



Rethinking environmental, social, and governance (ESG) investing for successful sustainability and human rights

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Abstract: Addressing the climate emergency and pressing sustainability issues requires rethinking the way in which the economy operates. Directing capital toward sustainable initiatives and divesting from harmful ones are key to building resilience for future generations. However, are ESG investments capable to fulfil these objectives under the current format?

The term 'ESG' originates from a [UN report](#) issued in 2004, referring to business strategies promoting a 'better inclusion of environmental, social, and corporate governance (ESG) factors in investment decisions'. It is clear that this sustainable perspective is directly linked to a human rights-based approach to the issue of economic growth and development, given that human rights considerations are an integral part of a green and just transition. Indeed, the '[Leaving No One Behind](#)' principle of the 2030 Agenda requires *inter alia* that states respect the

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economic and social rights of all people throughout their efforts towards reversing climate change.

The 'S' factor of the ESG framework, referring to 'social' factors, encompasses precisely the human rights assessments that investors need to conduct prior to investing in specific companies. It is usually done under the format of a human rights due diligence ([HRDD](#)) process that seeks to evaluate a company's compliance with human rights standards, not without obstacles as demonstrated later on. Currently, there is a mounting interest among investors and companies regarding ESG considerations, while ESG assets [exceeded](#) 41 trillion dollars at the end of 2022, and 'ESG' is cited more and more during companies' [earning calls](#). Nevertheless, the popularity of ESG investing also reveals its weaknesses. Almost two decades after the birth of this concept, it seems that, under the present conditions, it cannot efficiently finance sustainable development for a number of reasons that will be addressed below, laying out the necessary changes that will take ESG investing out of its current deadlock.

The issues of ESG investing under its current format

One of the main issues of ESG investing relates to the question of who benefits from it, as ESG considerations usually follow a business-centred approach which focuses on the impact of ESG crises on the corporations' revenues rather than the other way around. Indeed, the 'financial materiality' of ESG factors (being the impact of those factors on the financial performance of a company) is the core of sustainable investing, another way of cost minimisation - or reversely profit maximisation - for shareholders. By way of illustration, a [survey](#) conducted by Callan Institute in 2021 demonstrated that US institutional managers do not invest in ESG strategies because they are not convinced about their connection to financial performance or because the benefits of doing so are unclear. This reveals how making an ESG impact remains secondary to profitability. In addition, some companies have tried to take advantage of the increasing interest in ESG investing, attempting to attract investors by distorting their sustainability practices. Incidents of green or social washing hinder the effectiveness of ESG investing, as they occur in [more than half](#) of the companies claiming to promote sustainability. In the European context, the very recent ESG controversy regarding DWS's (German asset management company) allegedly [misleading statements](#) about the greenness of its investments in its 2020 annual report, raises serious questions about the investors' motivations in a field characterised by insufficient regulation.

The inadequacy of ESG investing, in its current form, to finance sustainable development is further connected to the lack of reliable data regarding companies' ESG performance. According to a [survey](#), 72 percent of corporate executives from different countries and industries reported that they lack confidence in their own ESG reporting. If we compare this extensive mistrust with the high number of companies claiming sustainability, we notice a clear

misalignment, something partly explained by the [enormous variation](#) of ESG data providers. Even more worrisome is that the correlation between the scores of different ESG data providers is gauged at 0.54, which is seen as very low [compared](#) to the 0.99 correlation between scores of credit rating agencies. With no external benchmarking, licensing, auditing, or certification system, companies are allowed to cherry-pick the ratings that present a more favourable image of their ESG practices, while crucial questions pertaining to the number or nature of the measured ESG factors, their grouping, the used indicators, or the applied weights for each factor, remain unclear to ESG investors.

The way forward

As it seems that ESG investing is conducted in an environment without externally established standards, the only realistic solution would be stricter government regulation. However, given that policymakers often experience difficulties in agreeing on what should be enforced, and keeping in mind that they do not possess the [90 trillion needed](#) for addressing climate action, excluding other ESG factors, it is apparent that private investors are needed on board, with the use of a smart mix of carrots and sticks.

Nonetheless, regulatory action is deemed a necessary component of the way forward. A good regional example that advances accountability is the recent European Central Bank (ECB) [disclosure](#) that, if necessary, it will enforce measures against European banks failing to identify climate risks in their investment decision-making with specific deadlines and targets that will be monitored (with 2023 being the first milestone). Investigation of misleading ESG statements, such as the ones allegedly issued by the DWS, and adequate fines are also indispensable for regulation. Finally, linking executives' salaries to demonstrated ESG results, as [suggested by the UN](#) regarding climate action, is an option to be explored and a strong incentive for taking into account environmental issues when making a corporate or investment decision.

Regarding data reliability, efforts should be made to standardise corporate reporting, methodologies, measurements, and reported items. ESG rating agencies should be registered and certified. In this context, the EU taxonomy, envisaged in the [European Green Deal](#), is a good starting point to conceptualise what is good ESG performance and set regional benchmarks. [Studies](#) have shown that currently only 2.8 percent of investors' portfolios are aligned with the green taxonomy, something that has raised questions about the usefulness of the new instrument. However, this percentage might just reveal the size of greenwashing, proving that when portfolios are assessed with standardised criteria, self-reported sustainability is far from reality.

Nevertheless, the EU taxonomy could be further improved by paying equal attention to the 'S' and the 'G' of the ESG. For instance, although there have been some [developments](#) towards establishing a social component (relating to human rights) of the taxonomy, progress has been halted mainly [because of the energy](#)

[crisis](#) triggered by the war in Ukraine. The EU taxonomy [regulation](#) addresses only environmental impacts, while social considerations can only be made with combined interpretation of articles 3 and 18 about general 'minimum safeguards'. Therefore, a bolder approach is needed for making investors and companies assess social and governance risks too.

Last but not least, a paradigm shift from the binary division between financial and non-financial reports is necessary. Integrating reliable ESG data into mainstream financial reporting, instead of simply using a performance ranking based on a set of subjective criteria, will lead to the monetisation of ESG performance, with both companies and investors being able to measure the financial value of a business's positive and negative [externalities](#). This could serve as a significant incentive for investors to boost ESG financing, as they realise the links between good ESG practices and greater financial value.

Conclusion

It is true that ESG financing is often balancing between contradictory interests, those of shareholders who prioritise the maximisation of profit and those of stakeholders (such as employees, suppliers, communities, and civil society) who want ESG factors to be central in all investment decisions.

A smart mix of carrots and sticks is needed in order to achieve reconciliation, requiring targeted state intervention, while also relying on engagement with investors and companies with the provision of the right incentives. Most importantly, we need to move from a 'tell me' to a 'show me' approach when it comes to corporations reporting on ESG, meaning that reliable, standardised data should inform any sustainable investment decision.

States must use the COVID-19 crisis and their recovery practices which involve redirecting capital to build resilience, as an opportunity to rethink sustainable financing with a view to respond to imminent crises. In the end, ESG is neither a tick box nor the end goal, but a long journey that must become an integral part of any decision related to sustainable financing.

By doing so, sustainable investing will contribute to the European Union's objective for an '[economy that works for people](#)' and to the United Nations Office of the High Commissioner for Human Rights initiative for a [human rights enhancing economy](#) which is to guarantee a human rights-based approach to macroeconomic policies.