Building ESG trust with stakeholders

Boardroom Leadership Center (India)

ESG has been of key focus among boards globally with accelerated integration in India. According to the KPMG CEO Outlook 2022[1], 34 per cent of CEOs agree that ESG programmes improve financial performance (higher than last year). When asked where CEOs in India see corporate purpose having the greatest impact, building brand reputation was recognised as the leading indicator with 78 per cent. Boards and CEOs understand that ESG integration within business strategies is critical not only to build investor trust but also to secure talent, strengthening employee value proposition, retain customers, and advance capital. However, CEOs have reported that a lack of budgets to invest in the ESG transformation of an organisation accounts for 15 per cent of the ESG integration challenge[2]. Thus, ESG has transformed from a 'nice-to-have' to a 'must-have' prominence, being integral to long-term financial success and value creation[3]. In this backdrop, where ESG is imperative for financial performance, building investor trust is crucial for growth.
To understand how investors are looking at ESG and the role of Boards, the KPMG Board Leadership Center (India) spoke with Mukund Rajan, Independent Director on multiple boards and Richa Arora, Independent Director on multiple boards. Below is an edited excerpt of the conversation.

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Independent Director on multiple boards

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Independent Director on multiple boards

What is the change you have been observing among investors when it comes to ESG in India?

The sense we get is that investor groups are paying much more attention to ESG parameters when they are making calls on their investments as well as which companies to back. In the private equity (PE) segment in India, for instance, we see large international and domestic PE firms creating dedicated ESG teams, and applying an ESG lens when looking to channel investments. Some of them tell us that there is also pressure from their limited partners to ensure that all investments go through a structured ESG assessment process. In the mutual funds and insurance space too, investors in the public markets are now covered by Stewardship Codes and required to go through some level of ESG evaluation, even if limited presently.

Overseas, of course, there are many nuances in investor behaviour. Some investors, for instance, feel that returns should never be compromised. So, if there was a tradeoff between ESG performance and short-term financial returns, some of these investors would prefer to secure their financial returns; this was brought sharply into relief during the outbreak of hostilities in Ukraine, when the price of oil jumped and investors in ESG-unfriendly oil and gas stocks saw high returns. There are also, as we know, several states in the USA, where retirement funds are being directed not to consider ESG factors when looking at investments.

In India, though, the broad investor sentiment seems to be in favour of more ESG-friendly behaviour, driven by local agendas such as a focus on good corporate governance and increasing concerns about climate change reflected in the higher frequency and intensity of extreme climatic events in India. Whether it is to look for resilience in companies, the way they are managing risks, or looking for opportunities in the future, there is a perceptible change within investors and how they are looking at ESG investments.

1. KPMG 2022 CEO Outlook: Growth strategies in turbulent times | KPMG International | 2022
2. KPMG 2022 CEO Outlook: Growth strategies in turbulent times | KPMG International | 2022
3. KPMG market insight survey 2022 | Delivering on the promise of value creation | KPMG International | 2022

What role does the Board of Directors play in creating effective prioritisation and implementation of ESG?

The tone for all important agendas for an organisation is always set at the top. For the benefits of sustainability efforts to have the significant impact they can potentially have, sustainability needs to be embedded in an organisation and not remain at the periphery. This is where boards have to play a role in bringing ESG as an extension of their business strategy when envisioning an ESG integration. To do so, the board's competencies and skillsets should align with the need to understand ESG risks and opportunities. If you set aside progressive boards, there is a need to augment skills, and in some cases even awareness around what ESG is and how it can benefit an organisation. While there is some level of awareness around ESG, most Boards don't know where to start and guide the management team, creating a knowledge gap in driving the sustainability agenda.

Like in the case of digitisation, boards upskilled themselves to understand the unfamiliarity around 'digital'. Similarly, depending on the sector in which a company is, there would be a greater or lesser requirement for Board members with technical skillsets around ESG.

What according to you are the immediate ESG initiatives organisations need to target to enhance trust among stakeholders?

While initiatives can be defined based on the context and sector in which an organisation exists, there is a need to prepare themselves for a future in which ESG considerations will rank highly among all stakeholders. Thus, a systematic, thought-through but flexible approach is what is desirable. What that means is as follows:

- Firstly, having an ESG strategy in place which gives confidence to stakeholders in the thinking of an organisation. Following the strategy, an action plan on achieving the strategy is also crucial for building stakeholder trust, catalysed by communication around the expectation that ESG is a long-term journey and all potential areas of focus may not give results and returns immediately
- Secondly, establishing the right governance structures in the form of an ESG committee of the Board and Board oversight of ESG particularly enhances stakeholder trust
- Thirdly, ESG oversight cannot be limited to just the Board but embedded within the management of the firm. Having said that, while we have seen an increase in appointments of Chief Sustainability Officers (CSOs), CSOs alone cannot drive the ESG agenda. Cross-functional teams could offer good results in developing an ESG strategy and ensuring effective implementation
- Lastly, to achieve meaningful results, Key Performance Indicators (KPIs) must be defined and integrated into the organisation's performance management system. Incentives and executive pay can then be aligned with the ESG agenda, without which things will not move.

When an organisation takes such measures, it automatically creates stakeholder trust, because of the positive ESG intent that the organisation establishes. Of course, the above-mentioned approach is a broad framework, and actual initiatives would vary across organisations. For the manufacturing sector, for instance, planning for GHG reduction can be a crucial priority whereas, for software companies, focus on employee engagement can build greater confidence. Capex set aside for green research and development is reflective of an ESG strategy focused on the long term, while conducting lifecycle assessments, can also display intent and play a significant role in helping create circular solutions and identifying the right partnerships across the value chain.

What are the expectations or concerns that investors have from ESG among MSMEs?

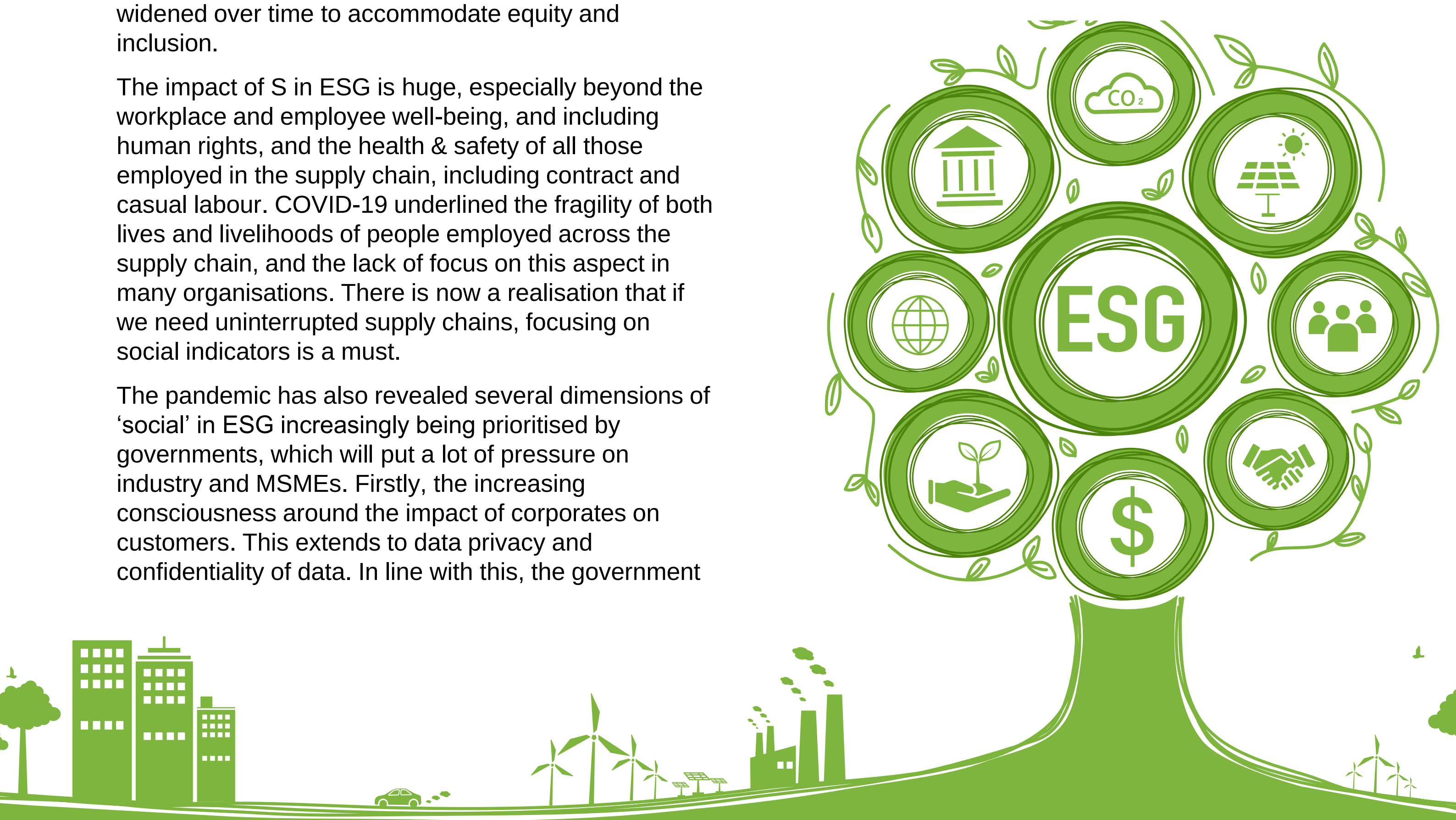
Much of what happens in the economy, particularly in the world of manufacturing, is consequentially impacted by what happens in supply chains, and much of what happens in the supply chain is in the hands of MSMEs. 40 per cent of industrial output is produced within MSMEs in India that serve larger corporates. It is also well known that a major contribution to climate change arises from scope 3 emissions in the supply chain, typically within MSMEs. Against this backdrop, investors ought to be concerned about not only the first level where their investment may be going, but further beyond into the value chain of the organisation they are backing. These organisations in turn must take responsibility and accountability to inform investors about how they are looking at ESG practices in the supply chain. We have seen how many large industries, such as textiles for instance, have witnessed global brands being adversely impacted by deficiencies in ESG practices within their supply chains, including infringements on human rights and poor safety practices. There is therefore a particular onus on larger companies to interest themselves in the ESG practices of their smaller supply chain partners, and assist them in the improvement of these practices through advice, mentorship, financing and technology transfer, as appropriate.

Recently, the COVID-19 pandemic and the resulting economic uncertainty brought greater focus to how companies approach the 'S' in ESG. Have investors started observing 'S' in ESG with more rigour than before?

While 'S' is still not looked at on equal footing with 'E', there is definitely more focus on the Social in ESG than before. When we talk about ESG, it cannot be without social factors, but there is a tendency for S to be overlooked in light of the noise around E issues such as net zero pledges and climate change narratives. Moreover, there is a tendency to equate 'S' with gender diversity only, even though the scope of diversity has widened over time to accommodate equity and inclusion.

The impact of S in ESG is huge, especially beyond the workplace and employee well-being, and including human rights, and the health & safety of all those employed in the supply chain, including contract and casual labour. COVID-19 underlined the fragility of both lives and livelihoods of people employed across the supply chain, and the lack of focus on this aspect in many organisations. There is now a realisation that if we need uninterrupted supply chains, focusing on social indicators is a must.

The pandemic has also revealed several dimensions of 'social' in ESG increasingly being prioritised by governments, which will put a lot of pressure on industry and MSMEs. Firstly, the increasing consciousness around the impact of corporates on customers. This extends to data privacy and confidentiality of data. In line with this, the government has initiated discussions on the Privacy and Data Protection Bill in Parliament. This will lead to increased interest in how corporates handle data and respect customers. Secondly, the issue around cybersecurity has also gained traction because of the volume of threats that are increasing rampantly in an increasingly digitised economy.



How do you see the utility of ESG data and what roles can technology-based solutions play in enhancing the utility of ESG data?

Surfacing ESG data, especially in companies starting their ESG journey, can be extremely challenging but also equally rewarding. Data becomes a baseline for organisations to commence their ESG journey in terms of identifying KPIs, and measuring progress and achievement. Data also helps organisations conduct peer benchmarking and identify areas of improvement such as process efficiency and safety. On the flip side, organisations that don't have such data cannot accurately capture their ESG baseline position and determine areas of improvement. Thus, digitisation emerges as a key tool for ESG integration. Digitised technology-based solutions will allow not only tracking of data but also developing predictive ability over time.

Many practical and interesting usages of technology already exist. For instance, in plantations where human and animals/ wildlife coexist, technology tools like RFID are used for tracking the movement of wildlife and alerting plantation workers and local communities. Artificial Intelligence and Machine Learning algorithms are now used to scan millions of news articles on companies and categorise positive and negative sentiments producing potential predictive governance indicators. The list goes on. The potential of ESG data must be leveraged in line with the speed of digitisation to create meaningful solutions for ESG assessment and improvement.

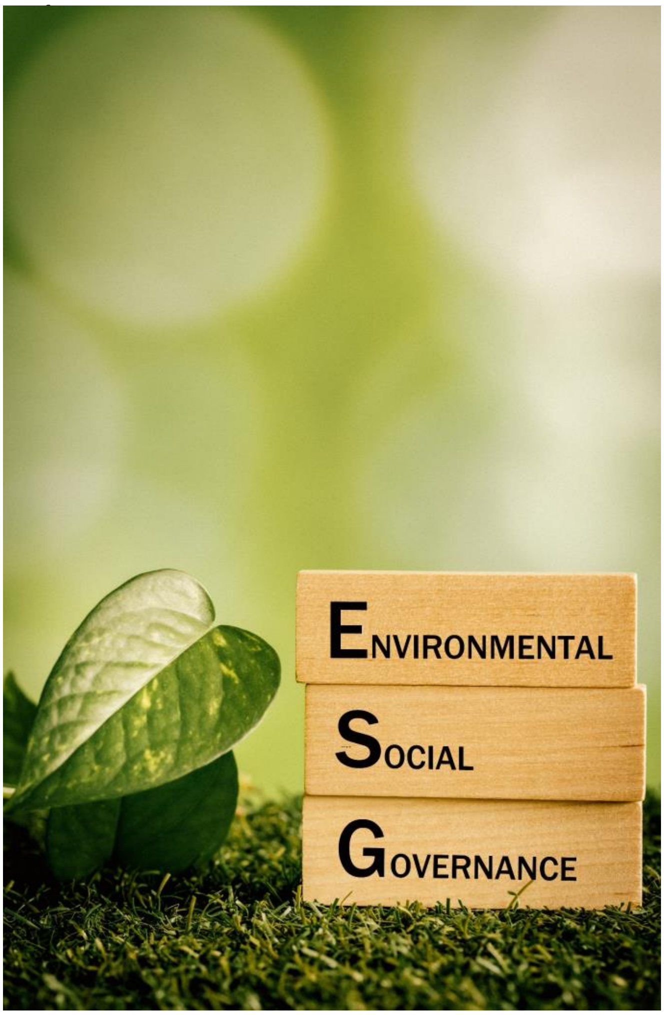
ESG disclosures have increasingly gained traction. Do you think the BRSR provides enough information for stakeholders for decision-making in its current state?

The BRSR and the way it is currently configured provides a lot of information that will take a while for the market to fully digest. Stakeholder groups like equity analysts, think tanks and non-profits will play a role in analysing the BRSR disclosures, compare and contrast business performance, and create league tables. This will result in naming and shaming of poor ESG performers, and skew investments in favour of the best ESG performers.

Eventually, one expects the market will head towards sectoral BRSRs, which would allow investors and other stakeholders to undertake better comparisons of businesses within their relevant peer sets. Businesses, meanwhile, should focus not only on the disclosures they are obliged to make, but also the broader narrative communicating how they look at ESG-related risks and opportunities. Likewise, investors should not merely rely on the ESG scores that will emerge, linked to BRSR disclosures, but also form judgments on where businesses they are evaluating are headed in their ESG journeys.

Do you think long term value creation is a key aspect of ESG and do you think ESG valuation will help investors understand the true value of the company?

Many studies show that a large part of enterprise value is now in the form of intangibles, and a big part of intangibles with implications for brand equity and reputation is ESG-linked. That said, we are still in the early stages of drawing correlations and establishing causality between issues such as adverse impact on the natural environment and the true economic cost and potential implications for businesses. On specific E, S, and G attributes, a lot of work has already gone into drawing correlations, for instance between productivity and employee engagement in turn impacting financial performance. However, more work is needed. Likewise, the work of groups like the Task Force on Nature-related Financial Disclosures (TNFD) will help to more clearly attribute value to key ESG issues. The kind of international cooperation we see happening in the work of the fledgling International Sustainability Standards Board (ISSB), with multiple constituencies including regulators, auditors, academics, think tanks and non-profits being consulted, will be required to establish more authentic and accurate value that can be ascribed to ESG



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