THOUGHT LEADERSHIP 05

THE RAPID CHANGES IN ESG

How ESG Legislation is Changing the Approach to Business

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Ahead of incoming legislation and amidst much change, Praxity published an introduction to Environmental, Social and Governance reporting in May 2023. This thought leadership report aimed to contextualise the rapid rate of change and the new parameters for ESG exploration, as well as exploring how Praxity Alliance member firms are leading adoption for their clients.

Much has changed in the Environmental, Social and Governance space in this short time. Legislation has had time to be tested against the demands of the real world, and member firms' ESG measures are ever evolving as their clients' operating environments change. While headlines have been dominated for the coordinated pushback against legislation and perceived overreach, business has nevertheless continued to make progress on the underlying principles of ESG.

> *When one looks beyond the inflammatory headlines and reported death of ESG, progress is being made by investors, companies, and governments [...] The term ESG may have become toxic in some quarters, but the underlying problems have not receded. Firms with a view towards long-term viability and competitiveness understand the issues at hand, whatever the label.* [1]

In the face of lively and often mischaracterised debate about the benefits or flaws of ESG, definite progress has been made in making environmental and social measures work for stakeholders.

PURSUING CREDIBILITY

Credibility of methods, initiatives and results are becoming the key measure of ESG reporting. As ESG matures and begins to leave the headlines, though perhaps some way off yet, is where the true test will be. ESG is necessarily part of a long-term planning structure, as it is only in the fullness of time that measures can be judged, and that the quality of leadership is tested against reality.

This credibility is the metric that always seems to be tested by sceptics. Choosing statistics selectively and de-emphasising business gains, especially in the short term, seems to be the favoured tactic of undermining ESG legislation. It is, however, only by exploring the shortcomings of measures and refining them that progress will be made.

> *No one can assess what a firm is doing better than the firm itself. What we as auditors can do is to ensure that the right questions are being asked of the correct people, looking at due diligence and action on claims that are made. We often see Sales departments reporting that their business hinges on their board's sustainability measures – it has become a deal breaker and will only get more pertinent as it begins to extend to SMEs.*[2]

Legislating for Greenwashing

Verifying ESG measures as more than lip service has been a key theme in recent years, with many experts in the Alliance and beyond seeking and furthering assurance processes.

In the UK, the Financial Conduct Authority (FCA) has new anti-greenwashing laws that will have come into force on 31 May 2024. From this date, all FCA-authorised firms will be required to ensure that any reference to the sustainability characteristics of a product or service is consistent with its substantive content and is fair, clear and not misleading. This is set out in detail, accounting for the many subtle ways in which regulations may have been circumvented.

> *From 31 May 2024, all FCA-authorised firms will be required to ensure that any reference to the sustainability characteristics of a product or service is consistent with the sustainability characteristics of that product or service and is fair, clear and not misleading [...] A consumer will have a right of action under section 138D of FSMA for perceived breaches.* [3]

Perhaps the stand-out characteristic of the new guidance is the introduction of a clear labelling system, to help investors and consumers assess the value of a company's ESG measures and/or an investment product. Under the rules set out in the Policy Statement, there will be four labels available to firms, applying to products with different profiles, with no hierarchy between the labels:

- **'Sustainability Focus'** will be available for products with an objective consistent with an aim to invest at least 70% in environmentally and/or socially sustainable assets.
- **'Sustainability Improvers'** is intended for products the objective of which is consistent with an aim to invest at least 70% in assets with the potential to improve environmental and/or social sustainability over time (even if they are not sustainable now).
- **'Sustainability Impact'** covers products with an objective consistent with an aim to achieve a pre-defined positive measurable impact for an environmental and/or social outcome and invest at least 70% of their assets in accordance with that aim.
- **'Sustainability Mixed Goals'** is intended for products that have an objective to invest at least 70% in accordance with a combination of the sustainability objectives for the other labels, with the requirements for each relevant label being met.

Only the first three labels were included in the FCA's Consultation Paper; the fourth has been introduced in response to concerns that funds which are invested with a combination of attributes would not qualify for any label, even though they may have sustainability characteristics.[4]

Firms will be able to apply for any of the labels that apply to a particular financial product. From this point, it is up to them to audit regularly to ensure that their product is still compliant. The FCA also gives guidance as to what areas firms should be looking at when assessing if they are able to apply –

- **An explicit sustainability objective**
- **Investment policy and strategy –** with limited exceptions, at least 70% of the product's assets must be invested in accordance with the sustainability objective.
- **KPIs** to measure progress.
- **Resources and governance –** to ensure the feasibility of delivering on promises.
- **Stewardship –** firms must identify the investor stewardship strategy required to deliver the sustainability objective.[5]

The final point to consider is that all of this must be independently verified. This can either be done third-party or in-house, but this function must be entirely independent of the investment function. This provides a stark contrast to the vague and difficult-to-enforce rules of just a few years ago.

ESG IN THE TAX SPACE

Tax and compliance with regulations are hugely relevant ESG issues, impacting upon business profits as well as how that business conducts itself. New Pillar 2 rules are designed to disrupt the practice of offshoring profits, ensuring that the final beneficiaries pay the appropriate level of tax in the jurisdictions in which they operate. This process is arguably a more equitable way of pursuing taxation, making it ever harder for nefarious actors to dodge taxes, even within legal limits.

We've seen many examples where a particular corporate's tax position has harmed that business's reputation. This focus on tax has led to a raft of extra regulations in the UK and globally, for example the requirements to publish tax strategies in the UK for larger businesses. We're also seeing an increasing number of groups choosing to voluntarily publish their total tax contributions. Other rules in the UK, such as the Corporate Criminal Offence and Senior Accounting Officer rules, are effectively tax governance – the 'G' of ESG – borne out of a focus on corporates' societal impact. Even the OECD's BEPS and Pillar 2 rules are such responses to the 'S' of ESG. [6]

Compliance here is a huge issue, with Praxity Alliance member firms leading work to steer their clients through the difficulties. With a breadth of experience worldwide and cross-border, Alliance members have been refining their processes over many years and can offer a wealth of solutions to their clients, with audit and reporting processes pre-empting legislation by many years.

Fair taxation is a key element of corporate social responsibility, but in today's business environment defining "the community" can be ever harder. Often operating across borders and with differing laws and labour costs, it can be a challenge for any business leader to get an idea of where ESG priorities should lie. There will always be compromises, and despite the new legislation, businesses have ample freedom to pursue the ESG ends that suit their aims the best.

Since the EU regulations will require larger companies, regardless of the participation in the capital markets or not, to publish an extensive and detailed set of information with respect to ESG matters, our clients realise that the preparation of the reporting will be time consuming und complex. Therefore, several clients reach out to us for guidance and advisory work to assist with their upcoming legal obligations.

There is a certain shift towards the acceptance, that even those companies that do not see a "business case" for being sustainable (usually because their specific customers do not ask or pay a premium for it), understand that certain standards must be met. At the same time, our clients frequently emphasise that the pressure from their own customers increases.

Dr Jörn Obermann, FIDES

MATURE MARKETS AND EMERGING ECONOMIES

As emerging economies find their feet and some mature markets have slowed down post-pandemic, new frontiers have opened in ESG. This, as ever, brings new challenges and new opportunities for those who can meet them.

Finding an equitable solution can be a challenge here. For example, there has been a lot of debate about the ecological impact of emissions from developing countries, whose rate of use of fossil fuels has increased exponentially in the last few decades. There is a difficulty in establishing "one rule for all" and context does need to be considered when targets are laid out. On the other hand, emissions continue to be a global problem that is neither region-specific nor respects international borders and political divisions – this is an inherent difficulty of both focus and of legislation.

This is not to say however that economies outside the traditional powerhouses are not incorporating ESG into their strategies. With an acute awareness of how developing countries have been impacted by exploitative business practices, the focus is shifting to sustainable development and redressing the balance somewhat. A few examples of measures globally in 2023 include –

- The Johannesburg Stock Exchange (JSE), following the 2022 launch of its first Green Finance Taxonomy, urging South African companies to take action on sustainability in advance of JSE mandating requirements, potentially consistent with the ISSB standards.
- Nigeria announcing that it waill be an early adopter of the ISSB standards, with disclosure requirements for Nigerian companies starting as early as 2024.
- Mexico launching the country's Sustainable Taxonomy, and Brazil becoming the first country to adopt the ISSB standards via resolution from its securities and exchange commission. [7]

There are some interesting aspects to navigate here. How does a government establish what is appropriate and what is legislative overreach? How does the urgency of action on climate change stack up against the longer-term business cases for ESG reporting? Perhaps most importantly, how do we define success over such a broad swathe of industries and territories, especially when successful ESG measures have no defined finish line?

A Focus on Supply Chains

Increasing awareness of unscrupulous labour practices, or even forced labour in supply chains has been a dawning realisation among the general public. Along with the priority placed on supply chain security post-pandemic, there has been much scrutiny to ensure that third-party suppliers operate to the same principles as the company itself. While it can be argued that this was always important, it is clearly something that has lagged behind in legislation. It is no longer acceptable for companies to turn a blind eye to unethical practices elsewhere in their chain, if it ever was.

This, of course, extends to where investors are prepared to put their capital. Abuse of the workforce and employing the services of shady individuals clearly points to a governance problem – leadership either doesn't know or worse, doesn't care. So why would an investor put their money into a company that is not overseen properly?

A recent case brought against Shell by a group of shareholders from Client Earth was a headline-grabbing case in point. The argument, so it went, was that the board had not done enough to divest away from fossil fuels into renewable energy. This not only meant that the company was not going to be able to meet its own net-zero carbon targets, but that the board was aware of this and engaging in mismanagement. This short-termism, it was argued, endangered the environment, the future of the company and that of major economies, and therefore the investments of shareholders –

> *The energy transition also presents companies with commercial opportunities. Companies that continue to pursue carbon-intensive, business-as-usual strategies not only expose themselves to seismic risk; they are also likely to miss out on the significant opportunities presented by the transition to a low-carbon economy.* [8]

This would be easy to dismiss this as a stunt practiced by activists, were the business case not so well articulated. In short, the idea of ESG being a "vested interest" by a minority is a dead end, as a company that is not run with ESG as a big part of its remit is destined to shrink and fail sooner or later, taking its investors' money with it. Safeguarding profits and safeguarding environment and society lead us to the same conclusion.

Nearshoring, Inshoring and Supply Chain Security

There has been a marked rethink of global supply chains in recent months and years. The influence of the COVID-19 pandemic, followed by multifaceted geopolitical problems, has given industry leaders cause to move their once-global operations closer to home. This has taken three main forms –

- **Inshoring -** As opposed to "offshoring", bringing production back inside a home nation's borders. This brings national control of both manufacturing and the workforce.
- **Nearshoring –** Siting operations in a nearby neighbouring country, so as to make supply chains shorter and more manageable. For example, countries in Latin America have seen a trend in US companies setting up operations on their territory and have benefitted financially.
- **Friendshoring –** Bringing operations into a foreign nation that is reliably friendly or neutral, making supply chains less liable to disruption through geopolitics.

The implications of all of these can be felt in all aspects of ESG. Environmentally speaking, these measures will reduce carbon and greenhouse gas emissions in the transport of goods, as well as freeing up funds that can be reapportioned. However, it will also bring any pollution and waste products from manufacturing closer to home, which is not a pattern that developed economies have become accustomed to.

In the social and governance areas, it's clear that this will have an impact on how a company addresses its responsibilities. Quite apart from what might be stark differences in the regulatory environment, the company also interacts with its community in a different way. While social impact and governance quality will come under the microscope wherever the business operates, it is particularly pertinent in its base locale. Issues such as employment opportunity and retainment, pollution and waste and social initiatives will all be that much more visible to core regulators.

The "China +1" Rule

While China remains the biggest manufacturer of consumer goods, and a major producer of goods of many kinds, many businesses in the West are adopting a "China +1" model, meaning that there are alternative channels of production should relationships with the nation take a volatile turn. This has knock-on effects for compliance, with the finance industry having to learn new regulations quickly so their clients can operate legally in the tax space.

The COVID-19 pandemic saw many just-in-time supply chains fall short of consumer need, in some cases with serious consequences – the delays in vaccine acquisition in India, for example. Business is understandably keen to ensure that they are not vulnerable to the same shortages should unexpected things happen, leading to the rise of "just-in-case" supply chains, with excess capacity and leeway built-in. This is not to say that cross-border trade is any less widespread or important, more that it's the weakest link in any chain that causes it to fail. Stakeholders have been made acutely aware of this, often to their cost, and are looking for an ongoing commitment to the safety and security of their businesses and investment portfolios.

Quite aside from any geopolitical aspect, having important assets in more than one place is clearly an appropriate safeguard against interruptions or shocks. As is usually the case, ESG metrics remain arguments for where resources are allocated, adding more or less weight to discussions about the value of ESG to strategy. It is up to businesses themselves to decide whether setting up operations near to their base is worth the initial cost, and whether risk management takes precedence over raw short-term profit.

ENERGY SECURITY IN EUROPE

In the face of conflicts and political instability, both worldwide and closer to home, there have been increasingly loud calls for developed countries to shore up their energy supplies. Whether via increasingly efficient fossil fuel extraction, or via newer renewable sources of energy, arguments have come from both ends of the political spectrum.

Western Europe has been particularly affected by an energy crisis, with conflicts affecting both Russia and the shipping lanes in the Red Sea, both crucial producers and supply routes for oil and gas. The drive towards energy security and energy self-sufficiency in Europe has a twofold effect. One is that longer-term environmental concerns may have slipped down the list of priorities, in favour of short-term fixes to an energy crisis. However, it can also be argued that hastening transition to green energy and renewable sources would have prevented this crisis from happening in the first place.

The price caps on Russian oil have undoubtedly made fossil fuels more expensive commodities, especially in Western Europe, driving up prices across the board. There have also been issues in developing nations with the traditional breadbaskets of Europe – Ukraine and Southern Russia – becoming unavailable or only sporadically accessible. This has globally increased prices of crucial goods, leading to high inflation in even the most stable economies, and potential famines in less developed nations.

As with shifting manufacturing, this greatly affects emphasis of spending, and any business has to decide how to respond. There may be an improved business case for relying on renewable energy, or from limiting the use of imported goods, both of which would have knock-on effects for an ESG report. It's impossible to ignore the business reputation and public relations aspect to this too, as these are emotive matters to both the public and to internal and external stakeholders.

THE POLITICALISATION OF ESG

The ESG space has been a battleground of sorts, with competing priorities, political positions and even ideologies clashing over what the scope and importance of ESG measures should be. Social media, and the dishonest posture that it enables or encourages, has aided polarisation and encouraged cynicism in certain sectors of politics and among the public at large. There have indeed been concerted efforts by political voices to misrepresent the ESG conversation and frame it as frivolous or ideologically motivated.

Some industries may feel unfairly legislated against. For example, fossil fuels and heavy industry remain important cornerstones for many economies, including highly developed ones, and there is a narrative that suggests these industries are being unfairly targeted. While clearly any fossil fuel or heavy metal extraction would have a higher economic cost than many industries, the argument goes that it is not fair for these industries to be targeted for punishment when the modern world still relies upon their products and their businesses succeeding.

Misrepresentation and Creative Accounting

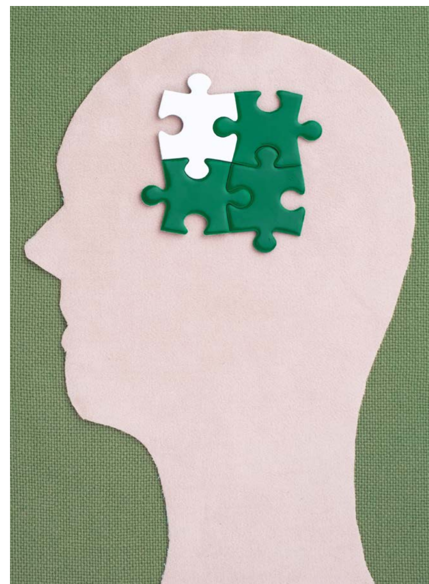
Loosely speaking, there are three ways in which environmental measures can be misrepresented to the public and to stakeholders –

- **Greenwashing –** representing a business or product as more sustainable than it really is. Having a corrosive effect on trust and public image, this has been the focus when establishing standards and stricter frameworks for ESG certification.
- **Greenwishing –** setting unrealistic targets for environmental measures, or making bold claims without setting out steps to achieve them. This is generally thought to be too ambitious rather than dishonest, but there is a grey area that also erodes trust.
- **Greenhushing –** minimising communications about ESG measures, in order to avoid political or PR backlash. An interesting and somewhat dispiriting mutation, this demonstrates how ESG has been co-opted as a "woke" culture wars signifier. Greenhushing limits the amount of information that is available, with the effect of less transparency on ESG and less robust data to analyse.[9]

These terms, while somewhat clunky, show well the variety of approaches to ESG in business and how the area has become such a minefield.

> *"Look to the lawsuits against ESG and understand this is all about how companies don't want to be told what to do. That's fair. However, changing legal and regulatory environments are squeezing those who purposely set out to do nothing. Eventually they will have to act, which is strategically a bad move; being forward-looking is a key tenet of good corporate leadership. What will impact the business and future growth? The topics embedded across the ESG paradigm need to be considered; a failure to do so is a failure to understand the numbers."*

Ed Olson, MNP



Battlegrounds in North America

The US in particular has seen significant pushback against attempts to make ESG reporting mandatory, or to bring in legislation with teeth on a nationwide basis. As of February 2024, there are around 61 anti-ESG bills stuck in the US Congress. While there are many that have little chance of passing due to legal structures in each state, it gives some idea of the depth of anti-ESG activism within business and legislature.

Praxity's last ESG piece discussed tit-for-tat boycotts and counter-boycotts, which are an ongoing concern in the US. This cannot be dismissed as grandstanding; while it's not clear how a business ends up on one of these lists or how they remove themselves from one, but it can affect how they are able to invest their money in the real world -

> *"Apart from legislation, certain states have also compiled restricted lists, which target financial institutions that allegedly boycott industries like fossil fuel and firearms. Several states such as Kentucky, Oklahoma, Texas, and West Virginia have enacted these anti-boycott laws in the last two years, which authorize the state comptroller or treasurer to maintain a list of restricted financial institutions that will be barred from contracting with or doing business with the state.* [10]

As with much in the modern United States, these arguments have organised themselves along party lines and become something of an "elites" vs "real Americans" issue. Certainly, states with Democratic majorities have been aggressive in pursuing legal avenues to inscribe ESG as part of corporate practices –

> *"The Climate Corporate Data Accountability Act (SB 253), signed into law by California Governor Gavin Newsom, is the first-of-its-kind mandatory climate emissions disclosure rule in the United States. A second bill, SB 261, requires disclosure of climate-related financial risks, in accordance with recommendations from the Task Force on Climate-Related Financial Disclosures (TCFD).* [11]

Despite significant backlash, in state legislature, board rooms and in the echo chambers of social media, ESG investing remains successful and is growing strongly across North America –

> *"Investors who use one or more ESG criteria or push companies on such issues as a group controlled $8.4 trillion in U.S.-domiciled assets in 2022. That's according to the most recent count by US SIF, a trade group representing the sustainable and responsible investing industry. That's enough money to buy Tesla, one of the most valuable U.S. stocks, more than 11 times over. It also means ESG accounted for $1 of every $8 in all U.S. assets under professional management.* [12]

In short, there is a suggestion that ESG measures prioritise liberal values (in the American sense) over profit and as such are ideological, rather than business driven. While there is some argument to be made over whether returns on ESG investing have matched predictions, there is also plenty of evidence that the backlash is itself about ideology rather than fact.

Pushback in Europe

This friction is not only evident in North America, but has spread across Europe and the EU too. Politically speaking, the disagreement has been framed along similar lines, with a friction between the proto-libertarian right wing and left-wing environmental activists, with the truth being somewhere in the middle of this manufactured culture war. With ESG legislation in Europe having found its teeth, there is inevitable pushback as new realities begin to bite. For example, while European territories, even those outside the EU, tend to be in close step with each other, there is a (somewhat justified) fear that not every major economy is bound by the same rules, especially in reference to the USA and China -

"The European Banking Federation (EBF) says lenders in the region won't be able to compete with their US rivals if regulators continue to pile on environmental, social, and governance (ESG) rules that Wall Street remains free to ignore. [...] The warning from the bloc's main bank lobby comes as the European Central Bank (ECB) puts pressure on lenders to capture ESG risks, including in loan-loss provisions, marking a new frontier in ESG reporting standards.[13]

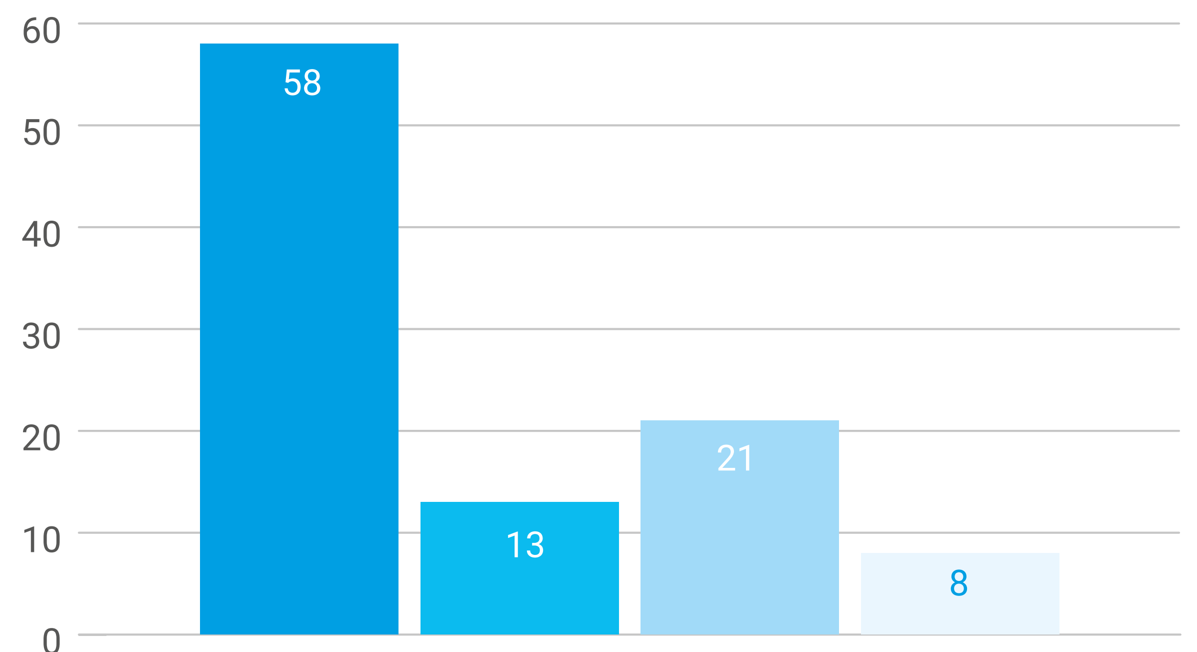
Investing trends can unfortunately be a case of reality following perception and not the other way around: as in many things in the current media environment, a few influential voices can make a difference, whether they speak the truth or not. European business, while traditionally extremely strong, continues to fall behind US institutions in the perception of value, arguably in part due to the lack of a level playing field –

"Banks in Europe are already falling behind their US peers in investors' perceptions. JPMorgan Chase, the largest Wall Street bank, has a market value that's 1.9 times the value of the assets on its books, according to data compiled by Bloomberg. Market pricing shows investors think Morgan Stanley is worth 1.7 times its book value. Meanwhile, BNP Paribas, the EU's biggest bank, has a price-to-book valuation of 0.7, meaning investors think it's actually worth less than the value of its assets. Deutsche Bank's price-to-book is even lower, at just 0.5.[14]

Both ESG and anti-ESG rhetoric are accused of being social theory first and foremost, with the business case coming a distant second. In reality, an increasing number of industries are seeing ESG as fundamental, finding value and increasing returns in careful governance and in safeguarding profits for the medium-to-long term. The financial performance for firms that see ESG as part of their business remit continues to trend upwards –

Correlation of ESG metrics to financial performance

In % of studies. Financial performance measured by Return over Equity (ROE), Return over Assets (ROA) and Stock Prices.



Source: 2021 Meta Analysis by Rockefeller Asset Management & NYU Stern Center for Sustainable Business

Whilst it's true that the definition of ESG is loosely defined, this is a necessary feature; once the thread is pulled, it's easy to see how the principles of ESG connect to every aspect of how a company operates and performs.

ALL POSSIBLE FUTURES

Despite a vocal minority, ESG as a holistic assessment of how a business works seems to be here to stay. Not only does ESG accounting place a firm in its broader context, the field also seems to be finding success at helping businesses make more profit.

Hostility to ESG stems from a variety of sources; whether businesses want to be free to make their own profit decisions, whether they feel that their sectors are unfairly maligned, or whether they see it as social justice extending into areas where it has no place. These voices, even today, feel like dead ends. The social and environmental cases seem to be self-evident in their necessity going forward, and if the business case is currently proving itself even under increasingly stringent rules, then the review of a firm's governance almost writes itself.

The area is clearly a rapidly developing one, which is why Praxity's two ESG reports, just over a year apart, are so radically different from one another. It is possible that legislation has gone either too far, or not far enough, and is likely to need further tweaking according to each jurisdiction's priorities and material concerns. Perhaps the real question is whether unity can be found, without compromising to the point of meaninglessness. There will always be voices that believe their own concerns to be the only ones that matter, but as the business case proves itself to be more than just optics, those who make a point of putting their fingers in their ears are likely to find their days numbered.

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* International Accounting Bulletin World Survey 2022

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