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ESG Investing: Toward a Common Framework

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ESG investing, short for environmental, social and governance investing, has been booming globally in recent years, with asset owners and managers increasingly incorporating ESG into their financial analyses and decisions. The Global Sustainable Investment Alliance reports that the value of assets under management with an explicit ESG mandate reached "USD35.3 trillion in 2020, a growth of 15% in two years, and in total equating to 36% of all professionally managed assets across regions covered" (GSIA 2020: 5). Investment strategies that incorporate ESG criteria command a significant fraction of all professionally managed assets, ranging from 24.3 per cent in Japan to 61.8 per cent in Canada.

Several factors drive this enthusiasm. The benefits of identifying and managing ESG risks in addition to the financial risks for a firm and its investors are well documented. Reducing exposure to polluters or companies with poor waste management policies, for example, can help mitigate regulatory risk. Similarly, screening for good social practices (such as respectful workplace culture) can reduce exposure to scandals that could damage a company's reputation.

Furthermore, the number of investors who rely on ESG investing to meet their values (e.g., ethical, religious, political or cultural) keeps increasing. Investors, for instance, may integrate ESG factors into their financial decisions to identify and exclude companies engaging in practices they find morally questionable, including low labour standards or human rights violations.

Finally, some investors, such as institutional investors or financial ad-

visors acting on behalf of a third party, may rely on ESG criteria to satisfy specific legal requirements. One of the world's largest investment funds, for example, the Norwegian Government Pension Fund Global, is mandated to avoid companies that contribute to or are responsible for "serious or systematic human rights violations, […] serious violations of the rights of individuals in situations of war or conflict, severe environmental damage, […] gross corruption, [or] other particularly serious violations of fundamental ethical norms" (NBIM 2018).

As a result, many investors have already been incorporating ESG issues into their investment frameworks. However, the modern reference to ESG investing denotes a more explicit, systematic integration of ESG factors into the investment process instead of a more informal, less structured approach.

Table 1 | Examples of environmental, social and governance factors

Environmental	Social	Governance
• Climate change policies, plans and disclosure practices • Air and water pollution • Deforestation • Biodiversity impact • Water stress • Waste and hazardous materials management • Usage of renewable energy	• Community engagement • Human rights • Labour practices • Product safety • Data security and customer privacy • Diversity and inclusion • Customer relations • Ethical supply chain sourcing	• Management structure • Executive compensation • Board composition • Business integrity • Transparency • Bribery and corruption • Lobbying • Whistleblower schemes • Shareholder relations

Source: Lopez et al. (2020): 11.

8.1 Investors' standpoint

Despite its growing popularity, ESG investing remains confusing for investors (State Street Global Advisors 2018). From substantial terminological and conceptual inconsistencies to the lack of standardised assessment, it is increasingly difficult to assess a firm's ESG performance.

ESG ratings have become essential in that process. There are currently at least 125 organisations, including niche players and major data providers and credit rating agencies, providing ESG ratings and research (Kram-

er et al. 2020). Yet, recent surveys find that many investors lack clarity around ESG terminology and definitions and find the ratings challenging to use, especially due to their lack of comparability (Wong and Petroy 2020, GAO 2020).

Divergences in ESG ratings are well documented. Berg et al. (2020) find that divergence in the definition of ESG, its scope and the factors used to measure it, explain the low correlation across ratings. Lopez et al. (2020) show that even when ratings rely on similar definitions, assessment of a firm can differ. Using publicly available data,[1] they identify two further issues that impact the ratings.[2] First, the measurement is an issue: rating providers may measure the same ESG factor differently. They employ hundreds of ESG-related variables. Some information comes from company reports and regulatory filings and should be consistent across agencies. Yet much information comes through interviews or questionnaires and third-party analyses that can diverge widely. Second, the methodology used differs. Each ESG agency has developed its methodology to decide what ESG-related indicators to consider and how to aggregate them into an overall score.

The inability to reconcile some of these rankings or understand why they differ makes it challenging for investors to integrate them in assessing a firm's risk profile.

8.2 Firms' standpoint

Incorporating an ESG framework into business operations and processes can help safeguard a company's long-term success by taking steps to mitigate ESG risks and potential related economic costs and reputational

[1] A total of 207 ESG indicators (58 related to environmental factors, 70 to social factors,and 79 to corporate governance factors), as well as 35 financial variables and information on both headquarters location and economic sector. The indicators were publicly available.

[2] Using machine learning technique called random forest, Lopez et al. (2020) analyse three distinct and complementary angles: (i) the variables' ability to predict the ESG scores; (ii) their contribution to the ratings predicted by our estimation; and (iii) the importance of the variables' interaction when predicting the ESG scores. Exercises (i) and (ii) help understand how informative individual variables are regarding the content of the ratings. On the other hand, (iii) provides insights into how that information is aggregated into a single score (not how agencies actually do it, but how it is done in terms of the estimated relations between ratings and explanatory variables).

damage (Lev 2021). Yet the increasing number of inquiries from investors and different disclosure forms depending on the framework or standards makes it challenging for companies to identify and disclose the relevant information.

So far, there are five major alternatives to help firms understand the key materiality issues they should consider and report on. These frameworks have different purposes, audiences and articulations of the materiality concept. More specifically, the global initiatives are as follows (Rifkin 2019: 5):

- CDP, formerly the Carbon Disclosure Project, "runs the global disclosure system for investors, companies, cities, states and regions to manage their environmental impacts."[3]
- CDSB, the Climate Disclosure Standards Board, "committed to advancing and aligning the global mainstream corporate reporting model to equate natural capital with financial capital."[4]
- GRI, the Global Reporting Initiative, "helps businesses and other organizations take responsibility for their impacts, by providing them with the global common language to communicate those impacts."[5]
- VRF, the Value Reporting Foundation, "offers a comprehensive suite of resources designed to help businesses and investors develop a shared understanding of enterprise value—how it is created, preserved and eroded." It now combines the Integrated Reporting (IR) Framework, previously known as International Integrated Reporting (IIR), which "provides principles-based, multi-capital guidance for comprehensive corporate reporting" and the Sustainability Accounting Standard Board (SASB) Standards that "inform disclosure to investors and guide investor decision making when embedded in investment tools and processes."[6]

SASB and GRI have the most holistic approach to ESG. With investors as their primary audience, the SASB standards strongly emphasise ESG is-

[3] See CDP website: *Who We Are*, https://www.cdp.net/en/info/about-us.

[4] See CDSB website: *About the Climate Disclosure Standards Board*, https://www.cdsb.net/our-story.

[5] See GRI website: *About GRI*, https://www.globalreporting.org/about-gri.

[6] See Value Reporting Foundation website: *About*, https://www.valuereportingfoundation.org/about.

sues expected to have a significant financial impact. In contrast, GRI standards focus on the firms and facilitate sustainability-reporting for them. CDP and CDSB focus solely on collecting critical environmental data.

In addition, there are two frameworks from the intergovernmental side:

- TCFD, the Task Force on Climate-related Financial Disclosures established by the Financial Stability Board, strengthens and expands climate-related financial disclosures "around four thematic areas that represent core elements of how organizations operate: governance, strategy, risk management, and metrics and targets".[7]
- UNGC, the UN Global Impact, is a "voluntary initiative based on CEO commitments to implement universal sustainability principles and to take steps to support UN goals".[8]

It is worth noting the distinction between ESG reporting standards and reporting frameworks. SASB and GRI standards provide specific instructions on what should be reported on ESG issues and which metrics should be disclosed. Frameworks such as TCFD or UNGC provide principles-based guidelines on what areas organisations should report on and how the data should be organised. While reporting standards and frameworks should go hand in hand, their current complexity and the numerous reporting alternatives available make understanding the disclosure process difficult.

Beyond these voluntary sustainability reports, several countries already require ESG disclosures. Krueger et al. (2021: 2) identified 29 countries that "introduced mandates for firms to disclose ESG information [between 2000 and 2017], including Australia (2003), China (2008), South Africa (2010) [and] the United Kingdom (2013)." Since 2018, EU companies with more than 500 employees have been required to report on environmental and social- and employee-related matters, human rights, anti-corruption and bribery matters following the corporate sustainabil-

7 See TCFD website: *About*, https://www.fsb-tcfd.org/about.

8 See UNGC website: *About the UN Global Compact*, https://www.unglobalcompact.org.

ity reporting – the EU directive on non-financial reporting.[9] Since 2020, all listed companies in Indonesia are required to publish sustainability reporting under the Financial Services Authority.

ESG disclosure is not mandatory at the federal level in the US. Still, the Securities and Exchange Commission (SEC) requires all publicly traded corporations to publish their environmental compliance costs.

8.3 Toward global standards

The different frameworks and formats, combined with the growing demand for information from investors, make it challenging for the firms to identify which information they should report and how it may impact them. Even if they use materiality to guide their internal strategy development process, firms are more and more reluctant to share their materiality matrices publicly.

In the face of the increased pressure from investors for information and complexity in reporting, public and private sectors seem to agree on the next step: ESG reporting needs to be consolidated, simplified and transparent.

In September 2020, the CDP, the CDSB, the GRI and the Value Reporting, combining SASB and IR Council, suggested that “existing frameworks, standards and standard-setting processes can provide the basis for progress towards a comprehensive corporate reporting system” (CDP et al. 2020: 13). In parallel, the Big Four accounting firms, Deloitte, EY, KPMG and PwC, unveiled their reporting framework for ESG standards (IBC 2020).

On the regulatory side, the International Organization of Securities Commissions (IOSCO) identified in February 2021 three priorities: “encouraging globally consistent standards”, “promoting comparable metrics and narrative”, and “coordination across approaches” (IOSCO 2021: 1). In March 2021, the European Commission published two reports on non-financial reporting standards, proposing a roadmap for developing a comprehensive set of EU sustainability goals and reforms to the existing governance structure to establish a non-financial reporting pillar to com-

[9] See the European Commission website: *Corporate Sustainability Reporting*, https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en.

plement the financial one (Gauzès 2021, EFRAG 2021). At the same time, the SEC announced the creation of a Climate and ESG Task Force in the Division Enforcement that will "develop initiatives to proactively identify ESG-related misconduct". The task force will also "coordinate the effective use of Division resources, including through the use of sophisticated data analysis to mine and assess information across registrants, to identify potential violations" (SEC 2021b).

In November 2021, the International Financial Reporting Standards Foundation (IFRS 2021) announced:

- The creation of a new standard-setting board, the International Sustainability Standards Board (ISSB), in order to design "a comprehensive global baseline of sustainability-related disclosure standards that provide investors and other capital market participants with information about companies' sustainability-related risks and opportunities to help them make informed decisions."[10]
- The consolidation with CDBS and VRF by June 2022.
- The publication of prototype disclosure requirements.

This is the first attempt by the CDP, CDSB, GRI and VRF to combine their standards and frameworks into a common approach for sustainability reporting focused on enterprise value. It has the support of multiple stakeholders, including the International Monetary Fund, the UN and the Financial Stability Board. Finally, the G7 finance ministers accepted it as an extension of the TCFD framework.

The consensus around the necessity of standards and a unified framework is encouraging. However, this initiative will be globally beneficial only if it is a coordinated effort across: (a) the different stakeholders, including the private sector, auditors, standard-setters, governments and international institutions, and the companies (this seems to be the case); and (b) the developed and less developed economies or jurisdictions (this is less clear).

The G20 is the right platform to support the last point. Unlike the G7, the G20 is the natural intergovernmental forum to ensure international coordination among developed and less developed markets. It also has

[10] See IFRS website: *About the International Sustainability Standards Board*, https://www.ifrs.org/groups/international-sustainability-standards-board.

some experience in facilitating the development of a global framework in response to a common shock: the macroprudential framework was designed under its leadership in response to the 2008 financial crisis. That is why it should play a larger role in designing the global standards and framework.

8.4 Necessary next steps

If properly designed, the global ESG framework and standards should guide firms to disclose ESG information that will help: (1) the companies to adjust their strategy depending on their goals and understand the corresponding impact on their ESG-assessment; (2) the investors to have a better understanding of a firm's non-financial risk and be able to compare that information across firms; and (3) the domestic and international regulators and authorities to better monitor how firm-level efforts help advance longer-term goals at the societal or country levels, such as the Sustainability Development Goal and other countries' specific ESG goals.

While points 1 and 2 above help mitigate firm and investment risks, point 3 is a longer-term goal. Depending on the criteria considered, this may require more guidance than realising 1 and 2 to achieve its goal. The timelines vary, ranging from years for a corporation business cycle to decades for societies and countries.

In their four actionable policy recommendations in the context of the G20, Lopez and Siaba Serrate (2021) highlight the importance of an overall and global ESG strategy and benchmarks to assess progress at the firm and the country levels. These would also help clarify the concept of ESG investing and its purpose to the different participants. The recommendations can be summarised as follows:

1) *What are the definition and goals of ESG investing in the medium term?* The definitions and goals differ depending on the context: corporation, society, and environment. While these can be reconciled, the prime focus of ESG investing is to mitigate non-financial risk at the firm level. The terminology should clarify this to avoid the current level of ambiguity: sustainability or resilience at a firm's level is different to sustainability at a country or society level. Furthermore, the definitions and goals should account for industry's specificities.

2) *What are the policies that will allow achieving these goals?* The ESG goals defined in the previous stage are global. However, the policies and the timeline to achieve them will differ depending on the country's level of development. This is why both developed and less developed economies needs to participate in designing the framework.

Countries' competing necessities and needs strongly influence their willingness to prioritise ESG goals in their policies. That is why the framework, or a companion programme, needs to provide the proper incentives and support to facilitate the buy-in of the countries where ESG goals are low in their priorities. Similarly, an inclusive process in defining the framework and policies will minimise potential unexpected consequences that usually arise when solely developed markets drive global regulation (Beck and Rojas-Suarez 2019).

3) *What are the relevant metrics, benchmarks and narratives?* In addition to the lack of international standards and a common framework, most of the current ESG metrics focus on whether organisations engage in specific ESG-related activities (O'Connor and Labowitz 2020). They do little to understand the impact of these policies and activities or measure their progress.

The metrics should leverage existing sustainability-related reporting frameworks and standards and identify the components that help assess progress toward the ESG goals. While the metrics are shared across the firms, the benchmarks and narratives may differ depending on the industry and the country.

Finally, in less developed countries where ESG goals are a low priority, creating a companion programme funded by international institutions to ease the burden of ESG monitoring while making sure the monitoring is done properly is necessary.

4) *How can it be ensured that both the data collection and the assessment process are transparent?* The previous steps will lead to a more transparent and streamlined information-collection process. The resulting data will be consistent across firms and of higher quality; however, third parties' aggregation process leading to the ESG assessment of firms needs to be more transparent. The ratings and scores are useful to companies and investors only if they understand what these assessments entail. Users then will choose which rating aligns with their priorities, alleviating the

concerns regarding different ratings or scores for the same firm.

Concluding thoughts

ESG investing's credibility lies in its ability to be held accountable for all its promises, from non-financial risk assessment and long-term valuation to the positive impact on societies and the environment. Global standards and a common framework are the necessary next step to ensure the proper changes at the corporation's level. If done properly, these changes will trigger societal and environmental changes.

There is little doubt that global sustainability-reporting standards focused on enterprise value will emerge in the next year or so. What is less clear is how inclusive the process to define them will be. As discussed, the different stakeholders from developed and emerging markets need to be involved in setting the goals, standards, benchmarks and timelines. It would be counter-productive to global sustainability to have developed markets imposing the rules.

That is why the G20 is a natural platform to facilitate this work across geographic jurisdictions and actors. It would not be the first time for the G20 to develop a global framework in response to a common shock across the globe. The previous one was the macroprudential policy framework after the financial crisis. This experience could provide helpful insights into the challenges of defining a framework and standards that will have the buy-in of most countries.

Furthermore, the process of developing the common standards and framework will be iterative. The metrics and benchmarks, similar to the scores and ratings, must be evaluated regularly in their ability to protect investors from significant underlying risks and help achieve the goals agreed. They should be adjusted when necessary.

However, the framework and standards are not an end in themselves. The next question will be about their application: should they be mandatory and for whom?

There are clear arguments in favour of mandatory ESG disclosure. Krueger et al. (2021) show that it improves the availability and quality of ESG reporting, increases the analysts' earnings forecasts accuracy, and reduces harmful ESG incidents and the danger of a stock market crash.

Hence, mandatory ESG disclosure, according to the research, has both informative and real-world benefits. However, it places undue pressure on businesses while some are just beginning their sustainability journey. Many claim that voluntary reporting is market-driven and gives reporting enterprises a competitive advantage, making it inevitable. However, in April 2021, the SEC issued a risk alert to raise investors' awareness of "misleading statements regarding ESG investing processes and representations regarding the adherence to global ESG frameworks" (SEC 2021a: 3-4).

Furthermore, there is a question of firms' size. So far, most of the mandated reporting instruments focus on large or publicly traded enterprises. Small and medium enterprises (SMEs) represent around 90 per cent of businesses, but only 10 per cent of reports in the GRI Sustainability Disclosure Database.[11] SMEs are essential in achieving the UN sustainable development goals. Similarly, they will be essential in achieving the ESG goals at country and industry levels. The common framework and global standards will minimise the burden of compliance, especially when compared to the cost of filing for several reportings. It will make it feasible for SMEs to join and compete on the global ESG playing field.

Finally, mandatory or not, the sustainability reports need to be regularly and fairly checked by local authorities. Unfortunately, high levels of corruption in the less developed countries could erode public confidence in the environmental impact data provided nationally and to the international community.

In other words, for ESG investing to lead to societal changes, each participant must play its part.

[11] See the World Bank website: *Small and Medium Enterprises (SMEs) Finance*, https://www.worldbank.org/en/topic/smefinance.

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