

GREENPEACE

Sustainability Funds Hardly Direct Capital Towards Sustainability

Greenpeace-Briefing, original inrate study ([pdf](#))



As a globalised society in a climate emergency, we need to transition to an economic model that is sustainable and equitable. For societies, industries and corporations to undertake this systemic task of adopting a green and just business model successfully, **we need capital** – and lots of it.

Investors have a choice to make. They can continue to invest in fossil fuels and other carbon-intensive sectors, and by doing so face physical, legal and transition risks¹, while exacerbating the climate crisis. Or they can redirect funding to green companies and projects, thus both contributing to and profiting from a transition to economic sustainability, innovation and job creation.

Consumer sentiment appears to encourage the second option. The **demand for green financial products has skyrocketed** over the past few years and continues to grow. But are sustainable investment funds really able to attract capital and invest them in eco-friendly projects? Can they **redirect financial flows into having a positive effect** on the environment and our societies?

Looking to answer these questions, Greenpeace Switzerland and Greenpeace Luxembourg commissioned a study from Inrate, an independent Swiss sustainability rating agency, to investigate whether sustainable investments are actually channelling capital into a sustainable economy.

Key findings

Sustainability funds in Switzerland and Luxembourg do not sufficiently support the redirection of capital into sustainable activities. The current sustainable investment approaches need to be questioned by all stakeholders.

Sustainable investment funds have a higher ESG Impact Score than conventional funds. However, the difference is so small that it hardly leads to a better rating.²

With the exception of the production of cement and the defence industry, there was no significant reduction when comparing conventional and sustainability funds in terms of involvement in other critical activities.

On the plus side, the analysed sustainable investment funds were less involved in environmental controversies (deforestation, oil spills, etc.).

While the EU Sustainable Finance Taxonomy is supposed to provide valuable methodological foundations, there should be regular reviews of whether green finance regulations are proving to be effective, practical and pragmatic. For instance, it is crucial that the EU Taxonomy is exclusively based on science, leaving aside political and business interests.

¹ Transition risks can occur when moving towards a less polluting, greener economy. They include policy changes, reputational impacts, and shifts in market preferences, norms and technology.

² The difference was 0.04 points. The ESG Impact score for conventional funds was 0.48 compared to sustainable funds with a score of 0.52 – on a scale from 0 to 1 (zero corresponding to a very negative net impact, one to a very positive net impact).

All flash, no substance?

Green is in. Due to growing climate-change awareness and global consumer demand for sustainable financial products, the creation and marketing of corresponding investment vehicles has skyrocketed. Though commendable in principle, there is a problem with the 'green finance' trend: there is neither a clear definition of nor an accepted industry standard for sustainable investments. Without clear guidelines on what constitutes sustainable investments, there is a great danger of **greenwashing**, misleading customers into thinking they are making sustainable investments when in fact their money does not end up having a positive impact on the environment and society. Indeed, sustainability funds are not technically required to have a measurable positive impact, even if their title clearly implies an eco-friendly or ESG (Environmental, Social, and Corporate Governance) concern. This is all the more alarming considering that redirecting financial flows to sustainable economic activities is crucial in the fight against climate change as stipulated in the Paris Climate Agreement.

In the context of the growing greenwashing risk in the finance industry,³ Greenpeace Switzerland and Greenpeace Luxembourg commissioned Inrate to investigate whether or not sustainable investments actually manage to channel capital into a sustainable economy. This is called the **capital allocation effect**: do sustainable investment funds manage to amass more capital for eco-friendly companies and projects than conventional funds?

The study includes a statistical analysis of 51 'sustainable' funds in the retail segment that are authorised for sale in both Switzerland and Luxembourg. Why these two countries? Because Switzerland is one of the most important financial centres in the world in terms of wealth management and Luxembourg is the largest investment fund domicile in Europe and the second largest in the world. For both financial centres, sustainable investments and the associated greenwashing risk are therefore of great importance.

Sustainability funds fail to live up to their name

As mentioned above, this study analysed whether there is a positive capital allocation effect when comparing sustainable investment funds with conventional investment funds. Can they divert capital from non-sustainable investments to sustainable investments?⁴

To measure the capital allocation effect, the study took into account **four measures**:

- weighted average ESG Impact score⁵
- weighted average carbon intensity (WACI)
- weighted percentage of revenues derived from critical activities⁶
- weighted involvement in major environmental controversies⁷

The results were sobering. The sustainability funds assessed in the study **hardly channelled more capital towards sustainable economic activities**. It seems that, overall, sustainability funds are only effective in redirecting when it comes to major environmental controversies or specific activities such as cement production and the defense industry, but **not effective in terms of climate and sustainability portfolio impact improvements**. This suggests that the funds' contribution to achieving the UN Sustainable Development Goals and the climate targets of the Paris Agreement is **not yet sufficient**.

³ European Commission, *EU Sustainable Finance – April Package*, 21 April 2021

⁴ Sustainable investments are defined as investments in which ESG factors are integrated into investment decisions.

⁵ For a description of the Inrate ESG Impact score, see Annex A.1 (page 83) of the Inrate study.

⁶ The following economic activities were labelled as critical due to their detrimental impact on the environment and society: agricultural industry and fishing (meat, dairy/eggs, seafood/fish, fertilizer & pesticides), defence industry, fossil fuels, mining and production of metal, nuclear energy, production of cement, transportation industry (road transportation, excl. public transport, and air transportation).

⁷ Inrate evaluates the ESG Impact of a company based among other things on controversies from different categories, e.g. governance practices, working conditions, legal compliance, impact on local communities or environmental damages (for further information, see Annex A.1 of the report).

Not yet the right tools for the job

Sustainable investment funds apply specific **investment approaches** to achieve their portfolio goals. But given the observable lack of the desired capital allocation effect, the study examined if these methods are in fact effective in redirecting capital toward sustainable opportunities.

The investment approaches that the study took into consideration are the following: best-in-class; engagement; ESG integration; exclusion; impact investment; positive selection; and thematic products.⁸

Our analysis examined which of the 51 funds employed which methods and what – if any – impact this had on our four measures (ESG impact score, carbon intensity, investment in critical activities, and involvement in environmental controversies). Again, the results leave much to be desired:

- Exclusions did not significantly reduce investments in critical economic activities or major environmental controversies.
- Best-in-class and positive selection did not significantly improve the ESG impact, climate impact, or involvements in critical economic activities.
- The thematic funds studied neither reduced the climate impact nor involvements in critical economic activities or major environmental controversies, despite their focus on the environment, climate or sustainable energy.

The study concluded that the **application of sustainability approaches had mostly no significant effect on investments**. Further, the missing intention for short-term capital shifting was not the reason, as all of the funds aimed at short-term capital allocation.

It is therefore evident that the way in which the investment approaches are applied today is **largely inappropriate** in delivering capital allocation effects.

⁸ For a detailed description of the investment approaches, see 'Table 2: Definitions of sustainability approaches' on pages 42–43 of the Inrate study.

No shortcuts, no loopholes, no cutting corners

The unsatisfactory performance of the applied investment approaches underlines the need for new methods to assess the sustainability of a portfolio. Sustainability funds require effective **rules and regulations** if they are to achieve the desired capital allocation. The study proposes the following as a starting point:

- Definition and implementation of minimum impact-related goals and appropriate controls
- Use of relevant, exhaustive and reliable data
- Application of clear and comprehensive standards in terms of transparency and methodologies
- Promotion of adequate sustainability-related education in the financial system

Asset managers that label their funds as sustainable must be **conscientious and transparent in their investment approach** to deserve said label and stay away from any practices that might be considered 'greenwashing'.

Case study: ESG fund

The fund we examine in this case study is an example of a fund that included "ESG" in its name but failed quite clearly to deliver on this promise. The fund was passively managed, i.e. aimed to replicate the performance of its sustainability benchmark.

The sustainability approaches used in the company selection for the benchmark were exclusion criteria and best-in-class. In this case, we knew that the exclusion was focused on controversial weapons, controversies (not further specified) and compliance (including ethical standards).

Quite strikingly, 12% of this fund's volume was invested in companies that had an ESG Impact in the D range (D+, D or D-). In total, over 60% had an ESG Impact in the C or D ranges resulting in an overall ESG Impact score of 0.39. Over a third of the fund's capital (35%) was invested in critical activities, which was more than double the average share amongst the conventional funds. Most of the critical activities that the sustainability fund was invested in were fossil fuels (16%, half of which were derived from coal and oil), climate-intensive transportation (6%) as well as mining and production of metal (5%).

It turns out that the mere application of exclusion and best-in-class approaches does not necessarily lead to a positive portfolio impact. This does not mean that these approaches should not be used. The missing portfolio impact could be due to missing strictness of the approaches or the lack of consistency in their application.

The way forward

Redirecting enough capital to enable the transition to a sustainable economy will have to be a team effort by policymakers, regulators and financial actors. The EU has been developing an action as part of its Sustainable Finance Strategy. At the heart of this action plan lies the **EU Taxonomy**, one objective of which is the prevention of greenwashing.⁹ The Taxonomy classifies fitting economic activities as “green” and thereby aims to achieve a redirection of capital. However, it already became clear during the development phase of the Taxonomy that this rating system would be difficult to implement. Moreover, a rating system into “green” and “non-green” activities is hardly sufficient to map complex economic activities. A clear definition of impact and how it should be measured and reported for sustainable investments is also missing. Recent developments further show that the Taxonomy is becoming a plaything of politics and businesses and the criteria once defined by scientific expertise are under threat of being diluted.¹⁰ In Switzerland, however, no measures have yet been defined to regulate sustainable investment funds or to prevent greenwashing. This is despite the fact that the Federal Council wants to make Switzerland a leading location for sustainable financial services.

Greenpeace Switzerland and Greenpeace Luxembourg demand comprehensive requirements for so-called sustainable investment funds. Policy makers need to define legally binding, sufficient and clear standards in terms of **transparency, methodologies and minimum impact-related standards for sustainable investments**. The funds in question must at least be required to invest exclusively in real economy actors whose emissions reduction path is aligned with the goals of the Paris Agreement.

For the financial sector, setting high standards for sustainable investment rules as well as impact-related controlling and reporting is crucial. Most sustainability funds implicitly or explicitly signal improved portfolio impacts; not fulfilling this promise poses reputational and legal risks due to greenwashing and decreases client trust.

In conclusion, sustainable investment products must lead to **lower emissions in the real economy**. Promoting true sustainability in the financial markets is all-important in accomplishing the shift toward a greener, fairer economy and ultimately counteracting the worst effects of the ongoing climate crisis.

⁹ European Union website, [EU taxonomy for sustainable activities](#)

¹⁰ Euraktiv, [Brussels postponed green finance rules after 10 EU states wielded veto](#), author: Frédéric Simon, 18 January 2021 (updated: 29 January 2021)