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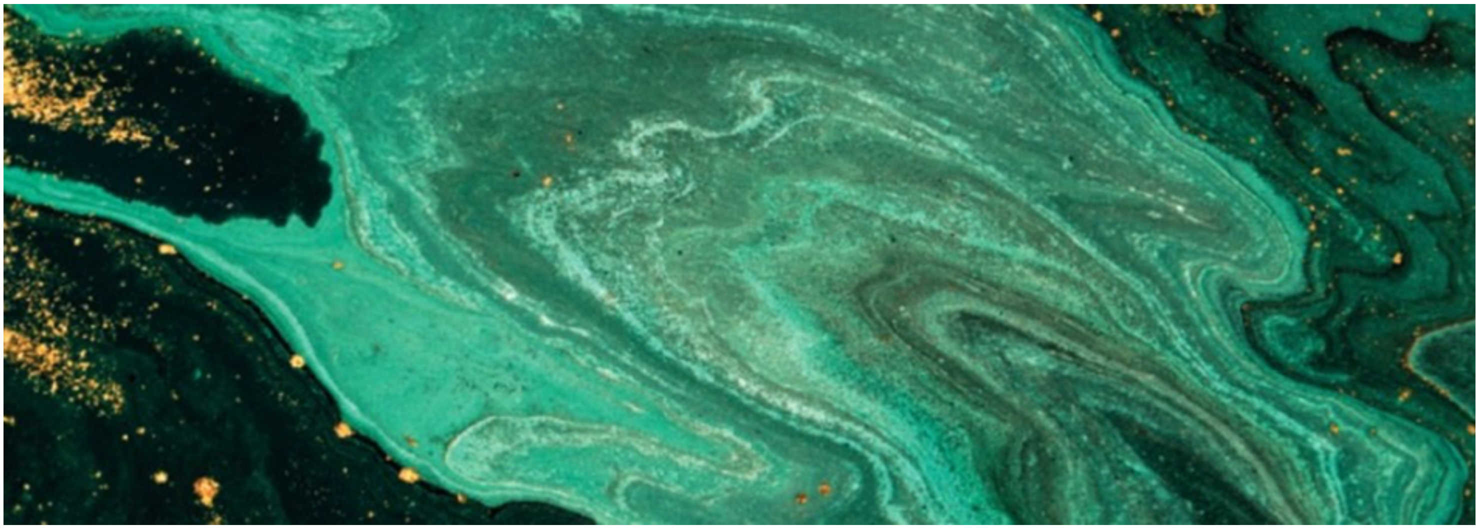
FROM BIG DEBATE

ESG: Serving social needs or greenwashing?



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Alexander Burdulia, Registered Foreign Lawyer, Mayer Brown, Hong Kong

We face big problems that require big changes in the ways we do business. We will experience (https://www.ipcc.ch/report/ar6/wg1/downloads/report/IPCC_AR6_WGI_SPM_final.pdf) some of the worst effects (https://climate.nasa.gov/news/2865/a-degree-of-concern-why-global-temperatures-matter/) of climate change in this century without deep reductions in greenhouse gas emissions. Around the world, almost (https://www.ilo.org/global/topics/forced-labour/lang--en/index.htm) 25 million people—roughly equivalent to the population of Australia—are in forced labour, and it's been suggested that bribery costs us anywhere from US$600 billion (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=829244) to US$2 trillion (https://www.imf.org/external/pubs/ft/sdn/2016/sdn1605.pdf) annually.

ESG is a relatively new development in the evolution of our global capitalist system that addresses these big problems. As an approach that helps orient capital toward their solutions, or at least mitigates their risks, ESG serves our most important social needs. Even better, research confirms that it does so without sacrificing returns. Meta (https://www.tandfonline.com/doi/full/10.1080/20430795.2015.1118917?src=)-studies (https://www.stern.nyu.edu/sites/default/files/assets/documents/NYU-RAM_ESG-Paper_2021%20Rev_0.pdf) show the vast majority of 3,000+ empirical studies find a non-negative correlation between ESG criteria and financial performance.

Greenwashing must be taken seriously to ensure the integrity and effectiveness of this approach as it develops. In the financial sphere, regulation helps prevent bad behaviour and ESG-related regulation is starting to catch up—the EU's Sustainable Finance Disclosure Regulation (SFDR (https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32019R2088)) is now in effect, ESG fund disclosure requirements will soon apply in Hong Kong (https://www.eyeonesg.com/2021/07/new-hong-kong-guidelines-on-enhanced-disclosures-for-esg-funds-in-2022/) and the US Securities and Exchange Commission (SEC (https://www.eyeonesg.com/2021/03/us-sec-announces-the-creation-of-a-climate-and-esg-task-force/)) has formed a task force to combat greenwashing. The International Organisation of Securities Commission (IOSCO) has even issued recommendations (https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf) for regulating the providers of underlying ESG data and ratings. Critics must give regulators time to rein in greenwashing concerns before passing judgment on an approach that can change our world for the better.

L.Burke Files, President, Financial Examinations & Evaluations, Inc

My evolution of thought on ESG has gone from “Oh, that is sweet but misguided” to – “looks like virtue signaling at the expense of the shareholders” to – “ESG is unwise, over time dangerous.”

ESG came to the forefront as sovereign pension and investment schemes chose to only invest in ESG compliant companies and funds. Major corporations' pensions schemes followed. So, what did the fund industry do? They said, "Hey, we are ESG; come invest with us." The funds poured and continue to pour into the ESG companies and funds to this day. So, what's wrong with that? A semi-scientific review of 30 of the leading ESG funds found, on average, the funds had 70 per cent of AUM (Assets Under Management) in only 25 different equities. The disproportionate amounts of money chasing limited targets generates overvalued equities. So why are ESG investments reported to perform better? Too much money chasing too few assets creates overvalued assets.

Claiming ESG compliance means investment funds will flow your way. Not so fast. You claim to be ESG compliant through self-certification, what if you're wrong? Will you become a target for litigation? To hedge against this risk, you retain an ESG ratings company. They are not much help either. The principal ratings agencies' debt ratings on a scale of 0-100, on several companies were within 15 points of each other (good correlation). Their ESG ratings on the same companies varied by 45 up to 75 points (almost no correlation). Why? ESG is poorly defined. The best a rating committee can do is to conjure a numerical rating scheme from subjective and competing standards. The finite ESG ratings are based on a mere opinion market.

The big peril in any ESG rating is the company's supply chain. How many intermediaries removed is a company from, for example, Congolese child labour, slave harvested fruits, or re-education camp manufactured goods? Two, three, five, or it does not matter how distant the supplier? Does knowingly buying goods and services that are not ESG compliant mean you are not ESG compliant? Claim you are ESG compliant, and someone has a different expectation of what constitutes ESG, expect to be sued for misrepresentation, deceptive business practices, and securities fraud.

ESG compliance is expensive. Excluding the green technology sector, ESG is not economical for companies with revenue under US$100 million and funds with less than US$500 million AUM. These firms, since they cannot afford ESG compliance, are excluded from investments from most institutional investors. Get it wrong, it’s more expensive.

ESG compliant investments exclude investing in most developing economies. Opportunities are left to be exploited by non-western investors. Rare earth mining and refining, metals key to green technology, are already dominated by non-western investors. Mining and refining are not ESG. What of global oil, spirits, farming, pharmaceuticals, chemicals, aerospace, and defence? Sorry, not ESG.

ESG: a nice idea, with perverse impacts. ESG inadvertently causes harmful externalities through limiting investments in strategic industries and increasing volatility and assets bubbles in ESG and non ESG investments.

Mark Elliott, Chairman of the Guernsey International Insurance Association

Guidance and frameworks can be established to ensure ESG best practices are followed and ‘greenwashing’ is avoided.

This is becoming common practice in Guernsey. In the insurance sector specifically, the Guernsey International Insurance Association (GIIA) launched a world-first ESG Framework for its members earlier this year, creating a kitemark which validates insurers' considerations in respect of the impact on the environment and communities through a third-party accreditation process.

It was designed to help member organisations manage ESG opportunities and risks and to deliver positive ESG impact. It follows the UN's recommended approach of incorporating ESG processes to align sustainable development goals with the outcomes of financial services products, services, and investments made by the insurer.

GIIA has also signed up to the SME Climate Hub's Climate Commitment, pledging to be carbon neutral by 2050.

Outside insurance, Guernsey also established the world's first regulated green fund regime – the Guernsey Green Fund – in 2018, which has clear parameters for structuring a green fund, aligned to the EU's Sustainable Finance Disclosure Regulation.

The Guernsey Financial Services Commission has also amended its Finance Sector Code of Corporate Governance, asking boards to consider the impact of climate change on strategy and risk profiles and, where appropriate, make climate change related disclosures.

Lakshmi Ganapathi, CEO/Founder, Unicus Research

There has been an ongoing discussion on ESG's authenticity. Investors, corporations, and consumers drive the "ESG revolution" by weaving it into their investment decisions. Investors focus on corporations that are conscious about their carbon footprints, labour policies, gender-conscious board make-up, etc. But are corporations making any impact on everyday lives? Or addressing social needs? The premise of ESG is authentic while the lure to greenwash is omnipresent.

The evolution of social responsibility is injected into the marketing of products. For example, the "buy one, give one," or "BOGO" model is a prominent and popular trend in the socially responsible corporate model. While some corporations have exploited the model, companies like Warby Parker have used the "BOGO" model by addressing the global problem of impaired vision in communities that lack access to affordable glasses. Also, companies like Bombas give away a pair of socks/undergarments/shirts to a homeless shelter to distribute for every pair of garments bought by its consumers.

However, a trillion-dollar greenwashing industry attracts investors and consumers by focusing only on the "E" part of the ESG, addressing only the third of the ESG equation – The Electric Vehicle Sector. Corporations like Tesla (TSLA) successfully create a relatively affordable electric vehicle in a mission to save the environment. But, sadly, when it comes to sourcing minerals, addressing labour relations, diversity, inclusion, etc., Tesla scores relatively low ESG ratings.[1] As a result, Tesla and other EV car companies consciously engage in “greenwashing.” To be genuinely ESG compliant, the EV car companies need to focus on responsible sourcing of minerals that go into their batteries to be environmentally mindful in recycling those EV batteries.

Therefore, the general view is that some corporations will continue “greenwashing” as a method to scam the investors and consumers who desperately want to be part of “saving the world”. However, to embrace the ESG in its entirety, corporations, governments, investors, and consumers need to change. Until then, the term ESG will be synonymous with greenwashing.

[1] *https://cnb.cx/3rsN3TQ*

Simon Mills, Lead Consultant Sustainable Finance, The Z/Yen Group

The answer is neither.

In the last eight editions of the *Global Green Finance Index* (https://www.longfinance.net/programmes/financial-centre-futures/global-green-finance-index/), financial services professionals have consistently rated ESG analytics as having a very significant impact on the spread of green finance. This is probably because ESG delivers.

ESG is often conflated with SRI (socially responsible investment) or impact investment. The former is a tool whereas the latter two are investment goals.

The primary purpose of ESG is to enhance risk management and spot price disparities - for ESG managed funds, environmental, social or reputational benefits are just positive externalities.

Evidence from multiple sources shows a slight, but consistent, performance premium by ESG managed funds. There is, however, little evidence showing a premium associated with SRI funds, and impact investment focuses on mission-orientated results rather than returns.

Twenty years ago, when I first started working in the City, ESG analysts were the hippies in the portacabin in the car park. Today, those people are all gone. Competent fund managers use ESG and enhanced analytics to shape their investment decisions as a matter of course.

They can’t be blamed if marketing departments spin unicorns and rainbows around what is fundamentally actuarial/accountancy/ratings best practice.

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