Sustainability: Re-defining environmental, social and governance investments, digital finance

Jan 31 2019 Denisse V. Rudich

The author was recently given a brief to speak about market-driven environmental, social and governance factors and financial crime at the Financial Conduct Authority's (FCA) senior management off-site conference. These were the main highlights discussed.

Defined terms

ESG: Environmental, social and governance factors that are increasingly used by companies to report on sustainability and by investors to make sustainable investment decisions.

Financial crime: Criminal acquisition of another person's property or vehicle used by criminals to protect and/or grow their ill-gotten gains.

Digital finance: The use of digital technology as related to finance leading to new products, services, operating processes and customer interactions.

Climate change, inequality and corruption

There needs to be greater political will and public-private collaboration to address the threats posed by climate change, inequality and corruption. While many countries have signed up to the United Nations' (UN) Sustainable Development Goals (SDGs) and the Paris Agreement, the costs of doing little are untenable.

The language used when referring to climate change is along the lines of "the demise of civilisation". It is an existential threat with heavy incremental economic costs. Schroders has estimated that a rise in temperature of four degrees centigrade will cost £32 trillion and escalate, which is three or four times the cost of the 2008 financial crisis.

With regard to inequality, in addition to what has been unearthed by the #MeToo movement and the need for better social practices in the work place, the cost of human trafficking is $150 billion, much of which is linked to modern slavery. Today, there are 40.3 million people in modern slavery, the majority of whom are women and children.

Investors and millennials driving ESG-investment

Investors and millennials are leading the drive toward ESG investment by calling for more government action, supporting the divestment movement and by voting with their investment choices. In 2018, investors with more than $20 trillion assets under management (AUM) met with G7 and G20 governments to discuss how to collaborate, boost long-term returns and support sustainable development. At the 24th Conference of the Parties to the United Nations Framework Convention on Climate Change held in December 2018, 415 investors with $32 trillion AUM called on governments to step up action on climate change. They urged an acceleration of low carbon transition, a phasing out the use of coal power and fossil fuel subsidies and setting a meaningful price on carbon.

As for the divestment movement, it has led to a rise of fossil fuel divestment funds which total $8 trillion. The millennials are moving away from the "throwaway age", pursuing ethical and sustainable investments at a rate that is twice as high as that for the population as a whole. A 2017 Morgan Stanley survey found 86 percent of millennials were interested in sustainable investing and 61 percent had made a "sustainable investment" in the past year. This is significant as it is anticipated that wealth transfer to millennials will total $30 trillion in the next few decades.

In the UK, people are investing in green bonds; more than 70 are publicly listed, worth in excess of $22 billion and rising. Kept unchecked, however, the development of new green finance products could lead to a rise in fraud and other financial crime.

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Any new products launched must be subjected to adequate risk assessment, to identify how they could be abused by criminals or used to finance crime, and to ensure controls are put in place to protect consumers and market integrity.

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Transparency and accountability in ESG reporting

Data is needed to promote transparency and accountability in ESG reporting, and where there is data, there needs to be a discussion about sustainable digital finance. The amount of data created is expected to reach 44 zettabytes by 2020. Regardless of what that means there is plenty of information flowing that must be managed, stored and accessed. For individuals looking to make sustainable investment choices, there needs to be a framework that makes sustainability data standardised, reportable by firms, commonly understood and easy to access. This requires technology.

An initiative was launched recently looking at how technology can re-shape the financial system to deliver sustainable development outcomes, and made recommendations to the G20 in the " Digital Technologies for Mobilising Sustainable Finance" report.

The report found that new forms of technology, such as MLAI, big data, the Internet of Things, blockchain, and mobile platforms, are speeding up the adoption and development of responsible investment strategies and products by making data faster, cheaper and more accessible.

Digital Finance and Banking

- 90% of IT budgets are spent on managing and maintaining legacy systems
- Digital Transactions are 90% cheaper to process
- Digital Finance can add US$4.2 trillion in new deposits & US$2.1 trillion in new credit
- Digital Finance can turn 1.6 billion of the 2billion unbanked people into formal financial customers by 2025
- By 2015, mobile money subscribers worldwide grew to 400 million

Source: *Digital Technologies for Mobilizing Sustainable Finance* (2018)

This in turn is: addressing information barriers to growth; increasing transparency and access to information; enabling the development of sustainability rating methodologies and benchmarking activity and indices; and promoting greater financial inclusion and innovation, unlocking new sustainable business models.

Overall, digital finance is contributing to 13 of the 17 SGDs. The poster child for sustainable digital finance is the Ant Forest scheme launched on Alipay mobile that has gamified carbon footprint tracking. The app awards "green points" to users that carry out carbon-reducing activities (i.e., paying bills online or walking to work) that go toward planting trees. Points can be shared with their social networks to help friends and family earn points to plant trees. As of May 2018, the app had more than 350 million users, which is more than the population of the United States, and had led to the planting of 55 million trees in China.

A tree planting digital sustainable finance app is a great initiative because illegal logging is leading to widespread deforestation. It is estimated that between 50 and 90 percent of all logging in the main producing tropical countries involves criminal activity, with the estimated worldwide value of illegal logging worth up to $100 billion. This is a statistic that must be actively searched for.

Links between financial crime and sustainability need further exploration

Targeting financial crime forms a major part of the UN's SDGs, which tackle trafficking and exploitation of children, illicit financial flows, corruption and bribery and terrorism. Nevertheless, the connections between financial crime and other aspects of sustainability should be subject to more study for better results.

More thinking is needed concerning the cycle of how financial crime feeds environmental degradation, inequality and governance issues and vice versa. How could fighting financial crime lead to better outcomes for women and children? It is estimated financial crime costs up to 5 percent of global GDP, or $2 trillion. This amount erase hunger, eradicate malaria, bridge the international infrastructure gap and provide basic education to all children.

Additionally, the tools used to fight financial crime also promote transparency and accountability through due diligence, understanding source and destination of financial flows, capital and assets, and continuous monitoring of relationships and transactions. The intelligence gathered with these tools could be used to support ESG reporting and sustainable investment initiatives.

Many anti-money laundering/counter-terrorism financing tools are customer-focused, not necessarily investment-facing, whereas modern slavery and bribery and corruption legislation tend to focus on the supply chain. How can these initiatives support each other? As always, the devil is in the detail, and this requires multi-disciplinary collaboration. There was a session at the 2019 World Economic Forum in Davos, exploring inequality and financial crime (#FightFinancialCrime) with the Coalition to Fight Financial Crime.

It brought together Catherine De Bolle, executive director of Europol, Rani Hong, a human trafficking survivor and founder of Rani's Voice and the Freedom Seal Initiative, and Tim Adams, president of the Institute of International Finance. This was a step toward generating awareness and linking these two otherwise self-contained topics.

Role for government and financial regulators

Governments and regulators have begun to gain a better understanding of market-led ESG investments. Much more remains to be done, however, and as Kate Kuper, director of Bateleur Partners and a former team leader for World Bank projects, mentioned during a conversation, regulators have great convening power to bring people together, crowd-source ideas, test hypotheses and identify champions to drive forward initiatives. By creating enabling frameworks, they could support financial services firms and others under their regulatory umbrella to promote principles such as sustainability-by-design or sustainability-by-default, similar to the General Data Protection Regulation (GDPR). They have the ability to work with other governments and regulators to create standard approaches and the sandboxes to test new digital sustainable finance technology in a safe environment. Moreover, they have a responsibility to protect and educate consumers and citizens, preserving market integrity.

The FCA's Discussion Paper 18/8, "Climate Change and Green Finance", is open for consultation until January 31, 2019.

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