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“All Round ESG-ellence" - Developing an effective ESG Sustainability and Responsibility Programme #1: The fundamentals

UK financial services and other firms will be aware of the growing legal and regulatory pressures they face in respect of climate-related financial risk management, especially in the form of current or prospective disclosures, However, regulators are developing a wider set of expectations and standards in respect of environmental, social and governance (“ESG”) factors.

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However, regulators are developing a wider set of expectations and standards in respect of environmental, social and governance (“ESG”) factors.

Firms needs to invest now in a process to enable them to meet these expectations.

This article is the first in a series designed to help firms achieve the necessary ‘ESG-ellence’.

Below we address the fundamental propositions which firms need to achieve and maintain good standing in respect of ESG. The substance of these propositions was recently addressed by the European Banking Authority (“EBA”) in its June 2021 Report. All quotes are from that report unless otherwise stated.

1. Climate is only part of the challenge

“Climate change is both a subcategory of environmental risks and...interlinked with other environmental risk types...[it] contributes to the degradation of the environment and vice versa...Not all...degradation is necessarily a result of climate change...pesticides...can lead to biodiversity loss...and air and water pollution.”

2. Be 'aligned', not just 'resilient'

ESG issues present both risks and opportunities (see e.g. Climate-related reporting requirements | FCA) including “increased demand for [environmentally] sustainable products”.

As such, a mere focus on ‘resilience’, or the ability to withstand or adapt to threats, is only part of the story. The regulation of firms’ ESG standing is more about ‘alignment’ with regulatory objectives devolved from political objectives. For instance, the United Nations Environmental Program Finance Initiative (unepfi.org) aims to align banks’, insurers’ and investors’ business strategies with the Sustainable Development Goals (un.org) (“SDGs”).

Moreover, the nature and time-scale of the manifestations and effects of ESG risks and opportunities are uncertain: they “could affect macroeconomic factors, such as labour productivity...government debt...and socioeconomic changes...[and] interact with each other, amplifying shocks and stresses...which could lead to spill overs that could simultaneously disrupt multiple parts of the financial system...[and] have an impact on...institutions’ financial performance and solvency.”

Firms need to anticipate and respond to such changes, and “competent authorities should analyse institutions’ business plans and strategies for a period of at least 10 years ahead”.

3. 'E', 'S' and 'G' issues are inter-linked

The UNEPFI takes into account all three components of ESG, in alignment with the SDGs’ aim of being a blueprint to address “the global challenges...including...poverty, inequality, climate change, environmental degradation, peace and justice...[such that the SDGs] are...interconnected, and [aim] to leave no one behind ...”

The EBA gives an example of ESG interconnectedness: “increasing temperatures could lead to a significant decrease in workforce productivity or [the] ability to grow crops. The relative adjustment of prices...may create additional disruptive effects...potentially increasing social unrest ...”

On the other hand, the UN’s ‘Positive Impact Initiative’(“PII”) seeks to achieve commercial benefits from a holistic approach:

“For most current business models...impacts to people, planet and the economy are externalities and are therefore considered as a cost centre. PII’s approach is based on the idea that there is an as-yet unexplored potential for positive impacts to generate revenues and be the heart of business models...new...business models can significantly decrease the cost of achieving the SDGs and give rise to business and financing solutions at scale, including...where needs are most acute.”

4. ESG effectiveness requires a healthy culture

The EBA recognises that culture has a discrete role in enabling firms to address ESG issues successfully. In particular, the EBA takes the view that there is currently a general failure among institutions that “ESG factors are not sufficiently integrated into company culture”. The EBA does not however elaborate on this.

For more extensive thinking on the role of culture, firms should revert to the FCA’s publications in recent years, in which it has articulated concepts such as ‘healthy’ and purposeful cultures (DP20/1). In particular, the FCA regards an explicit ‘purpose’ for a firm as being a driver of its culture: “An authentic animating purpose makes an emotional connection for employees; and it will have a widespread impact across a firm and its customers if it both demonstrates business rationale and allows people to associate with it personally.”

However, the FCA has stated that firms’ articulation of their purposes has too often failed to stimulate the effective handling of ESG issues by treating such issues as if they can be comprised by a self-contained, standalone function (as per the PII’s ‘cost centre’ point above): “...executives and management need to play a bigger role in the formulation of purpose statements where these are (sometimes, and wrongly in our view) seen as the responsibility of corporate communication and ESG departments” [emphasis added].

5. 'G' shapes 'C' shapes 'G'

While recognising that ESG issues can present opportunities, the EBA report is focused on risks. The report refers to ‘risk culture’ but the substance of its points are no less valid for broader issues of culture. In particular the report explicitly identifies the role of “the management body and its ‘tone from the top’” as a key factor in determining how corporate culture encompasses ESG.

6.Leadership enables commercial ESG sustainability and responsibility

There is of course a ‘virtuous circularity’ between the leadership shown by senior management in engendering an effective approach to ESG overall, and the management of risks in respect of governance in particular:

- the greater the importance a firm’s leadership attaches to business sustainability and responsibility,
- the healthier the firm’s culture,
- the more effective its approach to ESG, and
- the more sustainable the firm’s business model and activities in the face of socio-economic changes will be – the report emphasises the importance of alignment with changing social mores to guard against “reputational risk” and allegations of “mis-selling”.

The report recommends that firms take “a sound and comprehensive approach to the incorporation of ESG [issues] into business strategy, business processes and risk management” by the issues being “integrate[d] in[to] governance structures [via]...

- clear working procedures and responsibilities for business lines, internal control functions, the relevant committee(s) and management body...
- adequate internal capabilities and
- remuneration policies that are aligned with the institution's long-term interests, business strategy and objectives..."

7. Regulatory demands on ESG will involve ever greater resource

Based on an Interim study produced by BlackRock for the European Commission in December 2020 the EBA took the view that "Many banks lack a holistic and granular approach to measure and monitor the ESG business profile of their...activity". The EBA's recommendations for supervisory techniques include challenging firms on "whether...

- "...ESG...objectives, sustainable...products or engagement with customers on their preparedness and alignment with [energy] transition are success drivers of the business strategy...
- the institution accounts for...ESG matters in its macroeconomic assumptions...[and] has the execution (know-how) capabilities to implement any ESG...objectives...judging from the track record of previous strategic adjustments and the availability of relevant expertise while acknowledging the relative novelty and potential complexity of ESG-related strategies."

For many firms, commercial and ESG sustainability starts now.

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