Risks to stakeholders of ESG-oriented organisations

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Organisations that prioritise 'Environment, Social and Governance' (ESG) aspects are becoming increasingly preferred by the employees, consumers, and investors. India is on a path to transform its ESG landscape to be future-ready. Recently, India was ranked #8 (two spots higher) in the Climate Change Performance Index (CCPI) 2023, which can be attributed to India's low emissions and the increasing use of renewable energy[1] and stands committed to reducing emissions intensity of its GDP by 45 per cent by 2030 from the 2005 level[2]. This makes India a major market for sustainability solutions and has an immense potential for growth in sustainable investing with an opportunity to mobilise USD1 trillion by 2030[3] towards the top ESG priorities, particularly for financing climate transition and achieving the sustainable development goals (SDGs).

The preference towards ESG focus is driven by the fact that a strong ESG objective can ensure long-term success for an organisation, which would further enhance its reputation and shareholder value, among others. According to KPMG's 2022 Global CEO Outlook, 69 percent of CEOs see significant stakeholder demand for increased transparency and reporting on ESG matters (up from 58 percent in 2021).

With increased amounts being invested or lent towards ESG priorities, the potential risk of misrepresentation of the ESG performance, diversion and misuse of funds, as well as other ESG related non-compliances is higher. As per the World Economic Forum Global Risks Report 2023, in the past one-decade, ESG-related risk is among the top five global risks in the world. Such unethical (and even illegal) risks lead to financial and reputational implications on investors, lenders and other stakeholders, and they need to be proactive in undertaking adequate due diligence prior to investing in ESG organisations as well as post the funds are invested or lent to an organisation.

1. India jumps 2 spots higher, and now ranks 8th as per Climate Change Performance Index (CCPI, 2023), 22 November 2022, Press Information Bureau, New Delhi
2. India stands committed to reduce Emissions Intensity of its GDP by 45 percent by 2030, from 2005 level, 22 December 2022, Press Information Bureau, New Delhi
3. India can attract $1 trillion in ESG investment, The Hindu Business Line, 27 September 2022

Understanding ESG fraud risks

To safeguard from financial and reputational damage, it is prudent for investors, lenders and board of directors of ESG organisations to proactively evaluate the key risks, which may include but not limited to:

A. Diversion, misuse or abuse of funds and credits

1. Green funds may be used for unauthorised/ineligible projects, which may be in contravention to the spirit of the ESG initiative, stated intent and purpose
2. Transferring funds to subsidiaries/group companies or other corporates for purposes unrelated to ESG, often without prior permission of the investors/lenders
3. Pledging of shares or other assets of ESG organisations for obtaining loans/funds for related/connected organisations and the purposes of application of funds for these related/connected entities may not be related to ESG.

B. Environmental risks

1. Greenwashing: False/misleading statements or claims about the sustainability and environment friendly activities of an organisation such as:
    a. False labelling or advertising
    b. Misleading recycling claims
    c. False low emission claims
    d. Unverifiable carbon-footprint claims
2. Blue-washing: Advertising about registration with UN Global Compact (UNGC) without following the requisite UNGC principles
3. Deliberately compromising monitoring systems and mechanisms over environmental controls, such as emissions, air and water monitoring systems, amongst others
4. Improper disposal of waste generated and lack of segregation of recyclable and non-recyclable waste
5. Lack of periodic assessments or ineffective assessments to monitor environmental impact.

C. Social risks

1. Non-compliant labour/working conditions and inadequate industrial safety standards for protection of workers
2. Forced savings and deposit programmes: withholding a portion of a worker’s salary, creating an element of servitude over fear of losing the withheld assets
3. Inadequate insurance policies, health and safety management systems for employees
4. Purplewashing/Pinkwashing: organisations deliberately attempting to appeal to the diversity and inclusion of women/LGBTQ communities to distract from contradicting internal practices, such as significant gender pay gaps, discrimination in appraisals, lack of mechanisms for prevention of sexual harassment, among others
5. Brownwashing: organisations creating a public image of support for communities, irrespective of their caste, creed and race, whereas on ground, not supporting their own employees on these factors.

D. Governance risks

1. Facilitation payments and bribery of statutory authorities to obtain fraudulent licences/permissions or overlook non-compliances during inspections
2. Lack of adequate controls to prevent data breaches and cybercrimes, which could lead to loss of sensitive personal data of employees, customers, vendors and other third parties
3. Regulatory non-compliances such as financial statement frauds, evasion of taxes, insider trading and stock price manipulation among others
4. Improper disclosures and regulatory reporting pertaining to ESG initiatives, programmes and metrics
5. Weak internal control mechanisms and inadequate management oversight leading to significant instances of frauds and unethical environment amongst employees, vendors and other third parties associated with the organisation.

What may be done to mitigate such risks?

It is imperative for investors, lenders and board of directors of ESG organisations to adequately assess fraud risks prior to any investing and/or lending in the ESG organisations and monitor them periodically. Some of the key potential steps that may be undertaken by the organisations include the following:

Area	Key monitoring steps
Pre-investment due diligence	a. Identify any adverse or criminal information about the promoters, shareholders, or lenders of the ESG organisation b. Validate genuineness of ESG related activities and ESG reporting metrics/ claims made by the ESG organisation c. Review adequacy of ESG framework, internal control systems, anti-bribery and corruption framework, key policies/procedures and other governance mechanisms implemented by the ESG organisation d. Ascertain the veracity or genuineness of the revenues and expenses of the ESG organisation and review adequacy/genuineness of the supporting documents for the same.
Post-investment proactive reviews and monitoring	a. Identify whether the invested or borrowed funds have been utilised for the given purpose or objective (ESG related activities) or there are any instances of diversion/mistutilisation of funds b. Periodic diagnostic reviews to identify red flags pertaining to any malpractice, corruption or bribery related instances in the ESG organisation c. Periodic assessment of the adequacy of ESG framework, policies and procedures, monitoring mechanisms and regulatory reporting for ESG initiatives and compliance d. Impart trainings and create awareness among employees and third parties associated with the ESG organisation to build a strong ESG framework.

Global focus on ESG is expected to significantly increase in the coming years, which will also drive ESG oriented investing/lending. Laws and regulations regarding ESG related compliances and reporting mechanisms are expected to get more stringent. In this scenario, taking proactive actions would help safeguard the ESG organisations, its board of directors, investors and lenders from any regulatory penalties, unforeseen litigations, financial or reputational damage arising from any ESG related issues.

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