Bloomberg Environmental Social Goverance - Module 1

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Introduction to ESG and Sustainable Finance

Introduction to ESG: The Volkswagen Story

Why are so many investors and company stakeholders interested in environmental, social, and governance—also known as ESG—issues? The interest is there and growing, in part, because of corporate missteps that result in substantial losses for everyone involved. For example, let's take a look at German auto manufacturer Volkswagen. In 1937, the German Labor Front founded the company to meet the demand for a cost-effective mode of transportation. Volkswagen is German for "the people's car," and by 1968 it had become the largest, most profitable company in Europe. By 1970, nearly 70 percent of Volkswagen's total output was sold abroad. Close to 570,000 units, or 40 percent of total output, were sold in the U.S. alone. This heavy dependence on one export market was an important factor in the subsequent decision to invest in the U.S. The company continued to evolve, dominating the passenger car diesel market by late 2010 and promoting their vehicles as environmentally friendly. Then, in September 2015, the news broke: the U.S. Environmental Protection Agency (EPA) was going after Volkswagen for violating the Clean Air Act. The EPA accused the company of rigging its cars to cheat on government emissions tests, releasing 40 times more nitrous oxide pollutants than are legal in the U.S. To everyone's shock, the manufacturer admitted to purposefully engineering software to cheat on the tests. These "defeat devices" were installed in Volkswagen's popular lines of "clean-diesel" engine passenger cars. This is how the defeat devices worked: when the software sensed it was being tested, it would trigger mechanisms that would show the car meeting emissions standards. But during normal operation, these mechanisms were intentionally deactivated, possibly in order to help the cars excel at other performance features. Volkswagen deployed this software in about 11 million cars worldwide, including 500,000 in the United States, in model years 2009 through 2015. The scandal led to the resignation and indictment of CEO Martin Winterkorn, jailing of former U.S. Executive Oliver Schmidt, 25% reduction in U.S. auto sales, 37% drop in share price, over $25 billion in fines, and long-term reputational damage. Since then, scandals old and new have undermined the automaker's effort to make amends.

Practice: Using Bloomberg

`NIESG <GO>` allows you to screen for news about controversial events, like the Volkswagen story we saw earlier, for various entities from the perspective of environmental, social, and corporate governance (ESG) matters. Click "ESG Controversy Screening" in the dropdown to learn more about this new search feature. Hover over the filter in the amber box on the top right and click "Analyze the Search" to open the news category page. This takes you to the news category page, where you can refine news results by companies mentioned, people mentioned, or by topic breakdown. Click "Negative Equity News Sentiments" to narrow the search by topic breakdown. The search has now been narrowed to 14,410 news stories related to ESG controversies and negative equity news sentiments. Click "Next" to move on.

Benefits of Integrating ESG into Investment Valuation

Volkswagen's violation also raised a number of questions about all automakers' product management practices. Australian Shadow Climate Change and Energy Minister Chris Bowen said lab tests did not give people a clear picture of the cars they were buying. The Australian Automobile Association (AAA) has pushed for Australia to follow Europe and other parts of the world to make car manufacturers report how their cars perform in the real world, not just in a lab. In 2020, half a decade later, VW's effort to compete with Tesla for electric-vehicle supremacy had many investors hopeful. But they're still putting tough questions to top executives whose predecessors were behind the scandal. Ingo Speich, a fund manager at Deka Investments, asked Volkswagen management, "What will you do to make sure the stock market can honor the ambitious strategy of the VW group in the area of electric vehicles and isn't frequently scarred by reports about scandals?" Beyond deceiving consumers and regulators, the scandal highlights the failure of traditional valuation models—such as discounted cash flow—to capture the full range of risks companies face today. It shows the potential benefits of assessing companies with non-financial data that highlight environmental, social, and governance (or ESG) signals, flagging risks that traditional financial analysis doesn't identify. The Volkswagen scandal is evidence of the need for greater corporate transparency and acts as another argument in favor of analyzing sustainability and integrating ESG factors into the investment decision-making process.

ESG Terms and Concepts

Before we explore the concept of sustainable investing, let's examine some common terminology related to ESG investing and sustainability. Sustainability in finance refers to investment decisions that take into account the environmental, social, and governance (ESG) factors of an economic activity or project. It represents the intersection between the economy, social realities, and environmental health. Externality refers to the positive or negative effects on third parties arising from manufacturing and consuming goods and services. Ideally, the negative effects of economic transitions on third parties should be reduced. An example of a negative externality is pollution emitted by a factory producing fossil fuels that negatively impact the surrounding environment or the health of nearby residents. Education, on the other hand, is a positive externality of schools because students develop career and life skills. Corporate social responsibility, or CSR, is a management concept whereby companies integrate environmental and social concerns into their business. Companies aim to contribute to the well-being of the communities they affect and on which they depend. For example, Europe's biggest toymaker Lego plans to use environmentally friendly materials to produce all of its core products and packaging by 2030. After decades of relying on fossil fuels to make plastic bricks, the company designated a team to develop green toys as part of their commitment to sustainable materials. Sustainability reporting refers to companies' public disclosure of non-financial performance to communicate their impact—both positive and negative—on the environment and people. It helps corporations move beyond focusing solely on financial reporting by disclosing relevant information on ESG issues that matter most to internal and external stakeholders. Investors and stakeholders use sustainability reports to assess risks and opportunities. Examples of topics in these reports include carbon emissions, accident rates, workplace fatalities, and the percentage of women on company boards. Companies that properly report their sustainability progress can benefit from greater savings, better decision-making, improved stakeholder relations, enhanced reputation, and greater credibility. The term *triple bottom line* is closely related to sustainability reporting and refers to the measuring of environmental and social performance alongside economic performance. This is broken down into what is called the "3 Ps": Profit, People, and the Planet.

What is ESG?

Now let's examine what ESG refers to. An increasing number of investors are concerned about unsustainable human activities that have generated threats such as climate change, growing inequality, governance scandals, biodiversity loss, deforestation, human rights violations, and disruptions to food and fresh water supplies. ESG, or environmental, social, and governance factors, is a set of criteria used by socially conscious investors to screen investments for social responsibility. The "E" in ESG refers to a company's environmental stewardship, which includes how it manages the environmental effects of its operations. Environmental factors impact issues such as climate change, global warming, pollution, and rising sea levels. Some metrics investors use to analyze environmental issues include greenhouse gas emissions, water use, and energy consumption. The "S" stands for social factors, such as a company's support for its employees and how well it serves stakeholders. This includes health and safety, human capital development, and the impacts the company has on surrounding stakeholders in the community. To analyze social issues, investors look at metrics like accident and fatality rates. The "G" stands for corporate governance and considers the effectiveness and independence of the board structure, executive compensation, and accounting management. To analyze governance issues, investors look at metrics like board diversity and sustainability policies. ESG signals can be critical in identifying both positive and negative outliers.

ESG Metrics

ESG metrics are non-financial indicators that allow businesses to measure their environmental, social, and governance performance. They provide an alternative way to assess a company beyond traditional financial statements like balance sheets or income statements, by showing how businesses impact society and the planet. ESG metrics offer valuable insights into areas such as how companies limit waste of natural resources, treat their employees, and manage governance practices and accountability. To understand a company's performance through an ESG lens, consider the example of Equifax. In spring 2017, the credit reporting agency was alerted to a software vulnerability from a third-party vendor. Equifax failed to patch the software, and for 76 days hackers siphoned names, Social Security numbers, addresses, birth dates, and other sensitive data unnoticed. Though Equifax stopped the breach on July 30, more than 140 million Americans' personal information had already been compromised. The company didn't disclose the breach until September, when CEO Richard Smith publicly apologized, calling it a disappointing event and apologizing to consumers and business customers. The breach caused Equifax's share price to drop, led to lawsuits, and cost the company millions in settlements. Interestingly, ESG data providers had already downgraded Equifax's ESG rating months before due to data privacy concerns. This shows how ESG metrics can help identify risks early. Companies that are more transparent about ESG performance and disclose more ESG metrics help investors better evaluate ESG progress. Similar to how Bloomberg tracks financial data, it also tracks ESG metrics such as carbon footprint, employee investment, and board diversity. To access these metrics on the Bloomberg Terminal, type `FA ESG` into the command line and select Financial Analysis. There are over 3,300 ESG data fields across more than 12,600 companies. Users can scroll through the environmental, social, and governance tabs to explore the breadth of data points. All displayed data are publicly sourced from annual and sustainability reports.

Practice: Using Bloomberg

Take a moment to practice navigating to ESG metric sources. Type `FA ESG` into the Bloomberg Terminal command line and press Enter. Click on the Environmental sub-tab. Then, click on the value that shows the total greenhouse gas emissions for the selected company. For example, click on the value `69,000`. The source document will appear. Here, you can view all of the underlying values that make up the total greenhouse gas emissions figure.

Financial Materiality

Investors and stakeholders care about ESG data because it impacts financial performance. They have traditionally focused on governance performance and how well companies are run, but in recent years, environmental and social performance have become increasingly financially material. Financial materiality refers to the relevance of ESG factors—both positive and negative—on a company's financial performance. For example, in the case of the Equifax privacy breach, data privacy policies and procedures, which fall under the social factor, are especially important for a credit reporting company. Protecting sensitive consumer data is material to the business and directly affects its valuation. Materiality in the context of environmental, social, and corporate governance (ESG) has become a key focus area over the past decade, with increasing progress made in understanding its role in asset valuation. A 2015 Harvard Business School study was the first to present strong evidence that sustainable investment strategies outperform general strategies when investors focus on material ESG matters. These material factors influence company profits and are relevant to share prices and bond spreads. Materiality assessments help companies identify which issues to track in order to manage business risks and opportunities. However, material factors vary by sector. For example, carbon footprint is very material for steel manufacturers due to the carbon-intensive nature of steel production. In contrast, for technology companies, which are less carbon intensive, data privacy policies and procedures are typically more material.

Practice: Using Bloomberg

As you saw in the video, materiality assessments help companies prioritize the issues they should track to identify business risks and opportunities. Bloomberg can also provide insight into the issues that are most material. Let's explore how Bloomberg allows you to identify material matters across industries. In `BESG <GO>`, you can access resources to identify industry-specific issues that drive financial impact. Click on "Bloomberg's Scores" in the menu on the left. The ESG Score Industry Materiality Framework shows the underlying input data fields that drive ESG scores. You can use this document to identify specific material issues across all scored industries. Click on the blue link to open the document. Currently, APA—an oil and gas company—is loaded, so the material issues displayed pertain specifically to the oil and gas industry. Notice that when you switch to a food and beverage company, the material matters change to reflect the issues most relevant to that sector. In other words, these issues drive financial impact for the respective industry.

Practice: Using Bloomberg

Another resource available in `BESG <GO>` is the Industry-Specific ESG Scores Methodology document, located under the Bloomberg Scores tab. Click on "Industry-Specific ESG Scores" to open this resource. You can select any industry you wish to view. In this example, let's examine the scoring methodology for agricultural producers and wholesalers. Click "Methodology" to open the document. The ESG Scores Methodology Industry Guides provide detailed guidance for each industry, explaining how Bloomberg evaluates companies within that sector. These guides include explanations of the specific ESG issues deemed financially relevant for each industry being scored. Click on the document to read a snippet of information included in these guides, then click "Continue" to move on.

The Rise of Sustainable Investing

In recent years, institutional investors and pension funds have grown too large to diversify away from systemic risks, prompting them to consider the environmental and social impact of their portfolios. Investors increasingly see value in sustainable investments and are prioritizing environmental, social, and governance (ESG) issues. A 2022 outlook report from Bloomberg Intelligence notes that pressure is mounting on both companies and governments to step up efforts to build a more sustainable and equitable future. The rise of ESG investing is evident in the exponential growth of ESG Assets Under Management (AUM), which surpassed \$35 trillion in 2020 and is projected to exceed \$41 trillion by 2022 and \$50 trillion by 2025—representing one-third of the estimated \$140 trillion in global assets under management. While ESG has moved from a niche to a mainstream—and now mandatory—focus, it is profoundly reshaping the financial industry. Increased regulatory scrutiny aims to reduce greenwashing and misinformation about the environmental or social performance of companies. Until 2018, Europe held more than half of all global ESG assets, but the U.S. has since taken the lead, with ESG debt and ETFs showing strong growth. Flows measure the net movement of cash into and out of investment vehicles like mutual funds and ETFs. ESG ETF flows alone reached \$156 billion in 2021, a 70% increase. Bloomberg Intelligence's ESG ETF Flow Tracker helps monitor these trends. It tracks inflows and outflows into various sustainability themes, giving a clear picture of market demand. For instance, flows to clean energy were 18 times higher in 2021 than in 2019, and the year also saw a record 130 new climate-themed ETFs—triple the amount from any previous year. ESG investing has grown not only in volume but also in the diversity of asset classes and stakeholder types. One key indicator is sustainable debt, where companies, financial institutions, and governments raise capital for green and social objectives. By June 2021, ESG-themed bonds and loans had reached \$3 trillion in volume since the first issuance in 2007. In the first half of 2021 alone, sustainable debt issuance grew 83%, totaling \$866 billion compared to \$473 billion in the second half of 2020. The ESG debt market is expected to grow to $15 trillion by 2025, even if it expands at only a third of its current pace. While investor demand is a major driver, stronger regulations have also played a significant role in accelerating ESG expansion.

The Origins of ESG

While ESG investing has become more mainstream in recent years, the concept of sustainable investing—sometimes referred to as ethical investing or socially responsible investing (SRI)—is not new. Its origins lie in the practice of institutions excluding products that conflicted with social, personal, or moral values. Socially responsible or ethical investing is rooted in faith-based investing, civil rights, antiwar, and environmental movements of the 1960s and 1970s. One of the earliest forms of ethical investing is Islamic financing, which dates back to the 7th century. Islamic Finance refers to investing in accordance with Shariah law, which prohibits, for example, financing companies involved in the consumption, production, or sale of alcohol. Investing in such companies would breach Islamic principles and be considered non-compliant. In the 1960s, socially responsible investing gained momentum as Vietnam War protestors pressured university endowments to divest from defense contractors. This period also saw rising social unrest in North America and Europe, with increasing attention to issues like apartheid in South Africa. The anti-apartheid movement took shape on American college campuses, where protests led to a strategic divestment campaign. In 1977, Hampshire College became the first U.S. school to divest, inspiring 155 schools to follow by 1988. The movement extended beyond academia, with over 200 U.S. businesses cutting ties with South Africa between 1985 and 1990, resulting in $1 billion in divested capital. The combined influence of anti-war and anti-apartheid protests and responsible investing significantly contributed to institutional and legislative change. Over time, research has supported sustainable investing as a strategy. Companies that emphasize environmental stewardship, consumer protection, human rights, and other socially responsible practices tend to offer added value for investors. The term ESG was officially coined in 2005 following an initiative led by then-UN Secretary General Kofi Annan in collaboration with the UN Global Compact, the International Finance Corporation (IFC), and the Swiss government.

Reporting Frameworks and Standards

In June 2004, a group of 20 financial institutions with over $6 trillion in assets under management published and publicly endorsed a report facilitated by the UN Global Compact titled *Who Cares Wins: Connecting Financial Markets to a Changing World*. The report presented a series of recommendations targeting various financial sector actors, aiming to address the integration of environmental, social, and governance (ESG) value drivers into financial market research, analysis, and investment. Initiatives like the United Nations 2005 Who Cares Wins conference supported this vision and led to additional frameworks such as the UN Principles for Responsible Investing (PRI), the Global Reporting Initiative (GRI), and the U.S.-based Sustainability Accounting Standards Board (SASB). In October 2005, a separate initiative by the United Nations Environment Program Finance Initiative (UN EPFI), in collaboration with Freshfields Bruckhaus Deringer, produced the *Freshfields Report*. Building on the insights of both reports, this work reinforced the argument that integrating ESG factors into financial markets promotes greater societal impact and financial relevance. By 2015, the UN launched *Transforming Our World: the 2030 Agenda for Sustainable Development*, outlining 17 Sustainable Development Goals (SDGs) intended to tackle poverty, improve living standards, and protect the environment. The growing importance of global green initiatives has accelerated ESG activity through efforts such as COP21 (the 21st Conference of the Parties), the Net Zero commitments in the Paris Agreement, the Task Force on Climate-Related Financial Disclosures (TCFD), the European Green Deal, the Sustainable Finance Disclosure Regulation (SFDR), and the EU Taxonomy. On March 21, 2022, the U.S. Securities and Exchange Commission (SEC) proposed new rules requiring public companies to make "certain climate-related disclosures" in public reports, helping standardize corporate reporting on carbon emissions within the TCFD framework.

How ESG Impacts the Financial Services Industry

The rise in demand for ESG investing has impacted financial firms, with many becoming more attuned to aligning finance with sustainable business models to reduce negative ESG exposure. Asset owners and asset managers are the primary groups concerned with ESG matters. Asset owners are increasingly focused on long-term risk and return. A Nuveen survey of over 800 global institutional investors revealed that many asset owners are reexamining traditional investment approaches as they navigate highly volatile markets, rising inflation, tightening monetary policy, disruptions from the global pandemic, and heightened awareness of social inequality. Investors recognize the need to understand how ESG issues may affect their portfolios. At the same time, many asset managers are developing more sustainability-focused products and promoting responsible business practices. This shift has created a demand for professionals with expertise in sustainable finance, opening up new career opportunities for recent graduates and others interested in contributing to a more sustainable future.