SUSTAINABLE FINANCE BEYOND PRECONCEPTIONS

ItaSIF Italian Sustainable Investment Forum

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1 INTRODUCTION

In recent years, sustainable finance has emerged as a critical concept in the business and investment landscape, reshaping the way companies operate and investors evaluate potential opportunities. The sustainable finance approach considers both economic/financial as well as environmental and social aspects and plays a crucial role in creating longterm value, managing risk, and promoting a positive impact on society and the environment.

Sustainable finance has extended beyond the boundaries of the finance sector, capturing the attention of a wide range of stakeholders, including governments, corporations, civil society and the general public. This phenomenon has led to sustainable finance being discussed outside its traditional scope. The increased attention has been sparked by urgent global challenges we face such as climate change, social inequality, and natural resource depletion. Financial institutions and investors have a crucial role to play in promoting sustainability and leading the transition to a more inclusive, low-carbon and resilient economy. The broad awareness of sustainable finance outside the financial sector highlights the interconnectedness of finance, the economy, and the well-being of society and the environment. This underscores the importance of aligning financial practices and systems with sustainable development goals, promoting responsible investment, and contributing to a more sustainable and equitable future for all.

Despite its growing popularity, sustainable finance is facing increasing criticism, especially regarding environmental, social, and governance (ESG) factors. The Italian Sustainable Investment Forum (ItaSIF) aims, through this position paper, to debunk some of the main arguments raised, offering an analysis based on the European market to refute these criticisms and highlight the concrete benefits offered by sustainable finance. Through arguments grounded in technical and scientific evidence, we aim to reaffirm the importance of sustainable finance as a major driver of economic, social, and environmental progress. It is essential to emphasize that pursuing sustainable finance does not imply a departure from the free market principles but emphasizes the need to integrate sustainability into financial decisions, promote a holistic and long-term approach to investments, and contribute to the overall well-being of present and future generations.

In this position paper, we analyze the main arguments used against sustainable finance, demonstrating their groundlessness from a scientific point of view. We have tried to use reliable and unbiased sources, not biased by lobbies[1] or ideological and political opinions[2].

In particular, we examine claims about greenwashing, lack of standardization, and the relationship between financial performance and sustainability. Through an evidence-based analysis, we demonstrate the solidity of sustainable finance and refute the notion that sustainability harms investment profitability by highlighting the economic benefits of sustainable finance. Using case studies[3] and best practices, especially from Italy, we show how adopting sustainable practices generates performance and reduces risk. We show that considering sustainability in investments correlates positively with risks and returns, leading to reduced volatility and improved long-term financial performance. We recognize the need for continuous improvements and efforts to develop global standards and improve transparency and data quality. In addition, we emphasize the importance of collaboration among companies, investors, and regulators to ensure the efficiency and integrity of sustainable practices. In a surprising manner, the criticisms and attacks have contributed to the development of sustainable investment, promoting the education of the various stakeholders and increasing awareness that there is no such thing as a universal investment, financing, or insurance strategy.

[1] Dharna Noor (2023) *Rightwing war on 'woke capitalism' partly driven by fossil fuel interests and allies.* The Guardian: https://tinyurl.com/262vjv4w
[2] Pleiades (2023) *STATEHOUSE REPORT: Right-Wing Attacks on the Freedom to Invest Responsibly Falter in Legislatures:* https://tinyurl.com/2junzcfr
[3] The studies and research cited in the paper are to the best of our knowledge drawn from reliable and unbiased sources and not influenced-to our knowledge-by lobbies or ideological and political opinions.

2 PREFERENCES OF THE INVESTOR

The criticism is that sustainable finance does not consider the preferences of the investor. FALSE

The free market is based on the premise that participants can choose where to invest their resources, and financial preferences play an important role in shaping investment decisions. The investor preferences refer to the individual or institutional investor's personal inclinations, desires, and priorities in making investment decisions. These preferences can vary greatly from investor to investor and can be influenced by a number of factors:

- » **Regulatory initiatives:** current regulations, tax policies, and legal frameworks can incentivize or discourage investment in certain sectors or asset classes.
- » **Social and environmental aspects:** investors' preferences may be influenced by social and environmental considerations.
  For example, some investors prioritize investments that show sustainable practices or support renewable energy.
- » **Personal values and beliefs:** investors may have personal values or beliefs that determine their preferences. They may choose to invest in line with their religious or ethical principles.
- » **Information and education:** access to information, as well as the degree of financial education of investors, can affect preferences. Investors who are well informed about financial markets and investment options can make more conscious choices.

In synthesis investor preferences are a key element in investment decision-making and can be influenced by a wide range of individual and institutional factors.

2.1. FIDUCIARY DUTY

In addition, and equally relevant in the context of investor preferences, is the fiduciary duty that all financial market participants must observe and for which they are directly responsible. Fiduciary duty implies an obligation to pursue the best possible result for the client, considering existing conditions and available information, through an appropriate application of diligence and expertise, and this necessarily includes the integration of ESG factors and sustainable practices. Fiduciary duty requires risk assessment, and this implies consideration of ESG criteria since disregarding them increases risk. In summary, fiduciary duty requires the adoption of prudent behavior, acting in good faith, and observing impartial loyalty to clients or beneficiaries. This responsibility includes assessing the risks, returns, and liquidity characteristics of investments in order to make informed decisions that are consistent with the interests of the beneficiaries. Accordingly, considering sustainability in the approach is an integral part of this duty.

2.2. DIVERSIFICATION OF INVESTMENTS

The omission of sustainability considerations in investments can limit diversification opportunities for investors, thereby increasing the level of risk. Diversification is a key strategy in risk management, as it allows potential losses to be mitigated. In an environment characterized by profound environmental, social, and geopolitical changes, failure to consider sustainability factors could hinder the achievement of an optimal diversification, thereby increasing risk exposure. The consideration of sustainable aspects promotes diversification by stimulating innovation and increases market efficiency by enhancing competition.

Overall, in a free market limiting diversification can hinder competition, increase costs, reduce returns, encourage the development of dominant positions, and slow down innovation. It is essential that the free market promotes diversified and competitive financial offerings, giving investors a wide range of options and opportunities to satisfy their financial goals.
Consideration of sustainability factors is critical precisely because it broadens the choices available to investors.

Case Study

TEXAS MUNICIPAL BONDS

Daniel Garrett and Ivan Ivanov's study analyzes how government regulation limiting the adoption of ESG policies can distort financial market outcomes. *"...The state of Texas enacted laws in 2021 that prohibit municipalities from contracting with banks that have certain ESG policies. This led to the exit of five of the largest municipal bond underwriters from the state..."* [4].

The law was enacted to protect certain industries present in the state of Texas. The authors of the study conclude that: *"We find that municipal bond issuers with previous reliance on the exiting underwriters are more likely to negotiate pricing and incur higher borrowing costs after the implementation of the laws. Among remaining competitive sales, issuers face significantly fewer bidding underwriters and higher bid variance, consistent with a decline in underwriter competition.*

Additionally, under-pricing increases among issuers most reliant on the targeted banks and bonds are placed through a larger number of smaller trades. Overall, our estimates imply Texas entities will pay an additional $303–$532 million in interest on the $32 billion in borrowing during the first eight months following the Texas laws." [5]

The conclusion shows that these kinds of laws, contrary to the incorporation of ESG assessments, have acted against the underlying premise of the free market, namely that investors can freely choose where to invest their resources, and have instead diminished profits, reduced competition and diversification, and stifled innovation.

[4] Angie Basiouny (2022) *Texas Fought Against ESG. Here's What It Cost. Knowledge at Wharton*: https://tinyurl.com/3ttx63ne
[5] Daniel G. Garrett Ivan T. Ivanov (2022) *Gas, Guns, and Governments: Financial Costs of Anti-ESG Policies*: https://tinyurl.com/mrx2d6s4

2.3 PREFERENCES AND REGULATIONS

Sustainability preferences are embedded in the European financial regulations. Several key regulatory frameworks, such as Delegated Regulation (EU) 2021/1253 incorporating MiFID II (Markets in Financial Instruments Directive II)[6], IDD (Insurance Distribution Directive)[7], and IORP (Institutions for Occupational Retirement Provision)[8], emphasize the importance of identifying and considering beneficiaries sustainability preferences.

Under these regulations, financial players, including banks, investment companies, insurance companies, and pension funds, are required to assess and understand the sustainability preferences of their customers. This means that they must collect information about their customers' sustainability preferences, values, and goals when providing investment or insurance services in order to offer products aligned with these preferences. Integrating sustainability preferences aims to improve transparency, enables clients to make informed decisions, and promotes the growth of sustainable finance. The inclusion of sustainability preferences in European regulations reflects the growing importance placed on sustainable investments. Overall, this regulatory emphasis on sustainability preferences ensures that financial intermediaries play an active role in promoting sustainable finance and supporting clients' sustainable investment choices. Additionally, it fosters a more customer-centric approach and contributes to the broader goal of aligning the financial sector with the principles of sustainable development.

3 NORMS AND THE ACTIVE ROLE OF STATES

The criticism is that the role of states in finance is only that of a regulator. FALSE

In the moment a government commits to aligning its public policies with certain sustainability goals, for example by joining the Paris Agreement, it explicitly positions itself as a key player in the financial arena. Indeed, the commitment to fight for a climate transition requires a government to be not only a regulator, but an active participant in financial matters. In Europe, this perspective has been embraced not only through the establishment of defined and set targets, but also through the passage of legislation in support of these efforts.

The regulatory framework for sustainable finance under development aims to integrate consideration of sustainability aspects into financial activities. The European regulators have taken significant steps to promote sustainable finance and to ensure that financial decisions give due consideration to the risks and opportunities associated with sustainability. Sustainability norms aim to direct investments toward economic activities that have a positive impact on the environment and society and to enable more effective management of associated risks. Financial markets should thus align with sustainability goals such as the fight against climate change and the United Nations Sustainable Development Goals (SDGs).

[6] Directive 2014/65/EU of the European Parliament and of the Council (MiFID II): https://tinyurl.com/424235yc
[7] Directive (EU) 2016/97 of the European Parliament and of the Council (Insurance Distribution Directive): https://tinyurl.com/vhzpz6fu
[8] Directive (EU) 2016/2341 of the European Parliament and of the Council on the activities and supervision of institutions for occupational retirement provision (IORPs) - consultation on the technical advice for the review of the IORP II Directive:: https://tinyurl.com/5n78jcta

Several key legislation initiatives have been introduced in Europe to facilitate the integration of ESG factors into financial practices.
We list a few to highlight the scope and complexity of the legislative body being enacted.

3.1. TAXONOMY

The so-called Taxonomy Regulation[9] establishes a classification system (or taxonomy) that defines which economic activities can be considered environmentally sustainable. It provides finance with a common language and supports the European Union's goal of fostering the climate transition.

3.2. CORPORATE SUSTAINABILITY REPORTING DIRECTIVE (CSRD)

The Corporate Sustainability Reporting Directive (CSRD)[10] requires companies to disclose sustainability information by amending the Non-Financial Reporting Directive (NFRD). The goal is to increase the quantity, quality, and comparability of sustainability information.

3.3. CORPORATE SUSTAINABILITY DUE DILIGENCE DIRECTIVE (CSDDD)

The Corporate Sustainability Due Diligence Directive (CSDDD)[11] aims to promote sustainable and responsible corporate behavior along the "value chain" and provides legal certainty to companies and greater transparency to consumers and investors. In fact, companies will be required to integrate due diligence into corporate policies. This legislation is awaiting final approval.

3.4. SHAREHOLDER RIGHTS DIRECTIVE II (SRD II)

Shareholder Rights Directive II (SRD II)[12] aims to strengthen investor rights and improve communication between listed companies and their shareholders. It promotes shareholder engagement and transparency by requiring institutional investors and asset managers to disclose their engagement policies and exercise voting rights responsibly. This encourages shareholders to consider ESG factors in their engagement actions with investee companies.

3.5. SUSTAINABLE FINANCE DISCLOSURE REGULATION (SFDR)

The Sustainable Finance Disclosure Regulation (SFDR)[13] establishes disclosure requirements for financial market participants and asset managers regarding the integration of sustainability factors into their investment processes. The goal is to improve transparency and provide investors with information on how sustainability considerations are integrated into investment decisions.

3.6. MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE (MIFID II)

The Markets in Financial Instruments Directive (MiFID II)[14] provides a legal framework for financial instrument markets, financial intermediaries, and trading venues. The directive provides harmonized regulation for investment services in the European Union (EU). Its main objectives are to increase competition and investor protection and to create a level playing field for investment participants.

[9] Regulation (EU) 2020/852 of the European Parliament and of the Council (Taxonomy Regulation): https://tinyurl.com/25b999ue
[10] Directive (EU) 2022/2464 of the European Parliament and of the Council (Corporate Sustainability Reporting Directive): https://tinyurl.com/33vnubrh
[11] Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937 (Corporate Sustainability Due Diligence Directive Proposal): https://tinyurl.com/yn2ucwbd
[12] Directive (EU) 2017/828 of the European Parliament and of the Council (Shareholder Rights Directive II): https://tinyurl.com/etrr2dnz
[13] Regulation (EU) 2019/2088 of the European Parliament and of the Council (Sustainable Finance Disclosure Regulation): https://tinyurl.com/mu7t4n59
[14] See footnote 6

3.7. SOLVENCY II

EU Delegated Regulation 2021/1256 amends EU Delegated Regulation 2015/35 (Solvency II)[15] by introducing new tasks for the risk management function. In particular, reference is made to the amendments that require the risk management function to identify and assess emerging risks and sustainability risks both at the level of the Risk Appetite Framework (RAF) and the Risk policy and to integrate these risks into the assessment of the firm's overall solvency needs.

3.8. INSURANCE DISTRIBUTION DIRECTIVE (IDD)

The Insurance Distribution Directive (IDD)[16] regulates the design and distribution models of insurance products in the EU. It aims to provide a base regulatory framework for consumer protection.

3.9. EU EMISSIONS TRADING SYSTEM (EU ETS)

The Emissions Trading System (EU ETS)[17] is a European Union emissions trading system and is one of the main instruments underpinning the EU's climate change politics. It is an essential tool for cost effective reduction of greenhouse gas (GHG) emissions. The EU ETS operates under the principle of a "Cap and Trade," according to which a cap or limit is set, which establishes the maximum amount that can be emitted by installations covered by the system. Within this limit, companies can buy or sell allowances according to their needs.

3.10. CARBON BORDER ADJUSTMENT MECHANISM (CBAM)

The Carbon Border Adjustment Mechanism (CBAM)[18] is an EU border adjustment mechanism to address emissions embedded in certain types of goods when they are imported into the EU, thereby encouraging more sustainable industrial production outside the EU as well. It is a tax designed to protect European industry undergoing decarbonization from those external competitors that are not subject to the EU's climate goals. It works in tandem with the phase-out of allowance allocation under the EU ETS Cap and Trade. It is one of the key elements in achieving the European Union's climate goals.

3.11. EUROPEAN SINGLE ACCESS POINT (ESAP)

The EU will establish the European Single Access Point (ESAP)[19], a single point of access to publicly available financial and sustainability information about EU companies and investment products. The database is currently being developed.

3.12. CLIMATE BENCHMARKS REGULATION

The Climate Benchmarks Regulation[20] defines investment benchmarks that incorporate specific targets related to the reduction of greenhouse gas (GHG) emissions and the transition to a low-carbon economy.

[15] Directive 2009/138/EC of the European Parliament and of the Council (Solvency II): https://tinyurl.com/yt5e38ue
[16] See footnote 7
[17] EU Emissions Trading System: https://tinyurl.com/cb7ze7m5
[18] Carbon Border Adjustment Mechanism: https://tinyurl.com/86sww4sd
[19] Proposal for a Regulation of the European Parliament and of the Council establishing a European single access point: https://tinyurl.com/mtzxze8y
[20] Implementing and delegated acts - EU Climate Transition Benchmarks Regulation: https://tinyurl.com/2nbkf4sx

3.13. EU GREEN BOND STANDARD (EUGBS)

The EU Green Bond Standard (EUGBS)[21] establishes a voluntary standard for green bonds. Green bonds are playing an increasingly important role in financing the activities necessary for the transition and achievement of the European Union's climate goals.

In conclusion, legislation is moving at a rapid pace in Europe. For example, among the new developments coming, is the directive on Green Claims[22] against greenwashing which is being considered. In addition, as stated previously, ESG risk considerations are becoming increasingly important, on regulations such as Basel III[23] , Solvency II[24] , and IORP[25] that impact the entire financial sector.

Italian best practices

ANIA

Considering the rapid succession of the regulatory updates on sustainability, which represents a key issue for the Italian insurance sector, ANIA decided to launch in 2022 an observatory on sustainability for insurance companies. Through periodic updates, the publication aims to provide a useful guide on the ongoing developments of the regulatory framework of sustainable finance. ANIA has also launched in 2021 "ANIA Exploring Sustainability", a newsletter in English language, that aspires to provide useful information about the rapidly evolving regulatory context of sustainability, addressing specific features of the legislation in question in each issue. Starting from an initial focus on the SFRD and the Taxonomy Regulation, the series has subsequently started to deal with the level 2 regulation, focusing on the different taxonomy delegated acts which the 2023 edition is continuing to address.

[21] Proposal for a Regulation of the European Parliament and of the Council on European green bonds: https://tinyurl.com/yvy5uk7w
[22] Proposal for a Directive on green claims: https://tinyurl.com/2mcp93zp
[23] Directive 2009/138/EC of the European Parliament and of the Council (Basel III): https://tinyurl.com/2w8zrz6f
[24] See footnote 15
[25] See footnote 8

4 THE ROLE OF MEASUREMENT, PROCESSING AND DATA COLLECTION

The criticism is that sustainability cannot be measured. FALSE

Sustainability assessment in investment practices involves measuring the sustainability performance of issuers that are part of portfolio and the investment, financing, or insurance products. Measurement is made complex given the insufficient standardization and lack of data. At the same time, with the increasing availability of ESG data from different sources, the risk of information overload arises. Investors and financial professionals may find it difficult to select the most relevant and reliable information within the vast amount of data available. In addition, for some metrics, such as Scope 3 emissions, it may be complex to collect complete data, which may require the use of estimates. Assessing social impacts can also present challenges, but it is not impossible when appropriate data and tools are available. In any case, it is essential that the methodologies used are clearly defined and rendered transparently to avoid "greenwashing."
It is essential to make efforts to achieve standardization and consolidation of data to simplify the collection, the reporting, and analysis of ESG data. Despite recent European regulations aimed at improving the transparency and quantity of available information, there still remain many open challenges, including insufficient data standardization, data gaps, difficulties in understanding the importance of ESG issues, and potential labeling and rating problems.

4.1. STANDARDIZATION OF DATA

One challenge is the lack of standardized data on ESG factors. To measure sustainability, investors often rely on data collected and communicated by the companies themselves or third-party data providers. However, benchmarking across companies and sectors is complicated by the lack of uniformity in sustainability reporting methodologies across companies and sectors. Efforts are underway to develop global reporting standards by various bodies such as the Global Reporting Initiative (GRI)[26], the International Sustainability Standards Board (ISSB)[27] and the European Financial Reporting Advisory Group (EFRAG)[28] to promote consistent and comparable ESG data. For example, EFRAG and GRI have published a joint statement on the high level of interoperability achieved between the European Sustainability Reporting Standards (ESRS) and GRI Standards[29]. The sustainable investment regulatory landscape is evolving globally, with variations in regulatory frameworks, standards, and disclosure and reporting requirements across jurisdictions. This can create challenges for investors and financial institutions operating in multiple markets. The harmonization and convergence of approaches make the work of GRI, the ISSB, and EFRAG even more important.

4.2. BENCHMARKING

Relevant and reliable benchmarks are needed to assess the performance of sustainable investments. The development of appropriate benchmarking methodologies that can capture the characteristics of sustainable investments is essential to provide meaningful comparisons of performance. The EU has started on this with the Climate Benchmarks Regulation on climate benchmarks already mentioned, but it will need to continue to evolve to establish consistent measurement methodologies, as well as to improve

[26] Global Reporting Initiative (GRI): https://tinyurl.com/2bd7bpye
[27] International Sustainability Standards Board (ISSB): https://tinyurl.com/ehu2p8fz
[28] EFRAG: https://tinyurl.com/2d7p3nn9
[29] EFRAG-GRI (2023) *Joint statement of operability*: https://tinyurl.com/3xw2pfm9

the quantity, quality, and transparency of data. This will be critical to building accurate and comparable assessments of sustainability performance[30].

4.3. GAPS IN DATA

Despite the increasing availability of ESG data, there are still gaps in some sectors, regions, or nations, which make assessment difficult. Closing data gaps requires ongoing collaboration among regulators, companies, and data providers to encourage more comprehensive and standardized reporting. Two of the regulations that are addressing this issue are the Corporate Sustainability Reporting Directive (CSRD)[31] and the Corporate Sustainability Due Diligence Directive (CSDDD)[32].

4.4. UNDERSTANDING

Investors and market participants may have a limited understanding of ESG factors and their relevance in financial processes. This lack of understanding can hinder the effective integration of sustainability considerations into investment practices. Initiatives such as investor and financial advisor education programs, as well as education/training tracks and sector campaigns, can help improve knowledge and awareness of the importance of sustainability in finance. To make such initiatives effective, however, it is essential to standardize the terms and definitions used so that communication is clear and consistent. Developments in the European regulatory framework aim precisely at this.

4.5. LABEL AND RATING

The expansion of sustainable investments has led to an increase in the number of financial products that present themselves as sustainable. However, cases of greenwashing occur, which can undermine the confidence in the financial market. To address this issue, it is essential to establish clear standards and requirements for classifying sustainable investments to ensure transparency and credibility in the market.

It is critical to understand investors' preferences and provide them with accessible information on sustainable investment products and the provision of robust tools to assess the sustainability performance of investments. Overcoming these challenges requires the collaboration of all stakeholders, including governments, regulators, financial institutions, rating agencies, and investors, to promote transparency, standardization, and education about sustainable investments. Despite efforts to establish industry standards, improve data quality and accessibility, and strengthen the verification and validation of sustainability claims, this remains an open challenge.

[30] Opinion of the European Economic and Social Committee on the Proposal for a Regulation of the European Parliament and of the Council establishing a European single access point: https://tinyurl.com/mrkj6sh9

[31] See footnote 10

[32] See footnote 11

Italian best practices

ETICA SGR

Proprietary ESG risk measurement methodology

In addition to traditional financial risks, the study and management of risks stemming from ESG factors are gaining increasing importance. Etica Sgr, which has stood out with its ethical and sustainable approach to investments since its founding in 2000, has developed a proprietary rating known as ESG Risk. This metric calculates the investment risk derived from environmental, social, and governance factors. The starting point for the development of ESG Risk is the concept of entropy, which in statistics represents the measurement of disorder, and it takes as inputs the weights of securities in the portfolio and the ESG scores assigned by Etica Sgr to issuers based on their consideration of sustainability issues. This way, securities are categorized into categories of ESG Risk. Studies have shown that financially riskier portfolios also exhibit a more significant ESG Risk. This metric, integrated into the security selection process, is therefore an important tool to define the Investable Universe of investment funds in such a way that there are no significant discontinuities in sustainability risk value over time.

Furthermore, in the management process, ESG Risk allows for monitoring the impacts of sustainability risk on investment fund returns, calculating performance adjusted for ESG Risk, as required by current regulations. Robust evidence[33] has demonstrated that ESG Risk control reduces unexpected volatility of portfolios and helps to optimize diversification, thus offering a competitive portfolio risk management over time.

[33] P. Capelli, F. Ielasi, A. Russo (2021) *Forecasting volatility by integrating financial risk with environmental, social, and governance risk.* Corporate Social Responsibility and Environmental Management: https://tinyurl.com/bd5j7xs5

Italian best practices

MIROVA

To enhance investment decisions, as well as monitoring and reporting on the environmental and social performance of assets, Mirova (Natixis Group) relies on quantitative indicators as a complement to its qualitative views. It monitors these indicators at several levels:

- » At the level of the invested assets, Mirova uses them as parameters in the investment decision process and as a basis for follow-up exchanges with management after investment. Indicators are tailored to reflect the specificities of each asset
- » At the portfolio level, to ensure the alignment and performance of invested assets with respect to the ambitions of a given fund.
- » Consolidated at the asset class level, these indicators illustrate the consistency and impact of Mirova's overall roadmap.

These indicators can take several forms.

- » **'Physical' indicators**
  Quantification of certain key monitoring indicators expressed in physical units, e.g. tons of CO2, number of jobs created, share of women in management positions.
- » **Level of exposure**
  How much of the investments or market indices are exposed to certain issues, e.g. share of investments offering solutions to climate issues or exposure to controversial human rights issues.

In addition, in partnership with Iceberg Data Lab and consulting firm I Care, Mirova has contributed to develop Corporate Biodiversity Footprint (CBF), a tool to model the impact of listed companies on biodiversity.

5 THE PERCEIVED COST BIAS OF SUSTAINABLE FINANCE

The criticism voiced is that the costs of sustainable products are higher than the costs of traditional products. FALSE

A major misconception about sustainable finance is that the costs of ESG products are higher than those of non-sustainable products. For example, when the Commissione Nazionale per le Società e la Borsa (CONSOB)[34] analyzed Italian investor households' knowledge, interest, and underwriting of sustainable investments, only 14% perceived them to be less expensive than non-sustainable products.
As already stated in this paper we are discussing EU sustainable financial products, and this is relevant since the geographical location in which financial products are sold plays a crucial role in determining their fee structures. According to Morningstar, the EU region accounts for more than four fifths of sustainable fund assets globally. The analysis of fees always considers the assets under management (AuM) being addressed. In an article in Morningstar magazine of 2022 states: *"...scale is correlated with lower cost, more choice, and generally higher transparency, all of which clearly benefit investors..."*[35]. Cost analysis typically involves calculating averages, which naturally results in the presence of outliers both above and below the average; in this context, we concentrate on the EU average, since it gives a broader picture without concentrating on single exceptional outliers. The year the financial product was placed on the market is another factor that affects cost structures. Newer products tend to have lower fees as they are not burdened by legacy issues. Moreover, the commercial decisions made by asset managers play a role in cost analysis. In the case of highly coveted or highly competitive asset classes or categories, asset managers may opt for lower commissions in order to attract clients and remain competitive in the market.
Consideration of these numerous factors provides a more complete understanding of the cost structures associated with financial products and, therefore, enables investors to make informed decisions through a cost assessment that takes into account geographic variations, AuMs, the year of product launch, and the strategic decisions of patrimonial managers.
One factor we considered when choosing the available analyses and research is that the source had to be a reliable source. The methodologies differ, but all the studies come to the same conclusion: fees are lower in sustainable products than in their traditional counterparts; as a result, one of the main criticisms made of sustainable finance can be considered refuted.

5.1. EUROPEAN SECURITIES AND MARKETS AUTHORITY

The European Securities and Markets Authority (ESMA) publishes *"Costs and Performance of EU Retail Investment Products"*[36] annually. This is an analysis of costs and performance of retail investment products in Europe, focusing on the Undertakings for Collective Investment in Transferable Securities (UCITS), that follow ESG strategies compared to traditional UCITS. UCITS represents the largest retail investment sector in the EU, and the analysis by ESMA covers a sample of financial products amounting to €10 billion in AuM, of which retail investors held just under €6 billion in 2021.

[34] CONSOB (2022) *Report on financial investments of Italian households*: https://tinyurl.com/mwnd6stw
[35] Morningstar (2022) *Will Anti-ESG Forces Undermine What Made American Mutual Funds Great?*: https://tinyurl.com/4p9z5796
[36] ESMA (2023) *Costs and Performance of EU Retail Investment Products 2023*: https://tinyurl.com/swjx34p6 Annexes: https://tinyurl.com/3arftp6r

ASR-CP.19
UCITS net performance and costs over one year
ESG funds outperformed in 2021

	ESG	NON-ESG
	All funds (equity, bond and mixed UCITS)	
Costs	1.3%	1.4%
Net performance	22.8%	16.8%
Number of funds	1,916	12,137
	Equity UCITS	
Non-ETFs		
Costs	1.4%	1.9%
Net performance	32.8%	28.8%
Number of funds	952	4,017
ETFs		
Costs	0.6%	0.4%
Net performance	31.8%	31.8%
Number of funds	115	648
	Bond UCITS	
Costs	0.9%	1.0%
Net performance	3.6%	4.2%
Number of funds	398	3,384
	Mixed UCITS	
Costs	1.6%	1.8%
Net performance	15.0%	13.1%
Number of funds	451	4,088

Source: ESMA

ESMA states in its 2023 analysis that *"…Costs have declined further, albeit at a slow pace; they were higher for cross-border funds than for domestic funds, mainly due to the heterogeneity of distribution channels and costs. Inflation and its negative impact on portfolio values started to rise in 2021. Costs for active equity and bond UCITS were higher than for passive and UCITS exchange traded funds (ETF)…Across EU Member States, cost heterogeneities persisted. ESG funds remained, on average, cheaper in 2021 compared to non-ESG equivalents and outperformed in net terms…"*

"…The previous reports concluded that ESG UCITS (ETFs excluded) were less expensive than non ESG equivalents. This conclusion remains valid in 2021 (ASR-CP.19) (see below): at 1.3%, the total costs of ESG UCITS were on aggregate lower than the costs of non-ESG equivalents (1.4%). This result holds for the three asset classes considered (ETFs excluded) [37].

In conclusion, it can be said that since ESMA began its annual analysis in 2019, fees on sustainable UCITS products (excluding ETFs) are lower in all categories analyzed by ESMA.

[37] See footnote 36

5.2. EUROPEAN ETF INDUSTRY YEARBOOK: REVIEW 2022 AND OUTLOOK

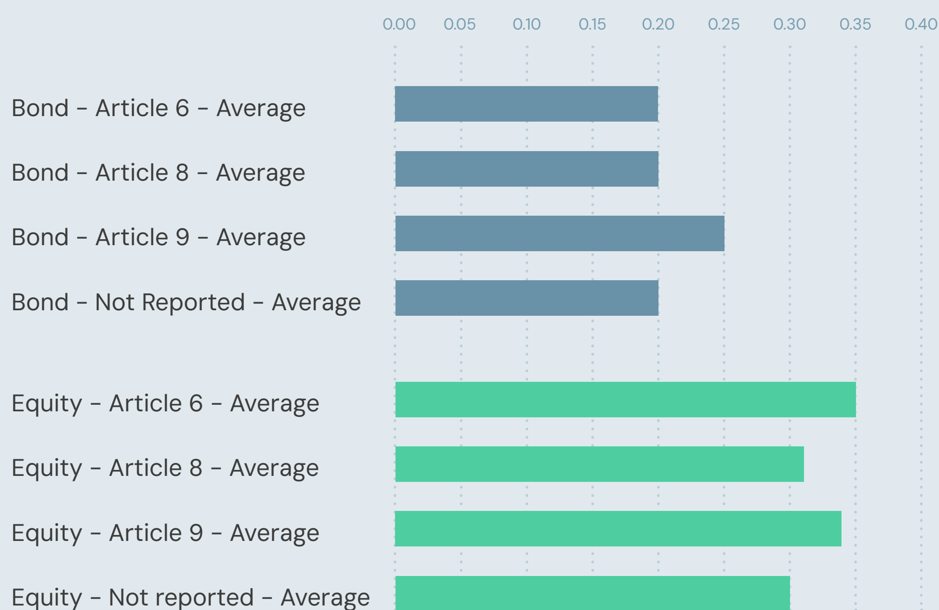
In its report, ESMA stated that it did not have sufficient data to create a separate category for ESG bond ETFs and mixed ESG ETFs, due to the limited number of ETFs on the market. Therefore, in order to verify the costs related to these product categories, it was decided to consult Refinitiv's publication[38]. Refinitiv notes that: *"…Assets under management in the European ETF industry stood at €1,242.2 bn at the end of December 2022…"*

Refinitiv continues by analyzing the data according to SFDR[39] categories:

"…One of the prejudices that ESG-related products face is that these products are too expensive compared to their conventional peers. That said, it seems to be logical that ESG-related products are more expensive than their peers, since the managers and index promoters need more data to determine the constituents of their portfolios/indices… A detailed view on all bond and equity ETFs in Europe grouped by their respective SFDR article shows that the TER of the average article 8 equity ETF (0.31%) and the average article 9 equity ETF (0.34%) are below the average conventional (article 6) equity ETF (0.35%). Within the bond segment, we see that the average TER of article 9 bond ETFs (0.25%) is substantially higher than the TER of conventional (article 6) bond ETFs (0.20%), while the average article 8 bond ETF had the same average TER (0.20%) as conventional bond ETFs…"

In addition, Refinitiv confirms the argument of the initial cost of an ETF and the relationship between cost and AuM: *"…That said, it seems to be logical that ESG-related products are more expensive than their peers, since the managers and index promoters need more data to determine the constituents of their portfolios/indices. […] Since the European ETF industry is very competitive and European investors are often seen as cost cautious, we may witness falling TERs for ESG-related bond ETFs when the number of ETFs in the respective Lipper Global Classifications is increasing, since the ETF promoters in Europe may use the TERs of their products as marketing tools. […]. It can be concluded that ESG-related ETFs are*

Graph 31: Average Total Expense Ratios by Asset Type and SFDR Article – December 31, 2022 (in %)



Source: Refinitiv Lipper

[38] Refinitiv (2022) *European ETF industry yearbook: review 2022 and outlook*: https://tinyurl.com/murskt8x
[39] See footnote 13

in general not too expensive. That said, ETFs with higher-than-average TERs will have to prove their value-added for the investors over time, as it can be expected that investors will change to a cheaper solution otherwise. As said before, it is to be expected that the high competition in the European ETF segment will bring the costs for ESG-related ETFs further down over time..”[40] – Therefore, even for most ESG-linked ETFs, the cost is lower or equal to that of traditional products. The higher cost mentioned for Article 9 bond ETFs seems to stem from the need for a license for specific benchmarks. In fact, ETFs following new or customized benchmarks rely on third-party ESG research, and this applies to any ETF regardless of whether they are sustainable or not; therefore, any specialized ETF might initially have a higher cost until the ETF reaches a certain size.

It will certainly be necessary to delve deeper into the analysis using available data in the coming years and with the update of the study conducted by ESMA. In conclusion, costs are lower in sustainable products compared to their traditional counterparts, and for categories still in the initial phase, further research will be necessary. One of the major misconceptions about sustainable finance has thus been debunked, and it is up to all of us to communicate it more clearly and change the market's perception.

6 PERFORMANCE AND RISK

The criticism is that the performance of sustainable products is lower than those of traditional products. FALSE

The criticism is that the risk of sustainable products is higher than that of traditional products. FALSE

6.1. PERFORMANCE

Another criticism raised against sustainable investments concerns their performance, which, according to critics, is lower than that of traditional investments. First, it should be remembered that sustainable investments have a medium to long-term investment horizon; therefore, any analysis should be based on this time horizon.

Numerous studies and meta-studies have been conducted that have yielded different results. The main problem with all of these studies is that they classified sustainable investments differently, used different methodologies, or came from unreliable sources. Instead of delving into this field, therefore, we focused on the analysis conducted by ESMA and supplemented them with analysis from Morningstar and Refinitiv Lipper when we looked at a specific area of products with medium to long-term time horizons. 2022 was a unique year from the perspective of sustainable investments, so we attached specific case studies. All of these analyses come to the same conclusion: over a medium to long-term investment horizon, ESG investments do not underperform; in fact, in many cases they outperform.

[40] See footnote 38

ASR-CP.19
UCITS net performance and costs over one year
ESG funds outperformed in 2021

	ESG	NON-ESG
	All funds (equity, bond and mixed UCITS)	
Costs	1.3%	1.4%
Net performance	22.8%	16.8%
Number of funds	1,916	12,137
	Equity UCITS	
Non-ETFs		
Costs	1.4%	1.9%
Net performance	32.8%	28.8%
Number of funds	952	4,017
ETFs		
Costs	0.6%	0.4%
Net performance	31.8%	31.8%
Number of funds	115	648
	Bond UCITS	
Costs	0.9%	1.0%
Net performance	3.6%	4.2%
Number of funds	398	3,384
	Mixed UCITS	
Costs	1.6%	1.8%
Net performance	15.0%	13.1%
Number of funds	451	4,088

Source: ESMA

European Securities and Markets Authority

In ESMA's analysis[41], already mentioned in the section on costs, the performance of UCITS funds for ESG strategies compared to traditional UCITS that do not consider them. ESMA notes that: *"…ESG funds remained, on average, cheaper in 2021 compared to non-ESG equivalents and outperformed in net terms…""… Regarding net performance, the evidence for 2021 also confirms previous (years) findings: the average net performance of ESG UCITS funds over one year was 22.8% (6 percentage points (pps) higher than for non-ESG UCITS funds)…This was driven by outperformance of both equity (4 pps for non-ETF) and mixed (1.8 pps) ESG funds.*
However, this year ESG bond UCITS underperformed compared to their non-ESG equivalents (-0.6 pps).." In Morningstar's study[42], the explanation as to why ESG Bonds underperformed in 2021 was the fact that they have a longer duration. (*Please see Case Study*).
Looking at the three-year performance, ESMA affirms that. *"…ESG UCITS outperformed on aggregate non-ESG funds (the net performance of ESG UCITS is 4.2 pps higher than the performance of non-ESG UCITS). Among the different asset classes considered, ESG equity and mixed funds outperformed their non-ESG equivalents (2.8 pps and 1.3 pps, respectively). However, in the case of bond UCITS, the net performance was higher for non-ESG funds…"*
Similar to the fee analysis, the underperformance of individual categories is due to specific requirements within those categories. In conclusion, ESMA's analysis confirms that UCITS ESG funds outperform non-ESG UCITS.

[41] See footnote 36
[42] Morningstar (2022) *How do European ESG Funds Perform in 2022?*: https://tinyurl.com/2prsv6yz

UCITS gross performance and costs over 3 years
ESG funds outperformed in 2019

	ESG	NON-ESG
	All funds (equity, bond and mixed UCITS)	
Costs	1.3%	1.7%
Net performance	11.0%	6.8%
Number of funds	850	2,607
	Equity UCITS	
Costs	1.3%	2.0%
Net performance	15.6%	12.8%
Number of funds	475	932
	Bond UCITS	
Costs	1%	1.5%
Net performance	1.7%	2.8%
Number of funds	177	769
	Mixed UCITS	
Costs	1.6%	1.8%
Net performance	6.9%	5.5%
Number of funds	198	906

Source: ESMA

Morningstar

Morningstar has analyzed long-term ESG performance, and this gives us a clearer view pending the update of the ESMA analysis[43]. As pointed out, the medium to long-term investment horizon is a key factor for sustainable investments. Morningstar's analysis shows that:
"...Average returns and success rates across our sample suggest there is no performance trade-off associated with ESG funds over the medium and long term. In fact, over three, five, and 10 years, the average ESG fund beat its average traditional peer...The odds of picking a winning ESG fund with high excess returns relative to traditional peers increase as the holding period extends... A similar proportion of ESG funds (36%) and traditional funds (35%) carry 4 or 5 stars, but significantly more ESG funds (38%) than traditional funds (32%) are awarded Gold, Silver, and Bronze ratings. This means our analysts have stronger conviction in the ability of ESG funds to outperform..."

[43] See footnote 36

ESG Funds' Rates by Morningstar Category by Q4 2022 (%)

Category	1 Year	3 Years	5 Years	10 Years
Global Large-Cap Blend Equity	45	67	68	68
Eurozone Large-Cap Equity	37	56	60	58
EUR Diversified Bond	32	31	23	46
Europe Large-Cap Blend Equity	46	59	58	55
EUR Cautious Allocation - Global	28	42	54	57
EUR Corporate Bond	21	28	50	63
US Large-Cap Blend Equity	39	67	66	65
France Equity	43	30	36	45
Global Emerging Markets Equity	62	60	58	63
Global Large-Cap Growth Equity	64	65	52	51
EUR Government Bond	42	42	69	75
Global Bond	24	48	53	57
Weighted Average	**41**	**53**	**56**	**58**
Japan Large-Cap Equity	35	33	46	42
Asia ex-Japan Equity	54	50	59	56
Global Large-Cap Value Equity	14	69	50	44
Europe Large-Cap Growth Equity	46	54	56	56
UK Large-Cap Equity	25	18	13	40

Source: Morningstar Direct. Morningstar Research. Data as of Decembre 2022. Based on 2,052 ESG funds and 5,911 traditional funds from the 17 categories shown above.

In addition, Morningstar's analysis shows that: *"...Over the trailing three, five, and 10-year periods, an investor would have been better off with an ESG fund over most conventional peers, as Exhibit 4 shows. For example, over the trailing five-year period through 2022, the weighted-average success rate for an ESG fund in the most popular categories rose to 56%, suggesting over half of the ESG funds beat their average traditional non-ESG peers..." "...Over the 10-year period ended Dec. 31, 2022, close to 60% of surviving ESG funds across the 12 categories are considered to have beaten their average surviving traditional peer..."*

Therefore, over a medium to long-term investment horizon, one of the criticisms leveled at sustainable finance, that ESG funds involve a "sacrifice" in terms of performance, is refuted. The research also found that the longer the investment horizon extends the greater the likelihood of better performance in ESG funds.

In addition, the study found that ESG funds on average have a higher risk-adjusted and cost-adjusted return relative to category peers and ESG Funds have a higher alpha-generating capacity in the long term.

Morningstar also analyzed[44] the relationship between overperformance and fees and concluded that *""... While a majority of ESG funds across the 12 categories considered here beat their average traditional peers over the past five or 10 years, the level of excess returns varied depending on fees. Like with any other type of investment, fees are a crucial consideration when selecting an ESG fund..." "...This means that investors selecting an ESG fund in the lowest fee quartile five years ago were more likely to capture higher excess return and thus improve the odds of picking a winner..."*

[44] See footnote 42

Excess Return Distribution for ESG Funds in Global Large-Cap Blend Equity Category

Source: Morningstar Direct. Morningstar Research. Data as of December 2022. Based on 501, 336,267 and 141 ESG funds in the Global Large-Cap Blend Equity category with one-, three, five-, and 10-years excess return data, respectively.

Looking at the sustainability indexes, Morningstar[45] analysts conclude that *"...Despite poor performance for sustainability indexes in 2022, the five-year numbers remain strong. From 2018 to 2022, 78% (99/127) of Morningstar sustainability indexes with five-year performance histories beat their equivalents. For the five-year period ending 2021, 80% had outperformed..."*

The general conclusion is that ESG funds outperform in the medium to long term. Unexpected events may impact short-term performance, but long-term performance is positive compared to traditional funds. We all need to communicate better that there is no compromise on performance, and, on the contrary, performance is positive in the medium to long term.

[45] Morningstar (2023) *In a Period of Poor Performance for Sustainable Investments, Gender Equality and Renewable Energy Were Bright Spots*: https://tinyurl.com/mr3ew6jz

Case Study 2022

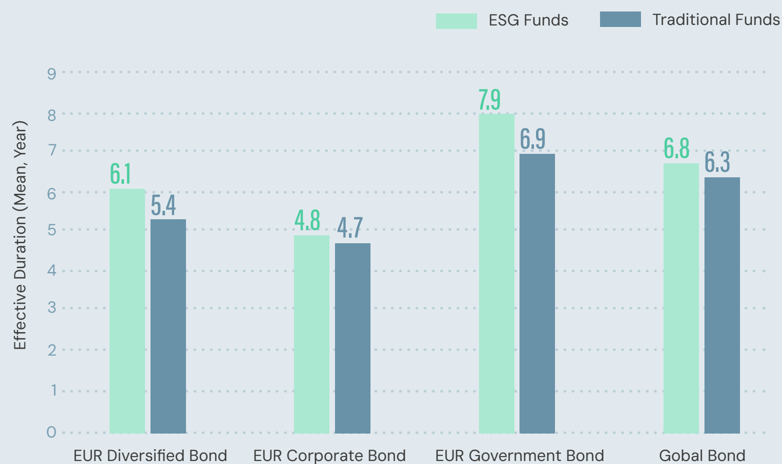
THE IMPACT OF DURATION ON ESG BOND FUNDS

Morningstar's analysis[46] also explored the impact of duration on the performance of ESG bond funds with longer durations in 2022.

"ESG bond funds were among the worst performers last year [...]. This poor performance can be largely attributed to the rise in interest rates. ESG bond funds typically have a longer duration because they structurally overweight investment-grade bonds, which generally have lower yields and longer durations. The more attractive investment-grade bonds are similar to high-quality government securities (which also tend to have above-average durations). In an inflationary context like that of 2022, strategies with longer durations are more sensitive to interest rate changes and therefore tend to incur greater losses. The chart shows that ESG funds in the four most popular fixed-income categories of Morningstar have a higher duration compared to traditional funds."

This is related to the long-term investment horizon of ESG bond funds, considering, for example, the issuance of green bonds for infrastructure projects.

Effective Duration of ESG Funds vs Traditional Funds



Source: Morningstar Direct. Morningstar Research. Data as of December 2022. Based on 131 ESG fundsand 598 traditional funds from the four categories shown above.

[46] See footnote 42

Case Study 2022

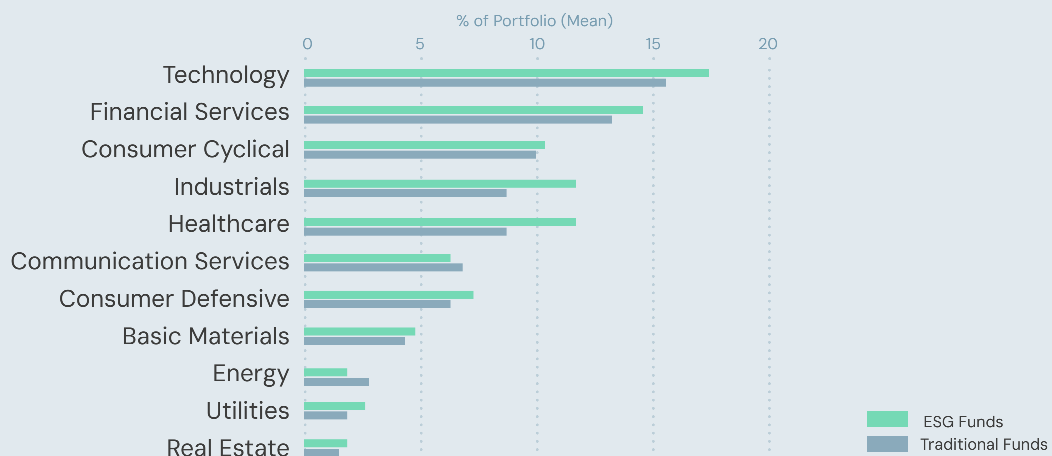
IMPACT OF SECTOR ALLOCATION ON ESG FUNDS

Geopolitical events, like the war with Ukraine, and shifts in economic conditions can introduce volatility and uncertainty in financial markets, affecting investment performance and risk levels. Understanding and analyzing these factors, along with ESG considerations, can help investors and financial institutions navigate potential risks and make informed decisions. In 2022, ESG fund performance suffered due to the high fossil fuel prices as a consequence of the war in Ukraine, and as ESG funds tend to be underweighted in traditional energy companies this had a marked impact. The second sector bias in ESG funds is they tend to overweigh the technology sector which also underperformed in 2022. Morningstar's analysis confirms this.

"...Relative to traditional funds, many ESG funds have a structural underweighting to the energy sector, which was the best-performing unit of the Morningstar Global Markets Index last year, gaining a remarkable 34%. On the other hand, as shown in the exhibit below, ESG funds tend to be overweight in technology, industrials, and healthcare relative to traditional funds. In 2022, technology was among the worst performing sectors in the Morningstar Global Markets Index, losing 32.2%, while industrials and healthcare had negative 13% and negative 8.3% returns, respectively. The opposite was true in 2020, when the tech sector gained 48% compared with energy's 27% loss. Such reversal in 2020 was also seen in healthcare (17.2%) and industrials (11.1%) ..."

In conclusion, sustainable funds' structure will have sectoral exposures that will impact the short-term performance. All investments, including sustainable ones can go through periods of underperformance. However, when taking a medium to long-term time horizon, sustainable investments remain competitive in terms of returns.

Sectoral Exposure of ESG Funds vs Traditional Funds



Source: Morningstar Direct. Morningstar Research. Data as of December 2022. Based on 1,338 ESG funds and 3,478 traditional funds from the most populated 12 categories. Each sectoral exposure is weighted by the respective numbers of ESG funds and traditional funds in individual categories.

6.2. RISK

Investment products

Another criticism raised against sustainable investments concerns the risks related to sustainable finance products. The aforementioned study by Consob[47] analyzed the knowledge, interest and ownership of sustainable investments by Italian investor families. The report found that only 13% of respondents perceived them as less risky than non-sustainable products.

The risk discussed in this section is that associated with a sustainable investment product, not the risk of not considering ESG factors in a company. In fact, the latter will be covered in the next section on stakeholders and shareholders.

The easiest way to check the impact of ESG risk on sustainable investment products is to observe the downside capture ratio for sustainable indices. Morningstar[48] analyzes the downside capture ratio, which it defines as follows: *"…Downside Capture Ratio % Downside Capture Ratio measures a managed investment's performance in down markets. A down market is defined as those periods (months or quarters) in which market return is less than 0. In essence, it tells you what percentage of the down market was captured by the managed investment. For example, if the ratio is 110%, the managed investment captured 110% of the down market and therefore underperformed the market on the downside …"*[49].

In its analysis Morningstar[50] analyses Morningstar sustainability indices that have a track record of more than 5 years and concludes that: *"…On the risk side, 70% (89/127) of Morningstar sustainability indexes with five- year histories lost less than their non-ESG equivalents during down periods between 2018 and 2022, as measured by the downside capture ratio…"*

Therefore, the argument that sustainable investment products are supposedly riskier proves unfounded. Since risk tends to be more stable over a specific time frame than returns it follows that any protection that counteracts market declines is an advantage for a product. The inclusion of ESG issues in risk management is critical because such an approach provides a more comprehensive view of risk, and the identification of risks also implies opportunities. In addition, the inclusion of ESG aspects in risk management is important when it comes to financial products, as these risks can have a significant impact not only on financial performance but also on the reputational dimension.

Insurance risk

The European Insurance and Occupational Pensions Authority (EIOPA) points out that, as long-term investors and risk managers, insurance companies have a central role in promoting sustainable finance. Because sustainability risks can have major implications for insurance companies' investment and underwriting activities, EIOPA believes it is important to ensure that Solvency II as a risk-based framework adequately reflects sustainability risks. EIOPA is therefore taking a gradual approach to assessing whether specific prudential treatment is warranted for activities and assets associated with environmental or social objectives under Solvency II.

Specifically, EIOPA's analysis focuses on three distinct areas of analysis:

- » **activities and exposures to transition risk:** this first area covers the investments of insurance companies and proposes methodologies for assessing how risks arising from the transition to a low-carbon economy could potentially have an impact on the prudential risks associated with stocks, bonds and real estate;
- » **underwriting risk and climate change adaptation:** the second area of analysis focuses on non-life insurance and examines the potential effect of climate change adaptation measures on underwriting risk and related loss exposures from a prudential perspective;
- » **risks and social objectives:** the third area analyzes how social risks or harms to social objectives can translate into prudential risks and assesses the corresponding prudential treatment in the requirements of governance, risk management, reporting, and communication.

Ivass (Institute for insurance supervision) also intends to supervise key financial stability profiles at the national level related to growing environmental risks.

In summary, the integration of ESG risks into the risk management of financial products and insurance products is essential because it provides a more complete understanding of risk. Identifying and managing these risks not only helps to mitigate potential negative impacts, but also allows to capitalize on opportunities arising from sustainable and responsible practices.

[47] See footnote 34
[48] Morningstar (2023) What is an upside/downside capture ratio?: https://tinyurl.com/ybkrjxkj
[49] See footnote 45
[50] See footnotes 45 and 42

Case Study

EXTREME WEATHER EVENTS AND INSURANCE COVERAGE

The inclusion of ESG factors in risk management within the insurance sector is crucial for the economic outcome of the insurance company. Recent news of insurers ceasing to provide insurance coverage to homeowners in various states in the USA[51] due to the rapid increase in catastrophic events caused by climate change[52] should be more than a warning sign that neglecting ESG factors in risk assessment can have severe adverse consequences.[53] In Europe, the changes introduced by Solvency II amendments require the risk management function of insurers to identify and assess emerging risks and sustainability risks. This pertains not only to the Risk Appetite Framework (RAF)[54] but also to their Risk Policy; these risks must be integrated into the overall solvency assessment of the company in the Own Risk Self Assessment (ORSA). To ensure the proper implementation of sustainability risks within the RAF framework and subsequently within ORSA scenarios, EIOPA has published papers addressing the issue of supervisory expectations regarding the integration of climate risk scenarios by insurers into their ORSA[55] scenarios. These papers cover the frequency of updating parameters in the Natural Catastrophe standard formula[56] methodological principles for designing bottom-up stress test exercises to assess insurers' vulnerability to climate risks[57], as well as general insights and examples regarding the materiality assessment for companies required to identify and integrate climate change risks into ORSA scenarios[58].

[51] New York Times (2023) *Climate Shocks Are Making Parts of America Uninsurable. It Just Got Worse*: https://tinyurl.com/5fxf7pux
[52] LA Times (2023) *It's not just State Farm. Allstate no longer sells new home insurance policies in California*: https://tinyurl.com/262k335t
[53] USA Today (2023) *Another company avoids risky Florida home insurance policies. Here's what caused the crisis*: https://tinyurl.com/3pxw6wz4
[54] ANIA (2022) *L'integrazione dei principi di sostenibilità in Solvency II:* https://tinyurl.com/bdhekdwk
[55] EIOPA (2021) *Opinion on the supervision of the use of climate change risk scenarios in ORSA:* https://tinyurl.com/5576fce9
[56] EIOPA (2021) *Methodological Paper on potential inclusion of climate change in the Nat Cat standard formula*: https://tinyurl.com/ycxvm3pc
[57] EIOPA (2022) *Methodological Principles of insurance stress testing – Climate change component*: https://tinyurl.com/5ypezttt
[58] EIOPA (2021) *Consultation paper on Application guidance on running climate change materiality assessment and using climate change scenarios in the ORSA*: https://tinyurl.com/48ud26y8

Italian best practices

PROMETEIA

On the path to sustainability: opportunities and challenges of the climate transition for sectors of the Italian economy

With the Green Deal, Europe has asserted the central role of sustainability-related investments. An effective implementation of this approach requires significant efforts in terms of investments (in research, innovation, clean technologies, product and process transformation, etc.) and entails risks, but it also represents a significant opportunity.

A simulation exercise conducted using the TRE (Transition Risk Engine) model developed by Prometeia allows for the quantification of the long-term impacts of the climate transition on the sectors of the Italian economy, under an "orderly" climate transition hypothesis (Net Zero 2050 scenario, Network for Greening the Financial System - NGFS). The model quantifies the costs (e.g., payment of a carbon tax on GHG emissions, increases in energy input costs due to the transition) and the additional investments required to mitigate emissions. The analysis extends to the evaluation of the economic and financial sustainability of the impacts related to the climate transition, incorporating their effects on sectoral aggregated balance sheets.

The performed simulations classify maritime transport, agriculture, forestry and fishing, ceramics and cement production, and gas and electricity production among the sectors most at risk, while the food industry, transportation services, electromechanical industry, commerce, and construction are among the less vulnerable sectors. A more detailed presentation of the model is available here: https://tinyurl.com/yc39ebn4

7 SHAREHOLDERS OR STAKEHOLDERS

The criticism is that stakeholders and shareholders have completely opposite interests. FALSE

The current debate on the importance that companies should accord to shareholders versus stakeholders respectively, ultimately, when looking at it from a financial standpoint, revolves around the concept of internalization or externalization of costs by a company, which naturally affects the cost of capital and impacts financial results. Externalization of costs refers to the practice of passing on costs associated with a company's operations to external parties (stakeholders), rather than internalizing and accounting for these within the company. Externalizing costs allows a company to lower operating expenses while avoiding taking on financial responsibility to mitigate the negative impacts of its activities. This can potentially increase profitability in the short term. By externalizing costs, a company can offer products or services at lower prices than competitors that internalize such costs. This competitive advantage can attract customers and, as a result, increase market share. In addition, cost externalization can lead to higher returns to shareholders, as it reduces the

company's costs and increases its profitability. Cost externalization, on the other hand, can often lead to negative impacts on the environment, society, or other stakeholders. These can include pollution, resource depletion, social inequalities, health risks, or harm to communities. In the long run, such externalities can harm public welfare, create conflict, and erode the company's reputation and licence to operate.

Cost externalization can lead to the violation of laws, regulations or industry standards related to environmental protection, workers' rights or consumer safety, increasing the likelihood of litigation.

Externalizing costs by the company means that these costs will be borne by the community (stakeholders). At the end, the investor in his role as taxpayer (stakeholder), is indirectly without his knowledge paying for these costs. Sustainable finance brings these costs to light by quantifying them in a transparent manner. By highlighting the source of these costs, it enables investors to make informed decisions about their investment choices.

If we consider some regulations enacted in Europa, for example CBAM[59], it will have impacts on companies operating in certain sectors subject to CBAM that produce outside the EU and may cause more emissions, and this will have a negative impact on the company's profits. Costs that were previously outsourced by companies without any consequences will now have to be internalized and paid for. With the introduction of new sustainability laws and regulations, companies that outsource or neglect ESG costs face several challenges such as reputational damage and litigation, as stakeholders and regulators are increasingly demanding transparency and accountability regarding a company's environmental and social performance.

In addition, outsourcing ESG costs can increase the cost of capital for a company. Investors are increasingly incorporating ESG factors into their decision-making processes, and companies with poor ESG performance may find it difficult to attract investment and obtain favorable financing terms. Higher financing costs and limited access to capital can undermine the financial health of the company and limit the company's prospects of growth[60]. It is therefore a financial impact[61]. The evolution from a focus solely on the economic result of the company to a consideration of the broader impacts on society is an important shift. Recognizing that the company's actions have consequences beyond immediate stakeholders, such as employees and shareholders, highlights the interconnectedness between the company and society as a whole. By embracing sustainable practices and considering the interests of various stakeholders, companies can contribute positively to society, address systemic challenges, and support sustainable development. Overall, internalizing ESG aspects in a company increases its resilience, competitiveness, and long-term sustainability (including economic).

Many companies are adopting more inclusive approaches that consider the interests of a wider range of stakeholders, rather than focusing exclusively on maximizing shareholder value. This shift reflects the realization that sustainable and responsible business practices bring to long-term success and positive outcomes for both shareholders and stakeholders. For example, integrating environmental sustainability practices can help a company mitigate environmental risks, reduce resource consumption, discover resource saving opportunities, and develop new products and services aligned with sustainable goals, thereby gaining a competitive advantage. Similarly, by focusing on social aspects such as employee welfare, diversity, and local community involvement, a company can promote a positive organizational culture, attract, and retain talent, and build stronger relationships with customers and local communities. In summary, although cost externalization can offer immediate benefits in terms of cost reduction and increased profitability, it carries significant risks and disadvantages in the long run. Negative externalities, legal and regulatory challenges, sustainability concerns, and stakeholder reactions can have negative reputational impacts on a company's operations and financial performance. Therefore, the adoption of sustainable business practices and consideration of ESG aspects become fundamental for successful and responsible business management.

[59] See footnote 18
[60] MSCI (2020) *ESG and the cost of capital*: https://tinyurl.com/29rt6hh6
[61] I. Yilmaz (2022) *ESG-Based Sustainability Performance and its Impact on Cost of Capital: International Evidence from the Energy Sector*: https://tinyurl.com/3f9rpfjs

8 ENGAGEMENT AS AN EFFECTIVE STRATEGY

The criticism is that the engagement does not bring results. FALSE

Engagement is a theme that has often been mentioned in critiques of sustainable finance. Engagement is part of stewardship, which can be defined as: *"the responsible allocation, management, and oversight of capital to create long-term value for clients and beneficiaries, with sustainable benefits for the economy, environment, and society."*[62] Engagement is one of the stewardship tools that can be used by investors. This tool refers to investor-issuer dialogue on sustainability issues. It is a long-term process aimed at positively influencing behaviors of the issuer (e.g., company, region, state) and to increase the degree of transparency. The objective is to establish and maintain a two-way dialogue between the issuer and investors to facilitate the sharing of public information and collaboration on matters related to corporate governance, environmental and social practices, strategy, performance, and other relevant issues. Engagement is part of the fiduciary duties and is regulated by directives such as the Shareholder Rights Directive II (SRD II)[63] and the OECD Guidelines for Multinational Enterprises[64].

Engagement has evolved over time from a dialogue with shareholders to a dialogue with shareholders and bondholders, which is of utmost importance in Italy, since Italians tend to invest in bonds more than in equities and hold significant portions of public debt. Engagement has moved from a simple dialogue to a dialogue aimed at achieving measurable and quantifiable results, to which both parties (investors and issuer) contribute.

The benefits of engagement are numerous and include, for example, better communication and more transparent and effective relationships between issuer and investor, which fosters and contributes to long-term value creation. Through dialogue, issuers can gain valuable insights, ideas, and perspectives to identify and mitigate potential risks and opportunities. By understanding investors' concerns and expectations, issuers can proactively address challenges, avoiding potential conflicts and reputational damage.

In addition, engagement practices can help investors align their reporting with emerging norms and standards in sustainable finance. This includes the reporting requirements set by SRD II and EU reporting frameworks, as well as sustainability reporting standards. By integrating engagement activities and results into their reporting, investors can show their commitment to responsible investing and meet stakeholder expectations. In sum, engagement fosters a collaborative relationship between the issuer and its investors, promoting transparency, good governance, and long-term value creation.

[62] Financial Reporting Council: https://tinyurl.com/2p9td78u
[63] See footnote 12
[64] OCSE (2011) *OECD Guidelines for Multinational Enterprises on Responsible Business Conduct*: https://tinyurl.com/232v7v58

Italian best practices

ENGAGEMENT GENERALI INSURANCE ASSET MANAGEMENT

SAP

The engagement with SAP was focused on a key tool in **anti-corruption practices** which seemed underused by the issuer: the whistleblowing system. Following Generali Insurance Asset Management (Generali Investments) suggestion and other inputs, the issuer launched a new system to foster and protect whistleblowing.

ČEZ

Regarding ČEZ (biggest Czech Republic utility) GIAM stressed to the company the importance of validating their strategy by the "Science Based Target Initiative" (SBTi). In 2022, ČEZ publicly announced that it had obtained the "well below 2°C by 2030" validation from the SBTi for its climate strategy until 2030. GIAM and ČEZ published a joint statement[65] following this result.

[65] CEZ Group (2022) *Investors welcome validation of CEZ Group´s carbon reduction targets:* https://tinyurl.com/3b7536cj

ENGAGEMENT GROUPAMA

INTERROLL

The Interroll Group is the world's leading provider of intralogistics solutions. The company was founded in 1959 and has been listed on the SIX Swiss Exchange since 1997. Human capital management and environmental strategy are fundamental issues for the sector. For this reason, in the dialogue process with the company, Groupama Asset Management has set the goal of increasing transparency in existing policies and future objectives. In April 2021, GAM shared with Interroll a list of indicators and requested their inclusion in the ESG reporting. Throughout 2021 and 2022, Groupama AM participated in various meetings and the company's general meetings to monitor progress. In 2023, the company published its first ESG report, which included most of the indicators requested by Groupama, such as:

- Environment: greenhouse gas emissions (Scope 1 and 2), total energy consumption and the percentage of renewable energy use, energy efficiency, water consumption, waste production, and recycling rate.
- Human capital: training (number of hours and budget per employee), turnover, absenteeism rate, and accident frequency.

The successes achieved during the initial phase of the engagement initiative allowed Groupama to work with the company to identify objectives for the 2023/2024 period, which include: 1) greater transparency regarding involvement in the SBTi initiative and the work undertaken with Ecovadis 2) improved gender balance in managerial roles.

8.1. ESCALATION PROCESS

The purpose of an escalation process in engagement is to outline the actions and steps an investor can take when an engagement has been unsuccessful[66]. Depending on the nature and importance of the engagement, there may be instances when the investor will escalate his or her engagement activities. In the escalation process, the investor (shareholder or bondholder) may explore additional avenues to address the issue, such as increasing the frequency of engagement, increasing meetings with the Board, and collaborating with other investors or stakeholders to amplify their voice. In addition, equity investors may submit resolutions on specific ESG issues at shareholder meetings; they may exercise voting rights to support or oppose certain board appointments and/or proposals related to sustainability. Investors may pursue legal action or opt for partial or total divestment. However, the specific actions taken in the escalation process will depend on the circumstances, the local laws and regulations, the available resources, and the investor's objectives.

8.2. ENGAGEMENT VS EXCLUSION

Exclusion involves excluding specific companies/issuers or sectors from investment portfolios based on specific ex-ante ESG criteria. This approach ensures consistency between investment strategies and sustainability goals, and protects against the risk of greenwashing and potential negative reputational repercussions. Exclusion, however, can also have drawbacks, such as a reduction in the investor influence on issuers' ESG practices. In addition, by excluding an issuer, investors lose the opportunity to actively engage and promote positive changes within the company. Exclusion, however, represents a "signal to the market" that can have impacts on the issuer.

Engagement enables investors to collaborate with issuers to identify and implement shared solutions to sustainability challenges. By engaging in constructive dialogue and engagement, investors can help find effective solutions. On the other hand, engaging with issuers involves the risk that engagement efforts do not lead to results. Despite ongoing dialogue, issuers may fail to address or follow up on issues raised by investors. This risk highlights the importance of continuous evaluation of the effectiveness of engagement strategies; otherwise, investors may face reputational risks. In the event that an engagement fails to succeed, the investor will apply the escalation process he has previously outlined.

It is important that investors carefully consider the benefits, risks, and trade-offs associated with both exclusion and engagement strategies, aligning their approach with their sustainability goals, their desired impact, and the current laws and regulations.

[66] OECD (2017) *Responsible business conduct for institutional investors: Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises* :https://tinyurl.com/yc6327s3

Case Study

ENGAGEMENT AND DISINVESTMENT - CHURCH OF ENGLAND

In June 2023, the Church of England Pensions Board announced its divestment from oil and gas companies after 10 years of engagement[67].

"... The Church of England Pensions Board is today announcing its intention to disinvest from Shell plc and other oil and gas companies which are failing to show sufficient ambition to decarbonise in line with the aims of the Paris Agreement. The new investment restriction announced today will apply to all oil and gas companies that do not have short-, medium- and longterm emissions reduction targets aligned with limiting global warming to 1.5°C, as assessed by the independent Transition Pathway Initiative. The exclusion will apply to equity and also debt investments[68].

"Today we announce our intention to disinvest from all remaining oil and gas holdings across our equity and debt portfolio," said John Ball, Chief Executive Officer of the Church of England Pensions Board. "There is a significant misalignment between the long-term interests of our pension fund and continued investment in companies seeking short term profit maximization at the expense of the ambition needed to achieve the goals of the Paris Agreement. Recent reversals of previous commitments, most notably by BP and Shell, have undermined confidence in the sector's ability to transition."

The Pensions Board has engaged the sector over the past ten years with a view to bolstering the level of ambition in company strategies to decarbonise in line with the Paris Agreement. While some companies have come close to achieving alignment as assessed by the TPI, none have met the threshold to remain investible.... As a result, the Pensions Board will no longer prioritize engagement with the oil and gas sector on climate change and will instead refocus its efforts on reshaping the demand for oil and gas from key sectors such as the automotive industry.... The Pensions Board will be seeking robust commitments related to the use of oil and gas from demand sectors such as aviation, utilities, automotive, and steel. It will continue to engage policymakers on the need for greater ambition in public policy – including a phasedown of oil and gas which take account of the different needs of emerging and developing countries."[69]

[67] The Church of England (2023) *Church of England Pensions Board disinvests from Shell and remaining oil and gas holdings:* https://tinyurl.com/3pbzbtkc
[68] See footnote 67
[69] See footnote 67

8.3. COLLECTIVE ENGAGEMENT

The challenges facing the world right now have increased the use of collective engagement initiatives[70]. Collective engagement sees a group of investors collectively engaging with an issuer. This can be done through an informal network or an association. Investors within the initiative can play diverse roles in the engagement. A collective engagement does not require or seek a collective decision-making process or action regarding the acquisition, holding, or joint voting rights of the held investments. This type of engagement seeks to speak to issuers with a unified voice: investors can effectively communicate their concerns to corporate management. The result is generally a more informed and constructive dialogue. Collective engagement has many benefits for investors, who can increase their capacity to influence the issuer. In addition, collective engagement can contribute to a more efficient use of resources, as the work is spread over a group of investors. However, this approach can also present diverse challenges related to the effort needed to coordinate and align the view of a group of investors with potentially very different goals and priorities. In addition, it is essential that all participants know and respect the legal constraints in place in the different jurisdictions[71]. Constantly keeping abreast of regulatory developments and the resulting compliance review can be a challenge for investors engaged in collective engagement; notwithstanding these are necessary elements, as each investor is responsible for his own investment and voting decisions, and acts independently to determine his own strategies, policies, and practices in the best interests of his clients and beneficiaries, as required by fiduciary duty. Collective engagement is of fundamental importance in various contexts, especially when addressing complex and systemic challenges that require widespread and coordinated efforts by diverse stakeholders. It plays a crucial role in addressing complex societal issues, such as climate change. This collaborative approach consents pooling resources and expertise to address these challenges more effectively. Collective engagement fosters synergies and collaboration among governments, businesses, nongovernmental organizations, and communities, leading to innovative and comprehensive solutions. It promotes a sense of shared responsibility, enhancing accountability among stakeholders and increasing the legitimacy and social acceptance of decisions and actions taken. In sum, collective engagement is a powerful tool for addressing complex issues and promoting largescale positive change, offering a more inclusive and collaborative approach to problem-solving and building a sustainable and prosperous future.[72]

[70] Climate Action 100+ (2023) *Climate Action 100+ Signatory Handbook*: https://tinyurl.com/nhfmf434
[71] Bafin (2023) *Collaborative engagement and the attribution of voting rights: When can things get tricky*?: https://tinyurl.com/t5d3b82p
[72] P. Mülbert & A. Sajnovits (2022) *Emerging ESG-Driven Models of Shareholder Collaborative Engagement* European Corporate Governance Institute - Law Working Paper No. 668/2022 https://tinyurl.com/ymcwapru

Italian best practices

THE ENGAGEMENT WORKING GROUP OF ITASIF

Since 2015, ItaSIF has played a key role in the debate and education concerning engagement, the constructive dialogue between investors and issuers on sustainability issues. In 2021, ItaSIF initiated a permanent working group aimed at its members to foster joint engagement initiatives. ItaSIF members participated in the 2021, 2022, and 2023 editions of the Sustainability Week promoted by Borsa Italiana (the Italian Stock Exchange), by submitting a letter prior to the event, to the attending companies with the priority themes in the environmental, social, and governance sphere. This allowed companies to delve into these topics and gather necessary information before scheduled meetings with investors. Building on this common ground, lead investors for various issuers focused the dialogue on priorities specific to each company, considering their industry sector and their specific sustainability results and commitments.

For the **environmental aspect**, the priority themes identified for the 2023 engagement were: alignment with the European taxonomy for sustainable economic activities; disclosure of environmental data through CDP (formerly Carbon Disclosure Project) assessments; aligning climate emission reduction goals with the standards of the Science Based Targets initiative (SBTi); introducing corporate policies for sustainable water resource management and biodiversity conservation. In the **social sphere**, priority themes shared by the working group focused on: the Just Transition; workplace safety; sustainability in the value chain; interaction with local communities; generational equality, and workforce stability. Lastly, concerning **governance**, the identified themes for 2023 encompass: shareholder approval of the climate transition plan; gender equality; remuneration policies; tax and lobbying policies.

8.4. SOVEREIGN ENGAGEMENT

Engagement with sovereign states presents a series of unique characteristics and is often more uncertain and lengthier. At the same time, sovereign issuances play a crucial role in addressing global sustainability challenges, including climate change. Sovereign issuances are essential to accelerating transformation and mobilizing investments and can contribute to mitigating risks. Engagement should not be confused with lobbying or political activism. Sovereign engagement may involve multiple parties at various levels. It can increase transparency and create opportunities. Some of the benefits for investors resulting from this engagement can include obtaining more detailed information on strategic plans for sustainable challenges and their impact on sovereign ESG ratings. Engagement encourages better disclosure of national ESG data and communicates demand for sustainable sovereign issuances by investors. Sovereign issuers gain a better understanding of the actual demand for sustainable issuances by investors, how sustainability affects sovereign bond evaluations, and how to improve transparency to access new capital sources for the state. Sovereign bonds represent a significant portion of investments, especially in Italy, where Italian retail and institutional investors hold more than 70% of public debt.[73]

[73] Eurostat (2023) Structure of government debt: https://tinyurl.com/vx2xmcv4

Italiane best practices

ENGAGEMENT WITH THE ITALIAN STATE BY MEMBERS OF ITASIF

Within the aforementioned working group (refer to p. 34), in 2023, ItaSIF members initiated a collective engagement initiative with the Italian State, in its role both as an issuer and a key player in achieving nationally set sustainability objectives. The goal is to establish a constructive dialogue between investors and the Italian State on certain ESG issues that hold economic and financial significance. Specifically, the dialogue focuses on Italian State policies concerning various **environmental issues** (climate change adaptation and mitigation, pollution prevention, and biodiversity conservation), **social aspects** (just transition, promotion and protection of human rights, reducing inequalities), and **governance** matters (gender equality, prevention and fighting corruption). The letter addressed to the Presidency of the Council of Ministers and the Ministries involved aims to achieve two objectives: firstly, to signal to the Government that these elements are crucial for investors and secondly, to gather information about Italy's sustainability policies, crucial for their implications on the Italian economy and therefore, investments in the country. Forty institutional investors, including pension funds (led by the pension funds Cometa and Pegaso), asset managers, banks, and insurance companies, have joined this initiative, along with the support of 37 other organizations not directly investing in government bonds. Clearly, there is a convergence of interests among diverse stakeholders, as paying attention to these issues benefits not only investors on a medium to long-term perspective but also, more broadly, all individuals living in Italy.

9 THE ROLE OF VOTING

The criticism is that the shareholders' vote has no impact. FALSE

The exercise of voting rights is one of the principal tools through which institutional investors can exercise their "voice" in the governance of listed companies and constitutes, together with monitoring and engagement, one of the pivotal activities of stewardship. The responsible exercise of shareholder prerogatives for the purpose of sustainable value creation in the medium to long-term, in the interests of their clients/beneficiaries, is one of the roles of institutional investors. Active participation in shareholder meetings is favored by the legislation, as this is also recognized as a sign of a well-functioning capital market. This objective is met by the mechanism of the so-called "record date," which has assigned the right to vote to those who are shareholders in a company on the 7th day prior to the shareholders meeting in Italy. This has had the effect of significantly increasing the rate of participation, better reconciling the interest of investors in participating in the shareholders' meetings of listed companies with undue constraints on portfolios under management and shareholdings.

9.1. PROXY VOTING ADVISOR

Shareholders can use the services of "proxy voting advisors," specialized companies that provide research, analysis, and voting recommendations. Proxy advisors support shareholders in making informed voting decisions based on their own voting policies, guidelines, and assessment of corporate governance practices. The analyses of proxy advisors are a very useful tool for institutional investors for the purpose of making voting decisions, as they invest in hundreds or thousands of listed companies and are required to exercise voting rights in each of these companies. Although the support of advisors can be crucial, it should be reiterated that the exercise of these rights and the decision-making process remain the exclusive prerogative of institutional investors. They must therefore carefully examine proxy advisors' recommendations and compare them with their own internal analyses and voting policies to arrive at an informed voting decision. The use of a proxy advisor cannot therefore replace investors' responsibility to ensure that votes are cast in an informed and responsible manner and in accordance with their own publicly disclosed voting policy. One of the recent criticisms of sustainable finance refers to the power of influence of proxy advisors, considering the small number of companies operating in this market. In addition, the limitations of standardized recommendations are highlighted from several quarters. In response to these attacks, proxy advisors should declare the other activities in which they are involved in (to avoid conflicts of interest) and increase transparency regarding the reasons underlying general guidelines for voting recommendations. In addition, there should be greater regulatory oversight of the process[74]. Proxy advisors have developed a code of conduct (Best Practice Principles for Shareholder Voting Research & Analysis)[75] and have an Oversight Committee, an independent body that oversees the implementation of this code of conduct.[76] Shareholders, for their part, can counter these criticisms with more specific and clearer voting guidelines and with requests for detailed information on how proxy advisors have defined their recommendations. In addition, even when it comes to voting policies, pension and mutual fund managers need to consider the preferences expressed by their beneficiaries and clients.

[74] Krahnen, A. Boot, L. Senbet & C. Spatt (2023) *The controversy over proxy voting: The role of asset managers and proxy advisors.* Hardard Law School Forum on Corporate Governance: https://tinyurl.com/2p8r2vhu
[75] The BPP Group *Best Practice Principles for Shareholder Voting Research*: https://tinyurl.com/yv8a5r6u
The BPP Group (2022) *Independent Oversight Committee Best Practice Principles for Providers of Shareholder Voting Research & Analysis*: https://tinyurl.com/yjpvfr5t
[76] C. S. Spatt (2019) *Proxy Advisory Firms, Governance, Failure, and Regulation.* Hardard Law School Forum on Corporate Governance: https://tinyurl.com/m57vs733

9.2. PASSIVE INVESTMENTS AND PASS-THROUGH VOTING

The evolution from active to passive investments, at the same time as the evolution from passive to active shareholders, has changed voting in recent years. Along with an increased awareness of the long-term risks and opportunities associated with sustainability and recognition of the potential impact shareholder activism can have on corporate behaviour, the need for greater clarity has emerged. The predominance of passive investments with a few large asset managers has focused attention on the execution of voting rights by those managers. Concentration by both a few large managers and proxy voting advisors makes the power of influence exercised by both parties over corporate decisions enormous. The criticism being made is that passive managers are not attentive enough in the exercise of their voting rights. In response to this criticism, some passive managers are exploring (some already implementing) the possibility of using Pass-Through Voting, which allows an investor in a mutual fund to vote his shares proportionately to the AUM he has invested in the fund. Voting rights remain with the Asset Manager but are exercised as "split" or "partial" votes[77]. Pass-through Voting can present specific, technical, legal, and comprehension challenges and may not be the best solution, but it can meet the needs of more sophisticated institutional investors. More sophisticated institutional clients might decide for themselves how to vote, while asset managers could vote on behalf of retail clients. This would require asset managers to explain their voting guidelines in more detail and to specify better how they implement them. This will allow the retail client to decide, also based on the voting guidelines, which fund to invest in, without the burden and cost of making an informed decision for each present company in the portfolio.

"…Neither shareholder proposals nor companies are one-size-fits-all. Proposals on the same topic may differ in their details or in how they affect companies. Similarly, as with ballot propositions, shareholder proposals might be framed in ways that make it difficult for retail investors to predict their impact…"[78]

In this context of change, the role of civil society has become even more important as it analyzes the results of the shareholders' meeting. For example, some NGOs have analyzed and made public the voting results and individual resolutions in details[79]. Other NGOs have examined the voting records of both asset owners and asset managers and analyzed whether or not these are aligned with their sustainable commitments[80]. Such disclosures promote transparency, accountability, and good corporate governance practices.

In summary, voting is informed by engagement activities and stewardship principles, and is a tangible expression of responsible asset management. By actively engaging and exercising voting rights, asset managers and institutional investors fulfill their responsibilities as stewards and defend the interests of their clients or beneficiaries.

[77] Tumelo "A deep dive into pass-through voting": https://tinyurl.com/fwhdcm4e

[78] J.E. Fisch, J. Schwartz (2023) *Corporate Democracy and the Intermediary Voting Dilemma*. European Corporate Governance Institute - Law Working Paper No. 685/2023: https://tinyurl.com/37zzp3nd

[79] Shareaction (2022) *Voting matters 2022 – General findings:* https://tinyurl.com/yfeuc378

[80] Proxy Preview (2023) *Helping Shareholders vote their value*: https://tinyurl.com/399522s3

Italian best practices

VOTING IN ITALY – VOTO DI LISTA

authored by Assogestioni

The Italian corporate law stipulates that the Boards of Directors of listed companies are elected through a mechanism known as the "voto di lista". This mechanism allows minority shareholders to nominate at least one member of the Board of Directors and the chairman of the board of statutory auditors. Specifically, the "voto di lista" requires that administrators be selected from lists of candidates submitted by shareholders. While most directors are elected from a list presented by the majority shareholder or the outgoing Board of Directors, the remaining part (at least one) is drawn from the so-called "minority lists," presented by minority shareholders.

Procedure

Lists can be presented by all shareholders who own a minimum number of shares, known as the minimum threshold, set by CONSOB. This threshold varies from 0.5% to 4.5% of the company's share capital and is inversely proportional to the market capitalization (higher market capitalization corresponds to a lower threshold).

Minority shareholders can pool their shares to reach the required threshold: according to Italian law, the joint presentation of a minority candidate list is not considered "acting in concert." Lists must be submitted at least 25 days before the assembly scheduled for the renewal of corporate bodies and can be submitted electronically, for example, via certified email. No specific approval from the company is required for list submission; it suffices that shareholders demonstrate, on the day of submission, that the number of shares they own exceeds the minimum threshold by presenting the electronic communication issued by the authorized depository certifying ownership of these shares. This electronic certification can be provided to the company even after the list submission, as long as it is done at least 21 days before the assembly. Each shareholder can present and vote for only one list. Each list must contain the names of one or more candidates listed in progressive order. Additionally, the list must specify which candidates are considered independent according to the law and the Corporate Governance Code. All candidate lists must be published by the company at least 21 days before the shareholders meeting, allowing shareholders to review the proposed candidates and make informed decisions regarding the election of corporate boards. At the conclusion of the shareholders meeting, candidates from the list receiving the highest number of votes are elected, provided that at least one member of the Board of Directors and the chairman of the board of statutory auditors are elected from the list receiving the second-highest number of votes.

[81] | Legislative Decree No. 146 of Sept. 25, 2009, introduced in the TUF (Art. 101-bis, paragraph 4) a general definition of persons acting in concert, which reads: "persons acting in concert are those who cooperate with each other on the basis of an agreement, whether express or tacit, verbal or written, even if invalid or ineffective, aimed at acquiring, maintaining or strengthening control of the issuing company or at thwarting the achievement of the objectives of a takeover or exchange offer"

Implications for institutional investors' role

In Italy, since 1996, the "voto di lista" has proven to be one of the most effective tools in stimulating the role of institutional investors in the corporate governance of listed companies. For many years, the "voto di lista" has provided minority shareholders–coordinated through the "Comitato dei Gestori"[82] with a means to present and elect minority candidates to the Boards of Directors of the companies in which they invest, without having to oppose the management or controlling shareholder.

The "voto di lista" enables investors to engage with the companies in which they invest continuously and in a more sophisticated manner. Indeed, as previously argued by legal scholars[83] and acknowledged by the Italian Principles of Stewardship[84], independent directors appointed by minority shareholders are often considered one of the most effective aspects of corporate governance systems, since they serve not only as a monitoring tool but also as a means of engagement by the companies themselves. This aligns with both the rules and prerogatives of funds (which are prohibited from exerting control or any significant influence over the invested companies) and the principle of the absence of a mandate constraint on elected candidates.

In Italy, therefore, the "voto di lista" mechanism stands as one of the pillars on which institutional investors can base their stewardship role.

[82] Assogestioni - Managers' Committeei: https://tinyurl.com/2vc3rr77
[83] Cfr e.g., J. Ronald Gilson, A. Lilli, A. Gordon & J. Pound (1991) *How the Proxy Rules Discourage Constructive Engagement: Regulatory Barriers to Electing a Minority of Directors*: https://tinyurl.com/4br4wm2c
[84] Assogestioni (2016) *Italian Principle of Stewardship*: https://tinyurl.com/yxp4zy6m

10 GREENWASHING

The criticism is that sustainable finance can promote greenwashing.
FALSE

Another critique directed at sustainable finance concerns greenwashing. According to ESMA's definition, greenwashing refers to market practices where the publicly disclosed sustainability profile does not accurately reflect underlying ESG risks and impacts. This sustainability profile can refer to both financial instruments/products and issuers.[85]

In the financial sector, ESMA has emphasized that greenwashing harms investors that are allocating their resources toward sustainable economic activities. All participants are aware of this risk and are working to counter it. Greenwashing not only damages the interests of investors and consumers but also affects competitors who do not present themselves and/or their products as sustainable.

"Moreover, greenwashing poses a real risk to the credibility of the market as a whole and undermines the trust that participants (companies, investors, and consumers) place in it." [86]

At this stage, given the growing interest in sustainability, the spread of greenwashing fosters scepticism toward any sustainability-related statement.

The risks and consequences faced by companies practicing greenwashing and financial operators supporting them (through investments, financing, or insurance policies) can be divided into three main categories:

» Reputational risk due to potential damage to the company's image and consequently to the reputation of its investors/financiers/insurers, and the resulting

[85] ESMA (2022) Sustainable Finance Roadmap 2022-2024: https://tinyurl.com/3tbhpua8
[86] ItaSIF (2022) Greenwashing and sustainable finance: risks and countering resources: https://finanzasostenibile.it/attivita/paper-greenwashing-ita/

loss of credibility with clients and competitors.

- Legal risk associated with potential legal actions and sanctions under sustainability regulations.
- Financial risk as a result of legal actions and sanctions, as well as a drop in stock prices and loss of customers/market share.

European institutions are establishing a framework to combat greenwashing and improve transparency on ESG issues. The goal is to increase the quantity, quality, and comparability of sustainability information about companies, financial operators, and products. Regulations working in this direction are, for example, the Taxonomy Regulation[87], the CSRD[88], the CSDDD[89] and the SFDR[90]. Of course, there are also regulations in place at the national level[91]. For Italy, for example, greenwashing may fall within the framework of unfair competition, which is regulated by Articles 2598, 2599 and 2600 of the Italian Civil Code. Other normative references related to greenwashing can be found in Article 20 of the Consumer Code[92] or in Articles 9 and 41 of the Italian Constitution.

While waiting for a clearer and more comprehensive regulatory framework, the Italian Sustainable Investment Forum has identified some general recommendations to prevent and counteract greenwashing[93]. First, in order to define oneself as "sustainable," it is necessary to act on the whole corporate culture and business processes: it is not enough to integrate sustainability only in the area of communication. Second, it is better to communicate less, but to be sure of what is communicated, starting with reliable data and sound sustainability policies. The key word to combat greenwashing is transparency; communication must be effective but at the same time accurate, truthful, and verifiable.

As for the financial sector, the engagement of asset owners and asset managers is essential to prevent and counteract greenwashing. The former define sustainable investment policies and are responsible for guiding and monitoring the operation of asset managers, who must ensure that investment policies are properly implemented, and that procedures and controls are in place on sustainable aspects. Finally, asset managers are required to design, classify, and market financial products in a way that accurately reflects the sustainability profile of the underlying investments. The commitment of all financial players is necessary to counter greenwashing, which poses a threat to market credibility.

In conclusion, the phenomenon of greenwashing represents a major challenge for all financial actors who are more attentive to the issue both in terms of the enforceability of regulations and awareness of the reputational damage this phenomenon can cause. Transparency, which is one of the most important aspects of sustainable finance, is of great help here. We expect that rules and regulations will be reinforced to prevent and sanction greenwashing[94], guaranteeing that progress toward real sustainability will not just be superficial, but will lead to concrete and meaningful change.

[87] See footnote 9
[88] See footnote 10
[89] See footnote 11
[90] See footnote 12
[91] See footnote 86
[92] Legislative Decree No. 206 of September 6, 2005.
[93] See footnote 86
[94] See footnote 19

11 CONCLUSIONS

In conclusion, sustainable finance represents the key to a better future; a future in which equity, prosperity, and environmental protection are at the heart of financial decisions. We have shown that sustainable finance not only creates long-term value and reduces risk, but also has a positive impact on companies, communities, and the financial system overall.

We have dispelled baseless misconceptions, making our case with concrete evidence and rational arguments. The importance of aligning financial practices with sustainable development goals is evident, promoting responsible investment for a more sustainable future.

Now, it is imperative to act without delay. Time is a precious commodity, and we cannot afford further delay. Awareness and understanding of sustainable finance must spread among investors, financial professionals, and the general public. It is time to collaborate and adopt innovative solutions that can bring about the necessary change. In short, sustainable finance is not just a desirable option, but a compelling necessity. Our future and that of the planet depend on the decisions we take today. It is time to act with determination and responsibility, for a better world for all of us.

ACRONYM	SIGNIFICANCE
CBAM	Carbon Border Adjustment Mechanism
CDP	Carbon Disclosure Project
CONSOB	Commissione nazionale per le società e la borsa
CSDDD	Corporate Sustainability Due Diligence Directive
CSRD	Corporate Sustainability Reporting Directive
EFRAG	European Financial Reporting Advisor Group
ESAP	European Single Access Point
ESG	Environmental, Social and Governance
ESMA	European Securities and Markets Authority
ETF	Exchange-Traded Fund
EU ETS	EU Emission Trading System
EUGBS	European Green Bond Standard
GHG	Greenhouse gas
GRI	Global Reporting Initiative
IDD	Insurance Distribution Directive
IORP	Institutions for Occupational Retirement Provisions
IPCC	Intergovernmental Panel on Climate Change
ISBB	International Sustainability Standards Board
ItaSIF	Italian Sustainable Investment Forum
MiFID II	Market in Financial Instruments Directive II
NFRD	Non-financial Reporting Directive
PRI	Principles for Responsible Investment
SBTi	Science Based Target initiative
SDGs	Sustainable Development Goals
SFDR	Sustainable Finance Disclosure Regulation
SRD	Shareholder Rights Directive II
UCITS	Undertakings for collective investment in transferable securities

Study realized by

The Italian Sustainable Investment Forum (ItaSIF) is a not for profit association founded in 2001. Its membership base is multistakeholder: its members are financial actors and other organizations interested in the environmental and social impacts of financial activities. ItaSIF mission is to promote the awareness and the strategies linked to sustainable investments, with the aim to encourage the inclusion of environmental, social and governance criteria into financial products and processes. ItaSIF activities are divided into three main areas: research, projects, and advocacy. Within these sectors ItaSIF:

- runs research and education activities and facilitates working groups to promote best practice and contribute to the analysis and growth of sustainable investments;
- informs and advises the financial community, the media and society as a whole, on sustainable finance through the organization of communication campaigns, conferences, seminars and cultural events;
- engages with Italian and European institutions to encourage the implementation of a regulatory framework promoting sustainable investments.

Since 2012, ItaSIF has organized the Italian SRI Weeks, one of the leading initiatives in Italy on sustainable and responsible investment. ItaSIF is a member of Eurosif, the association for the promotion of sustainable investment in the European market.

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