GENERALI INSURANCE ASSET MANAGEMENT

Focal Point

The Ukraine war will lead a rethinking of the ESG investing

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Our Focal Point series explores topical issues on macro, markets and investment

- The Russian invasion of Ukraine raised new questions for ESG investment and complicated existing trade-offs. For sovereigns, it showed that a good average ESG rating is not enough. Outright exclusion based on poor governance may become more popular.
- Finding alternatives to Russian gas can stand in the way of reducing emissions. Longer-term, accessing the resources for the green transition requires tighter links with countries with a patchy record on human rights.
- On the corporate side, mounting political pressure to improve ESG perception of the Defence Sector will face a challenging implementation. Most large players are selling to non-democratic countries exposing investors to significant reputational risk.

The Russia-Ukraine conflict has generated an intense debate regarding some established ESG practices, in particular:

- The failure of ESG asset managers and data analytics firms to consider the escalation preceding the war. The conflict has prompted them to stop new investments in Russia or divest when possible, demonstrating how investors "have failed" by not managing risks before the latest invasion. They missed capturing the warning signals of the conflict. This raises questions on how ESG risks should be assessed.
- Weaning off Russian oil and gas will require new investment in "brown" technologies as supply chains for fossil fuels need to be adjusted. It is unclear whether and how this is reflected in the ESG rating for both corporations and countries. The war has accelerated the transition to green technologies to produce energy, leading to an even faster increase in demand for the materials needed for related goods, e.g. batteries, etc. Yet, most of them come from countries with a high level of corruption and political instability. Again, it is unclear how corporations will solve this trade-off and tackle it by rating agencies.
- The defence sector was shunned by ESG investment. Yet, Ukraine needs weapons to defend itself from an unprovoked and unjustifiable invasion. Would that lead to a reassessment of the industry?

Rethinking ESG sovereign risk

While the ESG practices have been developing fast over the past years, focusing on corporates and especially the E component, the ESG sovereign side has gathered less attention and analysis. In our view, the Ukraine invasion will reshape the ESG sovereign assessment.

Indeed, there has been a failure to measure correctly the risk related to the G component in Russia and Belarus. Before the conflict, both countries had a below-average G component. However, for some ESG rating agencies the overall ESG score was for Russia on par with Greece and Chile until December 2021. The G component, which accounts for 50% of this score, was more than offset by good E and S components. in early 2022, Russia and Belarus were downgraded rapidly to the lowest ESG level. Likewise, credit rating agencies downgraded Russia by six notches from BBB- to SD within a month.

This event highlights several caveats to the current ESG framework for sovereigns.

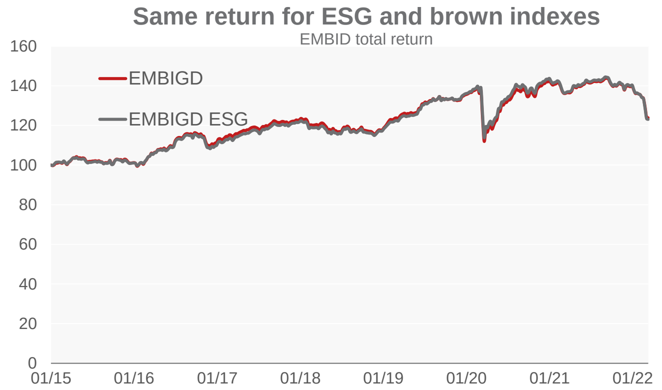
Firstly, the sovereign ESG analysis is purely quantitatively driven without a qualitative overlay. There is a substantial lag in the data, often years, especially at the sovereign level, and so it creates a discrepancy between the actual risk and the final rating. For instance, it induced ESG rating agencies like MSCI to cut the Russia ESG rating discretionary, despite the lack of change in governance data. While a corporate can rapidly disclose its data and have a timely revision of its ESG score, sovereign data are updated more slowly.

Secondly, the crisis showed the limitation of an aggregated score where a good E and S score offset a poor G component. ESG sovereign scores are usually only a weighted average that considers the E, S, and G components independently while there are relationships and cross-risks between the three components in our view. It raises the question of whether an average of the three scores is the correct method. Most investors tend to only look at the final score without necessarily looking at the composition.

Thirdly, it is more difficult to assess only quantitatively the governance and the related political risk of a sovereign than, for instance, the environmental risk where norms and data are more numerous. Governance is a variable concept that can deteriorate rapidly, and it will not be immediately seen in the data.

Moreover, the governance risk analysis of some ESG rating providers does not include involvement in armed conflicts. Eventually, the Russia ESG rating was downgraded after the Ukraine invasion. It seems that the rating of Russia is the only one suffering from a downgrade following a military intervention. It could be explained that the conflict drove more international outcry than others. This metric could be used as a qualitative risk assessment. For example, Saudi Arabia's intervention in Yemen does not seem to have led to any movement in the country's rating, or at least not to the same extent.. However, this is where the risk of double standards steps in. Depending on the perception of the morality of the intervention and its international support, a different outcome could arise.

These ESG sovereign rating shortcomings lead to the fundamental question of the inclusion of countries into ESG indices. Surprisingly, both Russia and Belarus were included before the war in the JP EMBI ESG index, one of the largest EM sovereigns ESG credit indexes. Despite their weak governance, they even had higher weights than in the traditional non-ESG indices. A close analysis of the two indices' (ESG vs. traditional) composition shows very little difference, and only distressed countries with very weak scores were excluded from the ESG index. Beyond the failure to measure the ESG risk correctly, it casts big questions on how ESG indexes are constructed.



Source: Bloomberg, JP, GIAM

ESG to matter more for sovereign investment

The Ukraine invasion will have numerous relevant consequences on sovereign investing, especially in EM countries with low ESG scores.

The war is a telling example that high ESG risk can have significant financial consequences. Therefore, their metrics must relate to the traditional credit approach to credibly measure the sovereign credit risk. Thus, we expect a growing focus on sovereign governance and political risk. Moreover, political risk has often been considered a long-term risk that was not seen as highly relevant in a short-term investment decision. However, the latest geopolitical events show that it is not a linear risk, and it can trigger binary outcomes in a short period.

Investors will likely run a deeper governance analysis before investing in a country. For instance, according to the International Institute of Finance (IIF), China has seen sizable equity and bond outflows year-to-date that may also be related to ESG concerns. Likewise, it raises questions about Kazakhstan, which has weak governance despite a robust external balance sheet and an IG credit rating.

Questions related to hybrid democratic regimes can emerge too.

Moreover, the rapid and large-scale sanctions initiated by the US and Europe create a precedent. They suggest that a country exhibiting tensions with the West could suffer sharply in the future. A solid external balance sheet and large FX reserves, like Russia had, are not enough to offset the governance and the sanction risk any longer. In the Russia case, for some ESG rating agencies, sanctions are not part of the ESG rating methodology. It is only considered as a separate screening metric. In addition to the focus on the G pillar, such additional screening metrics could help identify the risk some sovereign investments entail, such as the involvement in armed conflicts or defense spending.

Within this new environment, the exclusion approach for countries based on minimum standards will gain traction in our view. Of course, it will not be trivial to establish a commonly agreed list of minimum standards. Moreover, a qualitative analysis is required as a sovereign analysis cannot rely only on quantitative data, given the lag in data availability, especially for governance and political risks.

Cutting gas exposure to Russia delays the green transition

The war also turned the green transition into a national security priority. This will speed up the transition, but the need to wean off Russian gas and oil as fast as possible will make the transition choppy. The RepowerEU plan announced by the Commission at the beginning of the war envisages complete independence from Russian energy export "well before" 2030. It also foresees – very ambitiously – to cut demand for Russian gas by more than 60% (around 101 bcm) by the end of 2022. Limits to gas usage may increase the carbon content of the energy mix. Resource-poor EU countries such as Germany and Italy may be forced to turn to readily available coal to replace gas, even to a larger extent than what happened in 2021, when soaring gas prices led to a 16% increase in coal induced emissions from electricity production. European carbon emission prices have rebounded from the trough of € 58 per ton reached at the beginning of March but, at just above € 80/ton, are significantly below the €100 peak reached in February. Once fuel and emission costs are considered, prices should increase faster to make coal-based energy generation more expensive than gas-based ones.

The shift to coal may indeed become global. Europe's high reliance on liquified natural gas (LNG) will create competition with Asian demand. With supply incapable of adjusting quickly, the price will rise globally, forcing many emerging economies to switch to cheaper coal partially. This shift is expected not to last beyond 2023. However, the unprecedented nature of the current situation reduces the confidence in any forecast.

Moreover, weaning off Russian gas and oil imports may, in the short run, increase investment in brown assets: the US and the UK have already announced a plan to increase domestic fuel production. Additionally, increasing the reliance on LNG will require a significant stepping up of the network of terminals. It takes up to two years to build one, and breakeven is usually reached within a decade. This could imply more substantial and prolonged gas usage unless the public sector steps in to cover the losses associated with a faster decommissioning of the plants. Moreover, several countries are delaying the phasing out of nuclear energy. Some like France and UK have planned to increase reliance on that, and others may consider investing in plants. However, given the controversies around nuclear power, it is uncertain whether and how this will be considered in sovereign ESG assessment.

Over the longer term, however, the structural changes driven by the EU's new plan imply a significant acceleration in electrification. Renewables are at the heart of the policy, with a target of 70% of wind and solar energy production by the end of the decade. To put things into perspective, last year Europe increased production by 30 GW of wind and solar energy, while the new plan for REPowerEU implies a peak of 150 GW by 2030. On top of wind and solar energy sources, green hydrogen production is also accelerating in the REPowerEU plan, with targets of 20 mln tons for 2030, from the previous 6.5 mln tons over the same timeframe. The reduction in the price of green hydrogen with respect to grey hydrogen will spread it use and lead to an upgrade of green hydrogen technologies and upsides to the electrolysis capacity in Europe. On the demand side, several energy-intensive processes such as high-heat chemicals process for steel and cement. can be electrified, which would lead to a substantial greening of EU manufacturing. In the end, the war is accelerating the green transition but at the cost of a temporary backpedaling on the cut on coal/nuclear usage and some untimely higher investment in brown fossil fuels.

Will "E" clash with "S" and "G"?

The infrastructure needed to boost green energy production increases the demand for specific materials. According to the World Bank, complying to keep global temperature rise below 2°C implies a 300% increase in demand for the minerals used for solar panels. A spike in demand is also expected for cobalt, lithium, and rare earth elements needed to produce wind turbines, electric vehicles (EVs), and batteries. However, locking long-term contracts for these materials will expose countries and the energy sector to tough choices. The bulk of global reserves is in countries known for not applying international standards for the treatment of mining workers or are prone to widespread corruption and/or at high risk of civil war. Of course, much of the ultimate impact on the workers and citizens of commodities-producing countries will also depend on the behaviour of mining companies, to the extent to which they accept corruption or other unlawful practices.

Mineral	Used for…			% of reserves in states defined as	
	Solar	Wind	EV	Fragile(1)	Corrupt(1)
Bauxite	x	x	x	44	68
Chromium		x		55	100
Cobalt		x	x	70	70
Copper	x	x	x	41	41
Graphite			x	73	100
Iron	x	x	x	42	60
Lead	x	x	x	49	49
Lithium			x	21	34
Manganese		x	x	66	86
Molybdenum		x		70	72
Nickel	x		x	42	59
Rare Earths		x	x	58	94
Selenium	x			76	76
Silver	x			52	52
Tellirium	x			67	67
Tin	x			69	84
Titanium			x	57	62
Zinc	x	x		52	59

Source:"The Geopolitics of the energy Transition" Springer, 2020
(1) "Fragile" or "Very Fragile" according to the Fund for Peace score
(2) "Corrupt" or "Very Corrupt" according to Transparency International

Yet experience shows that the economic boon related to increased demand for metals and minerals often leads to violence and human rights abuses. Conflict may also disrupt operation or clog the supply chains, and the high social costs may lead companies to incur potentially heavy reputational losses. As in the case of a sovereign, this complicates the ESG assessment of corporations and whole industries, with no clear-cut, ready-made solutions to the trade-off.

The Defence Industry through an ESG lens

In recent years, some asset managers have been backing away from the defence sector for fear of being in contradiction with sustainable finance and/or being tainted by controversy over the arms trade. However, Russia's invasion of Ukraine will, in our view, fundamentally change the landscape of the Defence Sector.

European defence spending will now be much higher than previously expected, as shown in Germany's announcements and the possible increase in military expenditures by up to 2% of the GDP of NATO allies. Europe, in particular, is calling for greater strategic autonomy in its own military capabilities to ensure the safety and security of its citizens. The ESG unfolded question is whether this qualifies now as an "S" element positively contributing to European countries' social sustainability and whether defence companies should be considered social impact companies.

Given the complexity of the topic, we highlight below some of the main arguments under discussion and the potential impact of the recent EU Taxonomy, SFDR regulations, and developing EU Social Taxonomy on the discourse of the topic. First, one can argue that peace is preserved by a readiness to go to war when needed. Intrinsically, it implies that technology is neutral and that weapons are only as good or / as bad as what the people make of them. This can apply to any other sector potentially facing ESG issues, like energy or metals. On the other hand, others postulate that technology is not neutral but directly affects – somewhat negatively - human conditions and relations. This also applies to weapons: i.e., the proliferation of weapons would increase the probability of war. Nuclear weapons best illustrate this: "*Nuclear proliferation is greatly enhancing the likelihood of nuclear war. It dramatically increases the number of scenarios for small-scale nuclear wars or nuclear terrorism*" (Taylor, 1988). This reasoning backs the Non-Proliferation Treaties signed since 1968.

Moreover, not all controversial sectors are equal— some serve critical social needs. For example, despite their negative externalities, areas such as oil & gas, nuclear energy, and defense serve critical social needs, providing a less clear-cut case than for tobacco, gambling, and controversial weapons. By the same token, all defence companies are equal. Those who do not abide by international treaties on developing and selling weapons or failing to develop appropriate anti-corruption programs should be "ESG penalized" or eventually excluded. Countries with "hybrid " / "non-democratic" regimes might also deter ESG investors. There are legitimate concerns over the sale of weapons; hence, authorized exports eventually consider the principle "contributing to the Defence of liberal democracies" valid if defense stocks sell their production to democracies only.

Notwithstanding the heavily regulated industry, many countries can be considered problematic from an ethical standpoint. Exposure to such countries could lead to exclusions, or, on the flip side, ESG investors may be willing to invest in stocks of defense companies selling only to democracies, provided it can be defined in a widely acceptable way. Currently, only very few Defence companies (if any) refrain from selling to non-democratic states, which are actually among the largest buyers. Another example regards companies that provide military equipment used in the violation of human rights or companies that are complicit in denying the right to self-determination. Therefore, there are experiencing controversies on the topics.

Conclusion: ESG needs a comprehensive overhaul

In this Focal Point we tackled what we considered the most pressing issues the war unveiled for ESG investment. We think a common thread emerges. The war stress-tested ESG criteria, and investors found them potentially context-sensitive, like the inclusion or exclusion of defence, or unable to address some long-term issues, such as the potential clash between green energy infrastructure and the need to deal with poorly governed countries. In the case of defence, saying "it depends on…" is not a credible solution. We think tying industry considerations with assessing the countries acquiring their goods would be sensible and clear for defense companies to explain the way out. Solving the tension between the need for materials for the green transition and the vow not to finance corrupted regimes looks harder. Engagement, both by companies purchasing the commodities and their domestic governments, can be a solution. However, compromises seem inevitable as the limited numbers of states supplying critical commodities give them much-negotiating power.

Most of the ESG analysis was silent about the autocratic nature of Russia and Belarus. They ultimately failed to factor in Moscow's aggressive behaviour in the war run-up, as it was neglected in 2014 (invasion of Crimea and Eastern Ukraine). Yet, as far as sovereigns are concerned, the wealth of information provided by ESG scores remains useful. Some form of exclusion approach regarding the G score may be needed to get a more credible assessment and avoid exposure to military aggressors. Moreover, some degree of "soft" qualitative judgment will be required in the ESG rating as lagged scores may not cover significant looming risks on the political side.

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