Resilience Development Initiative

The Evolving Landscape of ESG Measurement and Improvement in Impact Investing

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In the realm of finance and investment, a profound transformation is underway—one that transcends the traditional pursuit of profits to embrace a broader mission. Impact investing, a strategy that seeks to generate positive social and environmental outcomes alongside financial returns, is no longer a niche concept but a driving force reshaping the global investment landscape.

At the heart of this transformation lies the growing prominence of Environmental, Social, and Governance (ESG) criteria. ESG factors are no longer mere buzzwords; they have become the cornerstones of responsible and sustainable investing. Investors increasingly recognise that assessing a company's impact on the world is as essential as evaluating its balance sheet.

This article explores the evolving landscape of impact investing and the imperative of scoring or measuring ESG factors. As we navigate the complexities and challenges of integrating ESG into investment decisions, we discover the burgeoning frameworks and tools available and the critical role of regulation and potential solutions.

Is Prioritising ESG Financially Rewarding?

As we navigate the evolving landscape of corporate sustainability, where businesses are increasingly adopting greener and socially responsible practices, a crucial question arises: Would prioritising ESG principles potentially hinder financial rewards? ESG performance is sometimes underestimated, as there is a presumption that emphasising sustainability could deter economic benefits.

However, significant research findings challenge this presumption. An NYU Stern Center for Sustainable Business study, which analysed over 1,000 studies, revealed compelling insights. It found a strong correlation between effective corporate management of ESG criteria and several key financial metrics, such as improved Return on Equity (ROE), Return on Assets (ROA), stock price performance, operational efficiency, and risk management (NYU Stern, 2021, p. 7). This robust empirical evidence suggests that ESG integration goes beyond ethical considerations; it directly impacts financial outcomes.

Furthermore, a report published by S&P Global Ratings reinforces the connection between ESG performance and financial success (S&P Global, 2019). This report underscores that companies demonstrating strong ESG performance tend to experience enhanced corporate financial performance and deliver superior investment returns. These findings emphasise that ESG is not merely a checkbox for companies to fulfil social responsibility; it is a strategic imperative that can enhance their bottom line. These insights bridge the gap between sustainability and financial viability, highlighting the importance of quantifying ESG performance in the corporate world.

ESG Scoring, As It Stands

Measuring the multifaceted dimensions of ESG performance is undoubtedly a complex endeavour. ESG factors encompass a wide array of qualitative and quantitative data, ranging from a company's carbon emissions and supply chain ethics to its board diversity and community engagement efforts. This complexity has led some sceptics to argue that ESG quantification is a daunting if not an impossible, task.

Nevertheless, in recent years, there has been significant progress in developing a comprehensive ecosystem of tools, methodologies, and data sources aimed at assisting both investors

and companies in navigating this complexity. To promote consistency in reporting ESG impact, several ESG standards boards have emerged, functioning in a manner similar to the Financial Accounting Standards Board (FASB). These boards establish accounting principles and reporting requirements. For instance, a company may be obligated to produce a statement detailing its environmental impact. Prominent examples of such standards boards include the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB), the Climate Disclosure Standards Board (CDSB), and other standardised measurements which offer frameworks for companies to effectively communicate their ESG performance (Multiview Financial, 2021).

However, challenges persist even with the proliferation of these sets of standardised scoring methods and frameworks. Accountants, who have long grappled with the complexities of navigating between Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS), are well-acquainted with the challenges of dealing with multiple sets of standards. This predicament often forces accountants to spend valuable time converting reports to different standards or leaves end-users struggling to make meaningful comparisons across diverse standards. When it comes to ESG standards, the situation becomes even more intricate. The reason for this lies in the fact that every ESG rating agency computes scores using unique algorithms and specific criteria, resulting in divergent evaluations of a company. Typically, ESG performance relies on data collected from diverse sources such as securities filings, voluntary corporate disclosures, government databases, academic research, and media reports (Conservice ESG, 2023).

Consequently, despite the availability of some ESG scores designed to enable the public to assess a company's ESG performance, a universally accepted global ESG standard has yet to emerge. Therefore, the ESG ratings assigned to a company by different firms can diverge significantly from one another, a phenomenon frequently observed by both the investors who rely on these ratings and the companies being rated. Interestingly, the level of divergence between ratings is striking. Researchers at MIT found that the scores given by six major ESG rating agencies only had an average correlation of 61%, compared to credit ratings that had a 99% correlation (Brackley, 2022). Moreover, a 2022 survey of over 1,000 global investors also highlighted that the biggest hurdle in using ESG investment strategies is the inconsistency in ESG scoring methodologies and standardisation (Capital Group, 2022).

This absence of a global standard can lead to confusion and hinder the ability to make direct comparisons between companies or industries, underscoring the persistent challenges within this evolving field. Furthermore, it may entice corporations to prioritise bolstering their ESG ratings while potentially overlooking indicators of trouble that critical ratings might signal.

The Role of Regulation in Advancing ESG Scoring

The role of regulatory frameworks must be considered in the quest to quantify ESG factors and integrate them into investment decisions. ESG Regulations refer to the regulatory measures designed to promote sustainable and responsible business practices. Governments and financial regulators around the world should recognise the significance of ESG considerations in the modern economy. They should implement policies and standards that compel companies to disclose their ESG performance, making it a critical aspect of ESG Measurement.

ESG regulations should require companies to disclose their ESG performance and risks to investors, which increases transparency and accountability. Companies that fail to meet ESG standards may face reputational damage and loss of investor confidence, which can significantly impact their bottom line. ESG regulations may also require companies to change their business practices to align with ESG standards, which would involve significant investments in new technology, processes, and systems.

Agencies worldwide have tried to address these concerns by disclosing companies' ESG data. Regulators in the United States, United Kingdom, European Union, and ASEAN (Association of Southeast Asian Nations) have started to recognise the need for a set of rules when it comes to ESG metrics. For example, in the US, the Securities and Exchange Commission (SEC) is working to standardise climate-related disclosures by public companies with the hope that it will aid in improving the accuracy of the ESG ratings of these companies (SEC, 2022). In the UK, the Financial Conduct Authority (FCA) has announced the formation of a group to develop a Code of Conduct for ESG rating providers (FCA, 2022). In the EU, the European Securities and Market Authority (ESMA) is considering introducing regulatory safeguards for ESG ratings (ESMA, 2021). Concurrently, in ASEAN, seven ASEAN Member States have already enacted sustainable finance regulations mandating companies to disclose their sustainability performance (WWF, 2020).

Companies' disclosure of ESG performance is pivotal to global ESG scoring standardisation. It increases the availability of ESG data, promoting transparency and trust among stakeholders. The collective effort of companies, investors, regulators, and international organisations to promote ESG disclosure creates a conducive environment for global cooperation. As more entities align with specific reporting standards and frameworks, it becomes easier to facilitate global discussions and agreements on standardised ESG metrics.

A Path Forward

Despite significant efforts to enhance ESG disclosure frameworks, reporting still needs to improve from consistency, comparability, and quality issues, which limit its usefulness to investors. Addressing these challenges involves focusing on universal core and sector-specific metrics within the E, S, and G categories.

Firstly, core metrics that form the core categories of E, S, and G should be standardised so that they can be promoted by exchanges and framework providers and utilised by ESG raters and end-users. Secondly, sector-specific metrics should be developed to capture industry-specific E, S, and G elements. For instance, the metrics used to assess environmental risks in the energy sector would differ significantly from those in the financial sector. These sector-specific adaptations should consider trade-offs between completeness and data availability and evolve as more consistent data becomes accessible.

Furthermore, emerging technologies such as Artificial Intelligence (AI) and machine learning can contribute significantly to refining ESG measurement. These technologies can help pinpoint specific industries or regions' most pertinent ESG factors. Collaborative efforts among stakeholders, including investors, corporations, regulators, and civil society, also play a crucial role in advancing ESG measurement. Through the exchange of best practices and the promotion of transparency, these collaborations facilitate a more comprehensive understanding of how ESG factors impact financial performance and societal outcomes.

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