Synopsis

This article demonstrates how evolving societal expectations and the well-being of future generations determine that ESG is both a key and a challenge to organizations pursuing long-term value creation and financial sustainability.

ESG and world change: the competing perspectives

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preparing for the future

Given their inherent sustainable nature, Environmental, Social, and Governance (ESG) issues appear to be here to stay. Increasing numbers of organizations are recognizing the benefits of leveraging ESG to optimize performance. Capital raised for private market ESG funds tripled between 2020 and 2022, while perceived ESG-related concerns are a growing consideration for whether investors pursue or reject deals[1]. The link between ESG and long-term value creation is becoming more and more evident.

Still, the stakes for business as usual are rising in the face of evolving regulatory expectations, political opposition, and legal challenges, and it is becoming difficult for organizations to balance pursuit of ESG against positive or negative public sentiment. This is where organizations must identify that there is no winner-take-all scenario in the face of competing perspectives. Regulators are pushing for comprehensive climate change-related disclosures to increase transparency and awareness for investors and other stakeholders. But many corporations are challenging these attempts as overly prescriptive, inconsistent, and premature in the face of ESG data scarcity and complexity of decision-making. Non-government organizations (NGOs) are moving the needle in the direction of ESG, but they cannot drive markets without corresponding product availability. On the other hand, consumers, especially younger generations, are interested in environmental and societal advancement— and are willing to funnel their money in this direction[2]. This is where organizations are quickly realizing they must not only align with regulatory expectations but need to adapt to consumer preferences, industry competition, and technological advancement in order to radically transform their business models and pursue long-term value creation.

the rise of ESG

ESG is not a new concept, but it has been slow to gain market traction. However, it came to prominence in 2021 due to myriad factors. The COVID-19 Pandemic and simultaneous, increasingly catastrophic weather events highlighted the mortal, economic, and supply chain repercussions that could result in the face of future extreme climate-related scenarios. Unprecedented social change as a result of the Black Lives Matter Movement in the United States and increased migration of refugees towards Europe in response to war and political instability have shaken perspectives on global and domestic unity. And consumer wariness over governance and ethics remains a key concern since the 2008 Great Recession.

COVID-19 also ushered in an existential crisis for many, prompting The Great Resignation (and the subsequent War on Talent) as people reconsidered their work and family-oriented goals. Increasingly, people want to align themselves with companies that uphold and exhibit their values, which is now one of the motivating factors in the flow of talent.

From a long-term view, ESG will continue to be driven by more environmentally and socially conscious millennials and Generation Z, who stand on the brink of inheriting the wealth accumulated by their baby boomer parents and grandparents. With this Great Wealth Transfer, the next wave of shareholders and investors will come into their prime—and intensify focus on ESG corporate strategy[3].

the regulatory landscape

The European Central Bank (ECB) has identified climate change as one of the major sources of systemic risk in the financial system[4]. Expectations are moving from voluntary disclosures to mandatory requirements to promote transparency for investors, appropriate market pricing, global alignment, and enhanced risk management around climate change. It is anticipated that these disclosure requirements will positively affect capital markets while encouraging sustainability as an integral part of business strategies in the long term.

While there are numerous climate-focused disclosure frameworks, the "Big Three"[5] are:

- Corporate Sustainability Reporting Directive (CSRD): Ushers in the first mandatory regulation to incorporate double-materiality attempts to put sustainability reporting on an equal footing with financial reporting, reduce systemic risk, allocate capital, and increase accountability[6]. Disclosure requirements will apply to 50,000 organizations within the European Union (EU)—including small and medium-sized enterprises (SMEs)—and impact 10,000 non-EU companies[7].
- International Sustainability Standards Board Disclosures (ISSB): Introduces a global baseline of sustainability disclosures to satisfy capital market needs. Additionally, ISSB should reduce fragmented disclosure requirements and complexity internationally, expand data access, create better transparency across capital markets to illuminate the true cost of risk, and promote enhanced decision making for long-term value creation[8].

- U.S. Securities and Exchange Commission's Climate-Related Disclosures for Investors: Unveils the most comprehensive guidance for U.S. publicly-traded companies regarding climate disclosures to date. The proposed guidance defines expectations regarding disclosure of Scope 1, 2, and 3 greenhouse gas emissions, actual/potential material climate change-related risk exposures, climate exposure risk governance, utilization of carbon offsets and renewable energy certificates (RECs), and transition plans (and related progress)[9].

While these disclosures are heavily predicated on Task Force on Climate-change Related Disclosures (TCFD), which affords a general consistency, they do not allow for comprehensive global alignment or eliminate ambiguity about ESG. How organizations (especially global companies) will navigate these still-evolving regulatory requirements remains to be seen.

legal challenges and legislation

Differing climate change-related litigation strategies have been deployed recently encompassing all perspectives. The biggest group of litigations relate to pro-ESG lawsuits and attempt to influence the debate around decision-making or policy outcomes and to change corporate and societal behavior. New types of cases on the opposite spectrum (anti-ESG) aim to delay or prevent climate action and to maintain the status quo. In the middle is the "Just Transition" litigation strategy, which balances advancing transition to a net-zero carbon economy against protecting the rights of affected stakeholders. Emerging strategic climate-related litigation against companies puts pressure on corporate value chains, or disrupts financing ("turn off the taps") to projects perceived to be harmful to people or the environment, exposes greenwashing, and promotes investment strategies key to supporting a low-carbon transition[10].

Lawsuits against European governments have been more common to date, such as suing the European Commission (over inclusion of gas and nuclear references in the EU taxonomy[11]) or Germany (due to accusations the Federal Climate Protection Act violated constitutional human rights[12]). While climate change litigation tends to be driven by younger generations, seniors are also championing lawsuits such as the Elderly Women vs. Switzerland suit, which argued human rights violations due to insufficient action against climate change and thus initiated a broader fundamental debate on the interpretation of the European Convention on Human Rights[13].

The first significant constitutional climate trial in the U.S. again saw a group of mainly minors challenge Montana regarding language in the state's Environmental Policy Act which prevents officials from weighing potential carbon and climate impacts regarding energy ventures[14]. In what is considered a precedent-setting judgement in the U.S., the final ruling was in favor of the plaintiffs, citing they had a constitutional right to a healthy environment[15]. It is anticipated Montana will appeal this ruling, adding to the growing efforts of Republican (red)-leaning states to enact anti-ESG legislation, while Democrat (blue)-leaning states are enacting laws to promote focus on climate change. The U.S. is unfortunately famous for its polemic behavior, and a new civil war of sorts is emerging as red and blue pit against each other on the burgeoning ESG battleground.

value creation

With the world changing in terms of both physical and emotional climate, how an institution approaches ESG is suddenly a demarcating factor in what may draw a much-desired reputational bonus— or less-positive scrutiny. While challenges remain (especially related to climate) regarding regulatory inconsistency, political opposition, legal challenges, and lack of global alignment, ESG offers a common ground for organizations not only to promote global economic stability but to drive company-specific entrepreneurial growth.

Organizations are poised to make a substantial impact on climate change, social equality, and ethical standards while catering to a future wave of investors by growing the baseline beyond mere financial profit-oriented considerations. Though return on ESG may be a long-term gain, there is a proven link between ESG and profitability. Companies prioritizing ESG have seen profits and revenues expand 9.1%, and 9.7% respectively over a three-year span, while 84% of ESG-focused companies recognize their ability to raise capital is less challenging[16]. Market practices with ESG priorities will contribute to better regulatory and legal alignment globally, in order to be held to a minimum for enabling companies and consumers to thrive in a low-carbon economy. Becoming more sustainable in terms of ESG will also ensure financial sustainability and stability in the long run, as it will support the functioning of the global economy in harmony with nature and people.

By prioritizing ESG, organizations are catering to younger generations, who, thanks to their forebears, in many instances have grown up in wealthy societies with the benefit of disposable income. These younger generations are already showing their proclivity to put their money where their aspirations lie—and they represent the future shareholders, investors, consumers, and talent which organizations need to harness in order to remain competitive and to drive value creation. Entering the new market space with mainstreamed ESG-perspectives is therefore the key for organizations to effectively navigate a changing world—and shape the future.

Disclaimer

All views expressed in this article are our own and do not represent the opinions of any entities that we may be associated with.

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