Must ESG be bad news for emerging markets?

How to make funding flows fair
This has been a tough year for the environmental, social and governance (ESG) investing agenda. ESG has become a target of choice for conservative politicians in the US as its culture wars intensify. Financial companies making green pledges face increasingly intense scrutiny over fiduciary duty and antitrust questions — as well as possible greenwashing.

Most troublingly, concern has been raised that the ESG drive in its current form may not work for the developing countries where most of the world’s population lives — and could even be counterproductive. The worry, in a nutshell, is as follows: if ESG investors are too focused on avoiding risks — and too demanding over watertight governance and copious data — then they will shun poorer nations in desperate need of capital.

This issue goes to the heart of the debate about ESG’s purpose. Is it, as critics suggest, a mere means for financial companies to manage risks and charge higher fees, or a valuable tool for tackling humanity’s most urgent challenges?

This is the focus of the new Moral Money Forum report, in which Sarah Murray highlights the thorniest problems — and some potential solutions. The report draws on valuable insights from Moral Money readers. We are always keen to hear more: as ever, you can reach us at moralmoneyreply@ft.com. And if you aren’t already a Moral Money subscriber, click here to get our newsletter in your inbox three times each week.

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Simon Mundy
Moral Money Editor
Financial Times
Does ESG have to be bad news for emerging markets?

Calls are growing for investors to focus more on driving impact, and less on dodging risks, writes Sarah Murray

In 2020, when the world began to pay more attention to the activities of western multinationals in developing poor countries, troubling reports emerged of under-age workers in clothing factories in Cambodia. These revelations – along with a BBC documentary that uncovered sweatshop conditions in factories used by Nike and Gap – prompted companies to cancel their contracts with Cambodian suppliers.

Prospects for those workers left without jobs would have been dismal. Five years later, when another 20 Cambodian garment factories were shut, the UN raised its concern that the situation risked pushing thousands of women into prostitution. In 2022, leading consumer brands would be unlikely to make such a decision. Instead of simply cutting problematic operations from a supply chain, companies focus on engaging with suppliers to improve conditions and eliminate bad practices.

The long shadow cast by the Cambodian sweatshop stories still affects today’s sustainable investing industry. Many environmental, social and governance (ESG) investors fear the risks posed by emerging markets. Rather than contribute to improving livelihoods and conserving natural resources, they simply exclude them as a negative factor.

“It’s a strange morphing from the starting point, which was ‘how can investment make the world a better place’, to the place we are now, which is ‘how can investment not expose me to risk and make me more money,’’ says Stuart Theobald, co-founder of Intellidex, a research consultancy that specialises in African capital markets and financial services.

A study by the company, conducted for the UK government with suppliers to improve conditions and eliminate bad practices.

To address climate change alone, an extra $7tn a year will be required in emerging markets excluding China, says Nigel Topping, the UK’s UN high-level climate action champion. “We know that 70 per cent plus of that needs to be private finance,” he says.

Colin Mayer, of Said Business School at Oxford university, worries that private finance could be blocked by the ESG approach. “The potential effect on market flows is substantial,” he says. “In essence, ESG is a mechanism for discouraging investment to flow out of relatively high-risk emerging markets into what are perceived to be less exposed developed markets.”

This is not to say that investors whose portfolios include stocks from emerging market countries are without challenges. When we asked FT Moral Money readers what they considered the biggest risks in such markets, almost all pointed to corruption and poor governance, with three-fifths highlighting political instability. As well as threatening to starve emerging markets of capital, avoiding investment in them could have further perverse effects. As with divestment from fossil fuel stocks, it may mean that ownership of the assets will rest instead with investors who are less concerned about sustainability. “What it does is shift companies from investors who have a concern about these issues to those who are largely indifferent to them,” says Mayer.

Alison Taylor, a specialist in ethical business at New York University Stern School of Business, goes further. “This is arguably worse than divestment out of oil and gas, because if you divest from a country, you leave it to organised crime, terrorist financing and violence,” she says.

She points to a “conceptual emptiness” in the current form of ESG investing. “Because it’s focused on the win-win business case – you fight climate change and make more money – we have dropped the wider ethical and development arguments,” she says. “And if you look at emerging markets, you really see the problem with that.”

The question for ESG investors, emerging market governments and international development institutions is how a massive industry can be reshaped to enable greater funding flows to be directed into the markets that need it most.

One door opens, another closes

Among ESG investing’s early adopters were institutional investors such as pension funds and sovereign wealth funds. With long-term investment horizons and commitments to tackle social and environmental challenges through their holdings, they built teams of managers capable of implementing this approach at scale.

And in the debate over whether divestment or engagement does more to advance sustainability goals, they have generally backed participation. In one notable example, the California State Teachers’ Retirement System (Calstrs) lobbied against fossil fuel divestment legislation, which would have prevented it from owning stakes in oil and gas producers. This contributed to the bill’s failure to become state law.

Among Calstrs’ arguments against the legislation was that holding stakes in fossil fuel companies gave it the leverage to push the sector to address climate change. However, in their approach to emerging markets, the ESG strategies of some pension funds seem to take the opposite stance.

Interviews from the Intellidex report revealed a reluctance among funds “to take greater emerging and frontier market exposure because of reputational risk and, relatedly, the ESG screening approaches used”.

Some pension funds and sovereign wealth funds have developed active ESG ownership approaches. Research by Uncut found that of 20 funds studied, 17 employed impact investment strategies, compared with eight that used exclusion as a strategy.

Yet overall allocations to emerging markets among these investors remains small. SWF Global found that in 2021 state-owned investors collectively allocated 78 per cent of funds to developed markets, with only 22 per cent going to emerging markets.

For the world’s biggest sovereign wealth fund, ESG considerations have weakened its appetite for emerging markets. In 2021, as part of an effort to apply the same ethical and environmental standards to all its investments, the government of Norway instructed its $1.4tn fund to add no new emerging-market companies to its portfolio.

Makig the announcement, Jan Tore Sanner, the finance minister, cited weaker institutions and fewer protections for minority shareholders as barriers for responsible investment strategies.

Theobald of Intellidex says: “Some of the pension funds and sovereign wealth funds are really concerned to avoid headlines about exposures they have, whether to poor labour practices or government corruption. Operationally that means they’re screening out what they perceive as ‘higher reputational risk’ markets.”

While he sees different drivers behind the approach of the asset management industry – notably the pressure to meet client demand for clean portfolios – the effect is much the same.

“Asset managers end up with the screening approach as well,” he says.
The dangers of data
One of the most frequently cited barriers to ESG integrating in emerging markets is the lack of data. When we asked FT Moral Money readers in the investment sector to point out the biggest hurdles in allocating a greater amount of ESG-aligned funds to emerging markets, more than half pointed to this obstacle. When asked if they were satisfied with corporate disclosure on emerging-market ESG risk, they were unanimous no.

Data are certainly a challenge, but often this shows up in a mismatch between the information available on companies in emerging markets and what is required by ESG screens. Companies in these markets may also struggle to meet the international benchmarks that ESG investors require, particularly in areas such as biodiversity and compensation for displaced communities.

"Local laws require a company to undertake a social and environmental impact assessment, but the quality of that assessment is very poor," says Seynabou Ba, who founded ESG Africa, a consultancy that helps companies meet the benchmarks, risk profiles, reporting requirements and audit processes demanded by ESG investors.

The quest for standardisation continues. Almost half of Moral Money readers who responded to our survey said that before allocating more money to emerging markets, they would like to see standardised disclosures from companies. Yet even if they want to meet disclosure requirements, companies may lack the tools and knowledge to assess and present them in a way that is acceptable to international investors.

"The common criticism I hear of ESG is that it’s the imposition of unrealistic standards on companies that aren’t ready for it," says Taylor of Sterns.

Benjamin Weiss, head of Asia-Pacific business at Veracity Worldwide, a political risk consultancy, questions whether ESG data are the answer, particularly since most come from publicly available information and pronouncements made by the companies themselves.

"We’re very wary about all the data out there," he says. "And what could a company in Vietnam possibly disclose that could be comparable to a company in New York about things like labour practices or biodiversity issues? Local considerations around those things are very different from one place to the next."

Meanwhile, since emerging market companies tend to have lower ESG ratings than developed-market peers, or have not been rated at all, ESG screens may not be appropriate. "You have built-in screens that offer a safety net, but that’s what they should be," says Sarah Norris, head of ESG for equities at Abrdn, the asset manager. "They shouldn’t be the primary driver of portfolio construction."

One example of how this plays out is when companies are given a low score for "lack of transparency." This can be misleading, says Norris. "They’re giving you the business-relevant indicators, but the indicators might not be in the right format," she explains. "So it’s not about improving the disclosure, it’s about improving the formatting of the disclosure."

Another challenge with a data-driven approach is that emerging markets indices can be a blunt instrument. Larger markets such as China often dominate, leading to performance being seen as driven by east Asia. According to the Intellidex report, this imbalance is frustrating for fund managers who understand that emerging markets are economically, geographically and demographically diverse.

"A lot of ESG analysis treats the numbers in a context-free way as performance numbers," says Taylor. "So the inability to factor in the context is certainly an issue."

Among Moral Money readers, there is an appetite for a nuanced approach. "Two-thirds of our survey respondents cited affordable analysis services focused on emerging markets as something that would encourage them to allocate more funds to these markets," Weiss believes. Deeper research and insights tailored by region can pay off. "It’s a huge growth story, and if investors really care about the ESG criteria they are committing to, there are ways of engaging in emerging markets to try and see those things through," he says. "That’s more constructive than saying, ‘hands off’."

The risk of missing out
In emerging markets, some stubborn challenges will spark the innovation needed to develop attractive opportunities for ESG investment. Rosalind Kainyah, a Ghanaian consultant, looks across Africa and sees this everywhere.

"There are hidden gems to be unearthed because for many it is just a way of life," says Kainyah, who is managing director of Kina Advisory, a boutique consultancy that advises on responsible business and investment. "It’s a way of solving day-to-day problems or meeting needs."

A case in point is the lack of access in many countries to both energy and the means to pay for it. This has prompted the development of off-grid solar-powered services and innovative pay-as-you-go models that help poor communities to afford them.

The model has improved lives. For example, with light and power at night, students can study longer to improve their academic performance, and small-scale entrepreneurs do not have to shut up shop once it goes dark, or rely on expensive and unhealthy kerosene lamps.

The pay-as-you go model has also helped people with no credit history to build a record of loan repayments, enabling them to buy more extensive solar home systems with services such as TVs, fans, smartphones, water pumps, refrigerators and cooking stoves bundled into the package.

From its beginnings more than a decade ago, the market has expanded rapidly, with $1.3bn invested in the pay-as-you-go solar sector globally since 2012, of which $760m was invested in the past three years. Telecom companies have benefited since customers can pay their fees using mobile money. Meanwhile, more than 42m people now use solar products for energy and lighting.

This is the kind of opportunity ESG investors could miss if the focus on risk leads them to exclude emerging markets. "You need to know what you’re doing, what the externalities and the contextual risks are," says Ba of ESG Africa. "But the opportunities are there."

For FT Moral Money readers, emerging markets offer one clear ESG investment opportunity: the chance to tap into high-growth companies at an early stage.

Researchers looked at the world’s 50 largest public pension funds and 30 largest sovereign wealth funds. Of these the study focused on 20 (16 PPFs and 4 SWFs) which published a sustainable/responsible investment report in 2019.

### A few large economies dominate emerging markets stock indices

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<th>MSCI Emerging Markets Index country weights (%)</th>
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<tr>
<td>China 31.4</td>
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<tr>
<td>India 22.4</td>
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<tr>
<td>South Korea 12.3</td>
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<tr>
<td>Brazil 5.0</td>
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<tr>
<td>Other 22.5</td>
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<td>Taiwan 16.2</td>
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Source: MSCI, Intellidex

### Big pension and sovereign wealth funds favour impact investment

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<th>Impact investment</th>
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<td>General integration</td>
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<td>Positive screening</td>
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Results: Researchers looked at the world’s 50 largest public pension funds and 30 largest sovereign wealth funds. Of these the study focused on 20 (16 PPFs and 4 SWFs) which published a sustainable/responsible investment report in 2019.

Source: UNCTAD
From data to diligence

It is often easier for local investors such as Patama to manage the risks and harness the opportunities that emerging markets offer than it is for anyone sitting in an office in New York or London. However, if more detailed approaches are combined with ESG data, these investors can determine which companies to add to a sustainable portfolio, says Andrea Webster, who leads finance system transformation at the World Benchmarking Alliance. “It needs to be part science, part art,” she says. “There is science behind certain metrics and the element that’s art requires local knowledge.”

When evaluating ESG in emerging markets, Aberdeen takes unmet development needs as a starting point. In its EM sustainable development corporate bond strategy, the fund manager uses the databases of international institutions to define the unfulfilled needs of a country. It then works out which companies have the appropriate solutions. “The World Bank database is a huge resource,” says Norris. “We look at the different data sources that go into the database and pull in a few more for country-level indicators.”

Whatever the source, ESG investors need thorough analyses and local knowledge when entering emerging markets, says Witold Henisz, vice-dean and faculty director of the ESG initiative at Wharton School of Business, Pennsylvania. He is the author of a case study on the “ESG improvers strategy” through which asset manager AllianceBernstein identifies companies working to improve ESG investments and in broader investments. “We get on the phone and we travel when we think it’s necessary,” she says.

The approach has helped to identify what Phillpotts calls emerging market “diamonds in the rough”, both in the ESG improvers and in broader investments. “We get on the phone and we travel when we think it’s necessary,” she says. “I meet NGO leaders, companies, customers and suppliers so that we can take a 360-degree view of the core issues.”

This means that the firm can invest where others fear to tread. For example, lack of transparency landed a CCC rating — the lowest possible — for Anhui Conch Cement, Digging deeper, however, AllianceBernstein found that the Chinese company used 28 per cent less energy than its higher-rated peers.

As investors, AllianceBernstein worked with Conch to help it provide energy efficiency performance data to MSCI, contributing to an improved environmental score for the cement maker. Its MSCI rating is now BB, meaning that it has gone from red to amber.

Case study: AllianceBernstein finds its “diamonds in the rough”

Some investors go beyond the ratings to make better decisions, AllianceBernstein has its “ESG improvers strategy”. This identifies companies that might not have the best ESG ratings — or could even be ESG “offenders” — but which show improvement in areas from gender equality to carbon emissions.

The asset manager says this avoids the tick-box approach to ESG stock selection, which it regards as particularly unhelpful. “You end up not investing in emerging markets because you don’t want to deal with the risk,” says Christine Phillpotts, the portfolio manager for emerging and frontier markets equities. “To me, that is ignoring opportunities that could yield significant upside from an impact as well as a returns standpoint.”

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Could history repeat itself?

Two decades on from the fashion companies’ exit from Cambodia’s clothing factories, corporate engagement in emerging markets looks very different. There are lessons here for ESG investors.

Rather than shunning these markets, multinationals from sectors such as mining, textiles, food and agriculture now understand that they must contribute to sustainable development in the communities in which they operate. If they do not, they risk the ire of consumers, activists and others.

Corporate initiatives – often developed in partnership with governments and non-profit – range from the community development programmes established around mining operations to tech companies’ efforts to build skills in local communities.

Getting it right is not easy. Persistent human rights abuses and poor working conditions, as well as tragedies such as the 2013 Rana Plaza building collapse in Dhaka that killed and injured thousands of workers, indicate that businesses must do more to ensure they are operating safely, fairly and equitably in these countries.

Today, however, stakeholders including consumers have a broader understanding of the nature of global supply chains and expect companies to be active in improving lives and livelihoods.

While a comparable movement to the “corporate social responsibility” born in the 1990s has yet to emerge in the investment sector, the Church of England Pensions Board’s initiative reflects the need for ESG investing to go beyond simply making money while not doing harm.

As the criticism of ESG investing grows louder, a movement that set out to save the world could gain an unwelcome reputation for ignoring some of its most pressing problems. There may come a time for ESG investors when steering clear of emerging markets is no longer an option.
Advisory Partner

Where to find growth, diversification, and impact?
Emerging markets
Asha Mehta, CFA and CIO, Global Delta Capital, author of Power of Capital and co-chair of High Meadow Institute’s Investment Industry Leaders Forum

With more than half the globe’s footprint, most of the planet’s population and the world’s fastest growing economies, emerging markets represent an unparalleled opportunity — particularly for ESG investors.

Indeed, the asset class offers scope not only for outsized alpha but also outsized impact. It gives a chance to implement sustainable investing with non-concessionary returns: from integration, to positive tilts, to impact.

Countries in emerging markets have higher levels of corruption and greater sociopolitical risk, so it is no surprise that the implementation of ESG criteria can lead to higher payoffs than in developed markets.

For example, investing with management oversight and integrity in mind has to be a winning strategy. Big data gives us the tools to evaluate companies and countries: global news feeds can be parsed in minutes to identify a source of controversy.

Investors may find emerging markets a rewarding experience, too. Necessity is the mother of invention and promising advances in alternative energy happen in countries where access to traditional energy sources is limited.

Finally, the lower development base in emerging markets provides ample opportunity to deliver impact. The UN Sustainable Development Goals are particularly relevant here. There is a $5tn funding gap that needs to be filled to extend prosperity around the globe. Investments into this region can help bring about the infrastructure required to improve living standards, narrow inequalities and allay climate and health vulnerabilities.

As government leaders, multilaterals and the private sector unite to try to fill the gap, more than half of the world’s SDG investment opportunities are in the emerging markets asset class.

History shows that the quest for productivity, innovation and social security can transform communities and sovereign economies. In past decades, economic liberalisation has fuelled foreign investment. Examples of the power of invested capital abound:

- In Brazil, years of military rule gave way to a liberalised economic system that bolsters businesses and brings better lives for millions of people. Advances in fintech are particularly promising.
- Romania’s shift from communism to capitalism has reshaped the landscape. Look at the country’s advanced car technology and top-notch outsourced “software as a service” platforms.
- In India, the education of a generation, especially girls, combined with investment in technology have transformed this hot, crowded country into a global leader in solar and other technologies.

As we seek growth and diversification around our incredible planet, global investors might further embrace the power of capital, not just to generate an attractive return but also to build a global ecosystem that is prosperous, peaceful and free.

*High Meadows Institute’s views are separate from other advisory partners, the FT and the FT Moral Money Forum.
Emerging markets — at the coalface of ESG solutions? When asked to weigh in on the debate about whether ESG investing is bad news for emerging markets, it is worth pausing to think about how many assumptions are packed into that one question. First, it assumes a single and universally accepted interpretation of ESG; second, it assumes uniformity among emerging markets; and third, it creates a dichotomy between “good” and “bad” that is not necessarily helpful if a company does not yet meet ESG standards and we wish they did. Is this “bad” or is it a chance to bring about positive change?

Where we can make a difference

At Vontobel, we operate according to four ESG investment principles. Our investment process incorporates ESG considerations because we believe, over time, that this best enables our clients to achieve their investment objectives. As active investors, we make use of the tools of engagement and voting to perform our fiduciary duty as stewards of our clients’ capital. Our investment teams are accountable for the application of our ESG investment principles, and we commit to transparency through disciplined disclosure, reporting and dialogue.

As investors and investment advisers, it is our job to understand nuance. When it comes to ESG and emerging markets, nuances abound. We do not define an investor’s appetite for ESG or emerging markets. Instead, we enable investors to find a mix of investments that empowers them to build the future they want in line with personal and financial aspirations. Our clients and the companies in which we invest can benefit from our experience in understanding the relationship between ESG and investing in emerging markets.

Exclusion or improvement?

Let’s return to the question at hand: is ESG bad news for emerging markets? This depends on how ESG is interpreted and applied. If ESG criteria are used as an exclusionary filter — to rule out certain business activities or other norms-based criteria — then it is important to ensure that the context is considered and the buck is not passed (literally) to investors that are less concerned about broader societal issues.

At Vontobel, we recognize that emerging markets are often in the high-pressure zone of climate risks and demographic pressures. Rather than avoid areas with complex societal challenges and some of the most acute ESG concerns, we acknowledge that these are places where transformation can bring the biggest impact. In fact, emerging markets can be seen as the coalface of solutions.

Given that some investors will take a more activist approach, we see value in providing a range of strategies at different ESG-ambition levels, and in explaining and positioning them clearly to our investors. If we believe in one of the underlying principles of ESG — that it helps to address social and environmental challenges — then we can afford to look away from emerging markets, which generally face more complexity when it comes to ESG?

Working together is the only way

There is no right or wrong answer to our question. Instead, the answer lies in working harder, together, to advance ESG in emerging markets. Many of the challenges we face are global, such as the environmental effects of climate change. While urgent action has to be taken in many of these areas, we must also ask the big-picture questions.

Is it fair to penalize individual companies for policies and a legal backdrop set by a sovereign state or national government? Or, to pose another question that risks controversy, can the discussion about ESG be seen as the west imposing its solution for the world’s problems on to the east and global south? The responses will be complex and different but that is exactly what we need as we assess the way our world works, including how we conceptualise, talk about and invest in both ESG and emerging markets.

As a multi-boutique firm, Vontobel is poised to provide investors with both a macro and micro view of the multi-challenged world.

* Vontobel’s views are separate from other advisory partners, the FT and the FT Moral Money Forum

Notwithstanding the threat of an economic downturn, the momentum that drives the focus on ESG strategy is accelerating. The Financial Conduct Authority and the Financial Reporting Council recognised this trend in their assessments on the quality of first-year reporting of premium-listed companies by the Task Force on Climate-related Financial Disclosures. They found that companies are treating climate-related considerations as risks without adequately balancing such risks against the considerable opportunities.

Striking the appropriate balance is easier said than done, especially when directors feel much less confident in emerging areas, such as the requirements for climate-related disclosures. It is natural and prudent to be averse to risk.

International regulators have pushed forward with mandating and standardising ESG disclosure, with the EU pressing ahead with the Non-Financial Reporting Directive, the Sustainable Finance Disclosure Regulation and the Climate Transition Benchmarks Regulation. There is also the EU Taxonomy Regulation, EU Green Bond Standards, the Corporate Sustainability Reporting Directive and EU scoping extension proposals.

The rapid strengthening of EU disclosure regimes is driven by policies to enhance investor comfort and encourage European businesses to improve ESG performance, both in their own operations and value chains.

On the flipside, there are no mandatory disclosure regimes in the US, and federal regulators have been hesitant to follow the EU’s example. There has been considerable political pressure against pro-ESG investments. While the Securities and Exchange Commission has proposed climate disclosure rules, the risk is that adoption of such rules could lead to litigation that challenges the SEC’s authority based on the “major questions doctrine”, as recently seen in the West Virginia vs Environmental Protection Agency court case.

Emerging markets — with their perceived additional ESG-related risks — may in the short-term miss out on investment. However, the Paris Agreement targets and the Sustainable Development Goals can be achieved only if developed and emerging market stakeholders work together. This will be one of the headline topics to be addressed at COP27 in Sharm el-Sheikh, Egypt, in November.

Providing higher quality, reliable (and non-brokerplate) disclosure is critical to reducing the risks entailed in emerging markets investment. In parallel to regulatory risk, recent spates of naming-and-shaming press reports have increased reputational risk for companies who may “get it wrong” in their approach to ESG.

Investors may benefit from collaborating with external experts to develop knowledge and drive better-informed decisions on which projects are best aligned with commitments to internationally recognised principles and standards.

Investors can apply responsible investment approaches aided by increased regulatory intervention through the introduction of mandatory due diligence legislation. Examples are Germany and Norway and the EU’s proposal for a directive on corporate sustainability due diligence. The draft directive ensures the effective prevention and mitigation of potentially adverse effects on human rights by placing companies under an obligation to prioritise engagement with suppliers and other business relationships throughout the value chain, instead of using termination as a last resort.

The hope is that once investors realise how they can mitigate the perception of ESG risk by applying responsible investment approaches to emerging market investments, they can reap the financial and reputational rewards of gaining exposure to growing economies. This will not only diversify their portfolios but create long-term impact too.
The FT Moral Money Forum takes key issues from the ESG debate and explores them for FT Moral Money subscribers.

The forum highlights macro and philosophical questions and explores the experiences and solutions being proposed. We apply an editorial filter to these and present the most interesting ideas and experiences. We also engage our data visual team to find the best form of presentation.

The forum produces regular reports to highlight the ideas, policies and practices that are making a difference.

Find out how to take part in the FT Moral Money Forum by emailing moralmoneyforum@ft.com