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IMPACT OF THE COMPANY'S DEGREE OF ENVIRONMENTAL, SOCIAL AND CORPORATE GOVERNANCE (ESG) ON THE COST OF ITS SOURCES OF FINANCING

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This article is devoted to the impact of ESG on the cost of sources of corporate finance. The topic of the article is relevant, as the world is moving to ESG investing, reflecting a growing sentiment about how ESG considerations can affect portfolios and individual securities. ESG investing is a form of socially responsible investing that prioritizes financial returns as well as a company's impact on the environment, its stakeholders and the planet. The authors have highlighted in detail the criteria used to assess companies for ESG investing and the various issues covered by these. The article gives a brief history of ESG and how it has evolved over time. It also notes different tools used to help with sustainable investing. And at the end, the authors present an ESG rating and how scores can vary between companies, which may use different measures and weighting systems.

Keywords: *ESG investing; green bond; ETF fund; sustainable investing; ESG ratings*

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ВЛИЯНИЕ СТЕПЕНИ ЭКОЛОГИЧЕСКОЙ, СОЦИАЛЬНОЙ И КОРПОРАТИВНОЙ ОТВЕТСТВЕННОСТИ КОМПАНИИ НА СТОИМОСТЬ ЕЕ ИСТОЧНИКОВ ФИНАНСИРОВАНИЯ

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Данная статья посвящена влиянию ESG на стоимость источников корпоративного финансирования. Тема статьи актуальна, поскольку мир пе-

реходит к инвестированию в ESG, отражая растущее мнение о том, как соображения ESG могут повлиять на портфели и отдельные ценные бумаги. ESG-инвестирование – это форма социально ответственного инвестирования, при которой приоритет отдается финансовой отдаче, а также влиянию компании на окружающую среду, ее заинтересованных лиц и планету. Авторы подробно осветили критерии, используемые для оценки компаний для инвестирования в ESG, и различные вопросы, охватываемые ими. В статье дается краткая история ESG и то, как стратегия развивалась с течением времени. Также отмечаются различные инструменты, используемые для содействия устойчивому инвестированию. И в конце авторы представляют рейтинг ESG и то, как оценки могут варьироваться в зависимости от компаний, которые могут использовать разные меры и системы взвешивания.

Ключевые слова: *ESG финансирование; зеленые облигации; фонд ETF; устойчивое инвестирование; рейтинги ESG*

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Investing can help us achieve goals that go beyond monetary returns. Today, the world is faced with challenges that are rapidly eroding the sustainability of our way of life. Our increasing and inefficient use of resources has knock-on effects including climate change (global warming from fossil fuels due to greenhouse emissions), loss of biodiversity, pollution, poor healthcare and bad decision-making. All these issues are interlinked and in turn often exacerbate each other. The scale of the environmental/social/governance challenge is enormous.

Different forms of sustainable finance have grown rapidly. With the adoption of sustainability goals in everyday, corporate culture has grown significantly in recent years, but relates to the wider relationship between the organization, its key stakeholder groups and the community. A growing number of institutional investors and funds now incorporate various (ESG) investing approaches. Investors increasingly consider (ESG) factors when selecting and managing investments in terms of trying to make their operations more environmentally friendly, trying to help their communities, and trying to have good corporate governance.

ESG investing is a form of sustainable investing that considers environmental, social and governance factors to evaluate a company's performance when considering potential investments, and its overall impact. (ESG) Investing has grown rapidly over the past decade. This growth has been spurred by shifts in demand from across the finance ecosystem, driven both by the search for better long-term financial value, and a pursuit of better alignment with values.

ESG investing is often used synonymously with other investing terms such as:

- Sustainable Investing (SI) – a range of practices in which investors aim to achieve financial returns while promoting long-term environmental or social value. An investment's sustainability impact is evaluated using ESG factors.
- Responsible Investing (RI) – involves considering environmental, social and governance (ESG) issues when making investment decisions and influencing companies or assets to help better manage risk and generate sustainable long-term returns.
- Socially responsible investing (SRI) – an investment approach that aims to simultaneously achieve environmental and social goals, as well as financial goals.

Each of these terms (ESG, SI, RI, SRI) are unique. However, they refer to the same idea of including nonfinancial factors alongside financial factors when choosing and managing investments.

ESG investing covers different issues that apply to all industries and organizations in one way or another. The three criteria used to evaluate companies for ESG investing:

Environmental

This component generally includes a company's energy usage, pollution and waste, and use of natural resources. Organizations' efforts to mitigate climate change and other environmental disasters such as biodiversity loss.

Social

It correlates to a firm's impact on society and stakeholders in the company. Different issues took into account here are: human rights issues within an organization's supply chain, the safety of a firm's products, labor standards, impact on local communities, and employee diversity.

Governance

Is the internal system of practices (leadership effectiveness and business ethics), controls, and procedures a company adopts in order to govern itself, make effective decisions, comply with the law, and meet the needs of external stakeholders. Some popular metrics include board diversity, accounting policies, executive compensation, shareholder rights and overall ethical behavior.

The ideas behind the term ESG investing go back a long way. Thinkers and economists have warned of the dangers of environmental damage or the social ills caused by certain products or business practices for many centuries, including the theologian John Wesley (The Use of Money, 1744) and the economist Adam Smith (The Wealth of Nations, 1776). The practice of ESG investing began in the 1960s as socially responsible investing (SRI), during this period, there was an ongoing civil rights movement and protest, and boycott of companies involved in or in support of the Vietnam war. The first sustainable investing mutual fund launched in 1971 and it focused on the exclusion of certain companies due to ethical considerations. Throughout the 1980s, the concept continues to accelerate, ESG investing helped dismantle apartheid in South Africa, as the investment decisions of institutions such as churches, universities, cities and states during this period forced many American companies out of South Africa, causing serious economic instability in the country.

But the modern concept of ESG, which we're so familiar with today, was used first in a 2004 report from the United Nations titled "Who Cares Wins", which was a joint initiative of financial institutions, encouraging them to embrace ESG long-term. The focus of the report is a series of recommendations, targeting different financial sector actors (managers, directors, investors, analysts, brokers), which taken together seek to address the central issue of integrating ESG value drivers into financial market research, analysis and investment. "A better inclusion of environmental, social and corporate governance (ESG) factors in investment decisions will ultimately contribute to more stable and predictable markets, which is in the interest of all market actors". "Who cares win – connecting financial markets to a changing world", UN Global Compact, 2004.

In 2015, with the Paris Agreement (COP 21), we saw the rise of sustainable Investing. It has bolstered companies' recognition that improving their ESG performance will make them better corporate citizens. As a result, investors are seeking out companies that prioritize the Paris Agreement's objectives in the context of their ESG concerns and climate change actions.

The COVID-19 pandemic encouraged this trend notably. Market turbulence and uncertainty caused by the COVID-19 pandemic led many investors to turn to ESG funds for increased resiliency. Many companies with strong ESG track records showed lower volatility than their non-ESG counterparts. A perfect storm created by the pandemic and the green recovery in countries like the U.S, EU and China will likely reveal how ESG can help assess a new set of financial risks and harness capital markets.

ESG investing is based on the assumption that ESG factors have financial relevance. Today, ESG investing is estimated at over $20 trillion in AUM, roughly a quarter of all professionally managed assets globally. Asset managers globally are expected to increase their ESG-related assets under management (AuM) to US$33.9tn by 2026, from $18.4 trillion in 2021. Many asset managers (nine out of ten, according to a survey) believe that investments that consider sustainable metrics can help clients pursue long-term success in their portfolio and will improve overall returns. A majority of institutional investors, 60%, reported that ESG investing has already resulted in higher performance yields, compared to non-ESG equivalents.

Despite the rapid rise of this global phenomenon, various issues still need to be addressed as regulators and investor behavior have yet to fully shape ESG investment standards. Even though ESG is not new, it is still very new in the way Wall Street regulates it (with a lack of both standardization and regulation). A global report by S&P identified $8.4 trillion in investment assets in the United States at the start of 2022 held by companies that consider environmental, social and governance issues in their decisions. That was a steep drop from the last assessment in 2020, which recorded $17.1 trillion in ESG assets under management.

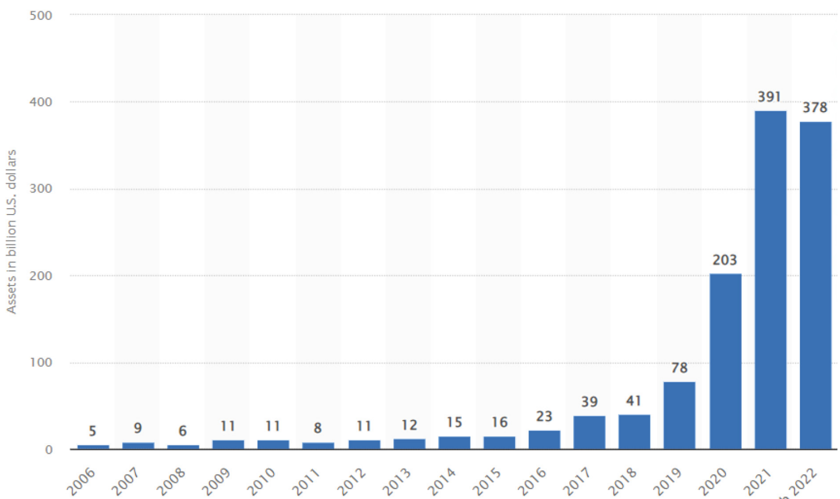
ESG bonds refer to any bond with set environmental, social, or governance objectives. This can include everything from affordable housing to improved infrastructure, reduction of racial or gender inequity, or renewable energy. Broadly, there are four types of ESG bonds (green, social, sustainability and sustainability-linked). Sustainable finance has become crucial to initiatives on reducing the devastating effects of the climate crisis. One of its most revered instruments are green bonds.

Green bonds are a subset of ESG bonds (debt instrument) issued by any sovereign entity, inter-governmental groups or alliances and corporates with the aim that the proceeds of the bonds are utilized for projects classified as environmentally sustainable. They use to finance projects that help reduce the effects of climate change or protect the environment (eco-friendly projects). Green bonds can finance sustainable mobility, energy efficiency, pollution prevention and control, sustainable infrastructure, waste management and so on.

The European Investment Bank (EIB) issued the first green bonds in 2007 in what was a giant leap towards building a responsible banking industry. The World Bank issued its first green bond in 2008. And since then, it has issued approximately $18 billion equivalent in green bonds across more than 200 bonds in 25 currencies, making it the largest issuer of green bonds.

Sustainability bonds are issues where proceeds are used to finance or re-finance a combination of green and social projects or activities.

In light of growing demand, the finance industry is creating more products and services related to ESG ratings, indices, and funds. ETFs or “exchange-traded funds” are a type of investment fund and exchange-traded product, i.e., they are traded on stock exchanges. ESG exchange-traded funds (ETFs) are ETFs that incorporate environmental, social, and corporate governance considerations into their investment approach. ESG ETF strategies saw record inflows for the first time in 2020, during the COVID-19 pandemic, driven by demand from asset owners looking to increase ESG integration and transparency in their portfolios. The value of assets allocated to ESG ETF funds increased markedly from five billion U.S. dollars in 2006 to 391 billion U.S. dollars in 2021. As of February 2022, allocated assets reached 378 billion U.S. dollars. Investment in sustainable funds, including ETFs, was primarily driven by developed markets mainly in Europe and the United States.



Pic. 1. Global ESG ETF assets

Launched in November 2021 on the New York Stock Exchange, the Schwab Ariel ESG ETF (SAEF) is the firm’s first ESG ETF and first actively managed ETF.

Several financial firms have come out with ESG ratings and scoring systems in recent years. ESG ratings can provide insight into a company’s long-term performance. It commonly reviews things like annual reports, corporate sustainability measures, resource/employee/financial management, board structure and compensation, and even controversial weapons screenings.

Table 1.

The Best ESG Funds of February 2023 ***(according to forbes)***

Index	Description
Vanguard FTSE Social Index Fund (VFTAX)	It tracks the FTSE4Good US Select Index. This index excludes companies dealing in what it calls vice products (adult entertainment, alcohol, gambling, tobacco), non-renewable energy (nuclear power, fossil fuels) and weapons (civilian firearms, controversial military weapons, conventional military weapons). It has reported a -16.7% one-year return, a 8.96% three-year return.
iShares MSCI USA ESG Select ETF (SUSA)	This index uses three MSCI ESG Research products to construct its portfolio: MSCI ESG Ratings, MSC ESG Controversies Score, and MSCI ESG Business Involvement Screening Research. It has yielded an 11.1% three-year return, 13.0% ten-year return.
Parnassus Core Equity Investor (PRBLX)	It is an actively managed fund. It does not invest in companies that derive “significant revenues” from the manufacture of alcohol or tobacco products, weapons, direct involvement in gambling, or generation of electricity from nuclear power. It recorded a 11.5% five-year return, and a 13.0% ten-year return.
iShares Global Clean Energy ETF (ICLN)	This index consists of 30 companies from around the world involved in “clean energy-related businesses, comprising a diversified mix of clean energy production and clean energy equipment and technology companies.” It posted a 6.71% one-year return, a 21.45% three-year return, and a 18.66% five-year return.
Shelton Green Alpha Fund (NEXTX)	it selects green economy companies that fund management believes work “to improve human well-being and increase economic efficiencies, while significantly reducing environmental risks and ecological scarcities.” It reported a 22.1% three-year return, a 16.0% five-year return.

Using ESG factors to steer investment decisions is now becoming much more widely accepted, because ESG risks, such as unsafe working conditions, lack of board independence, energy dependence, or questionable accounting practices can have serious financial consequences.

ESG scores represent ratings that research firms assign to individual companies. Scores generally follow a 100-point scale: the higher the score, the better a company performs in fulfilling different ESG criteria and the lower the total risk. Scores may vary among firms, which may employ different metrics and weighting schemes. Bloomberg, S&P Dow Jones Indices, JUST Capital, MSCI and Refinitiv are a few of the most well-regarded ESG research companies. The MSCI USA, which is one of the most widely used ESG rating systems, measures risk across industry-specific issues, which are weighted by potential impact. The industry-specific scores and weighted scores are combined to give each company a score between 0 and 10 and are then converted into letter grades from CCC to AAA.

ESG criteria and ratings can differ from company to company, so it's not an exact science when it comes to comparisons. ESG methodologies are improving and becoming more transparent, but scoring remains in a state of transition. Some rating providers still in the way of refining their methodology through the inclusion of factors such as materiality. There is a range of scoring methodologies in terms of determining which data to analyze and include, metrics weighting, materiality and how to consider missing information.

Table 2.

ESG World Ranking *(according to Refinitiv)*

Company	Country	industry	Management assessment
International Business Machines Corp	United States of America	Software & IT Services	97.76
SAP SE	Germany	Software & IT Services	97.6
Tata Consultancy Services Ltd	India	Software & IT Services	97.52
Microsoft Corp	United States of America	Software & IT Services	97.4
Johnson & Johnson	United States of America	Pharmaceuticals & Medical Research	97.21

Conclusion

With its exponential growth, ESG now impacts almost every organization. Experts claimed that financial firms worldwide would have "no choice" but to embrace it. Numerous central banks in advanced and emerging market economies have committed to integrate ESG assessment and investing practices into some of their responsibilities, such as reserve management and supervisory practices including stress tests.

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