# Mainstreaming environmental, social and corporate governance

Businesses in today's marketplace, in both the financial and non-financial sectors, have to pay attention to the environmental and social impact of what they do, as well as to respect high standards of corporate governance. The group of standards is commonly referred to as 'ESG'. ESG is now a mainstream activity. President Trump resists. He is mistaken (again).

I see a need to improve the authentication, oversight and scrutiny of ESG claims, ratings and indexing. Despite the efforts of bodies such as the SASB (Sustainability Accounting Standards Board) and the Principles for Responsible Investment body (PRI) supported by the UN, there are conflicts of interest that produce a lack of rigour and consistency. The labels are scattered around like sprinkles on a tray of cupcakes.

**The setting**

On 30 May 2019, the Washington Post ran a story on how Salesforce, a dominant provider in the US of software for businesses in managing their customers and orders, had decided to cease to provide their software to a client company that sold semi-automatic guns to members of the public. Apparently, the sales were seen to violate Salesforces' standards and policies on what constituted a socially 'acceptable use' of their software platform.

On 1 July 2019, the BBC reported that Swiss-based insurer Chubb is to cut its exposure to the coal industry. It announced it would no longer underwrite the building and operation of new coal-fired plants or new risks for companies that generate more than 30 per cent of their revenues from coal mining. According to the BBC, Allianz, Hannover & Lloyds banking Group have also scaled back on their exposure to coal mining.

In the UK, the financial regulator, the FCA, has been moving to ensure that pension funds, insurers and other asset managers have independent governance committees to try to ensure consistency between the fiduciary duties of asset managers to clients and the widening of their investment remits to take account of ESG concerns. What is common to each of these developments is the mainstreaming of ESG considerations.

**The conflict of private and public interest**

Some market theorists view the mainstreaming of ESG as a negative development. According to the classic model of the firm, a business enterprise comes together because it can bring within itself activities that it can perform more cheaply and effectively through internalisation, rather than by sourcing them from others in the market. What is important in this model is the sharp distinction between costs that are internal and incurred within the enterprise and costs that are external. It seems to imply that those costs that can be externalised should be. Otherwise, earnings are not being maximised and the market capitalisation of a firm based on future projected earnings will be impaired. Such market theorists argue that a firm's management is not acting in the best interest of investors and shareholders by blurring the lines between internal and external costs.

According to this kind of distinction, when the costs of polluting mainly fall outside the firm, they are of no concern to the firm itself. Similarly a shoe or clothing brand and marketing company should have no concern about working conditions in the supply chain, and equally an online platform provider should have no concern about the uses that might be made of the platform, and a pharmaceutical company should have no concern about the use of its products in the growth of addictions.

This interpretation of the model of a firm immediately suggests a potential conflict of interest between corporate objectives and the wider public interest, and a challenge for investment fiduciaries who have an obligation to consider the best interests of their clients.

It is this potential conflict that provides the context for the Executive Order (EO) issued by Trump's White House in April 2019 on 'Promoting Energy Infrastructure'. The EO requires the Department of Labor to review the investment of retirement plans in the energy sector so as to ensure that they meet their fiduciary duties to maximise shareholder returns over the long term. It is an effort to keep ESG concerns at arm's length and to protect fossil fuels.

**Filling the gap**

We can think of this potential conflict of interest in terms of a 'gap' or a 'wedge' between the incentives operating with the managers of a firm and the societal interest. ESG has become 'mainstream' because a restricted interpretation of what is of concern to a firm and to its managers and what is not, based on what is internal and what is external, is no longer accepted. ESG closes or reduces the gap or wedge between the incentives for the managers of the firm and the wider societal interest. The drivers of this change are both outside the firm and within the firm.

**External drivers of ESG**

The drivers of change outside the firm are often advocacy groups. They take the familiar form of environmental NGOs, or those concerned with employment conditions in supply chains, or those concerned with the implications of internet platforms for online misuse. It seems likely that they will increasingly revert to litigation to try to get their way. Litigants point to a general 'duty of care' incumbent on the boards and managers of companies to observe ESG criteria, and also to specific harms such as in the case of the opioid litigation ongoing in the United States.

Despite the fact that NGOs have notoriously poor standards of governance themselves, the stakes for the corporate world in terms of reputation and profits are high. In addition, investors have their own increasing concerns. They may not want to invest in companies making or selling arms, alcohol or tobacco products, or mining coal. So-called 'sin' stocks may perform well in the short term. But from an investor perspective, investments in companies with environmentally or socially 'harmful' activities may leave them with exposure to companies with stranded assets, facing higher regulatory risks or declining sales.

Investors also look to positives. They apply filters. They want to select investments in companies with good standards of corporate governance, good employment practices, who take account of the environment in what they do, and that deal honestly and fairly with the consumer.

**Internal drivers of change**

There are also internal incentives for managers. Some evidence suggests that at least part of the ESG agenda has a direct and positive implication for corporate performance. Companies that have high standards of corporate governance, for example, that separate the role of chairman from that of CEO, that embrace gender and ethnic diversity at senior corporate levels, including in the boardroom, may outperform their rivals.

More generally, some comparisons between market performance of stocks in a general index, compared with stocks weighted according to ESG criteria, suggest better performance by ESG stocks. In addition, there are management incentives around the market valuation of companies. There is empirical evidence that if a company is included in a market benchmark or index used by investors and investment managers, such as the S&P 500, then the its cost of capital is reduced relative to those outside the index. The same applies to the inclusion of a firm in an ESG benchmark or index. There is thus an incentive to be included in ESG benchmarks. There is a penalty to being dropped.

What this means is that the incentive structure for managers has changed. There are costs to ignoring societal and investor concerns. There are gains from paying attention to a wider set of performance signals. Both external and internal drivers help close the gap or wedge between the private interest and the public. President Trump's EO that tries to solidify the gap is doomed to failure.

**Measurement and authentication**

The mainstreaming of corporate activities around ESG raises the question of how much of what is going on is 'real' and how much is window dressing and sprinkles on the cupcake. In a speech earlier this year, the chair of the International Accounting Standards Board (IASB) referred to the huge array of ESG measures being deployed. This is where the authentication of ESG claims in benchmarking and indexing becomes crucial.

There are three main questions around authentication:

- the validity and transparency of what exactly is being measured and how it is being used;
- the consistency of measurement between firms and between ratings; and
- who is doing the measurement.

What is being measured is important because it addresses concerns about window dressing and potentially misleading marketing and labelling. Consistency of measurement is important because, in its absence, inter-firm comparisons become invalid and financial indexes grouping different firms together, or differentiating between groups according to ESG classifications, also become suspect. Who is doing the measurement is important because it affects confidence in the validity of ESG benchmarks and their uses.

These concerns mean that a lot rides on who exactly is doing the authentication of ESG claims and labelling. As with any other form of market relationship, questions about potential conflicts of interest become of paramount importance.

**The different sources of ESG labelling in the market place**

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| **Self authentication** | A firm makes known to its shareholders and the public what standards it follows and how it measures up to them. | The conflict of interest in this case is with their self-interest in image laundering. We are all familiar with companies that change their name, or brand image, in order to present a different face to the world and different gloss on their activities while nothing much changes in the core of what they are actually doing. |
| **Advocacy groups** | Advocacy groups can be an important source for authenticating ESG claims. We are also all familiar with various types of labelling that certify ‘fairness’ or ‘sustainability’ in sourcing. | The difficulty is to know their own governance standards. In addition, the relationship with the firm being benchmarked may not always be clear. There is a risk of mutual backscratching. SASB has a governance structure that aims to avoid this kind of problem. |
| **Fund promoters** | There is a growing number of investment funds available to investors with ESG concerns and aims. The promoters of these funds have an obvious self-interest in providing ESG assurances. | The difficulty is to know what standards have been observed and how comparable they are across different funds. Fund promoters also have a need to avoid funds that are too narrowly constructed in order to meet regulatory requirements about composition. This too may have an impact on selection criteria. |
| **Investment managers** | Investment managers also face a conflict between the costs of bringing ESG scrutiny ‘in-house’ versus relying on the uncertain standards of out-of-house benchmark providers. It is not always clear what standards they use or how they use them. They may use ESG criteria as filters about what goes into their funds, or to change the weightings in their funds, or simply as talking points in evaluating stocks. | Investment managers increasingly want to have their cupcake and eat it too. They market "ESG" funds that purport to have the same or better performance than non-ESG funds. From a classical portfolio theory perspective this is a dubious claim, as a portfolio with constraints can at best perform as well as a portfolio without constraints, assuming the portfolio without constraints operates on the efficient frontier. |
| **Index compilers** | Financial sector companies that compile and track indexes that observe ESG ratings also are a source for benchmarking. In theory they can provide inter-firm consistency. In practice there is a lack of consistency. | The potential conflict of interest arises in part because of their interest in promoting the number and coverage of such indexes. In addition, there are questions around how they are getting compensated and how far it is by the companies that are being rated, or the investment managers that use their services. |
| **Independent ratings agencies** | Finally there are independent ratings agencies that offer ESG benchmarks and ratings. They are neither index constructors or fund promoters or managers or advocates but exist simply to meet a market need for certification.They too can offer inter-firm consistency in their labelling. | The difficulty is that they are working in a novel field, where standards and analytic techniques are not yet established. Grabbing market share may be important. There are different measures for judging what ESG factors are material to the analysis of risks and returns. The same questions around potential conflicts of interest arise in connection with who is providing their compensation. |

**Oversight**

The need to recognise the broader definition of what is of concern to a company, its managers and shareholders is here to stay as a permanent feature of the marketplace. ESG reporting is encouraged by international bodies such as the UN-supported PRI, IOSCO & the IFC (a World Bank affiliate). In the EU, the Shareholders Rights Directive that comes into force this year recommends that director performance be reviewed including ESG factors. As a consequence, questions around the authentication of ESG labelling have become pressing.

In the 2008 financial crisis, ratings agencies took a share of the blame. They provided reassuring ratings for financial products for investors, notably in the mortgage market, that were in fact high risk.

The lessons drawn by regulators were that ratings agencies required oversight, their standards of measurement needed to be fully transparent and open to inspection, and safeguards needed to be in place that protected against potential conflicts of interest between providers of ratings and the subjects of rating.

ESG ratings and benchmarks are not yet used in ways that suggest that false measurement presents a systemic risk to the market in ways that false AAA claims did. There is much to be said for allowing a market discovery process to take place in order to improve ESG claims. However, we still need to be concerned about the authenticity of ESG claims.

ESG ratings and indexes are a fast-growing sector of financial markets. Unreliable ESG ratings impair investor decisions, market valuations, inter-firm and inter-market comparisons and risk assessments. Regulators need to engage in much more active oversight of compensation, incentives and transparency in this fast-growing field.

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**Frank Vibert** is a senior visiting fellow at LSE's department of government. He won an Open History Scholarship to Exeter College, Oxford and obtained a first class degree in Philosophy, Politics and Economics (PPE). He has been a senior advisor at the World Bank in Washington DC and a senior fellow at UNU/WIDER in Helsinki. He co-founded and was director of a London based think tank, the European Policy Forum, between 1992 and 2008. Since then he has been a senior visiting fellow at LSE. His main fields of interest are constitutional theory and regulatory governance, including international governance and the European Union.