THE ESG ECOSYSTEM

A Framework For Understanding The Scope Of Sustainability KPIs

BY PAUL JACOBS

Scientists tell us that more than 80% of the world's oceans remain unexplored. These vast expanses are known only in part and mostly at surface level. To those outside the field, ESG has the same sense of intimidating mystery. We know it is big, we know it is important, but we are not quite sure of its breadth or depth.

A BASIS OF UNDERSTANDING

ESG refers to a set of non-financial environmental, social, and governance factors used to evaluate companies with regard to their sustainability risks and societal impact. ESG metrics are used by investors and other stakeholders to evaluate a company's non-financial risks and performance. This information is then used for comparison purposes to evaluate the company's performance against their competitors when making capital allocation decisions. Investors and other stakeholders are increasingly requesting that companies disclose sustainability risks and opportunities. Although not yet required, companies are providing material sustainability information in their annual reports or in separate sustainability reports.

The ESG ecosystem is comprised of four main groups of organizations: framework and standard setters, data and analytics providers, investors, and stakeholders. The first group, framework and standard setters, are the building blocks of ESG reports. Organizations such as the Sustainability Accounting Standards Board (SASB), the Global Reporting Initiative (GRI), the Task Force on Climate-Related Financial Disclosures (TCFD), the International Integrated Reporting Council (IIRC), and the Climate Disclosure Standards Board (CDSB) all work to develop standards and define materiality. These standards are then used by corporations as guidance documents to determine which ESG metrics should be disclosed in their reports. Some of these organizations, like SASB, develop industry-specific standards through a collaborative effort between industry and stakeholders.

The second group, data and analytics providers, interpret published information about corporations to identify trends and corollaries between ESG and financial performance. Firms that could be referred to as ESG ratings agencies compile and score company ratings based on non-financial factors, much like Moody's or Standard & Poors establish credit ratings based on financial factors. There are over 100 ESG ratings and research organizations worldwide, with Sustainalytics, Bloomberg, MSCI, CDP, RepRisk, and Thomson Reuters among the most widely known.

The data, analytics, and ratings are then used by the third group, investors, to help them make informed decisions regarding corporate investments. As ESG performance is directly linked to the financial performance of a corporation, investors will use the data and analytics to compare the ESG performance of multiple companies in the same industry (see "An Introduction To ESG," First Quarter 2021 *ESG Review*, p. 2). Sustainability investing is a separate topic, but it underpins the growing importance of a company's ESG performance.

Investors are not the only users of ESG performance information. Non-investor stakeholders, the fourth group, are also increasingly aware of a company's sustainability. Stakeholders include society, communities, employees, local governments, suppliers, and customers. Stakeholders are directly and indirectly affected by the decisions companies make. For example, a company that utilizes large amounts of water from an area could have a negative impact on the nearby communities.

ESG CRITERIA OVERVIEW

What follows is an overview of the major ESG criteria. As with oceans, borders are sometimes ambiguous, and nomenclature can vary by location and point of view. Also, there are no deep dives into specific topics. However, taken as a whole, this overview can provide greater understanding of the all-encompassing nature of ESG and its usefulness as a framework for assessing the sustainability performance of an organization.

ENVIRONMENTAL

The environmental portion of ESG measures how well a company performs as a steward of nature. It considers the way a company uses natural resources and how their direct operations and supply chains impact the environment. While some environmental factors are universal, such as waste reduction, others are industry-specific, such as the elimination of biohazards in the medical industry or the reduction of flaring in oil and gas.

Moving forward, organizations must give first priority to managing risks associated with their environmental footprint. What actions are being taken to reduce carbon emissions? How is the company transitioning to alternative energy? Will climate change threaten operations worldwide? Does the company source materials from threatened areas? How will climate change threaten a company's financial performance? Does the company own contaminated land? Can toxic waste streams be reduced? Is the company in compliance with all governmental regulations?

Environmental factors are often the most visible component of ESG performance and high-profile issues such as climate change, water scarcity, and carbon footprint will expose stakeholders of unprepared companies to high levels of financial risk.

Environmental Themes & Issues

Climate Change
Greenhouse Gases (GHG)
Carbon Emissions And Fossil Fuel
Efficiency In Carbon-Intensive Practices
(Carbon Footprint)
Financing Environmental Impact
Climate Change Effects On Operations
Resource Depletion
Conservation Of Water And Other Natural Resources
Raw Material Sourcing
Biodiversity
Deforestation
Responsible Land Use
Pollution & Waste
Solid Waste
Toxic Emissions
Water Pollution
Packaging Material And Waste
Electronic Waste
Environmental Opportunities
Clean Technology
Green Building Practices
Energy Efficiency
Renewable Energy Solutions

Impacts

A company's environmental disclosure, impact, and efforts represent tangible risks and opportunities for all stakeholders. These factors are increasingly used as a guide for including or excluding certain companies, products, or services from investment portfolios. Potential investors want full disclosure of any risks a company might face up front, as well as any plans the company has for mitigating those risks.

Companies that ignore the impacts of their policies and practices on the environment leave themselves exposed to financial and legal risks. Failure to protect against extreme environmental incidents, such as hazardous material spills or explosions, leave companies open to regulatory penalties, criminal prosecution, damage to their brand reputation, and harm to shareholder value.

Climate risks can have devastating consequences for both people and organizations. This fact was driven home recently as some of the coldest weather to hit Texas in decades led to massive failures in the state's electric power grid (see "Why Was Wind Energy Blamed For The Texas Winter Freeze Power Outage?" Second Quarter 2021 *ESG Review*, p. 20). Cascading effects from days without power in below-freezing temperatures took a tragic toll in death and human suffering. Damage and economic losses are estimated as high as US$130 billion in Texas.[1]

Climate change vulnerabilities must be effectively assessed so companies can plan for any necessary investments in new sources of energy or technologies that reduce waste streams, control emissions, and decarbonize. Companies that rank high in managing environmental disruptions and opportunities will put themselves in the best position to enhance shareholder value.

SOCIAL

The social component of ESG centers on relationships. In particular, it addresses how a company manages its interactions with its workforce, financial stakeholders, the societies in which it operates, and the broader political environment.

Social issues demand a wide-ranging review of the way an organization's operations affect people. What is the company's safety record? Are there initiatives in place to promote diversity and inclusion? What is the likelihood of labor unrest or strikes? Does the company make financial contributions to local communities? Does it support the volunteer efforts of its employees? Will sourcing arrangements expose the company to questionable labor practices or induce political pressure? Will geographic expansion increase shareholder dissatisfaction over human rights issues? Does a new product increase liability for consumer safety? How adept is the company in recognizing and adapting successfully to social trends and changes in public opinion?

Social risks and opportunities have direct impacts on a company's financial performance, workforce satisfaction and productivity, and public perception as a responsible corporate citizen.

Social Themes & Issues

Human Capital
Workforce Diversity And Inclusion
Labor Management
Human Capital Development
Health And Safety
Working Conditions
Supply Chain Labor Standards
Product Liability/Consumer Protection
Product Safety And Quality
Chemical Safety
Financial Product Safety
Privacy And Data Security
Responsible Investment
Health And Demographic Risk
Stakeholder Opposition
Conflict, Including War And Civil Unrest
Controversial Sourcing
Human Rights
Animal Welfare
Social Opportunities
Access To Communications
Access To Finance
Access To Healthcare
Opportunities In Health And Nutrition

Impacts

Social factors increasingly influence the availability of capital. A company that fails to manage the social impacts of its business decisions will not have the ESG performance necessary to attract investors or progress toward an initial public offering (IPO). Investors will try to minimize the risks from societal issues and will show a preference for companies that reflect their values while generating attractive returns.

Companies that minimize social risks are rewarded with decreased volatility in their businesses. For example, avoiding controversial products, eliminating reliance on raw materials from geopolitical hot spots, and maintaining positive labor relations lead to greater stability in production capacity and market demand.

High-performing companies protect and nurture their human capital. Addressing equality, diversity, safety, and quality of life issues improves a company's ability to attract and retain talented employees and boost productivity through increased internal morale and employee engagement.

Social factors impact public perception on multiple levels. High-scoring companies avoid product liability issues, recalls, and fines that damage brand value. They protect their employees and the surrounding areas with robust environmental, health, and safety practices. They also invest in the well-being of their communities and act as responsible corporate citizens.

In short, success in social factors proves that sustainability and profitability go hand-in-hand.

Corporate governance focuses on the responsibilities of the ownership and management of an organization — primarily its board of directors, executives, shareholders, and other key stakeholders.

A governance analysis will examine company policies, standards, information disclosures, auditing, compliance issues, and other areas for potential risks. Is the leadership group diverse, accountable, and fairly compensated? Are shareholders given the opportunity to vote on key issues? Does the company encourage shareholder engagement? Are accounting practices accurate and transparent? Does the organization make political contributions without expectation of improper influence? Are policies followed through with action?

Stakeholders want to know that people throughout the company conduct business ethically and responsibly.

Governance Themes & Issues

- Corporate Governance
- Board Diversity
- Executive And Employee Compensation
- Ownership And Control
- Management Structure
- Employee Relations
- Accounting Controls
- Corporate Behavior
- Business Ethics
- Anti-Competitive Practices
- Tax Strategy And Transparency
- Political Affiliations And Support
- Corruption And Instability
- Financial System Instability

Impacts

Governance standards set a baseline for integrity to protect the interests of stakeholders, from investors and employees to suppliers and creditors. The standards signal to board members and managers that ethics and accountability are priorities in decision-making. Equally important, standards inspire confidence to cautious investors looking to avoid exposure to mismanagement, scandal, and tarnished reputations.

Good governance correlates with good stewardship of capital, resulting in improved corporate profitability and shareholder value. According to the European Bank for Reconstruction and Development's Transition Report 2019-2020,[2] firms that have better governance are significantly more productive than those that do not: "Improvements in governance can be regarded as a relatively low-cost and low-risk way of improving companies' performance by increasing the efficiency with which physical capital, human capital, and material inputs are combined to produce goods and services."

In terms of improved diversity and inclusion, governance also pays dividends in attracting and retaining top talent, boosting employee commitment, and increasing innovation.

The connection between responsible governance, value creation, and risk reduction is clear and increasingly important as cultural and political pressures magnify public scrutiny.

AN ONGOING COMMITMENT

A final thought on grasping the meaning and implications of ESG: Like eroding shorelines and changing sea levels, the ESG ecosystem is constantly evolving. Companies that excel in ESG performance today must remain vigilant in addressing tomorrow's themes and issues. ESG metrics are not set in stone; they evolve with economic and societal priorities.

References

[1] "AccuWeather Raises Texas Damage, Loss Estimate from Winter Storm to $130B," March 5, 2021, https://www.insurancejournal.com/news/southcentral/2021/03/05/604122.htm#:~:text=Damage%20costs%20and%20economic%20losses,billion%20range%20AccuWeather%20estimated%20previously.

[2] "European Bank for Reconstruction and Development's Transition Report 2019-2020," November 19, 2019, p. 73, https://www.ebrd.com/transition-report.

About The Author

Paul Jacobs is a principal consultant at M&H Consulting with over 15 years of advisory and project management experience. Specializing in concept selection and decision analysis, Paul assists clients by learning their project drivers and developing teams to help them successfully execute their projects. In short, Paul helps clients solve the right problems and maximize returns on their efforts.

Paul earned a Bachelor of Science degree in Electrical Power Engineering Technology from the University of Houston, completed Rice University's Advanced Management Program, and is currently pursuing the Fundamentals of Sustainability Accounting (FSA) Credential from the Sustainability Accounting Standards Board (SASB).

Paul has volunteered his time and expertise to provide practical insights to aspiring business executives, most recently sponsoring a Rice University MBA program exercise simulating the development of a grassroots sustainability program for a major corporation.

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