ESG in the time of the 21st century's sustainability crisis

In recent years, ESG related issues have become a point of interest for shareholders, governments and investors as a risk management concern while firms have begun to use the concept of ESG as a competitive strategy. Companies today are increasingly aware of the level of scrutiny under which their practices and policies are being monitored and what is needed to ensure they can meet the expectations of their stakeholders, including shareholders and society in general. ESG factors are strongly connected to business ethics and compliance and to the regulatory and reputational risks associated with non-compliance.

As awareness of ESG factors and their impacts have grown so have the number of companies who know better how to communicate them and what to do in the area of corporate social responsibility. Yet a growing number of ethical and compliance issues are still rising. Unfortunately ESG targets are not always clear for businesses.

Is sustainability a "one size fits all"?

Sustainability for larger organisations is not "one size fits all" but instead depends on the company's culture and activities. ESG measures mean responsible or sustainable decisions and actions. The 'E' or 'Environmental' stream includes energy usage, water management, biodiversity, waste reduction and carbon emissions. The 'S' or 'Social' focuses on human capital management, human rights, diversity, health and safety and modern slavery. Lastly, the 'G' means 'Governance' which addresses shareholder transparency, board structure and ownership structure as well as how a company is managed.

ESG reporting gives investors guidance that the company is socially conscious and aims for a positive impact in the long-run on environment, society and business performance. It demonstrates a holistic approach to sustainability.

There have been a few key factors identified as drivers of the increased focus on ESG investment for businesses:

- Sustainability issues are more important than ever. We are living longer, by 2050, there will be 2.3 billion people in the world over age 65. These issues will affect the financial security of these retirees and will potentially impact business activities and decisions.

- Large corporations' value chains are increasingly global. Investors are focusing more on issues such as human rights, environmental impact and on poor governance practices. Investors can be quick to punish organisations for unlawful practices, human rights issues, discovery of modern slavery in their supply chain and environmental issues.

- There is an increasing appreciation of the impact of climate change. It is impossible to predict exactly what the future holds, but given the current knowledge of climate science, demands will increase on this and related topics. There is no doubt that the effects of climate change will become a lot harder to ignore.

- Good governance is central and as important as environment and social factors. COVID-19 has demonstrated the interconnection between the three factors of the ESG. Good governance often means certainty in uncertain times. Companies' financial performance is no longer disconnected from stakeholder issues which are sources of risk and opportunity. Strong corporate governance indicates strong corporate culture which in turn is a sign of robust long-term resilience.

- Energy sources are changing and renewable energy sources are becoming cheaper and popular. Companies are looking for new, innovative ways to embrace green tech and energy efficiency. There is a global demand for the transition to renewable energy and to net zero strategies. Emissions in the buildings sectors have begun to reduce, thanks to decarbonisation, the transport sector is also coming around to greenhouse gas emission reduction but we can also see significant changes in businesses related to agriculture and even technology businesses are focusing on energy consumption.

- ESG risk management is business critical. If a damaging environmental, social or governance event occurs, it could cause a potentially material negative impact on the value of the investment. There are no regulatory definitions for these events or conditions yet.

COVID-19 has fuelled ESG demand

COVID-19 has been detected in nearly every country, and this crisis has not only brought the greatest recession since World War II, but investors are also calling this period the first 'sustainability' crisis. The landscape has changed and renewed the focus on climate change and prioritised a more sustainable approach to investments. COVID-19 seems to be a long-term catalyst for ESG.

ESG in numbers

The ESG Market was expected to reach
$45 trillion
in Assets Under Management (AUM) in 2020

Europe and North America account for more than
90%
of the ESG market

Over the past year, assets in ESG more than doubled to
$80 billion

Adopted: J.P. Morgan Global Equity Research, 2020, ETF Handbook

The COVID-19 crisis has also shown that companies with strong ESG credentials have performed significantly better during the past year. In fact, it was found that during the first nine months of 2020, company stocks with higher ESG ratings outperformed those with weaker ESG ratings. It shows that companies with good characteristics that embraced ESG components have better management and demonstrate greater resilience in a crisis.

New EU laws, the Transparency Regulation which became applicable as of 27 March 2021 that sets standards for the transparency of businesses and the EU Sustainable Finance Disclosure Regulation (EU) 2019/2088 that came into effect on 10 March 2021, will impact those companies who made false claims or "green washed" the sustainability of their offerings. There will be two important results flowing from these new laws. First, as with many regulatory issues, the EU can dictate standards to anyone doing business within its borders: be it America, China or Japan. Therefore, the regulations will spread and impose strict disclosure requirements. Second, EU laws will flow down from banks who hold stocks in corporations or in investment trusts to the managers of these entities. They will be hit with demands for broader data on their own sustainability profiles.

We can state that COVID-19 has supercharged the ESG movement and created a new, more balanced appreciation for ESG factors. Boards and Governance Professionals should ensure they remain up to date on this issue, which is progressing at a fast pace. The tone is set at the top and it is essential that sufficient thought should be given to formulating a clear strategy on this, including the setting and regular reporting of environmental targets. A strong ESG proposition can create value for companies and their shareholders in the long-term.

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