Role of ESG in Tackling Environmental, Social and Business Issues

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> The concept of ESG (Environmental, Social and Governance) framework is the pillar of judging the Business Sustainability of any firm.

In a landmark judgement, on 26 May 2021, a Dutch court ordered Royal Dutch Shell and the group companies to significantly deepen planned greenhouse gas emission cuts. The company was ordered to cut the carbon-dioxide emissions by a net 45% by the end of 2030 compared to level of emissions in the year 2019. The verdict was an aftermath of the petition filed by a group of environmental NGOs, led by Friends of the Earth based in Holland. The Royal Dutch Shell group companies were accused of violating the domestic and international laws which govern the climate change and human rights. This was the first instance that a MNC has been found lacking and ordered against deficient climate policies. Financial Times, London, reported On 10 June 21 that stricter environment rules in China can potentially reduce supply of metals, fuelling price rise. This will have consequences for the companies operating out of China as well as trading with China. Engine No. 1, the $250 million California-based tiny hedge fund, despite its shareholding of only 0.02% in Exxon Mobil Corp forced the Board of Directors to reckon with the risk of failing to realign its business strategy towards matching the global efforts towards combating the climate change. It won two board seats at Exxon Mobil's annual shareholder meeting held in May 2021. In 2011, it came to light that the manufacturing facilities of companies in Bangladesh, were supplying garments to Primark, were using child labour, Primark and these companies came under fire from the international bodies for such practices. Primark immediately terminated supplies from those companies.

As per the report by CDP (formerly Carbon Disclosure Project), an environmental non-profit body working on a global disclosure system for investors, total inherent financial impact on climate risks on Indian companies in the next 5 years is estimated at Rs 7,138 billion (Almost $ 100 billion). Apple, Google, Dell, Microsoft and Tesla (all US tech giants) have been named as defendants in a lawsuit filed in Washington DC by human rights firm International Rights Advocates, in Dec 2020, on behalf of 14 parents and children from Democratic Republic of Congo as they were alleged to have been child labour in their supply chain for supply of cobalt. In October 2019, USA Commerce Department blacklisted 8 Chinese companies on economic blacklist for human rights violation. As per an investigation carried by an independent agency, in USA the companies which were poorly prepared against the cyber-attacks, under-performed the market by as much as 20% during 2010 and 2020. The International Energy Commission (IEC) says that the energy group companies must stop new oil and gas projects in order to reach net zero emissions by 2050. The EU has enacted some of the most stringent and extensive environmental laws of any international organisation and it will have an impact on international aviation and trade as well. Till now it is only the banks and insurance companies who have borne the brunt of the market risks posed by the climate change. Now the individual companies are being held explicitly accountable for the risks of global warming, as seen by the incidents with Royal Dutch Shell and Exxon Mobil. All such developments, call for an extreme indulgence by the leadership and Board of Directors (BoD) of the companies.

It may be apt here to visit some of the regulations enacted at the world stage. As per the Paris agreement at the United Nations Climate Change Conference held on 12 December 2015, signed by 196 nations, the aim was to strengthen the global response to the threat of climate change. Article 2 of the document mandates, "holding the increase in the global average temperature to well below 2°C above pre-industrial levels and pursuing efforts to limit the temperature increase to 1.5°C above pre-industrial levels, recognizing that this would significantly reduce the risks and impacts of climate change", amongst others. Article 4 therein mandates, "in order to achieve the long-term temperature set out in Article 2, Parties aim to reach global peaking of greenhouse gas emissions as soon as possible, recognizing the peaking will take longer for developing countries, and to undertake rapid reductions thereafter in accordance with the best available science, so as to achieve a balance between anthropogenic emissions by sources and removals by sinks of greenhouse gases in the second half of the century, on the basis of equity, and in the context of sustainable development and efforts to eradicate poverty", amongst others. The 17 goals laid down under UN SDGs (Sustainable Development Goals)-2030 also mandate the measures towards protecting environment, society and humanity. These have all been directed towards the nations.

The UNGC GRI-G4 (United Nations Global Compact Global Reporting Initiative) compliant business sustainability standards also lay the guidelines for corporate bodies for reporting their progress on various articles on environmental, social and business impact that their corporate activities are creating. In 2011, the international community came together to adopt the UN Guiding Principles on Business and Human Rights, a universal framework which clarifies once and for all where the government duty to protect human rights converges with the corporate responsibility to respect human rights. They are applicable to all nations and business enterprises. UNGC GRI-G4 standards have become the guidelines for the corporates to report their annual progress through Annual Sustainability Reports. This has to be filed with the respective regulatory bodies where they carry out their business, like SEC in USA, SEBI in India, FRC in UK, et al. All the governments have instituted appropriate enforcement mechanism through formation of government institutions such as EPA by USA, NGT by India, EA by UK, et al.

Against this backdrop, the order issued by the Dutch court for implementation by the Royal Dutch Shell group companies and the action by the activists on climate change, threaten to become a turning point. This will encourage many active user groups and NGOs to maintain a zealous watch on the environmental, social and business impact of the companies operating in the host country. This places a humongous responsibility on the companies in general, and those aspiring to spread their footprint globally in particular. All of them will have to abide by the guidelines stipulated by the respective host countries in order to ensure business sustainability (BS) of their operations. Some nations are already imposing carbon tax. The Indian stock-market regulatory authority SEBI issued National Guidelines on Responsible Business Conduct (NGRBCs) in March 2019. The basic aim was to keep pace with UN SDGs-2030, Paris Agreement on Climate Change of 2015 and UN Guiding Principles on Human Rights and Business. Now it has already mandated 1000 largest listed companies by market capitalization vide its directive issued on 10 May 2021, to report annual sustainability progress voluntarily in FY 2021-21 through BRSR (Business Responsible and Sustainability Reporting) as per the format issue by it, and mandatorily from FY 2022-23 onwards.

The concept of ESG (Environmental, Social and Governance) framework is the pillar of judging the BS of any firm. Firms are here to do business on a continuous basis, by complying with all the regulations, and also formulating and adopting progressive policies which will ensure their sustainable journey, through tapping of funds and adopting best practices. For this they have to ensure BS, which implies performance on triple P front: planet, people and profit. The Indian businesses have made a humongous progress in the field of ESG over the years. However, it is a continuous journey. Those aspiring to spread their geographical footprint across the globe will have to tread cautiously. The logic is not far too complex to comprehend. BS following best global ESG practices, has to be the central theme of planning for any business activity. The risks in the absence of due ESG compliance can be as under:-

- Loss of reputation
- Loss of business opportunity
- Legal and regulatory intervention risks
- Risk to project financing: by project financing agencies as well as ESG funds.
- Poor leverage with the government and institutions
- Loss of credit rating by the agencies such as Moody's, CRISIL, ICRA, CARE, et al.
- Loss of stakeholder's confidence

The following are the advantages of the ESG compliance:-

- Top line growth
- Cost reductions, higher profit margins
- Less legal and regulatory interventions
- Improvement in employment productivity
- Investment and asset optimization
- Eligibility for ESG funds inflow

Recommended Plan of Action

In a worldwide survey carried out in 2019, it was discovered that 21 out of 30 most polluted cities were in India, something definitely not to be proud of. What is more, air pollution in India has caused a loss of up to $36.8 billion (US$) in and 1.67 million deaths in 2019, as per the joint study carried out by Global Observatory on Pollution and Health at Boston College, the Indian Council of Medical Research and the Public Health Foundation of India. Around 9 million people die every year in the world every year, which includes 3.1 million children below 5 years of age, due to poor nutrition and hunger. The number of hungry people globally was 822 million in 2018. This is basically to highlight the loss to economy and human life and malnutrition. That is where a joint action by all the stakeholders is called for. A strong mechanism to address at level of corporates, is through a proper ESG mechanism. All the stakeholders in a business have to take the ownership for ensuring ESG compliance. This implies that all the business partners in supply chain management, customer relationship management, suppliers of utilities, employees, leadership, management, et al; have to be taken on board for ensuring compliance on environmental, social and business front. The various tenets of good governance need wholehearted collaboration and participation from all the stakeholders. BoD has a special role in ensuring this. The following action plan is recommended:-

- **Developing a Climate Resilience, Adaptation Strategy**

  Developing a strategy which is resilient to any climate change is of paramount importance. Hence factoring in the worst-case scenarios for critical factors such as carbon footprint, discharge of effluents, oil spillage as happened in case of British Petroleum in 2010, child labour, human rights violations, cyber-security, et al; must be carefully selected for a special attention and planning. These could become the priority areas while formulating a business strategy. This strategy must be capable of addressing any changes in regulations with due nimbleness and minimum resources. Any BS policy which is flexible, and capable of addressing any situations with VUCA (vulnerability, uncertainty, complexity and ambiguity) situation should be laid down. These situations could be outlined meticulously through brainstorming, environmental scan and simulation. Contingency planning is a must, wherein the possible scenarios and synchronized response could be articulated and laid down in a proper framework, and SOPs laid down.

- **Scenario Planning**

  In situations where there is a great degree of uncertainty and unpredictability, merely strategic planning may not yield the desired results. Scenario planning must be done assiduously to complement corporate planning. Such scenario planning, could have been helpful in handling the different waves of the pandemic and could have yielded better results in dealing with the business and human life, throughout the world. The computational power (modeling and simulation) along with the AI, machine learning and deep learning could also be leveraged for simulating various scenarios and customized action plans. These should be country and region specific.

- **Use of BS and management tools**

  There are great many BS tools such as eco-innovation, lean thinking, design thinking, steps to minimize waste, continuous improvement (kaizen), et al. One must use them judiciously through properly defined SOPs. These tools are extremely potent. They ensure that BS gets embedded into strategic planning, design and operations, in a holistic manner. BS has to become a part of company culture. That compels the people decisively. Innovation driven companies such as 3M have used progressive strategies such as Pollution Precaution Pays (3P) and elimination of any pollution at the source of manufacturing stage itself.

- **Training and Up-skilling**

  Proper training and creation of awareness in employees is extremely important. There are various responsibilities which are assigned to various stakeholders. Their training and up-skilling are important. The complete value chain needs to be addressed in a holistic manner. In a dynamic and uncertain times as in the current pandemic, these aspects are extremely important, as the key to any success in business activities is the 'right talent'.

- **Sound Corporate Governance**

  A proper framework for monitoring the progress on control of emissions in the environment (space, water and ground) and its linkage with the target specified in UN SDGs-30 along with UNGP GRI-G4 documents including situations arising out of cyber-security, should be devised and overseen. This will be a prime responsibility of the Board of Directors. The risk management strategy has to be honed for various kinds of scenarios as could be conceptualized and visualized through various means including computer-based simulation models. It is not merely risk management policy, but the proactive policy for management of environment. This will cater for mitigating disasters, compliance issues, measures for improvement thereof through various measures such as reduction of pollution, optimal use of water and energy and raw materials, packaging materials, sequestering of CO_2 through agro-forestry if possible, product life cycle management, et al. The aspect of society will encompass human and community well-being, particularly important in the present pandemic, human rights issues, equity, inclusivity, child labour, contribution to society and community, et al. The SOP for business ethics should be laid down. The economy aspect is and should be well taken care of. These should be country and region specific. Proper SOPs are advisable at operational level.

- **Preparation of Sustainability Materiality Matrix (SMM)**

  It is extremely prudent to have this SMM constructed truthfully. This comprises of all the elements of BS, plotted on the X-Y axis, with importance to stakeholders on the X-axis and impact on company reputation on Y-axis. This will enable the BoD to evaluate and assess the elements which require their intervention. The progress particularly on the environmental front has to be monitored through data in form of suitable charts, as that will reflect the exact position. The corresponding gap analysis could be carried out and suitable measures initiated. A typical SMM as reported by 3M to SEC is in its Annual Sustainability Report of year 2017, is shown in Figure No.1. The size of the circle or blob shows the weightage in terms of perceived ability of 3M to make a positive difference to all stakeholders, environment and society. The biggest advantage of the SMM is that it injects that discipline and rigour in ensuring BS at all levels. If done meticulously and truthfully, this has the potential of lifting the culture of the company to a higher orbit.

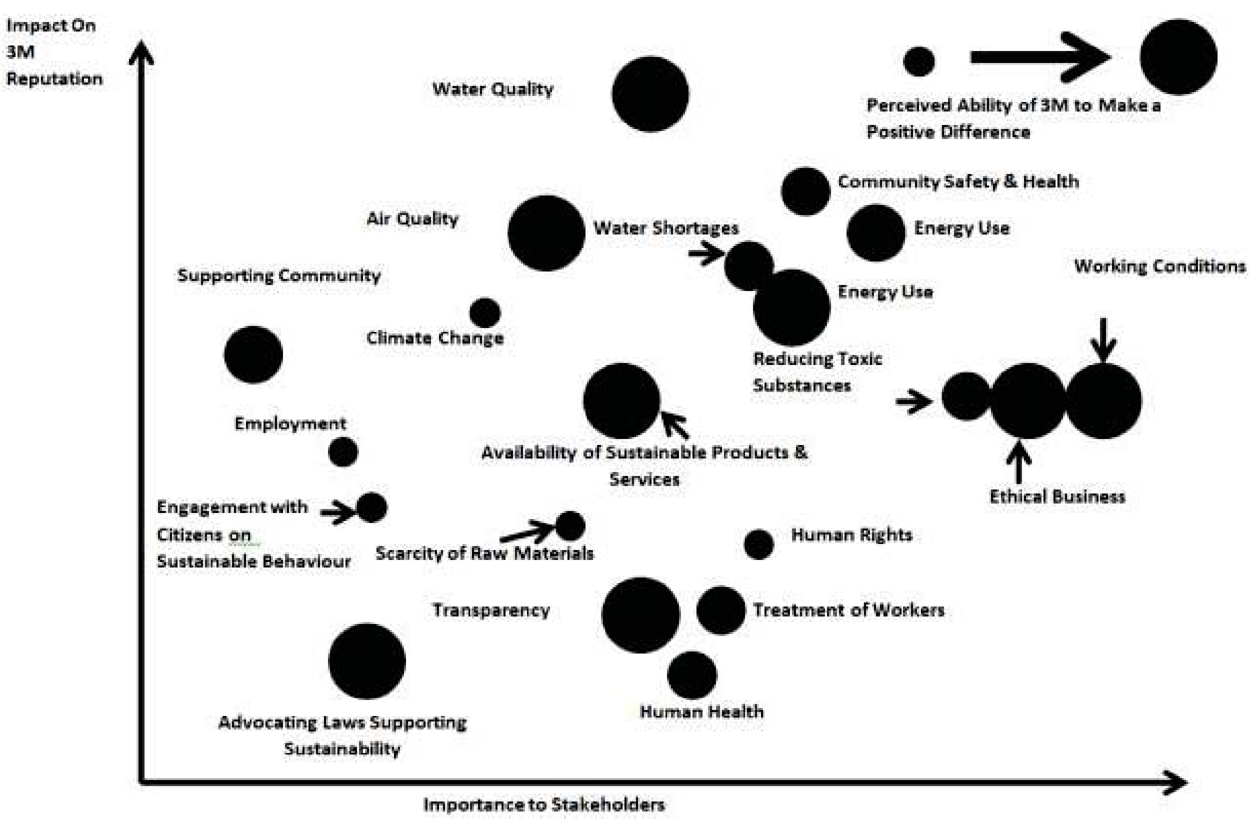

Figure No.1: Sustainability Materiality Matrix (Submitted to SEC for Year 2017)

Conclusion

There have been enough warnings which are serving as foreboding of what lies in future in case ESG is not taken seriously. A case in point is an apparel maker will be heavily impacted due to the risk of flood, drought, heat or pestilence, as a result of adverse climate change. We have seen how two companies namely JBS (meat supplier) along with the connected farmers and restaurants in USA, as well as McDonald in USA, South Korea and Taiwan were hit by the ransomware, exposing the chink in their cyber security armour. We have seen the rapidity of cyclones, floods and draughts which have caused miseries, and also have had an adverse impact on the supply chain. These issues will have to be mulled over by the BoD, as the destiny of the company is being guided by them along with the top leadership. The machinery manufacturer will be forced to pay the carbon tax, upsetting the price competitiveness calculus. In the hyper-connected and interwoven world of today, the global corporate entities have to abide by the international as well as the national laws in case they want to do business on a sustainable basis. ESG provides such a framework. Bloomberg Intelligence study carried out and published on 23 February 2021, projects that global ESG assets tracks are on track to exceed $ 53 trillion by 2025. This will amount to more than one third of the estimated global assets of $ 140.5 trillion under management by various agencies. In India a number of ESG mutual funds have already been floated such as ICICI Prudential ESG Fund, Axis ESG Equity Fund, Quantum India ESG Equity Fund, SBI Magnum Equity ESG Fund, Kotak ESG Opportunities Fund, and others. Besides, there are many foreign investment funds which are entering India which are focused only on investing in the companies with sound ESG practices. Hence to avail of this increasing pie, it will make eminent sense for the companies to transcend themselves into an orbit of ESG compliant entities. Moreover, those companies operating across the national boundaries, particularly in East Asia, Europe and USA will have greater opportunities. The rising activism against the environmental pollution, social issues and poor governance (which we have observed in quite a few companies in India and abroad too), across the world, often end in judicial, government and corporate interventions. This is not a welcome scenario for business entities. This makes it mandatory for the Indian business houses to adopt sound ESG practices, particularly in view of their legitimate global ambitions. This places onerous responsibility on the BoD and the leadership of the company.

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