ALN KENYA
Anjarwalla & Khanna

Applying ESG Standards to Business

A Mere Tick-Box Exercise?

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Introduction

Over the last few years, the term Environmental, Social and Governance "ESG" has made its way into boardrooms, strategy discussions and annual reports in the West and more recently in Africa. Gone are the days when investors, CEOs and boards of directors' sole focus was on the traditional objective of making profits and ensuring shareholder returns. The tangible and intangible benefits of ESG have been questioned by many and were discussed at an ESG Event hosted by ALN Kenya in the context of finance transactions.

In our previous article in this series, *ESG – A Peek into the Future: Mission Possible?*, we explored the elementary aspects of ESG highlighting what it is as well as outlining the legal framework of ESG in Kenya.

In this article, we set out to contextualise the ESG discussion to businesses generally and also explore what benefits and opportunities, if any, are available to businesses that adopt ESG strategies. Further, we shall discuss the challenges and drawbacks of ESG and what ESG means in the African context and specifically to lenders.

Benefits and Opportunities of ESG

Over the years, businesses and ESG experts have reported various benefits and opportunities that ESG offers to businesses.

1. The Ethical Consumer

According to the Sustainably Lifestyle Frontier Group, almost 93 percent of global consumers wish to see the businesses that they buy goods or consumer services from, support worthy social and environmental issues. Consumers want to associate with brands whose values align with their own.[1]

With the advent of technology, customers have been availed the means of easily verifying goods and services that are aligned with their values. Many customers across the world now prefer to align their spending with businesses that give back to their communities, boast diversity across each level of the corporate ladder, treat their employees well, and protect the environment.

Some businesses report that owing to their alignment with ESG principles, they are more likely to not only avoid negative press that would otherwise damage their reputation but are also likely to enhance customer loyalty.[2]

In the 1980s, during the anti-Apartheid-movement, consumers across the world boycotted South African products. It was reported that by the mid-1980s, one in every four Britons refused to purchase South African goods. Memorably, the musicians' unions impeded South African artists from playing on the British Broadcasting Corporation (BBC).[3]

More recently, customers boycotted Harry Winston, an American luxury jeweller, and its owner Swatch Group Limited, a Swiss manufacturer of watches and jewellery. In June 2021, the International Campaign for Rohingya called for the boycott of the high-end jewellery retailer as they sourced their gemstones from Myanmar's gemstone industry, which the Myanmar military profited from.[4] The Myanmar military's actions against Rohingya Muslims which reportedly began in August 2017, led to a mass exodus of the Rohingya Muslims to Bangladesh.[5]

Both the International Campaign for Rohingya and the No Business with Genocide[6] presented a petition with over 25,000 signatures to Harry Winston, demanding the Company cut ties with gemstones from suppliers that had links to Myanmar. That same day, the Harry Winston website announced that it would no longer source gemstones from suppliers that have Burmese origins.[7]

Closer to home, UK supermarkets Tesco, Sainsbury's and Lidl suspended their purchases of avocados from a large producer in Kenya following allegations of assault and sexual misconduct by some of its employees. Even though they were just allegations, the impact was forceful due to UK supermarkets deciding to suspend the producer as their supplier even though no court had made a ruling on the matter.

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1 Why good corporate citizens keep great employees | Investis Digital
2 Why is ESG Important? 5 Benefits of ESG – Perillon
3 Boycotts and sanctions – Apartheid
4 History of Successful Boycotts – Ethical Consumer
5 Myanmar Rohingya: What you need to know about the crisis - BBC News
6 'No Business with Genocide' is a coalition-led campaign to bring an end to genocide across the world.
7 History of Successful Boycotts – Ethical Consumer

2. Employee Loyalty

Businesses that take a strong stance on social issues are reportedly more likely to attract and retain talent as people want to work for institutions whose values align with their own.

According to Gartner's February 2021 Post-Election Survey, 68 percent of employees in the United States are likely to consider leaving their job to work with businesses that have stronger stances on social issues that align with that of the employee.[8]

In a 2019 report published by Brighter Monday on the top 100 companies to work for in Kenya, it was reported that 1 of the 5 most highly ranked extrinsic traits of a company that matter most to employees is its strong relatable company values and goals.[9]

3. Regulators have Pressed Acceleration on the ESG-Gas-Pedal

The fusing of ESG principles with a company's goals and policies will ensure that the company is compliant with existing legal regulations.

Governments and regulators have not shied away from going full throttle on ESG regulations and laws, and this has also been evident in Kenya. Led by the Capital Markets Authority and the Central Bank of Kenya, the ESG campaign in Kenya has been bolstered by the Capital Markets Authority's Corporate Governance Code for Listed Companies, 2015; the Nairobi Securities Exchange's ESG Disclosure Guidance Manual, 2012; and the Central Bank of Kenya's Guidance on Climate-related Risk Management (for more information, see *ESG – A Peek into the Future: Mission Possible?*).

Elsewhere on the continent, South Africa has long been an ESG role model as evidenced by the country's impressive ESG frameworks,[10] including the King Code on corporate governance and the 2011 Code for Responsible Investing in South Africa (the SA Code). The SA Code calls for both institutional investors and service providers to align investment decisions with ESG issues.[11]

8 Gartner HR Research
9 The Best 100 Companies 2019 in Kenya – Brighter Monday
10 The State of ESG in Africa – ESG Enterprise
11 Code for Responsible Investing in SA (CRISA) – Institute of Directors in Southern Africa (IoDSA)

The Challenges of ESG

Despite the reputed benefits of ESG, some businesses are hesitant to implement ESG compliance.

1. No Standard Measure of ESG

It is difficult for businesses to measure their ESG compliance, considering that there are no standard measures that exist for businesses to use. This also poses a challenge to lenders, as discussed further below.

That said, there have been efforts to arrive at a standard benchmark for determining a business' ESG compliance. In early 2021, the World Economic Forum and its International Business Council announced that many of the world's largest companies vowed to utilise a uniform set of Stakeholder Capitalism Metrics (SCM) which had been released in September 2020, in order to streamline the reporting of ESG measurements across the world.[12] In the words of Bruan Moynihan, the Bank of America President and CEO, the SCM will ensure that *"we can spend less time worrying about what to measure and what measurement system and more time measuring progress".*

Stakeholder capitalism is a system in which companies prioritise serving the interests of their stakeholders, be it customers, suppliers, employees, shareholders and/or local communities. For instance, companies may consider such programs as mental health awareness, sexual harassment awareness, and donating to local charities in serving the needs of their employees.

The SCM is divided into 4 main groups, namely:

a. **People Metrics** – which is focused on diversity and inclusion, health and wellbeing, and employee training within a company;

b. **Planet Metrics** - which delves into such factors as the company's greenhouse gas emissions and water consumption, air pollution and water pollution;

c. **Prosperity Metrics** - which looks at such things as community investment including charitable efforts and innovation in product and services to better society; and

d. **Governance Metrics** – which, amongst other things, scrutinises the quality of the governing body of the company and the ethical behaviour of all persons in the company.

2. ESG is Expensive

Being ESG compliant is not cheap.[13] A company committing itself to meet ESG principles must be prepared to invest a lot of money. For instance, green businesses are costly and risky, and not many sustainable businesses across the world that solely focus on organic supplies, solar energy and waste management make immense profits. Many of them even fail. Pro-ESG advocates counter the expense of ESG compliance with, for instance, the benefit that ESG compliance would have on the health of humanity and the environment. In the words of Geoffrey Jones, the Isidor Straus Professor of Business History at Harvard Business School, *"a green entrepreneur can change the world but it's going to be extremely difficult, and they're probably not going to get incredibly rich in the process."*[14]

What do these ESG-related expenses mean in the Kenyan context? In September 2022, Kenya's inflation rate was reported to be at a high of 9.2 percent, which is the highest inflation figure since June 2017.[15] Kenyans across the country are feeling the pinch of the increase in food and fuel prices, and generally the cost of living.[16] Is it therefore fair to place the added burden on Kenyan businesses to be ESG-compliant, a feat that would require investing even more money amid a reeling economy?

12 The SCMs are the combined effort of corporate members of the International Business Council, including Deloitte, PwC, EY and KPMG.
13 'ESG and carbon data is becoming extraordinarily expensive' – Citywire (citywireselector.com)
14 Green Businesses Are Incredibly Difficult to Make Profitable. Try It Anyway – HBS Working Knowledge
15 Kenya Inflation Rate – Trading Economics
16 Pain for Kenyans as cost of living hits five-year high – The Standard (standardmedia.co.ke)

The Drawbacks of ESG

Not only does ESG pose various challenges that may limit a business from fully implementing it, but various drawbacks have been raised as far as ESG's implementation is concerned

1. The Conflict between Africa's Industrialisation and the "E" in ESG

African economists contend that there is a strong correlation between the deployment of human and natural resources, including fossil fuels, and industrialisation. Many of the world's largest economies are where they are today due to the use of these natural resources,[17] which also led to the exponential growth of some of the biggest companies the world over.

This thesis notwithstanding, emerging economies are being called on to decarbonise, which arguably will slow down African countries' industrialisation metamorphosis and the growth of companies within the continent. Major sources of revenue in Africa in most cases are resource-based, and heavily rely on fossil fuels. Some African leaders, therefore, believe that instead of forcing Africa to leapfrog to renewables, it should be a gradual transition. This is especially due to the infrastructural cost that would be required, such as the installation of solar and wind.[18]

It is worth bringing to the discussion the fact that if development institutions and foreign investors were to fail to fund projects in emerging economies due to concerns about the "E" in ESG, the "S" is likely to suffer. This is especially true where a country is dealing with high poverty levels and would benefit from businesses getting loans which would create opportunities such as employment. Therein arises the concept of "just transition". Just transition calls for climate action in corporates while also mitigating any adverse effects that may affect stakeholders such as employees.[19] Perhaps businesses in emerging countries should be given the leeway to gradually implement the "E" in a phased approach while still balancing the "S".

2. A Mere Tick-Box Exercise

For some companies, ESG compliance is merely a tick-box exercise and no concerted effort is put into ensuring a thorough implementation of ESG principles.

Companies may boast diversity, yet diversity often lies in their lower positions and not within the C-suite. For instance, in the United States, a paper published by the Rock Center for Corporate Governance at the Stanford Graduate School of Business stated that *"women are underrepresented in positions that directly feed into future CEO and board roles, and they have greater representation in positions that are less likely to lead to these appointments. Women hold only 13 percent of positions with high potential for CEO promotion and board recruitment."*[20]

Diversity in the C-suite is dismal, yet the C-suite is the level of the organisation where crucial business and policy decisions are made. As advanced in the article *Why a Diverse Board is Important for your Business*, only 21 percent of women were appointed as board chairpersons in listed and non-listed companies in Kenya by 2021, and as at June 2021,[21] only 5 percent of boards of directors of listed companies were chaired by women.[22]

On the world stage, these statistics for Kenya are better than in many other jurisdictions. That said, diversity, be it based on gender, culture, and ability, may be merely a buzzword for the vast majority.

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17 Are Western ESG policies keeping African in poverty? Investment Monitor
18 Are Western ESG policies keeping African in poverty? Investment Monitor
19 The Clash of 'E' and 'S' of ESG: Just Transition on the Path to Net Zero and the Implications for Sustainable Corporate Governance and Finance, SAFE Working Paper No. 325, Alperen A. Gözlügöl.
20 The sorry state of C-suite diversity – Cooley PubCo
21 Women still missing in the C-suite – Newsplex, Nation Africa
22 Women missing in the C-suite – Newsplex, Nation Africa

The Predicament Lenders are Placed In

The above discussion is mostly centred on what ESG means for businesses. Yet, we also need to consider what ESG means for lenders.

Lenders are currently being placed in a predicament where businesses that are sound with the likelihood to grow are not necessarily ESG compliant. Does this mean that the business then should not receive any financing? What is ESG investing, and how practicable is it?

1. Towards ESG Investing

World over, investors are gearing towards ESG investing. ESG investing entails financial institutions entering loan agreements with companies that align with ESG principles. ESG investors are keen on ensuring that the company serves all of its stakeholders– be it its customers, suppliers, employees, shareholders, local communities and the environment. Furthermore, ESG investors recognise that an ESG-compliant company is more likely to be a sustainable one that avoids regulatory fines and court cases, maintains consumer demand, avoids workers strikes or high turnover. The rationale is that an ESG-compliant company will according to them, yield higher returns and incur fewer losses, therefore leading to a higher likelihood of companies paying back their loans.

Additionally, banks and financial institutions are being encouraged to tailor their lending practices to align with environmentally friendly policies. In Kenya, the Government continues to make efforts to encourage ESG compliance. In October 2021, the Central Bank of Kenya published the Guidance on Climate-related Risk Management (the CBK Guidance). The purpose of the Guidance, amongst other things, is for banks and other financial institutions to embed climate-related risk considerations into their existing risk management practices.

Notably, banks across the world are increasingly receiving backlash for lending to companies that do not carry out their business activities in an environmentally friendly manner. Earlier in the year, some of Canada's biggest banks faced scrutiny following having significantly increased funding into highly polluting oil projects,[23] despite having committed themselves to reach net zero emissions by 2050.[24] That said, there are evident moves in the US by some to penalise efforts of those who align themselves with the ESG mantra as BlackRock, one of the world's largest asset managers, is experiencing. BlackRock is being accused by Republican attorney generals in 19 states of misusing its market power by boycotting fossil-fuel firms.[25] We will look at this in more detail in the next article in this series.

2. No Standard Measure of ESG

Practically, how should lenders go about measuring ESG compliance across the board? There exists no standard measure for financial institutions to use, and this in itself poses a problem. For instance, earlier this year, Morgan Stanley Capital International (MSCI), the world's leading rater of green credentials, rewarded some of Wall Street's largest banks by giving them a higher scoring despite them having lent billions of dollars to polluting companies. Banks included Wells Fargo, Citigroup and Morgan Stanley.[26] Meanwhile, Elon Musk's company Tesla was downgraded in the S&P 500 ESG Index due to issues of racial discrimination and poor working conditions at one of its factories, despite Tesla playing a crucial role in the world's transition to sustainable energy with electrical cars.

3. To Finance or Not to Finance – That is the Question

Market practice proves that financial institutions do not necessarily have to only lend to fully ESG-compliant companies. The market practice also shows that banks ought to, at the least, ensure that companies are making tangible efforts towards ESG compliance. Financial institutions must be wary, however, to ensure that their own reputations are not damaged as a result of lending to certain companies. While this is not a major concern in Kenya at present, it is worth keeping in mind.

23 Banking on Climate Chaos – Fossil Fuel Finance Report 2022
24 Six of Canada's Largest Banks Join United-Nations-convened Net-Zero Banking Alliance
25 The fundamental contradiction of ESG is being laid bare – The Economist
26 Banks Get ESG Upgrades Despite Fossil-Fuel Financing – Bloomberg

Conclusion

While business owners and lenders across the country worry about the developing ESG legal landscape, as well as the greater burden to comply with ESG requirements, they should weigh this against the possible benefits and opportunities that their businesses may reap in the ESG era.

The price of so doing is likely to be significant, which begs the question of fairness particularly in a climate where economic conditions are already so fraught with increasing borrowing costs, rampant inflation, unemployment and skyrocketing expenses.

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