

Foreword

Linking ESG scenarios to real economy outcomes

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I was very pleased when asked to provide the Foreword to this important book on how environmental, social and governance (ESG) factors are fast becoming the most critical considerations in 21st Century investing. The risks, opportunities and trade-offs presented by ESG strategies, approaches and tactics are unprecedented; further, the speed and the breadth in which ESG is penetrating investment decision-making is unmatched. That said, there is still much to do to mainstream ESG analysis. That is why I believe this book, authored by a wide array of highly experienced academics, market participants and industry stakeholders, is essential reading for experienced and entry-level financial professionals alike.

Most investment professionals are aware of the risks associated with the environmental pillar of ESG. Environmental laws have been around since the 1960s. The risks to investment cashflows associated with water and air pollution, asbestos, plastics and soil contamination have grown steadily over the years. Remediation, liability risk and cost to capital, and share price performance associated with these once free-riding negative externalities has increased markedly. Even now, much of the costs of these negative externalities continue to be borne by society in the form of poor health and increased taxes. However, laws, regulation, shareholders and public demand have pushed the environmental pillar to the forefront of corporate boards' agendas, along with the need to alter business models to mitigate these public harms.

Since the early 2010s, carbon emissions and their impact on global warming has become the preeminent environmental risk due to their existential nature. The focus on curbing carbon emissions in the real economy accelerated at pace with the signing of the Paris Agreement in 2015. The challenge for the financial services industry is to influence their real economy clients to transition their way of doing business to one that is sustainable. The financial services industry has played, and will continue to play, a central role in providing capital via equity and debt to clients to fund such transitions. The fundamental challenge and risk to investment professionals is how to respond to companies and sectors that are not transitioning. This book examines the risk of stranded assets and loss of corporate value that are directly correlated with corporations' unwillingness or inability to adapt and meet the demands of a low carbon economy.

The second pillar within the ESG suite of obligations is social. Social obligations consider the treatment of workers and clients, workplace safety as well as human rights associated with supply chain and other workers. Corporate reputation and responsibility are at the heart of social conduct that aligns with ESG. Over the past few years there have been high-profile instances within companies where senior executives that bullied or undertook inappropriate relations with employees were required to exit their firms. In one case, the extreme actions of the senior executive resulted in the company ultimately collapsing and all its equity value being wiped out. The scope of "S" has progressively widened over the years and is increasingly dynamic. For investors and risk professionals, a strong understanding of a company's social policies and how well it follows them is therefore critical for investment decisions. In short, poor social conduct is a meaningful risk and can destroy value.

The final pillar within ESG is governance. Governance is leadership infused with integrity, challenge and inclusion. Research shows that if a corporation has inquisitive, diverse and widely experienced leadership, it has a much higher probability of recognising "E" and "S" risks and producing long-term sustainable decisions and returns. Conversely, one of the greatest risks an investment professional can come up against is a company without strong governance. Nowadays, an executive and non-executive

leadership team must be dexterous and have a keen eye on macro and micro risks across the fast-evolving ESG landscape.

This book will explore in detail many of the risks, opportunities and trade-offs of ESG investing. However, it is important to also step back and place the broadening scope of ESG into a wider macroeconomic context. Governments and regulators regionally and around the world are coordinating approaches to eliminate or mitigate negative externalities that are commonly making headwinds in the ESG space. They are rolling out green and social taxonomies, disclosure policies and carbon pricing, as well as reduction schemes that will have spill-over effects into regional and global markets. Investors will need to deploy variations of classical risk measurements such as climate/ecosystem value-at-risk (VaR) scenarios, and credit-related and tail risk assumptions.

There is much at stake as the global real economy and financial services sector undertake ESG-aligned actions to create a sustainable economy. However, what is most at risk is the economic well-being and welfare of billions of people. The global energy transition must also be a “just transition”. Such a transition that is inclusive, equitable and fair must hence assure that the significant benefits created by a sustainable economy are shared with those who stand to lose most, or with those who were never beneficiaries of the “old system”.

This book has assembled, as co-authors, a distinguished and notable group of experts and scholars across the investment value chain, resulting in a comprehensive study on ESG investing assessing strategies, approaches and tactics. The methods and models developed in the book have strong relevance and are of practical value for financial institutions, ranging from asset managers to commercial banks and insurance companies. The case studies and examples are practical and come from leading financial experts looking across industry sectors.

With the help of all stakeholders and sharp ESG-aligned risk and opportunities management for real economy outcomes, I strongly believe that we can and will live in a cleaner, greener and more sustainable world.