



Sustainable Investing: Addressing the Trust Deficit

by Sunil Rana, April 2022

Two things took off unexpectedly when the pandemic hit. One, the stock price of Zoom, which became the lynchpin of life – personal and professional, during the pandemic. Two, the tsunami of investment that has flowed into the ESG funds over the past two years. According to Bloomberg estimates, the overall size of the sustainable finance market is now estimated to be over USD 35 Trillion¹. As the sustainable finance market growth continues its rapid climb, the regulators have taken notice and a raft of new measures are being put in place. Is it working though?

First, do no significant harm

The principal of “Do no significant harm” is a good lens to view sustainability of underlying assets with, to begin with. But it is also too basic in its application, as is obvious. The real challenge lies beyond this question. How do you determine that an underlying asset is truly ‘green’. Several asset managers have continued to repurpose and recategorise their assets as green as the sustainable investments market has grown. The widespread repurposing of the existing assets without appropriate oversight and regulation (and some despite the regulation) has inevitably led to an enormous challenge and risk to the investors due to ‘greenwashing’.

Fifty shades of green

The launch of SFDR is designed to assuage the investor community’s fears around greenwashing but we believe that at best it only partially addresses the real underlying concern. SFDR, as an example, recognises varying degrees of shades of ‘green’ when it comes to categorising the ESG assets based on Articles 6, 8 and 9. Due to this, there has been real concern regarding the greenwashing issue as hundreds of funds have (re)labelled themselves as “green” – albeit with varying

¹ <https://www.bloomberg.com/news/articles/2021-11-08/the-35-trillion-sustainable-finance-market-gets-greater-clarity>

shades of 'greenness'. Therein lies the first problem that needs to be tackled. If the underlying idea of ESG funds is to make a meaningful impact towards the overarching developmental / sustainable / climate goals, the cut-off for being considered compliant must be meaningful and have a clear hurdle. It ought to be based on the materiality of its 'potential' to deliver the desired impact. SFDR with its Articles 6, 8 and 9 recognising varying shades of 'green' will unfortunately not solve the issue that it is intended to address. Implications of this approach are already starting to be visible. Financial Times recently reported that Morningstar, an influential investor services firm, removed 1,200 funds with a combined value of USD 1.4 Tr from its 'sustainable list'. The sheer size of the combined assets is unnerving in terms of the impact this will have had on the investors in those funds.



The Trust Deficit: An urgent need for making ESG Ratings and disclosures more reliable *and* meaningful

The trust deficit - Key drivers

The challenge of competing regulations, jurisdictions, interoperability, alignment etc. makes the progress tardy at best when it comes to assimilating policies and regulation across the global markets. Also at the core of the issue is another factor - data assurance, that needs addressing urgently and comprehensively. Breadth, availability and veracity of the underlying ESG data is key to addressing the issue of greenwashing, and the subsequent risk to the investors. In order to tackle this, we need to comprehend three specific issues that have led to the data challenge:

- 1. Paucity of knowledge and ESG expertise:** The growth in sustainable finance market has outpaced the capacity and capability required to service and support the market. This has led to a significant talent gap in the ESG services market – both service delivery as well as service consumption side. This ultimately impacts the application of ESG concepts and the quality of the underlying data being provided and collated. Global professional services firms

are committing billions of dollars to develop ESG advisory services and talent capacity². Such announcements confirm three issues –

- The significant gap in the availability of ESG talent in the market
- The sheer size of the investment required to address it, and therefore...
- The criticality of the issue (and the size of the opportunity), given the magnitude of these investments

But talent development is a lengthy and arduous process, and alongside, the capability issue still needs to be addressed through alternative interventions.

- 2. Lack of meaningful tools and analytics capabilities:** The expertise / talent gap is further magnified due to the lack of strong codified systems and tools that can help the end clients and investors to engage effectively on the ESG front. Vast majority of the analytics is still focused on reporting rather than making any real sense of the underlying ESG data – beyond the standard correlations (short-term and/or longitudinal) amongst equities and returns. There also needs to be greater effort to address the issues of scalability and data quality assurance. This gap (and the associated challenges) will get magnified even more as the regulators push to expand the coverage of the ESG regulations to a broader set of companies – mid caps and SMEs particularly, in their quest to make the participation meaningful. A combination of all these factors ultimately impacts the quality of the underlying data driving the ratings.
- 3. Light touch application of ESG:** ESG continues to be broadly applied as a light touch ‘tick-mark’ exercise and there has not been any material effort when it comes to practically integrating it with the day-to-day business management decision making. The rigour is far from what is generally observed in the areas such as financial analysis or business planning. Our own research and discussions across a cross section of global firms indicate that the topic continues to get bulk of the investment from marketing angle rather than any real integration and traction with the decision-making units in the c-suite and board rooms. Perhaps, a strong indicator of this is that even the so-called ‘rigorous ESG exercise’ by a large number of organisations today is focused on a handful of metrics (primarily D&I, pay equity, Board diversity, etc) and needs to go much deeper with real integration with the business impact analysis. The latter is a complex and expensive exercise today considering that it requires involvement of the relevant experts and consultants, which in turn makes it a competing priority amongst other strategic initiatives.

² <https://www.reuters.com/business/sustainable-business/pwc-planning-hire-100000-over-five-years-major-esg-push-2021-06-15/>

Addressing the Issue

We propose a three-pronged approach to comprehensively address the issues that are creating impediments to a broader and more meaningful adoption of ESG to drive impact through sustainable investing:

A.Regulation:

It is inevitable that the ESG ratings will become regulated in the near future. The financial risk, as well as other sustainability agenda related risks, are simply too great for it not to be. However, the regulators, like the market and the end users, need to move rapidly to learn and adapt on the fly as the regulation unfolds, and the issues emerge with the application of the policies. Agility in this regard is key. But this is also difficult given the very nature of how regulations emerge – a long and an arduous process of consultations, feedback and revisions. Hence, they need to be equipped with their own mechanisms to monitor the data quality and, enhance and broaden the engagement with the market participants towards maturing the regulation rapidly. Having the ability to form independent view in this regard will be crucial for the regulators.

B.Private markets and asset managers:

Financial Market Participants (FMPs) and other non-regulatory stakeholders need to play their part too. A large part of the ‘burden’ of ensuring quality ESG integration ought to be on these stakeholders too. Claims that are made need to be verifiable and backed by proper internal oversight, rigour and data quality. These stakeholders need to invest time, effort and capital to build the appropriate capacity and capabilities to augment the efforts of the regulators and data service providers. Perhaps, just as the quality of financial disclosures and data is enhanced through external audits, ESG audits ought to become de rigueur. In this regard, the audit firms (and other qualified entities) could become a key enabler of broad-based quality assurance and consistency.

C.Service and data providers:

Service and data providers such as ESG rating services providers, advisory and accounting firms will need to look for mechanisms to fundamentally enhance the quality and consistency of the coverage. This is already a challenge given the current lack of capability and capacity with the advisory firms, and the often-divergent ratings from the ESG ratings companies. The latter is a major challenge from investors’ perspective given the importance and sway that these ratings have begun to have on the sustainable

investment flows. To highlight the magnitude of the issue, a recent study³ by MIT Sloan School of Management and University of Zurich found that there was very low correlation at the aggregate as well as category (E,S,G) level ratings amongst major ESG ratings companies. This further increases the onus on part of the major investors to be able to conduct their independent due-diligence to ensure greater certainty when it comes to integrating ESG within their ratings. While part of this is owing to differing methodologies and applications of the taxonomy, a key reason is also the reliability of data provided / collected. The advisory firms and ratings companies can improve the reliability through a scalable and enhanced engagement with the companies, which ought to become central to the process. It is also the way to hold the individual companies accountable for their data quality.

The Bottom Line

ESG rating is no longer the fringe trait that was good to have for a company's profile. With the increasing activism around climate change and sustainability amongst customers, and the already sizeable size of the sustainable finance market, it is key to ensure that ESG becomes core to business decision making, just as finance and strategy are today. While critical, the push by the regulators can only go that far, and that fast. An approach that enables as well as ensures shared accountability for all stakeholders is key to resolving the challenges and the risks that the current landscape poses for successful ESG integration. A crucial aspect of the success of this shared approach will depend on the stakeholders' access to knowledge and capability in a cost efficient and scalable manner. For only when the trust deficit is addressed, can we expect ESG to truly become an impactful lever for change that it is intended to be.

³ Aggregate Confusion: The Divergence of ESG Ratings by Berg, Koelbel and Rigobon , MIT Sloan, May 2020

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Sunil is the Founder & CEO of Vyzrd. Prior to founding Vyzrd, Sunil held senior and leadership positions across leading global management consulting firms such as BCG, Mercer and Oliver Wyman. He has extensive experience in advising the CxOs and Boards of some of the largest global firms and government organisations on topics related to investment, growth and risk. He also served as senior advisor to one of the top ESG investment research firms, which was subsequently acquired by a leading global ESG ratings company.

About Vyzrd:

Vyzrd™ is an AI enabled analytics platform that provides scalable, incisive and innovative portfolio of business Growth Acceleration, Risk Management and Climate & Sustainability solutions.

Our ESG solution: Vyzrd's research and analytical solutions focus on ensuring that we enable the investment managers to meaningfully address their ESG investment priorities. We believe our approach to ESG investment analytics is arguably the most comprehensive and uniquely differentiated in the market today. Our model enables our clients and investors to rapidly assess and effectively integrate ESG with the key business fundamentals that drive the overall business performance of their target investment or portfolio companies.

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