

# Walk the walk

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## **Companies need to be honest about environmental, social and governance issues**

When in March 2016 the Honduran activist Berta Cáceres was shot dead, after protesting against the Agua Zarca hydroelectric project, news of her death spread around the world in hours, prompting investors to suspend their support for the proposed dam. Activists have embraced social media, and protestors coordinate their activities via messaging apps, use crowdfunding to launch legal challenges, and post slick online videos that can assassinate a company's reputation overnight. Even remote communities now post clips on the web minutes after an incident occurs.

Companies are very vulnerable to such online activism. Thanks to the internet, anyone can voice a grievance to a global audience and the public is now aware of environmental, social and governance (ESG) issues that previously lay hidden. Stakeholders' expectations have increased and companies need to align their activities with this new era of transparency. For this reason, management of ESG risks is no longer niche; it has become a normal part of risk management.

**“Many risk managers continue to analyse a company's policies, instead of looking at its actions”**

Financial institutions were rocked by the 'Panama Papers' and 'LuxLeaks' revelations, which exposed the widespread use of offshore companies to help companies and wealthy individuals

launder money and avoid taxes. However, many risk managers continue to analyse a company's policies, instead of looking at its actions. Corporations proudly announce their membership of international sustainability initiatives, but often fail to disclose their exposure to risk incidents. Unfortunately, CSR reports are often used as a PR tool and many stakeholders do not even bother to read them.

## **Outside sources**

ESG research provider RepRisk bases its analysis solely on data provided by outside sources, as only information from stakeholders such as media, non-governmental organisations, trade unions, and government agencies can show whether a company's policies and commitments are translating into performance, or whether the company is 'walking the walk'.

Prior to the Volkswagen emissions scandal that hit the headlines in September 2015, the company was highly regarded and was listed on almost all major ethical investment indexes. VW announced record sales of €202.5 billion for 2014, and in March 2015, Moody's forecast 'improvement in Volkswagen's operational performance in the next 12 to 18 months'. RepRisk was the only research provider that flagged the high-risk exposure relating to VW before the emissions scandal broke.

As early as May 2013, and again the following month, RepRisk identified NGO reports accusing VW of using technical tricks to tamper with emissions data to reduce vehicle and road taxes. RepRisk considered VW 'high risk' as early as September 2014, when the company reached a RepRisk Index (RRI) of 66, well above the high-risk threshold of 50.

As well as tracking early warnings, companies also need to realise that risks can suddenly materialise from small, unlisted companies – eight out of the ten companies ranked in RepRisk's 'Most Controversial Companies of 2016' report (MCC 2016) were from emerging markets.

Mossack Fonseca, the company at the centre of the Panama Papers scandal, was not on the radar of most research companies prior to the 2015 leak of more than 11.5 million documents, but RepRisk had already linked the company to money laundering through a network of shell companies as early as 2013.

## **Issues-driven**

RepRisk's methodology is issues-driven, rather than company-driven, which means it screens media and stakeholder sources for ESG issues, rather than tracking a defined list of companies. RepRisk's 28 key ESG issues have been determined in accordance with international standards, such as the Equator Principles, the United Nations Global Compact Principles and the International Labour Organization conventions.

On a daily basis, RepRisk systematically screens media and stakeholder sources for any risk incidents linked to these issues. As of March this year, the RepRisk ESG Risk Platform has linked more than 84,000 companies and 21,000 projects to ESG risk incidents, and these numbers grow daily as new incidents are identified.

## “Local NGOs highlighted slave labour in the Thai seafood industry as early as 2007, years before the news hit the headlines”

This coverage is especially crucial for corporates monitoring ESG risk in supply chains that may straddle various industries and continents. To date, Western companies have managed such risks by requiring their suppliers to sign up to policies and codes of conduct, answer questionnaires, and submit to periodic audits. However, such solutions may miss what is happening on the ground. Local stakeholders often identify emerging risks long before they reach the mainstream news.

Local NGOs highlighted slave labour in the Thai seafood industry as early as 2007, years before the news hit the headlines and food companies dumped their shares in Thai seafood companies. In Brazil, local institutes warned of risks associated with Samarco Mineração’s Fundão Tailings dam two years before the dam collapsed in November 2015, causing one of Brazil’s worst environmental disasters.

However, it is not enough just to identify the risk, it is important to assess it in a systematic and rules-based way. This is why RepRisk combines artificial intelligence with human analysis to evaluate the severity of the criticism, the influence and credibility of the news source, and the novelty of the issue for each company. These three factors impact the RepRisk Index, a proprietary algorithm that dynamically captures and quantifies reputational risk exposure related to ESG issues. The RRI allows the comparison of a company’s exposure with that of its peers and helps track the risk trends over time.

### **Advanced risk management**

Financial institutions tend to be more advanced in ESG risk management, as they have been aware of these issues for more than a decade. Recent supply chain incidents, such as the explosions of Samsung’s Galaxy mobile phone batteries and Takata’s airbags, have now focused the minds of multinationals on ESG issues. Scandals such as the horsemeat debacle have made multinationals realise that ESG issues can destroy a company’s good name overnight.

## “Eight of the ten companies ranked in RepRisk’s MCC 2016 report faced governance-related issues involving corruption and fraud”

The data is also used to track trends. It is interesting to note that currently the most controversial issue on RepRisk’s ESG Risk Platform is child labour, which is mostly linked to the food and beverage, personal and household goods, and mining sectors. Other issues that were extremely controversial in 2016 include forced labour, tax optimisation, and fraud.

It is also interesting to note that eight of the ten companies ranked in RepRisk’s MCC 2016 report faced governance-related issues involving corruption and fraud. Many of these companies were

linked to embezzlement, creating slush funds, aggressive lobbying, overcharging, nepotism, cronyism, and connections to organised crime, all issues that violate the UN Global Compact Principle No 10.

We have recently seen increased transparency in the field of corporate social responsibility reporting. Traditionally, sustainability reporting was primarily driven by voluntary initiatives such as the UN Global Compact. However, legislation such as the UK Bribery Act, the US Foreign Corrupt Practices Act, the UK Modern Slavery Act, the Dodd-Frank Conflict Minerals Disclosure Provision, and the EU Directive for Multinational Enterprises are now encouraging companies to tighten up their due diligence processes.

### **Growing demand**

Activism will continue to grow. NGOs have already had some successes: banks are withdrawing financing from projects such as mining near the Great Barrier Reef, and the Dakota Access Pipeline in the US, as these projects invite too much stakeholder backlash.

Consumers too are voting with their feet. Although they might love the low prices in a high-street store, they dislike the idea of wearing fashion items created in a building that is lethally unsafe for workers.

We have seen a growing demand from banks and other organisations looking to manage their ESG risks, as they realise that ESG risk incidents, such as human rights abuses, corruption, and fraud, can lead to compliance, reputational, and even financial risks. They want to enter relationships with clients, partners, or suppliers with their eyes fully open. This transparency around potential ESG risks allows companies to make better-informed decisions.

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