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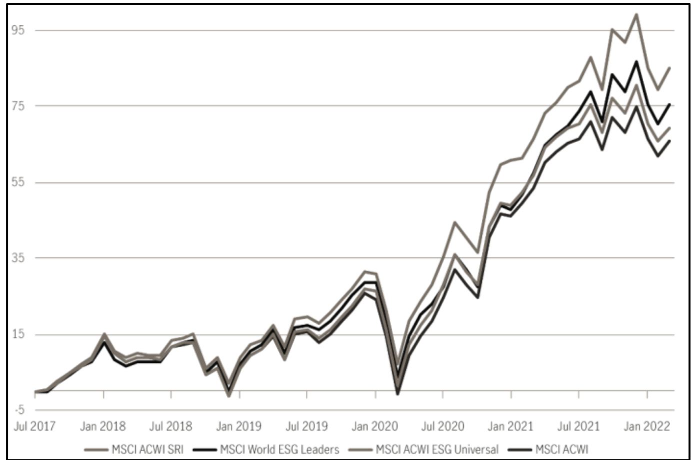
ESG-oriented Organizations: Risks to Stakeholders

As climate action continues to be a focal point, ESG investing strategy has soared to become the most popular investment strategy for investors of all types. Global investments in ESG are likely to surpass US$53 trillion by 2025 on the back of growing investor demand.

Sustainability-focused organizations tend to be more efficient, save money, have lower employee turnover, are innovative, retain talent, reduce compliance costs, and manage risk better - all of which may contribute to rise in shareholder value.

Illustration 1: Chart - Index performance of select MSCI ESG Indexes and MSCI All Country World Index (ACWI)



Source - https://www.manulifeim.com.ph/insights/5-benefits-of-esg-investing.html

India's ESG landscape is transforming as it prepares for future challenges. It is committed to reducing greenhouse gas emissions by 45% by 2030 compared to 2005. India has recently been ranked 8th position (two places higher) in the Climate Change Performance Index (CCPI) 2023, reflecting its low emissions and increased use of renewable energy.

The Indian market is a major player in sustainable investment, with an enormous potential to mobilize USD1 trillion in the next decade to finance climate change and accomplish Sustainable Development Goals (SDGs), making it a significant market for sustainability solutions. As a result, ESG-focused organizations are inclined to be more successful in the long run, which can improve their reputation and shareholders' value.

The rise in investment or lending towards ESG priorities implies a higher risk of misrepresenting ESG performance, diversion, misuse of funds, and other non-compliances. The Global Risks Report of the World Economic Forum (WEF), 2023, reports that ESG-related risks have been among the top five global risks over the past decade. In order to avoid such risks from affecting investors, lenders, and other stakeholders, it is required to conduct adequate due diligence before investing in ESG organizations and after making investments in the organization.

A. Identifying ESG Fraud Risks

Investing, lending, and evaluating the key risks of ESG organizations is crucial to safeguard financial and reputational damages. These risks comprise but are not limited to:

i. Fraudulent Transfers, Misuses, and Abuses of Funds & Credits

- There is a risk of green funds being used for unauthorized/ineligible projects in violation of the ESG initiative's stated purpose and intent.
- Funds are transferred to subsidiaries, group companies, or other corporates for purposes unrelated to ESG without the investors' or lenders' permission.
- In some cases, the purpose of applying for funds for connected/related organizations may not be related to ESG issues, such as pledging shares or other assets of ESG organizations.

ii. Environmental Risks

- Greenwashing: False or misleading claims about the sustainability and environmental practices of an organization, such as false advertising, misleading recycling claims, false claims regarding low emissions, and unsupported carbon footprint claims.
- Blue washing: UN Global Compact (UNGC) registration advertising without adhering to UNGC principles.
- Consciously undermining environmental monitoring systems, including air, air quality, and water quality monitoring.
- Inadequate waste disposal and failure to separate recyclables & non-recyclables.
- Monitoring environmental impacts ineffectively or without periodic assessments.

iii. Social Risks

- Inadequate industrial safety standards for worker protection and non-compliant working conditions.
- Savings and deposit programs that force workers to withhold a portion of their wages, creating a sense of servitude.
- A lack of health and safety management systems for employees and inadequate insurance policies.
- Purple washing/Pink washing: Organizations that intentionally attempt to emphasize the diversity of women/LGBTQ communities in order to distract from contradictory internal practices, such as significant gender pay gaps, discrimination in appraisals, and inadequate prevention mechanisms for sexual harassment.
- Brown washing: Publicly portraying support for communities, regardless of their caste, creed, and race, but failing to support their own employees on these factors.

iv. Governance Risks

- Obtaining fraudulent licenses/permits or overlooking non-compliances during inspections through facilitation payments and bribery.
- Deficiencies in data security and cybercrime controls, which could lead to loss of sensitive and confidential data of employees, customers, vendors, and others.
- Non-compliance with regulatory requirements such as financial statement fraud, tax evasion, insider trading, and stock price manipulation.
- Initiatives, programs, and metrics related to ESG disclosures and regulatory reporting.
- Inadequate management oversight and weak internal control mechanisms resulting in significant instances of fraud/unethical behavior among employees, vendors and other third parties associated with the organization.

B. How Can Such Risks be Mitigated?

Prior to investing or lending in ESG organizations, investors, lenders, and board members should adequately assess the risks and monitor them periodically. Following are some potential steps that the organizations may take:

i. Due Diligence Prior to Investment

- Assess if there is any adverse information about the company's promoters, shareholders, or lenders.
- Verify the authenticity of ESG-related activities and claims made in ESG reporting metrics.
- Evaluate the effectiveness of the ESG framework, internal control systems, anti-bribery and corruption framework, key policies/procedures, and other governance mechanisms in place in the ESG organization.

- Examine the adequacy and genuineness of the supporting documents of the ESG organization and determine the veracity and authenticity of the revenues and expenses.

ii. Reviewing and Monitoring Post-investment

- Reviewing ESG frameworks, policies, procedures, and monitoring mechanisms periodically in order to assess their adequacy and compliance with ESG requirements.
- Identifying red flags of malpractice, corruption, or bribery in the ESG organization through periodic diagnostic reviews.
- Assessing the effectiveness of ESG frameworks, policies, procedures, monitoring mechanisms, and regulatory reporting.
- Impart training and create awareness among employees and third parties associated with the ESG organization to build a robust ESG framework.

C. The Gist

There is a well-anticipated robust surge in the global emphasis on ESG in the coming years, which will also drive ESG-oriented investing and lending. Subsequently, as regulations and laws regarding ESG compliance and reporting mechanisms evolve, they are likely to become more stringent. Proactive actions in this scenario are a requisite to safeguard the ESG organizations, their board of directors, investors, and lenders from any regulatory penalties, unforeseen litigation, and financial or reputational damage arising from any ESG-related issue.

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