ESG AT A GLANCE…
LOOK AGAIN!

I was speaking with an Accountant friend sometime ago and I used the term **"sustainability"**. I noticed that while he was thinking and speaking about the long-term viability and profitability of an entity, in contrast I was thinking more about the **impact of a business on the environment, the social fabric and/or the broader communities in which the business operates.** That conversation is just one example that illustrates some of the issues and challenges currently affecting the bandwagon that is ESG. About 160 providers, including the three biggest corporate-credit rating agencies and Bloomberg LP, the parent company of Bloomberg Businessweek, compete to sell sustainability ratings and data to money managers (see The ESG Mirage by Simpson, Rathi & Kishan, 2021).



The sustainability industry is now a multi-billion-dollar sector… so it's no wonder everyone is getting in on the game. In this article, we examine what ESG means and some of the tools that are currently being used to report on it. The International Financial Reporting (IFRS) Standards released S1 and S2 in June 2023. These standards specifically set the framework for general requirements for sustainability-related financial disclosures (S1) and climate-related disclosures for all companies (S2). The standards aim to set a generally acceptable basis for ESG reporting because many of the earlier reporting frameworks were rather complex or too narrow in scope.

Admittedly, **ESG (Environment, Social and Governance issues) is now a buzzword in sustainability.** But do we all have the same idea when we use this term? It is now essential for corporates to show their customers and key stakeholders (shareholders, regulatory authorities, investors, even critics…) that they are responsible corporate citizens. **But how can they do this without falling into the greenwashing whirlpool?**

ESG Rating tools have been around for some time, and they are increasingly becoming the yardstick by which people rate or measure the performance of a company with regard to its environmental and social responsibilities. However, Akshat Rathi of Bloomberg argues that ESG ratings measure just the opposite of what they claim to be doing, i.e. the impact of the environment on a company and not the impact (supposedly positive) that a company is having on the environment, communities, etc. (Simpson et al., 2021).

ESG FRAMEWORK TO EVALUATE COMPANIES



SO, WHAT'S THE CATCH…?

The logic is simple: with the growing concerns about greenhouse gas emissions, various forms of uncontrolled pollution (such as the rapid rise in plastic waste in marine ecosystems and contamination of freshwater resources), companies are increasingly under pressure to report on their compliance and/or performance vis-à-vis ever-more-stringent regulations, Norms and Standards dealing with several aspects of environmental control, governance and social impact management, from air quality, lifecycle assessments, prohibition of child labour, community benefits, to sustainable use of natural resources. This pressure translates to the need for companies to comply with regulations such as Directives, national and global norms and standards.

Corporates also need to inform their concerned stakeholders about their actions/projects and or activities to become more environmentally and socially responsible. Some sectors have adopted their own standards, such as the **Forestry Stewardship Council (which advocates for the sustainable forestry; FSC® is trusted by NGOs, businesses, and consumers worldwide to protect healthy, resilient forests for all…, according to their website).**

Therefore, a company that seeks to show that it is "doing well" on the sustainability front will choose a rating tool or reporting framework that enables it to report adequately on its ESG performance scorecard. Thus, investors, customers and other interested and affected stakeholders would be likely to interpret these scores to mean that the company is indeed taking measures to protect the environment, to limit its impact on the environment, to manage impacts on local communities and/or enhance benefits for them and that the appropriate governance structures and policies are generally in place. It also implies that these structures support ESG initiatives and have appropriate oversight on them.



THAT IS THE THEORY;
BUT WHAT IS THE REALITY?

Firstly, many companies operating in Europe are mandated by various EU directives to comply with environmental regulations (see EU Directives: for instance). Also, the negative impacts of a company may not necessarily be reflected in a lower/poor ESG score. The issue of "greenwashing" is a long-standing problem in the sector because the original idea behind ESG was all about managing a company's exposure to risks emanating from Environmental issues (such as changing and/or more stringent regulations), Social imperatives (customer preferences, employment practices/policies, shareholder activism and investors' concerns), and Governance (i.e. how the company's leaders react to such risks).

The underlying assumption is that ESG ratings are much like credit ratings; i.e. a good ESG Score implies good environmental practices, good social practices, and good governance (at least with regard to the environment and the company's impact thereon). But upon a closer look: these scores are based on almost always the same data sources, which are monopolised or controlled by the biggest rating agency.

Does anyone critically analyse the underlying data? No. Do fund manager/investor know what it really means…? Probably not. Most ratings work to give the effect of a simple (single digit or simplistic scoring system), which means that people just base their decision on the score and that's that.

Other debates around ESG include the contention that it means different things to different people. Some may be more concerned about social aspects, while others may be more worried about governance and ethical decision-making by corporate leaders. Fundamentally ESG and environmental social responsibility is a moral issue. Moral choices are essentially subjective. Albeit morality itself is a fundamental issue underpinned by objective criteria.

In a relativist, pluralist, post-modern society who can bring about unanimous agreement on what a good ESG rating looks like? By whose standards and for whose ultimate gain? This is proven by the fact that competitors in ESG rating, often disagree with one another. This is largely because each ESG rating provider uses its own proprietary system, algorithms, metrics, definitions, and sources of nonfinancial information, most of which aren't transparent and rely heavily on self-reporting by the companies they rate. No regulator examines the methodology or the results (Simpson et al., 2021).

What should you do as an Executive tasked with this role? Where should you start? And why should you take a closer look before embarking on the ESG journey? To answer these questions, we can examine some absurdities in ESG Ratings.

UPGRADED FOR DOING "NOTHING"



MSCI is the leading ESG ratings company on the planet. However, it does not give any weight to greenhouse gas emissions in the ESG Rating. In fact, almost half of the 155 companies that got MSCI upgrades in a report, never took the basic step of fully disclosing their greenhouse gas emissions. Only one of the 155 upgrades examined by Businessweek cited an actual cut in emissions as a key factor. As the Organization for Economic Cooperation and Development warned in a 2020 report, this means investors who rely on "E" scores and ratings, even high-ranking ones, can unwittingly increase the carbon footprint of their pensions or other investments (Simpson et al. 2021).

RISK AVERSE OR EMISSIONS AVERSE?

What makes a company achieve a favourable ESG rating? Is it because the company is risk-averse (i.e. geared towards protecting itself from regulatory risks) or because it tracks and reports on the impacts of its operations on climate (such as greenhouse gas emissions)? This is a fundamental question that all ESG-savvy investors and well-intentioned organisations should be asking… But they are not. Many investors simply take the ESG ratings from companies like MSCI, Sustainalytics, etc. and use them at face value, with the underlying assumption that they are as credible and as reliable as a good credit rating. This is the case for example with BlackRock, the largest investment firm on the planet.

BlackRock's website states

"The metrics are not indicative of how or whether ESG factors will be integrated into a fund. Unless otherwise stated in fund documentation and included within a fund's investment objective, the metrics do not change a fund's investment objective or constrain the fund's investable universe, and there is no indication that an ESG or Impact focused investment strategy or exclusionary screens will be adopted by a fund"

(emphasis added by the author).

To analyse this statement one would need to interrogate the underlying data and information (in lengthy ESG reports) of each company. A cursory look at the types of companies in which the fund is invested includes industrials, real estate, communication, consumer discretionary, energy, materials, information technology, health care… Companies like Chevron, Apple, Merck, and Coca-Cola are on the list. From this list it is clear that a hotchpotch of companies is included. Therefore, it is not a safe bet (as purported) to indicate that an investor will definitely be investing in a company whose environmental, social and governance practices are favourable. How do we know (or agree on) what "favourable practices" means? Each company is rather different it terms of its climate risk profile (an industrial chemicals company is very different to an ICT firm). So it may be misleading to group them into one pot as companies with "favourable ESG practices".

Most fund managers are not so interested in these underlying fundamentals. Their mandate or key concern is to make money and avoid risks. They are not interested in the impact of the company on the planet, but on the impact of the planet on the company (risks). So whose responsibility is it to tell the correct story and by so doing be more responsible (i.e. providing more clarity) about the company's impact on the planet?

These are just some of the challenges and loopholes of the ESG game. That is why if you're thinking of embarking on this journey, you need to take a closer look and tread carefully. We usually advise clients to define their own business and strategic objectives and then link them with their own idea or chosen sphere of how they aspire to become a responsible corporate citizen. This is where a Materiality Assessment comes in handy. If you are not sure where to begin or you'd like to approach ESG differently, you should give us a call!

SUSTAINABLE INSIGHTS

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