ESG – How stock exchanges are accentuating positive change

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Capital markets are playing an integral role in facilitating the move towards net zero. FMIs (financial market infrastructures) such as SIX, operator of the Swiss stock exchange, are using their unique position in the market to support this transition.

1. ESG is here to stay

A failure to meet climate targets risks plunging not just our capital markets – but the entire human habitat – into an existential and potentially irreversible crisis. Having recognised the scale and urgency of the problem, governments around the world are passing legislation which requires companies to publish information detailing their ESG (environmental, social, governance) policies and practices.

Governments are also providing subsidies to institutions and corporates which pursue sustainable objectives, and are imposing punitive costs on behaviours and activities which are not considered helpful to the climate change cause. A recent example is the EU, which moved to further cut emission allowances, expand carbon fees on additional sectors, impose carbon fees on imports, and ban the import of deforestation-linked goods. And this trend of pro-sustainability market interventions is expected to accelerate. In the article «A new world order seeks to prioritise security and climate change» published on 11 May 2023, The Economist observed that «After the cold war, America and Europe established an economic order based upon markets … and limited state meddling in the economy … Not anymore. Policymakers on both sides of the Atlantic have come to the conclusion that national security and climate change must now come first.»

Additionally, regulators are taking a harder line against greenwashing, by imposing fines on asset managers for poor business practices – including misdemeanours such as mis-labelling their investment products as being sustainability-compliant.

But it is not solely governments who are engaging with sustainability. Increasingly, investors are taking note too, and are incorporating ESG data into their investment decisions. This is evidenced by the strong flows we are seeing into ESG investment products. According to PwC, ESG assets could account for 21.5% of all global AuM (assets under management) – or $33.9 trillion – by as early as 2026.[1]

2. To reach critical scale and impact – the returns need to be there

The topic of sustainability, and thus ESG data, are here to stay. But to successfully transition to a more sustainable economy, it is not enough for sustainability to stay in the spotlight. Success requires that a large number of pro-sustainability projects be undertaken. If net zero targets are to be met, McKinsey believes projects costing around $9.2 trillion will be required each year until 2050 to fund climate-change mitigating projects – 60% more than what is currently being deployed.[2]

Most of these projects will have to be undertaken – and funded – by the private sector. Clearly, this is primarily a call for action from companies. But financial markets can have a decisive influence on which projects are carried out. By shaping the behaviour of companies, investors and shareholders can drive positive change.

So what is needed for investors to support pro-sustainability projects? A study by PwC found that while 27% of investors would be willing to accept a lower rate of return on having exposure to a company whose activities have a positive impact on society or the environment.[3] This is a slight drop from 2021 when 34% of investors told PwC that they would compromise on returns in exchange for a societal or environmental benefit.[4] And a closer look a the data reveals that the relevant number is likely much lower because 81% of investors say that they would not accept either any reduction in returns or would tolerate a drop of 1% or less.

In other words, the vast majority of investors oppose pro-sustainability projects – unless these projects positively affect the company's bottom line.

3. Exchanges can accelerate positive change by enhancing capital-market efficiency

The acceleration of pro-sustainability market interventions suggests that we can expect sustainability improvements will increasingly have a positive effect on profitability in the future. This means we can expect to see more investors back sustainability improvements. This is why we believe that stock exchanges can support the transition to a more sustainable economy by reducing two types of capital market inefficiencies that hinder optimal capital deployment towards sustainability.

First, exchanges can leverage their position to reduce costs for issuers and investors by providing economies of scale/scope. If tasks require less OPEX/CAPEX to complete, capital is released which can be used productively elsewhere – for example, to finance more sustainability improvements. Reducing costs related to data may additionally increase transparency, allowing investors to make better-informed decisions. Minimising the costs related to the collection, review, reporting, and dissemination of data may indeed encourage companies to make more ESG information available as well.

ESG-data-related costs are substantial. An analysis by the Sustainability Institute shows that US corporations spent on average $530,000 each year on climate related reporting, while climate related data costs the average institutional investor around $1.37 million per annum. This means that even a small percentage reduction in the costs related to the collection, verification, disclosure, acquisition, or usage of ESG data would enable significant amounts of capital to be used more effectively. This is why SIX Swiss Exchange provides reporting guidance aimed at clarifying the regulatory disclosure requirements and offers insights on investor expectations.

1 PWC, Asset and wealth management revolution 2022: Exponential expectations for ESG (October 2022).
2 McKinsey – The Net Zero Transition.
3 PWC Global Investor Survey 2022.
4 PWC Global Investor Survey 2021.

Second, exchanges can also help drive capital towards pro-sustainability activities by improving transparency which allows investors to make better-informed decisions by facilitating the detection of the highest-potential sustainability improvements. By providing investors with the relevant ESG information, stock exchanges play a crucial role in facilitating the detection of the highest-potential sustainability improvements. To name just one example: SIX Swiss Exchanges has created a set-up to provide investors with information on green bonds and on other bonds with a strong link to sustainability.

4. Harmonised standards and transparency cannot be compromised on

The lack of harmonisation between disclosures is a key issue facing ESG data. Today, there are dozens of different ESG standards which makes investing and reporting both complicated and costly. The same applies to ratings agencies and other ESG data providers, which often use tailored methodologies when assigning ESG ratings to issuers. The scores bestowed by the different ratings agencies – even to the same companies – are rarely consistent, which creates further complications for investors.

Although widely-perceived as the most objective ESG data points, the lack of harmonisation even plagues the reporting of Greenhouse gas (GHG) emissions. The GHG protocol left a significant amount of discretion in how companies estimate their emissions – because the goal was to track inter-temporal progress of individual companies. This, however, can lead to substantial differences in total emissions, especially at a Scope 3 level which includes both upstream and downstream variables. [5]

This lack of standardisation not only consumes substantial resources at companies, but it also prevents investors from making proper comparisons between companies.

A homogenous approach to ESG standards and data would therefore allow more capital to be directed towards sustainability improvements, and even help capital to flow towards better improvements. This is why a key pillar of the sustainability strategy of SIX Swiss Exchange is to support the harmonisation of disclosures through its membership of various industry groups.

5. A driving force for positive change

As a leading European FMI, SIX and the stock exchanges it operates can leverage the listing, trading, clearing, settlement and custody infrastructure to accelerate positive change by reducing the sustainability-related capital market inefficiencies that impede optimal capital allocation across the economy. Tackling the challenges facing the ESG-data market is an absolute priority, in order to drive investment into this segment.

5 SRN – October 29, 2022 – Designing for comparability: A foundational principle of analysis missing in carbon reporting systems.