ECONOMIST IMPACT

The ESG conundrum

How investors and companies can find common purpose in ESG

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Acknowledgements

To understand the potential disconnect between perception, on the investor side, and reality, on the issuer side, when it comes to accurately defining and measuring ESG performance, and how investors and companies can find common purpose in ESG, Economist Impact conducted two surveys of senior executives based in the US, the UK and Asia-Pacific (China, India, Singapore). The first survey collected insight from 300 senior executives working at asset owners (corporate pension funds, endowment funds, family offices, government agencies, insurance companies, pension funds, sovereign wealth funds and reinsurers). The second survey collected insight from 313 senior executives (half of which were C-suite executives) working in the energy, food, healthcare and travel sectors.

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Foreword by Stuart Dunbar, partner, Baillie Gifford & Co

Baillie Gifford is delighted to have commissioned Economist Impact with this research into the preferences and views of companies and asset owners on ESG issues—and reporting in particular. This is a topic of huge importance to the investment management industry, as we act as intermediaries between these two groups. It is essential that we find practical ways for companies to respond to the growing investor demand for responsible investment approaches, facilitating change and focusing on tangible outcomes whilst continuing to generate the investment returns that are required to generate pensions and meet other savings goals.

In a world where consumer and regulatory pressures on companies with poor ESG performance are intensifying, allocating capital to generate investment returns is not only compatible with responsible investing, it will increasingly be driven by the latter. Many of the greatest long-term investment opportunities in the coming decades will relate directly to tackling our biggest environmental and social challenges. Conversely, the long-term future is not bright for companies that continue to impose significant negative externalities on society as governments respond to pressure to rein them in.

In order to act as responsible owners and, ultimately, to benefit from strong investment returns, investors need to understand if companies are effectively managing the environmental and social impacts of their operations. This has created a need, and in some countries a regulatory requirement, for the growing use and improved disclosure of ESG metrics such as greenhouse-gas emissions, health and safety records, and labour practices. According to the Economist Impact research, companies are driven to make ESG disclosures more by their own corporate purposes and regulatory reasons than they are by investor demands. The explanation for this likely lies in the very high proportion of both investors and companies who also say that direct engagement on ESG issues is vital, reducing the emphasis on, and need for routine disclosures.

This is a positive sign that participants in the financial system are starting to focus on progress and plans rather than static snapshots. In turn, this lends itself to a more nuanced understanding of a company's contribution to the economic system and moves investors beyond

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simple exclusion-based policies—which in certain cases may actually starve companies of the capital they need to transition to sustainable operations and business models.

ESG disclosures are important and useful if thoughtfully interpreted and contextualised. Poor ESG scores as calculated by data consolidators may be indicative of issues that should be investigated and discussed with company management. Investors can also use ESG metrics to measure progress in companies that need to improve certain practices. But context is everything: for example, a mining company that sells its thermal coal mines will improve its own ESG score but achieve nothing of environmental consequence if the mines are still operated in the same way by a new owner. An electric vehicle manufacturer will likely have an increasing carbon footprint as its sales rise, but to see this as purely negative would fail to take into account the many internal combustion engine cars it is displacing. And this is the key point: while ESG data is a vital component of our understanding, small-world closed observations cannot directly be applied to tackling big-world, systemic challenges that are highly interdependent.

We hope that the findings from this report are food for thought. It is encouraging to see that the benefit of company-by-company engagement beyond one-size-fits-all metrics is recognised, and that investors and companies broadly agree on which ESG metrics are of strategic importance. Moreover, it is a big step forward that meaningful efforts are being made via the International Sustainability Standards Board to harmonise reporting requirements. However, we must strongly guard against the urge to reduce an inherently complex, interlinked and dynamic set of challenges to a simple set of numbers and measures against which we gauge a portfolio's ESG credentials. Progress and purpose must be factored into our thinking at company level, and above all we must push for an ESG industry that is firmly focused on real-world outcomes rather than artificial targets.

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Executive summary

There has been a growing recognition of the role that investors can play in driving change in the companies in which they invest. Investors are increasingly using environmental, social and governance (ESG) metrics within their investment processes to not only assess risks but also to identify potential real-world impacts—both positive and negative—of corporate operations and future investment opportunities. They are using this information to push for changes in business strategies and models that support the shift to a low-carbon economy, a fairer society and numerous other goals as outlined by the UN Sustainable Development Goals (SDGs).

However, according to our research, disparate reporting frameworks, voluntary guidelines and often conflicting ESG scores from data providers may be hindering companies' and investors' efforts to achieve actual impact. Two surveys by Economist Impact conducted on behalf of Baillie Gifford found that:

- There is a **general alignment between investors and companies when it comes to ESG metrics**, with both segments seeing environmental and social metrics as slightly more important than governance metrics. The top key metrics for investment decisions and corporate strategy are energy efficiency and health and safety records.
- **Both groups broadly agree that existing ESG metrics are fit for purpose and meet their needs.** Investors are reportedly confident in the robustness of ESG data while corporates are confident in their level of disclosure and choice of measured and published ESG metrics.
- **However, this confidence is not supported by the still-significant gaps seen in ESG reporting.** Of the 17 ESG metrics asked about, only ten are measured and published by more than half of corporate respondents. In terms of geographical differences, US companies have the highest level of disclosure across all ESG metrics and US investors show high levels of confidence. Looking specifically at social metrics, companies in Asia-Pacific have the highest levels of disclosure and investors have the highest confidence. Overall, the UK lags in terms of disclosure and investor confidence.
- **Investors' confidence in ESG reporting may stem from their growing use of direct engagement and in-house due diligence to get the information they need.** For nine out of the 12 main ESG metrics, a plurality of investors engage directly with companies to assess performance. But it is not a one-way street—corporates are increasingly speaking with investors to understand what information they need. Engagement is also seen by both investors and companies as a vital tool to implement ESG agendas, meaning that a bottom-up approach may be a vital complement to the historical top-down approach used by stakeholders to effectively achieve impact.

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- **Regulation (with mandatory rather than voluntary guidelines) and standardisation (as exists in carbon emissions reporting) are needed to set baselines in each industry for the full spectrum of ESG metrics.** Investors and corporates both believe that an environmental regulator should be responsible for determining material factors for each sector—that is, the ESG indicators and measures that materially impact a company's bottom line. Stewardship refers to the responsible oversight of capital by asset owners on behalf of their clients, and involves direct engagement between companies and investors to address both risks and opportunities within a business from a sustainable angle. The adoption of guidelines for stewardship, such as the Financial Reporting Council's UK Stewardship code, the Investor Stewardship Group's Framework for US Stewardship and Governance, and the Principles of Responsible Ownership in Hong Kong, is also needed in further jurisdictions to set principles and best practices for engagement between companies and investors.

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Introduction

Born of the socially responsible investing practiced by religious institutions and university endowments in the 1960s, environmental, social and governance (ESG) investing went mainstream in the 2010s as global institutional investors gained a better understanding of the material impact of ESG-related risks on the assets that they owned, as well as the opportunities awarded by new "green" investable themes.

Investors are not alone in undergoing this humane makeover, however. Increased public awareness of key ESG issues such as climate change, diversity and human rights, and the need for greater accountability and transparency is pushing the corporate world into a new era: Milton Friedman's "shareholder primacy" is gradually making way for "stakeholder capitalism", a concept coined by the World Economic Forum, in which companies "seek long-term value creation by taking into account the needs of all their stakeholders, and society at large."

While the covid-19 pandemic has further put ESG considerations in the spotlight, it has also highlighted the financial resilience of ESG-minded companies in turbulent times, leading investments integrating ESG factors to hit US$40trn by mid-2020, up from US$20trn in 2016. ESG investments now account for a third of global assets under management and are on track to exceed US$50trn by 2025.

These investors are motivated not just by a desire to do good but by the belief that strong ESG performance leads to better risk-adjusted financial performance. This is seen explicitly in the average 12-month forward price-to-earnings ratio for companies within heavy carbon-emitting sectors that have a set timeline for achieving carbon neutrality, which trade at a significant premium (about 60%) to those that have not done so. Companies with relatively high emissions trade at a 15% discount compared to companies with low emissions, and those companies that do not disclose their carbon footprints are valued even less.

At the recent UN COP26 in Glasgow, a major focus was on the role of finance in accelerating the shift to a low carbon economy and keeping global warming to no more than 1.5°C. One of the focal points of

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discussion was the consolidation of ESG frameworks, a move that addressed a major pain point in sustainability reporting (the large collection of standards-setting bodies and certification schemes has earned the unflattering nickname of "alphabet soup".)

Countries such as the UK announced moves to make ESG disclosure mandatory rather than voluntary, and the International Financial Reporting Standards Foundation (the IFRS Foundation) announced the creation of a new body, the International Sustainability Standards Board (ISSB), to create a new set of standards that companies must follow for climate-related disclosures.

While encouraging, this push to "standardise the standards" by introducing yet another framework may be met with scepticism by companies that saw their reporting burden become unmanageable as a string of new guidelines were introduced over the past decade.

Moreover, it bears asking whether these frameworks actually help companies with their strategy and ESG performance, and investors with their investment decisions. Does following these frameworks and reporting on ESG metrics promote actual impact, or is it placing investors and companies in an echo chamber where box-ticking has become the norm? And will a new, harmonised set of metrics allow investors and companies to find common purpose in ESG?

Based on findings from two surveys—of investors and companies—this Economist Impact report aims to uncover how ESG performance is determined, whether investor and company interests are aligned when it comes to ESG, how direct engagement can help achieve actual impact, and what measures will improve both disclosure and engagement.

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Chapter I. Defining ESG metrics

A common complaint of both investors and corporates is that the sheer number of ESG frameworks and reporting standards—more than 600, as of 2020—make it difficult for companies to decide how to demonstrate their ESG credentials and for investors to determine how to assess them.[1] With so many options, the possibility of a mismatch between what companies disclose and what investors want is high.

Companies have greatly increased their ESG reporting over the past decade. A study of the top 100 companies in each of 52 countries found that 80% overall now report on sustainability. North America leads with 90% of companies reporting, followed by Asia-Pacific with 84%, Europe with 77% and the Middle East and Africa with 59%. However, only 43% of companies acknowledge the financial risks of climate change.[2]

In the US, of the Russell 1000 index, which tracks the top 1,000 US firms by market capitalisation, 70% of companies produce a sustainability report. Of the top 500 companies—the S&P 500—the figure rises to 92%, which is up from just 20% a decade ago. However, what is featured in those reports still varies greatly.[3]

While some frameworks are more prevalent, there is variation between geographies and industries, and each company will need to make its own assessment about which metrics are most relevant to its business. "Key metrics will vary by organisation, and even change over time," says Phil Redman, offering manager, ESG at OneTrust, a compliance solutions provider helping corporates with their ESG reporting. "It's important that an organisation defines its priorities and assesses where it would have material impact. Then it becomes clear which metrics are most relevant and what strategies can be implemented. Too often, a company might just pick a standard or framework and try to fill in data for a report, even if some of the questions may not be relevant."

For real-estate services firm JLL, there is a similar assessment—for itself and the real-estate investors it works with—to determine what is most relevant. "Our strategy development process figures out what's important on an organisational level, what's materially relevant," says Richard James, the company's head of sustainable client solutions. "That goes from compliance—existing and likely future regulation—to best practice. We work with our clients on actionable strategies through to implementation underpinned by data and assurances that may be needed to meet certain reporting standards."

[1] https://www.sustainability.com/thinking/rate-the-raters-2020/
[2] https://assets.kpmg/content/dam/kpmg/be/pdf/2020/12/The_Time_Has_Come_KPMG_Survey_of_Sustainability_Reporting_2020.pdf
[3] https://www.ga-institute.com/

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PREFERRED FRAMEWORKS

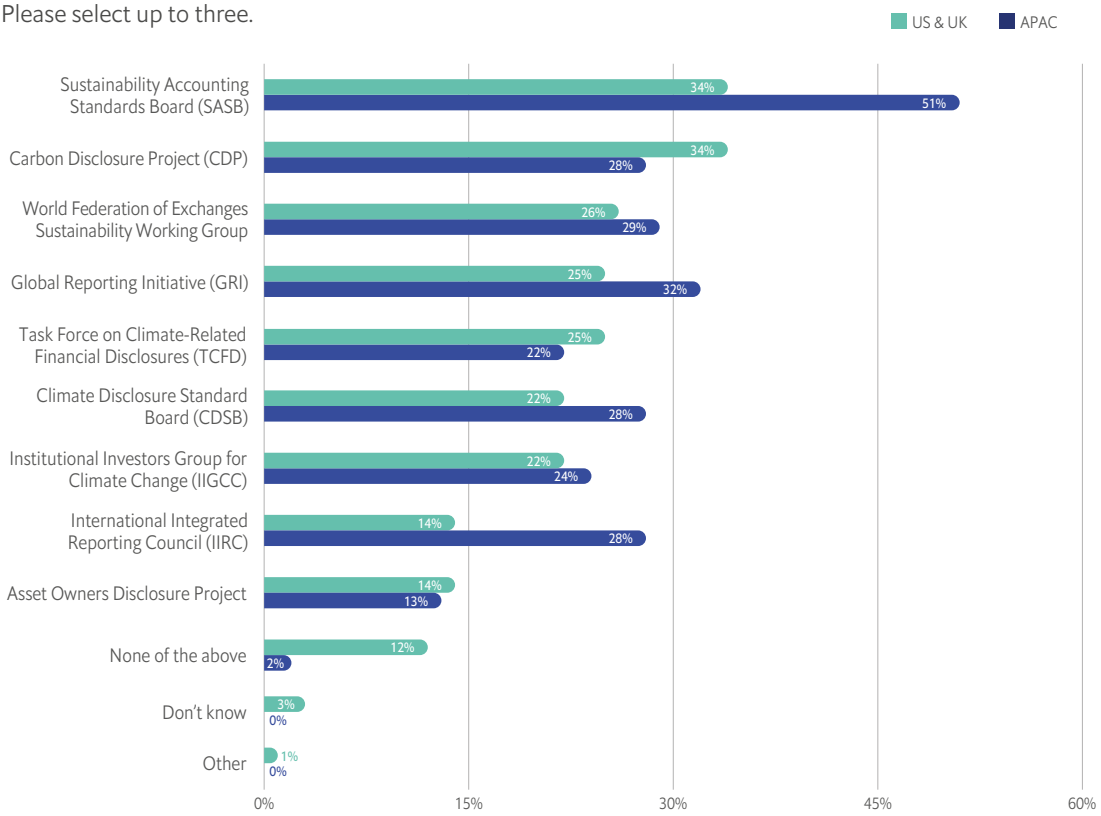
For our corporate survey respondents, the top most followed frameworks are the Sustainability Accounting Standards Board (SASB), Carbon Disclosure Project (CDP), World Federation of Exchanges (WFE) Sustainability Working Group and Global Reporting Initiative (GRI). Of the nine frameworks included in the survey, only SASB is used by more than a third of respondents; however, the list seems to be comprehensive, as just 1% said that they follow another framework. A sizeable minority (9%) said that they do not follow any framework; they seem to be concentrated in the US and UK. There were other regional differences, with SASB much more popular in Asia-Pacific while CDP and GRI are more popular in the US and UK.

The choices of our investor survey respondents are fairly similar, except with less interest in WFE. However, there is a strong similarity in terms of desire for the usage of particular frameworks. More than a third would like companies to use SASB and CDP, with just under a third wanting to see use of GRI. None stated that they preferred another framework. Again, there were some regional differences, with GRI and Institutional Investors Group for Climate Change (IIGCC) more popular in the US and UK, while CDP, Carbon Disclosure Standard Board (CDSB), WFE and Asset owners are more popular in Asia-Pacific.

Our interviewees also expressed a preference for SASB, with Kirsty Jenkinson, director, sustainable investment and stewardship strategies (SISS) at CalSTRS, a US retirement fund, pointing to its sector-specific approach as an advantage. "The framework that we rely on the most is the SASB standard," she says. "I don't think metrics are all equal, and this is why we've been such strong

FIGURE 1. Which frameworks or guidelines do you follow in reporting on your ESG information?

Please select up to three.



Source: Economist Impact survey

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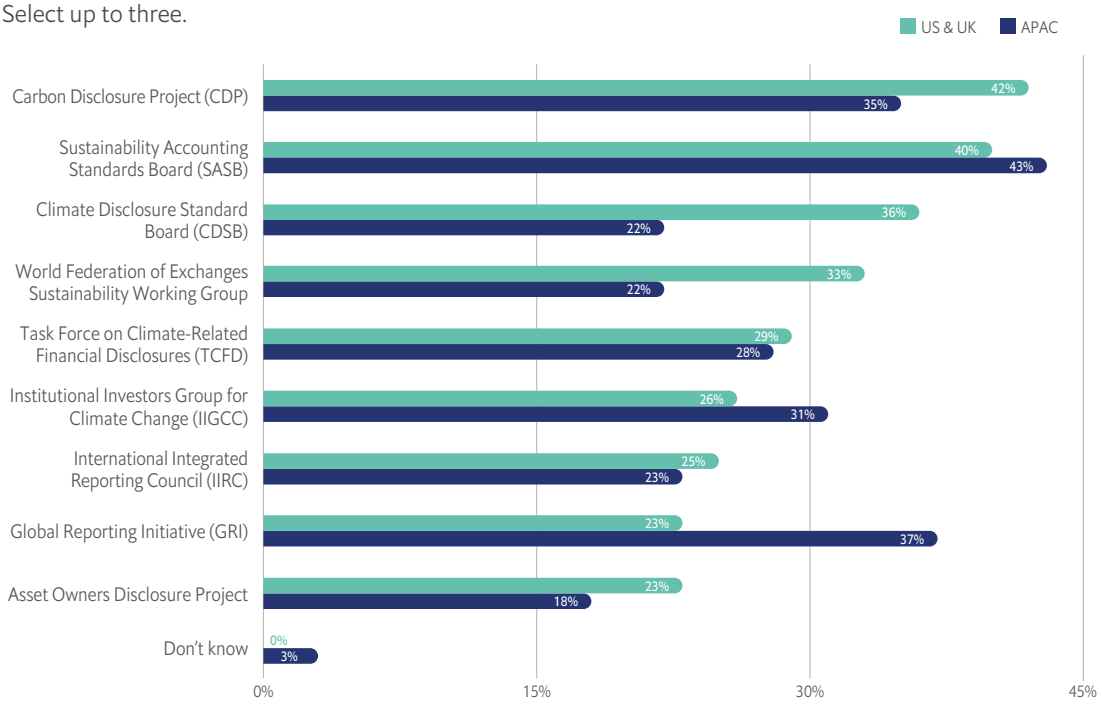
FIGURE 2. What frameworks or guidelines would you prefer companies to follow in presenting their ESG information?
Select up to three.



Source: Economist Impact survey

supporters of SASB from the very start. There's a recognition that not all ESG factors are of the same level of decision usefulness for investors. What we like is that [SASB has] gone sector by sector very painstakingly over many years, building this consensus that in certain sectors certain ESG issues are more relevant and more attuned to long-term enterprise value creation."

Border to Coast Pensions Partnership, a UK-based asset manager, uses SASB, as well as the outputs from other standards, but recognises that expecting reporting against multiple frameworks makes things complicated for companies—and may lead to distortions in how companies' ESG performance is perceived. "Companies are saying they have stretched resources, they've got to get on with their day job, and they're being asked to fill in multiple different disclosure frameworks," says Jane Firth, the company's head of responsible investing. "Smaller companies or medium-sized companies that might not have the resources that the big blue chips have might end up scoring less well. They actually might be doing more than the ones that have big shiny teams that can tick all the boxes and score disproportionately higher." She adds: "We need to try and consolidate—not just for companies, for investors as well. So we're working with standard-setters, making sure that they're all talking to each other."

"We need to try and consolidate—not just for companies, for investors as well. So we're working with standard-setters, making sure that they're all talking to each other."

Jane Firth, Border to Coast Pensions Partnership

While investors are talking with standard-setters to urge consolidation, companies are increasingly speaking with investors to understand what information they need. After reviewing an individual business's strategy, the current legislation and upcoming policy that may

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affect what needs to be reported, and looking at what the peers in their sector are doing, JLL conducts an investor expectation analysis.

"The investor agenda is always evolving. There may be emerging ESG considerations that investors need to build into their sustainability strategies," says Mr James. "For example, there has recently been a tidal swell of net-zero carbon needs, and we're now seeing increasing focus on social value and biodiversity."

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Richard James, JLL

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Consolidating ESG disclosure frameworks

The International Integrated Reporting Council and the Sustainability Accounting Standards Board merged in 2021 to become the Value Reporting Foundation (VRF). The VRF, along with the Global Reporting Initiative (GRI), Carbon Disclosure Project (CDP), and the Climate Disclosure Standards Board (CDSB), constitute what is known as the Group of Five or The Alliance. In 2020 the group launched a prototype global sustainability reporting framework.

The IFRS Foundation—which oversees the International Accounting Standards Board (IASB), which develops and approves International Financial Reporting Standards (IFRS)—is now creating a new International Sustainability Standards Board (ISSB), which, by June 2022, will consolidate the VRF and CDSB. The technical standards and frameworks of the CDSB, VRF, Task Force on Climate-related Financial Disclosure (TCFD) and the World Economic Forum (WEF) Stakeholder Capitalism Metrics will provide the basis for the ISSB's prototype climate and general disclosure requirements.[4]

The GRI, which will remain independent, is currently co-constructing the European Sustainability Reporting Standards with the European Financial Reporting Advisory Group. The CDP will also stay separate from the ISSB, although both groups have agreed to alignment with the new standards.

The ISSB has also received strong support from other organisations, such as the International Organisation of Securities Commission (IOSCO).[5] IFRS standards are used in 140 countries, with the major exception being the US. However, the IASB works with the Financial Accounting Standards Board to align the standards as closely as possible with the US's Generally Accepted Accounting Principles (GAAP).[6]

So the ISSB—incorporating VRF and CDSB, with standards also based on those of the TCFD and WEF, aligned with the GAAP, GRI and CDP, and supported by IOSCO—has a real chance of delivering a global convergence of ESG disclosure standards.

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[4] https://www.regulationasia.com/issb-offers-baseline-for-global-sustainability-reporting/
[5] https://assets.kpmg/content/dam/kpmg/be/pdf/2020/12/The_Time_Has_Come_KPMG_Survey_of_Sustainability_Reporting_2020.pdf
[6] https://capitalmonitor.ai/institution/a-guide-to-sustainable-reporting-standards/

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Chapter II. Aligned for good?

The wave of net-zero expectations is a part of the recent prioritisation of the E factor of ESG. While the focus on climate change is relatively recent, many environmental factors have long been seen as easier to measure and thus report. There has also been more regulatory guidance to help define metrics, unlike with social factors. "The challenges to developing quantitative measures around social value is the variation in how they're reported right now and there's very little regulatory guidance and consistency around this," says Mr James.

The companies surveyed report a high level of measurement of metrics across environment (75% on average), social (82%) and governance (78%) factors, but a significant number do not publish the results. Of the 17 ESG metrics asked about, only ten are measured and published by more than half of respondents: direct carbon emissions, water usage, waste management, energy efficiency, health and safety records, product safety records, supply-chain principles, board diversity, business ethics policy, and ownership structure. Health and safety records are the only metric measured and published by more than two-thirds of respondents, and at least a fifth of respondents do not currently even measure nine of the metrics.

Which metrics are seen by corporates as most important to their strategy map fairly well to those that they report, with Asia-Pacific respondents scoring all metrics (except indirect carbon emissions) more highly than those in the UK and US.

As seen in Figure 3, the two most commonly published metrics are health and safety records and product safety records, highlighting the fact that companies tend to publish standalone indicators that are straightforward for them to measure, when they should be extending their analysis to other material metrics and how impacts are interconnected.

However, Mr James says that environment and social factors are increasingly tackled in a systematic way. While environmental metrics have traditionally received more attention, Mr James notes that in the property sector "we are undoubtedly seeing an increase of focus on the social side and a large part of that is around 'the healthy building'. When clients refurbish buildings, in addition to improving energy performance, they are seeing that there's a lot of value in creating healthy spaces for people. Research is increasingly linking healthy, green spaces to increased productivity, better retention and a happier workforce. We have taken this approach in recent fit-outs at our offices in Manchester and Water Street in London—not just focusing on low carbon and circularity, but very much on health and wellbeing aspects as well. We will study the performance of these buildings, allowing us to learn lessons and take that to our clients. We are also increasingly assessing the social impact of real estate on local areas—the impact on employment and creating communities."

SETTING MATERIALITY FROM THE TOP

Being able to understand the real-world impact of their operations should be one of firms' goals

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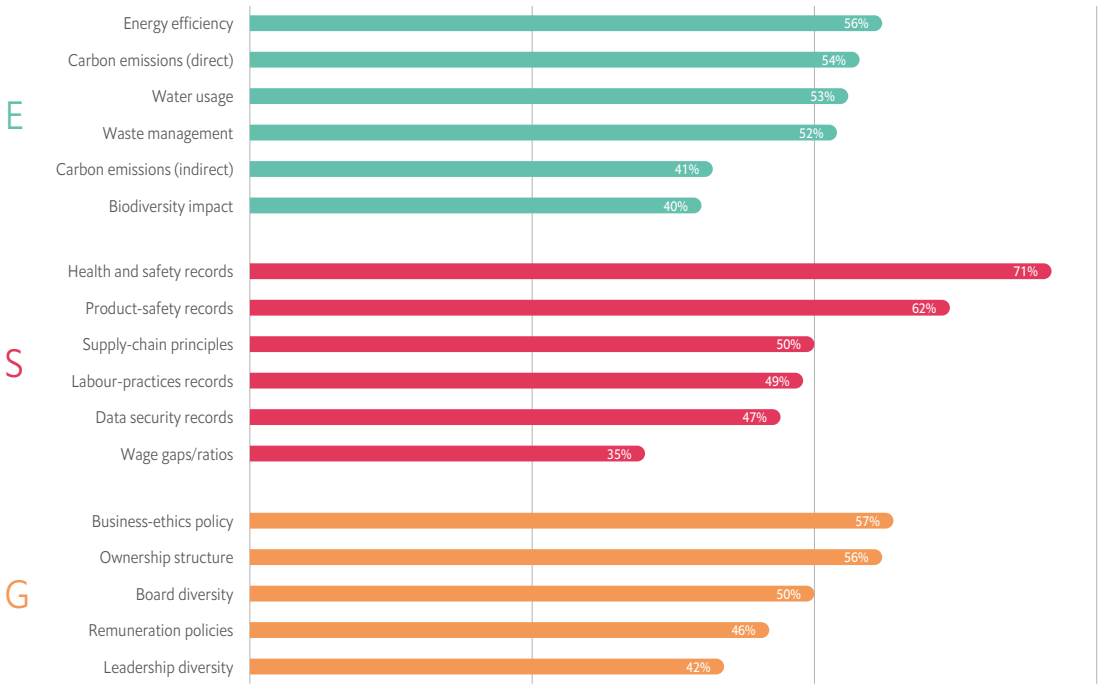
FIGURE 3. Which ESG metrics do you measure and publicly share?



Source: Economist Impact survey

of ESG disclosure, and this is only possible if the right metrics are chosen. Responsibility for making that decision diverges between Asia-Pacific and UK/US respondents, with the chief sustainability officer taking the lead at over half of Asia-Pacific companies compared with at just over a third in the US and UK, where the CEO is more likely to be the decision-maker at about half of organisations, compared with a quarter in Asia-Pacific.

Mr Redman agrees that responsibility should sit at the top. "It is important to understand a number of stakeholders' interests, not just company leaders, but employees, customers, investors, suppliers and partners. Each is an important link in the ESG chain and creates the whole picture. But ultimately it is up to the leaders of an organisation to define what's most material at the moment and create a top-down culture supporting ESG initiatives."

"But ultimately it is up to the leaders of an organisation to define what's most material at the moment and create a top-down culture supporting ESG initiatives."

Phil Redman, OneTrust

The responsibility for reporting is more evenly spread. Almost a quarter say that all departments or functions have some reporting responsibility, particularly at UK and US companies. Of those that say one department has the primary responsibility, corporate social responsibility has the most accountability, followed by IT (particularly in Asia-Pacific), and operations (more so in the US and UK). Corporates in Asia-Pacific are more likely to have a new, specialised unit for ESG reporting. Interestingly, investor relations takes the lead at only 2% of UK and US corporates and zero Asia Pacific companies.

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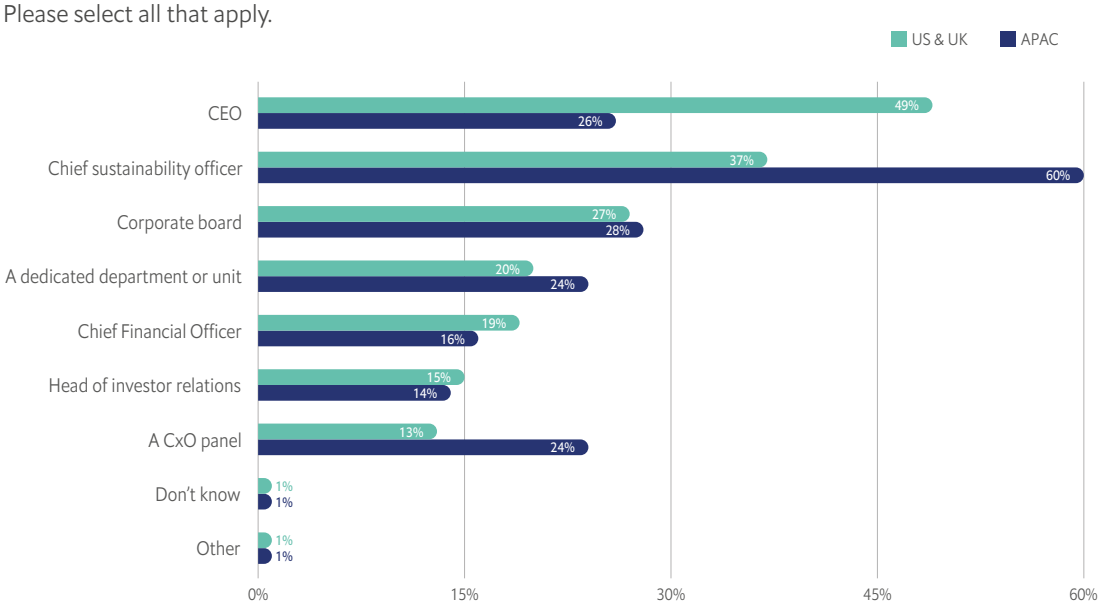
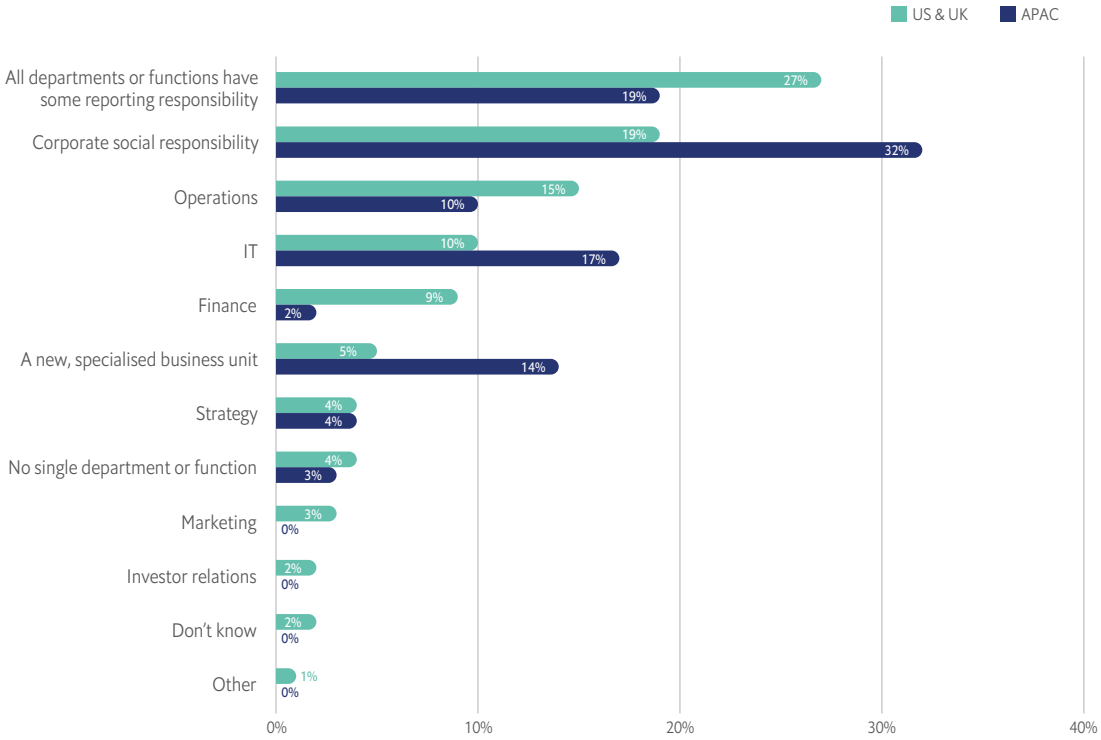
FIGURE 4. Who decides which metrics are material for ESG-related reporting in your organisation?
Please select all that apply.



Source: Economist Impact survey

FIGURE 5. Which best describes the department or function at your organisation that determines and/or compiles non-financial metrics for ESG reporting?
Please select one.



Source: Economist Impact survey

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WHAT INVESTORS WANT

The preferences of corporate respondents are mostly matched by those of investor respondents. Asked to rate the importance of individual ESG factors for their investment decisions on a scale of 1 to 5, investors rated all factors between 4 and 5. Again, Asia-Pacific respondents score most metrics more highly than their US and UK counterparts.

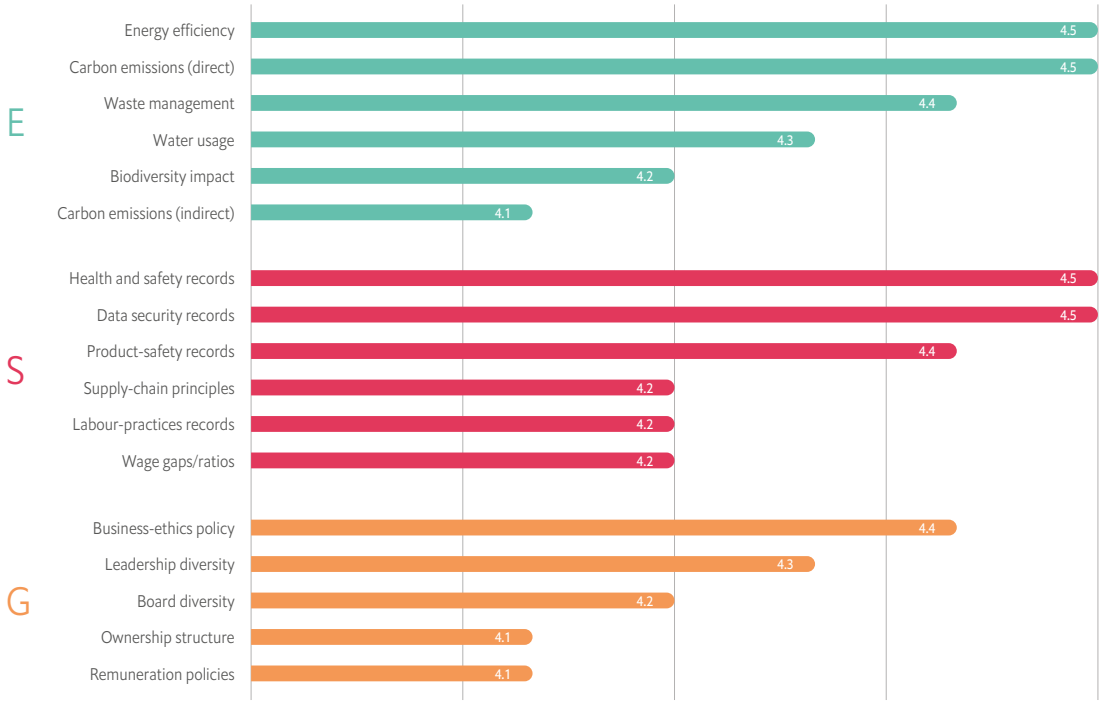
Ping An, a Chinese insurance conglomerate, considers a range of qualitative and quantitative measures when assessing the ESG performance of potential investments. Richard Sheng Ruisheng, director of Ping An's group ESG office, says that the important metrics are "qualitative indicators, such as board management, business code of conduct, employee benefits/talent strategy, sustainable supply-chain management, information security and privacy protection, and companies' measures to mitigate climate-change risk. Secondly are quantitative indicators, such as employee retention, carbon emissions of enterprises, and so on."

As with companies, Border to Coast sees a focus among investors on environmental metrics but warns that social and governance metrics cannot be ignored. "The social factor has tended to be the ignored middle child," says Ms Firth. "But we can definitely measure and see the impact of a company not addressing this. That's why we support the Workforce Disclosure Initiative, to make sure companies are disclosing more about human capital management and what they're doing with supply-chain management. It's particularly a big issue for companies in retail and distribution."

For Lombard Odier Private Bank, the importance of metrics varies by industry and company. "Not all metrics should be equally weighted; what is important depends on your sector—if you're a car manufacturer, it's not going to be the same metrics as if you're a bank," says Stéphane Monier, chief investment officer.

Ms Jenkinson is starting to see a clearer breakdown of what metrics are important, not only by sector but also by type of investment.

FIGURE 6. Please score the following ESG metrics by importance to your organisation's investment decisions, where 1 equals not important at all and 5 equals very important.



Source: Economist Impact survey

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"Not all metrics should be equally weighted; what is important depends on your sector"

Stéphane Monier, Lombard Odier

However, how CalSTRS uses that information in the investment process will vary. "The majority of our investments in public equity markets through our managers are passively managed. We have a different way to measure performance of that versus, say, a co-investment opportunity in real estate or in private equity" she says.

Ms Firth agrees and adds that the approach for ESG integration also varies across different asset classes. "Particularly for more esoteric asset classes, it does differ as to how much disclosure that you get from providers. We will still look at the same ESG issues that are pertinent to those particular sectors and companies, we will still expect our managers to engage on the issues, but you may not have the same set of tools—such as being able to vote," she says, "It's not screening out; it's just screening for risks and then challenging those managers on the stocks that they hold that I've rated low on ESG issues." When appointing external managers a specific section on ESG is included in the tender, and managers are subsequently monitored on a quarterly and annual basis.

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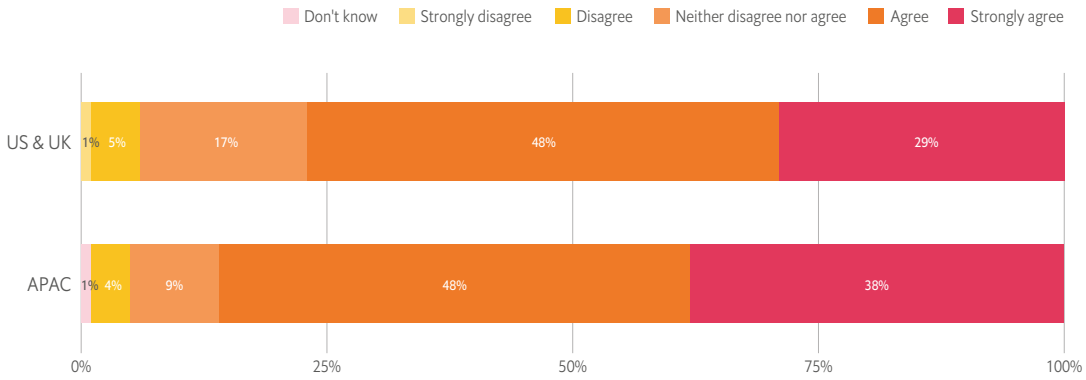
Chapter III. Moving from metrics to stewardship

While investors and corporates seem to agree on the importance of ESG metrics for corporate strategy and investment decisions, are investors confident they are getting what they need from corporates to accurately assess performance? At least seven in ten investors surveyed say that they are very or somewhat confident in the robustness and accuracy of companies' reporting on all ESG metrics. In addition, overall, four-fifths of investors agree that they generally have confidence that existing ESG metrics are fit for purpose and meet their needs as an asset owner.

Corporates are even more confident, with nine out of ten saying that their investors and shareholders seem satisfied by the choice of ESG metrics that they publish and their level of disclosure. A similar number also have confidence that existing ESG metrics are fit for purpose and meet their corporation's needs.

That confidence is somewhat more muted among our interviewees. "We're seeing progress, but we've still got some pretty significant gaps from the companies in our portfolio," says Ms Jenkinson. "My internal analysis has found that, even on what I would consider very uncontroversial metrics, most public equities in our portfolio still don't disclose their scope-one and -two greenhouse-gas emissions. Lots of companies outside the US don't disclose the results of the proxy votes at their annual general meetings. I mean, we're not looking at great complexity here. So that's really challenging."

FIGURE 7. Generally, I have confidence that existing ESG metrics are fit for purpose/meet my needs as an asset owner.



Source: Economist Impact survey

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That concern was echoed in a survey in July 2021 of 300 European and US asset managers by the Index Industry Association, which found that two-thirds were concerned about insufficient transparency and corporate disclosure in relation to firms' ESG activities, while 61% said that there was a lack of meaningful metrics and 58% complained that there was a lack of data standardisation.[7]

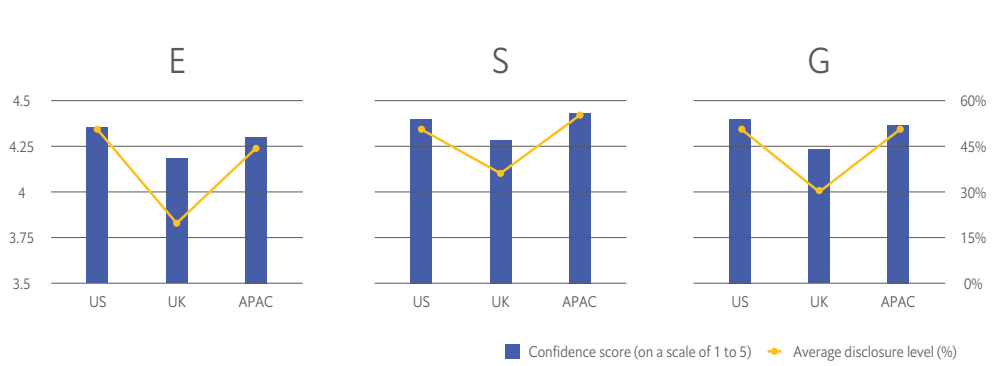
THE GROWING ROLE OF ENGAGEMENT

With still-significant data gaps, the overall confidence in ESG metrics is surprising. Do ESG frameworks create an ideological echo chamber where investors tick disclosure boxes without considering the real-world impact of companies' operations? Or is there more to the story than the lack of universal disclosure implies?

POSITIVE FEEDBACK LOOP

Encouragingly, our research shows that there is a positive correlation between levels of investor confidence and levels of corporate disclosure. As seen on Figure 8, US and Asia-Pacific companies display high levels of disclosure and high levels of investor confidence, although the UK lags behind on both aspects, especially for environmental metrics. According to a 2020 study by the UK's Financial Reporting Council, disclosure by UK-listed companies lacked a sufficient level of granularity when it came to climate-related targets and metrics.[8] This was later addressed by the UK government, which has set out new legislation coming into force in April 2022, making it mandatory for the largest UK-listed firms, as well as private companies with over £500m in turnover, to disclose climate-related financial information in line with Task Force on Climate-Related Financial Disclosures (TCFD) recommendations.[9] Positive correlation means that this increased disclosure should in turn increase investor confidence in climate-related indicators.

FIGURE 8. Average investor confidence scores and corporate disclosure levels for E, S and G metrics by region.



Source: Economist Impact survey

[7] http://www.indexindustry.org/wp-content/uploads/2021/07/IIA-ESG-Executive-Summary-2021-vFINAL.pdf
[8] https://www.ft.com/content/233c52d6-0233-4447-8316-81f383285ac1
[9] https://www.gov.uk/government/news/uk-to-enshrine-mandatory-climate-disclosures-for-largest-companies-in-law

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One reason for the confidence of investors may be the growing role of engagement and in-house due diligence, which means that they are less reliant on the ESG disclosures that corporates make in their own reporting. Our survey found that engagement with company management is the favoured way for investors to measure performance for nine out of the 12 ESG metrics studied. In-house due diligence is preferred for metrics including board diversity, labour-practices records, and health and safety records, although third-party analysis is used more often for some more complex-to-measure indicators such as indirect carbon emissions and biodiversity impact.

"Companies are increasingly considering investors as an audience for their sustainability communications, but what we've seen is information that is a little bit anecdotal from an investor perspective," says Ms Jenkinson. "So we engage significantly to try and encourage companies to provide us with better corporate disclosures to meet the demand that we're looking for."

At Ping An, in-house due diligence is vital to get the information that the firm requires. "We will analyse the industry, region and basic situation of the target enterprise, follow relevant laws and regulations, regulatory policies, industry dynamics and media information, and preliminarily analyse and identify key ESG risks and opportunities of the enterprise," says Mr Sheng. "Then we will collect further ESG data and information through on-site investigation and personnel interviews."

For Lombard Odier, this is a way of going beyond the information and scores supplied by ESG data providers. "What is important are the qualitative discussions that our analysts have with the companies, which give us an assessment of what is the level of action that is taken by the management of the company to address the issues," says Mr Monier. "We can check with them on a regular basis to see how much progress they have made, as it's very important for us to differentiate between the management that are telling us what we want to hear and the ones that are doing what we would expect them to do."

He adds: "For us, it's much more a question of looking at companies in a forward-looking way, and seeing if those companies are willing to revisit their business model in face of the various sustainability challenges."

According to our study, engagement is seen as a vital tool to influence companies' integration of ESG considerations into their business strategies—and thus affect broader change. Close to nine in ten investors agree that direct engagement with companies is vital to the implementation of ESG agendas that will drive system-wide change. Almost as many corporates agreed that their company seeks and values investor guidance when it comes to shaping and implementing their ESG agenda. Consequently, there may be value in taking a bottom-up approach to ESG, where investors help companies to pinpoint areas of improvement through regular engagement, in order to promote real-world impact.

However, different types of investors may adopt different methods. Direct engagement will see investors define corporate interactions, setting aims and objectives and using voting as part of the stewardship toolkit. As an asset manager for 11 pension funds, Border to Coast believes in engagement as the best way to influence companies, using a range of methods, engaging directly and also, utilising the clout of its external asset managers and specialist engagement providers to get the information it needs and exert influence on companies. "We have some big external managers with big teams, so we make sure that they're engaging and we're aware of their tools and what they're seeing," Ms Firth says. "We also have an external voting and engagement provider to engage with companies on a global basis across a variety of ESG themes. So we've also got access to the engagements that they're undertaking on our behalf with companies across our portfolios, and that also feeds into our investment analysis."

When engagement is outsourced, investors will need to actively define their expectations and assess the managers or service providers acting on their behalf. Investors may also engage through a combination of direct and external practices, and if choosing to outsource, they can

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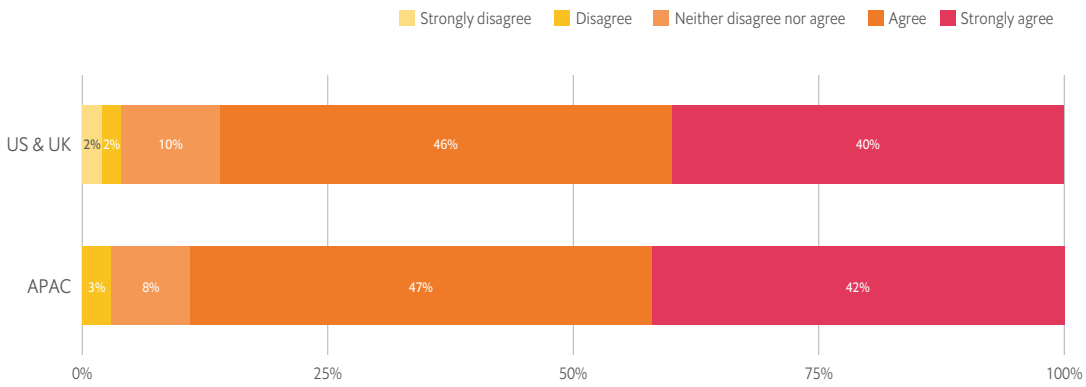
maintain a high level of involvement by signing letters for companies or attending meetings.[10]

PUSHING FOR SYSTEM-WIDE CHANGE

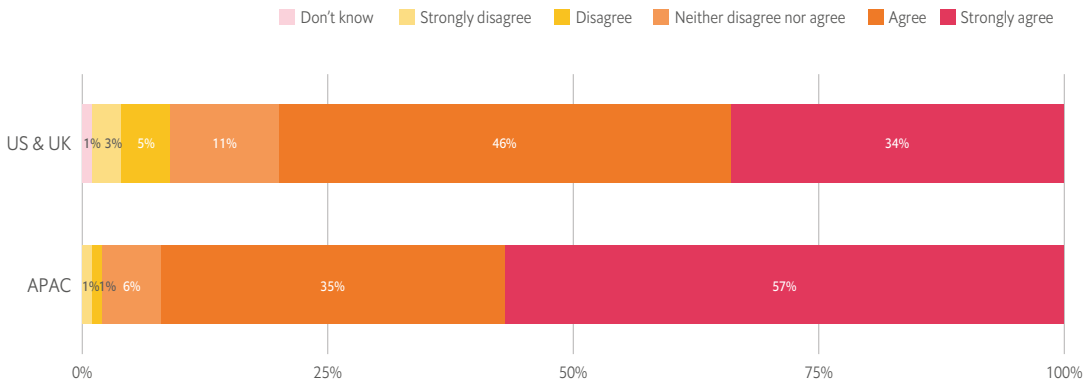
Investor engagement can take the form of helping companies to better understand the impact of their business activities, for example on climate change. Lombard Odier has collaborated with Oxford University to ensure that its sustainability framework is scientifically sound, "so when we ask questions of companies, we ask the right questions from a scientific point of view," says Mr Monier. "We look at the climate value impact, which is the percentage of the turnover of the company that is potentially impacted by climate transition. We have another tool that gives the temperature trajectory of a company with its current business model. With

FIGURE 9. Direct engagement with companies is vital to the implementation of ESG agendas that will drive system-wide change



Source: Economist Impact survey

FIGURE 10. My company seeks and values investor guidance when it comes to shaping and implementing our ESG agenda



Source: Economist Impact survey

[10] https://www.unpri.org/listed-equity/introduction-to-active-ownership-in-listed-equity-/2719.article

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these we can have good discussions with the company's CEO."

At CalSTRS, it means using the tools at the disposal of shareholders. "As we have a strong history in stewardship and proxy voting, we've been looking at ways to amplify our voice and escalate engagement where we think it's most relevant," says Ms Jenkinson. "We did that this year in supporting [ESG-focused investment firm] Engine No 1's campaign for new directors at Exxon. When we see companies financially underperforming, and we think that a lot of it is linked to sustainability factors, we will act in ways that we believe make companies more accountable."

As with Engine No 1's campaign, engagement increasingly means joining with other investors in order to have a greater impact. "There is power when investors work collaboratively together; we have seen this especially on climate. [Climate-focused investor alliance] Climate Action 100+ has made great strides over the last four years engaging with companies and that engagement will be ramped up over the next couple of years," says Ms Firth. "We're also seeing improvements in emerging markets. Those companies have really recognised the importance that investors attach to ESG issues and are much more open to dialogue with investors now."

Groups such as the UN-convened Net-Zero Asset Owner Alliance, the IIGCC and the Investor Group on Climate Change (IGCC) are increasingly vocal. In September 2020 all three joined the UN Principles for Responsible Investment and the UN Environment Programme Finance Initiative in calling on companies and auditors to fully reflect the effects of climate change in their financial reports.[11] They have also made demands for the implementation of new corporate governance measures to ensure that shareholders can hold companies to account in achieving net-zero emissions commitments.[12]

"When we see companies financially underperforming, and we think that a lot of it is linked to sustainability factors, we will act in ways that we believe make companies more accountable."

Kirsty Jenkinson, CalSTRS

[11] https://www.unpri.org/news-and-press/investor-groups-call-on-companies-to-reflect-climate-related-risks-in-financial-reporting/6434.article
[12] https://www.iigcc.org/download/investor-position-statement-vote-on-transition-planning/?wpdmdl=4798&refresh=6103b7c61998f1627633606

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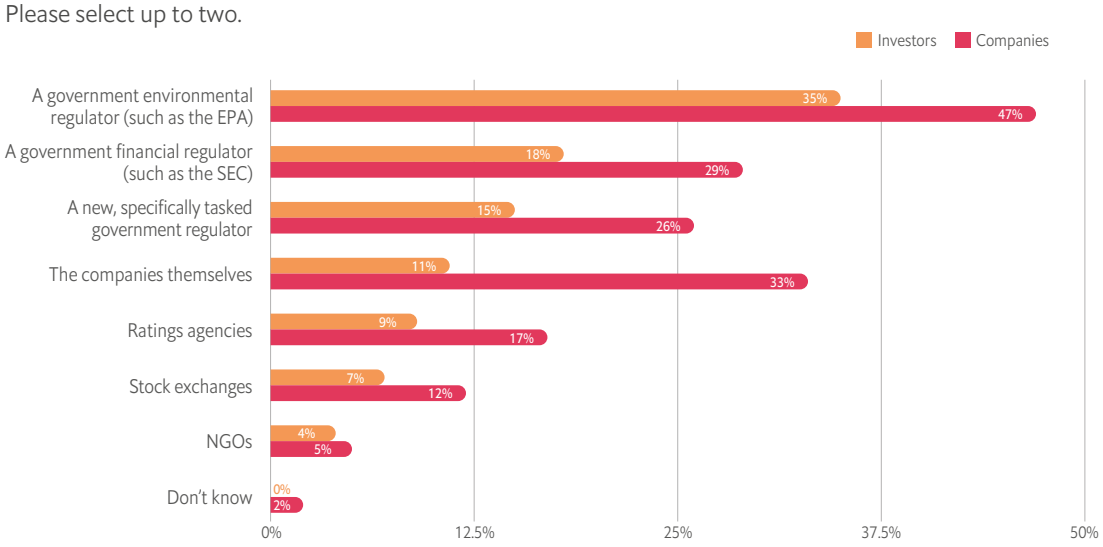
Chapter IV. Improving disclosure and engagement

The coalescence of support behind a new International Sustainability Standards Board (ISSB) (see box in chapter I.) reflects the desire for more consistent, comparable metrics that give investors the information that they need to understand not only companies' ESG performance but the financial materiality of those factors. Some investors—and corporates—would like to take that convergence a step further with government-mandated ESG disclosure. There has also been a regulatory push to include mandatory stewardship into asset owners' fiduciary duty.

Almost half of companies surveyed believe that a government environmental regulator (such as the Environmental Protection Agency in the US) should determine the materiality of ESG reporting metrics for publicly traded companies, with another three in ten saying that a government financial regulator (such as the US Securities and Exchange Commission—SEC) should play that role.

Mr James says that while real estate businesses continue to lead the way, he also believes in the benefits of government intervention to support

FIGURE 11. In your opinion, who should determine the materiality of ESG reporting metrics for publicly traded companies?
Please select up to two.



Source: Economist Impact survey

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consistency. "In the UK, TCFD regulations come into force this year for certain businesses, providing much-needed harmonisation of reporting across large organisations initially, and filtering down along the implementation roadmap to other organisations over the next three to four years. The EU 'green taxonomy' is not yet incorporated within the UK, but we're expecting a transition in the near future to provide a regulatory framework for defining environmentally sustainable activities," says Mr James. "Greater consistency will be needed across other reporting measures, including social impact, to ensure there's consistency and transparency of what's being reported."

THE ROLE OF GOVERNMENT

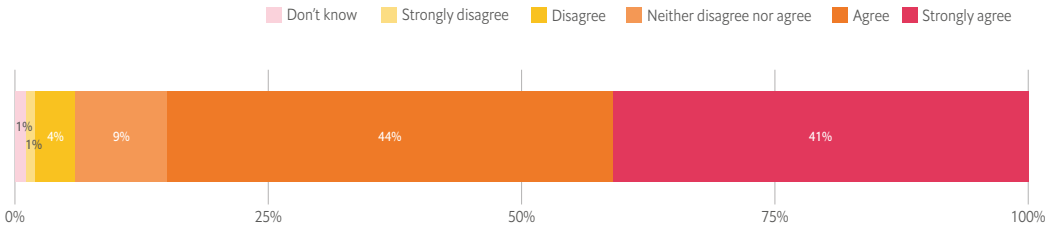
The investors surveyed agree that government regulation is needed to mandate companies to disclose more ESG information. However, they are divided on which regulator has the right skills to do the job. As seen in figure 11, just over a third want an environmental regulator, and less than a fifth a financial regulator, to dictate disclosure. Interestingly, 15% suggest a new, specifically tasked government regulator.

The investors interviewed have mixed feelings about regulation. "I'm a little bit hesitant to be honest, because I think it's hugely complex and I'm not sure there is a single regulator that can understand all the implications—on so many challenges that we are facing, on so many industries, so many companies—to make useful mandatory disclosures," says Mr Monier. "The worst is a regulation that is not very well thought out, or that people consider as a tick-box exercise. If they impose their own framework, this might have a counterproductive effect."

CalSTRS would prefer if regulators built upon already established frameworks. "I think the market-driven and voluntary solutions that are being delivered by financial regulators are good for investors," says Ms Jenkinson. "But we get nervous when we see new organisations trying to reinvent the wheel by creating new sustainability metrics from scratch or further crowding and confusing the market with untested standards. We are really supportive of policymakers and regulators who are building on existing frameworks—like the Value Reporting Foundation, which is [based on] IIRC [International Integrated Reporting Council] and SASB and TCFD—and taking this a step further."

The UK is heeding the call to build on existing frameworks, making TCFD reporting mandatory for firms.[13] The SEC has started its process of implementing a mandatory climate-related disclosure framework, with its chair, Gary Gensler, stating that it should establish a new regime appropriate for US markets; he added that SEC staff should "learn from and be inspired" by existing frameworks such as TCFD.[14] The SEC is also looking at social factors, with plans to consider human capital disclosure, which could include metrics such as diversity, compensation and workforce turnover.[15]

FIGURE 12. Government regulation is needed to mandate companies to disclose more ESG information



Source: Economist Impact survey

[13] https://responsible-company.com/smart-papers/tcfd-are-companies-focusing-on-the-issues-important-to-investors/
[14] https://www.willistowerswatson.com/en-US/Insights/2021/08/sec-considering-mandatory-climate-risk-disclosures
[15] https://www.esginvestor.net/us-regulatory-update-making-up-for-lost-time/

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Mr Sheng also sees the need for collaboration. "The development of standards requires joint efforts of the government, industry associations, enterprises, investors and other institutions," he says.

Ms Jenkinson circles back to the potential of the new ISSB. "I think the IFRS Foundation's interest in establishing the ISSB, and the fact that IOSCO [the International Organisation of Securities Commission] is supporting that, feels important—a consolidation and recognition of where this proliferation of standards fit together and how they can all play well together."

Yet reporting on metrics is not enough to properly move the needle. According to the UN Principles for Responsible Investment, stewardship and ESG incorporation are complementary strategies that form the basis of responsible investment. A successful engagement strategy "identifies relevant ESG issues, sets objectives, tracks results, maps escalation strategies and incorporates findings into investment decision making."[16] Government guidelines for stewardship, such as the Financial Reporting Council's UK Stewardship Code and the Securities and Futures Commission's Principles of Responsible Ownership in Hong Kong, as well as investor coalition initiatives such as the Investor Stewardship Group's Framework for US Stewardship and Governance, have helped to set principles for engagement between companies and investors, although most frameworks remain voluntary or work on a "comply-or-explain" basis.

Additional initiatives are needed in further jurisdictions to help investors make clear their expectations when it comes to ESG performance and, consequently, real-world impact. Moreover, guidelines should include how investors and companies can determine relevant milestones and how they can track progress against these targets.

"The development of standards requires joint efforts of the government, industry associations, enterprises, investors and other institutions."

Richard Sheng, Ping An

[16] https://www.unpri.org/an-introduction-to-responsible-investment/an-introduction-to-responsible-investment-stewardship/7228.article

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REGULATING ESG DATA PROVIDERS

Issues around sustainability data have led to the rapid growth of data providers supplying both ESG data and ratings, with the market expected to be valued at US$1bn by the end of 2021.[17]

However, lack of consistency in the approaches of data providers—sometimes resulting in quite different ESG scores for companies—is an issue itself. A recent study by the International Organisation of Securities Commissions (IOSCO) found a lack of transparency about the methodologies underpinning ratings and data products, and uneven coverage of products across industries and geographical areas, which could lead to gaps and inconsistencies for the investment managers using them.

"The data from data providers are not necessarily easy to use because they provide aggregated scores," says Stéphane Monier, chief investment officer at Lombard Odier Private Bank. "There have been studies done on the correlation between scores of the main providers—Bloomberg, MSCI and Sustainalytics—and the correlation is only 0.4 because they have different methodologies. Each is a little bit like a black box. So we developed a proprietary methodology back in 1997, using the raw data from many providers."

The IOSCO study also highlighted potential conflicts of interest, such as fee structures and insufficient separation between the ratings services and the business lines that provide advice to issuers on how to improve their ratings.[18]

The influence of data providers on how companies report is seen in our survey. More than four-fifths of corporates agreed that ESG scores from ratings agencies influence internal policy or operational changes at their organisation.

As data providers influence company strategies, Jane Firth, head of responsible investing at Border to Coast Pensions Partnership, believes that investors should influence the providers. "We engage with the data providers that we use and will challenge them if we don't think that a company rating is right."

To address the challenges highlighted by its study, IOSCO has proposed ten recommendations, including the regulation of ESG ratings and data products providers. The latter may be on the cards in the UK. A recent Treasury report outlining the framework for new Sustainable Disclosure Requirements said that data providers give assessments that are not always comparable and that have more gaps and assumptions than ratings in other areas of the market; the report said that the Treasury may therefore bring them under the scope of the FCA.[19]

Investors also hope that clearer standards (via the work by the new International Sustainability Standards Board) will help them to better understand how companies are rated by different providers, as ratings promoters will need to disclose their methodologies in a transparent way.[20]

[17] http://www.opimas.com/research/547/detail/
[18] https://www.iosco.org/news/pdf/IOSCONEWS613.pdf
[19] https://www.etfstream.com/news/uk-government-mulls-regulation-of-esg-data-providers/
[20] https://www.etfstream.com/news/iosco-to-force-the-issue-on-quality-of-esg-data-disclosure/

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Conclusion

Companies increasingly see the importance of a strong ESG agenda for their long-term strategy and are expanding their measurement and publication of different metrics. While there are still significant gaps, efforts on multiple fronts aim to improve the information that investors can access. The intention of the ISSB to consolidate various frameworks provides the first real hope of an international standard for disclosures. That work, along with IOSCO's recommendations to improve the ESG data industry, will also improve transparency of data providers' methodologies.

The support of governments in making existing ESG disclosures mandatory, rather than voluntary, will also improve investors' insight into corporates' ESG performance, and therefore their confidence in the disclosed metrics. But transparency and reporting will not achieve real-world impact on their own. Enforcing disclosure from public companies will not prevent harmful assets from being taken over by less-accountable private entities, which would only kick the sustainability can further down the road. This top-down push must also be supplemented by a more bottom-up approach to address individual companies' issues.

Both investors and companies agree that direct dialogue is the key to this: increased engagement by investors, and their external managers, is helping to provide them with the intelligence that they need to accurately integrate ESG into their investment process and support companies in translating their ESG efforts into real-world impact. To that effect, more frameworks and proper binding requirements are needed in many jurisdictions to promote the setting of milestones and incentives—and the tracking of progress against these targets—within a sound investor-stewardship programme.

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