance**

For a number of economic activities such as tar sands extraction, there is no justification for further investment if the world is to remain within 1.5C of warming at a maximum, and/or to meet urgent biodiversity and nature restoration targets. These activities should be targeted for immediate winding down, including by restricting access to capital for their continuation. In addition to the real world imperative of doing so, excluding these activities can be justified according to financial risk concerns, as per a recent Network for Greening the Financial System technical report, which states:

“If supervisors find that the level of risk driven by climate-related and environmental factors is excessively high, they could require institutions to reduce such risks by applying
measures such as [...] limiting or prohibiting them from carrying out certain categories of activities.”

This process could begin immediately with long-term institutional investors with a binding responsibility to beneficiaries over several decades such as pension funds, restricting the allocation of pension fund assets to these activities. Their mandated exclusion from index-tracking investment funds could also be justified in the immediate term in light of the evidence showing passive investment strategies are not associated with effective use of the shareholder position to demand rapid transition from companies engaged in these activities. Further, in line with the IPCC’s 1.5C trajectory, there is a clear justification for excluding investment in certain extremely harmful activities across all forms of investment as rapidly as possible.

4. **Ban the inclusion of all ‘harmful’ assets in passive indexes considered ‘ethical’, ESG, or sustainable.**

The rapid growth of passive investment strategies in the UK means they now require tailored regulation. In particular, prior research has suggested passive funds risk becoming “holders of last resort” of fossil fuel assets owing to their unique investment mechanisms, which could prolong the life of fossil fuel assets which rapidly need to be wound down. Recent research, for example, found that BlackRock’s passive funds were more ‘coal intensive’ on the whole than their active funds, meaning that dollar for dollar, passive funds were invested in more coal than their active counterparts.

As noted above, a key justification used by asset managers for the inclusion of high emitting companies in ESG and climate-focused funds is that positions in these companies enable managers to pressure companies to change their behaviour. Further, many activities within this category such as thermal coal exploitation and use are fundamentally incompatible with a 1.5C trajectory and, therefore, the engagement approach. Even if engagement strategies are able to drive rapid, deep changes in the emissions of high emitting companies in necessary industries – which has yet to be demonstrated - the comparative dearth of engagement power associated with passive investment should render this justification invalid; BlackRock, for example, maintains a stewardship team of just 45 individuals worldwide, relative to its total staff of over 11,000.

Additionally, research has found passive funds vote overwhelmingly in line with management on shareholder resolutions, rather than using their positions with discretion to drive change; US Justice Leo Strine has described index funds as “the least active in exercising voice and judgment.” Further, passive funds effectively waive the right to divest from a company should it not respond to engagement from managers – a common strategy of last resort used by investors who take the engagement approach – because the holdings of funds are determined by indices and not manager discretion. Given this, ‘harmful’ assets should be immediately excluded from inclusion in ‘green’ or ‘ethical’ indices constructed by external index providers like MSCI or S&P to prevent passive funds becoming holders of last resort, particularly as their influence over capital allocation grows. This should be followed with a general ban on their inclusion in all indices over a timeframe commensurate with the science of remaining within a target of 1.5C of warming above pre-industrial levels.

5. **Delist companies from the London Stock Exchange that cannot prove and disclose compliance with the IPCC 1.5C trajectory and key nature and biodiversity targets.**

Companies can be required to delist based on failure to comply with regulation or to meet certain minimum financial standards. Given that the climate and nature emergencies
constitute significant material financial risks, and urgent legally binding regulations for mitigating emissions and environmental damage need to be implemented for the UK to meet its existing climate and environmental targets - let alone the more stringent ones needed in line with standards of climate justice\textsuperscript{161} - the delisting of companies based on failure to demonstrate compliance with these science-based targets can be justified on both grounds. It should be noted that established, binding targets for biodiversity have yet to be agreed internationally, though COP15 on Biodiversity in 2021 could resolve this. The Nasdaq has recently lobbied for mandatory delisting of companies based on failure to disclose reasons for a lack of board diversity;\textsuperscript{162} to support rapid decarbonisation and environmental sustainability, equivalent requirements should be implemented for the London Stock Exchange based on binding targets. Implementing this regulation would restrict financing to many companies engaged in the most extreme ‘harmful’ activities under the taxonomy, supporting the goal of rapidly shifting capital flows away from these activities.

5.2 From ‘Feeble’ to ‘Forceful’ Stewardship\textsuperscript{163}

6. Establish minimum requirements for effective engagement compliant with the 1.5°C trajectory and other key environmental objectives, and mandate full, accessible public disclosure of proxy voting actions to ensure transparency.

The introduction of mandatory Task Force on Climate-Related Financial Disclosures (TCFD) reporting for financial institutions should be brought forward to reflect the urgency of the climate crisis – not delayed until 2025, as recently proposed by the Treasury\textsuperscript{164}. With many financial institutions already signed up to the TCFD, a much more rapid timeline than currently advocated by the Treasury is achievable; it should be noted that the FCA will be requiring stringent TCFD disclosures from “premium listed companies” as of January 2021, suggesting the delay to 2025 for all financial institutions to become compliant is not justified.\textsuperscript{165} Importantly, disclosures should be required to use the established taxonomy framework.

Mandatory disclosures - while not sufficient to drive change - should be extended beyond climate-related portfolio risks and include public reporting of proxy voting activities. Should asset management firms remain committed to investing in higher emitting companies and industries on the premise of engaging with these companies to change their business models, engagement should be required to adhere to firm standards including a clear timeline for action and response, an escalation strategy, and defined outcomes of success.\textsuperscript{166} This would ensure much-needed accountability in this opaque space, rather than enabling ‘tea and cookies’ engagement or the abdication of responsibility in shareholder voting on issues pertaining to the climate crisis and sustainability. All proxy votes should be made publicly available to ensure transparency and accountability.

7. Create a requirement for financial intermediaries to vote at shareholder events in line with the instructions of the institutional beneficial owner of the assets (e.g. pension fund trustees).\textsuperscript{167}

As a natural extension of the preceding recommendation, ensuring that asset managers use their immense shareholder voting power in line with the expressed wishes of institutional beneficiaries would reduce the firms’ ability to abdicate responsibility on key issues. This requirement, as advanced in Common Wealth’s ‘Green Recovery Act’ should supplement and extend the recent requirement for pension funds to report on the climate risks to their portfolios, and place on pension fund trustees a binding duty to vote on issues pertaining to the climate and environmental crisis in a way that is compliant with the 1.5°C target and IPCC-defined (or equivalent) nature and biodiversity targets. Rather than a contravention of fiduciary duty,
this obligation should be recognised as an essential component of fiduciary duties over all time horizons, taking a precautionary approach to mitigating systemic risks that jeopardise beneficiaries’ best interests – both financial and with respect to ensuring a habitable, stable society and economy. Importantly, these recommendations should form part of a broader agenda for democratising asset management and, with it, influence over the real economy (see Chapter 6).

### 5.3 Building Economic Democracy: Against the Wall Street Climate Consensus

Greening the private financial system is a necessary and urgent first step as part of a Green New Deal programme, by eliminating a major driving source of destructive and environmentally unsustainable economic activity. However, just as the New Deal sought to dismantle the structures that enabled the Wall Street crash of 1929 and break the power of finance over the economy, a Green New Deal should also transform institutions and economic logics that generate crises by design, and which hold back the creation of a just, equitable and sustainable economy.

As discussed in preceding chapters, this will require the democratisation of asset management. The ongoing and accelerating consolidation of assets under the control of a small number of vast firms creates significant obstacles to rapid and just decarbonisation by concentrating shareholding voting and capital allocation power within entities whose model is premised on the further accumulation of assets, rather than the performance of individual holdings. As ESG continues to grow in prominence, the monopolisation of the ESG industry by a handful of players should be resisted, and the increasing reliance of governments on the investment strategy for leveraging private finance to deliver environmental and social goals heavily scrutinised. To that end, this report proposes a three of principles for approaching the mobilisation of finance for rapid decarbonisation and environmental protection 1) Democratically, enabling everyone to have a stake and a say in this transition, and 2) Justly, ensuring both costs and benefits are distributed fairly both geographically and temporally.

1. **Building economic democracy:** Ensuring that everyone has a stake and a say in the economy requires a two-pronged approach to, first, embed democratic mechanisms between individuals, financial intermediaries, and the real economy; and second, drastically reduce inequality and scale up public wealth, so that the exercise of democratic voice is not restricted to those with financial assets or proportional to wealth. This should include the extension of company voting rights to stakeholders beyond shareholders, such as workers; it could also include mechanisms for growing employee stakes such as the Inclusive Ownership Fund. Further, the capitalisation of a public wealth fund with clear climate, environmental and social mandates should be pursued to build collective wealth, reduce inequalities in asset ownership, and drive targeted, patient investment in rapid decarbonisation and a just and sustainable economy.

2. **Mainstreaming sustainability in finance:** Rather than viewing ESG or sustainable/ethical investing as a niche industry, regulations for investing that support rapid decarbonisation and just social and economic outcomes should be mainstreamed, so that the financial system can serve the needs of society, rather than the interests of finance and the asset-rich. This could begin with legal reinterpretation of fiduciary duty, for example, requiring these duties to reflect the systemic risks posed by environmental and climate degradation. The UN Environment Program’s Finance Initiative, for instance, concluded that a failure to integrate ESG criteria constitutes
a violation of fiduciary duty, and an increasing number of cases are being brought against pension funds pertaining to fiduciary duties and climate change.

It’s notable that such a change would run directly counter to recent moves by the Trump Administration, which passed a rule effectively banning pension funds (401k) from using ESG strategies in the pension default option, and discourages the inclusion of ESG options for pension holders whatsoever. Importantly, greening of finance should also be reflected in regulation of the real economy to restrict carbon-intensive activity – thereby restricting investment in it – rather than relying on a finance-led approach. Indeed, the urgency of the climate crisis is such that we need to be restricting emissions-generating activities immediately, in addition to the sources of investment for those activities.

3. Championing public finance: A critical task in the coming years is the mobilisation of finance for underfunded areas like the decarbonisation of cement and steel, as well as crucially for the protection of nature and biodiversity and the pursuit of a socially just transition. In contrast to the emerging ‘Wall Street Climate Consensus’, governments should be encouraged to embrace ambitious, patient public investment in these areas, while resisting the commodification and financialization of the natural world. As Mariana Mazzucato argues, the ‘entrepreneurial state’ should be embraced as an investor in its own right, particularly in areas where the risk is too high for private finance, rather than as a vehicle for ‘de-risking’ these areas on behalf of private finance. In lieu of ‘socialising risks, privatising returns’, public investment banks with climate-focused mandates should be established to drive rapid decarbonisation.

Importantly, non-market based mechanisms for supporting investment in countries on the frontlines of the impacts of climate and environmental breakdown - while generally having done the least to contribute to these - must be rapidly scaled up, and private debts cancelled, rather than temporarily relieved as they have been during the Covid-19 crisis. As the Jubilee debt campaign notes, over a third of external debt owed by the 73 countries included in the G20’s Covid-19 debt relief agreement is owed to private speculators. As long as these creditors are excluded from debt relief agreements and remain the primary source of investment for these economies, debt relief negotiated between governments will continue to bail out these private creditors without enabling countries in need to use the relief to invest in public services or other vital areas like climate mitigation and adaptation. This system is both deeply unjust and holds back the necessarily global effort to mitigate climate change. Importantly, it will likely be exacerbated by a reliance on ‘sustainable’ private finance, leaving governments with high borrowing costs and highly vulnerable to market shocks and capital outflows.

Public finance should be embraced as a mechanism for investment that prioritises public good, not private return; many of the most urgent tasks ahead, from ecosystem restoration to reparative finance for global South nations on the frontlines of climate breakdown, cannot be commodified or securitised. Further, a failure to act on the historically low cost of public borrowing that has continued throughout the Covid-19 pandemic in order to drive economic recovery and rapid decarbonisation would be to miss an unprecedented opportunity to build a more sustainable, equitable and resilient economy. Rather than seeking ever-more ‘innovative’ financial mechanisms for meeting sustainability goals through private finance, the UK government should recognise its unique responsibility and capacity for delivering climate justice, and act on it.
Conclusion

With the world currently woefully off-track for the necessary task of limiting warming to 1.5°C, there is an urgent need to shift finance toward driving rapid decarbonisation and environmental sustainability. However, in the rush to do so, it’s imperative that mechanisms for generating investment in climate mitigation and adaptation are both effective and contribute to building an economy that is more equitable, democratic and sustainable by design. This is not just desirable - it is necessary, and studies continue to underscore the indissoluble relationship between inequalities of wealth and power, and soaring emissions and resource use. As is well documented, current distributions of consumption, emissions and economic power are fundamentally incompatible with a sustainable future, and guarantee destructive extraction of resources and land from global South communities in order to maintain the activities of comparatively wealthy countries including the UK. In light of this, as asset management and ESG investing in particular continue to grow in terms of both assets and influence, greater scrutiny of their respective uses and impacts is vital.

Policymakers and campaigners should be vigilant concerning the significant risks of green and impact-washing inherent to the current ESG landscape and supported by some of the findings in this report, and demand policies that not only shift finance from harmful to green investments, but actually drive the equivalent shifts in the activities of the real economy. Further, the drive toward green finance should be paired with steps to radically democratise an increasingly concentrated site of power and wealth in order to facilitate a just transition, as well as address the roots of climate and environmental breakdown in economic inequality both within and between countries.

As a policy programme, the Green New Deal should recognise the limitations of private finance, countering the ideological adherence among wealthy governments in Europe, North America and beyond to the role of the state as a ‘de-risking’ tool for private investors – rather than an investor in and of itself. Finally, it should firmly resist the extension of financial logics and mechanisms into new territories for profit-making, such as ‘development’ and ecosystem preservation, recognising that the solutions to the challenges we face lie in a shared and necessary commitment not to the collective good, and not in maximising returns for those with financial assets.
### Appendix: Climate-Themed Funds, Key Data

<table>
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<tr>
<th>Name</th>
<th>Fund Management Company</th>
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<td>Wellington Climate Strategy Fund USD N</td>
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14 For details see: https://www.nbim.no/.


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examining the rise of environmental, social, governance (esg) investing

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for further explanation, see chapter 4.3

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See CDP analysis, available at: https://www.cdp.net/en/companies/companies-scores

See InfluenceMap analysis, available at: https://influencemap.org/company/Ford-Motor/projectlink/Ford-Motor-In-Climate-Change


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‘Doing Well by Doing Good’? Examining the rise of Environmental, Social, Governance (ESG) Investing

Adrienne Buller


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All data is derived from the Thomson Reuters Eikon and Lipper databases. Date of disclosure/filing may vary between funds. The analysis in this report of portfolio holdings and total assets/flows is based on the most recent filings available, which may be as recent as 30 September 2020, or backdated to anywhere up 31 December 2019, for instance if a fund’s filings are only integrated to the database annually.

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Doing Well by Doing Good? Examining the rise of Environmental, Social, Governance (ESG) Investing

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This recommendation first appeared in Common Wealth’s ‘Green Recovery Act’, authored by Ewan McGaughey (2020). See: https://uploads-ssl.webflow.com/5e1b5c6919c05c76379535f9/5f16bc66347f3cc851542a04_Green%20Recovery%20Act_CW.pdf


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