What is ESG?

ESG, short for environmental, social, and (corporate) governance, is a set of standards used to evaluate a business’s operational performance as it relates to social and environmental impact.

Environmental pillar covers climate change, energy usage and efficiency, greenhouse gas emission, air and water pollution, waste management, biodiversity, etc.

Social pillar covers community engagement, equal opportunity, employee benefit, customer satisfaction, data security and privacy, labor and human rights, etc.

Governance pillar covers business integrity, financial transparency, regulatory compliance, risk management, leadership diversity, etc.

ESG Risk

Physical risk: The intensifying impacts of climate change present physical risk to assets, publicly traded securities, private investments, and companies.

Transition risk: Global shift away from carbon-intensive energy sources and industrial processes presents transition risk to many companies, communities, and workers.

Consequence: The failure of financial institutions to appropriately and adequately account for and measure these physical and transition risks threatens the competitiveness of U.S. companies and markets, the life savings and pensions of U.S. workers and families, and the ability of U.S. financial institutions to serve communities.

In a famous speech given on 29 September 2015, then Bank of England Governor, Mark Carney, warned that financial stability may be undermined by the increasing financial risks linked to climate change and identified three major risks:

Physical risks are strictly linked to the physical effects of climate change. There can be acute physical risks caused by disruptive events (cyclones, hurricanes, floods, etc.) or chronic physical risks caused by a longer-term shift in climate patterns (e.g. higher temperature and consequent food and water scarcity because of drought). Physical risks may have financial implications for households and organisations, such as direct damage to assets and indirect impacts from supply chain disruption;

Transition risks are linked to the transition to a less polluting, greener economy, which may lead to changes in the value of a wide range of assets. They are associated with regulatory changes (e.g. stricter rules for CO2 emissions) and technological changes (e.g. electrification of the car industry) due to the decarbonisation process. On the demand side, they can be caused by a change in consumer behaviour due to an increased environmental consciousness. Transition risks may have financial implications for organisations, such as stranded assets and higher costs of doing business;

Liability risks are strictly linked to the consequences of the above two risks. The actual trend shows an increasing number of litigation procedures from individuals and business claiming compensation for losses. There can be claims for failed attempts to mitigate the impacts of climate change, to adapt to climate change, or to disclose climate-related risks to shareholders. As pointed out in the latest Climate Chance 2020 Report, the financial sector may become a target of climate-related litigation, and this risk is already perceptible.

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ESG Funds

Funds, like ETFs and mutual funds, may consider a wide range of factors that are consistent with their objectives and strategies when selecting investments. This can include ESG, which stands for environmental, social, and governance.

ESG investing has grown in popularity in recent years, and may be referred to in many different ways, such as sustainable investing, socially responsible investing, and impact investing. ESG practices can include, but are not limited to, strategies that select companies based on their stated commitment to one or more ESG factors —for example, companies with policies aimed at minimizing their negative impact on the environment or companies that focus on governance principles and transparency.  ESG practices may also entail screening out companies in certain sectors or that, in the view of the fund manager, have shown poor performance with regard to management of ESG risks and opportunities. Furthermore, some fund managers may focus on companies that they view as having room for improvement on ESG matters, with a view to helping those companies improve through actively engaging with the companies.

Funds that elect to focus on companies’ ESG practices may have broad discretion in how they apply ESG factors to their investment or governance processes. For example, some funds integrate ESG criteria alongside other factors, such as macroeconomic trends or company-specific factors like a price-to-earnings ratio, to seek to enhance performance and manage investment risks. Other funds focus on ESG practices because they believe investments with desired ESG profiles or attributes may achieve higher investment returns and/or encourage ESG-related outcomes. For example, some ESG funds select companies that have shown their commitment to a particular ESG factor, such as companies with policies aimed at minimizing their negative impact on the environment.  Some funds may implement shareholder voting rights in particular ways to achieve ESG goals, while others may only focus on selecting investments based on ESG criteria.

Fund managers focusing on ESG generally examine criteria within the environmental, social, and/or governance categories to analyze and select securities.

* The *environmental*component might focus on a company’s impact on the environment—for example, its energy use or pollution output. It also might focus on the risks and opportunities associated with the impacts of climate change on the company, its business and its industry.
* The *social* component might focus on the company’s relationship with people and society—for example, issues that impact diversity and inclusion, human rights, specific faith-based issues, the health and safety of employees, customers, and consumers locally and/or globally, or whether the company invests in its community, as well as how such issues are addressed by other companies in a supply chain.
* The *governance*component might focus on issues such as how the company is run—for example, transparency and reporting, ethics, compliance, shareholder rights, and the composition and role of the board of directors.

An ESG fund portfolio might include securities selected in each of the three categories—or in just one or two of the categories. A fund’s portfolio might also include securities that don’t fit any of the ESG categories, particularly if it is a fund that considers other investment methodologies consistent with the fund’s investment objectives.

Sustainability Finance

Sustainable finance is an evolution of green finance, as it takes into consideration environmental, social and governance (ESG) issues and risks, with the aim of increasing long-term investments in sustainable economic activities and projects.

Climate finance provides funds for addressing climate change adaptation and mitigation, green finance has a broader scope as it also covers other environmental goals (e.g. biodiversity protection/restoration), while sustainable finance extends its domain to environmental, social and governance factors (ESG).

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ESG Regulations

https://[www.sec.gov/oiea/investor-alerts-and-bulletins/environmental-social-and-governance-esg-funds-investor-bulletin](http://www.sec.gov/oiea/investor-alerts-and-bulletins/environmental-social-and-governance-esg-funds-investor-bulletin)

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One of the essential functions of financial markets is to price risk to support informed, efficient capital-allocation decisions.

Sources:

Financial Stability Board: <https://www.fsb.org>

U.S. Department of State Climate Policy: <https://www.state.gov/policy-issues/climate-crisis/>