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The Risk of Ignorance

How Financial Institutions Can Make a Difference in Large-Scale Media ESG News Monitoring

sentometrics

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Abstract

When firms overlook ESG news in the media and become ignorant, they face four key pitfalls:

(i) adverse selection, where they might inadvertently engage with less sustainable partners;

(ii) moral hazard, where ignoring ESG issues could lead to irresponsible practices;

(iii) heightened reputational risks; and

(iv) negative societal impacts due to overlooked externalities.

Conversely, a synergy between firms and media outlets in actively scanning for material ESG events can lead to superior societal outcomes. This approach reduces the likelihood of firms becoming embroiled in ESG controversies and enhances their capability to respond effectively to relevant ESG incidents, especially when they have direct exposure. We delve into the challenges facing this proactive system and underscore the pivotal role of financial institutions as agents of change. They are instrumental in steering towards a society where both positive and negative ESG events receive the attention they deserve from the media and corporate decision-makers.

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Introduction

Environmental, social, and governance (ESG) objectives are becoming more prominent in the mission statements of companies. Accurately measuring progress towards these goals is a crucial aspect of genuinely embracing ESG principles. Many organizations achieve this through voluntary reporting by companies within their supply chain. An additional, often more immediate, source of data comes from media reports on ESG disputes and positive ESG actions taken by related companies. Given that corporate decision-makers often lack the capacity to track all such events, they typically depend on specialized news agencies to keep an eye on global developments for them. However, this system breaks down when these decision-makers do not utilize the ESG-related information provided by these specialized news sources, leading to a scenario where stakeholders might wrongly believe that “no news received is good news”.

In this study, we examine companies as stakeholders (clients, suppliers, financiers) in relation to others involved in significant ESG events. Adhering to the Corporate Sustainability Reporting Directive (CSRD), we assess exposure from two perspectives: financial materiality (the impact of ESG risks on a company’s finances) and impact materiality (the societal impact of companies within the value chain).

A minority of business decisions systematically incorporate ESG information from media sources. Notable exceptions include reputation management, where media monitoring is extensively utilized (e.g., RepRisk, 2023), compliance and fit-and-proper analysis in the financial sector, and equity investing where substantial progress has been made in incorporating media information into ESG scores of listed companies (e.g., LSEG, 2023).

We characterize companies that overlook media disclosed ESG events as adopting an 'ostrich view'. This stance carries the inherent risk of ignorance, which manifests as: 1. adverse selection; 2. moral hazard; 3. societal negative externalities; 4. increased reputational risk, as detailed below.

Our paper advocates for a coordinated system between companies and news media, leading to a more balanced ecosystem with positive feedback loops between corporate ESG actions and media reporting. We explore the benefits and potential challenges of this system. We particularly urge financial institutions to lead the change by integrating media news as extra-financial data, quantifying their business lines' impact on environmental, social, and governance aspects. Their pivotal role in economic financing makes them crucial for the successful implementation of ESG policies based on extensive media monitoring.

The paper is structured as follows: We begin with a succinct overview of related literature, followed by introducing a framework for integrating large-scale ESG media monitoring into stakeholder decision-making. We then discuss the four aforementioned pitfalls and propose a solution through coordination.

Related literature

Our paper explores the intersection of two vital areas of research: the phenomenon of active information ignorance by companies, and the integration of ESG data in corporate decision-making processes.

We direct our readers to Golman et al. (2017) for an extensive discussion on why firms might opt to ignore information. From a strictly profit-maximizing standpoint, this occurs when the marginal benefit is lower than the marginal cost. Companies might deliberately eschew information to prioritize self-interests, neglecting externalities. For instance, firms may choose ignorance over information that necessitates actions beneficial to others but disadvantageous to them if unaware (Nyborg, 2011). Furthermore, firms might shun information to evade responsibility, fearing that knowledge acquisition could hold them accountable for ethically questionable actions (Rayner, 2012). Golman et al. (2017) also attribute this avoidance to cognitive dissonance: managers may resist information that contradicts their prior decisions.

In this paper, we posit that shareholders require firms to consider ESG data in decision-making. This mandate could stem from ESG preferences of clients, suppliers, investors and policy makers affecting cost of capital and expected cashflows (Baker et al., 2022; Pástor et al., 2021), the financial risk insights inherent in ESG data (Ardia et al., 2023), or adherence to regulatory frameworks like the Corporate Sustainability Reporting Directive and the Sustainable Finance Disclosure Regulation. Under this framework, we can consider that ESG-conscious behaviour by managers is the social norm and that deviating from this affects the reputation of the firm and the manager. Dyck and Zingales (2002) model the impact of media attention on corporate behaviour when managers can be of two types, good or bad. If the payoff of being identified as a bad manager is sufficiently negative, the bad manager will decide not to take negative ESG actions. Hence, when media monitoring is more effective in detecting the bad ESG actions, the more likely it becomes that managers will behave in an ESG-conscious way.

Detecting relevant ESG news amidst a deluge of data is akin to finding a needle in a haystack. A potent strategy involves sophisticated information retrieval techniques and the creation of composite indicator time series. These news-based ESG indicator time series consider entity relevance, ESG thematic pertinence, and a controversy or positive impact intensity score. Deployment requires data scientists to collaborate with data engineers to ensure the latest value of the indicator time series reflects the most up-to-date ESG information in the news data. Boudt et al. (2024) elaborate on the deployment of a thematic media monitoring system for Belgian companies, utilizing open-source intelligence for precise entity disambiguation. The approach is transparent and allows for drilldown analysis. Integrating it into a watchlist management system ensures that the alerts do not slip through the cracks.

General framework of integrating large-scale ESG media monitoring in stakeholder decision processes

In today's dynamic and complex economic environment, companies find themselves interlinked with a diverse array of other businesses. These connections expose them to decisions that carry significant impacts beyond just the financial - encompassing Environmental, Social, and Governance (ESG) aspects as well. Given the vastness of these networks and the prevalent information asymmetries, decision-making for companies is often shrouded in uncertainty.

To effectively navigate these uncertain waters, entrepreneurs and company leaders can greatly benefit from leveraging trusted information sources, such as news media. The insights provided by these outlets are critical for understanding the broader ESG ramifications of their business choices.

Figure 1 illustrates our conceptual framework. Echoing the approach of Nimark and Pitschner (2017), we posit that individual stakeholders lack the resources to keep track of all ESG events on their own. Consequently, they depend on specialized news providers for global monitoring. In this model, stakeholders subscribe to a subscription license from a media aggregator, gaining access to news from a wide array of sources (Wuytack, 2021). Following the principle of revenue sharing, the media aggregator ensures a fair share is used to remunerate the contributing news outlets.

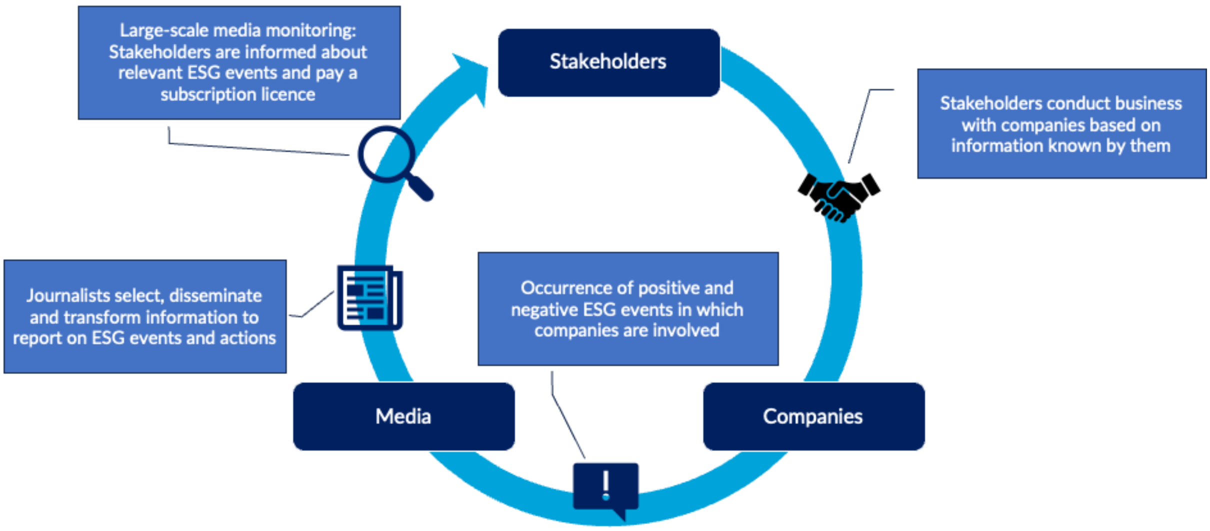

Figure 1. Conceptual Framework for the Feedback Loop in Media-Informed Decision Making on Material ESG Events

In return, media organizations employ journalists to monitor global events and report on ESG. The act of publishing an article itself generates information. Given that resources are limited, news events vie for a journalist's attention. This selection process is shaped by stakeholders explicitly expressing their interest in ESG events while purchasing content licenses. Additionally, journalists play a crucial role in agenda-setting in this context (McCombs and Shaw, 1972) as well as in framing and information augmentation.

As discussed by Ardia et al. (2022), in response to a material company event, the media tend to disseminate the readily available information about the event and augment it further by transformation. This transformation includes any modification, completion, or contextualization of the information that is readily available.

Journalists disseminate their news through both print and online platforms across various media outlets. Media aggregators then compile and centralize this diverse information. However, since standard recommender systems are not specifically tailored for materiality assessment, a specialized process of news screening and summarization becomes essential. This ensures that stakeholders are informed about only those ESG news events which are pertinent to them. For this purpose, statistical algorithms rooted in information retrieval theory prove to be highly effective (Borms et al., 2021 and Boudt et al., 2024). These algorithms can filter, prioritize, and summarize vast amounts of data, pinpointing the most relevant ESG news for stakeholders

Upon receiving ESG signals derived from news sources, stakeholders are prompted to reevaluate their expectations and modify their decisions accordingly, as discussed by Ardia et al. (2023) and Baloria and Heese (2018). As media focus on the ESG impacts associated with a particular company increases, we expect a corresponding escalation in the company's reaction to these events. Conversely, a reduction in media focus is likely to lead to a lessened corporate response. This dynamic creates a positive feedback loop that can yield significant benefits for society. Enhanced media scrutiny not only holds companies accountable but also encourages proactive engagement with ESG issues, leading to more informed and responsible decision-making that aligns with societal and environmental well-being.

Threats to this positive feedback loop ecosystem

While ESG objectives are crucial, they represent just one among many goals and constraints that stakeholders juggle. The system's effectiveness faces three primary challenges.

The first challenge is greenwashing: stakeholders might declare lofty ESG goals and publicize them yet fail to implement these ambitions in practice. One stark example is the reliance on financial algorithms for decisions on loans and insurance that bluntly ignore ESG data. Another is delegating decision-making to relationship managers without giving them access to reliable ESG information. A third instance involves monitoring ESG news without acting on it. While a bankers' oath might address this issue, it is still miserably ineffective if relationship managers lack access to essential ESG information or if there is insufficient monitoring and incentives, as indicated by the ECB (2023).

The second challenge lies in the potential disparity between the total cost and the perceived benefits of integrating ESG information from media into business decision-making processes. This total cost encompasses payments to news publishers, expenses for algorithms to identify relevant news, and the costs involved in processing these signals for decision-making. Given the large number of potential sponsors and subscribers to the system, there is however ample scope for economies of scale to reduce the cost per user. Therefore, the system thrives if there is a large enough group of stakeholders willing to pay for content licenses, supporting a diverse range of media journalists who report on pertinent ESG events.

The third challenge is the tendency for some firms to purposedly take the ostrich view, believing in the self-fulfilling prophecy of systemic success. The trap of self-fulling prophecy is to believe that a positive feedback loop ecosystem will emerge naturally. This is a key misconception. If the prevailing attitude among companies is to avoid contributing to the system, the necessary critical mass for the system's effectiveness will never be achieved. It requires a significant commitment to societal responsibility and a belief in the system's benefits for companies to actively participate.

By investing in the system, companies can help foster a cycle of positive outcomes: increased funding for journalism focused on ESG events leads to more accurate and timelier ESG alerts. In turn, these alerts enable companies to take more effective and immediate actions in response to ESG matters. This proactive approach contributes to a societal framework that actively rewards actions with a positive ESG impact and penalizes those involved in ESG controversies. The overall effect is a more informed, responsible, and sustainable business environment, benefiting all stakeholders.

The risk of ignorance

Free riding, which refers to firms that think they benefit from the system without contributing to its costs, remains a serious threat unfortunately. Free riding might seem like a cost-saving strategy, but it can result in greater long-term costs compared to participating in the positive feedback loop ecosystem that we promote.

When firms free ride, they become ignorant over time. As they neglect their ESG reputation and ignore ESG news in the media, they face four major pitfalls.

Competitive Disadvantage and Adverse Selection

Firms that free ride miss out on the knowledge and insights gained from actively engaging with ESG information. They become less informed than their competitors who are more engaged with large-scale media monitoring companies. This ignorance and lack of engagement can lead to a competitive disadvantage, as more informed competitors have more effective sales leads, make better strategic decisions and avoid adverse selection issues. Adverse selection occurs when firms unknowingly associate with less sustainable partners (clients, suppliers and financiers) due to a lack of ESG awareness. It can lead to partnerships or investments that are unsustainable or unethical, potentially harming the firm's long-term interests.

Moral Hazard and Regulatory Risk

Heese et al. (2022) show that local press is an effective monitor of corporate misconduct. Ignoring media information about ESG issues could lead to irresponsible practices within the firm, particularly in situation where it engages in riskier ESG behaviour because it does not bear the full consequences of that behaviour. This refers to moral hazard. In the context of ESG, this could mean neglecting sustainable practices because the immediate costs of such practices are perceived as high. However, governments are increasingly imposing stringent ESG regulations. Firms that neglect active engagement in ESG monitoring face heightened regulatory risk. They are more likely to fall into non-compliance, potentially incurring legal penalties or operational disruptions. These consequences can significantly exceed the initial costs of ESG compliance, sometimes leading to financial strain severe enough to hasten the company's bankruptcy. This outcome underscores the importance of proactive ESG engagement to mitigate long-term risks and ensure sustainable business operations.

Investor Relations and Reputational Risk

Investors are progressively valuing ESG compliance. A firm that neglects these factors risks alienating current and potential investors, affecting its access to capital. The stake is high and goes beyond shareholders. Becchetti and Manfredonia (2022) emphasize the role of reputation as a key mechanism through which media affect corporate performance. In today's highly interconnected and socially conscious market, ignoring ESG issues can indeed severely damage a firm's reputation. In response to negative reputation events, banks may become more cautious and alter the financing terms. The empirical evidence of Becchetti and Manfredonia (2022) seems to support this claim: they find that negative media attention tends to increase bank loan costs. Also consumers and investors are increasingly holding firms accountable for their ESG performance, and failures in this area can lead to loss of customer trust and investor confidence.

Negative Societal Impacts

Overlooking the broader societal implications of business decisions can result in negative externalities, i.e., costs that are inflicted on the environment or society at large, rather than the firm itself. These can range from undermining collective efforts to heightened environmental damage. First, when significant players in the market free ride, it undermines the collective efforts towards sustainability. The financial burden and effort are unfairly distributed, potentially discouraging proactive firms. Second, the effectiveness of ESG initiatives often relies on a strong feedback loop between media reporting, corporate response, and stakeholder engagement (Dyck and Zingales, 2002). Free riders weaken this loop, reducing overall momentum towards change in society. Third and perhaps most crucially, it only takes one major negative ESG event by a prominent free rider to unleash substantial negative externalities. These events can cause widespread environmental damage, social unrest, or economic disruptions, affecting not just the responsible firm but the broader society and economy. The cost of rectifying such a situation often far exceeds the investments required for proactive ESG engagement.

Conclusion: Financial institutions as changemakers

From the work floor to the board room, augmenting decisions with ESG information from the media has clear benefits. While individual firms might perceive free riding as a cost-saving strategy in the short term, the long-term consequences for both the firm and society can be dire. A holistic and engaged approach to ESG is therefore not just beneficial but essential for the sustainable progress of both individual businesses and society.

We are convinced the media can play an increasingly important role of uncovering unlawful, unsustainable or unethical behaviour of companies and stimulating positive impact actions by firms. However, this potential is not fully materialized today since many companies do not systematically use media news as source of information about ESG events. This remains a lose-lose Nash equilibrium as long as firms free ride.

Firms and media outlets can of course collaborate in actively monitoring and responding to material ESG events. This collaborative approach can enhance corporate accountability, drive sustainable practices, and build a more informed and responsible business environment. However, it is important to acknowledge that there is no certainty in achieving the critical mass required for this ecosystem of positive feedback loop to function optimally.

Leading corporations, especially financial institutions, must pave the path to progress. With their pivotal role in the economy's financial mechanisms, their commitment to comprehensively monitor ESG events through media channels is crucial for initiating transformative change, from a prevailing culture of the 'ostrich view' - where issues are ignored - to one of proactive engagement with ESG matters. Specifically, we recommend that media-based alerts about ESG news trigger further communicative dynamics in which information is exchanged and actions are discussed. The information exchange may happen internally within the financial institution (e.g. between the relationship manager and the ESG and reputation management team) as well as between the financial institution and the external stakeholders involved in the ESG event.

Financial institutions are uniquely positioned to integrate these media-derived ESG signals and subsequent information exchanges into their core operations, including loan issuance, insurance underwriting, and payment facilitation. By doing so, they can drive the entire system towards a reality where both the positive and negative aspects of ESG are given due attention by those making critical decisions. In such a world, decision makers can be assured that receiving no news is indeed good news: A lack of news would truly signify that there are no pressing ESG concerns, providing a more reliable indicator of stability and responsibility.

We, therefore, urge financial institutions to embrace their potential as catalysts for positive change, rather than merely adapting to changes imposed by others. Their leadership in this arena can set a precedent for others, fostering a more aware, responsive, and responsible global business community. This is our call on financial institutions to be changemakers instead of changetakers.

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