RECASTING ESG - SEPARATING DRIVERS FROM IMPACTS

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Summary

The building blocks of Environmental, Social and Governance ('ESG') metrics were never intended to be equal or commensurable. Good governance is a <u>driver</u> of positive environmental and social outcomes and impacts, rather than the impact itself. Yet the desire to create marketability for products based around ESG ratings has led to a distortion of their original purpose of raising awareness and triggering transitions towards sustainability. Of late, practitioners, academicians and civil society voices have criticised ESG metrics, questioning their purpose and legitimacy, pointing to the proliferation of frameworks and their lack of transparency, consistency, comparability or standards. Despite this, funds using ESG themes are on course to be over one third of global assets under management by 2025.

In this paper, we argue that it would be more credible, and more effective for sustainability transitions, if environmental, human and social <u>impacts</u> were evaluated separately from evaluations of governance <u>drivers</u>. Evaluation of investment impact using the Four Capitals valuation framework already exists as a robust alternative to the use of ESG ratings as surrogates for impact metrics. It enjoys consensus and is moving towards standardisation. It monetizes positive and negative externalities, thus introducing materiality into the analysis and enabling comparisons between companies and sectors with scientific and economic rigour.

Introduction

Corporate decision makers today must work within an increasingly complex global landscape where time, money, and energy must be invested into mitigating existential crises such as climate breakdown and biodiversity loss addressing social imperatives such as recruiting and respecting diversity, promoting inclusion, increasing human capital, and maximising shareholder value. This expanded ask can scarcely be managed given the tools traditionally prescribed for C-Suite managers. Reporting corporate performance following IFRS, capturing only impacts on shareholder financial capital, no longer suffices to meet the growing demand for responsible stewardship of social fabric, public health and the global commons which investors are now calling for, nor does IFRS reporting provide the comprehensive impact measurement which investors seek to evidence that their demands are being met. Sir Ronald Cohen writes of an ongoing "impact revolution" ("Impact: Reshaping capitalism to drive real change", 2022) with significant traction for the way we integrate impacts- on our society and our environment - into the way we think, act and make decisions. This transformation needs to be reflected, inter alia, in the way corporate executives and investors measure corporate performance.

The encouraging news is that investing in significant trends makes good business sense and there are no trends bigger than the transition to net zero (Winston, 2022). Technologies for sustainable business are likely to be assimilated into all corporate activity, similar to the way in which every company became a .com with an internet strategy over the first two decades of this century. The most recent debate, however, is whether the private sector is capable of delivering real sustainable investment through its role of allocating capital. Critics of ESG-based investments are focused on climate and the need for government regulation to ensure genuine progress, over a light green profit-driven version that may do more harm than good (Grote and Zook, 2022).

Expecting ESG measures to address the particular issue on which a critic is most focused is an unrealistic task for a measure that is an amalgamation of multiple metrics.

Some might argue that the variety of ESG rating entities that have sprung up to address multi-dimensional risk measurement are a response to the range of crises corporate managements are now obliged to address. The question we address here is whether there is any logic to a single measure of multiple factors, and if a better alternative exists.

Since their introduction in 2005, ESG factors and ratings have steadily become the accepted standard for both investors and corporate leadership to measure and target corporate sustainability – for better or for worse. Today, over 80% of the world's largest corporations report some kind of ESG information and Bloomberg Intelligence estimates that at half the growth rate of the past five years, ESG-labelled assets could rise from \$35 trillion to surpass \$50 trillion by 2025, accounting for over one third of global assets under management (Bloomberg, 2021).

But as ESG ratings and reporting frameworks continue to gain more traction, a growing body of literature has called the validity and utility of ESG scoring methodologies into question (Pagano, 2018; Gibson et al. 2019; Berg, 2019 among others).

The two most common issues raised with ESG metrics are a lack of transparency, and a lack of consistency and correlation between raters. Gibson et al. (2019) raise a third issue when they determine that some metrics are internally correlated, raising the question of bias from the point of view of the rater.

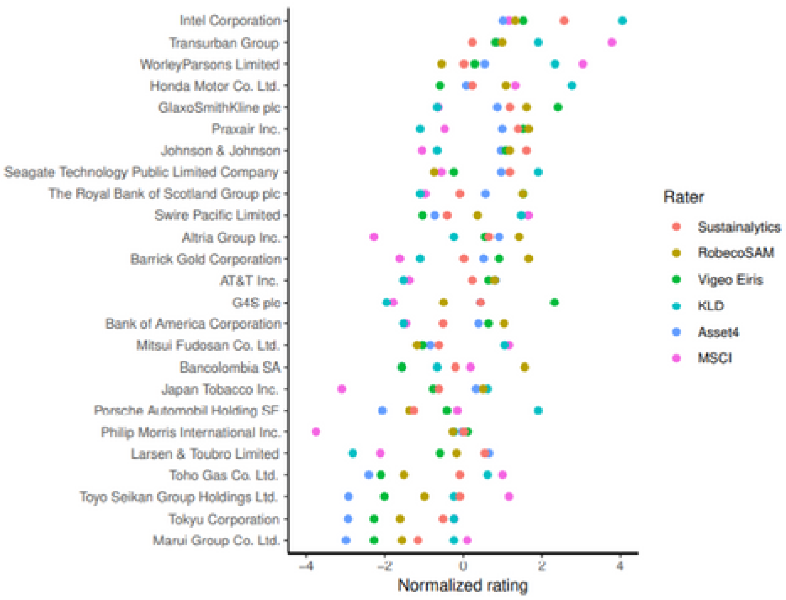
There was initial evidence showing that ESG-labelled funds, and therefore the sustainably-rated companies of which they are composed, outperformed the market both in good times and in bad (Khan et al. 2015, Whelan et al. 2020). Subsequently, these single empirical studies have been called into question. Research incorporating model uncertainty analysis has undermined the link between funds using materially-weighted ESG measures and stock price outperformance (Berchicci and King, 2021). In any case, there is widespread disagreement as to which element of ESG performance most closely correlates with or predicts future financial success. The very nature and proliferation of ESG rating systems makes a comprehensive analysis of which ESG factors are influencing the price of securities impossible.

Disagreement Among Ratings

An aggregate score or rating does not inform as to which of the Environmental, Social or Governance factors is influencing share price or to what degree, let alone the components of each of the factors. Furthermore, with a divergence between ratings from different providers, it is not possible to disaggregate the rating, because there is no agreement over what this rating is or how it should be derived. Correlations between ratings and share prices are, therefore, simply correlations, and neither causal nor explanatory.

Figure 1: Companies with High Disagreement

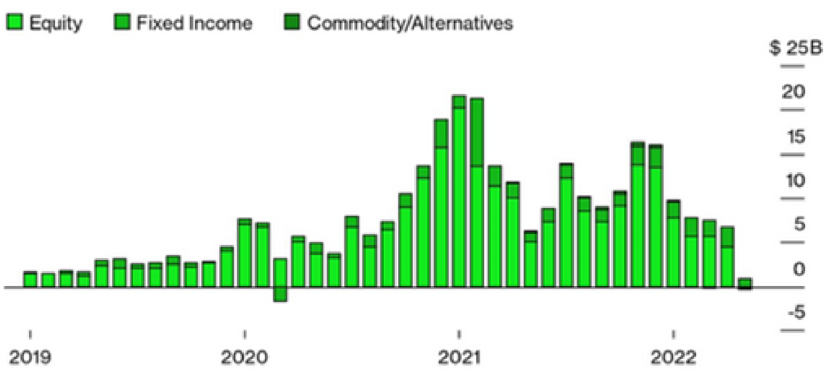
Normalized ratings for the 25 firms with the highest mean absolute distance to the average rating (MAD) within the normalized common sample (n=924). Firms are sorted by their average rating. Each rating agency is plotted in a different colour



Source: Berg et al, 2020

When demand is high for ESG products, then the flow of funds into them is in excess of the broader market trend and would be expected to cause outperformance of sustainable companies (Hartzmark, Sussman 2019).

Figure 2: Global ESG exchange-traded funds flow by month



Source: Bloomberg Intelligence

This flow-of-funds effect on individual securities would be diluted to the extent that the wide dispersion of company ratings across different providers of metrics means ESG funds have a reduced number of common constituents. For this reason, the marketing power of a fund manager or ratings provider may be as important a determinant of stock performance as the comparative strengths and weaknesses of individual ESG metrics. Rather than debate the merits of various metrics, this paper focuses on a critique of the fundamental approach of ESG ratings that treat Environmental, Social and Governance factors as independent and distinct 'impact categories' to be monitored side by side or, worse, combined into a single rating or score.

If there is a flaw in the construct of ESG ratings, then well intentioned investors may be guided to inappropriate investments and it is important to determine whether or not from a methodology perspective there is a superior measure of sustainability.

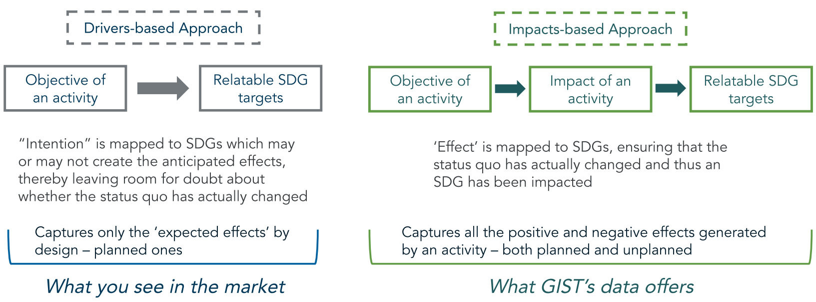
Drivers and Impacts

The term ESG was originally coined in UNGC's landmark publication 'Who Cares Wins', which was the result of a joint initiative comprising twenty financial institutions from nine countries (UN Global Compact, 2004 and IFC, 2004-08). Their goal was to increase awareness around growing investor interest in understanding company performance in governance and a company's impact on the environment and society. Despite where we have ended up, clarity was provided at the time that the three metrics were not designed to be combined and treated as equal contributors to a company's overall impact.

In fact, the UNGC state that: "Sound corporate governance and risk management systems are crucial pre-requisites to successfully implementing policies and measures to address environmental and social challenges." p. 2 (emphasis our own).

In other words, governance is neither an impact nor an outcome, it is a driver. Diverse boards with high turnover and limited connection to the day-to-day running of the company have been shown to correlate positively to accounting returns (Post and Byron, 2014). This is just one example of a potential governance driver. Others include: R&D investing, staff retention policies and performance bonus schemes.

Figure 3: Measuring Impact vs Intention



Source: GIST Impact

Environmental, social, and governance factors are not created equal. Good governance is a prerequisite to proactive leadership in sustainability, careful risk management, and long-term profitability. The size and severity of a company's environmental and social impacts - alongside its profitability and the risk or volatility of its returns - are all driven by the quality of governance. There is thus a fundamental dissonance in any performance rating system which conflates drivers with outcomes and impacts, and assumes any long term positive impact on environmental and social issues.

Information on a company's governance performance provides investors not with a measure of the external impact, but instead a lens into the internal working of the company from the top down. This information can guide investors about the reliability of the information declared, the trustworthiness of high-level executives, any legal & financial risks that are tied to corruption, labour rights issues, and the likelihood of civil lawsuits and their contingent liabilities. All of this is useful information for investors, however, none of this can measure the size and scale of positive or negative externalities.

Taking a step further, every company has tangible external impacts on the environment and on society. Some of these impacts are in the form of value delivered to clients by products and services at the market price they pay, plus some additional value (so-called 'consumer surplus') that might exceed prices. In addition, there are also unaccounted impacts on third-parties which are termed 'externalities'. These too can and should be measured to better understand the overall contribution of a company to the world in which it operates. These impacts can be both positive or negative; which of these depends on leadership and the nature and principles of governance they envision and enforce.

Thus we would argue that the authors of 'Who Cares Wins' were correct in stating that:
"Successful investment depends on a vibrant economy, which depends on a healthy civil society, which is ultimately dependent on a sustainable planet. In the long-term, therefore, investment markets have a clear self-interest in contributing to better management of environmental and social impacts in a way that contributes to the sustainable development of global society."

However, the biggest issue facing ESG scoring systems is that they typically combine quantitative environmental and social risks, as opposed to impacts, with generally qualitative governance drivers. Metaphorically, they are not just combining apples and oranges, but rather, apples and farmers.

To address this fundamental flaw, company performance must be considered comprehensively while respecting the distinction between drivers and impacts – each of which contributes its own valuable information to understanding a company's nature: its purpose, culture and all dimensions of its performance.

From Theory to Practice

Over the past thirty years, the discussions on companies' societal impact have evolved substantially, bouncing back and forth between academics and economists on the one hand, and green-fund managers and CSR departments on the other. The reality is that corporate impact is as much about theory as it is about implementation. John Elkington's Triple Bottom Line (measuring impacts on 'People, Planet and Profit' from Cannibals with Forks, 1999) is an example of a complex academic theory translated into an easy to understand and easy to apply framework for considering a company's impact. The power of the Triple Bottom Line stems as much from its concise presentation as from the core philosophy behind it.

Challenges arise when practical application falls out of step with theoretical underpinning. While the academics involved in coining the term 'ESG' would have never confused the driver (governance) with the environmental and social impacts of a company, when time came to market ESG funds to potential investors, the intricacies were glossed over in the interest of convenience and marketability.

To solve this issue, it is essential that those who implement sustainability metrics respect and abide by the academic framework upon which it is built. This leads us to consider how impacts are generally quantified, valued, and expressed in economic terms in order to bring in the economic concept of materiality. This approach generally follows the pathway and metaphor of capitals, the economic framing of value and wealth.

Four Capitals

The United Nations used the neo-classical framing of value in terms of four capitals, thus expanding and elucidating the "triple bottom line" to four capitals in the UN's Inclusive Wealth Index: Produced, Social, Human, and Environmental capital (Dasgupta, 2012). These four capitals are the widened lens that is essential for any transition from "shareholder capitalism" to "stakeholder capitalism".

Looking at just one single capital segment at a time, with generally a preference for and focus on what was then considered scarce (i.e. financial capital) has been the tradition for almost the past three hundred years, even though what is "scarce" has changed so much and so obviously. Therefore, continuing (in today's climate-challenged, ecologically-constrained, socially-stressed, human health-impaired world) to use only one capital to measure performance will inevitably leave the company in the dark about its total impacts, and its stakeholder performance.

Figure 4: The Interaction of Capital and Ownership

Capital Classes

Ownership Categories	Produced capital	Human Capital	Natural Capital	Social Capital
Private Ownership: ('Private Goods')	Factories Securities Software Patents	Health Education Job Skills	Mines Fields Private Forests	
	Market design, regulations, rules, etiquette Civil & Criminal Laws; Judicial systems			Social Capital
Community Ownership: ('Club Goods')	Community Centres Community Schools	Traditional Community Knowledge	Community Forests Grazing Commons	
	Community rules, norms, customs, culture			Social Capital
Public Ownership: ('Public Goods')	Roads Bridges Public Hospitals	Public Databases Non-patent Knowledge	High Seas Fisheries National Parks/ Forests	
	Constitutions; Judiciaries; Law & order; Tax systems Social equity; Communal harmony; Cultural diversity			Social Capital

Source: GIST Impact

Not only does the four capitals system provide a more comprehensive understanding of a company's impact on society as a whole, but it allows for impacts to be monetised even when the impact is felt outside of the company's balance sheet. Whether this manifests in quantifying the social cost of carbon, summing the increase in wage-earning power through staff training, or calculating the value derived from local biodiversity, the final metric is expressed as a dollar value, making comparisons across the capitals not only possible but transparent.

Of course, such a radical course correction in finance and accounting is not without its critics. Elkington has argued for the need to reset the Triple Bottom Line concept because it has been unable to shift corporate focus from the single accounting bottom line (HBR, 2018). King and Pucker go further, calling impact accounting a centralised solution wrought with practical difficulties, while recognising the value at the individual company level of taking action based on measurement of environmental externalities. Even if the four capitals is the accepted framework, competing methodologies for implementation, or the ignorance thereof, may require regulatory intervention to ensure general application.

Impact Accounting is a necessary but not sufficient condition for sustainability. Sukhdev argues as much in Corporation 2020 (2012), identifying roles for regulators and governments in prioritizing a range of micro-policy reforms in corporate performance metrics, financing limits, advertising ethics and taxation. A sustainable company is one whose impacts do not, if multiplied by an increasing population of such companies or rising business volumes at the company, result in losses of human well being in any of its key dimensions: health and earnings capacity (Human Capital), nature and climate (Natural Capital), manufactured goods & services (Produced Capital) and the quality of relationships and institutions (Social Capital). If companies are permitted to generate impacts which are systematically negative in any or all of these dimensions of well-being, any growth in their number or business volume will be of detriment to human well-being. Conversely, if companies operate in a manner which positively impacts each of these four dimensions, any such growth will be positive and by definition sustainable. The <u>absence</u> of these yardsticks, however, will leave regulators and governments in the dark when it comes to designing improved regulations, policies and incentives for sustainable development.

Monetising Impact

From a corporation's perspective it is easy to imagine the negative implications of including the four capitals in every annual report. Large agrochemical companies pull in billions in revenues and profits while paying often little or nothing to make up for the widespread impacts of their fossil fuel and fertiliser subsidies, and their on-farm and off-farm health impacts (TEEB for Agriculture and Food, 2018). This leads to large distortions from any single-capital image of their performance. And equally, there may be invisible <u>positive</u> sides of the equation.

Case study: Sveaskog

Take for example Swedish forestry company Sveaskog. It owns 14% of the country's forests, covering approximately 4.1 million hectares of land. Not only did Sveaskog have sales of SEK 6.920 million in 2021 and employ over 800 people across Sweden, Latvia and Finland, it also placed a large emphasis on maintaining the quality of the forest for the ecosystem services it provides to the domestic populations. What positive value did those public ecosystem services provide?

According to its 2016 Integrated Profit and Loss, the largest contribution of the business' operations wasn't the net income for its government owner through sale of timber products, but in fact Carbon Sequestration services (valued at 4.1 billion SEK) and Water Conservation services (valued at 2.7 billion SEK) provided by the millions of hectares of forested land it owned. These two services are helping to combat climate change and to regulate freshwater.

Furthermore, Sveaskog forests serve as valuable recreation destinations, sources of fruit and wildlife for local people, and areas for exploration and learning for the nation's children. The Sámi people benefit from free access to grazing lands, which alone was worth 76 million SEK in value. In total, the societal value of Sveaskog's operations was found to exceed the traditional 'PAT' measure by almost a factor of ten. Such is the difference between "single capital" and "multiple capital" accounting, between shareholder performance and stakeholder performance, and it can genuinely distort the picture in either direction, positive or negative.

When properly measured, a company's impact across all four capital classes is the truest measure of the real contribution that the company is delivering to our society as a whole. Through impact monetisation, a company's societal performance may be summed up to a suite of four dollar values: that in part is the power of this metric. It should be borne in mind that the four capitals are not generally commensurable or interchangeable, as they are economic metaphors for what is generally public wealth belonging to different communities, such as the human capital of its employees, the natural capital of communities who live where its material inputs are extracted, the social capital of the countries in which it sells its goods, and the produced capital which are part of the company's net assets belonging to shareholders. Furthermore, a company's current impacts are not necessarily indicative of its future impacts. However, once each of the four capital classes are included in companies' standard annual disclosures, corporations and their supporting financial institutions will have impact transparency (in the words of Sir Ronald Cohen), and be incentivised to determine what are the drivers that best predict improving impact and hence sustainable growth.

A Question of Materiality

One further benefit of the monetisation of impact is that it allows for comparison between companies and across industry which is much harder when companies are graded on independently owned ESG scoring rubrics whose methodologies are undisclosed. By providing monetisation methodologies that are publicly accessible in peer-reviewed literature, such as the work under way at the Value Balancing Alliance (https://www.value-balancing.com) many academicians are providing a framework upon which the future of accounting can be built.

However, there must remain some amount of flexibility in data disclosure so that companies in different geographies and different industries can focus on the issues that most impact their stakeholders. How to determine what is material and what is not is a discussion that should be encouraged and not rushed. Only in November 2021 did the IFRS announce the creation of a new standard-setting board—the International Sustainability Standards Board (ISSB) - to meet the demand for high quality, transparent, reliable and comparable reporting by companies on climate and other environmental, social and governance (ESG) matters. However, it is paramount that conversation about corporate impact evolves beyond score cards and that independent governing bodies begin to set standards that companies can follow.

Conclusion

Corporate performance reporting systems and their concomitant impact methodologies must capture a company's impacts within a multi-dimensional world of capitals. This is about real and deep impact across society and not just risk management within a single capital framework for a single class of beneficiary.

The good news is that this can be done. Impact monetisation is not only possible across all four main capitals, but it has been done already. Integrated reporting (integrating all four capitals) delivers deeper insights, superior performance metrics and better readiness for the future. There is also gradual convergence now towards a framework and methodologies to value impacts: the era of impact transparency is here.

Impact valuation frameworks go far beyond "ESG Ratings," which inform companies about their governance strengths and weaknesses and their environmental and social risks and opportunities. They are about measuring the value added by a company to society at large, beyond its shareholders. They are a prerequisite for stakeholder capitalism, which recognises and values scarcities in public goods and services, not just private goods, and recognises corporate purpose beyond profits.

Milton Friedman’s caricature of a corporation as a mere machine to make money for shareholders is history. In today's brave new world, C-suite demands for multi-dimensional information will expand exponentially, as will the disclosure expected by shareholders and stakeholders. This is both a challenge and a tremendous opportunity for companies and investors, their regulators, as well as society at large.

About GIST Impact

GIST Impact is a leading data and analytics provider. We have been measuring and quantifying impact for more than 16 years. Our team of 100+ scientists, engineers, data scientists, subject matter experts and technologists around the world use impact economics to understand the full value contribution a business makes to the world. With this intelligence, our clients – some of the world’s leading corporations and investors – make better, more sustainable decisions.

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