HIGHLIGHTS

SUSTAINABLE AND RESILIENT FINANCE

OECD Business and Finance Outlook 2020

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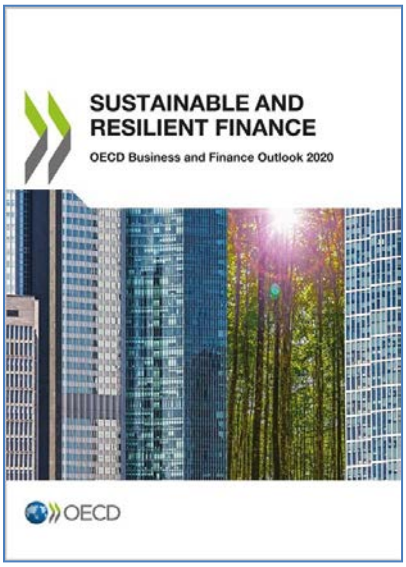
Environmental, Social and Governance (ESG) investing has grown considerably and is fast becoming mainstream. Yet market participants across the board are missing the relevant, comparable ESG data they need to properly inform decisions, manage risks, measure outcomes, and align investments with sustainable, long-term value.

The funds flowing into sustainable investment have grown steadily in recent years, with over USD 30 trillion of assets worldwide incorporating some level environmental, social and governance (ESG) consideration. This growth has been spurred by shifts in demand from across the finance ecosystem, driven both by the pursuit of traditional financial value, and by the pursuit for non-financial, values-driven outcomes.

From a value perspective, asset managers and institutional investors increasingly recognise that non financial ESG risks can have a material impact on risk-adjusted returns and long-term value. From a values perspective, we have seen the rise of ‘social investing’ as financial consumers become more attuned with how their savings are invested, with a growing share looking to avoid supporting activities that do not align with their values. More widely, the social license to operate has also moved, with an expectation from some governments and citizens that private finance helps meet global challenges like climate change adaptation and mitigation or delivering on the United Nations Sustainable Development Goals, which may mean reputational risk for investors and institutions that do not keep up.



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At the same time, the COVID-19 pandemic has highlighted an urgent need to consider resilience in finance – not just in the financial system itself, but the role of capital and investors in making economic and social systems more dynamic and able to withstand external shocks. Beyond the pandemic, physical and transition risks associated with climate change, including for financial stability, are perhaps the most pressing challenges to resilience.

This year's OECD Business and Finance Outlook, with its focus on sustainable and resilient finance, comes at a time when ESG considerations are rapidly becoming a part of mainstream finance. And yet, as our analysis shows, there is little common understanding within the market – from retail consumers and asset managers to financial service providers, market regulators and other stakeholders – on what the goals of ESG investing are or should be.

For the vast majority of investors, incorporating ESG factors has the stated objective of enhancing management of material risks to improve long-term risk-adjusted returns. However, as the original research in this Outlook shows, in practice market participants often lack the tools they need, such as consistent data, comparable metrics, and transparent methodologies, to properly inform value-based decision-making through a sustainability risk lens. This is despite a proliferation of ratings, methodologies and metrics on ESG performance.

This lack of comparability of ESG metrics, ratings, and investing approaches makes it difficult for regulators, consumers and fiduciaries to draw the line between managing material ESG risks within their investment mandates, and pursuing ESG outcomes that might require a trade-off in financial performance. It makes it difficult for lenders to carry out appropriate due diligence on the activities they are financing. It makes it difficult to compare infrastructure projects across sustainability metrics. And it makes it difficult for those who are prepared to make a trade-off between returns and social outcomes to do so with the confidence that the outcomes they are investing in are actually being achieved.

The growth and development of ESG and other sustainable finance products is promising, and evolving regulatory frameworks and international principles are beginning to form a more solid foundation. But much more needs to be done for ESG practices to support market efficiency and integrity. We cannot rely on finance to deliver better environmental, social or governance outcomes if investors do not have the tools and information to price related risks and direct investments accordingly.

This year's Business and Finance Outlook is a call to action for governments and market participants to make ESG investing fairer, more transparent and more efficient. It provides a comprehensive map of fiduciary duties and the extent to which ESG can be incorporated into investment decisions under current legal frameworks, and the challenges in doing so. It sets out priorities for policymakers to help markets deliver the data needed to identify and manage material sustainability risks. It lays out existing areas for governments to drive better ESG approaches, for example as owners of companies and as infrastructure investors, or through existing international policy standards and guidelines.

Critically, this Outlook helps governments take stock of what markets can reasonably deliver in terms of ESG impact, where alignment is – and isn't – between private and public objectives, what can be left to market forces and what must be taken up by public policy. This is particularly important where markets have difficulty connecting the management of short and medium-term risks with long-term material consequences, such as the eventual impacts of today's carbon emissions. To this end, governments can usefully help business and investors to better price longer-term ESG risks by providing consistent and reliable forward guidance on the timing, character and extent of forthcoming reforms that will influence the viability of assets, to provide certainty and incentivise the necessary adjustments in investment patterns.

None of these efforts can happen in a vacuum; financial markets are inherently global, and so demand global solutions. Governments and regulators will need to work together internationally to pursue the priorities outlined in these pages and ensure a level playing field. Close engagement with the industry, including institutional investors and lenders, ratings and index providers, and international standard setters, will be critical. Together, we can drive positive change in financial markets towards better sustainability and resilience, and ensure finance meets the needs of investors, our economies and of society now and in the decades to come.

Sustainable and Resilient Finance: Leveraging ESG Practices for Long-term Value

This high-level launch event brought together senior representatives and thought leaders from government, business, academia and the media. Discussions focused on what governments and businesses can and should be doing to drive more sustainable and resilient outcomes in finance, for the COVID-19 recovery and beyond. Watch the webcast

Executive summary

Current market practices, from ratings to disclosures and individual metrics, present a fragmented and inconsistent view of ESG risks and performance.

ESG ratings and investment approaches are constructive in concept, and potentially useful in driving the disclosure of valuable information on how companies are managed and operated in reference to long-term value creation. To this end, investors looking to manage ESG factors, particularly large diversified institutions, typically rely on external service providers of indices and ratings as a cost-effective means to guide the composition of ESG portfolios. However, the lack of standardised reporting practices and low transparency in ESG rating methodologies limit comparability and the integration of sustainability factors into the investment decision process. The link between ESG performance and financial materiality is also ill-defined, with little evidence of superior risk-adjusted returns of ESG investments over the past decade.

This fragmentation and incomparability may not serve investors in assessing performance against general ESG goals, or targeted objectives such as enhanced management of climate risks.

The relationship between Environmental ("E") scores and carbon emission exposures is highly variable within and between ratings. In some cases high "E" scores correlate positively with high carbon emissions, due to the multitude of diverse metrics on different environmental factors and the weighting of those factors. This illustrates the broad challenges in ESG investing, but also the specific difficulties facing investors looking to consider both financial and environmental materiality. It also underlines how current ESG tools cannot be relied on to manage various climate risks, or to green the financial system, at a time when these are rising priorities for investors and policymakers alike.

Fiduciaries such as asset managers and boards should be managing material ESG risks in a way that supports long-term value creation – but are not necessarily getting the data and information they need to do so.

The OECD's global survey of pension funds and insurers reveals the growing consideration of ESG risk factors in portfolios, the extent to which such institutional investors rely on external ESG data and service providers, and reiterates the challenges mentioned above in reference to investor experiences. These challenges extend to infrastructure financing, where the investment horizons of institutional investors and the nature of the assets increase exposure to longer-term sustainability risks. For corporations, managing and disclosing ESG performance and related risks is no different from their interest in managing and disclosing other material information as a key function of corporate governance.

Effective disclosures are important to the communication of forward-looking, financially material information, but practices remain at an early stage.

Inconsistent disclosure requirements and fragmented ESG frameworks mean both institutional investors and corporates encounter difficulties when communicating ESG-related decisions, strategies and performance criteria to beneficiaries and shareholders respectively. This in turn makes it hard for beneficiaries to assess how their savings are used, and for companies to attract financing at a competitive cost that fully considers ESG factors. There is also an implicit ESG scoring bias in favour of larger companies and larger, advanced markets, which could affect the relative cost of capital and corporate reputation of companies outside of these groups, which is due in part to the high cost of ESG disclosure.

Banks are also looking to scale up ESG integration in lending transactions, but also face capacity, competition and data challenges.

Given the scale and significance of lending and underwriting activities globally, stronger due diligence in reference to ESG risks would help align global capital with activities that avoid negative impacts on society and the environment, and enhance resilience in the financial sector, including to climate-related risks. To this end, banks would benefit from enhanced ESG risk management practices and sustainability reporting in their lending activities, and the development of metrics and methodologies to facilitate meaningful measurement of ESG risk.

Governments have levers available to drive better ESG outcomes as both enterprise owners and as investors.

Around one-fourth of the largest global companies are entirely or largely state-owned enterprises (SOEs), and these companies can and should serve not only long-term value but also the fulfilment of widely held public policy priorities, including on sustainability measures. SOEs tend to have higher ESG scores than private companies, but this is not a given and depends in part on state ownership policy. A case study into the energy sector demonstrates how state ownership has sometimes been an obstacle to sustainability goals, such as the low-carbon transition, because of political concerns over the value of energy assets.

If left unaddressed, challenges in ESG investing could undermine investor confidence in ESG scores, indices, and portfolios.

Developments and progress in ESG practices to date are promising, and they have the potential to be valuable, mainstream tools to manage risk, to align incentives and prices with long-term value, and to lessen the impact of future shocks like climate impacts or future pandemics. They can also be a valuable input into policymaking, by better articulating what the market can and should deliver in terms public outcomes, and what kind of further government intervention is needed to meet stated policy objectives. Taken together, the chapters of this Outlook conclude more needs to be done to fully harness this potential.

There are clear priority areas for policy action in facilitating fit-for-purpose data and disclosures in ESG investing.

Greater attention and efforts are needed by regulators and authorities – including through guidance and regulatory requirements – to improve transparency, international consistency, alignment with materiality, and clarity in strategies as they relate to sustainable finance. This extends to the appropriate labelling of ESG products, with information that delineates the financial and social investing aspects of ESG investing.

At the same time, existing frameworks and policy instruments can drive better ESG outcomes and provide a solid foundation for reform.

Closer adherence to, and wider implementation of, OECD standards, policy guidance and international best practices can already address some of the challenges described in this Outlook, especially around the assessment of risk and disclosure of material information. Key examples include the G20/OECD Principles of Corporate Governance, the OECD Guidelines on Corporate Governance of State Owned Enterprises, and the Guidelines for Multinational Enterprises and accompanying guidance, with specific guidance on Responsible Business Conduct for Institutional Investors and Due Diligence for Responsible Corporate Lending and Securities Underwriting.

Close engagement and cooperation between jurisdictions and with the financial industry is needed to strengthen the policy environment and drive better outcomes in ESG investing.

Regulators of large jurisdictions with developed financial markets are already engaging on these very topics, and making good progress. However, capital markets are global in reach, as are many of the environmental, social and governance factors ESG practices seek to assess and manage. Therefore, global principles are needed to help establish good practices that acknowledge regional and national differences, while ensuring a constructive level of consistency, transparency, and trust.

Environmental, social and governance (ESG) investing

Forms of sustainable finance have grown rapidly in recent years, as a growing number of institutional investors and funds now incorporate various environmental, social and governance (ESG) investing approaches. This growth has been spurred by shifts in demand from across the finance ecosystem, driven both by the search for better long-term financial value, and a pursuit of better alignment with values. New OECD reports monitor developments in ESG rating and investing:

- ESG Investing: Practices, Progress and Challenges
- ESG Investing: Environmental Pillar Scoring Reporting

Download the reports at https://oe.cd/esg

This booklet reproduces highlights from the 2020 OECD Business and Finance Outlook which focuses on the environmental, social and governance (ESG) factors that are rapidly becoming a part of mainstream finance. It evaluates current ESG practices, and identifies priorities and actions to better align investments with sustainable, long-term value - in particular, the need for more consistent, comparable and verifiable data on ESG performance.

Find the OECD Business and Finance Outlook online at https://oe.cd/bizfin.

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