MILKEN INSTITUTE
ASIA CENTER

ROUNDTABLE SUMMARY

Shared Responsibility: The Future of Green Financing

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The Milken Institute is a nonprofit, nonpartisan think tank focused on accelerating measurable progress on the path to a meaningful life. With a focus on financial, physical, mental, and environmental health, we bring together the best ideas and innovative resourcing to develop blueprints for tackling some of our most critical global issues through the lens of what's pressing now and what's coming next.

ABOUT THE ASIA CENTER

The Milken Institute Asia Center extends the reach and impact of Milken Institute programs, events, and research to the Asia-Pacific region. We identify opportunities to leverage the Institute's global network to tackle regional challenges, as well as to integrate the region's perspectives into the development of solutions to persistent global challenges.

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INTRODUCTION

As the demand for green financing gains momentum, so too does the demand for complementary and proxy industries, standards, and regulatory frameworks. Ensuring that this industry and these asset classes continue to grow and provide new investment avenues will require greater cross-sector alignment among investors, regulators, and business leaders.

In a private roundtable co-hosted with Elevandi at the inaugural Point Zero Forum in Zürich, the Milken Institute gathered chief sustainability officers, leading investors, and financial regulators to discuss what could be done to crowd in more sustainability-linked investments, generate returns on capital, protect against risks, and ensure positive impacts on the environment. (Elevandi is a nonprofit created by the Monetary Authority of Singapore [MAS] to foster open dialog between the public and private sectors to advance FinTech in the digital economy.)

The plenary was co-moderated by Hiromichi Mizuno, special advisor to the Milken Institute and special envoy of the United Nations (UN) secretary-general on innovative finance and sustainable investments, and Darian McBain, PhD, chief sustainability officer of the MAS.

This roundtable is the first in a series of sessions the Milken Institute and Elevandi will be convening. Further iterations for 2022 will be organized at the Milken Institute Asia Summit and the Singapore Fintech Festival. Through this partnership, we hope that these convenings and research on environmental, social, and governance (ESG) issues can help smooth and support the catalytic role of finance in shifting businesses, regulators, and societies toward a more sustainable future.

STANDARDIZING ESG-RELATED DISCLOSURE

ESG in the Mainstream

At no other point in history has ESG commanded the limelight as it does today. ESG-related disclosures have become increasingly widespread in recent years. Ninety-two percent of the S&P 500 companies published a sustainability report in 2020,[1] two new ESG funds are launched every day,[2] and sustainable financing surged past $2 trillion in 2021.[3] Participants were optimistic that as awareness continues to grow, sustainable investing will become increasingly mainstream, providing solid foundations for further conversations on the assessment of outcomes, the allocation of finance, and the role of regulation.

But with widespread attention comes noise. Participants kicked off the discussion with the lack of clarity about which reporting standard to follow. More than 600 ESG ratings and rankings exist globally,[4] and many diverge wildly in their assessments of the same companies.[5] This lack of uniformity can significantly raise costs for both businesses and investors. The former need to dedicate headcount to answer the multitude of ESG-related surveys, along with resources to collect the gamut of data requested by various ratings providers. The latter pay subscriptions to multiple providers in order to get the most comprehensive data possible.

Without clear direction on which standards to follow, any criticisms of the innate bias of self-reporting, incomplete and unaudited disclosures, cherry-picking by ratings providers, gaming of ESG rankings, and even greenwashing cannot properly be addressed. This has led to many calls for regulators to mandate standardized ESG reporting for businesses.

Standardizing Disclosures

Participants were split on the standardization of ESG-related disclosures. Many called for greater standardization, but some remained unconvinced of its practicability, and others were wary of the unintended consequences.

Supporters noted that standardization would establish a quality baseline for the data reported and enable greater comparability among different companies and even industries. Affirming this outcome, participants and independent surveys alike have found that some investors prefer ratings providers with the broadest coverage and, in some cases, prioritize coverage over quality.[6]

One participant added that standardizing frameworks helps to push internal discussions and create transparency within businesses. This can be very helpful because, even if existing businesses cannot be transformed, it informs executives on which new businesses should be created and holds companies accountable over longer time frames. Other proponents believed that the two standards proposed by the International Sustainability Standards Board (ISSB; see box) are a useful step toward global convergence on ESG disclosures.

The ISSB was established at the UN Climate Change Conference (COP26) to develop sustainability disclosures for capital markets. Its first two proposed standards set out general sustainability-related and climate-related disclosure requirements,[7] building on the framework put forth by the Task Force on Climate-Related Financial Disclosures (TCFD) under the Financial Stability Board. The ISSB further incorporates the work of both the Sustainability Accounting Standards Board[8] and the World Economic Forum's Stakeholder Capitalism Metrics.[9] The Climate Disclosure Standards Board[10] and Value Reporting Foundation[11] were also fully consolidated into the ISSB in 2022.

Other supporters of standardization were more contrarian. One participant remarked that although investors constantly call for standardization, in reality, active money managers rely on first-mover advantage to make good returns. The participant thus believed that standardization is at times used as an excuse to procrastinate on change, and that in turn, greater standardization would invalidate that excuse. Despite such misgivings, the participant still believed the ISSB standards would provide better information for those who really want to use it.

"In private equity, no one ever complained about the lack of standardized information."

However, other participants were unconvinced that standardization was achievable in a timely manner. One participant pointed out that there is no widely used method to avoid double-counting carbon emissions between countries, let alone businesses with complex supply chains. Proper attribution of emissions to the business lines that emit, the investors that fund them, and the geographies in which they operate will necessitate distributed and authenticating technologies such as blockchain, but deployment will take time.

Others were concerned that universal requirements would lead to one-size-fits-all assessments that fail to account for the different challenges and opportunities faced by various industries and geographies. This could hinder the drive toward "materiality"—where companies identify and track only the metrics material to their business—by making corporations collect data that are irrelevant to their businesses. Worse, one participant warned that standardization could inadvertently lead to capital outflow from developing countries, as these markets have fewer data and tend to perform worse in ESG rankings. Such outcomes would be highly damaging because emerging markets are more vulnerable to the impacts of climate change.

That said, critics of standardization were also split on what the alternative should be. Some called for harmonization (reducing variance) over standardization (eliminating variance), arguing that while smaller companies may look for standardization to integrate sustainability practices, larger companies, which formulate their own views, want more customized pieces. Others remarked that newer sectors, such as bitcoin, should themselves be working out how carbon footprint should be calculated, given the large variance in different methodologies. Some participants drew parallels with tax-harmonization initiatives, noting that these have been ongoing for three decades with limited progress. They called instead for a focus on creating minimum standards.

Who Does Reporting Serve?

Discussions on the pros and cons of standardization eventually led to the broader question of whom ESG reporting is meant to serve. Although standardization helps clarify disclosure requirements, reducing the staffing and resources needed for ESG reporting, it can compromise materiality, particularly for larger companies that have already devoted resources to identifying the aspects of ESG most relevant to their businesses and communities. Companies may even claim intellectual property rights on data to be disclosed.[12] And while standardization improves the comparability of data for smaller investors, a participant also noted that many larger investors already have in-house models to assess investments. Consequently, standardizing measurements, scoring, and data may deprive them of proprietary advantage. There needs to be a balance between how much to standardize and how much to leave to the market.

> *"Why do we do reporting, and for whom? Much of the guidance is not relevant."*

In this vein, participants noted that the TCFD framework (on which the aforementioned ISSB proposals are based) appeals to many because it is relevant and lean. Others added that the TCFD is the right global framework around which to corral Western capital markets but said that it should continue to evolve as new asset classes surface.

According to other participants, ESG reporting should be aimed primarily at benefiting people and the planet, which shifted the conversation toward data quality.

HIGH-QUALITY, RELIABLE METRICS

Focusing on Outcomes

For ESG to be oriented directly toward benefiting people and planet, some participants stressed the importance of outcomes-focused targets, such as net-zero commitments, so that companies do not report only for reporting's sake or measure what is easy.[13] Other participants concurred that the total amount of green financing in global circulation was less important than where capital flows to and the impact it makes.

Participants further pointed out three interrelated areas of focus. First, most companies currently plan to take most of their sustainability actions in the 2030s. Participants concurred that this timeframe is far too late, and there's an urgent need to focus on transitioning heavily polluting industries toward cleaner practices.

Second, failure to focus on outcomes can hinder real progress. Participants remarked that input-based metrics, such as the real-time "green-ness" of one's portfolio, tend to encourage divestment, in turn curbing real change. For one thing, divestment strips an investor of the ability to influence decision-making and bring about positive change in the business. Moreover, these assets could very well be purchased by investors less concerned about ESG, under which polluting assets are even less likely to be operated according to the best standards and efficiency. Consequently, outcomes-based metrics are needed so there is no disincentive to acquire polluting businesses and transition them into greener practices.

This point extends even to a regional level. Participants noted the worrisome trend that ESG capital was not flowing to emerging markets due to poorer ESG scores and lower availability of data. However, some financial institutions have found empirically that transition strategies in decarbonization produce a much larger impact in developing than in developed markets.

Conversely, outcomes-based metrics would empower developing countries to demand sustainable investments and technologies from developed markets, and subsequently encourage the inflow of green investments to transition developing countries. This would further enable ESG-minded institutional investors to develop sustainable investment frameworks that broaden participation from the global investment community.

That said, participants candidly acknowledged several difficulties with outcomes-based measurements. Data on outcomes are sparse, and impact measurement tends to be time-consuming, costly, and difficult to generalize. Interests are also misaligned: Portfolio managers are mostly interested in how environmental and social factors impact the risk-return profile of their investments; hence, their attention would be focused mainly on sustainability risk assessments. Measurements of impacts are of lower priority and do not fit neatly into traditional portfolio assessments.

Participants thus raised the need to interlink risk and impact over the long term, with some calling for more respected, transparent, and understandable ratings to educate investors. Others believed that to be successful, financial institutions will also need to collaborate with new stakeholders, such as UN agencies, the World Bank, and non-governmental organizations, in order to have a deep understanding of local contexts and opportunities.

Dealing with Heterogeneous Data

Participants reached no consensus on whether ESG risk should be integrated into credit ratings; a separate ESG rating should be created; or separate ratings should be created for the environmental, social, and governance components individually. The main issue was that with multiple data sources, investors might be unsure of which to use.

One participant believed that if—and only if—credit and ESG ratings are highly correlated, they can be blended into a composite rating. This echoes the earlier point that some investors would rather have consistent data than perfect data. Others believed that as the number of ratings providers rises, investors must learn to be comfortable with assimilating heterogeneity in information and disclosures.

On a helpful note, participants observed that divergent ratings between different providers on the same company are less common these days, thanks to more comprehensive and standardized disclosure. However, others remarked that some differences between providers simply cannot be bridged. Participants noted that credit ratings have been developed over many decades, whereas ESG ratings are new. Because they are unestablished, ESG ratings are less likely than credit ratings to converge between different providers. Moreover, ESG ratings involve value decisions and long-term forecasts, which invite variance among providers.

The distinction between ESG and impact investing is related to how heavily analysts weight ESG against other metrics. Broadly speaking, ESG investors see ESG metrics as just one part of a holistic view of company fundamentals and, at a minimum, demand market levels of risk-adjusted return. These investors believe they are simply investing in the strongest companies and that any alignment with ESG is fortunate but coincidental. Conversely, impact investors invest in mission-oriented companies with high intentionality, weight ESG metrics more strongly in their assessments, and have varying tolerance for concessionary returns. Where these two camps overlap in their investments, it can be difficult to attribute the climb in the company's stock price to either camp.

Explainability is also a challenge for ESG data. Some providers do not explain their methodologies, and some make ongoing but unannounced changes to historical ratings such that past ESG scores correlate better with future stock market performance,[14] whereas other providers use black box technologies such as machine learning, which are inherently difficult to explain. Hence, ESG ratings across different providers (or even the same provider across time) can be difficult to compare. It's indicative that surveys have found large investors simply using external ESG ratings as a first pass to filter out broad swaths of unaligned companies, after which they mainly focus on the underlying data, rather than the rating itself, to form their own view.[15]

It is also widely acknowledged that environmental, social, and governance issues are highly disparate. Nevertheless, participants have observed some benefits from grouping them together. One participant remarked that grouping all three into one ESG category makes people pay attention to multiple issues and orients thought processes through a more multidisciplinary, systems-level lens, which can be beneficial. This overarching view is important in scenarios where there is a short-term tradeoff between various ESG metrics: for instance, when shutting down polluting assets could lead to mass unemployment in a developing region.

Moreover, focusing only on social or governance issues may attract heavier pushback because, individually, it can be difficult to come up with comprehensive metrics, demonstrate return on investment, and improve the ESG performance of a company or portfolio. Conversely, grouping social or governance issues with reductions in CO_2-equivalent emissions, which have established measurement technologies and pricing systems, may ease buy-in.

On some level, this speaks to the tendency to count what can be counted (and monetized easily), not what counts. To align investment behavior better with the public good, participants turned to the role of regulation.

RECOMMENDATIONS FOR REGULATION

The impact of regulations on incentives and behaviors cannot be overstated. Without regulatory pressure, even environmentally minded companies may find it difficult to move toward sustainability, knowing that their competitors will capitalize on their losses in the short term, while not knowing how the general public will receive initiatives. For instance, some fossil fuel companies invest in cleaner energy production, only to find that other companies avoid purchasing their carbon credits in order to distance themselves in the eyes of the public. For similar reasons, without international alignment, individual governments can also find it difficult to push their markets towards net zero.

By making appropriate changes to the rules of the game, governments would formally legitimize initiatives in sustainability, rather than leaving businesses fully exposed to the vagaries of public opinion. Businesses themselves might then derive first-mover advantage by working toward their ESG goals, prompting systemic reorientation toward ESG.

Most regulators currently focus on building resilience, including risk-oriented measures, disclosures, and reporting standards. But few to date have sought to advance market solutions, enable data infrastructure, and build deeper capabilities in the ecosystem. Participants had multiple suggestions for both areas, which are covered sequentially below.

Regulating Reporting

The need for more respected, transparent, and understandable ratings, together with greater investor education, was a common theme to which participants continually returned. With regions such as Asia yearly requiring billions, if not trillions, of green financing, existing financing mechanisms and ecosystems are insufficient to enable and encourage such levels of funding.

One participant suggested that regulators could survey the landscape of ESG ratings and inform investors which ESG ratings are comparable. This would reduce investor misunderstanding surrounding ESG ratings and perhaps help accelerate green finance. Another participant believed that regulators could select standardized ESG metrics and make reporting mandatory for companies. This would clarify reporting requirements and provide comparability of data. If this were the case, the participant added, top-line ESG ratings by ratings providers should be made publicly available, to ensure that the benefits of reporting were shared with the rest of the ecosystem.

Supporting Innovation

Participants generally believed that regulations should support innovation but acknowledged that this was not always clear-cut. Some mentioned that ESG regulations take time to develop because much consideration is needed on the inclusion or omission of certain metrics. Moreover, negative impacts may surface in edge cases, and there could be knock-on, system-wide reactions to narrow and broad actions alike.

One participant raised the example of carbon offsets versus carbon removal. Carbon offsets are increasingly established and adopted, but adoption alone is insufficient to keep the planet within 1.5°C of warming. Conversely, carbon removal, while more effective at slowing warming, is expensive and remains on a small scale to date. Noting that there was no easy answer, the participant asked whether ESG credentials should more heavily prioritize carbon removal or carbon offsets, and whether regulators had a role in shaping the incentives to nudge the market in either direction.

Another participant believed that if ESG initiatives are to be focused on impact, there is a need to invest as much capital as possible in private companies contributing to SDGs. This, in the participant's opinion, is because listed companies can already obtain capital easily. As a related matter, there is also a need to focus on private or state-owned companies. By some estimates, these companies account for more than two-thirds of global emissions,[16] yet do not operate under the sway of institutional funds. Regulations would thus be needed to align such companies better with ESG goals.

One challenge is that because of existing regulations intended to limit risk and illiquidity, bankers cannot ask their clients to invest in private companies. The participant suggested that one mechanism to assuage regulators' concerns might be an investment fund, supplied with both public and private capital, that could serve liquidity to impact investors contributing to the private market. Another participant noted the rising popularity of blended finance in ESG, proposing that regulators allow banks to take on more risk for sustainable projects in developing countries.

Another participant raised the idea of using technology to lower the barriers to sustainable finance, thereby crowding in capital from the broader public. For instance, distributed ledgers could be harnessed to let a large number of retail investors each invest a small amount in a credible organization or asset, such as a World Bank bond. This could help crowd-in large volumes of ESG capital from the general public.

ENDNOTES

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