

The Ethics of Sustainable Investing

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The COVID-19 pandemic is expected to accelerate the trend of incorporating sustainability considerations in investing (J.P.Morgan, 2020). This is a remarkable outlook, given the eye-opening growth in such investments in recent years. Already between 2014 and the first quarter of 2020, assets under management of signatories of the Principles of Responsible Investing grew by over 100 per cent (State Street, 2020).

The spectacular growth has, however, led to some concern over the field's ability to deliver on sustainability outcomes. Disquiet has come from both market participants and academic circles; it ranges from the criticism of investors' focus on the bottom-line (Richardson, 2009) to doubts over the validity of ESG metrics (investors surveyed in McKinsey & Company, 2019).

In this essay, I unpick many of these concerns to demonstrate the complexities of the ethics of sustainable investing. Firstly, I outline the intentions of market players who incorporate sustainability considerations in their investment decisions. I focus specifically on (i) investors' pursuit of financial returns and (ii) the priorities of shareholders or beneficiaries. I argue that the former is helpful in explaining the size and shape of the market for sustainable investments.

Secondly, I discuss what we know about the outcomes of sustainable investments. Given the breadth of sustainable finance approaches, investing methods, and asset classes, I focus on green bonds and ESG integration, two of the most common topics to gain public attention. For both, I demonstrate

the challenges of impact accounting, and the importance of detail and care in ensuring that sustainable investment capital is allocated in line with sustainability outcomes.

Thirdly, I discuss the implications of my findings and argue that the adoption of a consequentialist approach is needed among finance professionals dealing with sustainability issues. A nuanced and careful consideration of the outcomes, as opposed to only the virtues of sustainable investments, is needed.

What is in a name?

The definitional challenges behind the sustainable investing terminology necessitate a short pause at this stage. The terms “sustainable finance”, “ESG investing”, “socially responsible investing” (SRI), and “impact investing” are often used interchangeably. This is likely due to the common connotation behind these terms: that investors include more than only financial considerations when making decisions. Even when the differences between the terms are acknowledged, the definitions are not always consistent across the academic literature and the public domain (see for example the difference between definitions used in Caplan, et al., 2013; Townsend, 2020; S&P, 2020).

One useful way to distinguish between some of these terms is by their approach to value. ESG investing emphasises long-term *investment* value, achieved by

incorporating environmental, social, and governance considerations (Investopedia, 2019). This stands in contrast to the older concept of socially responsible investing, which emphasises accounting for *moral* values in investment decisions (Investopedia, 2019). Following this distinction, impact investing can be thought of as a sub-group of socially responsible investing, which strives to identify the most impactful investments.

The other, though related, way to think about the vast sustainable investment universe is that it is squeezed in between traditional investing and philanthropy (see Figure 1, adapted from Paetzold, 2017). Approaches such as ESG integration are thought to be closer to traditional investing, characterised by a greater focus on financial returns. Thematic investing, placing money in investments which have a particular sustainable focus (for example, green investments), and impact investing are closer to philanthropy, driven by values and impacts.

For clarity, throughout this paper, I follow the taxonomy used by Paetzold (2017). This means that I use the all-encompassing term “sustainable investing” to describe investing approaches that include any environmental, social or governance considerations. I use the term “ESG integration” as a way of referencing a sustainable investment approach that takes into account ESG metrics to drive

long-term financial performance. I treat the term “impact investing” as a reference to an approach that prioritises the positive outcomes of investments. As such, I refrain from using the terms “ESG investing” and “socially responsible investing”, though I acknowledge the popularity and long-standing history of the respective terms.

Intentions

How much do sustainable investors value financial returns?

A recent survey of institutional investors found that the most common motivations behind sustainable investing are (i) enhancing returns; (ii) strengthening risk management; and (iii) aligning strategies with the priorities of beneficiaries and shareholders, including those relating to social, political, and environmental values (McKinsey & Company, 2017).

The first two motivations listed in the survey are closely related to the search for long-term investment value. The most hotly debated

subject in the sustainable investment literature is, indeed, whether companies with better sustainability metrics have better financial returns.

There is comparatively little evidence that these metrics would be seriously detrimental to financial returns. One of the most influential studies on the subject is a meta-study by Friede, et al. (2015) effectively incorporating two thousand previous empirical analyses. The meta-analysis suggests that various ESG criteria have a non-negative effect on financial performance. This provides - in the words of the authors - an “empirically well-founded” business case for pursuing sustainable investments. That said, the answer varies significantly across studies, depending on the data samples and time periods considered, and on the methods of analysis (Halbritter & Dorfleitner, 2015). It is also worth pointing out that these studies generally focus on investment approaches which explicitly use ESG metrics, such as ESG integration; hence they may not be representative of all sustainable investment approaches.

Figure 1: Taxonomy of sustainable investment approaches

Traditional investing	Sustainable investment approaches					Philanthropy
	Exclusions	ESG integration; Best-in-class	Voting and engagement	Thematic investing	Impact investing	

Source: Adapted from Paetzold (2017).

The focus on financial returns has raised concern among some scholars, who worry that the demand for sustainable investments is increasingly being driven by ethical egoists (Eccles, 2010). A hypothetical ethical egoist, motivated by self-interest, invests in companies with stronger sustainability credentials because they expect better long-term returns and improved risk management practices. As argued by Eccles' (2010) thought experiment on the anti-apartheid socially responsible investment movement, sustainable investing with egotistic motivations may however result in socially malignant decisions. This is because of investors' inability to send a constructive and consistent signal on a given ethical issue, such as apartheid, when their attention rests with the bottom line. The focus on returns has also been criticised more broadly for perpetuating a "business-as-usual" attitude, risking sustainable finance's ability "to [leverage] lasting change for environmental sustainability" (Richardson, 2009).

The concern that such motivations may be insufficient for the financial sector to become a driver for sustainability outcomes gains further traction when we consider the types of sustainable investments which are most popular among investors globally. Negative screening and ESG integration featured in two-thirds of sustainable investments in 2018 (author's calculations based on data from the Global Sustainable Investment Alliance (2018)). In

contrast, impact investing and thematic investing featured in only around 3 per cent of the global sustainable investment market in 2018. This points to a very heavy bias towards investment approaches on the left-hand side of the taxonomy in Figure 1, where investment returns matter more than values or impact. As suggested by the data from the Global Sustainable Investment Alliance, these approaches have also experienced remarkable growth since 2016, despite their already very high levels that year.

This points to the fact that financial returns must take centre stage when explaining the current state of the market for sustainable investments. The increased mainstreaming of sustainability considerations in investing seems, at least partly, related to the search for financial returns.

How do sustainable investors incorporate value judgements?

The third motivation mentioned in the survey of institutional investors - aligning strategies with the priorities of beneficiaries and shareholders - directly involves ethical value judgements. These can stem from intentions to "do-no-harm" or to "do-good". "Do-no-harm" motivations, if realised, would reduce negative externalities. "Do-good" motivations create positive externalities. Such distinctions between motivations and the externalities they link to are more common in the literature on

corporate social responsibility (Crilly, et al., 2016) than sustainability investing. However, it is valid also in this context.

Through exclusions, stakeholders may want to avoid investing in companies or industries which they deem unethical, with tobacco companies being the classic example. At the same time, on the other side of the spectrum, stakeholders may want to actively make investments which they think are most likely to have a positive impact. These two sides of the spectrum also happen to coincide with sustainable approaches on opposing sides of the taxonomy in Figure 1: exclusions and impact investing.

As an example, the European Union's Taxonomy Regulation - the EU's classification system for sustainable activities - explicitly features the "do no significant harm" criterion for sustainable activities. By definition, the motivation to "do-no-harm" is likely not to create positive outcomes which "do-good" motivations may create. That said, the former already tackles both willing acts of harm, as well as the mere (intentional or unintentional) allowance of harm to happen. As such, it requires investors to be conscious of the wider context of the investments they make.

Drawing again on the evidence from the report from the Global Sustainable Investment Alliance, we see a high share of investments being motivated by the "do-no-harm" motivation, as opposed to "do-

good" considerations. Exclusionary (also known as negative) screening - the classic investing approach demonstrating "do-no-harm" considerations - is the single most common sustainable investment approach globally, featuring in more than a third of sustainable investments worldwide in 2018.

Whose intentions matter?

The presence of many market participants, who sometimes play multiple roles, complicates the analysis of intentions behind sustainable investing. A company issuing a green bond, for example, may have different motivations than the investor purchasing the bond. The former may want to positively contribute to reductions in greenhouse gas emissions by investing in energy efficiency improvements. The latter may view the green bond purely as a good investment, which will decrease the company's operating costs (and hence increase profits) going forward. The situation could also easily turn out to be the opposite. The same company could also purchase green bonds issued by another company under either motivation or have their employees' pensions unknowingly invested in other companies' green bonds.

For this reason, in the second part of this essay, I take a more consequentialist approach to the analysis of the ethics of sustainable investing. Indeed, utilitarianism is the ethical position most commonly used in the analysis of sustainable

investments (Viviers & Eccles, 2012). On the face of it, it should be easier to quantify benefits stemming from investment approaches to the right of the taxonomy in Figure 1, as these approaches target specific projects or outcomes. Approaches towards the left-hand side appear to be more difficult to quantify, as they are woven into more classic investment approaches and target benefits at higher levels of aggregation than individual projects.

In practice, however, impact accounting is extremely hard to conduct across the spectrum. Understanding the impacts of the remarkable growth in sustainable investments is inhibited by the fact that we do not know the counterfactual state of the world in which the investments had not taken place. Instead of attempting the impossible exercise of quantifying the outcomes of specific investments, I evaluate the severity of two problems which inhibit the pursuit of sustainable investment outcomes. I discuss (i) accusations of greenwashing, based on the example of green bonds; and (ii) the criticism of ESG metrics, in relation to ESG integration.

Outcomes

What shade of green are green bonds?

On the face of it, the impact and outcomes of projects done with the help of green bonds (an example of thematic investing, on the right of the taxonomy in Figure 1) are transparent. Regardless of their type

or category, the very definition of green bonds indicates that the use of proceeds must be associated with specific environmentally friendly projects (Deschryver & de Mariz, 2020). The first-ever green bond, the Climate Awareness Bond, for example, was issued by the European Investment Bank, with proceeds earmarked for renewable energy and energy efficiency projects (Deschryver & de Mariz, 2020).

Digging a little bit underneath the surface of green bonds, however, we uncover growing concerns about greenwashing, defined as “misleading consumers about [...] the environmental performance or the environmental benefits” (Delmas & Burbano, 2011). A recent survey found that over 60 per cent of fixed-income investors view greenwashing as a major concern, in this case among Asian companies (Asset Benchmark Research, 2020).

From a consequentialist perspective, greenwashing is problematic as it undermines the tangible outcomes spurred by sustainable investments. It is easy to see this in extreme cases: when environmental benefits are exaggerated or when the proceeds of a green bond do not end up supporting an environmental cause. Consider for example a green bond issued by the government of Mexico in 2016 and 2017 to help with the construction of a piece of infrastructure. The incoming president scrapped the project in 2018, and soon afterwards the government launched a buy-

back package. However, the residual bonds - while downgraded for their environmental credentials - remain in the market as green bonds (Krebbbers, 2019). Since the use of proceeds is now unclear, it is not hard to argue that the bond's green credential is likely to be invalid, despite the fact the bonds may still be included in some green bond indices.

Greenwashing accusations are more difficult to evaluate in cases where the use of proceeds supports an environmental cause, but the broader implications of the investment are less green or less clear. Let us go back to the example of the green bond issued by the Mexican government. If the authorities had not scrapped the project, Mexico City would soon boast another airport, the New Mexico City International airport, funded by green bonds. Yet, even if the project adhered to the strictest environmental standards, the consequences of its creation would likely include increased air traffic, and hence increased CO₂ emissions from planes, adding to the stock of CO₂ accumulated in the atmosphere and causing climate change. This has led many to question whether the bond deserved a green stamp in the first place (Kapraun & Scheins, 2019).

Green bonds from the Australian state of Queensland faced a similar backlash around the context in which they were issued. While the bonds were earmarked for environmental purposes, including

the protection of barrier reefs, the state pursued an expansive coal business at the same time (Financial Times, 2020). On the one hand, Queensland's green bond should please a consequentialist, since - assuming the money is appropriately ring-fenced - their proceeds will only fund environmentally conscious projects. On the other hand, some investors expressed concern that Queensland's access to green funding may hinder environmental causes by perpetuating a business-as-usual mentality (Financial Times, 2020), leading to forgone environmental benefits in the longer run. Concerns have also arisen in the case of green bonds issued by companies with fairly strong green credentials, but poorer social or governance credentials; for example in the case of Walmart (Bowman, 2019).

The examples above point to the difficulty associated with assigning the binary "green" tag to bonds. This is due to the unenumerable consequences associated with every investment - many of which are clear from the onset, others becoming apparent only over the longer term. Unsurprisingly, growing greenwashing concerns have led to the emergence of "dark green" investments, a colour that is meant to signal extra scrutiny in applying the label, in contrast with light green investments (Deschryver & de Mariz, 2020). The Climate Bonds Initiative, an international organisation, has also promoted the use of climate bonds whose

sustainability credentials are subject to verification and a review process based on a set of Paris-alignment criteria. The emergence of such initiatives - both dark green bonds and climate bonds - demonstrates the growing necessity for outcome-orientation in sustainable finance. They also demonstrate how wide is the spectrum of what currently constitutes sustainable investments.

Looking beyond green bonds, we see that the same complexities apply to other types of sustainable investments. The term “impact washing”, going beyond greenwashing more generally, is now also gaining prominence.

Does ESG integration allocate capital efficiently to most sustainable companies?

Some of the concerns around greenwashing in the context of green bonds have led to the increasing popularity of sustainability-linked bonds (Financial Times, 2020). These are bonds whose interest rates are linked to performance in specific quantifiable targets; for example greenhouse gas emissions intensity or the company’s ESG metric. The integration of ESG ratings in investments brings us to the opposite (left) side of the taxonomy in Figure 1, where - arguably - understanding the impacts of specific investments becomes even more difficult. These approaches take the focus away from specific projects and instead put more emphasis on the performance of a company as a whole.

ESG integration is “the explicit inclusion of ESG opportunities and risks in traditional financial analysis and investment decisions of asset managers” (Wild, 2017). Such inclusion can take many forms, from qualitative to - more often - quantitative, and provides asset managers with “signals that encourage investment in more sustainable regions, sectors, and companies” (Wild, 2017). As such, the accuracy and consistency of the signals underpin the whole investment approach. These signals take the form of ESG metrics. Increasingly, however, concerns have arisen over (i) self-reported disclosures of raw data or indices of companies’ performance; and (ii) the methods used to process and aggregate the raw data.

Let me start by focusing on the raw ESG data, as reported by individual companies. As suggested by Kotsantonis and Serafeim (2019), “data inconsistency is worse than you think.” Having reviewed disclosure on employee health and safety from a random sample of fifty Fortune 500 companies, the authors found it challenging to make any comparisons of performance. This is because of the myriad of indicators used to demonstrate employee health and safety performance. Such incomparability is a common problem. A McKinsey Sustainability Reporting Survey has found that “inconsistency, incomparability, or lack of alignment in standards” (McKinsey & Company, 2019) are a

top challenge associated with current sustainability-reporting practices. The same source quotes a major asset manager who lamented that “[w]e have positions in over 4,500 companies. Unless [sustainability information] is comparable, hard data, it is of little use to us.”

Such problems with self-reported data and indices come despite cross-organisational efforts and initiatives to develop common reporting standards. While the Sustainability Accounting Standards Board (SASB) and the Global Reporting Initiative (GRI) have been instrumental in this area, reporting practices continue to differ significantly within and across sectors. The reliability of self-reported data has also been questioned, due to unclear data gathering practices, leading to calls for audits of sustainability disclosures (Benow, et al., 2019). This stands in sharp contrast with high reporting standards and audit practices used for financial disclosures.

How companies’ raw data is being processed and aggregated has raised further concern. Kotsantonis and Serafeim (2019) specifically point to problems with (i) benchmarking; and (ii) with different imputation methods to produce final metrics. According to the authors, the process of benchmarking, or assessing a company’s performance within a range of other companies’ performances, often lacks transparency. While it may appear to be a mere methodological detail, the choice of the comparison group

- be it a set of all companies or only companies in the sector - matters a lot for the final result. Kotsantonis and Serafeim (2019) demonstrate that the same company can be either a top performer or a mid-performer, depending only on the choice of the peer group. Imputing missing data, which happens often as companies rarely provide the same information, can also be done in a variety of ways, again allowing the possibility that the same set of inputs yields contrasting results.

Altogether, this has led to little agreement across data providers when creating a metric of a company’s sustainability performance. A recent study has found that the average correlation between a company’s ESG ratings produced by different data providers is poor (only 0.4), while alignment is close to perfect for issuers’ credit ratings based on financial performance (OECD, 2020). Worryingly, the disagreements between data providers actually grow with the amount of publicly available information (Kotsantonis & Serafeim, 2019). At the same time, Dremptic, et al. (2020) noted a significant positive correlation between company size and ESG score, suggesting that the way in which the scores are compiled may give an advantage to large firms due to higher organisational legitimacy.

The fact that ESG metrics can differ so significantly for the same company suggests that they may not help investors allocate resources in companies with the

best performance in matters relating to the environment, and social and governance performance. By extension, this also means that these methods may not lead to optimal ESG outcomes and not incentivise companies to act in a way that will achieve the most impact, only in ways which maximise their scores.

As with the discussion of green bonds previously, a careful consideration of details around investment products is crucial. Alignment in indices, uniform units, and transparency do not immediately appear to be decisive for the success of sustainable investing. The literature on the link between ESG and financial performance does not address these topics frequently. In fact, as suggested by Kotsantonis and Serafeim (2019), it is remarkable that “we find signals and meaningful relationships with economic outcomes given the poor quality of the data”. Given the volume of money invested in approaches such as ESG integration and green bonds, these seeming details nonetheless make a big difference for a consequentialist

Where do we go from here?

Sustainable finance is no longer in its nascence. Yet more than ever, it needs a clearly specified direction and set of objectives. If current growth continues unchecked, sustainability investing will enter the investing mainstream. There is already much pressure on fund managers to keep sustainability on

the agenda; the pressure is likely to only intensify in the coming years. While there is much appeal in seeing more growth in sustainable finance, this growth and popularity come with caveats.

As demonstrated in earlier parts of this essay, a large share of sustainable investments is focused on approaches that emphasise and prioritise the bottom line. Such focus, while good for growth in such investments, may not lead to sweeping changes to sustainability outcomes. This comes as an exclusionary practice, the single most common approach in sustainability investing, actively prioritises avoiding harm, as opposed to creating a positive impact. At the same time, ESG integration - the second most common approach globally - relies on metrics that are often inconsistent across data providers, putting their reliability into question. Other types of sustainable investments such as green bonds are also increasingly facing scrutiny over their eventual impact and outcomes.

Much depends on whether finance professionals see sustainability as a feature of business-as-usual investment decisions, or whether they want to use finance to actively tackle sustainability concerns. As we have seen throughout this essay, these two goals do not overlap perfectly, but they are also not mutually exclusive. Importantly, however, a consequentialist mindset is helpful in either case. As companies' approach to sustainability is

likely to have an impact on their long-term financial performance, finance professionals need reliable information on the companies' sustainability performance. There is no better measure of sustainability performance than tangible impacts on people and the environment. At the same time, if finance is the way to tackle the problems of our times, we also need finance professionals to be able to discern where actual impact is being made.

The adoption of a focused, consequentialist mindset is needed among finance professionals who deal with sustainable investments. Greater attention and awareness need to be placed on the impacts and outcomes of specific investments, as opposed to their proclaimed virtues. This includes the need for finance professionals to turn their attention to the more gruelling fine-print details, and absolute and relative benefits and outcomes. Such an approach would address much of the criticism of sustainable investing, including accusations of green-washing, impact-washing, and virtue signalling. As an extension, it would also actively help tackle some of the burning problems of our times.

A systemic reorientation towards the outcomes of sustainable investments would require a coordinated effort, including in the form of improved disclosure practices of companies, consistent methodologies of data providers, increased transparency of both data producers and data handlers, and

strengthened regulatory environment. This would likely impose additional costs on companies and investors, including costs related to data gathering, disclosure, or audit. Higher costs may halt some of the impressive growth we have observed in recent years, though it is arguable that the reorientation may eventually lead to improved sustainability outcomes.

Some reorientation is already on its way. While the growth in sustainable investments globally has gone largely unchecked by regulators, this is now changing, particularly in Europe, the largest market for sustainable investments (Global Sustainable Investment Alliance, 2018). New regulation and guidelines, mostly coming from and being applied to European finance, include a range of abbreviations, such as EU GBS (EU Green Bond Standard); SFRD (Sustainable Finance Disclosure Regulation); ESG risks in ITS (Planned incorporation of ESG risks in the European Banking Association's Implementing Technical Standards); the EU Sustainable Finance Taxonomy; and TCFD (Task Force on Climate-Related Financial Disclosures). Some of the new rules and regulations aim to solve the very problems discussed in this essay, for example by providing clear definitions of green activities and unifying disclosure practices. European regulations may also have spillover effects on companies in other jurisdictions, which both sell their products in Europe and buy products from Europe.

However, it is still too soon to say if any regulation or guideline will match the scale of impact of the “Global IFRS revolution” (Zimmermann & Werner, 2013). In the span of a few years, International Financial Reporting Standards, led by the International Accounting Standards Board, replaced several other competing accounting standards. Eventual convergence in standards meant that companies’ performance could be compared directly, greatly simplifying investors’ decision-making. Such convergence is needed and much anticipated for sustainable finance.

In the meantime, greater appreciation of the differences in products and approaches in the market for sustainable developments would be a welcome development to ensure outcome-orientation. This could mean, for example, increased differentiation between investments which are compliant or non-compliant with specific guidelines and regulations. This is already the case for example with Certified Climate Bonds (which, however, constituted only a small fraction of the green bonds market in the first three months of 2021 (Climate Bonds, 2021)). Similarly, investments could also be differentiated along the “do-no-harm” and “do-good” axes, “assured” and “not-assured” sustainability credentials, or along the “impact-aligned” and “impact-generating” spectrum, as suggested by Busch, et al. (2021). As the sustainable investment universe

grows larger every year, more nuance is needed to ensure that capital is allocated in accordance with sustainability outcomes.

Conclusions

In this essay, I discussed (i) the intentions behind sustainable investing; and (ii) the need to focus on specific outcomes and impacts of sustainable investments. The essay’s conclusions can be summarised by the following points:

Intentions: The sustainable investments universe is dominated by sustainable investment approaches most closely related to traditional investing, such as exclusionary screening and ESG integration. This is consistent with investors’ motivations to seek improved financial returns, as opposed to creating most impact. Relatedly, the most popular sustainable investment approach globally - exclusionary (or negative) screening - reflects investors’ “do-no-harm” considerations, as opposed to “do-good” considerations.

Outcomes: Greenwashing and problems with ESG metrics inhibit the ability of green bonds and ESG integration to deliver on sustainability outcomes:

Greenwashing is an important concern among investors, as demonstrated by the example of green bonds. The rise of “dark green” investments and climate bonds reflects the growing calls for nuance, detail, and assurance in sustainability investments;

The concern with ESG ratings goes deeper than analysts' or economists' usual concerns over data limitations. Lack of alignment in ESG metrics is a structural issue that undermines the ability of investors to allocate capital optimally to companies with sound ESG performance. ESG ratings stand in stark contrast to credit ratings – used to help investors allocate capital to companies with sound financials – which are almost perfectly aligned, having the underpinning of unified

accounting standards.

A consequentialist mindset is crucial among finance professionals engaged in investing in sustainability. The focus on the outcomes of sustainable investments, as opposed to their virtues, may halt some of the impressive growth in sustainable finance. Yet those seeking to maximise long-term gains, and those hoping to use finance as a way to tackle problems of our times, both stand to gain from a reorientation to impact. •

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