A Short Introduction to ESG

Professorship of Finance and Corporate Governance
(Prof. Dr. Peter Limbach and Niklas Eberstadt)

University of Bielefeld

Contribution of the Professorship of Finance & Corporate Governance

Teaching

- Lectures and seminars covering ESG topics
- Bachelor and Master theses on ESG topics
- ESG workshops for students and practitioners

Research

- Empirical research with a focus on “S” and “G” topics
- Publications in internationally recognized journals
- Insights and recommendations for practitioners and legislators

E… S… what?

- The term “ESG” stands for **Environmental, Social, and Governance**, i.e., the non-financial, sustainability-related areas of corporate decision-making and responsibility

E

- “E” refers to environmental issues – such as the use of natural resources or greenhouse gas emissions – that companies face due to their business activities

S

- “S“ refers to social issues, such as occupational health and safety, product safety, and social commitment

G

- “G“ refers to corporate governance and leadership, including such topics as executive compensation and the rights and representation of shareholders and other stakeholders

Source: MSCI (2018).

ESG on the Rise

- ESG criteria have become enormously important to firms, investors and policymakers, particularly to ensure a socially responsible restructuring of the economy
- Paris Climate Agreement: 190 countries have committed to limit global warming to 1.5 degrees
  - This agreement means a short-term transformation of the economy, with firms facing increasing pressure to transform (e.g., Emissions Trading System, Fridays for Future, Green New Deal)
- In 2019, the Business Roundtable, a group of 181 CEOs of America's largest corporations, signed a statement to abandon shareholder primacy
  - They agreed on a new definition of corporate purpose under which firms serve not only their shareholders, but also deliver value to other stakeholders like customers, employees, and communities
- Germany's "Lieferkettengesetz" holds companies liable for social grievance along the supply chain
- High governance standards via codes (e.g., German Corporate Governance Code) and laws

Source: MSCI (2018); European Union (2021b).

Environmental ("E")

- Many investors, particularly so-called impact investors, focus on the environmental factor, making it the most popular sustainability criterion – sustainable investments tend to be driven by intrinsic motivations, not just pure risk and return considerations

Common Environmental Risk Factors
• Carbon intensity • Circular economy • Climate change strategy • Energy and water efficiency • Environmental impact of products • Environmental management system • Natural resource conservation

Source: MSCI (2018).

Social ("S")

- The social pillar of the ESG framework has lagged behind due to challenges around the definition and scope of this arguably "soft" factor – while being harder to quantify, social factors and the social value they create can be pivotal to firm performance

Common Social Risk Factors
• Customer and product responsibility • Equal opportunities and diversity • Freedom of association • Health and safety • Human rights • Social impact of products and services • Supply chain management

Source: S&P Global (2020).

Governance ("G")

- Corporate governance and leadership have been important to investors at least since the early 2000s when many countries introduced governance codes and regulations in response to severe corporate scandals (such as Enron, Parmalat, and Tyco)

Common Governance Risk Factors
• Board and management team composition • Corruption and bribery • Disclosure and transparency • Executive compensation and ownership • Risk and crisis management • Shareholder and stakeholder representation • Tax avoidance and strategy

Source: MSCI (2018).

Prominent ESG Incidents

E

S

G

Source: Financial Times (2015); Science and Technology (2021); CNN (2013).

Disregarding ESG Standards: The Case of “Dieselgate”

- “Dieselgate”, Volkswagen’s 2015 emissions scandal, is an example of how the disregard of ESG standards may translate into financial, legal, and reputational risks for companies

E

- VW cheated on the carbon emissions of its diesel engines leading to environmental damages

S

- VW generated health risks due to particulate pollution, violating its customer and product responsibility

G

- Questionable corporate culture and governance standards facilitated fraudulent behavior

- When the market learned about “Dieselgate”, VW’s market capitalization declined by €15.8 billion
- The scandal spilled over to other German car manufacturers and hit customers around the globe

Source: Financial Times (2015).

ESG Materiality

- ESG risks and opportunities differ across industries, and even across firms within an industry
  - For example, carbon emission risk is only of relatively minor importance for the health care industry, while it has a major impact on the ESG ratings of companies operating in the energy sector
- ESG materiality refers to the effectiveness and financial significance of specific aspects that define the ESG performance of a company
- How a firm's different ESG risks and opportunities should be weighted to derive ESG or ESG pillar ratings depends on a company's industry, environment, and characteristics

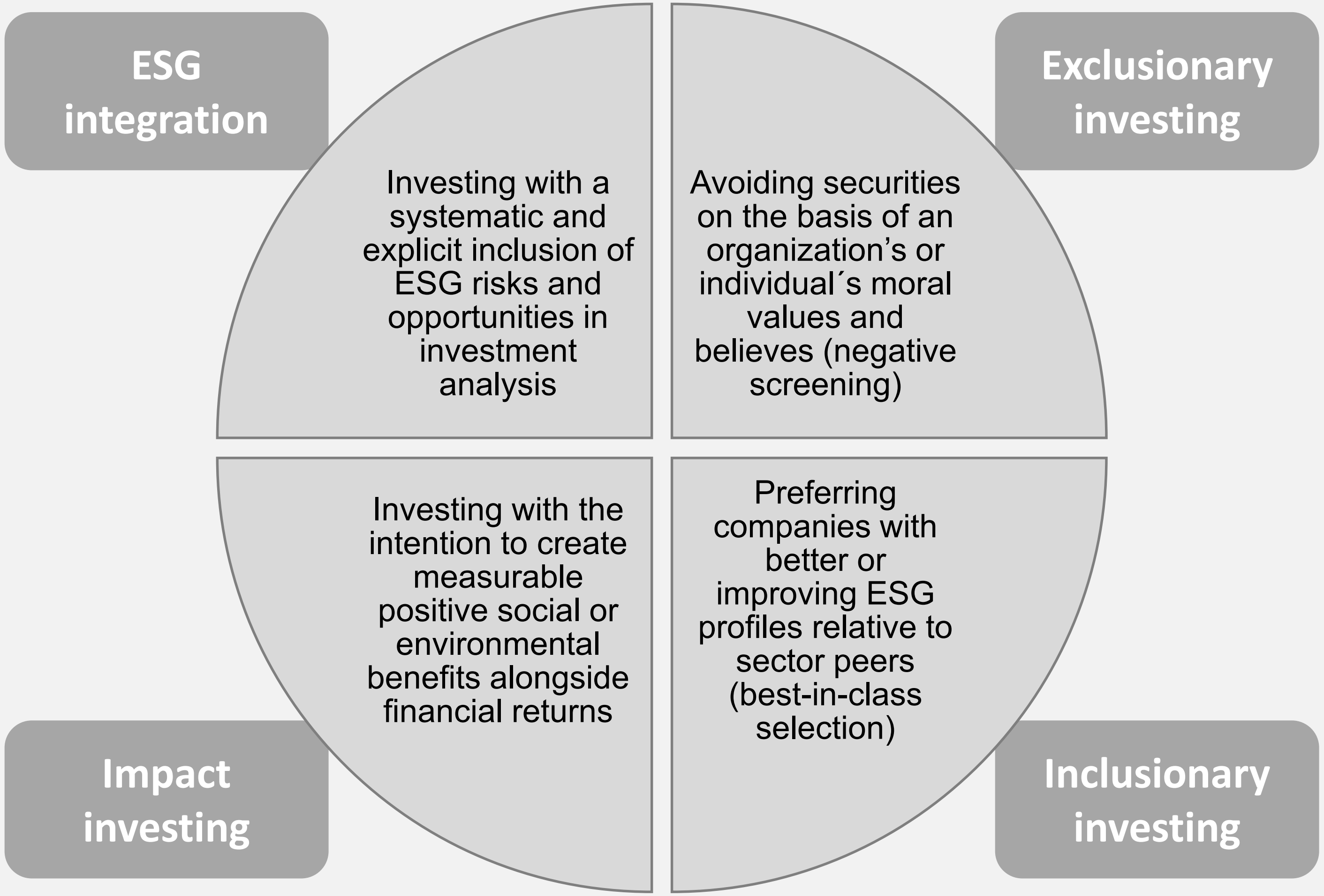
Industry analysis → Assessment of the impact of ESG risks and opportunities → Calculation of industry specific weights per pillar → Assessment of company specific ESG score

Institutional Investors and ESG

- In 2020, investors in mutual funds and ETFs invested ca. $300 billion in sustainable assets
- Institutional Investors play a significant role in enforcing ESG standards at the company level
- In an open letter, Black Rock CEO Larry Fink called for a shift away from the shareholder value approach toward a more holistic stakeholder approach, identifying global warming and its social consequences as a core responsibility of the economy
- The UN-backed Principles for Responsible Investments (PRI) were signed by over 1,500 investors representing $60 trillion in assets under management

Source: Black Rock (2021); McKinsey (2016).

Common ESG Investment Approaches



Source: MSCI (2018).

Greenwashing

- No sharp definitions of what makes corporate actions and investments sustainable
- Greenwashing describes the process by which a company markets itself, its products or policies as more sustainable than they really are
- It is one of the major concerns for investors that try to integrate ESG factors into their investment decisions
- Lack of transparency and mandatory reporting standards makes the comparison for investors even more difficult
    - With the proposal for Corporate Sustainability Reporting Directive (CSRD) the EU attempts to harmonize non-financial reporting across listed companies to address this issue

Source: European Union (2021a); Morningstar (2021).

References

- Black Rock (2021): Larry Fink´s 2021 letter to CEOs, Larry Fink CEO Letter | BlackRock.
- CNN (2013): Bangladesh factory collapse: Who really pays for our cheap clothes, Bangladesh collapse: What cost cheap clothes? – CNN.
- European Union (2021a): Corporate sustainability reporting, Corporate sustainability reporting | European Commission (europa.eu).
- European Union (2021b): Paris Agreement, Paris Agreement | Climate Action (europa.eu).
- Financial Times (2015): Boardroom politics at heart of VW scandal, https://www.ft.com/content/e816cf86-6815-11e5-a57f-21b88f7d973f.
- McKinsey (2016): What institutional investors should do next on ESG, Sustaining sustainability: What institutional investors should do next on ESG | McKinsey.
- Morningstar (2021): How to find the Right ESG Fund, How to Find the Right ESG Fund | Morningstar.
- MSCI Inc. (2018): Introducing ESG Investing – MSCI, bcac11cb-872b-fe75-34b3-2eaca4526237 (msci.com).
- MSCI Inc. (2020): ESG Industry Materiality Map, Materiality Map – MSCI.
- Science and Technology (2021): Where Did the Oil from the Deepwater Horizon Spill Go? Where Did the Oil from the Deepwater Horizon Spill Go? | JSTOR Daily.
- S&P Global (2020): What is the “S” in ESG?, What is the “S” in ESG? | S&P Global (spglobal.com).