ESG investing has made little impact on the green energy transition so far. Why is that?

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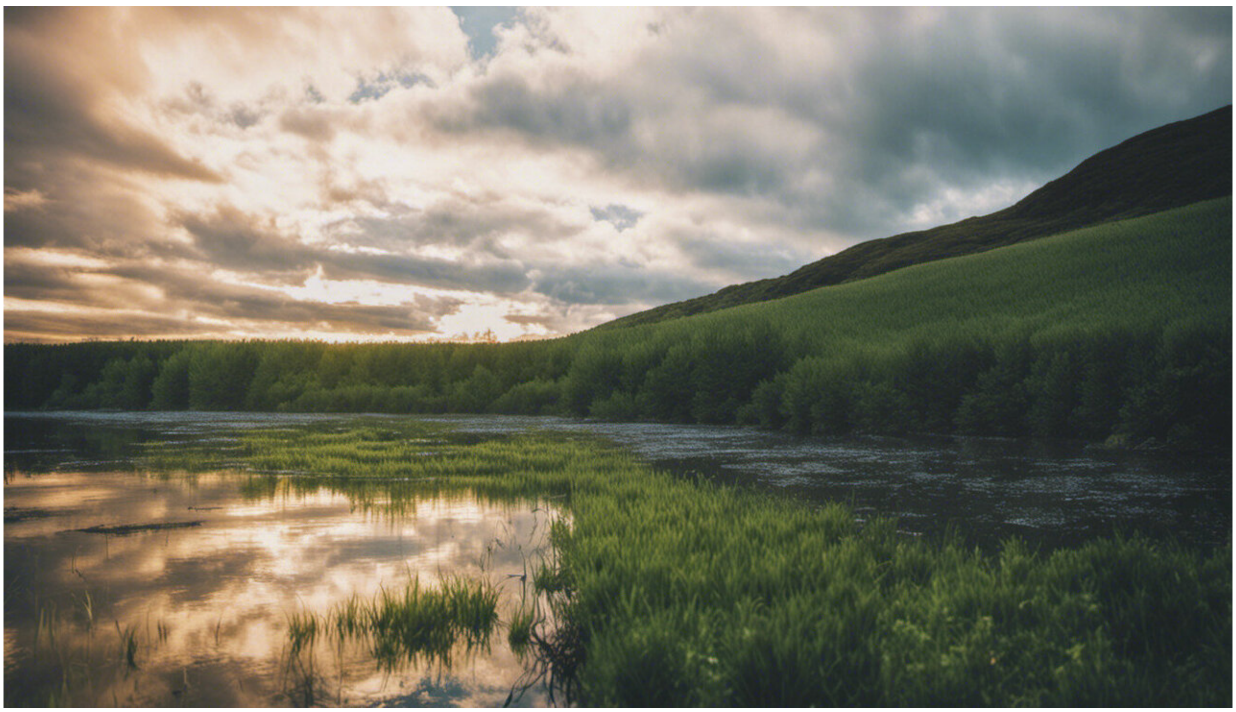

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As the United Nations Intergovernmental Panel on Climate Change ramps up its dire warnings about climate change and its subsequent impact on biodiversity, environment, food and health-care systems, the same reports also point out that we have solutions available in the form of clean, renewable energy.

There are a number of challenges in making the transition. One is carbon lock-in, which refers to the amount of money we have already spent on fossil fuel infrastructure compared to the cost of building new systems, like electric vehicle charging stations.

Other challenges include intermittent renewable energy sources, like solar and wind, because the sun doesn't always shine and the wind doesn't always blow. The challenges of energy storage also loom large.

But beyond these issues is an even more fundamental problem: finance.

Money makes the world go round

All industries and businesses rely fundamentally on finance. Finance is the lubricant that allows markets to work. As we saw during the 2008 financial crisis, when finance dries up, business activity can stall and throw the economy into a recession.

But finance needs regulation to ensure investments, business decisions and contracts are sound. The failure of such regulations contributed to the 2008 crisis. The clean energy transition is now facing a similar problem.

Some governments, such as that of the United States, have already invested in clean energy but our global financial system is still highly dependent on fossil fuels.

The International Monetary Fund estimates subsidies to global fossil fuels amounted to US$5.9 trillion in 2020—approximately seven percent of GDP.

Yet the International Energy Agency estimates that governments only spent US$1.34 trillion on clean energy from 2020 to 2023. We need to spend at least US$5 trillion annually if we want to avoid the worst effects of climate change.

Slow clean energy transition

Why do governments continue to heavily subsidize oil and gas? The answer is simple: they are powerful lobbyists with deep pockets. The top five companies spend at least US$200 million annually to influence governments.

By contrast, green jobs are more plentiful and growing faster, but are not well-organized and are spread across a variety of sectors. In order to combat this, a number of organizations have moved towards fossil fuel disinvestment in response to pressure from activists.

Some organizations are redirecting their funds away from fossil fuels towards so-called ethical investing. Some of the largest private equity firms, like Blackrock, are now involved in sustainable investing.

UBS, a multinational investment bank, has argued that half of all institutional investment—US$60 trillion globally—are purportedly invested in "green and socially responsible stocks." This would include all the large pension funds.

But despite all this activity, the transition toward clean energy from fossil fuels is happening at a sluggish pace. Why?

Pitfalls of ethical investing

Over the past three years, I investigated how investment money managers decide what is ethical when it comes to socially responsible investing.

The results of this investigation, and a broader study of corporate social responsibility reporting systems, are discussed in my new book, The Smoke and Mirrors Game of Global CSR Reporting.

I examined the reporting systems of investment firms like MSCI. These firms sell reports that offer assessments according to the four categories of environmental, social and governance investing, as well as a composite scores and peer ranking by industry.

While the approach seems comprehensive, I decided to take a closer look at these systems. I used [third-party databases] to develop my own database of alleged "killings" or "deaths" associated with companies in the electronics, mining and apparel sectors.

I also conducted case studies of major corporate incidents, such as the Rana Plaza factory disaster in Bangladesh. I anticipated that ethical disasters, like the series of worker suicides that took place in a FoxConn factory in China in 2010, would lead to consequences in the form of ethical investment shifts.

I found that, in some cases, ethical disasters were linked to serious business losses, such as the closing of Barrick's Pascua-Lama mine in Chile after environmental concerns.

However, there were little to no financial consequences for egregious ethical disasters. In some cases, there was a slight temporary dip in stock prices, but nothing substantial.

Financial reporting failures

Upon closer examination of the reporting systems, a number of sources of failure became clear. First, reporting agencies don't reveal their methods for their scores, and their methods changed over time.

Second, since there are at least five different scoring indicator categories, a bad score in one category didn't necessarily result in a bad score in other categories or the composite score.

Third, the few stories and reports about ethical performance were drowned out by the overwhelming amount of financial performance information.

Fourth, since reports are usually done annually, there is no incentive for companies to tackle long-term issues, such as improving working standards or investing in environmental technology.

In fact, no one is paying close attention to conditions on the ground. Reports are based on a few news aggregators, such as the Factiva research platform that captures a lot of events but doesn't analyze the sources or solutions to complex problems.

These, and other issues, explain why socially responsible investment has made such little impact on the green energy transition. There is minimal accountability for corporations that violate their ethical commitments.

Towards genuine ethical investing

It's clear fund managers—including those that oversee pension funds—don't have the necessary information systems to make ethical investment decisions. Nor do they face any pressure to go beyond avoiding scandals and prioritizing short-term returns on investment, regardless of the consequences to our health or the planet.

Anyone with a pension should carefully review their investment portfolios to ensure their funds are truly being invested ethically. Most investors take it for granted that the stated ethical principles are being upheld, when in reality they are merely grandiose gestures.

In fact, there's a good chance investment funds labeled as "ethical" are associated with companies that have climate change, labor or environmental issues.

We should pressure our money managers to shift their portfolios based on neutral party, in depth reporting of company behavior. This will force organizations to make genuine ethical choices that will benefit everyone in the long run.

If enough of us start paying attention, we can collectively use our financial and consumer leverage to change the world into a more ethical place and avoid climate disaster.

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