THE CORPORATE ESG GUIDE:
A 360 VIEW ON THE CURRENT LANDSCAPE AND TRENDS

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Environmental, Social, and Governance (ESG) concerns are increasingly prominent in shareholders’ minds; however, the market is saturated with differing views and opinions spread across articles and papers focusing on individual topics. We have researched, analysed and summarised the latest issues, attitudes and trends across the entire ESG community to cut through the noise and enable you to make better informed decisions on this important topic in one, concise document to be used as a guide and reference tool.

Part I serves as a corporate guide examining the main ESG market trends. It outlines the main challenges investors and corporates encounter on their ESG journey and provides an overview of current prominent global ESG standards, disclosure frameworks, and upcoming regulation.

Part II presents the views from ESG specialists, drawn from 35 interviews with prominent investors, corporates, rating agencies and advisors. They shared their perspectives on the key ESG issues ranging from ESG ratings to investor engagement and the EU Taxonomy.
Part 1: Corporate ESG Guide

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Part 1: Corporate ESG Guide

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Executive summary

UNDERSTANDING OF ESG: DEFINITIONS, INVESTMENT STRATEGIES AND GREENWASHING

Understanding of ESG

Part I of the White Paper aims to serve as an issuers’ guide to the key current developments in the ESG space. It also sets up a background to the topics discussed in Part II, which offers relevant market insights that can add more detailed guidance on key ESG concepts. One of the key challenges highlighted in Part I was a lack of clear understanding of the term ‘ESG’ by many market actors. Corporates we interviewed generally view ESG as understanding, addressing, and reporting on risks and opportunities that environmental, social, and governance factors bring to their business operations. Alternatively, some view ESG through a more holistic concept of sustainability, which focuses on the long-term impacts on their business, or a greater focus on stakeholders rather than just shareholders. Some companies also highlighted the importance of ESG in context of maintaining the licence to operate, referring to the need to preserve a positive image of a company in the eyes of the wider public.

ESG elements

In the context of definitions and terminology concerning ESG, we took a closer look at its separate elements – Environmental, Social, and Governance factors. Corporates mentioned different material ESG factors depending on their industry (corporate participants in this Paper cover pharmaceuticals, automotive, consumer products, energy, industrial, construction, mining, financial and IT sectors). We also asked investors which ESG elements they felt were particularly important. In general, in addition to governance, investors highlighted the growing focus on environmental issues that intensified over the last few years, as well as the increased attention to social factors brought on by the Covid-19 pandemic. Topics discussed concerning the environment include carbon emissions, water consumption, and waste. In terms of social factors, supply chain, labour relations, and health and safety stood out. Covid-19 has also brought additional scrutiny to governance considerations such as dividend pay-outs and renewed focus on management compensation.
ESG investing

The first part of the White Paper highlighted various ESG investing approaches used by asset managers. In the Part II, we asked investors how they incorporate ESG in their investment process. The responses indicated that ESG integration was the most adopted ESG investing strategy. Generally, it involves including ESG factors in investment decision-making alongside traditional financial indicators. This strategy is increasingly applied across all asset classes (including mainstream funds that do not have an ESG mandate). As ESG integration becomes more and more mainstream, companies that do not target ESG-focused funds will have to consider their ESG strategy to retain existing investment. Impact investing, a strategy that involves investors looking for companies that achieve measurable targets on environmental or social goals, is another fast-growing trend in ESG investing.

Size of the ESG market

Part I mentioned considerable disparities between different estimations of the ESG investment universe, from $560 billion (2019 IMF report) to $30.7 trillion (GSIA 2018). Interview participants confirmed the suggestion that the estimation of ESG AUM would depend on the adopted definition of ESG. Investors’ comments indicate that ESG integration strategy takes up a bigger portion of the market as more and more asset managers incorporate it across their funds. A smaller proportion of ESG assets fall into the SRI strategies bucket, which are usually based on an exclusionary approach to investing (such as tobacco or controversial weapons). Impact investing, which focuses on companies that create a measurable positive change in environmental or social spheres, is a small but quickly growing part of the market.

Greenwashing

Greenwashing generally describes the practice of performative commitment to ESG without taking any genuine action. Part I of the Paper shows greenwashing as an ongoing issue for both corporates and investors, as they try to navigate the ESG environment in the absence of common definitions or mandatory frameworks. In Part II, interviewees generally recognised greenwashing as a problem. At the same time, participants observed that on occasion, some companies that start their ESG journey greenwashing, eventually develop an effective approach to ESG as a result of external pressures. Some investors commented that as the amount of available ESG data increases, it becomes easier to differentiate between companies with a marketing-based ESG approach and those genuinely committed to ESG change. This means that greenwashing is rapidly ceasing to be a viable approach to attract ESG investors or demonstrate commitment to sustainability.

IMPORTANCE AND COST OF ESG FOR CORPORATES

Is ESG only for companies that can afford it?

Many corporates are still unclear on how the increasing importance of ESG might impact their business. This issue is especially pertinent for smaller companies, which can be in a somewhat disadvantaged position with regards to attracting ESG investment. Part I of the White Paper highlights that companies without sufficient resources can struggle to address ESG concerns in a world of opaque terminology and complicated disclosure frameworks. As a result, small and mid-cap companies might need more convincing that improving their ESG profile will bring positive business outcomes, before committing to necessary expenditure. In Part II, we asked corporates to comment on the significance of addressing ESG as part of business policy and strategy.

Most corporate participants agreed that a lack of an effective ESG strategy is likely to have a significantly negative effect on a company. This is due to the increasing social pressure, consumer attitudes, growing investor preference for ESG-focused investing and regulatory change. As a result, a flawed approach to ESG can become an existential question for many businesses. Additionally, addressing relevant ESG issues can reduce risks and make it easier for companies to attract growing pools of ESG investment, as well as retaining existing investment from investors on their ESG evolutionary path. Improving ESG practices is also likely to have a positive effect on stakeholder relationships, which are important to the long-term business prospects. Corporates and investors also suggested a number of ways to reduce the amount of resources needed for effective ESG implementation.

TAKING ACTION ON ESG: INTEGRATION, EVALUATION, COMMUNICATION, AND REPORTING

Integration

Following the conclusion that ESG considerations should form an integral part of business strategy, we asked corporate participants to outline their approaches to ESG integration. This discussion touched on strategy formulation, board appointments, key ESG targets and KPIs. With regards to the strategy, the prevailing view was that the direction on ESG should come from the top. Senior management conviction was generally seen as one of the key factors for effective ESG integration, alongside appropriate accountability structures and processes. There were divergent views on the merits of having a separate ESG policy versus integrating ESG into the general, overarching corporate strategy. Most corporates had a dedicated ESG strategy, while some advocated for the full integration of ESG into the overall equity story. There were different approaches to establishing board accountability: some issuers make board appointments based on ESG credentials, some have ESG factors integrated into general board appointment criteria, and others make a head of sustainability a board-reporting position. In terms of key ESG goals, most respondents had specific emissions reduction targets. Other common targets included waste reduction, health and safety and sustainable packaging. Most issuers also had KPIs related to ESG targets, with some incorporating ESG KPIs into their compensation schemes.

Evaluation

One of the main topics highlighted in the Part I of the White Paper is the influential position of the ratings agencies and data providers in the ESG space. Without regulatory standards and mandatory disclosure, they enable investors to rate and compare companies’ ESG practices. At the same time, issuers expressed frustration with the increasing proliferation of ESG ratings agencies, their data collection processes, opaque methodologies and lack of communication. In particular, companies were concerned that agencies evaluate them with a one-size-fits-all approach that doesn’t allow for nuance.

In response, most ratings agencies taking part in this White Paper generally stated that a degree of standardisation of data is inevitable, especially considering the lack of mandatory reporting frameworks and the resulting abundance of incomparable data. Some agencies take an alternative approach to this problem and gather data directly from corporates, which could, arguably, allow for greater accuracy. Regarding differences in ratings agencies’ final scores, agencies pointed out...
that different ratings address different investor demands. When asked to comment on best ESG practice for companies, most agencies stated that companies should focus on addressing their material ESG factors and not try to tailor their ESG approach to external scores; the score would improve as a result of improvements in ESG performance.

Generally, investors appreciated the wide coverage provided by ESG ratings agencies. Several participants noted that ratings agencies played a significant role in popularising ESG by allowing investors a convenient way to incorporate ESG factors into their investment process. However, most asset managers developed or are in the process of developing internal ESG evaluation models, which means that external scores become one of many indicators of ESG performance. Alongside the third-party ratings, investors consider information on various ESG factors such as employee turnover, health and safety, and carbon emissions in their analysis. A low overall ESG indicator does not always result in a negative investment decision – for some investors the final decision would depend on engagement with a company. In such cases, a positive response and willingness to change from a company can, sometimes, compensate for a low ESG score.

Communication and reporting
Choosing the right channels is integral for the effective communication of ESG policy. Issuer participants spoke of communicating their ESG strategy through reporting, information published on their corporate website, and direct investor interaction.

Website
ESG-related information presented on a website can include ESG-themed investor presentations, relevant targets and KPIs, and sustainability reporting materials. Investor participants were especially supportive of using company websites as a key ESG communication platform, with several participants suggesting that companies should make sure that information on their websites can be easily picked up by AI tools.

Direct communication
Commenting on direct interaction with investors, most issuers chose to channel their ESG communication through IR. This is mostly due to the close contact with the market IR traditionally have. While investors recognised that IR would be a reasonable first point of contact, most prefer to communicate with senior management. Overall, investors thought that it is crucial for senior management to demonstrate a good understanding of relevant ESG issues. With regards to ESG-focused roadshows, the general consensus was that ESG issues are increasingly being discussed during standard NDR roadshows. Most investors also expressed a preference for integrated roadshows, where ESG discussion forms part of an overall narrative.

Reporting
All corporates we spoke to regularly report on ESG (at least annually). Some incorporate ESG indicators into their annual reports, while others produce a dedicated sustainability report. Several corporates also provide quarterly reporting on select ESG KPIs. Investor participants did not express a unified view on the frequency of ESG reporting, with some preferring quarterly updates and others thinking they are unnecessary. Generally, investors supported companies publishing regular sustainability reports, however some expressed preference for integrated ESG reporting. Many investors also highlighted that corporates should make sure to focus on ESG factors material to their business in their reporting.

ESG DISCLOSURE GUIDELINES, REGULATION, AND THE FUTURE

Disclosure guidelines
Part I of the White Paper outlines several ESG disclosure frameworks (GRI, SASB, TCFD). In Part II we spoke to industry participants to find out which frameworks are being used by some of the largest corporates and which are valued by investors. Most corporates participating in this research use GRI in their reporting. However, several companies are working on incorporating SASB and TCFD into their reporting. This trend is supported by the increasing investor support for SASB and the growing influence of TCFD. While many investors view SASB positively, there was no overall strong preference for a particular disclosure framework. Some investors highlighted that transparency in ESG data (including data showing negative results) is the key concern with regards to ESG reporting.

Regulation
Part I discussed the ongoing incorporation of ESG into the EU regulatory framework. The most significant part of this process is the Taxonomy, which provides a comprehensive classification of sustainable activities (currently focused on environmental factors). Throughout Part II, participants expressed a strong wish for a greater standardisation of ESG definitions and reporting frameworks. Overall, the Taxonomy was seen as an important step towards this goal and therefore viewed in a positive light. Another common view was that regulatory involvement is necessary to ensure timely action on climate change. However, issuers and investors also expressed doubts with regards to some aspects of the new regulatory regime. Concerns included narrow focus on environmental issues, overly prescriptive rules, and limited geographical reach.

Future direction
Shifts in societal attitude, the onset of climate change, expanding regulation – these developments make it evident that ESG will remain an important topic for the foreseeable future. Comments by interview participants confirm this view. Climate change and the resulting drive to reduce emissions was mentioned as one of the key issues that needs to be addressed by companies in all industries. Corporates commented that an effective ESG approach is central to responding to investors, stakeholders and the regulatory demands, securing funding sources, engaging with their employees, and attracting new talent. Investors thought that ESG integration is likely to become increasingly ubiquitous as an investment approach, to the point of being seen as default. More targeted ESG investment strategies, such as impact investing, will continue to expand in response to the ever-increasing societal demand for companies to make a meaningful difference.
Preamble to Part 1

Environmental, Social and Governance (ESG) factors are drawing increasing attention from the investment community, governments and regulators, who are driven by the need to address the effects of climate change. This creates a new challenge for issuers looking to attract new capital from this ever-increasing investment pool and retain existing investment from investors who are increasingly incorporating ESG factors into their decision-making process. However, the substance of ESG is still poorly understood by many market actors. As a result, companies are unclear on the actions they need to take to incorporate ESG into their operations and satisfy their stakeholders.

This White Paper aims to address this problem by pulling together the most relevant information on ESG to provide issuers with a useful handbook. This part of the White Paper outlines the main issues and developments in the ESG sphere, including: issuers’ perception of ESG, current trajectory of ESG investment, investors’ voting and engagement on ESG issues, greenwashing, and various approaches to defining and understanding ESG. This discussion sets the background for the questions we addressed to the market participants in the Part II.

Notable developments and challenges in the ESG space that became evident in this part of the Paper:

Developments

→ ESG investment universe is expanding rapidly
→ While active investors hold a significant part of ESG market, passive ESG investment is catching up fast
→ Investor demand for ESG data caused an expansion in the number of ESG ratings agencies and data providers
→ Reporting frameworks refine their definitions with newcomers, such as TCFD, playing an important role
→ ESG ratings are used by investors, but usually in addition to an in-house evaluation
→ European authorities are focused on incorporating ESG considerations into the regulatory framework; their goal is to redirect capital towards greener companies
→ Meaningful integration and disclosure of ESG are key for companies looking to improve their sustainability profile
1. Current ESG market trends

ESG assets under management grew rapidly in 2019 and 2020, with varying views on exact numbers.
Governance accounts for a major part of ESG reporting.
Most problems for issuers and investors seem to stem from the lack of universal ESG definitions and methodologies.

Companies are facing increasing pressure from the investment community (some of the latest examples coming from BlackRock’s CEO 2020 letter and State Street Global Advisors’ promise to focus their 2020 proxy voting on ESG standards), regulators and the public to tailor their operations to prioritise ESG issues. At the same time, ESG-focused investing is growing rapidly. However, estimation of the ESG investment universe varies significantly, depending on the source and methodology: a 2019 IMF report puts Global ESG Equity AUM at $560 billion, while the Global Sustainable Investment Alliance’s 2018 report shows a figure of $30.7 trillion in sustainably managed assets globally with 51% of that in public equity. The differences likely stem from the inconsistencies in defining ESG and ESG strategies discussed below. Regardless of the exact estimation, the upward trend is likely to continue with the generation change – according to a global survey conducted by deVere Group, 77% of millennials prioritise ESG-friendly investing when considering investment opportunities. Currently, even the Covid-19 pandemic did not impede ESG investing momentum – according to Bloomberg, ESG-focused funds hit record inflows in the second quarter of 2020. There is also a strong regulatory push with the UK and EU authorities introducing ESG requirements into their frameworks (see the EU initiative on sustainable finance, the new edition of the UK Stewardship Code and the Green Finance Strategy, discussed later in this report). As a result, companies increasingly find themselves needing to address ESG in their investor communications, disclosures, and public releases.

1.2.1 What drives investors towards ESG?

In response to mounting environmental challenges and the consequent social and political pressures, an increasing number of investors are adopting global sustainability initiatives and disclosure frameworks such as the United Nations Principles of Responsible Investment (UNPRI) and Sustainability Accounting Standards Board. These initiatives require a commitment to environmental and human rights principles and associated disclosures. Investors also increasingly view ESG as a part of their fiduciary duty. This focus on ESG is unlikely to decrease – 65% of investors believe that...
will become standard practice in 5 years (2019 Natixis Survey)\(^9\). In addition to responding to societal and regulatory pressure, ESG investing helps to minimise risks (according to the Natixis survey cited above, 38% of investors cited that as a reason for implementing ESG). The strong push towards greater adoption of ESG practices can also be illustrated by large asset managers and owners such as BlackRock, California State Teachers’ Retirement System and Ontario Teachers’ Pension Plan using their influence to push for greater disclosures on climate change, human rights, and other sustainability issues.

The majority of ESG investments still flow through active funds, reflecting the historical dominance of active investors in the ESG field. However, passive ESG funds are growing at a fast rate, with net inflows in passive ESG funds overtaking inflows into active funds by $4 bn in the US in 2019\(^7\). This growth is likely to increase exponentially, considering the rapid expansion of passive funds in recent years (holding nearly half of the US equity market in 2019\(^8\)) and ever-growing demand for sustainable investments. Recent research suggests that passive vehicles will soon overtake active managers in sustainable investment volumes, as many institutional investors plan to increase their exposure to ESG ETFs in the coming years\(^8\).

Considering the growth of ESG investing, it is important to understand how those institutions allocate their investments and their methods of engagement. According to the Global Sustainable Investment Alliance, the most widespread forms of a sustainable investment strategy are negative screening and ESG integration ($19.8 and 17.5 trillion globally as stated in the GSIA 2018 Global Sustainable Investment Review). Negative screening involves the exclusion of stocks from certain sectors or industries (for example, weapons, alcohol, or tobacco) from the investment portfolio. ESG integration involves making ESG factors part of financial analysis. Other strategies include positive screening (investing in companies that perform well on ESG), norms-based screening, sustainability-themed investing, and impact investing.

Passive funds usually rely on ESG indices offered by ESG data providers such as MSCI, Sustainalytics, STOXX, Bloomberg and FTSE to construct their ESG products. As an example, MSCI (Morgan Stanley Capital International) has been providing equity indices since the 1980s and is currently one of the best-known benchmark index providers. It offers funds a range of indices that include ESG integration, exclusion and impact strategies. These indices are formed using MSCI’s proprietary ESG rating methodology. Different types of ESG indices offer exposure to:

- **Negative screening** – a selection of shares that excludes companies based on low ESG scores, non-compliance with global norms, or belonging to a controversial industry
- **Positive screening** – a selection of shares targeting a particular ESG topic (low carbon) or companies with high ESG ratings
- **a combination** of the above.

For example, the MSCI ESG Universal Index is based on the MSCI World Index (the parent index which includes large and mid-cap shares across several developed markets). The MSCI ESG Universal excludes stocks with weak ESG profiles based on the parent MSCI Index and focuses on companies with good current ESG profiles (based on MSCI ESG ratings) and positive ESG projections\(^6\). Other indices, such as MSCI ACWI ESG Leaders, target companies with high ESG performance relative to the industries (based on MSCI research and ratings)\(^9\). While ratings agencies significantly influence passive ESG investment, some argue that active strategies offer a more precise approach to sustainable investing than relying on a third-party score. For example, it allows investors to target companies that are in process of improving their ESG practices, and as such would not necessarily receive a high score\(^1\). In addition, some question the data collection processes and relative lack of transparency of ESG index providers, suggesting that they could be unreliable\(^1\).

1.2.2 What do the passive ESG funds invest in?

One of BlackRock’s largest ESG ETF products, iShares MSCI USA ESG Leaders ETF holds $2 bn AUM (as of August 2020). It tracks the MSCI USA Extended ESG Leaders Index, which lists Microsoft, Alphabet, Visa, Mastercard, and Intel in its top 10 largest holdings. Vanguard’s ESG US Stock ETF ($5.8 bn as of July 2020) Top 10 also includes Apple, Amazon, Facebook, and JP Morgan Chase. Financials and large technology companies benefitted the most from the surge in ESG investments – they don’t have the disadvantage of being part of high-emissions industries and tend to have better ESG scores. Also, their large market capitalisation means that they are better represented in most portfolios than smaller renewables companies. Sectoral preferences of passive funds come into contrast with active ESG investors, who tend to invest in consumer and industrial sectors\(^1\).

1.2.3 Proxy voting and engagement: current ESG trends

Investors’ voting records provide an interesting insight into their priorities. ESG issues (especially climate change) were the most frequent topic of shareholder proposals in 2019\(^10\). A survey conducted by Morgan Sodali in 2019 showed that 85% of institutional investors consider climate change the most important engagement topic\(^11\). According to research conducted by Ceres, funds such as DWS, PM, Allianz, Eaton Vance, Credit Suisse, Guggenheim, BMO, Wells Fargo, American Century increased their support for climate-related shareholder proposals significantly\(^12\). For example, American Century supported 56% of ESG proposals in 2019, a major increase on 6% support in 2018\(^13\).

Growing importance of sustainability is also evident in the increasing number of hedge funds incorporating ESG into their strategies. KPMG International 2020 Sustainable Investing report shows that hedge funds are quickly advancing in their adoption of ESG. As stated in the report,...

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\(^6\) MSCI World ESG Universal Index https://www.msci.com/documents/10199/4027f04a-e4b2-4430-b2c4-bf07870e864b

\(^7\) MSCI ACWI ESG Leaders Index https://www.msci.com/documents/10199/7e5b3443-34b0-4f92-9953-5d066e9376f4

\(^8\) MSCI World ESG Universal Index https://www.msci.com/documents/10199/4027f04a-e4b2-4430-b2c4-bf07870e864b

\(^9\) MSCI World ESG Universal Index https://www.msci.com/documents/10199/4027f04a-e4b2-4430-b2c4-bf07870e864b

\(^10\) MSCI World ESG Universal Index https://www.msci.com/documents/10199/4027f04a-e4b2-4430-b2c4-bf07870e864b

\(^11\) MSCI ACWI ESG Leaders Index https://www.msci.com/documents/10199/7e5b3443-34b0-4f92-9953-5d066e9376f4

\(^12\) MSCI ACWI ESG Leaders Index https://www.msci.com/documents/10199/7e5b3443-34b0-4f92-9953-5d066e9376f4

\(^13\) MSCI ACWI ESG Leaders Index https://www.msci.com/documents/10199/7e5b3443-34b0-4f92-9953-5d066e9376f4

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this development is mainly driven by the demand coming from institutional investors, consultants, and regulators20. Hedge funds are also expanding their ESG activism, with such funds as TCJ and Trian Partners pushing companies to improve their emissions disclosures and adopt a more diligent approach to sustainability21. Increasing uptake of ESG by hedge funds points not only towards the increasing demand from institutional investors, but also to a link between better ESG practices and financial value.

The rise in passive ESG investment puts the spotlight on their engagement practices. Historically, passive investors have been known to lack the incentive to engage in active ownership due to their low fees and the high costs of engagement; however, this is currently changing with the largest passive investors (such as BlackRock, Vanguard, State Street) increasingly taking a more active stance on ESG issues. This can be illustrated by BlackRock joining the Climate Action 100+ initiative, which focuses on reducing emissions of the largest polluting companies. CA100+ signatories include over 450 investors who manage over $40tn in AUM. In addition, Larry Fink, BlackRock CEO, highlighted the importance of climate change to companies’ long-term prospects in his 2020 annual letter. In yet another demonstration of an attitude shift by large passive funds, State Street declared that they would vote against directors of companies that underperform in terms of ESG standards in 2020. This trend is especially important as large passive investors have considerable holdings in many high emissions companies in the oil & gas, manufacturing, and other higher-risk industries. Engaging with them can offer a better chance of improving their ESG practices than divesting.

Another factor behind the drive for more active engagement on ESG is regulation. In addition to the numerous voluntary standards such as the Principles for Responsible Investment, UN Global Compact and others, ESG is becoming embedded into regulatory requirements. A prominent example is the recent set of initiatives under the umbrella of the EU Sustainable Finance Action Plan. The EU measures aim to direct capital towards sustainable investment by establishing a classification of sustainable economic activities, setting new disclosure requirements for corporates and investors, and other ESG regulations is discussed in more detail later in the report. The regulatory push for asset managers to demonstrate how they integrate ESG at all stages of their investment process leads them to pay closer attention to the ESG performance of companies in their portfolios, and more actively engage on it.

In addition, the disruption caused by the Covid-19 pandemic seems to have accelerated the shift towards ESG investing. According to recent research published by JP Morgan, most investors believe that the awareness of sustainability risks will increase in the aftermath of the current crisis22. In addition to bringing investors’ attention to systemic ESG risks, the pandemic brought to light the S (social) part of the acronym. Issues such as employee relations, health and safety, that were frequently overlooked before, are now increasingly scrutinised by the investor community and the media. Superior performance of ESG investments versus traditional equity during the Covid-19 outflows further demonstrates growing investor preference for sustainable stocks. According to data provided by the Financial Times, European sustainable funds saw a €30bn increase during the first three months of 2020, contrasted with €148bn outflows across Europe overall23.

1.2.4 Current challenges in ESG investing

The existing problems with a lack of universally accepted ESG standards and methodologies affect investors and issuers alike. Nativé’s ESG Investing Survey, published in 2019, shows that a lack of reliable ESG data prevents 44% of investors from adopting ESG strategies; 43% mentioned difficulties with measuring ESG performance. A significant number of investors still hold a sceptical attitude towards existing ESG data, as evident from KPMG International’s 2020 Sustainable Investing report. This report shows that for hedge funds, the lack of consistent ESG data (63%) and unclear terminology (36%) are among the main obstacles to ESG implementation24.

Investors’ approach to ESG can vary depending on the jurisdiction. In their 2019 report, Cerulli Associates highlighted that some large US funds are still resistant to meaningful ESG integration into their investment decision-making process25. In the same report, investment managers reveal clients’ distrust in ESG factors, highlighting unfamiliarity, potential negative impact on performance, and a lack of consistent definitions of the term. A lack of governmental and societal push towards ESG in the US compared to Europe contributes to the resistance. Divergence between these two jurisdictions can potentially increase as a result of the regulatory approach expressed in the latest proposals from the US Department of Labour, discussed later in this report.

1.3 ‘Greenwashing’, box-ticking and rebranding

- Marketing does not equal commitment
- Some ESG-oriented funds have recently attracted negative media attention due to exposures to tobacco and defence industries
- A number of “new” ESG funds are rebranded products
- Confusion on ESG terms facilitates greenwashing

The practice of publicly declaring a serious commitment to ESG while continuing with contradicting practices has been labelled ‘greenwashing’. Sometimes it can even lead to legal challenges, as illustrated by a 2017 case involving Walmart allegedly using misleading green labelling on its plastic products. Vague language around ESG makes it easier for companies to greenwash: a European banking institution used ‘impact investing’ as a general term to describe their range of sustainable and ethical products26. ‘Impact investing’ is usually used to describe investment into companies whose aim is to achieve a quantifiable impact on a particular ESG issue (for example, water supply or microfinance). Diluting the term can mislead investors looking to invest in companies that deliver meaningful change in a specific sector.

The absence of the common consensus on ESG makes it difficult for end investors to identify the funds that suit their preferences and can result in negative media coverage for some asset managers. Without commonly agreed definitions, holdings of some funds that are advertised as sustainable might surprise an individual with a more ‘purist’ understanding of the term. In some

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21 JP Morgan, Why Covid-19 could provide to be a major turning point for ESG investing, 1 July 2020. https://www.jpmorgan.com/article/b1k0ztq7n2wc6d/Hedge-Fund-Activists-Pivot-to-ESG
22 Attracta Mooney, ESG passes the Covid challenge, Financial Times, 2 June 2020. https://www.ft.com/content/10bdf83d-98ae-4aff-bf8c-75aa1bb98a48
26 Joe McGrath, Comment: Greenwashing is damaging our cause, ESG Clarity, 22 November 2019. https://esgclarity.com/comment-greenwashing-is-damaging-our-cause/
cases, sustainable funds can still have significant holdings in high-emissions industries. Last year, L&G, Vanguard, and Morgan Stanley attracted negative media attention due to their funds having exposure to the tobacco, gambling, and defence industries, while stating that they incorporate ESG into their investment approaches. The confusion results from different interpretations of ESG investing, while some understand it as focusing on companies with a good ESG track record, another approach to ESG involves investing in companies with imperfect ESG approaches and helping them to improve it through engagement.

Differences and inconsistencies between ESG scores produced by ratings companies, mentioned above, can contribute to greenwashing by making it difficult for funds to evaluate which companies are suitable to be included in an ESG fund. The most recent example is Boohoo, which was given an AA ESG score shortly before allegations of workers exploitation in their supply chain.

2. Trying to define ESG

- Ratings significantly differ in methodologies and can produce substantially different results
- Investors tend to take ratings into account in addition to their own in-house evaluation
- There is no universal ESG reporting framework; the most prominent ones are GRI, SASB and TCFD
- The EU has created a comprehensive sustainability-focused regulatory regime which includes a classification of sustainable activities (The Taxonomy)

2.1 Ratings agencies and ESG data providers

MSCI

MSCI is one of the largest providers of ESG ratings and indices. Their ESG ratings cover over 7,500 companies. Data used in their evaluations is acquired from public sources, which include company reporting, news sources, social media, and NGO reports, among others. This information is analysed against what MSCI considers to be the most important ESG risks and opportunities for the individual company and industry, and how they were dealt with by the management. ESG factors are divided into ten themes and 37 key issues, which are scored based on risk exposure and risk management. A weighted average score for each key issue and theme is formulated afterwards. The score is adjusted relative to industry peers and companies are rated on a scale from AAA to CCC.

MSCI provide a detailed explanation of their methodology here.

Sustainalytics

Sustainalytics ESG Risk Ratings focus on financially material ESG risks and covers more than 12,000 companies. Their methodology involves analysing companies’ exposure to material ESG risk and evaluating how companies manage that risk. Risk factors are determined based on sub-industry, with 20 material factors for each sub-industry. The score identifies unmanaged ESG risk, with lower scores indicating low levels of unmanaged risk. There are five risk categories that are reflected in the final rating: negligible, low, medium, high and severe.

Sustainalytics provide an outline of their ratings methodology here.

FTSE

FTSE ESG Ratings cover the constituents of the FTSE All-World Index, FTSE All-Share Index, and Russell 1000 Index using data available from public sources. FTSE ESG Ratings are also focused on materiality, which means the data is analysed against ESG issues that are the most relevant for a particular company. In addition, FTSE offers the Green Revenues data model which calculates the percentage of revenues generated from green products. This allows investors to measure companies’ transition to the green economy.

FTSE explain their ESG Ratings methodology here and the Green Revenues data model here.

ISS

ISS offers a number of ESG-related ratings, including Governance QualityScore, E&S Disclosure QualityScore, Carbon Risk Rating and ESG Corporate Rating. Governance QualityScore provides a 1 to 10 score which evaluates over 220 factors, with a focus on the qualitative aspects of governance. E&S Disclosure QualityScore rates companies based on their sustainability disclosures. The Carbon Risk Rating focuses on climate-related performance, evaluating a company’s CO2 efficiency, risk management, efforts to reduce their carbon footprint, and their exposure to carbon risk. ISS ESG Corporate Rating evaluates companies’ sustainability performance using over 100 indicators, with most being industry-specific. This rating also focuses on material issues at the industry level.

ISS provides information on their range of ESG ratings here.

Refinitiv

ESG scores provided by Refinitiv measure companies’ ESG performance across 10 themes that fit under the E, S, and G umbrella. The performance is measured relative to other companies in the industry, which allows for a focus on ESG issues material to each industry. The data used in their calculations is drawn from the public domain. Refinitiv also provides an overall rating that incorporates material ESG controversies in addition to a company’s ESG performance. More information on the methodology behind Refinitiv ESG scores is available here.

S&P Global

S&P Global, a widely known credit rating agency, introduced their own ESG assessment scores in 2019. Their ESG Evaluation service focuses on a forward-looking assessment of companies’ capacity to address the risks and opportunities arising from ESG factors. Contrary to many other ratings agencies, S&P Global incorporate data gained from direct engagement with companies’ management and boards in their ESG analysis.

S&P Global outlines their approach to ESG assessments here.

Bloomberg

Another newcomer in the ESG ratings space is Bloomberg who have recently launched their first package of proprietary ESG scores with the dual goal of rewarding performance and disclosure. The offering includes Board Composition Scores for over 4.3k companies and Environmental and Social Scores for 252 companies in the Oil & Gas sector. It’s a pure data quantitative driven score where only company reported data is used in the model. Bloomberg also offers Environmental and Social News Sentiment Scores, ESG Disclosures Scores, and Bloomberg Gender Equality Index Scores. More information on those scores is available here.

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These are not the only agencies and data providers offering ESG evaluations. Other notable entities include Vigeo Eiris, RepRisk, Carbon Disclosure Project, among others. A report produced by SustainAbility counted over 600 ESG ratings and rankings in 2018 and growing year on year. The differences in approaches and methodologies between ESG scores offered by this vast number of providers result in significantly different outcomes, which is challenging to both investors and issuers. This can be illustrated by the stark differences found in the evaluation of Tesla and Alphabet. Sustainalytics gave Tesla an average ESG score. The differences resulted from MSCI focusing on the industry issues such as carbon and clean tech opportunities, which gave Tesla a high score; while FTSE scored only the emissions from the factories, and not the cars. In addition, in the absence of disclosure, FTSE assumes the worst, while MSCI and Sustainalytics assume performance within the industry norms. In another notable example, Alphabet is a leader in the industry according to MSCI (AA score) and Medium Risk according to Sustainalytics (320 out of 726 in its industry group).

2.2 Global Standards

UN Sustainable Development Goals

The Sustainable Development Goals (SDGs) are a part of the 2030 Agenda for Sustainable Development, which was adopted in 2015. This initiative includes 17 Goals which relate to such issues as poverty, inequality, and climate change among others. While the SDGs are not legally binding, the UN Member States have a responsibility to develop appropriate sustainable development policies. The private sector is also expected to contribute to achieving these goals, for example, businesses can contribute to the SDGs by incorporating the principles of the UN Global Compact, which are outlined below.

The UN Global Compact

The UN Global Compact is the largest global corporate sustainability initiative, counting over 9,000 companies and 3,000 non-business organisations worldwide. Signing up to it is voluntary, but it comes with mandatory disclosure responsibilities. Signatories are required to publish a Communication on Progress on an annual basis, disclosing their efforts to operate sustainably. By signing up to the UN Global Compact, a company takes on responsibilities in relation to human rights, labour, environment and anti-corruption. If a company does not report or fails to implement the Principles, it may be removed from the list of signatories.

Ten Principles include:

→ Businesses should support and respect the protection of internationally proclaimed human rights; and
→ make sure that they are not complicit in human rights abuses.
→ Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;
→ the elimination of all forms of forced and compulsory labour;
→ the effective abolition of child labour; and
→ the elimination of discrimination in respect of employment and occupation.
→ Businesses should support a precautionary approach to environmental challenges;
→ undertake initiatives to promote greater environmental responsibility; and
→ encourage the development and diffusion of environmentally friendly technologies.
→ Businesses should work against corruption in all its forms, including extortion and bribery.

UN Principles for Responsible Investment (UN PRI)

UN PRI was launched in 2006 and is now the world’s largest investment network on sustainable investment, counting over 3,000 signatories in 2020. UNPRI signatories represented over $8 trillion in assets under management in 2018 (across all asset classes). Equity investment counted for 39%, or $29.5 trillion of the total, with $12.9 trillion in passive investments.

The Principles for Responsible Investment state:

→ We will incorporate ESG issues into investment analysis and decision-making processes
→ We will be active owners and incorporate ESG issues into our ownership policies and practices
→ We will seek appropriate disclosure on ESG issues by the entities in which we invest
→ We will promote acceptance and implementation of the Principles within the investment industry
→ We will work together to enhance our effectiveness in implementing the Principles
→ We will each report on our activities and progress towards implementing the Principles

Signatories are required to report annually. The reports are assessed and compiled into an Assessment Report that provides indicator scores and section scores. PRI shares data with the other signatories, academic organisations and think-tanks via a data portal. The UNPRI publishes snapshot reports containing key indicators on a publicly accessible website. Following the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), the PRI introduced climate indicators as a part of its Reporting Framework. Reporting on a subset of the PRI climate indicators becomes mandatory from 2020.

UNPRI is voluntary, allowing investors to be flexible in how they choose to incorporate them into their strategy. While this flexibility is useful for investment companies that are just starting to adopt ESG practices, the vagueness of the rules allows some institutions become signatories and keep large fossil fuel investments. SquareWell Partners found that in 2019, 96% of the top 50 asset managers became signatories. They managed a combined value of $50.6 trillion, while global sustainable investment assets across five major markets constituted $30.7 trillion (Global Sustainable Investment Alliance, 2018). This illustrates that signing up to the UNPRI does not necessarily mean that signatories stop investing in non-sustainable assets.

34 Alicia McElhaney, When it comes to ESG, institutions don’t walk the talk, 2 October 2019. https://www.institutionalinvestor.com/article/t39d3d3219224jy/orb/When-It-Comes-to-ESG-Institutions-Dont-Walk-the-Talk
2.3 Disclosure Frameworks

GRI – Global Reporting Initiative

GRI is the oldest corporate sustainability framework. It was established in 1997, and is the most widely adopted framework, with 75% of the world’s largest companies using it for their sustainability reporting. GRI standards are aimed at a broad range of stakeholders and therefore include a wide range of disclosure for a broader audience. They include general and topic-specific standards, which include economic, environmental, and social elements. Companies using the standards can employ them to produce a comprehensive sustainability report or choose individual topics to target particular stakeholders or regulators. In that way, companies can identify topics that are relevant to their businesses and use an appropriate part of the GRI framework. GRI standards can be accessed here.

SASB - Sustainability Accounting Standards Board

SASB reporting standards were introduced in 2018. According to the SASB website, 139 companies are currently reporting with SASB standards including BlackRock, Estee Lauder, Goldman Sachs, and Visa. These standards were developed based on consultations with SASB’s Investor Advisory Group which includes leading investors such as State Street, BlackRock, and Vanguard. SASB provides industry-specific standards that identify a baseline set of financially material sustainability topics and associated metrics. Financial materiality is defined as an issue that is likely to impact the financial condition or operating performance of a company. Disclosures based on the SASB framework might more likely be of interest to some investors. Big asset managers such as State Street use the materiality framework provided by SASB in their own evaluations. In addition, Bloomberg developed a SASB ESG index family, which uses an R-Factor score developed by SSGA based on SASB standards.

SASB sustainability topics fall under five broad themes of environment, social capital, human capital, business model and innovation, and leadership and governance. From there, the SASB Materiality Map provides 77 industry-specific standards. The SASB standards are intended to be a guide that allows a company using it to decide which standards are relevant, which disclosures are material for its business, and what it wants to report. SASB standards can be used to complement other reporting guidelines such as GRI and TCFD. In addition, amid calls for standardisation of ESG disclosure standards, SASB and GRI recently announced a collaboration. This initiative aims to illustrate how to combine the two reporting standards, by providing companies with resources and communication materials.

SASB standards can be accessed here. More information about GRI and SASB collaboration can be found here.

TFCD – Task Force on Climate-related Financial Disclosures

TFCD disclosure recommendations were released in 2017, offering voluntary guidelines for climate-related financial risk disclosures. According to the TFCD status report from June 2019, 340 investors with $34 trillion AUM are requiring companies to report under TFCD disclosures. The same report indicates that 76% of respondents use their disclosures to inform their financial decision-making (investing, lending, underwriting, and other financial matters). However, at the same time, the implementation of climate-related disclosures is happening at a somewhat slower pace. To accelerate change in the UK, in July 2019, the government announced that it expects all listed companies and large asset owners to provide TFCD disclosures by 2022 (as part of the UK Green Finance Strategy).

The climate-related risk in TFCD disclosures refers to two risk categories:

- Risks related to the transition to a lower-carbon economy
- Risks related to the physical impacts of climate change

The first category includes policy, legal, technology, and other risks that can materialise in the process of climate adaption or mitigation. The second includes risks arising from events such as extreme weather and other adverse climate change effects.

Core elements of TFCD disclosure include:

- Governance – governance arrangements related to climate-related risks and opportunities
- Strategy – actual and potential impacts of climate-related risks and opportunities on the business, strategy, and financial planning
- Risk management – how the business identifies, assesses and manages climate-related risk
- Metrics and targets – metrics and targets used to assess and manage climate-related risks and opportunities

An overview of TFCD standards can be accessed here.

5.4 Investors

ESG investors are not just guided by ESG ratings’ scores and companies’ disclosures. Typically, most investors construct their own ESG evaluation model. They can take into account ESG scores from a combination of ratings providers alongside other information including disclosures, media, NGO reports and other sources. This can make for a more comprehensive evaluation approach for asset managers, but at the same time, it leaves issuers in the dark with regards to ESG considerations. Asset managers can also take an exclusionary approach to ESG with some of their funds, entirely avoiding industries such as fossil fuels, tobacco and controversial weapons.

For example, the State Street’s R-Factor that, as mentioned above, evaluates data from several ESG data providers (Sustainability, ISS-ESG, ISS-Governance, Vigeo Eiris). The evaluation is done with an industry-specific approach, using the SASB (Sustainability Accounting Standards Board) materiality map and national corporate governance codes. Another asset manager, Lyxor, uses research provided by MSCI, Equaleap and Climate Bonds Initiative to inform their ETF construction. Vanguard applies a variety of approaches across their ESG funds. The Vanguard Global ESG Stock Fund evaluates how the company integrates material ESG risks and opportunities into its strategy (some of the factors include long-term ESG risks and opportunities, increased transparency into ESG practices, aligned managerial incentives, governance practice and appropriate resource allocation).
Corporate culture, employee engagement, and adaptability of a company are also evaluated. The Vanguard ESG International Stock ETF takes an exclusionary approach: adult entertainment, alcohol, tobacco, weapons, fossil fuels, gambling, nuclear power and companies that do not meet the UN Global Compact standards or diversity criteria are excluded. Active investors apply an even larger variety of ESG investing approaches, typically using ESG data from several of providers and supplementing it with their own research and analysis. We provide more detail on the active managers’ approaches to ESG evaluation in Part II of the White Paper.

5.5 Regulators

EU

The European Green Deal

The European Green Deal is a large-scale set of regulatory initiatives that was presented to the public in December 2019. It was developed by the European Commission (EC) based on the UN Sustainable Development goals and the Paris Agreement. This project is aimed at making Europe climate neutral by 2050. An essential part of this goal is creating a sustainable economy. The EU sustainable finance strategy aims to support this transition by directing capital towards sustainable investment.

Some of the main obstacles to facilitating sustainable investment is a lack of universal standards that define what economic activities could be considered sustainable, or a uniform sustainable disclosure standard. To overcome this, EU regulators needed to:

- introduce a new classification system that defined what investments could be named ‘sustainable’, which could serve as a foundation for disclosures and green standards on the EU level;
- ensure that companies make sustainability disclosures that could be evaluated by investors;
- ensure that the investors disclose their sustainability practices.

A proposal for a regulation to establish a framework to facilitate sustainable investment was introduced in 2018. EU regulators reached a political agreement on the Taxonomy Regulation, in December 2019. The Taxonomy constitutes a key part of the new regulatory regime. It defines which activities can be considered sustainable and can facilitate a transition to a climate-resilient economy. The Taxonomy Regulation provides a legal framework that will be supplemented with delegated acts throughout 2021 and 2022. More detail on the Taxonomy is provided in the section below.

The Technical Expert Group (TEG), established by the EC in 2018, has been working on developing technical screening criteria within the Taxonomy framework. The TEG Final Report, released in March 2020, provides comprehensive implementation guidance for companies and financial institutions. It can be accessed here.

Aside from the Taxonomy Regulation, the EU has introduced other regulatory measures aiming to accelerate sustainable growth and improve transparency sustainability disclosures. They include new disclosure requirements for financial institutions and large public companies, climate benchmarks and an EU Green Bond Standard. This comprehensive set of initiatives focused on entrenching sustainability sets a global standard for ESG-related regulation. The following sections outline the central parts of the new regulatory regime in more detail.


Taxonomy

Common classification of sustainable activities is an essential prerequisite to creating a financial system centred on sustainable finance. The Taxonomy aims to create such a classification with a goal to facilitate transition to a low emission, climate-resilient economy. For this purpose, the Taxonomy establishes six environmental objectives, which include:

- Climate change mitigation
- Climate change adaptation
- Sustainable use of water and marine resources
- Transition to a circular economy
- Pollution prevention and control
- Protection and restoration of biodiversity and ecosystems

To be considered environmentally sustainable, an economic activity must fulfil the following requirements:

- Make a substantive contribution to one of the aforementioned six environmental objectives
- Do no significant harm to the other five objectives
- Meet minimum safeguards (OECD Guidelines on Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, including the International Labour Organisation’s Declaration on Fundamental Rights and Principles at Work and the International Bill of Human Rights)
- Comply with technical screening criteria

Economic activity can also be recognised as substantially contributing to environmental objectives if it directly enables another activity to make a substantial contribution to one or more environmental objectives. To use an example provided in the TEG Final Report, this could be manufacturing low carbon products that improve the environmental performance of another activity. To qualify, the enabling activity must not cause harm to environmental objectives.

It should be said that the Taxonomy, especially with regards to technical screening criteria, will necessarily require revisions and updates with further scientific developments on sustainability and climate change solutions. The Platform on Sustainable Finance, which is being set up by the EC, will be tasked with updating and reassessing the Taxonomy. In that way, the Taxonomy will be a dynamic, changing regulation, which means that companies under its scope will have to keep an eye on any relevant revisions.

The Taxonomy Regulation is aimed at three groups of users: financial market actors, large public-interest companies who report under the Non-Financial Reporting Directive, and EU Member States. For financial market actors, the Taxonomy requirements supplement obligations in the Regulation 2019/2088, adding to the rules on the pre-contractual disclosure and periodic reporting. Relevant products carrying the Taxonomy obligations include UCITS funds, AIFs, portfolio management, pension products, insurance-based investment products, securitisation funds, private equity funds, and index funds.

For example, Article 5 of the Taxonomy Regulation requires financial market actors to communicate, as part of their pre-contractual disclosure for the sustainable investment products:

- information on the environmental objective to which the investment contributes
- how and to what extent the investment qualifies as Taxonomy-aligned.

If an investment is not marketed as sustainable or having environmental or social characteristics, it should either have a Taxonomy disclosure or a disclaimer stating that the investment does not consider the EU criteria for environmentally sustainable economic activities.
The implementation of the Taxonomy will require market participants to conduct a five-step checking process:

- Identify the activities that could be eligible
- For each potentially eligible activity, verify whether the company or issuer meets the relevant criteria
- Conduct due diligence
- Calculate alignment of investments with the Taxonomy
- And prepare disclosures at the investment product level

Large public-interest companies who are captured under the Non-Financial Reporting Directive will need to disclose:

- The proportion of their turnover derived from Taxonomy-aligned activities
- The proportion of the capital expenditure, and operational expenditure related to assets or processes associated with Taxonomy-aligned activities.

Companies should outline how, and to what extent their activities are Taxonomy-aligned. To fit the criteria, the activities in question should not cause significant harm to any of the six environmental objectives. Providing disclosures on turnover will allow investors to ascertain the percentage of their investments in Taxonomy-aligned activities, whereas information on the capital expenditure helps them to evaluate the company’s strategic approach to sustainability.

Finally, the Taxonomy will be used by the EU Member States in developing national standards for green financial products or bonds. The Taxonomy is the most significant part of the Action plan, providing clarity on the definitions of sustainable activities, and is closely linked with the rest of the EU initiatives on sustainable finance. It provides a basis for EU standards, labels, prudential requirements, and sustainability benchmarks. In preparation for the Taxonomy coming into force, the UN PRI have recently invited several signatories to implement the new requirements and share their experience in form of case studies. Many of the participating financial institutions employed Bloomberg’s solutions in their assessments.45

Climate Benchmarks

Regulation (EU) 2019/2089, introducing the new climate-focused benchmarks, passed in 2019 and was applicable from April 2020. This Regulation introduces two new EU benchmarks: EU Climate Transition Benchmark (EU CTB) and EU Paris-Aligned Benchmark (EU PAB). These benchmarks aim to respond to market demand for comparable climate-related benchmarks with transparent and reliable methodologies. This initiative is intended to discourage greenwashing by setting clear standards on decarbonisation. Both benchmarks pursue similar objectives, with EU PAB having more stringent environmental standards.

The latest updates related to Benchmarks Regulation can be found here.

EU Green Bond Standard

The TEG report on the Green Bond Standard (GBS) was published in June 2019, followed by a usability guide in March 2020. Currently, the EC is conducting a consultation on the establishment of the Green Bond Standard which will run until 2 October 2020.

GBS is designed as a voluntary standard that can be utilized by companies inside and outside of the EU. While traditional bond issuances focus on financial indicators such as interest payments and credit risk, GBS emphasises the way funds are used (what is called a ‘use-of-proceeds’ approach). This creates greater transparency for investors who aim to finance genuinely sustainable projects.

Projects eligible under GBS should be aligned with the Taxonomy, which means that they should:

- Contribute substantially to at least one of the six environmental objectives
- Do no significant harm to any of these objectives
- Comply with the minimum safeguards
- Comply with Technical Screening Criteria

The usability guide for the EU Green Bond Standard, produced by the TEG and published in March 2020, can be accessed here.

Climate Disclosures

The EU has also introduced supplemental guidelines to the Non-Financial Reporting Directive on climate disclosures. The Non-Financial Reporting Directive applies to large public companies with more than 500 employees, covering around 6,000 companies in the EU. The revised guidelines improve transparency of climate-related information in line with the recommendations of the Financial Stability Board’s Task Force on Climate-related Financial Disclosures. The Non-Financial Reporting Directive requires companies to disclose information on environmental, social and employee matters, respect for human rights, and bribery and corruption, to the extent that such information is necessary for an understanding of a company’s development, performance, position and impact of its activities. The reference to impact introduces a new element into the assessment of materiality of non-financial information. The Non-Financial Reporting Directive adopts a double materiality perspective:

- Firstly, it considers the concept of financial materiality, in terms of factors influencing a company’s financial value.
- The second dimension of the double materiality perspective refers to the environmental and social impact of a company’s activities.

The new supplemental guidelines suggest that companies make climate-related disclosures for the five reporting areas outlined in NFRD. These areas include company business models, policies and due diligence, outcome of policies, risks and risk management, and KPIs. For example, under the business model area, a company should report on the impact of climate-related risks and opportunities on its business model.

A summary of climate-related guidelines can be found here.

Regulation on sustainability-related disclosure in the financial services sector (SFDR EU 2019/2088)

Regulation 2019/2088 was adopted in 2019 and is applicable from March 2021. It aims to improve transparency by imposing an extensive set of sustainability disclosures on relevant financial firms (which includes MiFID, AIFM and UCITS firms). For example, firms under the scope of SFDR should make the following pre-contractual disclosures:

- how they integrate sustainability risks into their investment decisions or investment advice
- potential impact of sustainability risks on the returns of their products
- how the financial products consider adverse impacts on sustainability factors (such as environment or society)

Asset managers are also required to disclose their policies on integration of sustainability risks in their investment decision-making process and investment advice on their website. The SFDR is a significant contribution to the EU’s effort to embed sustainability considerations in the investment process. It is further reinforced by the amendments to MiFID II, UCITS and AIFMD rules, discussed below.

Regulation on sustainability-related disclosures in the financial services sector is available here.
ESMA work on sustainable finance and amendments to sectoral Directives

As a part of the Sustainable Finance Action Plan, the European Securities and Markets Authority (ESMA) will integrate ESG factors across all of its activities. This means integrating sustainability considerations into the Single Rulebook, supervisory convergence (working on a common approach to ESG implementation with national authorities) and direct supervision. ESMA will also monitor ESG market risks and include environmental systemic risk in its stress testing. Monitoring will be based on EU-level quantitative and qualitative indicators, which will be drawn from MiFID II, EMIR and other regulatory data.

The European Commission also developed amendments that integrate ESG risks and considerations into MiFID II, UCITS and AIFMD regimes. These amendments incorporate sustainability requirements into organisational structures, controls, and decision-making processes for relevant investment firms. This includes making sustainability part of the responsibilities of senior management, reporting lines, investment due diligence process, risk management, among other requirements.

Extensive disclosure requirements introduced by SFDR and the amendments to MiFID, AIFMD and UCITS rules are expected to put significant pressure on investors to increase their commitment to sustainability. This pressure applies to all levels from integrating sustainability structures within the firm to investment decision-making and investment advice. Notably, the amendments to the MiFID II Suitability Assessment puts more emphasis on their responsibility to take into account clients’ sustainability preferences when offering investment advice. The express language used in the amendments serves to put sustainability at the centre of the investment process, which is likely to have a positive effect on investment into ESG stocks.

The UK

The Stewardship Code

The increasing push towards ESG in the UK has manifested in the latest edition of the Stewardship Code, aimed at asset managers, asset owners, and service providers. This version of the Code came into effect in January 2020. The concept of sustainability is explicitly included in the Code’s definition of stewardship:

‘the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment, and society.’

The Stewardship Code also includes a requirement to disclose how effective signatories have been in serving the best interests of clients and beneficiaries (leading to sustainable benefits for the economy, the environment, and society) and how they have identified and responded to market-wide and systemic risks (including climate change) (Principles 1 and 4). It also requires them to systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities, and disclose the issues they have prioritised for assessing investments (including ESG and climate change issues) (Principle 7).

A more explicit approach to ESG stewardship and disclosure in the new Stewardship Code is another factor nudging investors towards more active engagement on sustainability-related issues. At the same time, this version of the Code attracted some criticism for taking a less stringent stance on ESG than its draft version, which included more ESG-related provisions with some of them being mandatory.46

The latest edition of the UK Stewardship Code can be accessed here.

Green Finance Strategy

In response to the increasing urgency surrounding climate change and following the recommendations of the Green Finance Taskforce, in 2019 the UK government announced the Green Finance Strategy. It set out 3 key elements:

- **Greening finance** – integrating environmental risks and opportunities into financial decision-making and ensuring a robust market for green financial products
- **Financing green** – directing finance to support the delivery of the UK’s carbon targets and clean growth, as well as relevant international objectives
- **Capturing the opportunity** – ensuring that the UK financial services capture the opportunities that arise from ‘greening of finance’ and ‘financing green’

Through this Strategy, the government aims to steer the private sector towards financing sustainable growth goals. To this end, the UK’s financial regulators (PRA, FCA, FRC, and TPRA) will integrate climate and environmental concerns into their supervisory approach. For example, in February 2020 the Financial Reporting Council (FRC) has announced a review of how companies and auditors approach disclosures on climate change, including the adoption of TCFD.

Facilitating the adoption of the TCFD disclosure recommendations is an important part of the Strategy. All listed companies and asset owners are expected to be TCFD-compliant by 2022.

The government will also be supporting the development of further climate-related transparency requirements for private actors.

The Green Finance Institute (GFI) was established to support the delivery of the Strategy. It is designed to serve as a forum for collaboration on green finance between the public and private sectors. The goal is to mobilise capital to facilitate the transition to a sustainable economy. The first of those collaborations is the Coalition for Energy Efficiency of Buildings - an initiative to develop the market for financing zero-carbon and climate-resilient buildings in the UK announced in December 2019.

More information on the UK Green Finance Strategy can be found here.

US

The rapidly expanding proportion of ESG assets under management and the active involvement of large pension funds was bound to attract attention of the US regulators. In recent months, the Securities and Exchange Commission has shown concern with the lack of transparency in the market. This is evident in the recent calls from Elad Roisman, a senior SEC official, for asset managers using ESG labels to provide clearer explanations on how their investment strategies fit those labels.

Another notable development is the US Department of Labour’s proposed clarification of the fiduciary duties of pension plans subject to the Employee Retirement Income Security Act 1974, published in June 2020. This proposal codifies the DoL position that fiduciaries should make investment decisions based purely on financial factors. In their view, the focus on ESG considerations might undermine the focus on financial return. To avoid that, the new rule provides that a fiduciary cannot sacrifice return or accept additional risk to promote any non-financial goal. However, at the same time, the proposal allows consideration of ESG factors if those factors present a ‘material economic investment consideration under generally accepted investment theories’. Additionally, if after an evaluation of two portfolios they appear indistinguishable in their economic characteristics, a fiduciary can make a choice based on a non-financial factor. The DoL states that this situation is unlikely to occur, and when it does the new rules require additional documentation detailing the selection process.

The DoL’s presumption that consideration of ESG factors comes at the expense of financial returns goes against the current trends in the asset management industry, which largely favours ESG. This

can be illustrated by some of the biggest American pension funds regularly speaking in favour of ESG investing, such as BlackRock and State Street. In response to the proposed changes, BlackRock CEO Larry Fink pointed out that ESG factors align with financial objectives and serve to provide investors better returns in the long-term. Fidelity, Putnam Investments and Legal & General were also among the investors speaking against the proposals.

The intention behind the new proposed rule also stands in opposition to the approach of EU regulators, who aims to direct capital towards ESG assets with the measures introduced under the Sustainable Finance Action Plan. This illustrates the difficulties there are on the way to international regulatory convergence of ESG, which would be desirable for many global businesses.

Conclusion

Should issuers consider ESG in their strategy? If so, how?

- ESG is a fast-developing field, despite existing problems
- The EU and UK are integrating ESG in their regulatory systems
- ESG plays an increasing role in the investment process of most investors, as a result of client demand, societal developments and mounting regulatory pressure
- Transparency and meaningful integration are key for companies wanting to improve their ESG performance
- Therefore, ESG is an essential part of a long-term strategy for any company

Was Warren Buffet right in saying that government-enforced regulation should play a large part in establishing an ESG-friendly market framework? Existing research on the link between ESG strategies and profit growth is not enough to convince all investors in the face of inconsistent data and murky definitions. At the same time, the reality of climate change and the significance of the climate-related risks is undoubtedly recognised as a material issue by the investment community. Regulation on ESG is necessary to address the lack of universal standards, which not only confuses companies, investors and the public, but also prevents any meaningful enforcement of the existing ESG initiatives. The voluntary nature of existing ESG disclosure frameworks, despite strong investor support, weakens their effectiveness in making a material impact on the climate.

In clear recognition of these issues, regulators in the UK and EU are working on large scale initiatives to redirect capital flows towards sustainable businesses and achieve a low carbon economy. Size of the ESG investments is growing every year; the number of shareholder proposals on climate and other ESG issues is also increasing exponentially. Social issues, and in particular, labour relations are attracting increasing attention as a result of the Covid-19 pandemic. Some large investors might take longer to meaningfully integrate ESG into their strategies, holdings, and engagement (particularly due to their size and significant holdings in highly polluting industries), but the continuous media scrutiny, societal shift and increasing regulatory pressure will inevitably take effect. In particular, the implementation of sustainability considerations into the EU financial system, introduced under the Green Deal, will hasten the pace of ESG integration for many investors.

Considering these developments, issuers that take a long-term view of their business must start taking ESG issues seriously. Meaningful integration of ESG into the company strategy and disclosure is essential for risk-proofing the business against climate risks, attracting the growing pool of ESG finance, and retaining existing investment. Improving ESG-related company processes and policies is also likely to improve profitability due to increased employee satisfaction and retention, a better risk profile, attracting and retaining eco-conscious customers, and a more positive public profile. Finally, acting on ESG now will ensure seamless compliance with climate regulations that will only become more stringent as governments try to combat climate change.

Issuers wanting to improve their ESG record can look to existing standards, such as SASB or GRI, as a guide. Investors tend to welcome comprehensive ESG disclosure, with many major asset managers favouring SASB. TFCD guidance is another increasingly important regulatory framework with strong support among the investor community and has regulatory backing. An industry-specific approach to key ESG risks and opportunities will allow issuers a more detailed understanding of the issues they need to address in relation to their business, and what the options are for the development of sustainable products and services. Between the different reporting frameworks, ratings agencies and various evaluation models used by investors, the only reliable way to improve companies’ ESG practices is to create a tailored strategy that addresses material ESG risks unique to their industry and business. Effective application of such a strategy is more likely to be welcomed by investors than a box-ticking approach aimed at a particular ESG rating or an evaluation model. Meaningful integration of ESG should be viewed not as a burden, but as an opportunity to adapt and ensure that a business has a future in the low emissions economy.

# Part 2: Market Perspectives

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Section 1
General discussion on ESG

1.1 Definitions and understanding of ESG

1.1.1 Issuers understanding of ESG

The majority of listed companies view ESG as understanding, addressing, and reporting on risks and opportunities that environmental, social, and governance factors bring to their business operations. Some (33%) issuers prefer to explain ESG through the concept of sustainability, which highlights the consideration of long-term impacts on the business model in an integrated fashion. Others understood ESG as putting a greater focus on stakeholders such as employees, consumers, and the wider society, in addition to shareholders. Greater focus on ESG was also linked to the need to maintain a license to operate for some companies. This concept refers to a need to maintain a positive perception and acceptance of a business in the eyes of society.

Below are some comments from corporate IR managers on their broad view of ESG as a concept.

Diego Martínez, Senior IR Manager at Iberdrola, highlighted how ESG expanded the scope of attention from shareholders to the wider stakeholder community:

“ESG is a way of deciding, from all participants in the market, from corporates to investors to advisors, that the focus will not be just on shareholders like it was in the past, but also on stakeholders.” He went on to say, “Stakeholders comprise not only the shareholders, but society, employees, suppliers; everyone involved in the activities surrounding a company and the broader economy.”

Daniel Bohsen, Head of IR at Novo Nordisk, views ESG through the lens of sustainability:

“For Novo Nordisk, ESG is all about how we manage and measure progress towards being a sustainable company, for us to make sure that we create long-term value for patients, employees, partners and shareholders by acting responsibly financially, environmentally and socially.”
1.1.2 Investors understanding of ESG

Investors discussed ESG in context of various investment approaches involving ESG considerations. According to 92% of the investors we interviewed, the most popular ESG investment approach considered ESG factors as part of their integrated investment process, with ESG factors as important as financial metrics. This approach is referred to as ESG integration. The mounting evidence of climate change and the changes in societal attitudes towards the environment in the last decade are some of the main factors that make ESG essential to company evaluations. Many investors link the way companies address their impact on the environment, local communities, their relationships with employees, consumers, and the wider society to the resilience of their business models. A large proportion of investors (69%) say that incorporating ESG factors in their investment analysis help them to form a more long-term, forward-looking view of an investment proposition.

Below are various comments from investors on the importance of ESG in the investment process.

David King, Head of ESG Stewardship at Fidelity Investments, points to the link between ESG and the resilience of companies in the face of future resource scarcity:

“We live in a world of finite resources, and how companies manage the use of their resources and their impact has an influence on their success and competitiveness in the long term.”

Andrea Carzana, ESG European Equities Fund Manager at Columbia Threadneedle Investments, shows that ESG and financial analysis together, help to form a complete view of a company:

“They are two sides of the same coin: one side is the financial fundamental analysis, where we look at the competitive advantages of each company and how they impact the company’s growth, cash flow and the return on capital employed. At the same time, it is important to look at non-financial data, and that is the ESG element – We look at internal governance practices, environmental policies and those elements that are in control of management. Controversies are pressure points on management and how they react is a very good window into the culture of management. We are not only concerned about the controversy itself, but more about the management reaction to it and what they did to mitigate it, to make sure it won’t happen again. We say that those are two sides of the same coin because by looking at non-financial and financial factors, you can actually invest in a company for the long term.”

Ashish Ray, Head of Governance and Sustainability at Jupiter Asset Management, talks about the connection between sustainability and long-term financial performance:

“Stewardship is about our clients’ long-term interests and represents our connectivity to the economy and wider society. We consider the leadership at investee companies and examine risk factors that focus on the sustainability of the business model. This may involve the consideration of environmental issues, but it is not exclusively tied to this area. Sustainability is much broader in terms of identifying the risks and opportunities for companies. We are thinking about long-term issues and how businesses navigate future challenges and treat stakeholders like employees, customers and suppliers, all of which underpins their future growth potential.”

Most investors say that the important environmental, social, and governance factors differ depending on the industry and the individual company. In terms of materiality, which we discuss in more detail later in the report, commonly mentioned individual factors include carbon emissions, water consumption, pollution, among others.

Investors expressed that corporate governance factors have historically been a well-understood part of their investment analysis. However, in recent years the focus has turned to environment and social concerns with the “Greta Effect” in 2019 and Covid-19 in 2020. Labour relations became even more important in light of the crisis, with investors focusing on the way companies managed their staff numbers and compensation. Covid-19 also put a new focus on governance. Companies had to consider the balance between paying dividends and senior management bonuses and the measures they had to take with regards to their workforce.

Maria Lombardo, European Head of ESG Client Strategies at Invesco, when speaking on the main factors she considers important within ESG, pointed towards environmental concerns such as climate change, waste, water, pollution. Those issues are important to all companies but crucial to companies in high emissions industries, such as mining, oil, and gas, that will have to transform their business model to continue to operate. In the context of social, she included factors related to
... an engaged employee base that has a sense of purpose is very important to the long-term performance of a company.

supply chain, human capital, including labour relations, health and safety and data privacy. In the context of governance, she mentioned board diversity and remuneration.

May Jaramillo, European Head for Sustainable and Impact Banking at Barclays Investment Bank, pointed out how the Covid-19 crisis reframed the perception and importance of social factors for investors, making it a more material consideration. She explained that, when companies spoke of social issues before this crisis, it was in the context of their corporate responsibility initiatives, and that wasn’t connected to the possibility of losing investors:

“Pre-COVID, when corporations discussed the ‘S’ (Social), they often pointed to corporate philanthropy, e.g. a school they opened in South America. It wasn’t really tied to the investment story, e.g. risks that can lead investors to stop holding your stock. Covid has brought that into the picture.”

Tanja Seiler, IR Manager at BMW, highlighted that Covid-19 concerns impacted dividend pay-out and management compensation this year:

“The dividend is a way of sharing the company’s success with our shareholders. It is distributed retroactively for the prior financial year. Providing reliability for our investors builds trust and ensures our company remains an attractive long-term investment. The economic consequences of Covid-19 will be reflected in dividends, management bonuses and employee profit-sharing for 2020. Accordingly, the consequences will affect our shareholders, our employees as well as our management.”

Finally, David King (Fidelity) spoke about how the Covid-19 crisis increased the degree of public scrutiny on labour relations:

“Customers and the public placed higher scrutiny on how companies were treating their employees throughout the crisis. The number of companies actively trying to manage the rapid progression of change, in the hope to keep employees engaged throughout the crisis, was very important and meaningful. We have seen through academic studies that an engaged employee base that has a sense of purpose is very important to the long-term performance of a company.”

Climate change and reducing carbon emissions was commonly identified as a material factor by 75% of issuers across different industries. Companies cited efforts to reduce their manufacturing and transportation footprint, with several having goals to become carbon neutral and carbon negative within the next decade. Reducing carbon emissions does not only involve adapting business operations of a company but also its supply chain. This makes decarbonisation especially difficult for large companies with extensive and complex supply chains. The supply chain was generally referred to as an integral factor in the context of achieving most ESG goals, including reducing carbon emissions and upholding environmental and labour standards.

Nick Stone, IR Director at AstraZeneca, spoke of AstraZeneca’s approach to managing the impact of their supply chain:

“When you look at the scope of emissions at AstraZeneca, obviously those are under our direct control. So clearly, we have a substantive piece of work to do around our suppliers. …We’re big advocates of the science-based targets initiatives, we’ve signed up to the most rigorous 1.5 degrees, and we are asking them to do the same. And we are actually ranking our suppliers now, whether that is gold, silver, or bronze, in terms of achieving the categories that we need them to achieve as it relates to the contribution to our own sustainability challenges.”

As mentioned above, material ESG factors depend on the sector and the individual company. Issuers taking part in this White Paper spoke of several important ESG factors across different industries. In the pharmaceuticals sector, some of the material factors mentioned included access to medicine, health and safety, manufacturing footprint, bioethics, and transportation impact. Factors material for the automotive industry included climate change and the circular economy. Consumer products companies mentioned environmental challenges, labour standards, human rights, health and safety, consumer data protection, plastic packaging, responsible sourcing, and nutritional value of their products. Industrial and energy sectors cited pollution, health, and safety, employee relations, impact on local communities, energy consumption, biodiversity, water security, human rights, anti-corruption, water security. Material factors identified by companies in the financial and IT sectors were employee relations, financial crime, gender diversity, data privacy, cybersecurity, customer satisfaction, disclosure, board diversity, and independence.

1.1.3 ESG investing strategies

Investors discussed various strategies in the context of incorporating ESG into the investment process. ESG integration, referred to in the previous section, was commonly described as a process where material ESG factors are incorporated alongside the financial analysis, where ESG factors add depth to a comprehensive evaluation of a company. ESG integration was adopted or is in the process of being adopted by the majority of investors (85%), across all asset classes. In addition to incorporating ESG considerations into their standard investment process, many investors have specific ESG-focused products. For these products, the standard of sustainability practices required of the investee company is typically higher.

Maria Lombardo explained the ESG integration process at Invesco:

“When we consider ESG integration – you want to have ESG factors alongside financial factors in the investment process. They do not just apply to an investment fund that has to be ESG-focused; it applies anywhere. …Invesco have a target of 100% of our investment funds integrated in three years (by 2023). We have to consider different degrees of integration, it’s a complex process that you have to introduce gradually.”
Some investors, as well as advisors, agreed with the view that ESG is an inclusionary investment approach, where stock-picking is based on positive selection and/or engagement, as opposed to the more exclusion-based approach taken by the ethical and SRI funds of the past, which tended to screen out companies engaged in tobacco, weapons, or other controversial industries. Some investors take ESG as an opportunity to identify companies that can be transformed to effectively address their sustainability challenges.

David King (Fidelity) spoke about the opportunities offered by industries in transition. He said, “We are in a world of more inclusionary strategies that are benchmarked to standard indices. Some industries might not be fully ESG sectors, but we are looking for companies that are taking this as an opportunity to transform their industry, their sector.”

Andrew Parry, Head of Sustainable Investing at Newton Investment Management, highlighted how companies that are not generally perceived as sustainable can gain excellent ESG credentials. He said, “If you keep coming back to thinking of ESG solely as a label, as a rating, then it will always tilt towards those companies with the biggest internal budgets for producing data just to get a good score. And that’s been a major problem, and that’s why naive ESG investors used to end up with a whole bunch of tobacco stocks. I’m not making a moral judgement, but most people buying an ESG labelled fund wouldn’t expect a tobacco stock in that fund.”

Impact investing was referred to as the more ‘purist’ form of ESG investing. This investment approach refers to investing in companies that make a measurable contribution to resolving societal or environmental issues, such as pollution or water scarcity. Impact investing offers a way to prioritise investing in companies that are making a tangible difference and is a rapidly growing investment strategy.

1.1.4 ESG investment universe

The overwhelming majority of investors (69%) agreed that the size of the ESG investable universe entirely depends on the definition of ESG. The approximations vary depending on the investment strategy chosen. Some pointed out that defining the ESG universe by looking at ESG-labelled funds would result in a significantly smaller number of the actual pool of ESG assets. This was linked to the popularity of ESG integration, described in previous sections. The prevailing view places integration as taking up the biggest portion of the ESG universe, with impact investing being significantly smaller (but growing quickly). SRI funds were said to remain a prominent, but smaller part of the universe.

Investors and advisors offered several ways to view the breakdown of ESG investment approaches. Clio Fitzsimons, Sustainable Investment Lead at Cazenove Capital, described the split between integration, sustainability, and the impact:

“... if you look at the managers who are integrating ESG data into financial metrics and investment decisions, that would now be about 75% of the market. If you are looking at more sustainable funds, or perhaps, thematic funds who are focused on the E or S, then your universe has just shrunk by a lot. If you are looking for the impact companies, companies that are producing a measurable impact on society, then the investment universe has shrunk even smaller.”

May Jaramillo (Barclays) also spoke of ESG integration attracting the majority of ESG assets:

“You can’t look at ESG AUM as pure impact, because then you get c $500bn, according to some estimates. It’s tiny. The number that we, as bankers, tend to focus on is ESG integration. And it doesn’t mean exclusionary-based. It just means laying over ESG analytical tools so you redefine your investment universe. That’s what we call ESG integration estimated at 44% of global AUM. That is both fixed income and equity.”

The views on defining the ESG universe through membership numbers of global sustainable investment organisations, such as PRI, diverged. Some investors thought that considering all the assets under management of the PRI members as ESG assets was the wrong approach. They expressed doubts that belonging to PRI signified the actual application of ESG in the investment process. Others thought it was a useful indication of ESG adoption.

1.1.5 Greenwashing

Greenwashing, or engaging in a superficial ESG marketing without making real changes, concerned both corporates and investors. With the ESG trend picking up steam in the last two or three years, investors spoke of many asset managers engaging in a superficial rebranding of their funds with ESG or SRI labels. Some said that with time, rebranding can translate into real change.

Clio Fitzsimons (Cazenove) said that greenwashing can change into genuine ESG integration:

“...when the momentum really picked up and when ESG became really important, managers have actually changed their processes and are now actually legitimately integrating ESG into their portfolios.”

This perspective was also applied to issuers, especially in the natural resources and other heavily polluting industries. Some companies that had initially adopted a marketing-focused ESG approach start making a genuine effort due to societal and investor pressure.
May Jaramillo (Barclays) illustrated how investors can facilitate adoption of better ESG practices:

“You see companies that started from thinking that all they have to do is put a little bit of money into the biofuel space, but soon after that their investors started coming out and asking – what is this going to do for your decarbonisation strategy? Are you aligned with Paris? Are those science-based targets? … Eventually, corporates will realise that lip service doesn’t work.”

Companies that continue to engage in greenwashing face increasing regulatory pressure and even the possibility of litigation.

Lucia Firth, Partner at Simmons & Simmons, commented on the dangers of exaggerating companies’ ESG achievements:

“There is a tendency for people to overemphasise green credentials that external stakeholders want to hear about. People have to be careful because before, sustainability was something that was put aside in a CSR report that no one really paid attention to. Now it is very much something that corporates and asset managers are focusing on. If a corporate or an asset manager is found to have misled people, they will use that as a lever, particularly if money has been lost. I think people need to take their ESG disclosure very seriously in a way it wasn’t before. Before, people might have overemphasised what they were doing, but now they need to make sure it’s genuine and it can be substantiated. Because if they do not, there is a risk of litigation.”

He went on to highlight the recent regulatory measures that address greenwashing in the financial industry:

“The European Sustainable Finance Disclosures Regulation (SFDR) that comes into effect in March 2021 has a core focus on combatting greenwashing by asset managers, pension providers and the like, by introducing stringent requirements for ESG related disclosures.”

Investors also noted that issuers’ attempts at greenwashing are becoming more and more transparent, with the ESG market maturing and accumulating knowledge and data. Investors are adapting their evaluation strategies in response to large companies dedicating time and resources to ESG marketing and disclosure without making tangible changes.

Robert De Guigné, Head of ESG Solutions at Lombard Odier Investment Managers, explains the methodology they’ve adopted to evaluate companies’ sustainability practices:

“We’ve seen companies having oil spills and on the other side, communicating on the fact that they planted five trees in the middle of a village. …To avoid being misdirected, we look at ESG information through their relative importance to the company’s activity and on a more dynamic aspect. For example, if a company attends ESG conferences, this would be a consciousness type of information, if it has set carbon reduction targets, this would be an action type and if it has reduced its carbon emissions this would be a result. In our ESG scoring methodology, we will give more importance to result and action types of information to keep focus on tangible achievements.”

Issuers and investors concluded that having a genuine ESG strategy is essential, especially considering the rapidly expanding number of asset managers who apply ESG integration across their assets. This means that the issuers now need to make sure that their ESG practices are effective to attract mainstream investment, as well as focused sustainability and impact funds. This was said to apply to all forms of financing: equity, fixed income, and traditional lending.
1.2 Importance of ESG

1.2.1 Impact of ESG policy

Most issuers (67%) agree that not having a comprehensive ESG policy can have a significant negative impact on a company. This is commonly linked to two factors. One is the increasing societal pressure to address the environmental and social challenges facing humanity. This pressure is expressed in the changing consumer sentiment, and NGO and media attitudes pushing companies to change. Issuers mentioned that flawed ESG practices can become a significant reputational risk and even an existential threat to companies in some industries.

The other factor that was discussed by the corporates was the changing investor sentiment. Many issuers (50%) mention that mainstream investors pay increasing attention to their ESG policies. Issuers observe that in the past, ESG was seen as a regional trend mostly practiced by investors from the Nordic and some European companies. Now it became a mainstream consideration that needs to be addressed and communicated to all investors.

Diego Martínez (Iberdrola) spoke of the change in investors’ attitudes:

“Most funds are increasingly introducing ESG factors, while four years ago it was only a trend followed by some French, German and Nordic investors. Over the last 18 or 24 months it has become the main trend among the largest funds worldwide, both private and sovereign.”

Lucian Firth (Simmons & Simmons) illustrated that companies now consider ESG factors in the context of corporate transactions and internal audit:

“Corporates are giving ESG factors serious thought in the context of M&A transactions. When parties are looking at each other’s M&A credentials, they are thinking about how that transaction is going to impact their ESG profile. It is becoming super mainstream. Other corporates are carrying out internal ESG audits, so that they can present themselves in the best possible light to investors. Sometimes this results in substantial changes, but in some cases it can look like box-ticking – does the firm have something to show for all their policies?”

Another concern that was discussed by issuers and investors was impending regulatory change. The regulatory standards around ESG are becoming stricter in many jurisdictions, with the EU Taxonomy being the most evident example. In this context, not having an effective ESG strategy can lead to costs from either having to implement one under a tight timeframe or having to face regulatory sanctions.

Changing societal attitudes to environmental and social issues also reflect on labour retention and hiring. Corporates thought that those who can demonstrate their commitment to ESG would have higher chances of attracting and retaining employees. This issue was especially relevant for hiring employees from the more environmentally conscious generations. Finally, corporates thought that paying attention to ESG issues will enhance a company’s risk management strategy, allowing it to identify and mitigate the risks arising from those issues.

Uwe Bergmann, Head of Sustainability Management at Henkel, illustrated that ESG is an essential element of adaptation to future challenges:

“It is going to have a massive impact on the world, on the global economy, one way or another. It can be resource scarcity, it can be political, regulations, consumer and investor sentiment, or a combination of all of the above. It can have different kinds of implications, whether it is climate, energy, water, materials. Everybody needs to make up their minds about what those trends will mean for them. That will depend on the sector they’re in, the country they’re in, and will also depend on their customer and investor base.”
John Armstrong, IR Officer at Nestlé S.A highlighted how increasing attention to ESG from investors and regulators creates new expectations for companies:

“Increased investor and regulatory interest in sustainability and consumer expectations around how a company manages ESG issues is shifting the scope of which actions and strategies might be considered material. Consumers in some markets are signalling to companies that they expect them to contribute to social goods, and not just minimize social bads. In a digital world, companies are increasingly under pressure to be more transparent.”

1.2.2 Cost of ESG execution

Is ESG only for companies that can afford it? The question of costs required to embed ESG in a company concerned most issuers. This is a pressing concern for mid, small, and micro-cap companies who don’t have the resources. At the same time, both companies and investors spoke of significant losses that underestimating the importance of ESG can lead to.

Several companies and investors pointed out that, now that ESG integration is becoming part of the mainstream investment process, cost of capital for companies that lack a competent ESG strategy will increase. The general opinion was that companies that do not address their ESG risks will find it increasingly expensive to obtain financing. That doesn’t just include ESG-focused funds, but also bonds and even bank loans.

Diego Martínez (Iberdrola) discusses the impact of a flawed ESG approach on obtaining funding from various sources from a long-term perspective:

“Companies with a poor ESG focus will bear higher cost of capital and costs of financing. Although the financial savings are not so clear in the current low financial costs environment (even negative), the gap will widen in the future. Regarding cost of capital, companies that base their strategic opportunities on their ESG strategy, like our Company, are and should benefit.”

Increased attention that is being paid by the wider society to environmental and social issues can place companies that do not consider ESG factors under significant reputational risk. This was mentioned to be especially pertinent in healthcare, consumer goods, and automotive industries. But ESG is no less essential for companies in other sectors. Every company in every industry has ESG factors material to their business models. Not addressing these issues is likely to have a damaging financial impact on a company.

Investors spoke about potential erosion of stakeholder relationships and various other risks that could stem from companies disregarding ESG.

Armin Peter, Head of Sustainable Banking EMEA at UBS, compared the magnitude of change brought by ESG to the tech boom:

“ESG change is as big as tech was. Once regulation starts, you cannot stop it. Also, every business has been looking for more growth, but we are now at a point where it’s not only about growth but sustainability of your business at a time where the next generation is shaping markets & products. That means you need to look backwards and understand how your business can continue to exist, not in the short term but in the long term. You also need to engage with the juniors and the next generation to understand how you need to position your business going forward.”

Nick Stone (AstraZeneca) highlighted the need for action on ESG:

“...in today’s society, you cannot take a position of no action. I think, regardless of the sector, regardless of the challenges that you’ve got, you’ve got to do the right thing in terms of making an impact on people that you work with, whether they’re partners, whether they’re customers, all the way through to advocating for change through governments, etc.”

Robert De Guigne (Lombard Odier) outlined potential risks that may arise from material ESG factors:

“Sustainability challenges obviously affect different industries unevenly, which requires a very detailed assessment of sectoral risks. The main risks may arise throughout a company’s value chain, from the supply chain management to the interactions with all stakeholders in direct operations, as well as through the impact of products sold. For industries with a long and complex supply chain, including natural resources sourcing or manufacturing processes in countries with low production costs and weak legislations, human rights violation and environmental degradation may represent major risks. For players involved in mobility or energy solutions, compliance with greenhouse gas reductions goals and innovation in clean technologies may be crucial. Good management of ESG issues comes at a cost to the company, but poor management of these risks can be much more painful: operational inefficiencies, regulatory sanctions, consumer disinterest, delays in new investments, and even business closures.”

My-Linh Ngo, Head of ESG Investment at BlueBay Asset Management, thought that maintaining good stakeholder relationships is integral for success:

“...for me, accounting for ESG just makes good business sense. If you think about, all businesses are made up of people or different stakeholder groups. Now these could be internal, like your staff; or external, like your customers, competitors, regulators or people in the local communities the company operates in. Understanding the nature and quality of those relationships and managing these to enhance them is not an optional add-on, it’s actually core to your business. If you don’t manage these intangibles as it were – these could get degraded - and could then have a negative impact on the company’s long-term financial sustainability.”
Issuers spoke of resource-related problems they can encounter on their ESG integration journey. Some viewed disclosure as an especially expensive aspect, while others thought that tangible integration of ESG into the production process takes up the most resources.

Vladimir Zhukov, Vice President IR at Nornickel, spoke of the costs involved in implementing ESG measures in a high-emissions sector:

“When you install new equipment that helps to reduce emissions, operating that equipment incurs cost. It’s not only that you have to afford investment into these things, you also have to be able to afford running that equipment and the expenses that come with it.”

Teodora Bozhilova, IR Manager at Wienerberger, thought that all companies can implement valuable ESG measures, even if they can't afford to advertise their efforts:

“I think that every company can do ESG independent of their size. Every company can make a positive impact on the environment and society, and every small impact counts. It’s more the “ESG marketing” which is becoming a challenge especially for smaller companies – e.g. engaging with investors, rating agencies and the topic around the non-financial reporting is becoming very resource intensive.”

Camilla Johansson, Head of Sustainability at Handelsbanken, spoke about problems that need to be addressed to improve quality of ESG disclosure:

“To reach full disclosure, ESG data needs to be much more available than it is today. And to reach a level of acceptable comparability we need common standards. These are issues that need to be solved in order to move forward.”

Issuers and investors discussed several ways to effectively address ESG with fewer resources.

Suggestions included:

→ Making sure a company has a detailed understanding of their business and its impact on the world
→ Ensuring transparency around ESG practices by putting as much data as possible on the company website
→ Prioritising ESG issues that need to be addressed and dedicating available resources towards the most material factors
→ Concentrating on the impact of ESG policies and not the marketing around it

Costs involved in setting up and implementing an ESG strategy can differ depending on the industry. The amount of resources required to implement an ESG in the tech industry would be lower than that of an oil or utility company. At the same time, some investors stated that for companies in carbon-intensive industries, such as energy or transport, reducing their emissions is even more crucial.

Yo Takatsuki, Head of ESG Research and Active Ownership at Axa Investment Managers, highlighted that companies from high-impact industries need to make a genuine effort to address their ESG challenges:

“If you’ve got a very high-impact business, and all you’re saying is that you are going to meet minimum regulatory hurdles, and the rest of the costs is just going to be put to digging a bigger hole in the ground to get more coal out, then, as an investor, we’re not going to buy into that argument.”

Corporates and investors concluded that considering the lack of a single disclosure framework or mandatory ESG standards, the essential ESG goal for companies should be addressing the impact of their business models on their internal and external stakeholders.

Nick Stone (AstraZeneca) spoke about the commitment to addressing ESG:

“. . . if you genuinely have a desire to make an impact, you can find ways to do it. In some instances, it may never be perfect. And you can allocate your resources in a way that makes sense for you to do what you can do.”

1.3 Conclusion

Most issuers see ESG as understanding, addressing, and reporting on the impact of environmental, social, and governance factors in their business. Most investors approach ESG by incorporating these factors into their investment analysis alongside financial metrics. This strategy is commonly referred to as ESG integration, which represents the largest proportion of the ESG investment universe. Other investment strategies under the ESG umbrella include SRI and impact investing, which represent a smaller portion of the market.

Each company and industry would have different material ESG factors, with some of the cross-industry issues including climate change and supply chain impact. It was observed that some companies and investors still engage in greenwashing, but with increasing pressure to address ESG concerns, many will have to make real ESG commitments. Changing attitudes of the wider society and investors make it essential to have an effective ESG policy. Companies that do not address their ESG challenges will likely face increasing reputational and regulatory risks, as well as difficulties in obtaining funding. In addition to the focus on governance and environmental issues in the past decades, the Covid-19 crisis has highlighted the social factors.
Section 2
Integration, evaluation, communication and reporting of ESG strategy

2.1 Integration of ESG strategy in companies

2.1.1 Formulation and implementation of ESG strategy
Most issuers (58%) thought that the formulation of their ESG strategy should be approached top-down, coming from the CEO and the board. Many also thought that it is essential for senior management to be convinced of the importance of ESG for it to be taken seriously by the company. Several issuers also noted that companies should make sure to effectively integrate ESG strategy into their internal structures.

Uwe Bergmann (Henkel) spoke about the importance of effective integration of the ESG strategy throughout the business:

“There are plenty of examples even of core business strategies that haven’t been cascaded down, understood, and supported by the whole organisation. And such broad and abstract concepts such as sustainability are very hard to cascade down. If I was an investor, I would be looking for understanding and commitment at the top, but also the wider organisation’s ability to deal with it in terms of culture, processes and systems.”

Diego Martínez (Iberdrola) said that executive commitment is central to effective adoption of ESG:

“Firstly, company management has to be convinced of the ESG trend. It would be very difficult to get a specific department to convince the rest of the organisation about the necessity of going in that direction, so the top management need to inspire the rest of the organisation. Introducing the Social Dividend in the Bylaws of the company several years ago was a key step in this direction.”

There were divergent views on having a separate ESG strategy and a dedicated sustainability department versus complete integration of ESG into the general corporate strategy and operations. Most issuers (67%) had a dedicated sustainability strategy. However, several companies were in the process of phasing it out in favour of fully integrating ESG into the overall corporate strategy.

Some of the arguments in favour of full ESG integration into the corporate strategy were:
→ Having ESG as part of corporate strategy will improve transparency
→ ESG creates long-term value for a company, therefore all organisational levels should be involved
→ It will improve communication with investors who are also integrating ESG into their investment process

Some of the issuers’ and advisors’ thoughts on integrating ESG strategy are expressed in the quotes below.
Teodora Bozhilova spoke about Wienerberger’s transition to an integrated ESG approach:

“Our Sustainability Roadmap will end in 2020, and we’re already working on a new Sustainability Strategy 2020+, so sustainability continues to be an integral part of our corporate values. We believe this is how companies need to look at ESG in the future. It needs to be a part of the corporate strategy, so everyone knows what the company’s mission is, what the targets are, and not see ESG as a side topic.”
If ESG is built into your thinking, if your strategy is long-term sustainable value creation, then everybody in a company should be involved.

Tanja Seiler described a similar ESG integration process at BMW:

“We have a sustainability strategy in our sustainable value report, with 10 targets, but they only go until 2020. At the end of this year, we will draw the line below these targets...and now we want to go one step further and integrate the strategy into our corporate strategy.” BMW also integrates ESG at the board level. “Sustainability is a topic that is important for the whole board of management. We don’t have a separate sustainability board anymore, we discuss all sustainability topics with the whole board, we get them all involved in the decision-making processes.”

John Armstrong (Nestlé) thought that ESG has to be an integral part of corporate strategy rather than a separate goal:

“We need to be careful to clarify what is meant by ESG strategy. For companies that build long-term sustainability as a goal and a consideration is something that should already be well-embedded into business strategies, i.e., sustainability is not a bolt-on. This isn’t just good practice, its likely recognition earned through experience that you need to be forward-looking on ESG risks. These can cost, and that cost is easier to absorb when you have time to prepare, mitigate, or ideally turn into opportunities.”

He went on to highlight that an inclusive approach to sustainability is likely to bring future benefits:

“The scope and detail of what sustainability means will vary by industry and geography. Not all companies will weigh factors the same way, especially over time. A lot of the difference comes down to how, and more specifically, with whom a company defines environmental, social and governance issues as being material. The more open and inclusive a company is during this process, the more aware they are of how these risks are evolving. I also think companies that understand that creating shared value needs to be part of the value creation model have been at work on this longer – and that has helped to better integrate ESG across the business. The benefits of this approach, especially in times of stress and uncertainty, such as COVID-19, are starkly visible.”

Finally, May Jaramillo (Barclays) highlighted that companies have to demonstrate how serious they are about ESG by incorporating it into the business strategy and establishing accountability structures:

“ESG investment is about setting up a strategy that really demonstrates to your investor base that ESG is an integral part of the business, and no longer just a part of your PR. With the number one question being: who is accountable for your ESG policy? Accountability is very important, as it will show how meaningful it is to the board and the direction the company is heading in.”

For companies operating in multiple countries, ESG strategy has to be balanced between ensuring consistency throughout the business and taking into account local factors. Some issuers provided their perspectives on dealing with this issue in the context of a global company.

Teodora Bozhilova (Wienerberger) commented that the strategy formulation process should consider the needs of local jurisdictions:

“We define our three big topics at the board level...and the local management needs to define local targets for their country and production sites. They also define how to achieve them and what measures they can take in their country due to different local legal frameworks – e.g. if they work in the UK, Switzerland or Netherlands.”

Nick Stone (AstraZeneca) spoke about the need for maintaining the balance between the consistency of certain standards and being flexible with others:

“We strive for consistency, but of course you have to take into account regional variations. If you look at it through the lens of access to healthcare, the challenges are clearly very different depending on a jurisdiction. If you look at it through the lens of environmental protection, AstraZeneca, as a global organisation, has very stringent standards across the board. The same goes for ethics and transparency.”

2.1.2 ESG board appointments

There are different approaches to establishing ESG accountability structures at board level. Some make specific board appointments based on the candidates’ ESG credentials and others use ESG criteria as part of the evaluation process for all board appointments. Another way to establish accountability is to make the head of sustainability a position where they report directly into the board or the supervisory board.

Comments below show some of the ways the issuers approach ESG accountability.

Diego Martínez described the approach at Iberdrola:

“We have 14 members on the board, of which four present a very significant ESG profile focused on different areas, including human rights and gender equality. Furthermore, the Head of Sustainability and Innovation reports directly to the Chairman and the Sustainability Development Committee.”

Daniel Bohsen commented that sustainability is integral to Novo Nordisk’s business philosophy, and that includes all board members:

“For Novo Nordisk, sustainability is integrated into how we do business, it’s not a separate function. For many years we have had it spelled out in our by-laws. Our experience is that for people who sign up to work at Novo Nordisk and be a part of the board, commitment to sustainability is a given.”

At BMW, the management board is accountable on sustainability, and there are ESG appointees at the supervisory level. Tanja Seiler commented:

“We have a two-tier board system in Germany. Our full board of management is responsible for sustainability topics and our CEO reports directly to the supervisory board on the status of sustainability KPIs. Also, on the supervisory board we have one or two members that have been appointed because of their sustainability know-how.”
2.1.3 Key ESG policies and targets

In terms of corporates’ key ESG goals, most (75%) spoke of their commitments to address climate change and reduce their CO2 emissions. This is a long-term undertaking for the majority of issuers, with some aiming to significantly reduce their carbon emissions by 2030 or 2040. This goal is sometimes broken down into smaller, shorter-term targets that facilitate their overall commitment to cutting emissions. For many companies, achieving their climate goals is tied to supply chain management. This creates a need for a strategy to monitor and reduce their supply chain emissions. Other popular ESG targets set by many issuers include the reduction of energy and water consumption, health and safety, and sustainable packaging. Several companies also noted that their ESG policies are driven by the desire to gain access to the wider pool of investment by eliminating grounds for potential exclusion.

The following quotes illustrate some of the issuers’ views on key ESG goals.

Tanja Seiler showed how BMW breaks down their overall commitment on emissions into smaller, trackable goals:

“One of the most important topics for our corporate strategy is that we are fully aligned to the Paris Agreement, but not only do we have a long-term commitment until 2050, we are setting ourselves clear targets for CO2 reduction up to 2030. For the first time, these extend throughout the entire lifecycle: from the supply chain through production to the end of the use phase. We will report on our progress every year and measure ourselves against these targets.”

Uwe Bergmann (Henkel) spoke about defining specific ESG targets from an overall strategy:

“We had an overarching goal of increasing our resource efficiency over 20 years, and it ends in 2030. From that goal, we can define more concrete targets - what it would mean for energy, for water, for our supply chain, for logistics and for the use of our products.”

John Armstrong (Nestlé) highlighted that it is important to make sure that ESG goals are communicated to stakeholders appropriately:

“Smart companies know they need to act. Responsible companies understand they also need to engage and even educate stakeholders on what and how trade-offs need to be managed. This may require tailored “communications strategies,” particularly as companies start to go into more detail on governance, goals, and impact. Again, the direction of travel is the same; managing ESG issues needs to be something that is cross-functional. IR’s role in helping to make investor expectations and company strategy mutually understood remains just as vital in this context.”

2.1.4 KPIs and board compensation

Key Performance Indicators (KPIs) are traditionally used to measure corporate performance expressed by financial metrics. These KPIs are also often used to calculate compensation of senior management, motivating them to make sure that a company achieves its financial goals. Using ESG KPIs similarly can, theoretically, ensure that executives take sustainability seriously and make an effort to achieve their relevant goals.

Most issuers taking part in this White Paper (83%) have KPIs related to ESG targets and goals. The common view is that KPIs help to track and drive progress on important ESG issues. However, not all issuers incorporate ESG KPIs into their compensation schemes. Those who do not provide different motives. Some suggest there is a lack of investor demand for including ESG KPIs in remuneration.

At the same time, a significant number of corporates (50%) do incorporate ESG KPIs in senior management compensation. The comments below show several approaches to ESG-inclusive remuneration structures.
Tanja Seiler commented on ESG remuneration strategy at BMW:

“Sustainability criteria are integrated into the variable element of our management compensation. Our board of management and executive management will also be measured against these new sustainability targets.”

Diego Martínez breaks down Iberdrola’s approach to ESG elements in compensation:

“In terms of the chairman or the CEO remuneration, economic and financial objectives are 50% of their annual bonus, with the other 50% linked to sustainable objectives. Moreover, the long-term incentive bonus set for management is fixed every three years. Out of the four targets of this long-term incentive bonus, the first one is related to net profit (30%), the second one to total shareholder performance (20%), the third one to financial strength (20%) and the remaining 30% is related to ESG criteria (emissions, gender equality gap and sustainable practices in our most relevant suppliers).”

Teodora Boshilova’s (Wienerberger) challenged the idea that investors are not interested in ESG elements in compensation:

“ESG needs to be another performance measurement for companies, next to financial performance. If it’s not measurable, I think it becomes marketing talk and greenwashing. …we discussed it with investors when we were laying out our new framework for our management remuneration policy. They fully supported it, on a condition that there are measurable targets that we can communicate on.”

Investors views on ESG elements in management compensation

Investors also had differing opinions on this topic. Some thought that compensation arrangements should be left to companies to decide on, while others suggested that including ESG KPIs could lead to a box-ticking approach with issuers. Several investors supported the idea of incorporating ESG KPIs in remuneration structures as a way to establish accountability.

Some of the investors’ perspectives on incorporating ESG KPIs in remuneration are shown below.

Maria Lombardo (Invesco) pointed out the importance of setting the right incentives and accountability structures for the board:

“TCFD principles are very important, but you need to link this to a KPI. If it’s not linked to a KPI, it’s not going to work for anyone. …I was looking at one Italian utility company and I was extremely impressed because immediately after COVID-19, they increased the level of targets to their existing sustainability linked KPI at board and management level.”

Ashish Ray (Jupiter) highlighted that companies should be allowed to decide what is the best way to incorporate sustainability into their remuneration structures:

“While we must monitor companies, it’s important to trust them to structure their own remuneration policies that are aligned with shareholder and stakeholder interests. Hard rules can lead to a box-ticking approach that can dilute a policy’s relevance to corporate strategy. We absolutely believe there is merit in adopting ESG KPIs, specifically geared towards customer and employee matters, but companies need to retain flexibility in how this is done.”

Andrew Parry (Newton) expressed concern that using ESG in remuneration can lead to greenwashing behaviour:

“If remuneration is linked to ESG as an acronym and a label, then yes, there is a risk of it becoming a box-ticking exercise. Because that just encourages more reporting without necessarily any action.”
2.2 Evaluation of companies’ ESG practices: ratings agencies and investors approaches

2.2.1 Issuers view of ratings agencies

How investors view companies’ ESG practices is one of the key concerns of corporate IR. In the absence of a common ESG reporting framework or regulatory standards, ESG ratings and data providers play an important role in benchmarking good practice, with the majority of issuers engaging with two or more ratings agencies. Most issuers (72%) mentioned MSCI and Sustainalytics as the agencies they prioritise. Other ratings and ESG data providers mentioned by issuers include ISS, Refinitiv, Bloomberg, Vigeo Iris, and CDP. Generally, issuers felt that ESG scores provide important feedback on their ESG strategy. However, they also expressed frustration with the agencies’ data collection process, opaque methodologies, and lack of communication.

The growing number of ratings agencies is a major headache for many issuers. All ESG ratings providers have different goals and methodologies, which leads to disparity between their scoring, leaving many issuers confused as to the way they should report ESG. Many expressed frustrations with agencies that gather data by sending lengthy questionnaires, putting additional pressure on IR resources. Several issuers expressed a desire for greater consistency and standardisation of corporate reporting. In their view, that would reduce the resource strain from having to engage with a growing number of ESG ratings providers. Corporates also expect further consolidation in the market and a reduction in the number of agencies over time.

The lack of transparency around ratings methodologies was another significant problem for issuers. The way ratings providers arrive at the final score was not clear to most corporates. This is compounded by the limited two-way communication most companies have with agencies. Many issuers thought that ratings providers conduct their evaluations with a one-size-fits-all approach without much consideration to factors that apply to a specific company/sector.

The comments below express some of the issuers’ concerns with regards to external ESG scoring.

**Nick Stone (AstraZeneca)** commented on the lack of clarity in ratings agencies methodologies:

“We think we know, across our strategy, what the key data points that we need to include are. The bit that I don’t like is that we make submissions to some of these ratings agencies that go into a black box, and then they reach their own conclusions.”

**Daniel Bohsen (Novo Nordisk)** commented on their intention to find a more investor-tailored disclosure approach:

“Our experience is that most of the ratings agencies use subjective criteria and lack transparency on their methodology. We take a different approach by assessing what key information our investors and external stakeholders need to make better informed decisions, which we will provide in the best possible way at the right frequency instead of it becoming a box-ticking exercise.”

**Vladimir Zhukov (Nornickel)** pointed out that ratings agencies focus on the general characteristics of countries and industries and disregard practices and circumstances of a specific company:

“They use a one-size-fits-all approach, where a significant part of the assessment is not about our performance, but about a certain country or industry assumptions. An example here would be bribery and corruption. They take the NGO, Transparency International’s ratings of bribery and corruption, where Russia rates low and then they say that because Norilsk Nickel is domiciled in Russia, and Russia ranks low in this bribery and corruption ratings, Norilsk Nickel has a high risk of bribery and corruption.”

2.2.2 ESG ratings agencies perspective

ESG ratings agencies would also prefer a unified approach to ESG reporting. Some commented that the current proliferation of regulation and voluntary standards around ESG reporting increased the amount of data that needs to be processed in order to arrive at a score. When addressing the lack of correlation in their ratings, agencies point to the differences in their methodologies and objectives. Some of them compare divergences in ESG scores to differences in the reports on companies’ financial prospects, provided by the sell-side. They also pointed out that the differences in methodologies and goals of the assessment allow investors to choose the ratings that meet their particular demands.

The ratings agencies’ views on divergence in their ESG scores are shown in the comments below.

**Leon Saunders Calvert**, Head of Sustainable Finance at Refinitiv, compared varying ESG ratings to financial projections and suggested that they don’t have to show similar results:

“When you look at stock forecasts, they don’t all agree with each other, and there is some value in them not agreeing. The same is true for the investment banking league tables – they don’t all have the same criteria and it’s quite useful. This is especially true of ESG considerations. ESG is not one thing. It is an amalgamation of a host of non-financial data points about a company relating to diverse issues such as climate, diversity and inclusion, human capita and employee rights, and resource usage, amongst other things. It also depends on what outcome you are driving for in a rating. A risk rating versus and score on alpha generation capability versus an impact credential would likely score the same underlying data differently. Given the thematic disparity underneath the ESG umbrella, and the disparity of outcomes that one might try and derive from it, there is an argument to suggest that diversity of thought and of approach to ratings can be useful here so long as the different approaches are transparent about what is being measured.”
He also suggested the differences could be partly attributed to a lack of standardised reporting:

“Today, there is no mandatory disclosure of ESG data. This means that you have different companies reporting on different things in different ways. With the lack of ESG accounting standards, and no clarity on who is required to report what data points, it’s not surprising that divergence between data providers is a consequence of this.”

Lotte Griek, Head of Corporate Sustainability Assessments at S&P Global, suggested that the final score can depend on the source of data used in the analysis:

“You can break down ESG disclosure into 3 main pillars: company philosophy, which is backed by documented policies; company management systems (programs that a company has to tackle certain topics within the ESG framework); and performance (metrics that allow analysts to measure performance trends). Our scoring approach is very much focused on the performance aspect of ESG disclosure, and our close engagement with corporates provide us with additional data that makes this possible. If you are only able to rely on information in the public domain, your methodology might be skewed more towards the policies or programs parts. If you’re focusing more on those two elements, your scoring will likely be very different. From our perspective, that’s where the differences in scores come from, namely which aspect of those three pillars the analysis focuses on - philosophy, management systems or actual measurable performance.”

Hendrik Garz, Executive Director at Sustainalytics, spoke about the different demands that ESG ratings providers have to meet:

“On the user side we have a very heterogeneous picture with a lot of different objectives in the context of ESG. One perspective is that ESG factors are considered to be financially material and relevant for investment decisions. And then we have the impact perspective – not the impact on their returns but the impact on society and environment. The challenge for ratings agencies is to provide products that speak to differing needs. You can’t speak to all the different objectives with one rating.”

Aurelie Ratte, Vice President of MSCI ESG Research, also thought that the variety in scores and methodologies exists because of market demand:

“There is an increasing amount of ESG data, but we need to understand that there is not just one investment goal, but a whole range of different ones across different investor types globally. Some identify emerging risks and opportunities and aim to maximise investment return, some identify positive external impact, or they approach their investments with a philosophy, management systems or actual measurable performance.”

Patricia Torres, Head of Sustainable Finance Solutions at Bloomberg, spoke about the challenges of collecting and evaluating ESG data:

“From our perspective, the biggest challenges for ESG reporting are: data availability, data comparability, and data assurance. In terms of data availability, the lack of a universal disclosure framework that allows for transparency across industries and geographies, some companies do not use the data if we do not feel confident in what was reported.”

She went on to illustrate how Bloomberg ensures accuracy of ESG data:

“At Bloomberg we have a number of measures in place to ensure that the company-reported data we are collecting is accurate. For us, it starts with having a team of more than 100 data analysts who closely review all data we receive from firms. If we think there are errors in the data we call the company directly for clarification, and in some cases will not use the data if we do not feel confident in what was reported.”

Also, some agencies said that even if all companies reported under one framework, such as GRI or SASB, that would not guarantee comparability of data. According to most ratings providers, they have to apply internal standardisation techniques that allow for comparisons, because companies report in different ways even under the same framework. They also did not express any preference for a particular existing framework. This is partly because disclosure is an important source of data for some of the ratings agencies, but it’s not the only one. In addition to company reports, they collect data from the media, regulators, NGOs, and other sources. Other ratings agencies, such as S&P, adopt a radically different approach and supplement reporting data with information gained from close engagement with companies. The importance of reporting for the overall score varies depending on the methodology used by each agency.

For example, Aurelie Ratte (MSCI) commented that most of the data needed to arrive at the final rating is not derived from disclosures:

“We have done some analysis, and about 2/3 of our rating is independent from the companies’ reports. We use thousands of global and local news sources in different languages. And we are increasing the use of social media, satellite images, NLP techniques, and machine learning to extract information that is not accessible through more traditional sources.”
Hendrik Garz (Sustainalytics) spoke about the challenge of evaluating inconsistent data and using alternative information sources:

“Companies report selectively, which is also the result of a lack of a binding reporting standard. They have the option to selectively report and they use it. We depend on what companies are disclosing, but we also use other sources of information. We have our controversies assessment, where we’re screening and evaluating news sources from around the world. We also use new AI-based technologies to search the internet for additional pieces of information.”

Lotte Griek (S&P Global) outlined an alternative approach to dealing with a lack of comparable data:

“If you were to rely solely on information in the public domain, you’re inevitably confronted with the fact that you have to absorb the information in the format provided by the company. Given the lack of standardisation in reported information, investors and other stakeholders cannot analyse certain metrics even though companies report on it. Health and safety data offer a clear example since there is less standardisation in reported figures. Environmental metrics are generally more uniform, but when we’re looking at health and safety information, it can be quite challenging to draw meaningful comparisons because of vast differences in categorization. By allowing companies to provide us information directly and substantiate that with internal documentation, we’re able to absorb a lot more data to inform the S&P Global ESG scores.”

Agencies prefer to rely on quantitative data to maximise the objectivity of their assessment. Leon Saunders Calvert (Refinitiv) suggested that qualitative data is something that can be better utilised by investment analysts rather than ESG data providers. At the same time, qualitative assessment can sometimes be necessary to evaluate issues that are not easily quantifiable, such as corruption.

Aurelie Ratte (MSCI) explained how qualitative data can be useful in an assessment:

“Quantitative indicators are not always available or appropriate. Qualitative data supplements quantitative data or makes up for the lack of quantitative data in some situations, for example controversies related to corruption cases, which are typically challenging to capture with quantitative data. Qualitative data can be used in a systematic, transparent way, such as when we use a consistent, rules-based approach to score the severity of controversy cases.”

All ratings providers said that various elements under the ESG umbrella are weighted differently depending on the material factors for a particular industry. Hendrik Garz described how Sustainalytics approaches different factors that fall under ESG:

“ESG factors enter the rating depending on the specific sub-industry and even the individual company. We rank factors depending on which ones would have the biggest impact on the financial or economic value of a company. Material ESG issues at the sub-industry level receive a score that represents risk exposure – (potential impact that these issues can have on a company’s economic value). And then we adjust them based on the individual company’s situation.”

Evan Greenfield, Global Head of ESG at S&P Global, outlined how they approach materiality in their methodology:

“The S&P Global ESG Score is derived from a unique approach in analysing and ranking an entity’s ESG performance. While we incorporate publicly available information, we also engage closely with corporates to find pertinent non-public data on their sustainability practices. At the core of the S&P Global ESG Score and our differentiated dataset is the Corporate Sustainability Assessment (“CSA”). The CSA is an in-depth survey that addresses ESG factors across the 61 different industrial categories. The CSA allows S&P Global to understand an entity’s positions on the most material ESG issues while stripping away extraneous information. In order to ensure the highest integrity of the disclosed responses we maintain a rigorous quality control process that includes a comprehensive review of the CSA submission, thorough data validation and an independent third-party review to assure consistency and robustness. We developed this approach and underlying methodology over 20 years ago so we have the benefit of decades of continuous refinement that is responsive to the corporate and investment communities.”

Patricia Torres (Bloomberg) offered a different perspective on evaluating E&S vs Governance factors:

“When assessing the E and S elements, we compare them from an industry perspective and region agnostic. The materiality framework is based on what could have a financial impact on companies’ operations, and it is industry specific. However, the G is a different story. Even though different nations have specific governance regulations and laws, we have a framework to consider them on a global level based on universal best practices. We have taken the liberty to say that, regardless of where you are in the world, investors strive for the same high standards of governance.”

Regarding the issuers’ concerns about the one-size-fits-all approach, ratings agencies highlight that they do take into account factors that depend on the industry, market, and an individual company. This can also be seen in the previous comments regarding the importance of material ESG factors, which are different for all companies and industries. At the same time, several agencies noted that data needs to be standardised to allow comparisons between companies in the same industry.

Aurelie Ratte (MSCI) illustrated that some degree of standardisation is inevitable:

“Investors demand a relative ranking for comparing securities. Companies in the same industry are rated using the same criteria because we’re standardising the data – we need to make sure the data can be compared across companies. We’re able to compare because we’re not comparing apples and oranges; we’re comparing, for example, pharma companies within the same industry under the same criteria.”

Other ratings agencies employ closer communications with issuers for the purposes of improving data comparability. Lotte Griek spoke about how this approach can aid ESG evaluations:

“Standardisation of the metrics poses the most significant challenge. There is still a huge amount of confusion from the issuers about the best format to report on ESG data. The benefit of S&P Global’s model of engaging with corporates allowing companies to submit private information beyond what they report in the public domain allows companies to provide those metrics and KPIs in exactly the right format to make the data comparable to their peers.”

At the same time, some agencies noted that not all companies have the willingness or resources to respond. The larger companies would be more likely to actively engage in dialogue, because they already have sustainability departments and invest in disclosure.

When asked about the measures companies could take to improve their rating, most ratings agencies participating in the White Paper suggested that it should not be the goal. The majority suggested that the issuers should figure out which ESG issues are material to their businesses and concentrate on addressing them and not tailor their disclosure to improve their rating.

Some of the ratings agencies thoughts on best ESG practices for issuers are shown in the comments below.

Leon Saunders Calvert (Refinitiv) thought that companies should consider ESG in the context of their financial impact:

“Companies should establish what they believe is material to their business and approach those issues similarly to how they would approach any other financial risk. For example, high or increasing carbon emissions, will, in the future, translate into financial risks for companies that won’t take steps to decarbonise.”

There is still a huge amount of confusion from the issuers about the best format to report on ESG data.
Hendrik Garz (Sustainalytics) thought that aiming to improve the ESG score is a wrong approach to this issue:

"Companies need to have an ESG approach that works for the context they’re operating in. They should focus on fundamental challenges they’re facing, have a structured approach to identifying the important issues, and then develop approaches to manage those issues. Corporates tend to ask for transparent evaluation in the ratings, but they are also asking questions like, how can I improve the G score? What they should really do is to integrate ESG into their thinking and then support the establishment of global reporting standards and report on it, give us their narrative, engage with us and see what comes out."

Aurelie Ratte (MSCI) also suggested that companies should focus less on trying to improve their ratings and disclosure and more on having an effective ESG policy:

"It is not our position to tell companies what to do, at the end of the day, the ultimate goal should not be to improve the rating only, but to address ESG considerations on the grounds that could impact the company’s future performance. If you do good, the rating improves because it captures progress made relative to peers. Improving the disclosure alone can only get you so far."

Patricia Torres (Bloomberg) highlighted the importance of a historical ESG trend over a particular score:

"First, you need to find and disclose data that follows a specific materiality framework, and each industry will have their own. Ultimately, it is important for companies to have guidance on which materiality framework is best for their industry, rather than companies looking for ways to achieve the highest score. The most important thing is to try to be honest and transparent and track their progress. The ESG story is not about the score, it is about where you are today vs where you were in the past and where you see yourself going and how you are changing your business model to support that vision. Investors will care more about that story than about a score."

She also observed that displaying data in a machine-readable format makes it easier to capture and evaluate disclosures:

"Additionally, a lot of ESG data is in a text format and it is hidden in ESG reports. While we have our team of ESG analysts reviewing the data manually, many providers rely on computers to dissect the data. It can be very challenging for a computer to decipher text instead of data provided in a table format which is why we recommend that companies use a table format so it can be used and correctly captured by a wider audience."

2.2.3 Investors approach to external ESG ratings

Investors are aware of the discontent expressed by issuers with regards to practices and methodologies of the ratings providers. From the investors’ point of view, the primary value of the ESG ratings agencies is in the wide coverage they offer. This readily available data allowed many asset managers to start incorporating ESG factors into their process. An important issue arises as some investors noted that as the market became more sophisticated and they started to develop their own ESG evaluation models, third party ratings seem to become less important as an indicator of a company’s ESG performance.

Most investors thought that ESG scores provided by the ratings agencies have a role in the investment process, but they need to be supplemented with comprehensive in-house analysis.

Yo Takatsuki (Axa) spoke about the evolution of the role of the ESG ratings providers:

"MSCI and Sustainalytics provided a great service in mainstreaming ESG within the industry in the last 10 years. They’ve played a role in allowing large numbers of asset managers, who don’t have the internal resources to take this first step in incorporating ESG into their investment process. Now, you’ll find that most asset managers have either hired full-time professionals or built their own internal analytical capabilities to incorporate ESG in a more meaningful way."

When considering market capitalisation, several investors noted that they take into account the size of a company when evaluating the importance of the external rating. This is done to adjust for the larger amount of resources large companies dedicate to disclosure and the better ESG ratings they tend to receive as a result.

David King (Fidelity) commented on the ESG ratings being skewed in favour of bigger companies:

"There is a huge bias for large cap right now in some of these third party ratings. Large cap can afford to track these numbers and reporting, and the bigger your report, the better your score will be. We have the benefit of a research platform that knows management and meets with them regularly to understand how they are approaching and managing these issues."

My-Linh Ngo (BlueBay) expressed a similar sentiment:

"We recognise there can be a potential size bias when it comes to a company’s level of public ESG disclosure and ESG practices. This is taken into consideration when we look at companies - we don’t apply one size fits all. If you are a large company, we set higher expectations. With smaller companies, we may say: that’s not bad for a company that size or in this region."

Most investors (62%) use ratings provided by several ESG ratings agencies, instead of relying on one provider. The majority of them have developed, or are in the process of developing in-house ESG evaluation models that rely on a variety of data. The data points used in these models include ratings provided by the agencies, among other information. MSCI was the ratings agency mentioned by investors most frequently, followed by Sustainalytics. Other agencies that were brought up by investors include ISS, RepRisk, Truvalue Labs, Vigeo Eiris. Some investors also expressed interest in ESG ratings services provided by the traditional credit risk agencies, such as S&P. Also, several investors stated that they use the datasets provided by the ESG ratings agencies, but not their scores.

The quotes below show how investors approach ratings and data offered by various providers into their investment process.

Armin Peter (UBS) observed that the existence of varied approaches to evaluating ESG is inevitable, considering the present lack of standardised data:

"Looking at one rating does not mean you are covering the entire concept of ESG in the right way. The ESG space is still in its infancy, regulation has just recently fully engaged with it and started to impact the market, there are different reporting standards... Everyone is hoping for standards. This is typical for a transitional topic because everyone wants to understand what the endgame is, what do we aim for. On that part, you need to be a little bit more patient. So what we’re doing, we’re collecting a lot of data, including inputs of rating agencies and reporting standards, and integrate it into our model. I think anyone who has been in the industry for long and put a lot of resources behind this like we have, came up with their own scoring model. There are no standards, and that’s a reason why you will have different approaches to ESG evaluation."
Robert De Guigne (Lombard Odier) illustrated that some investors are using ESG data provided by the agencies to inform their analysis rather than relying on the final score:

“Rating agencies collect a huge amount of qualitative and quantitative data that is processed to inform investors on companies ESG quality. As a result, the investment community has had the opportunity to integrate ESG information into their business processes on a large scale. However, we are in a world that is not yet completely standardised and the opinions of different agencies may vary greatly. We have decided for many years to use the raw information from these agencies by selecting the information we feel is the most consistent and of the highest quality. We have selected several data providers and then integrate their information into our own analysis models.”

Using the data provided by the ESG ratings agencies in some capacity is the common approach, but some investors take an alternative view. Cindy Rose, Head of Responsible Capitalism at Majedie pointed at the challenges arising from using ratings in the investment process:

“We don’t use third party research provider scores because they only focus on ESG. The score only looks at part of the picture. If it only considers part of the picture, then how do you accurately weight that score? The score doesn’t necessarily tell you, from a non-biased perspective, what the actual, material issues are for a particular company.”

May Jaramillo (Barclays) thought that companies should take a look at their disclosure and accountability structures if they are dissatisfied with their score:

“If you want to improve your rating, work on your disclosure, make someone accountable at the board level. Investors don’t care what you put on a glossy report, they want someone accountable and also be able to track progress. ESG Rating providers are a good source of input to IR teams as we all continue to work on our ESG integration journey.”

At the same time, George Richards, Audit and Assurance Director at KPMG UK, expressed concern with the quality of information used by agencies to formulate their scores:

“All of these scores are based on publicly available information and questionnaires. How robust is the information that they’re using to determine their scores? It is not necessarily being independently checked and assured. The inconsistency and quality of data used could undermine the scores.”

He went on to emphasise that agency ratings have only a limited role in investment decisions:

“While ratings have their place, no investor is going to make an investment decision based on one company’s score, particularly when they don’t have transparency on how that score is reached. So it’s important to remember that investors are using those ratings, but overlaying it with their own analysis and make decisions based on that.”

2.2.4 Investors internal evaluation

Alongside data from ESG ratings agencies, investors analyse and incorporate information on employee turnover, health and safety, carbon emissions, and other factors into their models. This information is extracted from various public sources, including company reports, NGO studies, news, Glassdoor reviews, and social media, among others, and combine data obtained from direct engagement with companies. This information is then evaluated in the context of ESG factors that are important for a particular company and industry. The resulting score is then used as a part of its investment analysis.

The weight of an in-house ESG evaluation in the final investment decision depends on the investment strategy chosen by the investor. In the context of ESG integration strategy, where ESG factors play a part but are not a decisive element in the investment process, a low score would not necessarily mean rejection or divestment.

My-Linh Ngo (BlueBay) described the investment decision process for non-ESG focused funds:

“For the majority of our funds our focus is ESG integration, which is making sure that we systematically identify and evaluate ESG risks to understand their investment relevance and materiality. These are ‘ESG-aware’ funds if you like, rather than being ‘ESG-orientated’ ones. If we don’t think the ESG factor(s) are investment relevant or material, then for such funds the ultimate decisions will depend on the investment case. But if we think they could be investment relevant or material, we would then look to understand whether these risks are reflected valuations to determine if investors are being sufficiently compensated for that risk. If not, we may not invest. The focus is on understand the risk and reward profile of the investment opportunity.”

For ESG or sustainability-focused funds, the approach would be stricter and the ESG score would hold more weight. Maria-Elena Drew (T Rowe) illustrated the contrast between ESG integration and stricter ESG-focused strategies:

“The vast majority of our funds at T Rowe employ ESG integration, which is incorporating ESG into the portfolio to improve investment performance. You can come across situations where a company has poor ESG aspects, but there are offsetting factors. For ESG integration funds, you would never put a rule that ESG comes first. For other portfolios we have that fall into an SRI bucket; there we do put ESG considerations ahead of financials because those clients signed onto that mandate.”
2.2.5 Engagement with corporates

Low ESG scores do not always result in a lack of ESG investment. For some investors, the result of an in-house ESG evaluation would indicate the issues that need to be discussed with a company, and the final decision would depend on those one-on-one interactions. A positive response from a company can sometimes compensate for a low ESG score.

Engagement is an important part of the process for many active investors, which is shown in the quotes below.

Andrea Carzana (Columbia Threadneedle) highlighted the part engagement plays in the investment and stewardship process:

“It’s not just about rating a company; through engagement we assess how management teams have responded to ESG controversies and what they have put in place to mitigate the same risk going forward. Engagement is key to keeping track of the progress made by companies in dealing with current and potential ESG issues and to suggest what ESG standards we expect them to have.”

Cléo Fitzsimons (Cazenove) described how a positive engagement experience can impact the in-house ESG evaluation result:

“If you can say – actually, I’ve met with that company, I talked to them about this issue, they are going to be applying so-and-so project, or so-and-so employee support group which we believed was right for that particular issue, we add this qualitative element to our model and change the score. Or perhaps, engagement with a manager made us think – right, they are not taking this seriously, there is no willingness to change.”

Andrew Parry (Newton) provided a similar perspective:

“In terms of the question, if a company has a low ESG score but great growth, would you buy it? Maybe, maybe not. It depends on, one, where is that score coming from? How material it is? And also, is there’s an opportunity to try to engage, to change certain behaviours?”

A company that currently has a low ESG score but is responsive to engagement and willing to improve its sustainability practices might be perceived as an attractive opportunity for some investors. Roland Rott, Head of ESG at La Française Asset Management, commented on this investment approach:

“I think it’s important to actually look for solid fundamentals. Financial fundamentals in combination with a relatively weak ESG score, gives you a screen of companies where there’s a need for change. And these are usually companies that I really like to invest in. It’s a bit riskier, and sometimes you have to push these companies, so you would enter into engagement territory, but if you, as a firm, are equipped to do that, then that’s fantastic.”

Armin Peter (UBS) offered a similar perspective:

“ESG is not a black and white discussion. The transition to sustainability involves analysing where a company is; it is a chance for investors to integrate ESG considerations and use their personal approach to sustainability. The question is, is there a chance to push a particular company to invest in their ESG transition? Maybe the opportunity is exactly in companies like that.”

When considering engaging with companies on their ESG practices, investors have to weigh the resources they have to spend against the potential payoff. To make sure engagement is effective, some investors turn to the collective engagement initiatives such as Climate Action 100+.
2.3 Communication and reporting

2.3.1 Issuers’ communication of their ESG strategy

Most issuers communicate their ESG strategy through multiple channels which include reporting, the company website, and direct interactions with investors. ESG reporting is usually done with a separate sustainability report, published annually. With other corporates including sustainability information into their annual report, next to their financial statements. The company website is another important communication channel used by issuers. Information on a website can include ESG specific investor presentations, ESG targets and KPIs, sustainability reporting, and other relevant materials.

Direct investor interactions usually involves attending sustainability conferences, hosting separate ESG roadshows, and organising web-based events to demonstrate issuers’ engagement with ESG. Many issuers integrate ESG communication into their general investor dialogue, such as capital markets days, mainstream non-deal roadshows, and conferences.

When discussing the ways to improve investor communication, several companies mentioned integrating ESG into their overall company messaging. Several issuers also stated that a common reporting framework would make investor interactions more efficient.

Issuers outline some of their ESG communication practices in the comments below.

Daniel Bohsen (Novo Nordisk) discussed integrating ESG into mainstream investor communications:

“We were early movers in integrated reporting and have, for many years, had a section with ESG data in our annual report, subject to the same criteria for quality and controls as for financial statements. Last year, in November, we had a capital markets day where we launched four strategic aspirations for 2025 that we report on quarterly. Purpose and sustainability come first, profitable growth is an outcome. We’ve always talked to investors about it, but now it’s an integrated part of the message we present to all investors.”

Georgios Galanis and Dimitris Katralis (Mytilineos) described how they are addressing the wider investor community through their website:

“We communicate with investors through our annual report, our sustainable development report, the dedicated Sustainable Development section in our website as well as with specific online communication tools. You can visit the first page of our website (www.mytilineos.gr) to view our Value Creation Scorecard and our Sustainability Action Map throughout the world. This is a way for us to address a much wider audience of investors.”

Vladimir Zhukov (Nornickel) talked about a variety of approaches to investor communication, including the website, reporting, and direct investor interaction:

“We have a special section on our website dedicated to ESG investors, where we publish relevant disclosure. This section on the website includes our ESG investor presentation and focuses on everything relevant for ESG. We also have a separate presentation on our performance against the UN Global Compact. We also publish semi-annual financial results as well as our annual strategy update for our capital markets day, where we include various ESG topics into a large investor presentation.”

All issuers we interviewed report on ESG at least annually. Several issuers incorporate ESG into their annual report, while others produce a separate sustainability report. Some also provide quarterly reporting on important KPIs, with the more detailed information provided annually. Others pointed out that quarterly reporting would involve a lot of additional cost and be difficult for companies without a sizeable sustainability department.

2.3.2 Investors views on reporting

Most (69%) investors commented that issuers should publish more ESG disclosure material on their websites, highlighting that it would reduce costs for IR departments and help them reach a wider audience.

Suggestions with regards to the content of ESG disclosure materials included:

- High-level information on strategy and relevant initiatives
- Historical performance metrics and targets
- Information should be presented succinctly, preferable as tables
- Links to PDF documents for a more in-depth view

Several investors commented that they use AI tools to scrape ESG data from companies’ websites. This makes it important for the corporates to present that information in an appropriate format and refrain from embedding key data into images, which cannot be easily picked up by AI bots.

A number of investors stated that they would welcome companies publishing an annual sustainability report. However, there were diverging views on quarterly ESG reporting, with some viewing integrated ESG quarterly updates positively and others stating it as overkill and unnecessary. Those investors that preferred quarterly ESG updates felt it shows how a company treats non-financial and financial indicators in the same way. Moreover, others commented that quarterly reporting would provide companies with the motivation to focus on their ESG KPIs.

Generally, investors supported sustainability reports. However, some expressed a preference for integrated reporting, with sustainability indicators being included in the annual report.

The appropriate level of detail in ESG disclosure was another divisive topic. Many investors prefer information to be more granular, while others maintain that disclosure should be concise and only refer to the main, material issues. Also, several investors expressed a strong desire for ESG data to be audited. (We discuss the topic of ESG auditing later in this paper).

The common thread in investors’ opinions on reporting was that issuers should be aware of ESG factors material to them and report on them regularly (at least annually), preferably in an AI-friendly manner.
Some of the investors’ opinions on the content and frequency of ESG reporting are shown in the quotes below.

Maria Elena Drew (I Rowe) spoke about the benefits of quantitative ESG reporting:

“If you do one thing, take the key data points, put them in a table that AI can read - that just means clear data points with no text, and put that on the website. That way, the AI tools used by ISS, Sustainalytics, MSCI ESG and other ESG ratings vendors can easily collect your data. - that is the only way we can analyse the company without making assumptions. Not providing data is worse than reporting bad data.”

Diego Martínez (Iberdrola) commented on the importance of materiality for ESG disclosure:

“I expect the company to undertake its own materiality assessment and tell me what is material to its business. And all of it should go in the annual report. They should have a list of important issues, why they think they are important to the business, how they see those issues changing over time, and what steps they are taking to either reduce the impact or mitigate the risk or take advantage of the opportunity.”

Maria Elena Drew (I Rowe) commented on the importance of materiality for ESG disclosure:

“I think it will continue to be done through the IR department because it’s very important to understand the dynamics of the market and investors, what their concerns are and how to address those concerns.”

He also explained how separate experts can be brought in for specific events:

“The IR team organises calls and conferences between investors and the Sustainability team and, when necessary, even with experts of the Company in certain ESG topics”. Teodora Bozhilova (Wienerberger) also highlighted the natural advantages of IR in ESG communications:

“We believe that communicating through IR is the best approach for us. We’re very close to the market, we’re in daily contact with investors, we also get the feedback from ratings agencies and the proxy advisors. We’re in the front line of communicating with the market.”

Leda Condroyanni (Mytilineos) showed how companies adjust their communications depending on the recipient:

“We’ve got certain institutional investors that have stewardship teams. When it comes to stewardship, our corporate governance team talks to them directly. But with shareholders that only have fund managers, all these issues are directed through IR.”

Topics that are brought up in investor interactions on ESG are usually company-specific. Depending on the business, they can range from access to medicine to emissions to cybersecurity. Questions on the workforce and corporate governance are common across the industries. Another important topic is compliance with particular ESG disclosure frameworks. Leda Condroyanni (Mytilineos) highlighted the lack of clarity that investors have on disclosure:

“Investors wanted to know whether we abide by the guidelines of TCFD and SASB. And the prevailing message was that there was an overall confusion about metrics, ratings, and subsequent profiling of companies. In the end, the conclusion was that it’s up to us, companies, to manage the process, report the information, and correct any misinformation.”

Some issuers also observed that while they haven’t seen substantial engagement on ESG from investors yet, the trend is shifting. Megan Geldens (Wolters Kluwer) commented on the change in investor feedback:

“We are not getting a lot of ESG questions yet, but it’s definitely on the rise. Ten years ago, we never got any questions on ESG, but it has now started to become integrated into many traditional portfolio managers’ approach to discussions, and we are starting to see more ESG fund managers who want to investigate if the company meets their specific ESG criteria or themes.”

2.3 Communicating with investors: points of contact

Most issuers prefer to channel their ESG communications through IR, sometimes in collaboration with the sustainability department. In their opinion, IR experience and close contact with the investor community make them ideally positioned to deliver the ESG message to the market. Experts from other departments, and sometimes, the senior management tend to be brought in for the relevant ESG-focused events such as conferences and seminars.

The quotes below represent some of the issuers’ approaches to communication.

Diego Martínez (Iberdrola) discussed why IR is well-positioned to communicate on ESG:

“The IR team organises calls and conferences between investors and the Sustainability team and, when necessary, even with experts of the Company in certain ESG topics”. Teodora Bozhilova (Wienerberger) also highlighted the natural advantages of IR in ESG communications:

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Armin Peter (UBS) noted the increasing presence of sustainability-focused roles within senior management:

“We have noticed an increasing development where you can see a CSO (Chief Sustainability Officer) included in the C-suite alongside the CEO and CFO. This is similar to the companies of previous generations needing to allocate responsibilities to the tech-driven people, when they realised that tech will be integral to their business and they needed to address it. If you speak to our engagement teams, they are having conversations with the C-suite. There doesn’t necessarily have to be a CSO, but maybe someone from the CSR department.”

2.3.5 ESG roadshows

Some issuers choose to integrate sustainability content into their mainstream roadshows that are aimed at the wider investor community. Most (58%) issuers observed that ESG is increasingly becoming part of a conversation in standard roadshows and a company should always be prepared to answer those questions. Incorporating ESG into an NDR presentation allows issuers to address the growing interest from mainstream investors. Other companies hold separate, NDR and ESG-focused roadshows.

Issuers’ thoughts on integrated roadshows are shown in the comments below.

Tanja Seiler (BMW) talked about using integrated roadshows to communicate with a mixed investor audience:

“We always combine our roadshows with investors from different backgrounds. We usually have the credit side, sustainability investors, equity investors with sustainability analysts all at the same table.”

Teodora Bozhilova described how Wienerberger is shifting from a having a separate ESG roadshow to an integrated one:

“We started ESG-specific roadshows two years ago, in 2018. At the beginning of the year in 2020 we did our second one. And in the future, it will just become a normal part of roadshows, next to strategy and financial topics. … we get more and more ESG questions and investors engage more and more either via ESG stewardship teams or buy-side ESG analysts.”

Diego Martinez (Iberdrola) commented that clarity on ESG is necessary for any roadshow:

“All approach is valid, knowing that, in whatever type of roadshow you are conducting, you need to be very clear on what is your ESG strategy and be able to explain it, since when you are in a roadshow, you usually meet the equity portfolio manager, and more often, an ESG specialist with him.”

Despite most issuers stating that investors have a strong interest in their ESG performance, some issuers observed that investors have a different viewpoint.

Nick Stone (AstraZeneca) also expressed that an ESG roadshow should only be held for a good reason:

“Any approach is valid, knowing that, in whatever type of roadshow you are conducting, you need to be very clear on what is your ESG strategy and be able to explain it, since when you are in a roadshow, you usually meet the equity portfolio manager, and more often, an ESG specialist with him.”

Investors’ view on ESG roadshows

When commenting on whether corporates should undertake ESG-related roadshows, most investors preferred them to incorporate ESG into their standard roadshows. According to investors who hold this view, integrated roadshows demonstrate a genuine commitment to making ESG part of everything a company does. Investors who expressed interest in ESG-focused events specified that issuers should make sure it’s dedicated to a specific event such as a green bond issuance or a major ESG campaign.

Investors’ attitudes to ESG roadshows are demonstrated in the comments below.

Robert De Guigne (Lombard Odier) expressed preference for integrated roadshows, aside from specific situations calling for a sustainability-focused event:

“We consider that sustainability considerations should become part of standard discussions between investors and companies. However, in certain circumstances, such as the issuance of green bonds or in the event of major changes in business practices or the business model, dedicated ESG roadshows may be justified. It is also important for companies to be very transparent in ESG matters. Public CSR reports are widely used by data providers, whose information is widely used by investors to form an opinion. This transparency should be considered before considering road shows on Sustainability.”

Ashish Ray (Jupiter) commented that integrated roadshows should be the norm, with ESG-focused roadshows happening once in a while, depending on the need:

“I would say, the relevant issues should be of a part of standard NDR. There might be a need, maybe every 12-18 months, to have a Chairman-led specific ESG session for investors, but, generally, it’s better if you just weave that strategically into your main financial communications.”

Cleo Fitzsimons (Cazenove) also expressed that an ESG roadshow should only be held for a good reason:

“Yes, (they should hold an ESG roadshow) if they have something to say. If they have a really big campaign that they want to demonstrate and they really know their stuff. Because if they are just doing a marketing ploy, they are going to find themselves in a room with sustainability analysts and they are going to get destroyed. If they can really hold their own, then it could be beneficial.”
Advisors also suggested organising integrated roadshows. Sergey Sedov, Global Head of Private Clients at Renaissance Capital, recommended integrating ESG into a standard roadshow to save investors the time of attending two different events:

“I think it should be integrated because of practical matters. Some managers don’t have the time to focus on one company two times. People would prefer to do it in one go.”

May Jaramillo (Barclays) suggested that incorporating sustainability into mainstream communications saves resources:

“If you are not sure, at the end of your capital markets day or whatever meeting it is, bring in the person who leads sustainability. Then you are opening the door, but not opening it too wide because you don’t have the resources to do a deep dive on ESG.”

Moreover, Lindsey Stewart, Senior Manager in Investor Engagement at KPMG UK, suggested that integrated roadshows are increasingly becoming common practice:

“I think it would be a fairly unusual situation to go on the road to all investors solely to talk about your ESG disclosures, unless you are responding to some kind of serious and highly specific issue. If ESG integration is to be real, it has to be that common thread throughout all corporate reporting and outreach.”

2.4 Conclusion

Most issuers adopt a top-down approach to the formulation of their ESG strategy. There is also an increasing trend for companies to integrate ESG into the overall strategy, rather than keeping it separate. Issuers usually establish board-level ESG accountability by either appointing specific candidates for their ESG know-how or making ESG criteria part of the evaluation process for all board appointments. Common ESG policy goals for many companies focus on climate change and reducing emissions. Another important ESG issue is supply chain management, with many issuers employing ESG KPIs to keep track of key factors. In terms of executive compensation schemes, ESG KPIs are a divisive topic for issuers and investors alike, with some supporting and others opposing the idea.

Many issuers are concerned with the lack of transparency around the methodologies and data collecting practices within ESG ratings agencies. They are frustrated with the large number of agencies and their time-consuming information requests that eat up IR resources. Also, many issuers felt that ratings agencies evaluate companies with a one-size-fits-all approach and do not consider the specific circumstances of a company, which can result in inaccurate scores. The divergence in ratings between different agencies also confused issuers. In response to this viewpoint, rating agencies mentioned difficulties with evaluating large volumes of ESG-related data. They pointed out that most information produced by issuers lacks uniformity and therefore requires some standardisation to allow for comparison. Also, the ratings providers stated that differences in their scores result from differing methodologies that aim to address investors’ various goals. They suggested that companies should focus on addressing their material ESG issues rather than trying to find a way to improve their score. Investors stated that they mainly use the scores provided by ratings agencies as one of many indicators of a company’s ESG performance. Most investors already have or are developing internal ESG evaluation processes, which play a larger role in their investment process. Many investors also use engagement to gather information on a company’s approach to ESG. In this context, positive interactions with investors where a company shows willingness to change can compensate for their current imperfect ESG profile.

Most corporates communicate their ESG policies through reporting, information on the company website and direct interactions with investors. ESG reporting is usually either incorporated into the annual report or is published in a separate annual sustainability report. Some issuers also provide quarterly reporting on key ESG KPIs, while others find it too resource heavy. Investors would welcome more emphasis on corporate websites as a disclosure platform, with many saying that they would prefer information in a format readable by AI. When commenting on communication channels, investors recognise that IR is a reasonable first point of contact. However, they prefer to have meaningful discussions on ESG with senior management. With regards to ESG roadshows, most investors felt that ESG content should be included into standard NDRs, which would allow companies to reach a wider audience of investors and show that they take ESG integration seriously.
Section 3
Disclosure guidelines, regulation, and the future

3.1 ESG disclosure standards

3.1.1. Notable existing guidelines

The two most popular ESG disclosure standards within the issuer community are SASB and GRI. Many issuers taking part in this White Paper (50%) follow GRI for their ESG reporting, with SASB and TCFD also being frequently mentioned. Issuers had differing views on the reasons behind the current popularity of GRI with some attributing it to GRI being created prior to SASB, while others claimed that GRI is more widespread in Europe and SASB more US-centric. Several issuers stated that they are looking to integrate SASB and/or TCFD into their GRI reporting, although there were concerns that divergence between the frameworks might make that difficult.

Corporates were also concerned with following investors’ preferences on ESG disclosure. Several issuers commented that investors tend to prefer concise ESG reporting that focuses on material issues. Companies also felt that investors prioritise transparency of ESG data regardless of a disclosure framework.

Aside from ESG reporting frameworks, green initiatives followed by various issuers include the UN Global Compact, UN Sustainable Development Goals, and CDP, among others.

Some issuers’ opinions on existing disclosure guidelines are shown in the quotes below. Nick Stone (AstraZeneca) spoke about creating a transparent reporting system that could be used to fit any existing framework:

“We’ve realised that hanging your hat on framework A, B, or C isn’t really the be-all and end-all. Actually what people want is transparency around your data. One of the things we’re working towards is how we put both non-financial and financial data together on a platform that enables people to interact with it. And that can be through the lens of an institutional investor, or GRI, SASB, Sustainalytics. You can then put data into a framework that makes sense to you.”

Actually what people want is transparency around your data.
Daniel Bohsen (Novo Nordisk) illustrated a way to approach the disconnect between the detailed SASB KPIs and a company’s view on materiality:

“Novo Nordisk was an early supporter of SASB. We took part in the development of the first sector-specific guidelines, and all our reporting is aligned with their approach to materiality and key principles. But many of its recommended specific KPIs are not relevant from our perspective, and we don’t collect data just for reporting purposes. We also follow the TCFD recommendations.”

Teodora Bozhilova (Wienerberger) pointed out that the level of detail involved in GRI reporting can be problematic for investors:

“We started to report based on the GRI framework 10 years ago. We now see that GRI is very granular, so investors actually ask us to focus more on the material things. They like to have GRI in the background, but rather than reading through 200 pages, they are looking for the big topics, key targets, and regular reporting, something more high-level as a framework.”

Investors on reporting guidelines

Many investors (54%) rated SASB highly. Some of the positive comments referred to SASB being primarily tailored towards investors and focusing on materiality. Investors also favoured TCFD for climate-related disclosures. The views on GRI diverged. Some investors felt that it was good for disclosure guidance, while others commented that it was too detailed and not well-suited for providing data for investment analysis. Investors acknowledge that the existing disclosure guidelines can be a significant burden on a company’s resources, and would present challenges for smaller companies. However, for large companies, the expectations are greater.

Some investors commented that issuers should choose whatever framework or method of reporting fits their company best. Several investors also stated that companies need to make sure that ESG data is available and transparent. They went on to say, even if the data shows negative results, a transparent company would be perceived more positively by investors than the one that attempts to obscure their issues.

Investors’ opinions on the most popular ESG disclosure guidelines are shown in the quotes below.

Cindy Rose (Majedie) suggested that SASB is a good starting point for companies that haven’t conducted materiality assessments before:

“SASB takes a top-down approach. They say, for example, that retail groups might have certain material risks and opportunities, and banks may have other material issues. SASB lists areas of potential materiality for companies and investors to consider and is a great starting place for those who might not know much about materiality assessment.”

Maria-Elena Drew (T Rowe) explained the reasoning behind the preference for SASB and TCFD:

“We advocate that companies use SASB and TCFD as they are. We find the TCFD framework useful as it helps us to understand the company’s accountability structures for managing the impact of climate change and the amount of risk they see from climate change in their business.”

She added:

“A frequent question we receive from our investee companies is how and what they should report when it comes to environmental and social data. We recommend that companies follow a simple principle: Consider which environmental and social factors are material to your business and report them alongside financial data. We also recommend providing comparable historical data. As for specific frameworks, we recommend using the SASB and TCFD.”

My-Linh Ngo (BlueBay) commented that both SASB and GRI can be useful for drawing companies’ attention to particular issues in reporting:

“What’s useful is that ESG disclosure frameworks like SASB and GRI are both sector-specific and materiality is linked to this. We are not prescriptive about companies disclosing against these frameworks, but it is obviously helpful if companies report consistently against a common reference point to facilitate benchmarking.”

She also spoke about the different expectations that depend on the size of a company:

“I believe many investors are favouring SASB more generally given its more explicit focus on financial materiality of ESG factors. We do generally see a company size bias in adoption of such frameworks, so I guess if a large company doesn’t report against this and the majority of its peers do, we may seek to understand why they don’t.”

Advisors also recommend that issuers should use one of the main disclosure frameworks to guide their reporting. Sergey Sedov (Renaissance Capital) suggested using GRI in an annual report to demonstrate commitment to ESG reporting:

“I think to have GRI in your annual report is good. In the absence of common ESG reporting standards (i.e. IFRS or GAAP) it gives the impression that you follow best practices to collect and present relevant information.”
Lindsey Stewart (KPMG UK) suggested that the investor community is currently developing a strong preference for SASB and TCFD:

“We were at an investor event a few months ago, where we spoke to several investors who told us they were very keen on SASB. But then at the same time, TCFD is being embedded in EU regulation. Now these two frameworks are the only ones you hear about from most investors.”

Sophie Bailey (KPMG UK) added that TCFD will likely soon become a requirement for companies:

“I think the expectation is that TCFD will be mandatory for PLCs in the UK by 2022. We’re heading in the direction of companies having to report against TCFD in one way or another.”

May Jaramillo (Barclays) thought that reporting under any of these frameworks is ultimately beneficial:

“If you follow one of the frameworks, it’s helpful as long as you are committed. Because everyone knows it takes a lot of resources.”

3.1.2 Single ESG reporting framework?

Most issuers think that a common ESG reporting framework would facilitate disclosure and help investors evaluate companies more efficiently. In their view, a single framework would allow companies to focus on collecting and reporting the data instead of trying to follow diverging requirements of multiple reporting initiatives, ratings agencies, and investor preferences. It would also streamline available ESG data. At the same time, there were concerns that a single framework could lead to companies adopting a box-ticking approach to ESG reporting.

The following quotes demonstrate issuers’ expectations of a uniform ESG reporting framework.

Tanja Seiler (BMW) pointed out that a single framework will make it easier for investors to compare companies:

“There are several well-accepted and much-used frameworks, but there isn’t a recommendation to use any particular one. And obviously, standards improve the comparability, which is something that we don’t have at the moment.”

Georgios Galanis (Mytilineos) highlighted that uniform reporting will streamline the amount of data produced by companies:

“SASB and GRI help investors understand how materiality and sustainability issues impact companies’ financial performance, but they also generate more information to sort through. They add more and more data. That’s why there is a need for a uniform ESG reporting framework, probably from the EU.”

Megan Geldens (Wolters Kluwer) thought that a single reporting framework would resolve conflicting disclosure demands:

“I think corporates and IR would love a standard reporting framework that everybody agreed on. Then we all could focus on meeting that standard, rather than spending time completing lots of different surveys or trying to satisfy the different standards of the many ESG ratings providers. A single standard would also enable investors to make better comparisons.”

Several investors also commented in favour of a unified mandatory reporting framework. But they also mentioned that such a standard would require regulation, which would be difficult to achieve.

Robert De Guigne (Lombard Odier) spoke about the obstacles on the way to unified reporting:

“There’s been a lot of attempts to get a global standard on publication of extra-financial information. I think, 8 or 9 years ago we were already talking about this, but nothing came up. It’s complicated because we’re looking at international standards. Moreover, we are in a world where new information and innovation is coming out continuously. Therefore, I would say that flexibility is key in term of reporting. You need to build reports which are able to integrate more and more new information that is expected in the coming years.”
3.2 The EU Taxonomy

Many issuers spoke in favour of greater standardisation of ESG reporting, represented by the EU Taxonomy. Some companies thought that the Taxonomy doesn’t go far enough because, at the current stage, it only focuses on the environmental aspect. There was also a call for greater attention to the social part of ESG at the regulatory level. Several companies were critical of current ESG regulatory initiatives, specifically in relation to the level of detail required for Taxonomy disclosures. In addition, there were doubts about whether other jurisdictions, such as the US and China, will adopt similar rules. Corporates were concerned that if stricter regulation such as Taxonomy will remain confined to Europe, its effectiveness in promoting good ESG practices and standardisation will remain limited.

The following comments show some of the issuers’ attitudes to the EU Taxonomy.

Diego Martínez (Iberdrola) thought that standardisation is necessary, although some industries might find it difficult to comply with the new requirements:

“Standardisation of ESG reporting is necessary for different companies, projects and investments to be comparable, and is something that the EU Taxonomy is developing, although the transition period is taking some time. This is due to the complexity of having many different players, activities and sectors. Hard to abate sectors find many difficulties to comply with the requirements of the transition standards set by the EU Taxonomy. In our case, we are the leader in green financing, complying with all those requirements.”

Tanja Seiler (BMW) said that many companies already consider more ESG factors than what is currently dictated by the Taxonomy:

“Most European companies have a sustainability strategy or corporate strategy that goes far beyond the scope of the EU Taxonomy at the moment. We have 20 years of experience in sustainability reporting, so our discussion goes deeper than just climate change and climate mitigation activities.”

Nick Stone (AstraZeneca) highlighted the challenges arising from the differences in regulatory standards around the world:

“I think the Taxonomy is a good thing, fundamentally. Why is the EU doing this? Part of this is to raise standards, and I think that is the right ethos because many companies probably don’t do as much as they can. The challenge then becomes whether the US or other jurisdictions adopt something similar. For a global company, it would be complicated if the US adopted something that then starts to conflict or contradict with what Europe is doing.”

Investors broadly supported the idea that regulatory initiatives are necessary to drive meaningful change on ESG. The general opinion was that the market on its own cannot adequately meet the current environmental challenges, especially considering the time pressure tied to climate change. At the same time, investors expressed caution with regard to the latest regulatory advances. My-Linh Ngo (BlueBay) emphasised that regulation should be precise enough to avoid being too restrictive:

“It’s a tricky balance to find, too much of the wrong type of regulation can stifle market innovation. It could also lead to unintended consequences if too prescriptive, and so undermine what they are looking to achieve in the first place. The key is smart regulation – characteristics of which are that it is joined up, it is informed, and it focuses on the right aspects to drive innovation and best practice. It’s about quality over quantity.”

Most investors (71%) viewed the Taxonomy positively. In their opinion, the mandatory aspect of regulation is crucial to ensuring wider adoption of better ESG practices. Investors also pointed out that the Taxonomy will significantly increase transparency in ESG data, which will aid their investment analysis. Similarly to issuers, some investors noted that the current focus on climate in the Taxonomy is too narrow, whereas others thought that the granular disclosure rules introduced by the Taxonomy were a sign of overregulation.

The following quotes illustrate some of the investors’ thoughts on the EU Taxonomy.

Armin Peter (UBS) thought that EU regulators showed a high degree of engagement with the markets:

“I think that standards have to come from a regulatory push. In this case, regulation has been listening to the markets very closely, and, hopefully, continues to do so. Often, in other market sectors, the regulators have not engaged with the broader markets at the same level as they have been in the case of sustainability in the past few years. So I think they found a good balance.”

Andrew Parry (Newton) thought that overly prescriptive regulation around ESG risks might create a bubble:

“I think there’s always a tendency to think that if you have a bunch of funds with a shiny green label on them, it will attract more capital. The problem with that is that everybody then has a tendency to buy the same stocks. There were about 90 stocks that seemed to meet the requirement in Europe. And that means that everybody’s using that to build portfolios, active and passive; you all have to be seen to have a label, and there’s only one definition of what good looks like, and that comes from the Taxonomy. Then you have this massive problem of everybody herding; the stocks become overvalued and then there is a danger that they underperform for years afterwards.”

Maria Lombardo (Invesco) spoke in favour of the Taxonomy:

“I’m not denying that regulation is required because I think it’s very good and challenging in setting the right direction. If I look at the Taxonomy, it might seem daunting and incredibly difficult to implement for both financial institutions and corporates, but on the other hand, it gives corporate a way identify, disclose and present their data in a consistent and comparable fashion that gives financial institutions better transparency in analysing data.”

Roland Rott (La Française) was concerned that the Taxonomy might be too prescriptive:

“The EU Taxonomy has all the hallmarks of overregulation because it goes one step too far in prescribing how everything in the world should work. It’s going in the right direction by saying that we need to be clear in what we mean when we say green, but it’s super ambitious. We need to ensure that we don’t end up with a box-ticking exercise but with a flexible approach that allows investors to support companies in the energy transition.”

... regulation has been listening to the markets very closely, and, hopefully, continues to do so
ESG ratings agencies were also mostly in favour of the Taxonomy. They expressed support for any regulatory measures that would standardise ESG disclosure and improve transparency. At the same time, ratings providers noted that standardisation of disclosure will not eliminate the discrepancy in scores, because these scores are intended to represent different viewpoints. They also thought that adapting to the new disclosure standard will be a challenge.

Hendrik Garz (Sustainalytics) commented: “The EU Taxonomy brings the need to fundamentally change the way ESG ratings providers do their research. It is going to be much more activity-based and more granular compared to what we have been doing so far, which was more on the overall company level.”

Advisors also perceived the Taxonomy as a beneficial development. Lindsey Stewart (KPMG UK) thought that it will shape the unification of ESG standards in the region:

“If there’s one thing investors have been crying out for, it’s standardisation. And given the reach of EU regulations, the Taxonomy is likely to become a foundation of whatever standardisation will look like in the coming years, particularly in Europe.”

Some advisors pointed out that stricter regulatory standards are necessary to achieve the climate goals established by international agreements. May Jaramillo (Barclays) commented:

“Without regulation, it will be much harder and much longer to see ESG broadly implemented. It will be very difficult to deliver on Paris without policy. We have started seeing a clearer path to policy development in Europe, U.S., China, and India.”

Finally, Lucian Firth (Simmons & Simmons) highlighted the significant impact the new EU regulatory regime will have on asset allocation:

“I think that for issuers, it is important to understand that asset managers are under immense pressure to be seen to be integrating ESG factors into their investment decisions. Investors are having to comply with these regulations, and therefore they will really be thinking about ESG in a way that they have never before. For example, one of the requirements under the Sustainable Finance Disclosure Regulation is that asset managers will have to disclose the external adverse impact across 32 mandatory indicators for all the assets in all their portfolios. So there will be an immense thirst for disclosure data. Corporate issuers will be well-advised to get up to speed on what their investors will be needing from them.”

3.3 ESG in the next few years: Emerging trends

All issuers that took part in this White Paper thought that ESG will continue to be an integral part of their company strategy in the future. For companies in the consumer sector, one of the most important factors in this context was the increasing environmental and social consciousness of the general population. This concern encapsulates packaging, chemical ingredients, emissions, and other production issues. The shifting societal attitudes also affect hiring—companies are having to attract and retain employees that have higher expectations in terms of ESG practices. Climate change is another matter that will continue to have to be addressed by companies in all sectors during the next decade. Issuers also have to adapt to an increasing amount of regulatory standards around ESG, from the international treaties such as the Paris Agreement to TCFD, the EU Taxonomy, and other emerging frameworks. Meeting these challenges will require a significant amount of resources. Teodora Bozhilova (Wienerberger) emphasised the long-term nature of ESG goals and the unavoidable expenditures required to meet them:

“If you take sustainability seriously, it needs to be part of your capital allocation. Companies need to invest into sustainability improvements but there will be clear pay-backs and it will pay-off in the mid- and long-term. Also, companies will have more potential costs in the future if they don’t take certain steps now. It’s also clear to investors that there needs to be a time period for companies to invest in sustainability.”

The comments below show the views of some issuers on the future of their business in the ESG context.

Diego Martinez (Iberdrola) commented on how societal change and the ongoing Covid-19 crisis is impacting the market:

“ESG is a key trend, as social and environmental consciousness is growing heavily in the minds of new generations. Society is becoming more aware of the world we’re living in, of the environmental problems, social problems, gender problems, race problems. And the investment world cannot operate separately from this trend. Moreover, due to the deterioration of the economy caused by COVID-19, the relevance of decarbonisation is currently growing, in order to use investment opportunities arising thanks to the EU Green Deal, as a tractive force to get out of this economic crisis.”

Daniel Bohsen (Novo Nordisk) spoke about the growing focus on sustainability, including the hiring aspect:

“Sustainability will be even more deeply integrated in the way we do business and the way we communicate about our business. As we pursue our purpose, we add value to society and to our future business. For us, contributing to sustainable development is a basic tenet to be a sustainable business. The external focus on ESG will surely help drive a more standardised approach, which we support. We also see that in terms of attracting new employees and younger talent, this only gets increasingly important.”

Nick Stone (AstraZeneca) thought that increasing consumer awareness on sustainability issues will lead to closer scrutiny of the medicine production cycle:

“Just think about how things have changed in the context of food. There are various movements where people want to see the amount of sugar, fat, or whatever it might be in certain products. People are a lot more informed in terms of medicines they take. But are they looking at the medicines and really understanding the production? I feel that consumers are going to drive a different agenda, which will lead to different requirements for us, and the regulators will probably force us to change.”
The majority of investors see ESG integration becoming more and more mainstream in the next few years. With regard to terminology, some thought that term ‘ESG’ will eventually disappear as it becomes a normal part of the investment analysis. Andrew Parry (Newton) illustrated this view:

“If you think of ESG, it’s about just having a complete picture of all the variables going into assessing the merits of a company so you can value it properly. Then it just becomes part of what we do. And therefore, increasingly, it sort of disappears as a high profile concept.”

He went on to say that companies should focus on a long-term view of their business models:

“People are increasingly focusing on how companies make themselves more sustainable and relevant in a rapidly changing and transitioning world. Being actually sustainable, and managing the impact of the business on society and the environment is going to be the big trend.”

Others thought that ESG as a concept will merge into a broader understanding of sustainability. Robert De Guigne (Lombard Odier) talked about the connection between these terms:

“I believe that, more and more, the ESG world is transforming to become the sustainable world. ESG is just a part of sustainability. I would say what is important for everybody today is to be in a sustainable world. Sustainability is adaptation to all these challenges, and also reducing all the negative impacts that we could have on our planet.”

Some investors predicted that impact investing will grow exponentially as retail investors start to pay more attention to environmental and social issues. Roland Rott (La Française) commented on this potential development:

“In 5 to 10 years’ time ESG integration won’t exist anymore, it’s just investing. And there will be a bigger market, compared to today, of impact investing, where we create outcomes in terms of environmental and social factors.”

Some of the investors’ thoughts on future ESG trends are shown in the quotes below.

My-Linh Ngo (BlueBay) outlined how ESG will continue its advance into the mainstream, supported by regulation:

“I think ESG will come into the mainstream and in Europe, it will be forced by regulation. And you can see that being replicated in other markets. Companies that operate globally will have to manage that. It doesn’t matter if they’re based in a country where it’s not relevant if they want to be able to have access to investors in the other markets they are going to have to adapt.”

Cléo Fitzsimons (Cazenove) emphasised the impact of climate change on the behaviour of retail investors:

“You see people changing the way they buy food, clothes, cycling instead of using a car or public transport. Naturally, that would also translate to the investment portfolio. Even for the pension funds, if all of a sudden the end investors are putting pressure on the institution about whether their investments are aligned with their values, they have to act on that. I think this trend will continue.”

Andrea Carzana (Columbia Threadneedle) spoke about potential funding difficulties for companies without an appropriate ESG policy:

“Companies that are not willing to be transparent and disclose their ESG credentials will be penalised by the capital market in terms of the higher cost of capital to incorporate a higher ESG risk in their operations.”

Advisors suggest greater unification of ESG reporting standards, a greater regulatory focus on environmental challenges, and improvements in data availability are some of the main future trends. Lindsey Stewart (KPMG UK) discussed how the gradual advance of ESG will continue in the next few years:

“Some of the major impediments to the growth of ESG were the lack of standardisation, and the investor perception that there was a trade-off to be made between doing good and maximising investment return. I think the future trends will reflect the removal of those impediments in the minds of investors. Greater standardisation is already happening, and as ESG becomes more integrated, eventually we’ll reach a point where ESG investing ceases to be a useful distinction for most of the capital. Maybe at that point we’ll see a greater focus on impact investing.”

May Jaramillo (Barclays) discussed what a greater emphasis on ESG will mean for supply chain management:

“Anything that affects the supply chain is going to be a big focus for ESG. Companies need to focus on how they source their energy, their contracts with employees, if they are liable for the trucks that are using diesel or renewables. It doesn’t matter if it’s contracted out – investors now want to know who it is contracted out to.”
3.4 Conclusion

While many investors positively spoke of SASB, most issuers use GRI in their reporting. However, this is changing as several companies that currently use GRI are looking to incorporate SASB and TCFD into their reporting. Issuers expressed uncertainty with regards to investors’ preferences on disclosure frameworks. They were also unsure what level of detail is necessary in terms of ESG disclosure. Despite viewing SASB in a positive light, investors did not express a strong preference for a particular framework. Some investors said that companies should pick the framework that suits their needs best. Others emphasised that what matters most is transparency around ESG data, even if it shows negative results. Both issuers and investors spoke in favour of a single, mandatory ESG reporting framework. Issuers felt that it would allow them to focus on reporting rather than trying to follow the demands of investors, ratings agencies, and different reporting initiatives. It would also make it easier to compare and evaluate companies.

Both issuers and investors expressed a clear wish for the greater standardisation of ESG rules and reporting. The Taxonomy was generally welcomed as a step towards that goal. However, there was some criticism from both sides. Some issuers thought that, at the current stage, the Taxonomy is too limited because of its single focus on environmental issues. There were also concerns about the new rules being overly prescriptive and limited in its geographical reach. Investors, while being supportive of the Taxonomy, were worried about the risks of overregulation. Moreover, ratings agencies and advisors also saw the Taxonomy as a beneficial development necessary to instil better ESG practice.

The overall sentiment from all participants was that ESG will continue to be a key strategic focus for the foreseeable future. Climate change remains an issue that needs to be addressed by companies in all industries. This encompasses the drive to reduce emissions and manage risks arising from environmental changes brought on by climate change. Issuers and investors thought that the increasing societal attention to sustainability will affect everything from the way companies do business to hiring to pension funds’ asset allocation. Some investors also expected ESG integration to become normalised as a part of investment analysis to the point of disappearing as a separate category. Impact investing is expected to grow in response to the demand for investment strategies that create positive societal and environmental changes.

Despite a number of distinct challenges, such as an absence of uniform standards and the resulting confusion between the market actors, it is clear that ESG is a development that cannot be ignored. Responses to this White Paper show that ESG will remain critically important to corporates and investors in the coming years.
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