The Rising Importance of ESG - Ecosystem Challenges and Future Opportunities
Abstract

Investing in the environmental, social and governance (ESG) area first came into prominence in 2004 when the erstwhile UN Secretary General, Kofi Annan, took the initiative to incorporate ESG into the capital markets. Since then, ESG has exhibited an upward trajectory and is now projected to hit the $1 billion mark in 2021.1

Different stakeholders such as ESG research firms, data providers, asset managers, rating agencies and stock exchanges have started to invest heavily in the various components that make up the entire ESG life cycle.

Keeping up with the changing trends, ESG ratings have come to be regarded as one of the important parameters by various institutional investors who intend to de-risk their investments.

In this paper, we are going to focus on key industry trends, the current challenges faced by organizations and the possible solutions to address such issues.

The Changing Face of ESG

ESG data trends reflect how organizations are becoming increasingly conscious of the environment and societal impact of their businesses in general, showing greater transparency in corporate decision-making. An ESG Data Market report estimated the ESG market to be at $617 million in 2019 growing annually by 20%. Along with 35% growth for ESG indices, the market is poised to hit $1 billion mark by end-2021. Some of the emerging trends in ESG are:

- Investors are increasing their focus on sustainable businesses over short-term profits. This in turn has raised the pressure on companies to disclose ESG parameters. In Oct 2020, Bloomberg and MSCI Inc. launched the Bloomberg Barclays MSCI Emerging Market Asia Credit ESG index suite.2 The objective was to track the performance of the emerging market US dollar-denominated credit debt in the Asia ex-Japan region, while incorporating measures for environmental, social and governance risk and exposures.

- Regulations around ESG are also strengthening. In Europe, asset managers will be required to integrate ESG considerations into their fiduciary duties by 2021. The US and others may also start following similar regulations.

- ESG disclosures reporting standards3 such as Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-Related Financial Disclosures (TCFD) have been highlighted as the regulator’s choice to project as reporting standard the companies that will adhere to report disclosure. Increasingly, public organizations, realizing the need to comply, have begun to disclose sustainability reports. Besides aiding compliance, such disclosures help to create a positive brand image to attract investments. Another motivating factor is the increasing awareness of the customers, who are willing to pay a premium to ensure that the products and services that they are procuring are produced in a sustainable way.

Credit Rating Agencies (CRA) have been focusing on building capabilities and enhancing the existing offerings via acquisitions or partnering with ESG specialist startups or data providers toward fulfilling investor demands.

The IT industry is a new entrant in the ESG ecosystem. By leveraging artificial intelligence (AI) and machine learning (ML) technologies it is best poised to support scaling up ESG operations.

Asset managers have started forecasting revenue, asset book value or company valuations based on the different ESG factors. Sell-side research brokers are considering inclusion of ESG factors into their investment recommendations (such as buy, hold and sell) and forecasted company financials.

Challenges in Leveraging ESG

Despite all these new growth trends, investment management firms are far from realizing the full potential of ESG incorporation. The challenges include:

• Lack of ecosystem collaboration for a common cause: Processes are disjointed and fragmented between various ESG ecosystem stakeholders including regulators, ESG reporting framework boards and data providers, ESG research firms, asset managers, rating agencies, stock exchanges, and other organizations. Ecosystem participation is a must to achieve ESG vision 2030 as agreed in the Paris Agreement.

• Plethora of ESG disclosure frameworks (and associated reporting bodies): Differences in methodologies followed are resulting in differences in scoring and interpretation. Companies need to be aware of the appropriate reporting standards to follow and internally equip themselves to accurately capture and report the disclosures.

• Different ESG ratings for the same company by different ESG rating providers: Varying scores occur as each rating firm has their own proprietary methodology for scoring. Their parameters, and biases are based on both perception as well as analysis based on the available data against the sustainability indicator.

• Authenticity of data is a must before reporting: While authenticity of company data is a prerequisite for accuracy, lack of auditing results in greenwashing and may be illegal.

• ‘Analyst inference’-driven and not ‘Data inference’-driven: Mostly, data is collected from publicly available sources where further detailed clarifications are not available, leading to analyst inferences.

• Absence of regulations: Where regulations are in force, enforcement is lax. Furthermore, ESG-related disclosures are hitherto voluntary and not mandated.

• Lack of awareness of ESG: Organizational lack of awareness of ESG and its benefits poses a problem. Moreover, the absence of a well-defined regulatory framework often results in involuntary disclosures, primarily arising from competition pressure or investor demands.

• Lack of ESG platform to capture data and report disclosure: Most existing ESG platforms and tools target investors and asset allocators to help them gain insights and better manage risks. ESG management platforms for organizations are not common. The implication - current processes to measure and report organizational ESG disclosures are manual and excel-driven.

Solutions for Effective ESG Implementation

Unless there are correlated efforts to support all the stakeholders involved in the ecosystem, the risks of lack of rigor will persist. Governments can align regulations to meet the goals of the Paris Agreement, while ESG framework bodies can create a blueprint for unifying global reporting standards. Primary stakeholders include organizations who need to step up their ESG performance, rating agencies and data providers who need to converge to common standards and increase their coverage by manifolds, and the general public, who need to be made more aware of the long-term impact of their choices.

The IT sector has an important role to play in this ecosystem. Potential solutions include:

For organizations in general:

• Create new platforms or augment existing enterprise resource planning (ERP) platforms to include collation of data to derive various ESG parameters.

• Ease of reporting with canned reports which are aligned with regulatory requirements.

• Deploy real-time intelligence with ‘if-what’ and ‘what-if’ analyses on ESG scores or compliance around the impact on the respective organization for operational decisions being taken.

For rating agencies and data providers:

• Leverage ML and democratized AI capabilities to efficiently decode qualitative information and create unbiased inferences.

• Enable intelligent platforms which can help rating agencies and data providers to scale and provide more real-time insights to enable informed investment decisions.

• Ensure compliance with the local regulatory demands with geography and segment-specific personalization.

• Augment current financial risk metrics with ESG scores to provide financial investors with a transparent tool for making better investment decisions.

For general public awareness:

• Integrate ESG information from various sources and display inferred data for every product being sold in online marketplaces such as Amazon.

• Make ESG-related news mainstream and not limit it to informed investors, as is the current trend.
Public domains are increasingly becoming huge information repositories, making information access easy for end customers and investors. Therefore, the onus of providing accurate ESG information rests on each organization. Lack of information may potentially be perceived as ‘insensitivity’ on the part of the company. Inaccurate information or misrepresentation is even worse as it may lead to serious and irreparable reputational damage.

**ESG as a Value Creator**

In the ESG context, value creation is often about building connections with the broader ecosystem of society and further fostering them. For starters, it builds resilience into the business model. On the contrary, compromising connections with stakeholders due to a myopic view on the short term destroys inherent value.

In the long term, businesses need to focus on satisfying customers, employees and communities – often global, to maximize value creation considering the ESG data points.

ESG assets are expected to continue to grow at a 16% compound annual growth rate (CAGR), totaling almost $35 trillion by 2025.\(^{15}\) According to the Deloitte Center for Financial Services (DCFS), investment managers are likely to respond to this demand by potentially launching up to a record 200 new ESG funds by 2023, more than double the previous three years.

What it means for the IT industry is simple – a sizeable market to tap into, with good business potential, but also to set an example for the world to do business in the right manner. This also opens up a new revenue channel for information services organizations to bring ESG-specific products or augment additional capabilities on existing products leveraging ESG insights. This will in turn, help consumers take the right decision and support the global cause.

About Tata Consultancy Services Ltd (TCS)

Tata Consultancy Services is a purpose-led transformation partner to many of the world’s largest businesses. For more than 50 years, it has been collaborating with clients and communities to build a greater future through innovation and collective knowledge. TCS offers an integrated portfolio of cognitive-powered business, technology, and engineering services and solutions. The company’s 469,000 consultants in 46 countries help empower individuals, enterprises, and societies to build on belief.

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With over two decades of experience, Anjan has played several key roles in TCS, and has been the lead analyst and solution architect for strategic and transformative solutions in the media and information services space.

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His close association with the IT industry spans almost two decades where he has worked across delivery and business relationship management. He is also involved in developing forward-looking strategies and key offerings for information services companies.

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