Transcripts of the interview with Annamaria De Crescenzio (Senior economist and manager, International Finance Unit, OECD) and Etienne Lepers (Economist and project manager, International Finance Unit, OECD) – February 2024

Mélina London:

Good morning everyone, and welcome to our new interview for the Sustainable Finance Research Forum of the European Commission. My name is Melina London and I am an economist working on sustainable finance at the Joint Research Center of the European Commission. Today, as part of our interview series of scholars and practitioners in the field of sustainable finance, I'm very happy to welcome not one, but two experts, Annamaria and Etienne. Good morning. Many thanks for joining us today.

Annamaria De Crescenzio:

Good morning.

M.L.:

So let me start by briefly introducing you both. Annamaria De Crescenzio, you are a senior economist and manager at the International Finance Unit at the OECD, the Organization for Economic Cooperation and Development based in Paris, and you've been working there since 2011.

You're a senior expert on multilateral instruments, on capital movements such as the OECD codes of liberalization, and you manage related negotiations on countries accession to the OECD.

You have led research that contributes to the OECD analysis feeding the G20 Finance Ministers' Track and have published more widely on capital flows and the effectiveness of capital control and macro prudential measures. Prior to joining the OECD, you worked at the Economist Intelligence Unit, Goldman Sachs and other management consultancies. So quite some expertise we have here.

Etienne Lepers, you're an economist and project manager at the International Finance Unit at the OECD, where you've been working since 2016, and you have published a number of peer review studies on capital flows and capital controls, working on early warning systems of financial crisis -we need that! - the effectiveness of micro prudential policy, and the political economy of finance.

You are also a co-instructor at the annual ESRB/ECB course on micro prudential policy implementation. Prior to joining into the OECD, you worked as the risk analysis team of the European Systemic Response hosted at the ECB.

I'm very happy to have you both today to discuss the research you're leading at the OECD in the G20 and the G7 context on sustainable capital flows to developed and emerging markets. And I believe you focus on investment funds.

I think we can start maybe with my first question to you, Etienne. Because there are a lot of talks about the promises and the suitability of green finance in helping the green transition and a major part of this debate has to do with the way we assess the greener from portfolio. How do we know that funds have like really green impact the green, green portfolio? And my question would be how does your work speak to this debate?

Etienne Lepers:

Thanks a lot Melina. First thanks a lot for the invitation. I think we're very happy to be here and following a great set of speakers in your series. So thanks for the invitation, it's a nice question.

So there's a lot of debate on the possibilities of green finance and we wanted to share a bit more lights and facts on this debate by leveraging on a specific data set that is on the investment fund portfolio, very granular that is called Morningstar.

So first maybe to your question, why do we approach the green transition topic from a from a capital markets from an investment fund perspective. First of all because there is a big potential there. It's a large pool of money. So there is important debates about whether the money for the green transition should come from public, private, cross-border or domestic sources. And the conclusion is basically that we should pull out as much as we can from a combination of sources and all of the sources. So in this respect investment funds hold currently 70 trillion U.S. dollar of asset under management. That's a very large sum of money.

And a second big reasons for why we focus on investment fund is because there is a momentum with a clear shift of preferences from investors that we can see in the data with for instance sustainable funds over the past decade that have tripled their assets in the past decade. So they are now reaching managing over 3 trillion U.S. dollar which is around 6% of total asset under management.

And so this big shift in preferences of investors that want to invest in sustainable things has led to a big politicization of the debate. For instance, in the US where you have this anti ESG backlash by some Republican states that have passed some laws that are limiting or banning the consideration of ESG. But also this magnitude of this shift has led to major debate for investors into knowing a bit more what they're investing in. So it's very difficult for retail investors to know whether the sustainable asset that it's investing in has anything to do with the climate or anything.

That's the whole debate about greenwashing the ratings, the real impact of the investments to which your question is speaking to and so first of all about our research. So we need to be clear about what an actual investment funds can or cannot do. So before going into whether the portfolio of these funds are green or not green, we have to be clear about what capital markets can truly achieve. And so there is kind of two, we usually typically think about two broad ways in which investment funds can have an impact.

The first one is stewardship where you can have the shareholders that are pushing for changes in the companies of the board. So it's proxy voting and engagement. This has seen a lot of research, some research has found that this was actually happening, but some others have found that this was a bit more mixed evidence.

The second big channel through which investment funds can have an impact is through the supply of capital and the cost of capital. The supply of capital, there you have some limits about what investment funds can do because except from a few specific markets, sustainable bonds or green bonds or specific infrastructure or private equity markets. Investment funds typically invest on secondary market. And so if you're buying a stock or a bond that is already held by another investors, then there is no direct change to the capital of the issuing firm. And so in this case, the benefits for the issuing firm can only be indirect. So by lowering the cost of capital of the firm and freeing up our resources for further investments. And so now that it's very clear through which the channel, through which channel the investment funds can have an impact, it's about how to know what is a green asset, what is a green fund. And in our work we try to push a bit more this work on the definition and on the classification. So the first avenue to kind of explore in this in classifying companies is ESG ratings, but they're not designed or meant to measure a climate impact. So in the press, you see a lot of articles about misinterpretation of the ESG ratings. And so the OECD work has been one of the first to show that there is basically zero correlation between the E pillar score and the emissions of the firm or the carbon intensity of the firm or even its environmental R&D or its use of renewable and so on. So we want to go beyond this avenue of the ratings.

Another avenue is the names or the prospectus of the funds if a fund is called green, if a fund is called sustainable. But that's not a good proxy either because of the green washing possibilities that you have and in fact there is a lot of, some studies have shown that there is a lot of changing of names and that actually calling the fund green is attracting much more money.

Another avenue is to go through the low carbon Avenue. So whether a company is not emitting much carbon, should it be classified as a green company? But that's not a good strategy either because that would include firms like tech firms that don't emit any CO2. But still we have nothing to do with the green transition. So that's the main contribution of our work is to kind of propose a new avenue, defining green assets and green funds. And this has to do with a variable that we found that is companies that make revenues in what is called carbon solutions. So what is carbon solutions? The data set includes renewable energy, energy efficiency, green building, and green transportation. So with this four kind of sector you have a bit like the best lowest common denominator of all the green, the taxonomy that you have out there. So you don't have any control to see whether you have nuclear in it or not. You have transport, you have energy, you have buildings and you have energy generation and efficiency. So that provides an intuitive way with good data availability to classify all the firms that are in the funds, portfolio that have activities that relates to carbon solutions. That's how we classify it in our work.

M.L.:

OK, Many thanks for this clear presentation. So if I understand correctly, first like having an idea of, what are the impact of the front for the green transition? Because I think it's always a question of how do we get to the real impact, how do we get to the actual transitioning of our economy. And like the financing is key because firms need the money to transition, but then like the, as you said, the secondary market is not where you have more impact. So I think it's very interesting to see how you can link this financial side and the real economy side. So thanks a lot for this and it's very clear how you can look at starting from the firm level then go to which are the firm benefiting from the funding from the investment front. So thanks for this.

What I can do as another question is maybe asking you what are the key patterns you mapping on financial flows, on green financial flows from the investment firms reveal in terms of geographic exposure. How does that contrast with countries estimating estimated financing needs? I don't know, maybe to Etienne again.

E.L.:

OK, thanks Melina. So that's exactly the one of the biggest contribution that we wanted to bring in this in this work that we conducted for the G20. And so we wanted to map basically where are these green investments or this financing of green companies that we just explained how we defined it, where it's coming. So is it coming from the US and is it going to emerging markets, is it going to other advanced economies. And so we wanted to do this mapping and give numbers of where are the green financial flows from investment funds going and where do they originate. So the definition that I just described and leveraging on our security level data, we were able to map if an investment fund located in country A is investing in green in another country. So, again, this whole work was commissioned to us by the Indian G20 Presidency. We tried for key priority to understand whether emerging markets which have big needs were recipients of some of these green investments from investment funds. So we analyzed 37,000 funds and in this mapping we focus on two big broad sets of funds. Within these 37,000 funds, on the one side, we're going to focus on specialized green funds, which are funds that are specialized in green, and we define them as funds that have more than 25% of their portfolio investing in carbon solution companies. And on the other hand, we're going to focus on traditional emerging market funds, so global equity, global equity funds and we want to understand whether the green specialized funds invest in EM, in emerging markets, and we want to understand whether the funds that are specialized in emerging markets invest in green. So you get the two reverse perspective. So starting from the from the green funds, so the ones that invest more than 25 percent of their portfolio into green assets, we find that they are mainly domiciled in the US, 50 percent of the funds are domiciled in the US and they mainly invest in the US as well. So 70 percent of the asset under management of such green funds are invested in the US. That's a huge skewed distribution towards the US. If we look at the investment to emerging markets, we see that emerging market companies represent only 13 percent of green investments, one three, and out of this 13 percent, 12 percent out of this 13 goes to China. So again, a highly skewed distribution within emerging markets towards China and Brazil comes a distant second within emerging markets, followed by Chinese Taipei, South Africa, India, Thailand and Mexico. And those just received 1 percent of these of these green investments. So very little. If we shift now the focus and we turn to the second set of funds which is global EM equity funds that are forced to invest in emerging markets by their investment mandate. And we want to understand how much they invest in green, right. The ones where you want to invest in emerging markets, you're going to go into EM equity fund and you want to understand whether some of that capital goes to green. We find that the average global EM equity fund invest only around 9.6 percent of its portfolio in green companies and that's even lower than the average allocation of the conventional funds into green. So that's very little. And again the geographic distribution is also skewed with a lot of the investments going to China for this time by Chinese Taipei, Brazil, India and Mexico.

So just to wrap up our findings, we find that the flows by investment funds towards green assets are very low and they're mainly goes to the US within the emerging markets, they mainly go to China. And from a green transition perspective that's problematic because this mapping doesn't align with the needs, right. So the IEA, the OECD, the IMF and so on have done a lot of work about what share of investment is needed in emerging markets. And they account for 2/3 of global emissions. They're the most vulnerable to climate hazard and they have constrained fiscal capacity. So that's, that's really where the money should flow. And just to conclude this geographic mapping, also kind of speak with a big theme that the OECD has also documented quite a lot, which is big trends in the structure of global capital markets today that are biased towards large companies in advanced economies. That is the conclusion of the work of our colleagues. They mainly rely on indices that are these indices and capital markets are biased towards large companies and these large companies are mainly in advanced economies and in the US because emerging markets have lower free float doubled due to an ownership of companies that is more concentrated and more owned by strategic individuals and states. So you have less share of the equity that can be that can be bought by investors all over the all over the world. So hope that replies a bit to your questions and manages to summarize a bit our main findings on the mapping, Melina.

M.L.:

No, that's great. Thank you very much for this. I think what's really interesting in new research is to something maybe we knew, we had the ideas of it. But it's great to have scientific research that proved that, OK, the money is not flowing where it's needed the most. And well, this idea of like it's all going into China, where OK, China has some financing needs, but all the emerging markets too. So I find it very interesting to have like to have a clear idea of that. And I think my next question was then like, OK, we have this observation of the money is not flowing where it needs to go. How can we change this? How can you finally explain and provide some ideas on how to increase investment funds potential in financing the green transition? Maybe Anna, if you have some ideas.

A.D.C.:

Yes, thank you. We have conducted an in critical analysis that follows up on what we just presented. So for the G20, we stopped with this analysis of trends and we highlighted some possible drivers while we didn't test them empirically. And now we've done a second part of the analysis where we have looked empirically at the drivers of investment funds allocations towards green, but also brown assets. So we're able to also bring the brown component in and we've been looking at the drivers both from our supply and demand perspective. So looking at the fund characteristics and the country characteristics. So starting with the fund characteristics, we've asked ourselves which funds are more or less likely to invest in green assets? Are there some characteristics that can help investment towards green assets? And we found that newer funds are investing more in green assets. So this may be interpreted by the fact that newer funds are picking up newer ideas, newer trends like the one towards green. Then we've been able to look at the fund strategy and we've found that ETFs and institutional investors are associated with a lower share of green investments. So they invest less in green, while a passing management approach doesn't significantly impact on the green share.

We've done another set of regressions looking at the fund exposure to emerging markets and here we found that the fact that the fund is domiciled in an emerging market or as a domestic emerging market mandate. For example, it has a mandate on a specific country, a mandate let's say on Thailand or Brazil. This is a positively correlated with the investment in green assets and this highlights that more specialized green funds tend to be funds that invest domestically in a given country, and this is giving a positive signal that the market is developing around these specialized green funds. We're also testing whether the fact that the fund has a sustainable scope in the mandate affects the green investment and we find yes, a positive correlation. So this shows that despite the fact that there is a lot of greenwashing, the aspect that Etienne was earlier mentioning the fact that our fund is labeled as sustainable is still is still more likely to invest a higher share into green. So it is a positive aspect. We conduct the same analysis on investment in fossil fuel and we find a striking mirroring picture, meaning that all the coefficients that were positive in the case of green investments are negative in the case of a brown investment and vice versa. So an element that did not come up with a significant coefficient for green is the size of the fund. This is significantly negative in the case of brown fossil fuel assets. So the bigger the fund is, the smaller is the share of the investment in fossil fuels. Secondly, older funds are investing more in fossil fuel assets than younger funds. When we look at the strategy, we have the mirroring picture compared to green. So institutional investors and ETFs are more likely to invest a higher share in fossil fuels. Emerging market exposure is negatively associated with fossil fuels allocation and finally the fact that the fund is labeled “sustainable” is affecting negatively investment in brown assets.

So all this part refers to the funds characteristics. We then do a second analysis to investigate cross-country heterogeneity. So what it can just describe the fact that we see that there is a skewed distribution and that there are difference among countries. So we ask ourselves the question: why do some countries receive more green investment than others? What is driving investment more to some countries than others? So here, we want to highlight the fact that global funds allocate investment following benchmarks, and these benchmarks have a certain country allocation. So a benchmark would allocate a certain share to Thailand, a certain share to Brazil, a certain share to China. And this happens regardless of whether the funds are passive or active. And we see that this is especially the case for emerging market investments. So in our analysis, we're able to find that a prime determinant of country allocation of green investment is the role of emerging market benchmarks. And in our analysis we use the MSCI Emerging Market Index. So this this regressor has a positive and significant coefficient. And then we have a set of other drivers that are traditional in the literature that deals with investment and which are the drivers of investments. So for example, the absence of portfolio in for restrictions, the level of openness and economic freedom of a country are important drivers of investment and also what we find of green investment. So our analysis is in line with the literature in the field, but then we're able to also find some determinants that are specific to portfolio allocations towards the green sector, and we find two. These are the country size of renewable exports. So how much the country is exporting in renewable manufacturing, for example solar panels, photovoltaic cells, electric vehicle batteries. So this is an important aspect that drives up investments in green assets. And the 2nd is the share or the renewable energy generation of the country. So whether the country has an important renewable energy production. We think that these two aspects are particularly important and there are additional contribution to the standard literature on drivers of investments.

In terms of policy considerations, we think that some ideas should be, could be, on policymakers agendas. For example, one aspect is how can we influence benchmark inclusion of certain emerging markets? Secondly, how to maintain openness, capital account openness, and a good investment climate? And thirdly, how to develop a green sector domestically to ensure a pool of green competitive and investment companies? So this is a first set of policy options, avenues, and another area relates to the ESG and green ratings development. ESG and green ratings have developed now driven by the markets, but there are clear issues that are related to their measurement, transparency, disclosure. ESG data metrics can be definitely improved and policy makers could direct some efforts at improving ESG ratings, in particular the E pillar. It is currently not aligned with the financial and environmental aspects, and within that further efforts could be undertaken to ensure that there is cross-country comparability.

M.L.:

Thanks so much for this very lot of information. So what I really like is well you look also at the brown side, which is something that's often like when we come to analyzing green, like the green transition. But I think, to transition we also need to know what is happening on the brown side and how then we defer and the whole economy transition toward the new model. So I think it's very interesting that you, you compare the two something if I understood correctly, you look at because brown usually it's hard to define like the green. So you force mainly focus on fossil fuel, correct?

A.D.C.:

Yes, we do.

M.L.:

OK, perfect. And I think it's really, really interesting too see like this impact of benchmark. That's not something I would have thought that has so much an impact for green investment. At the same time it makes sense when you are a new investor, you want to enter a country, you tend to follow what the benchmark tells you and it it's easy, I guess so. But it's interesting to see, OK, policy makers can have an influence here. They could make the allocation move. And so really a lot of important things in this, in this research.

A.D.C.:

Let's say that the benchmark is particularly relevant for emerging markets. So there are the benchmark for emerging markets, meaning that if you are an investment fund, a global investment fund and you're thinking whether investing in Brazil or Thailand, you're going to probably mirror the allocation that these big emerging market benchmark are giving to these countries. It will be different if we're talking about developed economies like you know US, Germany, France, it will probably different. The role of the benchmark would be not that significant there.

M.L.:

And do you see a difference if the investment fund is from an emerging market or from developed markets in terms of the investment fund knows more the emerging market economies, so they don't need to follow the benchmark, while developed market investment funds, they maybe have less knowledge, so they have to follow the benchmark. Is it like this?

A.D.C.:

Yes, developed economies global investment funds would tend to follow more the benchmark for this reason. Yeah. While a domestic EME is not following the benchmark, it has the mandate to invest in a certain country and yes it doesn't follow the benchmark. It's a little bit of a more complex analysis because well I didn't want to go into this but what we look it's also in our papers, we're also being sharing the paper if you want. So we look at the allocation that the benchmark does and we look whether certain countries are over invested or under invested compared to the benchmark. So for example, in the case of green investments in China, there is an over investment in China towards the Morgan Stanley Composite Index Emerging Markets where the proportion that China has is a little bit is much smaller than what you get in green. So we're able to go a little bit deeper. In the paper itself we're able to show which are the funds that are investing more, which are the funds that are investing less compared to the benchmarks. So there's more details.

E.L.:

And that's really depends on the fund sample that you're that you're looking at. This role of the NRS is very clearly in the pre-censor. If you have a domestic mandate, so if you're forced, if you're a Thai fund and you're forced to invest in Thailand there, there's going to be more, you're going to have less of this information asymmetry and so you would be more keen towards investing in green. If you look at global funds, so these are funds that could allocate their portfolio anywhere in the world, there is the impact of the benchmark where you basically try to follow this big benchmark even in green. So that that was the nice results about our finding is that the allocation of green investment basically follow the determinants of allocation of the previously tutored that was looking at allocation of funds in any types of assets.

M.L.:

And for over investment, is for instance like the share of a renewable export that you cited Annamaria as a determinant of green? Is it this explaining part of the over investment in green in some countries?

A.D.C.:

Yes it does, and I can provide a concrete example. So we have seen in what Etienne was mentioning that China is the biggest emerging market. And then we're able to look, we look at the investments done by each fund and we see the companies that these funds are investing to, and that we're able to see that these are companies that are producing solar panels, that are producing electric vehicle batteries. So is not is not even how much green is China, because we know that China is not the green, but is how much China is producing. So in green the fact that you have companies that are manufacturing, so there's this manufacturing aspect that becomes important. And the fact that these are manufacturing companies that also have an important role in the global value chain, meaning that these are market leaders in the global value chain of solar panels, electric vehicle, batteries, etcetera, makes them attractive to global investment funds, because global investment funds are looking at returns, are looking at companies that will provide a certain, you know, profits over time and these are market leaders in this field. So the advice for other emerging markets wanting to attract these funds is you need to have companies that are relevant in the global value chain, competitive enough to attract funds that are sitting in New York or in Europe etcetera and are going to look at your profits, cash flow analysis, etcetera. And it has to be a company on the other side that is investable and profitable enough to attract private financing. So this is very important, and we looked at the asset-by-asset analysis that these funds have and there is really a correlation with the manufacturing capacity of the emerging market.

M.L.:

That's really interesting. And I think it's quite close to my last question which would be: how do you see, what are the avenues for research you see going forward based on your findings? Maybe how to, because you said: OK these are few ideas for policymakers to have an impact on this. How can you see research to impact the policymakers ongoing efforts?

A.D.C.:

Yes, thank you for this forward-looking question. So we think that firstly we need to be the time series, The analysis that we have conducted focuses on the stock of investments at a time T in March 2023. And we have done our best to explore the data that we have. But I think a time series would allow a more detailed analysis. For instance, with a time series we could investigate how global investors are responding to changes in environmental policies. So for instance, whether an improvement or stricter environmental policies in the US, in the EU is affecting investment fund allocation in different markets. So we could see whether there is a rebalancing of portfolios towards some sectors, towards some countries, whether there are some spillovers. This will be very interesting to see. And at the moment, without the time series, we cannot go into this kind of analysis.

Second, it would be interesting to look at different sectors. The definition that we have just described, that, just as a reminder, focuses on renewable energy generation, energy efficiency, green buildings and green transportations, is the best that we could get with the data available. However, there are a number of sub-sectors that could be interesting to investigate. We talk about green, but of course green transportation or green buildings is not necessarily the same. So the more granular we could go the better.

A third element, we will be able to bring forward the analysis on brown whether it's still far from being complete. We think that another big research agenda could be on the exposures and drivers of investment in fuel over time within the countries are going to transition away from these energy sources more or less rapidly and this transition is going to entail some risk volatility. And it would be interesting to do an ex-ante analysis of these exposures. We also think that the COP 20 agreement on fossil fuels, the Paris agreements, so all these all these events are, let's say, influencing moving policy makers towards the transition from fossil fuels, and it will be interesting from a research perspective to look at the divestments. So these policy moves, which divestments would they entail in the near future, in the midterm future, how does the, how is the share of brown within a fund portfolio. It's going to evolve over time. In this regard BIS has done some interesting analysis that has been presented in the G20 context also. But of course I think that we need to go a little bit deeper in this fossil fuel and brown area.

Finally, that was the last point that Etienne mentioned. There are also some structural issues in global capital markets that are acting as a barrier for emerging markets or in general for investment in the green sector. Further research should be devoted to this. Our Directorate of Financial Affairs conducts some research on this, but more has to be done. So with this we are referring to the research on concentration of film ownership. What is the impact on free float levels? The biases that there are towards large companies, the fact that there is a bias in the inclusion of a large companies in an index? So further work could inform policy makers in this context as well.

M.L.:

Well, that is a great research agenda. Thank you so much. I think it's a lot to cover. And well, as a scientist, I see all the potential thing when you mentioned the time series trying because of course there's some ongoing implementation of regulation in Europe. So trying to see how this might have an impact on the location of firms also like abroad, because I think it's one of the axis the European Commission is following, trying to see how Europe can help also foster the green financing outside its border. So well, I see a lot of different interesting topics. So Many thanks for presenting that. And it's great to see that the OECD is really as a forum like joining research and policy making. So that's really nice to follow what you do and I think all our audience will want to look a bit of the different papers. So what we will do is maybe put the link on the page so that everyone can have a look.

I think it will be time to conclude the interview. Before doing that, maybe if you want to say last word you have the floor.

E.L. and A.D.C.:

Just to thank you. Yeah. Thank you. It has been a pleasure, and we look forward to working closely with the JRC and the European Commission on that.

M.L.:

Thanks a lot and thanks for your time. For our audience, please stay tuned for the next interview in March to hear more experts on sustainable finance. Many thanks everyone.