ESG Audit and Risk: Tools to Manage Reputational and Compliance Risks - A Practioner's Survey

Responsible Alpha

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ESG Integration ™

ESG Compliance & Fraud Risk Management 2023
June 13, 2023

Responsible Alpha advises institutions on their transition paths to a low-carbon, sustainable, and equitable future.

Our 10-step Process: Guides ESG Audit and Review Decisions Along the Value Chain

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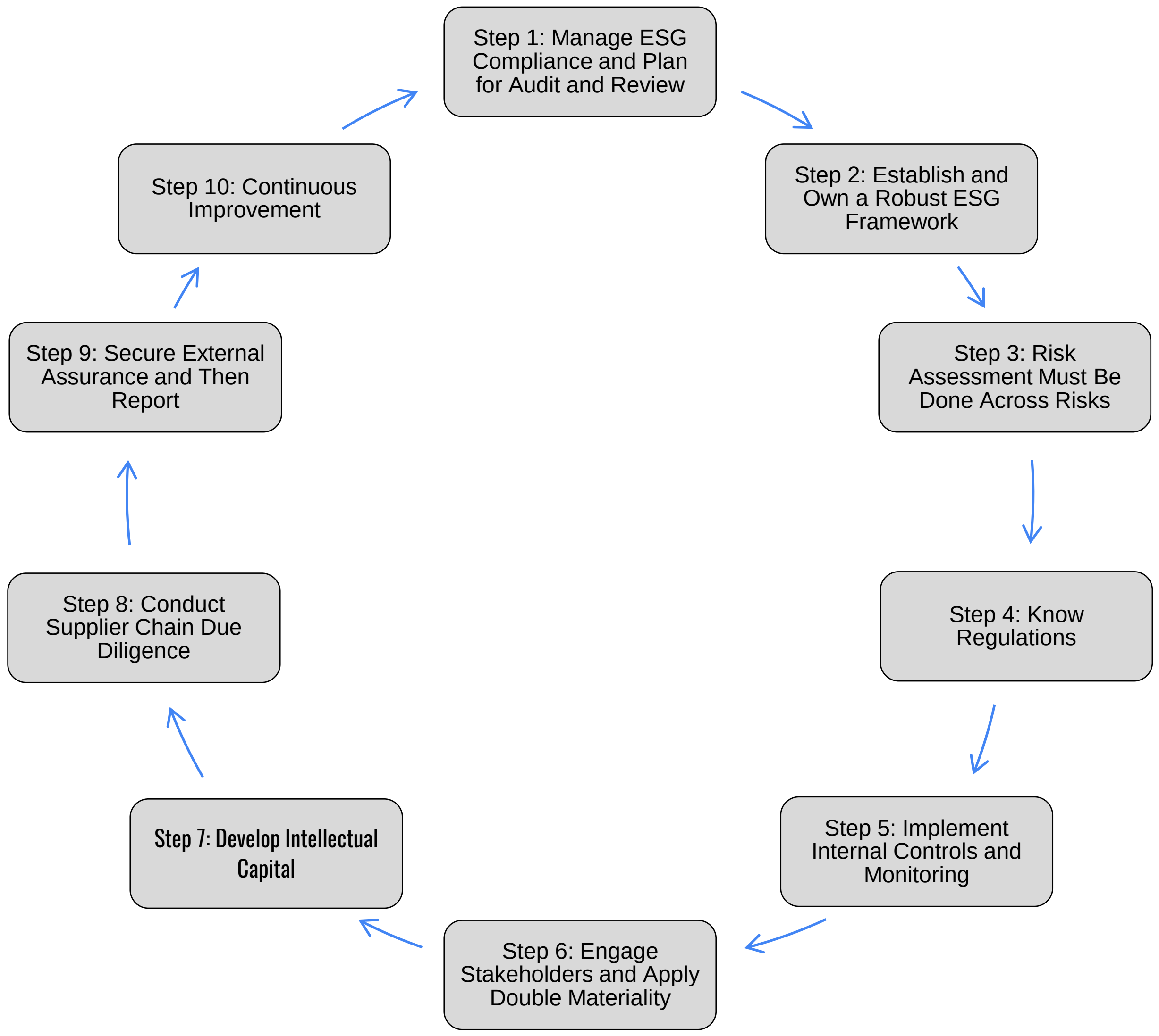

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Step 1: Manage ESG Compliance and Plan for Audit and Review

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ESG in practice

- Over **one thousand ESG-related regulations** have been issued for the investment industry alone (source PRI).
- EU-wide **ESG policies increase the compliance risk.**
- **No box checking!** Business leaders need to adopt appropriate policies with real impact to mitigate headline risks.
- SMEs, which represent 99.8% of all EU firms and about 65% of overall employment in the EU face an **immediate compliance risk**.

Romanian Context

- In 2021, Romanian **SMEs grew 13.3% in revenue and 2.6% in employment**, outperforming corporates, (respectively +9.8% and +0.9%).
- This ESG compliance presentation is **focused on SMEs in Romania**.

Step 1 Facts
- Unsubstantiated and misleading claims regarding ESG approaches must be addressed in marketing and advertising messages
- Expected first-mover advantage for the firms adopting compliance programs to improve product or service quality.
- Replicable data processes enable better decision-making.
- A cohesive ESG Integration™ across the firm improves internal and external communications.

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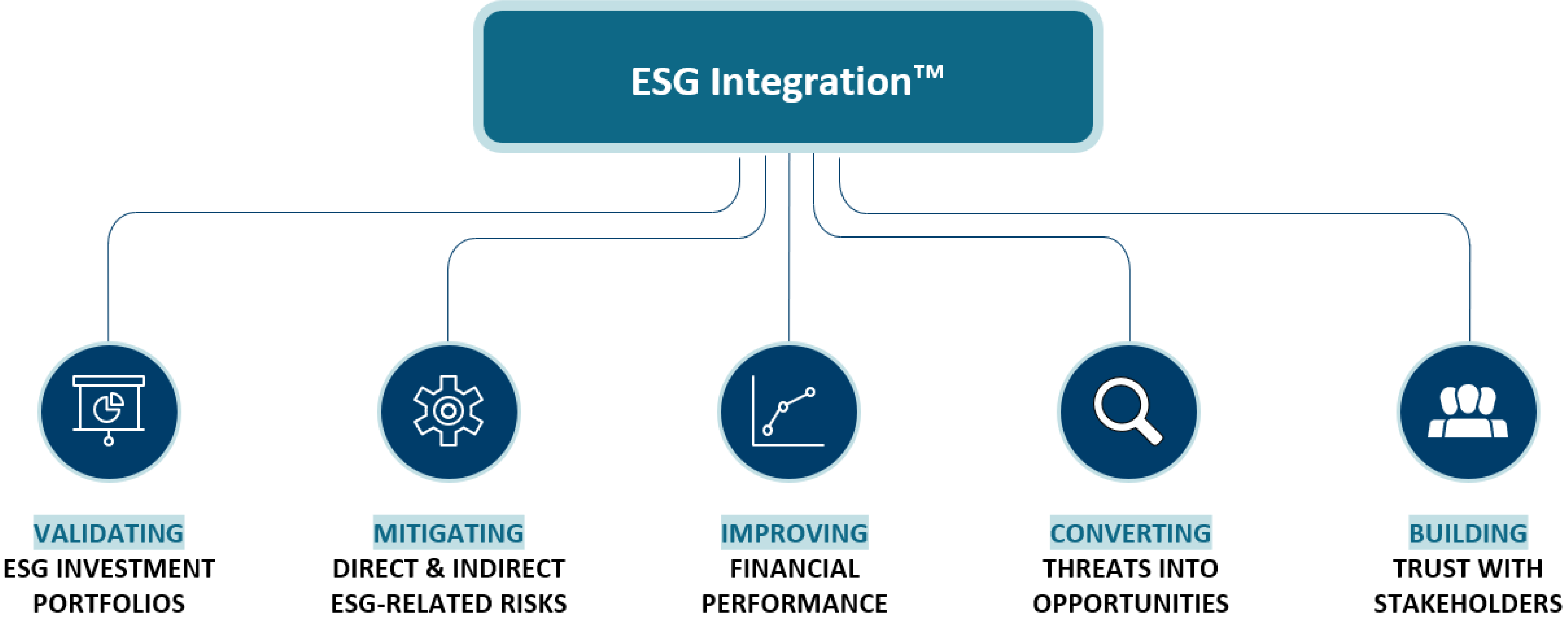
Step 2: Establish and Own a Robust ESG Framework



Step 2 Facts
- A firm’s ESG framework must be comprehensive and align with industry standards and regulatory guidelines.
- The organization's ESG goals, policies, and procedures, must be communicated across the organization.

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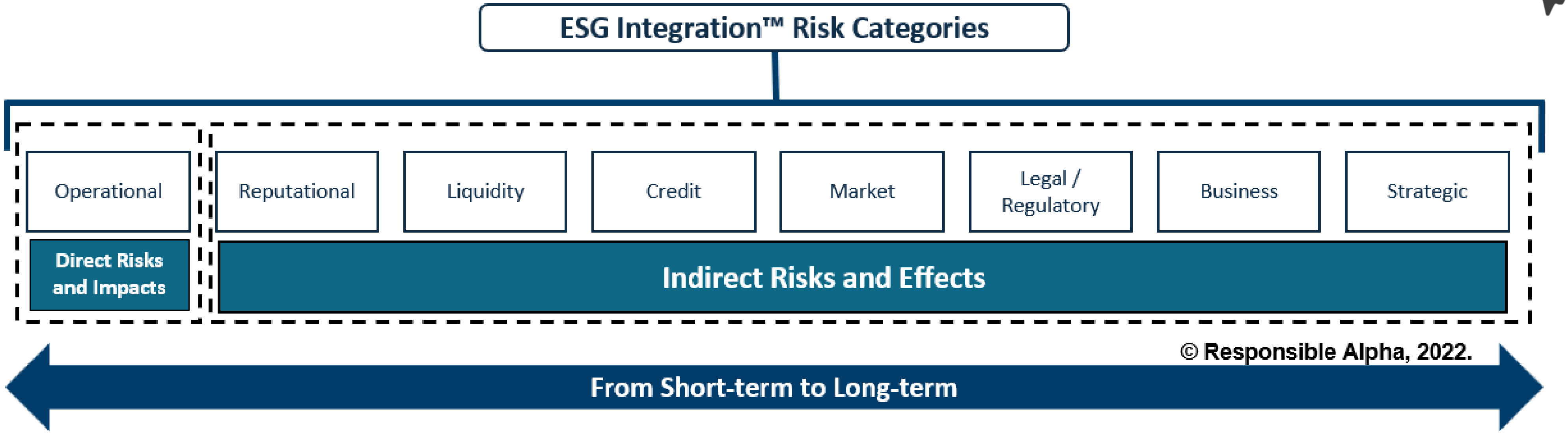
Step 3: Risk Assessment Must Be Done Across Risks



- **Operational:** We informed an asset manager to exit a multimillion-dollar position in a company before its shares collapsed.
- **Reputational:** We advised a G-SIBs bank on its ESG policy in mitigating reputational risks its peers faced with an inferior policy.
- **Liquidity Risk:** We assessed a commodity trader who lied about its ESG certifications resulting in 27 corporate buyers' suspended contracts.
- **Credit Risk:** For a hedge fund, we assessed a natural gas company that deceived shareholders about its clients and ESG practices.
- **Market Risk:** We assessed a commodity trader about its ESG-linked eco-label risks, with markets ceasing buying product.
- **Legal/Regulatory:** We informed the C-Suite of a corporation whose key supplier was violating national laws.
- **Business Risk:** We informed an energy trader about their ESG-linked erroneous financial statements, resulting in a multi-million-dollar loss.
- **Strategic Risk:** We informed an exchange about a company's ESG-linked erroneous financial statements, the company was delisted.

Step 3 Facts

- Regular ESG risk assessments are performed regularly to identify potential compliance risks and gaps. The environmental, social, and governance aspects of your operations, supply chain, and stakeholder relationships are assessed to understand areas of vulnerability and prioritize mitigation efforts.

Step 4: Know Regulations

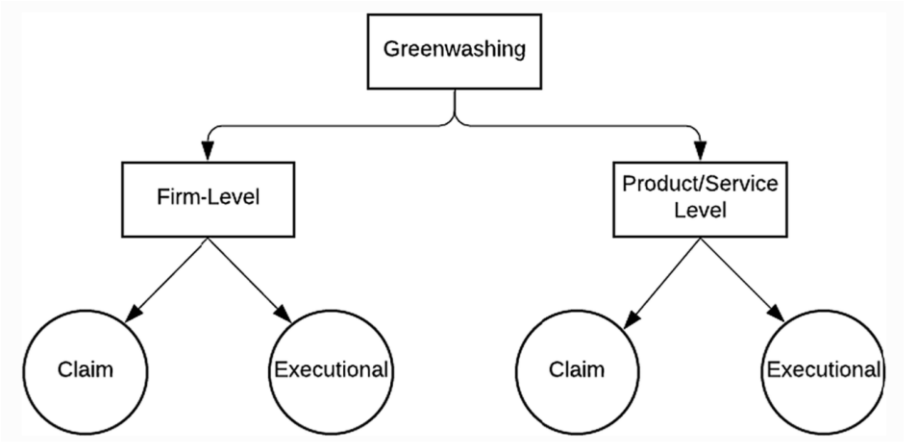
- The **Corporate Sustainability Reporting Directive (CSRD)** introduces new sustainability disclosure requirements for close to 50,000 entities in the EU (vs. about 12,000 currently). ~95% of companies in the scope of the new regulation will start reporting their first CSRD-aligned disclosures either in 2025 or 2026. Enables integration into financial analysis. It is based on **double materiality.** Some disclosures are mandatory, some are sector-specific.
- The **Green Claims Directive** aims to combat greenwashing. It requires companies to use scientific evidence and secure third-party verification to attach environmental claims or labels to their products and services. Companies will also have to explain exactly how much the purchase of **carbon offsets** will contribute to their climate claims, according to the proposal. The Green Claims Directive is a response to an ongoing greenwashing challenge; the Commission found in 2020 that **53% of corporate environmental claims** are vague, unfounded or misleading and that 40% were unsubstantiated.
- Proposed changes to **Sustainable Finance Disclosure Regulation (SFDR)** include mandatory social indicators proposed on tax, living wage, trade unions, and tobacco and new environmental disclosures include intermediate decarbonization targets.
- The proposed **Carbon Border Adjustment Mechanism (CBAM)** is an element of the Emissions Trading System. The mechanism would ensure a level playing field for domestic products and imports by taxing emissions-intensive imports in order to protect the EU's carbon objectives from being undermined by production shifts to countries with less stringent climate policies.

Step 4 Facts

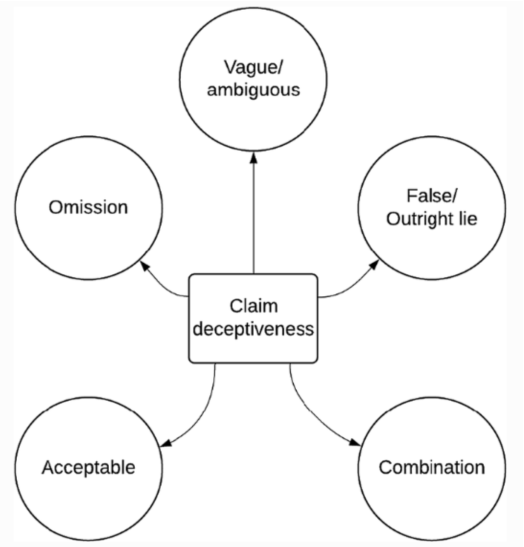
- Monitor changes in relevant laws and industry standards to ensure your organization remains compliant. Engage with industry associations and regulatory bodies to stay informed about emerging trends and best practices.

Step 5: Implement Internal Controls and Monitoring

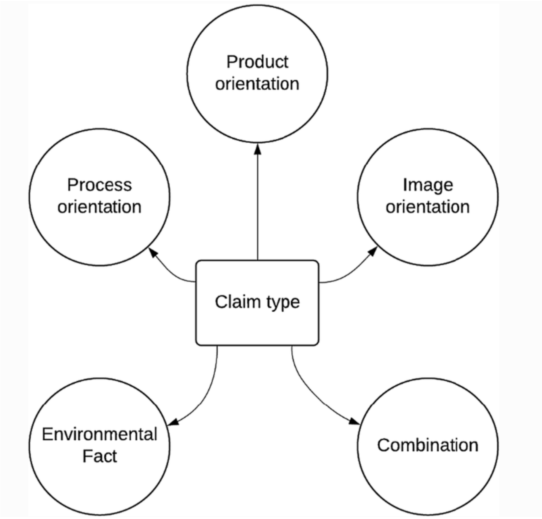
Identify



Deception



Clarity



Step 5 Facts

- Establish internal controls to ensure adherence to ESG policies and procedures. This may involve implementing monitoring systems, conducting regular audits, and tracking key performance indicators (KPIs) related to ESG goals. Implement whistleblower mechanisms and channels for employees to report potential compliance issues.

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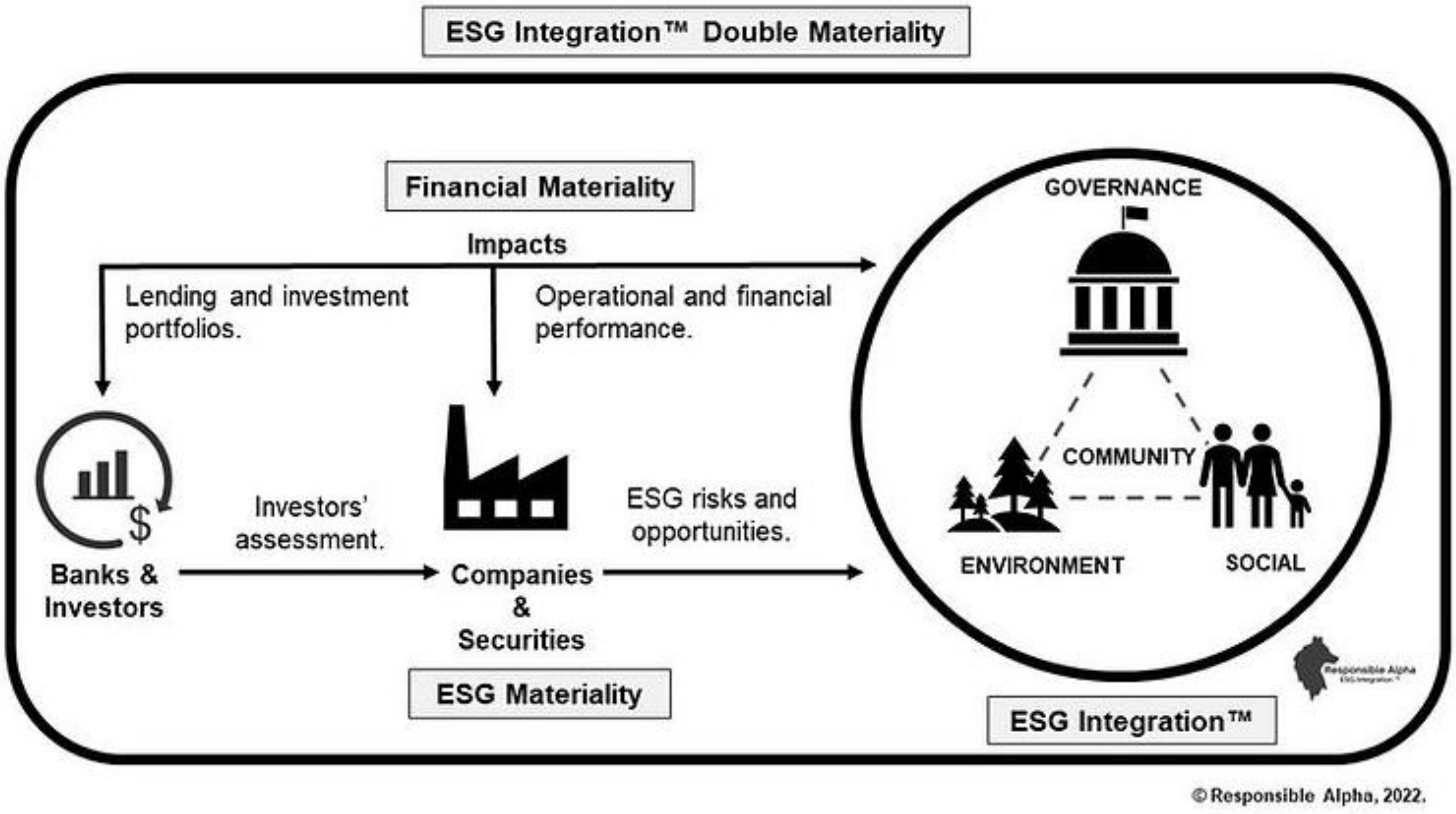
Step 6: Engage Stakeholders and Apply Double Materiality



Step 6 Facts

- Foster open dialogue and engagement with stakeholders, including employees, suppliers, customers, and investors. Understand their expectations and concerns regarding ESG practices. Regularly communicate your organization's ESG commitments, progress, and challenges to maintain transparency and build trust.

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Step 7: Develop Intellectual Capital

Greenwashing is the marketing of products or services with supposed environmental attributes when that is not the case.

- **Decoupling** is when organizations claim to fulfill stakeholders' expectations for action on sustainability, without actually making any changes in what they do in practice.
- **Attention deflection** is when organizations hide unsustainable practices from stakeholder attention, prepare selective and inaccurate disclosures, make incomplete comparisons with other products and services, and use vague and irrelevant statements.

Greenwishing is well-intended efforts to tackle sustainability challenges, which may not make enough of a difference or encourage superficial changes when more structural ones are required.

Green-bleaching is a term coined to describe financial market participants choosing not to claim ESG features of their products in order to avoid extra regulation and potential legal risks.

- The UK financial regulator – the Financial Conduct Authority – found in 2019 a very wide range of financial products that did not have a material different exposure before and after marketing as green.
- EU securities regulator is implementing a set of principles and scoring to assess products' claims so that fund management firms' claims are "fair, clear, and not misleading."

Step 7 Facts

- Develop working knowledge and apply standardized definitions inside the firm.
- Provide ESG training and awareness programs for employees at all levels. Educate them on the importance of ESG compliance, their roles and responsibilities, and the potential risks associated with non-compliance. This will help create a culture of compliance throughout the organization.

Step 8: Conduct Supplier Chain Due Diligence

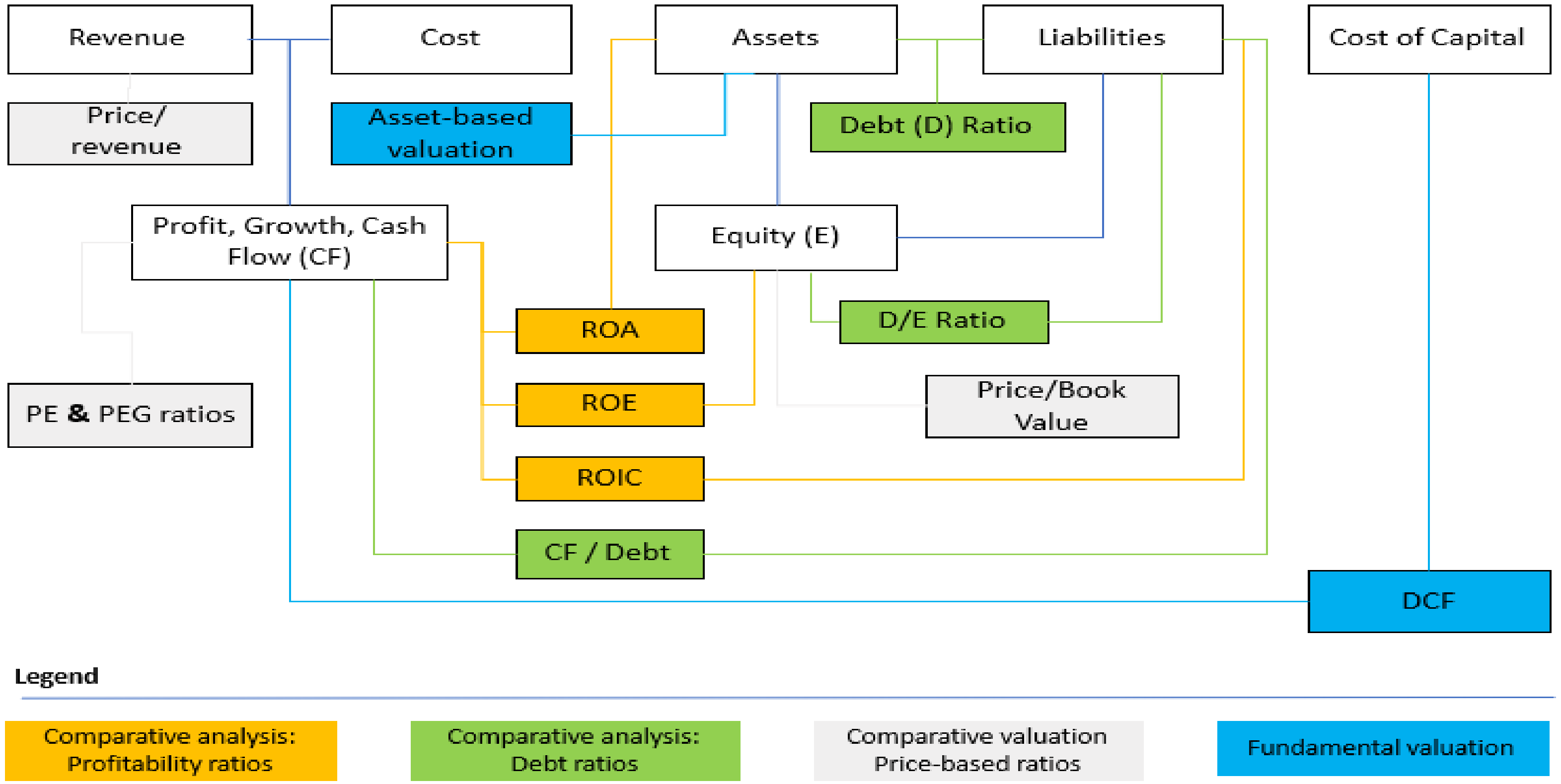
An FMCG asked us to review systemic ESG risks facing a large agriculture and food commodity sector across the U.S. Our independent ESG analysis allowed the sector to petition for improved government policy that would enable a sector-wide transition towards sustainability.

Step 8 Facts

- Conduct due diligence on your suppliers and business partners to ensure they align with your ESG values and standards. Consider factors such as their environmental impact, labor practices, and ethical conduct. Establish contractual provisions that require suppliers to meet ESG requirements and regularly monitor their compliance.

Step 9: Secure External Assurance and Then Report

A hedge fund asked us to review their possible deal flow for ESG risks and opportunities. Our independent ESG second-opinion supported the company in raising $50 million for an EV manufacturing facility.



Step 9 Facts

- Seek external assurance for your ESG disclosures and reports to enhance credibility and transparency. Engage third-party auditors or sustainability experts to review your ESG performance and provide assurance on the accuracy and reliability of your disclosures.

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Step 10: Continuous Improvement

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A large financial institution asked us to continuously review their ESG practices to support greater market acceptance of various ESG-linked products. This resulted in an increase in product sales along with improvement in their ESG strategy.

Step 10 Facts

- Regularly evaluate and improve your ESG practices. Monitor the effectiveness of your mitigation strategies, learn from any compliance incidents or shortcomings, and adapt your policies and procedures accordingly. Embrace a continuous improvement mindset to ensure long-term ESG compliance and performance.

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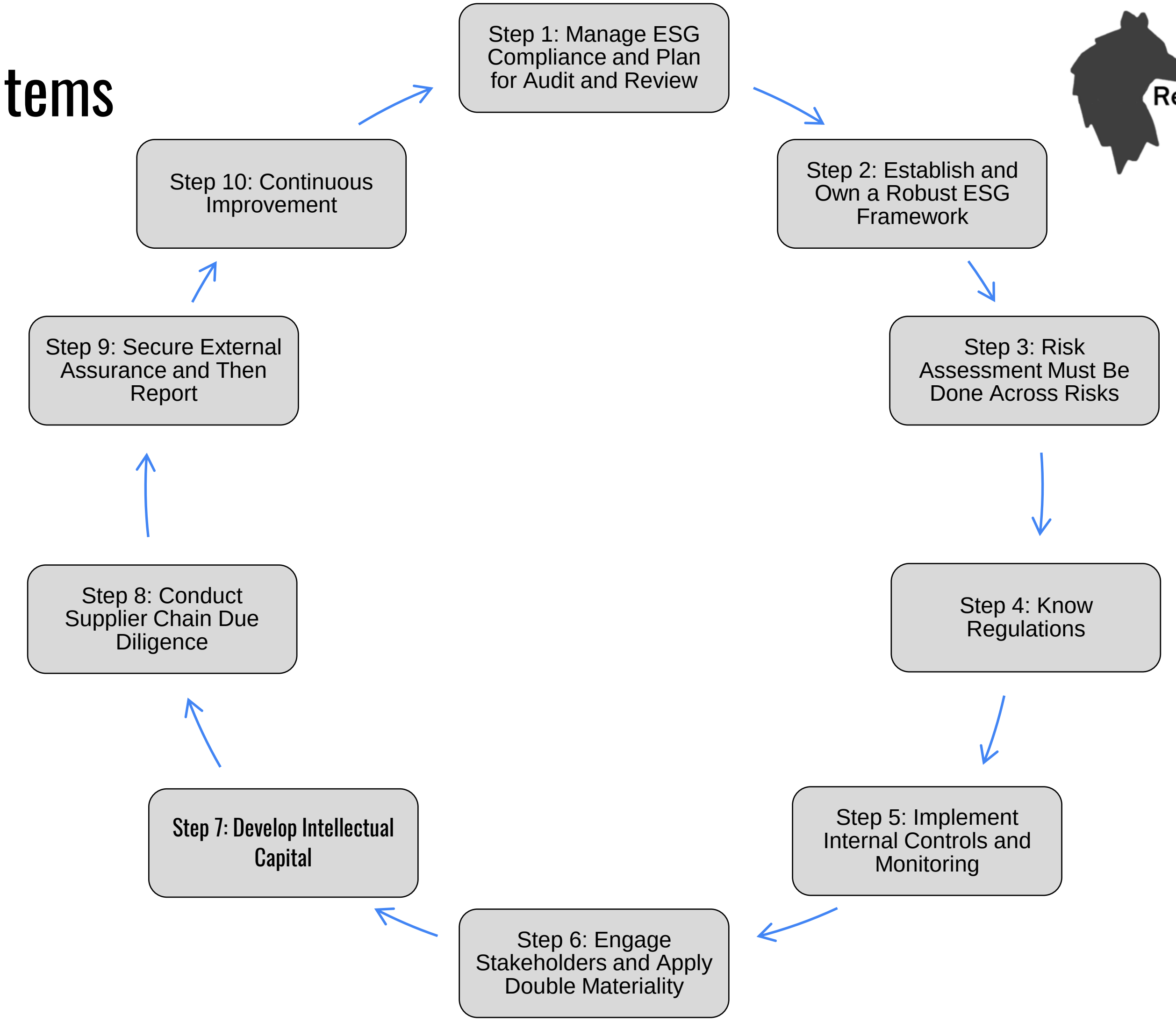
Why Audit and Review Matter: Action Items

Take action today:

- Good firms monitor their risks, better firms manage their risks, while the best firms mitigate their risks.
- Review your products and services for ESG risks.
- Do not focus on regulations. It is a distraction. Move beyond the regulations and think and act strategically focusing on the long-term.
- Understand your data and prepare to use it as necessary.
- Embrace audit and review tools to inform your strategic decision-making.



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Today's presentation sources include JPMorgan, ING, Kepler Cheuvreux, professional interviews, EU Annual Report on European SMEs 2021/2022: SMEs and environmental sustainability – Background document, Global Association of Risk Professionals, SASB, and Thomson Reuters. Source materials are available upon request.

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Thank You – Your ESG Audit and Review Team

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