RE-SOURCING
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Author: Dr. Masuma Farooki
Affiliation: MineHutte

The Role of Financial Markets in Driving Responsible Sourcing

Abstract:
This briefing document details the discussions in the 'Investment, Stock & Commodity Markets' session at the opening conference of the RE-SOURCING Project: '[Drivers of Responsible Sourcing – Common Ground, Collective Action, Lasting Change]' (18-19 January 2021). The financial sector is learning to leverage its financial power through direct engagement and greater sustainability reporting requirements from companies. Challenges remain in furthering their use of such leverage, including lack of standardised reporting metrics, weak regulations on RS, dealing with non-compliance, need for constant monitoring and a sizeable number of asset managers not engaging with the sustainability agenda in a meaningful way. The sector can contribute greatly to the RS agenda, but it is important for policy stakeholders and civil society to understand the diversity within the financial sector and how to engage with these actors. The full panel discussion can be found here.

The **RE-SOURCING Project** aims to build a global stakeholder platform for responsible sourcing. The project addresses the challenges facing businesses, NGOs, and policymakers in a rapidly evolving ecological, social, business and regulatory world; through a collective, consultative, and industry & civil society driven approach. RE-SOURCING is funded by the European Commission's Horizon 2020 programme and runs from 1 November 2019 to 31 October 2023.

1. Financial Markets: Session Focus

The interplay of social, economic, environmental and political factors is currently driving the Responsible Sourcing (RS) Agenda across global value chains in the extractive and related industrial sectors. The actors and processes that support this agenda are well identified, as are the RS frameworks and standards proposed and implemented by them. However, the operationalisation of concrete practices is multifaceted, and the RE-SOURCING Project is keen to promote peer learning and knowledge sharing around the how, what and why.

The Session Participants:

- **Andreas Hoepner:** University College Dublin
- **Elina Rolfe:** Principles of Responsible Investment (PRI)
- **Eric Rasmussen:** European bank for Reconstruction & Development (EBRD)
- **John Howchin:** Swedish National Pension Fund
- **Sara Blackwell:** UN Working Group on Business & Human Rights

In the session on Investment, Stock & Commodity Markets, at the first annual conference of the RE-SOURCING Project, experts explored the question of how the financial sector could push for more responsible sourcing?

The session discussed the diversity of actors within financial markets and their ability to influence companies on responsible sourcing (RS) issues. Acknowledging that most investment institutions were 'new' to the RS and sustainability arena, investors have initially struggled to understand reporting requirements and application of sustainability driven strategies. However, investors have now begun to better understand the leverage they have in engaging with companies over sustainability issues. Challenges remain in furthering their use of such leverage, both inside and outside the financial sector.

2. Diversity in Financial Markets & Leveraging Power

It is important to distinguish between financial markets as different markets allow for different levels of engagement between investors and companies on RS issues.

2.1 Commodity Markets

Commodity markets trade contracts for commodities (such as metals, agricultural products, meat etc, see box for an example). The actors participating in commodity markets tend to be investors (both short term investors such as speculators and long-term investors such as pension funds) and to a lesser extent by consumers (manufacturers) and producers (such as mining companies) of metals.

Commodity markets such as the London Metals Exchange, set the price for internationally traded metals (such as aluminium, cobalt, copper, nickel, tin, zinc) that is then used as a benchmark for contracts between mining companies and metals consumers. While speculative activity in commodity markets can drive up prices- price does not reflect market fundamentals- the buyers and sellers are unable to directly engage with individual extractive, smelting or manufacturing companies.

Given that these actors can only influence the commodity price and not the practices of individual companies, they have no direct power for holding companies to account. Note: The LME Responsible Sourcing Requirements issued by the LME in its capacity as exchange regulator apply to any company wishing to use the LME warehouse system. As such, it is a market access tool and not a price setting one.

LME Copper Contract Specification:

- Lot size: 25 metric tonnes
- Tick value: US$12.5
- Contract Types: Futures, Options, TAPOs, Monthly Averages Future, LMEminins and HKEX London Minis traded on HKEX London Minis traded on HKEX derivatives platform.

2.2 Stock Markets

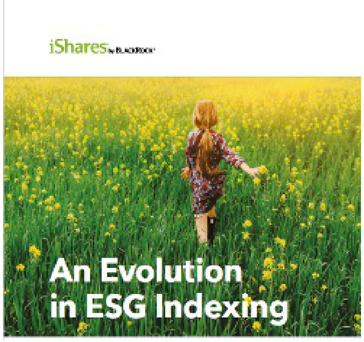
Also known as equity markets, these markets trade shares in individual companies and funds. A fund is a collection of company shares, thereby an investor can hold equity in a number of companies in one transaction rather than individually investing in each company. The emergence of 'Green Funds' is a way for investors to select a distinct set of companies that have been judged to either contribute to green technologies (such as Tesla) or have evidenced good performance on Environmental, Social & Governance indicators. As a shareholder, equity markets allow for the investor to directly engage with the company on matters of RS and sustainability. Where enough like-minded shareholders get together, they can influence and change the company's RS strategy and processes.

2.3 Bond Markets

Also known as debt markets, investors trade debt securities, i.e., a contract for the repayment of debt with interest. Companies and countries use bond markets to secure financing, either for new projects or, more commonly, to pay off previous debt. Bond markets are the major source of finance for both companies (in addition to equity shares) and for countries (such as the U.S. Treasury Bonds). Given the importance and extent of debt financing for companies and governments, particularly in the context of re-financing their existing debt, bond market investors can exert a great deal of influence on these actors. They can if they choose to do so, charge higher interest rates for projects with weak sustainability profiles or even refuse financing all together. Of the three markets, bond markets can exert the most leverage on the RS behaviour of companies and governments.

"Map & understand the investment eco-system and the actors that are involved and how they relate to each other; understand how to use leverage points between those actors, holding investors as accountable as other actors".

Sara Blackwell,
UN Working Group on Business & Human Rights



2.4 Ownership of Leveraging Influence

Translating leverage into action requires financial actors to understand their level of influence on corporate behaviour. Investors have traditionally focused on rates of return on investment and compliance with regulations in their interactions with those they invest in. Shareholder activism from equity investors has gained traction in recent years – with shareholders actively engaging with companies on their practices and influencing change. Using ESG performance indicators to direct investment flows has also emerged over the past five years – such as BlackRock (private equity) and the Swedish National Pension Fund (government agency). The leveraging of financial power may differ – for example BlackRock focuses on ESG performance indicators, while the Swedish National Pension Fund actively engages with companies to improve their RS and ESG performance. Therefore, while different markets allow for different levels of engagement with companies, taking ownership of this engagement and using leverage to influence companies also greatly differs amongst financial actors.

"The buy side is your friend; the sell side sells anything to anyone"

Andreas Hoepner,
University College Dublin

2.5 The Buy & Sell Side

Within the investment community, it is also important to differentiate between those who buy and sell investments. Capital owners, whether they be individuals or pension funds, purchase investment assets and can decide on the requirements of these assets. For example, buyers may require no arms manufacturers will be included in their investment asset, or that only companies with acceptable green credentials will be part of the investment asset. Investment brokers, which can include hedge funds and large investment banks, sell these investment assets. These actors respond to client demands and market trends and will construct an investment asset to meet market demand. Their motivation is to sell assets and they are not concerned with RS and ESG metrics, unless it is required as part of the sales process. Buy side investors on the other hand are more likely to engage with the sustainability credentials of an asset and should be the focus on engagement by other actors to further responsible investments.

3. Assessing Responsible Sourcing & Sustainability

Whether an equity investor or a bond investor, asset managers need to be able to assess a company's sustainability performance. Apart from those investing in particular mining projects, asset managers will be investing in companies and often in a cross-section of companies i.e., they will not all be from the mineral sector. Therefore, decision making needs to be informed by data and performance analysis at a standardised level. Five common means of assessment are used within the financial sector with regards to RS and ESG measurement.

3.1 Green Taxonomy

A common definition of what classifies as sustainable environmental, social and governance performance is not available at this time. Similarly, there are no agreed definitions for measuring RS and sustainability. Therefore, when companies were required to report on their RS/ESG performance, there has been hesitance in complying with such reporting, partly related to measurement and reporting metrics.

The lack of a standardized metric of measurement also leads companies to report on different aspects and not in a uniformed manner – thereby making comparisons across companies difficult. The EU Taxonomy for Sustainable Activities is a step to address this gap, with the tool expected to be available in 2021. It aims to provide appropriate definitions for companies, investors and policymakers on which economic activities can be considered environmentally sustainable. Green Taxonomy is focused on company performance.

3.2 ESG Reporting & Ratings

In judging the validity of a company's ESG performance, an important question to ask is 'who is paying for it'. This distinguishes between self-reported performance (such as Annual Sustainability Reports) or by a rating that is assigned by a third-party. Self-reporting, while encouraged for transparency, should not be fully trusted by good investors. It allows the company to choose what it reports and 'no company wants to report on its pollution more than it has to' (Andreas Hoepner). This axiom also applies to companies following voluntary standards – as they can choose how much information to volunteer. Third-party reporting has emerged over the past five years, such as ESG ratings from S&P Global, MSCI, Sustainalytics and FTSE Russell amongst others. These ratings provide a more independent assessment of a company's performance, although they are not freely available in the public domain, nor is the methodology behind these ratings clear. ESG ratings and reporting reflect company performance.

MSCI ESG RATINGS

CCC	B	BB	BBB	A	AA	AAA

MEMBER OF
Dow Jones Sustainability Indices
In collaboration with SAM

3.3. Advanced Research Services

Stepping away from numerical/scoring systems, a narrative performance assessment is available from third parties, including NGOs and global media services. Given the advancements in artificial intelligence and machine learning, there is increased ability to digest information from diverse sources on the internet. Advance research services provide reputational risk analysis, as well as combing data from diverse sources (including company and NGO reports) to provide investors with an assessment of a company and countries performance. For example, RepRisk uses machine learning and human analytics to provide an ESG Risk Platform for company assessments.

3.4 Non-payable Media

Civil society groups, NGOs, independent think tanks and social media report on issues related to sustainability performances. So far, they do not use all-encompassing ESG or RS metrics, but report on individual issues such as corruption, environmental damage, human rights abuse etc. These are available in multiple languages, from multiple regions. These diverse sources can be used by investors to evaluate company performances as well as country performance.

3.5 Global SDGs Indicators

Investors are also aware that sustainability performance is not limited to companies, and countries of operations should also be considered. A company operating in a weak sustainability jurisdiction will tend to face lower regulatory requirements on RS and ESG performance. Country performance is also an indicator for debt investors looking at financing sovereign governments. The UNSTAT datasets on country performance on Sustainable Development Indicators can be a useful guide for investors for country performance, as its methodology is clear and allows for benchmarking of country performance.

4. Opportunities for Leveraging Finance

The panel discussion of the RE-SOURCING opening conference indicated that the relationship between investors and companies has evolved over the past decade, with investors now more willing to leverage their investment power than before. Previously, some may not have been even aware that they had financial power that could be leveraged. This ownership of influence has emerged in various ways:

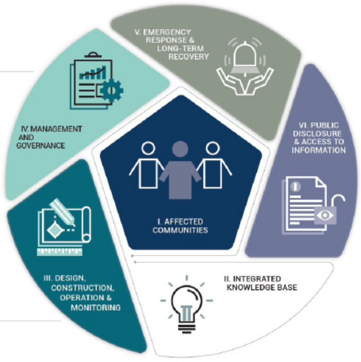
4.1 Evolving through Answering Questions

The expectation of investors to report on their own sustainability performance from capital owners, i.e., which companies do they invest in and how these companies perform on sustainability issues, has led to a self-questioning exercise by investment managers. In order to respond to the owners of capital, investors have had to internally examine their own outlook on sustainable finance and how they understand and implement it in practice. This process is still evolving, with investors defining their ability to leverage their power for better ESG and RS performance from the companies they invest in. The PRI is working towards a common understanding, reporting and impact assessment for responsible investments with its signatories.

4.2 Working with Companies to Improve Performance

Where investors are directly involved in project funding with a company (either through equity or debt financing), a deeper due diligence process can be implemented. From looking at company policies, the calibre of Environmental and Social Impact Assessments (ESIAs) carried out, the response of local communities, the labour rights and security policies of the company, the investor can gauge not only the current performance of the company but also existing gaps. Thus, working with companies, through jointly designed action plans, the investor can push a weak performer to a strong performer and assist in the wider implementation of RS practices. Rather than declining a project with weak sustainability performance, investors (such as the EBRD) are choosing to work with companies to improve their performance.

4.3 Tailings Dam Standards – Leveraging Financial Power



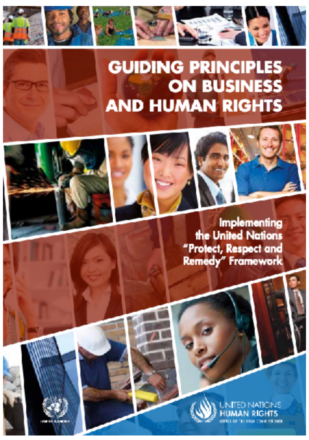
Global Industry Standards on Tailing Management. Global Tailings Review. April 2020

Within a week of the tailings dam failure at Brumadinho in January 2019, at a Vale iron ore mine, the Swedish Pension Fund, together with a number of other pension funds, issued a public call for a global independent and transparent classification system of the world's tailings dams. The system required publishing safety standards corresponding to the type of dams, and dams to be independently audited to these standards. The information was required to be made available and free to access for communities, workers, insurers, lenders and regulators and is now available online. Together with PRI (Principles for Responsible Investment), UNEP (UN Environment Programme) and the International Council on Mining & Metals (ICMM), the two pension funds also pushed for a Global Industry Standard on Tailings Management. These major milestones – transparency and global standards have been achieved within two years of the tailings dam disaster – show that the financial sector can have a clear and measurable impact, where it chooses to leverage its power.

5. Challenges Facing the Financial Sector

5.1 Standardized Reporting

As noted earlier in this document, and in other briefing documents, the need for a standardised reporting mechanism and accompanying taxonomy is urgent. This reporting mechanism is not only required from the companies that financial markets invest in, but also for investors themselves to better understand the scope and implementation of their own RS and ESG strategies.

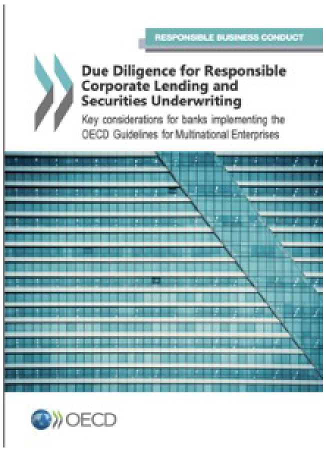


5.2 Understanding Greenwashing

The conference's panel on RS in finance agreed that the issue of greenwashing is also linked to the lack of clear reporting guidelines and definitions for RS and ESG. Where companies are unclear on what needs to be reported, they choose to report on a number of issues – particularly those that show them in a better light. This information is disregarded by the markets as either being irrelevant or inefficient to gauge company performance – hence the term greenwashing. For better reporting from companies, not only do the RS and ESG indicators need to be defined, but also a standardized (preferably regulated) reporting model needs to be used. Regulatory disclosure will require companies to report on all metrics, and not allow company to cherry pick their performance indicators.

5.3 Weak Regulations

RS reporting and implementation requirements need to move from a voluntary to a mandatory condition for company operations. While debt investors can require companies to report and implement RS as a pre-requisite to finance, this would remain piecemeal and only applicable to certain companies. Requirements for individual companies only also inhibit the creation of industry benchmarks, where high performers can be compared with weak performers. Where regulations are weak, investors can struggle to leverage their power in asking for better RS performance from companies.



5.4 How to Tackle Non-compliance

Related to the issue of weak regulations is the issue of non-compliance of operations in jurisdictions where regulations or standards do not exist at all. Supply of minerals and their processing occurs in a number of non-EU jurisdictions, some of which have not fully developed RS policies and standards for their jurisdictions. The session discussed cases, for example in the former Soviet Republics, where engagement with both companies and government agencies was required to explain how the sustainability agenda is an important element for natural resource investments and to introduce measures and policies that entrench this concept. Additionally, jurisdictions with weak implementation capacity for monitoring activities leave the investor unable to scrutinize RS and ESG compliance. Disengagement is not an option, given that natural resource investments can be a valuable source of employment generation, export and government revenues for a number of regions.

5.5 Constant Monitoring

Evaluation of a company's performance should not be a one-off consideration. For example, if a company has been certified once to a standard (such as the IRMA Standard), it should continue to be monitored on its performance afterwards. This brings in the aspect of regular audits and certification validation and checks, and also require RS practices to be embedded within a company's process rather than a standalone exercise. Investors are seeking assurance that once a company has met a particular standard, it continues to do so in the future.

5.6 Missing Asset Managers

While the number of Green Funds and investors are growing and engaging with companies and civil society on RS and ESG matters, mainstream asset managers are still missing from this conversation. For responsible investment to truly become normalised, these asset managers need to engage with the RS arena. The session discussion suggests that younger asset managers are more in tune with the sustainable finance debate, as a reflection of the generational priority that differs from their older counterparts.

6. Next Steps

As the different actors within the financial sector evolve in their understanding of sustainability and develop strategies for RS, there are a number of steps that can aid this process.

The need for education. Engagement and education of financial sector actors on what is RS, what it entails, standards available and the debate and progress around measurement are essential for a larger number of financial actors to leverage their financial power for wider RS implementation. In return, civil society and governments need to educate themselves on how the financial sector ecosystem works and where best to focus on their efforts on engagement. As noted earlier in this briefing document, the ability to influence companies varies across sectors.

Accountability. Investors need to be held to account for their commitments to responsible funding. An approach to generate transparent, public domain mechanism, needs to be developed to hold investors to account on their commitments to responsible investing.

At this time, there appears to be three avenues for accountability:

- **Regulations**, where investors must comply with disclosure requirements under the law. This is at a preliminary stage under the EU non-financial reporting directive.
- **Alliance based reporting**, such as that undertaken by the signatories of the Principles of Responsible Investment.
- **Shareholder Activism**, where capital owners and equity owners in investment funds require the executive board to explain their sustainable investment practices. Again, this is limited to shareholders only.

"Very soon only responsible companies will make money".

John Howchin, Swedish National Pension Fund

Taxonomy & Language. Investors are challenged to understand the requirements for RS and ESG as the taxonymy for these concepts is not available. Apart from hindering the implementation of these practices within investment strategies, it also hinders the investors' capability of requiring the companies they invest in, to report on the required measurements. In addition, the investment sector has a language of its own, often different to the one used in the social sciences. Concepts such as engagement, informed consent, participation, impact, and conservation are treated differently in the financial sector than in the social and governance sectors. Therefore, the financial actors need to be exposed to the language and its meaning used by mainstream RS stakeholders. Focused engagement with different actors within the financial sector can address this gap. Reciprocally, the social and governance sector must familiarise itself with the language used by the financial sector, to better engage with it.

Mapping the Finance Eco-System. It is often noted that the RS landscape is a complex ecosystem, with multiple stakeholders and it can be difficult to navigate for newcomers, with all the multiple linkages that exist. Similarly, the financial eco-system has multiple nodes, chains and is a large complex of its own. To successfully engage with this ecosystem, proposers of RS implementation need to first map and understand how the system works, before fully engaging with the relevant financial stakeholders. Cross-sector engagement through seminars/webinars, conferences and meetings is a useful first step in this direction.

7. Summary

This session focused on the question of how the financial sector could push for more responsible sourcing. In answering this question, the experts agreed that the financial sector had initially struggled to understand its role and what shareholders, governments and civil society required of it. However, the sector has generally undertaken a period of self-examination and is now beginning to address and drive RS and ESG implementation. Some actors in the financial sector are beginning to drive RS by leveraging their financial power through direct engagement with companies. Some of their actions have already shown tangible impacts, such as a global standard on tailings dams. Others, such as the PRI and the UN Working Group on Business and Human Rights, are driving RS forward by working together with investors to help them better understand the sustainability agenda and how they can embed it in their policies and practices. The sector can contribute a great deal to the RS agenda, but it is important for policy stakeholders and civil society to understand the diversity within the financial sector and how to engage with these actors.

The findings from this session will be taken up in the Road Map development and Global Advocacy Fora being organized under the RE-SOURCING Project over the next three years.

The full panel discussion is available here.

Recommended readings from session:

- **Business & Human Rights**: Towards a decade of global implementation
- **European Bank of Reconstruction & Development (EBDR)**: Extractive Mining Industries Strategy
- **Danish Institute for Human Rights**: Tech Giants & Human Rights- Investors Expectations
- **Human Rights Assessment of** Goldcorp's Marlin Mine

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