Investment Challenges and Opportunities for Treasurers as ESG Drive Accelerates

Environmental, social and governance (ESG) is now a major area of responsibility for organisations – and treasurers have a crucial role to play in its implementation. A recent TMI webinar featuring Aberdeen Standard Investments, S&P, and corporate sustainability leader Tideway looked at the practical reality of rolling out ESG initiatives within treasury, with a focus on short-term investing.

The majority of corporate boards have not been strangers to ESG over the past few years, but recently they have experienced a marked increase in pressure from investors and regulators to deliver much more – and at pace – on factors including sustainability, governance, diversity, and inclusion.

With that greater scrutiny and pressure has come the need for firms to develop innovative solutions and gather more detailed, verifiable data that clearly demonstrates their progress in integrating ESG into their operations. This hardening of the nexus between ESG, financial performance and 'investibility' has led to treasurers being called upon to play an increasingly vital role in meeting the many and varied challenges ESG poses.

Kate McGrath, ESG Analyst, Fixed Income, Aberdeen Standard Investments (ASI), provides an insight for treasurers into just how seriously institutions are taking ESG factors into account when assessing a company. "ESG criteria are now a key part of any investment research at ASI because they help us to understand material risks and opportunities a company faces. To avoid greenwashing, what we're really looking for is solid evidence that a company's actions really do match up to its words."

Such intense institutional scrutiny means it is "really critical" treasurers also examine any fund in their portfolio that claims to be ESG compliant, says McGrath. ASI's own assessment process for funds indicates how clinical treasurers need to be in this regard. "Does the fund just exclude a few stocks such as, for example, cluster munitions manufacturers or companies shrouded in human rights abuses? That

By **Kam Patel**, Columnist

is classed as simple negative screening. Or does the fund conduct ESG analysis on every single financial instrument that they invest in? That is known as ESG integration. At Aberdeen Standard Investments, we integrate ESG into every single investment decision and by doing so we can be confident our funds are not simply greenwashing. They are making a positive difference."

Noémie de la Gorce, Director & Lead Analyst, Sustainable Finance, S&P Global, further underlines the importance attached to ESG by investment researchers and warns firms against complacency. "It would be a mistake for companies and their treasurers to think ESG is a temporary fad for the investment industry – it's actually an accelerating trend. The growing integration of environmental and social factors into S&P research is underpinned by serious and growing concerns around the financial impact of environmental and social trends on industries globally."

As at Aberdeen Standard Investments, S&P Global researchers are also mindful of making a meaningful impact. She adds: "ESG-washing is the number one risk in the industry at the moment. Box-ticking approaches to implementation of ESG are also a major concern."

Tideway shows the way

Construction engineering firm, Tideway, which is building a 40-mile (25km) 'super sewer' under the River Thames – the biggest infrastructure project ever undertaken by the UK water industry – is one company showing the way forward in ESG. The firm's award-winning ESG treasury team has successfully implemented a sustainable financing strategy to align with its mission to reduce polluting sewage discharge into the Thames.

Elina Todorova, Assistant Treasurer, Tideway, says the strategy has led to the issue of £1.5bn of green debt and a revolving credit facility (RCF) structured as sustainability linked loans. The RCF includes agreed ESG key performance indicators (KPIs), which, so far, the firm has managed to achieve. She explains the evolution of the strategy: "We began with the green bond framework, which we then expanded into a sustainable finance framework and that now enables us to use a wider range of instruments to support our sustainable financing strategy.

"We also obtained a Green Evaluation from S&P, which provided a second opinion that we are aligned with the Green Bond Principles. We now issue an annual Sustainable Finance Report, which tells our investors about the allocation of proceeds and the impact of the project. Our reporting is aligned with the United Nations Sustainable Development Goals [UN SDGs]."

Todorova believes Tideway's experience with ESG should provide encouragement for other treasurers. "Tideway has a great ESG story to tell, and everything we do is 'green' – so it's easy for us as a treasury team to engage in this. It's important, though, to recognise that all organisations have pockets that readily lend themselves to ESG initiatives and there is always somewhere that treasury can become involved. Having a board that's focused on the company's ESG strategy and supportive of its development and implementation, though, is crucial."

In terms of the types of tasks treasury can undertake, Todorova says: "The idea is to incorporate ESG considerations into risk management, into financing, into investment management and so on. Working out how ESG can integrate into treasury can be a very exciting process. At Tideway, it created a lot of learning and development opportunities for treasury. It also created engagement with the wider business – we've worked more closely with other parts of the organisation, especially with the sustainability team, for example."

And with the UK government having announced its intention for Great Britain to become the first country in the world to make Task Force on Climate-related Financial Disclosures (TCFD) reporting mandatory for companies and financial institutions, Todorova believes embedding ESG into everyday activities has become even more urgent for treasurers. "We really need to start demonstrating as businesses and as treasurers how well positioned we are to deal with climate-related, ESG-related risks and opportunities."

KATE MCGRATH

ESG Analyst, Fixed Income, Aberdeen Standard Investments (ASI)

Mounting regulatory pressure

The UK's TCFD proposals, scheduled to be fully phased in by 2025, will only amplify investor scrutiny of firms' ESG credentials, not least as investors themselves are coming under regulatory pressure to demonstrate how they incorporate environmental and social risk into their investment decision making. S&P's de la Gorce points to the EU's Sustainable Finance Disclosures Regulation, which came into effect in March 2021, as an instance of how ESG is steering investor decisions. The regulation, which aims to push private investment towards sustainable investing while preventing greenwashing, sets specific rules for how and what sustainability-

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related information must be disclosed by financial market participants and financial advisers operating in the EU.

More broadly, says de la Gorce, there is growth in regulation requesting investors to demonstrate not only how they consider the risks in their investment strategy but also how they are contributing positively to sustainability objectives such as the Paris Agreement and the UN SDGs. She believes it is inevitable that, as investors strengthen their ESG expertise, they will ask companies more and increasingly complex questions about their ESG practices.

As a key interface between investing clients and companies, asset managers such as Aberdeen have every incentive to ensure that, when it comes to ESG, they are practising what they preach. "It's one of the lessons we have learnt on our ESG journey," says McGrath. "If we're asking investee companies to display best practices, then we really need to have them in-house ourselves. So, we've improved our paternity leave policy, we've improved our governance, and we've recently joined the [UN-convened] Net-Zero Asset Owner Alliance.

"ESG really is no longer optional for anyone and at corporate level, we too have to follow high ESG standards, not least as ESG is financially material and is here to stay. As investors, if we're not on top of material ESG issues that a company faces, they might encounter huge financial repercussions and that will directly impact us as investors and it'll harm treasurers that have invested in our funds."

McGrath says the robust ESG credit framework in place at ASI means its analysts now rate all companies as high, medium or low ESG risk. The asset manager will not invest in anything in its cash management funds that is rated 'high' unless it is being compensated for the credit return. She highlights the case of one bank that has been excluded from money market funds (MMFs) ASI makes available to treasurers because it is deemed high-risk due to its poor governance.

More transparency needed

As treasurers strive to minimise risk by embedding ESG across processes and financial decision-making, one area that is likely to pose a few challenges is the investing landscape available to them. While it is developing quickly, it's still a work in progress. McGrath says: "We are seeing a growing green and sustainable deposit market and that does allow investors who are short term, like treasurers, to invest in shorter-term green projects. However, there really isn't a large enough supply of these yet. We hope to start investing in them in a more meaningful way in perhaps three to five years' time when the market is more developed."

Todorova echoes this, noting there has been a definite improvement in the ESG investment universe available for treasurers compared with when her team first started looking around two years ago. Nevertheless, more is needed in terms of choice and quality: "There are more ESG-labelled investments available now certainly. Even ones that are not classed as ESG products as such are starting to think about factoring ESG risks more actively. There is more innovation going on.

"But what I'd like to see more of is greater transparency from product providers generally, more willingness to have an open conversation and to share more information. As a corporate client, we need to be able to assess how fully integrated ESG assessments are in the funds or in the banks' processes and how these assessments are performed. That's important to us. It's not good enough if the fund manager has what looks like a really great product, but if you examine their overall ESG strategy, it doesn't match up. We need to be presented with a cohesive ESG story, not just in terms of the particular product, but in terms of the overall organisation."

As such, detailed questioning by treasurers of their banks and asset managers when considering ESG investments is crucial, says Todorova. "'What's your investment strategy? How do you identify, assess and integrate ESG factors into your decisions? Do you have a systematic approach? How exposed is your portfolio to ESG risks? Do you have any ESG rating? And how is your ESG policy overseen at senior level?' Those are the kinds of questions we asked. To see even more investment and effort in this area, there needs to be more meaningful, critical engagement from both investors and treasurers and asking those questions is essential."

Apples and oranges

Ratings agencies are of course set to play a major role in providing treasurers with guidance on ESG going forward. De la Gorce says S&P's new initiatives in the space include an increase in the analytics being provided to markets on the link between the ESG factors and credit quality. More recently, S&P has started developing specific methodologies – separate from credit ratings – to explore and assess the sustainability credentials of companies and transactions. And, as deployed for Tideway, it has developed an ESG rating called the 'ESG Evaluation' to further improve transparency across the burgeoning space.

De la Gorce notes, however, that the most significant challenge facing S&P, and the industry as a whole, is the lack of standardised data. The absence of equivalents such as International Financial Reporting Standards (IFRS) or US Generally Accepted Accounting Principles (GAAP) for the ESG space is a major hindrance for all parties as it is difficult to benchmark companies if they are not reporting comparable data. "Because of this low level of comparability across ESG reporting, we don't think an ESG rating can be purely quantitatively driven or algorithm-based. Instead, we have developed a methodology that incorporates qualitative information because there are many ESG aspects that can't be really captured quantitatively.

"We have also developed a framework within which analytical judgment is key. Direct engagement with companies is critical in our process. We talk to the sustainability team of the company, and other stakeholders within the organisation, like Human Resources, for example. We request meetings with board members too as we want to assess not only the operational, environmental, social governance risk a company may face but also its strategic thinking around ESG. Is the board engaged? Have board members identified ESG as a potential future disruption? Is sustainability included in key strategic positions?"

S&P's comprehensive green evaluation of Tideway is an example of the agency's ESG methodology in action. It involved qualitative and quantitative analysis of the company as well as direct dialogue with key players at Tideway and the leveraging of expertise on the sector and Tideway from S&P colleagues in the infrastructure and utilities and teams. "In the case of Tideway, we also took into account that it is a regulated entity and factored in aspects where it goes beyond local regulations, for example, in terms of biodiversity, and inclusion initiatives," says de la Gorce. "Additionally, we carried out an analysis of Tideway's sustainability credentials, the environmental risk associated with the construction of the tunnel as well as the positive environmental impact associated with the tunnel once it's in operation."

ELINA TODOROVA

Assistant Treasurer, Tideway

Tideway's Todorova says that S&P's evaluation was the output of a thoughtful discussion which also involved the company's board. She adds: "One of the main reasons we wanted to have the assessment was to have a report to make publicly available as we were starting to get numerous ESG-related requests for information from many different directions, including our shareholders and investors. The questions were coming in different formats and it was becoming time consuming dealing with them.

"At the same time, we were also aware of rating agencies completing unsolicited assessments about our ESG credentials on behalf of investors. Sometimes we would have the opportunity to comment, fix some inaccuracies and provide more information, but in most cases we would not have the opportunity to get involved with comments at all. So, it became very important to have a comprehensive report that tells our story in a clear way that is publicly available, that is also an independent and objective view of how we're doing, how engaged the board is, and how prepared we are to deal with ESG risks and opportunities. And the evaluation from S&P produced exactly that."

Even as corporate treasurers look to address the many challenges being presented by ESG right now, it is clear to Todorova they will only intensify over the coming years: "Mandatory reporting requirements, for example, are certainly coming our way and we do need to get serious about what they will represent. Also, we just cannot afford to ignore the potential repercussions from failing to recognise and manage ESG risks and opportunities of relevance to our businesses. By tackling such challenges head on, I think treasurers can and will play a key part in driving the sustainability agenda."

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