Grant Thornton

ESG resilience: A true measure of success

Activating ESG through the risk lens

Environmental, social and governance (ESG) has been a hot topic throughout 2021, fueled by the momentum of the Biden administration, investor letters, and heightened employee and consumer concern about climate change. Some interpret ESG as an investment philosophy; others might intuitively refer to ESG as a proxy for "good risk management" and alignment with core values. In a risk context, these ESG topics represent underlying risk factors considered by investors and in risk assessment strategies incorporated into both investment decisions and risk management processes.

As the middle market tries to act in accordance with ESG reporting and compliance, key stakeholders are engaging more deeply with the issues. Increasingly, those situated within organizations' second and third lines of defense are asking why and how ESG physical and transitional risks impact the business, including how they can get ahead of these trends.

Move on ESG efforts even as standards are formulated

Studies from the COVID-19 pandemic have suggested that organizations embracing and applying ESG standards are more risk resilient and more likely to succeed in the face of volatility. They are also delivering higher returns to shareholders. In turn, as the U.S. market gains greater climate consciousness and moves from asking "What does this mean?" to "What can I do?" the emergence of ESG risk as an executive agenda item is inevitable. From the asset managers to the chief legal, risk and compliance officers, the imperative is to govern risks that seek to provide transparency for accountability, actions and assurance. According to the Institute of Internal Auditors, whether unpacking first- and second-line roles with management and uncovering ESG topics in managing risk, or third-line audit functions that uncover independent and object assurance and adequacy on what is being reported, ESG risks have broad implications for organizational leadership in both the immediate and long-term.

Studies have shown that organizations embracing and applying ESG standards are more risk resilient and more likely to succeed in the long run. They are also delivering higher returns to shareholders.

Another consideration in solving for an ESG strategy is that the definitions for ESG risks are also a moving target. Today, America's ESG taxonomy is largely borrowed from the EU and drawn from policy commitments, such as the Paris Agreement on climate change. We continue to see nonregulatory entities such as the Organisation for Economic Co-operation and Development, Carrot & Sticks, World Business Council for Sustainable Development, Global Reporting Initiative and Sustainability Accounting Standards Board play a role in providing updates in terminology and methodology that will yield the highest value-driven insights for various stakeholder groups. As trends pointing toward the consolidation of standards continue, those middle market leaders most able to build a robust and forward-looking ESG lexicon that translates into effective risk management will be best poised to adapt and drive growth under future U.S. regulatory regimes.

Why look at ESG through a risk lens?

ESG represents a subset of nonfinancial performance indicators that include sustainable, ethical and corporate governance issues such as managing a company's carbon footprint and ensuring there are systems in place to create accountability. These are essentially risk factors considered by investors and in risk assessment strategies incorporated into both investment decisions and risk management processes.

ESG represents three central elements often discussed through the lens of gaining an improved understanding of the risks, compliance and reporting of the ESG factors:

- Return on invested capital
- Cash flow
- Overall financial returns for investors and stakeholders

Though nonfinancial, the factors represent specific ESG exposures that can have a material impact on an organization's financial performance.

"The increased emphasis on ESG has required some risk professionals to make adjustments to their risk management strategies. Unlike the more tangible operational risks that affect an organization's performance, ESG was long considered a modest if not minor financial risk exposure. Consequently, little was done to assess the loss potential. Now, as awareness increases and regulatory takes note, the times are changing. This means that understanding the loss potential and risk exposures is critical to any ESG risk management strategy," said Yvette Connor, Grant Thornton leader of Strategic Risk Services.

ESG factors are more and more often being risk assessed and then incorporated into risk mitigation, compliance and investment reporting strategies.

The CFA Institute's guide, *Environmental, Social and Governance Issues in Investing: A Guide for Investment Professionals*, states, "There is…a lingering misperception that the body of empirical evidence shows that ESG considerations adversely affect financial performance," and adds, "For investment professionals, a key idea in the discussion of ESG issues is that systematically considering ESG issues will likely lead to more complete investment analyses and better-informed investment decisions." Investors are increasingly striving to evaluate companies using ESG criteria as a risk-based framework to screen investments or to assess risks and performance across investment portfolios; the CFA Institute's "Toward ESG Alpha: Analyzing ESG Exposures through a Factor Lens" highlights how to do this. In particular, funds with high environmental scores tend to have high-quality and momentum factor loadings. In partitioning the ESG scores into components related to ESG factors and idiosyncratic components, they find a strong positive relationship between fund alphas and factor ESG scores.

The three ESG factors (environmental, social and governance) are generally defined as follows:

1. **Environmental factors relate to a company's stewardship of the environment and focus on waste and pollution, resource depletion, greenhouse gas emissions, deforestation and climate change.** Environmental risks in business activities have actual or potential negative impact on air, land, water, ecosystems and human health. Company environmental activities can include managing resources and preventing pollution, reducing emissions and climate impact, and executing environmental reporting or disclosure. Environmental positive outcomes include avoiding or minimizing environmental liabilities; lowering costs and increasing profitability through energy and other efficiencies; and reducing regulatory, litigation and reputational risk.

2 **Social factors are encompassed in how a company treats people and focuses on employee relations and diversity employee relations and diversity, working conditions, local communities, health and safety, and conflict.** Social factors refer to the impacts that companies can have on society, including risks in inaction or inappropriate action. They are addressed by company social activities such as promoting health and safety, encouraging labor-management relations, protecting human rights and focusing on product integrity. Social positive outcomes include increasing productivity and morale, reducing turnover and absenteeism, and improving brand loyalty.

3 **Governance factors relate to corporate policies and principles including overall risk appetite and risk tolerance levels, and third-party and supplier requirements and oversight. How factors and risks are addressed is generally tied to how a company is governed by its board and leadership team.** Governance also encompasses organizational decisions on tax strategy, executive remuneration, donations and political lobbying, corruption and bribery, and board diversity and structure. Governance risks concern the way companies are run. Governance addresses areas such as corporate brand independence and diversity, corporate risk management and excessive executive compensation. It does so through company governance activities such as increasing diversity and accountability of the board, protecting shareholders and their rights, and reporting and disclosing information. Governance positive outcomes include aligning interests of shareowners and management, and avoiding unpleasant financial surprises.

What's next in your ESG journey?

Move from strategy to execution

As the momentum behind ESG continues to mount within American markets, boards and executives are issued the imperative to continue reimagining their organizations through the lens of ESG.

Whether nascent in their ESG journey or having begun to think systemically about the implications ESG issues have on the business, by translating information to strategy and strategy to execution provides opportunities for business leaders to chart responsive and resilient trajectories.

In the context of ESG risk, this means moving beyond routine compliance and on to identifying high-impact risks to the organization's assets, infrastructure, operations and service delivery in the short, medium and long terms. Anticipated ESG-related risks, as identified by the Climate Disclosure Standards Board, will likely consider the business and its strategies and financial planning, which should paint a holistic picture of the interdependencies among the factors that affect an organization's ability to create value over time.

As proven by the way 2020's COVID-19 pandemic, ardent calls for social justice reform and climate-related disasters indelibly marked the way we think about and do business, embracing uncertainty and considering the extremes may well yield dividends. Reflecting on organizational responses to these current risk trends may also serve as a meaningful thought exercise:

- Has the business established the sufficient first, second and third lines of defense to effectively navigate turbulence?
- How is the business considering climate risk, both physical and transitional? Will there be a Task Force on Climate-Related Financial Disclosures (TCFD) disclosure?
- Are appropriate processes, systems and personnel in place, and is there effective leadership from the top?
- Is effective ESG risk mitigation embedded within organizational strategy to the extent that it complements established goals, creates competitive advantage and drives success?
- Can the organization demonstrate the efficacy of these initiatives by tracking investment in ESG and relating it to meaningful outcomes for the business and its stakeholders?

Who is responsible for ESG risk?

"We are witnessing a shift of the ESG and sustainability agenda from the C-suite to the risk and audit functions as organizations think through ESG as a matter of operational resilience. Baking ESG risk into the way organizations plan for the future is quickly becoming the normal operating procedure as we navigate topics such as climate and diversity that are here to stay," said Angela Jhanji, Grant Thornton's director of ESG & Sustainability Services.

First line: Chief sustainability officer (CSO), investor relations and/or communications

- First line is best embodied by an organization's CSO. Emerging at the forefront of organizational efforts to embrace ESG and climate-smart strategies, CSOs have the primary responsibility for interpreting the complex, dynamic external sustainability landscape and helping to draft responsive strategy, enhance risk mitigation tactics and design new operations and controls.
- Supported by communications personnel, the CSO also serves as a key voice, distilling organizational and sustainability complexities as they drive the firm to deliver on ESG goals and TCFD disclosure.

Second line: Chief risk officer (CRO), and/or equivalent risk management leaders (supply chain and third-party risk management, compliance, etc.)

- The second line comprises the CRO and equivalent risk management leaders. They are responsible for adapting standard risk frameworks to ESG topics and enabling ESG-related risk identification, risk measurement, monitoring and reporting.
- Risk management leadership often reports to the CEO and/or a board risk committee, where risk management performance and emerging risks, such as ESG, are considered and solved for across various operational-, financial-, technological- and compliance-aligned risk management strategies.
- In this oversight role, CROs work in tandem with first-line personnel to develop decision-useful policies, tools and techniques to aid lower-level risk managers across the organization in identifying, monitoring and ultimately managing ESG risks.
- Through collaboration and integration, CROs also play a role in ensuring ESG data is applied across a variety of first- and third-line use cases. This allows front-line risk owners to receive and apply ESG risk insights, and better manage emerging risks or unwanted performance trends. Similarly, internal audit (IA) requires assurance related to the organization's alignment with its ESG principles, compliance requirements, risk assessments and overall ESG risk management performance.

Third line: Chief audit executive (CAE) or equivalent IA leaders

- The CAE or equivalent IA leaders spearhead the third line, assessing the effectiveness of the first two lines and providing independent and objective assurance. Through this work, the third line will ultimately report to the board and liaise with external regulators and auditors to validate that the controls and culture of the organization are sufficient for effective ESG risk remediation.

What is ESG resilience best practice?

In a recent risk alert, the SEC pointed to effective procedures and stated that companies where controls and practices were aligned to ESG frameworks and disclosures had more effective impact than those that were executing ESG initiatives in a silo. From across the C-suite, and risk and audit committees, chief risk and audit executives seek to answer the following questions. "How well are we managing and governing our ESG principles and program execution?" "Are ESG disclosures subject to controls procedures?" and "What is my role in helping cascade the adoption of ESG policies?"

Critical to successfully embracing ESG is considering the broad range of stakeholders that may be impacted by adapting business practices and recalibrating long-term strategy.

How does this impact your stakeholders?

ESG standards and principles offer additional guiding perspectives available to both investors and organizational teams. The United Nations launched the Principles for Responsible Investment in 2006 and subsequently Bloomberg and Morgan Stanley Capital International started tracking ESG measures. From there, the focus on risk assessment increased as it became increasingly clear the ESG conversation was not a short-lived fad. ESG scoring continued to mature with a deepening focus on finding ways to identify and solve for risks associated with the factors. Scoring took into account the corollary companies that retain outdated corporate practices associated with lower ESG adoption and weaker overall financial and resiliency performance, with direct impacts to investors and stakeholders. Studies show that organizations with higher ESG scores have higher Tobin's Q scores, as well as higher return on invested capital and lower cash volatility.

Many of the higher scored companies are also members of the Dow Jones Sustainability Index. It's important to note that higher ranked ESG companies positively correlate with organization that have more mature risk management functions. This fact enables ESG risk assessments and monitoring across the business and in alignment with ESG principles. Risk is minimized for investors, as they invest in more responsible companies with a greater likelihood of succeeding in the long run, and for organizations as they consider their own supply chains, third parties, workforce strategies and corporate social responsibility monitoring actions.

In spite of a lingering misperception that ESG considerations adversely affect financial performance, studies throughout the COVID-19 pandemic nearly universally indicate that ESG and sustainably invested funds outperform the market on average. What's more, the CFA Institute's guide referred to previously states, "…for investment professionals, a key idea in the discussion of ESG issues is that systematically considering ESG issues will likely lead to more complete investment analyses and better-informed investment decisions." Accordingly, investors are increasingly striving to evaluate companies using ESG criteria as a risk-based framework to screen investments or to assess risks and performance across investment portfolios.

Whether climate risk disclosure or net-zero campaigns are top of mind, the best practice in ESG transformation is grounded in resilience.

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