Using Risk To Evaluate Industry-Specific ESG Issues In 2023

By **Lanier Saperstein, Marc Kushner and Cat Ulrich** (January 4, 2023)

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To paraphrase rock band U2 from its live recording, "Under A Blood Red Sky," there's been a lot of talk, maybe too much talk, about the environmental, social and governance framework.

ESG is a broad umbrella term, often meaning different things to different people. Some view it as a radical device designed to thwart election results or the free functioning of markets, while others view it at as a rally cry for vital change.

But what about the poor compliance officer, who has to make sense of ESG? What should they do to protect the interests of their company? The short answer is what you would expect from your typical lawyer: It depends. There really is no one size fits all.

But the compliance officer can turn to a methodology that companies, especially financial institutions, have employed for decades: a risk-based approach. Just as no one anti-money laudering program exists to assess risk of money laundering at all financial institutions, no one ESG compliance program can assess ESG risk at all companies.

This article provides a brief user's guide to ESG, outlines a risk-based approach by looking at certain industry-specific concerns and identifies three developments to watch for in 2023.

Focus on the E, S or G?

It might be tempting to some to view the current regulatory focus on climate change-related financial risk as a political trend, driven by a Democratic president and, until recently, a Democratic-controlled Congress. In November, for example, five Republican U.S. senators wrote, the "ESG movement attempts to weaponize corporations to reshape society in ways that Americans would never endorse at the ballot box."

However, the E of ESG is here to stay, especially relating to the effect of climate change on the environment, because it can have sudden and potentially profound effect on a bank's or company's balance sheet. Just ask insurance companies, who have had to price climate change-related risk for years. Investors care.

The media remains interested and is keen to report on alleged greenwashing. Even if the federal banking and other regulators shift their focus under a Republican administration, many state regulators will remain focused on climate risk and marshal the enforcement mechanisms available to them.

Putting aside the political rancor, compliance offices still need to ensure the safety and soundness of their institutions. Compliance officers, led by their companies' leadership, should analyze their business, identify the top risks related to climate change — whatever the cause of that change might be — and identify ways to mitigate those risks. That approach should be familiar to most, if not all, compliance officers.

What about the S and G? These social and governance issues are a little harder to pin down and can take different forms year-to-year, but the trend shows an uptick in shareholder proposals on these issues, and growing support for those proposals, which means compliance officers likewise should pay close attention.

Recent S and G proposals have taken the form of requests to initiate racial equity and civil rights audits, with proposals suggesting engagement of a third party to audit and analyze the adverse impacts of a company's policies and practices passing at companies such as Apple Inc., Johnson & Johnson Services Inc., Home Depot Inc. and McDonald's Corp. Average support for such proposals has risen to approximately 45% of voters.

Industry-Specific ESG Concerns

Each industry, in addressing ESG, will have a different set of issues to face. As an illustration of the risk-based approach suggested by this article, let's consider the following three industries, the key industry-specific ESG concerns for each and certain mitigating actions companies should consider adopting.

Banking Industry

The banking industry is heavily regulated, therefore the relevant regulators, in addition to each bank's customer base or business focus, will shape how banks address ESG-related concerns.

For national banks, the main regulator, the Office of the Comptroller of the Currency, is mandated to focus on safety and soundness. That includes the risk of climate change on each bank's balance sheet. In October, the OCC identified 13 areas of heightened supervisory focus, one of which was climate-related financial risk.

These remain nascent days, as the OCC stated it is still working to understand the climate-related financial risks, and it is in the process of information gathering on this issue, particularly taking a look at large banks. The OCC reiterated its position on Nov. 16, 2022, before the U.S. House of Representatives' Committee on Financial Services, stating that "our focus is on risk management. ... We are committed to staying in our safety and soundness lane, not on setting industrial policy."

State regulators are similarly focused on safety and soundness, and banks should not expect state regulators' stances to change if the political party in the White House changes in 2024. Regulators are making clear they care about this issue and are looking closely at it because it reflects a substantive risk, not a political preference, and consequently banks need to be ready because the regulators can be expected to take action.

Publicly traded banks will need to review the U.S. Securities and Exchange Commission's proposed climate change rules, understand what the rules require of them, identify their risks and ensure compliance.

While banks have a lower greenwashing risk, there are still reasons to be pay close attention to what the SEC is doing. Take, for example, the SEC's recent enforcement action against The Bank of New York Mellon Corp. for alleged misstatements and omissions about ESG considerations. BNY Mellon agreed to a cease-and-desist order, a censure and a $1.5 million penalty in May 2022.

Banks certainly are not immune from the pitched political battles. Indeed, they are becoming a central focus for the anti-ESG movement.

In August 2022, for example, Texas Comptroller Glenn Hegar released a list of 10 financial firms and 350 investment funds he deemed were boycotting energy companies.

Such a statement, of course, brings with it serious risks a bank must consider, including the potential loss of revenue from both Texas and customers with similar concerns. Implementing ESG policies can often be a double-edged sword, making some stakeholders happy while upsetting others.

Considering the implications of any ESG policy from all angles is critical to a risk-based approach, a focus on the long-term risks ESG concerns directly and indirectly pose to the safety and financial soundness of the bank will allow the bank to make rational and informed decisions on ESG that, consistent with their regulatory obligations, reflect the long-term interests of the bank.

Energy Industry

There has been a strong push in the energy industry by the government, regulators, consumers and investors to move toward clean and renewable energy. But for many companies, the move toward clean energy and renewables is multifaceted, complicated and time-consuming.

If a company is looking to move to toward renewable energy generation and shut down its coal plants, it must address the equitable concern about putting those who work at the coal plants out of work and disrupting the communities in which they operate.

A thoughtful risk-based approach would address these concerns as part of a comprehensive approach, for example, by including consideration of retraining workers and building renewable energy plants in the same city as part of a program to implement the structural and operational changes an energy company might have determined are needed to address the long-term risk that ESG concerns pose to shareholder value and stakeholder concerns.

Because the energy industry is getting pushed very hard on climate change, transparency is also critical. Publishing climate impact studies, sustainability reports, Sustainability Accounting Standards Board reports, company policies, etc., is an effective way of demonstrating to key stakeholders that the company is implementing ESG initiatives responsibly.

However, the energy companies must be thoughtful about what they share. The greenwashing risk is high for energy companies that market to consumers, especially in the current market environment, where consumers are more likely to purchase products from a socially responsible company.

These pressures make it enticing to embellish the company's policies or positions, or overpromise certain goals. To mitigate greenwashing risks, all companies, not just the energy sector, should create lines of communication between their legal and marketing department, conduct internal audits on the reports, policies and goals disclosed to the public, and consider hiring a third-party auditor to ensure accuracy.

Food Industry

One critical consideration for companies, particularly those in the food industry, is the impact implementation of ESG policies will have on sales and profits of their products.

For example, in the last few years, the food industry saw a major push to move away from genetically modified organisms. As one can imagine, shifting to non-GMO products can be costly, and in many cases there was limited increase in revenue as a result of eliminating GMOs from food products.

This potentially adverse commercial result illustrates an asymmetry frequently present with ESG policies, and one that informs a company's risk-based approach to ESG. A negative customer reaction to a certain action, or inaction, taken by a company can affect profits.

Consumers may boycott a certain product, e.g., food containing palm oil, but may not reward a seemingly positive action, such as eliminating GMOs from food products.

Striking the correct balance is key when responding to these ESG issues, and may lead to difficult decisions, such as:

- How much profit can reasonably be lost in the service of ESG; or
- Should a company adopt a different strategy to mitigate its ESG risk, like for example, investing in carbon credits to address stakeholders ESG concerns while continuing a business practice that is too costly to fix.

Though not specific to just the food industry, companies that employ their fair share of workers must also think about ESG from a retention perspective. Consumers increasingly want to work for and are more likely to trust companies that are dedicated to ESG.

This is especially true for the younger generations where they tend to care more about their company's principles and ideologies. Implementation of ESG, or failure to implement these policies, can result in key employees leaving a company, which is costly in and of itself.

ESG Trends

ESG is not going away, and three emerging developments for 2023 demonstrate the need for a risk-based approach.

The first development we have seen in the ESG world, and which we may see more of, is an increase in both SEC enforcement and other litigation related to greenwashing.

The SEC recently established the Climate and ESG Taskforce within the Division of Enforcement, signaling its intention to hold companies accountable to their ESG obligations and promises.

This follows on several high-profile actions by others. In June, environmental groups filed a class action in the District Court of Amsterdam against the Dutch subsidiary of Air France KLM for marketing that its customers who purchased carbon credits would offset the environmental impact of flying.

Another example is Massachusetts v. Exxon Mobil Corp. in the Massachusetts Supreme Judicial Court, the Massachusetts attorney general's ongoing lawsuit against Exxon Mobil Corp. for allegedly misstating or failing to disclose information related to the company's products and their impact on the climate.

While taking action is important, doing so in a thoughtful, measured fashion can protect from unanticipated consequences.

The second development, and one that will dominate ESG in 2023, is the headline-making SEC proposed rules on climate-related disclosures. Every company ought to stay abreast of these rules.

While ball has not stopped bouncing, each company should understand what is required of them once the rules are adopted and implemented. That includes not only developing a plan of what needs to be disclosed, but planning for the increased compliance costs.

And this risk-based assessment extends to private companies that do business with public companies, e.g., what ESG related certifications will my public company customer require as a condition of maintaining our sales volume?

Finally, state regulators are not sitting quietly on the sidelines. On Dec. 21, 2022, New York State Department of Financial Services Superintendent Adrienne Harris announced new proposed guidance for New York state-regulated banking and mortgage entities to "help them manage safety and soundness risks related to climate change."

The Department of Financial Services is a particularly important regulator, as it supervises and regulates the activities of nearly 3,000 financial institutions with assets totaling more than $8.8 trillion as of Dec. 31, 2022.

Like the OCC, Harris explained that the "DFS is committed to working with all stakeholders to further refine expectations and finalize guidance appropriate for Institutions to address material climate-related financial risks." The DFS is seeking public comments by March 21.

Therefore, while the landscape of ESG reaches as far as the eye can see and is ever evolving, a compliance officer's best bet is to remain adaptable and bring the tried-and-true risk-based approach to the issue. This should allow companies flexibility to address ESG issues as they arise, and as they change, with a focus that is specific to their industry and their company's specific circumstances.

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