Transcripts of the interview with Linda Zeilina (Founder & CEO of the International Sustainable Finance Centre) – March 2024

Caterina Rho:

Hello everyone. Welcome to the new episode of Interviews with the top sustainable finance scholars, the European Commission Sustainable Finance Research Forum interview series. My name is Caterina Rho, you may know me already for other interviews. I am the Secretary of the Forum and I have the pleasure of having here today Linda Zelina, the founder and CEO of the International Sustainable Finance Center, an independent think tank headquartered in Prague, where she overseas its work on sustainability strategies, sustainable investing and international ESG standardization efforts. Welcome, Linda!

Linda Zeilina:

Thank you very much, it's a pleasure to join. Thanks for the invite.

C.R.:

Linda is also a member of the EU Platform on Sustainable Finance and a member of the very first cohort of EIB Woman's Climate Leader Network launched in February by the European Investment Bank. She is also an Advisory Board member at the Polish Sustainable Investment Forum and the Romanian Sustainable Investment and Finance Association and the Czech Sustainable Investing Forum. In 2021, Linda spent a few months as a Policy Leader Fellow at the EUI School of Transitional Governments in Florence, where she focused on the EU sustainable finance rules and the role of impact investing. Linda is now working with the Florence School of Banking and Finance on climate related prudential supervision and green bonds. Over the years, Linda has worked as an advisor to prominent politicians, large asset managers, pension funds and European investment funds on the topics of sustainable finance. Thank you very much Linda for having accepted our invitation to participate in our series of interviews on key challenges on sustainable finance! Considering all your experience working on sustainable finance, both on the regulator side and with the financial market participants, have the use of sustainable finance regulations that changed anything? Are we focused on creating incremental changes and do we need a paradigm shift?

L.Z.:

Well, thank you very much, Caterina. Thank you for the invitation and also for reading out the biography etcetera. So I think it's an interesting question because there is a lot of argument that we have never seen so much activity in the sustainable finance space. Ten years ago this was a niche subject that was nice to have. People were trying to do some thought leadership on it and predominantly be focused on pledges. So we had investor and bank pledge just to try and get to net zero and that was for a very long time the only main topic of conversation and I think what people underestimate is how much has changed over the last two to three years. And that has been predominantly thanks to the EU leadership, and to the very hard work of entities such as DG FISMA. The EU Sustainable Finance Agenda, while many will agree has some issues, for example with the oil and gas being part of the EU Taxonomy, however, that does not invalidate the fact that what we have is finally a much more coherent framework of sustainable finance, which consists of multiple different pieces of regulation that actually has led to a very direct impact on how businesses and the financial sector has started engaging with the topic.

If a few years ago we had to do a lot of explanation and try and create at least some baseline understanding of what sustainability means in practice for finance and business, now that conversation has completely shifted. Most organizations, large entities, especially the ones to which the corporate social responsibility applies, already know the main tenants of CSRD, SFDR and CSDDD, so all of the main files of the EU regulatory framework. So they know the basics.

And finally, in the last year, we have shifted from: why are we doing this? What is it? To: how do we implement, what are the best practices? How do we create the disclosures, how do we streamline data, we gather data? And then finally, the next step: how do we manage the sustainability performance and how we link it to business and financial strategies? And I think that shouldn't be underestimated.

A couple of weeks ago, the EU Platform and Sustainable Finance hosted a webinar as well and launched a compendium of early market practices, showing how the different stakeholder groups from banks to corporates to insurance companies, how they're actually using EU taxonomy and all these different pieces of regulation. And what it showed was that there is significant market uptake, that there are an emergence of very solid integration of these new disclosure regimes already into the strategies and into the DNA of organizations. And why this shouldn't be underestimated is that we always start a bit slow, but then it's like a snowball effect. So I think what we can expect next is that financial institutions and corporates and also the whole rest of the spectrum will get used to the topic, will build internal knowledge, internal practice, and from some niche regulatory/compliance issue it will actually become a standard practice across the board and that's why it's so exciting to see how many more events, conversations and even activity is happening in this space. So it's been a complete change in the last few years. So let's see what next year will bring. There will be a new EU Commission, but this topic will not go away. And I think what we will do next is also try and focus a lot more on transition finance and these other types of financial mechanisms and financial solutions to bring about actual solid change on the ground. So actually starting to change the real economy as well.

C.R.:

Yeah, this is very interesting. It is, really! As a person working in the topic, I agree it has been really interesting to see the topic passing from a niche of a very specialized regulators and policy makers and researchers to wide discuss topics in the industry. And now we are at the implementation stage. So everybody knows what we are talking about and that is important, that is really crucial. But considering these important steps, where we are now, implementation. When it comes to investing, in your opinion, are there any new practices emerging that are different from business as usual, and how they are different? What are the main innovations that can be important for the implementation of this new sustainable finance regulation?

L.Z.:

Thank you. So I think actually the new practices are one of the most interesting topics because in some cases these still remain relatively niche. But the hope would be that in the next couple of years, we'll see major expansion of them. And because of that, I will quickly share a couple of slides just to visualize and help our audience understand how these practices are different and why they're so important. So let me just share a few slides.

I think one of the most exciting things that we're seeing in the market is ESG-linked carry mechanisms for investment funds and in particular they're used by private equity. We see predominantly these funds in existence in France. We've seen a few in Germany. We have actually carried out a major consultation globally. So we spoke to people in Hong Kong, in the US, etcetera to see, to actually interview all of the people involved in the creation of such funds and what are actually these funds. That's the most interesting part.

What these funds do is, they set very concrete environmental, sometimes also social KPI, so key performance indicators and targets, and then they link the incentive structure, so the remuneration for the fund managers, directly to these targets, to the achievement of these targets. Why is that very interesting? Well, because we have had a lot of greenwashing in this space, unfortunately, one way or another, whether it's intentional or not. But the main issue has been that the data hasn't been verified in a lot of cases, and in a lot of funds they would call themselves an ESG fund or a sustainable fund. But then, where is actually the proof that they've managed to create some sort of tangible environmental impact or that they were aligned with some sort of philosophy etcetera of sustainability? This is why this is particularly interesting, because it links the fund managers money to the achievement of environmental or sustainability performance. And then you actually start seeing how in practice things are a lot more complicated than in theory. When we reviewed the theory it seemed very clear, easy, you do this, that, these are the steps, this is how it's going to work, and then the theory meets the real world. And here we have multiple issues.

The first one is actually: what do you choose? Do you choose CO2 emissions or GHG emissions? Because both are very important and you will have a very different type of measurement and different type of impact depending on which metric you select. Then the question is: do you select an easy to reach metric, so you definitely will have the extra money for achieving this amazing environmental impact? Or do you actually put some ambition in it? So you know it's not going to be easy, so you actually put ambition into the target?

Of course, one of the most important issues is also the Scopes. So Scope 1 and Scope 2 usually are the most common practice of including into a target. But then the question is, well, why don't we also have Scope 3? Because upstream, downstream, there's a lot more impact hidden in Scope 3. And the good news is that more and more investors include Scope 3. And whether they use estimates, and what kind of methodology they use for the estimates, is a different question. But the point is that Scope 3 is becoming one of the big questions. You cannot always market your fund or your initiative as fully sustainable or driving great impact if you don't have Scope 3. So you know you will be open to criticism. So the good news is, Scope 3 is becoming a lot more streamlined practice to be included.

Then the targeted reduction of the KPI it's also very interesting. You can set an aggregate target. So let's say you have a portfolio and you would like to reduce its carbon emissions by 20% or 30%. So the fund decides and then it has a whole portfolio approach. But what that means is that if you see a company that's acquiring a new facility etcetera and increasing its carbon emissions, what you could potentially then do is play around with the portfolio composition to still reach the overall target. So again, how you set these targets very important. You could set them per asset or you can put them as an aggregate portfolio level target. And because of these small differences, your actual final impact on carbon emissions can be quite different. So again, how it's set up is very, very important.

At portfolio level, what we saw is also very interesting, to have a look at how many companies are ready are put into the portfolio with tangible plans of great reduction. And then again the incentives matter so much. We actually came across a fund which had an ESG link carry mechanism, nice fund. Everything was going very well until two years before the fund was supposed to be terminated. And you know, the ESG carry mechanism would hit it. Two years before that, one of the companies managed to do a big acquisition and merged with another company. What it meant was that the value of this company pretty much went times 10, so an incredibly valuable investment for the investor. But what it also meant was that, well, the carbon emissions went times 20. So all of a sudden the ESG carry mechanism, well, you lose the money because you haven't achieved the impact on the carbon emissions. But what happened in this case was of course according to the calculation, the fund managers got a lot more money from their successful merger of this company. So they were actually happy to lose the money that was embedded in the ESG carry mechanism. So you can see how the incentives can also misalign. Just to quickly finish off on this particular interesting case, it is also interesting to have a look at the compensation structure. So in some cases it is, do you achieve the target? Yes/No. Then you decide on when the ESG carry gets paid out. In some cases to minimize the risk what fund managers have done, they have put a sliding scale. So, if we reduce emissions by 70% then we get X amount of the carry paid out, actually to minimize the risk and still get some money. So that's also very interesting. So it's not pass or fail, you have a sliding scale.

The level of emission reduction. What we thought was super interesting is also when you measure it, this was something that we never thought that you could even figure out. But interestingly, depending on where your companies are and what sector they are in, which geography, etcetera, what you can also do is you can gain the system by measuring the emissions at a different time of the year. For a lot of companies in cold countries, the highest emissions will be in winter. So what you will do, you will actually time the emissions measurement at the time of the year when the emissions are the lowest. So that way, if you figure it out very smartly, what you can do is by the time you need to exit the company and calculate the emissions, you can actually get a better result than maybe you could have if you were measuring it a different time of the year. So there are all these small details that actually need more research and we'll need more analysis going forward because this is again as I mentioned, a nascent new practice.

And finally, of course, the most interesting part about this particular carry mechanism is the data verification. Our audience and anybody working in sustainable finance will know that this is the greatest pain and suffering of sustainability professionals is small entity data. So SMEs are not obliged to report, so we don't have enough data. What's the data quality, assurance and verification is expensive, etcetera, etcetera. Well, the interesting thing about this ESG carried link mechanism, because it's linked to money and an additional payout that means that usually there is verification of the data. So that is a very important thing. We will need, one way or another, to teach smaller entities, SMEs etcetera, how to do at least some basic reporting. We know that EFRAG and also the EU Commission is working on at least some sort of simplified way how SMEs would report under EU taxonomy or other types of disclosure. It's very important because we don't, we might not need hundreds and hundreds of data points from the SMEs, but there are certain ones that are material to all SMEs, which are carbon emissions etcetera. So those ones we do need to have some sort of verified information. And I think this is very interesting because here you can see that the verification model and frequency does exist. The baseline is created by when it's done through the acquisition, when actually the asset enters the portfolio and then again at the exit level at the same time because it's linked to the final payout, what funds do, they actually try and verify that information every year or every second year so that they know how the company is doing and whether it's actually accurately reporting. So that is fantastic.

The other good news is that since there's a lot more money in it, and often the money varies between what can be captured by big accounting companies or bigger companies versus smaller, we also have a lot more very efficient digital tools that help companies to quantify their emissions and their sustainability performance and those are becoming a lot more cost effective. So the old argument that this is very expensive, we can't do it, also will change in the next year or two as we start using different types of digital technologies, whether it's machine learning or AI enabled, different types of software, etcetera. So actually a lot of the information can be aggregated much more effectively, and a lot of it, what we found out, companies already have. So just streamlining it internally is very, very important.

So that's pretty much I thought would be an interesting way of looking at a very tangible existing practice of how funds are doing it. And actually one of the entities in Europe suggesting that funds explore this is the European Investment Fund. So again, through its engagement with its own stakeholders, it's driving the kind of exploration of different types of approaches that have some sort of more tangible sustainability impact on the ground.

C.R.:

Linda, this is very, very interesting as a researcher, I see so many avenues to work on and we need that.

L.Z:

We need more research in this!

C.R.:

More research, absolutely! I see avenues for research. Just to mention some of the things that you were describing: in portfolio construction and management, check on green washing because this is a way of limiting green washing, but we still have a lot of work to do on the data, you know. Even if somebody has to report the data for big companies, you still have to check this data. And without entering into the discussion on SMEs or sovereign sustainable investment that is still a land to be explored, right. Also it's very interesting the point of how green and digital can go hand in hand and how new technologies can help the green transition and the implementation of this new regulation. So many new ideas! I hope also our audience will be inspired by this. This are ideas for the current new practices, and what about the future? What is preventing these new approaches that you say that are bit niche, from becoming mainstream? What can help to popularize them?

L.Z.:

Well, I think the main reason why they remain niche is because we still haven't aligned all of our incentive structures, whether we're talking about public finance and what kind of things public finance enables, what kind of public private partnerships we build. And also our regulatory space has just started working in terms of sustainable finance.

I think first one of the reasons why we have sustainable finance agenda first and how much harder we find to do, for example industrial policy and other big policies and also subsidy regimes. I think that one way or another we will need to start rethinking what do we subsidized, what kind of enablers are created through the public finance. And I think one of the remain systemic reasons why we're seeing so much less uptake is because currently sustainability doesn't always pay more. And that's sadly, one way or another, is a reality. We have so much research going on. And is there any Greenium, or like, you know, additional benefit from using a green bond? And the fact that it's inconclusive in some cases, maybe there's early signs that's changing. But the fact that for such a long time there was an argument that it's probably inconclusive is shocking. So that just shows that there is not proper undisputable evidence that being sustainable pays off more. And I think that the only conclusive evidence we had during this horrible attack on Ukraine when of course those ones that had a lot more energy independence and renewables actually suffered maybe a bit less from the high costs.

Other than that, systemically, we now need to integrate actually the kind of cost-benefit analysis and we need to start rewarding those businesses and those entities that actually are fully committed to monitoring and really having some positive impact, sustainability performance impact, not just financial impact. So I think that that needs to change and there's certain pressure points or points in the system that can change a lot. And what we need is, I guess a political agreement on national and European, and global even sometimes, levels to agree that we need the transition and that to enable the transition, we actually need to also decide how do we use the money.

I think there's been a lot of interesting research and discussions whether ECB should do some green quantitative easing, et cetera, which of course comes with systemic issues, et cetera. But I think that those are the kind of conversations we should have more, figuring out how do we use public finance, which should be used as an impact investment for the correct impact we want by 2050. Because, sadly, with money and investment, there's a time lag on the actual sustainability impact. And I think that's not something that people want to engage with because we all want change and we want change soon. But to have that change at all, we actually need to speed up the investment in the volumes now for the effect to materialize in potentially 10 to 20 years.

And one good example is the real estate. So for example, if you want to transition an asset, a building from badly performing one to a very well performing one, it's actually going to be a lot of money, that's potentially not going to be taxonomy aligned initially, but then in after all the renovations, after all the refitting is done, it will actually be a much more valuable asset, much more long term asset and also better performance sustainably. So we need to tweak also how we work on the transition and transition instruments.

C.R.:

Yeah, these topic of who should invest and how it's definitely crucial. It will be probably one of the challenges for the next year. I was thinking, in terms of focus for policymakers and regulators, in your opinion, what will be the main trends, what should we expect in terms of a sustainable finance developments next year or in 2025 after also the new Commission will be will be announced?

L.Z.:

So I think one of the main issues I already mentioned, we will have a lot more attention paid to transition finance. We will also potentially start looking at more concrete indicators for the social transition, because currently when you look at minimum safeguards, we need a little bit more clarity and concreteness in some cases, so that the information that we will collect also on the social transition is, is more uniform and standardized. And I think one of the most interesting conversations that we will have going forward is what kind of certification systems, for example, we create.

We have an EU life project that is a research project also with a practical side, where we are trying to create a standardized, well, a standardized certification system for clean energy SMEs under the EU taxonomy. Very complicated work, it turns out, not as easy as one might think initially, but actually it would be such a high impact initiative if we had certified information provided by these SMEs. The SME is certified, then it goes to a bank and the bank knows that they are reporting in a way that plugs nicely into their system. That can be quite life changing and I think tweaking all of these, what I call the piping of the financial and business system. If we fix that piping and make it easy to finance sustainable things where you know that it's definitely the data is correct, it's aligned, actually could be very, very powerful. Because currently what we see also systemically is that more and more investors, more and more financial institutions are looking for green assets. So how do we actually put more money into green? And then we have that disconnect where we actually don't have sufficient large scale, big ticket size projects and entities that are going fully green.

And that's what we need to change. We also need to figure out a bit more innovation in the financial space. Good innovation hopefully, with not as much risk as in the past, but actually aggregating maybe smaller green projects in some ways so that also you can reach different regions and different businesses, so that we don't end up stifling competition and growth through what some would argue over-regulation. But the truth is that currently with so much new stuff coming out, the ones that can catch up the fastest are big entities. So we also need to make sure that we enable the smaller ones to join the transition and to pretty much get the benefits of more money going towards them.

C.R.:

Thank you very much. This are a lot of ideas and programs for the future. So not only to help bigger organizations with ESG-linked carry mechanism for fund managers that maybe are more targeting bigger realities, but also not forgetting the smaller entities with better regulation of certification systems and integrating more and more SMEs into the taxonomy and into a regulation dedicated to them. So that's this is this is very interesting.

L.Z.:

Well, I think that's exactly what you're saying, that the integration is so key and when you think about who actually feels like their reputation or name or liability is on the line, I think what CSRD has changed is also that directors at board level have realized, oh, we might have to sign off on this. So actually aligning the incentives with the top management, like why should they bother, is a very important part. And this is what I think ESG-linked carry mechanism maybe on a more technical level, but actually aligns those incentives at the top level so that it gets streamlined through the rest of the organization as well.

C.R.:

Yeah. I totally agree. And that we need also to these technical approaches that that are well that can be well known and putting practice because also time is key. We have these misalignment between the immediate gain or market gain and the long term goals that are those of sustainable finance in the end because climate risks are always on the long term. So that's really key to put on the regulations in time to tackle these long term risks.

Thank you very much Linda. I think today we had a very insightful conversation and I personally got many ideas from your talk and also your presentation. So I'm sure that also our audience will have some ideas and they will take advantage from the depth of all your replies. Thank you very much.

L.Z.:

Thank you very much for having me. And yeah, I look forward to future collaborations in this space.

C.R.:

Thank you, thank you very much. So to close our interview, I will also say goodbye to our audience. Stay tuned there for the next episode of the Sustainable Finance Research Forum Interview Series that will be uploaded in April. See you again on this channel!