RESEARCH NOTE: ESG INVESTING MUST 'DO NO HARM' TO DEVELOPING COUNTRIES

August 2023

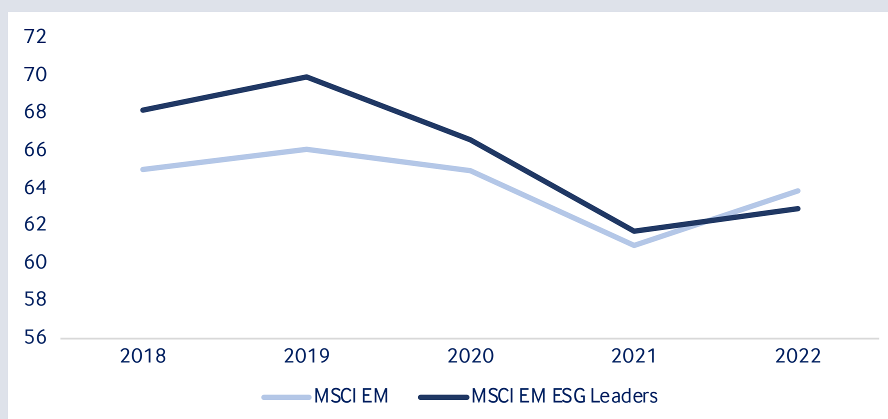
SUMMARY

- **MOBILIST research finds that the mainstreaming of environmental, social, and governance (ESG) considerations can divert capital from emerging market and developing economies (EMDEs).**
- **This potential capital diversion is caused by data scarcity, data bias, and increasingly stringent ESG regulations in developed market jurisdictions.**
- **EMDEs are responding with tailored ESG frameworks that emphasise 'transition' – scoring progress regarding the journey, not only the destination.**
- **The ESG paradigm must itself 'do no harm' by impeding sustainable development in EMDEs. Developed market and global standard setters must work with EMDEs to develop interoperable ESG policies and regulation and to build capacity where required.**

CONTEXT

The mainstreaming of environmental, social, and governance (ESG) considerations can divert capital from emerging market and developing economies (EMDEs). According to MOBILIST-funded research by BMI (previously Fitch Solutions[1]), EMDEs' collective weight in ESG-focused indices has fallen more significantly than their weight in mainstream benchmarks, suggesting ESG screens may be a contributing factor to the decline of the former. Figure 1 demonstrates this dynamic by comparing middle-income countries' combined weight in MSCI's mainstream Emerging Markets Index with their weight in MSCI's Emerging Markets ESG Leaders Index. Middle-income countries' share in the ESG index was 5 ppts greater in 2018 but had declined steeply to a weight that was 2 ppts smaller than in mainstream Emerging Markets Index by 2022.

Figure 1 – MSCI EM and ESG Leaders Equity Index - % allocation to lower- and upper-middle income economies

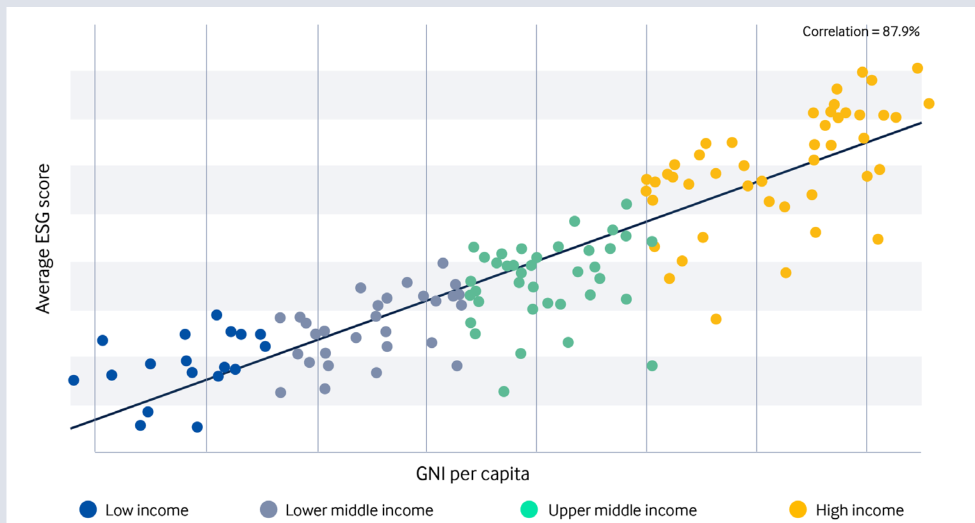


1 https://www.mobilistglobal.com/research-data/resetting-the-esg-investment-paradigm-to-support-emerging-markets-developing-economies/

This potential capital diversion is partly driven by data scarcity, data bias, and the use of backwards-looking metrics. ESG data available from multilateral sources and proprietary ESG data providers is weaker and lower quality among EMDEs, particularly in smaller markets and among smaller firms. When corporate data is unavailable, allocators often resort to using Sovereign ESG data that is highly correlated with a country's income level. This substitution and correlation mean that companies can be penalised for operating from EMDEs, regardless of their performance on ESG issues.

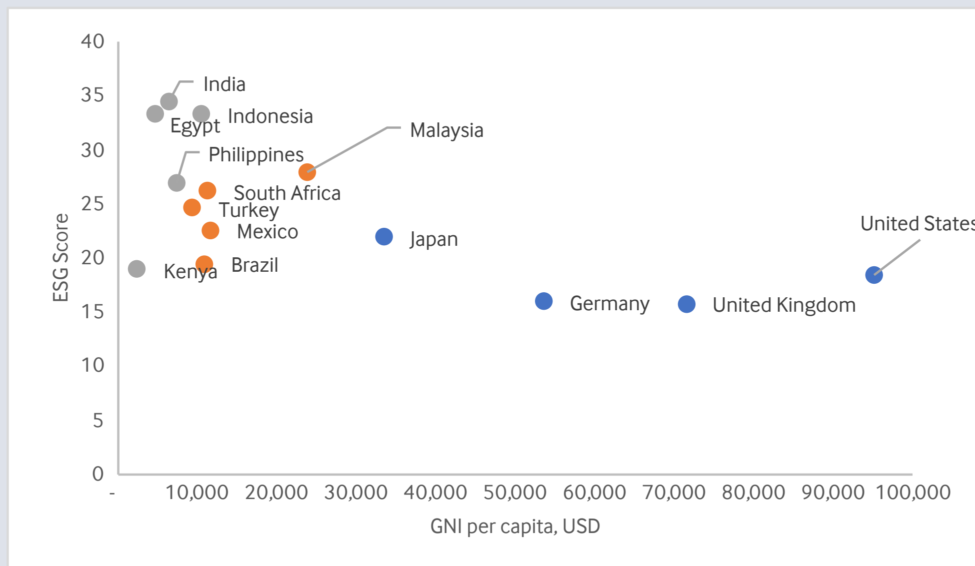
Figure 2 illustrates this correlation, while Figure 3 demonstrates a similar relationship at the corporate level. The telecommunications sector clearly illustrates the correlation between corporate ESG scores and GNI per capita, as companies in this sector have similar core business operations across countries. Data issues are further exacerbated by prevalent ESG metrics, often focusing on historic ESG performance and failing to capture a country or company's ESG transition or journey.

Figure 2 – Sovereign ESG scores and GNI Per Capita



Note: Sovereign ESG scores for each country are an average of seven ratings providers. Source: World Bank, JP Morgan[2]

Figure 3 – Telecoms corporate ESG Scores and GNI Per Capita



Source: Sustainalytics, World Bank, Fitch Solutions
Note: see Annex Table 2 for ESG scores for individual telecoms operators. The higher the score on the y-axis, the higher the ESG risk, and the lower the score, the lower the ESG risk.

2 A New Dawn – Rethinking Sovereign ESG, World Bank & JP Morgan, 2021

EMDEs' challenges with ESG data and metrics are set to deepen as advanced economy (AE) regulation around ESG is strengthened to protect investors from 'greenwash-ing'. During 2021-2026, the European Union (EU), the United States (US), and the United Kingdom (UK) expect to reach at least 15 major regulatory milestones related to ESG. More stringent ESG reporting requirements are likely to increase compliance risk for asset managers and non-financial firms investing in (and trading with) EMDEs with limited ESG data disclosures or weak scores. For example, should the US Securities and Exchange Commission (SEC) require Scope 3 GHG emission reporting for global supply chains, as is currently proposed, US firms will be incrementally disincentivised to trade with firms that lack this data. Such firms are more prevalent in EMDEs.

In this context, EMDEs are responding by adopting AE norms and standards, developing tailored ESG disclosure frameworks, and with a range of initiatives to enhance data availability. For example, the ASEAN Taxonomy for Sustainable Finance is broadly aligned with the EU Taxonomy but uses a multi-tiered approach to classify the sustainability of an activity instead of the EU's binary sustainable/non-sustainable approach. The ASEAN Taxonomy uses a traffic-light system that allows for transitional 'amber' activities, such as natural gas power generation. These tailored approaches suit regional blocs with adequate internal scale but present the risk of fragmentation when taxonomies are misaligned.

Most fundamentally, the very definition of ESG remains contested. The International Financial Reporting Standards (IFRS) considers ESG analysis to be that which assesses the materiality of ESG factors on a company's enterprise value. This differs from the broader idea of 'sustainability' more prevalent in the EU, which also considers a company's impact on external stakeholders. In the US, a risk-based approach is more frequently applied, with a particular focus on ESG risks to companies' and investors' reputations. The International Sustainability Standards Board (ISSB) offers a critical platform to ensure global standards are based on a shared understanding of the objectives of ESG mainstreaming and consider EMDE perspectives equally to prevent the above-mentioned biases from being locked into regulation over the long term.

POLICY IMPLICATIONS

MOBILIST takes its lead on ESG from frontier managers in the market. These managers look beyond short-term reputational risk management, regulatory disclosures, and third-party data to holistically assess the long-term financial materiality of ESG considerations alongside other factors. This approach is not impact investing but is driven instead by the recognition that effective corporate stewardship and stakeholder management are essential to commercial success in EMDEs. This has allowed successful managers to uncover and capitalise on market inefficiencies they would have missed when using a blunt negative ESG risk screen.

We also encourage AE policymakers and global standard setters to fully consider the impact of their decisions on capital flows to EMDEs. The most effective approach will be to proceed in full partnership, including through the ISSB and the International Organisation of Securities Commissions (IOSCO), through collaboration between regional AE and EMDE blocs, and through bilateral initiatives to enhance interoperability between AE and EMDE approaches to ESG. Where necessary, EMDEs should be supported to engage in these forums to ensure that they are makers and not only takers of ESG policy and regulation.

A particular emphasis should be placed on transition planning and management. Progress on ESG is a continuous journey – no company or country has reached perfection by any measure, nor can they. EMDE companies should be incentivised to make ambitious commitments within the context of their sector, market, and stage of development and must be rewarded for delivery against these plans. Transition planning is increasingly prominent in both AE and EMDE regulations and should be central to global norms.

MOBILIST will continue to advocate for an ESG paradigm that does no harm to EMDEs and is anchored in their individual and collective interest to maximise capital flows for sustainable development.