Why ESG has moved from nice-to-do to must-do

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Investors increasingly care about environmental, social and governance (ESG) factors. Traditionally, we could rely on authorities to take our concerns into account and update the regulatory framework accordingly. But, with political polarisation increasing, this mechanism is coming undone. As a community of companies and investors, the onus is on us to step in and co-operate to develop an ESG structure that works for all of us.

Until recently, community expectations in Western democracies were translated into rules through a bipartisan legislative approach. That meant investors could reasonably expect ESG factors to be incorporated into investment guidelines over time. But that's no longer the case.

Political polarisation is increasing, and community expectations are not being effectively synthesised through the political process. Of course, many issues are partisan, and political impasses around them can reflect genuine disagreements. However, some expectations are either broadly held across the community or rooted in rigorous science and analysis. It's these consensus- and evidence-based expectations which, if they do not flow through political channels, lead to regulatory stagnation.

The investment community is finding it increasingly difficult to have its preferences preserved in regulation, and is seeking alternative routes to achieve that outcome. One way is for large investors to use their clout to influence companies into more ESG-aware behaviours.

The theory of regulation

Economic theory frames regulation in terms of externalities. Companies already efficiently manage what is in their direct interests, but many of their activities create externalities where the benefits of their actions accrue to them, but the costs are paid by the environment and society.

Historically, regulation has been used to force companies to internalise their externalities. Under this framework, companies had to comply with the rules so they could claim they had met community expectations. Importantly, companies only have to meet a threshold to be in compliance; they do not need to go beyond the requirements. This means that the rules must be continually revised and updated to reflect the changing community expectations. When regulations fail to be adequately updated, they stop meeting the needs of the community.

A useful analogy is a 'tragedy of the commons' type scenario. Imagine a park where people enjoy having picnics. Once park-goers finish, they have little incentive to collect their litter, which spoils the enjoyment of other visitors. The park ranger steps in and enforces a rule that everyone pick up their own litter, restoring the satisfaction people derive from the park. However, over time, the park pavilion suffers wear and tear and needs a new coat of paint, while the turf needs resurfacing. If the community cannot get the ranger to update the rules or charge an admission fee to pay for the upkeep, the community's expectations will be unfulfilled and everyone loses out.

In a similar way, what should companies do if regulations are not keeping up with what is in the interests of all stakeholders? They could follow the requirements and go no further in order to maximise profits, but that may prove perilously short-sighted. While companies used to compete with other companies on all fronts, there is now cause for industries to co-ordinate among themselves, if necessary, to achieve outcomes which are mutually beneficial. Competition will always drive some firms to free-ride on the efforts of others, but this does not negate the need to try. If governments are not providing the co-ordinating mechanisms, industry groups may need to fill in the gaps.

The role of investors

Some companies will be slow to adapt to the new reality, but they risk being increasingly shunned by consumers and investors, resulting in a higher cost of capital. Management teams and boards should engage with asset-owners and investment managers to understand what their interpretations of the requirements are.

Investment analysts should cultivate a deep and long-term understanding of the fundamental characteristics of the companies under their coverage, and not exclusively rely on formulaic applications of principles or a narrow perspective from merely speaking with the company.

These two competencies, of companies and investors engaging and intimate familiarity with corporate fundamentals, should complement each other and form the basis of an active ESG approach. The worthwhile prize is that ESG outcomes are achieved for each company, at each point in time. And that's in all of our interests.

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