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Hope on the horizon: addressing the ESG challenge

A growing number of financial institutions, investors and policymakers have shifted focus toward sustainability investing, or incorporating environmental, social and governance (ESG) matters into the investment process. Although the topic of ESG may seem like a novel phenomenon, the financial services industry has weighed in on certain financially-material ESG factors for some time. What is different now is a heightened sense of urgency given the physical devastation of climate change has become measurably real.

There are two key drivers in this focus shift. The first is increased client demand for sustainable investment and their general changing mindset requiring more stable returns over the longer-term that poses no harm the wider environment. Even amid the current market turmoil due to the Coronavirus pandemic, investors appear keen to maintain ESG values, for instance by monitoring companies' treatment of employees. The second – perhaps, in part, driving client demand – is regulation which has prioritised policies broadly relating to ESG in recent times, albeit globally divergent approaches have emerged. Clearly, the paradigm has changed and progress has been made.

Nevertheless, persistent key challenges must be addressed. The first step, especially from an investor perspective, is to achieve a common language – or taxonomy – on what constitutes a sustainable investment. The European Union has made headway in classifying economic activities that contribute to its environmental objectives. To articulate a common understanding of sustainability in practice, however, binary definitions that could limit choice of sustainability products and services should be avoided. Moreover, for financial market participants to apply any taxonomy, there needs to be significant improvements in the quality of sustainability data. Specifically, greater clarity and simplicity is needed for corporate ESG disclosures. This means harmonisation of reporting standards as well as convergence of data sets and scoring methodologies, at the international level, to allow for better comparability of the sustainability of investments.

Financial institutions, investors and policymakers continue to develop toolkits needed to incorporate sustainability into the investment process. Efforts by the Sustainability Accounting Standards Board (SASB) and the Taskforce on Climate-Related Financial Disclosure (TCFD) have already been important contributions to help industry coalesce around common metrics and reporting standards, akin to what the major credit rating agencies use today to measure credit risk. Importantly, these international frameworks ensure the concept of materiality is upheld when considering ESG integration. Ultimately, we need to be mindful that the policy goal is not to elevate sustainability risks above other critical components of the investment process, rather it is to ensure ESG is on an equal footing so as to enable private capital flows to be reoriented towards a more sustainable future. ●