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10 ESG Questions Companies Need to Answer

by Dambisa Moyo

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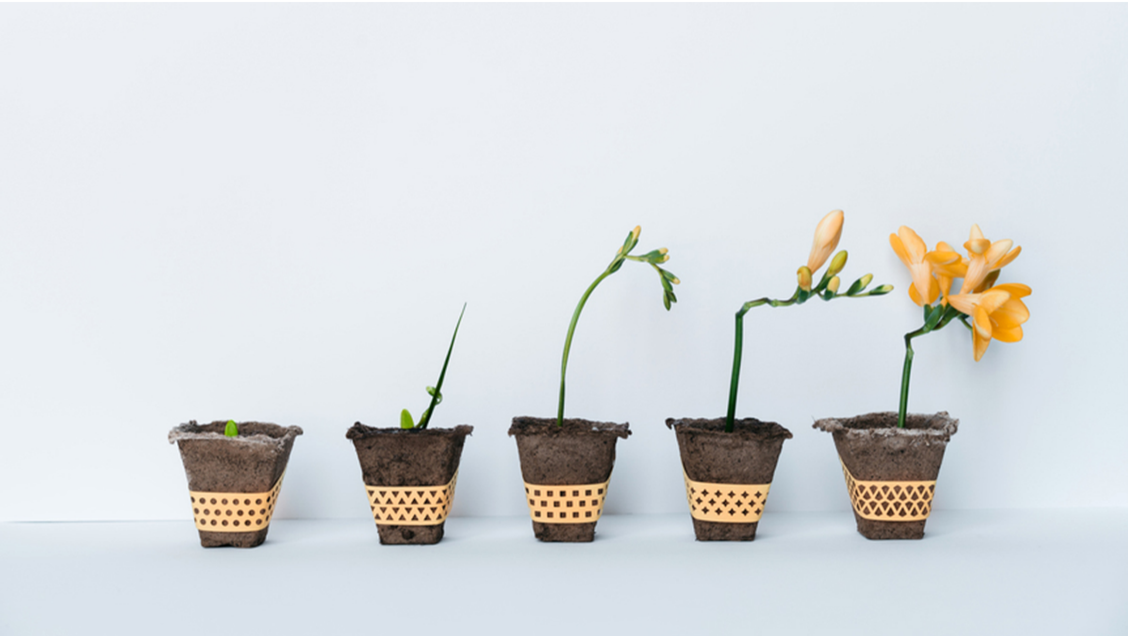

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Summary. Companies have been responding in increasing numbers to the imperatives set by the 2019 Business Roundtable statement of intent and changing cultural dialogues to adopt ESG strategies, as well as how to translate these goals into practical, measurable, and... **more**

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Corporations have been grappling with the Business Roundtable's all-important 2019 statement of intent — to move from financial shareholder primacy to broader stakeholder capitalism — and how to translate these goals into practical, measurable, and trackable ESG efforts in their businesses. According to Bloomberg Intelligence, Global ESG assets could exceed $53 trillion by 2025.

Based on more than a decade serving in corporate board rooms, here are 10 questions I believe every company should address as they embed an ESG strategy. If corporations fail to address these questions, there is a risk that they will be overtaken by rivals and, at the extreme, could even cease to exist.

1. Is ESG undermining your company's competitiveness?

Fears that excessive emphasis on ESG could harm a company's competitiveness are not misplaced. In fact, there are valid questions about whether, if a company places too much energy into ESG objectives, it risks losing its focus on growth, market share, and profits. In March 2021, for example, Emmanuel Faber, Danone's chief executive and chairman, stepped down amid pressure from activist investors, one of which suggested that Faber "did not manage to strike the right balance between shareholder value creation and sustainability." More generally, if a company focuses too much on ESG, it could struggle to compete against companies from countries with less rigorous standards, such as China.

But if a company does not focus enough on ESG, it risks falling behind in the market, losing the support of employees, customers, and investors, and potentially even losing the license to trade in more stringent regulatory/ESG environments, like the U.S. and Europe. Finding the correct balance will be hard because the parameters will vary across sectors and geographies, as well as over time. What is essential is that boards consistently review their focus on ESG and judge whether they are managing the trade-offs.

2. Does driving the ESG agenda mean sacrificing company returns?

Business leaders should be aware of the risk that a dogged ESG focus could be seen by some shareholders as harmful or compromising financial shareholder returns. That said, ESG advocates suggest that returns from ESG investment funds are not lower than those of traditional equity funds. In fact, returns can be higher than on broad base indices.

Over the 18 months from November 2019-March 2021, the MSCI World ESG Leaders index outperformed the traditional MSCI World by +1.84%. At the same time the JP Morgan ESG EMBI Global Diversified index outperformed the equivalent non-ESG index by +1.94%. However, it's important to note that big tech companies are core holdings to many ESG funds — and that the technology sector has dominated strong equity index returns in recent years. This raises the question of whether the ESG agenda itself yields returns, or if it's simply that the highest yielding sector also has strong ESG scores. Even so, investors should not discount the value that an active ESG agenda grants companies in terms of the license to trade — the right to operate a business, which is granted by governments and regulators.

3. How are you navigating ESG trade-offs?

The shift from a world of financial shareholder primacy to broader stakeholder capitalism encompasses a far-reaching agenda — including climate change, worker advocacy, the pursuit of gender and racial diversity, voter rights, and more. All these aspects of ESG are beset with trade-offs that business leaders must navigate.

For example, energy company boards have to weigh urgently tackling climate change against meeting the needs of the over 1 billion people who do not have access to reliable and affordable energy. In addition, business leaders are forced to balance the needs for climate action and decarbonization with the risk that curbing supplies of conventional energy sources could drive up inflation and the cost of living through higher costs of power, heating, and electricity bills.

4. How does ESG change due diligence?

Traditionally, evaluations of a company's assets (such as in assessing the value of M&A transactions) tend to focus on a set of conventional factors. These include business synergies, tax consequences, and anti-trust considerations. Today, thorough due diligence efforts also require an audit of how an acquirer or acquiree meets certain ESG standards. ESG audits will also matter when raising capital; debt-rating agencies and investors require this additional data, too.

Areas that could come into ESG due diligence include adapting products and services to climate-friendly materials and processes, evaluating diversity and wider employment practices, as well as revamping how companies engage with communities. Corporations today must be ready to demonstrate that they are ESG compliant — with actions and results.

5. Should you become a public benefit corporation?

Traditionally, many U.S. corporations are formed legally under Delaware LLC structures that prioritize financial shareholders over environmental and social stakeholders. Although under Delaware LLC structure, the Business Judgement Rule allows boards to take broader stakeholder concerns into consideration, there remains a push by campaigners for environmental and social causes for companies to switch to either a public benefit corporation (PBC) or B-corps structure.

Both PBC or B-corps registrations aim to legally enshrine the interests of broader stakeholders, not just financial shareholders. However, PBCs are signed up to a governance code that is recognized in 37 states, whereas B-corps are corporations that are certified by the non-profit B-lab as meeting higher standards of accountability, transparency, and social purpose than traditional listed companies.

Financially, companies need to examine the implications of changing their status from Delaware LLC to a PBC or B-corp — for example, whether or not PBCs are allowed to trade on various stock markets around the world. Business leaders must be alert to any changes in decision rights and restrictions of a PBC structure — for example does it restrict how the company raises capital or pays dividends? Can valid like-for-like comparisons can be made with Delaware registered peers when reviewing performance?

6. How should corporations address societal concerns such as racial equity?

Business leaders must be guided by a framework that is transparent and consistent in addressing current events that highlight injustice. Recently, boards have been challenged to ensure that they are consistent in defending racial justice across all racial, ethnic, and religious groups. For example, in 2020, while the murder of George Floyd was met with near universal condemnation and statements of intent to redress inequality in support of Black Lives Matter, acts of violence against Asians were met with a less consistent and assertive corporate response, as Shalene Gupta highlighted in HBR.

For the sake of employees, customers, and clients, corporations must be more transparent on how business leaders will handle these concerns, and broader ESG issues, as they emerge. An inconsistent approach risks fostering division among employees and creating a culture of “us versus them.”

7. How do you develop a global approach to ESG?

A more comprehensive ESG approach must be inclusive of different countries and cultures. For example, Western workers advocating for work-life balance, notably in the technology sector, sit in stark contrast to some Chinese employees willing to work 9-9-6 — that is, from 9 AM to 9 PM, 6 days a week. Political and business leaders must weigh the risks, not only of Chinese values being rejected by employees and customers in the West, but also of western liberal attitudes being rejected by workers and customers in China.

Likewise, in the case of the environment and climate change, it is impossible to make meaningful progress globally without having China and India on board — even if their desired speed of change might differ materially from those in the Western world.

8. How do you build an ESG framework that is future-proofed for tomorrow's economic realities?

Business leaders need to focus on ESG design and a system of thinking that applies to how the economy will be shaped in the future — not just how it is structured today.

For example, many retail companies point to strong diversity data within their staff today. But the reality is that a large proportion of the workforce are less-skilled workers who are most vulnerable to losing their jobs to increased automation and digitization, such as the prospect of driverless cars. According to the World Economic Forum, 85 million jobs will disappear due to automation by 2025.

While 97 million tech-driven jobs will be created, many of them will require higher levels of skills and qualifications. Schools and education public policy must ensure that new generations of workers are equipped with the knowledge to thrive in the workplaces of the future. But there is also an onus on companies to take active steps to reskill their existing workforce — and specifically to aid its most vulnerable members — to be able to transition into new roles. This can be achieved through well-developed trainee programs, apprenticeships, and on-going internships, such as in different areas of coding. Inaction will lead to greater net unemployment of precisely the diverse set of employees this ESG strategy is hoping to protect.

9. How do you vet company performance of ESG?

Business leaders must decide how their ESG results will be vetted for compliance. Companies already use independent external auditors for financial, operational, cyber, and worker audits. The question is whether ESG standards will need to be assessed and monitored by independent third-party accounting or law firms, or whether ESG will be overseen by a global body or by national regulatory organizations.

For now, although independent firms and regulatory bodies continue their efforts to design metrics and standards, ESG benchmarking remains highly fragmented. Therefore, the challenge for boards is to assess which metrics to choose and use.

The trend is to make companies accountable to external bodies: not only regulators, but also industry associations and trade bodies. The SEC, for example, is seeking greater clarity on the sustainable credentials of ESG-labeled investment funds. But simply obtaining clarity on how many different organizations define ESG is not enough. For the market to function properly, an open audit system requires harmonized rules followed by all.

One notable step came in 2021, when the International Capital Markets Association (ICMA) launched harmonized principles for green bonds, used by corporations to finance environmentally sustainable projects.

10. How should corporations navigate the ever-changing landscape of ESG?

As companies devise metrics to track ESG progress, they must be able to compare performance across time, peers, other industries, and against evolving regulatory standards. As they do so, they need to anticipate where regulation on all aspects of ESG will land. Therefore, business leaders must maintain a dialogue with regulators and policymakers, and companies should look to cooperate and coordinate on best practices with their industry peers.

Global corporations must approach ESG in a way that is transparent, consistent, flexible, innovative, sustainable, sensitive to cultural differences, dynamic, and future-proofed.

Furthermore, corporations should focus not only on mitigating the risks of ESG, but also on the opportunities it presents to continue to support human progress.

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Dambisa Moyo is an international economist who serves on the boards of the 3M Corporation and Chevron.