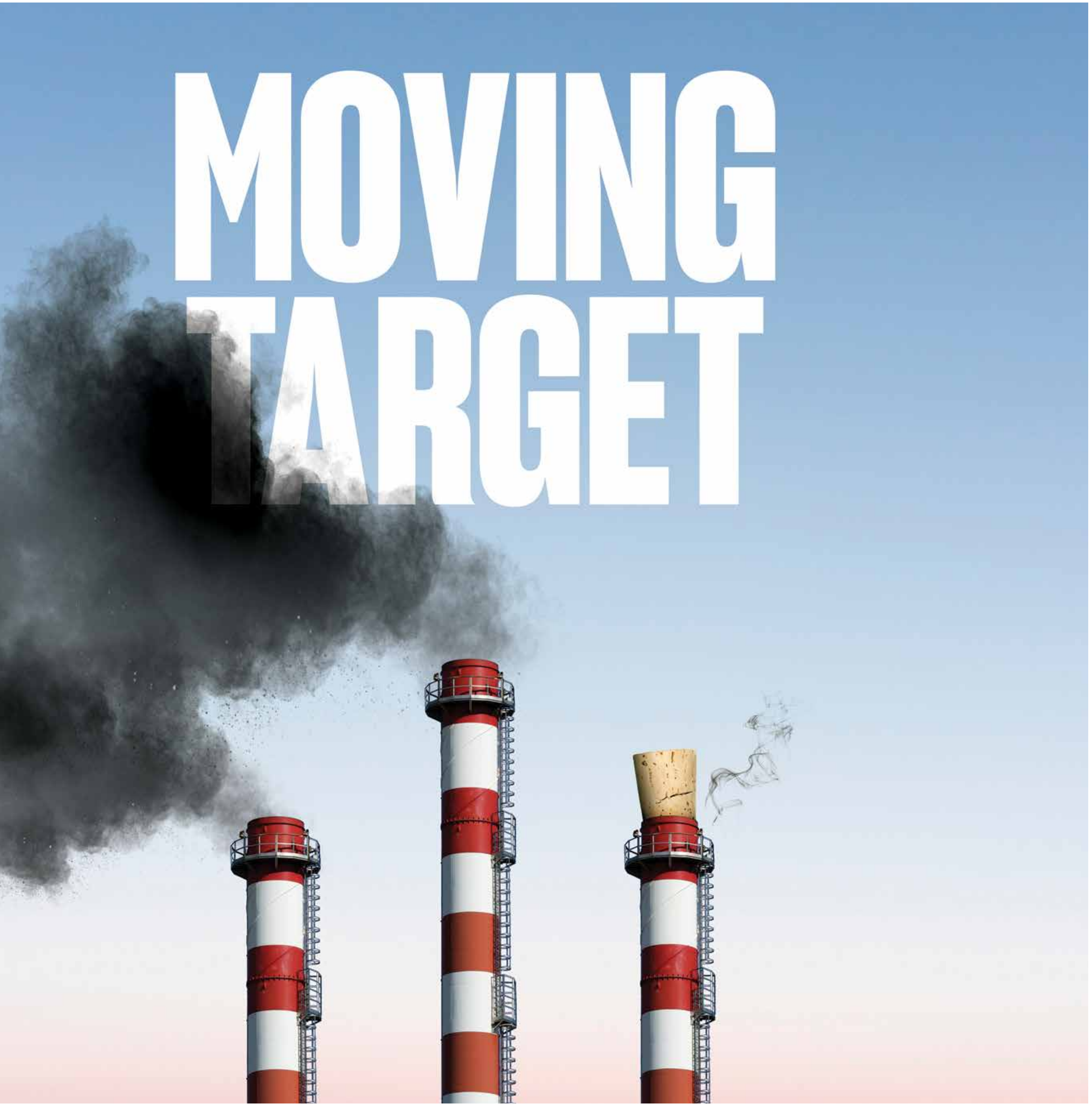
MOVING TARGET



Canadian companies and investors have much to gain from ESG. Yet its benefits risk being overshadowed by some vocal critics.

BY SRIVINDHYA KOLLURU

Many in the U.S. and Canada have latched onto a hotly debated investment philosophy: ESG, or the ways in which a company's commitment to the environment, social issues, and corporate governance affect its bottom line. While American politics are far more polarizing, ESG has still become the target of some politicians north of the border, namely Alberta Conservative MP Tom Kmiec. Last year, Kmiec proposed a bill that would require shareholder approval before a company made any statements on social or political issues, i.e., ESG.

Still, Kmiec might find himself part of a noisy, but small, group of ESG critics. At least in this country.

"In Canada, we have a lot at stake when it comes to the sustainability conversation that makes us quite unique from the U.S., and yet a little less likely to see the same level of headwinds toward ESG," explains Sarah Keyes, CEO of ESG Global Advisors. "That's actually because our natural resource sectors, namely oil and gas and mining companies, have been providing ESG disclosure and developing ESG and climate change strategies for a long time in order to access capital."

Indeed, Enbridge, North America's largest natural gas utility, is one of the firms that already takes ESG seriously—going so far as to host an "ESG forum" in 2021. And, Enbridge is just one of the dozens of Canadian public companies that have seemingly embraced ESG, along with Royal Bank, Canadian National Railway, Rogers, Telus, Teck Resources and Sun Life Financial.

As well, some of the world's biggest investment firms, including BlackRock, have funnelled billions of dollars into their ESG strategy, with these investments making up a fast-growing chunk of their assets under management. In Canada, Caisse de dépôt et placement du Québec (CDPQ), Canada's second-largest pension fund, has pledged to make its holdings more environmentally friendly. In 2021, CDPQ said it plans to increase its exposure to low-carbon assets from $39 billion to $54 billion by 2025.

Despite its growing presence, some experts say Canadian companies are making slow progress on corporate sustainability reporting to stakeholders—and that there should be clear, measurable metrics for ESG reporting, along with practices that can better hold corporations accountable for their promises.

PHOTO ILLUSTRATION BY ADAM CHOLEWA

BUT FIRST, WHAT IS ESG?

Some components of ESG date back to the 1960s, but the ESG umbrella term most investors are familiar with now was solidified in the 2000s. It was in 2004 that ESG was formally coined in a report by the United Nations titled "Who Cares Wins." The report, developed in collaboration with 18 financial institutions across the world, offered various recommendations for weaving ESG factors within the financial sector—from companies to stock exchanges to asset managers. In 2009, in the aftermath of the Great Recession, ESG gained greater momentum. Many Americans blamed banks for the crisis, condemning financial institutions for letting greed overtake proper governance. The public wanted institutions to devote more resources to issues other than cash flow and long-term debt, as well as focus on social and environmental issues. Investors began taking heed, putting around US$23 trillion towards assets that incorporate some element of sustainable investing as of 2018. That number is expected to soar to around US$34 trillion in 2026, according to PwC, as ESG-focused institutional investments skyrocket by 84 per cent over the next few years.

The state of the ESG nation

While flaunting ESG can please consumers and investors, policies surrounding ESG reporting in Canada are currently a messy patchwork of regulations and guidelines. This is because, when it comes to ESG, there are no set global standards for companies to abide by.

The regulations in Canada are all at different stages, says Keyes. In late 2021, the Canadian Securities Administrators released a proposal that would require all public Canadian companies to report climate change disclosures.

"But that has been put on hold right now while the regulator is waiting for the development of the global standards," says Keyes. Currently, the International Sustainability Standards Board is working on accounting standards, which Keyes says are expected to be reviewed and endorsed by the Canadian Sustainability Standards Board (CSSB). But, even the CSSB is just becoming established: The board recently announced their chair, former president and CEO of CPA Canada, Charles-Antoine St-Jean.

In March 2023, Canada's financial regulator announced that banks and insurers will need to begin reporting climate-related risks starting in 2024. But "it does have a number of areas where it is going to be subject to updates, so [it] can harmonize with other regulations," says Keyes. This means

PHOTOGRAPH BY ALAMY

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88
Percentage of TSX firms that disclose their emissions

84
Predicted percentage increase in ESG institutional investments by 2026

77
Percentage of Canadian companies that don't disclose a TCFD report

that Canadian companies have to report things like their greenhouse gas emissions, although many of them already do so in the hopes of attracting additional investment. Indeed, Canadian companies that do disclose their emissions make up 88 per cent of the Toronto Stock Exchange's market cap.

The lack of a standardized framework signals a big problem for companies and investors. Currently, either a company will measure its own ESG progress according to its own set of standards, or it will use a score developed by rating agencies—such as S&P Dow Jones or Thomson Reuters. This means that as investors, comparing one fund or firm's progress on ESG to another can sometimes feel like comparing apples to oranges, making it harder to differentiate the companies that are serious about their commitments versus the ones that are not.

With a growing number of investors depending on ESG reporting, a recent PwC report finds "Canadian companies are missing important opportunities to add credibility to their sustainability disclosures." One of these is the Task Force on Climate-related Financial Disclosures framework. Introduced in 2015, the TCFD framework was established to develop a consistent manner for companies to report their climate-related financial risk disclosures to investors and other stakeholders. Per the report, 77 per cent of the Canadian companies evaluated do not disclose a TCFD report

"We are seeing an improvement compared to last year. However, actual progress is failing to keep pace with rising stakeholder expectations," said Sarah Marsh, Partner, National ESG Report and Assurance Leader, PwC Canada, in a 2022 news release.

For publicly-traded companies that publish annual reports, there's a real motivation to dedicate sections of the report to ESG, says David Soberman, a professor of marketing at the University of Toronto. This is because mutual funds and investors use that as a basis for deciding where they will place their money.

"But when you're in a situation where people don't agree on things, there tend to be many different standards," adds Soberman. "So what happens then is that funds and investors establish their own standards, whether you like them or not."

There are other motivations for committing to ESG standards and disclosures.

Vowing to ESG principles earns some companies social clout, especially from younger consumers. The millennial and Gen Z cohort accounts for over 40 per cent of the world's population, and many care deeply about their societal and environmental impact.

There's only a messy patchwork of guidelines instead of firm ESG standards for companies to use

That societal clout can translate to cold, hard cash. Almost two-thirds of young millennial investors have some exposure to ESG investments. On the corporation side, there are noticeable returns for companies that uphold—or at least claim to uphold—ESG values. According to CIBC World Markets, money flowing into ESG funds has doubled every year since 2018. In the first half of 2021, global funds almost approached record levels hit in 2020, bringing total assets under management to about US$1.5 trillion. Soon, companies both in Canada and around the globe might not have a choice. According to a report from McMillan LLP, a Canadian business law firm, companies that opt out of non-mandatory ESG reporting may later be forced to comply anyway as regulatory landscapes evolve to reflect the societal demands for things like greener corporate practices and inclusive workforces. There are benefits for the C-Suite, too, as a 2022 report from WTW found 80 per cent of Canadian public companies use at least one ESG factor in putting together their executive compensation plans, including annual bonuses. Another benefit of ESG is that it can help companies, including start-ups, access more capital that can fast-track their growth.

80

Percentage of companies that use at least one ESG factor when developing executive compensation plans

The backlash against ESG

For all the fans of ESG, there are also equally vocal critics who say the strategy is nothing more than virtue signalling. That criticism has taken centre stage south of the border, where ESG has been caught in an intense political crossfire. Since late 2022, ESG's apparent influence in corporate spheres has drawn the ire of some Republican politicians. In December 2022, Florida Governor Ron DeSantis singled out BlackRock for its ESG investing, withdrawing US$2 billion from the world's largest investment firm. (BlackRock oversees around US$8 trillion in assets.) DeSantis complained about BlackRock's "woke" investment strategy, which he said, "sacrifices returns at the altar of the select few, unelected corporate elites and their radical woke agendas." Since then, Republicans in other states, such as Texas and Louisiana, have pulled billions of dollars from BlackRock's management.

The heated back-and-forth reached a boiling point in late March when it made its way into the Oval Office. U.S. President Joe Biden used the first veto of his term to defend a ruling on ESG investing.

Florida governor (and ESG foe) Ron DeSantis

His veto blocked a Republican effort to prevent retirement fund managers from evaluating environmental and social concerns in their investment decisions.

Yet, Keyes says that despite all of the noise in the media about the anti-ESG sentiment and the politicization of it in the U.S., the country's Inflation Reduction Act has unleashed an incredible amount of capital into low-carbon products and solutions.

It's clear that there remain many gray areas in the world of ESG. From a puzzling patchwork of regulations to various ranking methodologies, stakeholders and everyday investors will need to do proper due diligence when evaluating the true impact of a firm's social and environmental pledges.

"I think the sentiment in the U.S. is being noticed by both Canadian investors and Canadian companies," says Keyes. "I would say the reality of the fact, though, is that the capital markets care more about policy than politics." ◆