FinSights from the FinLabs

Episode 3: ESG- no longer a buzzword but how far away is global adoption?

Transcript:

0:00 - Natalia Zurowski
Hi everyone, live from our virtual finlabs, I'm your host, Natalia Zurowski, Marketing Lead, UK and APAC at Synechron. And welcome to finsights from our finlabs, your podcast for the latest in innovation and transformation from our finlab experts. In our new series, InvestTech, we'll be focusing on the latest trends within the world of asset management, as well as innovation across financial services and what lies ahead. Today I'm joined by Rajul Mittal, Head of Sustainable Finance at Synechron Amsterdam and Bermet Dordoeva, Senior Consultant at Synechron Amsterdam. Thank you both for joining me.

0:33 - Bermet Dordoeva
Thanks for having me Natalia.

0:36 - Rajul Mittal
Thanks for having us, Natalia.

0:39 - Natalia Zurowski
Thank you, guys, it's going to be a great show and just before we dive in, can you please give a quick introduction to our listeners about yourself, Bermet, you go first.

0:49 - Bermet Dordoeva
I am Bermet Dordoeva, a consultant based in Amsterdam. Together with Rajul, we are working on sustainable finance propositions and then a personal note, I'm coming from Kyrgyzstan. It's a little mountainous country in Central Asia so actually, all the topics related to nature are really close to me, because in this country, you can actually see how the nature was before all the industrial developments came in. I can tell you how it looks.

1:22 - Rajul Mittal
Thanks, Bermet. I'm Rajul Mittal. I'm with Synechron for almost 11 years now, based out of Amsterdam. I lead the sustainable finance and ESG practice within Synechron. Sustainability is a topic that has been close to my heart for more than 16 years since I graduated, but I left it in latency and did not really pick it up. But for the last four or five years, it's really caught my eye. Also, on the personal front, I'm very busy with sustainability having solar roofs on the house. In my professional capacity, for last 18 to 24 months in Amsterdam, we have been really focusing on how we can help our clients with pension funds, banks, asset managers with sustainability and ESG.

2:09 - Natalia Zurowski
That's excellent. I don't think I have the solar panels quite yet but perhaps after this call, that might be the first thing that I end up doing. Thank you both so much for those introductions. Just for our listeners, for today's show we're looking at ESG as an increasingly important role within financial services, what investors want, the development of global metrics and standards, and really, is the 'E' in ESG in a league of its own. So, let's just dive right in. A survey by the World Economic Forum found that 86% of executives agree that reporting on a set of universal ESG disclosures is important and would be useful for financial markets in the economy. When did we really begin to see the evolution of ESG from a conference buzzword? I remember seeing it at every conference in the last couple of years. When did we go from seeing it from that conference buzzword to really a serious topic of conversation and is it the result of the next generation of your high net worth and your ultra-high net worth of investors, urging companies they invest into to do what they perceive is the right thing or is ESG something that was becoming really inevitable? Bermet, let's start with you.

3:22 - Bermet Dordoeva

I think it's the latter because not only ESG, but everything related to sustainability is booming nowadays. And I think the reason for it is very simple. If we look at the world around us, we're in the midst of a pandemic and climate changes are happening, we see global warming coming with unprecedented speed. Therefore, everything related to sustainability is booming. And you can say everything related to sustainability is a buzzword nowadays. And ESG is a very important part of it. ESG is a very important part of sustainable finance and it's one of the tools of sustainable finance. So, by using ESG, we will be able to know what is actually sustainable just to distil from all the businesses and from all the activities around us, we can distil what is truly sustainable. So, I think it's just the results of developments around bigger topics.

4:25 - Rajul Mittal
Thanks. Bermet I think for this particular topic, I'll take a historical point of view. So, what at least I have read and I know and I was not even born in 1969, is responsible investing has been with us since the 60s and the 70s and it kind of started in the US because the US in terms of capital markets was more mature. But we remember the 2000 election when which Al Gore and George W. Bush were fighting and after he lost in Florida, I think Al Gore took a complete U-turn or became an environmental champion. And I think a lot of credit goes to him to bring this topic to the fore. And then we saw 2008, the financial crisis, the crashing of the markets. And that is where you saw that lot of retail customers, the public at large, had dissatisfaction, frustration with the financial sector as a whole. And that was also definitely a trigger of this topic slowly and gradually coming to the fore. And what we see in the last four to five years, is that there is a definite pull from not only the Chennai's, or ultra high net individuals, but from the public at large. To be able to see that the money is deployed through the matrix of ESG. So definitely money should be going towards the companies, which are doing good for the planet, or at least not doing bad for the planet. So I think, if we take a historical perspective, this was a long time coming. Finally, we are at an inflection point where in the next five to seven years, this would be mainstream, if not already.

6:15 - Natalia Zurowski
Yeah, excellent. Without question ESG and push from investors have really caused companies to feel at the very least compelled to clean up their act but I'm going to be just a tiny bit cynical for a moment and I appreciate this movement has been coming for a while and I do think it's overdue. But just if I'm going to take on a slightly cynical lens to this. Let's take a look at rating shopping, so right now, there are currently over 1000 ESG indexes in the market. So you have your MSCI's, your Bloomberg's, sustainalytics, etc, all in this world. And they all differ in their methodologies and how they examine the same exact firms and their ESG ratings. So just as an example, one firm can be using sustainalytics and in their annual shareholders report rate, they rate themselves as medium in their ESG efforts. But that can be low or high with another. Do you think there's a risk of over saturating the market with these indices but also the risk of perhaps false representation from companies to pick an index that best aligns to their goals? Rajul, I'm gonna pass this one on to you.

7:22 - Rajul Mittal
Natalia, my take is, I agree with you, that there are more than, 1000 indexes or companies which provide ESG rating. But we need to segregate the larger topic of sustainable finance, regulation and ESG. So sustainable finance regulation is something that is from the regulator and it has a standard. When it comes to ESG and we already talked about the historical evolution of ESG or responsible investing, that is more of an evolution, rather than something being pushed by the regulator. So, the industry is evolving on its own and that is what you see, in terms of different geographies, different asset classes, be it equities or funds. You have niche players, you have large data players, which are now also foraying into ESG. And you rightly said that the methodology is not a standardised methodology. So we talk about sustainalytics, which has a score from zero to 100. Zero being the best score you can get. On the other end of the spectrum you have Refinitiv as a big data provider, which also has a score from zero to 100, but then 100 being the best score. So, I would say that, at this point in time, the risk is not about saturation but there is definitely a need for convergence in the next three to five years. The more pertinent question is the adoption and I think we are still in the early stages of adoption. So, once we have passed that curve of adoption, where at least the main financial institutions or the big banks, the asset managers and pension funds have already jumped on the bandwagon of ESG, we would see that there is a convergence in terms of standardisation, in the kind of data that is provided and the data quality. So, I think its adoption, and then the convergence in terms of having a structured ESG, methodology data and data providers.

9:31 - Natalia Zurowski
In terms of adoption, you have your early adopters, you have your believers and then you have your laggards. You have the ones that come on at the end or they're sceptics from the very start. In a State Street Global Advisors 2018 ESG survey, 80% of respondents say they have some form of ESG strategy within their portfolios but with the 20% of those that were actually surveyed, who do not yet have exposure to ESG strategies, 71% stated that they're not actively considering them. So with the clearly cited benefits of reporting on ESG ratings, we've been saying this is a long time coming, there's obviously plenty of benefits to ESG, such as helping companies control their full corporate value or the ability to potentially realign capitalism really for the benefit of broader society for looking at things at a more macro level. But why would a company then be, for example averse to adopting an ESG strategy? We know the benefits; we know this is coming from the market. We've been expecting this to happen, but why are some companies still so averse to it?

10:38 - Rajul Mittal
I think you raise a very good question in terms of, how companies see ESG. One important concept that we need to establish and within the world of sustainable finance, we talk about sustainable finance one, sustainable finance two and then sustainable finance three. And sustainable finance, one, in that realm, the financial performance of the financial indicator is always leading compared to say the social indicator or the environmental indicator, or what we call the integrated value of looking at investments. So, we are still at a stage where financial performance is definitely leading compared to the ESG performance or the social or the environmental performance. Until that is the case, the adoption and the level of embedment of ESG within companies would vary to different degrees but as we move towards a realm, where the integrated value that is not only the financial value but also the social value and the environmental value is looked from through the single lens, that is where we will see the transition in a more holistic manner. I think, also this links to the earlier question that we have seen in 2013 and 2014 with Basel II and Basel III, that the risk methodologies that the bank used in terms of how much capital they need, was varying from bank to bank, because the regulator did not impose a single methodology. The industry is evolving, you have different companies looking at that, differently. I even question that, when companies claim that, they are looking at ESG, to what level is this embedded within the organisation? Are they having a complete view, are they building their own models? Things like that. So, I think, currently ESG as a topic and how companies see it is all over the place but I'm pretty hopeful. And that is also the need of the hour, in terms of not only environmental change, but social change and governance as a factor, that we look at it in a more holistic manner. And that change is not long view, it's coming our way in the next two to five years.

13:25 - Natalia Zurowski
I'll be looking to you, then Rajul in the next three to five years to see if that change has happened. Again, I'm being perhaps slightly a bit of a sceptic but at the same time, hopeful and optimistic for the future. I'm going to touch back on something that you said when we're talking about the 1960s and that's where we started to really see sustainable finance and ESG come about. It hasn't been the past few years at conferences, this is something that, we've been aware of for quite some time now but you were also saying before, how it's started in the US, and that's where we've seen a lot of the momentum come out of. The adoption of ESG is higher in the US than in Europe. But according to the EFT and something I was reading was that Europe actually has a tendency to favour government driven frameworks, whilst the US prefers bottom-up, industry led solutions. So just as an example, and what we saw on the news at the end of September; The European Commission created their own green taxonomy last June whilst in contrast, we saw the Big Four come together, along with the World Economic Forum, and the International Business Council, it's currently run by Bank of America's CEO Brian Moynihan to create a new set of 21 ESG metrics split into four pillars including governance, planet, people and prosperity. Is there a middle ground then between the two approaches between the US and the European approach that we're seeing and where should solutions be coming from. Bermet, I'm going to turn to you.

14:50 - Bermet Dordoeva
I do believe that most of the data on ESG that is being gathered in the US is coming mostly from SEC filings, from filings from publicly listed companies, so publicly traded companies. So, I cannot call it a purely industry-up approach, but I do believe that yes, indeed that we can distinguish two approaches when it's top-down like in EU one day, legislators coming with new taxonomy. And, of course, bottom-up what is coming from

industry, but I think the challenge in both is that, what are we trying to build taxonomy upon, what industry we're looking at? Because it's really, really broad and it's really big and why, it's hard to say which approach is better because the challenges, will be the same everywhere in all the regions, in the US or Europe, that there's so many industries and ESG metrics, they're truly, truly detailed and they cover a lot of aspects. Some ESG metrics can be straightforward, like emissions and these are the most important ones, but some are really hard to track and trace like, share responsibility or anything related to labour law. So, I think the problem with taxonomy is that too many stakeholders are trying to get too much at the same time. So, I would say that looking at the approach, it's good to take little steps. If industry approach works, it's perfect. If a top-down approach with EU taxonomy will work, it will be great, and it will also have precedent to other countries and regions. So, I think the most important thing is to act and do something, and to see which one will work better because now it's still hard to say which one is better.

16:50 - Rajul Mittal

If I could add to how I see the US unfolding. Me and Bermet are both are based out of Amsterdam, and we definitely see the evolution of ESG in the European Union more closely compared to US, but we've also been interacting and recently I interacted with the Head of Sustainability of a US investment bank. His take on the topic of ESG adoption in the US was, that why it is currently lacking, is because of three reasons. One is the lack of definition and nomenclature when it comes to ESG data providers. Second, is that the ESG knowledge and conviction as a proven concept is very low for an average US investor. If you look at the whole Midwest, a lot of money is there and traditional investors are there, for them environment, or ESG doesn't mean anything, as of yet. And thirdly, the relationship managers and the advisors who actually have to sell the products to these investors have not reached the stage of inflection, where they start pursuing ESG based investments very aggressively. So, if you look at these three reasons, the US has been quite mature in terms of ESG but if you look on the ground adoption of ESG, it is lacking. The final point in this regard would be the election of Donald Trump in 2016. And I think that's where it came to a standstill and as we talk, we are in the midst of having a new president in the US. So, let's see which way the tide turns and if the US goes back to the trajectory of better ESG adoption, or if it lurks in the dark when it comes to ESG for the next four years.

18:54 - Natalia Zurowski

To really just continue what you're talking about there, Rajul and Bermet is the adoption of these metrics. How soon will we really begin to see the adoption? Perhaps we are seeing on a smaller scale now but when will we sort of start to see that go out a bit wider? Most of the accountancy firms themselves only reported information on the third of the 21 metrics that they created a couple of years ago, but now are rushing to provide the right reports as standards and are supposed to be adopted as early as next year. So, when do you think we're going to start seeing the adoption of them? We're seeing it to a smaller extent but when are we going to see that really start to become a bit more widespread?

19:39 - Bermet Dordoeva

In terms of adoption of reporting on ESG metrics, I also would like to look at what triggers the reporting. One angle which is very common is the investment angle because of course, what triggers and what drives the market is investment and as soon as investors are starting to invest in sustainable companies, and they have already started to do so, then more and more companies want to be successful and want to start reporting on ESG and when they also want to do their best to improve their ESG rating, to make sure that they are in this investments area. And that's why I'm really excited about sustainable finance. I think it's cool, how powerful it can be to solve their sustainability issues. But with that said, we see that then it's happening, this trigger is mostly related to publicly traded companies, to the public market. And therefore, to make it even bigger, I would actually look today at another issue related to your question about the wider adoption; when will this trigger come, when this will come to private markets, and what to do with emerging markets? Because they don't have this push. And I think for those too, the regulation or top-down approach will help a lot.

21:17 - Natalia Zurowski

So, in terms of when we'll really start to see the adoption of the metrics, and what do we think is the fastest route to get there? If we take into consideration the different approaches to ESG standards by both Europe and the US, what is the fastest way for us to get there? Will we see all of the boards come together? Or is there a fear of one system? Or what do you think is the fastest way we can actually start to see more impactful change, whether that's from private companies, public companies, when can we start to see that movement come, and how quickly?

21:59 - Rajul Mittal
My take is that we should let it evolve. So be it in the US, Japan, or the European Union, let the systems evolve. And if you look at an analogue, for example, for the last five-seven years, on the hype curve, augmented reality, that is a very different topic that has been on everybody's mind, that augmented reality will take us by surprise. You have companies like Microsoft, and then you have companies like Magic Leap working on it, but things cannot go faster than the normal course of time. We have definitely seen a lot of traction in the last three-four years. The sense of urgency, not only from the companies, or the companies which deploy money, but also the demand from the end customer, the private, high net individuals. My take is that we should let the systems evolve. We definitely need some top-down approach in terms of the guidelines, but let's not try to box it as a complete regulation that you have got to do it because financial performance is the basis of capital markets. So we cannot force ESG onto the capital markets and then see how it churns. We have to let the blend happen in a more natural manner. I am pretty hopeful as well, that the next five to seven years, we will be standing in a much better place in terms of ESG adoption. That is not only good for us, as the end customer, it's good for banks, which deploy money, but it's also good for the planet at large and what we need.

23:55 - Natalia Zurowski
I don't think there is a need to rush into it. As you said, this is something that we're also learning and it's an ever-evolving process. In terms of having those standards, do we really need then global standards? Bermet what are your thoughts there?

24:17 - Bermet Dordoeva
In terms of global standards, versus regional or national, I would say that I'm not sure if we really need global standards, because I do understand that the issue is truly global at the moment, it's really exciting times we're living in. But if we look at, for example, other topics like anti-money laundering, or terrorist financing, which is also a truly global topic and if we look at how it evolved, like Rajul said, it can evolve naturally, all countries, they still have their own standards for AML and KYC. And the US has its own approach, and Europe is doing it differently, but I believe it works that way. So, I think the most important thing now is that all countries, and on the regional level as well, have good cooperation and they all take steps towards adoption of ESG. I think if we take little steps and if industries also do something, then it definitely will work.

25:23 - Natalia Zurowski
It think it really is just about those incremental steps, I think it is just taking it one day at a time and not necessarily feeling that you need to rush it and start making all of these changes all at once.

25:37 - Rajul Mittal
Finally, we all have been very busy or have seen how organic food was on the shelves for the last three to five years. Similarly, when it comes to ESG, or green investments, there is a lot of greenwashing that has happened, and we don't want that to happen perpetually. So, I think it has to take its natural course.

26:04 - Natalia Zurowski
I think in terms of greenwashing there, Rajul, I think we can start an entirely new podcast on that alone. We're just nearing the end of time. Thank you so much for joining me today. It was amazing to hear your views and how ESG is making investors, investment managers just think differently about their portfolios, how they run their businesses, but really also what we can expect to see in the coming years with new global standards metrics put in place and learning to take things one day at a time without rushing into them. Are there any final comments you'd like to leave our listeners with Rajul?

26:41 - Rajul Mittal
Please let me know when you put the solar panels in.

26:44 - Natalia Zurowski
I promise I will, I might need your help in installing them. I'll just FaceTime you. Bermet?

26:53 - Bermet Dordoeva
Thanks for having us. These were great questions and I'm happy that there's a podcast where people can hear more about these topics and I think it's a great initiative, very happy about it.

27:08 - Natalia Zurowski
I don't think it'll be the last time we have you both. Thank you so much for your views again and thank you so much to our listeners for tuning in. If you're interested to find out more about Synechron and what we do, please visit www.synechron.com and if you like what you heard, please like and subscribe. Catch you next time.