ESG analysis in deep water

One of the most important corporate irresponsibility stories of the year was the explosion and spill from the BP Deepwater Horizon oil rig in the Gulf of Mexico, destroying fisheries and tourism, as well as creating lasting ecological damage and health concerns. The leak was finally plugged in September 2010, ending five months of oil leaking into the Gulf. The spill raised critical issues about regulatory capture, dependence on oil; and whether international oil companies are either commercially or morally sensible to focus their efforts on extracting hydrocarbon fuels from the most technically challenging parts of the planet, rather than addressing issues of resource nationalism and their long-term strategy for profitability in a carbon-constrained world. For the community of practitioners and researchers in the field of corporate social responsibility (CSR), or ‘corporate citizenship’ as this journal describes it, the BP disaster raised deeper questions about the usefulness of voluntary CSR policies and reports, as well as the credibility and usefulness of the new profession of analysts and raters of corporate Environmental, Social and Governance (ESG) performance and the espoused commitments of institutional investors to Responsible Investment (RI). In September 2010 the Secretary General of the UN Conference on Trade and Development (UNCTAD), Supachai Panitchpakdi, reflected this concern, in the opening of its report on the state of global CSR and RI communications:

In the wake of the BP oil disaster in the Gulf of Mexico, questions have been raised about the meaningfulness of voluntary corporate responsi-
bility communications and the analysis of these by responsible investors. This report makes clear that both CSR communications and ESG analyses must now improve, to better indicate the contributions and impacts of business, rather than simply offer an engagement with the issues.¹

In the preceding month there had been a flurry of emails about the implications of the BP disaster on the mailing list of academics run by the UN-backed Principles for Responsible Investment (UNPRI). Dr Neil Eccles, head of the Responsible Investment Unit, and the University of South Africa, had kicked it off by noting that BP had just been delisted from the Dow Jones Sustainability Index. ‘What the hell are oil companies doing on a sustainability index at all?’ he asked, before noting that the FTSE4Good Environmental Leaders Europe 40 Index still listed BP as their top-ranked company.² Dozens of academics and reflective practitioners chimed in with different views, reflecting a general debate within the CSR, ESG and RI professions about the implications of BP for their trade, and for their aspirations for what they might achieve. The leading National Public Radio (NPR) radio show Marketplace also debated what the BP situation meant for RI.³

Also in August, the French arm of Friends of the Earth (Les Amis de la Terre) slammed the majority of France’s Socially Responsible Investment (SRI) funds as being ‘illegitimate’. The organisation said in its report, analysing 89 SRI funds, that 71 of them invested in companies it considered as ‘controversial’ for ‘disastrous’ social and environmental practices. They mentioned BP, but also Total, France Télécom, BNP Paribas and AXA.⁴ Amidst this growing debate about the role of ESG analysts, indices, SRI funds and RI in general, the consulting firm SustainAbility released a study on ESG raters. They had inventoried over 100 sustainability ratings and their attributes and surveyed over 1,000 sustainability professionals on their perceptions of ratings;⁵ ‘We sense a greater degree of interest and angst this Fall amongst companies and others who follow and use ratings,’ said Michael Sadowski from SustainAbility:

“This may be driven in part by the proliferation of ratings and the continued opacity of the raters’ methodologies and selection processes. Yet we believe there is something more pro-

found and promising happening: ratings are being taken more seriously. Companies are starting to link executive compensation to their standing in ratings. Mainstream asset managers are switching on to the ESG agenda. And citizens and consumers are starting to pay attention to sustainability issues. While this is good news, it is more important than ever that we get ratings right.⁶

The key message here is that as the scale of RI grows and ESG analysts and indices proliferate, so participants in this field will be challenged to demonstrate effectiveness and accountability. That was also the main message from the UNCTAD report, which said that CSR reporting and RI commitments are now so widespread worldwide that they could influence trade and investment flows and there is a need to ensure they do that effectively for sustainable development outcomes rather than having perverse or inefficient effects.⁷

Data on signatories to the UNPRI released in September indicated that US$22 trillion—over 10% of the estimated total value of global capital markets—are now being managed by institutions committed to social and environmental responsibility in investing.⁸ Meanwhile, Eurosif’s 2010 European SRI Study revealed the expansion of the European SRI market; now totalling approximately €5 trillion assets under management (AuM).⁹ Taken together, this growth in RI and SRI means a growth in demand for the research services of ESG analysts and the indices they inform or produce. No wonder, then, that of the 108 ESG ratings examined by SustainAbility, only 21 existed in 2000.¹⁰

This growth has led to growing interest from major players in the financial analysis. During 2010 acquisitions continued as MSCI, one of the world’s largest investment research houses, completed its acquisition of the risk and corporate governance advisory firm Riskmetrics.¹¹ That followed a number of takeovers in 2009: namely the KLD and Innovest acquisitions by Riskmetrics; the ASSET4 and Point Carbon buy-out by the news and information giant Thomson Reuters; the mergers of Centre Info and INrate and Jantzi Research and Sustainalytics; and the takeover of the environmental data provider New Energy Finance by Bloomberg.¹² ‘We believe this will be a long-term growth area for us. We’ve really only just

---

¹⁰ SustainAbility, ‘Rate the Raters, Phase Two’.
begun,’\textsuperscript{13} said Peter Grauer, Chairman of Bloomberg, at an ESG conference.

The implications of this growth and investment in ESG analysts and raters are summarised well by the founder of the Global Reporting Initiative, Allen White:

\begin{quote}
The confluence of multiple forces is escalating the demand and supply of ESG information. Whether ESG will achieve its full potential as a sustainability driver depends on the standards of transparency, integrity and rigor that govern these rapidly expanding markets.
\end{quote}

The BP disaster therefore brought into sharp relief an issue that has been growing for some time. It is time to shine some light on the hitherto deep-water horizons of how ESG analysts and raters conduct their business and how asset managers use such information.

\section*{The source of the matter}

\textbf{Both the Sustainability and UNCTAD} studies identified a number of weaknesses in the current practices of some ESG analysts and raters. From those studies, discussions on the UNPRI academic mailing list, and specific questions put to ESG analysts themselves and the users of such information, I identified nine key weaknesses to address as the ESG market grows.\textsuperscript{14}

The first key weakness is that many ESG analysts and raters rely predominantly on information published or provided directly by the companies being assessed, or by media that republish corporate communications. That is problematic because companies with challenging ESG issues are more likely to communicate on these issues and, when they do, it is with their particular opinion and choice of issues and data. ‘More than 60\% of the ratings in the inventory depend wholly or in part on information submitted directly to ratings organisations, thereby rewarding companies with the greatest capacity to respond to ratings requests rather than those with the best performance,’ reported SustainAbility.\textsuperscript{15}

For instance, Company A may report that it has an environmental policy, whereas company B does not—where Company A is a gold-mining company facing a range of challenges, concerning biodiversity destruction, pollution and influencing the spread of infectious disease, whereas Company B is a solar power company.

\textsuperscript{13} Brooksbank, \textit{op. cit.}

\textsuperscript{14} Jem Bendell thanks Anthony Miller, James Gifford, Tom Rotheram, Lucy Carmody, Antoine Mach, Allen White, Claire Veuthey, Stephen Hines, and Richard Welford for responses to various questions during preparation of this section.

\textsuperscript{15} SustainAbility, ‘Rate the Raters, Phase Two’.
facing many fewer ESG issues and providing a particular societal value. In addition, even if verified by an auditing firm, corporate ESG communications provide the corporate view of what are material issues and how they are being addressed, yet ESG issues are highly contestable, and more so than the verification of financial accounts.

Noting how BP was often ‘best in class’, Karen Reiner, a senior analyst at RepRisk, argued in Responsible Investor, ‘for investment decision-making purposes investment managers cannot only rely on the information provided by the company itself, but rather should primarily use independent assessments of the company’s associated ESG risks.’ Her employer, like Covalence and some other reputation trackers, focus on collecting information from a variety of sources to build an assessment of a company’s reputation on ESG issues.

A second key weakness is the focus on analysing management policies and processes rather than the actual ESG impacts and outcomes of the companies being assessed. This is problematic because companies with challenging ESG issues are likely to have more developed policies and programmes, but that does not mean they have the least negative or most positive impacts. CSR communications provide an indication of the awareness of a company on some ESG issues, their efforts on those issues, and their intention to share information and begin to be assessed on such issues. In other words, their communications demonstrate engagement with their wider responsibilities, rather than social or environmental performance being achieved. Although there are some protocols for reporting on actual performance (e.g. the GRI G3 guidelines), they are not widely used and need further development. There are some exceptions, such as Trucost, which provides quantitative data on resource consumption and pollution, but the majority of ESG analysts still focus on process not performance. These first two weaknesses result in some companies with the most significant impacts being rated very highly by ESG analysts.

Given these limitations, why do fund managers buy such data? One reason is to simply tick the box that ESG issues have been considered. Another reason is because of the theory that the existence of CSR management systems, rather than performance and impacts on ESG issues, provides an insight into how intelligent and open the management is, which indicates how well the company will perform financially.

Inside the analysts

The third weakness in current ESG analysis is that most assess companies within a downside risk framework, focusing on the management of negative externalities that can lead to damage to reputation or litigation. That is problematic because it does not consider which companies are likely to succeed by creating more social or environmental value for society, particularly where doing business in certain countries may be imply a higher potential for both positive or negative impacts. The CEO of Timberland, Jeff Swartz, asserts that,

> although many CSR funds have updated their ‘screens’ in recent years to ensure that they’re considering a company based on both positive and negative merit, the punishment is still more powerful—and prevalent—than the reward.

The negative risk management focus means that the enterprises innovating the technologies and approaches that are solutions to major social and environmental

---

16 Karen Reiner, ‘BP calls into question existing ESG research and shows the need for third-party information: The oil major was a high risk, reputation concern before the Gulf of Mexico spill’, Responsible Investor, 8 September 2010; www.responsible-investor.com/home/article/rep_risk.

17 Swartz, op. cit.
problems can be under-valued by some ESG analysts. In addition, the UNCTAD report noted that as RI grows and ESG analysis begins to effect trade and investment decisions, so an overemphasis on downside risk could have a protectionist effect on trade and investment. This is because some countries are considered by ESG analysts to present higher risks of social or environmental problems and therefore companies sourcing or operating in them are expected to have enhanced CSR policies otherwise they are marked down. Besides the fact that this categorisation of countries can be contested, as there are cultural issues shaping an analyst’s perception of the location of social and environmental risks, this ignores that there could be more benefit gained from investment in such countries, through the creation of decent work and technology transfer.

As a result some ESG analysts, such as Maplecroft, are offering information services focusing on innovations in lower-income countries. One organisation trying to rate companies according to their current or future positive impacts is the Global Impact Investing Network (GIIN), a not-for-profit organisation dedicated to increasing the effectiveness of ‘impact investing’. Impact investments aim to solve social or environmental challenges while generating profit. Rather than focus on the traditional ESG methodologies that analyse the actions of organisations to minimise socially negative behaviour, Ms Sarah Gelfand, director of GIIN’s Impact Reporting and Investment Standards (IRIS), explains that ‘The difference here is that we’re trying to look at the proactive, mission-driven organisations that maximise positive impact.’ Ms Gelfand adds:

This absolutely is meant to build a market for the for-profit investing world to participate, and to use standards, auditing practices, and rating agencies that would make [impact investing] more accessible to the broader investment community.18

Another benefit of GIIN’s system is that it generates data that allows investors to better compare the social benefit of their investments. This approach seeks to inform investors so that they can assess ‘whether 20 seasonal jobs on a Kenyan coffee farm produce the same social good as 20 full-time positions at a textile factory in Guatemala—and help investors use that information alongside financial returns data’.19 The mainstream ESG analysts could learn from these developments in impact investing.

A fourth weakness of much ESG analysis is that they use limited frameworks for understanding the complex and evolving field of corporate responsibility, with reductionist methods to assess companies, due to commercial constraints on the time, skills and advice available to them. This also means combining issues that perhaps should not be treated equally, and a masking of the cultural bias of the analyst organisation and the individual analysts by presenting interpretations as numbers.

As most ESG analysts keep their methodologies private, it is not so easy for researchers or clients to examine the completeness of the coverage of ESG issues relating to a particular business. However, from the three different ESG methodologies seen by your author, it is clear that they vary in how up to date their understanding of CSR is. In addition, when ESG analysts publish reports on industry sectors one can gain an insight into what issues do not appear to be addressed. For instance, at the launch of a report on the palm oil industry in Singapore in September, I was surprised to find out that one

---

19 Ibid.
very large palm oil company was ranked highly by the ESG analyst, while their spokesperson was arguing against any form of government action on the problem of the industries involved in incentivising forest clearance by burning. When pressed, the ESG rater explained that a company’s public policy stance and lobbying activity was not considered within the assessments. That was despite the issue of a firm’s political activity being recognised as an important aspect of its CSR since five years ago, when accounting bodies, NGOs, consulting firms, UN reports and leading peer-reviewed academic journals explained its importance to understanding CSR both from financial and moral standpoints.20

The ESG analyst in question uses a framework for assessing CSR practices that was developed by leading experts in the field, so the limitation in its comprehensiveness is not a result of a relative lack of expertise. In addition, they decided to upgrade their framework to include political activities after this issue was raised, showing that limitations were not the result of a disinterest in continual improvement. Rather, the lesson here is that as CSR is an evolving field of issues and practices, and will become more complex as different countries and cultures develop their own understandings and priorities, so a proprietary methodology will not evolve well given that developing complexity.

The second aspect of this weakness is in the actual analysis of those topics that are included. ESG analysts turn assessments of performance into numerical ratings, such as on a scale of 1 to 5 for whether a practice is considered sufficient or not. That gives an impression of unbiased ‘data’ when in fact it is all interpretation. In addition, very different issues as varied as policies on carbon management and child labour, are combined to produce overall scores. The process of weighting the different categories, including a 1 to 1 weighting for each, is again a matter of interpretation. For instance, if an analyst has twice as many environmental criteria to assess than social, and weights them all as equal, then the result is that environmental issues are being weighted as more important. As such, the numerical scores produced are a result of the cultural assumptions and priorities of the ESG analysts and their clients. Given that the data is socially constructed in this way it is important to understand how those judgements are made, yet this is impossible with most ESG analysts who keep such processes private.

Numbers will remain useful in ESG metrics, and in particular for producing comparable data on actual social or environmental performance. For instance, six years ago in this World Review, a need was highlighted for CSR reports to include more numbers on issues such as the percentage differentials of pay depending on race and gender, or the number of court cases concluded or pending or out-of-court settlements reached in a given period. Such figures need to be produced according to agreed and transparent guidelines. In addition to numbers, however, there is a need for more nuanced descriptive data on the ESG approach, activities and performance of individual companies. This was noted by the European Federation of Financial Analysts Societies (EFFAS), and the Germany’s Society of Investment Professionals (DVFA), in their combined report on Key Performance Indicators for ESG assessment. They suggested the need for ‘KPN’—Key Performance Narratives, whereby KPNs consist of responses to one to two questions, given that some aspects

of ESG cannot be expressed as numbers alone, thus requiring descriptions to put such numbers into context.\textsuperscript{21}

There are commercial reasons for this weakness in ESG methodologies. The founder of Innovest (which is now part of MSCI), Matthew J. Kiernan, explained that one of the ‘dirty little secrets’ of the industry is asset managers’ reluctance to pay for quality ESG research relative to the prices at which traditional financial research and analysis are purchased: ‘Institutional investors are much keener on getting the research in principle than on paying a living wage for it,’ he said.\textsuperscript{22} That is because many users of ESG research just used it to tick a box that they have included ESG considerations. Therefore the commercial incentive is to produce research that can be used to cheaply tick a box, rather than more comprehensive analysis which is more costly and might not be purchased.

A fifth weakness in ESG analysis is the concerns over the independence of the analysis and rankings, due to conflicts of interest. There are at least four key areas for conflict of interest, which arise when ESG analysts and rating agencies:

\begin{itemize}
\item[	extbullet] Sell services to the companies (including listed financial firms) that they analyse and rate, or are co-owned by consultants who sell such services. Therefore the rater could be tempted to favour a client in the ranking.
\item[	extbullet] Are owned or invested in by the companies they rate (including their pension funds). Therefore the rater could be tempted to favour their owners or investors.
\end{itemize}

As the use of ESG analysis in investment management grows, so these conflicts of interest will become more concerning. Clearly, credibility is important for the ESG analysts and this provides a commercial rationale for managing these conflicts of interest. However, is that enough? It is important to recognise the difficulties presented by existing conflicts of interest in the financial services community, as highlighted in extreme fashion by the Enron collapse and the sub-prime mortgage debacle. For Enron’s off-balance-sheet losses to be hidden in separate investment vehicles (which lent exclusively to Enron and were governed by Enron executives) the banks needed to agree to fund these new vehicles. In doing so they would win commissions on the deals. In addition, the financial analysts nearly always gave positive buy recommendations for Enron stock, and were rewarded for that by their banks receiving business from Enron.\textsuperscript{23} That experience suggests conflicts of interest require professional codes and government regulations to ensure their effective management. Part of that will be new levels of transparency. Antoine Mach, the head of Covalence, believes that these potential conflicts of interest mean that ‘there is a need for more disclosure regarding who are the ESG agencies’ clients, be they companies or investors’.

\begin{itemize}
\item[	extbullet] Produce ratings that are solicited or funded by clients, or their publication, launch and dissemination is sponsored by one of the rated companies. Therefore the rater could be tempted to favour that company or its interests in the ranking, in that or future rankings.
\item[	extbullet] Are active in investment management. Therefore the rater may want to artificially improve a company’s grade to keep it in the portfolio for financial considerations.
\end{itemize}


The experience with Enron also suggests that, until there are scandals that threaten the whole sector, most enterprises and professions have sought to be given the freedom to adopt their own codes of practice for managing such issues. We are likely to see this pattern play out with ESG analysts, whereby they will seek to define their own codes for managing conflict of interest, either soon, or after some future scandal. However, it would appear to be in the interests of both ESG clients and the companies being rated to promote good practice and thus ensure appropriate codes and regulations, something returned to below.

Mixing materialities

A SIXTH WEAKNESS IN ESG ANALYSIS is that the materiality of ESG issues for financial performance of investments and the materiality of those issues to the affected stakeholders and wider society are often conflated. Some assess the importance of an ESG issue on their estimation of whether it could affect financial performance, while others involve more moral judgements about what to assess, score and weight. For both approaches, the credibility and accountability of those judgements are in doubt.

Some ESG professionals regard this field as one of enhanced financial analysis, or smarter investing. One such investment professional, Nicholas A.J. Taylor, explained on the UNPRI mailing list that ‘I see ESG/Sustainability as about risk management, not morality. Thus what “ought to be” is not considered relevant.’ That view became popular in distinguishing the new emphasis on RI promoted by UNPRI, which presented ESG issues as materially relevant to all assets, rather than being something that financial institutions could consider if developing a specific investment option for ethically concerned clients, which had been the norm for SRI prior to 2005. The former has been termed enhanced ‘value-based investing’ and the latter ‘values-based investing’. Others professionals in this field disagree with such a distinction: they argue that ethical concerns do or should influence ESG assessments and investment decisions. Some of those seek to square this circle by arguing that an opening ethical focus can then lead to superior financial performance. That view was well expressed by a leader in the field on the UNPRI mailing list, Dr Craig Mackenzie of the University of Edinburgh, and former head of the ESG team at F&C:

One of the central insights of the ESG agenda is that ‘What ought to be’ is frequently highly ‘relevant’. Failure to manage ESG issues is such a big risk for companies because key stakeholders have strong moral opinions, and will rise up in moral indignation, boycotting companies that breach moral expectations and asking their elected representatives to punish them severely and extract swingeing restitution. BP’s recent experience with the US populace is a case in point. People don’t simply want BP to clean up the oil, they want to punish BP; many want to see it go out of business. These are moral responses. So in a world where people have strong views on what companies ‘ought’ to do, managing risk is not just technical issue. It is one that requires an understanding, debating and engaging with social expectations about responsible behaviour.

However, on the same list, the head of the Responsible Investment Unit at the
University of South Africa, Dr Neil Eccles, pointed out that if financial interests are used to justify ESG analysis in any way, even if not directly, then this can challenge the assumption that ESG analysis is necessarily going to improve social, environmental or governance outcomes. He wrote:

> If ESG/responsible/sustainability investment is all about investment risk management, then we can simply combine ESG analysis and derivative instruments to manage investment risk. So if we happened to have hindsight grade ESG analysis which told us that one of BP’s wells was going to blow its top somewhere off the US coast, we could ‘manage this risk’ by short selling BP stocks—and while we are at it we might even engage with BP management to cut costs on safety just to make sure of our investment strategy!? This manages risk. Of course it doesn’t in any way address the moral issues of BP’s (or any other oil company for that matter) wells blowing their top and messing up people’s lives. Which I actually suspect most of us in the RI space actually want to see. Some will invoke universal ownership and long-termism to dress up this moral objective so that is appears to satisfy investment rationality and the ‘amoral high ground’. But others will argue that these theories are not yet mature enough to be convincing and so we get nowhere.

This online debate exposed some of the conceptual ambiguities at the heart of both the CSR and ESG fields, which are often papered over in reports, analysis and ratings. The data in CSR reports and ESG analysis rarely distinguishes between the materiality of an issue to an organisation and its materiality (or relevance) to society. These are not always the same. For instance, due to questions of reputation, a company or investor may focus on eradicating child labour within their supply chain, yet an affected community may seek more labour rights in order to press for better pay and conditions, which would then allow them to put their children in school, by their own choice. The assumption that what is bad for society is bad for investors and therefore there will always be an alignment of interests is naïve. The case of carbon trading highlights this. For an investor a company’s leadership in promoting carbon markets can be seen as addressing an ESG issue in commercially useful ways. Indeed it presents more potential for revenues than if the company was active in pushing for a carbon tax and working to reduce its carbon intensity. Yet many climate policy analysts would argue that advocating for a carbon tax is the more responsible approach. If the ESG analyst is looking at what improves return on investment, then it would be unfounded to assume their assessment would correlate with the public interest.

For those with an interest in the financial significance of ESG issues, the way ESG analysts make estimations on whether an issue, country, industry or initiative presents a higher or lower risk is important, yet this conceptual ambiguity and a lack of transparency on how analysts apply their own conceptual framework means that ESG analysis is currently a weak financial tool.

On the other hand, for those with a broader interest in the ethical dimensions of investing, this ambiguity also presents problems. As described above, some believe ESG analysis and RI have a moral role to play in society. Craig Mackenzie asserted ‘that the ESG investment community has a very powerful role to play in pursuing ethical goals . . . and will only come into its full maturity if it develops a richer understanding of its relationship to ethics. There is an R in PRI.’ What would a mature approach imply? To begin with, answering the question of whose values, whose ethics, and whose morality matters. Answering that question casts light on whether the ethical approach to ESG is

---

actually very ethical at all. That is under-
stood by the Head of Covalence, Antoine
Mach, who explained that ‘In addition to
issues of independence and methodologi-
cal robustness, we have to deal with the
problem of defining ethics. So I believe
controversies about ESG ratings are here
to last.’

In practice the morals that matter in
ESG analysis and RI are the ones held
by the asset owners. Craig Mackenzie
noted that ‘for most shareholders there
are limits to pursuing a public-interest
agenda imposed by fiduciary duty (e.g.
advocating actions that will destroy mate-
rial shareholder value).’ The President &
Group CEO, Fifth Capital Ltd, Miroslaw
Izienicki, explained in the same online
discussion that ‘one of the fundamental
cornerstones of investment regulation is that
the intermediary must “know their cli-
ent” and demonstrate a mandate.’ Might,
therefore, the application of a more explicit-
ly values-based agenda in ESG analysis
and RI lead to privileging the values of the
wealthy and powerful? As discussed in
these pages two years ago, it would be in-
teresting to see how the Western business
communities might respond to explicitly
morality-based engagement by Sovereign
Wealth Funds from Arab nations. In such
a case we might hear people complaining
that the morality of might is not right, and
that there are universal codes of human
rights.

What is really happening in the ESG
field at this time is neither an applica-
tion of enhanced financial materiality or
of a clearly understood ethical system. In-
stead the cultural assumptions and norms
of the professional community of ESG
specialists and their clients are being ap-
plied in ESG analysis, often rushed and
without critical self-awareness. This situ-

**Box 1 PHILOSOPHIES OF RESPONSIBLE FINANCE**

1. Smarter Finance—considering environmental, social and governance (ESG)
   issues for an enhanced assessment of financial materiality in the near term and
   for single assets, projects or loans

2. Holistic Finance—considering ESG issues due to materiality for longer-term
   returns, and also due to interactions between assets in a whole portfolio (where
   the actions of one asset can help or damage another), or where some projects or
   loans reduce the performance of other financial products in the same portfolio.
   Some call this the Universal Owner concept

3. Moral Finance—considering certain ESG issues either as a bank manager or
   asset manager as the owner of the assets asks them to consider certain ESG
   issues because of their particular values or morals (i.e. where owners have inter-
   ests other than the financial and where these override the financial concern), or
   because the bank/asset manager holds certain values or morals (this latter form
   raises questions about whether fiduciary duty is being upheld; the former form
   raises questions about how fiduciary duty is often assumed in practice or by law to
   only concern the financial interests of owners rather than their other interests)

4. Accountable Investing—considering ESG issues out of a general principle that it
   is important, on moral grounds, for economic activity to be accountable to those
   affected by it, and that private financial institutions need to be accountable for
   their impacts on society for all their activities that impact on stakeholders. This
   concept was first introduced in a UN paper in 2004 as ‘capital accountability’

5. Accountable Finance—considering all activities and instruments of Private
   Financial Institutions (PFIs), not only asset management, for their accountability
   to those who are affected by them

Most ESG professionals appear to apply a mixture of the first three approaches. At the
time of writing I do not know anyone applying approach 4 or 5, although a few ESG
professionals have recognised these as the approach to work towards.
ation is made possible by how the ‘R’ in PRI is left undefined. It is highlighted well by Neil Eccles’s rhetorical question to members of the UNPRI mailing list: ‘If the Niger Delta were the Mississippi Delta, I wonder whether Shell would still be on the Dow Jones Sustainability Index? Although the pollution in the Niger Delta is chronic rather than acute, I think that it runs to about the same level of catastrophe.’ Whether your interest is ‘financial’ or ‘moral’, the conceptual ambiguities and incoherence in the ESG field confer a fundamental weakness in current ESG analysis and ratings. To aid in clarifying the different concepts I have heard over the years, I offer a typology of different philosophies of responsible finance in Box 1. I include two approaches, which I rarely hear, but which are based on concepts of universal human rights, and I first outlined in 2004.25

Drilling the depths of ESG

The weaknesses and challenges I have described above are enough to raise serious questions about the usefulness of current ESG analysis. There are three additional weaknesses that serve to make the CSR, ESG and RI areas somewhat murkier for everyone involved.

As SustainAbility’s report noted, not only do ESG analysts often produce ratings but the ratings they produce are then incorporated into composite ratings. The seventh weakness of ESG analysts is that the indices they produce, or supply data to, incorporate all forms of enterprise, including ones that would never be considered sustainable or socially progressive, and by doing that they confuse the issue of what is responsible investing for fund managers and private investors, as well as regulators and the wider public.

An example of this was mentioned at the start, when people criticised Dow Jones and FTSE for listing BP in their sustainability and responsibility indices. That BP was replaced in the list by controversial oil company and military contractor Halliburton, sparked even more ridicule for such indices.26 Halliburton was included as it was assessed to be in the top 10% among companies in the oil field services sector. Companies from most economic sectors can be in such indices if they are assessed as engaging ESG issues and actively managing associated risks. The existence of such indices could lead to public antagonism towards ESG and RI in general, as well as confusing ethically minded investors, and therefore undermining the potential for funds to flow to socially and environmentally beneficial companies. My colleague at Lifeworth Consulting, and former financial advisor, Ian Doyle, also believes that it reinforces an assumption of the primacy of financial interests over all else:

by not focussing on investing in companies that are doing good and in turn creating a vision of the world beyond finance, such analysis reinforces the system within which it is situated, namely an economic one that demands a return, without shedding any light onto the social effectiveness of such investments. This is exemplified by the all too common statements like, ‘there is no sacrifice in returns by investing in SRI’ and ‘long-term profitability needs to incorporate ESG’.

This situation frustrates many leaders in social and sustainable enterprise. The CEO of Timberland, Jeff Swartz, explains that ‘Too much “social investing” seems to me “screen and criticize” rather than invest behind CEOs and Boards that make real commitments to commerce and justice.’ He continued that ‘we’ve earned a


decent reputation as sustainable business and responsible brand . . . and yet SRIs only hold about one percent of our shares.’

He recommended that

CSR funds need to take a more thoughtful approach to company screenings, in recognition that as the world of CSR has evolved, so too their criteria for judging a company’s performance should be more sophisticated . . . CSR money managers should stop just Index investing—weighting their entire portfolio as per the market—and start making some principled, concentrated investments in companies whose social mission they believe in.

The eighth weakness I identified in current practice is that most ESG analysts and raters do not integrate their ESG products and ratings with the mainstream financial analysis products and ratings that their own firms, owners or business partners offer clients, partly because of a commercial interest in maintaining different products. That is problematic as it restricts the potential to integrate ESG considerations in normal financial investment analysis. As CSR consultant Ian Doyle explains, ‘we need a new system through which to interpret data, not new filters on an old system where short-term narrow financial returns remain prime. To do this ESG research cannot be a stand-alone consideration but must be as integrated as the financial considerations of the investment itself.’ With the wave of acquisitions in the ESG analyst market over the last two years, there are now ESG reports and indices being produced by teams of people in the same building where sub-prime litigation risk reports and indices, political risk reports and indices, and mainstream financial reports and indices are being produced. Such lack of integration is untenable, as ESG analysts can take up some of their own responsibility and leadership, rather than blaming the client, and trial new forms of integrated assessments.

The ninth weakness is that most ESG analysts are not transparent about their methods of research, analysis and ranking, or about their general operations, for stakeholders and regulators to assess their credibility in light of the various issues outlined above. The SustainAbility study found that 88% of professionals think disclosure of methodology is important for the credibility of an analyst or rater. The professionals have a practical interest in improved ESG analysis. On the finance side, it means they could conduct their fiduciary duty better, or enact their own or their clients’ moral interests more effectively, depending on the approach they take. On the corporate side, it means they could be recognised appropriately by investors when leading their companies towards superior performance on ESG issues. But there is a broader constituency that has an interest in improved ESG analysis, and that is all of us. Because, as RI grows, so ESG analysis and ratings will take on a quasi-governance role over enterprise, trade and investment. How effective, efficient, fair and accountable it will be as a system of ‘global private regulation’ will be a matter of growing public interest.

At a time when information is becoming more widely available, and online collaboration the norm, it is difficult to see what social justification there is for proprietary ESG methodologies. Instead, it appears a way of hiding from criticism, even ridicule, given the major flaws in many ESG analyst practices that I and others have chronicled. With a light cast on their inner workings, the newly acquired ESG empires may have few clothes to display. It seems only a matter of time before such a light is shone, and ESG analysts will need to improve their processes and evolve their business models accordingly—something I explore below.

The various weaknesses identified above are summarised in Box 2. The implication is that we urgently need more clarity in distinguishing between actual ESG impacts, the perceptions of stakeholders, the strategic competence of management, and the readiness of the organisation for responsible and sustainable innovations.

**Box 2** **THE NINE LIMITATIONS OF ESG ANALYSIS**

Many ESG analysts and raters:

1. Rely predominantly on information published or provided directly by the companies being assessed, or by media that republish corporate communications. That is problematic because companies with challenging ESG issues are more likely to communicate on these issues, and when they do it is with their particular opinion and choice of issues and data.

2. Focus their analysis on management policies and processes not on the actual ESG impacts and outcomes of the companies assessed. That is problematic because companies with challenging ESG issues are likely to have more developed policies and programmes, but that does not mean they have the least negative or most positive impacts.

3. Assess companies within a downside risk framework, focusing on the management of negative externalities that can lead to damage to reputation or litigation. That is problematic because it does not consider which companies are creating more social or environmental value for society—particularly where doing business in certain countries may be imply greater potential for both positive or negative impacts.

4. Use limited frameworks for understanding the complex and evolving field of corporate responsibility, and reductionist methods to assess companies, due to their commercial interests limiting the time, skills and advice available to them. This also means combining issues that perhaps should not be treated equally, and a numerical masking of cultural bias of the analyst organisation and the individual analysts.

5. Are not completely independent from the companies that they are rating, with a variety of conflicts of interest that need to be managed.

6. Conflate the materiality of ESG issues for financial performance of investments and the materiality of those issues to affected stakeholders and wider society. Some make assessments based on financial materiality and others involve more moral judgements. In both cases the credibility and accountability of those judgements are in doubt.

7. Run indices or supply data to indices that include all forms of enterprise including ones that can never be sustainable, and thus blur the issue of what is responsible investing for fund managers and private investors, as well as regulators and the wider public.

8. Do not integrate their ESG analysis products and ratings with the mainstream financial analysis products and ratings that their own firms or owners offer clients, partly because of a commercial interest in maintaining different products. That is problematic as it restricts the potential to integrate ESG considerations in normal financial investment analysis.

9. Are not transparent about their methods of research, analysis and ranking, or about their general operations, for stakeholders and regulators to assess their credibility in light of the weaknesses described above.
Impediments and drivers of change in ESG analysis

It would appear that many stakeholders in ESG analysis have an interest in the improvement of current practice. The clients of ESG analysts and raters have an interest in receiving good insights into either the financial or moral implications of firms’ strategies and performance on many ESG issues. The assessed companies have an interest in coherent and accurate forms of assessment and ranking, so that they can be recognised for the CSR efforts. Various CEOs have said that investors need to support companies for investing in sustainability, yet effective ESG analysis and advice is critical for such support from investors.28 The ESG raters themselves have an interest in building the credibility of their own operations and the concept of ESG analysis in general. Some are taking their own steps, such as Covalence, which lists its clients on its website and in connection with its reports, and detailing the methodology it uses. However, if other raters do not take such steps, then the sector as a whole could be damaged, and so there could be a collective interest in collective action, as we see in many professions, leading to professional standards being developed and monitored over time. The wider CSR profession has an interest in the financial system supporting CSR and sustainability leadership, and ESG analysis is key in making that connection. Other stakeholders in companies, from professional campaign groups, to trade unions to communities living near commercial operations, all have an interest in the more responsive and responsible companies being recognised by investors, and the more irresponsible ones finding it more difficult to obtain financing. Therefore they also have a stake in ESG analysis working effectively.

In the last few years we have seen more government regulations requiring CSR reporting from listed companies, and the disclosure of approaches to ESG issues by financial institutions. Noting this trend, Dr Anthony Miller from UNCTAD explained that ‘Regulators can work to strengthen the mechanisms through which institutional shareholders are able to influence the ESG practices of the companies in which they invest, while also encouraging investors to formally articulate their stance on ESG issues in public reports.’ Such measures are based on an assumption that these are useful practices, helping nudge corporate and investor behaviour towards public goals. Therefore they have an interest in ESG analysis being accurate enough to actually achieve that nudging effect: they have an interest therefore in not any form of reporting and engagement, but quality reporting and effective engagement. Otherwise, as discussed above, the growth of ESG and RI could have perverse impacts on trade and investment for sustainable development.

Despite all these interests in quality ESG analysis, the types of criticisms outlined in this World Review have been heard in some form or another for many years,29 while the industry of ESG analysts has grown without much significant change. That begs the question: why? Could it be that the ESG analysts were too focused on business development than doing a socially progressive job? That they assumed they were doing a socially progressive job? Could it be that stakeholders and regulators simply did not understand enough about this field in order to become involved and shape practices? Could it be that companies feared criticising ESG analysts in case this backfired in the assessments they received? Some of the causes of inertia in dealing with core


problems in what is an innovative field of practice may need further examination if things do not move forward now. Various participants in this field, however, point the finger at investment managers, for not being sufficiently interested in ESG issues to demand quality analysis, and, crucially, then pay for it.

Given that so many asset owners and managers are signed up to responsible investment via the UNPRI, one might wonder how this can be the case. It is important to note that currently the UNPRI focuses on encouraging its signatories to become more engaged responsible owners, not on what the substance of that actually means. Therefore some argue that, despite its emphasis on reporting, the UNPRI leaves us no wiser as to what actually occurs in investment decisions on ESG issues. One academic from Oxford University even suggested that ‘the UNPRI, after early successes in legitimizing the responsible investment ideology, appears to be acting as a shroud of legitimacy for traditional “non-responsible” investment practices.’

Other initiatives in the responsible investment field could be challenged for not addressing the lack of transparency. The Responsible Investment Association of Australasia (RIAA) is professionalising SRI, in a country with one of the highest proportions of pension funds signed up to the UNPRI, at 43%. The RIAA offers responsible investment certifications for fund managers, pension funds and financial advisers. Its certification programme currently does not specify standards for the practice of responsible investment, but how RI activities should be disclosed.

Bringing assessment to claims made by fund managers, RIAA may help to address confusion about what are or are not ethical funds. However, its audits are conducted by a commercial firm using its own confidential and proprietary methodology for assessment. As such, it misses an opportunity to cast some light on opaque practices. As the field of RI is professionalised, we should remember lessons from the lack of transparency in normal fund management. For instance, some investment research houses knew about the sub-prime meltdown before it happened and, rather than warning all their clients or the public, they incorporated it into their data for their own benefit.

There are a few examples that cast doubt on the meaningfulness of investor expressions of responsibility. One test case was the blacklisting of Rio Tinto by the Norwegian Government Pension Fund in September 2008. At the time their Fund’s ‘Ethical Committee’ announced they had sold USD$1 billion in Rio Tinto stock for grossly unethical conduct at the jointly operated Grasberg mine in West Papua (also known as Irian Jaya, Indonesia). More than three months of engagement took place prior to Rio Tinto stock being offloaded. In addition, Rio Tinto would have been aware that the co-owner of the mine, Freeport-McMoRan, had been pressed by the Norwegian Fund over the Grasberg mine for some five months in 2005 before being blacklisted. Some proponents of RI said that this illustrated the limits of adopting a negative screen, or avoiding bad companies. Innovest, which is now part of MSCI, issued a statement which claimed that the Norwegian Pension Fund had taken a traditional approach to SRI by screening out a company that does not meet its value-based mandate. In contrast, Innovest rates Rio Tinto highly because the company is


a sustainable-mining leader relative to sector peers. And while Rio Tinto’s involvement in Grasberg is of concern, Innovest feels the company is managing its overall ESG risks well, which should add to increased shareholder value over the long term.

Such a conclusion ignores the Norwegian fund’s engagement with Rio Tinto in the months running up to their decision to divest, and the lack of progress they achieved from that engagement.

BP also received much engagement from investors on its social and environmental performance. Despite the peculiar ESG rankings that used BP’s CSR reports to place them at the top, investment managers who knew more about actual performance were already concerned and pushing BP to change.

Between May 2008 and April 2010 BP consistently ranked among the most environmentally and socially controversial firms [on a reputation index tracking news media, NGO reports, court cases, among other sources], suggesting that its true risk exposure was always high, a fact that was not often taken into account by other types of analysis. This warning sign offered an indication of its serious risk exposure in terms of environmental and social concerns, particularly with respect to health and safety issues in the US, even prior to the Deepwater Horizon oil-rig explosion.  

Having been criticised for ditching Rio Tinto, the Norwegian Government Pension Fund stayed with BP despite this negative information. In August 2010 they reported having lost €1.1 billion with their investment in BP. It appears that even large investors can’t change company practices unless they work in concert with other investors. But it appears they can stop being complicit in ecological destruction and human rights abuse, and reduce their associated risks, by divesting in companies that pose such risks.

There are some developments in the past year that mean the time could be right for the interests identified above to outweigh the forces of inertia. The scale of commitment to RI is now so high, and the ESG market so large, that this is attracting more scrutiny. The acquisition of ESG raters by mainstream financial analyst firms means that more integration of ESG mainstream financial analysis is possible. An internationalising RI and CSR means that more difficult cross-cultural issues will emerge and need resolving. The growth of social media and open-source software means that new forms of collaboration are possible. Growing awareness of how the financial system is coping with our ever growing demands for resources, the weirdness of our weather, and high-profile disasters such as BP’s, will also continue to raise questions about what is being achieved in the name of responsible investment. We could, therefore, be on the cusp of a new agenda for improving ESG analysis, and in turn the meaning and practice of responsible investment.

An agenda for improving ESG analysis

To improve ESG analysis will require new training, codes of conduct for ESG analysts, more open-source approaches to analysis, higher revenues for code-abiding analysts and new regulations and government funding to guide practice. I discuss each in turn.

The Australian government donated 2.5 million Australian dollars to the RIAA

---

33 Karen Reiner, op. cit.
to develop the Responsible Investment Academy, which will develop training programmes. It is a move that could significantly increase the quality of practice in this emerging profession. The implication for professional practice from the critiques of current ESG and RI practice outlined in this column is that such trainings need to encourage critical evaluation of current practices and an awareness of how professional interests may sometimes militate against the public interest. Therefore, although the outlining of current best practices is important in any course on RI, as this is an emerging profession, training also needs to explore the limitations of current CSR reporting, ESG analysis and RI reporting, and the personal ethics and systemic risks of profiting from an opaque marketplace. If conceptual development and associated trainings are led within the two fields of finance and accounting, rather than drawing on sociological, political and organisational sciences, then there may be major limitations in effectiveness for either social change or enhanced investment.

A code of conduct for ESG analysts and raters is needed. Such a code does not need to include all the requirements placed on financial analysis, as some of that is inappropriate. However, in many areas it should go beyond what is required of normal financial analysts, as ESG raters are doing things that are more complex, contested and subjective. In addition, as they often claim to have a positive social impact through promoting CSR, this suggests more scrutiny of how they achieve that is required. Such a code would need to provide answers to all the nine weaknesses outlined above. Therefore it would need to encourage the use of multiple sources of information, assessments of actual performance, disclosed and thorough methodologies that provide clarity on the different theories of materiality, continual learning and dialogue about CSR topics and cross-cultural issues, management of conflicts of interest, and products that integrate ESG into mainstream financial analysis.

Some ESG analysts may not wish to develop or adopt such a substantive code, yet only a substantive and demanding code will require changes in ESG analyst practice will deliver for the interests of various stakeholders. Therefore it is important for all the stakeholders in ESG analysis to participate in a process to develop such a code. Upon its conclusion, ESG analysts could be invited to adopt the code and be audited. The benefit of doing so would ideally be the securing of more business from clients—something I return to below.

In addition to improving general ESG practice through a code, it is also important for new forms of open source ESG analysis to be developed. Responsible Investor magazine reported on a new initiative entitled the Global Initiative for Sustainable Ratings (GISR), designed to create a transparent sustainability ratings framework as a response to the proliferation of ratings products that have created confusion in the marketplace. The initiative has a goal to provide sustainability ratings products that are publicly available at no or nominal cost through an independent, non-commercial, multi-stakeholder process. Mark Tulay, former Head of ESG Solutions at RiskMetrics, explained:

We believe it is time for an independent, non-commercial initiative to produce a white paper on the rating agencies and, more broadly, to chart a longer term strategy for building a world-class, normative ratings framework to guide capital, procurement and business–NGO partnerships toward companies that are true sustainability leaders.

If initiatives like GISR develop, then other ESG analysts may need to evolve their business models to add value to cli-

36 Ibid.
ents in new ways. They will need to develop competencies that distinguish them from competitors. Geography, technology, interpretation and display of information, and being seen as providing an authoritative analysis from a particular standpoint, will all form part of those evolving business models.

There have been efforts to enhance the practices of financial analysts in the past: in particular the now defunct Enhanced Analytics Initiative (EAI). The problem with EAI was that investment managers did not want to pay for more and better ESG analysis. That is in a situation where investment managers spend millions on investment research, but the ESG research industry, including the sell side, only receive a fraction of that. That provides a real indication of what most investors think is valuable to informing their investment decisions: most ESG issues are currently not considered financially material by investment managers. Therefore if ESG analysts are going to up their game and adopt the type of code suggested above, there will need to be a shift in how investment managers view ESG issues. Indeed, they would need to incentivise code uptake by committing to buy more from code-certified ESG analysts and raters. The difficulty here is that investors do not seem likely to take such steps voluntarily—the failure of EAI suggesting as much. Therefore we come to the role of regulation.

Given the amount of resources now being put into ESG communications, and the growing range of institutions claiming to practise RI, governments could consider influencing the effectiveness of these activities in promoting fair and sustainable markets. That could mean more than providing funds, and actually providing direction on what is in the public’s interest. To address the conundrum where everyone seems to welcome RI as a good thing but little is being done by investment managers to resource quality ESG assessments, so governments could revise what is considered fiduciary duty. There are strong arguments for fiduciary duty being revised to include comprehensive assessment of ESG factors, and therefore that asset managers should seek independent, specialist, comprehensive and contemporary assessment of ESG risks and opportunities relating to whatever asset they are holding, buying or selling.

On the surface, the donation from the Australian government may be a measure of its commitment to incorporating ESG into investment analysis, but the RIIA is part of an industry serving its client and seeking profit, and so the positive public impact cannot simply be assumed. As the sociological study of professions has shown, professions need some visible hand of public interest, from the state, guiding their work. Given the international and complex nature of these issues, it lends itself to deliberation at the intergovernmental level. Organisations such as the United Nation Conference of Trade and Development (UNCTAD) could host processes to clarify goals, weaknesses, and the various approaches to improving performance. They could even host the process to develop a code of conduct for ESG analysts: concerns over the power of standard setters and assessors in world trade means that an independent body such as UNCTAD needs to balance the interests at play.

The politics of finance

If the practices of ESG analysts are improved we will see some progress in advancing the CSR and sustainability agenda. However, as I have alluded to above, to achieve that requires a larger shift in the way financial institutions work. It is important to note that considered and patient asset management is only a part of the financial sector and thus only part of their wider impact on economies and societies. There is a key difference between trading-based investment strategies and ownership-based investment strategies, with the former becoming more profitable given the ease of short-selling and
leveraging positions, and rising volatility in asset prices. If you take a trading-based approach, then ESG issues will never be material to your decisions. Therefore, if the shifts described above are to be significant, then a broader reshaping of financial practices is needed, and the only way for that to come will be through governments changing the rules.

In addition to trading-based strategies, there are a variety of other financial practices that are unhelpful either to financial market functioning, non-financial economic activity, and broader economic development, as well as in turn various social and environmental issues. Those forms of investment practice include high-frequency arbitrage, leveraged short-selling, highly leveraged buy-outs, short-term currency speculation, dark pool market trades, and unregulated commodity derivatives, among other things. As a larger share of a financial institution’s profits come from such activities, how interested will they be in investing in quality ESG analysis?

If such financial practices do not serve any public purpose, but cause public problems, should there be a proper discussion about whether to outlaw them or tax them heavily? Where is that debate today? Is it too complicated for unions and NGOs? Too tangential for companies? Too personally risky for politicians? Previously Western governments benefited from such financial imagination, but with the bailouts, crisis-caused recessions and sovereign debt crises, even they are not benefiting from these financial practices any more. In the past there has been a presumed innocence of financial products and services and this is likely to shift towards a presumed guilt, as the impacts of the financial crises are felt in universities, hospitals and homes. There is likely to be a new wave of political activism around these issues, and intergovernmental coordination of the debates and dialogues. For CSR, ESG and RI communities of research and practice to be more than a sideshow to history will require them to engage in these issues. Indeed, by engaging in them it may become clearer the goals of an emerging corporate responsibility movement. It is difficult to know what may result, but the most responsible financial institutions are likely to be the ones that prosper in this more observed and critiqued marketplace.

Clearly there were other important events and developments in the third quarter of 2010. Nonetheless, given the growing and decisive role of finance in shaping corporate practice, and the major debates about ESG and RI that the BP disaster then sparked, in retrospect it will be seen as a key issue of the quarter, and the year as a whole. As the financial turmoil of recent years has shown, even if you are not interested in finance, it is interested in you (and your employer and your government).

Opinions expressed in this World Review are the author’s and do not necessarily reflect those of Greenleaf Publishing.