42

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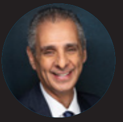
Contents



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Integrating ESG in an Organization's DNA

ESG, or Environment, Social and Governance is emerging as one of the most critical management imperatives facing leaders across organizations. It is no longer a viable option for these issues to be relegated to the fringe of corporate priorities, rather it has become necessary that organizations embed these issues in corporate strategy and risk management practices. Increasingly, organizations are required to report their ESG performance so that both internal and external stakeholders can make informed decisions about their association with them. Organizations must therefore achieve and report tangible and meaningful progress towards achieving strong ESG outcomes.

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As data standards for reporting ESG performance improve and better alignment on ESG reporting frameworks emerges, organizations will increasingly be required to report, and be benchmarked against, industry peers. This growing scrutiny and, increasingly, legal disclosure requirements, require attention from the most senior leadership within organizations.

This article will cover three themes. First, we highlight four common myths associated with ESG, which if not understood can lead to poor ESG outcomes. We demonstrate that those who fully understand ESG can deploy more effective ESG strategies, which transform such progress into enhanced competitiveness and business opportunities. Second, we review some of the key stakeholders that are disciplining organizations to improve their ESG performance, and how these stakeholders are shaping the ESG landscape. Third, we highlight that when ESG is approached strategically and fully integrated into organizational cultures, it can be a source of competitive advantage.

1. ESG Myths

Myth 1. ***ESG is all about climate.***
ESG includes issues related to climate and environmental sustainability, which covers the E, and is the component of ESG that gets the most attention both by leaders and many stakeholders, including the media. We are all aware of the risks associated with carbon emissions, and the need to achieve net zero by 2050. The catastrophic implications of not achieving this goal have been well documented, and while much work has been done in this

respect, there is much more to do. In addition, there are increasingly material "E" topics like biodiversity, deforestation and water, which are gaining traction.

But ESG goes far beyond environmental sustainability alone. It also includes S, or Social. This is a very broad pillar and includes human rights and treatment of employees and customers within organizations and across global supply chains. "S" also incorporates issues of diversity and inclusion, how the organization impacts the communities they serve, including indigenous communities, and many other issues.

And finally, ESG includes the G, or Governance, which incorporates how organizations are managed, risk management, and business ethics. It is often the case that deficiencies in governance processes end up in the news as scandals – such as the Audi emissions scandal, Facebook's privacy violations, and many others too numerous to list.

Those leaders that focus on E alone are only addressing a narrow slice of the full spectrum of ESG issues and are therefore more likely to face challenges from shareholders and other stakeholders, miss interdependencies, and be caught unprepared for increasing ESG disclosure requirements. While E may get most of the attention, there is accelerating focus on the other dimensions of ESG that cannot be ignored.

Myth 2. ***ESG is handled by a department in corporate functions.***

It is often viewed that an ESG department, executive or committee will suffice to ensure an organization has appropriate oversight of ESG issues. While specific accountability is helpful, this siloed approach can hinder the organization in making the required progress. Such an approach often results in an ineffective "tick the boxes" approach to ESG.

This is in sharp contrast to an approach in which every decision is made through an ESG lens. As the well-known saying goes, "culture eats strategy for breakfast". For organizations to fully integrate ESG into each of its decisions, that is, into its DNA, it is essential that ESG be part of the culture of the organization. Many organizations have implemented extensive training sessions to ingrain ESG strategies into each of the organization's functional areas – finance, strategy, HR, marketing, operations, innovation and design, and leadership training itself.

When this is done well, there will be no need for a separate office within organizations to oversee ESG because ESG will be ingrained in everything the organization does. However, change takes time and ESG is still nascent in its maturity for most organizations. While the ultimate goal is for full integration of an ESG lens, consistent with the organization's culture, most organizations are still developing the structures and mindset through specialized functions.

Myth 3. ***ESG is about the impact a business has on society and the environment.***
A limited view of ESG often held by many is that impact is a one-way street, focused on the impact a business has on society and the environment. The task force on Climate-related Financial Disclosures (TCFD) was amongst the first to highlight the impact of climate change on a company's financial performance, including the future potential price of the carbon it emits, and other societal and technological headwinds that could impact future performance. Insurance companies, for example, are feeling the impact of climate change by paying record claims for flooding and damage related to extreme weather. Consumer packaging companies are experiencing the impact of natural disasters on their supply chains. While extensive wildfire smoke within Canada during the summer of 2023 have resulted in significant disruptions to business, with the expectation of many costly health implications to follow.

The focus on the financial impact of climate change and other ESG factors on an organization became the litmus test for evaluating materiality to such a large

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extent that stakeholders began deprioritizing the organization's impact on society and the environment. To curb the outcomes of such a complete shift, the idea of double materiality emerged, which recognizes both the impact ESG factors have on a business, and the impact a business has on such issues.

Myth 4. ***ESG is a form of Woke Capitalism.***
In some jurisdictions, ESG has become politicized, and labelled Woke Capitalism. This development reflects a misunderstanding of what a focus on ESG is meant to achieve. The increasing rigour of reporting on ESG data that is relevant to business strategy and objectives is very different than the accusation that businesses are using their influence to advocate for social and environmental causes. They are two completely different topics. ESG was first coined in 2005 in a United Nations commissioned report by law firm Freshfields Bruckhaus Deringer, which found that "failure to consider all long term investment value drivers, including ESG issues, is a failure of fiduciary duty". ESG analytics were so focused

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on the impact to a company's future financial performance that, in 2021, Bloomberg critically observed that '[ESG] ratings don't measure a company's impact on the Earth and society. In fact, they gauge the opposite: the potential impact of the world on the company and its shareholders.' In its consideration of ESG integration, however, the Freshfields report was more prescient, reflecting on how investors' duties and obligations may further evolve over time with shifts in societal expectations, policies, technologies, and the climate.

Ten years later, Mark Carney, then Governor of the Bank of England, suggested this time had arrived in a speech on the impact of climate change on financial stability. Now the UN Special Envoy on Climate Action and Finance, Chair of Brookfield Asset Management and Head of Transition Investing at Brookfield Corporation, Mr. Carney notes that 'companies are recognizing that they are not islands, independent of the social system,

political system, economic system or climatic system. They are connected and take responsibility for those connections and help those to whom they are connected to move forward. With COVID-19, a sense of solidarity has grown and added to a sense of purpose for many companies.'

2. Stakeholders are raising the stakes!

Stakeholders have been defined as "those groups who affect and/or could be affected by an organization's activities, products or services and associated performance." **The list of stakeholders is often much broader than many leaders realize.** While there are stakeholders common to many organizations, the relative importance of these stakeholders will vary depending on the impact the organization can have on them, and the impact they

Paying close attention to all stakeholders is not a political agenda, but rather it makes good business sense

can have on the organization. As such, each organization should develop an appropriate stakeholder engagement strategy to ensure it fully understands the issues of importance to each stakeholder group, be able to manage conflicting interests across stakeholders, and to develop strategies to most effectively deal with those issues.

We now review the most important stakeholders for most organizations.

Financial Markets

Perhaps first on the list of many leaders are financial markets. An increasing number of investors across the spectrum are insisting that the companies they invest in perform well on ESG, with a requirement that the ESG performance be objectively measured and reported.

This trend was cemented by Larry Fink when he wrote in his 2020 letter to CEOs.

> *"But awareness is rapidly changing, and I believe we are on the edge of a fundamental reshaping of finance. The evidence on climate risk is compelling investors to reassess core assumptions about modern finance. ... Investors are increasingly reckoning with these questions and recognizing that climate risk is investment risk. ...These questions are driving a profound reassessment of risk and asset values. And because capital markets pull future risk forward, we will see changes in capital allocation more quickly than we see changes to the climate itself. In the near future – and sooner than most anticipate – there will be a significant reallocation of capital. ... As a fiduciary, our responsibility is to help clients navigate this transition. Our investment conviction is that sustainability – and climate-integrated portfolios can provide better risk-adjusted returns to investors."*

Estimates now put the level of investable assets committed to companies that have achieved an acceptable level of ESG performance in excess of US$30 trillion and growing. These investors are demanding that ESG performance be verifiable using objective metrics to back up such claims. Younger investors, namely millennials and Generation Zs, are twice as likely to use an ESG lens in making their investment decisions. As these trends increasingly permeate financial markets, the cost of capital for organizations with poor ESG performance will increase, thus impacting their competitiveness and profitability. In contrast, organizations that outperform on ESG will have a lower cost of and priority access to capital.

Employees

ESG performance is also an important issue to employees. Increasingly, companies that do not perform well in terms of ESG have difficulty both attracting and retaining talent. In sharp contrast, those organizations that embrace ESG have a competitive advantage in this regard. Employees are increasingly leaving organizations that are viewed as poor ESG performers. There are many examples of companies that serve as case studies on the importance of ESG as a recruitment strategy.

One such case study published in in Canada's national business newspaper, *The Globe and Mail*, documents how employees seek employment in firms that are ESG leaders. "Eco-friendly retailer Tentree doesn't have to advertise its carbon-reduction efforts to potential hires. Most applicants are familiar with the Vancouver-based company's values and mission, including the trees it plants with every purchase, and are looking to join the company partly because of it, says founder and chief executive officer Derrick Emsley." And this is just one example among many.

This pattern is confirmed in a survey conducted by PwC, which found that "86 per cent of employees 'prefer to support or work for companies that care about the

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same issues they do,' and that 84 per cent are more likely to work for a company that stands up for environmental causes." And the evidence goes further, indicating that workers who are satisfied "work harder, stay longer with their employers, and seek to produce better results for the organization." These trends are expected to accelerate as millennials and Gen Zs make up an increasing share of the labour force.

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Civil Society

There have been many organizations that have reacted strongly against companies that cause harm along their supply chains. According to the Harvard Business Review, "Companies are under pressure from governments, consumers, NGOs, and other stakeholders to divulge more information about their supply chains, and the reputational cost of failing to meet these demands can be high." Perhaps the most well-known disaster in the garment industry was the Rana Plaza factory collapse in Bangladesh on April 24, 2013, which resulted in the death of over 1,100 people and injured over 2,000. This unsafe facility was the site where many Western retailers had their textiles manufactured. Constituting the worst garment factory collapse ever, it received significant media coverage. In the immediate aftermath of this tragedy, multinationals from around the world lined up to defend their reputations, many arguing that they did not know that conditions were so bad.

The disaster led to calls for Western retailers, and manufacturers more generally, to be far more transparent about their global supply chains. By disclosing the facilities where their products are produced, they could no longer hide behind "ignorance". Rather, disclosing their suppliers would incentivize these Western retailers to ensure working conditions were up to their stated standards, and when that is not the case, either push suppliers to improve those standards or seek alternatives.

There are many such initiatives to enhance supply chain performance. One well known initiative is led by Human Rights Watch called *Follow the Thread: The Need for Supply Chain Transparency in the Garment and Footwear Industry.* This initiative pressures companies in the industry to adopt a Transparency Pledge, which involves the publication of names and addresses of factories that supply these retailers, the number of employees in those factories, as well as some additional information. According to *Follow the Thread*, such a declaration would constitute an important step in making retailers accountable to those who work in the facilities that produce the goods that they sell.

Such challenges extend to many other industries as well. For example, there is significant pressure being placed on food companies to provide more transparency in their supply chains, with stakeholders demanding information about the treatment of animals, the use of chemicals, impacts on the environments where they operate, and child labour. Chocolate companies have

received significant negative attention, with Hershey, Nestle, Cargill and others facing child slavery charges in the United States, brought about through a lawsuit launched by a human rights group, related to business practices on Ivory Coast cocoa farms. While these companies eventually won a dismissal in U.S. courts, it did have reputational implications.

While the importance of shareholders as a stakeholder group is still crucial, the interests of other stakeholders cannot be ignored. Fortunately, these two perspectives are increasingly aligned.

There is also a very recent case in the UK, where in July 2023, a Scottish court ruled against a tea company which is headquartered in Scotland. The court is allowing a legal case to move forward where 2,000 workers in Kenya are seeking damages for suffering which they claim resulted from poor working conditions. The court's ruling highlights the risks UK based companies have for their business practices in other countries.

The Legal System

Increasingly, companies, including members of their boards of directors, are facing legal challenges. According to a leading Canadian law firm, Torys, "The range of claims that may be advanced by stakeholders is wide and can relate to a variety of ESG issues, including efforts to address diversity and inclusion in organizational leadership, and failure to properly prepare for the future impacts of climate change." Accordingly, "Companies can mitigate the risks of ESG litigation by adopting regular audits of foreign operations, internal training, and meaningful grievance and remediation protocols."

3. ESG is not just a challenge: it can be an opportunity when approached correctly

The primacy of shareholders has been the dominant paradigm in corporate finance for many decades – that is, the fiduciary responsibility of corporate officers has traditionally been to shareholders alone. Firms deploy strategies to maximize profitability, and with that, shareholder value.

Increasingly, however, this view has been shifting – in Canada, the supreme court has ruled that legal obligation of corporate officers is to the corporation. While the importance of shareholders as a stakeholder group is still crucial, the interests of other stakeholders cannot be ignored. Fortunately, these two perspectives are increasingly aligned.

The pathway to maximizing shareholder value has evolved. Efforts to improve working conditions for employees inside the organization and along the supply chain leads to many benefits that enhance organizational performance. Deploying strategies that reduce

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carbon emissions reduces environmental impacts that are clearly having a negative impact on many businesses and society overall. Being systematic in deploying strategies that lead to more diverse and inclusive work environments has been shown to enhance innovation, employee engagement, and performance.

As noted in the seminal paper by Michael E. Porter and Mark R. Kramer entitled Creating Shared Value,

> *"In recent years business increasingly has been viewed as a major cause of social, environmental, and economic problems. Companies are widely perceived to be prospering at the expense of the broader community.... A big part of the problem lies with companies themselves, which remain trapped in an outdated approach to value creation that has emerged over the past few decades. They continue to*

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view value creation narrowly, optimizing short-term financial performance in a bubble while missing the most important customer needs and ignoring the broader influences that determine their longer-term success... Companies must take the lead in bringing business and society back together... Businesses must reconnect company success with social progress. Shared value is not social responsibility, philanthropy, or even sustainability, but a new way to achieve economic success. It is not on the margin of what companies do but at the center. We believe that it can give rise to the next major transformation of business thinking."

Conclusion

ESG has become the driving force of corporate value. Strong ESG performers manage not only the full spectrum of those environmental, social, and governance factors that are material to their businesses, but also recognize and address their interdependence. ESG is not a form of corporate advocacy for any one outcome, but a strategic response to the rapidly evolving market in which a business operates. ESG connects the business and scientific transformations happening today with the reforms in politics and institutional structures required to achieve a systems-based approach to creating value.

Companies that appropriately identify, assess, prioritize, manage, and report on ESG factors will gain a competitive advantage over peers.

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A fully referenced version of this article is available on request from editor@dl-q.com