

ESG in financial analysis: an irreversible trend

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In recent years, the world has seen a dramatic transformation (in a good way!) in the corporate environment and in business in general, with recognition of the need to develop a more conscientious form of capitalism that incorporates goals and parameters that go beyond the (until then overriding) objective of generating financial return for shareholders.

The ultraliberal doctrine championed by the celebrated American economist Milton Friedman no longer predominates, and the search for profit has begun to be associated with broader purposes, through best practices in sustainability, social economics, and governance. In fact, the much-discussed **“ESG” (Environmental, Social and Governance)** criteria are already part of the corporate reality around the world.

Corporations are feeling increasing pressure – not just from their shareholders but from their stakeholders in general, including employees, regulators, consumers, creditors and collaborators – to act in a more responsible manner, not just with respect to the environment but in relation to society as a whole. Market scrutiny of ESG practices is not only growing, but implacable. In today's world, listed companies have seen their market value drop dramatically in the course of a single day because of actions, omissions and missteps in the ESG arena. With the covid-19 pandemic and its demonstration of our planet's and humanity's fragility – not to mention all the various (and worrying) aspects of the global crisis the pandemic has brought on – the natural tendency is that initiative directed to a more sustainable economy will grow and spread.

In this “post-covid” world, the growing, global relevance of issues related to the environment and sustainability, positive social impact, diversity and good governance practices has become obvious and even essential if companies hope to survive and thrive in the market.

Inevitably, this change in the behavior of businesses has led to significant changes in the financial and capital markets, which, by offering companies various means of raising funds and financing their businesses, are major drivers of the global economy.

Adherence to ESG criteria has become a compulsory element in credit assessments by financial institutions, which now take into account the degree to which their clients have incorporated ESG factors into their businesses in financial risk and impact calculations. The financial sector's capacity to influence the development of a sustainable economy has been increasing over the last two decades. The first notable step was the large-scale adoption of the “Equator Principles”, a set of directives focused on environmental and social risk and responsibility in project financing, which

was quickly followed by financing through green, social and sustainability bonds and loans, which have reached record levels of growth and demand.

The financial market seems to be moving in the right direction. But what about the legacy of investments and financings in nonsustainable projects? It has become clear that simply increasing and accelerating “green” financing and investment in sustainable energy projects is not sufficient. Inevitably, financing for projects in the fossil fuel and other nonsustainable energy segments has been “black listed” since they end up hindering realistic and substantial progress toward a decarbonized, “clean” economy.

Lastly, agents in the finance market have – happily – felt the need to go a step further. Banks, development agencies and credit rating agencies have increasingly turned their attention to adoption and achievement of ESG goals by their clients and borrowers, which naturally has fostered the spread of ESG practices. Compliance with ESG criteria now serves an important metric in assessing businesses, financial assets, and the creditworthiness of players: both Fitch Ratings and Moody's, for example, have recently released reports aimed at reinforcing the importance of ESG issues. At the same time, there is no single, unified methodology for ESG analysis, and consistency in reporting is perhaps the greatest challenge in assessing the extent to which businesses have embraced ESG principles.

Sustainability is not a new question in Brazil's financial and capital markets. Since 2005, B3, the Brazilian stock exchange (then known as BM&FBOVESPA), has had a sustainability indicator, the Business Sustainability Index, the fourth such index to be created worldwide.

Some years later, Brazil's Central Bank published Resolution no. 4327/2014, establishing directives on social and environmental policies in financial institutions. Last year, the Central Bank included sustainability issues in its “AgendaBC#”, the institution's official plan of work, covering short-, medium- and long-term actions. By including sustainability in its official agenda, the Central Bank has recognized the existence of climatic risk for the financial system, with the result that climatic risk stress tests are now a regulatory requirement.

To meet the growing demand by investors for ESG information, Brazil's securities and exchange commission, the CVM (Comissão de Valores Mobiliários), included the issue in public hearings on the information that must be provided by listed companies, proposing changes to CVM Instruction 480, with a view to providing greater transparency, publicity and standardization of ESG-related information and to “align Brazilian regulation with advances that the issue has shown in all developed markets.” The SEC in the United States is now revisiting its Climate Change Guidance, issued a decade ago, to reflect lessons learned in recent years – lessons that will certainly be shared in the international market. The Brazilian banking sector's self-regulatory body, FEBRABAN, has revised the commitments that are expected of financial institutions in the area of social and environmental risk management, setting a transition period for member institutions to come into compliance with the new standards, with penalties for non-compliance.

Despite the challenges inherent in establishing a responsible, uniform benchmark for environmental, social and environmental principles in business, there can be no doubt that the growing concern felt by regulators and other financial system agents over greater transparency, uniformity in

disclosure, and compliance with ESG criteria will make a significant contribution in the transition to a clean, decarbonized economy by 2050, in line with the global warming reduction goals set by the Paris Accord.

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