SPECIAL REPORT

ESG: The opportunity for the sell-side

Commissioned by:

acuiti management intelligence

FIS

The rise of Environmental, Social and Governance (ESG) investing is one of the defining trends of the evolution of capital markets over the past decade. Assets under management of ESG funds have risen exponentially, and an entire industry has grown up around the movement, developing tools and services to facilitate ESG investment.

The growth of ESG and its impact on the buy-side has been well documented. What is less well covered is how the sell-side has evolved to facilitate this increased focus on responsible investment practices. This report seeks to fill that void and focuses on the services that banks are developing and the wider opportunity for the sell-side to accelerate its evolution in the ESG world. As ESG moves from the domain of larger or specialist asset managers to a fundamental part of investment, the opportunity for the sell-side to participate in it will continue to grow.

The opportunity in ESG

The term "ESG" was coined in a 2004 United Nations report published to support The Global Compact, a corporate responsibility initiative launched by then UN secretary general Kofi Annan.

Over the last decade, and arguably only in the last 5 years, ESG has gone truly mainstream and seen exponential growth in assets under management (AUM). Today, total AUM in ESG-driven funds is estimated to be as high as $40.5 trillion (according to research firm Optimas) and represents by far the fastest-growing segment of investment management.

The ESG movement has historically been driven by larger asset managers, most notably in the Nordics. However, as the concept has become standard, almost all buy-side firms are today integrating some element of ESG into their mandates and strategies.

For the sell-side, this presents a huge opportunity. Banks have traditionally been partners to their larger asset management clients as they strive to expand their ESG mandates. Now, as smaller firms and the wider buy-side increase adoption, and as ESG moves into multiple asset classes and deeper into every facet of capital markets, the sell-side has the opportunity to further develop and scale new products and services.

The opportunity is likely to grow exponentially with the phased introduction of the EU Sustainable Finance Disclosure Regulation, which takes effect from March 2021. The regulation will require all Alternative Investment Fund Managers and UCITS companies as well as financial advisers to integrate sustainable risks in investment decision-making processes and provide greater transparency of their ESG processes.

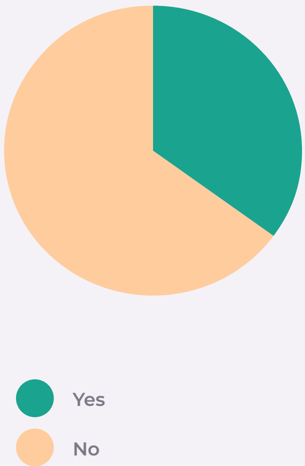
An Acuiti survey for this report found that 84% of sell-side respondents believed the growth of ESG investing was a significant opportunity to grow their business, and a further 12% believed it presented a small opportunity.

This report argues that the opportunity lies in product and service development. We focus on three core areas: research, data and quant services; product development and new trading opportunities.

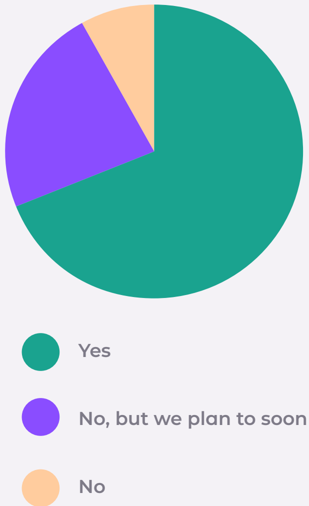
Seizing this opportunity requires innovation and investment in multiple areas of the business. First, to advance in providing services to ESG funds, sell-side firms need to invest in their own credentials. The Acuiti survey found that 83% of buy-side firms consider a bank's ESG credentials when considering which prime brokers to use; 11% of the respondents said it was fundamental to their choice.

Do sellside respondents see the growth in ESG investing among the buy-side as a opportunity to grow their business?

Have sell-side respondents stopped offering services or pulled out of markets or sectors as a result of ESG concerns?



Have sell-side respondents developed any new services or enhanced existing services to meet the demand for ESG?



The sell-side is responding to this pressure; 65% of sell-side respondents said they had stopped offering services or pulled out of a market or sector because of ESG concerns and banks are investing millions of dollars in ESG policies and outreach. Banks are also developing new services or enhancing existing services to meet the growing demand in ESG from clients - 69% of sell-side respondents had developed new services or enhanced an existing service and a further 23% planned to do so soon.

The FIS view

"It's interesting to see that the survey findings demonstrate 69% of the sell-side have developed new services, and enhanced any existing services to meet the increased demand for ESG investing from clients. We are seeing our clients are looking to grow in ways that minimize cost structures and maximize agility. We typically see development in offering services, trading opportunities, product development, research, data and risk management."

Pontus Eriksson, strategy director, FIS

In many respects, ESG is not fundamentally changing the services the sell-side offers to its clients but is requiring an ESG overlay in almost every aspect of the business.

Asset managers increasingly view ESG as having an impact across their relationship with the sell-side. While sell-side services such as research have for some time embedded ESG-considerations to meet client, demand the Acuiti survey found that most buy-side respondents considered a broad range of additional services from execution and clearing to repo and securities lending as having an impact on their ability to fulfill their mandate.

Which of the following services provided by prime brokers do buy-side respondents' say has an impact on their ability to fulfill ESG mandates?

Research: moving from thematic to quantitative

Research has long been the fundamental ESG service that the sell-side offers to its clients. To meet demand, sell-side firms have built ESG-focused research teams to develop inhouse ESG scoring systems as well as aggregating and rating third-party research for their clients.

Traditionally, this has been a relatively simple process of integrating ESG metrics into research on a thematic or issue-led basis, such as how various exclusion strategies will impact a portfolio or benchmark's performance or integrating ESG factors into investment recommendations.

Today, ESG research is going deeper and becoming more sophisticated. As the taxonomy of ESG has evolved, so too has the ability to use data to analyse the world of ESG. Pioneering sell-side research departments have invested in quantitative analysis and machine-learning tools to develop frameworks and understanding of what is material and what is not in terms of ESG performance.

Banks are increasingly embedding ESG into their fundamental equity research, breaking ESG factors down into hundreds of constituent parts and running complex historical analyses against company performance to ascertain which factors have the biggest influence on company performance.

This trend is likely to accelerate as hedge funds grow their ESG focus and seek to better understand how to drive alpha through responsible investment. In addition, as ESG moves deeper into fixed income, the requirement for ESG research will significantly expand, as will the need for natural-language processing, big data and machine learning to analyse alternative data sets.

The FIS view

"The Acuiti survey confirms what we are seeing from our clients. ESG is not only a central responsibility of financial services but also a huge opportunity for sell-side firms to enhance their offerings. At FIS we are working closely with clients to ensure that they have the optimum technology infrastructure to meet the growing demand of their institutional client base for ESG investing."

Pontus Eriksson, strategy director, FIS

Product development: a new universe

As more asset managers and buy-side firms increase their commitments to ESG investing, they need more products to invest in, and many turn to their sell-side partners to build those products.

In its simplest form, this involves creating ESG variants on established products such as benchmark indices, building baskets of securities for clients to invest in based on their specific ESG requirements, or constructing ETFs and structured products.

New products are also being developed most notably from the sell-side's banking arm in the form of sustainable bonds. Sustainable bonds are debt securities issued to fund a specific investment goal linked to sustainability. Green bonds are currently the largest segment of the market, having been in cirulation since the European Investment Bank issued the first green bond 13 years ago.

Since then, the Green Bond market has grown to over $250 billion in annual issuance and is currently doubling in size each year. Offshoots include Blue Bonds, designed to invest in marine conservation projects, and a plethora of other sustainability-linked instruments.

These instruments, which include transition bonds and equity-linked bonds, are built around dedicated sustainability targets on a KPI-basis or work on a "use of funds" basis like the Green Bonds.

The sell-side has driven innovation in sustainability-linked bonds, which are issued with a coupon that varies depending on whether a defined ESG goal is achieved. The first such bond was issued by Enel Finance International in September 2019. The 5-year, $1.5 billion bond has a coupon of 2.65%, which will increase by 25 bps if the company fails to meet its target of at least 55% of its energy coming from renewable energy sources by the end of 2021.

To support the growing market, the International Capital Markets Association, which pioneered protocols around Green Bonds, has issued the Sustainability-Linked Bond Principles. The Principles are expected to accelerate growth in the industry by creating common standards.

Sustainability-linked instruments are also evolving in the derivatives market. Last year, BNP Paribas structured the first sustainability-linked FX hedge with client Siemens Gamesa (SGRE). The €174 million FX facility is a hedge for the company's sale of offshore wind turbines in Taiwan and has a rate linked to the company's sustainability rating. The premium to be paid is calculated using a metric provided by RobecoSAM. If SGRE misses its annual minimum ESG score, it pays a sustainability premium, which BNP Paribas has committed to reinvest in forestry projects.

New trading opportunities: OTC to futures

The rise of ESG investment is also creating new opportunities for sell-side market-making, delta 1 and other trading desks. The trading environment for ESG-linked products is rapidly evolving.

In derivatives markets, new futures and options launches based on established ESG indices are enabling asset managers to execute strategies at lower costs and with more precision than ever before.

While Nasdaq was the first out of the blocks with the October 2018 launch of its OMXS30 ESG futures, which excluded one tobacco company from the flagship Stockholm 30 Index, Eurex has taken the lead in the development of listed ESG futures and options.

In February 2019, the German exchange started trading in the Euro Stoxx 50 low-carbon ESG index, the Stoxx 600 ESG-X index and the Stoxx Europe Climate Impact index. At the time of writing, Eurex offers trading in 12 ESG-linked futures and options contracts with plans to launch more.

Other exchanges have also launched ESG derivatives. CME, ICE, Japan Exchange, Euronext and CBOE all now offer ESG-linked futures or options contracts and TMX is soon to follow. Liquidity is building, and increasingly asset managers are using options to execute their strategies.

This affords the sell-side the opportunity to make markets on screen as well as arranging block trades for clients. Asset managers that Acuiti spoke with during this study indicated that there was a fast-growing appetite from some sell-side firms to provide liquidity to ESG trades, in particular on the options side.

Trading desks at banks are investing in flow trading, Delta 1, and quantitative investment strategies to meet the demand from clients and the additional complexity of pricing, trading and hedging ESG trades for their clients.

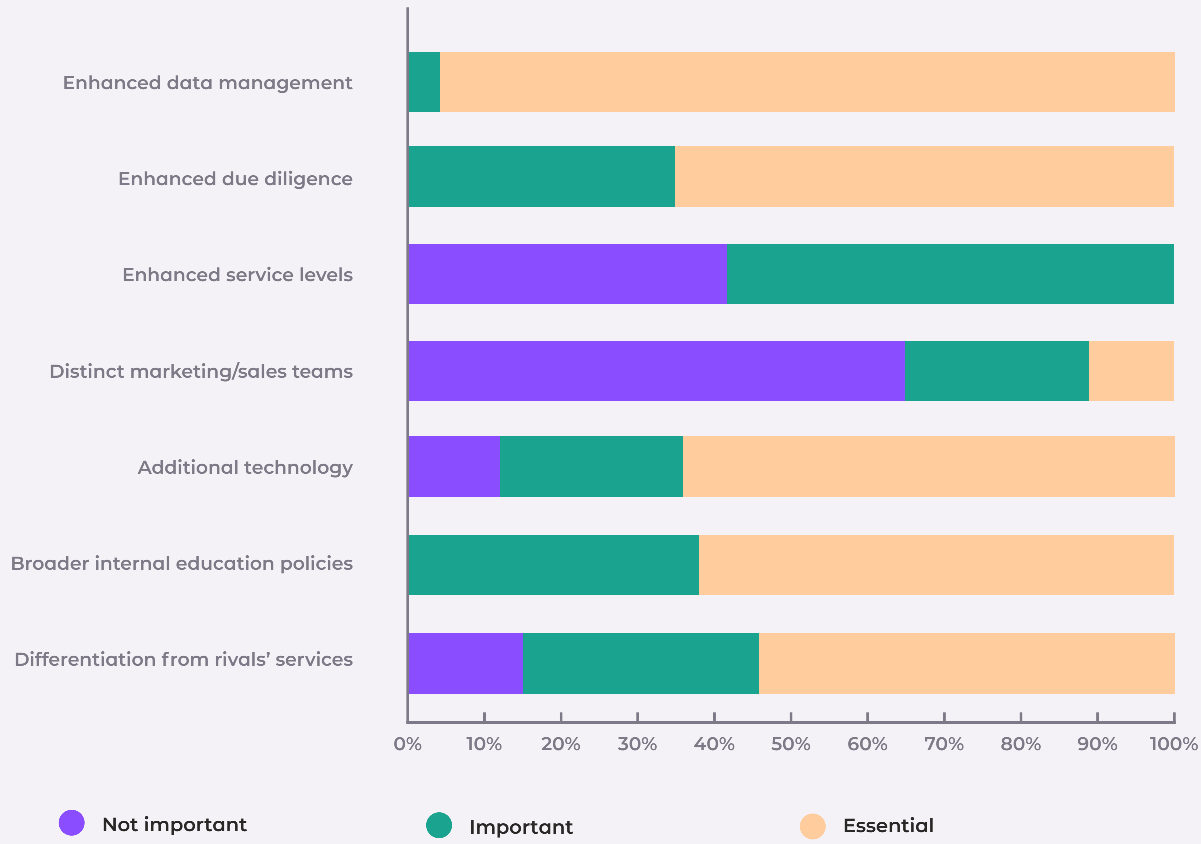
One of the largest such trades came in September 2020 with the €540 million inter-product switch by Swedbank Robur from the Eurex Stoxx Europe 600 index into the Eurex Stoxx 600 ESG-X index. The trade was structured by Barclays to increase the alpha on Swedbank Robur's portfolio. It was structured as a packaged trade by selling put options on the standard benchmark and buying call options on the ESG index at a lower implied volatility to reflect the different volatility profiles of the two indices.

Building up capabilities

Getting ahead in ESG for the sell-side requires investment and innovation. Sell-side firms surveyed for this report identified enhanced data management, enhanced due diligence and internal education as the key functions for success in delivering an ESG investment service.

Of these, the data element was considered the most challenging. ESG permeates both the front and back offices of a prime broker, from research to execution to securities lending to custody and settlement and data is at the heart of the ESG service in all areas.

What are the most important functions sell-side respondents have in place to succeed in delivering an ESG investment service?



The FIS View

"When we look at the future for ESG, FIS is already working with banks who need to measure, control and optimise their exposure to climate risks through counterparty exposures. And to help measure, control and optimise their lending exposure due to climate risks through ALM and loan origination functions. And on the buy-side, risk managers need to understand their climate exposures and run stress tests and scenario analysis similar to those already used today to help build low carbon indices and portfolios. We also have carbon and emission trading capabilities to manage, positions, exposures and transition risk."

Pontus Eriksson, strategy director, FIS

To deliver a world-class ESG service to clients, the sell-side needs to be able to provide and track ESG data across the trading cycle and the buy-side increasingly requires a view of ESG risk across an entire portfolio. Larger asset managers have traditionally developed these capabilities in-house, but as smaller firms adopt wider ESG mandates, they will look to their sell-side partners to do this for them.

Post-trade reporting systems therefore need to be upgraded to identify and tag ESG factors to provide real-time reports to clients on matters such as exposure to certain sectors or ESG risks.

Aside from investment in data processing, internal education is also essential to building out ESG capabilities. ESG is an overlay to existing services, and the sell-side executives Acuiti spoke with for this report warned against a top-down approach to developing ESG services.

Several banks have built internal committees to understand how clients' ESG mandates have an impact across their business, sharing information between the asset class or function silos.

While most banks now have in place a senior executive overseeing ESG development, there are different ways of structuring ESG product development. An emerging dominant structure is one in which product development is decentralised across each internal business, with the bank's head of ESG or sustainable investment overseeing and advising the services and products rather than developing them.

Each element of the trade cycle has its own requirements. From quantitative analysis in the research department to using artificial intelligence for predictive recall of stocks in securities lending programmes to enhanced post-trade reporting requirements, ESG touches every aspect of the sell-side's offering to its clients.

The same is generally true of sales and outreach but again there are differences in how this is structured. Of the sell-side firms Acuiti surveyed, only 12% viewed specialist ESG sales teams as essential, with 64% indicating that it was not necessary to have a specialist team and instead embedding ESG experts into existing teams.

The future of ESG

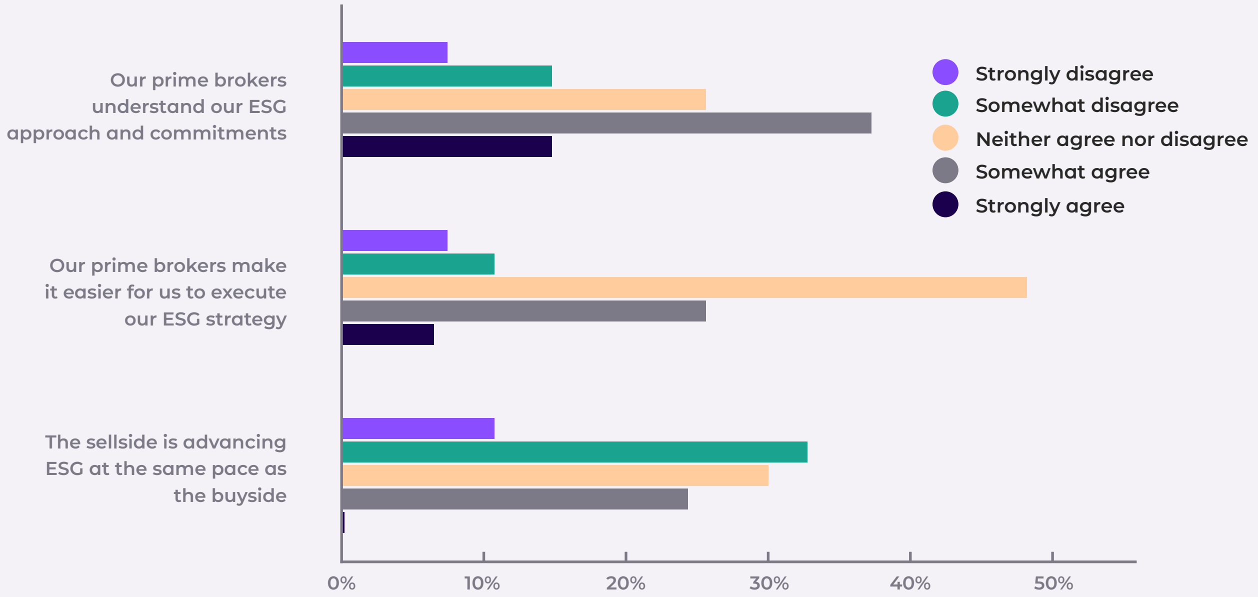
Over the past decade, the growth of ESG has been one the most dominant trends in the investment industry. That is likely to be true for the next decade as well.

Aside from the obvious increase in AUM, the last 10 years in ESG has been defined by an increasing sophistication of how ESG is analysed and applied. From simple screening and exclusion strategies in equities, ESG today is a multi-dimensional approach across muluple asset classes.

The sell-side has been a key partner for the buy-side as the ESG industry evolves. However, the Acuiti survey suggests it risks being left behind. While 52% of buy-side respondents agreed that the sell-side understands their ESG requirements, only 26% thought that the sell-side was advancing ESG at the same pace as them.

In the medium term, ESG will become embedded in more asset classes and instruments. As it has moved out of equities and into fixed income and other asset classes, so too is it moving from the corporate into the sovereign world.

Do you agree with the following statements (buy-side respondents)?



ESG expands in fixed income

ESG investing has historically been predominantly an equities play. However, it is gaining significant ground in other asset classes, with fixed income being the fastest growing. Expansion of ESG into fixed income is inherently more complex than in equities, owing to several key nuances of the market. The main challenge is the availability of data and the size of the investment universe. The transparency of listed companies is far greater than that of unlisted companies, and data reporting is more harmonised. At the same time, the number of listed firms is significantly smaller than unlisted. The data challenge in fixed income is increased by the fact that factors and considerations that are material to an equity investor are often not the same for debt investors, where limiting downside risk is the key objection. Another issue has been the perceived lack of influence bondholders have over shareholders. However, the growth of green bonds, transition bonds and KPI-linked debt securities is changing this. So too is the growing acceptance of issuers of ESG requirements and their willingness to engage with investors on ESG-related topics. These factors are driving change and increasing the focus on ESG in fixed income investing and creating similar opportunities for the sell-side as in equities in terms of research and structuring.

The focus is also shifting from what a company invests in to how it invests, and that trend will gather pace in the coming years. This is a growing but still niche part of the ESG market but aims to get to the core of what responsible markets are. This is likely to result in significantly greater scrutiny of trading practices with charges from regulators for market manipulation having an increasingly detrimental impact on sell-side business. It will also bring institutions that provide trading infrastructure, such as exchanges, more firmly into the ESG world as contributors to rather than facilitators of the ESG movement.

In the past decade, ESG has moved from a niche investment area to an overlay of almost all sell-side services. Over the next decade ESG will move from an overlay to a foundation of investing, permeating every aspect of capital markets and the investment industry. For the sell-side, this creates a huge opportunity but also a risk of being left behind.

Methodology: *Acuiti surveyed 71 specifically selected senior executives via a survey or an interview between August 28 and 2 October 2020. Respondents were limited to one per firm. For asset managers, the ESG lead at each firm was the primary target of each response. For banks, the respondents were senior ESG or Sustainable Investment executives within the capital markets or prime brokerage teams. Respondents were from banks (37%) and asset managers (63%). Respondents were based in the UK (33%), Europe excl UK (37%), North America (30%), APAC (7%) and ROW (3%).*

About FIS

FIS is a leading provider of technology solutions for merchants, banks and capital markets firms globally. Our more than 55,000 people are dedicated to advancing the way the world pays, banks and invests by applying our scale, deep expertise and data-driven insights. We help our clients use technology in innovative ways to solve business-critical challenges and deliver superior experiences for their customers. Head-quartered in Jacksonville, Florida, FIS is a Fortune 500® company and is a member of Standard & Poor's 500® Index.

Learn more about FIS' trading solutions here.

Follow FIS on Facebook, LinkedIn and Twitter (@FISGlobal).

acuiti management intelligence