ESG Credibility - Challenges & Solutions

Background

Now more than ever, capital market participants are urged to contribute to an economic system that ensures 21st-century capital markets remain **open, vibrant, and sustainable, and operate in the long-term interests of both shareholders and society.** Working with HMI's asset manager forum over the last few years, we have observed continued progress among asset managers in integrating environmental, social, and governance (ESG) factors across asset classes and increased focus on ESG as a value driver for long-term performance.

Impressive numbers have been recorded both in terms of assets under management and fund flows. Around the world, a remarkable **US$185 billion** flowed into sustainable funds in the *first quarter of 2021* alone and **111 new funds** were launched in that three month period. Research by Bloomberg Intelligence estimates that, by 2025, more than US$53 trillion in assets under management will have some sort of sustainability-related mandate – ranging from simply applying exclusionary screening criteria to investing with an aim to achieve meaningful sustainability outcomes. These developments allow for the assumption that leading players in capital markets, such as asset owners and asset managers, have recognized their role in advancing a sustainable, resilient capital markets system. Is that the case though?

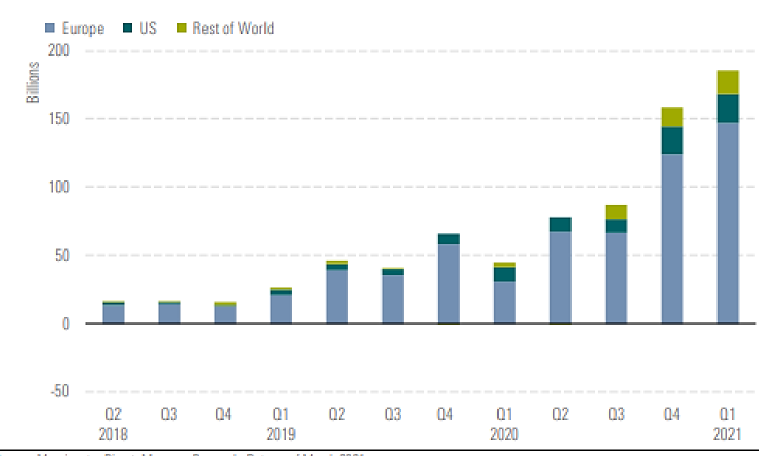

Figure 1: Quarterly Global Sustainable Fund Flows (US$ billion)

It comes as no surprise that with the flood of investment dollars now being labeled as "ESG" and directed to "sustainable funds,' there is also renewed scrutiny. Some ESG skeptics argue that ESG is currently experiencing its bubble moment as an investment theme, having "become something of a self-fulfilling prophecy, driven entirely by liquidity and flows." In March 2021, a former CIO of Sustainable Investing at BlackRock accused the financial world of **greenwashing** the public by making sustainable investing merely a PR stunt.*

Sidenote: *Pushback from the investment community on those specific accusations did not take long to emerge. For instance, representatives of Allianz Global Investors argued*: "The assertion that all asset managers want to fool investors with marketing strategies that are sustainable in name only is a blanket statement that ignores reality in service of a catchy headline. While we recognize that some asset managers are playing catch-up and jumping on the proverbial bandwagon, the truth is that ESG is an intrinsic part of the investment processes of some asset managers. […] ESG asset managers will continue to undertake this work to enhance standards, increase transparency, and continue to use the power of investing and capital markets to address the key issues facing governments and citizens alike while seeking better risk-adjusted returns for investors."*

Accusations of rampant greenwashing may not be completely unsubstantiated. The proxy voting records of index funds with explicit ESG mandates were found to be contradictory by the MIT Sloan finance faculty. Last month, The Economist took a closer look into the world's 20 largest so-called "ESG funds." Their findings? Not ideal:

- Each fund holds investments in seventeen fossil-fuel producers (on average)
- Six funds own stakes in the US oil giant ExxonMobil
- Two funds are invested in global oil producer Aramco
- Coal mining, gambling, alcohol and tobacco investments are also widely represented

These types of insights enforce the worry that "ESG investments" are not what they claim to be. In fact, research by Quilter recently revealed greenwashing as a key concern for **44%** of responsible investors.

Without a doubt, investors play a critical role in tackling the key sustainability-related challenges we face today. But the sustainable investment industry must work to avoid the loss of stakeholder trust.

In this briefing note, we examine some of the core factors fostering ESG skepticism and potential solutions for the industry to address these challenges.

Types of greenwashing

There is no "one type" of greenwashing in the investment industry. In a consultation report on "Recommendations on sustainability-related practices, policies, procedures and disclosure in asset management," the International Organization of Securities Commissions (OICU-IOSCO) describes a variety of ways in which greenwashing can occur – distinguished by firm and product level:

Firm level	1. Marketing communications that do not accurately reflect the level and/or extent of the asset manager's consideration of sustainability-related risks and opportunities in its processes 2. Failure of asset manager to meet its public sustainability-related commitments
Product-level	1. Lack of alignment between the product's sustainability-related name and its investment objectives and/or strategies a. Product's name refers to sustainability but its investment objectives do not b. Product's name refers to sustainability but its use of ESG strategies is limited c. Product's name refers to sustainability but the asset manager has discretion over whether the product takes sustainability into account 2. Marketing that does not accurately reflect the product's investment objectives and/or strategies a. Product is marketed as a sustainability-related product but it is not b. Product is marketed as focusing on all three ESG components but is only focused on one c. Extent and nature of product's use of ESG strategies are different than advertised 3. Failure of product to follow its sustainability-related investment objectives and/or strategies 4. Misleading claims about the product's sustainability-related performance and results 5. Lack of disclosure a. Lack of disclosure about product's investment strategies b. Lack of disclosure about product's use of proxy voting and shareholder engagement c. Lack of disclosure about a product's sustainability-related performance and results

Table 1: Types of Greenwashing (Source: OICU-IOSCO)

ESG Credibility Issues – Cause and Effect

1. Lack of a standard definition of what is considered "ESG"

Although there is general consensus that "ESG" means using environmental, social, and governance factors in the investment decision-making process, there are numerous approaches to how investors may achieve their objectives. The most common approaches include:

Exclusionary/negative screening: Exclusion from a fund or portfolio of certain sectors, companies or practices based on specific ESG factors (i.e., excluding tobacco or weapons industries).

- **Norms-based screening:** Investments are assessed against the minimum standards of business practice based on international norms, such as those issues by OECD, ILO, UN, and UNICEF.
- **Positive / best-in-class screening:** Investment in sectors, companies, or projects are selected for positive ESG performance relative to industry peers.
- **ESG integration:** **S**ystematic and consequential integration of financially material ESG factors alongside traditional financial factors in investment analysis and investment decisions.
- **Sustainability-themed investing:** Investment in themes or assets specifically related to sustainability (i.e., clean energy, green technology, or sustainable agriculture).
- **Impact investing:** Targeted investments aimed at solving social or environmental problems, including community investing, where capital is specifically directed to traditionally underserved individuals or communities, as well as financing that is provided to businesses with a clear social or environmental purpose.

ESG factors considered in each of the approaches can cover a wide range of issues from a company's use of energy and raw material sourcing (E), to employee pay and diversity and inclusion (S), to executive compensation and cybersecurity risk management (G). In short, "ESG" has become the catch-all phrase for a proliferation of sustainability factors that are now integrated into both corporate strategy and investment management.

The sheer depth and breadth of what is now considered "ESG" has contributed to the confusion we see playing out across geographies (regional differences in ESG priorities), asset classes (risk management vs. value creation), and even within organizations (across portfolio management teams/strategies). This makes it difficult to identify ESG laggards and leaders and presents the need (and opportunity) for more rules-based standardization, consistency, best practices definition, and tools to help analyze, assess, and validate ESG data and content.

2. Lack of regulations on what can be labelled "ESG" and how to prevent "greenwashing"

Without standards and regulations, there are few barriers to entry for labelling a fund as "ESG" or "sustainable." Against a backdrop of record new fund launches and flows into sustainable funds, the US SEC released a Risk Alert in April 2021 **after finding:**

- Misleading statements about ESG processes
- Claims of formal processes but no policies, procedures, or documentation
- Compliance programs not well-designed to guard against inaccurate ESG-related disclosures and marketing materials
- A lack of controls to match clients' ESG-related investing guidelines
- Proxy voting practices inconsistent with stated approaches

Addressing these issues and exposing inauthentic ESG practices is necessary for the long-term viability of the sustainable investment industry. Failure for the industry to do so will create a noteworthy risk that such accusations will magnify the cohort of ESG skeptics and that investors skepticism of sustainability-labelled funds will grow. This highlights the very urgent need for specific, standardized disclosure standards for investors and (stricter) regulations on what can be marketed as "sustainable" or "ESG."

3. Variability on what it means to "integrate" ESG

ESG integration is a process and not a binary practice. There are many ways to integrate ESG with two core areas of focus:

1. The number of activities within which a manager integrates ESG (***completeness of integration***); and

2. The depth of these integration practices for each activity (***sophistication of integration***)

Example: Manager #1 may have an investment process in place that considers ESG in their pre-investment research and analysis activities, but solely uses industry frameworks or standards. Manager #2 also performs pre-investment ESG analysis, but also uses internal and external ESG knowledge, data and insights to obtain an in-depth understanding of the current and future business-model specific material ESG issues of potential investments, as well as the investee's capabilities and track record in managing ESG issues. Further, manager #2 monitors ESG-related incidents and re-assesses material ESG issues and areas of growing ESG risk exposure during the holding period on an ongoing basis, while manager #1 does so on an ad-hoc basis. However, both fund managers may accurately label their strategies as "ESG."

In addition, ESG integration practices can differ significantly at the ***firm level vs. the fund level***:

- Firms may have integration processes that do not necessarily make it into the various investment funds.
- Alternatively, an investment fund may have a sophisticated ESG integration approach that is not adopted firm wide.

Example: A multi-asset investment manager with a range of offerings (including private debt funds, public equity funds and a global fund of funds) has established ESG integration as an integral part of the long-term business plan and strategic plan of the firm. Overall, the ESG integration at the firm level may be considered sophisticated. However, the level of *completeness* and *sophistication* in each of their funds may vary. The level of ESG integration may be scored as advanced for their private debt and public equity funds. However, due to in-house resource restraints and specific asset-class complexities, ESG integration across asset classes and specific funds may differ widely.

Without first identifying ESG best practices at the firm and fund levels, it is difficult to assess and compare managers' ESG integration practices and whether they are performed in a genuine manner.

This calls for a set of **comparable metrics** that will allow for a scoring of the *completeness of integration* and the *sophistication of integration* of ESG factors. Further it is important to note that, as ESG integration can differ depending on multiple factors, the **reliance on one overall score to assess ESG practices can create distortions** in how managers are viewed. To prove a clear and realistic view, granular scoring (e.g., separate evaluation of ESG integration components) is required.

4. ESG Data

It is a familiar refrain: in its current state, ESG data is not good enough and is causing most investors in the ESG space some degree of frustration. Common criticism includes:

Corporate reporting is still inconsistent:	For the most part, sustainability reports are lacking a common, universal framework that allows for comparability across companies (often even within an industry). This makes it hard for investors and ESG data providers to accurately assess whether companies are performing well on sustainability or not.
ESG rating methodology differences:	Despite the rising use of ESG ratings, there is substantial disagreement across the data providers on how to rate individual firms. Simply put, "How ESG stocks perform depends on who ranks them," e.g., the same company could be classified as an 'ESG leader' by one data provider while being perceived as an "ESG laggard" by another – much to the confusion of investors. In brief, inconsistent ratings can be explained by differences in rating methodologies and the use of different benchmarks.

	As described in a recent paper by Christensen, Serafeim, and Sikochi, greater ESG disclosure actually leads to greater ESG ratings disagreement. To the previous point above: standardized sustainability reporting, not excess reporting, is key.
Reported ESG information requires verification:	Non-financial information is – thus far – not typically included in financial statements and may not belong under the scope of an external audit's assessment. Unless a company completes an assurance of their ESG-related disclosures in a separate engagement, investors' (and other stakeholders') ability to wholly trust the reported data may be constrained. But there is another issue: for many ESG topics, accounting rules are immature (e.g., how to measure and manage labor issues in the supply chain).
ESG data is mostly reactive in nature:	Most ESG data providers are focused on corporate disclosure aggregation, and therefore are reactive and backward-looking by nature. This implies that ESG data serves as a starting point for understanding how a company has been performing, and that the data may signal its future intentions and exposures.

Irrespective of whether an investment portfolio is "ESG integrated," sustainability issue-themed or focused on impact, the construction of the portfolio requires reliable and accurate data. In the absence of such, investors run the risk of including issuers not aligned with their investment objectives and contributing to overall ESG credibility concerns.

5. Influence of investment consultants

A rise in global demand for ESG products has also resulted in a rise in demand for ESG investment advice. These market developments mean that investment consultants need to rapidly adjust their service offerings, but many still have a long way to go. A 2017 PRI study found that most consultants (and their asset owner clients) have not sufficiently considered ESG issues in their investment processes.

Without investment consultants fully on board, financial markets cannot reach a mature state of ESG authenticity. The world's most powerful capital allocators – recording trillions of dollars in investable assets – rely on their advice. Located in this influential position, the cohort of consultants must more widely acknowledge the multiplier effect of their ESG service deliveries (or the lack thereof).

6. Lack of knowledge

Integrating environmental, social and governance factors into the investment process, measuring associated sustainability outcomes and disclosing policies, processes and impacts adequately can be highly complex. One challenge that is closely linked to the above is a lack of ESG-related knowledge across the investment community.

To avoid (unintended) greenwashing, the investment community must consist of informed and financially literate individuals. These should be equipped to deal with the growing complexities of financial markets, understand ESG-related products, concepts and risks, develop skills and confidence to apply them in the investment process and make informed decisions.

Knowledge gaps are cited as the biggest barrier to advancing sustainable investments by advisors, according to research by Invesco. More than 60% of survey respondents pointed to an inability to distinguish between the different types of funds or strategies. In-house expertise was also found to fall significantly short amongst asset managers. This is also reflected in the current hiring boom for "ESG experts" – impeded by a lack of suitable candidates.

The International Organization of Securities Commissions (OICU-IOSCO) notes that scaling investor education initiatives with a focus on sustainability, however, is hindered particularly by limited financial resources, infrastructure and skilled human resources to conduct training.

To overcome credibility challenges and minimize the risks of greenwashing, individuals working in the sustainable investment space must undergo appropriate education and training.

Solutions to address credibility issues

1. Regulating the industry (hard-law mechanisms)

New global regulatory efforts have emerged to mandate and govern sustainability disclosures. The general aim of these efforts is to create consistency in the language used for ESG investing and to have fund managers provide more sustainability-related information to help ensure investors have the disclosures they need to draw distinctions between investment approaches and ultimately make more informed investment decisions.

- The **EU Taxonomy Regulation** aims to act as a framework to facilitate sustainable investment for market participants by establishing a classification system for "environmentally sustainable" economic activity. By the end of 2021, investors that offer funds in Europe labeled as such will need to explain how (and to what extent) they used the taxonomy in determining the environmental sustainability of the underlying investments. They are also required to disclose the proportion of underlying investments that are taxonomy-aligned as a percentage of the investment, fund, or portfolio.

- In Europe, the Sustainable Finance Disclosure Regulation (SFDR), which came into effect in March 2021, imposes phased-in sustainability-related disclosure requirements on investment firms (as well as banks, insurance companies and pension funds). Its scope captures financial market participants and financial advisers and sets specific rules for how and what sustainability-related information they need to disclose.

- In the US, regulatory efforts are underway to protect investors against greenwashing practices by investment firms. In March 2021, the US Securities and Exchange Commission (SEC) announced the creation of a Climate and ESG Task Force in an effort to "proactively identify ESG-related misconduct." The Task Force's work will focus on portfolio management, advertising, marketing, documentation, and compliance practices for the ESG strategies of investment advisers and funds.

Other emerging regulatory initiatives that may emerge include:

- Following its 2021 summit, the G7 announced its support for mandatory climate reporting based on the Task Force for Climate-Related Financial Disclosures (TCFD) guidelines in an effort to "green" the nations' financial systems. This comes as a follow up to previous commitments made by the UK and the European Union. Mandatory climate-related financial disclosures are expected to provide consistent and decision-useful information for market participants, i.e., investors, and support them in communicating the climate impacts of their investment decisions.

- SFDR-style regulations in the US? With SFDR's aim to combat greenwashing and drive capital into sustainable investment products, combined with the Biden administration's favorable approach to sustainable finance, it is quite possible that legislation in the US will be introduced that guides financial market participants and advisors on phased-in, mandatory disclosures.

2. Advancing self-regulatory efforts for the industry (incl. soft-law mechanisms)

While government regulations may assist in defining "sustainability," "ESG" and related investment products, and supporting accountability for ESG in investment management, industry and non-governmental initiatives are developing their own methods to approach ESG credibility challenges.

Globally applicable and standardized guidance for corporate sustainability-related disclosures

As presented above, developing a robust, credible and sustainable financial market system is deeply dependent on high-quality and decision-useful data. Thus far, ESG data lacks those characteristics to a large extent. But there is light at the end of the tunnel. Several initiatives are underway to develop standardized reporting guidance for companies. These include:

1. The Sustainability Accounting Standards Board (SASB) and the International Integrated Reporting Council (IIRC) have now officially merged to form the "Value Reporting Foundation."
2. Together with the Carbon Disclosure Project (CDP), Carbon Disclosure Standards Board (CDSB) and the Global Reporting Initiative (GRI), IIRC and SASB published an ambitious joint statement of intent to bring a single, coherent, global ESG reporting system to life.
3. In partnership with the World Economic Forum, the Big4 developed a corporate sustainability reporting framework that collates reporting metrics from GRI, Integrated Reporting (IR), SASB, the Task Force for Climate-Related Disclosure (TCFD), the Science Based Targets initiative and more.

Globally applicable standards for ESG investment products

The CFA Institute is currently developing a *voluntary*, global industry standard for ESG investment products. This standard aims to provide greater product transparency and comparability for investors by enabling asset managers to clearly communicate the ESG-related features of their investment products.

Nationally applicable standards for ESG investment products

Similar initiative is also occurring at the national level. For instance, the Canadian Investment Funds Standard Committee (CIFSC), which classifies Canada's mutual funds, is currently also working on a fund identification framework for ESG (in their words, "responsible") investments that would categorize funds based on their approach to responsible investments, aligned with the CFA Institute's standards.

Will applying *voluntary* standards be sufficient? Looking beyond the publication of the final product, should government-mandated disclosure in alignment with these standards follow?

Firm level leadership to advance transparency on ESG products or strategies

Rather than relying on regulators and other initiatives to determine a definition of what constitutes an ESG product or strategy, investment firms can take a more **proactive approach** to enhance their credibility by providing **more transparency** into their ESG integration practices.

Firm-specific disclosures:

Disclosures should cover descriptions of how ESG-related activities and considerations are integrated within:

- Firm strategy
- Fund strategy

- Investment process (e.g., in research, analysis, investment decision making, post-investment monitoring)
- Risk and opportunity management
- Strategy implementation
- Governance and oversight (e.g., policies and procedures)
- Stewardship activities (e.g., engagement practices, public policy, voting)

On a very simple level, this can happen via website disclosures. However, comparison across managers is limited if such disclosures are provided in a non-standardized format.

PRI disclosures:

Today, more than 3,000 investors have signed on to the Principles for Responsible Investing. As part of their commitment to investing in a responsible manner, signatories are required to report on their investment practices on an annual basis. Signatories are scored based on their disclosures and assessed against peers.

The PRI advocates for transparency and thus makes PRI reports available to the public.

Independent methodologies for evaluating ESG integration practices of managers that are agile, scalable, and able to evolve and adapt

Asset owners and asset managers seeking to understand the **maturity** of their ESG integration practices, both in terms of the *completeness of integration* and *sophistication of integration,* may employ tools from private sector initiatives that provide such assessments. As ESG integration approaches can largely differ across a firm's different funds, maturity can be assessed for the firm overall, and for each of the firm's funds.

Such ***maturity assessment tools*** evaluate investors' ESG profiles in detail. For instance, by assessing several sub-categories of ESG integration (e.g., governance and oversight), tools will score the firm using a certain number of maturity levels (ranging, for instance, from *ESG Integration not in place* to *Sophistication of ESG Integration*). Based on scores for these sub-categories, an overall score is established. The firm can decide whether to communicate the outcome of the assessment to stakeholders.

Third-party insights on fund-alignment with sustainability preferences

Private and civil sector actors are working to provide more visibility into funds labelled as "ESG," "sustainable" or similar. Examples include:

- Morningstar ESG Screener: *The Morningstar Sustainability Screener enables users to search for funds based on personal sustainability preferences. Users can define their search by using Morningstar's flagship Sustainability Rating, the Morningstar Low Carbon designation. They can also target funds that integrate ESG strategies into their selection process and can screen and segment the fund landscape by product involvement areas.*
- As You Sow – Invest Your Values search tool: *Tool which investors can use to learn more about their investments. Investors can search the name or symbol of mutual funds or ETFs in one of six search tools, including Deforestation Free Funds and Fossil Free Funds, and will be provided with a "report card" on the fund related to the issue.*

Investment consultant industry initiatives

An initiative established in 2020 points to the fact that investment consultants are recognizing their central role in advancing genuine sustainable investment practices and outcomes.

- ICSWG: 17 UK-based investment consulting firms, including Cambridge Associates and Willis Towers Watson, now form the *Investment Consultants Sustainability Working Group (ICSWG)*. The group's objectives include "seek[ing] investment outcomes which are genuinely sustainable and not treat sustainability as a tick box exercise" and "create[ing] a guiding set of principles that indicate good practice with practical advice." As part of

their efforts, the group launched its first guide early this year, which aims to support trustees with assessing their investment consultants on their climate competency. They also endorsed impact investing guidelines for pension schemes developed by the *Impact Investing Institute* together with *Pensions for Purpose*.
- ICSWG-US: In May 2021, US-based investment consultant firms with a collective US$33 trillion in assets under advisement followed suit and formed their own working group - the *ICSWG-US*.

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