Financing for Development

POLICY NOTE:

# Is Wall Street on a mission to make the world more sustainable?

Not a single day goes by without an article in the press on including environment, social and governance (ESG) factors in investment decision-making. One report claimed that "sustainable, responsible and impact investing represents 1 in 4 dollars of the total US assets under professional management in 2018." The finance industry is creating instruments to tap this growing interest. Investment indices with ESG ratings have mushroomed, rising by 60 per cent in the twelve months through June 2018.[1] A survey of asset managers in the United States shows that 75 per cent of the respondents say their firms now offer sustainable investing strategies, up from 65 per cent in 2016.[2] Nonetheless, there are also voices raising concerns about asset managers using other people's money to advance environmental and social objectives rather than focusing solely on profitability.[3] Are capital markets the solution for achieving the Sustainable Development Goals (SDGs)? Or is this too good to be true?

## Sustainability is good for business

There would be a "win-win" situation if taking sustainability factors into account did *not* require sacrificing financial performance. There is a compelling case why companies with "sustainable" business practices may outperform those without. Companies can strengthen risk management by incorporating a wider range of risks into their business strategy, such as by reducing exposures to natural hazards, avoiding reputational scandals or anticipating regulatory changes. The latter is salient in the climate space, where it appears that potential policy measures to limit carbon emissions are increasingly being priced into some markets.

According to a recent survey of asset managers, 82 per cent of respondents think strong ESG practices can lead to higher long-term profitability.[4] The reference here to "long-term" is important as many ESG elements do not have an immediate visible impact. For example, some climate change and water scarcity related-risks may require years to materialize.

Numerous studies have looked at empirical evidence to assess the material impact of ESG factors on long-term financial performance of investments. The majority of studies find a positive relation between incorporating these factors into investment decisions and profitability (see the review of ESG studies compiled by UN/DESA). In other words, there is evidence that investors can use sustainability information to better manage long-term risks and enhance returns.

## Where is the impact?

Yet, despite this positive news and trillions of dollars allocated to ESG investing strategies, progress towards the SDGs is insufficient and global carbon emissions continue to rise. Different reasons can explain why such investing has not enabled greater progress. First, as ESG is narrow in scope as compared to the SDGs, ESG-based investing cannot be expected to solve all sustainability issues. This is compounded by short term investment horizons of many investors, which means that many ESG longer-term risks can be overlooked.

Second, there is a misunderstanding about the goals of ESG investing. While some "impact investors" aim to maximize non-financial environmental and social goals, most investors focus primarily on financial return. For these investors, ESG factors are used to manage risks to profitability and maximize long-term value, rather than goals in their own right. Bundling ESG investment strategies and "impact investing" together can be misleading and create unrealistic expectations. For example, adding ESG factors into investment decisions is likely to help investors better pick stocks, but there are questions as to its effect on achieving sustainable development, such as whether ESG investing creates enough pressure on companies to incentivize change into their business practices, or how much weight is given to ESG elements compared to other factors in investment decision processes.

Third, there is also a risk that financial products are presented as sustainable when in reality they are not. For example, some ESG funds might include tobacco or fossil-fuel based companies based on their relatively good ESG performance compared to industry peers, while their impact on sustainable development is at least questionable.[5] Other companies can rank high on one sustainability index and low on another.

## The measurement conundrum

Measuring to what extent companies contribute to the SDGs remains a work-in-progress, making sustainable investing challenging. More than 80 per cent of companies in the S&P 500 Index issue sustainability reports, but there is no consistency in reporting metrics, reflecting the lack of internationally recognized standards in this area. This is in part because, unlike financial reporting, which uses a common unit (i.e., money), many factors included in sustainability reporting (e.g., tons of recycled waste, use of natural resources, gender balance) are difficult to capture in monetary terms. Companies use different metrics to measure similar issues and can choose from a variety of reporting frameworks. Sustainability reporting is also largely voluntary. Companies can choose to report only on positive results. These inconsistencies create challenges (and costs) for investors and other stakeholders in interpreting/comparing data.

## Cracking the code

The UN is working on building a shared understanding on what sustainable investing means and how to measure its impact. A globally recognized set of criteria or metric for sustainable investing should help bring more clarity, combat greenwashing and enhance understanding of investment impacts. Regarding impact measurement, there is a need to revise accounting and reporting rules to include key industry-based sustainability metrics in mainstream corporate reporting.

There are two elements to such reporting. The first is reporting on sustainability factors that have material impacts on financial performance. Information on these factors is critical to informing investors' risk and return analysis. However, some important sustainability factors may not have a material impact on profitability (e.g. the intensive use of plastic packaging). A second element is reporting on non-material sustainability factors, which inform the public about the impact of companies on global goals. Defining key metrics internationally would bring benefits in terms of coherence and comparability.

Addressing these questions is a priority area of the *Secretary-General's Strategy for Financing the 2030 Agenda for Sustainable Development*. This requires:

- **Tracking the impact:** Can existing data be used to measure the impact of companies on sustainable development? What is the overall quality and coverage? Where are the gaps and how can they be filled?
- **Comparing methodologies**: The growing interest in sustainable investing has resulted in a multiplication of initiatives that attempt to measure the impact of sustainable investing. Bringing them together would allow identifying similarities and differences while building more clarity in the industry on impact measurement.
- **Leveraging impact measurement**: Measurement is not a goal per se. It must change corporate behaviour to be effective. Could better measurement be used to develop sustainable indices that guide investors allocation? Can we standardize approaches to integrating impact? Develop a common methodology?

The UN Secretariat is committed to continuing work on these issues, engaging both governments and the private sector. The annual Financing for Development Forum provides a platform for sharing findings, building consensus, and committing to actions. The *'Global Investors for Sustainable Development' (GISD*) Alliance, a group of global business leaders convened by the Secretary-General, can support and enhance this work. Wall Street can make a difference – but we first need to develop the tools to hold companies accountable for their impact on our world.

## For more information consult

Financing for Sustainable Development Office http://www.un.org/esa/ffd
Inter-agency Task Force on Financing for Development http://developmentfinance.un.org

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