AFRICA DIGITAL DATABANK

Greenwashing under growing regulatory scrutiny

In the last few weeks, *The Financial Times* has produced over 30 articles that reference Environmental, Social and Governance imperatives as an integral part of ethical investing. Where does that leave your business?

INTELLIGENCE REPORT

Greenwashing under growing regulatory scrutiny

Executive Summary

On 10 March 2021, a set of 'green finance' rules designed by the EU to prevent greenwashing – the act of claiming that a fund is sustainable when in reality it is working against sustainability objectives – was applied to certain financial services sector firms in the EU. These rules – known as the EU Sustainable Finance Disclosure Regulation (SFDR) – effectively categorise products as sustainable and non-sustainable. Asset management firms will be subject to rigorous disclosure requirements should they want to credibly market their funds as promoting sustainability. These rules are an attempt to regulate what is currently a disordered market, where firms are quick to employ the ESG concept for marketing purposes, but investors have no way of ascertaining whether the claimed credentials are legitimate or verifiable. In our view, this regulatory trend towards preventing concept abuse is a welcome development and will help to separate the wheat from the chaff in a world that is under immense pressure to achieve low-carbon growth. Early adopters of ESG principles – those who mainstream social and environmental responsibility into how the firm is governed – will see optimal long-run returns. Those who engage in greenwashing or are too slow to adapt will suffer long-run decline.

What does this mean for your business?

For firms currently operating in African countries, or looking to invest on the continent, these advancements are important, especially for firms in the extractive industries seeking finance either for recapitalisation or to invest in new exploration or production activities. Access to capital will increasingly be subject to ESG compliance. Firms that are predominantly orientated towards extracting fossil fuels will be at risk of losing access to capital in the medium term as momentum towards genuine sustainability takes root. Firms that specialise in the extraction of minerals and metals required for renewable energy technologies will be better placed. However, the modes of extraction and social and environmental performance will come under increasing scrutiny. Our summary view is twofold:

- Firms that move away from fossil fuel extraction towards more sustainable activities will benefit.
- Firms that extract minerals and metals to supply demand for renewable energy technologies will benefit from these new rules, but only if they take seriously the ESG principles now being mainstreamed into global finance.

Securing sustained business performance in the long term will require de-risking. For extractive industry firms, this increasingly means reducing above-ground risks and not only the typical below-ground or 'operational' risks.

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Sustainable Development Goals mapped to ESG performance = sustainability

Impact

- ESG strategies are yielding significant fund performance differentials and will now continue to outperform non-ESG-aligned funds; this means that access to capital will require evidence of ESG mainstreaming into firms' production strategies.
- Funds in other parts of the world will increasingly start to follow the EU example given that ESG funds, on average, unequivocally outperform their less sustainable counterparts.
- The move by the EU is a significant step on the road to reducing negative externalities – the divergence between social costs and private returns – and will increasingly force firms to internalise the costs of environmental, social and governance underperformance.

Analysis

The 2015 Paris Agreement and the 2017 Sustainable Development Goals (SDGs) are two of the major recent global treaties that have started to shift the needle in terms of how global financing is allocated. Notwithstanding former US President Donald Trump's indifference to the agreement, the influence of populist leaders such as Brazil's Bolsonaro, or the intense lobbying of fossil-fuel dependent firms and countries, the shift towards a lower-carbon growth trajectory is now a reality. Many environmentalists argue that it is too little too late, but that would be an overly pessimistic view.

In 1972, political economy scholar Anthony Downs lamented the sheer extent of ecological destruction at the hands of firms. He astutely observed that despite the scale of the problem, issues such as pollution remained relatively abstract for most consumers.

By 2015, however, the impacts of climate change were more readily observable and less abstract. Humanity is at serious risk of overstepping a number of inter-related planetary boundaries, which may have irreversible consequences if action is not taken.

One of the hurdles that had to be overcome in the movement towards a lower-carbon growth path was the incentive structure that typically motivated corporate behaviour. If the bottom-line yielded profits from polluting activities and the deployment of environmentally destructive technologies, shareholders were receiving returns that incentivised them to ignore the social and environmental costs that were being offloaded onto those who could least afford them. Economists call these costs negative externalities – the divergence between social costs and private returns. Social costs manifest, for instance, in the form of negative health impacts on local communities near coal mines, or in the environmental destruction of rivers due to chemical dumping. Critical to reducing these social costs is to force firms to internalise them so that the bottom-line reflects reality rather than unsustainable profits.

RISK OF GREENWASHING

THE ENI CASE

Eni, an Italian multinational oil company, was fined EUR 5 million for the dissemination of misleading advertising messages used in a promotional campaign. This promotional campaign, related to Diesel+ fuel, was marketed as 'green' diesel across all advertising platforms including television, newspaper, digital media, and petrol station advertisements. The campaign falsely claimed that 'green' diesel has a positive impact on the environment and reduces greenhouse gas emissions. This was the first ruling made by the Italian Competition and Market Authority and it is reported to be the highest amount fined in respect of greenwashing. Though it is reported that Eni is to appeal the fine, it is critical to note that the risk of greenwashing can result in extensive financial repercussions and reputational damage for companies in question. This is a risk that is not worth taking in the climate of asset stranding becoming more of a reality for the hydrocarbon industry.

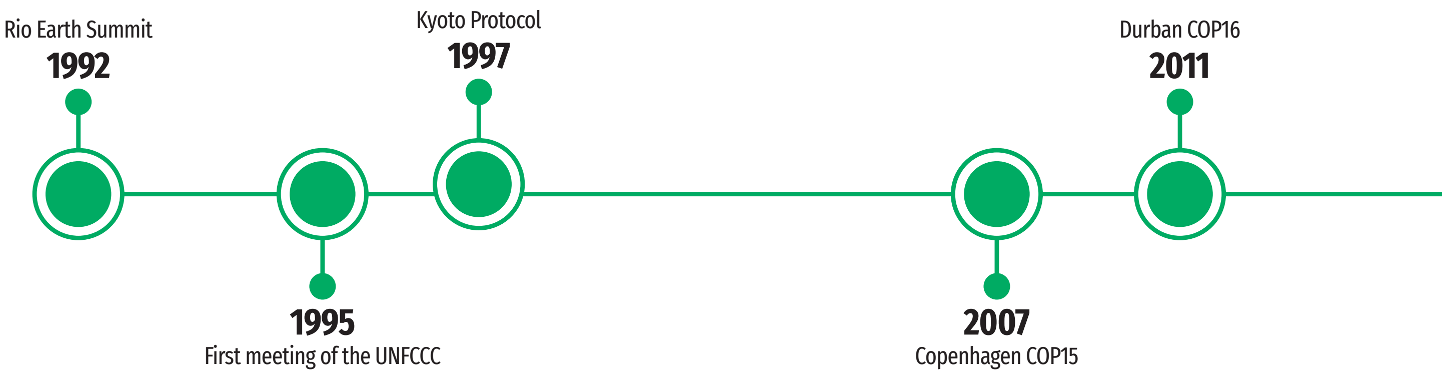
The EU's Green Deal was first presented in December 2019 and entails a number of important undertakings that have ultimately paved the way towards incentivising firms to internalise negative externalities. Economists typically favour a tax on polluting firms but changing the way that global financing thinks is not only a form of taxation, it's a strong incentive towards ensuring that sustainability considerations are mainstreamed into global business performance. The newly formulated SFDR rules are essentially a manifestation of overwhelming client demand for global production systems that protect the planet and people. The SFDRs are an integral part of the Green Deal. UK rules have also recently been developed that compel pension funds to weigh ESG considerations.

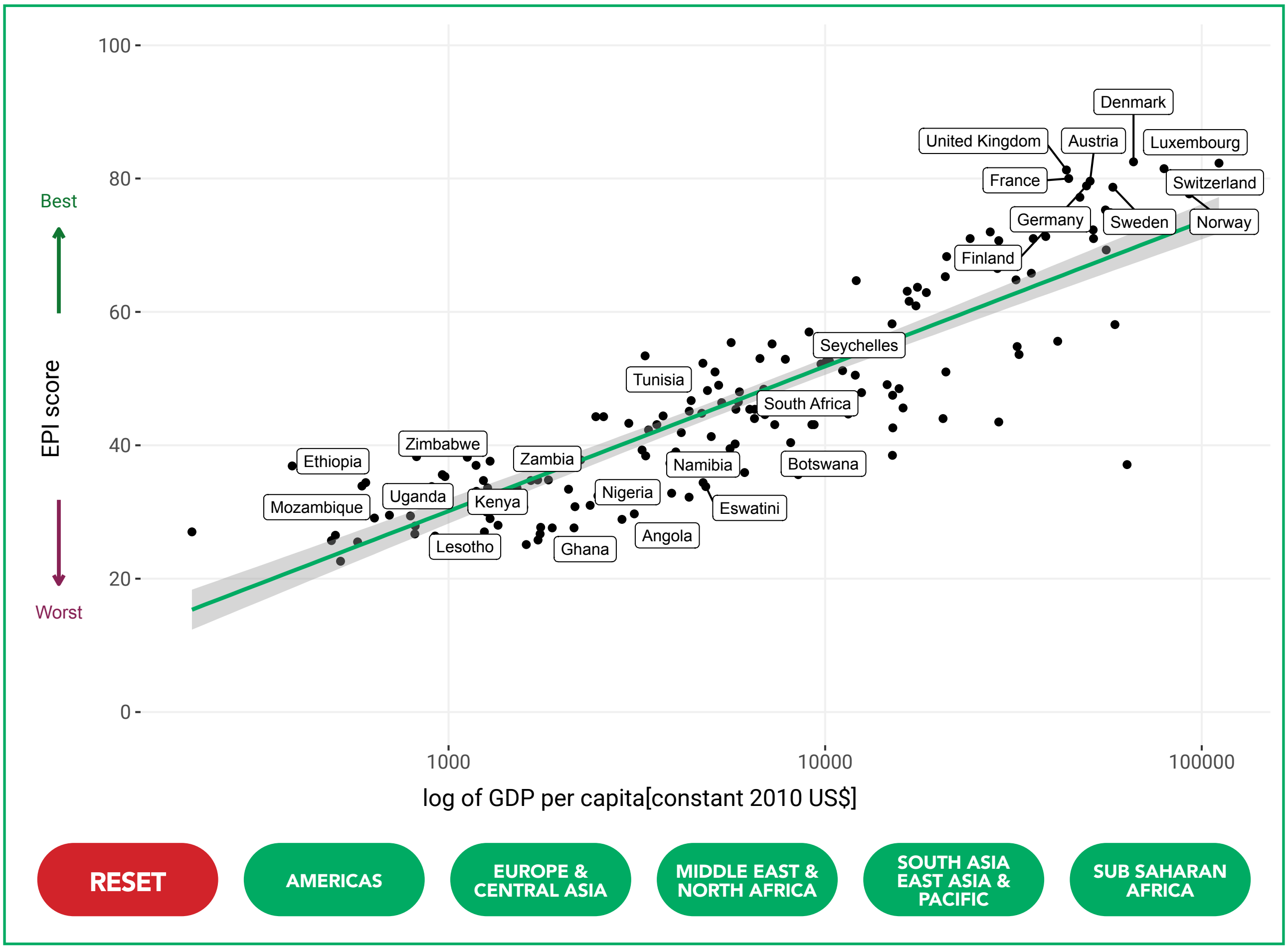
Why has it taken so long?

There are three primary reasons for why this shift has taken so long:

- Vested economic interests in unsustainable production patterns are politically powerful and therefore have the means to shape policy.
- Alternatives to dirty technology were few and far between and expensive as a result. Research and development funding for clean technologies (such as renewable energy) was not available for a long time because investors saw the opportunity costs as too high. Investments in renewable energy that may fail were seen as unnecessarily risky when that finance could otherwise be invested in activities that were known to produce higher immediate returns. Increasingly, however, there is acceptance among investors that climate change manifestations will have extensive financial repercussions.
- Global collective action to commit to reducing global warming was difficult to achieve because of arguments over who should shoulder which share of the burden to do so.

These three hurdles have now largely been overcome and the sheer necessity for low-carbon growth has created the space for ESG momentum to accelerate and be appropriated into investment decisions.





Source: Yale Center for Environmental Law & Policy and the World Bank

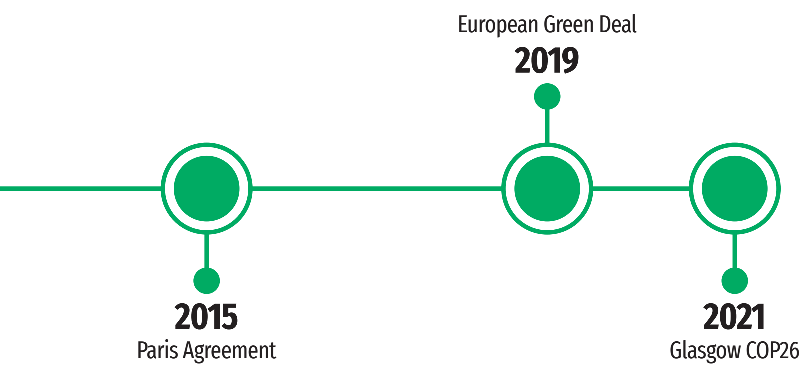
Positive correlation between the Environmental Perfomance Index and GDP per capita

Does ESG work?

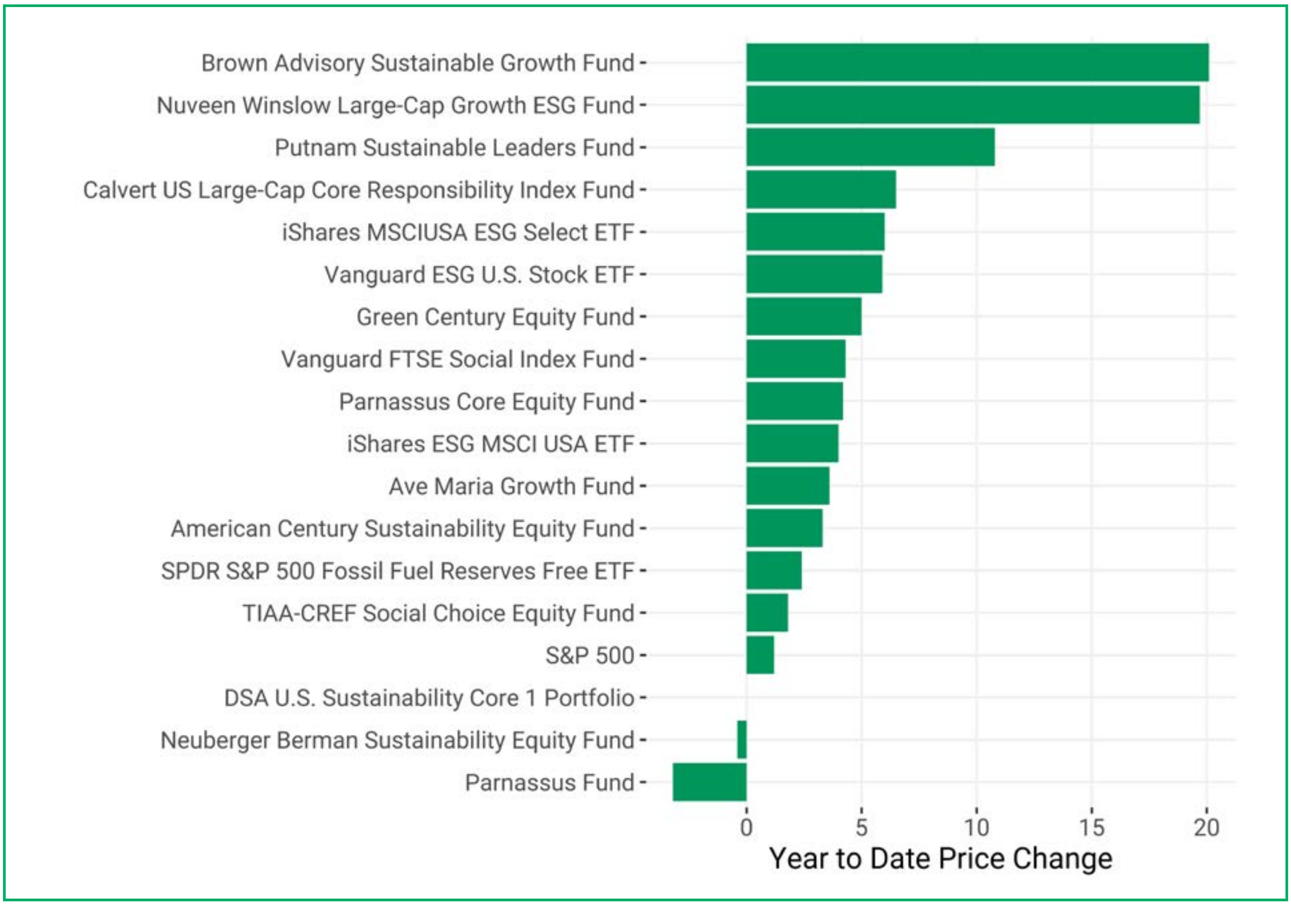
Notwithstanding that greenwashing has been a serious concern until now, the returns yielded by sustainable funds are impressive. The *Financial Times*, in an in-depth report on the matter, wrote the following: “ESG investing set record after record, with investors piling unprecedented levels of cash into sustainable funds, asset managers rushing to launch new products and research suggesting such investments outperformed mainstream rivals.”

The report further reveals that Fondita Sustainable Europe, an investment fund, yielded a 41.6% return in 2020 while its benchmark lost around 3%. Investors with more than $100tn in assets, such as Blackrock, Vanguard and Amundi have signed a commitment to the Principles for Responsible Investment (PRI) to integrate ESG information into investment decisions. The total assets invested in specialist sustainable mutual funds reached a record of nearly $1.7tn in 2020. BlackRock, the largest global asset manager, shows that in the first quarter of 2020, 94 percent of sustainable indices beat their parent benchmarks. PwC predicts that assets in sustainable investment products in Europe will escalate threefold to reach €7.6tn by 2025. According to the Investment Association, responsible investment funds saw net flows of £7.1bn in the nine months to September of 2020, which amounts to 275 percent more than the £1.9bn measured in the first three quarters of 2019.

Vested interests and naysayers do still play a role, however. One large oil multinational has claimed that ESG-orientated fund growth is simply a new bubble. Moreover, intense lobbying has resulted in the EU scrapping deforestation considerations from the SFDR. Nonetheless, BlackRock has not been deterred from maintaining that focus



LEFT: Infographic depicting major global climate agreements (starting with Rio Earth Summit 1992)



Source: S&P Global Market Intelligence 31 Dec. 2019 to 31 July 2020

Several ESG funds outperformed the S&P 500 in 2020

as a result. In March 2021, the firm published guidelines that indicated it would vote against the re-election of directors if companies did not effectively disclose or manage risks relating to the depletion of natural capital. The 2015 Paris Agreement is its guiding star in this respect.

The new EU rules essentially insist that firms which desire access to global capital must mainstream social, environmental and governance performance. In other words, ESG is now core business and greenwashing will not be tolerated. Firms that are stuck in extracting and producing fossil fuels will increasingly face the risk of stranded assets. Countries that are dependent on fossil fuel revenues must actively seek ESG-committed investment to replace current revenue losses and avoid excessive indebtedness. Firms that are ESG-approved will have the advantage of early adoption and first-mover entry into the market. This analysis is particularly relevant to extractive industry firms operating in African countries.

Signature:	
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For further information on how GGA can help you to genuinely mainstream ESG considerations into your business model, call our advisory team on info@gga.org

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