THE SECOND DOLOMITE CONFERENCE ON THE GLOBAL GOVERNANCE OF CLIMATE CHANGE

Trento, OCTOBER 5th – 8th 2023

A NEW HOPE FOR CLIMATE

Actions Beyond Words

PSG 1

MEASURE LESS AND MEASURE BETTER: BEYOND ESG. WHICH ARE THE MECHANISMS FOR STEERING PRIVATE INVESTMENTS TOWARDS SUSTAINABILITY?

Sustainable finance involves considering environmental, social, and governance (ESG) factors when making investment decisions[1]. This approach aims to promote long-term investments in sustainable economic activities and projects. Environmental considerations may include mitigating climate change and adapting to its effects, preserving biodiversity, and implementing circular economy practices to prevent pollution. Social considerations may encompass issues such as inequality, inclusivity, labor relations, investment in human capital and communities, and human rights. The governance of public and private institutions, including management structures, employee relations, and executive remuneration, is crucial in ensuring that ESG considerations are integrated into decision-making processes. Ultimately, sustainable finance seeks to align financial objectives with sustainable development goals to achieve a more sustainable economy and address pressing social and environmental challenges.

Nevertheless, there are several problems with ESG ratings that can make them difficult to interpret and use effectively[2]: lack of standardization, limited scope, data qualities, lack of transparency and difficulty to measure impact. ESG has become a popular approach for promoting sustainable investing, but it has faced criticism for its limitations as a measurement tool and risk management strategy. The criticism is that ESG may maximize compliance tasks (of what may be seen especially by smaller firms as an additional red tape) and not do enough for the gigantic task of making "capitalism more sustainable" (larger firms may use ESG as a tool for mere communication and even "greenwash" some of their core investments).

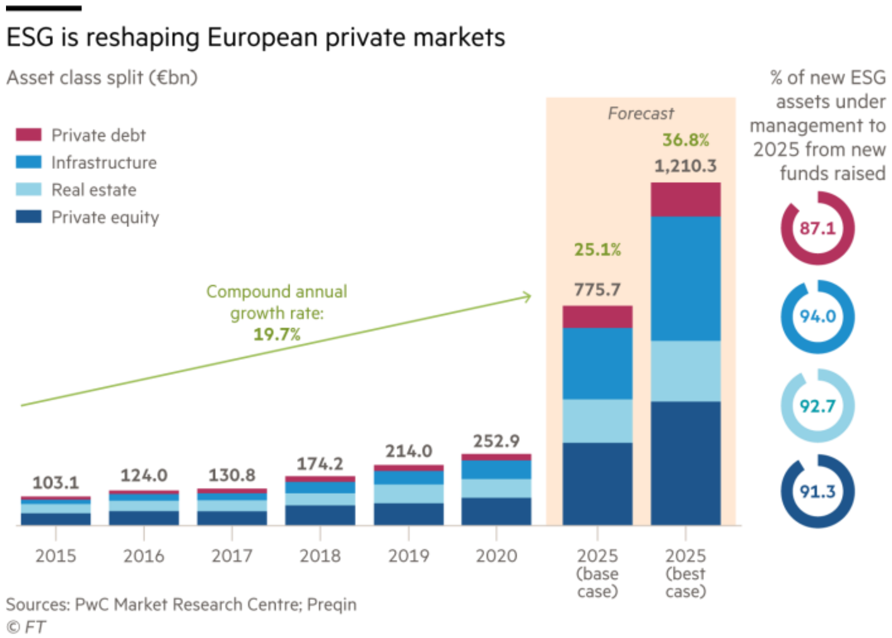
[1] EUROPEAN COMMISSION: WHAT IS SUSTAINABLE FINANCE https://finance.ec.europa.eu/sustainable-finance/overview-sustainable-finance_en

[2] Walter, Ingo, Sense and Nonsense in ESG Ratings (July 23, 2020). Journal of Law, Finance and Accounting, Available at SSRN: https://ssrn.com/abstract=3568104 or http://dx.doi.org/10.2139/ssrn.3568104

PROBLEM SETTING:

ESG INVESTING: THE CONTEXT

Private equity has become a major player in the global economy. In 2021 the industry had $6.3 trillion in assets under, and those assets are projected to exceed $11 trillion by 2026. On the one hand, society won't be able to tackle climate change without the active participation of private equity firms. On the other hand, the PE industry will fail to thrive if they don't address these challenges.



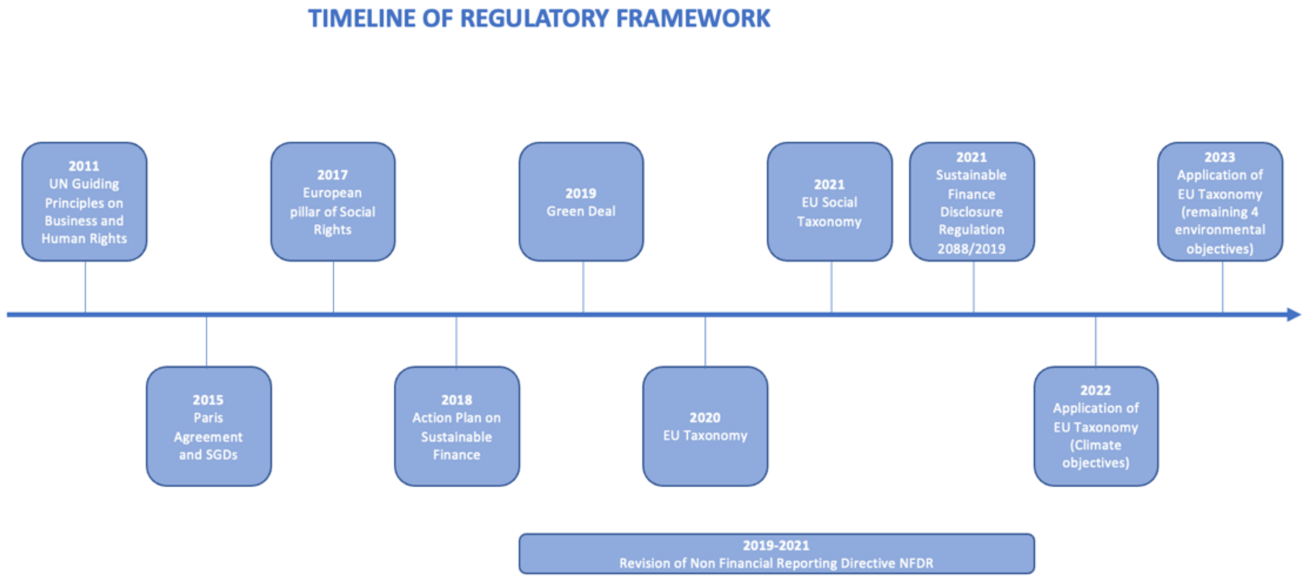
Although ESG has gained popularity as a technique to promote sustainable investing, mobilizing capital for green investments has been limited due to several challenges. Perhaps the biggest challenge faced by the sustainable finance market is the lack of standardization, transparency, and availability of ESG data.

The worldwide use of multiple ESG frameworks (e.g., GRI, EU Taxonomy, SASB, TCFD) induces inconsistency. As no single global standard for ESG reporting exists, most companies end up adopting multiple ESG reporting frameworks.

Moreover, conflicting regulations between markets might lead to tensions between countries, as evidenced by the EU new carbon tariff. The stricter environment in the EU may create regulatory arbitrage opportunities for some companies that are not fully integrated into the global economy or have limited exposure to the EU single market.

As investors increasingly integrate ESG considerations into the investment process, calls to regulate the ESG ratings sector have increased in recent years.

EVOLVING ESG REGULATIONS



As of March 2021, the new Sustainable Finance Disclosure Regulation (SFDR) became effective, requiring financial market participants to disclose 18 mandatory and up to 46 optional indicators. The Non-Financial Reporting Directive (NFRD) also underwent an overhaul, leading to the New Corporate Sustainability Reporting Directive (CSRD) being launched in 2022.

The SFDR emphasizes disclosure and reporting for social and environmental compliance among asset managers and investment funds, requiring them to define their sustainability strategies. The objectives of these regulations are redirecting capital flows to a sustainable economy, integrating sustainability into risk management, and promoting transparency and long-term commitments. SFDR classifies products as 'Article 8' and 'Article 9', based on their sustainability characteristics.

The EU taxonomy (Regulation EU 2020/852) establishes a unified language for sustainability, harmonizing criteria for assessing economic activities' sustainability. This framework underpins the EU's comprehensive ESG regulatory framework with legally binding standards for businesses and financial actors. The SFDR and CSRD are integrated into the taxonomy, to be further expanded by the EU Commission through delegated acts to define sustainable economic activities.

This brand-new institutional setting can significantly impact the finance industry's operations. Although the rule outlines different duties in terms of what must be disclosed and reported, asset managers and investment funds still lack a clear application process for the new policy. One of its biggest weaknesses is that it barely links to the methods for measuring social impact that are now accessible.

COMPLEX ESG DATA MANAGEMENT

To meet these new regulatory requirements, data management may be the biggest challenge companies will face. ESG reporting is already posing challenges to companies because sustainability is inherently hard to quantify. The connection between ESG results and financial performance isn't often well understood because businesses have no clear way to see how sustainable activities impacted the bottom line. Without a centralized source of financial and sustainability data, it's difficult to draw a line between ESG action and financial outcome.

ISSUES THAT SHOULD BE ADDRESSED

The conference should address the following issues:

- Which incentives can encourage businesses to put sustainability at the forefront of their strategies (by, for example, encouraging them to leverage their core expertise and technologies to support global sustainability goals)?
- What other strategies exist to encourage private investments in sustainability without the use of indices?
- What about the provocative decision to ignore the letters "S" or "G" in the ESG metrics in favor of the letter "E"?
- How can businesses from various industries be compared? What if we switched from measuring the footprint's absolute size to its temporal variation?